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Securities & Derivative Litigation Report

2006 FIRST QUARTER ELEVENTH CIRCUIT SECURITIES LAW UPDATE

Inside This Issue:

To keep our clients abreast of securities law developments in the Southeast, Carlton Fields' Securities Practice Group provides quarterly updates of significant securities decisions from federal courts within the Eleventh Circuit. This update summarizes decisions of interest within the Eleventh Circuit from January through March 2006.

Corporate Backed Trust Certificates

(1) *Halberstein Investment, Ltd, et. al v. Lehman Bros., Inc.*, No. 04-22517-CIV, 2006 WL 314334 (S.D. Fla. Jan. 10, 2006).

Summary:
Corporate Backed Trust Certificate (CBTC) issuers are not required to inform prospective buyers of the nature and extent of the risk that an underlying issuer will cease its filings.

Facts:
Plaintiffs, a group of investors, purchased CBTCs pursuant to a prospectus. Three months later, the issuer of the CBTCs de-listed and de-registered the securities, also known as opting out. Because the issuer failed to make required financial disclosures in its SEC filings, an investment firm liquidated the underlying securities and distributed a pro rata share to each investor. The investors claimed that the fact that the issuer was a prime candidate for opting out should have been disclosed in the prospectus. The firm filed a motion to dismiss, arguing that there was no duty to make any such disclosure.

Holding and Reasoning:
Motion to dismiss granted.

Because issuers of CBTCs are required to make periodic filings with the SEC, they are not required to provide this financial information in a prospectus, as long as the prospectus refers a buyer to the appropriate filings. *Id.* at *1. Additionally, the issuer is under no obligation to disclose "the factors that could impact upon the underlying issuer's decision to cease its SEC filings or to assess the magnitude of the risk that the underlying issuer will cease its SEC filings." *Id.* The court reasoned that there is no duty to disclose all information material to the offering of securities; the offeror must only disclose all material information specifically required by securities law. *Id.* at *5. Because there was no requirement to disclose information regarding the risk of an issuer's reporting failure, the omission of this information did not render the prospectus misleading. *Id.* at *6.

Demand Futility

(1) *Story v. Kang,* No. 8:04CV1587T-23TBM, 2006 WL 163078 (M.D. Fla. Jan. 20, 2006).

Summary:
To demonstrate demand futility in a derivative case, a shareholder must plead facts which raise a reasonable doubt that a majority of the board of directors would be capable of impartially considering the demand.

Facts:
A shareholder brought a derivative action against certain officers and directors of a company, but did not make pre-suit demand. The corporation moved to dismiss, contending that the shareholder did not plead demand futility with the specificity required to excuse his failure to make pre-suit demand on the board.

Holding and Reasoning:
Motion to dismiss granted.

Demand is excused as futile when there is a reasonable doubt that a majority of the directors is independent and disinterested with respect to the consideration of the lawsuit. *Id.* In this case, the corporation's board of directors comprised six members. *Id.* at *2. Thus, to establish demand futility, the shareholder was required to raise reasonable doubt regarding the independence and disinterest of a majority, or four, of the directors. *Id.* The shareholder pleaded facts regarding only four of the six directors, and with respect to one of these directors, the shareholder's allegations amounted to a claim that the director was compromised by a threat of personal liability in a parallel securities lawsuit. *Id.* The court reasoned that the mere threat of personal liability for approving a challenged transaction, without more, is insufficient to challenge either the independence or disinterest of a director. *Id.* Therefore, the court concluded that the shareholder did not establish that a majority of the board's directors would be incapable of impartially considering the demand. *Id.*

Liability For False Statements

(1) *SEC v. Dauplaise & Shinder,* No. 6:05CV1391 ORL 31KRS, 2006 WL 449175 (M.D. Fla. Feb. 22, 2005).

Summary:
An individual who does not personally draft a misleading filing can still be held liable for securities fraud if his misrepresentations and omissions influence the preparer and result in the deceptive filing.

Facts:
A corporation defaulted on a note in July, 2004. In August and November, 2004, the corporation's CEO and CFO entered into forbearance agreements with the holder of the note, acknowledging the default and consenting to the immediate enforcement of the holder's security interest. The CEO and CFO failed to advise the company's attorney and its board. Moreover, they caused the company's public filings to

contain misstatements and omissions about the transaction. The SEC brought a civil enforcement action against the corporation's CEO and CFO, alleging violations of Rule 10b-5. The CFO moved to dismiss.

Holding and Reasoning:
Motion to dismiss denied.

For a defendant to be found liable under Rule 10b-5, the statement must have been attributable to the defendant at the time of public dissemination. *Id.* at *5. The CFO argued that the SEC failed to establish that any misrepresentations were directly attributable to him. *Id.* at *6. Yet, during the preparation of certain filings, the CFO falsely stated to the preparer that the company never received a notice of default and that the forbearance agreements were oral, not written. *Id.* Additionally, the CFO failed to disclose other facts. *Id.* The court reasoned that although the CFO did not personally draft the misleading text, one could infer that the CFO was responsible for the omissions and misrepresentations that resulted in the deceptive filing. *Id.*

(2) *Kennedy v. Trustmark National Bank*, No. 3:05CV220-RS, 2006 WL 140707 (N.D. Fla. Jan. 17, 2006).

Summary:
Where an action under Rule 10b-5 involves a contractual relationship, the plaintiff must plead more than a mere breach of contract to state a claim for relief.

Facts:
The plaintiff, a former employee of a corporate defendant, received shares of the company's stock as part of his compensation. The employment agreement provided that upon cessation of employment the company would repurchase all of the plaintiff's stock at fair market value. Upon his termination, the company repurchased the plaintiff's shares for $1,500 per share. Ten months later, the company sold all of its stock to a third party for $4,000 per share. The plaintiff sued the company, contending that it paid book value for the shares rather than fair market value as contemplated by the employment agreement. The plaintiff alleged that the company fraudulently conspired to "cheat" him out of the fair market value of his shares, thus violating Rule 10b-5. The company filed a motion to dismiss, arguing that the complaint failed to satisfy the pleading requirements of the Private Securities Litigation Reform Act ("PSLRA").

Holding and Reasoning:
Motion to dismiss granted.

The plaintiff argued that the company falsely led him to believe it would repurchase his stock at fair market value, when it actually paid him book value. *Id.* at *1. However, the court found that the plaintiff failed to clearly allege specific misstatements or omissions. *Id.* at *3. For example, the plaintiff alleged simultaneously that he was fired for a legitimate reason and also that he was terminated wrongfully and deceitfully. *Id.* The court inferred that the plaintiff intended to allege that the company had terminated him without telling him of the imminent sale to a third party, in order to defraud the investor out of the ensuing increased value of the stock, and that the company misrepresented that it would pay fair market value when it actually paid book value. *Id.* However, as the court pointed out, because of the pleading's ambiguity it was not clear exactly what the plaintiff intended — or what specific misrepresentation or omission he alleged. *Id.*

Further, the court held that the plaintiff did not adequately allege scienter. *Id.* at *4. To satisfy the heightened pleading requirements of the PSLRA, a complaint must state with particularity the facts which give rise to a "strong inference" that a defendant acted with "severe recklessness" in making a misstatement or omission. *Id.* The court reasoned that not only did the plaintiff fail to communicate a basis for his belief that the payment he received was based on mere book value of his stock, he also failed to assert particular facts giving rise to a strong inference that the company knew it was paying only book value or that it was severely reckless in its belief that it was paying fair market value. *Id.*

Loss Causation / "Bespeaks Caution" Doctrine

(1) *Davidco Investors, LLC v. Anchor Glass Container Corp.,* No. 8:04CV2561T-24EAJ, 2006 WL 547989 (M.D. Fla. Mar. 6, 2006).

Summary:
In a securities class action, a shareholder fails to allege loss causation, and subjects his suit to dismissal, if he sells his shares prior to the alleged corrective disclosure. The bespeaks caution doctrine will not protect a failure to disclose the impairment of an asset in a prospectus because asset impairment is not a "future projection or forecast."

Facts:
The plaintiff-shareholders filed a complaint against an issuer, several officers and directors, its underwriters, and its accountants, alleging that defendants committed securities fraud in violation of, *inter alia*, Section 11 of the Securities Act and Rule 10b-5 by making certain misrepresentations in a prospectus issued in connection with an initial public offering, including, *inter alia*, (1) failing to disclose that one of the issuer's plants was impaired as a result of the loss of a large customer, and (2) overstating the issuer's cash flows from operations. The defendants moved to dismiss and argued that any alleged misstatement in the prospectus regarding its plant was accompanied by appropriate cautionary language and, with respect to two of the named plaintiffs, they failed to allege loss causation because those plaintiffs sold their shares prior to the corrective disclosures regarding the plant impairment and the allegedly misstated cash flows.

Holding and Reasoning:
Motion to dismiss granted in part and denied in part.

The court rejected the defendants' argument that the "bespeaks caution" doctrine protected issuer's failure to disclose the impairment of the plant in the prospectus. *Id.* at *13. The defendants contended that the doctrine applied because "(1) whether an asset is impaired necessarily requires a projection or forecast of the future economic performance of the asset, and (2) the alleged misstatement was accompanied by meaningful cautionary language." *Id.* at *12. The plaintiffs argued, and the court agreed, that asset impairment is not a projection or forecast because it relates to whether the assets were impaired at the time that the statements were issued. *Id.* at *13. Further, the court held that the cautionary language in this case was insufficient. *Id.*

The court agreed with the defendants, however, on loss causation. *Id.* at *21. The defendants argued that two of the named plaintiffs sold all of their stock prior to the disclosure that the plant was impaired. *Id.* The plaintiffs responded that the impairment of the plant was actually disclosed some months earlier, when they still held their stock, in press releases about higher energy prices and resulting higher freight prices and their effects on the company. *Id.* These increased costs, the plaintiffs claimed, were one of the problems that caused the plant to lose money after it lost a lucrative contract. *Id.* at *22. Rejecting the plaintiffs' "convoluted argument," the court found that these earlier press releases regarding energy costs did not correct a previous misstatement. *Id.*

As to allegations regarding misstated cash flows, the court likewise found that the same two named plaintiffs failed to plead loss causation because, again, both sold all of their shares prior to the corrective disclosure. *Id.* at *9-10. In fact, the issuer disclosed the particular facts underlying the ultimate cash flow misstatements several months after the plaintiffs sold their shares. *Id.* Because the relevant truth had not begun to "leak out" when the plaintiffs sold their shares, the court dismissed the plaintiffs' Section 10(b) and Rule 10b-5 claims based on cash flow misstatements. *Id.*

(2) *In re Teco Energy, Inc. Securities Litigation,* No. 8:04-CV-1948-T-27EAJ, 2006 WL 845161 (M.D. Fla Mar. 30, 2006).

Summary:
To adequately plead loss causation under Rule 10b-5, a plaintiff must allege that the corrective disclosure that allegedly exposed the "truth" actually corrected a prior, specific misstatement.

Facts:
Investors sued a public utility holding company, alleging that the company violated Rule 10b-5 by misrepresenting its financial condition, thus artificially inflating its stock price. The investors argued that when independent financial analysts "revealed the truth" about the company, the value of the company's securities fell. The company moved to dismiss, contending that the investors failed to plead loss causation.

Holding and Reasoning:
Motion to dismiss granted.

To plead loss causation, a plaintiff need only comply with the "short and plain statement" requirement of Fed. R. Civ. P. 8(a)(2). *Id.* at *2. Here, the investors alleged that the company's stock price dropped after independent financial analysts' reports questioned the company's prospects for future earnings and dividends. *Id.* at *3. However, while the analyst reports did not reflect favorably on the company, the opinions, predictions, and generalized statements in those reports did not identify or correct any specific misstatements or omissions by the company. *Id.* at *4. None of the purported revelations, in fact, indicated that the changes occurring with the company were associated with prior fraudulent conduct. *Id.* Moreover, the investors did not establish a sufficient nexus between the specific fraudulent activities alleged and a drop in stock price. *Id.* at *5. To prove loss causation, a plaintiff must allege that the defendant's misstatement or omission "concealed something from the market" which, when disclosed, affected the value of the defendant's securities. *Id.* "In addition to failing to reference any prior misstatement, omission or improper accounting practice, the information contained in the … revelations relied on by [the investors] does not specifically relate to the issues involved in the alleged fraudulent scheme." *Id.* (internal citation omitted). Therefore, "even applying a notice pleading standard," the investors' allegations did not establish that the company's fraud — as opposed to poor market conditions — proximately caused the decline in the company's stock price. *Id.*

SLUSA

(1) *Cordova et al. v. Lehman Bros., Inc., et al.*, 413 F. Supp. 2d. 1309 (S.D. Fla. 2006).

Summary:
In a state law class action involving retirement trust plans, plaintiffs' class claims were preempted by the Securities Litigation Uniform Standards Act ("SLUSA") even though the alleged misrepresentations and omissions did not strictly coincide with plaintiffs' investment in the plan or purchase of covered securities.

Facts:
Investors in retirement trust plans that provided life insurance and mutual funds brought an action against the plan trustees, alleging that they breached their fiduciary duties in managing the trust assets and aided and abetted the investment company in committing fraud and breach of fiduciary duty. The investors claimed that the investment company marketed itself by emphasizing that major financial institutions would serve as trustees, yet the company improperly utilized the invested funds for non-investment purposes, charged excessive front-load fees, and distributed fraudulent account statements. The complaint alleged that the trustees facilitated the fraud by allowing their logos to be used by the investment company to tout the safety of the investments and by authorizing misleading documents regarding fees. The trustees argued that the state law claims were preempted by SLUSA and should therefore be dismissed.

Holding and Reasoning:
Motion to dismiss granted.

To warrant dismissal under SLUSA, a defendant must show that (1) the suit is a covered class action, (2) the claim is based on state law, (3) one or more covered securities has been purchased or sold, and (4) the defendant misrepresented or omitted a material fact in connection with the purchase or sale of such security. *Id.* at 1315.

A "covered security" includes a security issued by a registered investment company. *Id.* at 1316. The investors argued that the retirement plans did not qualify as "covered securities" within the meaning of SLUSA because the plans included life insurance, which does not constitute a security, in addition to mutual funds. *Id.* The court rejected this argument, reasoning that the fact that the plan included both a life insurance component and a mutual fund investment component did not change the fact that SLUSA plainly applied to the extent the retirement plans involved mutual funds. *Id.* at 1317. Additionally, the court noted that the investment company was not registered pursuant to the Investment Company Act, but it determined, consistent with controlling case law, that SLUSA applies even where the selling company is not registered when the investment itself otherwise meets the test for a covered security. *Id.*

The investors also argued that any misrepresentation or omission was not made "in connection with the purchase or sale of covered securities" because they supposedly occurred only after the class members invested in the plans. *Id.* at 1318. The court reasoned that although the complaint carefully avoided any reference to misrepresentations made simultaneously with the purchase or sale of securities, the essence of the complaint was that these very misrepresentations and omissions — the promise that established financial institutions would serve as trustees and protect the retirement trust plans, and the failure to specify the harsh fees associated with the plans — induced the investors to purchase the plans. *Id.* As the court pointed out, "logic dictates" that the investment company's scheme operated by using these misleading assurances and omissions to encourage the investors to buy into the retirement plans. *Id.* Therefore, because the investors' class comprised persons who purchased securities in connection with the company's fraudulent scheme, the court found this element was satisfied. *Id.* at 1321.

For more information about this issue of *Securities & Derivative Litigation Report*, to receive it via mail, or for information about Carlton Fields' Securities Practice Group, contact Practice Group Leader Sam J. Salario at Carlton Fields either by telephone: 813.229.4337; by e-mail:ssalario@carltonfields.com; by mail: Corporate Center Three at International Plaza, 4221 W. Boy Scout Blvd., Suite 1000, Tampa, FL 33607; or visit **www.carltonfields.com**.

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