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Securities & Derivative Litigation Report

2005 THIRD QUARTER ELEVENTH CIRCUIT SECURITIES LAW UPDATE

Inside This Issue:

To keep our clients abreast of securities law developments in the Southeast, Carlton Fields' Securities and Derivative Litigation Practice Group provides quarterly updates of securities decisions from federal courts within the Eleventh Circuit. This update summarizes decisions of interest within the Eleventh Circuit from July through September 2005.

Derivative Actions

(1) *In re Friedman's, Inc. Derivative Litigation,* No. 1:03-cv-3831-WSD, 2005 WL 2246029 (N.D. Ga. Sept. 7, 2005).

Summary:
In a shareholder derivative action, presuit demand was not excused based on plaintiffs' conclusory allegations that a controlling shareholder dominated the board, that the directors were unwilling to subject themselves to liability, or that the directors were not independent or disinterested because they received compensation or other personal benefits.

Facts:
Shareholders brought a derivative action against officers, directors, and controlling shareholders of an issuer, as well as its auditor alleging, *inter alia*, violations of Section 304 of the Sarbanes-Oxley Act of 2002 and breach of fiduciary duty. Defendants moved to dismiss, arguing, *inter alia*, that plaintiffs failed to comply with the presuit demand requirement before pursuing a derivative action and that Section 304 does not provide a private right of action. Plaintiffs argued that demand would have been futile because the company's board was dominated by a controlling shareholder, the directors were unwilling to subject themselves to potential liability, and the directors received compensation or other benefits that precluded a finding that they were independent or disinterested.

Holding and Reasoning:
The court granted defendants' motions to dismiss with leave to amend. *Id.* at *10. Applying Delaware law, the court noted that "[d]emand on

a board of directors is excused as futile only if the particularized factual allegations of the derivative stockholder complaint create a reasonable doubt that, as of the time the complaint is filed, the board of directors could have properly exercised its independent and disinterested business judgment in responding to a demand." *Id.* at *3 (quotation, alteration, and citation omitted).

The court rejected plaintiffs' allegation of futility based on the controlling shareholder's alleged domination of the board, finding that most of the conduct plaintiffs relied upon occurred *after* plaintiffs filed the suit. *Id.* at *4. The court held that such post-filing conduct did not demonstrate how demand would have been futile at the time the *initial* complaint was filed. *Id.* The court also held that plaintiffs failed to plead with sufficient particularity that any pre- or post-filing conduct by the controlling shareholder "influenced or had the capacity to influence director discretion or independence." *Id.* at *4.

The court also rejected the conclusory allegation that the directors would be unwilling to approve a claim that would subject them to personal liability, reasoning that "[t]he mere threat of personal liability in the derivative action does not render a director interested; however, a substantial likelihood of personal liability prevents a director from impartially considering a demand." *Id.* at *5 (citation and quotation marks omitted). The court concluded that plaintiffs' allegations against the directors did not establish a substantial likelihood of personal liability, and if plaintiffs' allegations of futility were allowed, "a [presuit] demand virtually always would be futile." *Id.* at *5-6.

Lastly, the court held that certain directors' receipt of bonuses from the company, employment history with other companies controlled by the same controlling shareholder at issue, nomination to the board by the controlling shareholder, and receipt of consulting fees through an outside business were not sufficient, individually or collectively, to compromise the board's independence. *Id.* at *8-10.

The court declined to address defendants' argument that Section 304 does not provide a private right of action. *Id.* at *10. However, the court noted in a footnote that "[a]lthough no court has ruled on this issue, this [c]ourt is doubtful of the existence of a private right of action to sue under Section 304." *Id.* at *10 n.20.[1]

Pleading Standards

(1) *Marrari v. Medical Staffing Network Holdings, Inc.,* No. 040158CVDIMITROULEA, 2005 WL 2462047 (S.D. Fla. Sept. 27, 1999).

Summary:
In a class action alleging '33 and '34 Act claims, the district court held that (i) Fed. R. Civ. P. 9(b) does not apply to Section 11 claims if the claims do not rely upon the '34 Act claims and do not allege scienter and (ii) anonymous source allegations are acceptable under the PSLRA so long as the sources are described with sufficient particularity to show that the source would possess the information alleged.

[1] One federal court has since addressed this issue, holding that Section 304 of Sarbanes-Oxley does not create a private right of action. *See Neer v. Pelino*, No. CIV.A. 04-4791, 2005 WL 2434685, at *8 (E.D. Pa. Sept. 27, 2005).

Facts:
Shareholders brought a class action against an issuer, its management, and its directors under Sections 11 and 15 of the Securities Act and Sections 10(b) and 20 of the Securities Exchange Act, alleging that defendants misrepresented the success of a key element of the issuer's business strategy in an IPO prospectus and subsequent public statements. The allegations were, in part, based upon information allegedly gleaned from twelve confidential sources. Defendants moved to dismiss.

Holding and Reasoning:
The court denied the motions to dismiss, except to the extent that they related to certain misstatements alleged to violate the Exchange Act as to which plaintiffs' allegations of scienter were inadequate. *Id.* at *16. Two elements of the decision merit comment.

First, the court held that Rule 9(b) did not apply to plaintiffs' claims under the Securities Act. *Id.* at *7. The court reasoned that "[a] Section 11 count, as here, that does not rely upon the Exchange Act claims and steadfastly does not allege scienter . . . shall be interpreted as innocent or negligent misrepresentations and omissions, as opposed to fraudulent misrepresentations and omissions that would trigger Rule 9(b)." *Id.* (internal quotation and citation omitted).

Second, the court held that plaintiffs' failure to identify their confidential sources did not render the complaint defective under the PSLRA. *Id.* at *14. The court concluded that "[a]lthough the Eleventh Circuit has yet to directly address this particular issue, other Circuits have held that anonymous sources may be used to sustain complaints under the PSLRA so long as the sources are described with sufficient particularity to support the probability that a person in the position occupied by the source would possess the information alleged.... This court adopts this standard." *Id.* (internal citations omitted).

Public Offering Litigation

(1) *In re Airgate PCS, Inc. Securities Litigation,* No. 1:02 CV 1291 JOF, 2005 WL 2462043 (N.D. Ga. Sept. 29, 2005).

Summary:
In a class action under Sections 11, 12(a)(2), and 15 of the Securities Act, the court held that (i) directors, officers, and underwriters were not liable for alleged violations of Section 12(a)(2) where plaintiffs did not adequately allege that defendants were sellers or offerors of shares sold pursuant to a prospectus; (ii) defendants were not liable under Section 11 for misstatements incorporated by reference into a registration statement where the filing was amended to delete the offending statements before plaintiffs purchased stock; and (iii) many alleged misstatements were "forward-looking statements" entitled to protection under the PSLRA's safe-harbor and the "bespeaks caution" doctrine.

Facts:
Plaintiffs sued an issuer, its officers, directors, and underwriters on behalf of a class of shareholders who purchased common stock during a secondary public offering. Plaintiffs alleged that the SPO registration statement and prospectus were misleading because they misrepresented various facts about the issuer's finances and business operations. Defendants moved to dismiss the complaint, arguing that (i) it failed to allege defendants were "sellers" within the meaning of Section 12(a)(2), (ii) some of the alleged misstatements were removed from the registration statement when it was amended prior to the SPO,

and (iii) the remaining misstatements fell within the "safe harbor" provisions of the PSLRA and the "bespeaks caution" doctrine.

Holding and Reasoning:
The court granted defendants' motions in part, finding that plaintiffs had not adequately alleged claims under Sections 11 and 12(a)(2) of the Securities Act and that the bulk of the misstatements in plaintiffs' complaint were forward-looking and accompanied by meaningful cautionary statements. *Id.* at *19-20.

With regard to the Section 12(a)(2) claims, the court held that plaintiffs failed to allege adequately that the directors, officers, and underwriters "offer[ed]" or "sol[d]" the securities within the meaning of the statute. *Id.* at *6-7. Because plaintiffs merely alleged that they received securities in the offering – and not that the underwriters actually transferred title to plaintiffs – the court held that plaintiffs had not adequately alleged that the underwriters were "sellers." *Id.* at *6. As for the officers and directors, plaintiffs alleged only that they participated in the preparation of the registration statement and prospectus. *Id.* The court found this allegation insufficient because "preparation of the registration statement, prospectus, or activities relating to the sale of securities, standing alone, is insufficient to establish seller status" absent a showing of active solicitation of sales. *Id.* at *7.

With respect to the Section 11 claims, plaintiffs alleged that the initial registration statement for the SPO incorporated by reference various other public filings, including 10-Q and 8-K filings, that contained the misstatements at issue. *Id.* at *7. The court found, however, that the registration statement had been amended to remove any reference to the other filings and that the amendment occurred before plaintiffs purchased their stock, thereby foreclosing their reliance on the allegedly misleading information. *Id.* at *8.

Finally, the court held that most of the remaining misstatements alleged were related to the future financial success of the issuer and were accompanied by appropriate cautionary statements. *Id.* at *10-17 and 19. Thus, the statements fell within the safe harbor provision of the PSLRA. *Id.* However, the court found that certain optimistic statements regarding a pending network upgrade project were not entitled to safe-harbor protection where plaintiffs alleged facts showing that defendants knew that the project was undergoing difficulties at the time of the offering. *Id.* at *18-19.

(2) *In re CNL Hotels & Resorts, Inc. Securities Litigation*, No. 6:04CV1231ORL-31KRS; 6:04CV1341ORL-19JGG, 2005 WL 2291729 (M.D. Fla. Sept. 20, 2005).

Summary:
A complaint fails to state a claim under Section 12(a)(2) of the Securities Act unless it contains specific allegations that defendant (i) took title to the offered shares and transferred title to purchasers or (ii) directly solicited securities purchasers, resulting in actual sales of the offered securities.

Facts:
An issuer engaged a managing dealer to conduct a series of best efforts public offerings. The managing dealer hired several soliciting dealers to find eligible buyers. Plaintiffs who purchased the stock brought a class action alleging that the offering documents were misleading and that the managing dealer was liable under Section 12(a)(2) because it allegedly "offered, sold,

solicited and/or was a substantial factor in the sale" of the offered securities. The managing dealer moved to dismiss.

Holding and Reasoning:
The court granted the motion, holding that plaintiffs failed adequately to allege that the managing dealer was a "seller" within the meaning of Section 12(a)(2). *Id.* at *5. The court rejected plaintiffs' allegation that the managing dealer was a "substantial factor" in plaintiffs' purchases, noting that this standard was disapproved by the Supreme Court in *Pinter v. Dahl*, 486 U.S. 622, 654 (1988). *CNL*, 2005 WL 2291729 at *3. The Court held that the managing dealer would be liable only if (i) it actually transferred title to the security or (ii) it successfully solicited its purchase. *Id.*

With respect to an actual transfer, the court held that plaintiffs were required, but failed, to allege that the managing dealer took title to the shares and transferred title to purchasers. *Id.* at *4. And as for solicitation, the court held that plaintiffs must allege by whom plaintiffs were solicited and from whom they purchased their shares, and that these assertions must be supported by specific allegations showing a "direct relationship" between defendant and plaintiff. *Id.* at *5. The court explained that a "one-to-one exchange of information" was the "most typical" example of solicitation. *Id.* (internal citations and quotations omitted). Because plaintiffs' only real allegation of solicitation was that the managing dealer participated in the preparation of the offering documents, the complaint was "clearly insufficient to establish solicitation liability." *Id.*

Finally, the court rejected plaintiffs' argument that the managing dealer could be liable as a "solicitor" because the efforts of the soliciting dealers were "directly attributable" to those of the managing dealer. *Id.* at *6. The court held that this argument "highly resembles the 'substantial participation' test that *Pinter* explicitly rejected." *Id.*

Rule 23 Requirements

(1) *LaGrasta v. First Union Securities, Inc.*, No. 2:01-CV-251-FTM29DNF, 2005 WL 1875469 (M.D. Fla. Aug. 8, 2005).

Summary:
The district court certified a class in a Rule 10b-5 action based on allegedly misleading research analyst recommendations.

Facts:
Plaintiffs brought a Rule 10b-5 class action alleging that a research analyst's "strong buy" recommendations and price targets for a stock were misleading. Defendant opposed class certification on grounds that, *inter alia*, the prerequisites of commonality, typicality, and predominance were not met. Defendant argued that (i) plaintiffs did not read the analyst reports; (ii) plaintiffs purchased stock based on a broker's oral representations; (iii) plaintiffs were subject to a unique limitations defense; (iv) individual issues of reliance predominated because the fraud-on-the-market doctrine should not apply to analyst reports that had no discernible price impact on the stock; (v) plaintiffs adduced no proof that absent class members received the allegedly misleading reports; and (vi) the putative class period was overbroad.

Holding and Reasoning:
The court certified the class. *Id.* at *13.

The court rejected defendant's argument that plaintiffs' failure to read the analyst reports precluded a finding of typicality and commonality.

Id. at *4. It stated that "[t]here is no material variation between the misrepresentations and omissions made to the named plaintiffs and the misrepresentations and omissions made to the other putative class members." *Id.* Similarly, the court rejected defendant's argument that oral representations are not susceptible to class certification, stating that "[t]he written and oral communications essentially conveyed the same message." *Id.* at *4. The court further explained that while defendant may have a unique and viable statute of limitations defense, the issues of inquiry notice raised by such a defense were "issues of fact for a jury which the [c]ourt cannot resolve in a class certification motion." *Id.* at *6.

With regard to predominance, the court held that the fraud-on-the-market doctrine offered common proof of reliance, notwithstanding defendants' arguments to the contrary, because it could not "reject class certification based only on its assessment of plaintiffs' likelihood of success on the merits." *Id.* at *11-12. The court further held that the "common scheme" doctrine applied where "the common issues of fact are quite substantial and the circumstantial evidence that can be used to show reliance is common to the whole class." *Id.* at *12.

Lastly, the court shortened the class period so that it ended on the date of a magazine article that disclosed the alleged misrepresentations to investors. *Id.* at *13. The court held that investors who purchased stock after the date of the article "are deemed to be aware of the fraud and cannot rely upon a fraud on the market theory to establish reliance." *Id.*

Sale of Unregistered Securities

(1) *Dillon v. Axxsys International, Inc.*, No. 8:98CV2237T23TGW, 2005 WL 2012273 (M.D. Fla. Aug. 16, 2005)

Summary:
An officer of a corporation is not liable under Section 517.211 of the Florida Securities and Investor Protection Act ("FSIPA") for the sale of unregistered securities by the corporation solely because of her active involvement in managing the corporation's business matters.

Facts:
Investors sued an issuer and its officers for the sale of unregistered securities in violation of Fla. Stat. § 517.211. Plaintiffs alleged that the issuer's vice president "personally participated or aided in making the sale" of unregistered securities because she (i) attended a dinner meeting where the corporate "business plan" was discussed and (ii) periodically appeared in the corporate office and was sometimes involved in general corporate business. Following a jury verdict for plaintiffs, the vice president moved for judgment as a matter of law.

Holding and Reasoning:
The court granted the motion. *Id.* at *8.

Under Fla. Stat. § 517.211(2), a corporate officer is liable for the sale of an unregistered security only if the officer "personally participate[s] or aid[s]" in the sale. *Id.* at *3. This necessarily "implies some activity in inducing the purchaser to invest." *Id.* (citing *Nichols v. Yandre*, 9 So. 2d 157, 160 (Fla. 1942)). Although the vice president was involved in the day-to-day management of corporate business, she neither sold unregistered securities nor personally aided in any sale and, thus, could not be liable. *Id.* at *4. In short, the court held that "the remedies of [the statute] depend upon buying or selling a security and not merely running a business, however energetically." *Id.*

Statute of Limitations

(1) *Bozeman v. Lucent Technologies Inc.*, 378 F. Supp. 2d 1348 (S.D. Fla. 2005)

Summary:
Although the statute of limitations applicable to Rule 10b-5 claims is tolled when a class action is filed, it begins to run again when a class member opts out of the class.

Facts:
One month after an issuer announced that it would miss analysts' earnings estimates for the first quarter of fiscal year 2000, a class action alleging federal securities violations was filed against the issuer in federal district court in New Jersey. The case settled in March 2003. On or before November 25, 2003, plaintiffs opted out of the New Jersey class action. Thereafter, they filed suit against the issuer in the Northern District of Alabama on October 19, 2004. The district judge issued a severance order requiring the payment of certain filing fees. Plaintiffs failed to do so, and instead filed suit in the Southern District of Florida on January 19, 2005 alleging Rule 10b-5 violations. The issuer moved for summary judgment, arguing that the claims were barred by the statute of limitations.

Holding and Reasoning:
The district court granted the motion, holding that the claims were untimely. Actions brought under Rule 10b-5 "must be commenced within one year after the discovery of the facts constituting the violation and within three years after such violation." *Id.* at 1351 (citations omitted).[2] The filing of a class action tolls the statute of limitations for the claims covered by the representative action. *Id.* (citing *Am. Pipe & Constr. Co. v. Utah*, 414 U.S. 538 (1974)).

Though the earlier New Jersey class action tolled the statute of limitations, plaintiffs opted out of the New Jersey action on or before November 25, 2003. *Id.* at 1352. Adopting a view held by "many federal courts," the court held that the statute began running again on the date when the class members opted out of the New Jersey action and, accordingly, plaintiffs' claims here were time-barred because they were filed after November 25, 2004. *Id.*

The court rejected plaintiffs' argument that the Alabama action preserved their claims, even though that action brought identical federal claims. *Id.* Plaintiffs' claims in that case were dismissed without prejudice after plaintiffs failed to comply with the court's severance order and, as a consequence, were treated for statute of limitations purposes as if they had never been filed. *Id.*

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[2] Without comment, the court applied the limitations period that existed before July 30, 2002, when the Sarbanes-Oxley Act extended the limitations period to two years from discovery of the facts constituting the fraud or five years after the commission of the fraud. *See* 28 U.S.C § 1658(b).

For more information about this issue of *Securities & Derivative Litigation Report*, to receive it via mail, or for information about Carlton Fields' Securities & Derivative Litigation Practice Group, contact Practice Group Leader Gary L. Sasso at Carlton Fields either by telephone: 888.223.9191, Ext. 4256 or 813.229.4256; by e-mail: gsasso@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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