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Securities & Derivative Litigation Report

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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 October through December 2005.

"Bespeaks Caution" Doctrine

(1) *Primavera Investors v. Liquidmetal Tech., Inc.,* No. 8:04 CV 919 T 23EAJ, 2005 WL 3276291 (S.D. Fla. Dec. 2, 2005).

Summary:
The "bespeaks caution" doctrine applies to predictive statements about the future, not false statements of historical fact. Additionally, the doctrine does not apply where a defendant lacks a reasonable basis for making a statement.

Facts:
Plaintiffs sued an issuer and its officers and directors asserting claims under the antifraud provisions of the '33 and '34 Acts, alleging, among other things, (i) that the issuer's IPO prospectus failed to disclose that its president had agreed to sell his shares to a third party at a discount from the IPO price and (ii) that the financial statements in the IPO prospectus understated general, administrative, compensation, and total operating expenses. The defendants moved to dismiss arguing, *inter alia*, that the IPO prospectus adequately "bespoke caution" about the risks associated with investment in the issuer's securities.

Holding and Reasoning:
Motion to dismiss denied.

The court recognized that the "bespeaks caution" doctrine generally holds that where an issuer's statements about the future are accompanied by meaningful cautionary statements and specific warnings of the risks involved, the alleged omissions or misrepresentations may be

immaterial as a matter of law. *Id.* at *4. The court held, however, that the doctrine did not apply because the complaint sufficiently alleged that the prospectus contained numerous false statements of historical fact that stemmed from the issuer's failure to properly account for certain expenses. *Id.* Even assuming that the language in the IPO prospectus contained meaningful cautionary statements and specific warnings of risk that would otherwise "bespeak caution" to potential investors, such warnings would render immaterial defendants' false historical statement. *Id.*

Moreover, if a defendant "knew at the time of the statement of false and misleading content and thus lacked a reasonable basis for making the statement," cautionary language will not defeat a securities fraud claim. *Id.* The complaint alleged that, despite knowing of its president's planned sale of stock to a third party, the issuer touted the lock-up agreement prohibiting the officers and directors from selling their shares for 180 days after the IPO. *Id.* Because the complaint thus alleged that these statements were false and misleading, cautionary language "fail[ed] to provide a defense." *Id.*

"Control Person" Liability

(1) *SEC v. Scrushy,* No. CV-03-J-6155, 2005 WL 3279894 (N.D. Ala. Nov. 29, 2005).

Summary:
The SEC has standing to assert claims under the "control person" provisions of the Securities Exchange Act.

Facts:
The SEC sued the former CEO of HealthSouth Corporation, alleging securities fraud and control person liability under Section 20(a) of the Exchange Act. Defendant moved to dismiss the second amended complaint on grounds that, *inter alia*, the SEC was not a "person" as that term is defined in Section 3(a)(9) of the Exchange Act and thus lacked standing to bring claims under § 20(a), which provides that "[e]very person who, directly or indirectly, controls any person liable under any provision of this chapter . . . shall also be liable . . . to any *person* to whom such controlled person is liable . . . ." *See* 15 U.S.C. § 78t(a) (emphasis added). A "person" is defined as "a natural person, company, government, or political subdivision, agency, or instrumentality of a government." *See* 15 U.S.C. § 78c(a)(9).

Holding and Reasoning:
The district court denied the motion to the extent that it was based on the SEC's purported lack of standing to pursue § 20(a) claims. *Id.* at *7. Although it recognized that no Eleventh Circuit precedent controlled, the court relied on *SEC v. Smith*, No. C2-CV-04-739, 2005 WL 2373849, at *10 (S.D. Ohio Sept. 27, 2005), which held that the SEC was a "person" entitled to sue under § 20(a). *Scrushy,* 2005 WL 3279894, at *7. In *Smith*, the court reasoned that Congress amended the definition of "person" under the Exchange Act in 1975 specifically to bring the SEC within the definition of that term. *See Id.* at *6 (quoting *Smith*). Accordingly, the court held that the SEC was a "person" for purposes of the Exchange Act and had standing to assert § 20(a) claims. *Id.* at *7.

Definition of Security

(1) *SEC v. Merchant Capital, LLC,* 400 F. Supp. 2d 1336 (N.D. Ga. 2005).

Summary:

Interests in a registered limited liability partnership were held not to constitute "securities" under the federal securities laws where the SEC failed to prove that (i) the partnership in essence functioned as a limited partnership, (ii) the individual partners were so inexperienced as to be incapable of exercising their powers, or (iii) the partners were exceedingly dependent on the abilities of the promoter.

Facts:

The SEC brought a civil enforcement action against the managing general partner of several registered limited liability partnerships ("RLLPs") and its principals alleging violations of the registration and antifraud provisions of the federal securities laws and seeking injunctive relief, disgorgement, and money penalties. The RLLPs were formed to purchase and sell consumer debt, and were promoted by the managing general partner. Under the partnership documents and applicable law, the partners were to take an active role in managing the partnership and could oust the managing general partner, dissolve the partnership, and bind other partners. The managing general partner, however, undertook a wide range of duties, including locating, evaluating, and negotiating with vendors, administering the relationship with the RLLP's escrow agent, reconciling financial accounts and records, making recommendations regarding the purchase and sale of debt to the partners, reporting to the partners, and monitoring the collection activity on the debt owned by the RLLP. The case proceeded to a non-jury trial.

Holding and Reasoning:

Judgment for defendants. The court held that the SEC was not entitled to relief under any theory because the RLLP interests were not "securities" under the statutory definition of that term in the federal securities laws.[1] *Id.* at 1364-70. (*see* 15 U.S.C. §§ 77b(a)(1); 78c(a)(10)).

The SEC argued that the RLLP interests were "securities" because they were "investment contracts" within the meaning of the statutory definition of "security," which requires a showing of a "scheme whereby a person (1) invests his money (2) in a common enterprise and is led to expect profits (3) solely from the efforts of the promoter or a third party." *Id.* at 1365. (quoting *SEC v. W.J. Howey Co.*, 328 U.S. 293, 298-99 (1946)). The court held that the SEC's case failed on the third prong. *Id.* The court reasoned that, to satisfy that element, the SEC bore a "heavy burden" to show either (i) that the partnership agreement leaves so little power in the hands of the partners that it effectively distributes power as would a limited partnership, (ii) that the partners are so inexperienced or unknowledgeable that they are incapable of exercising their partnership powers, or (iii) that the partners are so dependent on the unique entrepreneurial or managerial ability of the promoter that they cannot exercise meaningful partnership powers. *Id.*

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[1] The court also determined that, even if the interests were securities, the SEC had failed to establish an entitlement to an injunction, disgorgement, or civil money penalties. *Id.* at 1370-74. Among other things, the court held that the SEC had failed to show the scienter required to establish its claims under Section 17 of the Securities Act and Section 10(b) of the Securities Exchange Act. *Id.* at 1372-73. On this point, the court emphasized that the defendants had cooperated fully with the SEC from the inception of the investigation that led to the enforcement action. *Id.* at 1372; *see also id.* at 1364.

In this case, the partners had ample power to control the partnership, notwithstanding the managerial activities of the promoter, because of the powers explicitly granted them by the partnership agreement and governing law. *Id.* at 1365-66. The court further determined that, because the partners were high net-worth individuals with significant business experience and access to the information necessary to allow them to make partnership decisions, they were not inexperienced or unknowledgeable. *Id.* at 1368-69. Finally, the court concluded that the partners were not dependent on the promoter because the nature of the debt-purchasing business was such that one could be successful with little capital and no prior experience and because the partners had, in some cases, actually replaced the managing general partner. *Id.* at 1367-68.

The SEC also argued that the RLLP interests were "securities" because they were "certificates of interest or participation in a profit-sharing arrangement" as set forth in the statutes. The court quickly rejected this theory, reasoning that "[b]ecause the partnership interests are not securities under the investment contract theory espoused by the SEC, the SEC's theory that they become a security because a physical certificate is issued to the partners elevates form over substance." *Id.* at 1369-70.[2]

[2] On January 6, 2006, the SEC filed a Notice of Appeal of the final judgment to the U.S. Court of Appeals for the Eleventh Circuit.

Imputation

(1) *In re Spear & Jackson Sec. Litig.*, 399 F. Supp. 2d 1350 (S.D. Fla. 2005).

Summary:
The district court held that, in an action under Rule 10b-5, the knowledge and conduct of a corporate officer will be imputed to the corporation unless the officer's actions are entirely adverse to the company's interests.

Facts:
Plaintiffs brought a class action under Rule 10b-5 against a company and its CEO, CFO, and auditors alleging that the CEO carried out a pump-and-dump scheme in order to sell his personal holdings of the company's stock through several nominee companies. The scheme allegedly consisted of falsely classifying a multi-million dollar pension liability as an asset. Defendants moved to dismiss on various bases. The company argued that because the scheme was intended to benefit the CEO's personal interests, his misconduct should not be imputed to the company.

Holding and Reasoning:
Motion granted with respect to the CFO and auditors, but denied with respect to the company and its CEO.

The court held that the knowledge and misconduct of the CEO was imputed to the company for purposes of sustaining a Rule 10b-5 claim against it. *Id.* at 1360-61. It explained that the acts of a corporate officer are imputed to the corporation except where the officer's interests are adverse to those of the corporation. *Id.* at 1361. The court held that this exception was not satisfied because, even though the CEO's motive was personal gain,

"it is difficult to argue that [the CEO's] interests were totally adverse to [the company's], or that [the company] did not benefit in some way, at least temporarily, from his scheme." *Id.* "While [the CEO] reaped the primary benefit by selling off his shares, [the company] would have enjoyed the benefits of appearing healthy and successful." *Id.* Moreover, because the CEO was also the company's majority shareholder, the court found it "much harder to separate his acts, and his interests, from the company's." *Id.* at 1362.

Scienter

(1) *In re Sawtek, Inc. Sec. Litig.*, No. 603CV294ORL31DAB, 2005 WL 2465041 (M.D. Fla. Oct. 6, 2005).

Summary:
Allegations in a complaint that an issuer made announcements to the public that were likely to *undercut* the price of its stock are significant in determining whether a plaintiff, in an action for securities fraud, has properly alleged that a defendant acted with scienter.

Facts:
Plaintiffs sued an issuer and its officers under Rule 10b-5, alleging a scheme to inflate the issuer's share price to increase the prospects of a merger and the value of the officers' personal holdings of the company's stock. They claimed that, contrary to public statements predicting strong sales, the issuer's sales forecasts were dropping significantly due to its customers having amassed large inventories as a result of various sales practices. Plaintiffs alleged that a subsequent announcement that the issuer was revising its revenue forecasts based on a predicted slowdown revealed the fraud, notwithstanding the fact that it said nothing about the underlying practices, and came before defendants sold any of their shares or even attempted a merger. Defendants moved to dismiss arguing, among other things, that plaintiffs failed to plead scienter with the particularity required by the Private Securities Litigation Reform Act ("PSLRA").

Holding and Reasoning:
Motion to dismiss granted.

To plead scienter with the particularity required by the PSLRA, a plaintiff must state with particularity facts giving rise to a strong inference that defendant made the representations or omissions knowingly or in a severely reckless manner. *Id.* at *5. The complaint, the court reasoned, failed this test because it merely parroted defendants' alleged nondisclosures without providing any particular facts showing knowledge or recklessness. *Id.* at *7-8.

It was significant, the court noted, that plaintiffs made allegations in the complaint that contradicted an inference of scienter by quoting multiple public statements in which the issuer predicted a *slowdown* in sales and disclosed *disappointing* financial results. *Id.* at *6-7. Such willing disclosures, the court reasoned, contradicted an inference that the issuer was acting recklessly or committing fraud to boost the price of its shares, particularly when they were issued before defendants sold any of their personal holdings. *Id.* at *7. The court noted that any announcement likely to undercut the share price was "significant," because it was also likely to undercut a merger. *Id.* "Though not dispositive, the [issuer]'s willingness to make such announcements before reaping the benefits of [its] alleged scheme is therefore relevant." *Id.*

Statute of Limitations

(1) *Belloco v. Curd,* No. 802CV1141T27TBM, 2005 WL 2675022 (M.D. Fla. Oct. 20, 2005).

Summary:

In a class action under Rule 10b-5, the court held that (i) certain disclosures in an analyst report and corporation's public filings were insufficient to put plaintiffs on notice of possible fraud; (ii) materiality of alleged "puffery" and statements of corporate optimism in corporate filings could not be resolved at the motion to dismiss stage; (iii) cautionary statements in corporate filings were not entitled to safe harbor protection; and (iv) plaintiffs sufficiently alleged liability for GAAP violations for failure to write down obsolete and unsaleable inventory.

Facts:

Shareholders brought a class action alleging that a corporation and its officers and directors violated Rule 10b-5 by falsely representing (i) the production volume and capabilities of a joint venture and (ii) the financial benefits of a corporate acquisition. Specifically, plaintiffs alleged that defendants misrepresented that the joint venture was proceeding as planned and that the acquired company was valuable when, in fact, both were performing poorly. The alleged misstatements included representations by defendants that "the market is strong and our objective is to be a major player in the industry," and that the company was "quickly expanding [the joint venture's] capabilities" and "rapidly ramping up production." Defendants moved to dismiss on various grounds.

Holding and Reasoning:

The court denied the motion to dismiss in part. *Id.* at *1.[3]

The court rejected defendants' argument that disclosures in certain public filings placed plaintiffs on inquiry or actual notice of the alleged fraud such that plaintiffs' claims were time-barred. *Id.* The court found that defendants' disclosures were facially insufficient and, when viewed together with contemporaneous statements of "corporate optimism," failed to put plaintiffs on inquiry or actual notice of fraud. *Id.* at *2. The court also rejected defendants' argument that the alleged misstatements should be dismissed as non-actionable "puffery," finding that defendants had not shown in their motion that the misstatements were "so obviously unimportant to an investor that reasonable minds cannot differ." *Id.* at *3. Similarly, the court found that the misstatements at issue were not entitled to safe-harbor protection because defendants failed (i) to sufficiently identify the cautionary language they were relying upon or (ii) to link such cautionary language to any of the alleged misstatements. *Id.* at *4. Lastly, the court found that plaintiffs adequately alleged liability for GAAP violations by claiming that defendants' failure to write down obsolete inventory through a charge to earnings during the class period caused the corporation to overstate its assets and income. *Id.*

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[3] Defendants' motion to dismiss was referred to a Magistrate Judge, who recommended that the motion be granted in part and denied in part. Defendants objected to the Magistrate Judge's recommendation that the motion be denied in any respect. The District Court's written decision addressed only defendants' objections and, thus, did not address the grounds upon which the motion to dismiss was granted.

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 Sam J. Salario at Carlton Fields either by telephone: 813.223.7000; 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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