

Securities & Derivative Litigation Report



2006 THIRD QUARTER ELEVENTH CIRCUIT SECURITIES LAW UPDATE

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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 July through September 2006.

Affiliated Ute Presumption of Reliance

(1) *Cooper v. Pacific Life Ins. Co.*, No. CivA CV203-131, 2006 WL 2699135 (S.D. Ga. Sept. 18, 2006).

Summary:

In a case where a plaintiff has employed the *Affiliated Ute* presumption of reliance on material omission, a defendant's "mere incantation" that trial of the matter will require a multitude of individual inquiries on reliance is insufficient to decertify a class. Defendant must put forth evidence to rebut the presumption.

Facts:

Investors purchased variable annuities from a NASD-registered broker-dealer using funds from a retirement plan operated by their employer. Upon discovering that the broker-dealer failed to disclose in the prospectus that the tax-deferral aspect of the annuity was redundant of features included in the retirement plan, investors brought a class action under the federal securities laws against the broker-dealer. The court certified a class, holding that common questions predominated over individual ones because the presumption of reliance on material omissions recognized by *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128 (1972), overcame any individual issues about reliance. The broker-dealer later moved to decertify the class.

Holding and Reasoning:

Motion to decertify class denied.

The broker-dealer argued that it and other broker-dealers disclosed the tax redundancy through various means other than the prospectus, and that the fact of these disclosures would require individual "mini-trials" to determine whether class members relied on the omission of these facts in the prospectus. *Id.* at *3-4. The court rejected this argument because the defendant could not put forth evidence to show which or how many class members actually received these later disclosures, whereas the record showed that all class members received the allegedly misleading prospectus that served as the basis for presuming reliance under *Affiliated Ute*. *Id.* at *4.

The court also rejected the broker-dealer's argument that the alleged omission regarding the tax-deferral aspects of the annuity was not material because the redundancy of such features is widely known in the marketplace. *Id.* at *5. This theory failed because the court concluded that it was the broker-dealer's duty to demonstrate that the class members were on notice of the alleged redundancy from some other source. *Id.* The court found that such matters went to the merits of the investors' claims, were thus for the jury's consideration, and did not warrant decertification of the class. *Id.*

Derivative Actions

- (1) ***Hantz v. Belyew*, No. 05-1012-CV-JOF, 2006 WL 2613447 (11th Cir. Sept. 12, 2006) (unpublished opinion).**

Summary:

Shareholders whose common stock was extinguished in a bankruptcy proceeding lost standing to bring a derivative lawsuit on behalf of the corporation in which they held stock.

Facts:

Shareholders filed two derivative claims alleging breach of fiduciary duty and conspiracy to breach fiduciary duty as well as a direct claim for fraud against several individuals. Before the shareholders filed the suit, their common stock was eliminated by a reorganization plan adopted in the corporation's Chapter 11 bankruptcy proceedings. After concluding that all of the claims asserted by the shareholders were derivative and not direct, the district court dismissed the complaint, holding that the shareholders lacked standing to bring a derivative action because, as a consequence of the extinguishment of their stock in the bankruptcy, they were no longer shareholders at the time they sued. The shareholders appealed.

Holding and Reasoning:

Affirmed.

Under both federal and Florida law, the so-called "contemporaneous ownership" requirement demands that, to bring a derivative action, the plaintiff must be a

shareholder both at the time the claim is filed and while the suit is pending. *Id.* at *1. The shareholders argued – relying on cases allowing shareholders to bring a derivative suit after losing their stock in a merger – that they should be exempt from the contemporaneous ownership rule because they involuntarily lost their stock in a bankruptcy proceeding. *Id.* The court rejected this argument, stating that involuntariness alone does not justify an exception to the contemporaneous ownership requirement and finding the merger cases distinguishable because a corporate board should not be able to use a merger to prevent judicial review of its actions by divesting shareholders of their stock. *Id.* at *2. The court noted that the shareholders had over a year to contest the company's reorganization plan before the bankruptcy court extinguished their stock pursuant to the plan. *Id.* The court concluded that where a shareholder's shares were eliminated by a bankruptcy proceeding, instead of by a merger, the proceeding itself provided them with an adequate forum to "air their grievances." *Id.*

Lead Plaintiff Provisions

- (1) ***Cordova v. Lehman Brothers, Inc.*, --- F.R.D. --- , 2006 WL 2422773 (S.D. Fla. Aug. 17, 2006).**

Summary:

In a class action subject to the Private Securities Litigation Reform Act, 15 U.S.C. § 78u-4(b) ("PSLRA"), plaintiffs were denied leave to amend a complaint to include new lead plaintiffs when the motion to amend was filed after motions to dismiss had been directed to the prior complaint and more than 60 days after notice was given to the class under the PSLRA.

Facts:

Plaintiffs filed a putative class action asserting federal securities law claims as well as claims for breach of fiduciary duty and knowing participation in a fraudulent scheme involving the sale of trusts. The original complaint named one lead plaintiff. Later, the plaintiff filed an amended complaint naming new lead plaintiffs. The court dismissed the complaint without prejudice, and the plaintiffs filed a second amended complaint. The defendants moved to dismiss. More than 60 days after

issuing the Notice of Pendency of Class Action, a new class of plaintiffs filed a motion to be appointed lead plaintiffs. The court treated the request as a motion to amend a complaint under Federal Rule of Civil Procedure 15.

Holding and Reasoning:

Motion denied.

Under Federal Rule of Civil Procedure 15(a), a plaintiff may amend or alter the complaint only with leave of court. *Id.* at *5. Leave may be denied because of undue delay or dilatory motive on behalf of the movant, or where it will unduly prejudice the defendant. *Id.* The court determined that the plaintiffs' request to amend the complaint for a fourth time to include a new class of lead plaintiffs was brought for the purpose of undue delay and with a dilatory motive. *Id.* Although the plaintiffs' counsel stated that it was "none of Defendants' business" why the new lead plaintiffs should be appointed, it was "the Court's charge, and therefore its business, to determine which plaintiffs will best represent the class." *Id.* at *5. The plaintiff offered no evidence to suggest which of the lead plaintiffs was most adequate, and the court concluded that the amended complaint was therefore merely for the purpose of undue delay. *Id.* at *6. The court explained that "it is not in the interests of justice nor is it procedurally correct to allow the new class plaintiffs to serve as lead plaintiffs" because the court could not "discern, based upon the record, whether the [new] plaintiffs would be more adequate lead plaintiffs than the [old] plaintiffs." *Id.* at *6. Further, allowing the plaintiffs to amend the complaint a fourth time would not be in the interests of justice because the defendants expended large amounts of time and resources drafting motions to dismiss in response to the third complaint. *Id.*

NASD Arbitration

- (1) ***Hasson v. Western Reserve Life Assurance, Co., No. 8:06-cv-523-T-23TBM, 2006 WL 2691723 (M.D. Fla. Sept. 19, 2006).***

Summary:

If an arbitration panel denies a claimant's request for

attorneys' fees, the claimant must file a motion to vacate, modify, or correct that portion of the award before seeking attorneys' fees from the court confirming the award. Further, where an arbitration award is not clear about whether the claimant has prevailed on a theory that would give rise to an entitlement to attorneys' fees, the claimant must ask the court to remand the matter to the arbitration panel for clarification of the award. Failure to take either approach within statutory time limits will bar the claimant's request for attorneys' fees.

Facts:

In a NASD arbitration, an insurance agent asserted claims against an insurance company and a broker-dealer for defamation, slander, breach of employment contract, and breach of fiduciary duty. The arbitrator awarded the agent \$68,000 in compensatory damages against the company and \$100,000 in compensatory damages against the broker-dealer. The arbitrator did not state the basis for the award, but denied the agent's request for attorneys' fees. The agent filed a motion to confirm the arbitration award in the district court, and asked the court to grant him attorneys' fees as the prevailing party pursuant to Florida law. The insurance company agreed with the confirmation of the award but disputed the request for attorneys' fees. A magistrate judge recommended that the district court grant the agent's motion for confirmation as to the money damages but deny the motion as to the request for attorneys' fees.

Holding and Reasoning:

Under both the Federal Arbitration Act and the Florida Arbitration Code, a party seeking relief from an arbitration award must ask the court to vacate, modify, or correct the award within a statutorily imposed time period. *Id.* at *4. For this reason, "[a] party seeking to enforce an arbitration award, but not exactly how it is written, must request modification or clarification from the panel within the statutory time limits under federal and Florida law." *Id.* at *5. The Federal Arbitration Act requires that notice of the motion to vacate, modify, or correct the award must be served within three months after the award is filed or delivered, and the Florida Arbitration Code requires that the application for relief must be made to the court within 90 days after the award is delivered to the claimant. *Id.* at *4. The court

concluded that the agent's failure to file a motion to vacate, modify, or correct the arbitrator's denial of the agent's request for attorneys' fees precluded him from seeking relief from the court. *Id.* at *5. Further, under Florida law, where the award does not specify which claims give rise to the damages awarded, and some of the claims permit an award of attorneys' fees while others do not, the district court may remand the award to the arbitration panel within the statutory time period to seek clarification. *Id.* However, after this period elapses, the district court must enforce the arbitration award as written. *Id.* The magistrate judge concluded that the agent's "failure to timely seek vacation, modification, clarification, or correction" of the award foreclosed his request for attorneys' fees. *Id.* at *5-6.

**(2) *SII Investments, Inc. v. Jenks, Inc.*,
No. 8:05-CV-2148-T-23MAP, 2006
WL 2092639 (M.D. Fla. July 27, 2006).**

Summary:

Sanctions will be recommended when a party seeks to vacate a NASD arbitration award for manifest disregard of the law and lacks a legitimate basis to satisfy this high standard.

Facts:

Investor filed a statement of claim against a NASD registered broker-dealer and its registered representative alleging several claims in connection with the investor's purchase of stock that had not been registered with the SEC. After a hearing, the NASD arbitration panel found the broker-dealer liable for the activities of the registered representative, even though he was no longer associated with the broker-dealer at the time the investor purchased the stock. The broker-dealer moved to vacate the arbitration award, alleging manifest disregard of a provision of Florida's Administrative Code which shields broker-dealers from liability for actions of a properly terminated registered representative.

Holding and Reasoning:

A magistrate judge recommended that the motion to vacate be denied and that the broker-dealer be sanctioned for bringing the motion. According to the Court's docket, the motion to vacate has since been resolved by stipulation.

Noting the Eleventh Circuit's recent decision in *Harbert Inter., LLC v. Hercules Steel Co.*, 441 F.3d 905, 910 (11th Cir. 2006), the magistrate judge concluded that the broker-dealer failed to demonstrate with clear evidence that the arbitrator was "conscious of the law and deliberately ignored it" because there were ample legitimate reasons to support the award notwithstanding the Florida Administrative Code provision relied upon by the broker-dealer. *Id.* (citing *Hercules Steel Co.*, 441 F.3d at 910). The court reasoned that, to demonstrate manifest disregard of the law, the party seeking to vacate an award must show that a position contrary to the law was taken, a "blatant appeal to disregard the law was explicitly noted in the award," the record lacked any indication that the panel ruled contrary to the law, and the evidence to support the award was "marginal." *Id.* (citing *Montes v. Shearson Lehman Bros., Inc.*, 128 F.3d 1456, 1461 (11th Cir. 1997)). Because the broker-dealer clearly failed to establish any of these elements, the magistrate judge recommended the imposition of Rule 11 sanctions under *Hercules Steel*, explaining that "if a party on the short end of an arbitration award attacks that award in court without any real legal basis for doing so, that party should pay sanctions." *Id.* at *5. The court read *Hercules Steel* to hold that parties are to either adhere to the exacting standards of judicial review of arbitration awards or "face the consequences." *Id.* at *6.

Pleading Requirements

(1) *Wagner v. First Horizon Pharmaceutical Corp., Inc.*, --- F.3d ---, 2006 WL 2661652 (11th Cir. Sept. 18, 2006).

Summary:

Claims under Sections 11 and 12 of the Securities Act must be pleaded with particularity pursuant to Fed. R. Civ. P. 9(b) when the facts underlying such claims are alleged to be part of a fraud claim alleged elsewhere in the complaint.

Facts:

Investors brought a class action against a pharmaceutical company in connection with a secondary offering designed to finance the acquisition of a new product line. The investors alleged that the company

pushed excess inventory into the supply chain to recognize revenue without increased market demand in order to control revenue growth and, in turn, maintain market confidence in its securities. The action alleged violations of the federal securities laws, including fraud claims under Section 10(b) of the Exchange Act and Rule 10b-5, and claims under Sections 11 and 12(a)(2) of the Securities Act.

The company moved to dismiss the action and the district court granted the motion, finding that the investors failed to “link their specific allegations to the causes of action pleaded in their complaint,” and thus failed to satisfy the pleading requirements of Rule 9(b) and the PSLRA. The court’s order also conditioned any motion to amend the complaint on a payment of the company’s costs and fees associated with the motion to dismiss. The investors appealed.

Holding and Reasoning:

Vacated and remanded with instructions to order repleading.

Section 11 of the Securities Act creates a cause of action against persons preparing and signing materially misleading registration statements. 15 U.S.C. § 77k(a). Section 12(a)(2) extends similar liability to misrepresentations in prospectuses and other oral communications. 15 U.S.C. § 771(a)(2). There is not a state of mind element for either claim, and liability is “virtually absolute, even for innocent misstatements.” *Id.* at *2 (quoting *Herman & MacLean v. Huddleston*, 495 U.S. 375, 382 (1983)). The question presented to the Eleventh Circuit – one that had not been resolved before – is whether there are circumstances when Fed. R. Civ. P. 9(b) would require such non-fraud securities claims to be pleaded with particularity. *Id.*

Recognizing a split among the circuits on this issue, the court held that Section 11(a) and Section 12(a)(2) claims must be pleaded with particularity “when the facts underlying the misrepresentation at stake in the claim are said to be part of a fraud claim, as alleged elsewhere in the complaint.” *Id.* at *2-3. In this case, the misrepresentations in the Sections 11(a) and 12(a)(2) claims were also “the beginning of – or otherwise part of – the predicate fraud for the Rule 10b-5 securities

fraud claim.” *Id.* at *3. The court explained that it would “strain credulity” to claim that Rule 9(b) did not apply when the complaint alleged essentially that defendant is “a no good defrauder, but, even if he is not, the plaintiff can still recover based on the simple untruth of the otherwise fraudulent statement.” *Id.* The court left open, however, the question whether Section 11 or 12 claims against an underwriter or other defendant who is not named in the fraud counts must be pleaded in accord with Rule 9(b). *Id.* at *2 n. 2.

(2) *Davidco Investors, LLC v. Anchor Glass Container Corp.*, No. 8:04-cv-2561-T-24 EAJ, 2006 WL 2092280 (M.D. Fla. July 26, 2006).

Summary:

Plaintiffs adequately pleaded a violation of Section 11 of the Securities Act where they alleged that financial statements in a prospectus violated generally accepted accounting principles (“GAAP”) by failing to recognize an impairment loss and disclose a contingent loss.

Facts:

Shareholders brought claims under the antifraud provisions of the federal securities laws against officers and directors of a public company, alleging that the defendants violated GAAP by failing timely to recognize an impairment loss in connection with a manufacturing plant when a customer chose not to renew a contract that allegedly accounted for 50% of the plant’s production and sales. The prospectus stated that “[i]n 2002, we lost a customer responsible for 3.9% of our 2001 net sales” and that the company could “replace these sales.” The shareholders alleged that there were no other prospects to replace the contract and that the contract was never replaced. Later, the company announced that it was closing the plant and reported charges related to the closing.

The shareholders argued that under GAAP, the company was required to report an impairment loss at the time it lost the contract and that it was required to disclose a contingent loss due to the loss of the contract. The defendants moved to dismiss the claims under Sections 11 and 15 of the Securities Act alleging that a GAAP violation had not adequately been pleaded.

Holding and Reasoning:

Motion to dismiss denied.

GAAP requires a company to recognize an impairment loss if the carrying amount of a long-lived asset is not recoverable from its undiscounted future cash flow. *Id.* at *4. The defendants argued that the shareholders' allegations were insufficient to meet this standard because they focused solely on the profitability of the plant, instead of addressing the future cash flows that the plant's assets could have produced. *Id.* The court determined that the shareholders' allegations were sufficient to survive a motion to dismiss. *Id.* Specifically, the court noted that after the contract was not renewed, operations at the plant declined. *Id.* At the time the prospectus was issued, the shareholders' alleged, the contract had not been replaced and the equipment used to produce the goods required by the contract was allegedly no longer used. *Id.* The court concluded that "it does not appear beyond doubt that [the shareholders] will be unable to prove that the undiscounted future cash flows of the assets of the plant were not sufficient to cover their carrying values at the time the prospectus was issued." *Id.*

Under GAAP, a contingent loss must be disclosed when there is at least a reasonable possibility that a loss may have been incurred. *Id.* at *5. The defendants argued that the shareholders failed to demonstrate that the loss of the contract was a contingent loss. *Id.* The court determined that the plaintiffs could prove that there was a reasonable possibility that the assets of the plant would become impaired after the loss of the contract and that the plant would close due to the loss of its customer base. *Id.*

Scienter

(1) ***SEC v. Roanoke Tech. Corp.***,
No. 6:05-cv-1880-Orl-31KRS, 2006 WL
2470329 (M.D. Fla. Aug. 24, 2006).

Summary:

To adequately plead the scienter necessary to establish fraud under the federal securities laws, a plaintiff must allege – at a minimum – that defendant made misrepresentations or omissions involving an "extreme

departure from the standards of ordinary care." That misrepresentation must have been either known to defendant, or so obvious that defendant must have been aware of it.

Facts:

The SEC sued a company, its CEO, and a promoter for engaging in a "pump and dump" scheme involving the company's stock. The CEO issued company stock to a promoter by way of Form S-8 registration statements that falsely asserted that the promoter was providing consulting services to the company. The SEC alleged that the investor provided no such services, and the investment was merely a means of raising capital. The SEC brought causes of action for fraud under Section 17 of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5. The promoter moved to dismiss and argued, *inter alia*, that the SEC failed to make proper allegations of scienter.

Holding and Reasoning:

Motion to dismiss granted.

Relying on the Eleventh Circuit's opinion in *Bryant v. Avado Brands*, 187 F.3d 1271 (11th Cir. 1999), the SEC argued that the allegations of its complaint gave rise to a strong inference of "conscious misbehavior" on the part of the promoter. *Id.* at *5. Specifically, the complaint alleged that the Form S-8 registration statements falsely represented that the shares were issued to the promoter as compensation for "consulting" services, but in reality the promoter provided little if any *bona fide* services to the company. *Id.* Instead, according to the complaint, within days after receiving the stock, the promoter sold the shares, wired the proceeds to his company's bank accounts, and then wired funds from those bank accounts to the CEO's bank accounts. *Id.*

The court rejected the *Avado Brands* "conscious misbehavior" standard of scienter and found that the panel in *Avado Brands* erroneously adopted the Sixth Circuit's standard rather than the accepted standard in the Eleventh Circuit. *Id.* In the Eleventh Circuit, the court held, the standard of scienter is severe recklessness, which is "limited to those highly unreasonable omissions or misrepresentations that involve not merely simple or even excusable negligence, but an extreme departure

from the standards of ordinary care, and that present danger of misleading buyers or sellers which is either known to the defendant or is so obvious that the defendant must have been aware of it." *Id.* (quoting *Ziamba v. Cascade Intern., Inc.*, 256 F. 3d 1194, 1202 (11th Cir. 2001)). Applying this standard, the court found that the SEC's allegations did not satisfy the scienter pleading requirements because there was no allegation that the promoter knowingly or recklessly acted with the intent to defraud. *Id.* at *6. The court noted that "half of the allegations relate to the improper issuance of Form S-8 stock ... but there is no allegation that [the promoter] knew anything about the circumstances under which the stock was issued or that he was responsible for its issuance." *Id.* Moreover, allegations regarding alleged kickbacks of the stock sale proceeds received by the promoter, standing alone, were insufficient to raise a strong inference of intent to defraud any investor. *Id.*

Statute of Limitations

(1) ***Securities and Exchange Commission v. Miller***, No. Civ. A. 1:04CV1655-JEC, 2006 WL 2189697 (N.D. Ga. July 31, 2006).

Summary:

The five-year statute of limitations in 28 U.S.C. § 2462 applies to the SEC's request for civil penalties arising from alleged violations of the federal securities laws. The SEC's claim accrues, for limitations purposes, when the SEC obtains actual or inquiry notice of the facts forming the basis of the cause of action.

Facts:

The SEC requested an injunction, civil penalties, and disgorgement against the head of a printing company, alleging that he violated federal securities laws by misclassifying salary and rent expenses in SEC filings. At some time before July 1999, the defendant instructed certain corporate officers to reclassify rent and salary payments for the first quarter of 1999 as prepaid expenses or receivables. In May 1999, the company filed a Form 10-Q that overstated the company's pretax first quarter earnings by 68% due to the rent and salary reclassifications, and this caused an increase in net

income. The company did not disclose the "potentially inappropriate" rent and salary reclassifications until February 2000. The SEC alleged that the defendant caused these misrepresentations in order to inflate the company's stock price and, in turn, to protect a \$6 million margin loan that he had secured with the company's stock. The defendant moved for summary judgment arguing, in part, that the claim was time barred.

Holding and Reasoning:

Motion for summary judgment granted in part and denied in part.

Under 28 U.S.C. § 2462, "[e]xcept as otherwise provided by Act of Congress, an action, suit or proceeding for the enforcement of any civil fine, penalty, or forfeiture, pecuniary or otherwise, shall not be entertained unless commenced within five years from the date when the claim first accrued." *Id.* at *7. The court concluded that the five-year statute of limitations applies to claims for civil penalties brought by the SEC. *Id.* at *8. The court recognized that Eleventh Circuit precedent suggests that the SEC is not subject to any time limitation when prosecuting actions to further the public interest, but reasoned that, because the SEC did not object to the application of the statute in this case, it should be applied to its claim. *Id.* at *8 n. 9.

Next, the court addressed when the SEC's cause of action accrued. *Id.* The defendant argued that the cause of action accrued when the SEC discovered the facts forming the basis for the action. *Id.* at *10. He argued that the SEC should have discovered the fraud after reading the May 1999 Form 10-Q because that form's number of days sales outstanding differed from previous filings. *Id.* The court noted that the "discovery rule" was applicable to a private party's securities fraud class action, and relied on *SEC v. Buntrock*, 2004 WL 1179423 (N.D. Ill. May 25, 2004), to conclude that the SEC was also subject to the discovery rule. *Id.* at *9. In *Buntrock*, the Northern District of Illinois concluded that the discovery rule should apply to SEC claims for civil monetary penalties and that the SEC's action accrues when the SEC "learns, or should have learned through the exercise of ordinary diligence in the protection of [its] legal rights, enough facts to enable [it], by such

further investigation as the facts would induce a reasonable person, to sue within five years." *Id.* Although noting that the decision was not binding, the court decided to follow its definition of the discovery rule. *Id.* at *10.

However, the court rejected the defendant's argument that the Form 10-Q was a "storm warning" that placed the SEC on inquiry notice of the alleged fraud. *Id.* at *10. Although public announcements can be sufficient to

put a plaintiff on inquiry notice, a "change in a financial statement figure that can only be recognized by comparison to a filing made in a previous quarter is something much different than a public announcement that a company will be filing bankruptcy or is under investigation." *Id.* The court concluded that whether the Form 10-Q put the SEC on inquiry notice was a question of fact for the jury and could not be resolved on motion for summary judgment. *Id.*

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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