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Securities & Derivative Litigation Report

2006 FOURTH 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 October through December 2006.

Immunity of Self Regulatory Organizations

(1) *Weissman v. National Ass'n of Securities Dealers, Inc.*, 468 F.3d 1306 (11th Cir. 2006).

Summary:

Under the federal securities laws, the NASD is entitled to absolute immunity from civil claims relating to actions in furtherance of its regulatory functions, but does not enjoy such immunity when engaging in non-regulatory activities.

Facts:

An investor in WorldCom, Inc. ("WorldCom") filed suit in federal court against the NASD alleging that it violated Florida securities laws by promoting WorldCom through its marketing and advertising without disclosing that the NASD derived revenues from increased trading in WorldCom stock. The investor also alleged that the NASD committed fraud by disseminating WorldCom's false financial statements. The NASD moved to dismiss, claiming absolute immunity from the suit because the investor complained of conduct undertaken pursuant to the NASD's quasi-governmental role as market regulator under 15 U.S.C. § 78(a) of the Exchange Act, which vests the NASD with a duty to promulgate and enforce rules concerning the conduct of its members. The district court denied the motion, holding that the complaint related only to private commercial conduct not governed by the Act. The NASD appealed.

Holding and Reasoning:
Affirmed in part and reversed in part.

The Eleventh Circuit reversed the district court's order insofar as it held that the NASD's dissemination of WorldCom's fraudulent financial statements was private commercial conduct, holding that such activity was clearly undertaken pursuant to the NASD's regulatory authority under 15 USC § 78o-3(b)(6) to "remove impediments and perfect" the free market. *Id.* at 1311. The court affirmed the district court's holding that the NASD's marketing and advertising activities were not immune from suit, however. *Id.* at 1311-12. According to the complaint, the NASD fraudulently touted WorldCom's stock in order to profit from increases in trading volume. *Id.* at 1312. The court found that such conduct, if it in fact occurred, did not fall "under the aegis" of the NASD's delegated disciplinary and regulatory authority. *Id.* The advertisements, the court held, "were in no sense mandated by, or coterminous with, any regulatory activity contemplated by the Exchange Act." *Id.*

In a dissenting opinion, Judge Tjoflat disagreed with the majority's holding that the NASD's advertising activity was not immune from suit. *Id.* 1314-20 (Tjoflat, J., dissenting). "Fundamentally, [plaintiff's allegations] do not implicate any activity by [the NASD] beyond the decision to continue listing WorldCom and the communication of that decision to the marketplace …." *Id.* at 1319. These activities, Judge Tjoflat suggested, fall directly within the scope of the quasi-governmental activities covered by the immunity statute. *Id.*

Loss Causation

(1) *In re TECO Energy, Inc. Sec. Lit.*, No. 8:04-CV-1948-T-27EAJ, 2006 WL 2884960 (M.D. Fla. Oct. 10, 2006).

Summary:

Shareholders properly alleged loss causation under the PSLRA by alleging that 1) the company in which they purchased stock misrepresented that it had a number of long-term contracts; 2) this misrepresentation was followed by a public statement that the company had actually failed to secure such contracts; and 3) after the statement, the stock price dropped.

Facts:

Shareholders brought a putative class action alleging that a company violated Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5, as well as Section 20(a) of the Exchange Act. After having a complaint dismissed in part for failure to adequately plead loss causation, the shareholders filed an amended complaint. The company again moved to dismiss, asserting a failure to plead loss causation sufficiently. The shareholders alleged that the company's alleged misrepresentations and omissions were corrected by statements in reports by research analysts covering the stock and the company's own public filings during the fall of 2002 and early 2003. The shareholders alleged that, upon these disclosures, the stock price fell 44% from August 12, 2002 to February 4, 2003.

Holding and Reasoning:

Motion to dismiss granted in part and denied in part.

Reasoning that loss causation is not subject to the PSLRA's heightened pleading requirements, the court held that a plaintiff need only provide a "short and plain statement" that puts the defendant on notice of the grounds on which the claim is based. *Id.* at *5. To prove loss causation, the plaintiff must "allege a disclosure or revelation of truth about a defendant's prior misstatement or omission that is in some way connected with a stock price drop." *Id.*

Applying these standards, the court held that the shareholders "barely" alleged loss causation with respect to a statement that the company had a number of long term contracts, which was specifically and clearly corrected by statements in two research analyst reports stating that the company had no such contracts. *Id.* at *6-8. The shareholders also adequately pled that as a result of these corrections, the stock price fell 9% on August 13; 4% on August 16; and 18% on September 3. *Id.* at *7. The court granted the company's motion to dismiss as to all other allegations, holding that the shareholders had either failed to identify a true corrective disclosure (e.g., had only identified statements of opinion, not disclosures of fact) or that the facts allegedly concealed had actually been disclosed in the company's public filings. *Id.* a *8-9.

PSLRA Pleading Requirements

(1) *Garfield, et al. v. NDC Health Corporation, et al.*, No. 05-14765, 466 F.3d 1255 (11th Cir. Oct. 12, 2006).

Summary:

Allegations of channel stuffing and the execution of Sarbanes-Oxley certifications by management are, by themselves, insufficient to support a cause of action under Section 10(b) and Rule 10b-5 of the Securities Exchange Act. In addition, claims of securities fraud against a company's independent auditor must be based on more than the mere allegation that the auditor violated generally accepted auditing standards.

Facts:

Shareholders filed a putative class action against a company alleging that it engaged in accounting fraud by "channel-stuffing" (i.e. paying distributor incentives so that distributors would purchase excess supply) to boost short-term revenue. The shareholders also alleged that the company's outside auditor engaged in securities fraud by failing to comply with generally accepted auditing standards when it audited the company's financial statements for the period at issue. The district court granted the corporation's motion to dismiss the shareholders' complaint based on its failure to meet the heightened pleading requirements of PSLRA and Rule 9(b) of the Federal Rules of Civil Procedure. The shareholders appealed.

Holding and Reasoning:

Affirmed.

Channel-stuffing is not per se fraudulent, and can be a source of legitimate revenue for a corporation. *Id.* at 1261. The shareholders alleged only that the company's officers knew that accounts receivable were high as a result of channel-stuffing, and that the officers signed financial certifications required by the Sarbanes-Oxley Act. *Id.* at 1265-66. These facts are insufficient to satisfy the scienter pleading requirements of the PSLRA, absent allegations that the officers knew about accounting irregularities, that they intended to deceive investors, or that there were red flags that the company's financial statements contained material misstatements or omissions. *Id.* at 1266-67. In addition, mere allegations that the company's outside auditor violated generally accepted auditing standards (GAAS) are insufficient to establish scienter in a securities fraud claim against the auditor. *Id.* at 1269. For GAAS violations to constitute actionable fraud, plaintiffs must additionally allege that the auditor was on notice of fraud, either directly or through red flags, and took no subsequent remedial actions. *Id.*

(2) *In re Immucor Incorporated Securities Litigation,* No. 1:05-CV-2276-WSD, 2006 WL 3000133 (N.D. Ga. Oct. 4, 2006).

Summary:

A corporation's exposure to significant criminal liability is a material fact. Failure to disclose such a fact, if coupled with scienter, is actionable under Section 10(b) and Rule 10b-5. For purposes of establishing scienter for the company's officers, knowledge of the company's core operations will be imputed to at least the company's key officers.

Facts:

Shareholders filed a securities class action against a corporation and certain officers for fraud in connection with the corporation's payment of bribes through its Italian subsidiary. The shareholders alleged that the corporation and its key officers materially understated the potential for Foreign Corrupt Practices Act (FCPA) charges against the company in the corporation's SEC filings, press releases, and analyst calls. The company's stock price substantially declined after the company announced that the SEC was conducting a formal investigation into the corporation's foreign payments. The defendants filed a motion to dismiss, arguing that the plaintiffs did not allege any false or misleading statements and did not allege sufficient facts to show scienter on the part of one individual defendant. The defendants also contended that the plaintiffs failed to adequately plead loss causation with the particularity required by the PSLRA and Federal Rule of Civil Procedure 9(b).

Holding and Reasoning:

Motion to dismiss denied.

For purposes of Section 10(b) and Rule 10b-5, a corporation's exposure to significant criminal liability is a material fact and must be disclosed because it is a fact that reasonable investors would view as "significantly alter[ing] the total mix of information made available" to the investing public. *Id.* at *11. Downplaying exposure to criminal liability to create the impression that the violative conduct and potential fines are significantly less severe than they actually are is materially misleading. *Id.* at *15 and *16. Accordingly, failure to disclose the full scope of a corporation's potential criminal liability, if coupled with scienter, is actionable under Section 10(b) and Rule 10b-5. *Id.* at *18. For purposes of establishing scienter, knowledge of the company's core operations will be imputed to at least the company's key officers. *Id.*

(3) *Amalgamated Bank, Trustee, et al. v. The Coca-Cola Company, et al.,* No. Civ.A. 1:05-CV-1226, 2006 WL 2818973 (N.D. Ga. Sept. 29, 2006).

Summary:

Allegations containing corporate officers' statements of opinion or vague expressions of optimism about the company's current or future performance are not objectively verifiable statements of fact that may support a claim for securities fraud.

Facts:

Shareholders brought a securities fraud class action against a corporation and its executive officers under Section 10(b) and Rule 10b-5. The complaint alleged that the company and its executives made misrepresentations concerning the company's current and expected financial results and the success of its marketing plan. The alleged misrepresentations included statements that the company had "the right leadership," had "restored its marketing system to health," "was confident it would meet its 11% - 12% annual EPS growth target," and that the company's year-end earnings reflected "flawless execution" of its "crystal clear strategy." The defendants filed a motion to dismiss the shareholder's complaint arguing, among other things, that the defendants' statements were not actionable statements of material facts, but were mere puffery or protected forward-looking statements.

Holding and Reasoning:

Motion to dismiss granted.

Allegations that corporate officers' statements of opinion, "corporate optimism," and forward-looking statements are materially misleading will not support an action for fraud under Section 10(b) and Rule 10b-5. To constitute fraud, a misstatement must be both material, and a statement of fact capable of objective verification. *Id.* at *3. Statements of opinion, or vague characterizations about a company's health, outlook, or the effectiveness of its programs, are not statements of fact. Thus, they are "insufficient as a matter of law to state a valid securities fraud claim." *Id.* In addition, even statements that "go beyond 'corporate optimism'" may not be actionable under PSLRA if they are "forward-looking and accompanied by meaningful cautionary language." *Id.* at *4. Qualifying "forward-looking statements" include projection[s] of revenue and earnings, management's plans or objectives for future operations, and management's performance projections. *Id.* Accordingly, the defendants' growth projections, which were accompanied by meaningful cautionary language, are "immunized from liability" under the PSLRA's safe harbor for forward-looking statements. *Id.*

Shareholder Derivative Actions

(1) *Vulcan Engineering Co. v. XL Insurance America, Inc.*, No. 06-12464, 2006 WL 2873204 (11th Cir. Oct. 11, 2006).

Summary:

Under directors' and officers' liability insurance policy covering derivative but not direct claims, insureds were not entitled to coverage for claims brought as direct claims, even though the claims were likely derivative in nature.

Facts:

A company and two individuals brought an action against their directors' and officers' liability insurer for the costs of defending a former minority shareholder's suit. The former minority shareholder alleged that the individuals breached fiduciary duties owed to him and engaged in fraud. Although the policy excluded from coverage direct insured versus insured actions, it did cover "Securityholder Derivative Actions," defined in the policy as "any Claim brought on behalf of or in the name or right of, the Insured Organization by one or more securityholders of the Insured Organization ...." The insurance company refused coverage, stating that the former minority shareholder's claims were direct. The district court granted the insurer's motion for summary judgment, and the company and individuals appealed.

Holding and Reasoning:

Affirmed.

The proper standard for evaluating whether a claim is direct or derivative for the purpose of insurance coverage is how those terms are defined in the policy. *Id.* at *1. The court noted that under the policy's definition of "derivative," "whether a claim is derivative turns on how that claim is brought, rather than on the injury underlying that claim." *Id.* at *2. The court concluded that although the company had a "strong argument" that the minority shareholder's claims were derivative in nature, the claims were actually brought as a direct action. *Id.* at *1-2. The court pointed out that the minority shareholder specifically stated that his "'claims . . . [were] individual rather than derivative.'" *Id.* The court concluded that "[b]ecause his lawsuit was not 'brought on behalf of, or in the name or right of, the Insured Organization,' it is not a 'Security Derivative Action' as that term is defined in the insurance policy" and the insurer therefore had no duty to defend the lawsuit. *Id.* at *2.

(2) *Hantz, et al. v. Belyew, et al.*, No. 1:05-CV-1012-JOF, 2006 WL 3266508 (N.D. Ga. Nov. 8, 2006).

Summary:

Under Georgia law, prevailing defendants were entitled to an award of attorneys' fees and expenses from the plaintiff in a shareholders' derivative action where the plaintiffs instituted the suit after their shares were extinguished in a bankruptcy proceeding.

Facts:

Shareholders filed a derivative suit against a corporation and its board of directors alleging that they entered into a financing plan with another company that would benefit the board members and harm shareholders. That financing plan ultimately was unsuccessful, and the corporation entered bankruptcy. The shareholders' stock was extinguished in the bankruptcy proceeding. The defendants filed a motion to dismiss, claiming, among other things, that the shareholders lacked standing because their shares were extinguished in bankruptcy, that their derivative claims were transferred to the bankruptcy estate, and that they did not plead fraud with sufficient particularity. The court granted the defendants' motion to dismiss on those and other grounds, and granted the defendants leave to file a motion for attorneys' fees pursuant to O.C.G.A. Section 14-2-746.

Holding and Reasoning:

Motion for attorneys' fees and expenses granted in part, and denied in part.

Under O.C.G.A. Section 14-2-746, defendants can recover reasonable attorneys' fees and expenses incurred in defending a derivative suit if the court finds "that the proceeding was commenced or maintained without reasonable cause or for an improper purpose." *Id.* at *3. The shareholders here plainly lacked standing to bring the derivative action because their shares were extinguished in the company's bankruptcy proceeding, and they also failed to plead fraud with particularity. *Id.* at *1-2. Therefore, they did not have reasonable cause to bring or maintain an action against the defendants, and the defendants were entitled to reasonable attorneys' fees and expenses. *Id.* at *3.

SLUSA

(1) *W.R. Huff Asset Mgt. Co. v. Kohlberg,*

***Kravis, Roberts, KKR,* No. 06-11861, 2006 WL 3544920 (11th Cir. Dec. 11, 2006) (unpublished).**

Summary:

Proposed amendment to class action complaint alleging violations of state securities laws, which would have reduced the number of plaintiffs below fifty, removed complaint from the ambit of the Securities Litigation Uniform Standards Act of 1998, 15 U.S.C. §§ 77p and 78bb(f) ("SLUSA"), and ought to have been permitted.

Facts:

A noteholder brought a class action against a corporate issuer asserting various claims under Alabama state law. The issuer moved to dismiss the initial complaint, arguing that SLUSA preempted the state law claims. After the three challenges and two dismissals of the suit on SLUSA preemption grounds, the noteholder moved to file a fourth amended complaint to decrease the number of plaintiffs to 46 noteholder clients, since SLUSA applies to actions filed by 50 or more plaintiffs. 15 U.S.C. §§ 77p(f)(2)(A)(i)(I), (II). The district court denied the noteholder's motion to file a fourth amended complaint. The noteholder appealed.

Holding and Reasoning:

Decision of the district court vacated and remanded.

The Eleventh Circuit held that the district court abused its discretion in denying the noteholder the opportunity to file his fourth amended complaint, which reduced the number of plaintiffs to below fifty, and thus outside the ambit of SLUSA. *Id.* at *2. The district court's order regarding the second amended complaint, the court held, could not have possibly precluded the noteholder from pursuing all state law claims. *Id.* By reducing the number of plaintiffs below fifty, the noteholder eliminated any question of whether the case involved a "covered class action," as that term is defined by SLUSA. *Id.* The amendment should have been permitted. *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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