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Securities & Derivative Litigation Report

2004 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 and Derivative Litigation Practice Group provides quarterly updates of securities decisions from federal courts in the Eleventh Circuit.[1] This Update summarizes decisions of interest within the Eleventh Circuit from July through September 2004.

Duty to Disclose

(1) *Nelson v. Pacific Life Ins. Co.*, 2004 WL 1592617 (S.D. Ga., July 12, 2004)

Summary:
Life insurance companies are required to disclose to those who purchase variable annuities as retirement investments that the tax deferral advantages of a variable annuity are duplicative of similar advantages available in an IRA.

Facts:
Plaintiffs, purchasers of variable annuities from a life insurance company, brought a Rule 10b-5 claim against the company alleging that it failed to disclose that plaintiffs already enjoyed similar tax deferral treatment in their respective IRAs. Plaintiffs alleged that the life insurance company – as distinguished from the securities broker who actually sold the annuity – had a duty to disclose the redundancy of the tax advantages because the broker, who had such a duty, was an agent of the company. The company moved to dismiss, arguing that it had no duty to disclose and, in any event, the complaint failed to satisfy the scienter pleading requirements of the Private Securities Litigation Reform Act of 1995 ("PSLRA").

Holding and Reasoning:
The Southern District of Georgia denied the motion, holding that plaintiffs' allegation that the life insurance company had a principal-agent relationship with the broker that sold the company's variable annuities sufficiently showed that there was a relationship of trust and confidence between plaintiffs and the company, and thus defendant bore a duty to disclose the redundant tax consequences of the variable annuity. *Id.* at *3-*4. In finding a duty to disclose, the

[1] This Update is intended for the general information of readers, and is not intended as legal advice or as a substitute for research and analysis of any of these issues.

court relied on NASD Notice to Members 99-35, which explicitly reminded NASD members of its responsibility to mention these characteristics of variable annuities. *Id.* at *3. Recognizing that the Notices were not legally binding, the court nonetheless found them to be persuasive evidence of NASD's interpretation of its own rules. *Id.*

The court also held that the complaint satisfied the PSLRA-required "strong inference" of scienter because it alleged that the life insurance company trained its agents to avoid disclosure of the tax deferral redundancy when selling the variable annuities to clients. *Id.* at *6.

Forced Seller Doctrine

(1) *APA Excelsior III, L.P. v. Windley,* 329 F. Supp. 2d 1328 (N.D. Ga. 2004)

Summary:
In the Eleventh Circuit, the "forced seller" doctrine provides an exception to the general requirement that a Rule 10b-5 plaintiff be a "purchaser" or "seller" of securities in circumstances where a defendant's fraud renders the plaintiff's investment "so fundamentally changed as to leave him with nothing more than a claim for the payment of money."

Facts:
Shareholder-plaintiffs brought a securities fraud action against an issuer, one of its directors, and others, alleging that they had been frozen out by the issuer's sale of corporate assets at a foreclosure sale and that the director made false statements and omissions regarding that transaction. The director moved to dismiss a Rule 10b-5 claim against him, arguing that, because plaintiffs had not actually bought or sold securities in reliance on any alleged misstatement, the action did not involve a "purchase or sale" of securities as required by the rule. The district court denied the motion, holding that the "forced seller doctrine," which relaxes the "purchase or sale" requirement in certain circumstances, might apply to plaintiffs' claims. The director again raised the issue on a motion for summary judgment arguing, among other things, that the "forced seller" doctrine is not viable in the Eleventh Circuit and therefore that plaintiffs lacked standing to bring the federal securities claim.

Holding and Reasoning:
The Northern District of Georgia affirmed the validity of the forced seller doctrine, and denied defendant's motion for summary judgment. *Id.* at 1348-50. The forced seller doctrine permits a Rule 10b-5 plaintiff to be treated as having effected a "sale" of securities "when his investment has been so fundamentally changed as to leave him with nothing more than a claim for the payment of money." *Id.* at 1348. The court reasoned that the doctrine had been recognized by the former Fifth Circuit – whose decisions are binding in the Eleventh Circuit[2] – in the context of a liquidation of corporate assets. *Id.* (citing *Dudley v. Southeastern Factor & Finance Corp.*, 446 F.2d 303, 307 (5th Cir. 1971).

The court explained that courts have generally applied the forced seller doctrine upon a showing of three elements – (1) a drastic reduction in the value of the plaintiff's investments, (2) a causal relationship between the alleged fraud and the altered nature of the plaintiff's investment, and (3) an elimination of the prior business entity as a result of the action complained of. *Id.* Although the court found a genuine issue of material fact with respect to the first two elements, it held that plaintiffs failed to identify record evidence showing the third – the elimination of the prior business entity. *Id.* Thus, although the court denied defendant's summary judgment motion for lack of standing, it instructed plaintiffs that, in order to salvage their federal securities claims at trial, they were required to offer evidence proving their contention that foreclosure of the corporation, like liquidation, left

[2] The U.S. Court of Appeals for the Eleventh Circuit adopted as binding precedent the decisions of the U.S. Court of Appeals for the Fifth Circuit handed down prior to September 30, 1981. *Bonner v. City of Prichard*, 661 F.2d 12061207 (11th Cir. 1981).

them with nothing more than a claim for cash. *Id.* at 1350, 1368.

Loss Causation

(1) *Barr v. Matria Healthcare, Inc.*, 324 F. Supp. 2d 1369 (N.D. Ga., July 7, 2004)

Summary:
A class action, Rule 10b-5 claim must be dismissed for failure to plead the required element of loss causation where the named plaintiff sells his shares prior to the corrective disclosure alleged in the complaint.

Facts:
Plaintiff brought a Rule 10b-5 class action alleging that defendant artificially inflated the price of its stock by concealing the fact that the rapid growth of its business was outpacing its information technology capabilities. Plaintiff alleged that, instead of being candid about this handicap, defendant instead misleadingly asserted that it retained a competitive edge in the field. After the defendant issued a press release detailing its IT shortcomings, the stock price fell. Defendant moved to dismiss, arguing (i) that plaintiff lacked standing to sue because he sold his shares before the corrective press release was issued and (ii) that plaintiff failed to state a claim because – in view of the fact that he sold his stock before the corrective disclosure – he could not allege the requisite element of loss causation.

Holding and Reasoning:
The Northern District of Georgia dismissed the complaint, holding that, although plaintiff did have standing to assert a Rule 10b-5 claim, he failed to allege loss causation. *Id.* at 1377, 1380. Citing the Eleventh Circuit decision in *Robbins v. Koger Properties, Inc.*, 116 F.3d 1441 (11th Cir. 1997), the court reasoned that a Rule 10b-5 plaintiff's standing is determined by reference to the "out-of-pocket rule," which provides that a plaintiff suffers a cognizable injury-in-fact when he purchases stock at an artificially inflated price and subsequently sells it at a net loss. *Id.* at 1379-80. That the corrective disclosure had not issued at the time of plaintiff's sale – and, as a consequence, that plaintiff sold his stock at an inflated price – was not dispositive of the standing inquiry. *Id.* at 1376-77.

However, the court did conclude that plaintiff could not state a Rule 10b-5 claim because he failed to plead the requisite element of loss causation. To assert a claim under the Exchange Act, the plaintiff has the burden of showing that the misrepresentation made by defendant "caused the loss for which the plaintiff seeks to recover damages." *Id.* at 1379 (quoting 15 U.S.C. § 78u-4(b)(4)). To assert loss causation, a plaintiff must allege "that the untruth was in some reasonable direct, or proximate, way responsible for his loss." *Id.* (quoting *Robbins*, 116 F.3d at 1447).[3] Because plaintiff sold his stock before the corrective information was disclosed, he could not satisfy the loss causation requirement. *Id.* at 1380.

NASD Arbitration

(1) *Multi-Financial Securities, Corp. v. Rua L. King*, 386 F. 3d 1364, 2004 WL 2246220 (11th Cir. Oct. 6, 2004)

Summary:
A customer of an NASD member firm may compel the member firm and its associated persons to arbitrate legal claims in the absence of an express contract between the customer and the firm requiring arbitration, provided that the claims are covered by the NASD Code of Arbitration Procedure (the "Code").

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[3] There is currently a split among the circuits as to whether proper pleading (and proof) of loss causation requires only a showing of purchase price inflation or instead demands a showing of purchase price inflation and a diminution in value caused by the disclosure of the true facts. These issues are before the Supreme Court, which this term is reviewing a Ninth Circuit decision holding that only purchase price inflation need be pleaded. *Broudo v. Dura Pharmaceuticals, Inc.*, 339 F.3d 933, 938 (9th Cir. 2003), *cert. granted*, 124 S.Ct. 2904 (2004).

Facts:
A customer instituted an NASD arbitration against a brokerage firm that was a member of the NASD alleging that she detrimentally relied on bad financial advice given by one of its registered representatives. Although the customer did not have a contract with the member firm – and thus had no contract provision requiring arbitration – she nonetheless demanded arbitration pursuant to Rules 10101(c) and 10301(a) of the Code.

Rule 10101(c) provides for the arbitration "of any dispute, claim, or controversy arising out of or in connection with the business of any member of the Association … between or among members or associated persons and public customers, or others…." NASD Rule 10101(c). Rule 10301(a) adds that the dispute must arise "in connection with the business of such member or in connection with the activities of such associated persons…." NASD Rule 10301(a).

The member firm filed a declaratory judgment action in the Middle District of Florida to determine whether, absent a written agreement to arbitrate, the customer could demand arbitration. The member further claimed that the customer was not a customer of the firm because the registered representative never identified the firm as being involved in her investments. In response, the customer moved to compel arbitration under the Federal Arbitration Act ("FAA"). The district court refused to order an evidentiary hearing and compelled the member firm to arbitrate the claims.

Holding and Reasoning:
The Eleventh Circuit affirmed, holding that, in the absence of an explicit arbitration provision, the Code serves as a "sufficient written agreement to arbitrate, binding its members to arbitrate a variety of claims with third-party claimants." *Id.* at *6. The only question, the court determined, was whether this particular claim was one covered by the Code.

Interpreting the Code, the court held that the customer could compel arbitration by showing, pursuant to Rules 10101(c) and 10301(a), that the claim: (i) involved a dispute between a member and a customer or an associated person of the member and a customer; and (ii) arose in connection with the business activities of the member or in connection with the activities of the associated person. *Id.* at *7.

The court rejected the member firm's contention that the claim was not arbitrable because the customer was not a customer of the firm, holding that it was sufficient that the dispute involved a customer and the associated person of a member. *Id.* at *8-*9. Unlike other sections of the Code, Rules 10101(c) and 10301(a) do not draw a distinction between a "customer" and a "customer of a member." *Id.* at *9. Because the NASD could have limited these Rules as it had others, the Eleventh Circuit held that the drafters intended to permit customers of associated persons to bring claims against any member with which the person was associated. *Id.* at *10. In so finding, the court rejected the notion that there must be some indicia of a direct relationship between the member and the investor for a claim to be subject to arbitration under the Code. *Id.* at *12-*13.

With respect to the second element, the court recognized that Rules 10101(c) and 10301(a) applied only to a particular type of dispute – that is, a dispute "arising in connection with the business of such member." *Id.* at *14. Here, the court determined that the customer's primary claim against the member firm was negligent supervision of its registered representative. Because Rule 3010 of the NASD Code of Conduct requires that its members supervise the activities of their associated persons as part of their business, the second condition was satisfied. *Id.* at *14-*15.

Sale of Unregistered Securities

(1) *Sec. and Exch. Comm'n v. Calvo*, 378 F.3d 1211 (11th Cir. 2004); *Sec. and Exch. Comm'n v. Diversified Corp. Consulting Grp.*, 378 F.3d 1219 (11th Cir. 2004)

Summary:
A principal in a limited liability company that sells unregistered securities is primarily liable along with the company for violating Section 5 of the Securities Act when the evidence shows that the principal took an active role in the purchase and resale of the stock.

Facts:
The SEC brought an enforcement action against a limited liability company, its principal, and others alleging that the company and its principal sold unregistered securities in violation of Sections 5(a) and (c) of the Securities Act and that the company engaged in market manipulation in violation of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act, and Rule 10b-5. The SEC moved for summary judgment against the company and its principal on the Section 5 claim, and the district court granted the motion. After a jury verdict in the SEC's favor on the remaining claims, the company and the principal appealed.

Holding and Reasoning:
The Eleventh Circuit simultaneously issued two opinions addressing the various contentions of the company and its principal. The court affirmed the summary judgment on the Section 5 claims against the principal, finding adequate evidence that he was a "necessary participant" or a "substantial factor" in the sale of unregistered shares. *Calvo*, 378 F.3d at 1215. The evidence showed that the principal negotiated and signed the contract to acquire the unregistered shares; opened an account on behalf of the company where the shares were deposited; signed the authorizations for transfers out of the account; and received proceeds – albeit through the company – from the sale of the shares. *Id.* The court held that evidence of the principal's active role in the company's sale of the unregistered securities was sufficient to render him strictly liable under the statute. *Id.*

The court also held that the principal was jointly and severally liable with the company for disgorgement, despite the fact that his liability under Section 5 was strict. *Id.* at 1215-16. Joint and several liability is appropriate in securities law case, when individuals have a close relationship and are engaging in illegal conduct. *Id.* at 1215. Such was the case here, the court determined, because the principal founded the limited liability company; retained a 50% ownership interest; served as the managing member; and engaged in securities law violations along with the company. *Id.* at 1216.

The court also addressed two issues raised by both the company and the principal. The first concerned whether the district court erred in rejecting defendants' statute of limitations defense. *Id.* at 1218; *Diversified*, 378 F.3d at 1224. The court held that a statute of limitations defense is inapplicable when the government brings suit in its sovereign capacity. *Calvo*, 378 F.3d at 1218. Because the SEC was vindicating public rights – even though the disgorged proceeds may be utilized to compensate injured victims – no exception to the general rule applied. *Id.* The court also noted that the framework of the Securities Act suggests that Congress did not intend to place a time limit on SEC enforcement actions because although the Securities Act places express time limitations on private rights of action, the SEC's enforcement power is not so bound. *Id.*

Finally, the court addressed defendants' "innocent purchaser" defense. In support of this defense, defendants relied on interpretations of the securities laws found on the SEC's website. *Id.* at 1218-19; *Diversified*, 378 F.3d at 1224. The Eleventh Circuit affirmed the district court's rejection of the defense, concluding that the interpretations on the SEC's website were not legally binding. *Calvo*, 378 F.3d at 1219. Because the website contained ample warnings to that effect, defendants could not reasonably have relied on any statements in those interpretations. *Id.*

SLUSA and Removal

(1) *Zia v. Medical Staffing Network, Inc.*, 336 F. Supp. 2d 1306 (S.D. Fla. Sept. 16, 2004)

Summary:
The Securities Litigation Uniform Standards Act ("SLUSA") does not authorize the removal from state court of class actions alleging solely violations of the Securities Act of 1933.

Facts:
A shareholder brought a state court class action against defendants alleging that defendants made untrue statements in a registration statement and prospectus in violation of Sections 11, 12(a)(2) and 15 of the Securities Act of 1933. Defendants removed the action to the Southern District of Florida. Plaintiff moved to remand, arguing that SLUSA only allowed removal of state court securities class actions based on state law and that removal was thus improper because the action alleged exclusively federal Securities Act claims.

Holding and Reasoning:
The court remanded the case. The court explained that SLUSA was passed to close a loophole in the PSLRA's strict requirements for securities fraud class actions, which many plaintiffs had evaded by bringing suit in state court under state law. *Id.* at 1309. SLUSA closed the loophole by providing for the removal and dismissal of state law class actions alleging fraud in the purchase or sale of nationally traded securities. *Id.* In connection with its removal provisions, SLUSA also amended Section 22 of the Securities Act, which generally prohibits the removal of federal Securities Act claims filed in state court, to provide that such state court claims are not removable "except as provided" in SLUSA's removal provisions. *Id.*

Relying on the Eleventh Circuit decision in *Riley v. Merril Lynch, Pierce, Fenner & Smith, Inc.*, 292 F.3d 1334 (11th Cir. 2002), the court interpreted SLUSA's removal provisions as applying only to those state court class actions that are founded on state law. *Id.* at 1308-09. Thus, although SLUSA might permit removal of a state law class action involving claims under both the Securities Act and state law, the court held that SLUSA did not permit the removal of state law class actions alleging solely federal Securities Act claims. *Id.* at 1310.

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