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Securities & Derivative Litigation Report

2005 SECOND 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. This update summarizes decisions of interest within the Eleventh Circuit from April through June 2005.

Class Certification

(1) *Avery v. Uniroyal Tech. Corp.*, No. 8:02CV2238T27MAP, 2005 WL 1205607 (M.D. Fla. May 20, 2005)

Summary:
In a putative class action brought under Sections 10(b) and 20(a) of the Securities Exchange Act of 1934, the court held that (i) the plaintiffs' claims were typical of those of a putative class notwithstanding a potential conflict between the legal theories of the named plaintiffs and other class members, and (ii) intra-class conflicts were insufficient to negate the named plaintiffs' adequacy to represent the class.

Facts:
Former shareholders of a corporation acquired by merger brought a putative class action alleging that the acquiring company and its officers and directors misrepresented facts about the acquiring company to induce the target company's shareholders to vote for the merger. The plaintiffs sought to certify a class consisting of all former shareholders, options holders, and warrant holders of the target who obtained stock from the acquiror in the merger.

The defendants argued that the Rule 23 requirements of typicality and adequacy were not met because a conflict existed between class members who benefited from the merger and those who did not. The class members who benefited from the merger included (i) persons who held non-liquid warrants with the target and, as a result, obtained stock in the surviving company, and (ii) employees of the target who had negotiated lucrative employment agreements and received valuable stock in the merger.

Holding and Reasoning:
The court granted class certification. *Id.* at *9. On the issue of typicality, the court construed the defendants' arguments "as potential defenses which may affect an individual class member's damages or ultimate right to recover, but do not affect the presentation of the class as a whole" on the issue of liability. *Id.* at *5.

The court concluded that, even if some class members' claims were barred because they benefited from the merger, it had "adequate procedural mechanisms" to address any issues this might raise, "such as designating other class representatives, reserving the right to create subclasses[,] excluding members from the class at a later juncture or decertifying the class." *Id.* at *5.

With regard to adequacy, the court stated that "minor conflicts alone will not defeat a party's claim to class certification; the conflict must be a *fundamental* one going to the specific issues in controversy." *Id.* at *6 (quotation and citation omitted) (emphasis added). Applying this standard, the court held that the defendants had not established a "fundamental" conflict within the class. *Id.* The defendants had not shown that the warrant holders and employees of the target company benefited from the same conduct that allegedly injured the rest of the class and, even if they did, that they benefited to the detriment of other class members *Id.* at *6-7.

D&O Insurance

(1) *Sphinx Int'l, Inc. v. Nat'l Union Fire Ins. Co.*, No. 03-13214, 2005 WL 1389234 (11th Cir. June 14, 2005)

Summary:
An "insured v. insured" exclusion in a directors and officers ("D&O") liability insurance policy, when construed in accord with Florida law, was held to preclude coverage for a securities class action brought against a company by a former director.

Facts:
A former director of a corporation was terminated for misrepresenting his qualifications and failing to disclose a non-competition covenant with a former employer. The director later initiated a securities class action against the corporation. The corporation's D&O carrier denied coverage for the lawsuit under an "insured v. insured" exclusion in the corporation's D&O policy, which excluded coverage for, *inter alia*, any claim brought by a "duly elected" director against the company or another officer or director. The corporation filed a coverage action, and, applying Florida law, the district court granted summary judgment in favor of the carrier.

Holding and Reasoning:
The Eleventh Circuit affirmed.

The court rejected the company's argument that the director was not "duly elected" because of his misrepresentations and omissions to the company. *Id.* at *3. Although neither the policy nor case law defined the term "duly," the Eleventh Circuit approved the district court's use of the dictionary to supply the plain meaning of that term and, relying on that definition, agreed that the director was "duly" elected because the election procedures were conducted "in a due manner, time, and degree." *Id.* at *4.

The court also rejected the company's argument that the exclusion should not apply because it was intended only to exclude coverage for collusive suits. *Id.* at *5. Because nothing in the policy limited the "insured v. insured" exclusion to collusive suits, the court concluded that Florida

law prohibited any attempt to "look behind [the] unambiguous polic[y] in search of countervailing rationales." *Id.*

Finally, the Eleventh Circuit rejected the company's argument, based on the Seventh Circuit's decision in *Level 3 Communications v. Fed. Ins. Co.*, 168 F.3d 956 (7th Cir. 1999), that the exclusion should apply only to that percentage of the claim attributed to the former director. *Id.* at *6. The court held that the decision in *Level 3* was distinguishable because the director in that case was a passive participant in the shareholder suit, while the former director in this case actually initiated the suit and sought out other participants. *Id.* at *7. Additionally, the policy language at issue in *Level 3* was significantly narrower than the broad "insured v. insured" exclusion before the court in this case. *Id.*

NASD Arbitration

(1) *SII Investments, Inc. v. Jenks,* 370 F. Supp. 2d 1213 (M.D. Fla. 2005)

Summary:
For purposes of eligibility for arbitration under NASD rules, an investor who relies on the advice of a broker may be deemed a "customer" of the firm that employed the broker at the time of the recommendation even though the investor entered into a transaction based on the recommendation with a different firm.

Facts:
A broker, acting as a registered representative of an NASD member firm, recommended that an investor purchase a particular investment. Later, the firm asked the broker to resign because of customer complaints. The broker joined a new firm and encouraged the investor to follow, but neither the firm nor the broker disclosed the reason for his move. The investor moved to the broker's new firm and invested $310,000 in accord with the broker's earlier recommendation. The investor later discovered that the investment was not registered and was much riskier than the broker disclosed. After the investor commenced an NASD arbitration against the former firm, the firm filed a declaratory judgment action and sought a preliminary injunction prohibiting the investor from proceeding with arbitration, arguing that the case was ineligible for arbitration because its former client was not a "customer" within the meaning of NASD rules governing eligibility for arbitration.

Holding and Reasoning:
The court denied the preliminary injunction and compelled arbitration, holding that the investor was a "customer" of the member firm, even though she did not actually make the investment until after the broker had joined a new firm. *Id.* at 1219 & 1221.

The court reasoned that, for a claim to be eligible for submission to the NASD, it must (i) be between a member firm or its associated person and a "customer" and (ii) arise in connection with the business activities of the member or associated person. *Id.* at 1217. Relying on the Eleventh Circuit's holding in *Wheat, First Securities, Inc. v. Green*, 993 F.2d 814, 820 (11th Cir. 1993) that customer status should be determined "at the time of the events providing the basis for the allegations," the firm argued that the investor was not a "customer" because she did not purchase her investment until *after* she moved to a new firm. *Id.* at 1218.

The court rejected this argument, reasoning that the claims in *Wheat, First* were based on a transaction that occurred entirely *before* the investors became customers of the defendant firm.

Id. at 1218-19. The investor's claims in this case, however, were based on the broker's recommendations while he was associated with the former firm coupled with the firm's failures to disclose its termination of the broker, to supervise the broker, and to investigate the particular investment prior to the broker's recommending it. *Id.* at 1219. The court held that, in these circumstances, customer status should be determined at the time the broker recommended the investment and the firm engaged in the conduct that was the subject of the statement of claim. *Id.*

Real Estate Investment Trusts

(1) *In re CNL Hotels & Resorts, Inc. Sec. Litig.*, Nos. 604CV1231ORL31KRS, 604CV1341ORL19JGG, 2005 WL 1126561 (M.D. Fla. May 9, 2005)

Summary:
In a putative class action brought pursuant to Sections 11, 12(2), and 15 of the Securities Act and for breach of fiduciary duty, (i) the shareholder plaintiffs sufficiently alleged liability against a real estate investment trust ("REIT") and its officers and directors, but not against business entities related to the REIT, (ii) the plaintiffs were not required to plead claims under Sections 11 and 12 with particularity under Fed. R. Civ. P. 9(b), and (iii) plaintiffs' fiduciary duty claim was derivative and, thus, required to be dismissed for failure to comply with the pre-suit demand requirement.

Facts:
Shareholders brought a putative class action against a REIT, its officers and directors, and certain related business entities, complaining of alleged misrepresentations and omissions in prospectuses, registration statements, and other SEC filings. The defendants moved to dismiss, arguing, *inter alia*, that (i) the related business entities of the REIT were not proper defendants, (ii) the plaintiffs failed to plead their claims with the particularity required by Fed. R. Civ. P. 9(b), and (iii) the plaintiffs' fiduciary duty claim against the individual defendants was derivative and, thus, required a pre-suit demand on the board of directors or an allegation of futility.

Holding and Reasoning:
The court granted the motion in part and denied it in part. *Id.* at *14. With respect to the related business entities, the court held that the complaint was "devoid of allegations linking the [entities] to the registration statements" at issue so as to permit a Section 11 claim. *Id.* at *9. The court also dismissed the Section 12 claims against these entities because the plaintiffs failed adequately to allege that they were "sellers" of the REIT securities within the meaning of the statute: "Other than [plaintiffs'] conclusory labeling of the [entities] as sellers and solicitors, the [p]laintiffs have not alleged any facts to show that any of the [entities] either sold or actively solicited the sale of [REIT] stock." *Id.* at *11.

The court rejected the defendants' argument that the Section 11 and 12 claims failed to satisfy Rule 9(b). *Id.* at *12. The court reasoned that "[c]laims under Sections 11 and 12 do not require allegations of scienter . . . and the [p]laintiffs disavow any attempt to assert claims of fraud." *Id.* Here, the complaint was "replete with allegations of intent to deceive," but the Court ordered that the plaintiffs delete these "superfluous allegations." *Id.* at *12-13.

The court also dismissed the plaintiffs' claim for breach of fiduciary duty against the individual officers and directors of the REIT. *Id.* at *13-14. The court held that the fiduciary duty claim was derivative because it was based on allegations of

mismanagement and self-dealing. *Id.* at *13. Thus, the plaintiffs were required to make pre-suit demand on the REIT's board of directors or explain why such a demand would have been futile. *Id.* at *14.[1] Having failed to do either, dismissal was required. *Id.*

Statute of Limitations

(1) *Tello v. Dean Witter Reynolds, Inc.*, 410 F.3d 1275 (11th Cir. 2005)

Summary:
The Eleventh Circuit stated that it could not decide the "statutory interpretation question" whether the extended statute of limitations for securities fraud claims established by the Sarbanes-Oxley Act ("SOA") revived claims that were time-barred at the time of the SOA's enactment without additional fact-finding concerning when the plaintiffs were on inquiry notice of their claims.

Facts:
The SOA, which became effective on July 30, 2002, provides that certain securities fraud claims shall be brought not later than two years from the discovery of the facts constituting the violation or five years after the violation. 28 U.S.C. § 1658(b). Previously, the limitations period for such claims was one year from discovery and three years from the violation. 15 U.S.C. § 78i(e); see *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350, 364 & n.9 (1991). There thus is a question whether the extended SOA limitations period revives claims that were time-barred under the shorter statute of limitations at the time of its enactment.

On November 15, 2002, an investor filed a Section 10(b) class action complaint alleging that the defendants manipulated the price of a stock by engaging in a short squeeze. The alleged misconduct took place between January 1, 1998 and August 19, 1998. The defendants moved to dismiss, arguing that the complaint was barred by the three-year statute in 15 U.S.C. § 78i(e). The investor countered that the SOA's two-year limitations period was applicable because the class was not on notice of the fraud until after the SOA's effective date, when the SEC issued an order against the defendants based on the conduct that was the subject of the complaint. The district court held that SOA revived previously time-barred claims, and denied the motion.

Holding and Reasoning:
The Eleventh Circuit refused to decide whether the SOA revives previously time-barred claims, and remanded the case to the district court to determine the date upon which the plaintiff class received inquiry notice of their claims. *Id.* at 1294-95.

The SOA applies to cases pending on or after its July 30, 2002 effective date. Thus, "[u]nder a plain, facial reading of the SOA statute of limitations, there is built-in, limited retroactive application for the earlier of two years after discovery of the facts constituting the securities fraud or five years after the fraudulent securities conduct that occurred prior to its enactment." *Id.* at 1279. The court concluded that the SOA "is applicable to the alleged fraudulent securities conduct in this case, provided inquiry notice was not sufficiently established to enable the plaintiff class to file this class action prior to" the SOA's effective date. *Id.* at 1282-83 & 1294 n.19. The court held that it could not properly reach the question whether the SOA revived time-barred claims until it knew whether the SOA even applied to this case, which meant that it needed

[1] The court applied Maryland law because that was the state of the REIT's incorporation. *Id.* at *13 n.43.

to know whether the plaintiff class had inquiry notice prior to or after the SOA's effective date. *Id.* at 1293-1295 & n.19.

The court spent significant time addressing the nature of the question of "inquiry notice," explaining that it turned on questions of when, upon receiving "storm warnings" of the fraud, the plaintiff class would, with reasonable diligence, have ascertained the information necessary to file suit. *Id.* at 1283-84. Because questions of inquiry notice are factual, however, the court determined that "[t]he current record is inadequate to permit us to proceed with the statute-of-limitations issue presented to us...." *Id.* at 1293. Accordingly, it remanded the matter "for the limited purpose of determining the date that the plaintiff class had sufficient factual information of their financial losses being the result of fraudulent conduct by Dean Witter to constitute inquiry notice...." *Id.* at 1295.

Viatical Settlement Contracts

(1) *S.E.C. v. Mut. Benefits Corp.*, 408 F.3d 737 (11th Cir. 2005)

Summary:
Viatical settlement contracts[2] are "investment contracts," and therefore "securities," within the meaning of the federal securities laws.

Facts:
The SEC sued a viatical settlement provider and others, seeking an injunction against their violations of the federal securities laws. The SEC alleged that the defendants committed fraud and engaged in other misconduct in connection with the sale of fractionalized interests in viatical settlements. The defendants moved to dismiss for lack of subject matter jurisdiction, arguing that the interests in viatical settlements were not "securities" within the meaning of the federal securities laws. After an evidentiary hearing, the trial court denied the motion to dismiss, granted the SEC's motion for preliminary injunction, and certified its order for interlocutory appeal.

Holding and Reasoning:
The Eleventh Circuit affirmed, holding that the fractionalized interests in viatical settlements constituted "investment contracts" within the statutory definition of the term "security."[3] *Id.* at 745. The court applied the long-standing *Howey* test, which provides that an "investment contract" is "a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party." *Id.* at 742 (quoting *SEC v. W.J. Howey Co.*, 328 U.S. 293, 298-99 (1946)).

The court held that the only issue under the *Howey* test in this case was whether an investor's expectation of profits was based "solely on the efforts of the promoter or a third party" (*i.e.*, the viatical settlement provider). *Id.* at 742-43. The defendants argued that it was not met because the efforts of the viatical settlement provider, if any, were undertaken before the investor made any payment and the profits depended not on the effort of the provider, but

[2] "A viatical settlement is a transaction in which a terminally ill insured sells the benefits of his life insurance policy to a third party in return for a lump-sum cash payment equal to a percentage of the policy's face value. The purchaser of the viatical settlement realizes a profit if, when the insured dies, the policy benefits paid are greater than the purchase price, adjusted for time value." *Mut. Benefits*, 408 F.3d at 738.

[3] The Securities Act of 1933 and the Securities Exchange Act of 1934 both define the term "security" to include any "investment contract." *Id.* at 742 (quoting 15 U.S.C. § 77b(a)(1) and 15 U.S.C. § 78c(a)(10)).

rather on the mortality of the insured. *Id.* at 743.

The court rejected both arguments. *Id.* at 743-44. With regard to the timing of the promoters' efforts, the court explained that "[c]ourts have found investment contracts where significant efforts included the pre-purchase exercise of expertise by promoters in selecting or negotiating the price of an asset in which investors would acquire an interest" and concluded, in any event, that the defendants engaged in significant post-purchase managerial activities. *Id.* at 744. And the fact that any profit was dependent upon the mortality of the insured was irrelevant because the investors relied heavily on the "efforts of the promoters in making investments in viatical settlement contracts profitable." *Id.* Indeed, the defendants engaged in significant managerial efforts both before and after a purchase by an investor, including selecting insurance policies for each investor, bidding on policies, negotiating purchase prices, determining the amounts to place in escrow to cover premium payments, and assessing the life expectancy of the insureds. *Id.* Based on these factors, the court held that the defendants "offered what amounts to a classic investment contract." *Id.*

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