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Securities & Derivative Litigation Report

2003 Eleventh Circuit Securities Law Update

Inside This Issue:

To keep our clients up to date on recent securities law developments in the Southeast, Carlton Fields' Securities and Derivative Litigation Practice Group provides this 2003 Eleventh Circuit Securities Law Update.[1] The Update summarizes decisions of interest from federal courts in the Eleventh Circuit over the past year, from January 2003 through January 2004.

Class Certification and PSLRA Lead-Plaintiff Requirements

(1) *Burke v. Ruttenberg*, 317 F.3d 1261 (11th Cir. 2003)

Summary: The issue of lead-plaintiff designation may not be preserved for appeal after settlement or trial; therefore, district courts should carefully consider requests to certify an interlocutory appeal.

Facts: The district court designated a committee of lead plaintiffs, including an investment manager. The committee then agreed to settle the class action in a settlement that included a lump-sum amount of attorneys' fees for all plaintiffs' counsel. After the court allocated the attorneys' fees among various plaintiffs' attorneys, the investment manager appealed both the fee allocation and the denial of its earlier claim for sole lead-plaintiff designation.

Holding and Reasoning: The court vacated the fee order due to the absence of findings of fact or rationale but held that the issue of lead-plaintiff designation was not preserved for appellate review.

The investment manager failed to preserve for appeal the issue of lead-plaintiff designation under the Private Securities Litigation Reform Act of 1995 ("PSLRA") because the investment manager consented to settlement, and the settlement itself lacked any reservation of rights regarding appeal. *Id.* at 1263. The court further noted that, even if a party reserves the right to appeal the lead-plaintiff designation, "there would be generally little or no remedy" after settlement or trial. *Id.* Thus, "we urge district courts to carefully consider requests to certify this issue for interlocutory appeal." *Id.*

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[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.

(2) *Cheney v. Cyberguard Corp.*, 213 F.R.D. 484 (S.D. Fla. 2003)

Summary: In order to overcome the presumption of reliance arising under the "fraud on the market" theory, a defendant must demonstrate that the named plaintiffs' decision to trade resulted from insider information or other facts unrelated to defendants' alleged misrepresentations. The defendants were not able to adduce such facts in this case. Although the defendants identified potential defenses specific to the named plaintiffs' claims, these were not sufficient to overcome the named plaintiffs' showing of typicality.

Facts: Plaintiffs alleged a fraudulent scheme by defendants to inflate the defendant corporation's financial results and attract investors and acquirers by distributing false representations. Plaintiffs contended that they were entitled to enjoy a presumption of reliance under the "fraud on the market" theory and moved on this basis for class certification. Defendants opposed the motion, arguing (i) the named plaintiffs' claims were not typical because they were subject to unique defenses, (ii) lead plaintiffs would not adequately represent the proposed class's interests, (iii) individual questions of reliance predominated over common questions because the market for defendant corporation's stock was not efficient during the class period, and (iv) plaintiffs violated the PSLRA's early notice requirements by publishing notices that omitted the proposed class period's first eleven months.

Holding and Reasoning: The court granted class certification.

Defendants challenged one named plaintiff because he admitted that he would have purchased the stock regardless of its price and therefore did not rely on defendant's stock price during the class period. *Id*. at 492. The court nonetheless held that the named plaintiff established reliance under the fraud on the market theory by purchasing stock on the presumption that the market price was validly set. *Id*. The court reasoned that "insider information or other facts must be presented to show a severance of a link between the misrepresentation and the plaintiff's decision to trade" in order to undermine the presumption of reliance. *Id*.

Defendants challenged another named plaintiff's typicality because he purchased stock both before and after the alleged misrepresentations were disclosed, thereby subjecting the named plaintiff to unique defenses. *Id*. at 493. The court rejected defendants' argument, holding that these specific defenses or counterclaims did not defeat typicality and that the named plaintiff suffered losses similar to those experienced by other plaintiffs when he purchased stock prior to the alleged misrepresentations. *Id*. at 493-94.

Defendants challenged a third named plaintiff's typicality because he purchased stock on behalf of a mortgage brokerage rather than on his own behalf. *Id*. at 494. The court recognized that such a party appeared atypical and requested memoranda from the parties regarding substituting the mortgage brokerage as a named plaintiff. *Id*. at 495.

Defendants challenged the named plaintiffs' ability to represent the proposed class adequately on the grounds that named plaintiffs lacked knowledge or involvement regarding the suit and lacked credibility. *Id*. The court held that plaintiffs met the adequacy of representation requirement for class certification, applying a limited analysis deeming plaintiffs adequate "unless their participation is so minimal that they virtually have abdicated to their attorneys the conduct of the case." *Id*. (citing *Kirkpatrick v. J.D. Bradford & Co.*, 827 F.2d 718, 728 (11th Cir. 1987)). The court refrained from undertaking an inquiry into plaintiffs' credibility at the class certification stage. *Id*. at 496.

Regarding Federal Rules of Civil Procedure Rule 23(b)(3)'s requirement that common questions predominate over individual questions, the court again focused on the presumption of reliance under the fraud on the market theory. *Id*. The court applied several factors in determining that the market for defendant corporation's shares was an efficient market, namely, market volume, coverage by securities analysts, the number of market makers, eligibility to file S-3 registration forms with the SEC, history of immediate movement in the stock price, market capitalization, bid-ask spread, and float. *Id*. at 496-502.

The court rejected defendants' assertion that plaintiffs had given inadequate early notice as inconsequential to a class certification determination. *Id.* at 504. Defendants had not previously objected to plaintiffs' earlier notices, and plaintiffs were not required to send additional notices under the PSLRA when they amended their complaint. *Id.* at 503-04.

(3) *In re HealthSouth Corp. Sec. Litig.*, 213 F.R.D. 447 (N.D. Ala. 2003)

Summary: Differences among class representatives such as the manner of stock acquisition, harm suffered, degree of reliance, or vulnerability to special individual defenses warranted denial of class certification.

Facts: Shareholders brought a securities fraud class action alleging violations of the federal securities laws and moved for class certification. Plaintiffs sought to establish a presumption of reliance through the fraud on the market theory.

Holding and Reasoning: The court denied class certification.

The court noted that while securities fraud class actions had "received favorable treatment," class certification of such matters was "not automatic." *Id.* at 456. Instead, "the court must perform a 'rigorous analysis'" and "conduct a searching inquiry, including a possible 'probe behind the pleadings.'" *Id.* Indeed, "inquiry into some aspects of the merits of plaintiffs' claims remains necessary to determine whether the representatives meet the requirements of" class certification. *Id.*

The court held that the plaintiffs had failed to demonstrate the typicality, adequacy, and predominance of common questions as required under Fed. R. Civ. P. 23. *Id.* at 458-64. At the outset, the court noted that the proposed class included "three separate and distinct groups" of shareholders, some of whom purchased defendants' stock on the open market, while others acquired defendants' stock by virtue of defendants' acquisition of various companies. *Id.* at 458. Those groups were further divisible into subgroups. *Id.* at 458-59.

Such distinctions led to problems regarding typicality, as two of the proposed class representatives were former employees of companies acquired by defendants. *Id.* at 459. Those class representatives' shares and options in their former employer were automatically converted into defendants' shares and options. *Id.* The class representatives' positions as employee/shareholders provided knowledge of material facts and information not available to the open market and created "unique claims of reliance apart from the fraud-on-the-market theory [that] would be subject to unique defenses." *Id.* Further, other class representatives who had purchased their stock on the open market lacked standing to assert the employee/shareholders' claims. *Id.* at 460. Therefore, typicality was lacking. *Id.*

Similar difficulties arose regarding adequacy of representation. *Id.* at 462. Again, the open market purchasers could not represent the employee/shareholders because the open market representatives actually benefited from the same conduct, the allegedly inflated share price, that harmed the employee/shareholders. *Id.*

For the same reasons, plaintiffs were unable to satisfy Rule 23(b)'s "bottom line inquiry" whether common issues predominated. *Id.* at 463-64. While the case overall might focus on whether defendants' alleged misrepresentations or omissions violated the securities laws, the lack of cohesiveness within the class meant that, "as a practical matter, the resolution of this overarching common issue breaks down into an unmanageable variety of individual legal and factual issues." *Id.* at 464. Accordingly, the court denied class certification.

Definition of Security[2]

(1) *S.E.C. v. Shiner*, 268 F. Supp. 2d 1333 (S.D. Fla. 2003)

Summary: An investment involving a share in profits derived from others' efforts is a "security" subject to the federal securities laws, even though the offering materials specifically disclaim that the investments offered are securities.

Facts: The SEC alleged violations of the Securities Act and the Securities Exchange Act in connection with defendants' sale to investors of partnership units "formed ostensibly to operate competitive local telephone exchange carriers in Western states."

Holding and Reasoning: The court granted the SEC's motion for a preliminary injunction against defendants.

The key issue for the court was whether defendants sold securities such as investment contracts "or merely units in general partnerships." *Id.* at 1340-41. Although the units at issue were labeled as partnerships by the defendants, the court reasoned that such units were actually securities. *Id.* at 1341.

The court based its reasoning on the fact that the "investors were dependent upon the unique entrepreneurial and management skills of [d]efendants . . ., that any power the investors exercised was illusory, and the efforts made by [d]efendants . . . were the significant ones that affected the success or failure of the LLPs." *Id.* Having concluded that the investments were securities, the court then held that the SEC established a prima facie case of federal securities violations and a reasonable likelihood of future violations. *Id.* at 1343. Accordingly, the SEC satisfied the requirements for a preliminary injunction. *Id.*

Duty Owed by Bank to Depositors and Non-Depositors

(1) *O'Halloran v. First Union Nat'l Bank*, 350 F.3d 1197 (11th Cir. 2003)

Summary: Under Florida law, a bank owes no duty to a non-depository investor. Regarding duties owed to depositors, a bank may be required to take additional steps to confirm a representative's authority when the bank possesses knowledge that the supposed representative actually intends to defraud the depositor. The bank's proper completion of those steps fulfills the bank's duty to the depositor.

Facts: Plaintiffs in this case included (1) individual "investors" in a Ponzi scheme operated by the Greater Ministries church and (2) the trustee in bankruptcy for the estate of the defunct church. The investors sought to represent a class of persons who invested in the "faith based" Ponzi scheme. Plaintiffs alleged that the church deposited funds obtained from defrauded investors in accounts at the defendant bank and that the head of the church later withdrew six million dollars of these funds and absconded with the money. Plaintiffs contended that the bank should be liable both to the investors and the church for permitting the church to conduct its banking business there and then for permitting the head of the church to withdraw funds from the church's accounts. The district court dismissed all counts with prejudice, holding that the bankruptcy trustee could not stand in the shoes of the church to complain about the consequences of the church's own fraudulent misconduct and that the individual investors failed to state a claim because the bank owed no duty to persons with whom it had no banking relationship.

Holding and Reasoning: The court upheld the district court's dismissal of the investors' claims with prejudice, holding that Florida law did not create a "duty to the individual investor plaintiffs; the bank's only obligations were to [the church], its depositor." *Id.* at 1201. The court also upheld the district court's conclusion that the trustee had not stated a legally viable

[2] The Supreme Court recently reversed a 2002 Eleventh Circuit decision involving the definition of a "security" for purposes of the federal securities laws. In *S.E.C. v. ETS Payphones, Inc.*, the Eleventh Circuit held that investments in pay telephones through sale and leaseback agreements providing for a fixed annual return were not "securities" because the applicable precedents excluded fixed return investments from the statutory definition. 300 F.3d 1281, 1284-85 (11th Cir. 2002). On January 13, 2004, the Supreme Court reversed, holding that "there is no reason to distinguish between promises of fixed returns and promises of variable returns" for purposes of determining whether an investment constituted a security. *S.E.C. v. Edwards*, 124 S.Ct. 892, 897 (2004).

claim against the bank. *Id.* at 1205-06. The court nonetheless remanded the case to afford only the trustee an opportunity to amend its complaint on the ground that the law in the Eleventh Circuit at the time of the dismissal (later changed) was that where, as here, a plaintiff does not request leave to amend, the district court was obliged sua sponte to afford the plaintiff an opportunity to amend unless any amendment appeared futile. *Id.* at 1206. The court held that it might be argued that an amendment in this case might prove futile. *Id.* As the court explained, a bank is generally responsible only for ensuring a representative's

> authority to make withdrawals on behalf of the accountholder entity. A bank's responsibility to a depositor may be somewhat heightened when the bank has knowledge that a particular individual ostensibly representing the depositor instead intends to cause financial injury to the depositor. Under such circumstances, the bank may be responsible for taking additional steps to ensure that the representative has complete authorization from the depositor.

Id. at 1205. In doing so, however, the bank must be careful not to breach its agreement with the depositor by refusing a duly authorized withdrawal. *Id.*

Here, the allegations showed that the head of the church was fully authorized by the church to conduct banking transactions. *Id.* at 1206. Further, the bank sought additional evidence of authorization from the representative, such as a transfer of assets plan, board resolutions, affidavits, and signature cards. *Id.* Accordingly, even if the bank's responsibility was somewhat heightened, "the bank met this higher standard of diligence." *Id.* Therefore, the bank was not responsible to the church for the representative's fraudulent withdrawals. *Id.* But the court afforded the trustee the benefit of the doubt in remanding the case.

Insider Trading

(1) *S.E.C. v. Yun*, 327 F.3d 1263 (11th Cir. 2003)

Summary: A spouse's expectation of confidentiality determines whether a duty of loyalty and confidentiality exists between husband and wife, and tippers are subject to insider trading liability only if shown to have expected to benefit from their disclosure.

Facts: The SEC brought an insider trading case under Section 10(b) of the Securities Exchange Act and Rule 10b-5 against two defendants, an outsider tipper and tippee. The SEC alleged that the outsider tipper received confidential information from a corporate insider, her husband, and then breached the duty of loyalty and confidentiality she owed her husband by disclosing the information to the tippee, and did so for "direct and/or indirect benefit." Further, the SEC alleged the tippee knew of the fiduciary duty but traded on the confidential information anyway. The jury found both defendants liable under the misappropriation theory of insider trading.

Holding and Reasoning: The Eleventh Circuit vacated and remanded, addressing two issues on appeal.

First, the court analyzed whether a duty of loyalty and confidentiality existed between the outsider tipper wife and her husband. The court, basing its reasoning on the dissenting view from *U.S. v. Chestman*, 947 F.2d 551, 580 (2d Cir. 1991), held that insider trading liability would arise when a spouse "trades in breach of a reasonable and legitimate expectation of confidentiality held by the other spouse." *Id.* at 1272. As a result, the SEC could establish liability by showing either "a history or practice of sharing" and maintaining business confidences, or an actual agreement of confidentiality between the spouses. *Id.* at 1273. The court concluded that sufficient evidence existed to find a duty of loyalty and confidentiality between the husband and wife in this case. *Id.* at 1273-74. Of note, the court observed that SEC Rule 10b5-2, adopted during the pendency of the action, effectively created a rebuttable presumption of trust and confidentiality between close family members. *Id.* at 1273 n.23.

Second, the court considered whether the SEC must prove that the tipper expected to benefit from the tip, or acted merely with "severe recklessness," in order to establish insider trading liability on a misappropriation theory. *Id.* at 1274. Unable to discern a reason to distinguish between insider trading liability under the classical theory involving corporate insiders and the misappropriation theory involving corporate outsiders, the court held "that the SEC must establish that all tippers, both insiders and outsiders, intend to benefit from their disclosure of confidential information." *Id.* at 1275-79. Although sufficient evidence existed under the facts to find the outsider tipper expected to benefit in this case, the court vacated and remanded for a new trial because the district court erred in instructing the jury. *Id.* at 1280-82. The district court erroneously instructed the jury under the "severely reckless" standard, and such error materially prejudiced the defendants. *Id.* at 1282.

Federal Jurisdiction

(1) *City of Birmingham Ret. & Relief Fund v. CitiGroup, Inc.*, No. CV-03-BE-0994-S, 2003 WL 22697225 (N.D. Ala. 2003)

Summary: The specific prohibition of removal in Section 22 of the Securities Act prevails over the general grant of federal jurisdiction over bankruptcy actions in 28 U.S.C. § 1334.

Facts: Plaintiff filed suit in state court against numerous underwriters after a third-party corporation filed Chapter 11 bankruptcy. The plaintiff alleged that the defendants violated Section 11 of the Securities Act by negligently underwriting sales of now worthless bonds and securities. The defendants removed, claiming that the action was related to the third-party's bankruptcy because of a potential indemnification agreement between the defendants and a third-party.

Holding and Reasoning: The court directed that the case should be remanded to state court.

Section 22 of the Securities Act "is a special statute that takes priority over the general removal statutes," including statutes such as 28 U.S.C. § 1452 allowing removal in bankruptcy cases. *Id.* at *2-*3. Section 22 "expressly prohibits removal." *Id.* at *3. Accordingly, the court must remand a plaintiff's Securities Act claims when the defendants remove the action based on an alleged relationship to a pending bankruptcy case. *Id.* Further, the defendants' potential claim against a bankrupt third-party for indemnification failed to establish that the instant action was "related to" a bankruptcy for purposes of federal jurisdiction. *Id.* at *4-*5.

Loss Causation

(1) *In re John Alden Fin. Corp. Sec. Litig.*, 249 F. Supp. 2d 1273 (S.D. Fla. 2003)

Summary: Loss causation requires a direct link between the disclosure of the allegedly misrepresented or omitted facts and the decline in stock price. Accordingly, the only actionable misrepresentations or omissions are those relating to the eventual disclosure.

Facts: Plaintiffs filed a securities fraud class action alleging violations of Section 10(b) of the Securities Exchange Act and Rule 10b-5. Plaintiffs claimed that defendants, a medical insurance company and several of its officers, artificially inflated earnings by fraudulently setting the corporation's year-end medical claims reserve too low. Defendants made several statements disclosing corrections to prior reserve levels because of increased claims, and defendant corporation's stock price fell immediately after each announcement. Defendants moved for summary judgment.

Holding and Reasoning: The court granted summary judgment because defendants' fiscal projections were reasonable, the sale of shares by one defendant failed to support an inference of scienter, and a press release alleged to be misleading included only a general statement of corporate optimism.

At the outset, the court concluded that the element of loss causation limited plaintiffs' numerous allegations of misrepresentations and omissions. *Id.* at 1277. The court stated

> [l]oss causation is an essential element of a 10b-5 claim, and requires not only that the alleged misrepresentation or omission caused the [p]laintiffs to pay more than they should have for the stock but that the disclosure of the true facts, which are alleged to have been materially misrepresented or omitted, must have caused the decline in the stock price.
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> . . .
>
> Therefore, [p]laintiffs' only viable claims are those based on misrepresentations or omissions

> that relate to the reserve increases described in [defendants'] announcements [that immediately preceded the drops in stock price].

Id. Having limited the claims through the loss causation requirement to alleged misrepresentations or omissions that caused the stock price to fall when the truth was eventually revealed, the court then held that defendants clearly had a reasonable basis for their initial reserve levels. *Id.* at 1278. First, "an inability to foresee the future does not constitute fraud," and "[t]he fact that in hindsight the projection turned out to be wrong does not mean that it lacked a reasonable basis when made." *Id.* at 1277. Second, defendants needed only a reasonable basis for their projection, even if other projections were more reasonable. *Id.* If defendants possessed such a good faith reasonable basis, "[a] jury should not be permitted to second-guess [their] actuarial and business judgment," regardless of the conflicting opinion of plaintiffs' actuarial expert. *Id.* at 1279. Further supporting defendants' argument were the facts that defendants extensively involved their auditor in the reserve process, and offered an innocent explanation why the subsequent correction was necessary. *Id.* at 1279-81.

The court also held that sales of stock by one defendant that were consistent with typical executive departures were insufficient to give rise to an inference of scienter, and a statement that defendant corporation was "on-track for an excellent year" was immaterial as a matter of law. *Id.* at 1282-83.

Pleading Requirements

(1) *Grippo v. Perazzo*, No. 02-11319, 2004 WL 98593 (11th Cir. Jan. 22, 2004)

Summary: Plaintiff is not required to plead the identity of a particular security purchased to state a claim for securities fraud, and Florida securities law differs from federal securities law regarding both the limitations period and scienter requirement.

Facts: The plaintiff filed an individual suit under both federal and Florida securities laws, alleging that he was deceived into providing money to a broker to invest in securities that the broker never delivered. The district court dismissed plaintiff's federal and state claims because (i) the plaintiff failed to allege the purchase of a specific security and (ii) the plaintiff failed to plead his claims with the particularity required by the PSLRA and Fed. R. Civ. P. 9(b). The district court also dismissed the federal claims as barred by the statute of limitations.

Holding and Reasoning: The court affirmed in part and reversed in part.

Reversing the district court's decision that the federal and state claims were defective for failure to allege the purchase or sale of a specific security, the Eleventh Circuit reasoned that the Supreme Court's decision in *S.E.C. v. Zandford*, 535 U.S. 813, 819-21 (2002), required a broad interpretation of the "in connection with" requirement of the federal and state securities laws. *Id.* at *4-*5. The phrase "in connection with," under both Rule 10b-5 and Florida Statutes § 517.301, encompassed the situation where a broker accepts and deposits an investor's money as a supposed payment for securities. *Id.* The broker's subsequent failure to deliver any securities does not render the investor unable to plead fraud based on an "inability to prove that his money was actually used to purchase any security." *Id.* at *5.

The court also reversed the dismissal of the Florida state securities claims for lack of particularity. *Id.* at *6. The district court erred in dismissing the state claims because Florida securities law follows a more lenient pleading standard regarding scienter than federal law: Although federal law requires a plaintiff to plead facts giving rise to a strong inference of intent or recklessness, Florida securities law would be satisfied by allegations of fact showing mere negligence. *Id.* (citing *In re Sahlen & Assocs. Inc. Sec. Litig.*, 773 F. Supp. 342, 371 (S.D. Fla. 1991)).

The court of appeals affirmed the dismissal of the federal securities claims on statute of limitations grounds because the plaintiff had inquiry notice of the fraud more than one year prior to the filing of his complaint (the limitations period in effect at that time). *Id.* at *5.

(2) *Druskin v. Answerthink, Inc.*, No. 02-23304-CIV-GOLD, 02-23304-CIV-SIMONTO, 2004 WL 95402 (S.D. Fla. Jan. 5, 2004)

Summary: Plaintiffs failed to plead scienter as required under the PSLRA and failed to establish loss causation. Accordingly, defendants' motion to dismiss was granted, with leave to amend.

Facts: Plaintiffs filed a class action alleging violations of Sections 10(b) and 20(a) of the Securities Exchange Act. The plaintiffs claimed defendants improperly recognized revenue from accounts they knew were uncollectible, failed to establish sufficient reserves for uncollectible accounts, and failed to disclose related-party transactions. Defendants moved for dismissal.

Holding and Reasoning: The court dismissed without prejudice, holding that plaintiffs failed to allege scienter with the particularity required under the PSLRA and also failed to establish loss causation.

Regarding scienter, the court held the group pleading doctrine inapplicable to the PSLRA's scienter requirement. *Id*. at *11. Therefore, "[p]laintiffs must allege specific facts showing that each [d]efendant acted with severe recklessness." *Id*. at *12. The court dismissed plaintiffs' allegations of improper revenue recognition for several reasons. First, the allegedly uncollectible accounts actually made payments to defendants during the class period. *Id*. at *13. Second, "the fact that a company is incurring a loss, running out of money, or even near-bankrupt, 'does not mean that it necessarily [lacks the] ability to generate revenues or make future payments to its creditors from such revenues.'" *Id*. (quoting *In re Smith Gardner Sec. Litig.*, 214 F. Supp. 2d 1291, 1303 (S.D. Fla. 2002)).

The court also dismissed plaintiffs' claims of insufficient loss reserves, pointing out that defendants actually maintained significant reserves and adjusted that amount annually. *Id*. at *15. Accordingly, plaintiffs failed to establish that defendants' reserve levels were fraudulent or "reflect[ed] an extreme departure from the standards of ordinary care." *Id*.

Plaintiffs' allegations of undisclosed related-party transactions lacked materiality because the transactions at issue represented an extremely small percentage of defendants' revenues during the class period. *Id*. at *16. Although plaintiffs claimed that defendants used the related parties to recycle revenue, plaintiffs failed specifically to allege such transactions. *Id*. at *17.

The court dismissed plaintiffs' further scienter allegations involving aging reports, a project report, and confidential witnesses because the plaintiffs failed to allege knowledge by the defendants that statements were false when made. *Id*. at *17-*19. Further, plaintiffs' claims regarding defendants' stock trades failed to establish scienter because the defendants either lost money, made small trades, or were forced to sell to meet margin calls. *Id*. at *21-*23.

Regarding loss causation, plaintiffs "failed to allege with specificity that [d]efendants' fraud, as opposed to general market conditions, caused the stock price to decline." *Id*. at *24. Defendants' stock price had already plunged significantly before the disclosure that allegedly revealed the earlier fraud. *Id*. Also, while defendants' earlier partial disclosures negatively impacted the stock price, the stock price quickly rebounded. *Id*. at *25. Accordingly, plaintiffs "failed to adequately allege that [d]efendants' false statements were in some reasonably direct way responsible for their loss." *Id*.

(3) *In re Eclipsys Corp. Sec. Litig.*, No. 02-80697-CIV-HURLEY/LYNCH (S.D. Fla. Nov. 4, 2003)

Summary: Plaintiffs failed to plead accounting fraud or an alleged omission with the requisite particularity under the PSLRA. Accordingly, defendants' motion to dismiss was granted, with leave to amend.

Facts: Plaintiffs filed suit against the defendant corporation and three individual corporate officers. Plaintiffs alleged violations of Section 10(b) and Section 20(a) of the Securities Exchange Act and Rule 10b-5, contending that defendants prematurely recognized revenue and recognized fictitious revenue in violation of both GAAP and defendants' own accounting policy.

Further, plaintiffs alleged that defendants' financial statements were materially false and misleading because they falsely assured the market that the majority of defendants' new sales bookings were subscription-based, were materially overstated and manipulated to match revenue objectives, and falsely promised error-free technology. Defendants were also accused of maintaining two sets of accounting books - one set accurately reflecting revenue and another set inflating revenue to match the corporation's goals.

Plaintiffs based their allegations of violations of GAAP upon statements by defendants' former revenue and billing specialist, a former sales executive, a former vice president of sales, and a former research analyst. According to the plaintiffs, these statements established that the defendants had engaged in the improper recognition of revenue and had attempted to offset rising software maintenance expenses by falsely reporting increased expenses in other areas.

Holding and Reasoning: The court dismissed the complaint for failure to plead fraud with the particularity required by the PSLRA.

The court applied a relatively strict particularity analysis from the Fifth Circuit, recognizing that "the Eleventh Circuit has not directly decided the level of particularity necessary to plead accounting fraud under the PSLRA." *Id*. at 17. The court dismissed the claims for accounting fraud, relying on a case dismissing similar claims when

> the complaint did not identify who in particular was instructing the employees to make the arbitrary accounting adjustments, what particular adjustments were made, how those adjustments were improper in terms of reasonable accounting practices, how those adjustments were incorporated into [defendant's] financial statements, and if incorporated, whether those adjustments were material in light of [defendant's] overall financial position.

Id. at 18 (citing *Shushany v. Allwaste, Inc*., 992 F.2d 517, 522 (5th Cir. 1993)). Under this standard, plaintiffs' accounting fraud allegations failed to specify the "'who, what, when, where, and how' of even one accounting violation" and therefore were insufficient under the PSLRA. *Id*.

The court also dismissed several of plaintiffs' claims because defendants' statements were non-actionable statements of present or historical fact, mere puffery, or forward-looking. *Id*. at 9-16. For example, plaintiffs alleged that defendants misled the market by failing to disclose that a significant percentage of new sales bookings resulted from one license agreement. *Id*. at 9. Plaintiffs relied on a SunTrust equity research report estimating that between 50% and 75% of defendants' bookings stemmed from one deal. *Id*. at 9-10.

Defendants countered that their practice of routinely announcing the percentage of new sales bookings was a statement of present or historical fact. *Id*. at 9. The court held that plaintiffs failed to plead adequately that defendants' alleged omission was material. *Id*. at 10. Under the PSLRA, plaintiffs needed to allege sufficiently the truthfulness of the alleged omission. *Id*. The court reasoned that "the blanket assertions of one analyst without more factual detail are insufficient to carry the Plaintiffs' burden under the PSLRA." *Id*.

Other statements referencing continued strengthening, increased market share, and strong positioning were non-actionable corporate puffery or were forward-looking and accompanied by cautionary language. *Id*. at 11-16.

Regulatory Enforcement

(1) *S.E.C. v. Vittor*, 323 F.3d 930 (11th Cir. 2003)

Summary: An SEC order sustaining NASD disciplinary sanctions is an "order" under Section 21(e)(1) of the Securities Exchange Act, and therefore the SEC may apply to a federal district court for enforcement of such an order. Further, Section 21(f) of the Securities Exchange Act applies only to SEC-initiated actions, and, as a result, does not limit SEC orders upholding NASD fines and orders for restitution.

Facts: The NASD's Market Surveillance Committee ordered restitution and imposed fines upon a broker-dealer for failing to honor trades and associating with an individual whose general securities representative registration had been revoked. The broker-dealer appealed the decision first to the NASD's appellate body, then to the SEC, and then to the U.S. Court of Appeals for the District of Columbia. Following the circuit court's denial of the petition for review, "the SEC filed an application in federal district court seeking enforcement of the SEC order affirming the NASD imposed sanctions." The district court granted the application under Section 21(e)(1) of the Securities Exchange Act, regardless of Section 21(f)'s limitations.

Holding and Reasoning: The court affirmed under Section 21(e)(1), which provides federal district court jurisdiction over several SEC actions, including SEC orders.

Specifically, the court held as follows:

> Although the SEC order does not expressly command [the broker-dealer] to pay the monetary sanctions, the order sustained the NASD's disciplinary action against [the broker-dealer] and effectively commanded him to pay the restitution, fines, and costs. Thus, the SEC's order sustaining the NASD's disciplinary sanctions against [the broker-dealer] was an "order" within the meaning of section 21(e)(1).

Id. at 934-35.

Having established the SEC's ability to apply to the district court for enforcement of the SEC's affirmance of the NASD decision, the court turned its attention to the limitations within Section 21(f). That provision, as applied to the instant facts, allows "the SEC to initiate an action against violators of the NASD rules only if the NASD is unable or unwilling to do so, or an SEC action is otherwise necessary or appropriate for the public interest or for the protection of investors." *Id.* at 935. The court held those limitations inapplicable because Section 21(f) limits only SEC-initiated actions. *Id.* "Accordingly, we hold that section 21(f) does not apply to SEC orders sustaining NASD fines and restitution orders." *Id.* at 936. Therefore, the court affirmed the district court's order to the broker-dealer to comply. *Id.*

(2) *Commodity Futures Trading Comm'n v. Heffernan*, 245 F. Supp. 2d 1276 (S.D. Ga. 2003)

Summary: Violation of antifraud provision of the Commodity Exchange Act (CEA) may be established without showing reliance by a particular investor.

Facts: Plaintiff Commodity Futures Trading Commission (CFTC) filed suit against a commodity futures trading advisor alleging violations of the CEA, CFTC regulations, and a previous CFTC consent order. The CFTC alleged numerous violations against the trading advisor resulting from the latter's operation of a web site marketing a "system" for trading commodities futures contracts.

Holding and Reasoning: The court granted summary judgment on nearly every claim.

The court held that Section 6o(1) of the CEA did not require the CFTC to establish reliance by a particular investor and that the defendant trading advisor made numerous material misrepresentations and omissions regarding his trading system, with the necessary level of scienter. *Id.* at 1290-1301. In particular, the defendant failed to disclose that the majority of his advertised trades were hypothetical "paper" trades, vastly overstated the expected success of his trading method, failed to include the required disclaimers within his advertising material, and falsely suggested CFTC endorsement of his web site and products. *Id.* The court denied summary judgment to the CFTC solely with respect to a direct communication between the defendant and a customer regarding a fee dispute, which was not an advertisement subject to the CEA or CFTC regulations. *Id.* at 1296.

(3) *Steffen v. Gray, Harris & Robinson, P.A.*, 283 F. Supp. 2d 1272 (M.D. Fla. 2003)

Summary: The SEC may bring a fraudulent transfer action to set aside a fraudulent attempt to conceal assets, and bankruptcy law does not shield assets gained via securities fraud.

Facts: Plaintiffs' legal malpractice claim arose from a 13-year "litigation odyssey" between one family and the SEC. During the course of events, the husband was convicted of securities fraud, and the SEC obtained a disgorgement order for more than $62 million. The husband then transferred most of his assets to his wife and filed bankruptcy. The couple also established a foreign trust in the Cook Islands and transferred their remaining assets to it. Eventually, the SEC obtained a civil contempt order against the husband, freezing the family assets, including the foreign trust, and incarcerating the husband. The wife negotiated a settlement with the SEC to release both her husband and her frozen assets.

The husband and wife sued their lawyers, alleging that they "negligently failed to advise [the wife] that creation of the Trust and transfer of her assets to it and its related entities would allow her husband's creditors to reach her assets." The defendants moved for summary judgment, arguing that plaintiffs could not establish causation.

Holding and Reasoning: The court granted summary judgment to defendants, holding that either the SEC or the court could have reached plaintiffs' assets regardless of the trust's formation.

First, the plaintiff husband's continuing interest in and control over property subject to the original disgorgement order rendered that property vulnerable to eventual disgorgement regardless of the trust. *Id*. at 1283-84. Second, "Florida law allows a creditor like the SEC to bring a fraudulent transfer action to set aside a constructively or actually fraudulent attempt to hide assets." *Id*. at 1284 (citing Fla. Stat. § 726.101, et seq.). Third, although bankruptcy law exempts certain property from debts arising prior to bankruptcy, nothing in the bankruptcy statutes would limit "the SEC's ability to seek disgorgement against assets held by [plaintiffs], if they were ill gotten gains from [plaintiffs'] securities fraud." *Id*. at 1285. Therefore, plaintiffs' transfer of assets into the trust did not make those assets more vulnerable to either the SEC or the court, and plaintiffs could not establish that defendants' alleged negligence caused any damage. *Id*.

Securities Litigation Uniform Standards Act [3]

(1) *Herndon v. Equitable Variable Life Ins. Co.*, 325 F.3d 1252 (11th Cir. 2003)

Summary: The definition of a "covered security" under the Securities Litigation Uniform Standards Act of 1998 (SLUSA) includes a variable life insurance policy.

Facts: Plaintiffs filed a class action suit in state court alleging that defendant deliberately misdesignated insureds as tobacco users to charge higher premiums. Defendant removed to federal court and the district court dismissed under SLUSA.

Holding and Reasoning: The court affirmed the dismissal.

"[A] variable life insurance policy is a 'covered security' under SLUSA." *Id*. at 1254. The court reasoned that variable annuities by themselves are covered securities under SLUSA, and the addition of a life insurance component to a variable annuity was "inconsequential." *Id*. Accordingly, the plaintiffs' purchase of the policy at issue met SLUSA's statutory requirements for dismissal, and the district court properly dismissed the plaintiffs' claims, with prejudice. *Id*. at 1253.

(2) *Greaves v. McAuley*, 264 F. Supp. 2d 1078 (N.D. Ga. 2003)

Summary: SLUSA's remand provisions require remand of an entire action to state court if any of the class action claims in the suit fall within SLUSA's so-called "Delaware carve-out" exception.

Facts: Shareholders filed a state court class action challenging a merger announcement and alleging five state law claims against both companies in the merger and certain individuals. Defendants subsequently removed, arguing that the Georgia state law

[3] For further SLUSA case developments regarding covered securities and the Delaware carve-out exception, *see infra* p. 14, Statute of Limitations, (4) *Raffa v. Wachovia Corp.*, No. 8:02-CV-1443-T-27EAJ (M.D. Fla. Feb. 24, 2003).

class action claims were preempted by SLUSA. Plaintiffs moved to remand.

Holding and Reasoning: The court remanded all of the claims.

While SLUSA generally preempts certain state law claims, the Delaware carve-out exception preserves state actions meeting certain requirements and requires remand of those actions. *Id.* at 1081-84. The exception covers actions arising under the law of the same state as the issuer's incorporation and involving

> (1) any recommendation, position, or other communication with respect to the sale [of securities of] any issuer; (2) that is made by or on behalf of the issuer to holders of equity securities of the issuer; and (3) concerns decisions of such equity holders with respect to voting their securities, acting in response to a tender or exchange offer, or exercising dissenters' or appraisal rights.

Id. at 1083 (citing 15 U.S.C. §§ 77p(d)(1)(A), 77p(d)(1)(B), 77p(d)(4)).

The court held that four of plaintiffs' five claims met the requirements for the Delaware carve-out and were therefore preserved as state law claims. *Id.* at 1083-84. One claim failed to qualify because it was a Georgia state claim asserted against a Maryland corporation and stated no allegation that the corporation "made any communication with respect to the sale of [its] securities." *Id.* at 1084.

The court then considered whether it was required to remand the entire case, even though the remaining state claim was preempted by SLUSA. *Id.* at 1084-85. Reasoning that SLUSA "mandates remand under certain circumstances," the court held as follows:

> If remand is appropriate, the entire lawsuit must be returned to state court, irrespective of the court's decision regarding removal. As such, the remand provision trumps the removal provision, and the entire lawsuit must be remanded.

Id. at 1085 (citing 15 U.S.C. § 77p(d)(4)). Accordingly, the court held that, if any one claim in a case meets the standards for the SLUSA exception, then the court must remand all the claims.

Statute of Limitations

(1) *La Grasta v. First Union Sec., Inc.*, No. 02-16215, 2004 WL 178937 (11th Cir. Jan. 30, 2004)

Summary: A sharp decrease in stock price, standing alone, is insufficient to place plaintiffs on inquiry notice of fraud for purposes of a motion to dismiss.

Facts: Purchasers of Ask Jeeves, Inc. stock brought a securities fraud class action against defendant, alleging that its research analyst inflated the price of Ask Jeeves stock through "strong buy" recommendations while defendant simultaneously sought investment banking business from Ask Jeeves. The district court dismissed the complaint, holding that the statute of limitations had expired because plaintiffs possessed inquiry notice of securities fraud when Ask Jeeves' stock price experienced a "steady and profound decrease."

Holding and Reasoning: The Eleventh Circuit reversed, holding that plaintiffs were not on inquiry notice of the possibility of fraud until the publication of a magazine article revealing defendant's conflict of interest.

The court adopted the reasoning of *Summer v. Land & Leisure, Inc.*, 664 F.2d 965, 969 (5th Cir. Unit B 1981), holding "that we could 'conceive of several factual situations in which a price decline, under the circumstances here, would not be indicative of fraud in the least.'" *Id.* at *6. "There may be numerous reasons, other than fraud, for a stock to decline (even steeply) in price." *Id.*

Among the reasons analyzed were the stock market's inherent risk, the high volatility of Ask Jeeves' stock price, as yet undiscovered reasons other than fraud for the price drop, the plaintiffs' undisclosed investment profiles, and the fact that plaintiffs were suing defendant and not Ask Jeeves. *Id.* at *6-*7. "It may be that even if the price drop alerted them to possible fraud on the part of Ask Jeeves, it would not necessarily have alerted them to misconduct by [defendant]." *Id*. at *7. The court noted that defendant, with the benefit of further discovery, might still be able to establish inquiry notice on the plaintiffs' part at the summary judgment stage. *Id*. The court also rejected defendant's actual notice argument based on disclaimers in the analyst reports and brokerage customer agreements. *Id*. at *9.

The court remanded the case with a "suggestion" to the district court to consider several loss causation issues on remand, namely, whether the PSLRA warranted a change in the Eleventh Circuit's loss causation analysis or traditional pleading standards for loss causation. *Id*. at *10.

(2) *In re Triton Network Sys., Inc. Sec. Litig.*, No. 8:02-CV-1041-T-27MAP (M.D. Fla. Sept. 26, 2003)

Summary: Plaintiffs had inquiry notice sufficient to trigger the statute of limitations applicable to their federal securities fraud claims by virtue of a discrepancy in defendants' prospectus, defendants' disclosure regarding a key customer's financial difficulties, and the key customer's later bankruptcy.

Facts: Plaintiffs filed suit under Sections 11 and 15 of the Securities Act, Section 10(b) (and Rule 10b-5) and Section 20(a) of the Securities Exchange Act against the directors and officers of a corporate issuer, the underwriters of the company's initial public offering, and the company's outside auditor. Plaintiffs alleged that the prospectus and SEC filings were false and misleading because the company had improperly recognized revenues, overstated inventory, and reported that it possessed long-term supply agreements with several key customers. The defendants moved to dismiss arguing, inter alia, that the claims were barred by the applicable statute of limitations allowing one year from the date of discovery and three years from the date of the violation.[4]

Holding and Reasoning: The court dismissed the complaint because plaintiffs failed to file suit within one year of inquiry notice of possible fraud.

The court held that plaintiffs' knowledge of any one of several documents or events "sufficiently alerted[ed] the plaintiffs to the possibility of the fraud." *Id*. at 10 (quoting *Theoharous v. Fong*, 256 F.3d 1219, 1228 (11th Cir. 2001)). First, the company's prospectus contained a discrepancy regarding the per share IPO price. *Id*. at 11. The court stated that plaintiffs were responsible for reading the prospectus, and the discrepancy would have at least placed a reasonable investor on notice that something was amiss. *Id*.

Second, the company issued a press release only four months after its prospectus announcing that its key customer had delayed a delivery from Triton to "conserve cash." *Id*. at 12. The press release immediately caused a fifty percent drop in the company's stock price. *Id*. The court concluded that the press release disclosing the key customer's financial difficulties and its effect on the company's stock price "was clearly a 'storm warning' putting plaintiffs on inquiry notice" of the possibility of fraud in the prospectus. *Id*. at 13, 15.

Third, only four months later, the company's key customer announced that it was seeking bankruptcy protection. *Id*. at 15. Therefore, as of that date, "any reasonable investor would have been on inquiry notice that Triton's key customer was not financially stable and Triton itself could not have been financially stable." *Id*. at 16.

Plaintiffs failed to file suit until approximately fifteen months after the latest of these events, and accordingly plaintiffs' claims were time-barred. *Id*. at 8, 15-16.

(3) *Roberts v. Dean Witter Reynolds, Inc.*, No. 8:02-CV-2115-T-26EAJ, 2003 WL 1936116 (M.D. Fla. Mar. 31, 2003)

Summary: The Sarbanes-Oxley Act's extended statute of limitations may retroactively apply to revive time-barred claims.

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[4] The case was filed before the effective date of the Sarbanes-Oxley Act of 2002, which lengthened the limitations periods applicable to federal securities claims involving "fraud, deceit, manipulation, or contrivance" to two years from the date of discovery and five years from the date of the violation. *See* 28 U.S.C. § 1658(b).

Facts: Effective July 30, 2002, the Sarbanes-Oxley Act (SOX) lengthened the statute of limitations for "claim[s] of fraud, deceit, manipulation, or contrivance in contravention of a regulatory requirement concerning the securities laws, as defined in section 3(a)(47) of the Securities Exchange Act" to the earlier of two years after the discovery of the facts comprising the violation or five years after the violation itself. 28 U.S.C. § 1658(b). Previously, the limitations period for most private securities fraud actions was one year from the discovery of the violation or three years from the date of the violation. Plaintiffs filed suit on November 15, 2002, alleging unsuitable and unauthorized trades during a period between January 1998 and August 19, 1998. Defendants moved to dismiss, arguing that plaintiffs' claims had expired prior to SOX's passage and were not revived under the extended limitations period.

Holding and Reasoning: The court denied the motion to dismiss, holding that SOX applied retroactively.

The court focused on legislative history, especially a portion stating that the longer limitations period "applie[d] to any and all cases filed after the effective date of the Act, regardless of when the underlying conduct occurred." Id. at *3-*4 (citing 148 Cong. Rec. S7418-01, *7418). Such language "demonstrate[d] that Congress intended for the extended statute of limitations to apply retroactively." Id. at *4. Therefore, SOX revived plaintiffs' claims even though they were time-barred when SOX was enacted.

Noting that "a difference of opinion may exist as to the interpretation of [SOX] and its legislative history," the court granted defendants' request to certify an interlocutory appeal. Id. The Eleventh Circuit heard oral argument on November 21, 2003, and the issue is currently pending.

(4) *Raffa v. Wachovia Corp.*, No. 8:02-CV-1443-T-27EAJ (M.D. Fla. Feb. 24, 2003)

Summary: The limitations period for subsequent class actions is not tolled during the pendency of a previously filed class action involving the same putative members. Also, certificates used to facilitate exchange of stock in conjunction with a merger were covered securities under SLUSA.

Facts: Plaintiffs filed a class action against defendant corporation alleging violations of Sections 11 and 12 of the Securities Act and breach of a merger agreement between the defendant and a corporation in which the plaintiffs held stock. Plaintiffs claimed defendant failed to disclose certain information affecting defendant's stock price that negatively impacted the ratio under which plaintiffs' shares were exchanged. Defendant moved for dismissal, arguing that plaintiffs' class claims were time-barred and that SLUSA preempted plaintiffs' state common law breach of contract claim.

Holding and Reasoning: The court granted dismissal of both the class claims under the Securities Act and the state law claims under SLUSA.

The court held that plaintiffs clearly possessed inquiry notice of the possibility of misrepresentations or omissions more than one year prior to filing suit. *Id.* at 3-4. The court then rejected plaintiffs' argument that the one-year statute of limitations was tolled until the denial of class certification in a related class action. *Id.* Eleventh Circuit law "makes clear that 'the pendency of a previously filed class action does *not* toll the limitations period for additional class actions by putative members of the original asserted class.'" *Id.* at 4 (quoting *Griffin v. Singletary*, 17 F.3d 356, 359 (11th Cir. 1994)).

The court also held that SLUSA preempted plaintiffs' state law claims because the certificates used to facilitate the merger between the corporations were covered securities as defined under SLUSA. *Id.* at 5-7. The Delaware carve-out exception did not preserve the claims because plaintiffs were not holders of defendant's equity securities at the time of the merger. *Id.* at 7-8. Accordingly, SLUSA preempted the state law claims and mandated dismissal. *Id.* at 8.

Truth on the Market

(1) *In re Andrx Corp.*, No. 02-60410-CIV, 2003 WL 23000953 (S.D. Fla. 2003)

Summary: Under the "truth on the market" doctrine, plaintiffs were unable to establish reliance when the market was clearly aware of, and advised of, facts contradicting any alleged misrepresentation.

Facts: Plaintiffs filed a class action alleging violations of Sections 10(b) and 20(a) of the Securities Exchange Act and Rule 10b-5 against a corporation and the corporation's president. Plaintiffs alleged a false and misleading statement regarding the pending approval of one of the corporation's products and attempted to establish reliance by pleading fraud on the market.

Holding and Reasoning: The court granted summary judgment for defendants because plaintiffs were unable to establish the necessary element of reliance in their claims under Section 10(b).

The court explained "[t]he truth on the market doctrine [is] a corollary to the fraud on the market doctrine, pursuant to which 'a misrepresentation is immaterial if the information is already known to the market because the misrepresentation cannot then defraud the market.'" *Id.* at *9 (quoting *Ganino v. Citizens Utils. Co.*, 228 F.3d 154, 167 (2d Cir. 2000)). To establish the truth on the market defense, "the [d]efendants must show that 'the information that was withheld or misrepresented was transmitted to the public with a degree of intensity and credibility sufficient to effectively counterbalance any misleading impression created by insider's one-sided representations.'" *Id.* (quoting *Provenz v. Miller*, 102 F.3d 1478, 1492 (9th Cir. 1996)).

The court cited numerous press releases and analyst reports, some issued prior to the class period and some issued during the class period, concluding that such statements "effectively counterbalanced" the alleged misrepresentation. *Id.* at *11-*12. Accordingly, no reasonable investor could have been misled by defendants' alleged misrepresentation, thus "conclusively rebutt[ing] the presumption of reliance" created by the plaintiffs' fraud on the market pleading. *Id.* at *10.

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