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Securities & Derivative Litigation Report

2006 SECOND QUARTER ELEVENTH CIRCUIT SECURITIES LAW UPDATE

Inside This Issue:

To keep our clients abreast of securities law developments in the Southeast, Carlton Fields' Securities Practice Group provides quarterly updates of significant securities decisions from federal courts within the Eleventh Circuit. This update summarizes decisions of interest within the Eleventh Circuit from April through June 2006.

Definition of Security

(1) *Haddad v. Ray Bahamas, Ltd.,* --- F.Supp.2d ---, 2006 WL 1321418 (S.D. Fla. May 10, 2006).

Summary:
An investor's joint venture agreement with a developer to develop land in the Bahamas did not constitute a security within the scope of the federal securities laws.

Facts:
An investor sued a real estate developer alleging violations of the antifraud provisions of the federal securities laws based on a multi-million dollar investment in a real estate development project in the Bahamas, which had been formalized in a joint venture agreement. The developer moved to dismiss, arguing that the investment was not a security under the federal securities laws.

Holding and Reasoning:
Motion to dismiss granted.

Under the federal securities laws, a security is defined to include any "investment contract." *Id.* at *4 (*see* 15 U.S.C. §§ 77(b)(a)(1), 78c(a)(10)). Under the well-established test of *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946), an "investment contract" is (i) an investment of money, (ii) in a common enterprise; (iii) with an "expectation of profits to be derived solely from the efforts of a third party." *Id.* The court held that the parties' joint venture agreement failed the "expectation of profits" prong of the *Howey* test. *Id.*

The court reasoned that the investment was offered to a single investor in a private, one-on-one transaction. *Id.* at 5. It was not publicly traded, and no prospectus was issued. *Id.* Moreover, the investor was sought out by the developer not only for his funds, but also for his expertise in real estate development, and the agreement between the parties gave the investor a substantial degree of control over the project. *Id.* Thus, the court concluded that there was no expectation of profits to be derived solely from the efforts of the developer. *Id.*

The court also rejected the investor's argument that the joint venture agreement constituted a security under the former Fifth Circuit's decision in *Williamson v. Tucker*, 645 F.2d 404, 424 (5th Cir. 1981).[1] There, the court held that a joint venture agreement can be a security when (i) the agreement leaves so little power in the hands of the venturer that the arrangement is essentially a limited partnership, (ii) the investor is so inexperienced or unknowledgeable regarding the business as to be incapable of controlling the investment, or (iii) the investor is so dependent on some unique managerial ability of the promoter that he could not replace the promoter or exercise meaningful venture powers. *Id.* (citing *Williamson*, 645 F.2d at 424). Because the investor had extensive development expertise and significant ability to control certain aspects of the project, the agreement did not leave so little power in investor's hands that his joint venture agreement with the developer could be deemed a security.

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[1] In *Bonner v. City of Prichard*, 661 F.2d 1206, 1209 (11th Cir. 1981) (en banc), the Eleventh Circuit adopted as binding precedent decisions of the former Fifth Circuit rendered prior to October 1, 1981.

Derivative Actions

(1) *McCabe v. Foley,* 424 F.Supp.2d 1315 (M.D. Fla. 2006).

Summary:

In a putative shareholder's derivative action, a plaintiff's conclusory allegations that corporate directors engaged in insider trading do not satisfy the heightened pleading requirements applicable to allegations that pre-suit demand on the board of directors would have been futile. The insider trading must be pleaded with sufficient particularity, including facts supporting all key elements of such a claim.

Facts:

A shareholder filed a derivative action against officers and directors of a company for breaches of fiduciary duty, abuse of control, gross mismanagement and waste of corporate assets. The shareholder pleaded that pre-suit demand would be futile because, among other things, several members of the corporation's board of directors had engaged in insider trading. The defendants moved to dismiss, arguing that the complaint failed adequately to allege demand futility.

Holding and Reasoning:

Motion to dismiss granted.

Because a derivative action belongs to the corporation and not the individual shareholder bringing suit on its behalf, a shareholder must make demand on the corporation's board of directors before instituting a derivative suit. *Id.* at 1319. Under Delaware law, which applied in this case, pre-suit demand may be excused by a proper pleading that demand would have been futile. *Id.* Pursuant to Fed. R. Civ. P. 23.1, such allegations must be pleaded "with particularity." *Id.*

Here, the complaint named the directors that allegedly traded on inside information, the number of shares sold, and the proceeds earned on each trade, but it offered no further facts to support its allegations. *Id.* The court held that "mere allegations of insider trading do not make a director interested" for purposes of assessing demand futility. *Id.* at 1322. Rather, the complaint must include particularized facts sustaining "the two key elements of insider trading, (1) knowledge of material, non-public information, and (2) sales that resulted from the receipt of that information." *Id.* (citing Delaware law). To properly allege demand futility, the complaint needed to contain factual allegations detailing "the precise roles that the directors played at the company, the information that would have come to their attention in those roles, and any indication as to why they would have perceived the accounting irregularities." *Id.* Because the complaint lacked such allegations, the court ordered it dismissed without prejudice.

NASD Arbitration

(1) *Variable Annuity Life Ins. Co. v. Joiner & Joiner,* No. Civ. A. CV206-110, 2006 WL 1737443 (S.D. Ga. June 23, 2006).

Summary:
A life insurance company was required to submit disputes with certain former employees to NASD arbitration because, even though the company was not a NASD member, it required its employees to work with a subsidiary that was an NASD member and required the employees themselves to register with the NASD.

Facts:
A life insurance company that issued variable annuities was not registered with the NASD but required its employees to so register. It also required its employees to enter into a "Registered Agent Agreement" with its NASD-member subsidiary. The life insurance company was not a signatory to this agreement, which committed disputes between the employees and the subsidiary to NASD arbitration but stated that disputes between the employees and any affiliated company that was not a NASD member would be resolved in court. Certain employees left to work for a competitor and solicited the company's clients. The company filed suit for breach of contract and misappropriation of trade secrets, and the employees moved to compel arbitration, even though their employment agreements provided that disputes with the company were to be resolved in court.

Holding and Reasoning:
Motion to dismiss denied.

The court held that the life insurance company's "close affiliation" with its NASD-member subsidiary "creates, at the very least, an ambiguity as to [the company's] obligation to arbitrate." *Id.* at *3. The company required employees to register with the NASD in order to sell the company's annuity products, and the NASD application obliged registrants to agree to arbitrate any disputes. *Id.* Moreover, the court reasoned, the NASD's Code of Arbitration Procedure gives the NASD jurisdiction over disputes among members and associated persons and "certain others." *Id.* A party is deemed a "certain other" if the party is "sufficiently immersed in the underlying controversy," meaning the party (1) plays an active role in the securities industry; (2) is a signatory to a securities industry arbitration agreement, or is an instrument of another party to the agreement; and (3) voluntarily participated in the events giving rise to the dispute. *Id.* In this case, the company qualified as a "certain other" because it actively participated in the securities industry; was the instrument of its subsidiary, which was a party to the arbitration agreement; and voluntarily participated in the events giving rise to the dispute with its employees. *Id.* Moreover, the court reasoned that the company should not enjoy the benefit of registration with the NASD — the ability to market its products — without also being bound by the obligations of such registration. *Id.* at *4. Therefore, the court held that the company was bound to arbitrate the dispute with the employees. *Id.*

Sale of Unregistered Securities

(1) *Dillon v. Reiser,* No. 05-15148, 2006 WL 1683462 (11th Cir. June 20, 2006)(not selected for publication).

Summary:
A corporate officer's presence at a dinner where her husband, who was also an officer of the company, solicited the sale of unregistered securities was not sufficient participation to implicate her in a subsequent sale of those unregistered securities.

Facts:
Defendant and her husband owned an internet service provider business. Seeking investors for their business, the husband prepared an offering memorandum and an asset list, and the information these documents contained was "intentionally misrepresented and grossly fictional." Investors met with defendant and her husband over dinner and, based on the husband's misrepresentations, invested over $1,000,000 in the company. Soon thereafter, defendant transferred $190,000 of the funds into personal accounts, the remainder of the money disappeared, and the securities became worthless. The investors sued defendant for, *inter alia*, selling unregistered securities in violation of the Florida Securities and Investor Protection Act ("FSIPA"). After a jury found defendant liable, the defendant moved for and received judgment as a matter of law. The investors appealed.

Holding and Reasoning:
Affirmed.

Under FSIPA, an officer of a corporation is liable for the sale of unregistered securities when the officer "personally participates, or aids in the sale of an unregistered security." *Id.* at *3 (*see* Fla. Stat. § 517.211(2)). The Eleventh Circuit agreed with the district court that there was insufficient evidence to support the jury's finding that defendant "personally participated or aided" in making the sale of unregistered securities. *Id.* at *3. Although she was present at the dinner meeting where the sale took place, she did not personally participate in any discussions concerning the company, its financial condition, or investments. *Id.* Rather, the defendant's husband handled those matters. *Id.* In addition, the investors failed to introduce any evidence that the defendant was personally active or involved in the solicitation, other than vague testimony that defendant was present at the table and seemed to be "on board with the whole idea." *Id.* at *4. The court held that this was not sufficient to show personal participation in the sale of the unregistered securities. *Id.*

Standing

(1) *Financial Security Assurance, Inc., v. Stephens, Inc.,* 450 F.3d 1257 (11th Cir. 2006).

Summary:
When an insurance policy between an underwriter of municipal bonds and an insurer provides

that the insurer will acquire the bonds in the event of default, the insurer has essentially purchased a contingent interest in the bonds and thus has standing to bring a 10b-5 claim for fraud in connection with that purchase.

Facts:
A county financed its new waste facility with municipal bonds. The underwriter of the bond offering obtained insurance in connection with the offering. Not long after the transaction closed, the county defaulted on the bonds. The insurer sued the underwriter, alleging violations of Section 10(b) of the Exchange Act and Rule 10b-5 for fraud and negligent misrepresentation. The trial court dismissed the insurer's claim on the ground that the insurer lacked standing because it was not a purchaser or seller of securities, and the insurer appealed.

Holding and Reasoning:
Reversed.

Under the Supreme Court's decision in *Blue Chip Stamps v. Manor Drug Stores*, Inc., 421 U.S. 723 (1975), only those who actually purchase or sell a security, and those with contracts to purchase and sell securities, may bring suit under Rule 10b-5. *Id.* at 1262. The insurer argued that it had standing under Rule 10b-5 because the policy gave the insurer the right to purchase the bonds in the event of the county's default. *Id.* at 1263. The court noted that the term purchase includes "any contract to buy, purchase, or *otherwise acquire* securities." *Id.* (emphasis added). The court reasoned that the policy thus granted the insurer a contingent interest in the bonds, and this qualified as a purchase. *Id.* at 1265. The court explained that it did not matter that the insurer's interest was contingent: the insurer held an ownership interest in the bonds regardless of whether it had physical possession of them. *Id.* Because the insurer had issued the policy and thereby acquired this interest in the bonds as a result of the underwriter's fraud, the insurer had standing to bring a 10b-5 action. *Id.* at 1267.

Statute of Limitations

(1) *Bailey v. Cumberland Casualty & Surety Co.*, No. 05-13740, 2006 WL 1288610 (11th Cir. May 11, 2006)(not selected for publication).

Summary:
A letter from the insurers of an investment advisor stating that they would no longer insure a certain mutual fund investment program was sufficient to put the investor-plaintiff on inquiry notice of her cause of action under Section 10(b) of the Exchange Act.

Facts:
In 1998, an investor was contacted by an investment advisor representing a securities brokerage firm. The advisor offered the investor the opportunity to invest in a "risk-free" mutual fund program in which the investor would receive a percentage of profits generated by the funds. The key selling point was the fact that the investor's principal would be fully insured against loss. The investor participated in the investment fund beginning in October 1998. In April 2001, the insurers cancelled the insurance policy covering the program because the brokerage firm failed to follow certain trading protocols. The following month, the advisor's brokerage firm sent the investor a letter informing her that its insurers were canceling coverage and that it was contesting the cancellation because it was "wrongful." In July 2004, the investor brought a putative class action claiming that the insurers engaged in fraud in violation of federal securities laws by wrongfully canceling

insurance coverage on her policy. The suit did not name the brokerage firm as a defendant.

The insurers moved to dismiss, arguing that the applicable two-year statute of limitations had run. The district court granted the insurers' motion, and the investor appealed.

Holding and Reasoning:
Affirmed.

The statute of limitations for private suit under Section 10(b) begins to run at the "discovery of the facts constituting the violation." *Id.* at *2 (citing *Theoharous v. Fong*, 256 F.3d 1219, 1228 (11th Cir. 2001) (internal citations omitted)). Discovery occurs when a plaintiff has inquiry or actual notice of the possibility of fraud — "not full exposition of the scam itself" — which occurs as soon as the plaintiff is "on notice that something is amiss." *Id.*

Here, the Eleventh Circuit found that the statute of limitations on the investor's claim began to run when she received the letter from the insurers that they no longer insured the program. *Id.* The court held she was on actual notice that these insurers would no longer perform under the insurance agreement with the brokerage firm, and at least on inquiry notice that the program would not be insured at all. *Id.* The trial court did not err in rejecting the investor's argument that the brokerage firm's promise to contest cancellation tolled her claim: "the assurances that [the brokerage firm] would seek to reinstate the insurance coverage may have been enough to trigger equitable tolling against [the brokerage firm], but not against [the insurers]." *Id.*

For more information about this issue of *Securities & Derivative Litigation Report*, to receive it via mail, or for information about Carlton Fields' Securities Practice Group, contact Practice Group Leader Sam J. Salario at Carlton Fields either by telephone: 813.229.4337; by e-mail:ssalario@carltonfields.com; by mail: Corporate Center Three at International Plaza, 4221 W. Boy Scout Blvd., Suite 1000, Tampa, FL 33607; or visit **www.carltonfields.com**.

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