Securities Regulation

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This Article surveys significant cases decided by the United States Court of Appeals for the Eleventh Circuit during 1999 and 2000 in the field of securities regulation. This Article also examines one rule adopted by the Securities and Exchange Commission ("SEC") during this survey period that affects Eleventh Circuit precedent.

I. SAFE HARBOR FOR FORWARD-LOOKING STATEMENTS

In *Harris v. Ivax Corp.*,[1] the Eleventh Circuit considered whether, under the Private Securities Litigation Reform Act of 1995 ("PSLRA"),[2] statements contained in the defendant corporation's press releases qualified as "forward-looking statements."[3] The Eleventh Circuit also addressed whether these statements were accompanied by sufficient "cautionary statements" to come within the safe harbor provided by the PSLRA.[4] In *Harris* investors sued defendant Ivax Corporation ("Ivax"), its chairman and chief executive officer, and its chief financial officer, alleging both fraud under Section 10(b) of the Securities Exchange Act

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1. 182 F.3d 799 (11th Cir. 1999).
2. Pub. L. No. 104-67, 109 Stat. 737 (1995).
3. 182 F.3d at 803-07.
4. *Id.* at 807.

of 1934, as amended (the "Exchange Act"),[5] and Rule 10b-5[6] thereunder and common law negligent misrepresentation.[7]

On August 2, 1996, Ivax issued a press release announcing its financial results for the second quarter of 1996. On September 30, 1996, Ivax issued another press release in which it announced that it anticipated a $43 million loss for the third quarter of 1996. On November 11, 1996, Ivax announced a $179 million loss for the third quarter of 1996, $104 million of which was a reduction in the carrying value of the goodwill ascribed to certain of Ivax's businesses. Neither the August 2 nor the September 30 press releases mentioned the possibility of the goodwill write-down.[8] Ivax had attached an italicized warning to each of its two press releases informing investors of "what kind of misfortunes could befall [Ivax] and what the effect could be."[9] The Ivax stock price fell upon the announcement of the write-down.[10] In the district court, plaintiff investors alleged liability based on two theories. First, plaintiffs alleged that Ivax's economic projections were fraudulent. Second, they alleged that Ivax's disclosure of factors that could affect its projections were misleading because the disclosure omitted the possibility of a goodwill write-down. Defendants moved to

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5. Section 10(b) of the Exchange Act provides:

> It shall be unlawful for any person, directly or indirectly, by use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
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> . . .
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> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78j (1994).

6. SEC Rule 10b-5 provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
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> (a) To employ any device, scheme, or artifice to defraud,
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> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
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> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5 (1998).

7. 182 F.3d at 802.

8. *Id.*

9. *Id.* at 807.

10. *Id.* at 802.

dismiss based on the safe harbor provision[11] and heightened pleading requirements[12] added to the Exchange Act by the PSLRA. The district court dismissed plaintiffs' complaint, and plaintiffs appealed.[13]

On appeal, plaintiffs' theories of liability included that Ivax had concealed its intent to write down goodwill by $104 million in the third quarter of 1996 in its statements disclosing an optimistic outlook and that the list of factors that could affect its projections omitted the risk of the goodwill write-down.[14] The court first analyzed four excerpts from Ivax's two press releases that contained the outlooks and list of potential risks to determine whether each was a forward-looking statement within the safe harbor.[15] The first statement was from the August 2 press release and stated that "[r]eorders are expected to improve as customer inventories are depleted."[16] The court found that the statement was a forward-looking statement because it was "'a

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11. 15 U.S.C. § 78u-5(c). Section 102 of the PSLRA amended the Exchange Act by adding Section 21E into the Exchange Act. The provision offers a safe harbor from civil liability for both written and oral forward-looking statements that project, explain, or estimate future events.

12. 15 U.S.C. § 78u-4(b). Section 101(b) of the PSLRA amended the Exchange Act to require a complaint predicated on the fraud provisions of the Exchange Act to "specify each statement alleged to have been misleading . . . [and the] reasons why the statement is misleading." 15 U.S.C. § 78u-4(b)(1). Section 21D(b)(1) provides:

> (1) Misleading statements and omissions
> In any private action arising under this chapter in which the plaintiff alleges that the defendant—
> (A) made an untrue statement of a material fact; or
> (B) omitted to state a material fact necessary in order to make the statements made, in the light of the circumstances in which they were made, not misleading; the complaint shall specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed.

Id. A complaint must also "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." 15 U.S.C. § 78u-4(b)(2). Section 21D(b)(2) provides:

> (2) Required state of mind.
> In any private action arising under this title in which the plaintiff may recover money damages only on proof that the defendant acted with a particular state of mind, the complaint shall, with respect to each act or omission alleged to violate this title, state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.

Id.

13. 182 F.3d at 802.

14. *Id.* at 804.

15. *Id.*

16. *Id.*

statement of the assumptions underlying'. . . 'a statement of future economic performance.'"[17] The same press release stated that "the challenges unique to this period in our history are now behind us."[18] The court found that this statement, taken in context, was also a forward-looking statement.[19] In rejecting the plaintiffs' argument that the statement could not be forward-looking because it was in the present tense, the court stated that "a statement about the state of a company whose truth or falsity is discernible only after it is made necessarily refers only to future performance."[20] Finally, the press release quoted Ivax's chairman and chief executive officer as saying, "'[O]ur fundamental business and its underlying strategies remain intact . . . . Only a limited number of companies are positioned to meaningfully participate in this rapidly growing market and, among them, Ivax is certainly very well positioned.'"[21] As a "statement whose truth can only be known after seeing how Ivax's future plays out," the court found this statement to be forward-looking and within the safe harbor.[22]

The court next considered a list of factors, both factual and forward-looking, contained in the September 30 press release that Ivax indicated would influence its financial results for the third quarter of 1996.[23] Plaintiffs alleged the list was misleading because it omitted the expectation of a goodwill write-down.[24] The court held that "when the factors underlying a projection or economic forecast include both assumptions and statements of known fact, and a plaintiff alleges that a material factor is missing, the entire list of factors is treated as a forward-looking statement."[25] Therefore, the list of factors was a "statement" within the safe harbor.[26] The court reasoned that it is appropriate to treat mixed lists as forward-looking for two reasons: First, a list will only qualify as forward-looking if it contains assumptions underlying a forward-looking statement;[27] second, "a defendant can fully benefit from the safe harbor's shelter only when it has disclosed risk factors in a warning accompanying the forward-looking statement."[28]

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17. *Id.* (quoting 15 U.S.C. §§ 78u-5(i)(1)(D), (C)).
18. *Id.* at 805 (internal quotation marks and citations omitted).
19. *Id.*
20. *Id.*
21. *Id.*
22. *Id.*
23. *Id.*
24. *Id.* at 806.
25. *Id.* at 807.
26. *Id.*
27. *Id.*
28. *Id.*

The court next considered whether the cautionary language attached to each press release was adequate, despite the fact that it did not explicitly mention the factor that ultimately rendered the forward-looking statements untrue, that is, the goodwill write-down.[29] The court held that the cautionary language satisfied Ivax's obligation to mention "important factors that could cause actual results to differ materially from those in the forward-looking statement[s]" and that the PSLRA did not require a listing of all factors.[30] Based on the foregoing, the court affirmed the district court's dismissal of plaintiffs' complaint.[31]

II. JUDICIAL NOTICE OF SEC FILINGS AND STANDARD FOR SCIENTER PLEADING

In *Bryant v. Avado Brands, Inc.*,[32] the Eleventh Circuit considered the proper scope of materials that a district court may consider in ruling on a motion to dismiss in a securities fraud case.[33] The Eleventh Circuit also addressed what standard a plaintiff must meet in order to plead scienter adequately under Section 21D(b)(2) of the Exchange Act.[34] In *Bryant* shareholders sued defendant Apple South, Inc. ("Apple South"), which is now known as Avado Brands, Inc., and several of its officers in a securities class action lawsuit alleging that defendants made false and misleading statements and material omissions in violation of Section 10(b) of the Exchange Act[35] and Rule 10b-5 thereunder.[36] Plaintiff shareholders also alleged that certain Apple South insiders had

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29. *Id.*

30. *Id.* (quoting 15 U.S.C. § 78u-5(c)(1)(A)(i)). The conference report relating to the PSLRA states that "[f]ailure to include the particular factor that ultimately causes the forward-looking statement not to come true will not mean that the statement is not protected by the safe harbor." H.R. CONF. REP. 104-369, at 44 (1995), *reprinted in* 1995 U.S.C.C.A.N. 730, 743.

31. 182 F.3d at 808.

32. 187 F.3d 1271 (11th Cir. 1999).

33. *Id.* at 1276-81.

34. *Id.* at 1282-87. Section 101(b) of the PSLRA amended the Exchange Act, in part, by adding Section 21D(b)(2), under which a complaint predicated on the fraud provisions of the Exchange Act must "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." 15 U.S.C. § 78u-4(b)(2). *See supra* note 12.

35. *See supra* note 5.

36. *See supra* note 6.

sold shares of Apple South stock in violation of Section 20(a)[37] of the Exchange Act.[38]

Apple South owned and operated several chain restaurants. During the class period defined by plaintiffs' complaint as May 26, 1995, through September 24, 1996, Apple South pursued an expansion plan, acquiring additional restaurants and expanding geographically. In May 1995, Apple South acquired eighteen restaurants located in the Midwest. Plaintiffs alleged that Apple South's integration of these new restaurants, along with restaurants in a chain previously acquired into its business model, was unprofitable and hurt Apple South's core business, which consisted of its restaurants located in the Southeast. Plaintiffs further alleged that Apple South's management knew the acquisitions were creating internal problems that would negatively affect earnings per share ("EPS"), but failed to disclose this negative material information.[39] Plaintiffs alleged that Apple South, in addition to concealing problems, "affirmatively misrepresented the direction in which the strategy was taking the company, telling analysts that the new restaurants would positively impact profit margins" and that EPS would grow by thirty percent in five years.[40] Plaintiffs claimed that during the class period, Apple South sold more than ten million shares of its stock and $125 million in debt securities. They also alleged that several high-ranking officers named as defendants personally sold more than $19.6 million of their stock in Apple South. Plaintiffs asserted that defendants' misrepresentations and omissions caused the climb of the Apple South stock price from $15.25 per share on May 26, 1995, to $28.25 per share by May 1996. On September 24, 1996, Apple South announced that its acquisition of the restaurants in the Midwest had negatively impacted its business, EPS for 1996 would not meet the forecasted growth and would likely not exceed EPS for 1995, and it was

37. Section 20A of the Exchange Act provides, in part:

> Any person who violates any provisions of this title or the rules or regulations thereunder by purchasing or selling a security while in possession of material, nonpublic information shall be liable in an action in any court of competent jurisdiction to any person who, contemporaneously with the purchase or sale of securities that is the subject of such violation, has purchased (where such violation is based on a sale of securities) or sold (where such violation is based on a purchase of securities) securities of the same class.

15 U.S.C. § 78-t(1)(a).

38. 187 F.3d at 1274.

39. *Id.*

40. *Id.*

scaling back its expansion plans for 1996 and 1997. After this announcement, the Apple South stock price fell by forty percent.[41]

The district court granted plaintiffs' motion to strike certain documents attached to defendants' motion to dismiss and ruled that the standard for pleading scienter under the PSLRA was that a "strong inference" of scienter could be raised by "'alleging facts that show the defendants had a motive and opportunity to commit fraud'" or "'alleging facts that constitute strong circumstantial evidence of conscious misbehavior or recklessness.'"[42] However, because the Eleventh Circuit had not addressed the PSLRA, the district court recommended the court of appeals permit an interlocutory appeal and consider the scope of materials that a district court may consider in ruling on a motion to dismiss and the standard for pleading scienter in a securities fraud case.[43]

The court first addressed the scope of materials to be considered in ruling on a motion to dismiss.[44] Defendants had attached documents filed with the SEC that they contended contained cautionary language to support defenses of the safe harbor protection for forward-looking statements under the PSLRA and the "bespeaks caution" doctrine.[45] The district court ruled that under Rule 12(b) of the Federal Rules of Civil Procedure certain exhibits attached to defendants' motion to dismiss could not be considered because the documents embodied matters outside the pleadings.[46] The Eleventh Circuit held that "the district court was authorized at the motion to dismiss stage to take judicial notice of relevant public documents required to be filed with the SEC, and actually filed, for the purpose of determining what statements the documents contain."[47] The court considered the reasoning of the Second Circuit on the issue: Rule 201(b) of the Federal Rules of Evidence provides that "'a judicially noticed fact must be one not subject to reasonable dispute in that it is . . . capable of accurate and ready determination by resort to sources whose accuracy cannot reasonably be questioned.'"[48] The court noted that the documents in question were

41. *Id.*

42. Bryant v. Apple South, Inc., 25 F. Supp. 2d 1372, 1379-81 (M.D. Ga. 1998).

43. *Id.* at 1383. The issues on appeal had not been considered by the Eleventh Circuit Court of Appeals under the PSLRA. The district court had adopted the standard for pleading scienter under the PSLRA formulated by the Second Circuit in *Shields v. Citytrust Bancorp, Inc.*, 25 F.3d 1124 (2d Cir. 1994). 187 F.3d at 1276-77.

44. *Id.*

45. *Id.* at 1276-81.

46. *Id.* at 1276-77.

47. *Id. See Bryant*, 25 F. Supp. 2d at 1376-77.

48. 187 F.3d at 1280.

"'required by law to be filed with the SEC, and no serious question as to their authenticity can exist.'"[49] Further, "the documents are the very documents that are alleged to contain the various misrepresentations or omissions and are not relevant to prove the truth of their contents but only to determine what the documents stated."[50] The court noted that in the typical securities fraud case a party should not be caught by surprise when SEC filings outside the pleadings are presented at an early stage because the plaintiffs are normally well aware of a defendant's SEC filings.[51]

The court next addressed the issue of what standard must be met in order to plead scienter under Section 21D(b)(2) of the Exchange Act.[52] Although it is clear under the PSLRA that scienter cannot be averred generally, the court posed two questions that had not been addressed in the Eleventh Circuit: "[1] Are well-pled allegations of recklessness sufficient to allege scienter . . . and . . . [2] are allegations of motive and opportunity to commit fraud sufficient . . . [?]"[53] With respect to the first question, the court noted that prior to the passage of the PSLRA, every circuit to address the question held that a showing of recklessness was sufficient to allege scienter.[54] Thus, the "required state of mind" for alleging scienter referenced in the PSLRA at the time of its passage encompassed reckless behavior.[55] Because Congress had the opportunity to change this standard when drafting the PSLRA but did not, the

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49. *Id.* at 1277 n.9 (quoting Kramer v. Time Warner, Inc., 937 F.2d 767, 774 (2d Cir. 1991)).

50. *Id.* (quoting *Kramer*, 937 F.2d at 774).

51. *Id.* (quoting *Kramer*, 937 F.2d at 774).

52. *Id.* at 1279.

53. *Id.* at 1276-81.

54. *Id.* at 1282. The court noted that four other circuits had issued opinions interpreting the PSLRA and addressing the scienter standard. *Id.* The Ninth Circuit had held that "allegations showing motive and opportunity to commit fraud are not sufficient to allege the necessary state of mind under the [PSLRA], and that conscious recklessness is required to raise a strong inference of scienter." *Id.* at 1283 (citing *In re* Silicon Graphics, Inc. Sec. Litig., 183 F.3d 970, 988 (9th Cir. 1999)). The Second and Third Circuits had held that "a strong inference of scienter can be alleged by showing a motive and opportunity to commit fraud or by showing circumstantial evidence denoting either recklessness or conscious misbehavior." *Id.* (citing *In re* Advanta Corp. Sec. Litig., 180 F.3d 525, 534 (3rd Cir. 1999) and Press v. Chemical Inv. Servs. Corp., 166 F.3d 529, 538 (2d Cir. 1999)). The Sixth Circuit had held that "scienter could be alleged by pleading facts that give rise to a strong inference of recklessness" but rejected "the proposition that allegations of motive and opportunity to commit fraud were sufficient to plead scienter, unless the facts demonstrate the required state of mind, namely that the defendant acted recklessly or knowingly." *Id.* (citing *In re* Comshare, Inc. Sec. Litig., 183 F.3d 542, 549 (6th Cir. 1999)).

55. *Id.* at 1284.

court reasoned that it had not eliminated recklessness as a basis for liability but had essentially codified "the well-established law that recklessness was sufficient to allege scienter."[56] Thus, the court held that "a complaint alleging with particularity that a defendant acted with a severely reckless state of mind still suffices to state a claim for civil liability under Section 10(b) and Rule 10b-5."[57] The court further held that allegations of motive and opportunity, without more, are not sufficient to demonstrate the requisite scienter in a securities fraud case in the Eleventh Circuit.[58] The court reasoned that, although motive and opportunity to commit fraud may contribute to an inference of severe recklessness, they are not its equivalent.[59] Further, motive and opportunity do not constitute a "state of mind" as required by the PSLRA.[60]

III. "KNOWING POSSESSION" TEST ADOPTED FOR SECTION 10(B) FRAUD CLAIMS

Section 10(b) of the Exchange Act and Rule 10b-5 thereunder prohibit insider trading, that is, buying or selling securities on the basis of material nonpublic information.[61] However, the circuits that have considered the issue have been split on what, if any, causal connection must be shown between a trader's possession of inside information and his or her trading activities. One circuit has held that a trader may be liable for trading while in "knowing possession" of material nonpublic information.[62] The Eleventh Circuit took the contrary view in 1998 and held that the proper test for determining whether a violation of the insider trading provisions has occurred is whether one in possession of material inside information used the information in connection with the trades that formed the basis for the alleged violations.[63] Effective October 23, 2000, the SEC adopted Rule 10b5-1 under the Exchange Act to address whether insider trading liability requires the "knowing possession" standard of material nonpublic information or proof that the

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56. *Id.*
57. *Id.*
58. *Id.* at 1283.
59. *Id.* 1285-86.
60. *Id.* at 1286.
61. *See supra* notes 5-6.
62. *See* United States v. Teicher, 987 F.2d 112, 120-21 (2d Cir. 1993).
63. *See* SEC v. Adler, 137 F.3d 1325, 1337 (11th Cir. 1998). *See also* David M. Calhoun & L. Briley Brisendine, Jr., *Securities Regulation*, 50 MERCER L. REV. 1081 (1999) (discussing *Adler*). The Ninth Circuit has also held that the use of material nonpublic information must be proven in a criminal case. *See* United States v. Smith, 155 F.3d 1051, 1069 & n.27 (9th Cir. 1998).

trader "used" the information and determined that the "knowing possession" standard is more appropriate.[64] Rule 10b5-1(a) states:

> The "manipulative and deceptive devices" prohibited by Section 10(b) of the Exchange Act and Rule 10b-5 thereunder include, among other things, the purchase or sale of a security of any issuer, on the basis of material nonpublic information about that security or issuer in breach of a duty of trust or confidence that is owed directly, indirectly, or derivatively, to the issuer of that security or the shareholders of that issuer, or to any other person who is the source of the material nonpublic information.[65]

Rule 10b5-1(b) further states that "a purchase or sale of a security of an issuer is 'on the basis of material nonpublic information about that security or issuer if the person making the purchase or sale was aware of the material nonpublic information when the person made the purchase or sale.'"[66] Generally, under the new rule, a trade is made on the basis of material nonpublic information if the trader was aware of the information at the time of the purchase or sale. In its adopting release, the SEC states that while the SEC staff believes the knowing possession standard best accomplishes the goal of protecting investors and the integrity of the securities markets, it recognizes that the standard could be overbroad in some respects.[67] However, the SEC staff stated that the new rule "attempts to balance these considerations by means of a general rule based on 'awareness' of the material nonpublic information, with several carefully enumerated affirmative defenses."[68] Some commentators responded to the proposed rule with concerns that the awareness standard for insider trading might eliminate the scienter element from insider trading cases.[69] However, the preliminary note to Rule 10b5-1 provides that Rule 10b5-1 does not modify the scope of insider trading law in any respect other than to define when a purchase or sale constitutes trading "on the basis of" material nonpublic information.[70]

Rule 10b5-1(c) provides an affirmative defense to alleged violations. It provides that a person's purchase or sale is not "on the basis of" material nonpublic information if the person demonstrates that before becoming aware of the information the person had (i) entered into a

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64. 17 C.F.R. § 240.10b5-1 (1998).
65. *Id.*
66. *Id.*
67. *Id.* §§ 230, 240, 243, 249.
68. *Id.*
69. *Id.*
70. *Id.* § 240.10b5-1.

binding contract to purchase or sell the security, (ii) instructed another person to purchase or sell the security for his or her account, or (iii) adopted a written plan for trading securities.[71] To meet the requirements for the rule's defense, the contract, instruction, or plan must either (i) specify (or provide a written formula or mechanism for determining) the amount, price, and date of the transaction in question, or (ii) not permit the trader to exercise any subsequent influence over how, when, or whether to effect sales or purchases. If this sort of influence is exercised, the person who exercises it must not be aware of material nonpublic information when doing so.[72] Obviously, the defense is only effective if the purchase or sale was made pursuant to the contract, instruction, or plan required by the rule.[73]

As outlined above, the new rule not only establishes the standard for the causal connection that is required to be shown between a trader's possession of inside information and the related trading activity, but it also provides an affirmative defense for properly structured transactions. The rule may also decrease the number of lawsuits alleging fraudulent acts committed in order to facilitate insiders' sales. Presumably, more often than not, the standard for transactions by an issuer's insiders will be transactions within the rule's affirmative defense.

IV. CONCLUSION

Although few in number, the cases decided during the survey period established important precedent under the PSLRA in the Eleventh Circuit. Undoubtedly, corporate insiders and their brokers and financial advisors will develop pre-arranged selling programs under new Rule 10b5-1, and counsel to these companies and their insiders will be faced with analyzing these programs for abuses and in light of existing insider trading policies.

71. *Id.*
72. *Id.*
73. *Id.*

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