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Southern District of Texas
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IN THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF TEXAS
HOUSTON DIVISION

MARK NEWBY, *et al.* Plaintiffs, v. ENRON CORP., an Oregon corporation, *et al.*, Defendants.	CIVIL ACTION NO. H 01-3624 AND CONSOLIDATED CASES

DEFENDANT KEN L. HARRISON'S REPLY MEMORANDUM
IN SUPPORT OF MOTION TO DISMISS *NEWBY* COMPLAINT

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I. INTRODUCTION

Plaintiffs' Opposition tacitly acknowledges the failure of the Consolidated Complaint ("Newby Complaint") to plead a claim against certain defendants, including Ken L. Harrison. Their 28-page "amendment on the fly" statement of facts in their Opposition is a failed attempt to fill in the missing pieces. More than that, it is an effort to get past pleading infirmities by reminding the Court of the intense public scrutiny fostered by the magnitude of Enron's collapse. Congress has established a comprehensive procedure for resolving disputes of this kind, and it is no less critical that the system operate in high-profile cases than in less dramatic circumstances. An important part of that system is that people against whom no valid claim has been made be dismissed. The size of Enron's collapse does not make up for pleading inadequacies.

Plaintiffs had 500 pages in the Newby Complaint to plead their claims against Harrison under Section 10b of the Securities Exchange Act of 1934[1] ("the 1934 Act") and the Texas Securities Act[2] ("TSA"). As Harrison made clear in his Motion to Dismiss, plaintiffs failed to plead these claims. Plaintiffs have not cited any statute, case, or rule that allows them to replead their claims in their Opposition papers. Indeed, as this Court has observed, "it is axiomatic that the Complaint cannot be amended by the briefs in opposition to a motion to dismiss." *In re Sec. Litig. BMC Software, Inc.*, 183 F. Supp. 2d 860, 915 (S.D.Tex. 2001) (internal citation omitted). Even if the 28-page fact section of their Opposition were incorporated wholesale into the Complaint, which would be impermissible, plaintiffs' claims against Harrison would suffer the defects found in the pleading filed on April 8, 2002.

We identified the following defects in the Newby Complaint in our opening brief: (1) plaintiffs' first claim for federal securities fraud fails because plaintiffs have not adequately

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1 15 U.S.C. § 78(a), *et seq.*

2 Tex. Civ. Stat. Ann. Art. 581-33.

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alleged Harrison's scienter; (2) plaintiffs' first claim also fails to adequately allege culpable participation sufficient to establish controlling person liability as to Harrison; (3) plaintiffs' second claim for contemporaneous trading fails because plaintiffs' primary liability allegations fail; and (4) plaintiffs' fourth claim for TSA liability fails because Harrison was not a seller and Texas law does not apply to these sales. In their Opposition, plaintiffs devote little time to these legal and substantive arguments.[3] They prefer to revisit at length what they perceive to be the strength of their case: stories about accounting issues brought into the spotlight by the media and Congress, but **which have not been connected in any way to Harrison**. (*See* Opposition at 2-28.)

Plaintiffs fall back on the same impermissible techniques that rendered the Section 10b and Rule 10b-5 allegations in the Newby Complaint ineffective as to Harrison. Plaintiffs' group pleading, "office or position" pleading, fraud-by-hindsight pleading, and motive and opportunity pleading fail to conjure up the required strong inference of scienter where none exists. The emotion generated by this case provides no substantive basis to allow claims to proceed against Harrison in the absence of factual allegations showing his scienter.

Below, we reply to plaintiffs' Opposition efforts to preserve these claims against Harrison. First, we show that plaintiffs' arguments do not rescue their failure to plead with specificity anything that links Harrison to the alleged fraud (Section II., p. 3). Second, we demonstrate how plaintiffs' impermissible pleading methods, which have been explicitly rejected by recent Fifth Circuit authority, fail to establish scienter (Section III. A., and B., pp. 4-6). Third, we show that plaintiffs' insider trading arguments—the centerpiece of their case against Harrison—fail to establish scienter (Section III. C., pp. 6-9). Fourth, we show that plaintiffs' belated and impermissible attempts to add assertions in their Opposition about specific meetings Harrison attended fail to remedy the scienter defects of the Newby Complaint (Section III. D., E.,

[3] Plaintiffs' limited response to Harrison's specific contentions may be found on pages 35, 52-53, 81-82, 121-122 and 159 of their Opposition.

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pp. 9-15). Fifth, we show that plaintiffs cannot satisfy the culpable participation requirement for controlling person liability (Section IV, pp 15-16). Finally, we demonstrate plaintiffs' utter failure to show that Harrison is subject to liability under the Texas Securities Act (Section V, pp. 16-18). For the reasons stated in our opening brief and in this reply, the Court should dismiss these claims against Harrison with prejudice.

II. PLAINTIFFS' HARRISON ALLEGATIONS FAIL TO MEET THE PSLRA AND RULE 9(B) PARTICULARITY REQUIREMENTS

The inadequacy of plaintiffs' efforts to bolster their pleading with argument is evident from their Opposition. The "specificity" paragraphs for certain executives such as Causey, Skilling, and Fastow show some detail.[4] Contrast plaintiffs' "specificity" arguments as to Defendants Causey (Opposition at 44-46); Lay (Opp. at 36-43); and Fastow (Opp. at 48-50); with their arguments about Harrison (Opp. at 52-3.) For certain defendants, plaintiffs at least try to allege what they knew, how they knew it, when they knew it, why they knew it, and why the fact that they knew it is probative of scienter under the federal securities laws.

But for Harrison, plaintiffs can say nothing more than the following:

- Harrison was a director. (Opp. at 52.)
- Harrison attended board meetings. (*Id.*)
- Harrison signed public filings in his capacity as board member. (*Id.*)
- Harrison was on the Management Committee. (*Id.*)
- Harrison sold stock during the six months after his retirement from Portland General Electric. (*Id.* at 122)
- Harrison's last stock sale occurred more than one year before the negative disclosures at issue in this case. (*Id.* at 122.)
- Harrison retained approximately half of his stock and rode it down to zero.

These and other unremarkable facts, without more, cannot lead to any inference of scienter, much less the requisite **strong inference**.[5]

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[4] We do not endorse plaintiffs' arguments as to any defendants. We merely highlight for the Court the significant differences in factual detail.

[5] Plaintiffs add new "allegations" in their Opposition including that Harrison attended the "Fastow Conflict" Board meeting on October of 1999, (Opp. at 52) and that Harrison attended a May 2000 Board Finance Committee meeting at which officers introduced the first Raptor SPE (*Id.* at 52-53). Plaintiffs may not amend their pleadings in the Opposition. Further, as discussed below, these additional "allegations" would not bolster the Newby Complaint, even if properly

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III. PLAINTIFFS FAIL TO PLEAD HARRISON'S SCIENTER

A. Plaintiffs' Legal Arguments In Their Opposition Do Not Save Their Inadequate Pleading Methods

Instead of attempting to show how specific, factual allegations in the Newby Complaint demonstrate Harrison's scienter, plaintiffs deploy a potpourri of legal justifications for their impermissible pleading techniques. Plaintiffs attempt to justify their "office or position" pleading, "fraud-by-hindsight" pleading and group pleading with various and sundry legal doctrines. None of these justifications can bypass the PSLRA's command that plaintiffs show as to each defendant both a specific act or omission and facts giving rise to a strong inference of scienter. 15 U.S.C. § 78u-4(b)(2). The fundamental problem with the Newby Complaint is that, as to Harrison, plaintiffs never factually link **actions** with **state of mind**.

Plaintiffs argue that despite their impermissible pleading methods, scienter is demonstrated because: (1) insiders played a significant role in a scheme to defraud (Opp. at 69-74, 78-82); (2) Enron's problems should have been obvious to insiders (*Id.* at 98-101); (3) internal complaints should have alerted insiders (*Id.* at 101-102); (4) bankruptcy followed positive statements so quickly (*Id.* at 102-103); and (5) GAAP violations were obvious (*Id.* at 103-104).

Plaintiffs' arguments are an attempt to gloss over the fundamental defect in the Complaint: They cannot allege that Harrison said or did anything with the requisite scienter. For example, their "scheme" argument (Opp. at 69-74, 78-82) fails because even a "scheme to defraud" claim requires scienter and further requires that "each defendant" commit "a manipulative or deceptive act in furtherance of the scheme." *Cooper v. Pickett,* 137 F.3d 616, 624 (9th Cir. 1998). The Newby Complaint nowhere makes a legally sufficient allegation that Harrison committed any manipulative or deceptive act with the requisite scienter. Plaintiffs' argument about Enron's problems and GAAP violations (*Id.* at 98-101, 103-104) are

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alleged in a pleading.

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impermissible fraud-by-hindsight arguments because they do not show how Harrison knew **at any time prior to Enron's meltdown** about business problems or GAAP violations. Finally, the arguments about internal complaints and positive statements just prior to bankruptcy (*Id.* at 101-103) are inapplicable to Harrison because he was no longer at PGE or Enron when these complaints and statements occurred. (*See, e.g.,* Newby Compl. 83(l), 86.)

B. The Fifth Circuit Recently Rejected Plaintiffs' Pleading Methods Against Harrison

The Fifth Circuit has just reaffirmed its discrediting of "office or position" and "fraud-by-hindsight" allegations typified by plaintiffs' allegations against Harrison:

> Based on case law in this and other circuits, these allegations fail to reach the required standard. Plaintiffs point to no allegations that the defendants knew about the internal control problems, only that they **should have known** or that their lack of knowledge **based on their corporate positions** demonstrates recklessness. A pleading of scienter may **not rest on the inference** that defendants **must have been aware** of the misstatement **based on their positions** within the company.

Abrams v. Baker Hughes, Inc., 2002 WL 1018944, * 5 (5th Cir. Tex. May 21, 2002) (emphasis added).[6] This Court condemned the same type of conclusory allegations in the *BMC Software* case:

> Conclusory allegations that they had the requisite scienter based on their executive positions at BMC, their involvement in day to day management of its business, their access to internal corporate documents, their conversations with corporate officers and employees, and their attendance at management and board meetings are insufficient.

BMC Software, 183 F. Supp. 2d at 887. Plaintiffs' legal arguments do not assist the Newby Complaint in its failure to state a claim against Harrison. In the following sections we show how

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[6] Indeed, plaintiffs Management Committee and director allegations are the "position" equivalent of allegations of ". . . unidentified daily, weekly and monthly financial reports that apprized them of the company's true financial status . . . ." *Abrams,* 2002 WL 1018944 at *5. When compared with the specific allegations as to certain other defendants, what they knew, how and when they knew it, the "position" allegations of "global knowledge" are glaringly unspecific and conclusory.

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plaintiffs' factual allegations and arguments do not overcome the pleading problems identified in our opening brief.

C. Harrison's Trading Activity Does Not Save The Complaint

Plaintiffs' fail in their attempt to save their claims by focusing on Harrison's trading activities. Plaintiffs have no answer to the facts apparent from the Newby Complaint: Harrison had insufficient tenure with Enron prior to the proposed class period to have any baseline trading history against which to compare his trading activity during the class period. His only trades followed his March 31, 2000 retirement from PGE, when he liquidated roughly half of his Enron stock and options for diversification purposes. Harrison never made another trade once he accomplished this goal and rode the balance of his stock and options to the bottom.

In response, plaintiffs offer up Dr. Hakala's statement that his statistical analysis provides a 90 percent confidence level that Harrison had inside information when he traded. Plaintiffs misleadingly argue that 90 percent is better than the 50(+) percent preponderance of the evidence standard for juries and therefore raises the necessary inference of scienter. Nonsense.

Whether a statistician can reach any conclusion at all about insider trading activity depends on reaching a confidence level well above 90 percent. The accepted standard in the scientific literature is 95 percent, as plaintiffs admit in their Complaint: "the scientific acceptance standard [is] (95%)." (Newby Compl., ¶ 415); *see, e.g.*, A. H. Studenmund, *Using Econometrics: A Practical Guide*, (4th ed., 2000), p. 127.[7] Short of this standard, the results are not statistically significant so as to allow the expert to draw **any** conclusion. The 95 percent level acts as an "on-off" switch, and 90 percent might as well be 30 percent – neither allows the

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[7] As Studenmund notes, small deviations from this standard may be appropriate when the researcher knows there is something unusual about the data. *Id.* But Dr. Hakala notes no unusual circumstances that would cause him to depart from the widely recognized 5 percent standard for statistical significance and certainly none that would justify doubling that standard to 10 percent.

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expert to reject the conclusion that the defendant at issue **did not** trade on inside information. By acknowledging that they cannot reach a 95 percent confidence level concerning Harrison's trades, plaintiffs admit they have no expert evidence for a jury even to consider.

Regardless of their effort to make more of their expert's work than the science of econometrics allows, plaintiffs still cannot avoid the cases holding that no inference of scienter arises from trading that coincides with retirement. *Greebel v. FTP Software, Inc.*, 194 F.3d 185, 206 (1st Cir. 1999); *In re Read-Rite Corp. Sec. Litig.*, 115 F. Supp. 2d 1181, 1184 (N.D. Cal. 2000). Recognizing that these authorities trap them, plaintiffs reveal their desperation by arguing that Harrison's trades were unrelated to his retirement because he did not trade all of his shares on April 1, 2000, the first day after his retirement. Even apart from the fact that April Fools' Day fell on Saturday that year, plaintiffs' argument flunks the "smell" test. That experienced securities lawyers would make such an assertion speaks volumes about the weakness of their case against Harrison. Had Harrison made all of his trades on April 3, 2000, (the first trading day after his options vested on retirement), plaintiffs and their expert would no doubt argue that selling so many shares at once would be irrational behavior that proves Harrison must have been trading on inside information.[8]

Plaintiffs' argument also ignores something that experienced securities lawyers know. Large, publicly-traded companies don't allow insiders to make significant stock sales on the day after a quarter closes or at any time before public release of an earnings announcement for the quarter, precisely because of insider trading issues.[9] *See, e.g., New York Stock Exchange Manual*, ¶ 309.00; *American Stock Exchange Company Guide*, § 402(F). Harrison's trades were

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[8] Indeed, plaintiffs manage to argue, within a single paragraph, that Harrison's trading was probative of scienter because it was both too late ("Harrison chose to wait, a riskier behavior" Opp. At 122); and too early ("Harrison's timing was suspect because he was under no obligation to exercise the majority of his stock options until . . . 2008" Opp. at 123.). This logic is a good example of plaintiffs' "analysis." For plaintiffs there is simply no trade that is not an illegal trade.

[9] Harrison retired on the last day of Q1, 2000. Newby Compl., ¶ 83(l).

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rationally spread out over two quarters and **followed** earnings releases. They coincided with his retirement by any reasonable measure and raise no inference of scienter.

Plaintiffs' timing arguments are equally unavailing. Their argument based on the fact that Harrison had no pre-class-period sales before his retirement ignores case law holding that no inference of scienter arises when a defendant has little pre-class-period service with the corporate defendant. *BMC Software,* 183 F. Supp. 2d at 901-02; *see, also, In re Silicon Graphics Sec. Litig.*, 183 F.3d 970, 987-88 (9th Cir. 1999).[10] Here, Harrison joined Enron roughly one year before the alleged class period, which was too short a time to develop a baseline trading history. Plaintiffs' arguments also ignore the obvious: Harrison's circumstances changed when he retired, and his retirement provides an alternative explanation that negates any inference of scienter. *Greebel*, 194 F.3d at 206.

Plaintiffs also try to dodge the fact that Harrison's last trade was more than a year before any corrective announcements, even though their own expert says that is the relevant time frame. (Hakala Decl., ¶ 11.) Their response is to chant the mantra that insider trading occurs when an insider trades on the basis of non-public information regardless of when that information comes out. Plaintiffs miss the point. **They** have the burden to allege facts showing a strong inference of scienter. Plaintiffs must show **in the first instance** that there is some basis to conclude that defendant's sales were based on non-public information. This burden is not satisfied simply by **labeling** trades as insider sales. Plaintiffs have no answer for the case law holding that no inference of scienter arises from trades that are remote in time to curative disclosures. *See, e.g., BMC Software*, 183 F. Supp. 2d at 903.

Plaintiffs have no basis to assert scienter other than the *ipse dixit* argument that Harrison's sales must have been insider sales. In our experience, when skillful lawyers try to

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[10] The Fifth Circuit cited the insider trading analysis of *Silicon Graphics* favorably in *Abrams v. Baker Hughes, Inc.*, 2002 WL 1018944, *8, n. 32 and n. 33 (5th Cir. Tex. May 21, 2002).

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avoid facts they have pleaded and to ignore case law directly on point, it is because they have no viable opposing argument. Plaintiffs' Rule 10b-5 claims against Harrison should be dismissed with prejudice.

D. Management Committee Arguments

Plaintiffs neither deny nor attempt to justify their core strategy of relying on improper group and status pleading to allege fraud claims against Harrison. Apparently recognizing that general allegations in the Newby Complaint of Harrison's service as a director and officer are not nearly enough to meet their burden, plaintiffs' Opposition brief now focuses on Harrison's service on the Management Committee. But that tactic does nothing more than focus on a different group without adding any of the required particularity:

> The day-to-day business of Enron was conducted by Enron's top executives and its "Management Committee," a collection of top officers who met regularly (weekly or bi-weekly) to oversee and review Enron's business. The Management Committee was aware of and approved all significant business transactions of Enron, including each of the partnership/SPE deals specified herein. * * *

(Newby Compl. ¶ 88.) Taking generality to an unprecedented level, in that single paragraph plaintiffs allege that over the course of **hundreds** of unidentified meetings, the Committee reviewed and approved literally **everything** that Enron and its affiliates ever did during the class period, including the formation of **thousands** of SPEs and the approval of many more **thousands** of SPE transactions.

What is missing entirely from the Newby Complaint is the most basic description of even a single meeting of the Management Committee, much less any meeting addressing any of Enron's alleged improper conduct. Which were the key meetings? Where were they held? What was discussed? Why were they important? Who was there? Was Harrison? Most importantly, how do the answers to any of those questions reasonably imply fraudulent conduct or strongly imply scienter? In short, precisely **what did Harrison himself learn at any particular Management Committee meeting that would clearly undercut the accuracy of**

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Enron's public statements? Paragraph 88, the Newby Complaint as a whole, and plaintiffs' Opposition all fail to answer any of those key questions. The absence of any specificity dooms this effort to overcome the scienter hurdle.

The fact is that paragraph 88 of plaintiffs' Newby Complaint fails to meet the requirements of Rule 11, much less those of Rule 9 and the PSLRA. If plaintiffs could have alleged some specific conduct of the Management Committee or its members relating to improper SPE transactions, the Court can be sure they would have done so to avoid dismissal of their claims. The very breadth of plaintiffs' allegations – that a committee they say met at least every other week somehow thoroughly vetted and approved every one of the thousands of transactions they say Enron did with SPEs – proves their absurdity. Plaintiffs have pinned their hopes on the suggestive title of the group and the official status of its members without any good-faith understanding of what the group did. Plaintiffs' overly general (and substantially false) allegations in paragraph 88 cannot support a claim for securities fraud.[11]

E. Board Meeting And Finance Committee Meeting "Allegations"

Plaintiffs attempt to rehabilitate the Newby Complaint by adding factual detail in their Opposition papers, something this Court has previously recognized is not permitted. *BMC Software,* 183 F. Supp. 2d at 915. These "allegations" about Harrison's attendance at one Board meeting and one Finance Committee meeting are not "well pleaded allegations" found in the Newby Complaint and are thus not entitled to be accepted as true. Even if plaintiffs' assertions about these meetings did appear in the Newby Complaint, they would fail to adequately plead plaintiffs' claims because they are rote, conclusory allegations that defendants "knowingly did this" or "recklessly did that" all of which fail to meet 9(b) pleading standards. *Lovelace v.*

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[11] Further, because no plaintiff was a member of the Management Committee, these allegations are necessarily made solely on information and belief. *ABC Arbitrage Pls. Group v. Tchuruk,* 2002 WL 975299, *11 (5th Cir. May 13, 2002). Plaintiffs do not identify any source for their allegations, much less with the "sufficient particularity" required in the Fifth Circuit. *Id.* at *12. They therefore fail as a matter of law.

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Software Spectrum, Inc., 78 F.3d 1015, 1019 (5th Cir. 1996) (internal citation omitted). Finally, the substance of these "allegations" is demonstrably false from the very documents on which plaintiffs rely, revealing the extremes to which plaintiffs will go to rope in "Insiders" as to whom they have no specific information. "[C]onclusory allegations and unwarranted deductions of fact are not admitted as true * * *" *Guidry v. Bank of LaPlace*, 954 F.2d 278, 281 (5th Cir. 1992)

1. October 1999 Board Meeting

In their Opposition, plaintiffs attempt to provide the Court with *something* to allow the Court to make an inference, any inference, as to Harrison's scienter. This is their Opposition "allegation" of Harrison's scienter:

> Harrison made false and misleading statements to the market when he signed Enron's Form 10-Ks and registration statements filed with the SEC in 3/98, 4/98, 1/99, 2/99, 3/99, 7/99, and 3/01 which included false financial statements, and materially false disclosures about Enron's related-party transactions **which he knew to be false** because he had personally approved waiving Enron's conflict-of-interest policy to allow CFO Fastow to control LJM2.

(Opposition at 52 (internal citations omitted) (emphasis added).)

This is plaintiffs' Opposition statement regarding the October 1999 Board Meeting:

> According to documents released by Congress, Harrison attended a crucial meeting in 10/99, at which the Board approved the creation of LJM2 and waived Enron's conflict-of-interest policies for Fastow in connection with LJM2. The Board passed a resolution authorizing the creation of a partnership (subsequently determined to be LJM2) to be managed by Fastow, which would serve as a "potential ready purchaser of the Company's businesses or assets or as a potential contract counterparty [that] could provide [Enron with] liquidity, risk management, and other financial benefits." Harrison approved the resolution authorizing the partnership and waiving Enron's conflict of interest policy for Fastow. Knowing Fastow controlled LJM2, Harrison still signed and endorsed Enron's false Form 10-Ks and registration statements.

(Opposition at 52.)

There is no **fact** here that says anything more than that Harrison was a member of

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the Board. That he attended meetings and allowed his signature to be affixed to certain public filings as required by law are natural consequences of his Board membership. What does not follow is the **inference** that presence at a meeting in October of 1999, and authorization of Fastow's involvement in LJM2 at its inception, led to any knowledge on Harrison's part that prior or subsequent public statements were misleading.[12] This sort of specificity is a good example of an effort to "couple a factual statement with a conclusory allegation of fraudulent intent." *Shields v. Bancorp., Inc.*, 25 F.3d 1124, 1129 (2d Cir. 1994). Merely knowing about Fastow's involvement with LJM2 does not permit an inference of knowledge of fraudulent activity in connection with LJM2.[13]

Moreover, the entire Board approved of Fastow's involvement. But plaintiffs have **not** named numerous **other** Board members in their Rule 10b-5 claim, thereby tacitly acknowledging that attendance at this Board meeting and voting to approve Fastow's involvement is not enough to establish scienter. The only difference between Harrison and the Board members excused from Rule 10b-5 allegations is that Harrison made trades, illustrating once again that plaintiffs' entire case against Harrison boils down to his trading activity. We have shown why Harrison's trades raise no inference of scienter.

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[12] Plaintiffs also cannot explain their timeline. How can presence at an October 1999 meeting result in knowledge or intent with respect to alleged company-wide accounting fraud in connection with public statements made before the meeting: "3/98, 4/98, 1/99, 2/99, 3/99, 7/99," Opposition at 52, or more than one year after the meeting, "03/01" Opposition at 52? Do plaintiffs suggest an inference that knowledge of new facts in October of 1999 (Fastow and LJM2) implies knowledge of these facts 18 months before they existed? This is a brave new theory of deduction.

[13] As is pointed out in Section II.D.3., below, Causey stated that Arthur Andersen LLP signed off on the governance structure of LJM2 in the May 1, 2000 Finance Committee meeting. Even if Harrison had any qualms, he was not "severely reckless" to heed assurances that Enron's accountants were comfortable with the arrangement. Indeed, Oregon law, under which Enron is incorporated, provides that a director is "entitled to rely on . . . opinions . . . if prepared or presented by . . . public accountants . . . as to matters the director reasonably believes are within the person's professional or expert competence." Or. Rev.Stat. 60.357(2)(b) (General Standards for Directors). The director is not liable for any actions taken if his actions comport with these standards. Or. Rev. Stat. 60.357(4).

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2. May 2000 Finance Committee Meeting

The Newby Complaint itself discredits plaintiffs' new argument that Harrison's attendance at one Finance Committee meeting is probative of Harrison's scienter. In the Newby Complaint, plaintiffs specifically disclaim any fraud allegations against numerous Finance Committee **members**, including Jerome J. Meyer, Paulo V. Ferraz Pereira, Frank Savage, Charles Walker, John A. Urquhart, Bruce G. Willison and its **chair**, Herbert S. Winokur, Jr. (Newby Compl. ¶ 2, n. 1.) How is it that Harrison developed fraudulent intent by simply attending one meeting, while the actual members of the Committee who attended all or most of the meetings had no such intent? The only distinction between Harrison, who was not a member of the Finance Committee, and these Finance Committee members is that Harrison is alleged to have traded. (*See,* Newby Compl. 401-402.) Plaintiffs' decision not to allege fraud against numerous Finance Committee members and its chair is an admission that membership and attendance at **all** of its meetings is not probative in any way of fraudulent intent. Therefore, the discussion in the Opposition of Harrison's attendance at one Finance Committee meeting does not bolster the retirement trading allegations that are the only reason plaintiffs hope to keep Harrison in this case.

There is even more wrong with plaintiffs' Finance Committee "assertions." The highlighted portions of these statements are demonstrably untrue, and also fail to allege Harrison's scienter:

> Harrison was also present at the 5/1/00 Finance Committee meeting, when Fastow reported on LJM2 and McMahon presented a liquidity report and **discussed Enron's guarantee portfolio – which included its guarantees to the Raptors** – and Enron's need for additional borrowing capacity. Harrison **had intimate knowledge of Enron's guarantees** to the various SPEs referred to in the Complaint and the significance of those guarantees to Enron's financial condition. Thus, he had **specific knowledge** that its financial statements were false and misleading because they inflated Enron's revenues, earnings, assets, and equity, and concealed billions of dollars of debt that should have been shown on its balance sheet. For example, the CC specifies that Enron's failure to consolidate subsidiaries and special-purpose entities into

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> its financial statements violated GAAP. For Enron's accounting scheme to work, the SPEs and subsidiaries had to be controlled by Enron and this control and affiliation had to be concealed, in violation of SFAS No. 57. Harrison **knew** that accurate disclosure of these related-party transactions would disclose their scheme to hide Enron's massive debt that it was keeping off its books.

(Opposition at 52-3 (internal citations omitted) (emphasis added).)[14]

Documents incorporated by reference into the Newby Complaint, and the exhibits attached to the Opposition, disprove the "facts" **referenced**. Plaintiffs say that McMahon made a presentation that included a portfolio of guarantees from Enron to the Raptors. Plaintiffs ignore that it was at this very meeting that the first Raptor was authorized. "Glisan and Causey presented Raptor I to the Finance Committee of the Board on May 1, 2000* * *" Powers Report at 105, relevant pages attached as Exhibit 1, hereto. This information is clear from the exhibit plaintiffs attach to their Opposition. "Project Raptor was approved for recommendation to the Board." (Ex. 26 to Pls. Opp. at 3.) No other Raptors existed at the time of the meeting. Raptors II, III, and IV were authorized in June, September and August of 2000, respectively. Powers Report 111, 112, 116, attached as Ex. 1 hereto. There were no guarantees from Enron to the Raptors that Harrison could have learned about at this meeting. Plaintiffs state a fact: Harrison's presence at the Finance Committee meeting where the first Raptor was authorized. They add an impermissible, conclusory statement of intent: Harrison's knowledge of alleged widespread accounting fraud was "intimate" and "specific." There is no causal connection that permits their conclusory scienter allegations.

3. Plaintiffs' Exhibit 26 Severely Undercuts Their Claim That Harrison Had Knowledge Of Accounting Fraud

Plaintiffs attach the Finance Committee Minutes for the May 1, 2000 meeting. Plaintiffs' basic allegation, and the inference they wish the Court to draw, is that Harrison had

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[14] Plaintiffs continue their strategy of pointing to a specific fact—attendance at a May 1, 2000 meeting—and then making conclusory statements of intent. This is not permissible. *Shields,* 25 F.3d at 1129. Further, these "allegations" are not well pleaded in the Newby Complaint so the Court is not required to accept their truth.

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"specific knowledge that its financial statements were false and misleading because they inflated Enron's revenues, earnings, assets, and equity, and concealed billions of dollars of debt that should have been shown on its balance sheet." (Opp. at 53 (internal citations omitted).) Any inference of such specific knowledge that might arise from Harrison's presence at either of the meetings referenced in the Opposition is severely undercut by Finance Committee minutes attached to plaintiffs' exhibit:

> Mr. Causey joined the discussion and stated that **Arthur Andersen LLP** had spent considerable time analyzing the **Talon structure** and the **governance structure of LJM2** , and was **comfortable with the proposed transaction**

(Ex. 26 to Pls. Opp. at 3 (emphasis added).) Board members are entitled to rely on the opinions of both corporate officers and accountants. Or. Rev. Stat. 60.357(2)(a), (b). Therefore, the facts plaintiffs attempt to bring before the Court in their Opposition papers are insufficient, alone or together with allegations that actually appear in the Newby Complaint, to raise any inference of scienter.

IV. PLAINTIFFS HAVE NOT STATED A CONTROLLING PERSON CLAIM

The Fifth Circuit expressly stated in *Dennis v. General Imaging, Inc.* , 918 F.2d 496, 509 (5th Cir. 1990) that the plaintiffs must prove that each defendant "induced or participated in the alleged [securities] violation" in order to state a prima facie case under Section 15 of the 1933 Act or Section 20 of the 1934 Act. Unable to satisfy this culpable participation requirement, plaintiffs instead assert in a footnote that the Fifth Circuit has since rejected *Dennis* as inconsistent with an earlier decision, *G.A. Thompson & Co. v. Partridge*, 636 F.2d 945 (5th Cir. 1981). (Opposition at 154 n.56)

Plaintiffs plainly misstate *Abbott v. Equity Group, Inc.*, 2 F.3d 613 (5th Cir. 1993), and their attempts to dismiss *Dennis* in a footnote are thus unavailing. The *Abbott* court did recognize an apparent inconsistency between *Dennis* (which specifically cites to *G.A. Thompson—see Dennis*, 918 F.2d at 509) and *G.A. Thompson* itself. However, it expressly

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declined to resolve this inconsistency. *See Abbott,* 2 F.3d at 620 ("We need not resolve this inconsistency, because our holding turns on [another issue]."). Moreover, *Abbott* expressly relied on *Dennis* for another point. *See Abbott*, *supra*, 2 F.3d at 620 (looking to *Dennis* for "guidance").

As such, *Dennis*, which imposes a culpable participation requirement, remains good law and is the most recent case on point from the Fifth Circuit. It is also consistent with recent cases from the Southern District (decided after *Abbott*). *BMC Software*, 183 F. Supp. 2d at 868, n.17 (S.D. Tex. 2001) (stating that plaintiffs may assert alternative claim for secondary liability based on "culpable participation"); *In re Browning-Ferris Indus. Sec. Litig.*, 876 F. Supp. 870, 911 (S.D. Tex. 1995) ("To establish a prima facie case under section 20(a) in the Fifth Circuit, plaintiffs must demonstrate that the individual participated in or induced the alleged primary violation.") (citing *Dennis*).[15] The district courts that have followed *Dennis* are not "mistaken." (Opposition at 154 n.56) The fact that other cases are more favorable to plaintiffs does not undercut the authority of the Fifth Circuit's decision in *Dennis*. Because plaintiffs have not pled culpable participation with sufficient particularity as to Harrison, this claim should be dismissed.

V. PLAINTIFFS HAVE NOT STATED A TEXAS SECURITIES ACT CLAIM

As to Harrison, plaintiffs' TSA claim fails because the TSA does not apply to the alleged transaction. As stated in Harrison's Motion to Dismiss, the TSA cannot apply to a transaction that takes place between a non-Texas buyer and seller, involving securities of an Oregon corporation. *See generally, Edgar v. Mite Corporation,* 457 U.S. 624, 641, 102 S.Ct.

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[15] Other district courts in the Fifth Circuit have also followed *Dennis*. *See RGB Eye Assocs. v. Physician Resource Group, Inc.*, 1999 U.S. Dist. LEXIS 21940 *39-40 (N.D. Tex.) (Fitzwater, J.) (stating that, in order to plead a §20(a) claim, plaintiff must allege "particularized facts as to each controlling person's culpable participation in the fraud perpetrated by the controlled person"); *Bornstein v. FDIC*, 1991 U.S. Dist. LEXIS 13415 *3 (E.D. La.) (citing *Dennis* as authority for culpable participation requirement). For the Court's convenience, unpublished and state-law authority is attached hereto as Exhibit 2.

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2629, 2640 (1982) (plurality opinion). Other defendants have elaborated on the reasons for this. Notably, the "sweeping extraterritorial effect" of such a statute would act as a restraint on interstate commerce in violation of the Commerce Clause. *Id. See also, Enntex Oil & Gas Co. v. State,* 560 S.W.2d 494, 497 (Tex. Civ.. App. 1978); *Rio Grande Oil Co. v. State*, 539 S.W.2d 917, 922 (Tex. Ct. App. 1976); *Allen v. Oakbrook Sec. Corp.*, 763 So.2d 1099, 1101 (Fl. Dist. Ct. App. 1999); *In re Revco Sec. Litig.*, No. 89CV593, 1991 WL 353385 (N.D. Oh. Dec. 12, 1991); *Cors v. Langham,* 683 F. Supp. 1056 (E.D. Va. 1988) *but cf. Baron v. Strassner,* 7 F. Supp. 2d 871, 876 (S.D. Tex. 1998).

Further, the TSA does not apply to Harrison because he is not a "seller" under the TSA. Plaintiffs argue a broad definition of "seller" that has been undermined by revisions to the TSA. *See, e.g., Frank v. Bear,* 11 S.W.3d 380, 383 (Tex. Civ. App. 2000, writ denied). In the present case, neither Enron nor Harrison was the seller of these securities. (Newby Complaint ¶ 1023.) The present statue contains a privity requirement. *Frank,* 11 S.W.3d at 383. Plaintiffs cannot meet this requirement where Harrison is neither buyer nor seller.

Further, the TSA claim fails to allege with adequate particularity any grounds for holding Harrison liable under the TSA. *Williams v. WMX Technologies, Inc.* 112 F.3d 175, 177 (5th Cir. 1997) (applying 9(b) particularity requirements to state law fraud claims). Plaintiffs' Opposition attempts to argue both control person and aiding and abetting theories for liability. Opp. at 156 and 157. A control person argument in the Opposition ignores the fact that plaintiffs' TSA control person allegations in the Newby Complaint **do not include Harrison.**[16] Once again, plaintiffs may not attempt to amend their pleadings in their opposition papers.

Further, aiding and abetting liability under the TSA, a theory not specifically referenced in the Newby Complaint, requires fraudulent intent or reckless disregard. *Frank,* 11

[16] (Newby Compl. ¶ 1028): "Defendants Lay, Causey, Buy, Fastow and Skilling, by virtue of their positions as directors and/or senior officers of Enron directly or indirectly controlled Enron and/or other defendants named in this Claim and are liable as a result thereof."

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S.W.3d at 384. For the same reasons plaintiffs have failed to adequately plead under Rule 9(b) Harrison's scienter for their federal claims, they have failed to plead with specificity fraudulent intent or reckless disregard for purposes of their state law claim. Perhaps recognizing the weakness of their state law intent arguments, plaintiffs simply ignore this required element for TSA liability in their Opposition. Plaintiffs have therefore failed to state a TSA claim against Harrison, and it should be dismissed with prejudice.

VI. CONCLUSION

Plaintiffs face several hurdles that they cannot surmount before pleading a sufficient claim against Harrison. The Newby Complaint alleges that Harrison signed certain public statements between 1998 and early 2001. They are unable to connect him with statements later in 2001 because he left Enron in the spring of that year. Further, they are unable to show that he ever had information that might lead him to believe any statements made might be misleading. Plaintiffs rely heavily on letters to the Board and officers from "whistleblowers" in late 2001. (Opposition at 101-102.) All of these events happened after Harrison left Enron. They also allege that he was a director, Management Committee member and CEO of PGE, apparently hoping to rely on a "should have known" theory. This will not suffice. *Abrams,* 2002 WL 1018944 at *6.

As to Harrison, plaintiffs have managed to allege nothing more than (1) he signed statements without knowledge of adverse information, (2) he held an office without knowledge of adverse information, (3) and he traded without an inference of adverse information. Plaintiffs

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simply have failed to establish Harrison's scienter. Claims I, II, and IV of the Newby Complaint should be dismissed with prejudice as against Harrison.

DATED: June 24, 2002

Respectfully submitted,

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REPORT OF INVESTIGATION

BY THE

SPECIAL INVESTIGATIVE COMMITTEE

OF THE

BOARD OF DIRECTORS OF ENRON CORP.

William C. Powers, Jr., Chair
Raymond S. Troubh
Herbert S. Winokur, Jr.

Counsel
Wilmer, Cutler & Pickering

February 1, 2002

2. Enron's Approval of Raptor I

Although the deal-closing documents were dated April 18, 2000, the transaction did not receive formal approval from Enron's Management or Board until several weeks later.

The approval of Raptor I by Enron's Management is reflected in two documents, an "LJM2 Approval Sheet" and an Enron Deal Summary. Both were executed between May 22 and June 12, 2000, long after the transaction closed. The LJM2 Approval Sheet very briefly describes the transaction and the distribution "waterfall" of Talon's earnings (including the initial $41 million payment to LJM2), and reports that Kopper—a Managing Director of Enron—negotiated on behalf of LJM2. The Approval Sheet was signed by Glisan, Causey and Buy, but the signature line for Skilling was blank.[49] The LJM2 Approval Sheet refers to an "attached" DASH. A Deal Summary is attached, which is largely identical to the Approval Sheet, but added: "It is expected that Talon will have earnings and cash sufficient to distribute $41 million to LJM2 within six months, yielding an annualized return on investment to LJM2 of 76.8%" This document was signed only by Glisan and Scott Sefton, the General Counsel of Enron Global Finance, Fastow's group.

Glisan and Causey presented Raptor I to the Finance Committee of the Board on May 1, 2000, with Lay, Skilling, and Fastow in attendance. According to the minutes, Glisan described Raptor as "a risk management program to enable the Company to hedge

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[49] We discuss Skilling's role in the management and oversight of transactions with the LJM partnerships in Section VII, below.

was restricted from being sold, pledged or hedged for a three-year period. These restrictions reduced the value of the stock, and were a key basis for PwC's fairness opinion. By agreeing to the collar, Enron had to lift, in part, the restriction that had justified the 35% discount on the stock ($187 million). Causey signed the document waiving the restriction.

Thus, on October 30, 2000, the value of Talon's principal asset, the Enron stock and stock contracts, was protected from future declines. Even so, the value of Enron's merchant investments was rapidly declining, so Talon's credit capacity was still in jeopardy.

B. Raptors II and IV

Enron and LJM2 established two more Raptors—known as Raptor II and Raptor IV—that were not materially different from Raptor I. (A fourth vehicle, Raptor III, is discussed in the next section.) Both Raptors II and IV received only contingent contracts to obtain a specified number of Enron shares.[52] Raptor II was authorized by the Executive Committee of the Board at its meeting on June 22, 2000. The minutes state

[52] As noted above in Section V.A.1., Enron contributed to Raptor I a contingent forward contract held by a wholly-owned Enron subsidiary, Peregrine, under which Peregrine had a right to receive Enron stock on March 1, 2003 from Whitewing. Enron contributed similar contingent stock-delivery contracts to Raptors II and IV. In all, Enron sold the rights to 18 million contingent Enron shares, to be delivered in 2003, to Raptor I (3.9 million shares), Raptor II (7.8 million shares) and Raptor IV (6.3 million shares). The contingency was based on Enron stock price on March 1, 2003. If on that date the price of Enron stock was above $53 per share, Raptor I would receive all of its shares; if it was above $63 per share, Raptor II would receive all of its shares; and if it was above $76 per share, Raptor IV would receive all of its shares. If, on the other hand, the price of Enron stock on that date was below $63 per share, Raptor IV would receive no shares; if it was below $53 per share, Raptor II would receive no shares; and if it was below $50 per share, Raptor I would receive no shares.

that Fastow told the Committee that a second Raptor was needed because "there had been tremendous utilization by the business units of Raptor I." In fact, at that point there had been no derivative transactions between Talon and Enron. A presentation distributed to the Executive Committee stated: "Initially, the vehicle can provide approximately $200 million of P&L protection to ENE [Enron]. As ENE stock price increases, the vehicle's P&L protection capacity increases as well." The closing documents for Raptor II were dated June 29, 2000.

Raptor IV was presented to the Finance Committee at its meeting on August 7, 2000.[53] With Skilling, Fastow, Buy and Causey in attendance, Glisan first discussed Raptors I and II. He "noted that Raptor I was almost completely utilized and that Raptor II would not be available for utilization until later in the year." (There is no indication that Glisan explained why Raptor II would not be available—under the unwritten agreement, Raptor II would not write derivatives with Enron until LJM2 received its specified $41 million or 30% return.) Glisan then informed the Committee that "the Company was proposing an additional Raptor structure . . . to increase available capacity." After a discussion that is not described in the minutes, the Finance Committee voted to recommend Raptor IV to the Board. Later that day, Skilling informed the Board that the Executive Committee had approved Raptor II at its June meeting, and that

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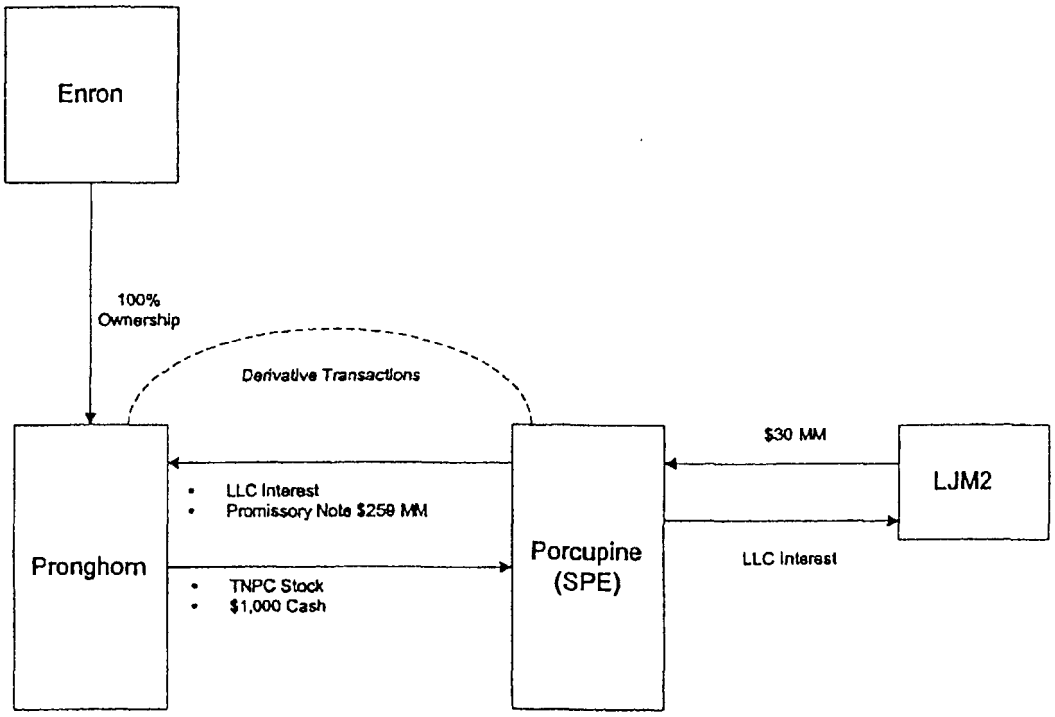
[53] The Finance Committee and Board minutes refer to this vehicle as "Raptor III," not "Raptor IV." However, as we explain below, another Raptor vehicle was activated after Raptor II and before what the Board referred to as "Raptor III." This Raptor vehicle, which is widely referred to as Raptor III by Enron employees involved in the transactions, was not brought to the Board for approval. In order to be consistent with the terms used by the parties at the time (and reflected in contemporaneous documents), we refer to what the Board called Raptor III as Raptor IV.

contribute to the vehicle. Rather than seeking Board authorization for new Enron shares, which would have resulted in dilution of earnings per share, Enron Management chose to contribute some of Enron's TNPC holdings to Raptor III's SPE, "Porcupine."

A very simplified diagram of Raptor III appears below:



Enron and LJM2 created Raptor III effective September 27, 2000. Unlike the other Raptor transactions, Raptor III was not presented to the Board or to any of its Committees, possibly because no Enron stock was involved. We have seen no evidence that the members of the Board, other than Skilling, were aware of the transaction. Nor have we seen any evidence that an LJM2 Approval Sheet, Enron Investment Summary, or DASH was prepared for this transaction.

Oregon Revised Statutes - 2001 Edition

Chapters 59 - 113

- ORS Chapter 59
- ORS Chapter 60
- ORS Chapter 61
- ORS Chapter 62
- ORS Chapter 63
- ORS Chapter 64
- ORS Chapter 65
- ORS Chapter 67
- ORS Chapter 68
- ORS Chapter 69
- ORS Chapter 70
- ORS Chapter 71
- ORS Chapter 72
- ORS Chapter 72a
- ORS Chapter 73
- ORS Chapter 74
- ORS Chapter 74a
- ORS Chapter 75
- ORS Chapter 76
- ORS Chapter 77
- ORS Chapter 78
- ORS Chapter 79
- ORS Chapter 80
- ORS Chapter 81
- ORS Chapter 82
- ORS Chapter 83
- ORS Chapter 84
- ORS Chapter 86
- ORS Chapter 87
- ORS Chapter 88
- ORS Chapter 90
- ORS Chapter 91
- ORS Chapter 92
- ORS Chapter 93
- ORS Chapter 94
- ORS Chapter 95
- ORS Chapter 96

60.357 General standards for directors. (1) A director shall discharge the duties of a director, including the duties as a member of a committee, in good faith, with the care an ordinarily prudent person in a like position would exercise under similar circumstances and in a manner the director reasonably believes to be in the best interests of the corporation.

(2) In discharging the duties of a director, a director is entitled to rely on information, opinions, reports or statements including financial statements and other financial data, if prepared or presented by:

(a) One or more officers or employees of the corporation whom the director reasonably believes to be reliable and competent in the matters presented;

(b) Legal counsel, public accountants or other persons as to matters the director reasonably believes are within the person's professional or expert competence; or

(c) A committee of the board of directors of which the director is not a member if the director reasonably believes the committee merits confidence.

(3) A director is not acting in good faith if the director has knowledge concerning the matter in question that makes reliance otherwise permitted by subsection (2) of this section unwarranted.

(4) A director is not liable for any action taken as a director, or any failure to take any action, if the director performed the duties of the director's office in compliance with this section.

(5) When evaluating any offer of another party to make a tender or exchange offer for any equity security of the corporation, or any proposal to merge or consolidate the corporation with another corporation or to purchase or otherwise acquire all or substantially all the properties and assets of the corporation, the directors of the corporation may, in determining what they believe to be in the best interests of the corporation, give due consideration to the social, legal and economic effects on employees, customers and suppliers of the corporation and on the communities and geographical areas in which the corporation and its subsidiaries operate, the economy of the state and nation, the long-term as well as short-term interests of the corporation and its shareholders, including the possibility that these interests may be best served by the continued independence of the corporation, and other relevant factors. [1987 c.52 §85; 1989 c.4 §8]

LEXSEE 1991 U.S. Dist. Lexis 13415

ARTHUR BORNSTEIN, ET AL v. FEDERAL DEPOSIT INSURANCE CORPORATION AS RECEIVER FOR BANKERS TRUST, N.A., ET AL

Civil Action No. 89-3052

UNITED STATES DISTRICT COURT FOR THE EASTERN DISTRICT OF LOUISIANA

1991 U.S. Dist. LEXIS 13415

September 5, 1991

September 6, 1991, Filed

JUDGES:
*1

Peter Beer, United States District Judge.

OPINIONBY:
BEER

OPINION:

This matter came before the Court on September 4, 1991, on the Motion for Summary Judgment filed by defendants Bob A. Hardesty, Raymond A. Lapino, Sr., Myron E. Moorehead, Robert M. Murphy, and Clifford E. Olsen. After a consideration of the argument of counsel and the briefs submitted, and after a review of the applicable law, it is the opinion of this Court that the motions for summary judgment must be denied.

I. Background

This is a suit brought by shareholders of First Banquers Holding Company ("FBHC"), the principal asset of which a was a 97% interest in Bankers Trust, a national banking association, for alleged violations of federal securities laws involved in the sale of FBHC stock to plaintiffs. Made defendants, herein, are the management of FBHC and several of the directors and officers of FBHC and Bankers Trust. Plaintiffs complaint alleges certain violations against the managing officers and directors of FBHC, and attempts to impose "control liability" upon certain directors of Bankers Trust on the grounds that they in effect controlled the actors who actually committed the violations.

Five of the "control" defendants have *2 filed this motion for summary judgment on the grounds that they cannot be held liable under the "control" language in the statutes.

II. Opinion.

Defendants contend that they cannot be held liable as control persons because although they were directors of Bankers Trust they were minority stockholders, and outside directors. They argue that they had no control over the issue of the FBHC stock. They further argue that they have a good faith defense in that they did not know and could not reasonably have known of the alleged violation. Defendants also dispute the existence of any securities violation.

Plaintiffs argue that movers were actually significant holders of FBHC stock and voted by proxy to approve the stock issues involved. They also argue that as directors of Bankers Trust, even outside directors, the movers were aware or should have been aware of the actions taken by Bankers Trust employees involved in the sale of the stock. Plaintiffs also argue that the board of Bankers Trust approved the stock offers in question.

Plaintiffs seek to impose secondary liability on defendants as "control persons" under Section 15 of the Securities Act of 1933, 15 U.S.C. § 77(o), Section 20 *3 of the Securities Act of 1934, 15 U.S.C. § 78(t), and the Louisiana Securities Law, La. R.S. 51:714B. 17 C.F.R. § 230.405 defines "control" for the purposes of the securities laws as:

the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise.

To make out a prima facie case of control liability against these defendants, plaintiff must prove that " 1) each had actual power or influence over the controlled person and 2) each induced or participated in the alleged violation. Dennis v. General Imaging, Inc., 918 F.2d 496 (5th Cir. 1990) (affirming Judge Arcenaux). Once a prima facie case is made, defendants can avoid liability by affirmatively proving that their supervision was adequate and

that they did not know of the conduct of the violator nor could they have reasonably known of it. Id. at 509; G.A. Thompson & Co. v. Partrige, 636 F.2d 945 (5th Cir. 1981).

Although the moving defendants claim to have been merely outsiders, and not aware of or responsible for the alleged securities *4 violations, it is the opinion of this Court that plaintiffs have adequately demonstrated the existence of evidence, including the defendants positions on the board of directors of Bankers Trust, their stock ownership, their extensive outstanding loans, and their approval of the stock offerings at issue, tending to establish that the moving defendants possessed at least the indicia of control. Such evidence although certainly not conclusive of the control issue, is sufficient to create a question of fact for the fact finder, and preclude entry of summary judgment.

Defendants' Motion for Summary Judgment is hereby DENIED.

LEXSEE 1999 U.S. Dist. Lexis 21940

RGB EYE ASSOCIATES, P.A., et al., Plaintiffs, VS. PHYSICIAN RESOURCE GROUP, INC., et al., Defendants.

Civil Action No. 3:98-CV-1715-D

UNITED STATES DISTRICT COURT FOR THE NORTHERN DISTRICT OF TEXAS, DALLAS DIVISION

1999 U.S. Dist. LEXIS 21940

May 13, 1999, Decided

May 13, 1999, Filed; May 14, 1999, Entered on Docket

DISPOSITION:
*1 Defendants' motion to dismiss plaintiffs' complaint pursuant to Rule 12(b)(6) granted.

COUNSEL:
For RGB EYE ASSOCIATES, PA, ROBERT BURLINGAME, MD, JW EYE ASSOCIATES, PA, JEFFREY WHITMAN, MD, LAWRENCE A SHAFRON, MD, RC EYE ASSOCIATES, PA, RUDOLF CHURNER, MD, JMH EYE ASSOCIATES, PA, JOHN M HALEY, MD, SAW EYE ASSOCIATES, PA, SHELBY A WYLL, MD, plaintiffs: William B Finkelstein, Attorney at Law, Craig W Budner, Attorney at Law, Thomas W Paxton, Attorney at Law, Hughes & Luce, Dallas, TX USA.

For PHYSICIANS RESOURCE GROUP INC, TEXAS PRG VII INC, TEXAS PRG V INC, TEXAS PRG VI INC, TEXAS PRG XV INC, TEXAS PRG II INC, TEXAS PRG III INC, defendants: Lawrence B Schreve, Attorney at Law, Andrews & Kurth, Houston, TX USA.

For PHYSICIANS RESOURCE GROUP INC, TEXAS PRG VII INC, TEXAS PRG V INC, TEXAS PRG VI INC, TEXAS PRG XV INC, TEXAS PRG II INC, TEXAS PRG III INC, defendants: Dennis N Ryan, Attorney at Law, Robert Benton Weathersby, Attorney at Law, Andrews & Kurth, Dallas, TX USA.

For JEFFREY SCHILLER, DIVERSIFIED INVESTMENT HOLDINGS LP, movants: Marc R Stanley, Attorney at Law, Stanley Mandel & Iola, Dallas, TX USA.

For EMMETT E MOORE, RICHARD M OWEN, RICHARD J D'AMICO, defendants: *2 Robert Benton Weathersby, Attorney at Law, Andrews & Kurth, Dallas, TX USA.

JUDGES:
SIDNEY A. FITZWATER, UNITED STATES DISTRICT JUDGE.

OPINIONBY:
SIDNEY A. FITZWATER

OPINION:

MEMORANDUM OPINION AND ORDER

The physician-plaintiffs in this case merged their ophthalmic medical practices into subsidiaries created by a physician practice management company, based on the receipt of common stock in the company, and promises that defendants would provide valuable services that would lead to reduced costs and administrative burdens, and increased revenues, profits, and personal wealth. In turn, the physicians conveyed the assets of their practices to the subsidiaries, paid them a service fee of 35% of their net profits, and reimbursed them for all expenses. When the transactions did not turn out as promised, the physicians and their professional associations sued, largely on state-law grounds, but also based on federal securities law, which is at issue in defendants' pending motion to dismiss. The court grants the motion, but permits plaintiffs to replead.

I

The court recounts the facts according to the standards that apply to federal securities law claims. Provided that plaintiffs plead specific facts, *3 not conclusory allegations or unwarranted deductions of fact, the court accepts the allegations of their complaint as true and views them in the light most favorable to plaintiffs. *Coates v. Heartland Wireless Communications, Inc.*, 26 F. Supp. 2d 910, 914, 915 (N.D. Tex. 1998) (Fitzwater, J.).

A

Defendant Physician Resource Group, Inc. ("PRG") is a publicly traded corporation that provides management and administrative services to ophthalmologists. n1 The individual defendants (collectively, the "Individual Defendants") are Emmett E. Moore, M.D. ("Dr. Moore"), a member of PRG's board of directors and the past Chairman and Chief Executive Officer of PRG; Richard M. Owen, PRG's prior President; and Richard J. D'Amico ("D'Amico"), former Executive Vice President and General Counsel for PRG. Also named defendants are various PRG subsidiaries that were used in the transactions with plaintiffs.

n1 There are other medical specialties to whom it provides services, but they are not pertinent to the present case.

*4

PRG engaged in the business of consolidating individual ophthalmic practices—traditionally conducted individually or as members of small professional associations—under an affiliation with PRG. PRG acquired an interest in each practice; the ophthalmologist, in turn, obtained PRG common stock. PRG and the Individual Defendants sold individual physicians on this arrangement by touting potential economies of scale, increased operational and administrative efficiencies, increased revenues through PRG network patient referrals, reduced operating costs, and higher profits.

In 1995 PRG began expanding rapidly. Lacking cash to purchase large numbers of practices, it used its common stock to do so. This strategy made it necessary for PRG stock to trade at a very high per share price, thereby enabling PRG to acquire medical practices in the least dilutive manner and preventing PRG's per share earnings from falling precipitously. It also permitted PRG to raise millions of dollars in additional capital to fund current operations and numerous planned acquisitions. PRG made its stock attractive to prospective investors by portraying itself as a profitable company with necessary management and *5 administrative expertise to acquire large numbers of medical practices, integrate them, achieve economies of scale, and increase the wealth of PRG shareholders and affiliated doctors.

After an initial public offering in 1995, PRG issued more than 14 million shares of common stock in the following 18 months. This enabled PRG to procure more than 150 ophthalmologist and optometrist practices and several large physician-practice management companies. Throughout 1995 and 1996 PRG reported that it was profitable, was successfully integrating the acquisitions into its operations, was on track to achieve economies of scale and synergies of operations, and that its management and administrative expertise, operational systems, and accounting systems and controls were in place and functioning. PRG claimed that it would continue to experience profitable growth and increased earnings in the future.

In 1996 PRG and the Individual Defendants solicited plaintiffs Robert Burlingame, M.D., Jeffrey Whitman, M.D., Lawrence A. Shafron, M.D., Rudolf Churner, M.D., John M. Haley, M.D., and Shelby A. Wyll, M.D. (collectively, the "Physicians") concerning their interest in PRG's acquiring their practices. *6 PRG proposed an integrated transaction in which PRG would invest in each doctor's practice through a tax-free merger with a PRG subsidiary that would be incorporated to acquire assets from the doctor's professional association. After the merger, the physician would operate under the PRG umbrella. In exchange for a service fee, the PRG subsidiary would provide management and administrative services, furniture, fixtures, and employees. This fee would be offset by cost reductions and increased office productivity. Operating much like a sale-leaseback, the physician's office space, furniture, fixtures, inventory, equipment, and non-medical employees would be provided to him under PRG's supervision and administration, eliminating the need for the physician to oversee practice management, administration, and business operations. PRG and its subsidiaries would provide exclusive management and administration of non-physician services such as billing, collections, payroll, accounting, bookkeeping, management, and files and records maintenance. Because of economies of scale in accounting and management services that would reduce their administrative costs, the Physicians' practices would become *7 more profitable.

PRG and the Individual Defendants represented that PRG had the necessary systems and staff to take over the administrative and management functions of the Physicians' practices, and that PRG would provide substantial marketing assistance, through opening the PRG network of physicians, to help them increase the size of their practices. They also repeatedly advised the Physicians that merger with PRG would increase the number of patients and revenues through PRG's expertise in negotiating, establishing, and supervising managed care contracts with insurers, health maintenance organizations, and other health care providers, and that PRG would add the Physicians to the managed care contracts and would improve the terms of the contracts. They also represented that, by affiliating with PRG, the Physicians could effectively compete to acquire new practice groups and attract new physicians.

In late February or early March 1996, a group

of PRG representatives, including Dr. Moore, Mark Kingston ("Kingston"), and Michael Casas ("Casas"), represented to certain of the Physicians that (1) PRG's acquisition program was moving forward successfully and ahead of schedule, (2) PRG *8 had the management expertise and experience and management information and accounting systems and controls necessary to permit it to continue its growth-by-acquisition program, (3) PRG had the personnel and experience to do the necessary due diligence on acquisitions to assure that it was acquiring only high quality, profitable practices that met its standards and could be quickly integrated into PRG, and (4) PRG was successfully integrating the practices that it had acquired to date (not mentioning any difficulties concerning systems integration that would adversely impact its ability to continue its acquisition program).

PRG and the Individual Defendants also used the offer of PRG common stock as a substantial incentive for entering into the merger. The proposed transaction used formulas that basically calculated the amount of stock according to multiples of the 35% net management fee that PRG would receive. Essentially, rather than earning a service fee based on the value of the services rendered, in exchange for PRG common stock, PRG was purchasing 35% of the Physicians' equity (net profits) in their practices. According to PRG and the Individual Defendants, this enabled the Physicians *9 to "sell" part of their practices and substantially increase their present and future personal wealth due to the continually increasing value of the stock. They also assured the Physicians that the structure of the proposed transaction was perfectly legal and a common industry practice by which physician practice management companies acquired medical practices.

PRG and the Individual Defendants made several representations—some oral and some in a PRG prospectus—to each Physician concerning the PRG stock that would be issued if he entered into the merger. These included the following representations set out in the PRG prospectus:

The Company believes that the physicians at the Affiliated Practices will benefit from having the supplemental management and administrative support provided by PRG. This support will reduce the amount of time the physicians are required to spend on administrative matters and will enable them to dedicate such time and efforts towards the growth of their professional practices. The Company believes that, due to its size and purchasing power, it will be able to negotiate discounts on office and medical supplies, health and malpractice insurance, and *10 surgical and diagnostic equipment. The Company intends to institute "benchmarking" programs to identify and promote the most efficient operational approaches of Affiliated Practices and others in the industry to enhance the efficiency of the Affiliated Practices. The Company also expects to improve Affiliated Practices' cash management and utilization of equipment and facilities.

The Company intends to provide Affiliated Practices with the necessary capital resources to (i) invest in new technologies, such as excimer lasers, (ii) develop complementary services, such as ASCs and optical shops, (iii) provide the Affiliated Practices with the capital and expertise required to complete consolidating acquisitions, (iv) implement sophisticated management information systems, (v) promote efficient practice patterns by focusing on clinical outcomes, (vi) develop coordinated marketing efforts and (vii) realize purchasing economics of scale, all of which practices may not otherwise be able to effect individually. The Company believes integrated delivery networks will afford the Affiliated Practices significant opportunities for cross-referrals, volume contracting with payors and their *11 intermediaries and expanded service capabilities.

The Company believes that it will be attractive to acquisition candidates because of its (i) governance structure, which promotes physician control and participation, (ii) fee structure under its Service Agreements, which allows physicians to participate in the cost efficiencies and revenue growth realized by the Affiliated Practices, and (iii) transaction structure, which permits physicians to become stockholders of the Company, thus further aligning the interests of the Affiliated Practices and the Company. (Emphasis added) sic

The Company's business strategy is to ... achieve operating efficiencies through purchasing leverage and more effective utilization of equipment, facilities, and personnel.

Compl. at P 49.

Based on the representations that PRG and the Individual Defendants made, each Physician entered into a transaction that made him part of the PRG network. In substantially identical transactions, the Physicians (with one immaterial exception) merged their medical practices and professional associations into newly-formed PRG subsidiaries, established new professional associations to receive all management *12 and administrative services from the subsidiaries, and executed service agreements that obligated the subsidiaries to provide general administrative services such as billing, collections, accounting, purchasing operations, inventory planning, management information services, and other business functions (such as preparation of financial state-

ments). The subsidiaries also became obligated to expand the Physicians' practices, such as by negotiating, establishing, and supervising managed care contracts with new and existing payor relationships, and by providing marketing and public relations assistance. In exchange for these services, the Physicians' professional associations paid 35% of their net profits to the subsidiaries and reimbursed them for all expenses.

As part of the transaction, each physician also received PRG common stock. Some of the shares were restricted (or at least contractually restricted) so that they could be sold only in compliance with the volume and holding period requirements prescribed by Rule 144 of the Securities Act of 1933.

Soon after the transactions were completed, the Physicians discovered that PRG and the subsidiaries could not perform as represented, *13 and that they were obligated to pay a 35% service fee that had no relation to the value of the services that they were or should have been provided. They aver that they were duped into joining the PRG network based on promises of substantial personal wealth that never materialized, and were issued PRG common stock that rapidly declined in value. Just one month after the acquisitions, the stock traded for $34 3/8 per share. A few months after PRG completed the acquisition of Dr. Shafron's practice, it traded for $2 3/8 per share, a 93% decline.

The Physicians allege on information and belief that, in late 1997 during a meeting in Tampa, Florida with physicians whose practices PRG had acquired, D'Amico, at the time a top PRG officer, made admissions that demonstrate that PRG's prior statements to the Physicians had been false. In December 1997, in an article in the *Review of Ophthalmology*, PRG board members Joseph Noreika and David Schulman admitted certain PRG deficiencies. Standard & Poor's lowered the rating on PRG debt a second time, to "junk" levels. PRG admitted in its 1997 10-K, filed April 15, 1998, that its independent public accountant had identified material weaknesses *14 in the internal control structure of the company. In recent proposals to affiliated physicians, as set forth in public filings, PRG has confirmed that it now understands that it cannot provide the services that it contracted to provide to the Physicians, has offered to provide dramatically reduced services, or eliminate previously offered services in exchange for *inter alia* a reduction of service fees, and has made numerous admissions that it failed to provide adequate services to physicians.

B

The Physicians and their associations filed this lawsuit against PRG, the Individual Defendants, and the PRG subsidiaries. In their amended complaint ("complaint"), the Physicians n2 allege that PRG and the Individual Defendants violated § 10(b) of the Securities Exchange Act of 1934 (the "Exchange Act"), 15 U.S.C. § 78j(b), and Securities and Exchange Commission ("SEC") Rule 10b-5 ("Rule 10b-5"), 17 C.F.R. § 240.10b-5 (1998), promulgated thereunder. The Physicians seek to hold the Individual Defendants liable as controlling persons for the alleged securities law violations, pursuant to § 20(a) of the Exchange Act, 15 U.S.C. § 78t(a). n3 *15

n2 The professional association-plaintiffs do not assert federal securities law claims in the complaint. *See* Ds. Br. at 2 n. 1. When in this opinion the court refers to "plaintiffs," it means the Physicians unless the context shows otherwise.

n3 Although plaintiffs do not explicitly cite § 20(a), they otherwise plead that the Individual Defendants are liable as controlling persons. *See* Compl. at P 90.

Defendants move to dismiss pursuant to Fed. R. Civ. P. 9(b), n4 12(b)(1), n5 and 12(b)(6). They seek dismissal based on Rule 12(b)(6) on the grounds that plaintiffs (1) have failed to satisfy the heightened pleading requirements imposed by the Private Securities Litigation Reform Act of 1995 ("PSLRA"), codified in relevant part at 15 U.S.C. § 78u-4, (2) have alleged misrepresentations that are not material, (3) have pleaded optimistic predictions that are not actionable misrepresentations, (4) have failed adequately to plead scienter, and (5) have failed to plead that their *16 Rule 10b-5 claim was filed in compliance with the statute of limitations.

n4 Defendants seek dismissal based on Rule 9(b) solely on the ground that the Physicians have pleaded insufficient facts to show that defendants acted with scienter—their alleged motive or conscious indifference. *See* Ds. Br. at 24 & n.35. The court grants this motion for the same reason that it grants defendants' Rule 12(b)(6) motion based on the Physicians' failure to plead scienter.

n5 Defendants advance a Rule 12(b)(1) motion, which challenges the court's subject matter jurisdiction. It is settled that the court must address questions of its subject matter jurisdiction before reaching the merits. *See, e.g., In re Pro-Snax Distribs., Inc.*, 157 F.3d 414, 420 (5th Cir. 1998). In the present case, however, defendants' challenge to the court's subject matter jurisdiction is derivative of their Rule 12(b)(6) motion.

They maintain that plaintiffs' federal securities fraud count fails to state a claim on which relief can be granted and that, once this cause of action is dismissed, "subject matter jurisdiction vanishes." Ds. Br. at 1. This assertion overstates the effect of 28 U.S.C. § 1367(c)(3), which permits the court to dismiss state-law claims without prejudice once the basis for federal question jurisdiction is eliminated, but does not require that the court do so. Subject matter jurisdiction does not "vanish." Under these circumstances, the court need not address the Rule 12(b)(1) motion as a threshold matter.

*17

II

Defendants contend first that plaintiffs' Rule 10b-5 claim must be dismissed pursuant to Rule 12(b)(6) because they have failed to satisfy the heightened pleading requirements imposed by the PSLRA.

A

Rule 10b-5, in relevant part, makes it unlawful for any person, directly or indirectly,

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 ... in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5(b). Because this claim sounds in fraud, plaintiffs must plead it with particularity. *See Oppenheimer v. Prudential Secs. Inc.*, 94 F.3d 189, 195 (5th Cir. 1996); *Shushany v. Allwaste, Inc.*, 992 F.2d 517, 520-21 (5th Cir. 1993).

The basic pleading standard for a fraud claim is established by Rule 9(b), which provides:

In all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be *stated with particularity*. Malice, intent, knowledge, and other condition of mind of a person may be averred generally.

(Emphasis *18 added). The "particularity" standard requires that a plaintiff specify the identity of the person who committed the fraudulent act; the time, place, and contents of the false representations; and why the statements were fraudulent. *Williams v. WMX Techs., Inc.*, 112 F.3d 175, 177-78 (5th Cir.), *cert. denied*, 522 U.S. 966, 118 S. Ct. 412, 139 L. Ed. 2d 315 (1997); *Tel-Phonic Servs., Inc. v. TBS Int'l, Inc.*, 975 F.2d 1134, 1139 (5th Cir. 1992). The purpose of requiring such detail in the pleadings is to "provide defendants with fair notice of the plaintiffs' claims, protect defendants from harm to their reputation and goodwill, reduce the number of strike suits, and prevent plaintiffs from filing baseless claims and then attempting to discover unknown wrongs." *Tuchman v. DSC Communications Corp.*, 14 F.3d 1061, 1067 (5th Cir. 1994).

The PSLRA, which governs the pleading requirements of federal securities fraud claims, generally adopts the pleading standards of Rule 9(b). *See* 15 U.S.C. § 78u-4(b)(1) (requiring complaint to "specify each statement alleged to have *19 been misleading and the reason or reasons why the statement is misleading"); *Williams*, 112 F.3d at 178 (noting in pre-PSLRA case that although the Act did not apply, it "adopted the same standard we apply today"); *Coates*, 26 F. Supp. 2d at 914. The PSLRA augments these standards, however, in two important aspects. Unlike Rule 9(b), the PSLRA expressly permits a party to make an allegation on information and belief, but only if the complaint states with particularity all the facts on which that belief is formed. 15 U.S.C. § 78u-4(b)(1). The PSLRA also includes an explicit standard for pleading scienter, which requires the complaint to "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); *cf. Tuchman*, 14 F.3d at 1068 (noting that courts under Rule 9(b) have required plaintiffs to "set forth specific facts that support an inference of fraud.").

B

Defendants contend that plaintiffs have failed adequately to plead a Rule 10b-5 claim based on the PRG prospectus. They assert that the Physicians *20 quote selected language from the prospectus, but fail to allege a specific statement that was false or made with knowledge of its falsity. Instead, the Physicians resort to a general allegation that PRG knew it could not perform as it stated in its prospectus and concealed the truth from its investors. Ds. Br. at 7-8 (citing Compl. at P 78).

The court agrees that the Physicians have not pleaded with requisite particularity a Rule 10b-5 claim based on the content of the prospectus. n6 The Physicians quote in P 49 of their complaint several representations contained in the prospectus. *See supra* § I(A) (reprinting, in pertinent part, Compl. at P 49). They then allege in P 78 that "PRG's prospectus, including the prospectus that the Physicians were given, contained false and misleading statements concerning material facts, and omitted material facts, about PRG's performance and future profitability. In reality, PRG knew that it could not perform as stated in its prospectus, and it concealed the truth from investors, including the Physicians." Compl. at P 78. The Physicians fail, however, to state specifically which statements in the prospectus were false, what in-

formation was omitted *21 from the prospectus, and why these statements or omissions were fraudulent. It is simply not enough to say that certain representations were made and then to allege in conclusory fashion, several paragraphs later, that the prospectus contained unspecified false and misleading statements. Nor is it sufficient for plaintiffs to set out a variety of allegations about the content of the prospectus, allege the manner in which defendants failed to perform, and leave it to defendants and the court to determine by deduction and inference how they should be linked together to allege that the prospectus violates Rule 10b-5.

n6 The Physicians assert in their summary of argument that they have "set forth the who, what, when, where, and how of their securities fraud" claim concerning "numerous misrepresentations from the PRG prospectuses." Ps. Resp. at 3. This assertion is not corroborated by the balance of their response or by the complaint itself.

The court holds that the complaint fails to plead with sufficient particularity *22 a Rule 10b-5 claim based on the prospectus. *See Williams*, 112 F.3d at 179 (pre-PSLRA case).

C

Defendants also assert that the Physicians' other allegations are inadequate to state a Rule 10b-5 claim. Although they advert to the contention that these allegations lack requisite particularity—contending that the court should dismiss them on this basis alone, Ds. Br. at 8—they then shift away from whether the pleadings are sufficiently particular to whether plaintiffs can state a claim on which relief can be granted. *Id.* at 10 ("We will demonstrate how these allegations ... are, in any event, inadequate to state a federal securities law claim."). They then follow this assertion by setting out four arguments about the viability of the Physicians' Rule 10b-5 claim. In these contentions they assert both that plaintiffs have failed to state a claim (the alleged misrepresentations are not material, or are not actionable misrepresentations, and plaintiffs have failed to plead compliance with the statute of limitations), and that the complaint is not sufficiently particular (plaintiffs have failed adequately to plead scienter).

Under Rule 12(b)(6), a party may move *23 to dismiss a complaint either because it fails to state fraud with particularity, *see Shushany*, 992 F.2d at 520-21, or because no relief can be granted under any set of facts that can be proved consistent with the allegations of plaintiffs' complaint, *see Rubinstein v. Collins*, 20 F.3d 160, 166 (5th Cir. 1994). The parties have intermingled both concepts in their briefing, at times without acknowledging that they are addressing different analytical predicates for seeking or opposing Rule 12(b)(6) dismissal. Because defendants' complaints about the adequacy of the non-prospectus-based representations appear to be briefed in the specific four arguments that follow the summary assertion, the court will address these grounds according to those four rubrics rather than as a pleading-with-particularity issue.

III

A

Defendants argue that plaintiffs have not alleged material misrepresentations, as is required to establish a Rule 10b-5 claim. Citing the "bespeaks caution" doctrine, they maintain that each of the alleged misrepresentations in question is not material when evaluated in the context of the total mix of information available to the Physicians. *24 Defendants maintain that pertinent parts of the prospectus precisely and sufficiently cautioned all investors about the known risks. They argue that nothing allegedly omitted would have altered the total mix of information provided to investors. Instead, any alleged statements that PRG hoped to integrate practices or believed that integration would improve practices in a variety of ways were predictive, optimistic statements that were accompanied by specific cautionary language that amply warned plaintiffs of the risks being undertaken.

Plaintiffs counter that defendants inaccurately treat the misrepresentations and omissions at issue as if each involved predictions rather than past or existing facts. They point to allegations in PP 46 and 49 of their complaint concerning PRG's then-existing ability to perform a variety of services under the service agreements and to be successful as a company. Plaintiffs argue that the "bespeaks caution" doctrine cannot immunize defendants from liability for misrepresenting existing facts; that, even if the doctrine applied, there is no apposite cautionary language; and that misrepresentations of the type in question are consistent with those that *25 courts have held to be actionable. Plaintiffs also argue that all their allegations that can properly be characterized as forward-looking or optimistic predictions are adequate to state a claim.

The Physicians contend that PP 46 and 49 of their complaint contain the following examples of actionable misrepresentations or omissions of past or existing known facts: Dr. Moore, Kingston, and Casas (1) stated at a meeting in late February or early March 1996 that PRG was successfully integrating the practices it had acquired to date; (2) made misrepresentations at

the same meeting (a) that PRG's acquisition program was moving forward successfully and ahead of schedule, (b) regarding PRG's existing management expertise and accounting controls, and (c) that PRG had adequate personnel and expertise; and (3) failed at the meeting to disclose significant existing difficulties that PRG was having with systems integration. Conceding that the following allegations can be characterized as forward-looking or optimistic predictions, they assert that PRG misrepresented (1) that it would provide sufficient management information systems, (2) that affiliation with PRG would allow the Physicians to compete *26 effectively to acquire new practice groups, (3) its ability to track inter-company accounts and provide accurate and timely accounting reports, financial statements, and balance sheets, (4) that it had competent centralized patient billing and collections systems, (5) that it had administrative, management, and marketing expertise, (6) that the structure of the acquisition transactions with the Physicians was "perfectly legal" and a "common industry practice," and (7) its ability to increase the revenues of the Physicians' practices by procuring managed care contracts. The Physicians maintain that these statements are material, not because they predict future success, but because they implicitly assured the Physicians that PRG was capable of performing as it represented that it would. Defendants argue in reply that when the factual bases for these contentions are analyzed in context—particularly in relation to cautionary language in the prospectus—they clearly were not material because they were not misleading.

B

The court cannot say at the Rule 12(b)(6) stage that no relief can be granted to the Physicians under any set of facts that could be proved consistent with these allegations. *27 The presence of cautionary disclosures in the prospectus undoubtedly affects the total mix of information and the materiality of the representations and omissions at issue. *Rubinstein*, 20 F.3d at 170. But until the court can analyze the facts in context—that is, in light of the surrounding circumstances rather than in the abstract—the court cannot say that they are immaterial as a matter of law. *See id.* Further, PRG's inclusion of general cautionary language in a prospectus does not excuse its failure to reveal known, material adverse facts. *Id.* at 171.

The court therefore declines, at the Rule 12(b)(6) stage, to dismiss plaintiffs' Rule 10b-5 claim on the ground that the alleged representations and omissions are immaterial as a matter of law.

IV

Defendants contend that the Physicians have not pleaded actionable misrepresentations. They ague did that the Physicians ground their claim on optimistic predictions, claims of mismanagement, and reports of past successes. The Physicians respond that they do not rely on such impermissible grounds.

A

Defendants' optimistic prediction argument relates to six assertions in the complaint: (1) "The Company *28 believes integrated delivery networks will afford the Affiliated Practices significant opportunities for cross-referrals, volume contracting with payors and their intermediaries and expanded service capabilities," Compl. at P 49; (2) "PRG had the management expertise and experience and management information and accounting systems and controls necessary to permit it to continue its growth-by-acquisition program," *id.* at P 46; (3) "By becoming affiliated with PRG, they could effectively compete to acquire new practice groups and would have an increased ability to attract new physicians," *id.* at P 71; (4) "PRG's acquisition program was moving forward successfully and ahead of schedule," *id.* at P 46; (5) "As an inducement to the various mergers, the Defendants repeatedly told the Physicians that PRG would increase the revenues of their respective practices and increase the number of patients through PRG's expertise in negotiating, establishing, and supervising managed care contracts with new and existing payors, *id.* at P 69; and (6) the transaction "would substantially increase the Physicians' personal wealth," *id.* at P 47; *see id.* at P 77 ("the *29 substantial personal wealth that PRG promised to the Physicians never materialized"). The Physicians respond to this argument at a general level, contending that these were representations concerning PRG's present ability, not optimistic predictions.

The court disagrees with the Physicians with respect to the first, third, fifth, and sixth assertions, which discuss only future events connected with PRG or the transactions. These non-actionable predictions stand in stark contrast to other parts of plaintiffs' complaint that set out allegations based on alleged misrepresentations of present abilities. *See, eg., id.* at P 37 ("PRG portrayed itself as a profitable company with the management and administrative expertise to acquire large numbers of physician practices, integrate those practices, achieve economies of scale, and increase the wealth of PRG's shareholders and affiliated doctors."); P 42 ("PRG and the Individual Defendants told the Physicians that PRG had the necessary systems and staff to take over the administrative and management functions of the Physicians' respective practices.").

The second and fourth allegations, however, pertain to PRG's representations of existing *30 abilities and events that had already occurred. These alleged misrepresentations do not merely predict the future, and are therefore actionable. The court dismisses the Physicians' Rule 10b-5 claim to the extent it is based on the first, third, fifth, and sixth assertions set out above.

B

Defendants argue next that the Physicians impermissibly rely on claims of mismanagement. Plaintiffs concede that allegations solely of mismanagement are not actionable, but maintain that the allegations pertain to misrepresentations about management ability to perform as promised. The court agrees that the complaint does not rely on claims of mismanagement *simpliciter*. Accordingly, the court denies the motion on this basis.

C

Defendants posit that the Physicians' assertion in P 46 that PRG representatives misrepresented that "PRG's acquisition program was moving forward successfully and ahead of schedule" does not state a claim because it amounts to accurate historical information, and the Physicians have not alleged facts that suggest that the statement was false when made. Plaintiffs address this argument in a footnote, *see* Ps. Resp. at 18 n.13, contending that defendants have incorrectly *31 assumed the factual accuracy of the statement. Because plaintiffs have failed to point to an assertion in their complaint that this assertion was not factually accurate in February or early March 1996, when the statement allegedly was made, *see* Compl. at P 46, the court grants defendants' motion to the extent of holding that plaintiffs cannot rely on this part of P 46 as a stand-alone Rule 10b-5 violation.

V

Defendants next challenge whether plaintiffs have adequately alleged scienter.

A

Scienter is a "mental state embracing intent to deceive, manipulate, or defraud." *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 n.12, 47 L. Ed. 2d 668, 96 S. Ct. 1375 (1976). It is an essential element of a Rule 10b-5 claim. *See Tuchman*, 14 F.3d at 1067. Under the PSLRA, a complaint 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). A plaintiff may be able to raise such an inference of fraudulent intent (scienter) either (1) by pleading facts that identify circumstances indicating the defendant's conscious or severely reckless behavior, *32 n7 or (2) by pleading facts that allege a defendant's motive and opportunity to commit securities fraud. *Press v. Chemical Inv. Servs. Corp.*, 166 F.3d 529, 538 (2d Cir. 1999). Under the motive and opportunity prong, the plaintiff must allege facts that indicate both that the defendant could realize a concrete benefit by one or more of the alleged misrepresentations or wrongful disclosures (motive) and that the defendant had the means and a likely prospect of achieving the concrete benefit (opportunity). *Shields v. Cityirust Bancorp, Inc.*, 25 F.3d 1124, 1130 (2d Cir. 1994).

n7 Because the Physicians maintain only that they have adequately pleaded defendants' motive and opportunity to commit securities fraud, the court need not address whether they have sufficiently alleged defendants' conscious or severely reckless behavior.

Defendants maintain that the Physicians' sole allegation concerning motive impermissibly rests on the assertion that PRG's acquisition strategy depended on *33 a high stock price to fund a number of the transactions with other physicians. Ds. Br. at 23 & n.33 (citing Compl. at PP 36-37). The Physicians respond that defendants have improperly lumped them into the same category as passive investors. Instead, they contend that defendants had a motive to defraud because the Physicians would pay PRG, as a service fee, 35% of their future net profits and would give up their practice assets. They argue that PRG wanted to acquire the practices to obtain the assets and revenues of the practices and generate the substantial service fee. According to the Physicians, without misrepresenting its abilities and the services that PRG would provide, PRG could not fuel its stock price, which was necessary to stimulate its growth.

B

The Physicians' scienter argument appears to rest on two components: first, PRG stood to gain financially—obtaining 35% of the Physicians' future net profits and their practice assets—by selling PRG stock; and second, PRG needed to maximize the price of its stock so that it could acquire other physicians' practices. The Physicians cite PP 35 and 47 of their complaint in support of the first element, *see* Ps. Resp. at 18, *34 and cite PP 36-37, 39, and 77-82 in support of the second, *see* Ps. Resp. at 19.

The Physicians' first basis—a motive to receive 35% of the Physicians' future net profits and their practice assets in return for PRG's stock—insufficiently pleads motive and opportunity to commit securities fraud. Scienter must be established by pleading particular facts that give

rise to a strong inference that the defendant acted with the required state of mind. *Coates*, 26 F. Supp. 2d at 918 n.5 (citing PSLRA, 15 U.S.C. § 78u-4(b)(2)). When the law permits an inference of fraud to be drawn, it necessarily recognizes that there are characteristics about a transaction that logically permit the conclusion that the defendant possessed such a motive. If the desire to reap financial rewards—indeed, to profit substantially—were enough to permit the inference, fraud could be inferred in a vast, undifferentiated array of financial transactions that occur daily in a capitalistic, entrepreneurial economy. Federal securities law does not permit so indiscriminate a deduction, in which it could be inferred that virtually everyone who sold stock that later dropped *35 significantly in value must have acted fraudulently. This explains why it is insufficient to plead that a person was motivated to commit fraud by the mere desire to successfully bring to fruition a public offering, *Melder v. Morris*, 27 F.3d 1097, 1102 (5th Cir. 1994), to raise capital, *Novak v. Kasaks*, 997 F. Supp. 425, 430 n.5 (S.D.N.Y. 1998), or to maintain a high bond or credit rating, *San Leandro Emergency Med. Group Profit Sharing Plan v. Philip Morris Cos.*, 75 F.3d 801, 814 (2d Cir. 1996). *See Melder*, 27 F.3d at 1102 ("Accepting the plaintiffs' allegation of motive ... would effectively eliminate the state of mind requirement as to all corporate officers and defendants."). The Physicians' contention that defendants' intent can be inferred from their desire to receive pecuniary benefits from the transactions at issue does not permit the drawing of a strong inference that they acted with intent to defraud.

The Physicians reliance in their response on *Cohen v. Koenig*, 25 F.3d 1168 (2d Cir. 1994), is misplaced. Even if *Cohen* were controlling, plaintiffs do not allege *Cohen*-type facts in *36 their complaint. Unlike the Physicians' general assertion that defendants were motivated by a desire to receive financial benefits, the facts in *Cohen* centered on whether the defendant-purchasers fraudulently induced the plaintiff-sellers to sell them a business based on repeated misrepresentations made during negotiations for the sale. *Id.* at 1170. The purchasers desired to purchase plaintiffs' company's assets on credit, and the sellers wanted cash. *Id.* The Second Circuit, applying New York substantive law and federal Rule 9(b) procedure, held that the sellers' complaint should not have been dismissed under Rule 9(b) because *inter alia* scienter could be inferred from the purchasers' eagerness to acquire the company's assets, the sellers' demand for cash or personal guarantees from the purchasers, and the purchasers' strong desire to make the purchase on credit. *Id.* at 1174. It was therefore reasonable to infer that purchasers in such circumstances had a motive to paint a far rosier financial picture than actually existed in order to induce the assets sale in exchange for a note. *Id.* In other words, in *Cohen* the plaintiffs pleaded *37 specific facts concerning defendants' initial desire to make the purchase on credit, and their making false statements concerning their financial data, to permit the inference that defendants were motived to act fraudulently. *Id.* The defendants' intent was not said to be a general desire to gain financially from the transaction, but specifically to make the sale occur on credit terms when it would not have been consummated otherwise.

The Physicians' second basis—a motive to maximize the price of PRG stock in order to acquire other physician practices—is insufficient as a matter of law to plead motive and opportunity to commit securities fraud. *Coates*, 26 F. Supp. 2d at 919 (holding that motive to inflate stock price because company was expanding through acquisitions and was primarily paying for them with common stock was indistinguishable from motive to inflate stock price to ensure successful public offerings, and thus insufficient to establish scienter).

Accordingly, the court grants defendants' motion to dismiss based on scienter, but permits plaintiffs to replead.

VI

Defendants also move to dismiss plaintiffs' Rule 10b-5 claim on the ground that plaintiffs *38 have failed to plead facts that show that they asserted the claim within the limitations period.

Citing three cases from other circuits, defendants maintain that plaintiffs have the burden to plead compliance with the limitations period in a Rule 10b-5 claim. These cases are distinguishable, however, because they involved claims brought pursuant to §§ 12(1) and (2) of the Exchange Act, both of which include compliance with the statute of limitations as an essential element of the cause of action. *See Davidson v. Wilson*, 973 F.2d 1391, 1402 (8th Cir. 1992); *see also Toombs v. Leone*, 777 F.2d 465, 468 (9th Cir. 1985); *Cook v. Avien, Inc.*, 573 F.2d 685, 695 (1st Cir. 1978). Plaintiffs' Rule 10b-5 claims do not, however, contain such an element. *See Williams*, 112 F.3d at 177 (listing elements). The Physicians need not plead their compliance with the statute of limitations.

Moreover, in order for defendants to prevail on the basis of limitations at the pleadings stage, the plaintiffs must normally plead themselves out of court. *See Whirlpool Fin. Corp. v. GN Holdings, Inc.*, 67 F.3d 605, 608 (7th Cir. 1995) *39 (holding that "if a plaintiff pleads facts that show its suit barred by a statute of limitations, it may plead itself out of court under a Rule

12(b)(6) analysis"). Plaintiffs have not done so here. *Cf.* Compl. at P 79 (alleging that D'Amico made admissions in late 1997 demonstrating that PRG's prior statements to the Physicians had been false). Accordingly, without suggesting that plaintiffs can or cannot avoid the affirmative defense of limitations, the court holds that defendants are not entitled to dismissal based on limitations in the context of a Rule 12(b)(6) motion.

VII

Defendants assert that plaintiffs have failed adequately to state a claim for § 20(a) liability against the Individual Defendants because they have not pleaded a core securities violation.

Section 20(a) imposes joint and several liability on any person who directly or indirectly controls any person who is liable under the Exchange Act. 15 U.S.C. § 78t(a). To plead such a claim, plaintiffs must allege (1) an underlying primary violation by the controlled person, (2) each defendant's control over the primary violator, and (3) particularized facts as to each controlling person's culpable *40 participation in the fraud perpetrated by the controlled person. *SEC v. First Jersey Secs, Inc.*, 101 F.3d 1450, 1472 (2d Cir. 1996). Plaintiffs have failed thus far adequately to allege a primary violation by PRG, the "controlled person." Accordingly, the court dismisses plaintiffs' § 20(a) claim against the Individual Defendants, with the opportunity to replead.

***

Defendants' motion to dismiss plaintiffs' complaint pursuant to Rule 12(b)(6) is granted. Plaintiffs shall have 30 days from the date of this memorandum opinion and order to file an amended complaint that complies with today's decision. *See Coates*, 26 F. Supp. 2d at 923 (granting motion to dismiss but allowing plaintiffs 30 days to file amended complaint).

SO ORDERED.

May 13, 1999.

SIDNEY A. FITZWATER

UNITED STATES DISTRICT JUDGE

LEXSEE 763 So.2d 1099

CHARLES D. ALLEN, CHARLES D. BECK, JR., BRUCE J. BERG, SYDNEY C. BOUWER, LEONARD CROWLEY, EILEEN ESCOTO, WALTER N. FRANK, JOHN E. GARWOOD, JOY A. GARWOOD, GARLAND G. GRANT, EVELYN GUITREAU, JEFFREY HAZLE, JUDITH KETTERER, LAWRENCE A. LANGE, ELWOOD LIKE, LOIS LIKE, DANIEL C. MEISINGER, LINDA P. NICHOLS, ARTHUR L. O'CONNOR, KENNETH M. RENNEY, PATRICK RILEY, and LEONARD S. SIEKMEIER, Appellants, v. OAKBROOK SECURITIES CORPORATION, an Illinois corporation, HARBOUR INVESTMENTS, INC., a Wisconsin corporation, D.E. FREY & COMPANY, INC., a Delaware corporation, JAMES FREDERICK GLAZA, KENNETH W. GERMAIN, FRANK A. SEBASTIANO, NELSON MARK WRIGHT, RICHARD S. DIYA, LINDA METAXA, LES B. GOLDSTEIN, CFS INVESTMENT TRUST, an Illinois trust, TIC PARTICIPATIONS TRUST, a Texas trust, USLC/CFS PARTICIPATIONS TRUST, an Illinois trust, BARBER & BRONSON INCORPORATED, a Florida corporation, COUSINS FINANCIAL SERVICES, INC., an Illinois corporation, COUSINS SECURITIES CORPORATION, an Illinois corporation, DOMINION CAPITAL CORPORATION, a Texas corporation, KITTLAUS, INC., an Illinois corporation, SUNPOINT SECURITIES, INC., a Texas corporation, TRIDENT INVESTMENT COMPANY, a Texas corporation, WA FINANCIAL, INC., a Texas corporation, ROBERT ALAN AMATO, GREGORY ALLEN ANDREWS, NICHOLAS JAMES ANDREWS, ERIC HARRIS ARONSON, ERIC H. CARLSON, WILLIAM ROY COUSINS, MICHAEL HENRY DEMUTH, GREGORY MASON EDWARDS, TAMARA MARIE FULLERTON, KARL L. KITTLAUS, EDGAR LEWIS, BRIAN DAMIAN O'TOOLE, HOWARD CHARLES RAPP, MARK SCHULTZ and DONALD SPINKS, Appellees.

CASE NO. 98-3390

COURT OF APPEAL OF FLORIDA, FOURTH DISTRICT

763 So. 2d 1099; 1999 Fla. App. LEXIS 16873; 24 Fla. L. Weekly D 2774

December 15, 1999, Opinion Filed

SUBSEQUENT HISTORY:
**1 Released for Publication January 3, 2000.

PRIOR HISTORY:
Appeal from the Circuit Court for the Seventeenth Judicial Circuit, Broward County; Jeffrey E. Streitfeld, Judge; L.T. Case No. 97-9119 (14).

DISPOSITION:
AFFIRMED in part; REVERSED in part; and REMANDED.

COUNSEL:
Philip Mugavero of Silverio & Hall, Miami, and Heather Hanneman and John F. Head of John F. Head, P.C., Denver, Colorado, for appellants.

Robert W. Pearce of Lerner & Pearce, P.A., Fort Lauderdale, for Appellee-Oakbrook Securities Corporation.

Mark F. Raymond and Daniel S. Newman of Tew, Cardenas, Rebak, Kellogg, Lehman, Demaria & Tague, L.L.P., Miami, and David A. Genelly of Vanasco, Wayne & Genelly, Chicago, Illinois, for Appellee-Harbour Investments, Inc.

Bruce Botsford and Edward R. Curtis of Curtis & Curtis, P.A., Fort Lauderdale, and Charles F. Brega, Stuart N. Bennett, and Eric B. Liebman of Brega & Winters, P.C., Denver, Colorado, for Appellees-D.E. Frey & Company, Inc., and James Glaza.

JUDGES:
GUNTHER, FARMER and KLEIN, JJ., concur.

OPINION:

*1100 PER CURIAM.

Plaintiffs appeal the trial court's order dismissing their securities fraud and negligent misrepresentation claims against Oakbrook Securities **2 Corporation, Harbour Investments, Inc., D.E. Frey & Co., Inc., and James F. Glaza. We affirm in part and reverse in part.

The security fraud claims are grounded on section 517.301, Florida Statutes, an anti-fraud provision of the Florida Securities and Investor Protection Act a/k/a The Florida Blue Sky Law. The trial court dismissed the claims brought under Chapter 517 because it is undisputed that the sales of the securities involved were not made in Florida. They occurred entirely in other states. Plaintiffs argue that they should be able to invoke Chapter 517, even though the sales occurred in other states, because the securities consisted of stock in *1101 a company which was incorporated in Florida and had its principal place of business in Florida.

The issue as to whether these claims can be brought under Chapter 517 is one of first impression in Florida; however, other courts considering the issue have uniformly rejected applying one state's blue sky law where the sale of the security occurred entirely in another state.

In Singer v. Magnavox Co., 380 A.2d 969 (Del. 1977), overruled on other grounds, Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983), **3 plaintiffs brought a class action alleging violations of the Delaware Securities Act, even though the activity violating the act occurred in another state. The Delaware Supreme Court refused to apply the Delaware Act, stating:

There is, of course, a presumption that a law is not intended to apply outside the territorial jurisdiction of the State in which it is enacted, and that principle is applicable to a Blue Sky Law.

380 A.2d at 981-82 (citations omitted); see also Arizona Corp. Comm'n v. Media Prods., Inc., 158 Ariz. 463, 763 P.2d 527, 531 (Ariz. Ct. App. 1988)(extraterritorial application of a state's blue sky law would violate the Commerce Clause of the United States Constitution); Cors v. Langham, 683 F. Supp. 1056 (E.D. Va. 1988)(complaint did not state a claim under Maryland Securities Act because acts complained of took place in Virginia); McCullough v. Leede Oil & Gas, Inc., 617 F. Supp. 384 (W.D. Okla. 1985)(Oklahoma Securities Act not applicable to sale conducted in another state).

The trial court dismissed the Chapter 517 claims on the ground that it did not have subject matter jurisdiction. Because the trial court **4 is a court of general jurisdiction, it did have subject matter jurisdiction over these claims. But, because it is undisputed that the securities sales occurred entirely in other states, and because plaintiffs seek only to allege blue sky violations under Chapter 517, Florida Statutes, those claims should have been dismissed for failure to state a cause of action. We therefore affirm the dismissal, but on a different ground.

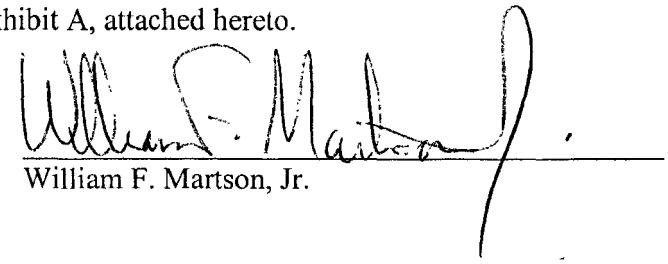
The trial court also dismissed the negligent misrepresentation claims, stating that it had no subject matter jurisdiction over those claims as well. Because the trial court is a court of general jurisdiction, it had subject matter jurisdiction over the tort claims. White v. Pepsico., Inc., 568 So. 2d 886, 888 (Fla. 1990). And the court had personal jurisdiction over the defendants. We therefore reverse the dismissal of the negligent misrepresentation claims.

AFFIRMED in part; REVERSED in part; and REMANDED.

GUNTHER, FARMER and KLEIN, JJ., concur.

CERTIFICATE OF SERVICE

I certify that on the 24th day of June, 2002, a true and correct copy of the **DEFENDANT KEN L. HARRISON'S REPLY MEMORANDUM IN SUPPORT OF MOTION TO DISMISS *NEWBY* COMPLAINT** was served via e-mail, United States mail, and/or facsimile on all persons listed on Exhibit A, attached hereto.



William F. Martson, Jr.

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The Service List

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