IN THE UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF PENNSYLVANIA

IN RE AMERICAN BUSINESS FINANCIAL SERVICES, INC. SECURITIES LITIGATION	:	MASTER FILE NO. 05-232

O'Neill, J. January 9, 2007

MEMORANDUM

This consolidated class action brought against defendants Anthony J. Santilli, Leonard Becker, Michael DeLuca, Harold Sussman, Albert W. Mandia, Jerome Miller, Warren E. Palitz, and Jeffrey S. Steinberg has been filed on behalf of all persons who suffered damages as a result of their purchase of Notes from American Business Financial Services, Inc. ("ABFS") during the Class Period.[1] Plaintiffs allege that Registration Statements that became effective in 2001, 2002, and 2003 were illegally issued without the use of broker/dealers, contained untrue statements of material fact, and omitted material facts. Plaintiffs seek to recover damages for violations of Sections 5, 11, 12(a)(1), 12(a)(2), and 15 of the Securities Act of 1933 ("1933 Act") and Sections 20 and 29(b) of the Securities Exchange Act of 1934 ("1934 Act").

Now before me is the individual defendants' motion to dismiss plaintiffs' consolidated amended class action complaint pursuant to Federal Rules of Civil Procedure 12(b)(6) and 9(b), plaintiffs' responses, and defendants' reply thereto.

BACKGROUND

The factual background of this case can be found in my decision of June 2, 2005, In re

[1]ABFS is not a defendant in this case because it filed for protection under Chapter 11 of the Bankruptcy Code on January 21, 2005.

American Business Financial Services, Inc. Securities Litigation, 413 F. Supp. 2d 378 (E.D. Pa. June 2, 2005) ("ABFS I"). Nevertheless, I will discuss the relevant facts here.

ABFS is a diversified financial services organization that sold and serviced business purpose home equity loans through its subsidiaries. ABFS also purchased home equity loans from financial institutions. Plaintiffs allege that the typical customers of ABFS and its subsidiaries were credit-impaired or high-risk borrowers who could not obtain traditional financing from banks or savings and loan associations. During the class period, defendant Santilli served as ABFS's chairman, chief executive officer, chief operating officer, and director, defendant Mandia was ABFS's chief financial officer, and defendants Becker, DeLuca, Sussman, Miller, Palitz, and Steinberg were all directors of ABFS.

This motion to dismiss addresses the amended consolidated class action complaint filed by Noteholders on November 16, 2006. In a related case, I granted defendant shareholders' motion to dismiss on June 2, 2005, largely because the complaint did not plead fraud with particularity. See ABFS I, 413 F. Supp. 2d at 389.

1. General Background

Plaintiffs allege that to raise capital ABFS used a financing technique known as securitization. In its Form 10-K filed with the Securities and Exchange Commission ("SEC") on October 10, 2000, ABFS noted that "[t]he ongoing securitization of our loans is a central part of our current business strategy." In each of its securitizations, ABFS transferred a pool of mortgage loans to a trust in exchange for certificates, notes, or other securities issued by the trust that were then sold to investors for cash. Plaintiffs allege that ABFS would often retain the rights to service the loans for a fee and would retain an interest in the cash flows generated by the securitized loans, called an “interest-only strip” (“IO strip”).

ABFS was able to securitize most of its mortgages from January 2002 through March 2003. In June 2003, however, ABFS was forced to change its business plan because investment banks refused to securitize pools of ABFS mortgages. ABFS began selling the mortgages it originated on a whole loan basis for cash, which was much less profitable than securitization.

ABFS borrowed directly from financial institutions to fund its mortgages. These financial institutions required ABFS to maintain a specific financial condition. If ABFS’s financial condition fell below the specified level, all outstanding loans from the banks would become due.

According to plaintiffs, ABFS pressured its mortgage originators to create as many loans as possible. Under this policy, ABFS mortgage originators frequently sold mortgages to people who could not afford the mortgage payments. One former employee has noted that approximately ten percent of loan customers defaulted on their first payment.

ABFS also funded its operation through the sale of Notes. ABFS sold these Notes through newspaper advertisements, direct mail, and sales calls without the involvement of underwriters or brokers. Plaintiffs assert that ABFS generally did not include a copy of a Prospectus in its solicitations. The Notes offered interest rates well above the prime rate. They were for varying terms, with maturity rates from a few months to as much as ten years. A buyer could choose either to receive interest during the term of each Note or have the interest reinvested in new Notes. The Notes were not transferrable and Noteholders could only cash in the Notes upon their maturity. ABFS rolled over a Note if the Noteholder did not request his money back within a few days of the Note’s maturity date.

For most of the class period, when a Note was coming due, ABFS called or sent notice to the Noteholder. In October or November 2004, ABFS stopped sending these notices. ABFS also began rolling over Notes instead of paying Noteholders, even if the Noteholder requested payment.

2. Materially False and Misleading Statements

A. Delinquency Rates

Plaintiffs allege that from January 27, 2000 to June 26, 2003 all of ABFS's registration statements were materially false and misleading. At the core of plaintiffs' claims is their allegation that ABFS engaged in improper practices to lower artificially the number of loans that were reported as delinquent.[2] These improper practices included forbearance agreements, deferment agreements, and the use of deeds in lieu of foreclosure. Forbearance agreements are agreements negotiated between a borrower and a lender whereby the lender foregoes a given remedy against the borrower for non-payment. Under a forbearance agreement, property held by a non-paying borrower would not be counted as delinquent. Under a deferment agreement, a lender will defer a borrower's payment (including past-due payments, plaintiffs allege) and roll the amount due onto the back of the loan to be paid back over time. Under these agreements, ABFS might also pay taxes, insurance and other fees owed by the borrower. Borrowers subject to these arrangements promised to repay the advanced amounts either at the end of the loan or in a monthly payment plan. A deed in lieu of foreclosure is one type of forbearance device where a delinquent borrower deeds a mortgaged property to a lender in exchange for a release from all

[2]ABFS maintained a department of people whose jobs were to keep delinquency rates as low as possible. One former employee believes that the real rate of delinquency on ABFS's mortgage loans was between 25 and 30 percent.

obligations under a loan.

According to plaintiffs, the 2001 Registration Statement was materially false and misleading because ABFS: (1) did not mention forbearance and deferment agreements by name; (2) did not quantify the number of forbearance and deferment agreements; (3) failed to add the forbearance and deferment amounts to reported delinquency rates; and (4) understated delinquencies by 37.8% as of June 30, 2001. The 2002 Registration Statement was materially false and misleading because ABFS: (1) did not quantify the number of forbearance and deferment agreements; (2) failed to add the forbearance and deferment amounts to reported delinquency rates; and (3) understated delinquencies by 44.8% as of June 30, 2001. The 2003 Registration Statement was materially false and misleading because ABFS: (1) failed to add the forbearance and deferment amounts to reported delinquency amounts and (2) misrepresented the actual forbearance and deferment rate by excluding forbearance and deferment balances that were past due. The 2003 Registration Statement reported balances subject to forbearance and deferment agreements and also included past due forbearance and deferment balances in the delinquency balances.

B. Additional Material Misrepresentations

Plaintiffs also allege that ABFS misrepresented the true purpose of the deferment and forbearance agreements. According to ABFS, the agreements were to relieve borrowers faced with hardship circumstances or temporary financial setbacks. Plaintiffs allege that the true purpose of these agreements was to keep delinquency rates low and to ensure that the securitization pools continued to maintain the value of the IO strips.

Further, plaintiffs assert that all of the Registration Statements informed investors that

ABFS expected to pay back the Notes and pay the promised interest. These representations, according to plaintiffs, lacked a reasonable basis because ABFS's loan portfolio was of poor quality, the value of the IO strips and servicing agreements was materially less than reported, and ABFS's assets and operating results were overstated. In fall of 2004, ABFS stopped paying principal or interest on the Notes and stopped honoring checks written on ABFS money market accounts.

On December 17, 2004, in an amended proposed Regulation Statement filed with the SEC, ABFS stated that it believed it could repay holders of the notes even if the SEC did not allow the proposed Registration Statement to become effective. Six days later, on December 23, 2004, ABFS announced in a press release that it was unable to make any payments on Notes as they became due. That press release also said that the company "may seek protection under the federal bankruptcy laws or may be forced into an involuntary bankruptcy."

According to plaintiffs, ABFS also failed to state that its internal accounting controls were weak or nonexistent. At one point, $4.8 million was allocated into the wrong account. ABFS employees with access to the general ledger could make entries into the accounting system with no apparent oversight, authorization, or review of the transaction being entered.

Further, in its 2003 Registration Statement, ABFS claimed that one of its demonstrated strengths was a "strong credit culture which consistently originates quality performance loans." Plaintiffs allege that this was a misrepresentation because twenty-five percent or more of ABFS's loans were delinquent and at least half of the borrowers could not afford to pay, were elderly and on a fixed income, had health problems, or did not realize that they also had to pay property taxes in addition to the mortgage.

STANDARD OF REVIEW

A Rule 12(b)(6) motion to dismiss examines the sufficiency of the complaint. Conley v. Gibson, 355 U.S. 41, 45 (1957). In determining the sufficiency of the complaint I must accept all the plaintiff's well-pleaded factual allegations as true and draw all reasonable inferences therefrom. Graves v. Lowery, 117 F.3d 723, 726 (3d Cir. 1997).

> The Federal Rules of Civil Procedure do not require a claimant to set out in detail the facts upon which he bases his claim. To the contrary, all the Rules require is "a short and plain statement of the claim" that will give the defendant fair notice of what the plaintiff's claim is and the grounds upon which it rests.

Id., quoting Conley, 355 U.S. at 47. I will not inquire as to whether plaintiffs will ultimately prevail, but only whether they are entitled to offer evidence to support their claims. See Oatway v. Am. Int'l Group, Inc., 325 F.3d 184, 187 (3d Cir. 2003). "Thus [I will] not grant a motion to dismiss 'unless it appears beyond a doubt that the plaintiff can prove no set of facts in support of his claim which would entitle him to relief.'" Graves, 117 F.3d at 726, quoting Conley, 355 U.S. at 45-46.

If plaintiffs' claims are grounded in fraud, Federal Rule of Civil Procedure 9(b) "impose[s] independent threshold pleading requirements that, if not met, support dismissal apart from Rule 12(b)(6)." In re Rockefeller Ctr. Props., Inc. Sec. Litig., 114 F.3d 1410, 1429 (3d Cir. 1997). A securities fraud claim may be dismissed under Rule 9(b) even if it would survive scrutiny under Rule 12(b)(6). Federal Rule of Civil Procedure 9(b) requires that "the circumstances constituting fraud . . . be stated with particularity." Although courts must be sensitive to a situation in which the factual information is in the defendant's control, in securities fraud cases, Rule 9(b) is to be "rigorously applied." In re Burlington Coat Factory Sec. Litig., 114 F.3d 1410, 1417-18 (3d Cir. 1997). "Unless Plaintiffs in securities fraud actions allege facts supporting their contentions of fraud with the requisite particularity mandated by Rule 9(b)[], they may not benefit from inferences flowing from vague or unspecific allegations - inferences that may arguably have been justified under a traditional Rule 12(b)(6) analysis." In re Rockefeller Ctr., 311 F.3d at 224. Any claims of fraud must be alleged with particularity, meaning that plaintiffs must plead "the who, what, where, when, and how: the first paragraph of any newspaper story." In re Advanta Corp. Sec. Litig., 180 F.3d 525, 534 (3d Cir. 1999).

Control person claims are not subject to the heightened pleading requirements of Federal Rule of Civil Procedure 9(b) or the Reform Act. In re Tel-Save Sec. Litig., 1999 U.S. Dist. LEXIS 16800, at *18-19 (E.D. Pa. 1999); see also In re U.S. Interactive, Inc. Sec. Litig., 2002 WL 1971252, at *20 (heightened pleading requirements of Rule 9(b) do not apply to control person claims).

DISCUSSION

1. Alleged Fraudulent Scheme

Defendants argue that plaintiffs fail to plead the existence of a purported fraudulent scheme to lower artificially the number of delinquent loans with the requisite factual particularity. Plaintiffs respond that they are not alleging fraud in their complaint; instead, they argue that their complaint sounds in negligence. "Fraud . . . is not a necessary element to establish a prima facie claim under Section 11 or Section 12(a)(2). In re Suprema Specialties, Inc. Sec. Litig., 438 F.3d 256, 270 (3d Cir. 2006). "Where a plaintiff's Section 11 or Section 12(a)(2) claims are not grounded in allegations of fraud, the liberal notice pleading requirements of Rule 8 apply." In re Suprema Specialties., 438 F.3d at 270. To determine whether a

Securities Act claim is grounded in fraud, I must assess each "particular claim to determine whether acts of fraud on the part of the defendants form the basis for the claim against them." Id.; see also Shapiro v. UJB Fin. Corp., 964 F.2d 272, 288 (3d Cir. 1992).

In each of plaintiffs' securities fraud claims, they include a sentence stating, "This count is not grounded on fraud." A one-sentence disavowment of fraud "does not require [me] to infer that the claims are strict liability or negligence claims." Cal. Pub. Employees Ret. Sys. v. The Chubb Corp., 394 F.3d 126, 160 (3d Cir. 2004) (hereinafter "CALPERS"). This case, however, differs from the CALPERS case in a few fundamental ways. In CALPERS, "[t]he linchpin of Plaintiff's action [was] their allegations that Defendants knowingly and intentionally committed accounting violations." Id. Further, the complaint in CALPERS was "completely devoid of allegations that Defendants acted negligently." Id. at 161.

In their motion to dismiss, defendants argue that the complaint is full of references to ABFS's intentional conduct. A problem arises, however, because the statements defendants mention in their motion are all directed at ABFS, which is not a party to this case.[3] Plaintiffs do not allege that the defendants, former officers and directors of ABFS, committed any intentional wrongdoing; plaintiffs attribute no fraud to the defendants. Instead, they assert that the defendants were negligent in signing the Registration Statements and failing to investigate and correct the material misstatements and omissions about loan quality and other material matters in those statements. For example, in their first claim for relief, plaintiffs allege:

> The individual Defendants each signed one or more of these Registration Statements, rendering them liable to plaintiffs and Class members for the untrue

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[3]Defendants argue that the complaint "brims with references to ABFS' intentional conduct."

> statements and omissions contained therein. The Individual Defendants were officers and/or directors of the Company at the time these Registration Statements became effective and were responsible for the contents of these Registration Statements.

Further, in their second claim for relief, plaintiffs discuss the negligence of the defendants:

> Defendants owed to the purchasers of the Notes, including plaintiffs and other Class members, the duty to make a reasonable and diligent investigation of the statements contained in these Prospectuses, to insure that such statements were true and that there was no omission of a material fact required to be stated in order to make the statements contained therein not misleading. Defendants knew of, or in the exercise of reasonable care should have know[n] of, the misstatements and omissions contained in these Prospectuses.

Throughout the complaint, plaintiffs' allegations do not focus on or refer to the defendants' state of mind. Cf. In re Adams Golf, Inc., Sec. Litig., 176 F. Supp. 2d 216, 229 (D. Del. 2001). Plaintiffs specifically disavow any fraud claims against the directors and officers and do not attribute any fraudulent conduct to them. Therefore, I find that the complaint is not grounded on fraud and need not meet the particularity requirements of Rule 9(b).

2. Statute of Limitations–Claims Based on Delinquency Rates

The individual defendants argue that their disclosures regarding delinquency rates in their Registration Statements and other SEC filings on Forms 8-K and 10-K were sufficient to put investors on notice of their potential claims. 15 U.S.C. § 77(m) provides that claims must be "brought within one year after discovery of the untrue statement or the omission, or after such discovery should have been made by the exercise of reasonable diligence." Inquiry notice applies to securities claims. In re NAHC, Inc. Sec. Litig., 306 F.3d 1314, 1325 (3d Cir. 2002) ("To the extent a securities fraud plaintiff was on inquiry notice of the basis for claims more than one year prior to bringing the action, his or her claim is subsequently time-barred by the requisite statute of limitations.”).

Under the inquiry notice standard, the statute of limitations period begins to run when the plaintiffs “discovered or in the exercise of reasonable diligence should have discovered the basis for their claim.” Id. (citations omitted). As the Court of Appeals has explained:

> Whether the plaintiffs, in the exercise of reasonable diligence, should have known of the basis for their claims depends on whether they had sufficient information of possible wrongdoing to place them on inquiry notice or to excite storm warnings of culpable activities. The test for storm warnings is an objective one, based on whether a reasonable investor of ordinary intelligence would have discovered the information and recognized it as a storm warning. Plaintiffs need not know all of the details or narrow aspects of the alleged fraud to trigger the limitations period; instead, the period begins to run from the time at which plaintiff should have discovered the general fraudulent scheme.

Id. at 1325-26 (citations and quotations omitted) (emphasis added). There is not an exhaustive list of storm warnings, but the Court of Appeals has mentioned: (1) “substantial conflicts between oral representations of the brokers and the text of the prospectus,” (2) “the accumulation of information over a period of time that conflicts with representations that were made when the securities were originally purchased,” and (3) “any financial, legal or other data that would alert a reasonable person to the probability that misleading statements or significant omissions had been made.” Id. at 1326 n.5. “[I]nvestors are presumed to have read prospectuses, quarterly reports, and other information relating to their investments.” Mathews v. Kidder, 260 F.3d 239, 252 (3d. Cir. 2001).

ABFS made numerous disclosures in its 2003 Registration Statement, effective November 7, 2003, that fall under the Court of Appeals’ definition of storm warnings. These disclosures informed plaintiffs that ABFS used forbearance and deferment agreements, that ABFS’s use of these agreements was subject to challenge and that ABFS had not been including accounts subject to forbearance and deferment agreements in their delinquency figures.

ABFS also made numerous disclosures in other public documents[4] that acted as storm warnings of its general fraudulent scheme. ABFS filed a Form 8-K on December 24, 2003, in which it announced a joint agreement with the U.S. Attorney's office regarding ABFS's policy of requiring a deed in lieu of foreclosure as part of forbearance agreements with seriously delinquent customers. Although this represented "a relatively small percentage of the Company's total loan servicing portfolio," it should have indicated to investors that ABFS had engaged in some culpable conduct.

Further, ABFS also filed a Form 10-K on September 29, 2003, which made multiple disclosures about ABFS's treatment of delinquencies. Specifically, the Form 10-K stated:

> Delinquencies in our total managed portfolio do not include $197.7 million of previously delinquent loans at June 30, 2003, which are subject to deferment and forbearance agreements. Generally, a loan remains current after we enter into a deferment or forbearance arrangement with the borrower only if the borrower makes the principal and interest payments as required under the terms of the original note (exclusive of the delinquent payments advanced or fees paid by us on the borrower's behalf as part of the deferment or forbearance arrangement) and <u>we do not reflect it as a delinquent loan in our delinquency statistics</u>.

(emphasis added). After the 2003 Registration Statement, the December Form 8-K, and the September 10-K, plaintiffs had specific information of wrongdoing to place them on inquiry notice of ABFS's treatment of delinquent loans. Even if any one of these disclosures, if taken alone, did not constitute a sufficient storm warning, the disclosures together certainly put

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[4]When evaluating a motion to dismiss, I may only consider the complaint, documents attached to the complaint, and "matters incorporated by reference or integral to the claim, items subject to judicial notice, matters of public record, orders, [and] items appearing in the record of the case." <u>Buck v. Hampton Township School District</u>, 452 F.3d 256, 260 (3d. Cir. 2006) <u>citing</u> 5B Charles A. Wright and Arthur R. Miller, <u>Federal Practice & Procedure</u> § 1357 (3d ed. 2004).

plaintiffs on notice of culpable behavior.[5] Therefore, at the latest, the statute of limitations on the delinquency numbers began tolling on December 24, 2003 and the plaintiffs claims regarding delinquency rates, filed on January 18, 2005, are barred by the statute of limitations. I will dismiss these claims from the complaint.[6]

3. Other Alleged Misleading Statements and Omissions

A. ABFS's Ability to Repay the Notes

Next, defendants contend that plaintiffs' claims based on the abilities of ABFS to repay the Notes are not actionable. Defendants argue that plaintiffs have proffered no support for their assertions that ABFS's loan portfolio was of poor quality, and that the value of the IO strips, servicing agreements, assets, and operating results were overstated. As I discussed above, however, the complaint is grounded in negligence, not fraud, and plaintiffs need only plead a short, plain statement of the claim demonstrating that they are entitled to relief. Therefore, I will not dismiss these claims.

B. Internal Controls

Defendants also assert that plaintiffs have not demonstrated in their complaint that ABFS

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[5]Plaintiffs argue that no cause of action existed until noteholders suffered damages. The cases they reference in support of this theory, however, discuss economic loss as one factor to consider in analyzing whether plaintiff was on inquiry notice of a claim. See, e.g., Mathews, 260 F.3d at 252 ("storm warnings may take numerous forms"). For instance, in Benek v. Alliance Capital, the Court of Appeals considered when a mutual fund investor would be on inquiry notice of a securities fraud claim. 435 F.3d 396, 403 (3d Cir. 2006). Unlike a direct investor, the Court held, a mutual fund investor may not know whether he or she is invested in the company until the fund suffers a loss. See id. A direct investor, however, "has or can be deemed to have consistent knowledge of his or her securities holdings." Id. at 401.

[6]Defendants also assert that the delinquency rates were not material, but I need not analyze that argument here because the claims are time-barred.

lacked adequate internal controls. Once again, plaintiffs need only plead a short, plain statement of the claim demonstrating that they are entitled to relief to survive a motion to dismiss. Plaintiffs have met this burden regarding ABFS's lack of internal controls, and thus I will not dismiss this claim.

C. Materiality and Puffing

Defendants argue that some of the alleged misstatements plaintiffs challenge in their complaint are immaterial puffery. For each statement, there must be a substantial likelihood that the statements or omissions in defendants' SEC filings and press releases "would have been viewed by the reasonable investor as having significantly altered the total mix of information available to the investor." In re NAHC, Inc. Sec. Litig, 306 F.3d 1314, 1330 (3d Cir. 2002), citing Basic Inc. v. Levinson, 485 U.S. 224, 231-32 (1988). "The materiality question asks of each statement: is the allegedly false statement, in the context in which it was publicized, 'information that would be important to a reasonable investor in making his or her investment decision.'" Loewen I., 2003 U.S. Dist. LEXIS 15680, at *44 (citation omitted). Materiality is a mixed question of law and fact and "[o]nly if the alleged misrepresentation or omissions are so obviously unimportant to an investor that reasonable minds cannot differ on materiality is it appropriate for the district court to rule that the allegations are inactionable as a matter of law." Weiner v. Quaker Oats Co., 129 F.3d 301, 317 (3d Cir. 1997) (quotation omitted).

"Vague and general statements of optimism that constitute no more than 'puffery' and are understood by reasonable investors as such" will not support a claim of securities fraud. In re Advanta, 180 F.3d at 538. Statements are immaterial when they are so exaggerated or so vague that reasonable investors would not rely on them in considering the total mix of available information. Hoxworth, 903 F.2d at 200, citing TSC Indus. Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976). "The theory behind not holding defendants liable for puffery is that reasonable investors would consider the source of such optimism and consequently not allow it to affect unduly their opinion of the stock." Loewen I, 2003 U.S. Dist. LEXIS 15680, at *42.

Defendants argue that ABFS's statement in the 2003 Registration Statement that its "demonstrated strengths" included "a strong credit culture which consistently originates quality performance loans" was immaterial puffery. I agree. The phrases "a strong credit culture" and "quality performance loans" are the type of vague statements that fall squarely under the definition of puffery. There is not a substantial likelihood that the above statement would have been viewed by a reasonable investor as significantly altering the total mix of available information. Therefore, I will dismiss the claims based on ABFS's "strong credit culture."

4. Section 12 Claims

Defendants next argue that plaintiffs' Section 12 claims should be dismissed because plaintiffs do not allege that the defendants were offerors, sellers, or solicitors of purchases of the Notes. Under Section 12 of the Securities Act of 1933, any person who "offers or sells" a security in violation of securities laws shall be liable "to the person purchasing such security from him." 15 U.S.C. § 77l. "The 'purchase from' requirement of § 12 focuses on the defendant's relationship with the plaintiff-purchaser." Pinter v. Dahl, 486 U.S. 622, 651 (1987). An issuer is not liable "solely on the basis of its involvement in preparing the prospectus." In re Craftmatic Sec. Litig., 890 F.2d 628, 636 (3d Cir. 1989). "The purchaser must demonstrate direct and active participation in the solicitation of the immediate sale to hold the issuer liable as a § 12(2) seller." Id.

In their complaint, plaintiffs allege that "all defendants were offerors and/or solicitors of sales of the Notes." For Santilli and Mandia, the complaint is slightly more specific, stating, "Defendants Santilli and Mandia, as control persons of ABFI, caused ABFI to sell new securities when it renewed the matured Notes of members of the Subclass." I agree with defendants that plaintiffs do not allege any facts that demonstrate the active participation of any defendant or any relationship between any defendant and any plaintiff-purchaser. However, the plaintiffs, at this point in the litigation, do not need to offer any facts. They must merely offer a short and plain statement of the claim, which they have done here. Therefore, I will deny defendants' motion to dismiss the Section 12 claims.

5. Section 5 Claims

Defendants also assert that I should dismiss plaintiffs' Section 5 claims in Counts II, IV, and V because there is no private right of action under Section 5 of the Securities Act. Plaintiffs agree that there is no private right of action under Section 5; instead, Section 12 of the 1933 Act gives the purchaser of securities a private right of actions for underlying violations of Section 5. Therefore, because plaintiffs may bring their Section 5 actions pursuant to Section 12, I will not dismiss plaintiffs' Section 5 claims.

6. Statute of Limitations for Count VI

Sabina Langdon is the only individual plaintiff asserting Count VI against defendants Santilli and Mandia for selling a security without a prospectus. Defendants claim that the claims asserted in Count VI for selling without a prospectus are barred by the one-year statute of limitations for these claims.[7] 15 U.S.C. § 77m. In their response, plaintiffs note that the complaint was filed less than a year after ABFS rolled over No Prospectus Subclass Plaintiff Sabina Langdon's Note. Defendants argue that this fact was not alleged in the complaint, and that therefore it should be dismissed. I disagree. The complaint alleges that, beginning in October or November 2004 and continuing throughout the class period, ABFS rolled over existing notes instead of allowing plaintiffs to cash them in. This rollover falls under the definition of "sale," and therefore the statute of limitations should be measured from the date of the rollover. See 15 U.S.C. 77b (a)(3) (defining "sale" or "sell" to include the exercise of a "right of conversion or subscription"). Therefore, at this point in the litigation, I cannot say that plaintiff Langdon cannot prove a set of facts in support of her claim which would entitle her to relief.

7. Count V

Count V of the complaint is based on plaintiffs' assertion that the 2003 Registration Statement was not effective after October 31, 2004. Defendants assert that the claims asserted in Count V are barred because plaintiffs cite no underlying violation of Section 5(a).

Specifically, in Count V of the complaint, plaintiffs allege: "Defendants Santilli and Mandia, as control persons of ABFI, caused ABFI to sell new securities when it renewed the matured Notes of members of the Subclass, after the date the 2003 Registration Statement was no longer effective, on or about October 31, 2004." Further, in their response, plaintiffs argue that ABFS could not sell more notes because the SEC refused to declare ABFS's October 2004

[7]According to Langdon's certification, she last purchased notes from ABFS on December 1, 2003.

Registration Statement effective. Plaintiffs argue that it is an issue of fact whether the November 7, 2003 Registration Statement ceased to be in effect.

I agree with defendants. Although registration statements must be amended or updated to reflect changes in information, they do not expire. See Louis Loss & Joel Seligman, Fundamentals of Securities Regulation 136 (5th ed. 2004) ("[I]n the absence of a stop order [a registration] statement remains in effect and sales may legally be made so far as § 5 is concerned."). Plaintiffs cite no cases or secondary sources to dispute this assertion and there is no disputed issue of fact as to the existence of the November 7, 2003 Registration Statement. Therefore, I will grant defendants' motion to dismiss Count V.

8. Count VI

Count VI of plaintiffs' complaint seems to assert a claim under Section 29 of the Exchange Act for rescission of a contract against defendants Santilli and Mandia. Section 29(b) of the Securities Exchange Act of 1934 provides, "Every contract made in violation of any provision of this chapter or of any rule or regulation thereunder . . . shall be void." 15 U.S.C. § 78cc(b). To void an agreement under Section 29(b), a plaintiff "must establish that: (1) the contract involved a prohibited transaction; (2) [plaintiff] was in contractual privity with [defendant]; and (3) [plaintiff] is in the class of persons that the securities acts were designed to protect." Berckely Investment Group, Ltd. v. Colkitt, 455 F.3d 195, 205 (3d Cir. 2006).

Plaintiffs have not alleged that they were in direct contractual privity with defendants Santilli and Mandia at any point. Instead, they suggest in their response to defendants' motion that Santilli and Mania controlled ABFS through employees who sold the Notes to plaintiffs, so as to bring them within the provisions of control person liability under Section 20 of the 1934

Act. Defendants argue that the officers or directors themselves must be in contractual privity with the plaintiffs and that plaintiffs cannot use control person liability to succeed on a Section 29 claim.

I agree with plaintiffs. Section 20 provides:

> Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.

15 U.S.C. § 78t. The plain language of § 20 provides that control persons can be found liable for the Securities Act violations of the companies they control. Therefore, I will not dismiss plaintiffs Section 29 rescission claim.

<u>9.</u> <u>Control Person Liability</u>

A. Underlying Claims

A corporate officer or director can be liable under Section 15 for exercising control over a corporation that commits securities fraud. Section 15 of the Securities Exchange Act of 1933 provides that:

> Every person who, by or through stock ownership, agency, or otherwise, or who, pursuant to or in connection with an agreement or understanding with one or more other persons by or through stock ownership, agency, or otherwise, controls any person liable under sections 77k [§ 11] or 77l [§ 12] of this title, shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person had no knowledge of or reasonable ground to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist.

15 U.S.C. § 77o.[8] Plaintiffs alleging a control person claim must plead facts showing a primary violation of the securities fraud laws by the company and circumstances establishing the individual defendants' control over the company. In re MobileMedia Sec. Litig., 28 F. Supp. 2d 901, 940 (D.N.J. 1998). Defendants first argue that plaintiffs cannot sustain a cause of action for control person liability because plaintiffs have not stated viable claims under either Section 11 or Section 12. As I discussed above, plaintiffs have met their burden and have stated viable securities fraud claims. Therefore, I will not dismiss plaintiffs' control person claims for failure to allege a primary securities law violation by ABFS.

B. Culpable Participation

Defendants also argue that plaintiffs' control person claims should be dismissed for failure to allege culpable participation. I disagree. The Court of Appeals has held that "secondary liability cannot be found under Section 20(a) unless it can be shown that the defendant was a culpable participant in the fraud." Rochez Bros., Inc. v. Rhoades, 527 F.2d 880, 890 (3d Cir. 1975). Courts in this Circuit have split over whether culpable participation must be pled in the complaint. Compare In re Digital Island Sec. Litig., 223 F. Supp. 2d 546, 561 (D. Del. 2002) ("the heightened standard of the PSLRA requires that a claim under Section 20(a) state with particularity the circumstances of . . . the defendants' culpability as control persons") with Jones v. Intelli-Check, Inc., 274 F. Supp. 2d 615, 645 (D.N.J. 2003) ("culpable participation does not have to be plead in order to survive a motion to dismiss").

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[8]Before I begin my analysis, I note that plaintiffs and defendants agree that control person liability under § 20 of the 1934 Act is the same as control person liability under § 15 of the 1933 Act, so my analysis may rely on decisions relating to either section. See Tracienda Corp. v. DaimerChrysler AG, 197 F. Supp. 2d 42, 55 (D. Del. 2002).

I agree with the reasoning in Derensis v. Coopers & Lybrand Chtd. Accountants, 930 F. Supp. 1003 (D.N.J. 1996). In Derensis, the Court reasoned that the plaintiff need not plead culpable participation because: "(1) the facts establishing culpable participation can only be expected to emerge after discovery; and (2) virtually all of the remaining evidence, should it exist, is usually within the defendants' control." Id. (citation omitted). Further, "the overwhelming trend in this circuit is that culpable participation does not have to be pled in order to survive a motion to dismiss." Freed v. Universal Health Svcs., 2005 U.S. Dist. LEXIS 7789, at *35 n.6 (E.D. Pa. 2005) (citations omitted). Accordingly, I will not dismiss plaintiffs' control person claim for their failure to allege culpable participation in their complaint.

C. Control of the Outside Directors

Finally, defendants assert that plaintiffs cannot sustain a cause of action for control person liability because plaintiffs have not alleged control by the outside directors, Becker, DeLuca, Sussman, Miller, Palitz and Steinberg.[9] Control person claims are not subject to the heightened pleading requirements of Federal Rule of Civil Procedure 9(b) or the Reform Act. In re Tel-Save Sec. Litig., 1999 U.S. Dist. LEXIS 16800, at *18-19 (E.D. Pa 1999); see also In re U.S. Interactive, Inc. Sec. Litig., 2002 WL 1971252, at *20 (heightened pleading requirements of Rule 9(b) do not apply to control person claims). "Allegations that a director signed a fraudulent SEC filing and was in a position to exercise control over the primary violator are sufficient to withstand a motion to dismiss." In re Tel-Save, 1999 U.S. Dist. LEXIS 16800, at *19. As I discussed above, I will not grant a motion to dismiss unless "the plaintiff can prove no set of

[9]Defendants do not contest ABFS's control by the internal directors, defendants Santilli and Mandia.

facts in support of his claim which would entitle him to relief.'" Graves, 117 F.3d at 726, quoting Conley, 355 U.S. at 45-46.

I will not dismiss plaintiffs' control person claim over the outside defendants for failure to demonstrate that defendants were controlling persons. I disagree with the cases that defendants cite that require a higher standard for pleading control over the primary violator. See, e.g., Picard Chem. Inc. Profit Sharing Plan v. Perrigo Co., 940 F. Supp. 1101, 1134-35 (W.D. Mich. 1996) (finding that "rational inference of control may not be drawn" from outside directors who signed the Registration Statement and served on director committees). Plaintiffs have pled that "defendants, by virtue of their positions as officers and/or directors of ABFI, had the power, which they exercised, to control the representations and actions of ABFI and of one another." I cannot say, at this point in the litigation, that plaintiffs cannot prove a set of facts which will entitle them to relief on the control person claims. Therefore, defendants' motion to dismiss the control person claims is denied.

An appropriate Order follows.

IN THE UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF PENNSYLVANIA

IN RE AMERICAN BUSINESS FINANCIAL SERVICES, INC. SECURITIES LITIGATION	:	MASTER FILE NO. 05-252

ORDER

AND NOW, this 9th day of January, 2007, after considering defendants' motion to dismiss, plaintiffs' opposition thereto, defendants' reply brief and for the reasons set forth in the accompanying memorandum, it is ORDERED that defendants' motion is GRANTED IN PART and DENIED IN PART. Defendants' motion to dismiss is GRANTED as to:

1. Plaintiffs' claims based on delinquency rates.
2. The claim based on ABFS's "strong credit culture."
3. Count V of the complaint regarding sales of a security without a Registration Statement.

Defendants motion to dismiss is DENIED as to all other claims.

s/ Thomas N. O'Neill, Jr.
THOMAS N. O'NEILL, JR., J.