

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

GERALYN R. WALISH and : CIVIL ACTION
ROBERT a/k/a RON COLE, :
Plaintiffs, :
 :
v. :
 :
THE LEVERAGE GROUP, INC., :
TENIC, INC., FRANK JERSEY, :
WENDY JERSEY, WILLIAM "BILL" :
THORTON, Ind. and as Senior :
Officers of Tenic, Inc., and :
as Senior Officers and :
Directors of The Leverage :
Group, Inc., Jointly :
and Severally, : NO. 97-CV-5908
Defendants. :

MEMORANDUM AND ORDER

J. M. KELLY, J.

June , 1998

Plaintiffs Geralyn Walish ("Walish") and Robert Cole brought this action claiming violations of federal securities laws and a number of related claims. The Motion of All Defendants to Dismiss the Complaint is presently before the Court. For the reasons stated below, the motion is granted.

BACKGROUND

According to the Complaint, Plaintiffs Walish and Cole purchased common stock of Tenic, Inc. ("Tenic").¹ ¶ 5. Walish was an employee of Defendant The Leverage Group ("TLG"). ¶ 94. Frank Jersey, Wendy Jersey and William Thorton ("The Individual

¹ On a motion to dismiss, the factual allegations in the complaint are accepted as true.

Defendants") were each shareholders, officers and directors of TLG and Tenic. ¶¶ 10-14.

The Plaintiffs purchased Tenic stock "based on certain representations by the Individual Defendants, specifically that Tenic would market 'lesser software products' i.e. software packages/programs costing less than \$250,000.00, via the internet and mail order catalogs." ¶ 6. This business strategy would require little overhead. ¶ 6. The Defendants represented to the Plaintiffs that Tenic would be a "viable corporation and begin generating revenue in 1996." ¶ 6. Despite this, on two occasions in the spring of 1995, Frank Jersey stated to two different employees of TLG that "If it [Tenic, Inc.] doesn't fly I'll just take the tax write-off." ¶ 18.

After the Plaintiffs began purchasing Tenic stock, the Individual Defendants made a number of decisions that caused Tenic to collapse. The Individual Defendants changed Tenic's product line from "lesser software products" (\$250,000 or less) to "substantial software products" (packages worth more than \$1.2 million). ¶ 21. They caused Tenic to employ Jennifer Jersey, even though Frank Jersey knew she was incompetent. ¶ 23. They failed to execute certain contracts with TLG and breached a contract with a vendor. ¶¶ 26, 31. The Individual Defendants also permitted "false and misleading accounting practices." ¶ 34.

In July, 1996, the Individual Defendants failed to make scheduled contributions to Tenic's operating funds and Frank Jersey unilaterally decided to shut Tenic down. ¶¶ 20, 24, 33. The Individual Defendants and TLG each received "tax relief or a tax write off" as a result of the failure of Tenic. ¶ 19.

The Defendants "participated in a continuous course of conduct and conspiracy to conceal adverse material information regarding Tenic," made "untrue statements of material facts" and failed to "state material facts necessary in order to make the statements made . . . not misleading." ¶¶ 41, 43. The Individual Defendants knowingly made false statements of material fact "with the intent to deceive and defraud the Plaintiffs" and "recklessly created a false and misleading impression regarding Tenic's viability as a corporation." ¶¶ 46, 82.

The Defendants were "sellers, offerors, and/or solicitors" of the shares offered to the Plaintiffs pursuant to a Memorandum (characterized as a "Defacto prospectus"), a "Business Plan" and other unspecified oral and written communications. ¶ 57. These communications also contained "untrue statements of material facts." ¶ 58.

The Plaintiffs claim that the conduct of all Defendants violated Section 10(b) of the Securities Exchange Act of 1934 ("1934 Act"), 15 U.S.C. § 78j(b), S.E.C. Rule 10b-5, 17 C.F.R. § 240.10b-5 and Section 12(2) of the Securities Act of 1933 ("1933

Act”), 15 U.S.C. § 771(a)(2). They also allege that each of the Individual Defendants are liable as “control persons” of Tenic under Section 20(a) of the 1934 Act, 15 U.S.C. § 78t(a) and Section 15 of the 1933 Act, 15 U.S.C. § 77o. The Complaint also asserts a number of state law claims.

LEGAL STANDARD

The purpose of a motion to dismiss under Federal Rule of Civil Procedure 12(b)(6) is to test the legal sufficiency of a complaint. See Sturm v. Clark, 835 F.2d 1009, 1011 (3d Cir. 1987). A complaint may be dismissed for failure to state a claim upon which relief may be granted if the facts pled and reasonable inferences therefrom are legally insufficient to support the relief requested. See Commonwealth ex. rel. Zimmerman v. Pepsico, Inc., 836 F.2d 173, 179 (3d Cir. 1988). In reviewing a motion to dismiss, all allegations in the complaint and all reasonable inferences that can be drawn therefrom must be accepted as true and viewed in the light most favorable to the non-moving party. See Wisniewski v. Johns-Manville Corp., 759 F.2d 271 (3d Cir. 1985).

DISCUSSION

A. 1934 Act Claims

Section 10(b) of the 1934 Act states:

It shall be unlawful . . . To use or employ, in connection with the purchase or sale of any security, . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission [SEC] may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78j(b).

S.E.C. Rule 10b-5 implements the above provision. It provides:

It shall be unlawful for any person . . . 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 light of the circumstances under which they were made, not misleading.

17 C.F.R. § 240.10b-5.

Because of concern that frivolous claims can seriously damage a defendant's reputation, fraud claims have long been subject to heightened pleading standards. Federal Rule of Civil Procedure 9(b) requires that "[i]n all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity." Fed. R. Civ. P. 9(b). A fraud complaint must state "the who, what, when, where and how: the first paragraph of any newspaper story." DiLeo v. Ernst & Young, 901 F.2d 624, 627 (7th Cir. 1990).

In 1995, Congress found that Rule 9(b) "has not prevented abuse of securities laws by private litigants." H.R. Conf. Rep. No. 104-369, 104th Cong., 1st Sess., at 41 (1995). Congress enacted the Private Securities Litigation Reform Act. Pub. L. No. 104-67 ("PSLRA"). The Conference Report states that the legislation was "prompted by significant evidence of abuse in private securities lawsuits" and that it "implements needed procedural protections to discourage frivolous lawsuits." Conference Report at 31.

The PSLRA requires that in any private action in which the plaintiff alleges that the defendant made an untrue statement of material fact, or omitted to state material facts:

the complaint shall specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed.

15 U.S.C. § 78u-4(b)(1). If a claim requires proof of the defendant's state of mind, the PSLRA requires that the complaint "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).

The "required state of mind" in Section 10(b) cases is scienter.² Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 n.12

² Courts have differed in their interpretation of the PSLRA and its legislative history. A number of courts have interpreted

(1976). The Third Circuit has held that in this context, scienter includes both intentional conduct and a form of "recklessness." In re Phillips Petroleum Sec. Litig., 881 F.2d 1236, 1244 (3d Cir. 1989). "Recklessness is defined as an extreme departure from the standard of ordinary care . . . which presents a danger of misleading . . . that is either known to the defendant or is so obvious that the actor must be aware of it." Id.

Therefore, a plaintiff claiming securities fraud must allege that the defendant "(1) made misstatements or omissions, (2) of material fact, (3) with scienter, (4) in connection with the purchase or sale of securities, (5) upon which the plaintiff relied, and (6) that reliance proximately caused the plaintiff's injuries." Id. The complaint must specify each statement alleged to have been misleading and the reason or reasons why the

the PSLRA to require the plaintiff to set forth specific facts that constitute strong circumstantial evidence of conscious fraudulent behavior. Friedberg v. Discreet Logic, Inc., 959 F. Supp. 42, 50 (D. Mass. 1997); In re Silicon Graphics, No. C-96-0393, 1996 WL 664639, at *6 (N.D. Cal. Sept 25, 1996); Norwood Venture Corp. v. Converse Inc., 959 F. Supp. 205, 208 (S.D.N.Y. 1997). Other courts have interpreted the PSLRA to require the plaintiff to allege facts that give rise to a strong inference of either conscious or reckless behavior. In re Baesa Secs. Litig., 969 F. Supp. 238, 240-43 (S.D.N.Y. 1997); Walther v. Maricopa Int'l Inv. Corp., 97-CIV-4816, 1998 WL 186736 (S.D.N.Y. April 17, 1998).

When Congress enacted the PSLRA, it changed the procedural requirements in securities fraud cases, but it did not change the underlying substantive law. The "required state of mind" in Section 10(b) cases was and is scienter.

statement is misleading. 15 U.S.C. § 78u-4(b)(1). The complaint must also state with particularity facts giving rise to a strong inference that the misstatements were made purposely or in reckless disregard of the truth. 15 U.S.C. § 78u-4(b)(2).

The complaint in this case does not meet these standards. The Plaintiffs do not specify the alleged misstatements and do not even attempt to identify the "who, what, when, where and how" of each statement. The complaint is largely made up of conclusory allegations without a factual basis. In re Donald J. Trump Casino Secs. Litig., 793 F. Supp. 543, 547 (D.N.J. 1992).

The complaint does not allege facts giving rise to a strong inference that any misstatements attributed to the Defendants were made purposely or recklessly. The rote allegations that Defendants "knowingly made false statements of material fact with the intent to deceive and defraud the Plaintiffs" and "recklessly created a false and misleading impression regarding Tenic's viability as a corporation" do not meet the standards for pleading scienter under the PSLRA.

The allegation that the Defendants decided to change Tenic's product line from "lesser" to "substantial" software products does not raise an inference of fraudulent intent. The allegation that the Defendants stated that Tenic would be a "viable corporation and begin generating revenue in 1996" also does not raise an inference of wrongdoing. "A plaintiff cannot simply

couple a factual statement with a conclusory allegation of fraudulent intent to adequately plead scienter. . . . Nor is it sufficient to simply allege statements of a prosperous future compared to a bleaker reality." Norwood Venture Corp, 959 F. Supp. at 208.

The allegation that Frank Jersey said "if it [Tenic, Inc.] doesn't fly I'll just take the tax write-off," does not raise a strong inference of fraud or recklessness. The fact that an investor plans to take a "tax write off" if an investment fails, without more, does not raise an inference of wrongdoing. Cf. San Leandro Emergency Med. Group Profit Sharing Plan, 75 F.3d 801, 815 (2d Cir. 1996)(company's alleged desire to maintain high bond and credit rating does not raise inference of scienter).

Plaintiffs' Section 10(b) claim is dismissed without prejudice. The pleading requirements of the PSLRA are relatively new. Justice requires that the Plaintiffs be afforded another opportunity to state a claim.

The Complaint also alleges that the Individual Defendants are liable as "control persons" under Section 20(a) of the 1934 Act. 15 U.S.C. § 78t(a). Because Plaintiffs failed to state a primary violation of the 1934 Act, their "control person" claims must also be dismissed. Shapiro v. UJB Fin. Corp., 964 F.2d 272, 279 (3d Cir. 1992).

B. 1933 Act Claim

Section 12(2) of the Securities Act of 1933 imposes liability upon any person who negligently:

offers or sells a security . . . by means of a prospectus or oral communication, which includes an untrue statement of material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading.

15 U.S.C. § 771(a)(2). Unlike Section 10(b) of the 1934 Act, Section 12(2) does not require proof of scienter or reliance. As discussed below, however, the right of rescission provided by Section 12(2) only applies to public offerings of securities by means of a "prospectus."

The Plaintiffs claim that a memorandum, written by Walsh, is a "Defacto Prospectus." The memorandum sets out a business plan, a budget and a schedule for investment of capital. The Plaintiffs claim that they relied on untrue statements in this "prospectus."

In Gustafson v. Alloyd Co., 513 U.S. 561 (1995), the Supreme Court considered whether Section 12(2) applies to private sales of securities. In Gustafson, disappointed purchasers of a privately held corporation sued for rescission. Id. at 565. The Plaintiffs' theory was that the parties' purchase agreement was a "prospectus" and that it contained material misstatements of fact actionable under Section 12(2). Id. at 566.

After examining the text, structure and legislative history of the 1933 Act, the Court held that the term "prospectus" "refers to a document that describes a public offering of securities by an issuer or controlling shareholder." Id. at 584. The private sellers in Gustafson were not subject to liability under the 1933 Act for statements in the purchase agreement. The Court unequivocally stated: "[t]he intent of Congress and the design of the statute require that Section 12(2) liability be limited to public offerings." Id. at 578.

Relying on Jenkins v. Fidelity Bank, 365 F. Supp. 1391, 1396 (E.D. Pa. 1973), the Plaintiffs respond that the motion to dismiss the 1933 Act claims is premature, because "the defendant has the burden of proving exemption from registration requirements." In Jenkins, the defendants sought dismissal on the ground that the securities they sold were exempt under Section 3 of the 1933 Act. Section 3 excludes certain types of financial instruments from the Act's coverage. 15 U.S.C. § 77c. Section 12(2) specifically states that a person who sells securities to the public by means of a prospectus may be liable regardless of whether the security is exempted by Section 3. 15 U.S.C. § 771(a)(2). Thus, under the facts of Jenkins, dismissal was not appropriate.

In this case, the Defendants do not claim that the interests they sold are exempt under Section 3. The Defendants contention

is that they did not make a public offering of securities, by means of a "prospectus," and thus their sale is not subject to Section 12(2). The complaint does not allege that the sale was a public offering of securities and the "defacto prospectus," on which the Plaintiffs rely, shows that this was a private transaction involving six investors. In re Burlington Coat Factory Sec. Litig., 114 F.3d 1410, 1426 (3d Cir. 1997)(on motion to dismiss, Court may consider documents "integral to" or "relied on" in complaint). Gustafson clearly states that Section 12(2) does not apply to private sales of securities. The Plaintiffs' contention, that dismissal would be premature, ignores the facts and controlling Supreme Court authority. Plaintiff's claim under Section 12(2) is dismissed with prejudice.³

The Complaint also alleges that the Individual Defendants are liable as "control persons" under Section 15 of the 1933 Act. 15 U.S.C. § 77o. Because Plaintiffs failed to state a claim for a primary violation of the 1933 Act, their "control person" claim must also be dismissed. Dennis v. General Imaging, Inc., 918 F.2d 496, 508-09 (5th Cir. 1990).

³ The heading of Count III of the complaint states that the claim is brought under Section 12(2), but the body of the count states that the claim is brought under Sections 12(2) and 17. The complaint does not allege facts sufficient to state a claim under Section 17 and the Plaintiffs do not discuss a claim under Section 17 in their response to the motion to dismiss.

C. State Law Claims

The only source for jurisdiction over Plaintiff's state law claims is the supplemental jurisdiction statute. 28 U.S.C. § 1367.⁴ Now that the federal claims have been dismissed, I will not exercise jurisdiction over the state law claims. 28 U.S.C. § 1367(c)(3).

⁴ The Plaintiffs alleges that jurisdiction is also proper under the diversity statute. 28 U.S.C. § 1332. The complaint does not, however, set out the citizenship of each of the parties.

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as Senior Officers and :
Directors of The Leverage :
Group, Inc., Jointly :
and Severally : NO. 97-CV-5908
Defendants. :

ORDER

AND NOW, this day of June, 1998, after consideration of the Motion of All Defendants to Dismiss the Complaint, and the Plaintiff's response, it is ordered:

1. Counts I and II (1934 Act claims), and Counts V through XIII (state law claims) of the complaint are dismissed without prejudice;
2. Counts III and IV (1933 Act claims) are dismissed with prejudice.
3. This case is now closed.

BY THE COURT:

JAMES MCGIRR KELLY, J.