

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

DONALD E. GARRETT,	:	CIVIL ACTION
Plaintiff,	:	
	:	
v.	:	
	:	
TSENG LABS, INC.	:	
Defendant.	:	NO. 98-1933

MEMORANDUM

Reed, J.

December 7, 1998

Presently before the Court is the motion of defendant Tseng Labs, Inc. (“Tseng”) to dismiss the complaint pursuant to Federal Rule of Civil Procedure 12(b)(6), (Document No. 2) the response of the plaintiff Donald E. Garrett (“Garrett”), (Document No. 3) and Tseng’s reply in support of its motion to dismiss (Document No. 4). Based on the following analysis, the motion will be granted.

I. Background

This dispute arises from the alleged failure of Garrett’s employer Tseng to tender stock in accordance with Garrett’s stock option agreement. (Complaint ¶¶ 7, 12.) According to Garrett’s complaint Garrett was employed by Tseng as an Engineer from July of 1993 until October of 1997. (Complaint ¶ 5.) Pursuant to the Tseng Labs, Inc. Stock Option Plan, Garrett was occasionally granted options to purchase stock. (Complaint ¶ 6.) Garrett asserts that in March of 1997 he was given the opportunity to replace his existing options with new stock options that had a different exercise price and would become exercisable or vest on either August 31, 1997 or on the vesting date of the existing shares depending on which was later. Garrett decided to receive

the new stock options. (Complaint ¶ 7.) Garrett alleges that on August 26, 1997 he contacted a broker in order to exercise his options and was advised that his order would be completed on September 2, 1997 which was the first business day after the vesting date of his options.

(Complaint ¶¶ 8-9.) Garrett alleges that on September 2, 1997 Tseng prohibited all employees from trading the company's common stock. (Complaint ¶¶ 10-11.) The complaint states that Tseng did not lift the prohibition until December 18, 1997 at which time Garrett alleges that the price of Tseng's stock was so low that it prevented Garrett from making a profit on his options. (Complaint ¶ 14.) Garrett asserts that if he had been able to exercise his options on September 2, 1997 he would have realized a gain of \$55,000.00. (Complaint ¶ 13.) Garrett states that the reason Tseng gave for the prohibition was that the prohibition was necessary to prevent the violation of insider trading rules. Garrett alleges that this reason was false and that Tseng knew it was false. (Complaint ¶ 19.)

Based on these facts, Garrett filed a complaint against Tseng in this Court for violations of federal and state law. Specifically, Garrett alleges liabilities under §10(b) of the Securities Exchange Act of 1934, 15 U.S.C. §78j(b) and Rule 10(b)(5), 17 C.F.R. § 240.10b-5, promulgated by the Securities and Exchange Commission (Count I, ¶¶ 16-24), and §501 of the Pennsylvania Securities Act of 1972, 70 P.S. §1-501 (Count II, ¶¶ 25-27). Garrett also alleges a claim under common law for breach of contract (Count III, ¶¶ 28-31).

II. The Arguments of the Defendant

Tseng argues that Count I fails to state a claim under federal securities laws because Garrett does not state a claim that occurs in "connection with" the purchase or sale of a security. Tseng also alleges that Garrett fails to allege the requisite fraud with sufficient particularity and

fails to adequately plead the necessary elements of scienter and reliance.

Furthermore, Tseng notes that the state securities claims have the same requirements as the federal claims: in order to state a claim one must plead fraud “in connection with” the purchase or sale of the security as well as plead fraud with particularity, as well as scienter, and reliance. Because Garrett has not done so, Tseng claims that Count II must also be dismissed. Tseng also argues that because the federal claims must be dismissed and the Court’s only basis for jurisdiction over the state claims is supplemental, the state claims in Counts II and III must also be dismissed.

III. Standard for a Motion to Dismiss

Rule 12(b) of the Federal Rules of Civil Procedure provides that “the following defenses may at the option of the pleader be made by motion: (6) failure to state a claim upon which relief can be granted.” In deciding a motion to dismiss under Rule 12(b)(6), a court must take all well pleaded facts in the complaint as true and view them in the light most favorable to the plaintiff. See Jenkins v. McKeithen, 395 U.S. 411, 421 (1969).

Generally, the Federal Rules of Civil Procedure hold claims to the standard of notice pleading. See Fed. R. Civ. P. 8(a) (stating that pleadings should contain “a short and plain statement of the claim showing that the pleader is entitled to relief”). A motion to dismiss the complaint for insufficiency of the pleadings should be denied “unless it appears beyond doubt that the plaintiff can prove no set of facts in support of his claim which would entitle him to relief.” Conley v. Gibson, 355 U.S. 41, 45-46 (1957); see also Hishon v. King & Spaulding, 467 U.S. 69, 73 (1984).

IV. Analysis

Tseng argues that Count I of Garrett's complaint fails to satisfy the "in connection with the purchase or sale of any security" requirements of 15 U.S.C.A. § 78j and Rule 10b-5 which was promulgated under this section. 15 U.S.C.A. § 78j states:

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

In Tully v. Mott Supermarkets Inc., the Court of Appeals for the Third Circuit construed this section to require a "causal connection between the alleged fraud and the purchase or sale of stock." 540 F.2d 187, 194 (3d Cir. 1976). See also Ketchum v. Green, 557 F.2d 1022, 1028 (3d Cir. 1977) (citing Tully 540 F.2d 187 (3d Cir. 1976)); Angelestro v. Prudential-Bache Securities, 764 F.2d 939, 943 (3d. Cir. 1985) (citing Tully, 540 F.2d at 194 and Ketchum, 557 F.2d at 1028). Tully involved a situation where plaintiff shareholders sued defendant shareholders over defendants' alleged failure to convey stock in accordance with an agreement made years earlier. Id. at 190-91. The court noted that the "fraud which the plaintiffs have alleged lies not in the actual sale of stock to them, but rather in the refusal to sell the remaining Class A shares in accordance with the 1966 agreement." Id. at 194. The court in Tully held that the breach of the agreement to convey was not sufficient to prove the causal connection necessary to satisfy the "in connection with the purchase or sale" requirement of section 78j. The court made clear that the purpose of section 78j is not to protect those who are merely "deprived purchasers." Id.

Since Tully the Court of Appeals for the Third Circuit has reinforced this view of the "in

connection with” requirement. In Angelestro the court found that if the plaintiff “can establish what she sets forth in her complaint -- that the defendants misstatements and nondisclosure of material terms induced her to purchase certain securities to her financial detriment -- she may very well be entitled to some recovery.” 764 F.2d at 945. Thus, the Court found the required connection because the plaintiff alleged the fraud was made in the initial representations that caused the plaintiff to buy stock.

The Eastern District of Pennsylvania has also reinforced this view of the “in connection with” requirement by finding the requisite connection only in cases where there was fraud in the initial stock agreements. In Sanzone v. Phoenix Technologies, Inc., the court noted that, in a claim under section 10(b), the fraud alleged was in the initial promise of stock as part of the plaintiff’s employment package. No. CIV.A. 89-5397, 1990 WL 50732 at *7 (E.D. Pa. Apr. 19, 1990) (“Plaintiff alleges fraud in the sale of stock, not just a failure to tender promised securities”). The court then refused to dismiss that count of the plaintiff’s complaint. Id. at *13-14. Also, in Tafari v. Air Products and Chemicals, the court noted that the plaintiff did not simply argue failure to convey stock in accordance with a stock option plan but claimed fraud “directly relating to the terms of the stock option plan and the defendants’ intentions to transfer stock to plaintiffs.” No. CIV.A. 97-3413, 1997 WL 643598, at *2 (E.D. Pa. Oct. 8, 1997). The court then held that such allegations stated a claim under section 10(b) and denied the defendants’ motion to dismiss. See id. at *3.

Similarly, the Fourth Circuit has followed the Tully rationale in Hunt v. Robinson, 852 F.2d 786 (4th Cir. 1988). Hunt involved a claim brought by an employee who alleged that his employer fraudulently refused to convey stock in accordance with his employment contract in

violation of section 10(b) of the Securities and Exchange Act of 1934. The court found that because “[t]he alleged fraud lies, not in the actual sale of stock, but rather in the defendant’s refusal to tender the shares as required by the terms of the contract” the plaintiff had not stated a cognizable action under section 10(b) of the Securities Exchange Act of 1934. See Hunt, 852 F.2d at 787.

In the instant case, assuming that the stock option plan constituted a sale of securities, Garrett alleges no fraud in the terms of the stock option plan. Garrett only claims that Tseng prevented him from exercising his options pursuant to the plan. (Complaint ¶ 12.) Thus, like the plaintiffs in Tully and Hunt, Garrett is simply a “deprived purchaser” who may have a claim for breach of contract but does not have a claim under section 10(b) of the Securities Exchange Act of 1934.¹ Accordingly, Count I will be dismissed.²

Because Count I will be dismissed on this ground, the Court need not address Tseng’s arguments that the stock option plan was not a security³, and that Garrett did not adequately plead fraud, scienter, and reliance.

Because the federal claims have been dismissed this court declines to exercise

¹ Garrett appears to allege that the order he placed with his broker was a contract to purchase and sell securities. (Complaint ¶ 18.) Garrett, however, does not allege any fraud in connection with his “contract” with the broker and thus this allegation has no relevance to this Court’s discussion.

² To the extent that Garrett seeks leave to amend his complaint this Court finds that in light of the facts already alleged by Garrett, no amendment of the Garrett’s complaint would state facts sufficient to survive the defendant’s motion to dismiss the federal claims.

³ Although the court does not need to address this issue it appears that in light of the recent decisions of Tafari v. Air Products and Chemicals, No. CIV.A. 97-3413, 1997 WL 643598, at *2 (E.D. Pa. Oct. 8, 1997) and Feret v. Corestates Financial Corp., No. CIV.A. 97-6759, 1998 WL 426560 (E.D. Pa. July 27, 1998) that this argument does not have much merit.

supplemental jurisdiction over the remaining state claims. See Clark v. Colden, No. CIV.A. 90-2071, 1990 WL 116323 at *5 (E.D. Pa. Aug. 8, 1990) (declining to exercise supplemental jurisdiction over remaining state claims once federal securities claims have been dismissed); Pennington v. Thomson McKinnon Securities, No. CIV.A. 86-3672, 1986 WL 14726 at *4 (E.D. Pa. Dec. 24, 1986) (declining to exercise supplemental jurisdiction over remaining state claims because federal securities claims have been dismissed).

V. Conclusion

Based on the foregoing, the motion to dismiss the federal claim will be granted and the state law claims will be dismissed without prejudice.

An appropriate Order follows.

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TSENG LABS, INC.	:	
Defendant.	:	NO. 98-1933

ORDER

AND NOW, this 7th day of December, 1998, upon consideration of the motion of defendant Tseng Labs, Inc. (“Tseng”) to dismiss the complaint of plaintiff Donald E. Garrett (“Garrett”) pursuant to the Federal Rules of Civil Procedure 9(b) and 12(b)(6) (Document No. 2), the response of Garrett (Document No. 3), and the reply of Tseng (Document No. 4), having found and concluded that the plaintiff has failed to state a claim upon which relief may be granted based on the reasons set forth in the foregoing memorandum, it is hereby **ORDERED** that the motion is **GRANTED** and Count I of the complaint is **DISMISSED**.

IT IS FURTHER ORDERED that Counts II and III of the complaint are **DISMISSED WITHOUT PREJUDICE**.

LOWELL A. REED, JR., J.