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

STEVENS	:	CIVIL ACTION
	:	No. 94-4577
v.	:	
	:	
O'BRIEN ENVIRONMENTAL ENERGY, INC., et al.	:	

O'Neill, J. May , 1999

M E M O R A N D U M

This is a putative class action for alleged securities fraud. Plaintiff Alan G. Stevens sues on behalf of himself and similarly situated persons who purchased stock in defendant O'Brien Environmental Energy Inc. ("O'Brien") between September 28, 1992 and September 16, 1993. O'Brien is an energy company whose shares traded on the American Stock Exchange. Plaintiff alleges that O'Brien and various former officers and directors of O'Brien (the "O'Brien defendants") issued misleading statements about the company's finances and engaged in insider trading in violation of Section 10(b) of the Securities Exchange Act, 15 U.S.C. § 78j(b), and Rule 10b-5 promulgated thereunder, 17 C.F.R. § 240.10b-5.

The claim presently before the Court, however, is plaintiff's claim against Morgan Guaranty Trust Co. ("Morgan Guaranty"), an investment bank and broker which held stock in O'Brien. Morgan Guaranty is alleged to have traded on inside information "tipped" to it by an unidentified O'Brien insider. Morgan Guaranty moves to dismiss for failure to state a claim under Rule 12 (b)(6) and for failure to plead fraud with particularity as required by Rule 9(b). Fed. R. Civ. Proc. 9(b), 12(b)(6).[1]

FACTUAL ALLEGATIONS

Plaintiff alleges the following facts relevant to this opinion. Between September 1992 and May 1993, O'Brien issued several financial reports and statements to analysts which were materially misleading and incomplete in that they failed to disclose or inaccurately minimized numerous incurred or potential losses, including, inter alia, losses associated with a fire at one of its plants; litigation expenses; and restrictions on deferred tax liabilities. Over the same period, plaintiff alleges, three of the five individual defendants disposed of all or nearly all their O'Brien shares.

Plaintiff purchased 13,200 shares of O'Brien's Class A common stock at prices ranging from \$4.25 to \$3.75 per share between March 3 and May 20, 1993. Plaintiff claims that the prices he paid for the stock was artificially inflated as a result of the O'Brien defendants' failure to truthfully disclose the company's financial performance and potential losses. The company's difficulties allegedly did not come to light until the

[1] The changes in the law governing securities actions wrought by the Private Securities Litigation Reform Act of 1995 do not apply to this action because it was commenced before the Reform Act became effective. See P.L. 104-67, § 108, 109 Stat. 737, 758 (1995).

company announced a projected loss of $15 - 20 million for fiscal 1993 after the market closed on September 16, 1993. The next day the stock closed at $2.69. The stock continued its decline as further details of the losses were revealed in a September 29 SEC filing and the market absorbed the bad news, closing at $2.18 on October 7, 1993.

On September 15, 1993, the day before O'Brien's bad-news announcement, Morgan Guaranty sold all of its 1.08 million shares in O'Brien. As a result of the sale, which represented some 8% of all of O'Brien's outstanding Class A shares, the stock price suffered a one-day decline of nearly 25%, from $3.75 to $2.81, and the American Stock Exchange suspended trading in the stock on September 16. Morgan Guaranty's identity as the seller was not disclosed by it or by O'Brien. Plaintiff alleges on information and belief that Morgan Guaranty made the trade based on a tip by an O'Brien insider in violation of Section 10(b) and Rule 10b-5.

DISCUSSION

A. Rule 12(b)(6) arguments.

Morgan Guaranty argues that plaintiff fails to state a claim against it for trading on inside information. In considering the motion, I accept as true the well-pleaded factual allegations in the complaint and construe them in the light most favorable to plaintiff.

Kost v. Kozakiewicx, 1 F.3d 176, 183 (3d Cir. 1993). I am not required to accept allegations that amount to mere legal conclusions or "bald assertions" without any factual support. See, e.g., id.; Morse v. Lower Merion School Dist., 132 F.3d 902, 906 (3d Cir. 1997). I may grant the motion only if I determine that plaintiff may not prevail under any set of facts that may be proven consistent with his allegations. Hishon v. King & Spalding, 467 U.S. 69, 73 (1984). "The issue is not whether a plaintiff will ultimately prevail but whether the claimant is entitled to offer evidence to support the claims." In re Burlington Coat Factory Litigation, 114 F.3d 1410, 1420 (3d Cir. 1997), quoting Scheuer v. Rhodes, 416 U.S. 232, 236 (1974).

1.

An "outsider" such as Morgan Guaranty may be held liable as a "tippee" for trading on inside (material, non-public) information pursuant to one of two theories. First, pursuant to the "classical" theory of insider trading, an outsider may be liable for trading on information passed to it by an insider "tipper" in breach of the tipper's fiduciary duty to his company's shareholders. See SEC v. Dirks, 463 U.S. 646 (1983); Chiarella v. United States, 445 U.S. 222 (1980). The tipper must act for his or her own benefit for the disclosure to amount to a breach of fiduciary duty. Dirks, 463 U.S. at 665-667 (employees and former officer who disclosed inside information to broker in order to reveal massive fraud by their company did not breach their fiduciary duty to the company by making their disclosures, so no claim could lie against the broker for trading or enabling others to trade on the information). Second, an outsider may be liable as the tippee of someone who has misappropriated inside information in breach of a duty to the source of the information.[2] See, e.g., United States v. Carpenter, 791 F.2d 1024 (2d Cir. 1986), aff'd by an equally divided Court, 484 U.S. 19 (1987) (brokers tipped as to contents of forthcoming Wall Street Journal financial columns were liable as tippees of journalist who breached duty to the newspaper by making the disclosures); SEC v. Willis, 777 F. Supp. 1165 (S.D.N.Y. 1991) (stock broker liable as tippee of psychiatrist who obtained inside information from patient in breach of his duty of confidentiality to her). Under either scenario, the tippee is liable only if it knew or should have known that the tip was made in breach of the tipper's fiduciary duty. That is, the tippee must have the requisite "scienter."

Initially, I note that the parties argue over which of these two theories plaintiff is asserting. The only point to this dispute, it seems, is the parties' common belief that tippee liability under the "classical" theory requires an allegation of "personal benefit" to the tipper (which plaintiff has not specifically alleged), while the "misappropriation" theory does not. Thus, according to Morgan Guaranty, plaintiff asserts tippee liability based on the classical insider trading theory, and therefore must allege that the tipper

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[2] Of course, an outsider may also be liable for trading on information which it has "misappropriated" itself. See SEC v. O'Hagan, 521 U.S. 642 (1997) (attorney liable for trading on information disclosed to law firm by client engaged in merger negotiations). Plaintiff, however, appears to allege only that Morgan Guaranty is liable as a "tippee."

made the tip for personal gain. According to plaintiff, he asserts that Morgan Guaranty was tipped with inside information "misappropriated" from O'Brien and therefore does not have to allege the tipper's personal benefit; in the alternative, he argues that he cannot be expected to make allegations about the tipper's motivation before he has had an opportunity to pursue discovery.

It appears to me that this dispute is much ado about little, at least at this early stage of the litigation when the sufficiency of the allegations rather than the sufficiency of plaintiff's evidence is at issue. First, when the tipper is a company insider, any difference between the "classical" insider trading theory and the "misappropriation" theory is likely to be immaterial. An insider who trades or tips others to trade on inside information is likely breaching both his duty to his company's shareholders and his duty to the company and could be held liable under either theory. Second, while Dirks expressly articulated a "personal gain" requirement for a tipper to be in breach of her duty to shareholders, a similar requirement seems implicit in the concept of "misappropriation." That is, courts are not likely to find information "misappropriated" where it was, for example, used to expose fraud or obtained by accident. Cf. Dirks, 463 U.S. at 661-662 (discussing examples of insider disclosures not likely to be actionable as breaches of the insiders' fiduciary duties). And third, given that plaintiff's allegations that Morgan Guaranty was tipped are based on information and belief and do not identify the circumstances of the tip or the tipper, it is hardly likely that plaintiff could allege whether the tipper "misappropriated" the information or was privy to it in his or her position. Either scenario is possible and consistent with plaintiff's allegations.

For these reasons, it is not necessary to decide at this point what theory plaintiff is asserting. The question is whether he has sufficiently set forth a claim that Morgan Guaranty traded on material, non-public information which it knew or should have known was disclosed to it in breach of the tipper's duty to O'Brien's shareholders and/or to the company itself.

2.

Defendant contends that plaintiff has not adequately stated such a claim because he does not sufficiently allege scienter and does not allege that defendant's unidentified "tipper" acted for his or her personal benefit. To properly plead scienter, plaintiff must plead facts giving rise to a "strong inference" that the defendant knew or recklessly disregarded that its conduct was fraudulent. In re Burlington Coat Factory Securities Litigation, 114 F.3d 1410, 1422 (3d Cir. 1997) (plaintiff must allege facts that suggest conscious or reckless behavior by the defendant, or a motive and a clear opportunity for defendant to engage in the fraud).

One way a plaintiff may establish scienter is to point to extraordinary stock trades. See, e.g., SEC v. Heider, 1990 WL 200673, at *4 (S.D.N.Y. 1990) (in case alleging insider trading on information of proposed merger, allegations that volume of call option purchases skyrocketed just prior to merger and that defendants were responsible for significant portion of that volume supported “strong inference” of defendants’ scienter); cf. In re Burlington Coat Factory, 114 F.3d at 1423 (considering whether allegations concerning insiders’ trading could establish scienter with regard to claims that company issued misleading statements); Acito v. IMCERA Group, Inc., 47 F.3d 47, 54 (2d Cir. 1995) (same).

Here, plaintiff has alleged that Morgan Guaranty sold its entire position of 1.08 million shares in O’Brien just hours before O’Brien’s “bad news” announcement. Plaintiff further alleges that this sale was of itself large enough -- representing about 8% of all the company’s outstanding stock --to depress the price of the stock by about 25%, which might in turn suggest that Morgan Guaranty sold its block for less then it might have expected to command in several smaller sales spaced out over time. Of course, it may turn out, as Morgan Guaranty argues, that the stock sale was just one of those coincidences bound to happen from time to time to a company that controls billions of investment dollars. It may turn out that Morgan Guaranty would normally sell its entire position at once rather than spread sales over time even if it did reduce its own return by doing so. But whether the sale proves coincidental or not will depend on a host of facts not now before the Court and, in any event, not properly resolvable at this stage of the litigation. All that can or should be said at this stage is that, taken in the light most favorable to the plaintiff, the alleged circumstances of Morgan Guaranty’s sale are sufficiently extraordinary to allow an inference of scienter.

As to the tipper's motivation in allegedly revealing inside information to Morgan Guaranty, I am not convinced that it is necessary in the ordinary case for a plaintiff to specifically allege that a tip was made for the tipper's personal benefit. While Dirks established that a tipper must act for personal benefit to be in breach of his fiduciary duty for disclosing inside information to outsiders, the Court did not purport to make this a pleading requirement, and I am not aware of any case imposing such a requirement. Cf. SEC v. Lambert, -- F. Supp. 2d --, 1999 WL 125867, at *4 (S.D. Fla. 1999) (that tip was made for tipper's personal benefit was merely element of establishing that the tip was made in breach of the tipper's fiduciary duty; as breach was alleged, there was no need for specific allegation concerning personal benefit). Indeed, requiring a specific "personal benefit" allegation would be a bit odd in light of the fact that in many, if not most, insider trading cases the "tipper" and/or the factual circumstances of the "tip" are not known to and cannot be uncovered by the plaintiff prior to discovery.[3]

Moreover, viewing insider trading allegations in the light most favorable to the plaintiff, one would ordinarily assume that a tipper acts for personal benefit, absent extraordinary circumstances suggesting the tipper sought to expose fraud or made the

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[3] It is not uncommon for insider trading complaints to be allowed to proceed even without allegations identifying the alleged tipper. See, e.g., SEC v. Lambert, -- F. Supp. 2d --, 1999 WL 125867 (S.D. Fla. 1999); Energy Factors Inc. v. Nuevo Energy Co., 1992 WL 170683, at * (S.D.N.Y. July 7, 1992); SEC v. Heider, 1990 WL 200673, at *4 (S.D.N.Y. Dec. 4, 1990). Indeed, Morgan Guaranty does not argue that plaintiff's claims are inadequate merely because he does not identify the alleged tipper.

disclosure accidentally or unknowingly. See Dirks, 463 U.S. at 661-62. In this case, there is no suggestion that the alleged tipper acted for some altruistic reason or disclosed information by accident. That fact, together with the circumstances of Morgan Guaranty's stock sale as set forth above, are sufficient to allow an inference that the tipper acted for personal benefit and therefore in breach of his or her fiduciary duty to O'Brien and/or its stockholders.

B. Rule 9(b) Arguments

Defendant also contends that plaintiff fails to plead fraud with particularity as required by Rule 9(b).[4] The particularity required by Rule 9(b) serves "to provide defendants with notice of the precise misconduct with which they are charged, and to safeguard defendants against spurious charges of immoral and fraudulent behavior." Seville Indus. Machinery Corp. v. Southmost Machinery Corp., 742 F.2d 786, 791 (3d Cir. 1984); see also In re Burlington Coat Factory, 114 F.3d at 1418 (Rule 9(b) "gives defendants notice of the claims against them, provides an increased measure of protection for their reputations, and reduces the number of frivolous suits brought solely to extract settlements.") Ordinarily, the Rule requires that plaintiffs plead the "who, what, when, and where" details of the alleged fraud.

[4] Federal Rule of Civil Procedure 9(b) 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.

However, the Third Circuit has frequently warned against taking an approach to Rule 9(b) that fails to take into account the "'general simplicity and flexibility contemplated by the rules'" or fails to "be sensitive to the fact that [Rule 9(b)'s] application, prior to discovery, may permit sophisticated defrauders to successfully conceal the details of their fraud." Christidis v. First Pennsylvania Mortgage Trust, 717 F.2d 96, 99-100 (3d Cir. 1983), quoting 5 Charles A. Wright & Arthur R. Miller, Federal Practice and Procedure § 1298 at 407 (1969). Accordingly, courts have "relaxed" application of the rule when facts are "peculiarly within the defendant's knowledge or control" and allowed plaintiffs to plead on information and belief. Weiner v. Quaker Oats Co., 129 F.3d 310, 319 (3d Cir. 1997), quoting Craftmatic Securities Litigation v. Kraftsow, 890 F.2d 628, 645 (3d Cir. 1989). Such allegations must, however, be accompanied by factual allegations that provide substantiation and make them plausible. See In re Burlington Coat Factory, 114 F.3d at 1418; Shapiro v. UJB Financial Corp., 964 F.2d 272, 285 (3d Cir. 1992), citing, inter alia, 2A James W. Moore & Jo D. Lucas, Moore's Federal Practice ¶ 9.03[1] at 9-29 to 9-29 (1991) ("where the facts are in the exclusive possession of the adversary, courts should permit the pleader to allege the facts on information and belief, provided a statement of the facts upon which the belief is founded is proffered"). In other words, the "relaxed" application of Rule 9(b) is not a license for plaintiffs to base fraud claims on speculation and conclusory allegations. See, e.g.,In re Burlington Coat Factory, 114 F.3d at 1418. Plaintiffs must employ some means of "injecting precision and some measure of substantiation into their allegations of fraud." Seville Indus. Machinery Corp., 742 F.2d at 791.

Defendant contends that plaintiff's allegations fail to meet even the "relaxed" application of Rule 9(b) because they fail to identify the tipper or the circumstances of the alleged tip or the tipper's motivation.[5] These contentions are largely repetitive of defendant's 12(b)(6) arguments and must be rejected for the same reasons. A few additional observations are in order, however.

First, though plaintiff's complaint does not identify the tipper or set forth when and where the tip took place or what the tipper's motivation might have been, it does detail the substance of the alleged tip and the circumstances of Morgan Guaranty's subsequent sale. These details provide defendant with "fair notice" of the precise fraudulent conduct with which it is charged -- namely, the sale of 1.08 million shares of O'Brien stock on September 15, 1993 while in knowing possession of inside information concerning the adverse news O'Brien would announce the next day. Accord SEC v. Heider, 1990 WL 200673, at *4 (S.D.N.Y. Dec. 4, 1990) (though plaintiff did not identify tipper, complaint provided adequate notice of inside trading charges against alleged tippee); Energy Factors Inc. v. Nuevo Energy Co., 1992 WL 170683, at *3-*4 (S.D.N.Y. July 7, 1992) (similar).

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[5] Defendant also argues that plaintiff is not entitled to the "relaxed" Rule 9(b) standards because Morgan Guaranty is not an "insider" of O'Brien but an outsider. Morgan's outsider status, however, has nothing to do with whether the relaxed standards should be applied to plaintiff's complaint. What matters is whether the supposed deficiencies in the allegations concern facts which are exclusively within defendant's knowledge and control.

In addition, the apparently extraordinary circumstances of the stock sale provide substantiation and plausibility for plaintiff's claim. Morgan Guaranty is alleged to have divested itself of its entire position as the holder of about 8% of O'Brien's outstanding stock one day before O'Brien's announcement of its "surprise" losses. The sale allegedly was enough of itself to cause a 25% depression in the stock price. Again, it may be that the timing of the sale was just a coincidence and that Morgan sold the stock for reasons that had nothing to do with inside information. Or it might be that the trade was based on inside information but that information was not imparted in breach of the tipper's fiduciary duties. Nonetheless, the allegations make plaintiff's claim plausible.

In sum, I find that "relaxed" Rule 9(b) standards are appropriate here and that plaintiff's claim against Morgan Guaranty meets them. The complaint provides sufficient detail and substantiation to give fair notice to the defendant of the fraudulent conduct with which it is charged and to demonstrate that plaintiff's fraud claim is not baseless or implausible. Construed in plaintiff's favor, the facts as presently alleged entitle plaintiff to seek and offer evidence in support of his claim. Accordingly, defendant's motion to dismiss the complaint will be denied.

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O R D E R

AND NOW this day of May, 1999, upon consideration of defendant Morgan Guaranty Trust Company's motion to dismiss the claims against it pursuant to Rule 12(b)(6) and Rule 9(b) of the Federal Rules of Civil Procedure and the various filings of the parties related thereto, it is hereby ORDERED that the motion is DENIED.

THOMAS N. O'NEILL, JR. J.