COMMODITY FUTURES TRADING COMMISSION, Plaintiff, v. ROBERT JOSEPH BEASLEY AND LONGBOAT GLOBAL FUNDS MANAGEMENT, LLC; Defendants.

No. C 05-2142 PJH

UNITED STATES DISTRICT COURT FOR THE NORTHERN DISTRICT OF CALIFORNIA, SAN FRANCISCO DIVISION

2005 U.S. Dist. Ct. Motions 94642; 2005 U.S. Dist. Ct. Motions LEXIS 46421

August 31, 2005

Motion to Dismiss

VIEW OTHER AVAILABLE CONTENT RELATED TO THIS DOCUMENT: U.S. District Court: Motion(s); Pleading(s)

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JUDGES: Hon. Phyllis J. Hamilton

TITLE: DEFENDANTS' REPLY MEMORANDUM OF POINTS AND AUTHORITIES IN SUPPORT OF ITS MOTION TO DISMISS

TEXT: I. INTRODUCTION

Notwithstanding the Commission's efforts to explain what it intended to allege in its initial pleading in this matter, the Complaint simply fails to apprise Defendants in short plain statements of the precise fraud of which they are accused so that they can formulate their answer, defenses and discovery as required by *Rules 8(a), 8(e) and 9(b) of the Federal Rules of Civil Procedure.* In short, the Complaint is lacking in fundamental details explaining:

. What exactly the fraud is Defendants are being charged with;

. How and when any communications Defendants conveyed were false or misleading;

. How - if at all - Defendants possessed the requisite intent to defraud the Fund's investors as to each alleged act of misconduct; [*2] and

. Whether any investors actually relied upon the alleged misstatements contained in the 2002 and 2003 annual reports underpinning the Complaint.

The Ninth Circuit has been clear that a plaintiff cannot shift the burden to the defendant or the court to decipher a complaint's meaning from disconnected and overbroad allegations and, in such circumstances, the district court should simply compel the plaintiff to amend its Complaint. That is all Defendants are asking here so that the pleading they must answer, and which will control discovery, adequately informs them through concise and organized statements of the fraud with which they are being charged. Thus, the Complaint should be dismissed, without prejudice, so that the Commission may amend its Complaint.

II. ARGUMENT

A. The Complaint is Ambiguous As to the Fraud Defendants Are Accused of Committing with Respect to the Note Investments.

According to the Commission, certain paragraphs of the Complaint - *i.e.,* 20, 24, 45, 50 and 55 - allege a concise fraud perpetrated by Defendants as to the "condition of and security for" ALL the notes invested in by the Fund. Plaintiff's Opposition Memorandum to [*3] Defendants' Motion ("Opposition Memo") at 3, 6-7. Taken out of context and reassembled together as the Commission directs, these isolated paragraphs seem to suggest Defendants misrepresented the condition or security for all the Fund's promissory notes. But as the Ninth Circuit has recognized, "[a] complaint is not a puzzle, ... and we are loathe to allow plaintiffs to tax defendants, against whom they have leveled very serious charges, with the burden of solving puzzles in addition to the burden of formulating an answer to their complaint." *In Re GlenFed, Inc. Sec. Litig., 42 F.3d 1541, 1554 (9th Cir. 1994); see also In re Autodesk, Inc. Sec. Litig., 132 F. Supp. 2d 833, 841 (N.D.Cal.2000)* ("In short, plaintiffs have left it up to defendants and the court to try to figure out exactly what the misleading statements are, and to match the statements up with the reasons they are false or misleading."). Further, when these allegations are read in context, the Complaint conveys a much more limited fraud allegedly perpetrated by Defendants concerning only the Fund's investment in notes issued by Beasley-related entities.

For example, following paragraph [*4] 20 and continuing almost uninterrupted until paragraph 45, the Complaint is devoted to a discussion of the Piranha Fund's investment in the Beasley-related notes. Further, in discussing the 2002 and 2003 annual reports through which Beasley and Longboat purportedly misrepresented "the condition and security of pool investments" (see paragraph 45), the Complaint then discusses in detail the notes issued by Beasley-related entities (*i.e.,* the Lewis & Clark and Diamond B Notes) as never having been secured by a security interest. *See* paragraphs 51, 52, 54, 55, 56, 57. The fraud underpinning the Complaint, therefore, appears grounded upon the Fund's investment in the Beasley-related notes, not every note issued to the Fund. Indeed, this construction of the Complaint is consonant with the Commission's own interpretation of the alleged misrepresentations and omissions contained in the 2002 and 2003 annual reports set forth in its Motion for Preliminary Injunction. In the section of its Memorandum of Points and Authorities in Support of its Motion for Preliminary Injunction entitled "Misrepresentations and Omissions Regarding Assets Purportedly Securing Promissory Notes," the Commission [*5] compares the statements made in the annual reports regarding the security for the notes but refers only to the notes issued by the Beasley-related entities as those which were not secured. "Despite the representations made by the Defendants in Piranha's 2002 and 2003 annual reports, the promissory notes totaling $ 3,875.000 between Piranha and Diamond B and Lewis & Clark were never secured by a security interest in any property located in the United States or overseas." Memorandum of Points and Authorities in Support at 8-9. If, however, as the Commission contends, the Complaint concerns the "condition and security" for all the notes invested in by the Fund, why does the Complaint also allege the lack of security for the Beasley-related notes, which would be superfluous?

At best, the Complaint is ambiguous, which is not alleviated by the Commission's inconsistent and changing interpretations of the fraud upon which the Complaint is based: now, facing dismissal, the fraud concerns all the Fund's notes, whereas in its Motion for Preliminary Injunction the fraud concerned only the Beasley-related notes. The Commission also argues that so long as the Complaint is clear as to some fraud, [*6] then the Complaint need not be dismissed. Opposition Memo at 7. The Commission misses the point: the Complaint is ambiguous as to the nature and scope of the fraud Defendants are accused of committing. Rules 8(a), 8(e) and 9(b) demand that a complaint provide a clear and plain statement of the allegations so that Defendants can formulate their answer, defenses and discovery. Rather than putting Defendants to the task of guessing at the fraud of which they have been accused, the Court should simply dismiss the Complaint or compel the Commission to clarify it. *See GlenFed, 42 F.3d at 1554* (stating that the district court has discretion to require plaintiff, as a matter of "prudent case management" to "streamline and reorganize

the complaint before allowing it to serve as the document controlling discovery, or indeed, before requiring Defendants to file an answer.").

B. The Complaint Fails to Plead the Defendants' Alleged Misconduct with Sufficient Particularity.

In their initial Memorandum of Points and Authorities in Support of their Motion to Dismiss ("Initial Memo"), Defendants demonstrated that the Complaint fails to provide simple and concise statements [*7] detailing the alleged fraud as required by Rules 8(a), 8(e) and 9(b). Initial Memo at 2-3. In response, the Commission simply recites a series of conclusory statements that it contends suffice to allege that Defendants "fraudulently omitted" to disclose numerous facts to the Fund's investors, including:

> . Beasley's personal guarantee for the notes to entities he controls;
>
> . Beasley's control of entities that made the notes and their failure to make payments on the notes;
>
> . Beasley did not enforce the terms of all the notes; and
>
> . Beasley continued to earn incentive and management fees on all the notes even though interest was unpaid.

Opposition Memo at 4-5 (*citing* Complaint PP 23, 52, 57, 58, 59, 60, 61, 62, 63, 64).

Even assuming Beasley failed to disclose these facts, the Commission fails to allege other basic elements necessary to state a claim for fraud under Section 4o(1) of the Commodity Exchange Act (the "Act"), including that the omissions were (i) material to investors and (ii) that defendants intentionally withheld this information. *See* Initial Memo at 5-7. The Commission must allege with particularity the facts upon which each claim [*8] for fraud in the Complaint is based as well as provide "a short and plain statement of the claim showing that the pleader is entitled to relief." *See Fed. R. Civ. P. 8(a)*, *8(e)* and *9(b)*. The conclusory nature of the Complaint's numerous allegations of "fraudulent omissions" simply fail to meet the requirements of Rules 8(a), 8(e) and 9(b), justifying dismissal. *See Moore v. Kayport Package Express, Inc., 885 F.2d 531, 540 (9th Cir. 1989)* (mere conclusory allegations of fraud are insufficient under Rule 9(b)); *Aureflam Corp. v. Pho Hoa Hiep Inc.,* Case No. 04-03824-*JW, 2005 WL 1562933,* at *4 (N.D. Cal. June 23, 2005) (finding that counterclaim failed to plead any particular fact with requisite particularity to establish a claim for fraud) (attached to Initial Memo in table of unreported cases). *See also In Re Splash Tech. Holdings Inc. Secs. Litig., 160 F. Supp. 2d 1059, 1073-75 (N.D. Cal. 2001)* (finding that the "structure" of the plaintiffs' "puzzle-style" pleading, with various alleged misstatements in no discernible order "failed to set forth a 'short and plain' statement of their claims in violation of Rule 8(a) and have failed [*9] to make each allegation 'simple, concise and direct' in violation of Rule 8(e).").

Further, in its Opposition Memo, the Commission does not refute that Paragraph 70 of the Complaint alludes to other misrepresentations and omissions not articulated in the Complaint. Paragraph 70 states that "[e]ach material misrepresentation or omission made during the relevant time period by Beasley, including but not limited to those specifically alleged herein, is a separate and distinct violation of Section 4o(1)(A) and (B)." (Emphasis added). Notwithstanding the Commission's representations to the contrary, this catchall pleading technique will expand the scope of discovery exponentially. *See* Opposition Memo at 8 (section II.B) (stating that "the Commission in no way intends to rely upon other memoranda filed with the Court to inform the Defendants of the fraud at issue in this case"). More importantly, it fails to inform Defendants of the specific misrepresentations and omissions they are accused of perpetrating. How can Defendants admit or deny this allegation in their Answer or defend against this claim if they do not know the nature of the misrepresentations or omissions? Rules 8(a), [*10] 8(e) and 9(b) do not permit such catchall pleading devices, especially to plead fraud. The Complaint should be dismissed for this additional reason.

C. The Complaint Fails to Plead Essential Elements of its Claims.

1. The Complaint Improperly Shifts the Burden to Defendants and the Court to Decipher the Grounds For Scienter.

Even though Rule 9(b) states that scienter "may be averred generally," plaintiffs must still allege some facts to show that Defendants acted with the requisite scienter for a violation of Section 4o(1)(A). *See Aureflam Corp., 2005 WL*

1562933, at * 3. Further, even allegations of scienter are guided by Rule 8(a) (requiring short and plain statements) and Rule 8(e) (that the allegations "shall be simple, concise, and direct."). The Commission contends that the Court should consider the Complaint as a whole to determine whether scienter has been sufficiently pled. Opposition Memo at 3 (*citing In Re Exodus,* Case No. C 01-2661 MMC, 2005 WL 1869289, at * 5 (N.D. Cal. Aug. 4, 2005)). n1 As discussed in sections II.A and B, *supra,* however, the Complaint is a jumbled mass of allegations that is neither clear as to the precise fraud [*11] Defendants have committed nor as to which statements were false and misleading as required for Rules 8(a), 8(e) and 9(b). Thus, the Commission has left it up to Defendants and the Court to try to figure out exactly what the misleading statements are and to match them up with each Defendants' conduct to determine when, how and whether Defendants either had knowledge of the falsity of each alleged misstatement or omission, or that it was so obvious Defendants must have known its falsity. Courts within this Circuit have been clear, however, that it is the plaintiff's burden, not a defendant's or the court's, to make its allegations of fraud clear and concise. *See GlenFed, 42 F.3d at 1544* ("These 'puzzle-style' complaints are an unwelcome and wholly unnecessary strain on Defendants and the court system"); *In re Conner Peripherals, Inc., Case No. C-95-2244, 1996 WL 193811,* *1 (N.D. Cal Jan. 18, 1996) ("The complaint as written requires the court to excavate for actionable claims ... Judicial resources are too scarce and worthy cases too pressing for a case to spend its time rooting around in bloated complaints by experienced lawyers for a handful of actionable [*12] allegations.").

> n1 Notably, *Exodus* was an action under the Private Securities Litigation Reform Act ("PSLRA") to which heightened pleading standards applied and therefore, may be of limited utility in determining the appropriate standard for pleading scienter in fraud claims under the Commodity Exchange Act. *In Re Exodus,* Case No. C 01-2661 MMC, 2005 WL 1869289, at * 1 (N.D. Cal. Aug. 4, 2005).

In a final attempt to resuscitate its deficient allegations of scienter, the CFTC contends that in any event it has pled sufficient facts to demonstrate Defendants had "a motive and opportunity to profit from the alleged fraud," which it contends is a viable basis upon which to plead scienter. Opposition Memo at 11 (*citing In Re Wells Fargo Sec. Litig., 12 F.3d 922, 931 (9th Cir. 1993)).* First, the Commission does not explain how, if at all, *Wells* directs the standard for pleading scienter in an action brought under the Commodity Exchange Act. *Wells* involved a claim under Section 10(b) [*13] of the Securities Exchange Act (*15 U.S.C. ß 78j(b)*), not the Commodity Exchange Act, and was also decided before the adoption of the PSLRA. Since the adoption of the PSLRA, however, the Ninth Circuit has determined that the "motive and opportunity" test for pleading scienter, as stated in *Wells,* is no longer sufficient. In *In Re Silicon Graphics,* the Ninth Circuit expressly stated that plaintiffs cannot aver intent in securities cases under the PSLRA based on the "general terms of mere 'motive and opportunity' or 'recklessness,' but rather, must state specific facts indicating no less than a degree of recklessness that strongly suggests actual intent." *In re Silicon Graphics Inc. Sec. Litig., 183 F.3d 970, 979 (9th Cir.1999).* Thus, *Wells* is no longer good law.

Because the Complaint does not even meet Rule 9(b)'s liberal pleading standard for scienter, the Court should direct the Commission to amend its Complaint to clarify how and whether each Defendant knew or was aware of facts that were so obvious they must have known their statements were false when made. *See Sunnyside Development Co., LLC v. Opsys Limited,* Case No. 05-0553- [*14] *MHP, 2005 WL 947720,* at * 3 (N.D. Cal. Apr. 22, 2005) (attached in appendix of unreported cases to Initial Memo). Further, given the Commission's reliance on *Exodus* in its Opposition Memo as the appropriate standard for pleading scienter in this matter, the Commission in amending its Complaint should observe the standard for pleading fraud discussed in *Exodus* - i.e., "Plaintiffs 'must plead, *in great detail,* facts that constitute *strong circumstantial evidence* of deliberately reckless or conscious misconduct.'" *Exodus, 2005 WL 1869289,* at * 4 (emphasis added) (citation omitted).

2. The Complaint Fails to Plead Any Facts Establishing Investors Relied Upon Defendants' Alleged Misstatements Sufficient to State a Claim Under Section 4o(1)(B).

The Commission admits that it failed to plead the investors' reliance on the Defendants' alleged misrepresentations or omissions in connection with its claims under Section 4o(1)(B) and for rescission under Section 9 of the Act. Nonetheless, it argues that reliance is not a required element or at least need not be pleaded at this stage of the proceeding. Opposition Memo at 10-11. The Commission [*15] is wrong.

To state a violation under Section 4o(1)(B) of the Act, the Commission must allege, and eventually prove, Defendants' alleged misstatements and omissions concerning the "condition and security" of the promissory notes issued to the Fund "operated as a fraud or deceit upon any client." *7 U.S.C. ß 6o(1)(B)*. Courts have interpreted the statutory lan-

guage "operates as a fraud" as focusing upon the *effect* of a trading adviser's conduct on its investing customers. *See Commodity Trend Serv., Inc. v. CFTC, 233 F.3d 981, 993 (7th Cir. 2000); CFTC v. Heffernan, 245 F. Supp. 2d 1276, 1291 n. 24 (S.D. Ga. 2003).* The *Heffernan* court effectively concluded that Section 4o(1)(B) required the Commission to demonstrate reliance.

The Commission seeks to minimize *Heffernan,* arguing that the Court did not hold reliance to be a required element of pleading a claim under Section 4o(1)(B). Opposition Memo at 10. It is true the *Heffernan* court did not rule on the Section 4o(1)(B) claim in that matter because the court found, on the CFTC's motion for summary judgment, that the CFTC had established its claim under Section 4o(1)(A). [*16] *Heffernan, 245 F. Supp. 2d at 1291 n. 24.* Nonetheless, the *Heffernan* court thoroughly analyzed the question of whether the CFTC, as compared to a private litigant, needed to establish reliance as an element under Section 4o(1)(B). Based on its analysis of the "operates as a fraud" language in Section 4o(1)(B) and the Seventh Circuit's holding in *Commodity Trend,* the *Heffernan* court concluded that "there appears to be some potential tension between the notion that the CFTC need not demonstrate reliance in an enforcement action and the notion that liability under Section [4]o(1)(B) exists when the CFTC has demonstrated that a CTA engaged in a transaction, practice, or course of business, that had the 'effect' of a fraud." *Id.* Consistent therewith, as the CFTC admits, reliance is a required element in actions between private parties for damages under Section 4o(1)(B). Opposition Memo at 10 (*citing First Nat'l Monetary Corp. v. A.J. Weinberger, 819 F.2d 1334, 1349 (6th Cir. 1987)).* Thus, the *Heffernan* decision highlights an open issue regarding the predicate elements of a claim under Section 4o(1)(B) when brought by the CFTC that [*17] the CFTC cannot - as a party to *Heffernan* - simply ignore and which this Court cannot avoid. Moreover, this issue is ripe for review at the pleading stage in this proceeding and should be addressed now rather than in a subsequent motion following discovery or at trial.

Finally, the Commission contends that it need not establish reliance even in support of its claim for rescission pursuant to Section 6(c), *7 U.S.C. ß 9*, of the Act, despite express Commission precedent to the contrary holding that "reliance is a statutory requirement of restitution" under Section 6(c). *See* Initial Memo at 6 (*citing In Re Staryk,* attached to Initial Memo in table of unreported cases). Incredibly, the Commission looks past the statutory mandate of the Act and the force of its own precedent on the grounds that "[n]othing in Rule 9(b) [of the Federal Rules] requires that additional information be included in the Complaint when restitution is sought." Opposition Memo at 11. Rule 9(b) does not establish or overwrite the Commission's pleading obligations under the Act. Further, the Commission characterizes the reliance requirement as simply "what is required for the Commission [*18] to prove at trial in order to obtain the requested relief of restitution, not what is required at the pleading stage." Yet, Rule 8(a) requires the Commission to state its claims for relief in its Complaint, not at trial. If it cannot plead sufficient facts to demonstrate reliance in its Complaint, then its claim for restitution should be dismissed or stricken.

In sum, the Commission has failed to plead any facts regarding the "effect" the alleged misstatements contained in the 2002 and 2003 annual reports had on investors, i.e., that investors relied on this information to their detriment, either in support of its claim for fraud under Section 4o(1)(B) or reliance for restitution under Section 6(c) of the Act. Of course, if the Commission is aware of such facts, it would be a relatively simple matter to require the Commission to amend the Complaint to include such allegations. The Complaint should be dismissed without prejudice, therefore, to allow the Commission to replead the Complaint with these required elements.

III. CONCLUSION

For all of the foregoing reasons and as stated in Defendants Longboat Global Funds Management, LLC and Robert Beasley's initial Memorandum of [*19] Points and Authorities in Support of its Motion to Dismiss, Defendants respectfully request that the Court dismiss the Commission's Complaint for failure to plead its claims for fraud under the Act with the requisite simplicity and particularity required under *Rules 8(a), 8(e) and 9(b) of the Federal Rules of Civil Procedure* or, in the alternative, compel the Commission to amend the Complaint with a more definite statement of the facts upon which its claims of fraud are based pursuant to *Rule 12(e) of the Federal Rules of Civil Procedure.*

Dated: August 31, 2005

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