

UNITED STATES DISTRICT COURT
DISTRICT OF MAINE

FRANK SIMON, II,
THOMAS HILLMAN,
RON BERNSTEIN, and
RAINFOREST AQUACULTURE
PRODUCTS, INC.

Plaintiffs

v.

TERRENCE N. CONWAY,

Defendant

Civil No. 95-293-P-C

GENE CARTER, Chief Judge

MEMORANDUM AND ORDER PARTIALLY GRANTING DEFENDANT'S
MOTION TO DISMISS

This matter is before the Court on Defendant's Motion to Dismiss (Docket No. 6) Counts V and VIII of Plaintiffs' Second Amended Complaint (Docket No. 22) which seek recovery for common law fraud and federal securities fraud, respectively. Defendant contends that Plaintiffs have failed to plead all the elements of the fraud counts with sufficient particularity. Defendant further contends that Plaintiffs lack standing to assert a claim pursuant to section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and Rule 10b-5 promulgated thereunder, 17 C.F.R. § 240.10b-5, because Plaintiffs were neither purchasers nor sellers of a security. As discussed below, the Court concludes that Plaintiffs have pleaded the fraud counts with sufficient particularity and that Plaintiffs do not lack standing

to assert a claim of federal securities fraud. Ultimately, the Court concludes that Plaintiffs have failed to assert all the elements of fraud with respect to some of Defendant's allegedly fraudulent misrepresentations. Accordingly, the Court will deny the Motion to Dismiss in part and will grant the Motion to Dismiss in part.

I. Factual Allegations

The relevant allegations in Plaintiffs' Second Amended Complaint (Docket No. 22) are as follows. Defendant was President of Rainforest Aquaculture Products, Inc. (RAP), a Maine corporation, from the formation of the corporation sometime in 1990 until March 18, 1993. Second Amended Complaint ¶¶ 8, 10. Defendant was also the President and a member of the Board of Directors of Aquacorporacion International, S.A. (ACI), a Costa Rican corporation. Id. at ¶¶ 12, 19, 36. ACI is in the business of propagating and growing fish, and pursuant to a fish brokerage agreement, RAP is the broker for all fish produced by ACI. Id. at 17, 20.

Defendant Terrence Conway and the three individual Plaintiffs, Frank Simon, Thomas Hillman, and Ron Bernstein, are all shareholders and directors of RAP. Id. at ¶ 9. Prior to September 1991, Hillman held one-third of RAP's stock. Id. at ¶ 31. Also prior to September 1991, RAP held twenty percent of the stock of ACI. Id. at ¶ 31. In their Second Amended Complaint, Plaintiffs have alleged four different factual scenarios by which they contend that Defendant made fraudulent

misrepresentations.

A. Stock Option Misrepresentations

Plaintiffs allege that starting in September 1991, Defendant made representations to Plaintiffs and RAP's Board of Directors that he was arranging a stock option plan by which Hillman and Simon would be given the option to purchase shares in ACI personally. Id. at ¶ 33(a). In addition, it is alleged that Defendant stated that because of the ACI stock options, it would be appropriate for Hillman's interest in RAP to be reduced. Id. at ¶ 33(b). Plaintiffs further allege that Defendant told them that ACI and its other shareholders were in agreement concerning issuing stock options to Hillman and Simon. Id. at ¶ 33(c). Based on Defendant's representations, Hillman agreed and Simon consented to a dilution of Hillman's interest in RAP from 33.33% to 20%. Id. at ¶ 35. By his Second Amended Counterclaim (Docket No. 16), Defendant asserts that this transaction involved RAP issuing additional shares of stock to each of its three shareholders (Conway, Hillman, and Simon) and by also issuing stock to two new shareholders. Defendant's Second Amended Counterclaim ¶ 10. Plaintiffs admit that allegation. Plaintiffs' Reply to Second Amended Counterclaim ¶ 10 (Docket No. 25). As a consequence of this transaction, Defendant's proportion of ownership of RAP stock in relation to the other shareholders increased. Id. at ¶ 35.

In December 1991, ACI established a stock option plan, but neither Hillman nor Simon were included in the plan. Second

Amended Complaint ¶ 37. Plaintiffs allege that Defendant failed to inform Hillman and Simon that ACI had instituted the option plan. Id. at ¶¶ 37, 39. Instead, Defendant continued to make representations concerning the stock options and allegedly even went so far as to indicate that the stock options would be issued once RAP increased its ownership interest in ACI. Id. at ¶ 38. On December 5, 1992, based on the representations of Defendant, RAP and its shareholders, which include Simon and Hillman, agreed to pay approximately \$175,000 to exercise cash calls and purchase additional shares of ACI to increase RAP's ownership interest in ACI from 20% to 70%. Id. at ¶ 35.

Plaintiffs allege that Defendant's representations concerning the stock options were false. Id. at ¶ 34. In fact, Plaintiffs contend that Defendant never approached ACI or its shareholders with the idea of issuing options to Simon and Hillman. Id. at ¶ 39.

B. Defamatory Misrepresentations

Starting on February 21, 1993, Plaintiffs allege that Defendant made defamatory statements concerning RAP and the individual Plaintiffs. Id. at ¶ 40. Among other things, Defendant stated that Plaintiffs had failed to comply with the sales and marketing agreement between RAP and ACI; that Plaintiffs had miscalculated the charges payable by ACI to RAP; that Plaintiffs had been responsible for insider dealings; and that Plaintiffs had harmed both ACI and its minority shareholders economically. Id. at ¶ 40. Plaintiffs allege that these

statements were made to ACI and the minority shareholders of ACI through several letters. Id. at ¶ 40. The defamatory statements caused ACI to question its relationship with RAP and to spend \$18,000 in hiring an accounting firm to check for the alleged financial wrongdoings. Id. at ¶ 40(b)(1), 60(a)(2).

C. Ownership Misrepresentations

By a letter dated June 15, 1994, Defendant stated that he was entitled to majority ownership of RAP because the other RAP shareholders had failed to respond to a cash call by RAP. Id. at ¶ 44. Plaintiffs contend that Defendant made intentionally false statements concerning the extent of his ownership and voting control of RAP. Id. at ¶ 43. Defendant's misrepresentations placed a cloud of ownership on RAP and precluded Plaintiffs from marketing RAP's assets and/or stock to several prospective buyers. Id. at ¶ 45.

D. Default of Note Misrepresentations

On June 26, 1992, Simon executed a promissory note and delivered it to the Defendant. Id. at ¶ 47. Evidently, to secure the promissory note, Defendant and Simon entered into a security agreement by which Simon placed his RAP stock in escrow as collateral See id. at Exhibits D and E. The escrow agent was RAP's corporate counsel. Id. at ¶ 50, Exhibits D and E. Plaintiffs allege that although Simon was maintaining his obligations required by the note, Defendant called a default on the note in September 1995. Id. at ¶¶ 48, 49. Defendant made a demand upon the escrow agent to issue all the shares held in

Simon's name to Defendant. Id. at ¶ 50. At the time of the wrongful demand, Simon's stock had a value in excess of \$1,000,000, but the amount outstanding on the note was less than \$10,000. Id. at ¶ 52.

II. Fraud claims

By his Motion to Dismiss, Defendant contends that Plaintiffs' fraud claims should be dismissed for failure to state a claim pursuant to Rule 12(b)(6) and for failure to make the allegations with sufficient specificity pursuant to Rule 9(b). Fed. R. Civ. P. 9(b), 12(b)(6). Although the parties treat the legal grounds as a singular issue, the Court will address them separately. That is, the Court will first address whether Plaintiffs have stated all the elements of an action for fraud and then will address whether those allegations have been set forth with sufficient specificity.

A. Elements of common law fraud claims

Under Maine law,¹ a defendant is liable for fraud or deceit if he (1) makes a false representation, (2) of a material fact, (3) with knowledge of its falsity or in reckless disregard of whether it is true or false (4) for the purpose of inducing another to act or to refrain from acting in reliance upon it, and (5) the plaintiff justifiably relies upon the representation as true and acts upon it to the plaintiff's damage. Diversified Foods, Inc. v. First Nat'l Bank of Boston, 605 A.2d 609, 615 (Me.

¹Because the parties do not address what law should apply to this case, the Court will apply the law of the forum.

1992); Letellier v. Small, 400 A.2d 371, 376 (Me. 1979); see also Wyman v. Prime Discount Sec., 819 F. Supp. 79, 85 (D. Me. 1993).

In entertaining this Motion to Dismiss, the Court assumes that all of the factual allegations set forth in the Second Amended Complaint are true and draws all reasonable inferences from its allegations in favor of Plaintiffs. Resolution Trust Corp. v. Driscoll, 985 F.2d 44, 48 (1st Cir. 1993). The Court, however, need not accept legal conclusions or bald assertions. Id. "Furthermore, the complaint should not be dismissed unless it appears beyond doubt that Plaintiffs can prove no set of facts which would entitle them to relief." Wyman, 819 F. Supp. at 81.

Although Plaintiffs have alleged only one count of common law fraud in their Second Amended Complaint, that single count of fraud is premised on the four categories of fraudulent misrepresentations by Defendant outlined above in sections I.A. through I.D., supra. Second Amended Complaint ¶¶ 33, 38, 40, 41, 43, 44, 45, 49, 50, 54, and 87. The Court examines each of the four categories of misrepresentations alleged by Plaintiffs to ascertain whether Plaintiffs have alleged the elements of fraud with respect to each set of misrepresentations.

The allegations concerning the stock option misrepresentations contain all the elements of fraud. Plaintiffs allege that Defendant falsely represented that he would arrange a stock option plan for Hillman and Simon to purchase shares in ACI personally. Second Amended Complaint ¶¶ 33, 34. Defendant, however, knew that such representations were untrue and, in fact,

never approached ACI or its shareholders with the idea of stock options for Hillman and Simon. Id. at ¶¶ 34, 39, 87. It can be reasonably inferred from the allegations that Defendant made the allegations for the purpose of inducing Plaintiffs to act in reliance upon the misrepresentations.² In addition, Plaintiffs reasonably relied on the false representations to their detriment in that (1) Hillman and Simon agreed to a dilution of Hillman's interest in RAP, and (2) RAP and its shareholders agreed to pay approximately \$175,000 for additional ACI stock. Accordingly, Plaintiffs have alleged all the elements of fraud with respect to the stock option misrepresentations.

The allegations concerning the defamatory misrepresentations and the stock ownership misrepresentations fail to assert the fifth element of a fraud claim. To meet this element of a fraud claim, the plaintiff must have reasonably believed that the defendant's misrepresentations were true and relied on them to the plaintiff's detriment. See Diversified Foods, Inc., 605 A.2d at 615 (the plaintiff must justifiably rely upon defendant's false representation as true and act upon it to plaintiff's

²Plaintiffs allege that Defendant stated that it was appropriate for Hillman's interest in RAP to be reduced because Defendant had arranged for the options. Second Amended Complaint ¶ 33. Plaintiffs further allege that Defendant falsely stated that the stock options would be issued once RAP increased its ownership in ACI from 20% to 70%. Id. at ¶ 38. Accordingly, the direct inference of these allegations is that Defendant made misrepresentations concerning the stock option plan so that Hillman and Simon would agree to have Hillman's interest in RAP diluted, augmenting Defendant's interest, and RAP would agree to purchase additional ACI stock.

detriment); Restatement (Second) of Torts § 537 (1977).³ It is not enough that a third person relied on the defendant's misrepresentation.

In this case, Plaintiffs have not alleged that they were induced to rely on Defendant's false statements and to act upon the misrepresentations to their detriment. Instead, Plaintiffs allege that Defendant made false representations to third parties which, in turn, caused damages to Plaintiffs. Moreover, Plaintiffs do not allege that Defendant's defamatory misrepresentations or ownership misrepresentations induced Plaintiffs to justifiably rely on them, believing they were true. In fact, there is no allegation that Plaintiffs ever believed that such statements by Defendant were true nor that they acted in reliance upon those statements. Accordingly, Plaintiffs have failed to state all the elements of fraud with respect to the defamatory misrepresentations and ownership misrepresentations, and the Court will grant the Motion to Dismiss with respect to those allegations of fraud.

Plaintiffs have also failed to state a claim with respect to the misrepresentations concerning the default on the promissory note. Plaintiffs have alleged that Defendant made a false representation to RAP's corporate counsel of the material fact

³Section 537 provides that "[t]he recipient of a fraudulent misrepresentation can recover against its maker for pecuniary loss resulting from it if, but only if, (a) he relies on the misrepresentation in acting or refraining from action, and (b) his reliance is justifiable."

that Simon had defaulted on the promissory note. Second Amended Complaint ¶ 50. Plaintiffs, however, fail to allege that either Simon or RAP's corporate counsel reasonably relied on Defendant's false representation. In fact, Plaintiffs do not allege that RAP's corporate counsel ever issued all the shares held in Simon's name to Defendant. Furthermore, Plaintiffs fail to specify how they were damaged by Defendant's false representation. Because Plaintiffs have failed to allege all the elements of this allegation of fraud, the Court will grant Defendant's Motion to Dismiss with respect to Plaintiffs' allegation that Defendant made misrepresentations concerning the default on the promissory note.

B. The "Particularity" Requirement

Defendant further contends that Plaintiffs have failed to plead the common law fraud allegations and the federal securities fraud allegations with sufficient specificity. Defendant contends that Plaintiffs have failed to specify the date, place, and content of the alleged misrepresentations and have further neglected to explain how each "false and misleading statement" is fraudulent.

Pursuant to Federal Rule of Civil Procedure 9(b), a complaint alleging fraud must allege the circumstances constituting the fraud with specificity.⁴ The Court of Appeals

⁴Federal Rule of Civil Procedure 9(b) provides:

In all averments of fraud or mistake, the circumstances constituting fraud or mistake shall

for the First Circuit, as well as this Court, has repeatedly required strict compliance with the particularity requirement of Rule 9(b). See, e.g., Greenstone v. Cambex Corp., 975 F.2d 22 (1st Cir. 1992); Romani v. Shearson Lehman Hutton, 929 F.2d 875, 878 (1st Cir. 1991); New England Data Services, Inc. v. Becher, 829 F.2d 286, 290 (1st Cir. 1987); Wyman, 819 F. Supp. at 81; In re One Bancorp Securities Litigation, 135 F.R.D. 9, 12 (D. Me. 1991). The three purposes of the particularity requirement are "(1) to place the defendants on notice and enable them to prepare meaningful responses; (2) to preclude the use of a groundless fraud claim as a pretext to discovering a wrong or as a 'strike suit'; and (3) to safeguard defendants from frivolous charges which might damage their reputations." New England Data Services, Inc., 829 F.2d at 289.

To meet Rule 9(b)'s particularity requirement, the plaintiff must specify the time, place and content of an alleged false representation. Romani, 929 F.2d at 878; In re One Bancorp, 135 F.R.D. at 12. "Although a plaintiff need not specify the circumstances or evidence from which fraudulent intent could be inferred, the complaint must provide some factual support for the allegations of fraud." Romani, 929 F.2d at 878. The particularity requirement of Rule 9(b) applies with equal force to claims for fraud pursuant to the federal securities laws.

be stated with particularity. Malice, intent, knowledge, and other condition of mind of a person may be averred generally.

Greenstone, 975 F.2d at 25; Hayduk v. Lanna, 775 F.2d 441, 443 (1st Cir. 1985); Wyman, 819 F. Supp. at 81-82; In re One Bancorp, 135 F.R.D. at 12.

Plaintiffs have made sufficient allegations to comply with the particularity requirement with respect to the allegations of stock option misrepresentations and securities fraud. Plaintiffs have alleged three separate dates, times, and places at which Defendant falsely stated either that he was arranging or had arranged for stock options in ACI to be issued to Hillman and Simon in exchange for Simon agreeing to have his proportional share in RAP reduced and for RAP agreeing to purchase additional shares of ACI. Second Amended Complaint ¶¶ 33, 38. Plaintiffs explain that these statements were false by alleging that Defendant made them even after ACI had already instituted the stock option plan and even though Defendant never approached ACI or its shareholders with the idea of stock options being issued to Hillman and Simon. Id. at ¶¶ 37, 38, 39. These allegations give Defendant notice of the alleged circumstances constituting the common law fraud and the securities fraud. Consequently, Defendant is able to prepare a meaningful defense. In addition, the allegations satisfy the Court that the claim is neither a pretext to discovering a wrong nor a frivolous charge that is intended only to damage Defendant's reputation. These allegations satisfy the purposes of the particularity requirement, and this Court will not dismiss the fraud claims for failure to make the allegations with specificity.

III. Standing to Assert Federal Securities Fraud

Defendant's final contention is that Plaintiffs do not have standing to assert a claim pursuant to the federal securities laws. That is, Defendant contends that Plaintiffs must have either purchased or sold a security to have standing to bring a claim but that Plaintiffs have failed to make such an allegation in this instance.

To prevail on a claim of securities fraud pursuant to section 10(b) and Rule 10b-5, "a plaintiff must prove the following elements: '(1) the defendant made a false statement or omission of a material fact (2) with scienter (3) upon which the plaintiff justifiably relied (4) that proximately caused the plaintiff's damages.'" Cooke v. Manufactured Homes, Inc., 998 F.2d 1256, 1260-61 (4th Cir. 1993) (quoting Myers v. Finkle, 950 F.2d 165, 167 (4th Cir. 1991); see also Fine v. American Solar King Corp., 919 F.2d 290, 300 (5th Cir. 1990), cert. dismissed, 502 U.S. 976 (1991); Harris v. Union Elec. Co., 787 F.2d 355, 362 (8th Cir.), cert. denied, 479 U.S. 823 (1986). Furthermore, to have standing to assert the claim, the plaintiff must have been misled either as a purchaser or a seller of a security. Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 730-31 (1975), reh'g denied, 423 U.S. 884 (1975); Jackvony v. Riht Fin. Corp., 873 F.2d 411, 414 (1st Cir. 1989); 15 U.S.C. 78j(b). Being misled to refrain from purchasing or selling a security is insufficient. See Blue Chip Stamps, 421 U.S. at 726-27, 731.

In this case, there are two transactions involving one or

more of the Plaintiffs that give rise to Plaintiffs' federal security claims. First, it has been alleged that on February 4, 1992, RAP issued additional shares of stock to each of its shareholders and to two additional shareholders. Second Amended Complaint ¶ 35; Second Amended Counterclaim ¶ 10; Answer to Second Amended Counterclaim ¶ 10. Second, Plaintiff has alleged that Defendant induced RAP to purchase additional shares of ACI for approximately \$175,000. Second Amended Complaint ¶ 35. There being two allegations regarding the purchase or sale of a security by one or more of the Plaintiffs, the Court concludes that Plaintiffs have standing to assert a violation of federal securities laws.

Accordingly, for the foregoing reasons, Defendant's Motion to Dismiss Count V is GRANTED with respect to the allegations of defamatory misrepresentations, ownership misrepresentations, and default of note misrepresentations. In all other respects, Defendant's Motion to Dismiss is DENIED.

So ORDERED.

GENE CARTER
Chief Judge

Dated at Portland, Maine this 15th day of March, 1996.