78128-1

No. 22704-9-III

COURT OF APPEALS, DIVISION III

OF THE STATE OF WASHINGTON

CLARK E. KINNEY, and BARBARA E. KINNEY, individually and the marital community, Appellants, vs. KENNETH B. COOK, a single man, Respondent.	)	BRIEF OF RESPONDENT

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I. STATEMENT OF THE CASE

A. Factual Background.

In December of 1993, Kinney and Cook agreed to form Spokane Freightliner, Inc. (the "Company"). (CP 4). The Company's name now is Freedom Truck Centers, Inc. They agreed that each person would contribute $225,000 to the company (a total of $450,000) as equity in exchange for fifty-percent of the shares of common stock issued by the Company. (CP 4). Kinney borrowed these funds from Cook, as evidenced by a promissory note (the "1993 Note" or "Note") issued from Kinney to Cook on December 31, 1993. (CP 4). After borrowing the money from Cook, Kinney contributed it to the Company in exchange for 50,000 shares of common stock. (CP 4). To secure payment of the Note, Kinney signed a Pledge Agreement, pursuant to which Kinney pledged his shares to Cook as collateral to secure payment of the Note. (CP 92, 304). Cook made the same investment. Kinney and Cook became equal shareholders of the Company.

Kinney and Cook remained equal shareholders of the Company until February 26, 1997. On that date, they entered into a Memorandum of Understanding that included Cook's purchase of Kinney's shares and cancellation of the Note and Pledge Agreement. (CP 5). On September 15, 1998, however, Kinney brought a lawsuit against Cook and the

Company in Spokane Superior Court, alleging that the purchase of the shares from him by Cook violated the Washington Securities Act. (CP 5). That lawsuit resulted in a jury verdict for the plaintiff on March 29, 2000. The Judgment, prepared by counsel for Kinney and entered on July 11, 2000, rescinded Cook's purchase of Kinney's shares, reinstated the 1993 Note, reinstated the 1993 Pledge Agreement, and reinstated Kinney as personal guarantor of the Company's debts. (CP 5, 41).

The Judgment entered by Judge Austin specifically stated:

> 1. For defendants' violation of Section 21.20.010 of the Securities Act of Washington, plaintiffs shall be entitled to the remedies provided for in RCW 21.20.430(2) as follows:
>
> a. Defendants <u>Kenneth B. Cook and Spokane Freightliner, Inc. shall return to Clark E. Kinney and Barbara E. Kinney 50,000 shares of Spokane Freightliner, Inc. common stock</u> who shall deliver possession to the secured party (Kenneth Cook) under the Pledge Agreement dated December 31, 1993. In exchange for the return of the 50,000 shares of Spokane Freightliner, Inc. common stock, plaintiffs shall return to Spokane Freightliner, Inc. all consideration paid to them for the 50,000 shares of common stock. Said consideration consists of the following: (1) <u>return to Kenneth B. Cook of the promissory note dated December 31,1993 made by plaintiffs in favor of defendant Kenneth B. Cook</u>, attached hereto as Exhibit "A" which is hereby reinstated, provided that no interest

> shall be payable on the promissory note during the period of the violation of the Washington Securities Act, from February 26, 1997 to the date of Judgment; (2) reinstatement of the Pledge Agreement dated December 31, 1993; (3) reinstatement of officer receivables in the amount of $48,654.77 as of February 26, 1997; (4) reinstatement of additional officer withdrawals in the amount of $9,500.00 as of February 26, 1997; and (5) reinstatement of Clark E. Kinney and Barbara E. Kinney as guarantors of the debts of Spokane Freightliner, Inc.

(CP 41-42, emphasis added).

Kinney was represented by Maris Baltins in that litigation. Kinney and his counsel have admitted repeatedly that the Judgment—and not some action by Cook—reinstated Kinney as a fifty-percent shareholder in the Company on July 11, 2000. (CP 92, 105, 151, 304). In fact, Kinney admitted again in the Appellants' Opening Brief that the Judgment returned the shares of common stock of the Company to Kinney as part of reinstatement of the 1993 Note and the 1993 Pledge Agreement. (App.Op.Br., pp. 3-4).

On July 12, 2000, Cook delivered to Kinney a Notice of Default on the Note and demanded payment in full; this demand was made in accordance with the terms of the Note and Pledge Agreement. (CP 6, 304-05). In response to the Notice of Default, Kinney paid $266,534.06 to

Cook on July 26, 2000, in satisfaction of the 1993 Note. (CP 6). If Cook had not loaned the money to Kinney in 1993, Kinney would not have been a shareholder from December 31, 1993 until February 26, 1997, or from July 11, 2000 forward.

Kinney states that he would not have been a shareholder in the Company if he had not paid the demanded amount. (Appellants' Opening Brief 15). There is no factual support for that statement. He became a shareholder again when the Judgment was entered. He paid the debt he incurred in 1993, not to purchase the shares but to keep the shares. Cook had the right, under the Washington Uniform Commercial Code and the terms of the Pledge Agreement, to foreclose on Kinney's shares of common stock in the Company if Kinney failed to pay the 1993 Note upon maturity. The shares of common stock were the collateral securing payment of the 1993 Note. See RCW 62A.9A-601. If the value of those shares in the foreclosure was worth less than the debt, Kinney would have been liable for the deficiency. Kinney chose to pay the 1993 Note rather than risk losing the shares of common stock in a foreclosure.

B. Civil Rule 12(b)(6) Standard.

The appellate standard of review for an Order on a Civil Rule 12(b)(6) motion is *de novo*. Port of Seattle v. Lexington Ins. Co., 111 Wn.App. 901, 906, 48 P.3d 334 (2002). Civil Rule 12(b)(6) provides that a complaint should be dismissed if it fails to state a claim upon which relief may be granted. CR 12(b)(6). The question under this type of motion is primarily a legal question, with the "facts" considered as a conceptual backdrop for the legal determination. If none of the facts alleged in the complaint justify the recovery requested by the plaintiff, then the complaint should be dismissed for failure to state a claim. Reid v. Pierce County, 136 Wn.2d 195, 201, 961 P.2d 333 (1998). Furthermore, if the plaintiff cannot present a set of facts, consistent with the complaint, which would entitle him to relief, the complaint should be dismissed. See Halvorson v. Dahl, 89 Wn.2d 673, 674, 574 P.2d 1190 (1978).

Based on this standard, the Trial Court correctly concluded that none of the facts alleged in Kinney's Complaint, nor in response to Cook's Motion to Dismiss for Failure to State a Claim, justified the recovery Kinney sought. (CP 418-420).

II. ARGUMENT

A. The Trial Court Correctly Determined that Kinney's Complaint Failed to State a Claim Upon Which Relief May be Granted.

Kinney's Complaint alleges a single cause of action for violation of the Washington Securities Act, specifically RCW 21.20.010. (CP 8). To state a claim under this statute, Kinney has to allege facts showing that Cook made a misrepresentation or omission of material fact in connection with a sale of security. RCW 21.20.010. Kinney attempted to do so by alleging that Cook violated the statute "in connection with the sale of the Company's common stock to Kinneys on July 26, 2000." (CP 8).

This allegation fails to support Kinney's claim for violation of the Washington Securities Act for three reasons: (1) The 1993 Note was not a security, (2) Cook was not a seller of securities on July 26, 2000, and (3) No sale occurred on July 26, 2000. Because there was no sale of a security, there could not have been a violation of the statute.

1. The Note was Not a Security.

Although the broad definition of a "security" in RCW 21.20.005 includes the word "note", the 1993 Note at issue here was not a security. Notes issued in a commercial context are not securities.

Kinney relies on the family resemblance test, as applied in Douglass v. Stanger, 101 Wn.App. 243, 2 P.3d 998 (2000), to determine whether the Note was a security. The family resemblance test is used to guide a court in deciding whether a note is a security in the hands of an investor and includes four considerations:

> First, why did the seller and buyer enter into the transaction? Specifically, is the purpose of the transaction to raise money for a business enterprise? Or is it, instead, for consumer goods or some other noncommercial reason? Second, is the note commonly traded for speculation or

> investment? Third, we look at the reasonable expectations of the investing public. What are the economic realities? Fourth, and finally, we look at whether another regulatory scheme significantly reduces the risk associated with the note and investment agreement and thereby renders application of the securities act regulation unnecessary.

Id. at 252-53. Legally, the test applied in Douglass is the correct one to apply here. Factually, Douglass is inapposite.

Under the legal test, the 1993 Note does not resemble a security. The 1993 Note was issued in a commercial transaction in 1993 to evidence a loan from Cook to Kinney. (CP 4). Kinney immediately used the money borrowed from Cook to purchase half of the outstanding shares of common stock from the Company. (CP 4). The purpose of the transaction evidenced by the 1993 Note, however, was a simple loan of money. Furthermore, this 1993 Note is not the type that is traded in a securities market.

Factually, Douglass does not apply. Kinney would like to compare his position with that of Douglass, as the plaintiff in that case. The comparison is inappropriate, however, because the parties are in opposite positions. Douglass was the party who loaned money in return for a note and an ownership interest in a business to be created by Stanger. Id. at 253-54. Douglass was the holder of the note; it was determined to be a security because it was issued as part of the transaction in which Douglass invested money and expected to be a participant in the new business enterprise with Stanger. Id.

In the case of a promissory note, the investor is the note's holder—not its issuer. See SEC v. Wallenbrock, 313 F.3d 532 (9th Cir. 2002). Douglass was the investor because he was the holder of the note.

In this case, Cook—not Kinney—is in the same position as Douglass. Cook, like Douglass, is the one who loaned money and held the 1993 Note. Cook is the investor whom the securities laws were meant to protect. Therefore, even if the 1993 Note is deemed to be a security under the family resemblance test, it is Cook who would be entitled to the protection of the securities laws.

Kinney asks that the securities laws be turned upside down by contending that Kinney, as the person obligated to pay the balance due on the 1993 Note, has the right to the protection of the securities laws. Congress intended the securities laws to protect those, like Cook, who permit others to use their money.

2. Cook Was Not a Seller of Securities.

Under the Washington Securities Act, only those who offer or sell securities may be found liable for misrepresentation or omission of material facts. RCW 21.20.430(1); Shinn v. Thrust IV, Inc., 56 Wn.App.

827, 851, 786 P.2d 285 (1990), review denied 114 Wn.2d 1023, 792 P.2d 535 (1990). More specifically, liability is limited to actions or omissions by individuals from whom title to the securities directly passes. Brin v. Stutzman, 89 Wn.App. 809, 830, 951 P.2d 291 (1998), review denied 136 Wn.2d 1004, 966 P.2d 901 (1998).

Cook does not fit this definition of "seller" because he did not transfer shares of common stock to Kinney—in 1993 or in 2000. In 1993, Cook's role in Kinney's purchase of shares was limited to financially enabling Kinney to make the purchase of shares issued by the Company. The Company was the seller and issuer of the shares for securities laws purposes. Cook loaned Kinney money; he did not sell him a security. The Judgment entered on July 11, 2000, returned Kinney to his former position as a shareholder. The trial court and jury were the acting parties. Kinney paid money to Cook in 2000 to satisfy a debt, not to buy securities. The Company was not raising money for the business, as inferred by Kinney. (App.Op.Br., p. 19). The shares were returned to Kinney when he was reinstated by the Judgment as a shareholder before he paid the Note. (CP 5, 41). The Pledge Agreement would have been worthless if Kinney had not been the owner of the shares. As stated by counsel for Kinney in the Response to Defendant's Motion to Dismiss (CP 304):

> As the secured party under the Pledge Agreement, Cook retained possession of the stock certificate evidencing the Kinneys' interest in the Corporation.

Cook could not have been a seller of securities on July 26, 2000, because he held the stock certificate as the secured party, not as the owner of the shares. Cook's security interest was terminated by Kinney's payment, and Cook delivered the stock certificate to Kinney. (App.Op.Br., p. 4). As stated by Kinney: "The Judgment Upon Verdict forced Cook to share ownership in the Corporation." (App.Op.Br., p. 4).

3. <u>No Sale Occurred on July 26, 2000.</u>

The Note was issued in 1993, and Kinney purchased his shares in the Company in 1993. (CP 4). Kinney sold his shares to Cook in 1997, but Kinney successfully fought for rescission of that sale in his first lawsuit against Cook on these issues. (CP 5). The Judgment in that case, entered on July 11, 2000, returned Kinney's shares and reinstated the original Note. (CP 5, 41). Therefore, Kinney already owned the shares he claims to have "purchased" on July 26, 2000.

There is no authority to support Kinney's theory that the payment of a note upon maturity is itself a new purchase of a security. Even if the 1993 Note was a security and Cook was a seller, the only transaction involving a security with any possible application of the Washington

Securities Act occurred in 1993. A transaction is not a security. RCW 21.20.005(12)(a) does not include "transaction" in its definition of "security." Kinney's Assignment of Error 2) and Issue 1) are not properly stated. (App.Op.Br. 1, 15, 16, 19-22). The applicable statute of limitations bars Kinney from suing on the 1993 transaction. RCW 21.20.430(4)(b).

B. Cook is Entitled to an Award of Attorneys' Fees Expended in Responding to this Appeal.

A party forced to respond to a frivolous appeal may be entitled to an award of sanctions, which may include reimbursement for attorneys' fees expended on appeal, against the appellant. RAP 18.1; RAP 18.9. An appeal is considered frivolous—and an award of attorneys' fees appropriate—if the appellant raises no debatable issues upon which reasonable minds could differ. Green River Community College v. Personnel Board, 107 Wn.2d 427, 443, 730 P.2d 653 (1986); Goad v. Hambridge, 85 Wn.App. 98, 105, 931 P.2d 200 (1997), review denied 132 Wn.2d 1010, 940 P.2d 654 (1997).

The above argument in support of affirmation of the Trial Court's dismissal of Kinney's Complaint likewise supports a finding that Kinney's appeal is frivolous. It is beyond debate that a party who already owns shares, as Kinney did beginning in 1993, does not purchase the shares again when he pays off the debt he incurred to buy them.

For bringing a frivolous appeal, which fails to raise any debatable issues, Kinney should be sanctioned in the amount of Cook's attorneys' fees on appeal.

III. CONCLUSION

Cook did not sell a security on July 26, 2000. The definition of a security in RCW 21.20.005(12)(a) includes "in general, any interest or instrument commonly known as a security." Shares of common stock are a security, but Kinney already owned those shares. A promissory note can be a security, but only in the hands of the person who loaned the money as an investor.

Because Kinney's Complaint depends upon the allegation that Cook sold a security on July 26, 2000, the Complaint does not state a claim for which relief may be granted. The Trial Court recognized this deficiency and correctly concluded that the only sale of a security occurred in 1993, that there was no sale of a security in 2000, and that the three-year statute of limitations barred any claims arising from any possible sale of a security in 1993.

The Trial Court accordingly dismissed Kinney's Complaint. CR 12(b)(6). That decision was supported by both law and fact and should be upheld. This appeal, therefore, is clearly without merit and should be dismissed, with an award of sanctions in the amount of Cook's attorneys' fees charged to Kinney.

DATED this 29th day of November, 2004.

PAINE, HAMBLEN, COFFIN
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CERTIFICATE OF SERVICE

I HEREBY CERTIFY that on the 29th day of November, 2004, I caused to be served a true and correct copy of the foregoing BRIEF OF RESPONDENT as follows:

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In the Office of the Clerk of Court
Washington Court of Appeals, Division Three
By

No. 22704-9-III

COURT OF APPEALS, DIVISION III

OF THE STATE OF WASHINGTON

CLARK E. KINNEY, and BARBARA E. KINNEY, individually and the marital community,	)	
Appellants,	)	RESPONDENT'S STATEMENT OF ADDITIONAL AUTHORITIES
vs.	)	
KENNETH B. COOK, a single man,	)	
Respondent.	)	

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In accordance with Rule of Appellate Procedure 10.8, Respondent Kenneth B. Cook ("Cook") submits the attached case, Amzak Corporation v. Reliant Energy, Inc., 2004 WL 1882482 (N.D. Ill. 2004), as additional authority on the issue of whether Cook sold a security to the Appellants on July 26, 2000.

DATED this 29th day of December, 2004.

PAINE, HAMBLEN, COFFIN
BROOKE & MILLER LLP

By: Erin A Jacobson

LAWRENCE R. SMALL, WSBA #2993
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CERTIFICATE OF SERVICE

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H
Motions, Pleadings and Filings

Only the Westlaw citation is currently available.

United States District Court,
N.D. Illinois, Eastern Division.

AMZAK CORPORATION, Countryside Cable, Inc., and Gerald Kazma, Plaintiffs,
v.
RELIANT ENERGY, INC. and its successor in interest Centerpoint Energy, Inc.; R. Steve Letbetter; Stephen W. Naeve; and Mary P. Ricciardello, Defendants.

No. 03 C 0877.

Aug. 19, 2004.

MEMORANDUM OPINION AND ORDER

LEFKOW, J.

***1** On January 27, 2004, this court dismissed without prejudice the First Amended Complaint of plaintiffs, Amzak Corporation ("Amzak"), Countryside Cable, Inc. ("Countryside"), and Gerald Kazma ("Kazma"), against defendants, Reliant Energy, Inc. (and its successor in interest CenterPoint Energy, Inc.) ("Reliant Energy"), R. Steve Letbetter ("Letbetter"), Stephen W. Naeve ("Naeve") and Mary P. Ricciardello ("Ricciardello") (collectively "defendants"). On March 3, 2004, plaintiffs filed their Second Amended Complaint which, similar to the First Amended Complaint, alleges that defendants (1) violated § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and Rule 10b-5 promulgated under § 78j(b), by knowingly making misrepresentations and by failing to state material facts concerning publicly traded securities in Reliant Energy; (2) violated § 20(a) of the Securities Exchange Act of 1934, 18 U.S.C. § 78t(a); (3) committed fraudulent misrepresentation under Illinois law; and (4) violated the Illinois Consumer Fraud and Deceptive Business Practices Act, 815 ILCS 505/1 *et seq.* Defendants have moved to dismiss the Second Amended Complaint for failure to state a claim upon which relief may be granted under Federal Rule of Civil Procedure 12(b)(6) and for failure to satisfy the pleading requirements of Federal Rule of Civil Procedure 9(b) and the Private Securities Litigation Reform Act of 1995, 15 U.S.C. § 78u-4(b) ("PSLRA"). For the reasons set forth below, defendants' motion is granted.

MOTION TO DISMISS STANDARDS

A motion to dismiss under Federal Rule of Civil Procedure 12(b)(6) challenges the sufficiency of the complaint for failure to state a claim upon which relief may be granted. *General Elec. Capital Corp. v. Lease Resolution Corp.*, 128 F.3d 1074, 1080 (7th Cir.1997). Dismissal is appropriate only if it appears beyond a doubt that the plaintiff can prove no set of facts in support of its claim that would entitle it to relief. *Conley v. Gibson*, 355 U.S. 41, 45-46 (1957); *Kennedy v. Nat'l Juvenile Det. Ass'n*, 187 F.3d 690, 695 (7th Cir.1999). In ruling on the motion, the court accepts as true all well pleaded facts alleged in the complaint, and it draws all reasonable inferences from those facts in favor of the plaintiff. *Jackson v. E.J. Brach Corp.*, 176 F.3d 971, 977 (7th Cir.1999); *Zemke v. City of Chicago*, 100 F.3d 511, 513 (7th Cir.1996).

In addition to the mandates of Rule 12(b)(6), Federal Rule of Civil Procedure 9(b) requires "all averments of fraud" to be "stated with particularity," although "[m]alice, intent, knowledge, and other condition of mind of a person may be averred generally." "The rule requires the plaintiff to state the identity of the person who made the misrepresentation, the time, place, and content of the misrepresentation, and the method by which the misrepresentation was communicated to the plaintiff." *Vicom, Inc. v. Harbridge Merch. Servs., Inc.*, 20 F.3d 771, 777 (7th Cir.1994); *see also* DiLeo v. Ernst & Young, 901 F.2d 624, 627 (7th Cir.1990) ("Although states of mind may be pleaded generally [under Rule 9(b)], the 'circumstances' must be pleaded in detail. This means the who, what, when, where, and how: the first paragraph of any newspaper story."). " 'Because only a fraction of financial deteriorations reflects fraud,'... plaintiffs in securities cases must provide enough information about the underlying facts to distinguish their claims from those of disgruntled investors." *Arazie v. Mullane*, 2 F.3d 1456, 1458 (7th Cir.1993) (quoting in part DiLeo, 901 F.2d at 628).

***2** Further, in addition to Rule 9(b), the PSLRA imposes "heightened pleading requirements" to discourage claims of "so-called 'fraud by hindsight." ' *In re Brightpoint, Inc. Sec. Litig.*, No. IP99-0870-C-H/G, 2001 WL 395752, at *3 (S.D.Ind. Mar. 29, 2001). Section 78u-4(b) "requires a court to dismiss a complaint that fails to (1) identify each of the allegedly material, misleading statements, (2) state facts that provide a basis for allegations made on information and belief, or (3) state with particularity 'facts giving rise to a strong inference that the defendant acted with the required state of mind." ' *Id.* at *4.

ALLEGATIONS OF THE COMPLAINT

Reliant Energy is an international energy services and energy delivery company providing services in North America and Western Europe. (Sec.Am.Compl.¶ 5.) During the time periods relevant to this action, Reliant Energy was the owner of approximately 82.4% of the stock of Reliant Resources, Inc. ("Reliant Resources"), an energy services company marketing power and natural gas in North America and Western Europe. (Sec.Am.Compl.¶ 5.) Also, defendants Letbetter, Naeve, and Ricciardello ("individual defendants") were executive officers of Reliant Energy and/or Reliant Resources. (Sec.Am.Compl.¶ ¶ 7-9.)

On May 10, 2002, Reliant Resources disclosed that it had engaged in so-called "roundtrip transactions" in which "it had engaged in transactions with other power traders to buy and sell power to each other simultaneously, and at the same price...." (Sec.Am.Compl.¶ 64.) Reliant Resources announced that it was undertaking a review of these transactions. (*Id.*) On May 13, 2002, after the review had taken place, Reliant Resources announced in a press release that the roundtrip transactions had the effect of improperly increasing revenues and improperly inflating trading volume. (Sec.Am.Compl.¶ 65.)

Plaintiffs allege that defendants made materially false and misleading statements in SEC filings, press releases and other communications regarding Reliant Energy's revenues before the disclosure of the round-trip trades, and that those statements artificially inflated Reliant Energy's stock price during the August 2, 1999 to May 10, 2002 time period. (Sec.Am.Compl.¶ 87.) Plaintiffs describe a numbers of actions they undertook with respect to Reliant Energy stock during that time period. On or about October 1, 2000, plaintiffs secured loans from Harris Bank by pledging their Reliant Energy stock as collateral. (Sec.Am.Compl.¶ 14.) Plaintiffs allege that this transaction effected a transfer to the bank of "conditional and defeasible interests" in their Reliant Energy stock. (*Id.*) When the price of the Reliant Energy stock fell in June and July of 2001 (due to normal market forces and not fraud), the Reliant Energy stock became insufficient collateral for plaintiffs' loans with their bank. Rather than allow the bank to foreclose on the stock, plaintiffs transferred to the bank additional assets to serve as additional collateral. According to plaintiffs, by doing this they "purchase[d] from Harris Bank with cash from assets other than Reliant Energy stock the conditional and defeasible interests in such pledged shares of Reliant Energy stock, thereby in effect redeeming their interests." (Sec.Am.Compl.¶ 15.)

***3** Plaintiffs allege a second similar scenario that took place in the fall of 2001 when the share price of Reliant Energy stock once again dropped and rendered plaintiffs' collateral insufficient. The loan agreements at this point were with LaSalle Bank. Plaintiffs again point out that they posted additional collateral to LaSalle Bank in order to avoid foreclosure on their Reliant Energy shares. (Sec.Am.Compl.¶ 18.)

Plaintiffs assert damages because, on May 10 and 13, 2002, in the wake of the curative statements disclosing the round trip trades, Reliant Energy's stock fell from $24.60 on May 9, 2002 to $15.87 on May 14, 2002. (Sec.Am.Compl.¶ 66.) Plaintiffs claim that absent the alleged misrepresentations they would not have transferred the additional collateral amounts to their banks and would have instead allowed the banks to foreclose on the shares. (Sec.Am.Compl.¶ ¶ 87- 88.) Plaintiffs also allege that they would have sold their Reliant Energy shares to several buyers who approached them during the time period, but did not do so because of the alleged misrepresentations. (Sec.Am.Compl.¶ ¶ 101- 05.)

DISCUSSION

A. Count I: Section 10(b)

Section 10(b) of the Securities Exchange Act of 1934 provides,

> 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 ... [t]o 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

[Securities and Exchange] Commission ["SEC"] may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Pursuant to this section, the SEC promulgated Rule 10b-5, which makes it unlawful for any person

(a) To employ any device, scheme, or artifice to defraud, (b) [t]o 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, or (c) [t]o engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5.

To establish liability under § 10(b) and Rule 10b-5, a plaintiff must prove that "(1) the defendant made a false statement or omission (2) of material fact (3) with scienter (4) in connection with the purchase or sale of securities (5) upon which the plaintiff justifiably relied (6) and that the false statement proximately caused the plaintiff's damages." *Caremark, Inc. v. Coram HealthCare Corp.,* 113 F.3d 645, 648 (7th Cir.1997); *Searls v. Glasser,* 64 F.3d 1061, 1066-67 (7th Cir.1995). Significantly, this remedy under § 10(b) and Rule 10b-5 is limited only to "actual purchasers and sellers" of securities. *Blue Chip Stamps v. Manor Drug Stores,* 421 U.S. 723, 732 (1975).

***4** Defendants once again argue that plaintiffs' Second Amended Complaint fails because it does not allege any purchase or sale of stock. Plaintiffs' § 10(b) claim in their First Amended Complaint was dismissed on this ground. *See Amzak Corp. v. Reliant Energy, Inc.,* No. 03 C 0877, 2004 WL 407027, at *3-5 (N.D.Ill. Jan. 28, 2004). In their First Amended Complaint plaintiffs described the transactions at issue as "constructive purchases" of additional shares of Reliant Energy's stock. Abandoning that theory in their Second Amended Complaint, plaintiffs characterize their payments to supplement their collateral as re-purchases of "conditional and defeasible interests" in Reliant Energy's stock. According to plaintiffs, when they first pledged the stocks they gave up these conditional and defeasible interests, and by pledging additional assets as collateral when the price of the stock went down, they purchased the conditional and defeasible interests back from the banks.

As defendants point out, whether these transactions are described as "constructive purchases" or purchases of "conditional and defeasible interests," this transaction only served as the transfer of additional assets to the banks to stop foreclosure on the pledged stock. For the reasons expressed in the January 27, 2004 memorandum opinion and order, the court does not believe that this is a purchase or sale of a security. Certainly no case has ever so held. Plaintiffs merely took action to prevent foreclosure of their stock and did not acquire any additional shares as a result of those actions. Because there is no allegation of a purchase or sale of securities within the relevant time period, the court dismisses the § 10(b) claims. [FN1]

FN1. Even if there was a purchase or sale of security under the circumstances pled in plaintiffs' Second Amended Complaint, as discussed below, plaintiffs cannot prove any actionable damages. Accordingly, that is an alternative ground for dismissal of the § 10(b) claims.

B. Count II: Section 20(a)

This claim's survival depends on whether plaintiff's complaint adequately states a claim under § 10(b) and Rule 10b-5. *See In re Allscripts, Inc. Secs. Litig.,* No. 00 C 6796, 2001 WL 743411, at *12 (N.D. Ill. June 29, 2001) ("If a Complaint does not adequately allege an underlying violation of the securities law ... the district court must dismiss the section 20(a) claim."). Because the claims under § 10(b) and Rule 10b-5 have been dismissed, the § 20(a) claim is likewise also dismissed.

C. State Law Claims

Having dismissed the federal claims, all that remains are plaintiffs' state law claims for common law fraud and misrepresentation and violations of the Illinois Consumer Fraud and Deceptive Business Practices Act. The plaintiffs have alleged original jurisdiction over the state claims pursuant to 28 U.S.C. § 1332, which requires that all parties be of diverse citizenship and the amount in controversy exceed $75,000 exclusive of interest and costs. The Second Amended Complaint states that both Amzak and Countryside are Delaware Corporations with their principal places of business in Illinois. Kazma is also listed as a citizen of Illinois. Reliant Energy and CenterPoint Energy, Inc. ("CenterPoint") are Texas corporations with their principal places of business in that state. The individual defendants are all Texas citizens. Also, the amount in controversy exceeds $75,000 exclusive of interest and costs. Thus, this court's jurisdiction to consider the state claims rests in 28 U.S.C. § 1332(a)(1).

1. Common Law Fraud and Misrepresentation

***5** To plead a claim for fraud under Illinois law, a plaintiff must show: (1) a false statement of material fact was made; (2) the defendant knew or believed the statement was false; (3) plaintiff was justified in relying on the statement; (4) the defendant intended to induce the other party to act; and (5) plaintiff suffered damage due to the reliance. *See Prime Leasing v. Kendig*, 332 Ill.App.3d 300, 308-09, 773 N.E.2d 84, 92 (2002). Defendants argue that plaintiffs' fraud claim fails for (a) a lack of damages, (b) failure to plead reliance with the required specificity, and (c) failure to plead that the individual defendants knew the alleged misrepresentations were false or that they intended to induce reliance.

Starting with defendants' damages argument, they assert that plaintiffs were not damaged by any alleged fraud insofar as they pledged the shares when the price was allegedly inflated by the false and misleading statements. Plaintiffs, in response, claim damages in two ways. First they claim to be damaged because they refrained from entering into "prepaid forward contracts" to sell the pledged shares due to the alleged material misrepresentations or omissions by defendants which created an inflated appearance of value of the Reliant Energy stock. Plaintiffs note that had they entered into these prepaid forward contracts, they would have obtained a minimum share price of $24.50 per share, as compared to a decline in value of approximately fifty percent when the stock fell to $15.87 on the date following the announcement of the improper round-trip trading. Second, plaintiffs claim damages when they had to make payments to their lenders to prevent them from selling the stock. According to plaintiffs, they repurchased rights in the stock at this time and to the extent the price at the time of the margin default buy-back was in excess of the later sales on the fraud-related collapse, they suffered a loss.

Both of plaintiffs' theories on damages are flawed. Their first theory, that they would have sold the shares based on prepaid forward contracts, essentially complains that they did not sell the stock while its price was artificially (and allegedly fraudulently) inflated. Plaintiffs admit as much: "The difference between the value at the time of the pledge and the later unfavorable prices represents demonstrable damages suffered by plaintiffs in forbearing a complete disposition of the shares." (Pl. Resp. at 5.) This amounts to nothing more than a claim that plaintiffs should be entitled to "profit from what they allege was an unlawfully inflated stock value." *Chanoff v. U.S. Surgical Corp.*, 857 F.Supp. 1011, 1018 (D.Conn.1994). Significantly, plaintiffs do not allege, and are not understood to argue, that the price after the disclosure was less than what the price would have been absent the alleged fraud. *See Small v. Fritz Cos., Inc.* 30 Cal.4th 167, 191 (2003) (Kennard, J. concurring). Phrased another way, plaintiffs' theory of damages is not that they are attempting to recover that amount (if any) which constitutes "the loss in value attributable to fraud from that attributable to the disclosure of truthful but unfavorable financial data." *Id.* Instead, as noted above, plaintiffs' theory is that they should recover the difference in value at the time of the pledge from the later unfavorable price after disclosure of the alleged round-trip trades. The court rejects such a theory of damages.

***6** Plaintiffs' second theory of damages also fails. Plaintiffs argue that they incurred out-of-pocket losses when they transferred "other assets" to their lenders as additional collateral when the loans became under-collateralized. But, once again, no where do plaintiffs allege that they in fact lost any of these out-of-pocket expenses. Instead, they assert that "[t]o the extent the price at the time of the margin default buy-back was in excess of the later sales on the fraud-related collapse, plaintiffs suffered a loss in that amount." (Pl. Resp. at 6.) As noted above, this would be nothing but a windfall to plaintiffs and is not a recoverable theory of damages. Thus, plaintiffs state law fraud and misrepresentation claims must fail on this ground.

Even if plaintiffs had brought forth a workable theory on damages, which they have not, the court agrees with defendants that the Second Amended Complaint also does not plead reliance with the requisite level of particularly mandated by Rule 9(b). To sufficiently plead reliance, plaintiffs would have to link one or more of the alleged misrepresentations with a specific act of reliance. *See Prime Leasing*, 773 N.E.2d at 93. Initially, plaintiffs could not have relied on many of the alleged misrepresentations for their "acts of reliance" (which include pledging the Reliant Energy shares for their loans, declining to accept offers to sell their Reliant Energy shares via forward sale contracts and choosing to prevent foreclosure by making additional payments to their lender) because these acts occurred between late 2000 through December 2001. (Sec.Am.Compl.¶ ¶ 101-04.) Defendants' alleged misrepresentations extended into April 2002. (Sec.Am.Compl.¶ ¶ 20-63.) Thus, none of these alleged misrepresentations in 2002 could have induced reliance in 2001 or earlier.

Moreover, the Second Amended Complaint does not establish a nexus between any particular alleged misrepresentation and a specific act of reliance by plaintiffs. Instead, plaintiffs' allegations of reliance in the Second Amended Complaint state that they relied on "information publicly disseminated about [Reliant Energy]'s business," "materially false and misleading information disclosed by defendants," or "financial and other information disseminated by Defendants." (Sec.Am.Compl.¶ ¶ 101, 103, 106.) There is not, for example, a particular allegation that an act of reliance (such as plaintiffs' declining to sell their shares via forward sale contracts) was influenced by any alleged misrepresentation. Plaintiffs' conclusional statements listed above do not comply with the particularly requirements of Rule 9(b). [FN2]

FN2. Plaintiffs could not and do not attempt to rely on a fraud on the market theory of reliance. Such a theory is not recognized under Illinois law. *See* Gilford Partners, L.P. v. Sensormatic Elec. Corp ., No. 96 C 4072, 1997 WL 757495, at *12 (N.D.Ill. Nov. 24, 1997) ("Illinois has never indicated that it would adopt the fraud-on-the-market theory.")

In response, plaintiffs point to *Small v. Fritz Cos., Inc.* 30 Cal.4th 167, 191 (2003), but that case does not help them with regard to reliance. All the *Small* case established (under California law) was that a plaintiff may file a so-called "holder action," where they could allege that they were wrongfully induced to hold rather than sell stock. [FN3] *Id.* at 171. Plaintiffs would still need to plead reliance with particularity, and the Court in *Small* noted as much. *See id.* at 184 (noting that a plaintiff must allege "specific reliance on the defendants' representations...."). The plaintiffs have not done so in this case and, accordingly, have not pled a required element for a fraud claim under Illinois law. As such, their fraudulent misrepresentation claim is dismissed on this ground also.

FN3. While Illinois law does recognize fraud where a misrepresentation causes a plaintiff to act or refrain from acting, *see Chicago Title & Trust Co. v. First Arlington Nat'l Bank,* 118 Ill.App.3d 401, 406, 454 N.E.2d 723, 727 (1983), no Illinois case has recognized the "holder action" allowed in the *Small* case. This court need not definitively decide if plaintiffs can bring such an action under Illinois law because, assuming that they can, they have not adequately plead a theory of damages or reliance.

2. Illinois Consumer Fraud and Deceptive Business Practices Act

***7** To state a claim under the Illinois Consumer Fraud and Deceptive Business Practices Act, 815 ILCS 505/1 *et seq.* (the "Act"), a plaintiff must allege specific facts that show (1) a deceptive act or practice by the defendant; (2) the defendant's intent that the plaintiff rely on the deception; (3) the deception occurred in the course of conduct involving a trade or commerce; and (4) the consumer fraud proximately caused the plaintiff's injury. *Perona v.. Volkswagen of Am., Inc.,* 292 Ill.App.3d 59, 65, 684 N.E.2d 859, 864 (1997). Additionally, the plaintiff must be a "consumer" with respect to a defendant's products. *See Menard Inc. v. Countryside Indus., Inc.,* No. 01 C 7142, 2004 WL 1336382, *2-3 (N.D. Ill. June 14, 2004). The statutory text defines a consumer as "any person who purchases or contracts for the purchase of merchandise not for resale in the ordinary course of his trade or business but for his use or that of a member of his household." 815 ILCS 505/1(e). As previously stated, the alleged misrepresentations or fraud in this case did not induce the plaintiffs to purchase any additional stock. Therefore, they are not consumers as defined by the statute. *See Camel v. Lincoln Nat'l Bank,* No. 96 C 6595, 1997 WL 321679, at *10 (N.D. Ill. June 6, 1997) (claim dismissed where plaintiff alleged that misrepresentations only induced him to retain or sell--but not purchase-- stock). Because they are not consumers, the plaintiffs cannot state a valid claim under the Act, and this claim must also be dismissed.

CONCLUSION

For the reasons stated above, defendants' motion to dismiss is granted [# 46]. Because this was plaintiffs' third opportunity to state a claim, and since they have not adequately done so, this court's dismissal of all the claims shall be with prejudice. This case is terminated.

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