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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 893025; 2006 U.S. Dist. Ct. Motions LEXIS 83882

January 11, 2006

Motion to Dismiss

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

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TITLE: DEFENDANT'S REPLY MEMORANDUM OF POINTS AND AUTHORITIES IN SUPPORT OF THE MOTION TO DISMISS AND STRIKE THE AMENDED COMPLAINT

TEXT: I. INTRODUCTION

Defendant Robert Beasley ("Beasley") brought this Motion to Dismiss and Strike the Amended Complaint (the "Motion") because the Commodity Futures Trading Commission ("Commission") improperly seeks to expand liability for fraudulent omissions under the Commodity Exchange Act ("Act") based on certain alleged omissions that fail to state a claim for fraud under the Act. As alleged in the Amended Complaint, Defendant Longboat Global Funds Management LLC ("Longboat") and Beasley (collectively "Defendants") omitted to disclose to the participants in the Piranha Capital, LP Fund (the "Fund") two "facts": (1) "Beasley disregarded his duties to pool participants when he failed to collect interest and principal payments for the Beasley controlled notes in a timely manner; and (2) "Longboat [*2] and Beasley used the value of the unpaid interest payments on the Beasley-controlled notes to calculate his management and incentive fees" (collectively the "Alleged Omissions"). In opposition to the Motion, the Commission simply dismisses most of the defects in the Amended Complaint as "red herrings" and defends that it satisfied the requirements of this Court's September 6th Order by filing an amended complaint setting out in logical fashion each fraud allegedly committed by Defendants. Despite these efforts, the Amended Complaint overreaches in alleging that Defendants engaged in actionable fraud by failing to disclose the Alleged Omissions. Thus the Amended Complaint should be dismissed in that:

. The Alleged Omissions fail to state a claim as a matter of law because they are based on theories of liability for fraud that have no basis under the Act.

- . The allegations underlying the Alleged Omissions are conclusory legal statements.
- . The Commission ignores the rule that documents relied upon in a complaint are considered part of and control over inconsistent allegations in the complaint.
- . Materiality is a question of law and the Amended Complaint fails to [*3] plead facts sufficient to demonstrate that the Alleged Omissions were material to investors based on the total mix of information disclosed.

II. ARGUMENT

A. The Alleged Omissions Fail to State a Claim as a Matter of Law Because They Are Based on Theories of Liability for Fraud that Have No Basis in the Act.

Even assuming the Amended Complaint pleaded sufficient facts to state a claim for fraudulent omission against Defendants - it does not -, the Amended Complaint suffers from two defects that mandate dismissal of its claims based upon the Alleged Omissions:

- 1) It fails to plead any facts demonstrating Longboat or Beasley had a duty to disclose the allegedly omitted information; and
- 2) It alleges conduct that amounts to no more than a failure to disclose a breach of fiduciary duty, which is not by itself actionable as fraud under the Act.

In its Opposition, the Commission dismisses these issues as "red herrings" and misstates (intentionally or otherwise) Defendants' position as arguing that Defendants did not know of any duties they owed to the Fund. Opposition at 9. As explained below and in Defendant's Initial Memorandum of Points and Authorities [*4] in Support of the Motion to Dismiss ("Initial Memorandum"), however, the issue is not what Defendants understood their duties to be. Rather, the Commission is improperly attempting to expand liability for fraudulent omissions under the Act based either upon a duty of complete disclosure or a failure to disclose conduct involving a breach of fiduciary duty. The Commission has previously rejected, however, the very theory upon which its complaint now depends, *i.e.*, that a failure to disclose facts about which defendants never made any representation, is not actionable as a fraudulent omission under the Act. Furthermore, federal courts have repeatedly rejected attempts to expand liability for fraud under provisions of the Securities Exchange Act virtually identical to those with which the Commission has charged Defendants when the alleged omission concerns the defendant's own corporate mismanagement, breach of fiduciary duty and financial motives. The Court should thus reject the Commission's attempt to expand Defendants' duties to establish liability for alleged fraudulent omissions under the Act and dismiss the Amended Complaint.

1. The Amended Complaint Fails to Plead Any Facts [*5] Establishing Defendants Had A Duty to Disclose the Alleged Omissions under the Act.

In its Opposition, the Commission does not cite a single fact establishing the source of Defendants' duties to disclose the Alleged Omissions. It is fundamental, however, that there is no liability for fraud by omission absent a duty to disclose the allegedly omitted facts. *See, e.g., Farmland Indus. v. Frazier-Parrot Commodities, Inc.*, 871 F.2d 1402, 1410 (8th cir. 1989); *Basic v. Levinson*, 485 U.S. 224, 239 n. 17 (1988). Further, the Commission has repeatedly held that only *two* circumstances give rise to a duty to disclose an omitted fact so as to give rise to liability for fraud under the Act: (1) the defendant must have either failed to disclose qualifying information necessary to prevent one of his affirmative statements from being deceptive, or (2) the Act or a Commission regulation specifically requires disclosure of that information. *See In re CMB Capital Mgmt. Corp.*, [1998-1999 Transfer Binder] *Comm. Fut. L. Rep. (CCH)* P27,592 at 47,780 n.4 (CFTC Apr. 6, 1999); *In re Staryk*, [1994-1996 Transfer Binder] *Comm. Fut. L. Rep. (CCH)* P26,701 at 43,926 n. 72 [*6] (CFTC June 5, 1996) (citing *Lehockzy v. Gerald, Inc.*, [1994-1996 Transfer Binder] *Comm. Fut. L. Rep. (CCH)* P26,441 at 42,923-24 (CFTC June 12, 1995)). If neither of these two conditions are met, the omission is considered to be a "pure omission," which is not unlawful nor actionable as fraud. *In re Staryk*, [1994-1996 Transfer Binder] *Comm. Fut. L. Rep. (CCH)* P26,701 at 43,926 n. 72 (CFTC June 5, 1996).

According to the Commission, a "pure omission" is "a subject upon which the seller has said nothing in circumstances that did not give particular meaning to his silence." *Harris v. Connelly*, [1992-1994 Transfer Binder] *Comm. Fut. L. Rep. (CCH) P 25,919 at 41,016 n. 25* (CFTC Jan. 3, 1994) (quoting with approval *In re International Harvester Co.*, 104 F.T.C. at 1059-1060), *summarily aff'd*, slip op. (CFTC Oct. 11, 1994). As the Commission explained in *Harris*, it could not declare pure omissions to be deceptive for two reasons: (1) it would expand the concept of fraudulent omissions "virtually beyond limits" because "the number of facts that may be material to consumers - and on which they have prior misconceptions [*7] - is literally infinite," which would be "impractical and very costly;" and (2) "pure omissions do not presumptively or generally reflect a deliberate act on the part of the seller." *Id.* Here, the Alleged Omissions for which the Commission is attempting to hold Defendants liable do not rise above the level of "pure omissions."

Nowhere in the Amended Complaint does the Commission allege that Longboat or Beasley made any affirmative statement regarding Beasley's duties to pool participants, the collection status of the various promissory notes or that he used the value of the unpaid interest payments on the Beasley-controlled notes to calculate his incentive and management fees. Rather, as the Commission concedes, the Amended Complaint alleges only that Defendants committed fraud by "failure to disclose their non-collection of interest and principal and calculation of management and incentive fees based on [sic] value of unpaid interest." Opposition at 9. *See also* Amended Complaint, PP 62, 66, 67. Indeed, in its Opposition, the Commission disclaims that the Amended Complaint is predicated upon any disclosures Defendants may have made to the Fund related to the Alleged Omissions. [*8] Opposition at 13-14. Because the Amended Complaint lacks any allegation that Defendants made any affirmative statements concerning the Alleged Omissions, by necessity, Defendants could not have failed to disclose qualifying information regarding the Alleged Omissions. Nor does the Amended Complaint recite any section or rule under the Act specifically requiring them to disclose the Alleged Omissions. n1

n1 The Commission's citation to Sections 4o(1)(A) and (B) in its Opposition to demonstrate Defendants had a duty not to commit fraud is not sufficient to establish Defendants had a specific disclosure obligation as to the Alleged Omissions. *Cf.* Opposition at 9; *with In re Staryk*, [1994-1996 Transfer Binder] *Comm. Fut. L. Rep. (CCH) P26,701 at 43,926 n. 72* (stating that the Act or its regulations must specifically require disclosure of the omitted fact).

The Amended Complaint should, therefore, be dismissed because it fails to plead any facts to establish Defendants had a duty to disclose [*9] the Alleged Omissions under either of the two tests giving rise to a duty to disclose.

2. Defendants' Failure to Disclose their Alleged Breaches of Fiduciary Duty Cannot Give Rise to a Claim for Fraud Under the Act.

While the Commission concedes in its response that it "believes" Defendants have breached fiduciary duties owed to the Fund (*citing Weinberg v. NFA*, [1986-87 Trfr. Bndr.] *Comm. Fut. L. Rep. (CCH) P 23,087 at 32,219* (CFTC June 6, 1986)), it denies that it has charged Defendants with only a breach of fiduciary duty in the Amended Complaint concerning the Alleged Omissions "because the Defendants' conduct was also manipulative and deceptive." Opposition at 9, n. 1. Notwithstanding the Commission's self-serving characterization of Defendants' conduct as "manipulative" or "deceptive," the fact remains that since the Supreme Court's decision in *Santa Fe*, Federal Circuit and District Courts have repeatedly rejected attempts to expand liability for fraudulent omissions where, as here, the defendants failed only to disclose their alleged corporate misconduct or breach of fiduciary duty. *See, e.g., Coronet Ins. Co. v. Seyfarth*, 665 F. Supp. 661, 667-68 (N.D. Ill. 1987); [*10] *see also Panter v. Marshall Field & Co.*, 646 F.2d 271, 288 (7th Cir. 1981); *Field v. Trump*, 850 F.2d 938, 947-48 (2d Cir. 1988); *Kas v. Financial Gen. Bankshares, Inc.*, 796 F.2d 508, 513 (D.C. Cir. 1986). Thus, the Amended Complaint fails to state a claim for fraudulent omission under the Act with respect to the Alleged Omissions that Beasley failed to disclose a purported breach of fiduciary duty to collect on the notes and his financial motives for doing so. *See* Initial Memorandum at 8-10. Finally, the Commission has not cited any authority in which an alleged breach of fiduciary duty was determined to be sufficient to state a claim for fraud under the Act. On this additional ground, the Amended Complaint must also be dismissed.

Finally, because the Commission's theory of fraudulent omission based on the Alleged Omissions cannot be cured with pleading additional facts, the Court should dismiss these claims with prejudice. *See Knevelbaard Dairies v. Kraft Foods, Inc.*, 232 F.3d 979, 983-84 (9th Cir. 2000) (upholding dismissal of claims with prejudice where no additional facts could overcome defects of complaint). [*11] Notwithstanding these incurable legal flaws, the Amended Com-

plaint fails to allege sufficient facts to support its claim for fraudulent omission with respect to the Alleged Omissions so that the claim must also be dismissed on these additional grounds.

B. The Allegations Underlying The Alleged Omissions Are Conclusory Legal Statements.

To establish that the Amended Complaint contained the requisite factual details to state a claim for fraud based on the Alleged Omissions, the Commission argues two seemingly inconsistent positions: (1) either the Alleged Omissions are "separate and distinct" acts of fraud as to which it has pleaded discrete factual allegations supporting these omissions; or (2) the Alleged Omissions are supported by, and inseparable from, the totality of Defendants' conduct described in the Amended Complaint as a whole. Opposition at 7-9, 13. Neither argument succeeds in demonstrating that the Amended Complaint contains facts rather than conclusory legal statements so as to provide Defendants with specific notice of the facts giving rise to Defendants' liability for failure to disclose the Alleged Omissions.

The Commission's first argument fails because [*12] the specific allegations to which the Commission refers as factual support for the Alleged Omissions employ either identical or nearly identical conclusory statements as the Alleged Omissions themselves. Opposition at 7-8, citing Amended Complaint PP 57 - 63. Closer scrutiny of these paragraphs reveals, however, that they are merely rewordings of, not factual support for, the Alleged Omissions. *Cf.* Amended Complaint, PP 60, 61, 62; *with* subparas. 3 and 4 of PP 66 and 67. Each of these paragraphs is defective because it relies upon conclusions - not facts - concerning Beasley's "failure to enforce" the notes, his "disregard of his duties" and his "failure to collect" on the notes. Initial Memorandum at 3. Because these allegations are predicated upon underlying legal assumptions regarding duties Beasley purportedly owed and breached, he cannot and should not be put to the task of answering them.

The Commission's second argument that the Alleged Omissions are supported by the totality of the Defendants' alleged misconduct fails for the same reason that the Court struck the initial Complaint. *See* Opposition at 9 ("The totality of Defendants' actions ... constituted fraud [*13] when Defendants failed to inform the pool participants of those circumstances"); at 13 ("It is the entire set of circumstances alleged in the Amended Complaint, and Defendants failure to disclose this information to pool participants, that comprises the fraud in this case."). Indeed, this argument seems to contradict the Commission's statement in its Opposition that the Amended Complaint alleges "four separate and distinct sets of fraudulent misrepresentations and omissions" predicated upon distinct factual allegations. Opposition at 6. Rather, it appears the Commission has reverted to lumping all of its allegations together into one combined fraud - not separate sets of fraud as it asserts - in violation of the Court's September 6th Order in this matter directing the Commission to set forth in a logical order the facts supporting the allegations of *each* alleged fraud at issue in this case so that Defendants would not have to "guess as to which allegations apply to which elements of which causes of action."

Thus, the conclusory nature of the factual allegations upon which the Commission attempts to rely in support of the Alleged Omissions fail to set forth the precise grounds [*14] for its claims of fraudulent omission. *See* September 6th Order at 3 (*citing In Re Autodesk Inc. Sec. Litig.*, 132 F. Supp. 2d 833, 841 (N.D. Cal. 2000)). The Amended Complaint should be dismissed.

C. The Commission Ignores The Rule That Documents Relied Upon In A Complaint Are Considered Part Of And Control Over Inconsistent Allegations In The Complaint.

Only by ignoring the documents relied upon by the Commission in the Amended Complaint as well as the broad scope of the fraudulent omission Defendants are charged with - *i.e.*, that they never disclosed the Alleged Omissions to the Fund in any communication - can the factual presumption in favor of the plaintiff on a motion to dismiss benefit the Commission. *See* Amended Complaint, PP 66, 67, subparas. 3-4. But where, as here, the allegations of the complaint are contradicted by documents referred to and relied upon by the complaint, then the court need not accept as true the allegations of the complaint. Initial Memorandum at 2 (*citing Informix Software, Inc. v. Oracle Corp.*, 927 F. Supp. 1283, 1285 (N.D. Cal. 1996)). Nonetheless, the Commission contends that the disclosures [*15] contained in the Annual Reports, the Private Placement Memorandum and other communications with investors (including the July 2, 2004 letter to investors) were not inconsistent with the allegations contained in the Amended Complaint, but rather contained "other" information insufficient to defeat the Alleged Omissions on a motion to dismiss. *See* Opposition at 11; *also* Initial Memorandum at 4-6. Either way, the Amended Complaint fails to state a claim for fraudulent omission.

If, as the Commission contends, the detailed disclosures contained in the Annual Reports, PPM and other correspondence relied upon by the Amended Complaint do not belie the Commission's claim that Defendants failed to disclose any information to the Fund's investors regarding the Alleged Omissions, then the Alleged Omissions were not

made in connection with any affirmative representations as to which Defendants failed to disclose qualifying information. In other words, the Alleged Omissions were pure omissions and not deceptive or actionable under the Act. See section II.A.1, *supra*. If Defendants are correct that the documents referred to in the Amended Complaint disclose information related to [*16] the Alleged Omissions, however, then the disclosures contained in those documents are part of the Amended Complaint and control over the contrary allegations that Defendant never disclosed any information to the Fund regarding the Alleged Omissions. Regardless of whether the documents referred to in the Amended Complaint apply, therefore, the Amended Complaint should be dismissed.

D. Materiality is a Question of Law and the Amended Complaint Fails to Plead Facts Sufficient to Demonstrate that the Alleged Omissions Were Material to Investors Based on the Total Mix of Information Disclosed.

The Commission insists that materiality is a factual issue that is adequately pleaded by stating in conclusory fashion that the Alleged Omissions made by Defendants were material. Opposition at 12. The Commission is wrong. The materiality of information to investors, especially in cases where liability for fraud is predicated upon omission, may be determined as a matter of law. See *Benzon v. Morgan Stanley Distributors, Inc.*, 420 F.3d 598, 608-09 (6th Cir. 2005). Thus, regardless of the general presumption that the factual allegations of a complaint are true for purposes [*17] of a motion to dismiss, if the information underlying the Alleged Omissions would not have significantly altered "the total mix of information already presented," then the alleged non-disclosures were immaterial as a matter of law and could not give rise to liability for fraud under the Act. See *Benzon*, 420 F.3d at 609; also *Sudol v. Shearson Loeb Rhoads, Inc.*, [1984-1986 Transfer Binder] *Comm. Fut. L. Rep. (CCH) P 22,748, at 31, 118-119* (CFTC Sept. 30, 1985).

As already discussed, the Commission fails to recognize that the Amended Complaint, by referring to the Annual Reports, Private Placement Memorandum and other correspondence with investors, necessarily incorporates the various disclosures contained in those documents related to the Alleged Omissions. The Commission cannot legitimately allege that the Alleged Omissions were "material" to the Fund without considering the "total mix of information" imparted to the Fund's investors through the Annual Reports, Private Placement Memorandum and other correspondence. The Commission's conclusory allegation that the Alleged Omissions were material to the Fund's investors should, therefore, be disregarded [*18] and the Amended Complaint should be dismissed. See Initial Memorandum at 4-6; also *Miranda v. Clark County, Nev.*, 279 F.3d 1102, 1106 (9th Cir. 2002) (holding court need not accept as true unreasonable inferences or conclusory allegations of law cast in the form of factual allegations).

E. The Court Should Dismiss the Amended Complaint.

Even though as demonstrated above the Amended Complaint suffers from numerous deficiencies, the Commission argues without support that Defendants "overreach" in seeking to dismiss the Amended Complaint because they only challenge two of the four claims for fraud. Opposition at 6. This argument is absurd. Regardless of whether the Amended Complaint adequately states other claims for fraud against Defendants, the inadequacy of the Amended Complaint as to the claims based on the Alleged Omissions necessitate that the Amended Complaint be dismissed. Consistent with Fed. R. 12(b)(6), therefore, Beasley respectfully requests that the Court dismiss the Amended Complaint or, if the Court deems it possible, to strike the improper Alleged Omissions from the Amended Complaint pursuant to *Fed. R. Civ. P. 12(f)*.

III. CONCLUSION [*19]

For all of the foregoing reasons, and those stated in its Initial Memorandum of Points and Authorities In Support of its Motion to Dismiss, Defendant Robert Joseph Beasley respectfully requests that the Court dismiss the Amended Complaint for failure to state a claim with respect to the Alleged Omissions pursuant to Rule 12(b)(6) or to strike these allegations pursuant to Rule 12(f).

Dated: January 11, 2005

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