

USDC SCAN INDEX SHEET



JAH 7/28/06 8:24

3:05-CV-00179 MCPHAIL V. FIRST COMMAND

121

O.

1
2
3
4
5
6
7
8
9
10
11
12
13
14
15
16
17
18
19
20
21
22
23
24
25
26
27
28

FILED
2005 JUL 27 PM 1:00
BY *AS*

**UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF CALIFORNIA**

MICHAEL MCPHAIL, et. al.,

vs.

FIRST COMMAND FINANCIAL
PLANNING, INC., et. al.,

Defendants.

CASE NO. 05cv179 IEG (JMA)
**ORDER GRANTING IN PART
AND DENYING IN PART
DEFENDANTS' MOTION TO
DISMISS**
[Doc. No. 111]

Presently before the Court is a motion by First Command Financial Planning, Inc., First Command Financial Services Inc., Lamar C. Smith, Howard M. Crump, James Peterson, Richard Giles and Martin Durbin ("defendants") to dismiss the second amended complaint ("SAC") of Michael McPhail, Robert Barr Kinnach III, Leonardo Giovannelli, Kevin Morrison, Jennifer Morrison, Scott Wagner, Krystin Wagner, Candace Hurley, Neil Hurley and all others similarly situated. ("plaintiffs"). For the following reasons, the Court grants defendants' motion as to plaintiffs' section 12(a)(2) claim. The Court denies defendants' motion as to plaintiffs' 10b-5 claim.

//
//
//
//

121 JAH

1 **BACKGROUND¹**

2 **A. Factual**

3 Defendant First Command is a leading provider of personal financial plans to senior
4 enlisted personnel and commissioned military officers. First Command's clients include
5 approximately 40 percent of the military's general officers and approximately 30 percent of its
6 commissioned officers. To market its investment plans, First Command employs approximately
7 550 representatives in the United States and Europe to conduct extensive meetings with service-
8 members and their spouses. Employing a sales device known as "affinity marketing," First
9 Command hires many former service members to pitch its products to current military personnel.

10 A core element of First Command's business is the marketing of systematic investment
11 plans ("SIPs"). Since 1970, First Command's customers have invested \$7.4 billion in First
12 Command SIPs. SIP investors pay 180 fixed monthly installments (15 years), which may be
13 extended to 300 payments. First Command customers pay a front-end sales load equal of 50
14 percent of the first 12 payments but pay no additional front-end sales load thereafter. First
15 Command receives this commission, sharing it with the sales agent. Assuming a fixed monthly
16 payment of \$100, an SIP investor would pay a total of \$1200 in the first 12 months. Of this
17 amount, \$600 is attributed to the 50 percent sales load and \$600 purchases an indirect interest in
18 mutual fund shares.

19 After an investor completes the first 12 payments, the effective sales load is reduced with
20 each payment. If an investor makes all 180 payments under the plan, the effective sales load in the
21 total investment is 3.33 percent. If the investor extends to 300 payments, the sales load is 2
22 percent. Conversely, if the investor ceases making payments or terminates the plan before making
23 all the required payments, the effective sales load may be higher than the average sales load
24 charged by a conventional load mutual fund. According to Lipper Inc., the average charged by a
25 conventional load equity mutual fund in 2003 was approximately 5.2 percent.

26 On December 15, 2004, First Command announced a settlement with the NASD and the
27

28 ¹Except as where otherwise noted, the Court has adopted the facts section from its April 10,
2006 order granting in part and denying in part defendants' previous motion to dismiss. [Doc. No. 108]

1 Securities and Exchange Commission regarding the marketing of SIPs. In connection with the
2 settlements, First Command submitted a Letter of Acceptance, and Waiver and Consent with the
3 NASD, and consented to the entry of a Cease-and Desist Order by the Securities and Exchange
4 Commission. In the settlements, First Command agreed that investors who had purchased and
5 terminated an SIP between January 1, 1999 and December 15, 2004, and therefore terminated
6 before the load fee was fully amortized over the life of the plan, would receive a partial refund.

7 **B. Procedural**

8 On January 31, 2005, plaintiffs filed their complaint, alleging violations of the Securities
9 Exchange Act of 1934, the Investment Advisors Act, the Texas Deceptive Trade Practices Act and
10 the California Business & Professions Code § 17200 *et seq.* [Doc. No. 1]. On March 30, 2005,
11 plaintiffs filed an amended complaint charging only violations of the Securities Exchange Act of
12 1934 and the Investment Advisors Act. [Doc. No. 29].

13 On July 22, 2005, plaintiffs filed a consolidated amended complaint charging violations of
14 the Securities Exchange Act of 1934, the Securities Act of 1933 and the Investment Advisors Act.
15 [Doc. No. 70]. Specifically, plaintiffs brought a 10b-5² claim under the Securities Exchange Act of
16 1934, a 12(a)(2)³ claim under the Securities Act of 1933 and an Investment Advisors Act claim.
17 (CAC ¶ 89-103.)

18 On April 10, 2006, the Court granted in part and denied in part defendants' motion to
19 dismiss the CAC. [Doc. No. 108.] The Court dismissed plaintiffs' Investment Advisors Act as
20 inapplicable. The Court dismissed plaintiffs' 10b-5 claim because plaintiffs had not pleaded
21 sufficient facts with the requisite particularity to show scienter. Finally, the Court denied
22 plaintiffs' motion to dismiss as to plaintiffs' section 12(a)(2) claim.

23 On May 1, 2006, plaintiffs filed a consolidated second amended complaint. [Doc. No. 110]
24 The SAC contains a 10b-5 claim alleging that defendants made material misrepresentations of fact

25 ²10b-5 is the Securities and Exchange Commission regulation prohibiting the making of untrue
26 statements of material fact or the omission of material facts necessary to make other statements not
27 misleading in connection with the sale or purchase of securities.

28 ³12(a)(2) imposes liability for material misstatements or omissions made in a written
prospectus or oral communications that relate to a prospectus in connection with a public offering or
sale of securities. Gustafson v. Alloyd Co., Inc., 513 U.S. 561, 567-8 (1995).

1 regarding First Command's SIP investment offerings. (SAC ¶90-93) The SAC also contains a
2 section 12(a)(2) claim alleging that in soliciting plaintiffs to purchase First Command SIPs,
3 defendants made untrue statements, in connection with a prospectus. (SAC ¶ 94-98).

4 On May 31, 2006, defendants brought the present motion to dismiss both of plaintiffs'
5 claims. [Doc. No. 111] On June 29, 2006, plaintiffs opposed. [Doc. No. 116]

6 LEGAL STANDARD

7 A motion to dismiss under Federal Rule of Civil Procedure 12(b)(6) alleges that the
8 plaintiff's complaint "fails to state a claim upon which relief can be granted." Fed. R. Civ. P.
9 12(b)(6). In other words, a complaint may be dismissed "if it appears beyond doubt that the
10 plaintiff can prove no set of facts in support of his claim which would entitle him to relief."
11 Navarro v. Block, 250 F.3d 729, 732 (9th Cir. 2001) (quoting Conley v. Gibson, 355 U.S. 41,
12 45-46 (1957)) (internal quotations omitted). Such a situation arises when the complaint either
13 lacks a cognizable legal theory or fails to plead facts essential to a cognizable legal theory.
14 Robertson v. Dean Witter Reynolds, Inc., 749 F.2d 530, 534 (9th Cir. 1984).

15 A court considering a Rule 12(b)(6) motion must accept all material, non-conclusory
16 allegations of fact in the complaint as true and must construe those allegations in the light most
17 favorable to the plaintiff. North Star Int'l v. Arizona Corp. Comm'n, 720 F.2d 578, 581 (9th Cir.
18 1983). However, a court is not required to credit "allegations that are merely conclusory,
19 unwarranted deductions of fact, or unreasonable inferences." Sprewell v. Golden State Warriors,
20 266 F.3d 979, 988 (9th Cir. 2001). A court may dismiss a complaint without granting leave to
21 amend only if it appears with certainty that the plaintiff cannot state a claim. See, e.g., Fed. R. Civ.
22 P. 15(a) (stating that leave to amend "shall be freely given when justice so requires"); Albrecht v.
23 Lund, 845 F.2d 193, 195 (9th Cir. 1988).

24 DISCUSSION

25 A. Plaintiffs' 10b-5 Claim

26 Defendants argue for dismissal of plaintiffs' 10b-5 on two grounds. First, defendants argue
27 that plaintiffs have not alleged sufficient facts to satisfy 10b-5's scienter requirement. (Memo. ISO
28 Motion at 6-12.) Second, defendants argue that plaintiffs have not pleaded falsity with particularity

1 as to each defendant and have not pleaded that any challenged statement was false at the time it
2 was made. Id. at 13-18. The Court finds that the SAC satisfies 10b-5's scienter requirement and
3 adequately pleads falsity.

4 I. Elements of a 10b-5 Suit

5 To state a claim under section 10b of the Securities and Exchange Act of 1934 and Rule
6 10b-5 promulgated thereunder, plaintiffs must allege the following in connection with the purchase
7 or sale of a security: (1) misrepresentation or omission of material fact; (2) made with scienter; (3)
8 which proximately caused plaintiffs' damages. McCormick v. Fund Am. Cos., 26 F.3d 869, 875
9 (9th Cir. 1994). "In addition, the alleged misstatement or omission must be misleading; in the case
10 of an omission, "silence absent a duty to disclose, is not misleading under Rule 10b-5." Id.
11 (quoting Basic Inc. v. Levinson, 485 U.S. 224, 239 n.17 (1988)).

12 II. Heightened Pleading Requirements Under the Private Securities Litigation Reform Act

13 To avoid dismissal under the PSLRA, a complaint must "specify each statement alleged to
14 have been misleading, the reason or reasons why the statement is misleading, and if an allegation
15 regarding the statement or omission is made on information and belief, the complaint shall state
16 with particularity all facts on which the belief is formed." 15 U.S.C. § 78u-4(b)(1). If a plaintiff
17 fails to plead the alleged misleading statements or omissions or the defendant's scienter with
18 particularity, the complaint must be dismissed. § 78u-4(b)(3)(A). In addition, the PSLRA requires
19 that the Complaint "state with particularity facts giving rise to a strong inference that the defendant
20 acted with the required state of mind," or scienter. § 78u-4(b)(2). The required state of mind is one
21 of "deliberate recklessness." In Re Silicon Graphics Inc. Securities Litigation, 183 F.3d 970, 975
22 (9th Cir. 1999). "[R]ecklessness only satisfies scienter under § 10(b) to the extent that it reflects
23 some degree of intentional or conscious misconduct." Id. at 977; Nursing Home Pension Fund,
24 Local 144 v. Oracle Corp., 380 F.3d 1226, 1230 (9th Cir. 2004).

25 In assessing whether a plaintiff has sufficiently pleaded scienter, a court must consider
26 "whether the total of plaintiffs' allegations, even though individually lacking, are sufficient to
27 create a strong inference that defendants acted with deliberate or conscious recklessness." No. 84
28 Employer-Teamster Joint Council Pension Trust Fund v. Am. West Holding Corp., 320 F.3d 920,

1 938 (9th Cir.2003). In determining whether a strong inference of scienter exists, a court must
2 consider all reasonable inferences, whether or not favorable to the plaintiff. Gompper v. VISX,
3 Inc., 298 F.3d 893, 897 (9th Cir. 2002).

4 III. Plaintiffs Satisfy The PSLRA's Heightened Pleading Requirements

5 In the SAC, plaintiffs have added a new factual allegation that, in January 2000, the
6 NASD⁴ sent a letter to First Command's Chief Compliance Officer (Howard Crump) with a copy
7 to Lamar Smith summarizing the NASD's concerns that defendants were making misleading
8 statements regarding First Command's SIPs. (SAC ¶ 1.) The SAC alleges that despite having
9 received this notice, defendants continued to make misleading statements about First Command
10 SIPs. Id. Plaintiffs further allege that the NASD sent a follow up letter when defendants failed to
11 make the necessary changes to their sales presentations. Id. Plaintiffs state that the "existence of
12 these letters in the NASD files has now been confirmed," but that the letters themselves are only
13 available pursuant to a subpoena. Id. Furthermore, plaintiffs note the NASD Order, which is
14 attached to the SAC, appears to reference some communication between the NASD and First
15 Command.⁵

16 As plaintiffs point out, this additional allegation powerfully augments their showing of
17 scienter. "The most direct way to show both that a statement was false when made and that the

18
19 ⁴ NASD has long served as the primary private-sector regulator of America's securities
20 industry. NASD oversees the activities of more than 5,100 brokerage firms, approximately 168,120
21 branch offices and more than 659,200 registered securities representatives. In addition, NASD
22 provides outsourced regulatory products and services to a number of stock markets and exchanges.
<http://www.nasd.com/AboutNASD/index.htm>.

23 ⁵The NASD Order states at paragraph 6, "During the relevant period, First Command Filed
24 certain scripts and charts with NASD's Advertising Regulation Department and that Department noted
25 certain deficiencies in these materials with respect to descriptions of the costs of the Plans and
26 language that could be construed as improper projections of returns. Although First Command
27 addressed certain comments from the NASD Advertising Regulation, it failed to adequately correct
28 the deficiencies noted by NASD in the areas listed above." Defendants protest that plaintiffs may not
rely on the NASD Order or the Securities and Exchange Commission Order to satisfy their
particularity or scienter requirements. (Memo. ISO Motion at 6.) However, courts generally have
allowed plaintiffs to satisfy particularity and scienter requirements with the findings of an
administrative agency when the agency's findings are relevant to plaintiffs' claims. See Ezra
Charitable Trust v. Tyco Intern., Ltd., 2005 WL 2127619 (D. N.H. 2005); See also Zouras v. Hallman,
2004 WL 2191034 (D. N.H. 2004); See also In re Serologicals Sec Litigation, 2003 WL 24033694
(N.D. Ga. 2003).

1 party making the statement knew that it was false is via contemporaneous reports or data, available
2 to the party, which contradict the statement.” Nursing Home Pension Fund, 380 F.3d at 1230.
3 Plaintiffs have pleaded the existence of a report indicating that the statements challenged in this
4 suit were misleading. Plaintiffs have pleaded that this report reached two of the individual
5 plaintiffs in this suit who were also control persons at First Command. This letter, combined with
6 the other facts alleged in the SAC give rise to a strong inference that defendants acted with the
7 required state of mind.⁶

8 IV. Plaintiffs Adequately Plead Falsity

9 A valid 10b-5 claim must plead a “misrepresentation.” McCormick v. Fund Am. Cos., 26
10 F.3d at 875. Defendants argue at length that the challenged statements in this case are not false
11 and, therefore, the SAC is deficient. (Memo. ISO Motion at 15-20.) However, the truth or falsity
12 of defendants’ statements is a question of fact inappropriate for a 12(b)-6 motion, where the truth
13 of a plaintiff’s allegations is assumed. In re QLT Inc. Securities Litigation, 312 F.Supp.2d 526,
14 535 (S.D.N.Y. 2004); See Bernheim v. Litt, 79 F.3d 318, 321 (2d Cir.1996) (when evaluating a
15 12(b)(6) motion, the “issue is not whether a plaintiff will ultimately prevail but whether the
16 claimant is entitled to offer evidence to support the claims”)

17 For the purposes of the present motion, it is sufficient that plaintiffs have cited to numerous
18 statements and indicated how each statement was alleged misleading. (SAC ¶1-77.) Plaintiffs
19 have provided additional support for their falsity claim by attaching to the SAC the NASD Order
20 and S.E.C. Order, both of which state that many of First Command’s statements were false or
21 misleading.

22 **B. Plaintiff’s 12(a)(2) Claim**

23 “Section 12(2) of the Securities Act of 1933 creates a private remedy for the buyer of a
24 security against the seller for material misrepresentations in connection with the offer and the sale.

26 ⁶Defendants argue that plaintiffs’ allegation regarding the NASD letters is unfounded, even
27 going so far as to state that no such letters exist. (Memo. ISO Motion at 5.) On a motion to dismiss
28 pursuant to 12(b)(6), a court must accept all material, non-conclusory allegations of fact in the
complaint as true. Arizona Corp. Comm’n, 720 F.2d at 581. Thus, the Court cannot look behind the
SAC to determine its evidentiary basis. However, if it later becomes clear that plaintiffs did not have
a good faith basis for pleading the existence of the NASD letters, the Court will take appropriate
action.

1 See 15 U.S.C. § 77f (1994). A ‘seller’ of the security is defined as anyone who offers or sells a
2 security ‘by the use of any means or instruments of transportation or communication in interstate
3 commerce or of the mails, by means of a prospectus or oral communication...’ 15 U.S.C. § 77f(2).
4 Once a buyer can establish privity with a seller, the buyer need prove only that there was a material
5 misstatement or omission in the prospectus or oral communication. The seller’s only defense is
6 that he did not know of the false material misstatement and, in the exercise of due diligence, could
7 not have discovered the misstatement. 15 U.S.C. § 77f(2). The plaintiff need not prove reliance on
8 the prospectus or oral statement.” In re NationsMart Corp. Securities Litigation, 130 F.3d 309, 318
9 (8th Cir. 1997) (citing to Austin v. Loftsgaarden, 675 F.2d 168, 176 n. 16 (8th Cir.1982)).

10 Defendants argue that given the theory of damages postulated by plaintiffs, *i.e.* that
11 plaintiffs suffered excessive sales commissions and fees, it is not possible for plaintiffs to allege
12 facts demonstrating they have suffered harm within the meaning of section 12(a)(2). (Memo. ISO
13 Motion at 21.) The basis for defendants’ argument is In re Mutual Funds Inv. Litig., 384
14 F.Supp.2d 845 (D. Md. 2005). In that case, the plaintiffs alleged that certain brokers facilitated
15 excessive trading by certain customers in a manner that harmed long-term “fund investors who
16 bore the transaction costs and other harms” of the excessive trading. Id. at 859. Based on this
17 allegation, the plaintiffs in that case brought a 10b-5 suit claim and a 12(a)(2) claim. Id. at 853 and
18 865. Upon a motion to dismiss, the In re Mutual Funds Inv. Litig. Court upheld plaintiffs’ 10b-5
19 claim but dismissed plaintiffs’ 12(a)(2) claim because “the only damages recoverable under
20 Sections 11 and 12(a)(2) are based upon price differentials.” Id. at 867. Plaintiffs could not satisfy
21 section 12(a)(2) because the harm they alleged was the added costs arising from defendants’
22 encouraging of excessive trading. Id. This “theory of damages that does not depend upon...
23 having paid more for their shares than they received (or could have received) in selling them.” Id.
24 at 867.

25 The In re Mutual Funds Inv. Litig. Court’s narrow construction of 12(a)(2)’s damages finds
26 support in the statutory text, which defines section 12(a)(2)’s remedy as the “consideration paid for
27 such security with interest thereon, less the amount of any income received thereon, upon the
28 tender of such security, or for damages if he no longer owns the security.” 15 U.S.C. § 77f(a). As
the In re Mutual Funds Inv. Litig. Court pointed out, this definition does not contemplate recovery

1 for other possible harms, such as excessive brokers fees, that are exogenous to the price of the
2 security. Additional support for a narrow definition of damages comes from Metz v. United
3 Counties Bancorp, 61 F.Supp.2d 364 (D.N.J. 1999), where a court dismissed an analogous claim
4 brought under Section 11. Id. at 378 (“The problem with the complaint and the plaintiffs’
5 argument is that, under Section 11, it is not enough to merely plead injuries, the plaintiffs must
6 plead a certain kind of injury. Section 11 only gives damages for a diminution in the value of
7 securities caused by the false or misleading statements or omissions of the defendant. Absent such
8 damages, the plaintiffs have no legally cognizable Section 11 claim.”)

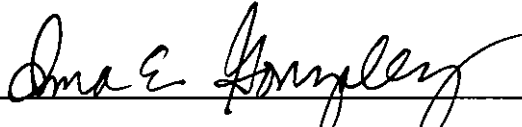
9 In light of these authorities, the Court agrees with defendants that plaintiffs are trying to fit
10 a square peg into a round whole. The “front end sales load” that plaintiffs allege as damages is not
11 a “price differential” caused by misrepresentation within the meaning of section 12(a)(2).

12 **CONCLUSION**

13 For the foregoing reasons, the Court **DENIES** defendants’ motion to dismiss plaintiffs’
14 10b-5 claim. The Court **DISMISSES WITH PREJUDICE** plaintiffs’ 12(a)(2) claim as there
15 appears to be no possibility that plaintiffs could allege a viable 12(a)(2) claim.

16 **IT IS SO ORDERED.**

17
18 Dated: 7/26/06

19 
20 **HON. IRMA E. GONZALEZ**, Chief Judge
21 United States District Court
22 Southern District of California

23
24
25
26
27
28
cc: Magistrate Judge Adler
All Parties of Record