Securities Reform Act Litigation Reporter

A Monthly Reporter Featuring Expert Analysis and Prompt Publication of Oral and Written Decisions

Editors

William F. Alderman, Esq. W. Reece Bader, Esq. James N. Kramer, Esq.
Michael C. Tu, Esq. Diana L. Weiss, Esq.
Orrick, Herrington & Sutcliffe LLP

Volume 26, Number 2 Washington, D.C. November 2008

Highlights

The most noteworthy decisions this month are the following:

- In *Teamsters Local 445 Freight Division Pension Fund v. Bombardier, Inc.*, No. 06-3794-cv (2nd Cir. October 14, 2008), Judge Parker, writing for the Second Circuit Court of Appeals, affirmed a denial of class certification of claims related to mortgage-backed securities, on the grounds that plaintiffs had not justified use of the fraud on the market theory for reliance. Review was only for abuse of discretion, and the district court reasonably limited discovery before ruling. It found that the evidence did not support the existence of analyst coverage for the certificates or market makers. The event study presented by plaintiffs was not successful in connecting public disclosures to movements in the price of the securities, so the court reasonably found a lack of evidence for an efficient market, as required for use of the fraud on the market theory.

- In *Morrison v. National Australia Bank Ltd.*, No. 07-0583-CV (2nd Cir. October 23, 2008), Judge Parker, writing for the Second Circuit Court of Appeals, affirmed a decision finding no U.S. federal jurisdiction over securities fraud claims brought by foreign plaintiffs who purchased shares in a foreign company on a foreign exchange. The court rejected a bright-line rule that all such claims were outside our jurisdiction, relying instead on the traditional conduct and effects tests. No domestic effects were at issue, and the U.S. conduct was accounting errors by a domestic subsidiary. Because the actual misrepresentations were made only by the foreign company and there was a causation chain that required the involvement of the foreign company, the court found that the foreign conduct, not that of the U.S. was central to the objectionable conduct.

(continued on page 150)

Contents

Page

A RECENT APPLICATION OF *STONERIDGE* TO SCHEME LIABILITY CLAIMS 151

PSLRA MEETS THE EXCHANGE ACT 155

RECENT DECISIONS 159

RECENT DEVELOPMENTS 191

DOCUMENTS

Opinion, *Teamsters Local 445 Freight Division Pension Fund v. Bombardier* .. 194

Opinion, *Morrison v. National Australia Bank Ltd* 208

Opinion, *Elam v. Neidorff* 218

Opinion, *In re Heritage Bond Litigation* 224

Opinion, *Thompson v. Paul* 238

Opinion, *Potter v. Hughes* 248

Opinion, *Mizzaro v. Home Depot, Inc* 261

Subscription price $2275 per year. Published by Computer Law Reporter, Inc., 1601 Connecticut Avenue, N.W., Suite 701, Washington, D.C. 20009 • 202-462-5755 • Fax 202-328-2430 • Copyright © 2008 Computer Law Reporter, Inc. All Rights Reserved. ISSN 1098-8602 Publications Director: John G. Herring. Production Manager: Laura Melton. The views expressed herein do not necessarily represent those of the Editors or the members of the Board of Advisors.

Securities Reform Act Litigation Reporter
1601 Connecticut Avenue, N.W., Suite 701, Washington, D.C. 20009 • 202-462-5755 • Fax 202-328-2430

A Recent Application of Stoneridge *to Scheme Liability Claims*

by

Todd G. Cosenza*

Introduction

Prior to the Supreme Court's very recent decision in *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*[1] the district court, in *In re Parmalat Securities Litigation*—one of the most prominent securities class actions pending in the Southern District of New York, had denied motions brought by various secondary actors (including two major financial institutions) seeking to dismiss Plaintiffs' Rule 10b-5(a) and (c) claims.[2] Notwithstanding the lack of any actionable misrepresentation or omission attributable to those actors on which Plaintiffs could rely, the district court found that the reliance element in a scheme case could be satisfied by showing that Defendants' conduct was a "substantial" cause of the investors' injury.[3] Because the financial institutions knew that the purpose of some of their transactions with Parmalat was to allow Parmalat to make various misrepresentations in its public disclosures, the court held that the secondary actors could be held liable for "actually and foreseeably" causing Plaintiffs' losses.[4] The district court's decision was a significant ruling and was cited to repeatedly by the plaintiffs' bar (as well as by the Ninth Circuit in *Simpson v. AOL Time Warner Inc.*[5] and the Southern District of Texas in the *In re Enron Corp. Securities, Derivative & "ERISA" Litigation*[6]) for the proposition that scheme liability under Rule 10b-5(a) and (c) was a viable legal theory.

Todd G. Cosenza is an associate in the New York office of Willkie Farr & Gallagher LLP. Contact: tcosenza@willkie.com. Reprinted from the September 12, 2008 edition of the New York Law Journal. © 2008 ALM Properties, Inc. All rights reserved. Further duplication without permission is prohibited.

Earlier this month, in one of the first decisions in the Second Circuit to apply the Supreme Court's decision in *Stoneridge* to scheme liability claims, the district court, in essence, reversed its prior decisions and granted the summary judgment motions of secondary actors in the *Parmalat* case.[7] This article will address the Supreme Court's recent rejection of secondary actor "scheme" liability under Rule 10b-5(a) and (c). It will then review the district court's application of *Stoneridge* to the facts of the *In re Parmalat Securities Litigation* case and discuss the implications of that decision going forward.

I. The Supreme Court's Decision in *Stoneridge*

The Supreme Court observed that there was a conflict among the circuit courts as to whether under Section 10(b) an investor could recover from a party that "neither makes a public statement nor violates a duty to disclose but does participate in a scheme to violate Section 10(b)." In its decision, the Court closely followed its ruling in *Central Bank* and held that Scientific Atlanta, Inc. and Motorola, Inc., two equipment vendors that had done business with Charter, (the "Vendors") were not liable to Charter's investors. The Court explained that "[r]eliance by the plaintiff upon the defendant's deceptive acts is an essential element of the § 10(b) private cause of action.

In its analysis, the Court expressly refused to apply either the *Affiliated Ute* or the *Basic* fraud-on-the-market presumptions of reliance to the case. First, the Court held that the *Affiliated Ute* presumption was inapplicable to the claims brought against the Vendors because the Vendors "had no duty to disclose" the transactions to investors. The Court

next considered the investors' argument (which was premised, in part, on the district court's decision in *In re Parmalat Securities Litigation*) that they were entitled to the fraud-on-the-market presumption because the Vendors had intentionally engaged in conduct that resulted in the falsification of Charter's financial statements—all as part of a larger scheme to misrepresent Charter's revenue. Rejecting the holding of *In re Parmalat Securities Litigation* and any notion that the reliance element could be satisfied as to the Vendors' conduct because in an efficient market investors rely upon the veracity of the transactions underlying the statements contained in a company's public disclosures, the Court stated that "[w]ere this concept of reliance to be adopted, the implied cause of action would reach the whole marketplace in which the issuing company does business; and there is no authority for this rule." The Court also noted that the Vendors' deceptive acts were not communicated to the public: "[n]o member of the investing public had knowledge, either actual or presumed, of [the Vendors'] deceptive acts during the relevant times." As a result, investors could not show any reliance upon any of the Vendors' actions "except in an indirect chain" that the Court found "too remote for liability."

Although the broad language of its decision could be read as eliminating (or at least severely restricting) secondary actor liability under Section 10(b), the Court noted that "[c]onduct itself can be deceptive" and can provide the basis for liability. According to the Court, the key inquiry is whether the secondary actors' actions or conduct "were immediate or remote to the injury." The Court added that it would be "erroneous" to conclude that the Eighth Circuit's decision be "read to suggest there must be a specific oral or written statement before there could be liability under Sec. 10(b) or Rule 10b-5." The Court further emphasized, as it did in *Central Bank*, that secondary actors are not immune from private suit, and Section 10(b) "continues to cover secondary actors who commit primary violations."

II. In re Parmalat Securities Litigation

A. Overview

In *In re Parmalat Securities Litigation*, Plaintiffs alleged that defendants Bank of America Corp. and Citigroup Inc. (collectively, the "Financial Institution Defendants") violated Rule 10b-5(a) and (c) by participating in deceptive transactions or "schemes." There were two alleged schemes that were primarily at issue. One scheme focused on Citigroup's securitization of allegedly worthless Parmalat invoices to inflate Parmalat's reported earnings; the other related predominately to Bank of America's equity investment in Parmalat's Brazilian operations that was allegedly, in substance, a loan recorded in a misleading manner. Pavia e Ansaldo ("Pavia")—a law firm that had represented Parmalat-- was also named as a defendant due t its purported role in structuring and orchestrating the deceptive transactions. In January 2005, the Financial Institution Defendants sought to dismiss the Rule 10b-5(a) and (c) claims asserted against them, arguing, among other things, that they had not made any actionable statements to the market and therefore Plaintiffs could not prove reliance or loss causation—essential elements of a Rule 10b-5 claim.

On July 13, 2005, approximately two-and-a-half years prior to the Supreme Court's ruling in *Stoneridge*, the district court conducted a detailed analysis of the claims asserted against the Financial Institution Defendants as well as the Financial Institution Defendants' arguments relating to the legal sufficiency of those claims. In its decision, the court cautioned that Rule 10b-5(a) and (c) liability should not attach if the alleged scheme "resulted from the manner in which Parmalat or its auditors described the transactions on Parmalat's balance sheets and elsewhere." However, the court ultimately concluded that liability under Rule 10b-5(a) and (c) would be appropriate if it was "impossible to separate the deceptive nature of the transactions [between the Financial Institution Defendants and Parmalat] from the deception actually practiced upon Parmalat's investors." Applying that test to the facts before it, the court found that although there was an absence of a false statement or omission from the Financial Institution Defendants on which Plaintiffs could have relied, the Financial Institution Defendants' conduct was a "substantial, i.e., a significant contributing cause" of Plaintiffs' injury. Because the Financial Institution Defendants were alleged to have known "that the very purpose of certain transaction was to allow Parmalat to make false misrepresentations," the court found that

Parmalat *and* the Financial Institution Defendants were therefore causes of the losses in question. The court also held that the reliance element of a Rule 10b-5 claim did not operate as a bar to scheme liability given that in an efficient market investors rely not only upon the public statements relating to a company but also upon the transactions those statements reflect. The court thus denied the Financial Institution Defendants' motion to dismiss the Rule 10b-5(a) and (c) claims asserted against them.

B. Parmalat Reconsidered After Stoneridge

After the Supreme Court's decision in *Stoneridge* expressly disapproved of the reliance and loss causation analysis of the district court's prior decision, Defendants Bank of America Corp., Citigroup Inc. and Pavia (collectively, the "Moving Defendants") moved for summary judgment, seeking the dismissal of the scheme liability claims asserted against them. The Moving Defendants emphasized that, as in *Stoneridge*, it was the issuer (Parmalat) that released financial statements with misleading figures to the public and that they had made no actionable representations in connection with the alleged scheme. As a result, they argued that *Stoneridge* made clear that Plaintiffs could not establish the requisite reliance against the Moving Defendants (even assuming that the Moving Defendants knew of and participated in the fraudulent transactions).

In response, Plaintiffs argued that the Rule 10b-5(a) and (c) claims survived *Stoneridge* for several reasons. First, they took the position that reliance could be presumed under the Supreme Court's decision in *Affiliated Ute*, as to Defendant Bank of America. Because it had acted as a placement agent, Plaintiffs contended that Defendant Bank of America had breached a duty to disclose fraudulent transactions to investors that purchased securities from it in private placements. Noting that none of the named Plaintiffs themselves bought Parmalat securities from Bank of America in private placements, the court rejected that position and found that "reliance is not presumed merely because named Plaintiffs in a purported class action allege that a duty was owed to other members of the proposed class." Second, Plaintiffs argued that claims against Pavia (the Italian law firm) were still viable (*i.e.*, reliance could be presumed) because the law firm had breached a duty to disclose the allegedly fraudulent transactions it engaged in by violating the Model Rules of Professional Conduct during its representation of Parmalat. Without much analysis, the court swiftly dismissed that argument and found that even if Pavia had violated the Model Rules, that would not show that Pavia had breached a legal duty to Plaintiffs (which were investors in Parmalat).

Lastly, Plaintiffs attempted to establish the *Basic v. Levinson* "fraud on the market" presumption of reliance by distinguishing the facts of *Parmalat* from those of *Stoneridge*. Plaintiffs maintained that the investors in Parmalat (unlike those in *Stoneridge*) were made aware of the allegedly deceptive transactions in which each defendant was involved through the company's public disclosures. The court found this argument "unconvincing" given that *Stoneridge* requires investors to show reliance upon a defendant's own deceptive conduct before a secondary actor can be found primarily liable. According to the court, nothing in Parmalat's disclosures described any of the Moving Defendants' own conduct, much less conduct that was deceptive. As a result, the court concluded that Plaintiffs' evidence fell "well short" of the *Stoneridge* standard. The court went further and commented that the most Plaintiffs could establish was that they had relied on Parmalat's false disclosures relating to transactions to which the Moving Defendants were parties. Such allegations do not establish reliance as to the Moving Defendants' conduct except "in an indirect chain the type of which the Supreme Court found too remote for liability" in *Stoneridge*.

Conclusion

The district court's decision is one of the first decisions in the Second Circuit to apply *Stoneridge* in a "scheme" liability case. By imposing liability on secondary actors under Rule 10b-5(a) and (c) only if their own deceptive conduct was publicly identified in the alleged fraudulent disclosures, the district court's ruling represents a sweeping interpretation of *Stoneridge*. This standard of imposing Rule 10b-5(a) and (c) liability will be quite difficult for Plaintiffs to meet in bringing claims against secondary actors.

It is also worth noting that the district court's decision did not address any allegations that the Moving Defendants had played a meaningful role in assisting with or drafting Parmalat's public disclosures for the fraudulent transactions. Thus, there still remains some question as to the impact of *Stoneridge* on non-scheme cases, in particular as to what type of conduct satisfies the element of reliance in a Rule 10b-5(b) claim against a secondary actor that assists in the drafting of an issuer's fraudulent public disclosures.

Notes

1 128 S. Ct. 761 (2008).

2 376 F. Supp. 2d 472 (S.D.N.Y. 2005).

3 *Id.* at 509.

4 *Id.*

5 452 F.3d 1040, 1051-52 (9th Cir. 2006).

6 439 F. Supp. 2d. 692, 724 (S.D. Tex. 2006).

7 *In re Parmalat Securities Litig.*, No. 04 Civ. 0030 (S.D.N.Y. Aug. 7, 2008).