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Client Alert

Standards Tighten for Imposing Securities Fraud Liability on Banks and Other "Secondary Actors," but Issue Awaits Supreme Court Review

In a recent decision in the long-running Enron class action securities litigation, *Regents of the University of California v. Credit Suisse First Boston (USA), Inc.*, 2007 U.S. App. LEXIS 6396 (5th Cir. Mar. 19, 2007), the Fifth Circuit Court of Appeals rejected class action certification in cases seeking to impose liability under § 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 upon banks who allegedly participated in transactions which Enron sought to use to misstate its financial condition. The Court's decision to reject class action treatment rested upon its conclusion that the banks had no duty to provide any information to investors about these transactions. As a result, the Court held there was no basis to presume reliance by all class members upon the banks' failure to provide such information, and thus no basis to treat such claims collectively in the form of a class action.

The issue of whether banks, advisors and other such "secondary actors" owe any duty of disclosure to the investing public by virtue of their participation in an alleged scheme to defraud shareholders (commonly referred to as "scheme liability") has split the circuit courts that have confronted it over the past year. Notably, just days after the Fifth Circuit aligned itself with those which reject such liability, the United States Supreme Court accepted review of one of the earlier circuit decisions on this issue, *Stoneridge Investment Partners, LLS v. Scientific Atlanta, Inc. (In re Charter Communications, Inc., Sec. Litig.)*, 443 F.3d 987, 992 (8th Cir. 2006), *cert. granted*, 2007 U.S. LEXIS 3582 (Mar. 26, 2007), thus seemingly assuring that ultimately the Supreme Court will pass upon the key issue in the attempt by investors to recover their losses from banks and other secondary actors in alleged financial frauds like Enron by making "scheme liability" claims.

The plaintiffs in the Enron securities fraud litigation against the defendant banks and investment banks alleged that these banks entered into various partnerships and transactions with Enron that allowed Enron to misstate its financial condition, and charged that the banks did so knowing Enron was engaging in these seemingly irrational transactions for that purpose. Over 30 such lawsuits making claims under § 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 were eventually consolidated in the federal district court in Houston, seeking to recover alleged damages of $40 billion. The case had survived motions to dismiss and was later granted class action certification by the district court. The defendants challenged the grant of class certification, and, on an interlocutory appeal under Rule 23(f) of the Federal Rules of Civil Procedure, the Fifth Circuit rejected class certification as improper.

Presumptions of Class-Wide Reliance

Class action certifications in fraud cases can be difficult to obtain if the case will present individualized issues of reliance upon the alleged fraud for each class member, because in such situations the case may fail to meet the requirement for class actions that the common issues in the case "predominate" over the individualized issues. In certain securities fraud scenarios, however, it is considered appropriate to use class-wide presumptions of reliance, and such class-wide

presumptions will overcome this problem by eliminating the need for a plaintiff-by-plaintiff inquiry. The question posed in the Enron securities fraud litigation was whether the investors' claims against the banks represented the kind of case where using such class-wide presumptions of reliance would be appropriate. The defendants argued that such presumptions were inappropriate against the bank defendants in a case like this.

Before dealing with these arguments, the Court first had to grapple with the question of whether it could even reach issues so closely tied to the actual merits of the case in the context of an interlocutory appeal of class certification pursuant to Rule 23(f). Although noting "unsettled questions of law concerning the entanglement of the merits with the class certification decision," the Court concluded that under Supreme Court and Fifth Circuit precedent, and the decision of other federal circuits (such as the Second Circuit's recent decision in late 2006 in *In re IPO Securities Litigation* (see Chadbourne & Parke LLP Client Alert: "Second Circuit Clarifies Standard for Class Certification" (Dec. 12, 2006)), the Court could address class certification arguments that implicated the substantive merits of the case "insofar as those arguments also implicate the merits of the class certification decision." Indeed, the Court expressed the view that, given how the class certification decision is often virtually dispositive of litigations such as this, it was all the more appropriate that the legal merits and the practical outcome of the case should coincide. The Court thus proceeded to analyze two issues relating to whether a presumption of reliance could properly be employed in this case.

The Court first addressed whether the plaintiffs could base their claim upon the presumption of class-wide reliance recognized in *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972), for securities fraud claims that are based upon omissions rather than affirmative misrepresentations. The Court held that they could not, because the *Affiliated Ute* presumption of reliance is only applicable when the party accused of having failed to disclose had been under a duty to disclose, and the banks here were not. The Court noted that the banks were not fiduciaries and did not owe any duty to disclose the nature of the alleged transactions to Enron's shareholders. The Court also explained that pleading a securities fraud violation based on a fraudulent scheme or act as opposed to misrepresentation did not eliminate the need to demonstrate a duty of disclosure. The Court stated that "where the plaintiffs had no expectation that the banks would provide them with information, there is no reason to expect that the plaintiffs were relying on their candor. Accordingly, it is only sensible to put plaintiffs to their proof, that they individually relied on the banks' omissions."

The Court next addressed whether the fraud-on-the-market presumption of *Basic Inc. v. Levinson*, 485 U.S. 224 (1988), in which an efficient market for a security is presumed to rely on any omission or misrepresentations regarding that security made in that marketplace. In order for the presumption to apply, however, the Court observed that a plaintiff must allege not only an efficient market but that the defendant made public and material misrepresentations. The lower court had taken the position (favored by the SEC) that the latter requirement could be satisfied by a defendant's participation in a "transaction whose principal purpose and effect is to create a false appearance of revenues." This was an issue on which the circuits were split.

Split Among the Circuit Courts

The Ninth Circuit (in *Simpson v. AOL Time Warner Inc.* (*In re Homestore.com, Inc. Sec. Litig.*), 452 F.3d 1040, 1048 (9th Cir. 2006)) essentially agreed with the SEC position, and a similar approach had been followed by the district court in the Parmalat securities fraud litigation in New York (*In re Parmalat Sec. Litig.*, 376 F. Supp. 2d 472, 499-503 (S.D.N.Y. 2005)). By contrast, the

Eighth Circuit, in *Stoneridge Investment Partners*, rejected this position as being essentially no different than just imposing aiding and abetting liability, which the Supreme Court had rejected for § 10(b) cases in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994).

The Fifth Circuit sided with the Eighth Circuit on this issue, holding that the banks' alleged conduct could not be considered a "deceptive device" (i.e., a "device, scheme or artifice to defraud" in the words of Rule 10b-5) unless it involved either a misstatement or a failure to disclose by one who has a duty to disclose. Since neither of those were present in the situation involving the banks and Enron, there was no misrepresentation that would justify a class-wide presumption of investor reliance under *Basic*. The Court also rejected the attempt to characterize the banks' conduct as "manipulation," noting that "manipulation" was a term of art in the securities arena which would require the defendant banks to "act directly in the market for Enron securities," which they did not.

Thus, because there was no basis under which any class-wide presumptions of reliance could be used, the grant of class certification was reversed. While frankly recognizing that this decision would be unpopular in certain respects since "[d]efendants do, after all, escape liability for alleged conduct that was hardly praiseworthy," the Fifth Circuit drew the line against a more inclusive scope of primary liability for bank transactions that "at most aided and abetted Enron's deceit by making its misrepresentations more plausible." The Fifth Circuit's decision is a major victory for the investment bank defendants in the Enron litigation, as well as for financing parties and advisors generally who become involved with companies engaged in financial fraud. Coming as it does in such a highly publicized and closely watched case, the decision represents a significant attempt by the Court to establish a more predictable, bright line test for liability of secondary actors for securities fraud under § 10(b).

In sum, the Fifth Circuit took a firm stance in drawing the line between what constitutes actionable primary violations under § 10(b) and Rule 10b-5 and non-actionable aiding and abetting by limiting the liability of secondary actors such as banks to circumstances in which the defendant (1) makes a public and material misrepresentation, (2) owes the issuer's shareholders a duty to disclose, or (3) directly manipulates the markets for the issuer's securities. While conceding that its ruling might not be popular with aggrieved former Enron shareholders who lost billions of dollars, the Court concluded that its limited interpretation of the words of § 10(b) followed the Supreme Court's guidance and maintained "Congress's balancing of competing desires to provide for some remedy for securities fraud without opening the floodgates for nearly unlimited and frequently unpredictable liability for secondary actors in securities markets." Ultimately, though, the stage is now set for the Supreme Court to have last word on this issue when it addresses the *Stoneridge Investment Partners* appeal during its 2007 fall term.

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