PACIFIC INVESTMENT MGMT. CO. v. *MAYER BROWN*: THE SECOND CIRCUIT REJECTS THE "CREATOR THEORY" AND ADOPTS THE "ATTRIBUTION REQUIREMENT" FOR 10B-5 LIABILITY OF SECONDARY ACTORS

On April 27, 2010, the United States Court of Appeals for the Second Circuit upheld the dismissal of Section 10(b) and Rule 10b-5 securities fraud claims brought by Pacific Investment Management Company, LLC (PIMCO) and RH Capital Associates, LLC against the law firm Mayer Brown LLP and Joseph Collins, a partner at Mayer Brown.[1] The plaintiffs alleged that the defendants violated federal securities laws while representing Refco Inc. (Refco), a brokerage firm, by facilitating fraudulent transactions between Refco and third parties and by drafting portions of Refco's offering documents that contained false information.

Rule 10b-5, promulgated under § 10(b) of the Securities and Exchange Act of 1934, makes it unlawful, in connection with the purchase or sale of any security, "[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 the light of the circumstances under which they were made, not misleading."[2] The Supreme Court of the United States has outlined six elements that a plaintiff must show to maintain a private cause of action under Rule 10b-5(b): "(1) a material misrepresentation or omission by the defendant; (2) scienter; (3) a connection between the misrepresentation or omission and the purchase or sale of a security; (4) reliance upon the misrepresentation or omission; (5) economic loss; and (6) loss causation."[3]

The plaintiffs in *PIMCO* claimed that Mayer Brown and Collins, in drafting and reviewing portions of Refco's offering documents that contained false information, had made "untrue statements of material fact" and were liable as secondary actors under Rule 10b-5, despite the fact that none of the documents specifically attributed any of the information contained therein to Mayer Brown or to Collins. The Second Circuit rejected the plaintiffs' theory and held that "a secondary actor can be held liable for false statements in a private damages action for securities fraud *only if* the statements are attributed to the defendant at the time the statements are disseminated."[4] The Court further held that the plaintiffs' claims for "scheme liability" were foreclosed by the 2008 Supreme Court ruling in *Stoneridge Investment Partners, LLC* v. *Scientific-Atlanta, Inc.*[5] In his concurrence, Circuit Judge Parker

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noted the Second Circuit's lack of clarity on the issue of attribution and the circuit split that existed on the issue and seemed to invite either *en banc* or Supreme Court review.

BACKGROUND: PLAINTIFFS' RULE 10B-5 CLAIMS

PIMCO arose from the bankruptcy and collapse of Refco in 2005. Mayer Brown had long served as Refco's chief outside counsel, and Collins as its primary contact at the law firm. In the late 1990s, Refco allegedly transferred a massive amount of uncollectible debt to an entity controlled by Refco's CEO, and then allegedly engaged in a series of "sham" loan transactions to conceal the losses. The plaintiffs in *PIMCO* claimed that Mayer Brown took part in engineering several of these sham transactions by negotiating, drafting, revising, transmitting, and distributing documents related to the loans. The plaintiffs further claimed that the law firm participated in creating false statements contained in certain Refco offering materials. The offering materials noted that Mayer Brown represented Refco, but none of the documents named Collins or specifically attributed any of the information contained therein to Mayer Brown or Collins. The plaintiffs, who had purchased securities from Refco during the time when Mayer Brown and Collins were allegedly engaging in fraud, brought claims against them for violations of § 10(b) of the Securities Exchange Act of 1934 and for "control person" liability under § 20(a) of the Act.

The US District Court for the Southern District of New York dismissed the plaintiffs' claims and found that none of the statements in Refco's offering documents could be attributed to Mayer Brown and Collins, and that at most their conduct amounted to aiding and abetting, which does not carry a private cause of action. The plaintiffs appealed to the Second Circuit.

THE SECOND CIRCUIT REJECTS THE PLAINTIFFS' "CREATOR THEORY" AND ADOPTS THE "ATTRIBUTION REQUIREMENT" FOR 10B-5 LIABILITY

On appeal, the plaintiffs claimed that attribution is not the sole means by which outside attorneys and other "secondary actors" can be held liable for securities fraud, and that the Court should "adopt a 'creator standard' and hold that a defendant can be liable for *creating* false statements that investors rely on, regardless of whether that statement is attributed to the defendant at the time of dissemination."[6] The plaintiffs further claimed that Mayer Brown and Collins were liable for "scheme liability" in that their facilitation of false transactions enabled Refco to make false statements upon which the plaintiffs relied. In an *amicus* brief, the Securities and Exchange Commission (SEC) supported the plaintiffs' request for a "creator standard," and argued that a person "creates a statement" if (1) he speaks or writes the statement; (2) he supplies false or misleading information that another person then uses in the statement; or (3) he "allows the statement to be attributed to him."[7]

Writing for the Court, Circuit Judge Cabranes rejected the plaintiffs' argument and upheld the dismissal of their claims. The Second Circuit analyzed controlling precedent on the issue of "secondary liability" in securities fraud, beginning with the 1994 Supreme Court decision in *Central Bank of Denver, N.A.* v. *First Interstate Bank of Denver, N.A.*, which held that Rule 10b-5 liability does not extend to aiders and abettors who did not make a material misstatement upon which purchasers or sellers of securities relied.[8] The Second Circuit applied this holding in *Shapiro* v. *Cantor and Wright* v. *Ernst & Young, LLP*, both involving allegations of an accounting firm's complicity in a corporation's false and misleading statements.[9] In *Shapiro*, the court found that a defendant "must actually *make* a false or misleading statement in order to be held liable under § 10(b)."[10] In *Wright*, the court went further and adopted a bright-line rule that "a secondary actor cannot incur primary liability under [Rule 10b-5] for a statement not attributed to that actor at the time of its dissemination."[11] The *Wright* court reasoned that attribution is necessary to satisfy the reliance element of a Rule 10b-5 claim, and that reliance on statements made by others cannot alone form the basis of liability.[12]

The *PIMCO* Court noted that a 2001 case, *In re Scholastic Corp. Securities Litigation*, held that a corporate officer—the individual responsible for corporate communications with investors and analysts—"could be held liable for misrepresentations made by the corporation, despite the fact that none of the statements had been specifically attributed to him," and that this decision had caused trial courts to "struggle[] to reconcile its holding with our earlier holding in *Wright*."[13] In 2007, however, the Second Circuit refused to impose liability on accountants who reviewed and approved a corporation's misleading financial statements unless that statement "is attributed to the accountant at the time of its dissemination."[14]

The *PIMCO* Court noted that a bright-line attribution rule is consistent with the recent Supreme Court decision (*Stoneridge*) that rejected 10b-5 liability in circumstances where the plaintiffs failed to prove that they relied on an issuing firm's customers and suppliers' own deceptive conduct.[15] This decision, the *PIMCO* Court noted, stood "for the proposition that reliance is a critical element in private actions under Rule 10b-5," and noted that "attribution is necessary to show reliance," and that it conforms to the requirements of 10b-5 liability under *Stoneridge*.[16] Based on this precedent, the *PIMCO* Court rejected the plaintiffs' and the SEC's "creator standard" for secondary liability and held that a bright-line "attribution" requirement is more consistent with prior Second Circuit and Supreme Court case law. The *PIMCO* Court noted that a bright-line attribution rule is simpler for district courts to apply and is likewise easier for secondary actors to follow.

Applying the attribution rule to the case, the Court upheld the District Court's dismissal and found that the plaintiffs failed to state a claim for a violation of Rule 10b-5(b). The Court noted that no statements in the offering documents could be attributed to Collins, and that he was "not even mentioned by name in any of [the] documents";[17] thus, the plaintiffs failed to show that they relied on any of his statements. Although certain of the offering materials noted that Mayer Brown represented Refco, they did not attribute any specific statements to the law firm.

The Second Circuit also rejected the plaintiffs' Rule 10b-5(a) and (c) claims based on a theory of "scheme liability." The *PIMCO* Court found that, although Mayer Brown and Collins were alleged to have enabled Refco's false and misleading statements by assisting in the transaction of sham loans, plaintiffs were unaware of the transactions when they purchased Refco stock and therefore did not rely on the law firm's dealings. Under *Stoneridge*, "the mere fact that the ultimate result of a secondary actor's deceptive course of conduct is communicated to the public through a company's financial statements is insufficient to show reliance on the secondary actor's *own* deceptive conduct."[18] The indirect reliance upon which the plaintiffs based their claim was "too remote for liability."[19]

While concurring in the judgment, Circuit Judge Parker observed that the Second Circuit case law on the issue of attribution was still "far from a model of clarity."[20] Judge Parker noted that the decision in *Scholastic Corp.* did not distinguish *Wright* or other former cases and that at least one district court had applied *Scholastic Corp.* as relaxing the attribution requirement in *Wright*. Additionally, Judge Parker highlighted dicta in a 2008 case that could suggest that strict attribution is not required for Rule 10b-5 liability.[21] Judge Parker spoke to the split among circuits on the issue of attribution, and noted that the SEC supported the plaintiffs' argument in this case, and that they believed the attribution requirement could "prevent the securities laws from deterring individuals who make false statements anonymously or through proxies."[22] Judge Parker concluded: "In light of the importance of the existence, *vel non*, of an attribution requirement to the securities law, the bar, and the securities industry, this case could provide our full Court, as well as, perhaps the Supreme Court, with an opportunity to clarify the law in this area."[23]

THE SIGNIFICANCE OF *PIMCO*

PIMCO is noteworthy in that it purports to settle questionable Second Circuit precedent on the issue of secondary liability for securities fraud under Rule 10b-5. After this decision, secondary actors, such as outside accountants and attorneys, may be held liable *only if* the false or misleading statements at issue can be attributed to them. Drafting, revising, or reviewing documents is not sufficient for attribution—the defendants must be named on the document, and the statements contained therein must be directly attributed to them. Moreover, a plaintiff must rely on the secondary actor's *own* fraudulent conduct, and not just the false documents resulting therefrom, to make a "scheme liability" claim.

As the Court noted, this is likely to affect the conduct of secondary actors: "those who sign or otherwise allow a statement to be attributed to them expose themselves to liability. Those who do not are beyond the reach of Rule 10b-5's private right of action."[24] The *PIMCO* decision may therefore serve as a deterrent for secondary actors to allow corporate documents to be attributed to them in any way.

It is important to note, however, that the decision in this case has two crucial limitations: (1) it relates only to civil actions under Rule 10b-5 brought by *private* individuals and does not speak to liability with respect to any government enforcement actions;[25] and (2) it explicitly refrains from addressing whether attribution is required for claims against corporate insiders, as in *Scholastic*.[26] The Court noted that "[t]here may be a justifiable basis for holding that investors rely on the role corporate executives play in issuing public statements even in the absence of explicit attribution."[27] Thus, corporate officials should not assume that they may only be held liable for statements directly attributable to them; their role and responsibilities in the corporate structure may still be sufficient for a finding of liability.

Perhaps most significant, however, is Judge Parker's concurrence. Judge Parker essentially calls for *en banc* review of the case, and even invites the Supreme Court to weigh-in on the matter. Thus, secondary actors and the corporate entities they serve should continue to monitor this case and should not necessarily rely on the Second Circuit decision as the final word on the subject.

We hope that you have found this advisory useful. If you have additional questions, please contact your Arnold & Porter attorney or:

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(Endnotes)

1 *Pacific Investment Mgmt. Co.* v. *Mayer Brown,* No. 09-1619, 2010 U.S. App. LEXIS 8642 at *5 (2d Cir. Apr. 27, 2010).

2 17 C.F.R. § 240.10b-5(b). The Rule also makes it unlawful to "employ any device, scheme, or artifice to defraud" or to "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, which constitutes so-called "scheme liability." 17 C.F.R. § 240.10b-5(a), (c).

3 2010 U.S. App. LEXIS 8642 at **12-13, quoting *Stoneridge Investment Partners, LLC* v. *Scientific-Atlanta, Inc.,* 552 U.S. 148 (2008).

4 2010 U.S. App. LEXIS 8642 at *5 (emphasis supplied).

5 552 U.S. 148 (2008).

6 2010 U.S. App. LEXIS 8642at *14 (emphasis in original).

7 *Id.*

8 511 U.S. 164 (1994).

9 *See Shapiro v. Cantor,* 123 F.3d 717 (2d Cir. 1997) and *Wright* v. *Ernst & Young, LLP,* 152 F.3d 169 (2d Cir. 1998).

10 *Shapiro,* 123 F.3d at 720.

11 *Wright,* 152 F.3d at 174-75.

12 *Id.*

13 2010 U.S. App. LEXIS 8642 at * 22, citing *Scholastic,* 252 F.3d 63, 75-76 (2d Cir. 2001).

14 *Id,*, citing *Lattanzio* v. *Deloitte & Touche,* 476 F.3d 147 (2d Cir. 2007).

15 *Stoneridge Investment Partners, LLC* v. *Scientific-Atlanta, Inc.,* 552 U.S. at 160-61.

16 2010 U.S. App. LEXIS 8642 at *27.

17 *Id.* at *34.

18 *Id.* at **38-39 (emphasis in original).

19 *Id.* at 36, quoting *Stoneridge Investment Partners, LLC* v. *Scientific-Atlanta, Inc.,* 552 U.S. at 159.

20 *Id.* at *43.

21 *Id.* at *44, citing *United States* v. *Finnerty,* 533 F.3d 143, 150 (2d Cir. 2008).

22 *Id.* at *45.

23 *Id.* at **45-46.

24 *Id.* at * 30.

25 In fact, defendant Collins in this case was convicted in a criminal case and sentenced to seven years in prison. *Id.* at *45, citing Amended Judgment, *U.S.* v. *Collins,* No. 1:07-cr-01170 (S.D.N.Y. Mar. 24, 2010).

26 *Id.* at n.6.

27 *Id.*