07-0583-cv

United States Court of Appeals

for the

Second Circuit

ROBERT MORRISON, individually and on behalf of all others similarly situated, RUSSELL LESLIE OWEN, BRIAN SILVERLOCK, GERALDINE SILVERLOCK,

Plaintiffs-Appellants,

MARIA KENNEDY, HARVARD B. KOLM and NORMAN HAUGE,

Plaintiffs,

– v. –

NATIONAL AUSTRALIA BANK LTD., HOMESIDE LENDING INC., FRANK CICUTTO, HUGH HARRIS, KEVIN RACE and W. BLAKE WILSON,

Defendants-Appellees.

ON APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

BRIEF FOR DEFENDANTS-APPELLEES HUGH HARRIS, KEVIN RACE AND W. BLAKE WILSON

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STATEMENT OF THE ISSUES PRESENTED

1. As to the Plaintiffs' first issue on appeal, the Complaint failed to set forth sufficient facts to support subject matter jurisdiction over any of the Defendants on federal securities claims.

2. As to Plaintiffs' second issue on appeal, the Complaint failed to set forth sufficient facts to support claims against Harris, Race, and Wilson as primary violators or under a scheme liability theory.

STATEMENT OF FACTS

Defendants Harris, Race, and Wilson adopt the Statement of Facts submitted in the Brief of Defendants NAB[1] and Cicutto. The only acts or omissions the Plaintiffs actually alleged on the part of Harris, Race, or Wilson are that they utilized an overly aggressive mortgage pre-payment assumption which, accompanied by an error on the part of their subordinates in inputting data into the operable computer program, resulted in a substantial overestimation of the value of HomeSide's mortgage servicing rights ("MSR"). By way of background, it should

[1] Defendant/Appellee National Australia Bank, Ltd. will be referenced herein as "NAB." Defendant/Appellee HomeSide Lending, Inc. (n/k/a Washington Mutual Bank, F.A.) will be referenced herein as "HomeSide." Defendant/Appellee Frank Cicutto will be referenced herein as "Cicutto." Defendants/Appellees Hugh Harris, Kevin Race, and W. Blake Wilson will be referenced as "Harris," "Race," and "Wilson," respectively. Plaintiffs/Appellees Robert Morrison, Individually and on behalf of all others similarly situated, shall be referred to as "Plaintiffs." As in the Brief of Plaintiffs/Appellants, pages of the Joint Appendix filed in this matter will be referenced as "(A. __)." References to documents cited in the Appendix shall be to the page number of the document and where applicable, the particular section or paragraph. The Consolidated Class Action Complaint, which was dismissed by the district court on October 25, 2006, shall be referred to as the "Complaint."

be noted that the events alleged in the Complaint occurred in a period of an unprecedented and unpredictable plummet in interest rates, which resulted in a similarly unpredictable rate of mortgage prepayments and subsequent refinancing, substantially reducing the value of HomeSide's MSR, along with that of virtually every other mortgage servicing company.

The Plaintiffs allege in a conclusory fashion in their Complaint (A. 70) that Harris, Race, and Wilson "deliberately and regularly overvalued [HomeSide's] portfolio, and resulting MSR, by hundreds of millions of dollars by modifying assumptions in the computer models used to produce the valuations." (A. 101, ¶ 116.) The Plaintiffs' later assertions, however, clarify this contention. These Defendants are not alleged to have misrepresented any existing fact. To the contrary, they are alleged, again in a conclusory manner, to have "manipulated prepayment and discount rate assumptions to lengthen the average life and duration of its mortgage portfolio, thereby artificially increasing the MSR yield of the portfolio and HomeSide's profitability." (A. 102, ¶ 121.) In other words, Harris, Race, and Wilson are, at most, alleged to have used an aggressively low assumption as to the rate at which the mortgages serviced by HomeSide would be prepaid,[2] which increased HomeSide's projected future earnings stream.

[2] The Plaintiffs' definition of an excessively low prepayment speed, apparently, is one that is below the median speed used in the mortgage servicing industry. (A. 103, ¶ 124.)

Plaintiffs allege only limited statements that were specifically attributed to these Defendants: two to Race (A. 83-84, ¶¶ 58 and 62) and one to Harris (A. 85, ¶ 65), all in news articles. There are no allegations as to any specific statements by Wilson. The statements attributable to Race and Harris do not form the basis for any of the Plaintiffs' claims, and are not actionable. Rather, they appear to be, at most, background allegations. Race is quoted as saying that the times "presented HomeSide and other mortgage bankers with 'a challenging environment' for hedging," and that "[w]e believed that mortgage spreads were wide and would tighten. We didn't anticipate how they would bounce around, particularly [in January]." (A.83, ¶ 58.) He is also quoted as saying HomeSide was "insulated from a downturn because it does not have retail branches and gets most of its mortgages from brokers, correspondents, and banks that agree to sell HomeSide all their loans."[3] (A. 84, ¶ 62.) Harris is quoted as saying "[o]ur real strategy for the last few years is to continue growing our servicing portfolio. With our preferred partner, we're not only getting a servicing portfolio, but we're getting a flow production for a period of time." (A. 85, ¶ 65.) The Plaintiffs do not contend any of these statements were false.

[3] This statement was, of course, unrelated to the value of HomeSide's existing MSR, which is the basis of Plaintiffs' claims; nor was there any allegation that this statement was ever published in Australia.

SUMMARY OF THE ARGUMENT

Plaintiffs' reliance on the "conduct" test to establish subject matter jurisdiction over these Defendants is misplaced. Plaintiffs allege no direct communication of false information from Harris, Race, or Wilson to anyone. In fact, the Complaint alleges only three representations on the part of these Defendants (two by Race, one by Harris, and none by Wilson), none of which are relevant to the Plaintiffs' claims. To the contrary, all communications to Plaintiffs - citizens of Australia who purchased their shares in Australia - were made to them in Australia by NAB or Cicutto. The requirement that the conduct complained of must have directly caused the losses sought to be recovered applies equally to foreign and domestic defendants, and there is no such direct causation on the part of the domestic Defendants here.

Additionally, Plaintiffs' attempt to evade the subject matter jurisdiction requirements by arguing that these Defendants are primarily liable for the alleged false statements of NAB is unavailing. Whether the Plaintiffs stated a claim or failed to state a claim against the domestic Defendants has no impact on the jurisdictional issue before the Court. Regardless, as set forth herein, Plaintiffs' arguments that they have properly stated claims against these Defendants are not well taken.

Because the Complaint fails to attribute any actionable false statement to Harris, Race, or Wilson, the allegations against them constitute no more than aiding and abetting, which the United States Supreme Court has recognized as insufficient to impose liability under Section 10(b) of the Securities and Exchange Act of 1934, 15 U.S.C.A. § 78j(b) ("§ 10(b)"). Plaintiffs urge an exception to the strict "attribution" requirement imposed by this Court in *Wright v. Ernst & Young LLP*, 152 F.3d 169 (2d Cir. 1998); that is, Plaintiffs argue that even in the absence of direct attribution of the allegedly false statements or omissions, a defendant may still be held liable for a false statement where that defendant's participation was so substantial that the defendant may be deemed to have made the false statement and where investors were sufficiently aware of the defendant's participation that they may be found to have relied upon it. This purported exception to the "attribution" requirement is inconsistent with the explicit holding of *Wright*, and the authority cited by Plaintiffs for the purported exception - *In re Scholastic Corp. Secu. Litig.*, 252 F.3d 63 (2d Cir. 2001) - provides no support. Regardless, there is no allegation that the Plaintiffs were remotely aware of any act, statement, or omission on the part of Harris, Race, or Wilson. Thus, even if such an exception were established, it would not be applicable to the claim against these Defendants.

Finally, Plaintiffs argue in the alternative that they stated a claim for "scheme liability" under 17 C.F.R. § 240.10b-5 (a) & (c) ("Rule 10b-5").

Plaintiffs failed to allege any acts or omissions on the part of these Defendants that would establish conduct intended to deceive investors by controlling the price of securities, and Plaintiffs fail in their attempt to inflate what is at most aiding and abetting into an actionable claim.

For the above reasons, the district court's order of dismissal should be affirmed.

ARGUMENT

I. NO SUBJECT MATTER JURISDICTION EXISTS OVER THE PLAINTIFFS' CLAIMS

Defendants Harris, Race, and Wilson adopt the argument set forth in the briefs of Defendants NAB/Cicutto, and HomeSide. Further, Plaintiffs have failed to allege sufficient conduct by Harris, Race, or Wilson to establish subject matter jurisdiction over the Plaintiffs' claims, irrespective of whether Harris, Race, and Wilson are domestic defendants.

Plaintiffs rely upon the "conduct" test to support subject matter jurisdiction over the domestic Defendants. Under the conduct test, subject matter jurisdiction over securities claims brought by foreign plaintiffs exists only where there has taken place, in the United States: (1) conduct material to the completion of the fraud; (2) perpetration of fraudulent acts themselves; or (3) the final steps in the fraudulent scheme. *Societe Nationale d'Exploitation Industrielle des Tabacs et Allumettes v. Salomon Brothers Int'l Ltd.*, 928 F.2d 398, 403 (S.D.N.Y. 1996)

(internal quotations and citations omitted). Thus, subject matter jurisdiction will not exist where the activities inside the United States are "merely preparatory" or "are relatively small in comparison to those abroad." *Id.* (quoting *Bersch v. Drexel Firestone, Inc.*, 519 F.2d 974, 987 (2d Cir. 1975)). As this Court noted in *Bersch,* "the anti-fraud provisions of the federal securities laws . . . [d]o not apply to losses from sales of securities to foreigners outside the United States unless acts (or culpable failures to act) within the United States directly caused such losses." 519 F.2d at 993 (emphasis added). Even the case law cited by the Plaintiffs makes it clear that for a loss to be "directly caused" by a defendant as required by the conduct test, there must be an "actionable misstatement or omission within the United States [which] is a 'substantial' or 'significant contributing cause' of the decision to purchase stock." *In re Gaming Lottery Secu. Litig.*, 58 F. Supp. 2d 62, 73 (S.D.N.Y. 1999) (citing *Itoba*[4], 54 F.3d at 122).

As set forth in the Statement of Facts, the Plaintiffs failed to allege that either Harris, Race, or Wilson made any such actionable misstatement or omission. The most that is alleged as to these Defendants is that they provided an erroneous projection as to the speed at which the mortgages being serviced by their employer,

[4] In the *Itoba* case, upon which Plaintiffs place significant reliance, there was found to be "a fraud occurring on an American exchange and persisting abroad that has impacted detrimentally upon thousands of United States shareholders." *Itoba Ltd. v. Lep Group PLC*, 54 F.3d 118, 124 (2d Cir. 1995). The *Itoba* court applied a combination of the "conduct" and "effects" tests to justify jurisdiction. *Id.* The "effects" test, of course, has no application to the case at bar, and Plaintiffs make no contention to the contrary.

HomeSide, would be prepaid and, on the basis of that erroneous projection (and after interest rates unpredictably plummeted), overestimated the value of HomeSide's MSR based upon this projected future income stream.

The Plaintiffs' contention that such alleged activity on the part of Harris, Race, and Wilson meets the "conduct" test is inconsistent with the case law. The case of *Froese v. Staff*, No. 02 CV 5744(RO), 2003 WL 21523979 (S.D.N.Y. July 7, 2003), relied upon by the district court below, is closely on point. The question there before the court was whether the alleged wrongful activity in the United States by the German defendant's subsidiary - a practice known as "channel stuffing," which resulted in overstatement of the defendant's revenues - was sufficient to invoke subject matter jurisdiction. *Id.* at *1-2. Here, the alleged wrongful conduct by NAB's United States subsidiary, HomeSide, and its officers, Harris, Race, and Wilson, was similar - that they manipulated the projection of mortgage prepayments to reflect an artificially slow rate, thus overstating projected revenues.

In *Froese*, the German parent "prepared and issued, from Germany, press releases and an annual report, which were materially false or misleading because of the channel stuffing." *Id.* at *1. In the case at bar, NAB prepared and issued from Australia press releases and reports which were alleged to be materially false and misleading because NAB's assets had been inflated by the alleged underestimate of

the prepayment rate for mortgages serviced by HomeSide. The *Froese* court held that the fraud, if there was a fraud, occurred "when the allegedly fraudulent statements were conceived, engineered, and published in Germany," and that it was "these misstatements and not any activity which lead to the alleged misrepresentations which 'directly caused' the financial losses." *Id.* at *2. The court held that the actions of the U.S. subsidiary failed to meet the "conduct" test for subject matter jurisdiction. *Id.* The only real difference between *Froese* and the case at bar is that here, the alleged representations were an overstatement of revenue projections, as opposed to an exaggeration of actual revenue. *See also Bersch*, 519 F.2d at 985, 987 (holding that preparation of part of the allegedly fraudulent prospectus, review of the draft prospectus, and opening of bank accounts in New York City in anticipation of deposits flowing from securities offering did not confer subject matter jurisdiction as to foreign plaintiffs); *Alfadda v. Fenn*, 935 F.2d 475, 479 (2d Cir. 1991) (finding that subject matter jurisdiction existed over foreign plaintiffs' security fraud claims where defendants were alleged to have conveyed false information to plaintiffs in meetings and negotiations in the United States); *In re Bayer AG Secu. Litig.,* 423 F. Supp. 2d 105, 111-12 (S.D.N.Y. 2005) (holding that where the "misstatements and omissions permeating the Complaint originated from Bayer AG in Germany and were included in Bayer AG press releases," the Complaint could not "support an

extension of jurisdiction over an overwhelmingly foreign putative class," where Bayer's United States subsidiary was alleged to have suppressed information regarding adverse effects of its product, Baycol, in the United States, issued a false press release and misleading SEC filings in the United States, and used this fraud to establish a United States market for Baycol); *Societe Nationale d'Exploitation Industrielle des Tabacs et Allumettes v. Salomon Brothers Int'l Ltd.*, 928 F. Supp. 398, 405 (S.D.N.Y. 1996) (finding no subject matter jurisdiction because the alleged false representations were made and received abroad); *CL-Alexanders Laing & Cruickshank v. Goldfeld*, 709 F. Supp. 472, 478, 479 & n.3 (S.D.N.Y. 1989) (noting that "plaintiff has not found, nor has this Court any case where subject matter jurisdiction was held proper under the 'conduct' test merely because fraudulent statements were prepared in the United States," and noting that to satisfy the conduct test, "some fraudulent statement must be alleged to have been communicated from [the United States]").

The Plaintiffs here allege no false representations or communications from Harris, Race, or Wilson directly to any Plaintiff. The only facts alleged as to these Defendants are that they at most manipulated mortgage prepayment projections to anticipate an artificially low prepayment rate, thus increasing HomeSide's MSR and projected earnings, which earnings were in turn reflected in the financial condition of NAB, which was then relied upon by Plaintiffs in purchasing NAB

shares. The Court found in *Bersch* that "[t]he fraud, if there was one, was committed by placing the allegedly false and misleading prospectus in the purchasers' hands." *Id*. at 987.

Similarly, if there was a fraud here (which these defendants vehemently dispute), it occurred when the representations regarding NAB's asset value were communicated, which took place in Australia. Accordingly, the Court lacks subject matter jurisdiction over Harris, Race, and Wilson.

II. THE COMPLAINT FAILS TO ALLEGE SUFFICIENT FACTS TO SUPPORT A CLAIM AGAINST THESE DEFENDANTS.

Plaintiffs, at Sections II.A and C of their brief, make the circuitous argument that if there is no subject matter jurisdiction over NAB and Cicutto, the Court still has jurisdiction over HomeSide and Harris, Race, and Wilson because the Complaint stated a claim against these Defendants. Stating a claim does not, obviously, create subject matter jurisdiction. Regardless, the facts alleged in the Complaint do not support the claims asserted as to Harris, Race, and Wilson, and these Defendants respond below to the arguments raised by Plaintiffs in Section II of their brief.[5]

[5] Plaintiffs do not raise the issue of scienter, and consequently that issue is not addressed in this brief. Lack of scienter is a significant issue in this case, however; particularly in light of the Supreme Court's very recent decision in *Tellabs, Inc. v. The Makor Issues & Rights, Ltd.*, 551 U.S. ___ (2007) No. 06-484 (June 21, 2007). Should this Court reverse the district court's decision and determine that subject matter jurisdiction exists, the case will presumably be remanded to the district

A. The Complaint Fell Far Short of the Requirements for a § 10(b) Claim Against Harris, Race, and Wilson as Primary Violators.

1. The Plaintiffs Fail to Allege any Actionable Misstatements or Omissions on the Part of Harris, Race, or Wilson.

The facts alleged as to Harris, Race, and Wilson, including the very limited and certainly irrelevant statements actually attributed to them, are set forth in the Statement of Facts above. As this Court has noted, in order to bring a securities fraud claim under § 10(b) and Rule 10b-5(b), "a plaintiff must plead that the defendant, in connection with the purchase or sale of securities, made a materially false statement or omitted a material fact, with scienter, and that the plaintiff's reliance on the defendant's action caused injury to the plaintiff." *Ganino v. Citizens Utils. Co.*, 228 F.3d 154, 161 (2d Cir. 2000). The Plaintiffs must also meet the heightened pleading requirements of Rule 9(b), Federal Rules of Civil Procedure, which requires that "the circumstances constituting fraud . . . shall be stated with particularity," as well as the Private Securities Litigation Reform Act of 1995 (the "PSLRA"), which requires that plaintiffs "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." PSLRA § 101(b), 15 U.S.C. § 78u-4(b)(2). More specifically, Fed.R.Civ.P. 9(b) requires that "a complaint making such allegations must '(1)

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court for a ruling on the Rule 12(b)(6) motions, which that court never ruled upon in light of its dismissal on jurisdictional grounds.

specify the statements that the plaintiff contends were fraudulent, (2) identify the speaker, (3) state where and when the statements were made, and (4) explain why the statements were fraudulent.'" *Shields v. Citytrust Bancorp, Inc.*, 25 F.3d 1124, 1127-28 (2d Cir. 1994) (internal citations omitted). The PSLRA requires a plaintiff to specify each statement alleged to have been misleading as well as the reasons why the statement is misleading. *Id*. (internal citations omitted). Thus, in order for a defendant to be held liable under § 10(b) for allegations of false statements or omissions, a plaintiff must set forth allegations with the particularity required by Fed.R.Civ.P. 9(b) and the PSLRA, establishing that the defendant made the allegedly false statements or that the allegedly false statements of another party are somehow attributable to the defendant.

The Plaintiffs' Complaint (A. 70) clearly fails to state a § 10(b) false statement claim against Harris, Race, or Wilson because these Defendants are not alleged to have made any actionable false statements and because the alleged false statements of the other Defendants cannot be attributed to these Defendants. Accordingly, these Defendants cannot be held primarily liable for those statements. As a consequence, regardless of whether subject matter jurisdiction existed over NAB and Cicutto, Defendants Harris, Race, and Wilson were properly dismissed from this action.

2. The Individual Defendants Cannot Be Held Liable Under § 10(b) for "Aiding And Abetting" the Alleged False Statements of NAB or Cicutto

The Complaint alleges two relatively innocuous statements to the press by Race (A. 83-84, ¶¶ 58 and 62) and one by Harris (A. 85, ¶ 65), none of which form the basis of Plaintiffs' claims. Rather, the gravamen of the allegations as to these Defendants is that they participated in inputting data for HomeSide's computer modeling system in order to artificially project a lower rate of prepayment of the mortgages that HomeSide was servicing, which in turn projected a rosier future income stream. As such, Plaintiffs essentially contend that Harris, Race, and Wilson may be held liable for aiding and abetting the alleged misstatements of the other Defendants.

As this Court has noted, however, the United States Supreme Court's decision in *Central Bank*[6] has held that aiding and abetting is no longer a basis for liability under § 10(b). *Shapiro v. Cantor*, 123 F.3d 717, 720 (2d Cir. 1997). Rather, a plaintiff must establish that a defendant is primarily liable for the alleged false statements or omissions. *Id.* The *Central Bank* decision effectively abrogated 25 years of case law, as well as precedent from eleven federal courts of appeals. *See In re Leslie Fay Cos. Secu. Litig.*, 871 F. Supp. 686, 689-90 (S.D.N.Y. 1995). On the basis of the *Central Bank* holding, this Court has held that "[a] claim under

[6] *Central Bank, N.A. v. First Interstate Bank, N.A.*, 511 U.S. 164 (1994).

§ 10(b) must allege a defendant has made a material misstatement or omission indicating an intent to deceive or defraud in connection with the purchase or sale of a security," noting that "[a]llegations of 'assisting,' 'participating in,' 'complicity in' and similar synonyms" all fall within the prohibitive bar of *Central Bank*. *See Shapiro*, 123 F.3d at 720-21.

Thus, at most, the strongest allegations as to Harris, Race, or Wilson fall within the "aiding and abetting" activities proscribed by *Central Bank* as grounds for a securities fraud action.

3. Plaintiffs Fail To Satisfy The Attribution Requirement

In their Complaint, the Plaintiffs identify 22 paragraphs of the Complaint which purportedly set out the "materially false and misleading" statements upon which their case is based (A. 108, ¶ 150.) Three of those were the statements of Defendants Race and Harris, as referenced above, but are immaterial to the alleged fraud. The remaining alleged statements are by the NAB or by its managing director/CEO, Cicutto. Assuming the NAB/Cicutto statements were actionable, the question before the Court would then be whether the Complaint sets forth sufficient allegations to establish primary liability on the part of Harris, Race, or Wilson for these statements. Because the statements were not made by Harris, Race, or Wilson, the critical question is whether they may be attributed to these defendants such that they may be held primarily liable for them under § 10(b).

With its decision in *Wright v. Ernst & Young LLP*, 152 F.3d 169 (2d Cir. 1998),[7] this Court added an additional requirement for securities fraud liability of a secondary actor: the statement must have been attributed to that actor.[8]

The Court reiterated its holding in *Shapiro*, in which

> we followed the "bright line" test after observing that "[i]f *Central Bank* is to have any real meaning, a defendant must actually make a false or misleading statement in order to be held liable under Section 10(b). Anything short of such conduct is merely aiding and abetting, and no matter how substantial that aid may be, it is not enough to trigger liability under Section 10(b)."

152 F.3d at 175 (quoting *Shapiro*, 123 F.3d at 720 (citation omitted)).

This Court noted in *Wright* that "a defendant must 'know or should know' that his representation would be communicated to investors" and acknowledged that "[t]here is no requirement that the alleged violator directly communicate misrepresentations to [investors] for primary liability to attach." *Id.* at 175 (citation omitted). The Court then added an additional requirement for such liability: "a secondary actor cannot incur primary liability under the Act for a

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[7] Although *Wright* involved claims against an accounting firm, the holding was clearly not limited to claims against accountants.

[8] While "secondary actors" are often outside professionals - accountants, attorneys or bankers - the courts have not limited the term to outside professionals. To the contrary, corporate officers have also been held to occupy that status. *See In re Sotheby's Holdings, Inc.*, 2000 WL 1234601 (S.D.N.Y. Aug. 31, 2000) (attribution requirement applied to financial officers of subsidiary); *Copland v. Grumet*, 88 F. Supp. 2d 326 (D.N.J. 1999) (attribution requirement applied to members of corporate management).

statement not attributed to that actor at the time of its dissemination." *Id.* (emphasis supplied).

This Court explained the basis for the additional requirement of attribution as follows:

> Such a holding [i.e., holding a secondary actor liable without attribution at the time of dissemination] would circumvent the reliance requirements of the Act, as "[r]eliance only on representations made by others cannot itself form the basis of liability." . . . thus, the misrepresentation must be attributed to that specific actor at the time of public dissemination, that is, in advance of the investment decision.

Id. (emphasis added).

The effect of this additional requirement of attribution, injected by the Second Circuit in *Wright*, is apparent in the district court's opinion in *Copland v. Grumet*, 88 F. Supp. 2d 326 (D.N.J. 1999). In a situation closely on point with the claims at bar, the plaintiffs in the *Copland* class action securities fraud litigation sought to amend their complaint to add claims against two prospective defendants, who were members of corporate management, alleging those defendants had participated in the process of generating false financial data. 88 F. Supp. 2d at 332. In denying the motion as futile, the district court noted "that the Second Circuit's opinion in *Wright* has added a new consideration, namely that in order to hold an individual liable for material misstatements, the misrepresentations must have been attributable to that specific actor at the time of public dissemination." *Id.* The

district court went on to hold that those prospective defendants' roles in formulating, preparing and/or compiling the alleged false financial data "does not amount to actually making a false misrepresentation which can be attributed to them." *Id.* at 333.

The allegations as to Harris, Race, and Wilson in the case at bar are even further removed from the requirements of *Wright*. Harris, Race, and Wilson are accused of artificially adjusting prepayment speeds in HomeSide's computer modeling system to enhance projections of HomeSide's future income stream. There are no statements in the Complaint attributed to Harris, Race, or Wilson, other than the innocuous representations referenced as to Race (A. 83-84, ¶¶ 58 and 62) and Harris (A. 85, ¶ 65.) Nor is it alleged that the NAB represented to any investor that Harris, Race, or Wilson had projected a lower rate of prepayments or a higher stream of earnings. In short, the Complaint fails to set forth sufficient allegations to establish a material misstatement on the part of these Defendants, nor can the Plaintiffs do so.

The Plaintiffs cite to several decisions which are not applicable to the case at bar. They rely upon *In re Kidder Peabody Secu. Litig.* , 10 F. Supp. 2d 398 (S.D.N.Y. 1998), where Kidder's employee, Joseph Jett, created phantom trades resulting in false profits to Kidder, which were communicated to the public by Kidder's parent, General Electric Company. 10 F. Supp. 2d at 405. This decision,

of course, predated the *Wright* decision, in which this Court laid down the attribution requirement.

Similarly, in *Menkes v. Stolt-Nielsen S.A.*, No. 3:03 CV 409(D.J.S.), 2006 WL 1699603 (D. Conn. June 19, 2006), also relied upon by Plaintiffs, the individual corporate officers of the subsidiary were held liable along with the parent, where their conduct rose "to the level of active participation in the dissemination of false or misleading information." *Id.* at *7. In contrast, the allegations as to Harris, Race, and Wilson involve economic projections. Plaintiffs fail to identify any false or misleading statements of fact actually made or disseminated by Harris, Race, or Wilson.

Some district courts have subsequently suggested that this Court, in the case of *In re Scholastic Corp. Secu. Litig.*, 252 F.3d 63 (2d Cir. 2001), may have receded from the strict "attribution" requirement of *Wright.* The district court in *In re LaBranche Securities Litigation*, 405 F. Supp. 2d 333 (S.D.N.Y. 2005) found that a plaintiff might state a claim for primary liability even in the absence of public attribution, "where the defendant's participation is substantial enough that s/he may be deemed to have made the statement, and where investors are sufficiently aware of defendant's participation that they may be found to have relied on it as if the statement had been attributed to the defendant." 405 F. Supp 2d at 351 (citing *In re Global Crossing Ltd. Secu. Litig.*, 322 F. Supp. 2d 319, 330-

32 (S.D.N.Y. 2004)) (emphasis added). The *Global Crossing* court acknowledged, however, that in the *Scholastic* decision the Second Circuit did not overrule *Wright*, nor did it even cite to *Wright* or *Central Bank*. 322 F. Supp. 2d at 331.

It is respectfully suggested that the district courts in *Menkes*, *Global Crossing,* and *LaBranche* read more into the *Scholastic* opinion than was there. In *Scholastic,* the plaintiffs had pleaded "on information and belief" that the individual Defendant, Marchuk, was involved in disseminating fraudulent statements. 252 F.3d at 75. The question before the Court was whether the plaintiffs met the pleading requirements of the PLSRA; that is, whether the facts upon which that belief was formed were stated with sufficient particularity. *Id.* The Second Circuit held the standard was met because the Plaintiffs had alleged that Marchuk, as vice president for finance and investor relations, was in a position "to control the extent to which [confidential information] was released to the public"; that Marchuk "was primarily responsible for Scholastic's communications with investors and industry analysts"; and that Marchuk was involved in "disseminating the false and misleading statements issued by Scholastic." *Id.* at 75-76. Obviously, the *Scholastic* Court found the plaintiffs there had sufficiently alleged Marchuk was the person primarily responsible for communicating with the investors and was himself involved in disseminating the false information directly to the investors. *Id*. at 76. This was not an exception to the attribution requirement

but, instead, was an explanation as to how Marchuk's alleged actions satisfied that requirement.

Regardless, if the *Scholastic* decision were deemed to create an exception to the attribution requirement, as suggested in *LaBranche* and *Global Crossing*, the allegations of the Complaint in this case are still woefully short of the requirements for § 10(b) primary liability on the part of Harris, Race, or Wilson. The "participation" alleged on the part of these defendants is simply that they made overly aggressive projections as to the prepayment rate of the mortgages serviced by HomeSide. More importantly, the essence of the purported exception to the attribution requirement is that the investors were aware of the Defendant's participation. *LaBranche,* 405 F. Supp. 2d at 351. There is no allegation that the investors allegedly damaged by the drop in NAB stock were remotely aware of any statement or action on the part of Harris, Race, or Wilson. Regardless of the rationale applied, the alleged statements and participation of Harris, Race, and Wilson are insufficient to create primary liability on their part.

4. The Complaint's Conclusory Allegations as to Harris, Race, and Wilson are Inactionable

The Complaint did not set forth sufficient allegations that Harris, Race, or Wilson made any false statement, or omitted a material fact, which would amount to an actionable misstatement under § 10(b). In addition to the allegations referenced in the Statement of Facts above, the Complaint (A. 70) is replete with

boilerplate and conclusory allegations as to Harris, Race, and Wilson. These allegations do not state a claim under § 10(b), however, because they fail to allege even the most basic facts required to establish liability on the part of Harris, Race, or Wilson and fail to meet the requirements of Fed.R.Civ.P. 9 or the PSLRA.

This Court has repeatedly emphasized that broad and conclusory allegations cannot serve as a basis for liability under § 10(b) and has identified the following such conclusory allegations as inactionable:

> "the defendants and each of them knowingly, or with reckless disregard of the truth, concealed from plaintiff and the class the material facts upon which this Amended Complaint is based . . ."
>
> "the defendants participated in, or knowingly or with reckless disregard for the truth lent material assistance to, and/or acquiesced in the foregoing acts and omissions and . . . played an active role in the preparation and dissemination of the false and misleading information and documents specified herein."

Decker v. Massey-Ferguson, Ltd., 681 F.2d 111, 119-20 (2d Cir. 1982). This Court went on to find that "[t]hese allegations are so broad and conclusory as to be meaningless." *Id.* at 120 (emphasis added).

Additionally, Plaintiffs may not rely upon conclusory allegations that these Defendants, because of their high-level positions, had access to undisclosed financial information through internal corporate documents and reports. Rather, a plaintiff must provide facts or details in support of these assertions. *See, e.g.,*

Goplen v. 51Job, Inc., 453 F. Supp. 2d 759, 768, 773 (S.D.N.Y. 2006) (noting that such "bare assertions, without any further facts or details, do not adequately demonstrate defendants' knowledge of facts or access to information contradicting their public statements"). *See also Xerion Partners*, 474 F. Supp. 2d 505, 518 (S.D.N.Y. 2007) (dismissing § 10(b) claim against individual defendants where plaintiff failed to plead anything other than the individual defendants' positions as insiders with access to confidential information, to support allegations that defendants knew or concealed the "true" state of the company's leasehold, goodwill value, or future business plans).

The Court has held as inactionable similar conclusory allegations regarding the standard of "reckless indifference" in securities fraud claims:

> [a]llegations that individual directors were in possession of all "material" facts with respect to the Company's operations and finances and personally knew or were recklessly indifferent to the fact that all the documents named in the complaint were false and misleading in all the respects referred to in the complaint likewise fail to furnish the required factual predicate for allegations of fraud and deception.

Decker, 681 F.2d at 120 (citations omitted) (emphasis added).

The Complaint in the case at bar sets forth a number of vague and conclusory allegations which are unsupported by any particular facts. Even in cases that do not involve the heightened pleading requirements applicable here, this Court has noted that it is "improper 'to assume that the [plaintiff] can prove

facts that it has not alleged . . . ." *Todd v. Exxon Corp.,* 275 F.3d 191, 198 (2d Cir. 2001) (discussing pleading requirements in antitrust cases). Moreover, as the United States Supreme Court has recently noted (and again in an antitrust case, which does not involve heightened pleading requirements): "a plaintiff's obligation to provide the "grounds" of his "entitle[ment] to relief" requires more than labels and conclusions, and a formulaic recitation of a cause of action's elements will not do." *Bell Atlantic Corporation v. Twombly,* 127 S.Ct. 1964-65 (2007) (emphasis added).[9]

B. The Allegations in the Complaint Do Not Support a Claim for Scheme Liability under Rule 10b-5(a) and (c).

The Plaintiffs contend in the alternative that they have plead a proper claim against Harris, Race, and Wilson for perpetration of a fraudulent scheme in violation of Rule 10b-5(a) and (c), prohibiting the use of "any device, scheme, or artifice to defraud" or the participation "in any act, practice, or course of business

[9] The Court went on to clarify the oft-quoted standard from *Conley v. Gibson*, 355 U.S. 41 (1957) that "a complaint should not be dismissed for failure to state a claim unless it appears beyond doubt that the plaintiff can prove no set of facts in support of his claim." *Id.* at 1968 (quoting 355 U.S. at 45-46). The Supreme Court's recent decision stated that "after puzzling the profession for 50 years, this famous observation has earned its retirement." *Id.* at 1969. Even in securities fraud cases, the courts have relied upon the classic *Conley* standard in determining when leave to amend should be granted. *See, e.g. In re Vivendi Universal, S.A. Secu. Litig.,* 381 F.Supp. 2d 158, 192 (S.D.N.Y. 2003) ("While I find certain elements of plaintiffs' complaint insufficient, I 'cannot determine that the plaintiff could not, under any circumstances, sufficiently allege his claims.'"). In light of *Bell Atlantic*, the reliance on *Conley* was misplaced. The Supreme Court has signaled that this standard is no longer viable, even where a heightened pleading standard is not required.

which operates or would operate as a fraud or deceit upon any person." The most that may be inferred from the facts alleged by Plaintiffs as to any "scheme" is that Harris, Race, and Wilson manipulated mortgage prepayment projections to artificially inflate HomeSide's projected revenue in order to improve their compensation and other prospects at HomeSide. The allegation that this ultimately translated into an increase in the value of the assets of HomeSide's parent, NAB, which was communicated by Australians to Australians, in Australia, does not constitute a "scheme" actionable under Rule 10b-5(a) or (c).

It should be noted that claims alleging "scheme liability" under § 10(b) have become more prevalent since the Supreme Court in *Central Bank* foreclosed claims for "aiding and abetting" the dissemination of false statements. The Southern District of New York noted earlier this year that the *Central Bank* foreclosure of "aiding and abetting" liability also applies to claims brought pursuant to Rule 10b-5(c). *See Kemp v. Universal Am. Fin. Corp.*, No. 05 Civ. 9883(JFK), 2007 WL 86942, at *16-17 (S.D.N.Y. Jan. 10, 2007). The court stated that for liability to attach: "[t]he defendant himself must have 'actively engaged in a significant, material act, practice, or course of business' as a primary participant." *Id.* at *16. *See also In re Charter Commc'ns, Inc., Secu. Litig.*, 443 F.3d 987, 992 (8th Cir. 2006), *cert. granted,* 127 S.Ct. 1873 (Mar. 26, 2007) (holding that "any defendant who does not make or affirmatively cause to be made a fraudulent misstatement or

omission, or who does not directly engage in manipulative securities trading practices, is at most guilty of aiding and abetting and cannot be held liable under § 10(b) or any subpart of Rule 10b-5").

The Plaintiffs place primary reliance upon *Global Crossing*, which sets forth the elements necessary to state a claim under Rule 10b-5(a) and (c): "plaintiffs must allege that '(1) they were injured; (2) in connection with the purchase or sale of securities; (3) by relying on a market for securities; (4) controlled or artificially affected by defendant's deceptive or manipulative conduct; and (5) the defendants engaged in the manipulative conduct with scienter." 322 F. Supp. 2d at 329 (citations omitted). The court went on to describe a "scheme" as a type of plan "masterminded" by one of the defendants and involving multiple transactions which concealed certain facts and created a misleading picture for investors. *See Id.* The allegations of the Complaint do not satisfy these requirements as to Harris, Race, or Wilson. "The use of the term 'manipulative' in section 10(b) itself 'connotes intentional or willful conduct designed to deceive or defraud investors by controlling *or artificially affecting* the price of securities.'" *Id.* at 337. (citing *Ernst & Ernst,* 425 U.S. 185, 199 (1976)).

In this case, Plaintiffs make various conclusory allegations that all of the defendants (collectively) employed "schemes and artifices" to "commit a fraud on the integrity of the market . . . ." (A. 115, ¶ 176.) Plaintiffs also contend that

"HomeSide executives," including Harris, Race, and Wilson engaged in "purposeful manipulation of the valuation methodologies that made HomeSide's financial situation appear significantly better than in fact it was." (A. 101, ¶ 115-16). Such allegations do not meet the pleading requirements of Fed.R.Civ.P. 9 and § 10(b) for allegation of scheme liability under Rule 10b-5(a) and (c). Plaintiffs fail to set forth, with particularity, allegations that Harris, Race, and Wilson engaged in conduct intended to deceive or defraud investors by controlling the price of securities. At most, Plaintiffs contend that these Defendants attempted to make the Company appear more profitable than it was. Such allegations do not meet the pleading requirements and, at most, vaguely allege the aiding and abetting of alleged misrepresentations as to the Company's profitability.

The case at bar presents yet another example of an attempt to transform the alleged conduct, which as noted by the district court was a mere "link in the chain," into a separate and independent claim for scheme liability under Rule 10b-5(a) and (c). The district court properly analyzed the alleged conduct by HomeSide and these Defendants as insufficient to establish subject matter jurisdiction. In addition, however, even if Plaintiffs can establish subject matter jurisdiction, these allegations fail to state a claim for scheme liability under Rule 10b-5(a) or (c). As previously noted, the claims against these Defendants are at

most allegations of "aiding and abetting" which are insufficient to state a claim under § 10(b).

CONCLUSION

These Defendants respectfully request that this Court affirm the ruling of the district court, on the ground that the court lacked subject matter jurisdiction over Defendants. Should the Court find subject matter jurisdiction exists, however, it is respectfully requested that the case be remanded to the district court for ruling on the original Rule 12(b)(6) motions, including issues of scienter.

Dated: June 29, 2007

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By: _____

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_____

Attorney for Defendants-Appellees
Harris, Race, and Wilson
Dated: June 29, 2007

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