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[District Of Columbia Circuit Holds That Certifications In Financial Statements Do Not Constitute Omissions That Qualify For A Presumption Of Reliance In Fraud Claims Under Rule 10b-5](#)

In *In re InterBank Funding Corp. Securities Litigation*, No. 09-7167, --- F.3d ----, 2010 WL 5299882 (D.C. Cir. Dec. 28, 2010), the [United States Court of Appeals for the District of Columbia Circuit](#) affirmed the dismissal with prejudice of a class action asserting securities fraud claims under [Section 10\(b\) of the Securities Exchange Act of 1934](#), 15 U.S.C. § 78j(b), and [Rule 10b-5](#), 17 C.F.R. § 240.10b-5, based upon a failure to adequately plead the essential element of reliance. The sole issue before the Court was whether the fraud allegations in the complaint involved material omissions, which would allow plaintiffs to invoke the presumption of reliance established by the United States Supreme Court in *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972). In affirming the district court's decision, the Court held that the complaint's allegations of fraud focused primarily on affirmative misrepresentations, not omissions, and thus did not qualify for the *Affiliated Ute* presumption of reliance.

Plaintiffs were purchasers of securities of InterBank Funding Corporation ("InterBank"). InterBank was formed in 1996 to buy and restructure or rehabilitate distressed loans. From 1996 through 1999, InterBank formed several funds that offered private placement notes to investors bearing interest between eight to ten percent annually, plus a share of gross profits. Without notifying its investors, InterBank established and adhered to a "related party transaction policy" that permitted it to purchase a loan from one of its funds if there was a question regarding whether the loan would be collected before the fund's scheduled liquidation. Pursuant to that policy, InterBank would pay the full amount outstanding on a loan, even if the loan was deemed "uncollectable." InterBank used proceeds from new offerings to pay off prior note holders – effectively, a Ponzi scheme.

Plaintiffs filed a complaint against InterBank, certain of its officers and directors, and InterBank's outside auditor, Radin Glass & Co., LLP ("Radin"), which had certified InterBank's financial statements as fairly presented in accordance with generally accepted accounting principles ("GAAP"). Plaintiffs alleged that InterBank's financial statements did not comply with GAAP, that Radin's audits did not comply with generally accepted audit standards and that Radin certified financial statements that failed to disclose related-party transactions.

The district court dismissed the complaint with prejudice. The Court of Appeals reversed, holding that the district court failed adequately to explain why the dismissal should have been with prejudice. After remand, the district court again dismissed the complaint with prejudice because it concluded that there was no indication that plaintiffs could cure the deficiencies in the complaint. On appeal again, the Court of Appeals

vacated in part, and remanded for the district court to consider plaintiffs' allegations of scienter. Following the second remand, a settlement was reached with the InterBank defendants, leaving Radin as the only defendant in the case. Plaintiffs moved for leave to file an amended complaint that asserted claims solely against Radin. The district court denied the motion, holding that the amendment would be futile because the proposed amended complaint did not and could not adequately plead reliance. Plaintiffs appealed.

To state a claim under Section 10(b) and Rule 10b-5, plaintiffs must allege that (1) defendants a material misrepresentation or omission; (2) defendants acted with an intent to deceive, manipulate or defraud, or with reckless disregard of the risk that investors would be misled; (3) they reasonably relied on that misrepresentation or omission; and (4) the misrepresentation or omission caused plaintiffs to suffer an economic loss. The only issue before the Court of Appeals was whether plaintiffs could demonstrate reliance. Plaintiffs took the position that they did not need to plead actual reliance because they were entitled to a presumption of reliance set forth by the Supreme Court in *Affiliated Ute*.

In *Affiliated Ute*, two bank managers devised a scheme to purchase shares of stock issued by the U.S. Government to each "mixed-blood" member of the Ute Indian Tribe at prices below fair market value. The managers were employed by the bank that served as the transfer agent for the shares. The Supreme Court held that the bank managers had an affirmative duty under Section 10(b) and Rule 10b-5 to disclose that they had a financial interest in the transactions, and that "[u]nder the circumstances of this case, involving primarily a failure to disclose, positive proof of reliance [on the alleged omissions] is not a prerequisite to recovery."

Plaintiffs in *InterBank* conceded that the *Affiliated Ute* presumption applies only to allegations of omissions, and not to allegations of affirmative misstatements. They argued, however, that their claims against Radin were not premised upon misrepresentations, but instead on an alleged omission by Radin in InterBank's financial statements that the company was being operated as a Ponzi scheme. The Court held that plaintiffs' characterization of their claims as alleging omissions only was "off the mark." In order to effectuate the scheme, the Court observed, InterBank's financial statements "necessarily misrepresented the company's financial position in order to attract new investors, and Radin affirmatively misrepresented the accuracy of these statements by stating that they fairly presented Interbank's financial position and conformed with GAAP."

Plaintiffs' argument also was contradicted by the allegations in their complaint. The complaint specifically alleged that Radin made public statements regarding the accuracy of InterBank's financial documents, which the district court correctly characterized as "positive statements." Had Radin not included express certifications in InterBank's financial documents, the Court held, its silence "might have been akin" to the bank managers in *Affiliated Ute*. However, because Radin did make express, affirmative misrepresentations, the reliance presumption of *Affiliated Ute* did not apply.

Plaintiffs also argued that the "primary importance" of Radin's non-disclosure of the Ponzi scheme to their case entitled them to application of the *Affiliated Ute* presumption. The Court also rejected this assertion, finding that a fraud's "significance" to a case is entirely irrelevant to whether or not it stems from a

misrepresentation or an omission, “which is the dispositive inquiry in determining the availability of the *Affiliated Ute* presumption.”

Finally, the Court also rejected the plaintiffs’ assertion that several district courts previously have held that the *Affiliated Ute* presumption applied “if a defendant fails to notify plaintiffs that they invested in a Ponzi scheme.” Without any detailed explanation, the Court found that, to the extent these cases were contrary to its analysis, they were unpersuasive.

In this case, the D.C. Circuit confirms that the *Affiliated Ute* presumption of reliance upon actionable omissions is of limited utility to most plaintiffs in securities fraud cases, as nearly all such cases spring first and foremost from affirmative misrepresentations.

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