UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

In re REFCO, INC. SECURITIES LITIGATION	:	05 Civ. 8626 (GEL)

LEAD PLAINTIFFS' MEMORANDUM OF LAW IN OPPOSITION TO DEFENDANTS' MOTIONS TO DISMISS THE FIRST AMENDED CONSOLIDATED CLASS ACTION COMPLAINT

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PRELIMINARY STATEMENT

The story of the collapse of Refco Inc. ("Refco" or the "Company") is by now well-known. Indeed, even in an era when high-profile public frauds are revealed with depressing frequency, the precipitous decline of Refco stands out as a particularly stark example of corporate malfeasance. This is true not only because of the magnitude and egregiousness of the wrongdoing, but also because of the swiftness with which its disclosure led to the Company's demise.

Between at least 1999 and October 2005, Refco concealed hundreds of millions of dollars of uncollectible receivables by first transferring them to Refco Group Holdings, Inc. ("Refco Holdings"), an entity that was owned by Refco's current and former Chief Executive Officers, Phillip Bennett ("Bennett") and Tone Grant ("Grant"). Rather than recognize its losses, Refco simply replaced its uncollectible customer receivables with receivables purportedly owed to the Company by a related party, Refco Holdings. Then, on a recurring basis just before the closing of its books at the end of each of its accounting periods, Refco arranged and engaged in sham "loan" transactions whereby, in effect, Refco Holdings' obligations to the Company were temporarily transferred to third parties to create the appearance that they were legitimate customer receivables. After each accounting period was closed, the transactions were undone and the books once again reflected the receivables as being owed to the Company by Refco Holdings.

The scheme to conceal these uncollectible receivables was simple in nature and should have been easy for Refco's auditors, bankers, and directors to detect. Not only did it involve the manipulation of hundreds of millions of dollars (amounting to many multiples of the Company's yearly net income) with clock-work regularity at the end of each financial reporting period, but it implicated numerous individuals and entities and was repeatedly documented in plain terms.

Nonetheless, while in the midst of perpetrating this fraud, and with the assistance of a virtual "who's who" of Wall Street professionals and the support of "clean" audit reports by Grant Thornton LLP ("Grant Thornton"), Refco publicly issued and sold over $1.2 billion in securities to unsuspecting investors.

On the heels of a Leveraged Buyout ("LBO"), Refco – together with its LBO partners (Thomas H. Lee Partners ("THL Partners") and its affiliates) and three Wall Street investment banks – issued and sold $600 million dollars worth of bonds to the public (the "Bond Offering"). The LBO and Bond Offering created enormous wealth for Refco's insiders, as they collectively received hundreds of millions of dollars in cash payouts and stock options. The ultimate prize, however, came when Refco – with the assistance of fifteen Wall Street investment banks – completed a lucrative $670 million initial public offering on August 10, 2005 (the "IPO"). Refco's IPO created even more personal riches for the Company's insiders: THL Partners and its affiliates made more than $170 million; Bennett made over $118 million; and, through the exercise of a "Green Shoe" option, an additional $87 million "special cash dividend" was paid to all of Refco's shareholders of record *before* the IPO, including the very same Refco insiders who orchestrated the sale of the fraud-ridden Company to public investors.

Bolstered by Refco's false financial statements, shares of Refco common stock rose from $22 per share to more than $28 per share following the IPO, further enriching Refco's insiders who retained a portion of the ownership of Refco. Just a short time later, however, the scheme unraveled when the huge related-party receivables were uncovered – not by the gatekeepers who had been associated with the Company for years, but by an employee who had been working at Refco less than two months. On October 10, 2005, a mere forty-two trading days after the IPO, Refco publicly disclosed the existence of a $430 million receivable owed to Refco by a Bennett-

controlled entity and that the Company's previously issued financial statements should no longer be relied upon. Nonetheless, Refco tried to downplay the impact of this disclosure, stating that the receivable had been repaid, and assuring the public that the Company had sufficient liquidity to continue its operations.

The price of Refco securities plummeted in response to the news of the undisclosed receivable. The Company's initial efforts to downplay the significance of the undisclosed receivable were ill-fated, as a mass exodus of customers soon left the Company with insufficient liquidity to continue its operations, and with no option but to file for bankruptcy protection. Unfortunately, Refco's public investors were left holding the bag. Within the span of a single week after the initial October 10 disclosure, the price of Refco's bonds declined by at least 80%, while its stock price dropped by nearly 98%.

On May 5, 2006, Lead Plaintiffs Pacific Investment Management Company, LLC ("PIMCO") and RH Capital LLC ("RH Capital"), on behalf of themselves and a class of investors who purchased or otherwise acquired Refco stock and/or bonds between August 5, 2004 and October 17, 2005 (collectively, "Plaintiffs"), filed an amended complaint (the "Complaint") asserting negligence-based claims pursuant to the Securities Act of 1933 ("Securities Act") and, separately, fraud-based claims pursuant to the Securities Exchange Act of 1934 ("Exchange Act"). Defendants are: Bennett; Grant; other senior executives of Refco;[1] the members of Refco's Audit Committee (the "Audit Committee Defendants");[2] Grant Thornton;

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[1] These senior executives include: Gerald J. Sherer ("Sherer"); William M. Sexton ("Sexton"); Santo C. Maggio ("Maggio"); Joseph M. Murphy ("Murphy"); Phillip Silverman ("Silverman"); Dennis A. Klejna ("Klejna"); and Robert C. Trosten ("Trosten").

[2] The Audit Committee Defendants are Ronald L. O'Kelley ("O'Kelley"); Leo R. Breitman ("Breitman"); and Nathan Gantcher ("Gantcher").

the investment banks who underwrote Refco's securities offerings; THL Partners; and certain persons and entities affiliated with THL Partners (collectively, "Defendants").

Although Defendants have filed over 280 pages of briefing in support of their motions to dismiss Plaintiffs' Complaint, there are many claims that have not been challenged. For example, none of the Defendants has moved to dismiss Count VII (alleging § 12(a)(2) violations by the underwriters of the IPO) or Count X (alleging violation of Rule 10b-5(a) and (c) by Refco Holdings). Further, most of the Defendants have not sought dismissal of Counts III and V, which assert claims pursuant to Section 11 of the Securities Act based on untrue statements in the registration statements for the Bonds and the IPO. Additionally, the THL Partner Defendants and the Audit Committee Defendants have not challenged Counts VI and VIII, which assert "control person" claims pursuant to § 15 of the Securities Act. Thus, virtually all of the Defendants will remain in the case on at least some of Plaintiffs' claims, regardless of the disposition of the motions to dismiss. For ease of reference, the attached Exhibit 1 sets forth the claims that are not subject to any motion to dismiss.[3]

To the extent Defendants have filed motions to dismiss, those motions should be denied. The Complaint separately delineates the Securities Act claims from the Exchange Act claims, and, therefore, Plaintiffs' Securities Act claims do not sound in fraud and are not subject to the pleading requirements of Rule 9(b) – although Plaintiffs' allegations are sufficiently particularized even if Rule 9(b) were applicable. While the Bond Underwriter Defendants[4] contend that they were not "underwriters" of the registered bonds for purposes of § 11 and that

[3] Only five Defendants have moved to dismiss all of the claims against them: Grant, Silverman, Klejna, Trosten, and Grant Thornton.

[4] The Bond Underwriter Defendants are Credit Suisse Securities (USA) LLC; Banc of America Securities LLC; and Deutsche Bank Securities, Inc. ¶ 70.

the Bond Offering was not a "public offering" for purposes of § 12(a)(2), those arguments place form over substance. Plaintiffs allege that the Bond Underwriter Defendants were instrumental and necessary players in the Bond Offering, who marketed and sold the Bonds to investors across the United States and were directly involved in the preparation of the offering memorandum and registration statement for the Bonds. As such, they are subject to §§ 11 and 12(a)(2) liability based on the untrue statements in those offering and registration documents. Defendants' motions to dismiss the bond purchasers' § 12(a)(2) claim should be denied for the same reason, and to the extent they contend that persons who exchanged unregistered bonds for registered bonds cannot recover under § 11, that argument is misconceived because § 11 expressly provides a cause of action to all persons who "acquired" registered bonds pursuant to a false registration statement.

With respect to Plaintiffs' Exchange Act claims, Plaintiffs have pleaded with particularity Defendants' false statements, and have alleged facts giving rise to a strong inference of each Defendant's scienter. Grant Thornton's effort to challenge loss causation at this early stage of the proceedings for post-October 10, 2005 losses is misplaced, because Plaintiffs have alleged that the disclosures on October 10 did not reveal the full extent of the fraud at Refco, and that the price declines subsequent to that date were the foreseeable and proximate result of Grant Thornton's issuance of false audit reports on Refco's financial statements. Additionally, Bennett's and the THL Defendants' motions to dismiss Plaintiffs' § 20A insider trading claim should fail, because Plaintiff RH Capital has alleged that it purchased stock contemporaneously with Bennett's sales in the IPO, and because Plaintiffs have alleged a predicate violation of the Exchange Act and the possession of material non-public information by the THL Defendants.

Plaintiffs' "control person" claims under § 15 of the Securities Act and § 20(a) of the Exchange Act have been properly pled. Contrary to Defendants' arguments, Plaintiffs have alleged that each Defendant named in those claims had sufficient "control" to be liable for Refco's violations of the federal securities laws. Further, to the extent Plaintiffs are required to plead Defendants' "culpable participation" for purposes of Plaintiffs' § 20(a) claim, Plaintiffs have done so by alleging Defendants' knowledge or reckless disregard of the fraud.

In sum, try as they might to distance themselves from Refco and its meteoric fall from grace, each of the Defendants played an important role in the events that led to that rise and fall, and is subject to liability under the federal securities laws. Defendants' motions to dismiss should be denied in their entirety so that Plaintiffs can proceed with the important task of trying to recover the enormous losses suffered by investors when Refco's insiders decided to place their own interests above the law, while Refco's well-compensated gatekeepers looked the other way.

STATEMENT OF FACTS[5]

I. Overview

Before its implosion, Refco was one of the world's largest providers of brokerage and clearing services in the international derivatives, currency and futures markets. ¶¶ 2, 382.[6] An integral part of Refco's business model was to extend loans to its trading clients. ¶¶ 2, 87, 382. These loans allowed Refco's customers to trade on "margin" and leverage their operating capital into increasingly larger trades in the derivatives and futures markets. ¶¶ 87, 382. These larger trades, in turn, generated larger commissions for the Company and led to increases in its

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[5] Unless otherwise noted, terms shall be used herein as defined in the First Amended Consolidated Class Action Complaint (the "Complaint").

[6] Paragraphs in the Complaint are cited as "¶ __."

revenues, income and profits. *Id.* In order to continue the steady flow of commissions, Refco began extending credit to its customers without making an adequate assessment of the customers' credit-worthiness or their trading activities. ¶¶ 2, 383. As *Bloomberg Markets* reported in February 2006, "Refco was like a used-car dealer: no money down, no credit, no problem." ¶ 383.

While these "no questions asked" loans allowed Refco to increase its commissions, revenues and profits, they also exposed the Company to the aggressive trading risks undertaken by its clients. ¶¶ 2, 384. In essence, and unbeknownst to the public, Refco was gambling its very survival on the ability of its customers to make successful trades in the volatile commodities and derivatives markets around the world. *Id.* Consequently, if Refco's clients suffered significant trading losses or otherwise became unable to repay their loans to Refco, the Company would be forced, according to applicable accounting rules and regulations, to "write off" the amounts of the loans from its books. *Id.* The inherent dangers posed by this business model materialized – though were not revealed to the public – in 1997 and 1998, when a number of the Company's most significant customers (and the Company itself) suffered massive trading losses in the wake of several world-wide financial crises. ¶¶ 31, 384-87.

These losses are described in a criminal indictment filed against Bennett on November 10, 2005 by the United States Attorney for this District (the "Indictment"), which states that "certain Refco customers to whom Refco had extended credit sustained hundreds of millions of dollars of market losses in their Refco account." ¶ 388; *see also* ¶ 121. As the Indictment explains, rather than disclose the fact that its customers could not repay the "margin" loans extended by the Company, "Refco liquidated certain of the positions and assumed the resulting losses in the customers' accounts." ¶ 388. Bennett – the newly-appointed CEO of Refco who

possessed over twenty-eight years of experience in the fields of commodity and commercial lending – knew that revealing the uncollectible loans and the huge trading losses would be catastrophic to the Company he now led. ¶ 393.

Instead of revealing these "life-threatening" losses and properly accounting for them on the Company's books, Bennett and other Refco executives transferred the uncollectible receivables onto the books of Refco Holdings – an off-balance sheet entity owned and controlled by Bennett and (at that time) Defendant Tone Grant. ¶¶ 4, 41, 394-97. Then, in order to avoid the severe repercussions that would result if Refco revealed that a company co-owned by its current and former CEOs owed hundreds of millions of dollars to the Company, these Defendants devised a simple scheme to hide the uncollectible receivables. ¶ 399. Beginning no later than 1999 and continuing through 2005, Refco – with the assistance of numerous other individuals and entities (as described below) – carried out a series of sham "loan" transactions at the end of each fiscal year, and many fiscal quarters as well, to pay down temporarily the receivable owed to Refco from Refco Holdings and replace it with receivables purportedly owed by third-party customers. ¶¶ 4, 41, 393-518.

This scheme involved the repeated manipulation of huge sums of money – as much as 75% of Refco's annual revenue and 500% of its annual net income – for at least six years. ¶¶ 4, 560. From at least 1999 until the scheme was discovered in October 2005, a few days before Refco closed its books for each financial period, it loaned hundreds of millions of dollars – $970 million on one occasion – from its subsidiary Refco Capital to a number of third parties, which simultaneously loaned the same amount to Refco Holdings. ¶¶ 4, 393-518. Refco itself served as guarantor of the loans between these third-parties and Refco Holdings. *See e.g.,* ¶¶ 142, 147, 415, 425, 433, 438, 444. Refco Holdings then used the proceeds from the Refco-guaranteed

"loans" to temporarily pay off the uncollectible receivables it owed to Refco, with neither the uncollectible receivable, the related-party transactions, nor the Refco guarantee being disclosed to investors. *See e.g.,* ¶¶ 158, 190, 517. Just days after the financial period ended and Refco closed its books, the circular transactions were "unwound," the loans were repaid, and the uncollectible receivables from Refco Holdings were returned to Refco's books (where they would have been apparent to anyone who had bothered or wanted to look for them). ¶¶ 4, 399-518. Each of these sham transactions followed a similar format, and each was designed so that the Company could fraudulently avoid taking hundreds of millions of dollars of write-offs for receivables that could not be collected.

The magnitude of this fraud is demonstrated by comparing the sums manipulated to the Company's net income for the pertinent periods:

"Loan" Date	**"Loan" Amount**	**Reported Net Income** (Relevant Financial Period)	**Percentage of Net Income**
February 2002	$625 Million	$93.6 Million (Year-ended February 28, 2002)	668%
February 2003	$750 Million	$140.119 Million (Year-ended February 28, 2003)	535%
February 2004	$970 Million	$187.156 Million (Year-ended February 29, 2004)	518%
May 2004	$700 Million	$59.270 Million (Quarter-ended May 31, 2004)	1,180%
August 2004	$485 Million	$44.20 Million (Quarter-ended August 31, 2004)	1,097%
November 2004	$545 Million	$17.9 Million (Quarter-ended November 30, 2004)	3,045%

"Loan" Date	**"Loan" Amount**	**Reported Net Income** (Relevant Financial Period)	**Percentage of Net Income**
December 2004	$550 Million	Not applicable	Not applicable
February 2005	$595 Million	$176.3 Million (Year-ended February 28, 2005)	337%
May 2005	$450 Million	$42.587 Million (Quarter-ended May 31, 2005)	1,056%
August 2005	$420 Million	(Financial Statements delayed because of 10/10/05 Disclosure of Uncollectible Receivable)	Not applicable

¶ 560. This scheme allowed the Company to overstate net capital, members' equity, net income and EBITDA, and understate reserves for doubtful accounts, thus rendering the Company's publicly reported financial statements (which were included in the documents provided to investors in the Bond Offering and IPO) materially incorrect and misleading. ¶¶ 118, 129, 135, 156, 183, 519, 530, 541, 551. By way of example, the Company reported more than $200 million in pre-tax income for fiscal year 2004, when it should have reported a loss of more than $769 million – a difference of approximately $960 million.[7] ¶ 520.

What is as notable as the simplicity and magnitude of the fraud is how far it spread. The scheme depended on the direct involvement of numerous individuals and entities both inside and outside of the Company, and the true nature of these circular transactions should have been evident to those with access to the Company's books and records. Indeed, it took an employee

[7] The massive impact of the Company's financial manipulations can be seen in the charts located at ¶¶ 520-23 in the Complaint.

who had worked at the Company for a mere two months to discover and blow the whistle on this massive fraud. ¶¶ 4, 7, 608. The actual knowledge of the fraud on the part of many Defendants, and the recklessness in failing to discover it on the part of others, is described in more detail in point III below.

II. <u>Refco's Public Offerings</u>

With the fraudulent scheme described above inflating its financial results, Refco was able to hide its massive losses and embark on a period of seemingly unprecedented growth. This, in turn, created untold wealth for its insiders. In early June 2004, Refco enlisted the assistance of the THL Defendants to effect an LBO. ¶¶ 93-96. As part of the LBO, the THL Partner Defendants acquired a 57% equity stake in Refco, with the remaining 43% held by Refco Holdings (now 100% owned by Bennett). ¶ 94. Thus, following the LBO, the THL Defendants held a dominant position on Refco's Board of Directors and maintained a controlling interest in Refco stock. ¶ 263(e). Indeed, from this point until Refco's collapse, Refco characterized itself as a "controlled" company within the meaning of New York Stock Exchange ("NYSE") rules. ¶¶ 263-64. Refco benefited substantially from its status as a "controlled company" because boards of directors of controlled companies are exempt from normal NYSE rules requiring that boards of directors, corporate governance committees, and compensation committees be independent. ¶ 263(e).

A. <u>The Bond Offering</u>

In order to raise funds necessary to cash-out the existing equity holders and complete the LBO, Refco and the THL Defendants, with the assistance of three Wall Street investment banks (the Bond Underwriter Defendants), conducted a Bond Offering in August 2004. ¶¶ 94-95. The bonds were issued in a two-step procedure that constituted a single plan of financing. ¶ 100. In the first step, Refco sold unregistered Rule 144A bonds to the Bond Underwriter Defendants,

who immediately resold them to "Qualified Institutional Buyers." ¶¶ 100-01. In the second step, Refco issued Registered Bonds pursuant to the Bond Registration Statement, and holders of the Rule 144A Bonds exchanged those bonds for Registered Bonds in what is known as an "Exxon Capital exchange." *Id*.

The Offering Memorandum for the bonds was prepared in contemplation of the Exxon Capital exchange and, accordingly, conformed in all material respects with the requirements for a prospectus included in a registration statement filed with the SEC. ¶¶ 101, 105, 106. The Offering Memorandum was prepared by, among others, the Bond Underwriter Defendants, the THL Defendants, Bennett, Trosten (Refco's Chief Financial Officer), and Scott Jaeckel (Managing Director of the THL Partner Defendants). ¶ 107. Additionally, Grant Thornton reviewed the Offering Memorandum prior to its issuance and consented to the inclusion of its "clean," unqualified audit report therein. *Id.* During the preparation of the Offering Memorandum, everyone involved knew that the Offering Memorandum would later be used as the basis for the Bond Registration Statement. ¶ 153.

Significantly, the bonds were priced from the outset as registered, freely tradable securities. ¶ 103. Thus, the purchasers of the bonds did not enjoy a higher yield on the bonds as a result of the lack of initial registration. Rather, because of the issuers' undertaking to complete the second-step exchange, the market accepted pricing on the Rule 144A Bonds as if they were registered. *Id.* In the exchange offer, the Registered Bonds were registered pursuant to the Bond Registration Statement and exchanged for the outstanding Rule 144A Bonds. ¶¶ 149-65. The Bond Registration Statement was prepared by (among others) the Company's senior executives and the Bond Underwriter Defendants, and was signed by Defendants Bennett, Lee, Sexton, Silverman, Maggio, and Klejna. ¶¶ 304, 307. Grant Thornton consented to the inclusion of its

unqualified audit reports for the fiscal years 2003 and 2004 in the Bond Registration Statement. ¶ 306.

The LBO and Bond Offering created enormous wealth for Refco's insiders. ¶¶ 583-87. As the co-owners of Refco Holdings (pre-LBO), Bennett and Grant received $550 million in cash plus all of Refco's interest in Forstmann-Leff International Associates, LLC (valued at approximately $231 million) in exchange for their 57% stake in the Company. ¶ 583. In addition, Bennett and Grant received another $120 million in compensation in the form of $12 million in cash and $108 million in debt forgiveness, as well as nearly $45 million in cash for early-redemption and other penalties built into their contracts with Refco. *Id.* Refco officers Murphy, Sexton, Maggio, and Klejna also benefited directly from the LBO. As a result of their participation in a Company-endorsed profit-sharing agreement liquidated by Refco Holdings, Murphy received $13.7 million, Sexton $9 million, Maggio $8.4 million and Klejna $6.5 million upon completion of the LBO and Bond Offering. ¶ 584.

Finally, these Defendants (along with the THL Defendants) took steps to ensure that they would be further enriched by the IPO that all of the insiders knew was forthcoming. Bennett retained a 43% equity stake in Refco and, as described below, the other inside Defendants (including the THL Defendants) received unusually large grants of Refco common stock prior to the IPO. ¶¶ 583-85. Consequently, as a former Refco Officer put it, the insiders at Refco were focused on only one thing: "get[ing] ready for the big payoff which was the IPO." ¶ 590.

B. The August 2005 IPO

In August 2005, with the help of fifteen Wall Street investment banks acting as underwriters (the "Stock Underwriter Defendants"),[8] Refco conducted a successful IPO, raising $670 million. ¶¶ 6, 166-98, 585-94. The August 2005 IPO was conducted pursuant to a Form S-1 registration statement, several Forms S-1/A registration statements and a Form 424B1 prospectus, which were filed with the Securities and Exchange Commission (collectively, the "IPO Registration Statement"). ¶ 168. Contained within the IPO Registration Statement were the Company's false and misleading financial statements for fiscal years 2003 through 2005, each certified in unqualified audit opinions issued by Grant Thornton, and the false and misleading unaudited financial statements for the three month periods ending May 31, 2004 and May 31, 2005. ¶¶ 174-75, 177.

The IPO was highly lucrative for Refco's insiders. In addition to the nearly 50 million shares owned by Bennett at the time of the IPO, Defendants Sherer, Sexton, Murphy, Maggio, Klejna, Breitman, Gantcher and O'Kelley all received substantial grants of Refco stock on the eve of the IPO. ¶ 585. The benefits of these grants could only be realized through the IPO, which would create a public trading market for the stock and substantially increase its value, thereby greatly increasing these Defendants' personal wealth. *Id.* Bennett sold over five million shares in the IPO, netting more than $118 million in cash. ¶ 586. A "lock-up" agreement with the Stock Underwriter Defendants was the only impediment preventing the other Defendants

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[8] The Stock Underwriter Defendants are collectively Defendants Credit Suisse Securities (USA) LLC (known at the time of the IPO as Credit Suisse First Boston LLC); Banc of America Securities LLC; Deutsche Bank Securities, Inc.; Goldman, Sachs & Co.; Merrill Lynch, Pierce, Fenner & Smith Incorporated; J.P. Morgan Securities, Inc.; Sandler O'Neill & Partners, L.P.; HSBC Securities (USA) Inc.; William Blair & Company, L.L.C.; Harris Nesbitt Corp.; CMG Institutional Trading LLC; Samuel A. Ramirez & Company, Inc.; Muriel Seibert & Co. Inc.; The Williams Capital Group, L.P.; and Utendahl Capital Partners, L.P.

from similarly cashing in all or a portion of their equity interests in the IPO. *Id.* That "lock-up" agreement prevented them from selling their shares for 180 days after the IPO – a date that was ultimately preceded by Refco's collapse. *Id.*

In addition, the insiders benefited directly from an unusual "Green Shoe" option built into the IPO. ¶ 587. This Green Shoe option partially circumvented the "lock up" agreement – at no cost to the insiders – by providing that Refco would register and sell an additional 3.975 million shares of stock in the IPO and distribute the proceeds *directly to the shareholders of record before the IPO*. *Id.* The IPO was "successful," and Refco issued and sold the additional 3.975 million shares pursuant to the Green Shoe option. Thus, Defendants Sherer, Sexton, Murphy, Maggio, Klejna, the THL Defendants and Bennett (through Refco Holdings) received direct cash payments in the form of a special "dividend" totaling over $87 million. *Id.*

The IPO also provided unique benefits to the THL Defendants. These Defendants sold a portion of their investment in Refco for approximately $210 million (plus an undisclosed portion of the Green Shoe option), while retaining a 38% stake in the Company. ¶ 687(h). Moreover, at the time of the IPO, the THL Defendants were in the process of marketing a new private equity fund, which required them to raise approximately $7.5 billion from institutional investors. ¶ 589. Therefore, a successful high-profile IPO by Refco would allow the THL Defendants to tout their quick profits and greatly increase their chances of raising capital to form a new buyout fund which, in turn, would enable them to reap huge additional fees and profits. *Id.*

Finally, the Officer Defendants and the Audit Committee Defendants received huge grants of Restricted Stock Units ("RSUs") in advance of the IPO. ¶¶ 591-92. Bennett received over 1.2 million RSUs, Murphy, Sexton and Maggio each received nearly 702,000 RSUs, and Klejna received 351,000 RSUs. ¶ 591. Under the terms of the Agreements governing the RSUs,

50% of a grant would vest ratably over four fiscal years, and the other 50% would vest upon the achievement of undisclosed EBITDA targets. *Id.* This created a strong motivation to avoid writing off uncollectible receivables, since doing so would reduce EBITDA. *Id.* Particularly troubling is the fact that each of the three Audit Committee Defendants – O'Kelley, Breitman and Gantcher – received 20,000 RSUs in advance of the IPO. ¶ 592. This arrangement was extremely unusual not only because of the impact on these Defendants' purported independence, but because the Audit Committee Defendants were the *only* members of the Board to receive RSU grants. Thus, the three board members responsible for the "integrity of [Refco's] financial statements" were specially compensated by a grant of RSUs that would have been rendered worthless by disclosure of Refco's true financial condition. *Id.*

III. Grant Thornton and the Inside Defendants Knowingly and/or Recklessly Allowed the Fraud to Occur and Continue

The fraud at Refco did not happen overnight, and it was not the result of the isolated activities of one or two people. Rather, it occurred (and continued unabated for years) because of Refco's "laissez faire" corporate safeguards and because the gatekeepers –the auditors, the Audit Committee and the senior officers – were either complicit in the fraud or recklessly abdicated their responsibilities. As has become painfully clear, if these gatekeepers had done their job, the Refco fraud would never have occurred, or would have been discovered *years* before Refco sold securities to the public.

As alleged in the Complaint, Refco had a culture that condoned subterfuge and chicanery. *See* ¶¶ 574-81, 590, 603-06. A former Refco officer stated that the accounting department at Refco "was an absolute shambles," and Refco had a "very, very laissez faire attitude toward risk management and compliance in general." ¶ 581 (the Company had "absolutely no financial controls or reporting systems"); *see also* ¶ 590 (management "didn't care, because ultimately

[Refco] was all a house of cards anyway."). The "laissez faire" attitude toward compliance inside Refco had existed for years and was reflected in the Company's staggering history of legal violations. *See* ¶¶ 576-80. As *Bloomberg Markets* reported, a former CFTC official involved in regulating Refco stated that "Refco was a firm that said 'show us where the edge is,' and then they played just over it." ¶ 576. Refco's culture of rule-breaking resulted in the Company being penalized by the CFTC at least 140 times for violations that included filing false trading reports, inadequate record-keeping, and inadequate supervision of its traders. *Id.* This was the *worst* compliance record of any company in the industry. *Id.* In the months leading up to the IPO, Refco also had been the subject of an SEC investigation relating to illegal short selling. ¶ 577. This investigation had centered on Defendant Maggio and resulted in the issuance of a "Wells Notice" to Refco. *Id.*

The 10(b) Defendants[9] also knew that Refco had been the target of several enforcement actions from the SEC, the CFTC and the Chicago Board of Trade where the Company was accused of improperly shifting funds between related party accounts – the same type of transactions that Refco used to effectuate the fraud in this case. ¶¶ 578-80. One such incident functioned like a Ponzi scheme, where Refco shifted funds between client accounts with losses and gains – placing profits in the accounts of clients who asked for their money back while losses were stashed in accounts that appeared dormant. ¶ 578. Refco paid $8 million to settle CFTC charges over this incident, and paid over $40 million in subsequent arbitration awards to its defrauded clients. *Id.* In another incident, the CFTC accused Refco of improperly using almost $123 million in client funds on an "almost daily basis" to pay off debts owed by Refco

[9] Grant Thornton, Sexton, Silverman, Klejna, Murphy, Sherer, Trosten and the Audit Committee Defendants (O'Kelley, Breitman and Gantcher) are collectively referred to as the "10(b) Defendants."

Capital. ¶ 579. In yet another forerunner of the circular transactions Refco used to effect the fraud in this case, Judge Richard Posner of the Seventh Circuit Court of Appeals wrote in an opinion issued in 2000 that Refco had attempted to hide a debt by "fund[ing] it *with a loan from its affiliate* . . . for the disreputable purpose of fooling the Board of Trade and the Commodities Futures Trading Commission." ¶ 580 (emphasis added). Again, rather than acknowledging the red flag of Refco's checkered past and digging a little deeper into Refco's financial reporting, Grant Thornton, the Audit Committee and Refco's most senior officers recklessly did nothing, allowing the fraud to continue.

Given Refco's corporate culture and its history of legal violations, the 10(b) Defendants should have been alert for fraudulent activity at the Company. *See* ¶ 237 (listing some of the "fraud risk factors" identified in Generally Accepted Auditing Standards, but ignored by Grant Thornton in conducting its audits). Nonetheless, these Defendants knowingly participated in, or recklessly failed to detect, a fraud which was so widespread that it involved numerous individuals and entities both inside and outside of the Company and was described in plain terms in numerous documents that were readily available to the 10(b) Defendants. *E.g.*, ¶¶ 400-67 (describing loan documents, guarantees, letters and memoranda relating to the transactions involving Customer X); 472-501 (describing emails, letters, "customer ledger reports," "monthly account statements" and wire transfers relating to the transactions involving BAWAG); 505 (describing documents relating to the transactions involving Ingram Micro, Inc. ("Ingram"); 509-10 (describing loan agreements and other documents relating to the transactions involving Delta Flyer); 554-58 (describing confirmation request); and 567(a)-(c) (describing line item records of transactions); *see also* ¶¶ 76-77, 269(a)(i)-(d) (describing documents relating to BAWAG's secret ownership interest in Refco).

As detailed in the Complaint, numerous individuals and entities had knowledge of certain aspects of the round-trip loans used to disguise Refco's uncollectible receivables. These included three different units of Refco (¶¶ 517-18); Refco Holdings (*id.*); and at least four separate third parties, including Ingram, Delta Flyer, BAWAG and Customer X (¶¶ 393-518). Moreover, several individuals were involved in various aspects of the fraud, including at least two different attorneys at Refco's primary outside law firm (¶¶ 404-05); several Refco executives, including Bennett, Maggio and Trosten (¶¶ 217, 380-81, 397, 402, 489-90); and several different individuals associated with BAWAG (¶¶ 482, 484, 490, 494).

The Complaint also describes in detail how the fraud was extensively documented in numerous documents maintained internally at Refco (and which the 10(b) Defendants had a duty to monitor) and sent externally to others. ¶¶ 400-67, 472-501, 505, 509-10, 554-558. For instance, the transactions with Customer X were formalized in dozens of written loan agreements, guarantees, letters, memorandum and amendments that were drafted by Refco's outside law firm, signed by individuals at Refco and sent to Customer X for its signature. *See* ¶¶ 400-67. Likewise, the transactions with BAWAG were documented in literally dozens of e-mails, "monthly account statements," "customer ledger reports," wire transfers, letters and other documents maintained within Refco. ¶¶ 472-501, 567 (summary of line-item records of the fraud). Lead Plaintiffs' investigation has further confirmed that the transactions with Ingram and Delta Flyer were documented in formal loan agreements. ¶¶ 505, 506, 508-10. These documents should have been a bright red flag to the 10(b) Defendants because they plainly set forth massive inflows of cash to Refco Holdings in the days immediately before Refco closed its books for the pertinent financial periods, and massive outflows of similar (and often identical) sums of cash several days after the fiscal period end. *See, e.g.,* ¶ 567. Nonetheless, apparently

none of the Defendants bothered to look at the documents even when the documents were handed directly to them. In at least one instance, Grant Thornton received, but ignored, a "confirmation" that contained significant indicia of the fraud (discussed below). ¶¶ 554-58.

Additional facts relevant to the Defendants who challenge scienter[10] are set forth below.

Grant Thornton

As a result of the fraudulent scheme described above, Refco's financial statements violated numerous key provisions of GAAP, including failing to adequately disclose related-party transactions (¶¶ 214-19); failing to account for uncollectible customer receivables (¶ 220); failing to disclose that Refco guaranteed loans made to Refco Holdings (¶ 221); and numerous other violations of GAAP (¶ 224). Indeed, on October 10, 2005, Refco admitted that its financial statements for years 2002 through 2005 could no longer be relied upon. ¶¶ 8, 200. Significantly, despite Refco's admission that its financial statements were false, as of the filing of the Complaint, Grant Thornton *still* had not publicly withdrawn its audit opinions for those years.

As Refco's auditor, Grant Thornton was required, under Generally Accepted Auditing Standards ("GAAS"), to exercise "due professional care" in conducting its audits and issuing its audit opinion letters. ¶ 227. As alleged in detail in the Complaint, Grant Thornton's audits were woefully deficient and violated GAAS in so many respects that they effectively amounted to no audits at all. ¶¶ 212-48. For instance, Grant Thornton either ignored or failed to identify numerous red flags at the Company that are specifically identified as "fraud risk factors" in the accounting literature. *See* ¶ 237. Grant Thornton also violated CFTC regulations that were applicable to Refco. ¶ 248.

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[10] The Defendants who challenge scienter are Grant Thornton, certain Officer Defendants (i.e., Sexton, Silverman, Klejna, Murphy, Sherer), Trosten, and the Audit Committee Defendants (O'Kelley, Breitman and Gantcher).

Grant Thornton's recklessness in conducting its audits is demonstrated by its *actual receipt* of a confirmation request that expressly identified one leg of the $325 million round-trip loan transaction that took place between Customer X, Refco and Refco Holdings in February 2002. ¶¶ 554-59. Specifically, in connection with preparing the Bond Registration Statement in the Fall of 2004, Grant Thornton conducted a purported "re-audit" of the Company's February 2002 year-end financial statements. ¶ 554. As part of that re-audit, Refco Capital sent a confirmation request to Customer X, asking Customer X to confirm certain information to Grant Thornton. *Id.* Attached to the confirmation request was a Statement of Account for Customer X's account at Refco Capital as of February 28, 2002. The Statement of Account indicated that Customer X had an account balance of $325 million, and described that balance as a "Time Deposit." ¶ 555. The confirmation request also showed that Customer X had received the $325 million from Refco Capital on February 25, 2002 – just three days prior to the end of Refco's fiscal year. ¶ 556.

The $325 million "Time Deposit" identified on the confirmation request was the very same $325 million "loan" from Refco Capital to Customer X that Customer X then shuffled to Refco Holdings and that Refco Holdings, in turn, had used to temporarily pay down part of the outstanding receivable it owed to Refco in February 2002. *See* ¶¶ 407-18. This loan was extended just three days prior to Refco's fiscal year end, and was, by written agreement, scheduled to be repaid in full only two weeks later – just after the close of Refco's fiscal year. ¶ 409. Grant Thornton, however, never asked a single question of Customer X regarding the nature, origin or purpose of the loan. ¶ 558. Had it asked, Grant Thornton would have learned about the simultaneous $325 million loan from Customer X to Refco Holdings and Refco's guarantee of that same loan. *Id.*

On its face, the confirmation request raises significant questions due to: (i) the amount of money involved – more than three times Refco's net income of $93.6 million for that year (*see* ¶ 560); (ii) the timing of the loan – just three days before Refco closed its books; and (iii) the suspicious description of the "loan" as a "time deposit." ¶¶ 555, 558. Moreover, Grant Thornton received this confirmation request at the same time that Refco's 35-year old CFO Trosten was paid a $45 million "severance payment." ¶ 574. This severance payment dwarfed Trosten's annual income and coincided with his highly unusual resignation just as the planning for the IPO had begun. ¶ 575. The sudden resignation of Refco's CFO on the eve of a public securities transactions should have stood out as another red flag to Grant Thornton.

To compound its reckless failure to follow-up on the confirmation request that it did receive, Grant Thornton recklessly failed to request any additional information from Customer X in connection with Grant Thornton's audits for fiscal years 2003, 2004 or 2005. ¶ 559. In those years, Customer X participated in round trip transactions involving short term "loans" from Refco Capital to Customer X of $500 million (2003); $720 million (2004); and $345 million (2005). *See* ¶ 516. These amounts represented massive sums that far exceeded the Company's net income for the respective year. ¶ 560. In light of the numerous red flags at Refco, Grant Thornton's failure to implement procedures to identify and test the Company's recurring related-party transactions was an egregious and reckless violation of auditing standards. ¶ 251.

There was an additional and more fundamental problem with Grant Thornton's re-audit, which may explain why Grant Thornton was so willing to ignore these facts. Grant Thornton partner Mark Ramler was the engagement partner on *both* the 2002 audit (when he was with Arthur Andersen LLP ("Andersen")) and the 2004 re-audit (with Grant Thornton). ¶ 596. Thus, he was essentially *verifying his own work* when conducting the re-audit. In such a circumstance,

it was impossible for Ramler to comply with GAAS and maintain his "independence" or bring any true level of "professional skepticism" to his re-audit. In essence, if he found fault with "Andersen's" 2002 audit of Refco, he would be finding fault with himself.

Grant Thornton's reckless disregard for conducting proper audits of Refco's financial statements was driven at least in part by its desire to retain Refco as one of its most prestigious clients – a client that it did not want to antagonize with probing or thorough audit inquiries. ¶ 596. Indeed, Refco had not historically taken its auditing business to Grant Thornton. Rather, the Company was audited by Andersen before that firm collapsed in the wake of the Enron and WorldCom scandals. *Id.* After Andersen's collapse, Ramler moved to Grant Thornton and brought the Refco account with him. This was a major triumph and a significant opportunity for Grant Thornton, which had managed to pick up fewer than 5% of Andersen's former clients. *Id.* Consequently, Grant Thornton was motivated to restrain its approach to auditing Refco in order to minimize the risk that the Company would take Grant Thornton's newly acquired business elsewhere. *Id.* Grant Thornton was also unduly solicitous of Refco because Refco was a company that actively anticipated conducting an IPO. ¶ 597. In the sluggish IPO market of the time, the prospect of acting as Refco's auditor in connection with an IPO, especially in a market eager for investment opportunities in the derivatives business, would have been seen as a major coup for Grant Thornton. *Id.*

<u>The Inside Defendants</u>

The Inside Defendants (Trosten, Sexton, Silverman, Klejna, Murphy and Sherer) were some of Refco's most senior officers. *See* ¶¶ 33-34, 36-38, 40, 260(b) and (d). As such, they had unfettered access to Refco's books and records and an undisputed duty to monitor the information within their control in order to ensure that Refco's financial statements were

accurate. *E.g.,* ¶ 565. Despite their positions of seniority, these individuals knowingly or recklessly permitted the fraudulent scheme to continue for years. In doing so, each of these insiders either knew about, or was willfully blind toward, a host of red flags concerning the fraudulent scheme. These red flags are described in detail in the Complaint and include the massive size of the loans as compared to the Company's yearly net income, the unusual timing and nature of the transactions, Refco's history of legal violations and the fact that Refco had inadequate internal controls and an accounting department that was in "shambles."

The Inside Defendants also ignored reams of documentary evidence that was available to them and set forth the major components of the fraud in plain terms, including dozens of written loan agreements, guarantees, letters, memoranda, e-mails, "monthly account statements," "customer ledger reports," wire transfers and other documents maintained within Refco that are described above. ¶¶ 472-502, 505, 506, 508-10, 567 (summary of line-item records of the fraud). Had the Inside Defendants bothered to look, these readily available documents would have provided them with a road map of the fraud. Unfortunately for investors, these insiders were more focused on enriching themselves than on doing their jobs.

Additional facts demonstrating the knowledge or recklessness of the Inside Defendants who challenge scienter are set forth below.

Trosten. Trosten was Refco's Executive Vice President and CFO from 2001 through October 2004, when he abruptly resigned on the eve of the second step of the Bond Offering. ¶ 40. Trosten is a trained CPA and previously worked in the Regulatory Accounting department at Lehman Brothers. *Id.* Trosten was known within Refco as one of the "New York Five" who ran the day-to-day operations of the Company, reflecting the degree of authority and management control he had at Refco. ¶ 260(d). Trosten had *actual knowledge* of the fraud and was a direct

participant in many of the fraudulent transactions with BAWAG. ¶¶ 468-502. The Complaint alleges in detail Trosten's direct involvement in a fraudulent $250 million round-trip "loan" with BAWAG in February 2003, including a March 3, 2003 email sent from BAWAG directly to Trosten which indicated that BAWAG was not earning any interest on a $175 million portion of the "loan." ¶ 490. Trosten was also the recipient of a February 24, 2004 e-mail from BAWAG that spelled out in precise detail the $250 million fraudulent round-trip transaction conducted with BAWAG at the close of Refco's fiscal year end on February 29, 2004. ¶¶ 494-96.

As a reward for participating in the fraud, Trosten received multi-million dollar salaries and bonuses in 2002 through 2005 (even though he resigned in 2004). ¶ 40. But Trosten's most lucrative reward was a $45 million "severance" payment he received in 2004 when he abruptly resigned – at the age of 35 and while Grant Thornton was re-auditing Refco's financial statements in advance of the bond registration. ¶¶ 40, 574, 575. The severance payment was not disclosed publicly and only came to light when Trosten testified in an arbitration proceeding in the summer of 2005. ¶ 574. Trosten's abrupt resignation less than ten months prior to Refco's IPO was highly suspicious (¶ 574) and his huge undisclosed severance payment was an obvious effort to buy his silence when he left the Company. ¶ 575.

Sexton. Sexton joined Refco in 1999, and became the Executive Vice President and Chief Operating Officer of the Company in August 2004. ¶ 34. After Bennett was forced to resign in October 2005, Sexton served as the CEO of Refco until he resigned on November 15, 2005. *Id.* Sexton's unique access to information at Refco is demonstrated by, among other things, the fact that he was regarded within Refco as one of the "New York Five" – along with Trosten, Bennett, Maggio and Murphy. ¶ 260(d). In addition, Sexton was one of a select group of officers who were subject to non-compete agreements with Refco. ¶ 260(b). Sexton's

agreement stated that he was employed in a "key capacity with the Company" and had access to "confidential information regarding the organization, business *and finances* of the Company." ¶ 260(c) (emphasis added). Reflecting his important position at Refco, Sexton was closely involved in the Company's efforts to minimize the impact of the October 10, 2005 announcement and contributed to the artificial inflation in the stock and bond prices following that announcement. ¶ 203. One week later Refco was bankrupt, and less than one month afterward Sexton resigned. ¶¶ 34.

Silverman. Silverman held numerous high-level executive positions within Refco (including Secretary and Controller) and was also the Secretary of Refco Holdings. ¶ 37. Silverman is a CPA and close confidant of Bennett who acted as his personal accountant and had significant influence over Bennett's decision-making on behalf of Refco. ¶¶ 37, 260(f). As the Controller of Refco Group from 2004 through most of 2005, Silverman was directly responsible for closing the Company's books, implementing and maintaining internal financial controls, and implementing accounting policies for Refco. ¶ 260(a)(vii).

Silverman's knowledge or reckless disregard for the fraud at Refco is illustrated by his direct involvement in an agreement with BAWAG whereby BAWAG obtained an undisclosed 27% or more equity stake in Refco. ¶ 269(a). Indeed, the undisclosed equity interest was obtained through a December 23, 2004 merger between a company incorporated by Bennett and Refco Holdings. ¶ 269(a)(i). Silverman and Bennett were the signatories on the plan of merger on behalf of Refco Holdings. *Id.* In addition, Silverman's position as Secretary of Refco Holdings gives him the distinction of being the only Refco officer besides Bennett (and prior to August 2004, Grant) to hold any position at Refco Holdings, an entity that was involved in all aspects of the fraud at Refco. Not only did Refco Holdings assume the huge uncollectible

receivables that Refco's customers were unable to pay (*e.g.,* ¶¶ 393-97), but it was also involved in *every single one* of the yearly and quarterly sham transactions whereby hundreds of millions of dollars (and nearly $1 billion on at least one occasion) were transferred to hide the existence of those receivables. ¶¶ 517-18. Silverman could not have held the senior positions he did at Refco and Refco Holdings and been unaware of the massive fraud taking place. *See* ¶¶ 566, 571. Tellingly, Silverman was placed on leave from Refco at or about the same time as Bennett and Maggio, and news sources have indicated that Silverman's leave was due to his involvement in the bookkeeping that allowed Bennett to conceal Refco's customer trading losses. ¶ 571.

Klejna. From 1999 until Refco's collapse, Klejna served as the Company's Executive Vice President and General Counsel. ¶ 38. Klejna's unique access to information at Refco and his important role at the Company is demonstrated by, among other things, the fact that he was one of a select group of officers who were subject to non-compete agreements with Refco. ¶ 260(b). As with the other agreements, Klejna's agreement confirmed his substantial authority over the day-to-day management and operation of the Company, stating that he was employed in a "key capacity with the Company" and had access to "confidential information regarding the organization, business *and finances* of the Company." ¶ 260(c) (emphasis added). In addition, as General Counsel, Klejna was responsible for reviewing Refco's legal bills and therefore was alerted to or recklessly disregarded the fraud as a result of the bills submitted by the law firm that documented the circular loan transactions with Ingram and Customer X. *See* ¶¶ 38, 595.

Murphy. From 1999 until Refco's collapse, Murphy was an Executive Vice President of Refco and also served as Vice President of various Refco subsidiaries. ¶ 36. Murphy's unique access to information at Refco is demonstrated by, among other things, the fact that he was regarded within Refco as one of the "New York Five" who ran the day-to-day operations of the

Company. ¶ 260(d). In addition, Murphy was one of a select group of officers who were subject to non-compete agreements with Refco. ¶ 260(b). Murphy's agreement stated that he was employed in a "key capacity with the Company" and had access to "confidential information regarding the organization, business *and finances* of the Company." ¶ 260(c) (emphasis added).

Sherer. Sherer joined Refco as Executive Vice President and CFO in January 2005, replacing Defendant Trosten in that position. ¶ 33. Sherer's unique access to information at Refco and his important role at the Company is demonstrated by, among other things, the fact that he was one of a select group of officers who were subject to non-compete agreements with Refco. ¶ 260(b). As with the other agreements, Sherer's agreement gave him substantial authority over the day-to-day management and operation of the Company, stating that he was employed in a "key capacity with the Company" and had access to "confidential information regarding the organization, business *and finances* of the Company." ¶ 260(c) (emphasis added). Sherer also signed Refco's 2005 10-K and its first quarter 2005 10-Q, and certified pursuant to the Sarbanes-Oxley Act of 2002, that these documents were accurate. ¶¶ 538-40, 545, 548-51. In April 2006, Refco requested the permission of the Bankruptcy Court to terminate and reject its employment agreement with Sherer. ¶ 33.

Sexton, Klejna, Murphy and Sherer were each motivated to participate in or recklessly ignore the fraud by the enormous personal wealth they achieved through their association with Refco. The Senior Management Bonus Pool Plan entitled each of them to receive certain bonuses only if the Company achieved set EBITDA targets, which would not have been achieved but for the fraud. ¶ 593. In addition, Sexton, Klejna, Murphy and Sherer each received a substantial cash payout ranging from $6.5 to $13.7 million in connection with the LBO and Bond Offering as a result of the liquidation of a Company-endorsed profit-sharing plan. ¶ 584.

Sexton, Klejna, Murphy and Sherer also received significant grants of Refco stock and RSUs on the eve of the IPO, thus providing each of them with a powerful motive to ensure that the IPO was successful and that Refco's stock price remained inflated. ¶¶ 585, 591. Specifically, Sexton held nearly 600,000 shares of Refco stock on the date of the IPO – stock that was worth over $13 million at the IPO price. ¶ 585. Klejna, Sherer and Murphy held approximately 260,000, 460,000 and 530,000 shares at the time of the IPO, respectively, worth between $5.7 million and $12 million. *Id.* As stockholders of record before the IPO, they also received an undisclosed portion of the $87 million "Green Shoe" option exercised in connection with the IPO. ¶ 587. Finally, Sexton, Murphy and Klejna each received between 350,000 and 702,000 additional RSUs in advance of the IPO. ¶ 591.

The Audit Committee Defendants

The Sarbanes-Oxley Act of 2002 highlights the important role that an audit committee plays with respect to the integrity of a company's financial reporting. ¶ 598. Recognizing that investors view a robust and talented audit committee as a critical part of a company's internal controls, Refco repeatedly touted the important role that its Audit Committee – Defendants O'Kelley, Breitman and Gantcher (¶¶ 42-44) – supposedly played in overseeing Refco's financial reporting. The IPO Registration Statement stated that one of the "primary purposes" of the Audit Committee was to oversee the "integrity of [Refco's] financial statements" and to ensure that the Company's "internal audit function" worked properly. ¶ 600. Likewise, the Audit Committee charter references the important role that Refco's Audit Committee supposedly played in dealing with "internal audit," "assess[ing] and manag[ing] the Company's exposure to risk" and "reviewing and discussing with management the progress and results of internal audit

projects." ¶ 601. The IPO Registration Statement even signaled out O'Kelley – the chairman of the Audit Committee – as an independent "audit committee financial expert." ¶ 602.

Despite the supposed expertise and active involvement of Refco's Audit Committee, each of its members knowingly or recklessly failed to detect – or put in measures to prevent – the fraud at Refco. ¶ 603. Indeed, even though the Audit Committee's own charter emphasized the importance of an internal audit function, there *was no such function at Refco.* To the contrary, according to a former Refco officer, Refco's accounting department was "an absolute shambles" and there was "no internal audit" or significant accounting infrastructure of any kind. ¶ 581. Rather than take steps to remedy this situation, Refco's Audit Committee allowed it to continue, thus contradicting their own public statements, violating their own charter, and fostering an environment that was ripe for fraud.

The Audit Committee Defendants' failure to perform their duties is further demonstrated by the fact that, as of February 28, 2005, Grant Thornton had reported two significant deficiencies in Refco's internal controls. ¶ 603. The specific deficiencies noted were "the need to increase [Refco's] existing finance department resources to be able to prepare financial statements that are fully compliant with all SEC reporting guidelines" and a "lack of formalized procedures for closing [Refco's] books." *Id.* These two deficiencies fell squarely into the Audit Committee's area of responsibility and should have alerted the Audit Committee Defendants that there was a significant risk of fraudulent activity at the Company. ¶ 604. These internal control deficiencies had existed through the entirety of fiscal year 2005 and in prior years as well. ¶ 605. However, they were not discovered, disclosed, or corrected by the Audit Committee Defendants. *Id.*

To compound their failure to identify or address these issues, the Audit Committee Defendants took no steps whatsoever to remedy them in a timely fashion. ¶ 606. For instance, the IPO Registration Statement states that Refco was "in the process" of hiring "additional internal audit and financial personnel" as of August 10, 2005. *Id.* Thus, *six months* after the Company publicly acknowledged these internal control problems – which were known or should have been known much earlier – the Audit Committee Defendants still had not remedied them. While this delay would be reckless under any circumstance, it is particularly reckless in this case, because in the intervening six months Refco had conducted two major transactions in public securities: the Exchange Offer and the IPO. *Id.* As set forth above, the fraudulent scheme was eventually discovered by a Refco employee who had been with the Company for less than two months. ¶ 608. If the Audit Committee Defendants had hired new employees in a timely fashion prior to the Exchange Offer and the August 2005 IPO, it is likely that the fraud at Refco would have been revealed much earlier, saving investors hundreds of millions of dollars of losses. *Id.*

As discussed above, the Audit Committee Defendants were motivated to recklessly ignore the fraud by the unusual grant of 20,000 RSUs that they each received on the eve of the IPO. ¶¶ 592, 607. These RSUs would only vest and become valuable after the IPO. The receipt of these RSUs by the Audit Committee Defendants was extremely unusual because it not only undermined their purported independence, but because the Audit Committee Defendants were the only members of the Board to receive these grants. ¶ 592. Thus, the three board members responsible for "the integrity of [Refco's] financial statements" were specially compensated with RSUs that would have been rendered worthless if Refco's true financial condition had been revealed. *Id.*

IV. The Truth Regarding Refco Is Finally (Albeit Haltingly) Disclosed

Refco's life as a public company was short-lived. On October 10, 2005, a mere forty-two trading days after the IPO, Refco issued a press release announcing the existence of an "undisclosed affiliate transaction" in the form of a $430 million receivable owed to Refco by an entity controlled by Bennett. ¶ 199. While the press release revealed that the receivable "may have been uncollectible," it advised that Bennett had already repaid the receivable in cash. *Id.* The press release also disclosed that Refco's Board of Directors had asked Bennett and Maggio take an immediate leave of absence. ¶ 201. Refco provided very little detail about the $430 million related-party transaction, and the press release failed to mention the multitude of fraudulent transactions or false and misleading statements that had transpired since at least 1999. ¶ 203.

In response to the press release, Refco's stock traded at a volume more than fifty times its daily average and fell from a closing price of $28.46 on October 9, 2005, to $15.60 on October 10, 2005 – a single day drop of 45% on very heavy volume. ¶ 202. Refco's press release, however, omitted material information, and failed to disclose the full extent of the fraud, thereby allowing the Company's stock price to remain artificially inflated. ¶¶ 203-04. For example, while the October 10, 2005 press release stated that Bennett had repaid the receivable, it failed to disclose that Bennett had obtained the funds from BAWAG, or any of the facts related to Refco's relationship with BAWAG. *Id.* Further, Refco downplayed the impact of the newly-released information on Refco's ongoing business and publicly stated that it had "adequate liquidity to run the business in the ordinary course." ¶¶ 203-05.

In the days that followed Refco's initial – but incomplete – disclosure of the related-party receivable, additional adverse disclosures caused further, significant declines in the prices of Refco securities.

On October 11, 2005, the SEC announced the commencement of a formal investigation of Refco. ¶ 205. In an attempt to mitigate the damage that such an announcement would cause, Refco issued a second press release assuring customers and investors that the "Company . . . has adequate liquidity to run the business in the ordinary course." *Id.* Refco's attempt to soothe stockholders may have worked temporarily. On October 11, 2005 the stock price fell to $13.85, on heavy trading volume. ¶ 205. This was a minor drop when compared to the previous day, but Refco's bondholders were just beginning to feel the pangs of Refco's disclosures. Refco's Bonds had never traded below 103% of par and were trading at an impressive 108.625% of par on October 7, 2005, shortly before the news of fraudulent transactions at Refco sent the Bonds into a downward spiral – trading at only 91.50% of par on October 11, 2005. *Id.*

On October 12, 2005, the United States Attorney for this District arrested Bennett, informing the public for the first time that Refco's problems were the result of fraudulent and criminal activity rather than simply accounting mistakes. ¶ 206. On this news, Refco's securities declined for a third straight day, with the stock falling to $10.85 and the Bonds falling to 76% of par. *Id.*

On October 13, 2005, Refco released a statement that completely contradicted its earlier press release with respect to the Company's liquidity, stating that "in light of recent events, the liquidity within the Company's non-regulated subsidiary Refco Capital Markets, Ltd., which represents a material portion of the business of the Company is no longer sufficient to continue operations." ¶ 207. Upon release of this news, Refco's stock price dropped to a mere $7.90 per share before the New York Stock Exchange halted trading in Refco stock. ¶¶ 208, 620. The Bonds continued to trade, however, and by the following day, October 14, 2005, had dropped to just 16% of par. ¶¶ 8, 208.

On October 17, 2005, Refco admitted that it was no longer able to carry on business as usual and announced that it was filing for bankruptcy protection. ¶ 209. The NYSE lifted the trading restrictions on Refco's stock on October 18. ¶¶ 208, 209. On that day, Refco's stock traded on a massive volume of 28.5 million shares and closed at just 65 cents per share. ¶ 209.

ARGUMENT

When ruling on a motion to dismiss under Fed. R. Civ. P. 12(b)(6), the Court must accept as true the facts alleged in the complaint, *Jackson Nat'l Life Ins. Co. v. Merrill Lynch & Co.*, 32 F.3d 697, 699-700 (2d Cir. 1994), and may grant the motion only if "it appears beyond doubt that the plaintiff can prove no set of facts in support of his claim which would entitle him to relief." *Thomas v. City of N.Y.*, 143 F.3d 31, 36 (2d Cir. 1998). "All reasonable inferences are to be drawn in the plaintiff's favor." *In re Global Crossing, Ltd. Sec. Litig*., No. 02 Civ. 910 (GEL), 2006 U.S. Dist. LEXIS 39030, at *10 (S.D.N.Y. June 13, 2006). *See also In re Initial Public Offering Sec. Litig.,* 241 F. Supp. 2d 281, 332 (S.D.N.Y. 2003) ("even under the PSLRA, the district court, on a motion to dismiss, must draw all reasonable inferences from the particular allegations in the plaintiffs favor"); *In re Philip Svcs. Corp. Sec. Litig.,* 383 F. Supp. 2d 463, 472 (S.D.N.Y. 2004) ("declin[ing] to interpret the PSLRA's 'strong inference' language so as to deprive plaintiffs of all reasonable inferences at the pleadings stage.").

I. THE COMPLAINT STATES CLAIMS UNDER THE SECURITIES ACT

The Complaint asserts claims pursuant to §§ 11, 12(a)(2), and 15 of the Securities Act based on the untrue statements in the Offering Memorandum for the bonds, the Bond Registration Statement, and the IPO Registration Statement. Defendants Grant Thornton, Silverman, Klejna, Refco Holdings, and the Bennett Trust argue – incorrectly – that all these claims are subject to the pleading requirements of Rule 9(b). Significantly, however, none of the Defendants has moved to dismiss the equity purchasers' § 12(a)(2) claim based on the IPO

Registration Statement (Count VII), and only Grant Thornton has moved to dismiss the equity purchasers' § 11 claim (Count V). Certain Officer Defendants, Refco Holdings, and the Bennett Trust have moved to dismiss the equity purchasers' § 15 "control person" claims (Counts VI and VII), while Sherer, the Audit Committee Defendants and the THL Defendants have not.

With respect to the bond purchasers' Securities Act claims, the Bond Underwriter Defendants contend that they were not "underwriters" of the registered bonds and thus cannot be held liable under § 11, while other Defendants — Sexton, the THL Individual Defendants, and the Audit Committee Defendants — seek dismissal of the § 11 claim only to the extent that it is brought on behalf of investors who exchanged Rule 144A bonds for registered bonds (as opposed to those who purchased registered bonds in the open market). Defendants Bennett, Trosten, the THL Partner Defendants, Jaeckel, and the Bond Underwriter Defendants also seek dismissal of the Rule 144A Bond purchasers' § 12(a)(2) claim on the grounds that the Offering Memorandum was not a "prospectus" and the Bond Offering was not a public offering. The THL Partner Defendants and Sherer have not moved against the bond purchasers' § 15 "control" person claims, but all other Defendants for those claims contend that Plaintiffs have failed to allege an underlying violation and/or failed to adequately plead Defendants' "control" of Refco.

As discussed below, all of Defendants' motions to dismiss Plaintiffs' Securities Act claims should be denied.

A. <u>Defendants' "Sounds in Fraud" Argument Is Without Merit</u>

Under §§ 11 and 12(a)(2) of the Securities Act, a plaintiff can recover damages resulting from untrue statements in connection with the offering and registration of securities, even absent proof of fraud. "Neither Section 11 nor Section 12(a)(2) requires that plaintiffs allege . . . scienter." *Rombach v. Chang*, 355 F.3d 164, 169 n.4 (2d Cir. 2004); *see also In re Suprema Specialties, Inc. Sec. Litig.,* 438 F.3d 256, 269, 270 (3d Cir. 2006) (§ 11 is a "virtually absolute

liability provision"). In addition, neither reliance nor loss causation are required to be pleaded by plaintiffs asserting § 11 or § 12(a)(2) claims. *Rombach*, 355 F.3d at 169 n.4; *Adair v. Bristol Tech. Sys.*, 179 F.R.D. 126, 135 (S.D.N.Y. 1998). A Securities Act plaintiff "need only show a material misstatement or omission to establish his *prima facie* case," which "places a relatively minimal burden on a plaintiff." *Herman & MacLean v. Huddleston*, 459 U.S. 375, 382 (1983).

Because fraud is not an element of claims under § 11 or § 12(a)(2), the pleading of a violation of these provisions is governed by Fed. R. Civ. P. 8(a), which requires only "a short and plain statement of the claim showing that the pleader is entitled to relief." *See In re WorldCom, Inc. Sec. Litig.,* 294 F. Supp. 2d 392, 406 (S.D.N.Y. 2003), *aff'd,* 366 F.3d 70 (2d Cir. 2004); *see also Rombach*, 355 F.3d at 178.

1. Plaintiffs' Securities Act Claims Are Not Subject to Rule 9(b)

Unable seriously to contest that the Complaint sufficiently alleges that the Bond Registration Statement, Offering Memorandum and IPO Registration Statement contained untrue statements of material fact, Defendants Grant Thornton, Silverman, Klejna, Refco Holdings and the Bennett Trust instead resort to the conclusory argument now routinely made in all Securities Act cases, namely, that Plaintiffs' §§ 11 and 12(a)(2) claims "sound in fraud" and, therefore, must comply with Rule 9(b). *See* Silverman Mem. at 22-24; Bennett Mem. at 19-20; GT Mem. at 15-16; Klejna Mem. at 31-32. This argument has no merit in this case.

The Securities Act claims in the Complaint do not sound in fraud. In the relevant portion of the Complaint, Plaintiffs expressly allege that Defendants acted negligently and failed to conduct reasonable investigations. ¶¶ 249-58, 270, 299, 329, 361.[11] Each Securities Act claim is

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[11] For example, the Complaint alleges that Grant Thornton "performed its audits of the Company's financial statements in a negligent manner, which did not comply with GAAS and did not constitute a reasonable investigation of whether the Company's financial statements were accurate and in compliance

(Cont'd)

enumerated and pleaded separately from the Exchange Act claims and fraud is expressly disclaimed. *See* Counts I-VIII. These claims do not include any allegations that Defendants acted with scienter, and while the Securities Act claims incorporate the allegations that precede them, *see, e.g.*, ¶¶ 270, 299, 329, 361, the preceding paragraphs likewise do not contain allegations of scienter. All of the allegations as to fraud or scienter appear separately in the second section of the Complaint, following all of the Securities Act claims. "[I]t is the intent requirement that distinguishes an action for securities fraud from an action for negligence…." *Robin v. Arthur Young & Co.*, 915 F.2d 1120, 1126 (7th Cir. 1990); *see In re Prestige Brand Holdings, Inc.*, No. 05 Civ. 06924 (CLB), 2006 WL 2147719, at *8 (S.D.N.Y. July 10, 2006) (where Judge Brieant stated, in holding that §§ 11 and 12(a)(2) claims did not sound in fraud, that the difference between Rule 10b-5 claims and §§ 11 and 12(a)(2) claims "have to do with motive and scienter (knowledge)."). Because Plaintiffs' Securities Act claims lack any allegations as to scienter, these claims do not sound in fraud.

Accordingly, the Complaint does not suffer from the defects that led the courts in the cases cited by Defendants to conclude that the Securities Act claims in those cases sounded in fraud. For example, in *Rombach v. Chang*, 355 F.3d 164 (2d Cir. 2004), the Securities Act claims expressly incorporated paragraphs containing allegations of fraud. *See Rombach v. Chang*, No. 00 CV 0958 (SJ), 2002 WL 1396986, at *4 (E.D.N.Y. June 7, 2002), *aff'd*, 355 F.3d 164 (2d Cir. 2004). In light of that fact, the court held that the plaintiffs' mere disclaimer that the claims sounded in fraud was ineffective. Moreover, the Securities Act claims in *Rombach* did

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with GAAP." ¶ 253. The Complaint further alleges that Grant Thornton "failed to exercise due care in the performance of its audit" and failed to adequately plan and supervise its audit." ¶¶ 253(a) and (b). Similarly, the Complaint alleges that Silverman, Klejna and other Refco officers "did not conduct a reasonable investigation of the statements contained in the Offering Memorandum and the Bond Registration Statement, and did not possess reasonable grounds for believing that the statements in those documents were true and not misleading." ¶ 252.

"not assert any claim of negligence," 2002 WL 1396986, at *4, and did not provide "any basis for the claims" other than fraud. 355 F.3d at 172. In this case, by contrast, the Securities Act claims in the Complaint quite clearly explain that they are based on Defendants' negligence and failure to conduct reasonable investigations. Many of these Defendants are not charged at all in the second half of the Complaint, which separately pleads Exchange Act violations.

Similarly, in *In re Alstom SA Sec. Litig.*, 406 F. Supp. 2d 402 (S.D.N.Y. 2005), Judge Marrero found a generalized disclaimer of fraud ineffective because the Securities Act claims expressly incorporated numerous paragraphs alleging fraud. *Id.* at 410. Indeed, the court noted two different approaches that plaintiffs might take in light of *Rombach*. One was the approach taken in *Alstom*, *i.e.*, for the Securities Act claims merely to disavow fraud. The second possible approach, the court said, would be "to draft two-part complaints, each portion sufficient to stand alone for its respective pleading purposes." *Id.* at 411 n.3. This approach, which has been expressly endorsed,[12] is the one taken in the Complaint in this case.[13]

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[12] *See, e.g., In re Suprema Specialties, Inc. Sec. Litig.*, 438 F.3d 256, 272-73 (3d Cir. 2006) (where the "defendants are accused in separate claims of the same complaint of having violated Section 11, Section 12(a)(2), and Section 10(b), the Securities Act claims do not sound in fraud if ordinary negligence is expressly pled in connection with those claims. In such a case, the fraud allegations cannot be said to 'contaminate' the Section 11 and Section 12(a)(2) claims if the allegations are pled separately . . . . A contrary result would effectively preclude plaintiffs from filing suit under Section 11 and Section 12(a)(2) as well as Section 10(b). There is no suggestion that Congress intended such an incongruous approach.").

[13] Defendants' other cases are similarly unhelpful to their position on this issue. In *In re Ultrafem Inc. Sec. Litig.*, 91 F. Supp. 2d 678 (S.D.N.Y. 2000), the plaintiffs made "little, if any, effort to differentiate their asserted negligence claims from the fraud claims." *Id.* at 690. The Securities Act claims incorporated paragraphs containing allegations of fraud and merely disavowed allegations that might implicate Rule 9(b). Judge Preska rejected this approach because it would "essentially request that the Court parse [the plaintiffs'] allegations to find a negligence claim." *Id*. In the case at bar, no such parsing is necessary; the Securities Act claims do not incorporate paragraphs containing allegations of fraud but rather allege that Defendants acted negligently and failed to conduct appropriate investigations. Further, in *OSRecovery, Inc. v. One Group Int'l, Inc.*, 354 F. Supp. 2d 357 (S.D.N.Y. 2005), the court noted that the sounds in fraud doctrine could apply where a complaint, unlike the Complaint in this case, did not provide any basis other than fraud for the claims asserted. *Id.* at 380 n.172.

There is no merit to Defendants' assertions that the §§ 11 and 12(a)(2) claims in the Complaint sound in fraud because they allege that the prospectuses and registration statements "contained untrue statements of material facts and omitted to state material facts required therein or necessary to make the statements therein not misleading." Klejna Mem. at 32; *see* GT Mem. at 16. Such allegations track the statutory language of the Securities Act almost *verbatim*. For example, § 11 affords a right of action against parties involved in the dissemination of registration statements that either "contained an untrue statement of a material fact or omitted to state a material fact . . . necessary to make the statements therein not misleading." 15 U.S.C. § 77k(a). *Rombach* cannot be read, as Defendants would have it, to hold that a § 11 claim sounds in fraud whenever plaintiffs allege that a registration statement contained "untrue statements of material facts." Were this the case, *every* § 11 claim pleaded according to the statutory language would sound in fraud. In *In re WRT Energy Sec. Litig.*, No. 96 Civ. 3610 (JFK), 2005 WL 323729, at *6 (S.D.N.Y. Feb. 8, 2005), Judge Keenan held that phrases such as "materially incorrect" and "untrue statements" are not enough under *Rombach* to implicate the sounds in fraud doctrine, because such phrases "merely allude to the language in Section 11 of the 1933 Act." *See also* H. Bloomenthal & S. Wolff, *Second Circuit Adopts "Sound in Fraud" with a Twist*, 3C Sec. & Fed. Corp. Law § 16:119 (2d ed.) ("[T]he essence of [a] Section 11 claim is 'an untrue statement of a material fact . . . required to be stated therein or necessary to make the statements therein not misleading'. . . . Section 11 was structured in this manner to avoid the common law concept of fraud and deceit...").[14]

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[14] Defendants also fail to mention that the *Rombach* court found that certain of the plaintiffs' § 11 counts – despite being based on allegations of "untrue statements of material fact" – sounded in negligence and thus were not subject to the heightened pleading requirements of Rule 9(b). *Rombach*, 355 F.3d at 178. Accordingly, *Rombach* does not stand for the blanket principle that a § 11 claim automatically sounds in fraud whenever plaintiffs plead "untrue statements of material facts."

2. Plaintiffs' Securities Act Claims Should Be <u>Sustained Even If Rule 9(b) Were Held Applicable</u>

Even assuming, *arguendo*, that the Court were to conclude that Plaintiffs' Securities Act claims are subject to Rule 9(b), the Complaint meets that standard. The Complaint pleads with particularity which statements in the various prospectuses and registration statements were untrue and why, and the role that each Defendant played with respect to such filings. *See, e.g.,* ¶¶ 109-43 (Bond Offering Memorandum); ¶¶ 153-65 (Bond Registration Statement); ¶¶ 172-98 (IPO Registration Statement and Prospectus). The Complaint also explains with particularity how the various Defendants acted improperly or failed to conduct reasonable investigations with respect to the statements in those filings. *See, e.g.,* ¶¶ 206-48, 253 (Grant Thornton); ¶¶ 249-51, 254-56 (Underwriter Defendants); ¶¶ 598-608 (Audit Committee Defendants); *see also* ¶¶ 552-81.

Therefore, Defendants' arguments that Plaintiffs' Securities Act claims do not meet the heightened pleading standard of Rule 9(b) are without merit. *See In re Philip Servs. Corp. Sec. Litig.*, 383 F. Supp. 2d 463, 476 (S.D.N.Y. 2004) (a complaint satisfies Rule 9(b) where it identifies the false statement, identifies the speaker of the statement, states where and when the statement was made, and explains why it was false) (*citing Mills v. Polar Molecular Corp.*, 12 F.3d 1170, 1175 (2d Cir. 1993)); *In re Flag Telecom Holdings, Ltd. Sec. Litig.*, 352 F. Supp. 2d 429, 460 (S.D.N.Y. 2005) (same); *Danis v. USN Commc'ns, Inc.*, 73 F. Supp. 2d 923, 932 (N.D. Ill. 1999) (finding that Rule 9(b) did not apply to § 11 claim, but that Rule 9(b) would be satisfied in any event because the plaintiff identified the misstatements, the documents in which they were made, the speaker or author, and why they were false or misleading).

B. Plaintiffs' § 12(a)(2) Claim on Behalf of Bond Purchasers (Count I) Should Not Be Dismissed

Section 12(a)(2) provides investors with a private right of action against those who "offer[] or sell[] a security . . . by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact . . ." 15 U.S.C. § 77l(a)(2). In *Gustafson v. Alloyd Co.*, 513 U.S. 561, 584 (1995), the Supreme Court held that "the word 'prospectus' is a term of art referring to a document that describes a public offering of securities . . ." The Court further held that, for purposes of § 12(a)(2), the term "prospectus" has the same meaning as in § 10 of the Securities Act, which provides that a prospectus "shall contain the information contained in the registration statement . . ." 15 U.S.C. § 77j(a)(1). However, the Court also recognized that § 12(a)(2) "*applies to every class of security . . . whether exempted from registration or not*." *Gustafson*, 513 U.S. at 580 (emphasis added). In ruling on a § 12(a)(2) claim, the Supreme Court thus provided two guide posts for the District Courts to follow: 1) the sale of the security must be a public (not private) offering; and 2) the securities offered may be registered *or unregistered* securities.[15]

In Count I of the Complaint, Plaintiffs have asserted a claim pursuant to § 12(a)(2) on behalf of all Class members who purchased Rule 144A Bonds in the initial unregistered, albeit public, offering. Plaintiffs allege that the Offering Memorandum was a prospectus which contained material untrue statements, and that the bonds were further offered and sold by way of materially incorrect verbal statements made during the Bond Road Shows. ¶¶ 272, 277. Defendants Bennett, Trosten, Jaeckel, the THL Defendants and the Bond Underwriter Defendants contend, however, that Count I should be dismissed because the Rule 144A Bonds

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[15] If the securities had to be registered, then § 12(a)(2) would be usurped by § 11, since a prospectus is generally filed with a registration statement.

were not sold in a "public offering," and because the Offering Memorandum was not a prospectus. Both of Defendants' arguments should be rejected on the merits, and certainly at the initial stage of pleadings prior to any discovery.

1. The Bonds Were Sold in a Public Offering

The bonds were issued in a two-step process, whereby Refco initially sold unregistered bonds to the Bond Underwriter Defendants, who resold them to investors pursuant to an exemption from registration under Rule 144A. ¶¶ 100, 101. Then, as was contemplated from the outset, Refco issued Registered Bonds in exchange for the outstanding unregistered bonds. *Id.* As discussed below, the first step of the two-step offering, whereby the unregistered bonds were first issued, was itself a public offering. Alternatively, even if the first step was not a public offering, the two-step offering was a public offering when viewed as a whole.

a. The Rule 144A Bond Offering Was a Public Offering

In *Gustafson*, the Supreme Court recognized that "[l]iability imposed by [§] 12(2)[16] has nothing to do with the *fact* of registration," and that § 12(a)(2) "applies to every class of security . . . whether exempted from registration or not." 513 U.S. at 579 (emphasis in original). *See also AAL High Yield Bond Fund v. Ruttenberg*, No. 00-C-1404-S, 2001 WL 34372980, *7 (N.D. Ala. Sept. 30, 2001) ("Whether the transaction in question was not registered because it is claimed it was exempt …is not dispositive" as to the availability of a § 12(a)(2) claim). Thus, the fact that the Rule 144A Bonds were initially unregistered does not preclude a finding that they were sold in a public offering.

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[16] At the time *Gustafson* was decided, what is now § 12(a)(2) was denominated as § 12(2).

In *Gustafson*, the Court did not have to (and did not) define the parameters of a "public offering" to which § 12(a)(2) applies, because the transaction in that case was a *concededly private* transaction, involving a single purchaser and a contract which did not contain the type of information that would be contained in a registration statement.[17] Likewise, in *Yung v. Lee*, 432 F.3d 142 (2d Cir. 2005) – upon which Defendants place heavy reliance – the "[p]laintiffs acknowledge[d] that they purchased the securities at issue through a series of private transactions, not any public offering" and "similarly acknowledge[d] that none of the [documents] pursuant to which they made their purchases qualifie[d] as a 'prospectus' under the definition articulated in *Gustafson*." *Id.* at 149. In this case, by contrast, Plaintiffs allege the Rule 144A Bonds were marketed and sold via a public offering to numerous institutional investors throughout the United States, pursuant to an Offering Memorandum that constituted a prospectus because it contained the same information required in a § 10 prospectus and in the Bond Registration Statement. ¶¶ 100-06, 144, 272. Thus, *Gustafson*, *Yung*, and the other cases cited by Defendants where the plaintiffs acknowledged purchasing securities in private

[17] The THL Defendants cite the following passage from the Securities Act's legislative history, which is quoted in *Gustafson*, as a purported indication that § 12(a)(2) liability is unavailable absent a false registration statement: "Fundamentally, these sections [11 and 12] entitle the buyer of securities sold upon a registration statement … to sue for recovery of his purchase price." *See* THL/Audit Comm. Mem. at 13-14. However, this is simply a generalized summary of the Securities Act, and the very next paragraph of the legislative history acknowledges that liabilities thereunder attach "when there has been an untrue statement of material fact … in the registration statement *or the prospectus* …." *See* H.R. Rep. No. 85, 73d Cong., 1st Sess., 5 (1933) (emphasis added). The THL Defendants also place undue reliance on the Court's comment in *Gustafson* that "as to private transactions, such as Alloyd's purchase, there will never have been a registration statement. If § 12(2) liability were imposed here, it would cover transactions not within the contemplated reach of the statute." 513 U.S. at 581. As discussed below, the transaction in *Gustafson* was an unquestionably private transaction, and thus the Court's comments should not be construed to mean that there can *never* be § 12(a)(2) liability in the absence of a registration statement. Indeed, such a reading would conflict with the Court's earlier recognition that § 12(a)(2) applies to securities that are exempt from registration. *Id.* at 580.

transactions,[18] provide no guidance on the question of whether the sale of the Rule 144A Bonds to numerous investors throughout the country constituted a public offering.

The Supreme Court's opinion in *S.E.C. v. Ralston Purina Co.*, 346 U.S. 119 (1953), however, provides some guidance insofar as it acknowledged that "to be public, an offer need not be open to the whole world." *Id.* at 123. Therefore, the fact that the Rule 144A Bonds were offered to a subset of the investing public does not mean it was not a "public offering." *Id.*; *Hill York Corp. v. American Int'l Franchises, Inc.,* 448 F.2d 680, 687 (5th Cir. 1971); *Flake v. Hoskins*, 55 F. Supp. 2d 1196, 1228 (D. Kan. 1999). Other courts have recognized that whether an offering is "public" depends on a variety of *factual matters* including the number of offerees, the size of the offering, and the types of marketing strategies employed. *See, e.g., Hill York Corp.*, 448 F.2d at 687; *In re Enron Corp. Sec., Deriv. & ERISA Litig*., 310 F. Supp. 2d 819, 862 (S.D. Tex. 2004); *AAL High Yield Bond Fund,* 2001 WL 34372980, at *8. As the Fifth Circuit has explained:

> "No particular numbers [of offerees] are prescribed. Anything from two to infinity may serve . . ." [quoting *Ralston Purina Co.*] Obviously, however, the more offerees, the more likelihood that the offering is public. The relationship between the offerees and the issuer is most significant. If the offerees know the issuer and have special knowledge as to its business affairs, such as high executive officers of the issuer would possess, then the offering is apt to be private. . . . Also to be considered is the relationship between the offerees and their knowledge of each other. For example, if the offering is being made to a diverse and unrelated group, *i.e.*, lawyers, grocers, plumbers, etc., then the offering would have the appearance of being public; but an offering to a select group of high executive officers of the issuer who know each other and of course

[18] *See, e.g., AIG Global Sec. Lending Corp. v. Bank of Am. Secs. LLC*, 254 F. Supp. 2d 373 (S.D.N.Y. 2003) (involving Rule 144A offerings that were not followed by an Exxon Capital exchange; there was "no dispute that … [the] securities were sold through private offerings"); *Emergent Capital Inv. Mgmt. LLC v. Stonepath Group, Inc.,* 165 F. Supp. 2d 615, 622 (S.D.N.Y. 2001) (transaction was undisputedly a "private placement"); *In re JWP Inc. Sec. Litig.,* 928 F. Supp. 1239, 1259 (S.D.N.Y. 1996) (not involving Rule 144A; the plaintiffs acknowledged that the securities "were issued privately"); *Glamorgan Coal Corp. v. Ratner's Group PLC*, No. 93 Civ. 7581, 1995 WL 406167, at *3 (S.D.N.Y. July 10, 1995) (not involving Rule 144A; complaint referred to stock sale as "private" placement).

> have similar interests and knowledge of the offering would likely be characterized as a private offering.
>
> * * *
>
> The smaller the size of the offering, the more probability it is private.
>
> * * *
>
> A private offering is more likely to arise when the offer is made directly to the offerees rather than through the facilities of public distribution such as investment bankers or the securities exchanges. . . .

Hill York Corp., 448 F.2d at 688-89 (citations and footnotes omitted).[19]

In this case, the Complaint alleges that: the Rule 144A Bonds were offered and sold to numerous investors across the country (¶ 144); the offerees did not have special knowledge of the business or a pre-exiting relationship with the issuer (¶ 280); the magnitude of the Rule 144A Bond offering was large ($600 million) (¶ 95); and the offering was accomplished through investment banks (¶ 97). These are all facts that have been found to weigh in favor of finding an offering to be a public offering. *See Hill York Corp.*, 448 F.2d at 687-88.

At the very least, given these facts and the fact-intensive nature of this inquiry, whether the Bond Offering was "public" should not be resolved on a motion to dismiss. In fact, a number of district courts have found that allegations similar to those in this case were sufficient to deny a motion to dismiss a § 12(a)(2) claim based on a Rule 144A offering. *See, e.g., Enron*, 310 F.

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[19] The Supreme Court's holding in *Gustafson* was premised, in part, on the fact that "[w]hen the 1933 Act was drawn and adopted, the term 'prospectus' was well understood to refer to a document soliciting the public to acquire securities from the issuer." 513 U.S. at 575-76 (citation omitted). It was equally well understood at that time that the term "public offering" included offerings to limited subsets of the public:

> A public offering is likewise not defined [in the 1933 Act] ... English courts have indicated that an offer is public even though it is to a "defined class of the public." *Nash v. Lynde*, [1929] A.C. 158, 171; see also *In re South of England Natural Gas & Petroleum Co., Ltd*., [1911] 1 Ch. 573. Any number from "two to infinity may serve." *Nash v. Lynde, supra*, at 169.

W. Douglas & G. Bates, *The Federal Securities Act of 1933*, 43 Yale L.J. 171, 185 n.62 (1933). *See also Gustafson*, 531 U.S. at 601 (Ginsburg, J., dissenting).

Supp. 2d at 864-66 (where complaint alleges that Rule 144A offerings were in excess of $125 million and widely targeted to qualified institutional buyers, court "cannot conclude that there is no chance that [the plaintiff] might be able to prove its claim that these were public offerings"); *AAL High Yield Bond Fund*, 2001 WL 34372980, at *8 (declining to dismiss § 12(a)(2) claim against investment bank that served as initial purchaser in a Rule 144A offering, because the distinction between public offerings and private placements is a factual question, and the parties had introduced contravening evidence relevant to the inquiry); *Sloane Overseas Fund, Ltd. v. Sapiens Int'l Corp.*, 941 F. Supp. 1369, 1376 (S.D.N.Y. 1996) (for an offering pursuant to Rule 144A and Regulation S, "the wide distribution of the Offering Circular made [the] Note offering public" for purposes of § 12(a)(2)); *accord Hirtenstein v. Tenney*, 252 F. Supp. 827, 830 (S.D.N.Y. 1966) (denying motion for summary judgment, because determination of whether a stock sale is part of a public offering "involves a thorough development of the factual situation"); *Flake,* 55 F. Supp. 2d at 1229 (factual inquiry into whether offering is "public" is "not well suited for a motion to dismiss").

In an effort to avoid highlighting the factual nature of this dispute, the THL Defendants rely on the language of Rule 144A(c), 17 C.F.R. § 230.144A(c), in arguing that a Rule 144A offering cannot be a public offering as a matter of law. That reliance is misplaced, for several reasons. First, Rule 144A itself says that its provisions "relate […] solely to section 5 of the [Securities Act], *and not to antifraud or other provisions of the federal securities laws.*" 17 C.F.R. § 230.144A, Preliminary Note 1 (emphasis added). Therefore, by its own terms, Rule 144A is irrelevant to the applicability of § 12(a)(2). Second, Rule 144A(c) does *not* say that a Rule 144A offering is not a public offering, but rather that securities sold pursuant to Rule 144A "shall be deemed not to have been offered to the public *within the meaning of section 4(3)(A) of*

the [Securities] Act." 17 C.F.R. § 230.144A(c) (emphasis added). Section 4(3)(A) has nothing to do with the remedial provisions of § 12(a)(2), but simply provides that dealers cannot sell unregistered securities during the first 40 days after they are first "bona fide offered to the public." 15 U.S.C. § 77d(3)(A).

Indeed, the SEC has made clear that its promulgation of Rule 144A was not intended to limit the reach of § 12(a)(2), and that it believes § 12(a)(2) *should* apply to Rule 144A/Exxon Capital exchange transactions. In a letter submitted as *amicus curiae* in *In re Safety-Kleen Bondholders Litig.*, the SEC explained that "[p]rior to *Gustafson,* the Commission had understood Section 12(a)(2) as applying to all offers and sales of securities, whether in a public or private transaction ...."[20] When promulgating Rule 144A – five years before *Gustafson* was decided – the SEC was not focused on the implications of how it characterized transactions within the rule (*e.g.,* public versus private) because it "could not have taken into account that the Supreme Court, a number of years later, would make the application of Section 12(a)(2) turn on whether or not a transaction was characterized as a public offer." *Id.* "Nor could the Commission's staff have anticipated that development when it was issuing the no-action letters that allow the combination of unregistered and registered transactions like these [Rule 144A/Exxon Capital exchange transactions]." *Id.*

In *Safety-Kleen* – which involved the same type of Rule 144A/Exxon Capital exchange transaction as this case – the SEC expressly stated that "a finding of Section 12(a)(2) coverage on the facts of this case is one with which the Commission would be in sympathy on policy

[20] *See* Letter dated Aug. 9, 2001 from David M. Becker to the Honorable Joseph M. Anderson (the "SEC *Amicus* Letter"), at 3 (attached as Exhibit A to the Declaration of John P. Coffey in Support of Lead Plaintiffs' Opposition to Defendants' Motions to Dismiss the First Amended Consolidated Class Action Complaint ("Coffey Decl.")).

grounds." *See id.* at 3. Although the SEC also speculated that the Supreme Court would not find § 12(a)(2) to be applicable (in light of *Gustafson*), it took pains to explain the factual differences between the *Safety-Kleen* case (which involved a Rule 144A offering) and *Gustafson* (which did not), and indicated that the SEC's preference would be for § 12(a)(2) to apply in the Rule 144A/Exxon Capital exchange environment. *See id.* at 2-3. Federal courts should give deference to the SEC's interpretation of its own rules (including Rule 144A).[21] Given the differences between this case and *Gustafson*, as well as all of the facts weighing in favor of a finding that the Rule 144A Bonds were sold in a public offering, the Court should not dismiss as a matter of law Count I of the Complaint.

b. Alternatively, the Entire Two-Step Offering Was a Public Offering

Even if the Court were to find that the initial offering of the Rule 144A Bonds was not a public offering, Count I states a viable § 12(a)(2) claim because the entire Rule 144A/Exxon Capital exchange offer should be viewed as a single, integrated transaction that constitutes a public offering. Indeed, the purpose and end result of the transactions was to transmit unrestricted, publicly-tradable securities into the marketplace.

The federal courts have long applied the principle of integration to ensure that the Securities Act is applied in accordance with the economic substance of related transactions when transactions are separate only in form. *See, e.g., S.E.C. v. North Am. Research & Dev. Corp.*, 424 F.2d 63, 70-71 (2d Cir. 1970) (integration principle used to apply law to "substance of the transaction," treating separate acts as "jointly conceived and jointly consummated"); *SEC v. Cavanagh*, 1 F. Supp. 2d 337, 363-67 (S.D.N.Y. 1998) (although the transactions at issue were

[21] *See Chevron U.S.A. Inc. v. Natural Res. Defense Council, Inc.,* 467 U.S. 837, 844 (1984); *SEC. v. Cavanagh*, 445 F.3d 105, 114 n.20 (2d Cir. 2006).

meticulously timed and documented to appear as being separate so as to fall within an exemption from registration, court applied the integration principle and concluded that no exemption was applicable). Integration is particularly appropriate when "two allegedly separate transactions ... [are] one in the minds of the individuals who structured them," are "part of a single plan of financing," and "shared the same general purpose." *Cavanagh,* 1 F. Supp. 2d at 364-65.

The integration principle applies to Refco's Rule 144A/Exxon Capital exchange offer. Plaintiffs have alleged that the two steps of the Bond Offering constituted a single plan of financing, and were for the same general purpose: "to obtain rapid access to the public capital markets in order to obtain funds at a costs of capital corresponding to registered, freely tradable securities." ¶ 100. The Rule 144A Bonds were priced as if they were registered securities, in anticipation of the second step exchange offer that was part and parcel of the entire transaction. ¶ 103. Absent the understanding that the exchange offer would occur, Plaintiffs would not have purchased the Rule 144A Bonds. ¶ 104. Under the circumstances, the policy of investor protection is fostered by application of § 12(a)(2) liability based on false statements in the Offering Memorandum, since the Offering Memorandum was an integral part of the transaction that ultimately brought publicly tradable securities into the marketplace.

Admittedly, a few districts courts have declined to apply integration principles to Rule 144A/Exxon Capital exchange offers and have dismissed § 12(a)(2) claims arising out of those offerings. *See American High-Income Trust v. AlliedSignal*, 329 F. Supp. 2d 534 (S.D.N.Y. 2004); *In re Hayes Lemmerz Int'l, Inc. Equity Sec. Litig.,* 271 F. Supp. 2d 1007 (E.D. Mich. 2003).[22] However, no Court of Appeals has ever addressed this issue, and Plaintiffs respectfully

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[22] Although the court in *In re Safety-Kleen Corp. Bondholders Litig.,* No. 3:00-1145-17, 2002 WL 32349819 (D.S.C. Mar. 27, 2002) rejected the integration principle, its opinion addresses that issue in the

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submit that these district courts reached the wrong result. For example, in *American High-Income Trust*, the court cited and adopted the reasoning of *Livent* (which addressed integration in the § 11 context *only*):

> To import underwriter liability for entities that serve as initial purchasers prior to an Exxon Capital Exchange would render Rule 144A ineffective for a very substantial number of securities transactions and defeat the capital market financing objections the Rule 144A exemption was designed to achieve, *a fact which would undoubtedly have been known and addressed by the promulgators of Rule 144A if such a major exception was intended.*

329 F. Supp. 2d at 541 (emphasis added) (quoting *Livent,* 151 F. Supp. 2d at 431-32). However, the "promulgator[] of Rule 144A" – the SEC – has said that it never anticipated that Rule 144A would relieve parties from liability under § 12(a)(2). Thus, its "failure" to address this issue when promulgating Rule 144A cannot be construed as consent to an exemption from § 12(a)(2) liability, or as support for the conclusion that Rule 144A/Exxon Capital transactions should not be integrated for § 12(a)(2) purposes. In fact, as discussed above, the SEC believes that § 12(a)(2) *should* be applicable to these transactions.[23]

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context of § 11 only. *See id.* at *1. Its dismissal of the plaintiffs' § 12(a)(2) claim was premised on the notion that: (1) there was no public offering because the offering was only open to QIBs; and (2) Rule 144A provides that offerings to QIBS "shall not be deemed to have been offered to the public." *Id.* at *2. On the first point, the court's holding ignores the well-established rule that an offering need not be open to the entire world to be public. *Ralston Purina,* 346 U.S. at 123. On the second point, as discussed above, Rule 144A only says that securities sold thereunder "shall not be deemed to have been offered to the public *within the meaning of section 4(3)(A) of the [Securities] Act.*" 17 C.F.R. § 230.144A(c) (emphasis added).

[23] Judge Swain's statement in *American High-Income Trust* that "offerings under Rule 144A are by definition non-public" is misplaced for the same reason. The SEC has explained that, to the extent Rule 144A refers to offerings thereunder as non-public, those references were not intended to preclude liability under § 12(a)(2), because Rule 144A was promulgated prior to *Gustafson*, when the SEC had no reason to expect that the Supreme Court would later import a "public offering" requirement into § 12(a)(2). *See* SEC *Amicus* Letter at 3. In *Hayes Lemmerz,* the court noted that the plaintiffs had argued for integration, but then the Court failed to address the issue and dismissed the § 12(a)(2) claim on other grounds – *i.e.,* that "Rule 144A expressly provides that offerings to QIBs are private, and *Gustafson* limits §12(a)(2) liability to public offerings..." 271 F. Supp. 2d at 1029. However, as discussed above, Rule 144A's provisions relate only to § 5 of the Securities Act, so its language is irrelevant to § 12(a)(2). *See* 17 C.F.R. § 230.144A, Preliminary Note 1. *See also* SEC *Amicus* Letter, at 3 ("when the Commission in

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2. The Offering Memorandum Was a Prospectus

According to the Supreme Court, the term "prospectus" has the same meaning for purposes of § 12(a)(2) as in § 10 of the Securities Act. *Gustafson*, 513 U.S. at 570. Section 10 states that a prospectus "shall contain the information contained in the registration statement …." 15 U.S.C. § 77j(a)(1). As alleged in the Complaint, the Offering Memorandum was prepared in anticipation of its being used as the foundation for the Bond Registration Statement, and it contained all of the information that would be required in a registration statement or a § 10 prospectus. ¶¶ 101, 105, 272. This has become the standard industry practice for these types of offerings, and is what Rule 144A bond investors expect and demand as a condition of their participation. *See* Latham & Watkins Comment Letter on the "Aircraft Carrier," 1150 PLI/Corp. 409, 418 (Nov. 1999) ("The practice of making the Rule 144A offering memorandum conform in all material respects with the requirements for a prospectus included in a registration statement on Form S-1 is driven by (1) the demands from the QIBs to have all material information, (2) the reputation of the initial purchasers (often investment banks) which typically act as market makers after the Rule 144A offering and (3) liability concerns.") (footnote omitted).

Although the Offering Memorandum states that it is "personal to the offeree" and "does not constitute an offer … to the public generally," Defendants' inclusion of these self-serving statements in the document does not change its nature. Given that the Offering Memorandum contained the information required of a registration statement and the bonds were issued and sold in a public offering, Defendants' motion to dismiss the bond purchasers' § 12(a)(2) claim should be denied.

1990 characterized a Rule 144A offering as not involving a public offering, it did so for purposes of Section 5 and not the liability provision in Section 12(a)(2)").

C. Plaintiffs' § 11 Claim on Behalf of Bond Purchasers (Count III) Should Not Be Dismissed

Section 11 of the Securities Act provides a private right of action to persons who acquire securities that have been registered pursuant to a registration statement containing materially untrue statements. 15 U.S.C. § 77k(a). Plaintiffs assert claims pursuant to § 11 based on materially incorrect statements and omissions in both the Bond Registration Statement and the IPO Registration Statement. Aside from Grant Thornton's misguided Rule 9(b) argument, none of the Defendants has moved to dismiss the § 11 claim based on the IPO Registration Statement (Count V), and although several have moved against the § 11 claim based on the Bond Registration Statement (Count III), those motions are limited to only certain aspects of the claim. Specifically, the Bond Underwriter Defendants contend that they are not subject to liability as "underwriters," and certain other Defendants contend that the § 11 claim should be available only to those Class members who purchased Registered Bonds in the open market, not those who acquired their Registered Bonds in the Exxon Capital exchange offer.[24]

As discussed below, Defendants' motions to dismiss Count III should be denied in their entirety. However, even if those motions were to be granted, Count III should proceed in so far as it is asserted on behalf of Class members who purchased Registered Bonds in the open market after the effective date of the Registration Statement. No one other than the Bond Underwriter Defendants has moved to dismiss Count III as against those Class Members.

[24] This argument is asserted by Defendants Sexton, Klejna, Grant Thornton, the THL Individual Defendants and the Audit Committee Defendants.

1. The Bond Underwriter Defendants Are "Underwriters" for Purposes of § 11

Investment banks such as the Bond Underwriter Defendants play a critical role in the marketing and sale of securities to investors. In recognition of this fact, § 11 expressly provides that "every underwriter with respect to [a] security" can be held liable if the security is issued pursuant to a registration statement containing material untrue statements. 15 U.S.C. § 77k. Section 2(a)(11) of the Securities Act defines the term "underwriter" to include "any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security, or *participates or has a direct or indirect participation in* any such undertaking . . . ." 15 U.S.C. § 77b(a)(11) (emphasis added). In light of § 11's remedial purpose of protecting purchasers from misstatements or omissions in registration statements,[25] as well as Congress's express creation of liability on the part of "participants,"[26] courts have "interpreted broadly the phrases 'participate in' and 'participation'" when applying the definition of an "underwriter." *Harden v. Raffensperger, Hughes & Co.,* 65 F.3d 1392, 1400 (7th Cir. 1995) (citing *Pinter v. Dahl*).

Despite having been paid as underwriters and having performed the functions of underwriters in connection with the Bond Offering – including contacting potential investors, organizing road shows, preparing the offering documents, and conducting a "due diligence" investigation[27] (¶¶ 107, 144, 147, 153, 273, 307) – the Bond Underwriter Defendants seek to

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[25] *See Ernst & Ernst v. Hochfelder,* 425 U.S. 185, 195 (1976).

[26] *See Pinter v. Dahl*, 486 U.S. 622, 650 n.26 (1988) ("Congress knew of the collateral participation concept and employed it in the Securities Act…. Liabilities and obligations expressly grounded in participation are found elsewhere in the Act, *see, e.g.,* 15 U.S.C. § 77(b)(11) (defining 'underwriter' … as including direct and indirect participants…)").

[27] According to a submission to the SEC by BAS, Credit Suisse, and thirteen other leading investment banks, "initial purchasers [*i.e.*, the investment banks who underwriter Rule 144A offerings] and their counsel typically perform substantially the same due diligence review of the issuer for a Rule 144A

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avoid § 11 liability by claiming that their involvement was limited to the sale of the Rule 144A Bonds, and that they were not underwriters of the Registered Bonds. Their motion to dismiss should be denied due to their substantial roles in the process leading up to the issuance of the Registered Bonds, including their involvement in the preparation of the Bond Registration Statement and further involvement with soliciting investors to participate in the offering.[28]

The Bond Underwriter Defendants prepared the Offering Memorandum for the Rule 144A Bonds, knowing that it would be used as the foundation of the Bond Registration Statement. ¶ 153; *see also* ¶ 307. In addition, Plaintiffs allege that the Bond Underwriter Defendants *participated in the preparation of the subsequent Bond Registration Statement itself.* ¶¶ 153, 307.[29] The Bond Underwriter Defendants identified potential investors and invited them to the Bond Road Shows, where they solicited them to participate in both steps of the Bond Offering. ¶¶ 106, 144-145. The Bond Underwriter Defendants then purchased the Rule 144A Bonds from the issuers with a view toward immediately reselling them to investors, and distributed them to investors with the understanding and expectation that the Rule 144A Bonds

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offering that they would for an offering registered with the Commission." Latham & Watkins Comment Letter on the "Aircraft Carrier," 1150 PLI/Corp. at n.22.

[28] The Bond Underwriter Defendants also contend that § 11 applies only to public offerings. *See* 144A Def. Mem. at 8. However, the cases they cite do not say § 11 requires a public offering, only that it applies only to transactions in *registered* securities. Count III is asserted only on behalf of those who acquired Registered Bonds.

[29] Plaintiffs' allegation of the Bond Underwriter Defendants' direct participation in the preparation of the Bond Registration Statement distinguishes this case from *In re Livent, Inc. Noteholders Sec. Litig.*, 151 F. Supp. 2d 371 (S.D.N.Y. 2001); *In re Safety-Kleen Bondholders Litig.*, No. 3:00-1145-17, 2002 WL 32795850 (D.S.C. Sept. 9, 2002); and *American High-Income Trust*, 329 F. Supp. 2d 534 (S.D.N.Y. 2004). In *Livent*, there was no allegation that the investment bank defendants were directly involved in the preparation of the registration statement or in the subsequent exchange for registered securities of unregistered securities. 151 F. Supp. 2d at 432. In *Safety-Kleen*, the court followed *Livent* and dismissed the plaintiffs' § 11 claim where "the Amended Complaint fail[ed] to allege that Defendants participated in the preparation of the registration documents at all." *Id.* at *2. Likewise, in *American High-Income Trust*, the plaintiffs "[did] not allege that [the investment banks] were involved in the preparation of the Registration Statement." 329 F. Supp. 2d at 542.

would later be exchanged for Registered Bonds. ¶¶ 102, 307. These allegations of the Bond Underwriter Defendants' "direct or indirect participation" in the offer, sale and distribution of the Registered Bonds are sufficient to state a claim against them for § 11 "underwriter" liability.

The case of *OCM Principal Opportunities Fund, L.P., et al. v. CIBC World Mkts. Corp., et al.,* Case BC 229 069, slip op. at 3 (Cal. Super. Sept. 21, 2000),[30] is instructive on this issue. In that case, the plaintiffs were purchasers of registered securities that were issued in the second step of a Rule 144A/Exxon Capital exchange offer. When the plaintiffs asserted a § 11 claim against the investment bank that underwrote the Rule 144A offering, the bank sought dismissal of the claim on the basis that it was not an underwriter of the exchange offer. The court refused to dismiss the claim, where (as in this case) the plaintiffs alleged that: both sets of securities should be viewed as a single integrated offering; the investment bank had drafted the offering memorandum and the registration statement; the purchasers of the Rule 144A securities were told that those securities "would shortly be replaced by freely tradeable securities;" and "these assurances contributed substantial additional value" to the Rule 144A securities. *Id.* at 3-4. *See also Harden*, 65 F.3d at 1399-1403 (affirming denial of motion to dismiss § 11 claim against "qualified independent underwriter," even though it had neither purchased notes with a view to distribution nor offered or sold notes in connection with distribution, where the defendant assisted in preparation of registration statement and otherwise fulfilled the role of an underwriter); *Activision*, 621 F. Supp. at 424 ("Professionals and underwriters who participate in

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[30] A copy of this decision is attached as Exhibit B to the Coffey Decl.

the preparation of the registration statement are liable [under § 11] subject to due diligence and reasonable investigation defenses.").[31]

The Bond Underwriter Defendants attempt to take refuge in the SEC's *Exxon Capital* no-action letter as "specifically confirm[ing] … that investment banks that participate in private placements do not incur Securities Act liability when issuers thereafter exchange those privately placed notes for registered securities." *See* 144A Def. Mem. at 11. That is a mischaracterization of what the no-action letter says. The *Exxon Capital* letter has nothing to do with the application of the Securities Act to investment banks in the Bond Underwriter Defendants' position. Rather, the only guidance sought from or given by the SEC was on whether "Exchange Offerees" – *i.e.*, non-underwriter *investors* like Plaintiffs in this case – could resell the securities received in the second-step exchange offer without further registration or prospectus delivery. *See Exxon Capital Holdings Corp.,* SEC No-Action Letter, 1988 WL 234336, at *1, *3 (publicly available May 13, 1986). Therefore, the Bond Underwriter Defendants' claim that "[t]he SEC Division of Corporate Finance confirmed that the investment banks that participated in the private placement were not underwriters of the exchange offer" is wrong. *See* 144A Def. Mem. at 11.

The Bond Underwriter Defendants also err in citing *Herman & MacLean v. Huddleston,* 459 U.S. 375 (1983), *In re N.Y. City Shoes Securities Litigation,* 1988 WL 80125 (E.D. Pa. July 9, 1988), and *Escott v. BarChris Construction Corp.,* 283 F. Supp. 643 (S.D.N.Y. 1968), for

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[31] Although the defendants in *Activision* were held not to be statutory underwriters, that situation was different from that of the Bond Underwriter Defendants in this case. The defendants in *Activision* were not investment banks that participated in the preparation of a registration statement, but merely venture capital firms who sold shares to the underwriters, which the underwriters then sold to investors. 621 F. Supp. at 419, 424. The language of *Activision* suggests that, had the defendants been involved in the preparation of the registration statements as the Bond Underwriter Defendants were in this case, they may have been deemed to be underwriters. *See id.* at 424 ("In their capacity as selling shareholders they do not participate in the registration statement process. On these facts no purpose is served in holding them liable under § 11.").

the proposition that participation in the preparation of a registration statement does not give rise to § 11 liability. *See* 144A Def. Mem. at 9-10. As discussed above, Plaintiffs' allegations rest on more than the Bond Underwriter Defendants' role in preparing the Bond Registration Statement. In any event, those cases are inapposite because they did not involve defendants who were alleged to be underwriters. In *Herman & MacLean v. Huddleston*, the court merely noted in *dicta* that there are categories of persons – such as corporate officers – who may assist in preparing a registration statement yet may be beyond the reach of § 11 because they do not fall within the statutory categories of potential defendants. 459 U.S. at 386 n.22. In *N.Y. City Shoes* and *BarChris*, the courts determined that the plaintiffs' allegations against attorneys who prepared registration statements were not sufficiently pleaded. *See N.Y. City Shoes*, 1988 WL 80125, at *2; *BarChris*, 283 F. Supp. at 683. Those opinions are irrelevant to the liability of *underwriters* in this case.

The few cases the Bond Underwriter Defendants cite that actually address the definition of an "underwriter" also do not support their position. In *McFarland v. Memorex Corp.,* 493 F. Supp. 631 (N.D. Cal. 1980), the defendants were warrantholders who sold their warrants to underwriters who then exercised the warrants and distributed the stock to investors. The court held that the warrantholders were not "underwriters" for purposes of § 11 because: (a) they did not purchase securities with a view to distribution; (b) they did not offer or sell any securities on behalf of the issuer; (c) they never owned the stock and thus bore no risk of being unable to sell the stock to the public; (d) they earned no commission on the sale of stock to compensate for the risk of not selling them; and (e) they had no role in preparing the registration statement. *Id.* at 644-46. Similarly, in *Ingenito v. Bermec Corp.,* 441 F. Supp. 525 (S.D.N.Y. 1977), the defendant was found not to be an "underwriter" where it was not alleged to have: (a) purchased

a security with an eye to redistribution; (b) sold a security; or (c) acted on behalf of the issuer "by paving the way for a public sale." *Id.* at 535-36. The facts of this case are entirely different. The Bond Underwriter Defendants: (a) purchased Refco securities with an eye to distribution; (b) sold those securities to investors; (c) bore the risk of being unable to sell the securities (because they had already purchased them and would be left holding them); (d) were compensated for their services by the difference between the offering price and the discounted price at which they purchased the bonds from the issuer; (e) participated in preparation of the Bond Registration Statement; and (f) acted on behalf of the issuer to "pave the way" for a public sale of Registered Bonds. ¶¶ 101-02, 153, 307. These are quintessentially the actions of "underwriters" and the Bond Underwriter Defendants should be held accountable as such.

2. Section 11 Claims Are Available to Class Members Who Acquired Their Bonds in the Exxon Capital Exchange

Section 11 provides an express private right of action, and unlike many provisions of the federal securities laws, it does not limit that cause of action to "purchasers" and "sellers" of securities. Rather, § 11 provides a right of action to any person "acquiring" a security that has been issued pursuant to a registration statement containing an untrue statement of material fact or omitting to state a material fact. 15 U.S.C. § 77k(a). This includes not only purchasers of registered securities, but also those who acquire them by other means, such as in an exchange for other securities in a stock-for-stock merger. *See, e.g., In re Interpublic Sec. Litig.,* No. 02 Civ. 6527 (DLC), 2003 WL 21250682, **6-9 (S.D.N.Y. May 29, 2003); *Giarraputo v. UNUMProvident Corp.,* No. 99-301-PC, 2000 WL 1701294, at *8 (D. Me. Nov. 8, 2000); *In re Cendant Corp. Litig.,* 60 F. Supp. 2d 354, 365-66 (D.N.J. 1999).[32]

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[32] *Cf.* 15 U.S.C. § 77*l*(a) (Section 12(a)(2) of the Securities Act provides right of action to "the person purchasing the security" from the defendant); 15 U.S.C. § 78r (Section 18 of the Exchange Act provides

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None of the Defendants disputes that those Class members who purchased Registered Bonds in the secondary market have standing to assert § 11 claims. However, certain Defendants have moved to dismiss the § 11 claims against them to the extent they are asserted on behalf of Class members who purchased Rule 144A Bonds and then exchanged them for Registered Bonds. Unquestionably, these Class members "acquired" bonds issued pursuant to the Bond Registration Statement. Nonetheless, Defendants seek to deprive them of a cause of action pursuant to § 11 by arguing that they made no new investment decision when they exchanged their bonds, and thus the untrue statements in the Bond Registration Statement could not have been material to them and could not have caused them damage. However, this argument presupposes that § 11 requires an investment decision to be made based upon the registration statement. It does not. Section 11 does not require proof of reliance on the registration statement unless the plaintiff acquired the security after the issuance of an earnings statement covering at least a one-year period after the effective date of the registration statement. 15 U.S.C. § 77k(a). That requirement is not triggered here, where the Company entered bankruptcy less than a year after the Bond Registration Statement took effect.

In *In re Cendant Corp. Litigation,* the defendants made an analogous argument to that made by Defendants here: that class members who acquired shares in a stock-for-stock merger but who were ineligible to vote on the merger (and thus made no investment decision) lacked standing to assert a § 11 claim. 60 F. Supp. 2d at 365. The court rejected that argument, finding that § 11 expressly permits "any person acquiring such security" to file suit, and that neither the

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right of action to "any person … who, in reliance upon such [false or misleading statement] shall have purchased or sold a security at a price which was affected by such statement"); 15 U.S.C. § 78t-1(a) (Section 20A of the Exchange Act provides right of action to "any person who, contemporaneously with the purchase or sale of securities that is the subject of such violation, has purchased … or sold … securities of the same class).

statute nor the case law required the acquirer to have voting rights. *Id.* at 366. Likewise, in this case, Plaintiff PIMCO and other Class members "acquired" Registered Bonds in an Exxon Capital exchange offer. The fact that the exchange did not involve a new investment decision should not deprive them of the right to sue under § 11.

Defendants' cited cases do not dictate a contrary result. In *Barnes v. Osofsky*, 373 F.2d 269 (2d Cir. 1967), and *Abbey v. Computer Memories, Inc.,* 634 F. Supp. 870 (N.D. Cal. 1986), there were already shares of stock outstanding when registration statements containing false statements were filed for the issuance of more shares of the same class of stock. The courts held that § 11 claims could not be brought by persons who could not establish that their shares were issued pursuant to the false registration statements. Such "tracing" is not an issue in this case, where the § 11 claim is limited to those Class members who acquired Registered Bonds issued pursuant to the Bond Registration Statement and there were no Registered Bonds previously outstanding.

Defendant Sexton's citation to *Blau v. Max Factor & Co.,* 342 F.2d 304 (9th Cir. 1965), is also off the mark. There, the issue was whether corporate insiders' exchange of common stock for Class A stock was a "purchase" of the Class A stock for purposes of the § 16(b) requirement that insiders disgorge profits realized on the purchase and sale of securities within a six month period. Thus, the court was interpreting the term "purchase" rather than "acquire," and it did so within the context of the purpose of § 16(b) – *i.e.,* to preclude the unfair use of inside information when engaging in short-term trading in securities. *Id.* at 306-08. The court held that the exchange was merely an extension of the insiders' long-term investment, and that treating it as a "purchase" for § 16(b) purposes would not further the statutory goal of deterring insider profiteering through short-term trading. *Id.* at 308-09. This holding is irrelevant to this case.

Likewise, Grant Thornton's reliance on *Dwoskin v. Rollins, Inc.,* 634 F.2d 285 (5th Cir. 1981), and *Elfenbein v. American Financial Corp.,* 487 F. Supp. 619 (S.D.N.Y. 1980), is misplaced. In those cases, the courts found that the plaintiffs' decisions to convert their preferred shares to common shares (in *Dwoskin*) or to accept stock in a merger (in *Elfenbein*) would not have been affected by disclosure of the alleged true facts, and therefore the alleged untrue statements and omissions were immaterial. Grant Thornton argues that, because Plaintiffs have not explained how a reasonable investor might have acted differently if the truth were disclosed in this case, their § 11 claim should be dismissed. *See* GT Mem. at 23. To the extent Grant Thornton is trying to create a reliance requirement, it should fail; Section 11 does not require reliance. Nonetheless, it is certainly reasonable to infer from Plaintiffs' allegations in this case – which include numerous untrue statements regarding the Company's financial condition and the omission of hundreds of millions of dollars of uncollectible receivables, related party transactions and guarantees from the Bond Registration Statement (¶¶ 118, 153, 161) – that a jury could find those statements and omissions to be material, and that there is a substantial likelihood that a reasonable investor would consider that information important when deciding whether to purchase the bonds and exchange them for Registered Bonds.

The only case Defendants cite that involves the same issue as this case is *In re Safety-Kleen Bondholders Litigation*, No. 3:00-1145-17, 2002 WL 32349819 (D.S.C. Mar. 27, 2002). There, the court found that a § 11 claim could not be maintained by persons who acquired registered bonds in the Exxon Capital exchange, because: (a) no damages could be demonstrated; and (b) no reliance on the registration statement could be shown. On reconsideration, the court struck the reference to reliance, acknowledging that there is no such requirement under § 11. *In re Safety-Kleen Bondholders Litig.*, No. 3:00-1145-17, 2002 WL

32795741, at *2 (D.S.C. June 14, 2002). The court also acknowledged that those who purchased registered bonds after the effective date of the registration statement were eligible to recover under § 11 – a fact which most Defendants do not dispute here. To the extent the *Safety-Kleen* court declined to alter its prior opinion that investors who participated in the Exxon Capital exchange could not pursue § 11 claims, Plaintiffs respectfully submit that it reached the wrong decision and that this Court should reach a different result.[33]

D. The Complaint Adequately Pleads Claims for Control Person Liability Under § 15 of the Securities Act (Counts IV, VI and VII)

1. The Complaint Adequately Alleges Primary Violations of the Securities Act by the Controlled Persons

There is no question that Plaintiffs have alleged primary violations of §§ 11 and 12(a)(2) of the Securities Act by Refco. As the issuer of securities in the IPO and in the Bond Offering, Refco is subject to strict liability for false statements in the IPO Registration Statement and in the Bond Registration Statement. *See In re Ames Dept. Stores Inc. Stock Litig.*, 991 F.2d 953, 961 (2d Cir. 1993); *Monroe v. Hughes*, 31 F.3d 772, 774 (9th Cir. 1994); *Milman v. Box Hill Sys. Corp.*, 192 F.R.D. 105, 106 n.3 (S.D.N.Y. 2000). Defendants have not moved to dismiss many

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[33] The fact that Class members who exchanged their Rule 144A Bonds paid no new consideration for the Registered Bonds should not be a bar to recovery under § 11. Although the issue of damages is premature at this stage, for purposes of determining these Class members' damages under § 11, the Rule 144A Bonds and the Registered Bonds should be viewed as a single security, such that the price Class members paid to acquire the Rule 144A Bonds is deemed to be the acquisition price of the Registered Bonds. After all, those Class members purchased the Rule 144A Bonds based on the understanding that they would temporarily hold unregistered bonds but that they would ultimately receive Registered Bonds. Because § 11 does not require reliance on the Bond Registration Statement, it should not matter that Plaintiffs' consideration was paid prior to the issuance of the Bond Registration Statement. The Class members paid hundreds of millions of dollars to purchase what they understood, in the end, would be Registered Bonds, and they should be allowed to recover under § 11 the damages they sustained when the Bond Registration Statement turned out to contain material untrue statements and omissions. As the First Circuit stated in *Versyss Inc. v. Coopers & Lybrand*, 982 F.2d 653, (1st Cir. 1992): "In passing § 11 Congress wished to control unsound and fraudulent business practices. Whether an acquisition occurs pursuant to a simple sale or a complex merger, the threat of such practices exists, and § 11 should protect all innocent purchasers against them."

of these claims. To the extent that Defendants have asserted challenges to Plaintiffs' §§ 11 and 12(a)(2) claims that would arguably apply to Refco, those challenges are without merit and should be rejected, as discussed above. Therefore, Plaintiffs have alleged primary violations of the Securities Act by Refco, which form the foundation of Plaintiffs' Section 15 claims for "control person" liability.

2. The Complaint Adequately Alleges Defendants' Control of Refco

"Control entails 'the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise.'" *In re Global Crossing, Ltd. Sec. Litig.*, No. 02 Civ. 910 (GEL), 2005 WL 2990646, at *8 (S.D.N.Y. Nov. 7, 2005) (quoting *S.E.C v. First Jersey Sec., Inc.*, 101 F.3d 1450, 1472-73 (2d Cir. 1996) (quoting 17 C.F.R. § 240.12b-2)); *see also* 17 C.F.R. § 230.405. In this Circuit, control "'requires only the ability to direct the actions of the controlled person, and not the active exercise thereof.'" *In re Flag Telecom Holdings, Ltd. Sec. Litig.*, 352 F. Supp. 2d 429, 458 (S.D.N.Y. 2005) (quoting *Dietrich v. Bauer*, 126 F. Supp. 2d 759, 764 (S.D.N.Y. 2001)) (internal quotations omitted); *see In re JWP Inc. Sec. Litig.*, 928 F. Supp. 1239, 1260 (S.D.N.Y. 1996). Thus, control only requires some "'indirect means of discipline or influence short of actual direction'" to hold a controlling person liable. *Landry v. Price Waterhouse Chartered Accountants*, 715 F. Supp. 98, 102 n.11 (S.D.N.Y. 1989) (quoting *Myzel v. Fields*, 386 F.2d 718, 738 (8th Cir. 1967)). Such "indirect means of discipline or influence need not be stock ownership. It may arise from other business relationships, interlocking directors, family relationships and a myriad of other factors." *Drobbin v. Nicolet Instrument Corp.*, 631 F. Supp. 860, 885 (S.D.N.Y. 1986) (internal quotation marks omitted); *accord Strougo ex rel. Brazil Fund v. Scudder, Stevens & Clark, Inc.*, 964 F. Supp. 783, 806 (S.D.N.Y. 1997).

a. Control Is a Factual Issue That Should Not Be Resolved on a Motion to Dismiss

The question of control "is necessarily fact intensive and cannot be resolved on these motions" to dismiss. *In re Executive Telecard, Ltd. Sec. Litig*., 913 F. Supp. 280, 286 (S.D.N.Y. 1996); *No. 84 Employer-Teamster Joint Council Pension Trust v. America W. Holding Corp*., 320 F.3d 920, 945 (9th Cir.), *cert. denied,* 540 U.S. 966 (2003) (reversing order granting motion to dismiss); *Hayes Lemmerz,* 271 F. Supp. 2d at 1022-23 ("whether one is a control person is a factual question;" denying motion to dismiss); *In re Oxford Health Plans, Inc. Sec. Litig*., 187 F.R.D. 133, 143 (S.D.N.Y. 1999) (control is "fact intensive" question for a jury); *Terrydale Liquidating Trust v. Barness*, 611 F. Supp. 1006, 1023 (S.D.N.Y. 1984) (determination of whether there is control "must be made at trial"); *S.E.C. v. Franklin Atlas Corp*., 154 F. Supp. 395, 400 (S.D.N.Y. 1957) ("The question of control is a factual question."). Thus, the issue of control "is not ordinarily subject to resolution on a motion to dismiss" and "dismissal is appropriate only when a plaintiff does not plead any facts from which it can reasonably be inferred the defendant was a control person." *In re MicroStrategy, Inc. Sec. Litig*., 115 F. Supp. 2d 620, 661 (E.D. Va. 2000).

b. Allegations of Control Are Subject to the Notice Pleading Requirements of Rule 8(a)

"[T]he relaxed notice-pleading standard of Rule 8(a) applies to allegations of control," *In re Global Crossing,* No. 02 Civ. 910 (GEL) 2006 WL 1628469, at *11 (S.D.N.Y. June 13, 2006), since "the allegation of control is not an averment of fraud and therefore need not be made with

particularity." *Neubauer v. Eva-Health USA, Inc.*, 158 F.R.D. 281, 284-85 (S.D.N.Y. 1994); *accord In re Parmalat Sec. Litig.*, 383 F. Supp. 2d 616, 627 & n.53 (S.D.N.Y. 2005).[34]

Plaintiffs' control allegations should be viewed in the aggregate. Defendants approach the issue of control by addressing each fact in isolation, such as a Defendant's minority stock ownership, or position as a corporate officer or director or member of the Audit Committee, and then arguing that each such fact, standing alone, is insufficient basis to infer control. This argument overlooks that Plaintiffs have pleaded multiple facts as to each Defendant, and that a court "must consider the total effect of the various indicia of control in combination," rather than examining any one fact in isolation. *In re Leslie Fay Cos., Inc. Sec. Litig.*, 918 F. Supp. 749, 763 (S.D.N.Y. 1996); *accord In re Adelphia Commc'ns Corp. Sec. & Deriv. Litig.*, 398 F. Supp. 2d 244, 262 (S.D.N.Y. 2005).

Further, Defendants' arguments rest primarily on this Court's opinion in *In re Global Crossing, Ltd. Securities Litigation*, No. 02 Civ. 910 (GEL), 2005 WL 1907005 (S.D.N.Y. Aug. 8, 2005).[35] After that decision, however, this Court held that dismissal of a control person claim "is improper as long as the complaint furnishes adequate notice of the basis of the plaintiff's claim . . . and 'relief could be granted under [some] set of facts consistent with the allegations.'" *Global Crossing*, 2005 WL 2990646, at *8 (quoting *Swierkiewicz v. Sorema N.A.*, 534 U.S. 506, 512-14 (2002)). Relying on the Second Circuit's recent decision in *Twombly v. Bell Atlantic Corp.*, 425 F.3d 99 (2d Cir. 2005), *cert. granted*, 2006 WL 1725627 (2006), this Court held that "even if the facts alleged do not, by themselves, permit an inference of control, dismissal is

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[34] Defendants do not dispute that Rule 8 applies to allegations of control. *See, e.g.*, THL/Audit Comm. Mem. at 36.

[35] *See, e.g.*, THL/Audit Comm. Mem. at 36; Sexton Mem. at 20, 23; Murphy/Sherer Mem. at 33; Bennett Mem. at 16-17; Klejna Mem. at 26; Grant Mem. at 15.

improper as long as it is at least plausible that plaintiff could develop some set of facts that would pass muster." *Global Crossing*, 2006 WL 1628469, at *9.

Therefore, contrary to Defendants' arguments that "conclusory allegations of control are insufficient as a matter of law" (Bennett Mem. at 16), "'naked allegations of control . . . will typically suffice.'" *Global Crossing*, 2005 WL 2990646, at *8 n.8 (quoting *In re Initial Pub. Offering Sec. Litig*., 241 F. Supp. 2d 281, 352 (S.D.N.Y. 2003)); *accord In re Vivendi Universal, S.A.,* 381 F. Supp. 2d 158, 187 (S.D.N.Y. 2003). A "short, plain statement that gives the defendant fair notice of the claim that the defendant was a control person and the ground on which it rests its assertion that a defendant was a control person is all that is required." *Global Crossing*, 2005 WL 2990646, at *8 n.8 (quoting *In re WorldCom, Inc. Sec. Litig*., 294 F. Supp. 2d 392, 415-16 (S.D.N.Y. 2003)); *accord In re Philip Servs. Corp. Sec. Litig*., 383 F. Supp. 2d at 485.

In any event, the allegations in the Complaint are sufficient even under a more demanding standard.

c. The Complaint Adequately Alleges Control

i. THL Partner Defendants

Plaintiffs assert control person claims against the THL Partner Defendants under § 15 with respect to the Bond Offering (Counts II and IV) and the IPO (Counts VI and VIII).[36] The THL Partner Defendants do not contest the adequacy of the Complaint's allegations as to their control of Refco.

[36] In addition, the Complaint alleges control person claims against the THL Partner Defendants under § 20(a) with respect to the Bond Offering (Counts XII and XIII) and the IPO (Count XIII).

ii. Audit Committee Defendants (O'Kelley, Gantcher and Breitman)

While the Audit Committee Defendants move to dismiss the § 15 control person claims with respect to the Bond Registration Statement (Count IV), they do not move to dismiss the § 15 control person claims with respect to the IPO (Counts VI and VIII). *See* THL/Audit Comm. Mem. at 35 n.23. These Defendants therefore challenge Plaintiffs' allegations of control only up to the time of the Bond Offering.[37]

The Complaint alleges that the Audit Committee Defendants were controlling persons of Refco Group at the time of the Bond Offering by reason of, *inter alia*, "their service on the Audit Committee of New Refco, which also performed the functions of an audit committee for Refco Group." ¶ 322; *see also* ¶ 45. Then, upon the formation of Refco, each of the Audit Committee Defendants was a director and member of the Audit Committee of Refco. ¶¶ 45, 268(a).[38]

The Complaint does not merely allege that these Defendants held such positions but also that "[a]s members of the Audit Committee, these Defendants were responsible for overseeing Refco Group's financial reporting, accounting, and internal controls; overseeing the activities of Refco Group's outside auditors and reviewing the scope and results of those audits with the auditors; and meeting with and making recommendations to the managers of Refco Group concerning the foregoing activities." ¶ 322; *see also* ¶ 268(b). The charter of the Audit

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[37] The Audit Committee Defendants also move to dismiss the § 20(a) claims against them (Counts XI, XII and XIII). While they state they are challenging whether they are control persons with respect to these claims, their brief merely refers back to their arguments in connection with the § 15 claims. *See* THL/Audit Comm. Mem. at 41. Because the Audit Committee Defendants do not challenge the § 15 claims relating to the IPO (Counts VI and VIII), *see* THL/Audit Comm. Mem. at 35 n.23, it appears that they also do not challenge the § 20(a) claim relating to the IPO (Count XIII).

[38] The Audit Committee Defendants' argument that they were not directors of the issuer but only of the issuer's corporate parent, THL/Audit Comm. Mem. at 37, misses the mark; they cannot deny that they served on the issuer's Audit Committee at the time of the Bond Offering. As discussed above, there is no dispute that the Audit Committee Defendants were control persons of Refco (and were directors of the issuer) at the time of the IPO.

Committee gave the Committee's members the responsibility for "[r]eviewing and discussing with management, internal audit and the independent auditor the adequacy and effectiveness of Refco's accounting and internal control policies and procedures." ¶ 268(d)(i). It further gave them responsibility for "meeting periodically with the general counsel, and outside counsel when appropriate, to review legal and regulatory matters, including (i) any matters that may have a material impact on the financial statements of the Company and (ii) any matters involving potential or ongoing material violations of law or breaches of fiduciary duty by the Company or any of its directors, officers, employees or agents." ¶ 268(d)(v).

Thus, the Audit Committee Defendants' assertion that Plaintiffs have not "allege[d] any facts that would allow the Court to conclude that the Audit Committee Defendants 'possessed in fact' the ability to direct the contents of the Bond Registration Statement," THL/Audit Comm. Mem. at 37, overlooks that these Defendants had the ability to control the content of the financial statements contained in the Bond Registration Statement. The Complaint specifically alleges that, as a result of their position and responsibilities, the Audit Committee Defendants "each had the power to influence and control, and did influence and control, directly or indirectly, the decision-making of Refco Group, including the content of its financial statements and of the Bond Registration Statement." ¶ 325. Indeed, the Complaint goes further and also specifically alleges that these Defendants had "approved . . . the October 12, 2004 Bond Registration Statement (including subsequent amendments) and the Company's fiscal year 2005 Form 10-K and Form 10-K/A." ¶¶ 42-44.

Plaintiffs' allegations are sufficient to give the Audit Committee Defendants fair notice of the grounds on which Plaintiffs rest their assertion that these Defendants were control persons,

and are sufficient to permit an inference of their control over the filings giving rise to Plaintiffs' claims. As stated in *In re JWP Inc. Securities Litigation*, 928 F. Supp. at 1260:

> [T]he audit committee was clearly the body charged with specific responsibility of overseeing JWP's accounting and financial reporting and, therefore with keeping JWP on the straight and narrow. A reasonable jury could find that the audit committee's recommendations would carry sufficient weight with the full Board, JWP's officers and [the outside auditor] that the audit committee had the practical ability to direct JWP's accounting policies. The audit committee defendants need not, of course, have actually exercised that authority to be held liable as control persons.

See In re Hayes Lemmerz Int'l, Inc. Equity Sec. Litig., 271 F. Supp. 2d 1007, 1029-30 (E.D. Mich. 2003) (upholding § 20(a) claim where it was alleged that "[t]he Audit Committee was intimately involved with and controlled the Company's accounting and its financial reporting, and knew facts or had access to information suggesting that the Company's financial statements, and public statements, were false"); *In re Lernout & Hauspie Sec. Litig.*, 286 B.R. 33, 39-40 (D. Mass 2002) (upholding § 20(a) claim where the audit committee had "access to [company] financial information," "frequent meetings with [the outside auditors]," and control over financial reports and SEC filings).

iii. THL Individual Defendants (Lee, Harkins, Jaeckel and Schoen)

While the THL Individual Defendants move to dismiss the § 15 control person claims with respect to the Bond Offering (Counts II and IV), they do not move to dismiss the § 15 control person claims with respect to the IPO (Counts VI and VIII). *See* THL/Audit Comm. Mem. at 35 n.23. They too, therefore, appear to challenge their control only up to the time of the Bond Offering.[39]

[39] These Defendants also move to dismiss the § 20(a) claims against them (Counts XI, XII and XIII). While they state that they are challenging whether they are control persons with respect to these claims – as with the Audit Committee Defendants – their brief merely refers back to their arguments in connection

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THL Partners acquired its 57% stake in Refco in June 2004, which was prior to the Bond Offering. The Complaint alleges that each of the THL Individual Defendants was a control person of THL Partners, and, therefore, each was a control person of Refco Group and is liable under § 15 for the Securities Act liabilities of Refco Group. As control may be indirect as well as direct, *Myzel*, 386 F.2d at 738, this is sufficient. *See also In re Parmalat Sec. Litig.*, 375 F. Supp. 2d 278, 310-11 (S.D.N.Y. 2005) (upholding § 20(a) claims against Deloitte & Touche LLP on the theory that it controlled Deloitte Touche Tohmatsu and that Deloitte Touche Tohmatsu, in turn, controlled the primary violator, Deloitte & Touche-Italy).

Plaintiffs' allegations of the THL Individual Defendants' control do not rest solely on their control of THL Partners, however, as each was an officer or director of Refco Group as well. The Complaint alleges that "Lee was a controlling person of Refco Group at the time of the Bond Offering due (among other reasons alleged in detail herein) to his position as Chairman and CEO of Thomas H. Lee Partners, and the fact that Thomas H. Lee Partners or Lee controlled each of the other THL Partners, which in turn controlled Refco Group." ¶ 292. Lee, Harkins, Jaeckel and Schoen were each directors of Refco (¶¶ 49-52) and together they constituted half of Refco Group's eight person Board of Managers. ¶¶ 263(b), 318. Each was also a senior executive of the THL Partner Defendants and hence a control person of these entities that were, in turn, control persons of Refco. *Id.* Jaeckel also participated in the nationwide road show to market the bonds to institutional investors, ¶ 51, a fact that evidences his influence over the Bond

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with the § 15 claims. *See* THL/Audit Comm. Mem. at 41. Because the THL Individual Defendants do not challenge the § 15 claims relating to the IPO (Counts VI and VIII), *see* THL/Audit Comm. Mem. at 35 n.23, it appears that they do not challenge the element of control with respect to the § 20(a) claim relating to the IPO (Count XIII).

Offering process. In addition, each of Lee, Harkins, Jaeckel and Schoen approved the Offering Memorandum for the bonds and the Bond Registration Statement. ¶¶ 49-53.

Further, control can be based on a contract. *See Global Crossing*, 2005 WL 2990646, at *8. Refco entered in a Management Agreement with THL Managers V, LLC ("THL Managers"), pursuant to which THL Managers was to advise Refco " in connection with the negotiation and consummation of agreements, contracts, documents and instruments related to [Refco's] or any of its subsidiaries finances or relationships with banks or other financial institutions" and "with respect to the development and implementation of strategies for improving the operating, marketing and financial performance of [Refco] and other senior management matters related to the business, administration and policies of [Refco] and its subsidiaries." ¶ 263(d). Lee, Harkins, Jaeckel and Schoen each provided services to Refco pursuant to this Management Agreement. ¶¶ 264(c), 265(c), 266(c), 267(c).[40]

These allegations are sufficient to give the THL Individual Defendants fair notice of the claim that they were control persons and the ground on which that assertion rests, and are sufficient to permit an inference of the THL Individual Defendants' direct or indirect means of influence over Refco Group.

[40] The THL Individual Defendants' factual arguments as to why the Management Agreement does not show control (THL/Audit Comm. Mem. at 40) simply demonstrate that there are issues that cannot and should not be adjudicated on a motion to dismiss.

iv. Sherer

Sherer was Executive Vice President and CFO of Refco. ¶ 33. The Complaint asserts § 15 claims against him relating to the Bond Offering (Counts II and IV) and the IPO (Counts VI and VIII). Sherer has not moved to dismiss these claims. *See* Murphy/Sherer Mem. at 3 n.1.[41]

v. Klejna

Klejna was Executive Vice President and General Counsel of Refco Group. ¶ 38. Plaintiffs assert control person claims against Klejna under § 15 with respect to the Bond Registration Statement (Count IV) and the IPO (Counts VI and VIII).[42] Klejna moves to dismiss all such claims against him.

Klejna signed the Bond Registration Statement. ¶ 38. This alone is sufficient basis for an allegation of control over Refco with respect to that Registration Statement. As Judge Cote stated in *In re WorldCom, Inc. Securities Litigation*, 294 F. Supp. 2d 392, 419 (S.D.N.Y. 2003):

> Where it is alleged that a defendant signed an SEC filing that contained the misrepresentations that are the subject of the Section 10(b) claim, this is sufficient to allege control of the authors of the filing, and the management and policies of the corporation behind the misrepresentations. *See, e.g.*, 17 C.F.R. §240.12b; *Thomson Kernaghan*, 2000 WL 640653, at *7; *In re Livent*, 78 F. Supp. 2d 194, 222 (while signing was presumed to reflect control, the court dismissed for failure to plead culpable participation); *Jacobs v. Coopers & Lybrand*, *LLP*, No. 97 Civ. 3374 (RPP), 1999 WL 101772, at *17 (S.D.N.Y. Mar. 1, 1999).

Chief Judge Mukasey agreed in *In re Philip Services Corp. Securities Litigation*, 383 F. Supp. 2d 463, 485 (S.D.N.Y. 2004), where he stated that it "'comport[s] with common sense to presume that a person who signs his name to a report has some measure of control over those who write the report'" (quoting *Jacobs v. Coopers & Lybrand, L.L.P.*, No. 97 Civ. 3374 (RPP), 1999 WL

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[41] The Complaint also asserts § 20(a) claims against Sherer relating to the Bond Offering (Counts XI, XII and XIII) and the IPO (Count XIII). Sherer moves to dismiss these claims on the ground of lack of culpable participation (addressed below), not lack of control. *See* Murphy/Sherer Mem. at 3 n.1.

[42] In addition, the Complaint alleges control person claims against Klejna under § 20(a) with respect to the Bond Offering (Counts XI, XII and XIII) and the IPO (Count XIII).

101772, at *18 (S.D.N.Y. Mar. 1, 1999)). *See also In re Flag Telecom Holdings, Ltd. Sec. Litig.*, 352 F. Supp. 2d 429, 457 (S.D.N.Y. 2005) (denying dismissal of § 15 claims as to all defendants who "signed the Registration Statement"); *Robbins v. Moore Med. Corp.*, 788 F. Supp. 179, 189 (S.D.N.Y. 1992); *In re Solv-Ex Corp. Sec. Litig.*, 210 F. Supp. 2d 276, 285 (S.D.N.Y. 2000).[43]

Klejna cites no cases to the contrary. Instead, he argues that the purpose of the control person provisions was to prevent those in control from evading liability by not signing documents, and therefore control cannot be inferred from the fact that a defendant signed a misleading SEC document. *See* Klejna Mem. at 25-26. Contrary to Klejna's circular argument, courts have specifically addressed the rationale behind the signing requirements and how that relates to control:

> [J]ust what is a signature on an SEC filed document meant to represent if it does not represent a degree of responsibility for the material contained in that document? The very fact that a director is required to sign these critical documents charges the director with power over the documents and represents to the corporation, its shareholders, and the public that the corporation's director has performed her role with sufficient diligence that she is willing and able to stand behind the information contained in those documents. As the SEC explained when it announced the requirement in 1980:
>
>> With an expanded signature requirement, the Commission anticipates that directors will be encouraged to devote the needed attention to reviewing the Form 10-K and to seek the involvement of other professionals to the degree necessary to give themselves sufficient comfort. In the Commission's view, this added measure of discipline is vital to the disclosure objectives of the federal securities laws, and outweighs the potential impact, if any, of the signature on legal liability.

WorldCom, 294 F. Supp. 2d at 420.

With respect to both the Bond Offering and the IPO, the Complaint further alleges that Klejna's position as Executive Vice President and General Counsel gave him a measure of

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[43] Klejna concedes that "several members of this Court" have held that signing an SEC document suggests a measure of control, Klejna Mem. at 25, but fails to mention the *WorldCom* decision.

control over Refco, and that he had direct involvement in its day-to-day operations, including its financial reporting and accounting functions. ¶¶ 321, 350, 678, 697. The Complaint's allegation of control is further based on Klejna's employment agreement with Refco, which stated that he was employed "in a key capacity" with the Company and had access to confidential information regarding the business and finances of the Company. ¶ 260(c). These allegations are sufficient to give Klejna fair notice of the claim that he was a control person and the ground on which that assertion rests.[44]

vi. Murphy

Murphy was Executive Vice President of Refco Group. ¶ 36. Plaintiffs assert control person claims against Murphy under § 15 with respect to the Bond Offering (Counts II and IV) and the IPO (Counts VI and VIII).[45] Murphy moves to dismiss all such claims against him.

Murphy signed the Bond Registration Statement. ¶ 36. As discussed above, this is a sufficient allegation for a control person claim with respect to that document, and Count IV should be sustained as to Murphy on this basis alone. Murphy acknowledges this precedent, *see* Murphy/Sherer Mem. at 35, but asserts that it should not apply to him because, according to Murphy, he "did not have any control over the transactions which caused the purported misrepresentations in the Registered Bond Offering Registration." *Id.* Thus, Murphy simply asserts that he "was shielded from the Hidden Receivables Scheme, and had no involvement in the preparation of either Refco Capital Markets' financial statements or the consolidated Refco financial statements." *Id.* These factual assertions must be disregarded, because on a Rule

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[44] Klejna correctly points out that he did not sign the IPO Registration Statement. Klejna Mem. at 7 n.9. It is for this reason he is not charged with §11 liability with respect to the IPO in Count V.

[45] In addition, the Complaint alleges control person claims against Murphy under § 20(a) with respect to the Bond Offering (Counts XII and XIII) and the IPO (Count XIII).

12(b)(6) motion to dismiss, the Court may not "rel[y] on factual allegations contained in legal briefs." *Friedl v. City of N.Y.*, 210 F.3d 79, 83-84 (2d Cir. 2000); *accord Fonte v. Bd. of Managers of Cont'l Towers Condo*., 848 F.2d 24, 25 (2d Cir. 1998). It is settled law that on a motion to dismiss, rather than accepting the version of the facts set forth in defendants' brief, the Court "accepts as true all allegations in the complaint and draws all reasonable inferences in the plaintiff's favor." *In re NTL Sec. Litig*., 347 F. Supp. 2d 15, 21 (S.D.N.Y. 2004).[46]

The Complaint alleges that Murphy "prepared and approved the Offering Memorandum for the Bonds, the Company's August 2005 IPO Registration Statement and the Company's fiscal year 2005 Form 10-K and Form 10-K/A," ¶ 36, and that he also "prepared, approved and signed the Company's October 12, 2004 Bond Registration Statement (including subsequent amendments)." *Id.* In addition, the Complaint alleges that Murphy had direct involvement in the Company's day-to-day operations, including its financial reporting and accounting functions. ¶¶ 321, 350, 662, 678, 697. Such allegations of control are sufficient. *See In re Solv-Ex Corp. Sec. Litig*., 210 F. Supp. 2d 276, 285 (S.D.N.Y. 2000) (upholding control person claim where complaint alleged that the defendants "participated 'in the day to day operations of the Company at the highest levels'" and "'participated in the drafting, preparation and or approval of the various public and shareholder and investor reports and other communications'").[47] The

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[46] Relying on *Global Crossing*, 2005 WL 1875445, at *7, Murphy argues that control means "control over the transaction in question," Murphy/Sherer Mem. at 32, but he misconstrues what this means. While Murphy argues that he did not have "control over the Hidden Receivables Scheme," Murphy/Sherer Mem. at 34, the relevant transactions here are the SEC filings giving rise to Plaintiffs' claims – the Bond Offering Memorandum, the Bond Registration Statement, and the IPO Registration Statement. Control in this case must be evaluated in terms of control over those documents and their contents, not control of the underlying circular transactions and loans themselves.

[47] Numerous other decisions similarly have refused to dismiss control person claims where control is premised on allegations that the defendant had direct involvement in the day-to-day operations of the company. *See, e.g., Parmalat*, 414 F. Supp. 2d at 440 (upholding control person claim alleging that the defendant "had direct involvement in the day-to-day operations" of the controlled entities); *Adelphia*, 398

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Complaint's allegation of control is further based on Murphy's employment agreement with Refco, which stated that he was employed "in a key capacity" with the Company and had access to confidential information regarding the business and finances of the Company. ¶ 260(c).

These allegations are sufficient to give Murphy notice of the claim that he was a control person and the ground on which that assertion rests with respect to all of the control person claims asserted against him and are sufficient to permit an inference of his control over the filings giving rise to Plaintiffs' claims.

vii. <u>Sexton</u>

Sexton joined Refco Group in April 1999, and served as Executive Vice President and Chief Operating Officer (COO) of Refco, LLC, a Refco Group subsidiary, from July 2001 until August 2004. He was Executive Vice President and COO of Refco Group from August 2004 through at least October 10, 2005, when he assumed the position of CEO, a position he held until November 15, 2005. ¶ 34. The Complaint alleges § 15 claims against him relating to the Bond Offering (Counts II and IV) and the IPO (Counts VI and VIII).[48]

Sexton signed the Bond Registration Statement. ¶ 34. As discussed above, this is a sufficient allegation for a control person claim with respect to that document, and Count IV should be sustained as to Sexton on this basis alone.

F. Supp. 2d at 262 (upholding control person claim alleging that the defendant "had direct involvement in the day-to-day operations of the Company"); *In re AOL Time Warner Sec. & "ERISA" Litig*., 381 F. Supp. 2d 192, 234 (S.D.N.Y. 2004) (upholding control person claim alleging that the defendant had "direct and supervisory involvement in the day-to-day operations" of the company and the ability "as a senior officer and director . . . [to] control the contents of the Merger Registration Statement and Bond Registration Statement and Prospectus Supplements thereto"); *In re Oxford Health Plans, Inc. Sec. Litig*., 187 F.R.D. 133, 143 (S.D.N.Y. 1999) (upholding control person claim alleging that the defendants "held high-level management positions in which they were involved in the day-to-day operations of Oxford.").

[48] The Complaint also asserts § 20(a) claims against Sexton relating to the Bond Offering (Counts XI, XII and XIII) and the IPO (Count XIII).

Sexton argues that the § 15 claims relating to the IPO (Counts VI and VIII) are insufficient because they are based solely on his status as a senior Refco Group officer. Sexton Mem. at 22. Sexton's argument overlooks that where "the corporate officers are a narrowly defined group charged with the day-to-day operations of a public corporation, it is reasonable to presume that these officers had the power to control or influence the particular transactions giving rise to the securities violations." *Maywalt v. Parker & Parsley Petroleum Co.*, 808 F. Supp. 1037, 1054 (S.D.N.Y. 1992) (internal quotation marks omitted).

Sexton's argument also overlooks that the Complaint does not base its § 15 claims against Sexton solely on his status as Executive Vice President and COO of Refco Group. Rather, the Complaint specifically alleges that Sexton "prepared and approved the Company's Offering Memorandum for the Bonds, the Company's August 2005 IPO Registration Statement, and the Company's fiscal year 2005 Form 10-K and Form 10-K/A." ¶ 34. In addition, the Complaint alleges that Sexton had direct involvement in the Company's day-to-day operations, including its financial reporting and accounting functions. ¶¶ 321, 350, 662, 678, 697.[49] Plaintiffs' allegation of control is further based on Sexton's employment agreement with Refco, which stated that he was employed "in a key capacity" with the Company and had access to confidential information regarding the business and finances of the Company. ¶ 260(c). These allegations are sufficient to give Sexton notice of the claim that he was a control person and the grounds on which that assertion rests with respect to all of the control person claims asserted against him.

[49] Sexton's argument that he cannot be a control person with respect to the Offering Memorandum because it was issued before he became Executive Vice President and COO of Refco Group (Sexton Mem. at 19, 22) fails because he held other senior positions at Refco Group prior to that time and the Complaint alleges that he helped to prepare and approved the Offering Memorandum. ¶ 34.

viii. Bennett

Bennett was President, CEO and Chairman of Refco Group from September 1998 until his resignation in October 2005. ¶ 32. The Complaint asserts § 15 claims against him relating to the Bond Offering (Counts II and IV) and the IPO (Counts VI and VIII). The Complaint also asserts § 20(a) claims against Bennett relating to the Bond Offering (Counts XI, XII and XIII) and the IPO (Count XIII). Bennett moves to dismiss these claims only on the ground that he cannot be sued both a primary violator and a control person, not on grounds of lack of control. *See* Bennett Mem. at 12-14. (This argument is addressed below.)

ix. Refco Holdings and the Bennett Trust

Refco Holdings[50] and the Bennett Trust were shell entities through which Bennett held his personal stockholdings in Refco. ¶ 28. The Complaint asserts § 15 claims against Refco Holdings and the Bennett Trust relating to the Bond Offering (Counts II and IV) and the IPO (Counts VI and VIII).[51] Refco Holdings and Bennett Trust move to dismiss all of these claims on the ground that they lacked control of Refco Group.

The Complaint alleges that, at the time of the Bond Offering, Refco Holdings owned approximately 43% of Refco Group. ¶ 261(b). During the fiscal quarter ended February 28, 2005, Refco Holdings transferred approximately 40% of its equity interest to the Bennett Trust, so that Refco Holdings owned approximately 26% of the equity and the Bennett Trust owned approximately 17%. After the IPO, Bennett's equity interest in Refco was approximately 33.8%, which was held 60% by Refco Holdings and 40% by the Bennett Trust. *Id.* In addition, Refco Holdings had the right to appoint two members to the Refco Group Board of Directors. ¶ 261(d).

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[50] Refco Holdings is referred to as RGHI in the Bennett Memorandum.

[51] The Complaint also asserts § 20(a) claims against Refco Holdings and the Bennett Trust relating to the Bond Offering (Counts XI, XII and XIII) and the IPO (Count XIII).

These allegations are sufficient to allege control of Refco by Refco Holdings and the Bennett Trust.

Refco Holdings and the Bennett Trust contest Plaintiffs' allegations as to control principally on the ground that minority stockholding is an insufficient basis for a control person claim. Bennett Mem. at 15-17. Such argument, however, is based primarily on this Court's August 2005 decision in *Global Crossing*, 2005 WL 1907005, and fails to take into account the Court's later decision in that case. *See Global Crossing*, 2005 WL 2990646, at *8 ("where Rule 8(a)'s pleading standard governs, dismissal is improper as long as the complaint furnishes adequate notice of the plaintiff's claim," and "as long as it is at least plausible that plaintiff could develop some set of facts that would pass muster" to establish control). In addition, Refco Holdings and the Bennett Trust ignore that the Complaint alleges that Bennett used these two entities as the vehicles through which he exercised his undisputed control over Refco Group. *See, e.g.*, ¶ 261(b) ("Bennett used Refco Holdings and the Bennett Trust as instrumentalities to hold and exercise his controlling equity interest in Refco.") Refco Holdings also ignores that Plaintiffs' claim is further supported by the fact that Refco Holdings had the right to appoint two directors to Refco Group's Board. *See* ¶ 261(d).

x. <u>Silverman</u>

Silverman was Secretary and Controller of Refco and Secretary of Refco Holdings.[52] ¶ 37. Plaintiffs assert control person claims against Silverman under § 15 with respect to the Bond Offering (Counts II and IV).[53]

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[52] Silverman disputes that he was Controller of Refco Group. Silverman Mem. at 7. This is a factual issue. At the present juncture, the allegations of the Complaint must be accepted as true. In any event, this allegation is consistent with a bankruptcy court filing, *In re Refco Financial LLC, Debtor*, Case Number 05-60013, S.D.N.Y., Statement of Financial Affairs, dated 12/29/05 and signed by Controller

(Cont'd)

Silverman signed the Bond Registration Statement. ¶ 37. As discussed above, this is a sufficient allegation for a control person claim with respect to that document, and Count IV should be sustained as to Silverman on this basis alone.

The Complaint also alleges that Silverman "prepared and approved" the Offering Memorandum for the bonds, the Bond Registration Statement, the IPO Registration Statement and the Company's fiscal year 2005 Form 10-K and Form 10-K/A and that Silverman had direct involvement in Refco's day-to-day operations, including its financial reporting and accounting functions. ¶¶ 37, 288, 321, 662, 678, 697.

Further, the Complaint alleges that Silverman was "a close confidant of Bennett, to whom Bennett turned for advice and guidance on accounting matters. Upon information and belief, Silverman had significant influence over Bennett's decision-making on behalf of the Company with respect to accounting-related issues." ¶ 260(f). While Silverman would brush off these allegations as "fluff" (Silverman Mem. at 10), the caselaw establishes that control may be premised on a wide variety of business and/or personal factors. Among those factors are "personal relationships with other directors and/or major shareholders." *Vivendi*, 381 F. Supp. 2d at 188; *see id.* at 189 (the defendant's "close collaboration with his long-time friend" (the CEO and chairman) supported inference of control).

Ultimately, Silverman's arguments boil down to the notion that the Complaint alleges that other Defendants controlled Refco, so therefore he did not. *See* Silverman Mem. at 8-11. Silverman's relative degree of control *vis-à-vis* other Defendants is not appropriate for resolution

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Peter F. James, at 6 (a copy is attached as Exhibit C to the Coffey Decl.), which lists Silverman as Controller of Refco Group at least within the previous two years.

[53] In addition, the Complaint alleges control person claims against Silverman under § 20(a) with respect to the Bond Offering (Counts XI, XII and XIII) and the IPO (Count XIII).

at this juncture, and in any case it is irrelevant, since control requires only some "indirect means of . . . influence short of actual direction." *Myzel*, 386 F.2d at 738; *Landry*, 715 F. Supp. at 102 n.11; *Strougo*, 964 F. Supp. at 806. *See In re Nat'l Century Fin. Enters., Inc. Inv. Litig.*, No. 2:03-md-1565, 2006 WL 469468, at *23 (S.D. Ohio Feb. 27, 2006) (rejecting argument that complaint failed to state a control person claim because it alleged that the defendants other than the moving defendant also were in control).

xi. <u>Trosten</u>

Trosten was Executive Vice President and CFO of Refco Group from 2001 until October 2004, when he resigned (receiving a $45 million severance payment). ¶ 40. Plaintiffs assert a control person claim against Trosten under § 15 with respect to the Rule 144A Bond Offering (Count II).[54]

While Trosten emphasizes that he left Refco prior to the issuance of the Bond Registration Statement, he cannot deny that he was CFO at the time the Offering Memorandum was issued on or about July 12, 2004. ¶ 105. Plaintiffs' control person claims against him under § 15 are limited to the Offering Memorandum.[55]

The Complaint alleges that Trosten prepared and approved the Offering Memorandum for the bonds, and, along with Bennett and others, participated in the nationwide road show to market the bonds to institutional investors. ¶ 40. As CFO, Trosten was directly responsible for the preparation of Refco's financial statements, the closing of its books, its adoption and

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[54] In addition, the Complaint alleges a control person claim against Trosten under § 20(a) with respect to the Bond Offering (Counts XI and XII).

[55] Trosten asserts that the § 20(a) claim asserted against him in Count XII relates only to the Bond Registration Statement. Trosten Mem. at 22-23. That is an incorrect reading of that Count, however, because Count XII asserts claims based on purchases of bonds after the Bond Offering in August 2004, but before the IPO in August 2005. This includes purchases prior to the Bond Registration Statement becoming effective on or about April 13, 2005. ¶ 150.

compliance with appropriate accounting policies, and its maintenance of adequate internal financial controls. ¶ 262(a). Trosten had direct involvement in Refco's day-to-day operations, and participated in the preparation and/or dissemination of public statements by Refco Group. ¶¶ 662, 679. And the Offering Memorandum stated that "[t]he loss of any member of our management team [which included Trosten at that time] . . . could adversely affect our ability to manage our business effectively or execute our business strategy." ¶ 262(b). These allegations are sufficient to give Trosten notice of the claim that he was a control person and the grounds on which that assertion rests with respect to all of the control person claims asserted against him.

xii. Grant

Prior to the Bond Offering, Grant owned 50% of Refco Holdings, which, in turn, owned approximately 43% of Refco Group. In connection with the Bond Offering, Grant was cashed out, leaving Bennett as the sole owner of Refco Holdings. ¶ 41. Plaintiffs assert a control person claim against Grant under § 15 with respect to the Bond Offering (Count II).[56]

Grant's principal arguments relating to his control of Refco are: (1) he was only a "minority" shareholder, Grant Mem. at 16; and (2) he sold his stock to Bennett on August 5, 2004. *Id.* at 6. Neither argument shows that relief could not "be granted under [some] set of facts consistent with the allegations." *Global Crossing*, 2005 WL 2990646, at *8. First, as Grant admits, "Grant and Bennett were co-equal owners of Refco Holdings," Grant Mem. at 6, and together they owned 43% of Refco – hardly the kind of small "minority" stake which might lead a court to conclude that a shareholder lacks control. Second, he is only being sued as a

[56] In addition, the Complaint alleges a control person claim against Grant under § 20(a) with respect to the Bond Offering (Count XI).

control person with respect to the Offering Memorandum, which was issued on or about July 12, 2004 (¶ 105) – at a time when he concededly was a "co-equal owner" with Bennett.

3. Culpable Participation Is Not an Element of a § 15 Claim

Only one Defendant, Sexton, argues that culpable participation is an element of a § 15 claim. *See* Sexton Mem. at 21. He is mistaken. The preponderance of judges in this Circuit have held that culpable participation is not required to establish a *prima facie* case of control person liability pursuant to § 15. *In re Deutsche Telekom AG Sec. Litig.*, No. 00 Civ. 9475, 2002 WL 244597, at *6 (S.D.N.Y. Feb. 20, 2002); *Vivendi*, 381 F. Supp. 2d at 188 ("the apparent majority of judges in the Southern District [of New York] . . . have determined that culpable participation is not an element of § 15"); *Dorchestor Investors v. Peak Trends Trust*, No. 99 Civ. 4696 (LMM), 2003 WL 223466, at *3 (S.D.N.Y. Feb. 3, 2003) (collecting cases). This Court is among those following this majority rule. *See Global Crossing*, 2005 WL 2990646, at *8. Sexton provides no reason for this Court to depart from this well-established law.[57]

Sexton argues that it would be appropriate in this case to require that the § 15 claims plead culpable participation, because, according to Sexton, the §§ 11 and 12(a)(2) claims in this case are premised on fraudulent conduct. *See* Sexton Mem. at 21 n.7 (citing *Rombach v. Chang*, 355 F.3d 164, 172 (2d Cir. 2004), and *In re Philip Servs. Corp. Sec. Litig.*, 383 F. Supp. 2d 463, 488 n.16 (S.D.N.Y. 2004)). This argument mischaracterizes the first portion of the Complaint, which, as explained above, does not sound in fraud. In addition, Sexton misinterprets the cases he cites in support of this argument. Those cases merely stand for the proposition that claims under the Securities Act that "sound in fraud" may be required to be pleaded with particularity

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[57] In any event, as shown below in the § 20(a) portion of this memorandum, the Complaint does adequately allege culpable participation.

pursuant to Rule 9(b); they do not hold that if such a claim sounds in fraud, the plaintiff is required to plead matters that are not elements of the Securities Act claim. *See Rombach*, 355 F.3d at 171 ("while a plaintiff need allege no more than negligence to proceed under § 11 and § 12(a)(2), claims that do rely upon averments of fraud are subject to the test of Rule 9(b)"); *see also In re Friedman's Inc. Sec. Litig.*, 385 F. Supp. 2d 1345, 1367 (N.D. Ga. 2005). Since culpable participation is not an element of a §15 claim, it does not have to be pleaded even if Rule 9(b) were somehow held to apply to the §15 claims.

4. The Complaint Appropriately Asserts Alternative Claims of Primary and Control Person Liability Against Defendants Bennett and Refco Holdings

Bennett and Refco Holdings argue that because they are being sued for primary violations of the securities laws, they cannot also be sued as control persons. This argument is contrary to the law in this Circuit and overlooks the fact that it is permissible for a complaint to plead alternative, even inconsistent, theories of recovery. *See* Fed. R. Civ. P. 8(e). Plaintiffs' recovery may be limited to only one such theory at the trial stage, but that does not mean that all of such theories cannot survive the motion to dismiss stage.

The same argument that Bennett makes in this case was made and rejected in *In re Parmalat Securities Litigation*, 375 F. Supp. 2d 278 (S.D.N.Y. 2005), where Judge Kaplan specifically held that it is permissible for a complaint to plead alternative theories of primary and control person liability: "Although a defendant ultimately may not be held liable as both a primary violator and a controlling person, such alternative theories of liability are permissible here." *Id.* at 310 (footnotes omitted). The same result was reached by Judge McKenna in *In re Adelphia Communications Corp. Securities & Derivative Litigation*, 398 F. Supp. 2d 244, 261-62 (S.D.N.Y. 2005), where he rejected the argument that Bennett makes and summarized the relevant law as follows:

> "'Controlling-person liability' under §20 of the Securities Exchange Act is a separate inquiry from that of primary liability and provides an alternative basis of culpability." *Suez Equity Invs. v. Toronto-Dominion Bank*, 250 F.3d 87, 101 (2d cir. 2001). "Although a defendant may ultimately not be held liable as both a primary violator and a controlling person, such alternative theories are permissible" in the pleadings stage. *In re Parmalat Sec. Litig.*, 375 F. Supp. 2d 278, 310 (S.D.N.Y. 2005) (citing *In re Scholastic Corp. Sec. Litig.*, 252 F.3d 63, 77 (2d Cir. 2001)); *see also In re Globalstar Sec. Litig.*, 2003 U.S. Dist. LEXIS 22496, No. 01 Civ. 1748, 2003 WL 22953163, at *13 (S.D.N.Y. Dec. 15, 2003); *Teamsters Local 445 Freight Div. Pension Fund v. Bombardier Inc.*, No. 05 Civ. 1898, 2005 WL 2148919, at *15 & n.207 (S.D.N.Y. Sept. 6, 2005) (quoting *Parmalat* with approval and allowing plaintiffs to proceed with both 20(a) and 10(b) claims against the same set of defendants); Fed. R. Civ. Proc. 8(e)(2) ("A party may set forth two or more statements of a claim or defense alternately or hypothetically, either in one count or defense or in separate counts or defenses.").

The case on which Bennett primarily relies, *Kalnit v. Eichler*, 85 F. Supp. 2d 232 (S.D.N.Y. 1999), is inapposite. First, because the § 10(b) claims in that case were dismissed, the § 20(a) claims failed for lack of a primary violation. Therefore, anything the court said about whether claims under § 10(b) and § 20(a) could be brought against the same defendants was *dicta.* Moreover, in *Kalnit*, the directors were sued "as control persons for misrepresentations and omissions made by them as the Board." *Id.* at 246. Alleging that defendants are control persons with respect to misrepresentations that they themselves made is obviously different from the situation in this case, where Plaintiffs' control person claims are based on primary violations committed not by themselves but by Refco. *See In re Van Der Moolen Holding N.V. Sec. Litig.*, 405 F. Supp. 2d 388, 412-13 (S.D.N.Y. 2005) (distinguishing *Kalnit*).[58]

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[58] Bennett's other cases provide no greater support for his argument. In *In re Regal Commc'ns Sec. Litig.*, No. 94-179, 1996 WL 411654 (E.D. Pa. July 17, 1996), the control person claim against Ernst & Young LLP was based on violations committed not by separate parties but by Ernst & Young's own auditors. Moreover, the ruling was in the context of a summary judgment motion, not a motion addressed to the pleadings. In *Lemmer v. Nu-Kote Holding, Inc.*, No. CIV. A. 398CV0161L, 2001 WL 1112577 (N.D. Tex. Sept. 6, 2001), the court admitted that its comments were *dicta*, stating: "The court need not decide the issue, however, as the § 20(a) claim would fail anyway." *Id.* at *12.

II. THE COMPLAINT STATES CLAIMS UNDER THE EXCHANGE ACT

A. The Complaint Adequately Pleads Claims Under Rule 10b-5(b) (Count IX)

1. Plaintiffs Have Adequately Pleaded That Each Exchange Act Defendant Made Material False Statements or Omissions

The Complaint pleads with sufficient particularity claims under Rule 10b-5(b) against Grant Thornton, Silverman, Klejna, Murphy, Trosten, Sherer, Sexton and the Audit Committee Defendants (*i.e.*, O'Kelley, Breitman and Gantcher).

Allegations of securities fraud in violation of § 10(b) and Rule 10b-5 are subject to the pleading requirements of Fed. R. Civ. P. 9(b) and the PSLRA. *In re Adelphia Commc'n. Corp. Sec. & Deriv. Litig.*, 398 F. Supp. 2d 244, 249 (S.D.N.Y. 2005). Rule 9(b) requires that a complaint alleging fraud: "(1) 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" (*i.e.,* who, what, where, when and why). *Id.* The PSLRA requires that:

> the complaint shall specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed.

15 U.S.C. § 78 u-4(b)(1)(B).

In examining a complaint for compliance with Rule 9(b) and the PSLRA on a motion to dismiss, a court must "read the complaint generously, and draw all inferences in favor of the pleader." *Id.* In addition, the complaint "must be looked at in its *entirety* for the sufficiency of its allegations." *In re Alstom SA Sec. Litig.*, 406 F. Supp. 2d 433, 455 (S.D.N.Y. 2005) (emphasis added).

To satisfy the pleading requirements of Rule 9(b) and the PSLRA, however, it is not necessary that Plaintiffs "plead with particularity every single fact upon which their beliefs

concerning false or misleading statements are based. Rather, "[p]laintiffs need only plead with particularity *sufficient* facts to support those beliefs." *Novak v. Kasaks*, 216 F.3d 300, 313-14 (2d Cir. 2000) (citing 15 U.S.C. § 78u-4(b)(1)). "Even with the heightened pleading standard under Rule 9(b) and the [PSLRA] [the Second Circuit does] not require the pleading of detailed evidentiary matter in securities litigation." *In re Scholastic Corp. Sec. Litig.*, 252 F.3d 63, 72 (2d Cir. 2001); *Liberty Ridge LLC v. RealTech Sys. Corp.*, 173 F. Supp. 2d 129, 137 (S.D.N.Y. 2001) ("While a complaint must give adequate notice of the charges against a defendant, 'it need not marshal all the evidence.'") (internal citation omitted).

a. The Complaint Adequately Alleges Facts Demonstrating that Grant Thornton Made Material False Statements

Grant Thornton issued unqualified audit reports on the Company's financial statements for fiscal years 2003, 2004, and 2005, and permitted those reports to be included, *inter alia*, in the Company's fiscal year 2005 Annual Report on Form 10-K and Form 10-K/A. ¶ 54. Unable to dispute that fraud occurred at Refco on its watch, Grant Thornton argues that the Complaint does not adequately allege why Grant Thornton's unqualified audit reports were false. GT Mem. at 16-17. This argument is without merit.[59]

Grant Thornton's audit reports falsely certified that it had conducted its audits in accordance with GAAS and that Refco's financial statements were presented in accordance with GAAP. The Complaint sets forth particularized facts demonstrating why both aspects of these

[59] It is well-settled that an outside auditor may be held liable as a primary violator under Rule 10b-5. *In re Global Crossing, Ltd. Sec. Litig*., 322 F. Supp. 2d 319, 330 (S.D.N.Y. 2004) (citing *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164, 191 (1994)). For example, allegations that an outside auditor knowingly or recklessly issued "clean" audit reports on financial statements that contained false and misleading statements are sufficient to trigger liability under Rule 10b-5(b). *See, e.g., Lernout & Hauspie Sec. Litig.*, 230 F. Supp. 2d 152, 163 (D. Mass. 2002); *Kinney v. Metro Global Media, Inc*., 170 F. Supp. 2d 173, 178-79 (D.R.I. 2001*); P. Schoenfeld Asset Mgmt. LLC v. Cendant Corp*., 142 F. Supp. 2d 589, 609-610 (D.N.J. 2001).

reports were false, describing in detail how Refco's financial statements did not comply with GAAP (¶¶ 212-25), and how Grant Thornton failed to follow GAAS when conducting its audits (¶¶ 226-48). Thus, the Complaint adequately alleges why Grant Thornton's audit reports were false, and Grant Thornton's suggestion that the Complaint puts the auditing firm "in the impossible position of trying to divine Plaintiffs' allegations" is unfounded. GT Mem. at 17.

Among other things, the Complaint alleges that Refco's financial statements for the fiscal years ended 2002 to 2005 were not presented in accordance with GAAP because the Company, in violation of SFAS No. 57, failed to disclose recurring significant related-party transactions. ¶¶ 215-19. The Complaint specifies that, for years, the Company engaged in off-balance-sheet transactions to remove related party receivables from its books at the end of each fiscal quarter, allowing Refco to materially mislead creditors and investors. *Id.* The Complaint also pleads specific violations of, *inter alia*, SFAS No. 5 (by failing to take a charge for uncollectible receivables); FIN No. 45 (by failing to disclose hundreds of millions of dollars of loans made to customers in the round-trip transactions); and APB Opinion No. 22 (by failing to disclose the Company's non-compliance with its own accounting policies). ¶¶ 220-44.

With regard to Grant Thornton's violations of GAAS – and its repeated failure to detect huge, nine-figure transactions at the end of each reporting period whereby Refco avoided disclosing repeated related-party transactions and uncollectible receivables – the Complaint specifies, *inter alia*, that throughout the years that it served as Refco's outside auditor, Grant Thornton sent only one confirmation to a customer that was receiving loans from Refco in the recurring transactions. ¶¶ 232, 239, 554-67; *see also* ¶¶ 400-18. This confirmation demonstrates that the loan had been made only a few days before the end of the fiscal year, yet (in violation of GAAS) Grant Thornton took no steps to determine whether it was a legitimate arm's-length

transaction. *Id.* The Complaint further details Grant Thornton's failure to implement procedures to identify and disclose related-party transactions, including procedures for reviewing the Company's large and unusual transactions that were taking place for years at the end of each fiscal quarter (¶¶ 229-31); Grant Thornton's failure to remain independent in keeping former Andersen partner Ramler in charge of the "re-audit" of his own prior work at Andersen (¶ 228); Grant Thornton's failure to adequately assess Refco's internal controls (¶ 236); and Grant Thornton's failure to identify fraud risk factors despite the existence of numerous red flags (¶ 237). These red flags included:

- "significant related-party transactions," including frequent loans of hundreds of millions of dollars to Refco Holdings at disproportionately high interest rates that, for a period of several years, appeared on the Company's books just after the beginning of each accounting period and then disappeared just before the end of each period;

- "unusual or unexpected analytical relationships," specifically that the Company's financial statements indicated significant increases in receivable balances without corresponding decreases in uncollectible receivables reserves;

- "weaknesses in internal control," including an ineffective accounting and internal audit staff and the lack of formal procedures for closing the books; and

- the Company's "history of violations of securities laws or other laws and regulations, or claims against the entity, its senior management, or board members alleging fraud or violations of laws and regulations," including that the Company had been under SEC investigation for short sales and aiding money managers in cheating municipalities, that the Company was fined approximately $7 million in a proceeding before the CFTC concerning inadequate record keeping, and that Maggio was under SEC investigation for stock manipulation.

¶ 237.

Accordingly, Grant Thornton cannot credibly argue that the Complaint does not sufficiently identify for purposes of Rule 9(b) why its statements (*i.e.*, its repeated "clean" audit reports) were false and misleading when made.

b. The Complaint Adequately Alleges That Murphy, Silverman, Klejna, Sexton and the Audit Committee Defendants Made False Statements

Like Grant Thornton, Defendants Murphy, Silverman, Klejna, Sexton and the Audit Committee Defendants cannot dispute that the Refco fraud occurred on their watch. Instead, they argue that the Complaint does not adequately allege that they made false statements. Murphy/Sherer Mem. at 14; Silverman Mem. at 15-16; Klejna Mem. 8-13; Sexton Mem. at 17, n. 6; THL/Audit Comm. Mem. at 24. Additionally, they argue that the Second Circuit does not recognize group pleading, or that group pleading does not apply to them. *Id.* For the reasons set forth below, these arguments are inapposite.

i. The Complaint Adequately Alleges Defendants' Individual Statements

A director or corporate officer who signs an SEC filing containing false or misleading statements is deemed to have made those statements, and thus may be held liable as a primary violator under § 10(b). *See Howard v. Everex Sys., Inc.*, 228 F.3d 1057, 1061-63 (9th Cir. 2000) (officer is subject to liability for statements in SEC filing he signed); *In re Atlas Air Worldwide, Inc. Sec. Litig.*, 324 F. Supp. 2d 474, 491 (S.D.N.Y. 2004) (same).

The Complaint alleges, and Defendants ultimately concede, that Murphy, Silverman, Klejna and Sexton each "prepared, approved and signed the Bond Registration Statement."[60] ¶¶ 34, 36-38; Silverman Mem. at 16; Klejna Mem. at 13; Murphy/Sherer Mem. at 14-16. Additionally, Klejna prepared and approved the IPO Registration Statement (¶ 38), and although the Audit Committee Defendants ignore these allegations in their brief, they approved and signed

[60] Silverman and Klejna insinuate that Bennett's signing on their behalf as "attorney in fact" somehow vitiates their liability, yet they do not disavow Bennett's authority to sign on their behalf. Silverman Mem. at 16 n.14; Klejna Mem. at 13. Murphy and Sexton did not join in this implausible position, obviously understanding that a corporate director cannot avoid liability under the securities laws by authorizing a fellow director to sign a document on his/her behalf.

the IPO Registration Statement. ¶¶ 42-44. Accordingly, these Defendants are liable for the false and misleading statements in these documents.

ii. The Complaint Adequately Alleges Defendants' Group Statements

Defendants Murphy, Silverman, Klejna, Sexton, and the Audit Committee Defendants are also subject to liability for certain false and misleading statements they did not sign, but which were issued during their tenures with the Company. Contrary to Defendants' assertions, Plaintiffs may "rely on a presumption that statements in 'prospectuses, registrations statements, annual reports, press releases, or other group-published information,' are the collective work of those individuals with direct involvement in the everyday business of the company." *Oxford Health Plans*, 187 F.R.D. at 142 (citations omitted); *In re Alstom SA Sec. Litig.*, 406 F. Supp. 2d at 449 (citing *In re BISYS Sec. Litig.*, 397 F. Supp. 2d 430, 438 (S.D.N.Y. 2005)).

To invoke the group pleading doctrine, a complaint must allege that the defendants were corporate insiders with direct involvement in the day-to-day affairs of the company during the time the corporate statements were made. *Alstom*, 406 F. Supp. 2d at 449.[61] The following allegations satisfy this standard with respect to Defendants Murphy, Silverman, Klejna and Sexton:

- Murphy was Executive Vice President of Refco Group, as well as President of various Refco subsidiaries, including two guarantors and co-registrants of the Registered Bonds.[62] ¶¶ 29, 30, 36. Murphy prepared and approved the Bond Offering Memorandum, the IPO Registration Statement and the Company's 2005 Form 10K and Form 10K/A. *Id.*

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[61] Murphy incorrectly cites *Global Crossing,* 322 F. Supp. 2d at 332-34, in an attempt to narrow the standard for group pleading. Murphy/Sherer Mem. at 14-15. The language Murphy cites, however, does not address group pleading. *See Global Crossing*, 322 F. Supp. 2d at 332-34.

[62] On October 10, 2005, Murphy was elevated from the positions of CEO of Refco Global Futures and President of Refco LLC, to President of Refco Inc. and Refco Capital Markets, Ltd. *See* October 10, 2005 Refco Press Release, referenced at ¶¶ 199-204.

- Silverman served as Secretary of the Company from at least 1999 until October 10, 2005, and held numerous other high-level executive positions within Refco and its subsidiaries, including Controller of Refco Group[63] and Secretary of Refco Holdings, the Bennett-controlled entity used to carry out the fraudulent "round-trip" transactions. ¶¶ 37, 260(a)(vii), 571. As Controller of Refco Group, Silverman was directly responsible for closing the Company's books, implementing and maintaining internal financial controls, and adopting and implementing accounting policies for the Company. ¶ 260(a)(vii). Silverman prepared and approved the Bond Offering Memorandum, the IPO Registration Statement and the Company's 2005 Form 10K and Form 10K/A. ¶ 37.

- Klejna was Executive Vice President and General Counsel of Refco Group throughout the Class Period. ¶ 38. Klejna prepared and approved the Bond Offering Memorandum, the IPO Registration Statement and the Company's 2005 Form 10K and Form 10K/A. *Id.*

- Sexton joined Refco in 1999, and became Executive Vice President and Chief Operating Officer in August 2004. ¶ 34. Sexton prepared and approved the Company's October 12, 2004 Bond Registration Statement (including subsequent amendments), the IPO Registration Statement and the Company's 2005 Form 10K and Form 10K/A. *Id.*[64]

- Murphy and Sexton were each a member of the "New York Five" – a reflection of their high-level positions and involvement in the Company's day-to-day operations. ¶ 260(d).

- Sexton's, Klejna's and Murphy's employment agreements explicitly stated that they were each employed "in a key capacity with the Company," and had access to "confidential information regarding the organization, business and finances of the Company." ¶ 260(c).

Audit committee membership may also provide a basis for liability under the group pleading doctrine. *Alstom*, 406 F. Supp. 2d. at 449-50. Factors that a court should consider when assessing whether group pleading is appropriate for audit committee members include: the

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[63] Although Silverman denies being Controller of Refco Group (Silverman Mem. at 7), as set forth above, this claim is contradicted by a bankruptcy court filing that lists Silverman as Controller of Refco Group Ltd, LLC at least within the previous two years (*see supra* note 52).

[64] Sexton's argument that he was Executive Vice President and COO for little over one year ignores that this one year period (from August 2004 until his resignation in November 2005) was the very time that members of the Class were defrauded and suffered all of their losses.

time frame of the membership, the member's role on the audit committee, the member's access to information concerning the company's day-to-day business, and the member's equity interests in the company. *Id; In re Gupta Corp. Sec. Litig.*, No. C 94-1517 FMS, 1995 WL 338893, *6 (N.D. Cal. Apr. 18, 1995); *In re MTC Elect. Tech. S'holders Litig.*, 898 F. Supp. 974, 980 (E.D.N.Y.), *vacated in part on other grounds*, 993 F. Supp. 974 (E.D.N.Y. 1995); *Adelphia*, 398 F. Supp. 2d at 250 (permitting group pleading where defendants were members of board with equity interests and access to information concerning company's day-to-day business).

As alleged in the Complaint, the Audit Committee Defendants (*i.e.,* O'Kelley, Breitman and Gantcher) served on the Audit Committee from at least October 12, 2004, when they approved the Bond Registration Statement through Refco's bankruptcy. ¶¶ 42-45. The Audit Committee Defendants had extensive access to Refco's internal information and were responsible for, among other things, overseeing the integrity of the Company's financial statements; overseeing the engagement, independence, qualifications and performance of Refco's outside auditor; reviewing the adequacy and effectiveness of Refco's accounting and internal control policies and procedures; and reviewing financial arrangements of Refco that do not appear on the financial statements of the Company. ¶¶ 45, 268. The Audit Committee Defendants approved Refco's financial statements for all relevant periods, including those contained in the Bond Registration Statement, the IPO Registration Statement, and the Company's fiscal year 2005 Form 10-K and Form 10-K/A. ¶¶ 42-44.

As further evidence of their insider status, the Audit Committee Defendants each received substantial equity interests in the Company, including 13,000 shares of Refco stock valued at $286,000 on the eve of the IPO. ¶ 585. The Audit Committee Defendants also received 20,000 RSUs each in advance of the IPO and, as noted above, were the only Board

members to receive such grants. ¶ 592.

Given their significant roles within Refco, Defendants Murphy, Silverman, Klejna, Sexton and the Audit Committee Defendants are subject to group pleading. Accordingly, in addition to the statements signed by and/or attributed to them, these Defendants are responsible for the false statements contained in the Company's quarterly financial statements during their tenure, as well as the statements made in: the Offering Memorandum (¶¶ 105-43); the Bond Registration Statement (¶¶ 149-65); the IPO Registration Statement (¶¶ 168-98); the May 2005 Press Release and May 2005 8-K (¶¶ 526-30); the Year-End 2005 Press Release and 2005 10-K (¶¶ 531-41); the First Quarter 2006 Press Release, July 2005 8-K, and First Quarter 2006 10-Q (¶¶ 542-51); the October 10, 2005 Press Release (¶¶ 199-204); the October 11, 2005 Press Release (¶ 205); and the October 13, 2005 Press Release. ¶¶ 207-08.

c. The Complaint Adequately Alleges That <u>Sherer and Trosten Made False Statements</u>

Sherer, who started working at Refco in January 2005, concedes that the Complaint sufficiently pleads his false statements from January 2005 forward. Murphy/Sherer Mem. at 13-14. Plaintiffs do not seek to hold Sherer liable for statements made prior to that time.

Trosten does not deny that the Complaint alleges that he made false statements in the Offering Memorandum and during the Road Show. Indeed, Plaintiffs allege that Trosten, as CFO of Refco Group, prepared and used the Offering Memorandum to solicit Class members to participate in the Bond Offering, and that he personally attended and made false verbal statements during the Road Shows. ¶¶ 144, 145, 153. Trosten attempts to evade liability for those false statements because he made them prior to the Class Period. Further, Trosten seeks to avoid liability for false statements in the Bond Registration Statement based on his resignation from the Company eight days before the filing of the Bond Registration Statement. Trosten

Mem. at 16-17. Both arguments should be rejected.

The definition of the Class Period is not a device for limiting the universe of actionable conduct. *Zelman v. JDS Uniphase Corp.*, 376 F. Supp. 2d 956, 966 (N.D. Cal. 2005). Instead, the purpose of the class definition is to identify the group of plaintiffs who were injured by the defendants' conduct. *Id.* Because of the nature of the Bond Offering – which was marketed to investors in July 2004 (one month before the bonds were available for purchase) there was necessarily a time lapse between the making of the false statements and Plaintiffs' purchase of the bonds beginning in August 2004. The fact that the proposed Class Period begins after these misstatements were made does not make those statements non-actionable. *Id.*; *In re Crown Am. Realty Trust Sec. Litig.*, No. 95-202J, 1997 WL 599299, at *15 (W.D. Pa. Sept. 15, 1997) (rejecting argument that liability cannot attach to pre-class period statements) (citations omitted); *see also Danis v. USN Commc'ns., Inc.*, 73 F. Supp. 2d 923, 932-33 (N.D. Ill. 1999) (finding false statements made in registration statement/prospectus prior to Class Period sufficient to state claims under Exchange Act). Therefore, Trosten is subject to liability for his false statements at the Road Shows and in the Offering Memorandum.

In addition, a defendant's resignation does not terminate his liability. *See In re Reliance Sec. Litig.*, 135 F. Supp. 2d at 510 (defendant's resignation not enough to break chain of causation). That is particularly true in this case, where Trosten is alleged to have prepared the Offering Memorandum with the knowledge and intent that its contents would be substantially repeated in the Bond Registration Statement. ¶¶ 106, 107, 153. That Trosten resigned just before the Bond Registration Statement was released does not extinguish his responsibility for making the false and misleading statements therein.

2. Plaintiffs' Allegations Raise a Strong Inference of Scienter

Defendants Bennett and Refco Holdings concede that Plaintiffs have adequately pleaded their scienter with respect to the fraud at Refco. However, Defendants Grant Thornton, Sexton, Silverman, Klejna, Murphy, Sherer, Trosten, and the Audit Committee Defendants argue that the Complaint's allegations fail to give rise to a strong inference of scienter. Those arguments should be rejected.

Plaintiffs may establish the required strong inference of scienter in one of two ways: "(a) by alleging facts to show that defendants had both motive and opportunity to commit fraud, or (b) by alleging facts that constitute strong circumstantial evidence of conscious misbehavior or recklessness." *Ganino*, 228 F.3d at 168-69, *see also Rothman v. Gregor*, 220 F.3d 81, 90 (2d Cir. 2000); *In re Carter-Wallace Sec. Litig.*, 220 F.3d 36, 39 (2d Cir. 2000).[65]

Conscious misbehavior or recklessness is adequately pled by alleging that defendants: (1) deliberately engaged in illegal behavior; (2) knew facts or had access to information suggesting that their public statements were not accurate; or (3) failed to check information they had a duty to monitor. *Novak v. Kasaks*, 216 F.3d 300, 311 (2d Cir. 2000). To plead facts supporting a strong inference of scienter by demonstrating a defendant's motive and opportunity,

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[65] "Although the inference of scienter must be reasonable and strong, it need not be irrefutable." *In re Regeneron Pharm., Inc. Sec. Litig.,* No. 03 CV 3111, 2005 WL 225288, at * 24 (S.D.N.Y. Feb. 1, 2005). The Second Circuit has noted that a plaintiff is not required to plead scienter with "great specificity." *Ganino v. Citizens Utils. Co.*, 228 F.3d 154, 169 (2d Cir. 2000); *accord Scholastic Corp.* 252 F.3d at 72 ("we do not require the pleading of detailed evidentiary matter in securities litigation."); *see also Alstom*, 406 F. Supp. 2d at 455; *In re Atlas Air Worldwide Holdings, Inc. Sec. Litig.*, 324 F. Supp. 2d 474, 488 (S.D.N.Y. 2004). The Court, in determining whether the Complaint alleges facts giving rise to a strong inference of scienter, must read the Complaint "in total and most favorably to plaintiff." *In re Complete Mgmt. Sec. Litig.*, 153 F. Supp. 2d 314, 333 (S.D.N.Y. 2001); *see also In re WorldCom, Inc. Sec. Litig.*, 294 F. Supp. 2d 392, 417 (S.D.N.Y. 2003) ("The allegations in the Complaint are entitled to be taken together to determine if the facts 'give rise to a strong inference of fraudulent intent.'") (internal citation omitted).

a plaintiff may allege facts "showing concrete benefits that could be realized by one or more of the false statements and wrongful nondisclosures alleged, and the means and likely prospect of achieving the concrete benefits by the means alleged." *Cromer Fin. Ltd. v. Berger*, 137 F. Supp. 2d 452, 469 (S.D.N.Y. 2001) (quotations and citations omitted); *accord Scholastic*, 252 F.3d at 74 (motive focus is on "…a concrete benefit defendant would realize by his conduct.").

As set forth below, Plaintiffs have adequately alleged both circumstantial evidence of Defendants' conscious misbehavior or recklessness, and their motive and opportunity to commit fraud.

a. The Complaint Alleges Facts Giving Rise to a Strong Inference of Defendant Grant Thornton's Scienter

i. Circumstantial Evidence of Grant Thornton's Conscious Misbehavior or Recklessness

The Complaint alleges circumstantial evidence of Grant Thornton's conscious misbehavior or recklessness by identifying a series of "red flags" of fraud that Grant Thornton ignored, despite having a duty and ample opportunity to investigate, including, among others:

- the suspicious timing, recurrent pattern and unusual nature of the related-party transactions, which for a lengthy period of time: (a) regularly took place between related-parties on an end-of-quarter basis; (b) involved guarantees and disproportionately high interest rates and interest payments by Refco-related entities other than the recipients of the loan monies; and (c) on their face served no legitimate business purpose (¶¶ 237, 398-518; 561-67);

- the massive size of the recurring sham loans, which, for example, amounted to $970 million in February 2004 – representing approximately 518% of Refco's net income for the corresponding financial period (¶ 560);

- Refco's history of legal violations, including allegations of false trading reports, securities fraud, and, most significant to this case, shuffling funds between client accounts to hide losses (¶¶ 576-80); and

- Trosten's abrupt resignation and remarkably large $45 million severance package at the time of Grant Thornton's re-audit (¶¶ 574-75).

In the face of these red flags, among others set forth in the Complaint, and an environment of what should have been heightened sensitivity to fraud, Grant Thornton failed to implement procedures to identify and test the Company's recurring related-party transactions, as GAAS required. ¶ 231. In fact, throughout the many years it served as Refco's public audit firm, Grant Thornton sent only one confirmation to a customer involved in a significant number of the quarter-end, round-trip "sham" loan transactions. ¶¶ 232, 554-59.[66] That single confirmation not only evidences Grant Thornton's knowledge of a $325,000,000 loan made to the customer just three days before the end of Refco's fiscal year, but demonstrates that Grant Thornton was reckless or purposefully ignored its duty to ask the customer for additional information regarding the highly unusual transaction. *Id.; see also* ¶¶ 400-67.

An auditor's reckless disregard of red flags, coupled with allegations of GAAP and GAAS violations, is sufficient to support a strong inference of scienter, as evidenced by a virtual mountain of cases.[67] Moreover, courts have specifically recognized that the frequent recurrence

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[66] Grant Thornton's unsupported suggestion that it sent out more than one request (GT Mem. 8) should be rejected as it improperly seeks to dispute the facts alleged in the Complaint on a motion to dismiss.

[67] *See In re Suprema Specialties, Inc., Sec. Litig.*, 438 F.3d 256, 279-81 (3d Cir. 2006) ("At the pleading stage, courts have recognized that allegations of GAAS violations, coupled with allegations that significant "red flags" were ignored, can suffice to withstand a motion to dismiss."); *Jefferson Ins. Co. v. Rouhana (In re Winstar Commc'ns.)*, Nos. 01cv3014, 01cv11522, 2006 WL 473885, at *11 (S.D.N.Y. Feb. 27, 2006) ("An auditor's reckless disregard of red flags, coupled with allegations of GAAP and GAAS violations, is sufficient to support a strong inference of scienter."); *Whalen v. Hibernia Foods PLC,* No. 04 Civ. 3182 (HB), 2005 WL 1799370, at *3-4 (S.D.N.Y. Aug. 1, 2005) ("Plaintiffs allege . . . [PricewaterhouseCoopers] knew about and ignored a wide variety of 'red flag' incidents or events, that should have put PwC on notice that fraud was afoot, and that taken together they are sufficient for the Court to find a strong inference of recklessness."); *In re AOL Time Warner Sec. Litig*., 381 F. Supp. 2d 192, 238 (S.D.N.Y. 2005) (plaintiffs pled § 10(b) claim against auditor with particularity where they alleged numerous "specific 'red flags' that were ignored by E&Y"); *In re Worldcom, Inc. Sec. Litig.*, No. 02 CV 3288 (DLC), 2003 WL 21488087, at *7 (S.D.N.Y. June 25, 2003) (auditor acted recklessly in conducting audit where complaint alleged that it reviewed company's books and records that contained no support for or documentation for certain accounting treatments); *In re Oxford Health Plans, Inc. Sec. Litig.,* 51 F. Supp. 2d 290, 295 (S.D.N.Y. 1999); *In re First Merchants Acceptance Corp. Sec. Litig.,* No. 97 C 2715, 1998 WL 781118, at *10 (N.D. Ill. Nov. 4, 1998) ("Other circumstances suggesting fraudulent

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of major transactions within the last few days of a quarter should be a significant red flag of fraud to an auditor. *See In re Homestore.com Sec. Litig.*, 252 F.Supp. 2d 1018, 1044 (C.D. Cal. 2003); *Winstar Commc'ns*, 2006 WL 473885, at *11 (allegations as to auditor's recklessness held sufficient where plaintiffs alleged "a litany of 'red flags' concerning suspicious transactions, such as a pattern of significant end-of-quarter transactions, which [the auditor] allegedly knew, but either intentionally or recklessly ignored."); *see also In the Matter of Kenneth L. Rubin, CPA and Michael W. Lewis, CPA*, Admin. Proc. No. 3-11748, 2005 WL 2180440, at *15 (S.E.C. Sept. 8, 2005) (noting that for auditors, "GAAS recognize certain factors arouse suspicion and require a more focused investigation. For example, large and unusual transactions require testing and special scrutiny under AU 316.20.") (internal citations omitted).

Grant Thornton's principal response to Plaintiffs' allegations of scienter is that it did not know what was going on at Refco and was unaware of the multiple "red flags." GT Mem. at 1, 5-13. However, the allegations in the Complaint belie this claim in at least three ways. First and foremost, the Complaint alleges – and Grant Thornton admits – that it received a confirmation of at least one of the round-trip loan transactions. GT Mem. at 7-9. Thus, Grant Thornton concedes that, at a minimum, it had actual knowledge of a considerable loan (*i.e.*, $325 million, which was over three times Refco's reported net income for the relevant year) that was made only three days prior to the end of Refco's 2002 fiscal year-end. GT Mem. at 9. This admission contradicts Grant Thornton's claim that it had no knowledge of the "red flags" alleged by Plaintiffs. GT Mem. at 9-12.[68] Indeed, as discussed above, the "confirmation request" that

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intent can include the presence of 'red flags' or warning signs that the financial reports are fraudulent, as well as the magnitude of the alleged fraud.").

[68] While Grant Thornton attempts to dismiss these transactions as a "normal" part of Refco's business, that argument is contradicted by Plaintiffs' allegations that the timing and nature of the end of quarter

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Grant Thornton received was highly unusual on its face, and should have alerted Grant Thornton to the fraud at Refco. Yet, no further audit steps were taken in that or any other audit.[69]

Second, in light of the massive sums (at one point nearly one billion dollars in loans bracketing the end of a single quarter), the involvement of related-parties and the suspicious timing and recurrent pattern of the fraudulent "round-trip" loan transactions, Grant Thornton's claim that it was completely clueless about the multiple, recurring transactions is itself a damning admission that its audits of Refco's books were effectively no audits at all. This is especially true in light of the fact that a Refco employee who had been working with the Company *for less than two months* unraveled and exposed the fraudulent scheme. ¶¶ 7, 608. Moreover, the fact that the fraud was so widespread – involving numerous individuals and entities inside and outside of Refco (*see, e.g.* ¶¶ 217, 380-81, 393-518), and documented in plain terms in numerous documents maintained at the Company (*see, e.g.,* ¶¶ 400-67, 472-501, 505, 509-10, 554-58, 567(a)-(e) (describing emails, letters, loan agreements, "ledger reports," "account statements," and other documents setting forth the fraud)) – demonstrates that Grant Thornton's purported audits of Refco were woefully deficient. *See, e.g., In re Oxford Health Plans, Inc. Sec. Litig.*, 51 F. Supp. 2d at 294 (plaintiffs sufficiently alleged auditor's scienter by

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transactions were anything but normal and that the transactions served no legitimate business purpose. *See*, *e.g.*, ¶¶ 561-64.

[69] *See, e.g., In re Winstar Commc'ns*, 2006 WL 473885, at *10 ("An auditor's reckless disregard of red flags, coupled with allegations of GAAP and GAAS violations, is sufficient to support a strong inference of scienter."); *In re Royal Dutch/Shell Transport Sec. Litig.*, 380 F. Supp. 2d 509, 570 (D.N.J. 2005) (finding that magnitude of fraud coupled with specific GAAS and GAAP violations created strong inference of auditor's recklessness); *MicroStrategy*, 115 F. Supp. 2d 620, 651 (finding strong inference of auditor's scienter could be inferred from magnitude and pervasiveness of *MicroStrategy's* GAAP violations; relative simplicity of the accounting principles violated; and importance of contracts involved); *In re Sunbeam Sec. Litig.*, 89 F. Supp. 2d 1326, 1345-46 (S.D. Fla. 1999) (scienter adequately pled based on allegations that auditor failed to adjust audit plan in the face of internal control deficiencies, violated GAAS by failing to identify fraud risk factors, and failed to follow up on accusations of improper accounting).

pleading "'in your face facts,' … that cry out 'how could KPMG not have known that the financial statements were false.'").

A third problem with Grant Thornton's plea of ignorance is that it fails entirely to account for the fact that Grant Thornton was charged with certain responsibilities under GAAS that it repeatedly claimed to have followed. So even if it is assumed, *arguendo*, that Grant Thornton did not have actual knowledge of the fraud at Refco, it does not preclude a finding that Grant Thornton acted recklessly with regard to the accuracy of its audit reports (including its own statements that it complied with GAAS when it knowingly or recklessly failed to do so). The claim of ignorance, therefore, does not exculpate Grant Thornton on a motion to dismiss. *In re Leslie Fay Cos. Inc. Sec. Litig.*, 835 F. Supp. at 698-99 (refusing to entertain, on motion to dismiss, an accounting firm's contention that it was as much the "victim" of fraudulent accounting as were the plaintiffs).

As an alternative strategy, Grant Thornton seeks to diminish the significance of Plaintiffs' allegations of circumstantial evidence by addressing some of the alleged "red flags" separately and then arguing that each, on its own, provides an insufficient basis to support a strong inference of conscious misbehavior or recklessness. In doing so, however, Grant Thornton fails to consider the *aggregate* effect of the multiple "red flags" set forth in the Complaint. *In re Philip Servs. Corp. Sec. Litig.*, 383 F. Supp. 2d at 475.

For example, Grant Thornton claims that, contrary to Plaintiffs' allegations, its scienter is disproved by its receipt of one confirmation from Customer X. GT Mem. at 7. Grant Thornton further argues that the absence of other confirmation requests is inconsequential, as this single confirmation exhausted Grant Thornton's duties under GAAS. GT Mem. at 8-9. Grant Thornton's attempt to treat the issue of this confirmation, and the lack of follow-up or other

confirmations, in isolation fails to recognize that Plaintiffs are alleging that all the circumstances surrounding the repeated "round trip" loan transactions support a strong inference that Grant Thornton acted with scienter in the form of conscious misbehavior or recklessness. The Customer X confirmation is one part of that overall suspicious pattern of quarter-end, related-party, loan transactions – to which Grant Thornton turned a blind eye. To claim that Grant Thornton did its job by narrowly confirming one aspect of a single transaction (which, on its face, should have raised significant questions) and ignoring everything else is not persuasive, but consistent with Grant Thornton's failure to perform a meaningful audit.[70] Indeed, Plaintiffs allege facts demonstrating such clear and material indicia of fraud that Grant Thornton's intentional or reckless disregard of these "red flags" – coupled with Plaintiffs' allegations of Grant Thornton's violations of GAAS and other applicable auditing guidance (*see* ¶¶ 226-48) – supports the strong inference that the audits of Refco's financial statements were effectively no audits at all.[71]

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[70] This also disposes of Grant Thornton's misguided attempt to claim that Plaintiffs' allegations relating to Refco's history of legal violations should be "rejected out of hand." GT Mem. at 11-12. The point is not, as Grant Thornton suggests, that Refco's history of legal violations itself somehow proves that Grant Thornton knew about the fraud. Rather, Plaintiffs allege that Grant Thornton deliberately or recklessly ignored that history – among the other "red flags" alleged. ¶¶ 576-80. In fact, contrary to Grant Thornton's assertions, the Complaint alleges that Refco's prior misconduct included improperly shifting client funds between related-party accounts, the same type of transactions that Refco used in the repeated, round-trip transactions at issue in this case. ¶¶ 578-80.

[71] Although Grant Thornton began auditing Refco in 2002 after the collapse of Andersen, the partner in charge of the Grant Thornton audit, Mark Ramler, previously audited Refco as a partner of Andersen. ¶ 228. Ramler's history and knowledge of Refco is imputed to Grant Thornton. *See, e.g., Cromer Fin. Ltd. v. Berger*, No. 00 Civ. 2284, 2002 WL 826847, **7-8 (S.D.N.Y. May 2, 2002) (scienter of partner in charge of audit may be imputed to accounting firm under traditional agency principles).

ii. Grant Thornton Had the Motive and Opportunity to Commit Fraud

Plaintiffs also allege facts demonstrating Grant Thornton's motive and opportunity to commit fraud, namely, the benefits associated with a rare opportunity to be retained by a large, lucrative client such as Refco, and to participate in a much-anticipated IPO in an otherwise sluggish IPO market. ¶¶ 596-97.

Grant Thornton argues that Plaintiffs' allegations of motive amount to no more than a claim that the firm was interested in generating fees or maintaining positive relations with a client. GT Mem. at 13. In that regard, Grant Thornton cites two cases for the proposition that the motivation to generate fees or keep a client – without more – will not suffice to allege scienter.[72] *Id.* However, Grant Thornton has misconstrued Plaintiffs' allegations and, consequently, its reliance on these cases is misplaced. Plaintiffs allege that Refco was a newly-obtained client which presented a special and unique opportunity for Grant Thornton, since Grant Thornton had failed to pick up very many of Andersen's former clients – and none in the S&P 500. ¶ 596. Refco provided Grant Thornton with a unique opportunity to work for a former "crown jewel" client of Andersen, and thus to increase its visibility and marketability to other potential clients. *See* ¶¶ 596-97.

Plaintiffs allege that Grant Thornton was highly motivated to ignore the "red flags" it encountered in order to ensure that Refco's IPO was successful. *Id.* Accordingly, Plaintiffs have sufficiently alleged Grant Thornton's motive and opportunity to commit fraud based on Refco's status as a unique client opportunity that was involved in an important transaction, which sufficiently alleges a 'concrete benefit' for purposes of the present motion. *See, e.g., In re Qwest*

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[72] Grant Thornton relies on *Fidel v. Farley*, 392 F.3d. 220 (6th Cir. 2004), and *SEC v. Price Waterhouse*, 797 F. Supp. 1217 (S.D.N.Y. 1992).

Commc'ns Int'l, Inc., 396 F. Supp. 2d 1178, 1208 (D. Colo. 2004) ("[a] desire to retain the business of a client who paid fees [of nearly $8 million] could motivate an auditor to disregard a client's accounting machinations," and finding scienter adequately pleaded based on allegations of auditor's motive, knowledge of accounting improprieties, and magnitude of improprieties).

b. The Complaint Alleges Facts Giving Rise to a Strong Inference of Trosten's Scienter

Plaintiffs allege particularized facts indicating that Trosten not only had actual knowledge of, but directly participated in, the fraudulent scheme to conceal Refco's uncollectible receivables. Among other things, as evidenced by several e-mails that are specifically identified and quoted in the Complaint, Trosten was the person BAWAG contacted to confirm the terms of the loans through which the receivables were temporarily passed off to BAWAG. ¶¶ 490, 494. These e-mails reflected that money would be transferred from Refco Capital to BAWAG, and then from BAWAG to Refco Holdings on the same date (near the end of an accounting period), and that the transactions would then be undone just after the end of the accounting period. *See id.* Moreover, the "loans" that BAWAG was confirming with Trosten did not involve any collateral or formal loan documentation, and in large parts required no interest payments. ¶ 570. Thus, it was clear from the face of these "loan" transactions (and from the e-mails Trosten received) that the transactions served no legitimate purpose and were shams designed to further the scheme to misstate Refco's financials. The fact that Trosten was in direct communication with BAWAG regarding these loans raises a strong inference that he had actual knowledge of the fraudulent scheme.[73]

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[73] *See S.E.C. v. U.S. Envtl. Inc.*, 155 F.3d 107, 111 (2d Cir. 1998) ("It is well-settled that knowledge of the proscribed activity is sufficient scienter under § 10(b)."); *Novak*, 216 F.3d at 311-12 (scienter was sufficiently pleaded where complaint alleged, among other things, that defendants knew about serious inventory problems and of need to mark down inventory, but refused to do so because it would damage

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As further evidence of Trosten's scienter, just a few months after the LBO, Trosten resigned from Refco and – at the age of 35 and having served as Refco's CFO for only three years – received a huge $45 million severance payment. ¶ 575. This payment was exponentially greater than Trosten's annual compensation (and far in excess of the eighteen months' pay that the Offering Memorandum indicated would be his severance pay if he resigned), and was grossly disproportionate to his level of experience and expertise. ¶ 576. Adding to the suspicious circumstances of this payment, it was not disclosed to the public and was paid at the same time Grant Thornton was conducting its "re-audit" of the Company's fiscal year 2002 financial statements. ¶ 575. The size and timing of this severance payment to Trosten, as well as the Company's attempt to conceal it from public scrutiny, raise a strong inference that it was "hush" money to keep Trosten from publicly disclosing the fraud he knew to be occurring at Refco. *Id.*

c. The Complaint Alleges Facts Giving Rise to a Strong Inference of the Officer Defendants' and Audit Committee Defendants' Scienter

The Complaint asserts facts sufficient to give rise to a strong inference of scienter against Defendants Sexton, Silverman, Klejna, Sherer and Murphy (the Officer Defendants) and Defendants O'Kelley, Breitman and Gantcher (the Audit Committee Defendants). Many of these Defendants' arguments on the issue of scienter offer little more than self-serving conclusions or

company's financial position); *S.E.C. v. First Jersey Securities*, 101 F.3d 1450, 1472 (2d Cir. 1996), *cert. denied*, 522 U.S. 812 (1997) (allegations that defendant "was intimately involved in" and "orchestrated" fraudulent scheme are sufficient to plead scienter); *In re Livent., Inc. Sec. Litig*., 78 F. Supp. 2d 194, 214-16 (S.D.N.Y. 1999) (scienter adequately pleaded where two defendants "are alleged to have orchestrated the fraud in general and to have personally carried out many of its specifics" and two others "are alleged to have participated in carrying it out with knowledge of its impropriety," even absent knowledge of effect of schemes on financial statements); *T.H.C., Inc. v. Fortune Petroleum Corp.*, Nos. 96-2690 & 96-2691, 1999 WL 182593, at *4 n.6 (S.D.N.Y. Mar. 31, 1999) (allegation that defendant directed manipulative transaction is sufficient to plead scienter); *In re Health Mgmt., Inc. Sec. Litig*., 970 F. Supp. 192, 204 (E.D.N.Y. 1997) (complaint furnishes "direct evidence of scienter" where plaintiff alleges the defendant convened meeting where inventory fraud scheme was developed, approved plan to engage in inventory fraud, and thus had actual knowledge of fraud).

simple denials of Plaintiffs' factual allegations. Such arguments cannot succeed on a motion to dismiss, where the Court must accept as true the facts alleged in the complaint, and where "[a]ll reasonable inferences are to be drawn in the plaintiff's favor." *In re Global Crossing, Ltd. Sec. Litig.*, 2006 WL 1628469, at *3. *See also In re Regeneron Pharm., Inc. Sec. Litig.*, 2005 WL 225288, at * 24 ("Plaintiffs need not foreclose all other characterizations of fact, as the task of weighing contrary accounts is reserved for the fact finder.") (internal citations omitted).

i. Circumstantial Evidence of Officer Defendants' and Audit Committee Defendants' Conscious Misbehavior or Recklessness

The Complaint sets out detailed allegations regarding the Officer Defendants' high-ranking positions and roles within Refco,[74] and alleges that the Officer Defendants were "responsible for the Company's operations and played a critical role in its management." ¶ 565; *see also* ¶ 60(d) (Trosten, Sexton and Murphy were part of the "New York Five" along with Bennett and Maggio); ¶ 260(b) (Officer Defendants are a select group of "key" employees with management agreements). Thus, all of these Defendants are alleged to have been intimately familiar with the Company's financial condition and reporting. *Id.* Silverman, moreover, was asked by the Board to resign at the same time as Bennett and Maggio – *i.e.,* as part of the fallout from the revelations of fraud. ¶ 37. The circumstances of the resignation of Silverman – an accountant and controller of Refco – further suggest his culpability in the fraud. *See, e.g. In re Mercator Software Inc. Sec. Litig.,* 161 F.Supp.2d 143 (D. Conn. 2001).

The Complaint also goes into significant detail regarding the Audit Committee Defendants' responsibility for the integrity of Refco's financial statements and for reviewing the

[74] For a detailed discussion of these allegations, see the statement of facts above and the discussion of control, *supra*.

effectiveness of Refco's internal controls. ¶¶ 565, 598-608. Additionally, the Complaint alleges that as of February 28, 2005 – before the Registered Bond Exchange Offer and the IPO – Refco's auditors had reported two "significant deficiencies" in the Company's internal controls. ¶ 603. In the Company's own words, a "significant deficiency" in internal controls creates "more than a remote likelihood that a misstatement of the financial statements that is more than inconsequential will not be prevented or detected." *Id.* These deficiencies included "the need to increase [the Company's] existing finance department resources to be able to prepare financial statements that are fully compliant with all SEC reporting guidelines on a timely basis," and the "lack of formalized procedures for closing [the Company's] books." *Id.* These deficiencies – which had existed well before 2005 and should have been readily obvious to the Audit Committee Defendants – created an environment where it was easy for Refco's executives to manipulate Refco's financial statements. ¶ 604-05. Incredibly, even after being expressly informed of these deficiencies in February 2005, the Audit Committee Defendants failed to remedy them in a timely fashion, and they remained unresolved six months later when the Company completed its IPO based on fraudulent financial statements. ¶ 606. Were it not for the Audit Committee Defendants' reckless failure to fulfill their responsibilities, the fraud would have been detected (or prevented) much earlier.

Taken together with the "red flags" listed above – and with the startling fact that a Refco employee who had been working for the Company for less than two months unraveled and exposed the fraudulent scheme (¶¶ 7, 608)[75] – Plaintiffs' allegations are sufficient to establish a

[75] While Sherer attempts to take credit for uncovering the hidden receivables scheme (Sherer Mem. at 2, 11) that claim is contrary to the allegations of the Complaint, which alleges that it was not Sherer, but an employee who had been at Refco for less than two months who brought the issue to light. *See, e.g.,* ¶¶ 7, 608.

strong inference of the Officer Defendants' and the Audit Committee Defendants' scienter. As the court stated in *In re American Bank Note Holographics, Inc.*, 93 F. Supp. 2d 424, 447 (S.D.N.Y. 2000), "the admitted falsity of the statements, the extraordinary degree to which they were false, the length of time (covering several years) that the statements were false, and [the defendants'] access [to the company's] actual sales and revenue information . . . combine to raise a strong inference that [the defendants] engaged in conduct that was either conscious or reckless."

The Officer Defendants and the Audit Committee Defendants dispute the sufficiency of Plaintiffs' allegations of conscious misbehavior or recklessness as being "too generalized" or constituting impermissible "group pleading," and argue that such allegations cannot suffice as circumstantial evidence of their scienter. Sexton Mem. at 9-10, Silverman Mem. at 22, Murphy/Sherer Mem. at 27, THL/Audit Comm. Mem. at 29. These arguments are misplaced in light of Plaintiffs' allegations concerning significant particulars of the massive nature of the fraud at issue and Defendants' high-level positions and responsibilities within Refco. As Judge Connor explained regarding the scienter of corporate officers:

> Knowledge of the falsity of a company's financial statements can be imputed to key officers who should have known of facts relating to the core operations of their company that would have led them to the realization that the company's financial statements were false when issued.
>
> * * * *
>
> [T]he individual defendants … were all high-level corporate officers during the class period who signed SEC filings containing the financial statements that plaintiffs have adequately alleged were materially false or misleading. As signatories to the SEC filings that contained the company's financials, each individual defendant who served as a high-level officer had a duty to familiarize himself with the facts relevant to the core operations of the company and the financial reporting of those operations. *See Howard*, 228 F.3d at 1062 ("Key corporate officers should not be allowed to make important false financial statements knowingly or recklessly, yet still shield themselves from liability to investors simply by failing to be involved in the preparation of those statements."). *The individual defendants were not entitled to make statements*

> *concerning the company's financial statements and ignore reasonably available data that would have indicated that those statements were materially false or misleading.*

In re Atlas Air Worldwide Holdings, Inc. Sec. Litig., 324 F. Supp. 2d at 490-91 (emphasis added); *see also In re NTL, Inc. Sec. Litig.*, 347 F. Supp. 2d 15, 28 (S.D.N.Y. 2004) ("Allegations of defendants' knowledge of facts or access to contradictory information usually are sufficient to state a claim based on recklessness.").

Defendants also place significant emphasis upon two other equally misguided arguments. First, the Officer Defendants mistakenly claim that the size of a fraud cannot be evidence of scienter.[76] Although size alone does not necessarily create an inference of scienter, it is an important factor to be considered, and can give rise to a strong inference of scienter in combination with other factors. *See, e.g., WorldCom*, 2003 WL 21219049, at *21; *Global Crossing*, 322 F. Supp. 2d 319, 347 (S.D.N.Y. 2004); *Rocker Mgmt., LLC v. Lernout & Hauspie Speech Prods., N.V.,* No. Civ. A. 00-5965 (JCL), 2005 WL 1366025, *8 (D.N.J. June 8, 2005); *In re Rent-Way Sec. Litig.,* 209 F. Supp. 2d 493, 506 (W.D. Pa. 2002). As one court has explained:

> [T]he magnitude of reporting errors may lend weight to allegations of recklessness where defendants were in a position to detect the errors. The more serious the error, the less believable are defendants' protests that they were completely unaware of [the company's] true financial status and the stronger is the inference that defendants must have known about the discrepancy.

Rehm v. Eagle Fin. Corp., 954 F. Supp. 1246, 1256 (N.D. Ill. 1997). *See also Microstrategy*, 115 F. Supp. 2d at 636-37 ("[C]ommon sense and logic dictate that the greater the magnitude of a restatement or violation of GAAP, the more likely it is that such a restatement or violation was made consciously or recklessly.").

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[76] Sexton Mem. at 11, Klejna Mem. at 21, Murphy/Sherer Mem. at 29.

Second, certain Defendants also mistakenly claim that, to establish scienter, Plaintiffs must allege the receipt or review of specific internal reports or statements containing information contrary to the false and misleading public statements.[77] In *Atlas*, the court specifically rejected that proposition, and held that "[a] plaintiff is required only to supply some factual basis for the allegation that the defendant had concluded or should have concluded that the statements were false at some point during the time period alleged." *Atlas,* 324 F. Supp. 2d at 495 (citations and internal quotation marks omitted). Indeed, it is well-established that a plaintiff can show conscious misbehavior or recklessness by alleging a defendant's "knowledge of facts or access to information that contradict[ed] the [defendants'] public statements," or by alleging that "[d]efendants failed to review or check information [that] they had a duty to monitor, or ignored obvious signs of fraud." *Novak*, 216 F.3d at 308; *see also In re Scholastic Corp. Sec. Litig.*, 252 F.3d 63, 76 (2d Cir. 2001); *S.E.C. v. Price Waterhouse*, 797 F. Supp. 1217, 1240 (S.D.N.Y. 1992) (recklessness is the "egregious refusal to see the obvious, or to investigate the doubtful") (internal citations omitted).

ii. **Facts Supporting the Officer Defendants' and Audit Committee Defendants' Motive and <u>Opportunity to Commit Fraud</u>**

In addition to the circumstantial evidence of scienter, Plaintiffs have alleged significant facts demonstrating that the Officer Defendants and Audit Committee Defendants had both motive and opportunity to commit fraud within the Class Period, including:

- the Officer Defendants' receipt of payments totaling $29 million through the liquidation of a profit-sharing agreement in the context of the LBO. Among others, Murphy received $13.7 million, Sexton received $9 million and Klejna received $6.5 million (¶ 584);

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[77] Sexton Mem. at 12, Klejna Mem. at 19, THL/Audit Comm. Mem. at 30-31. Of course, the Complaint *does* allege this for Trosten and Silverman. *See* ¶¶ 490-94, 496 (Trosten) and 269(a) (Silverman).

- the Officer Defendants' and Audit Committee Defendants' receipt of unusually large grants of Refco common stock on the eve of the IPO. The value of these grants was over $10 million to Sherer, Sexton and Murphy, $5.7 million to Klejna, and $286,000 to each of the Audit Committee Defendants (¶ 585);

- the Officer Defendants' receipt of cash payments pursuant to the "Green Shoe" oversubscription option on the IPO, where Sherer, Sexton, Murphy, and Klejna received an undisclosed portion of the $87 million paid to the limited group of shareholders of record before the IPO (*see* ¶ 587 (estimating payments based on a pro-rata distribution));

- grants to the Officer Defendants and the Audit Committee Defendants in the form of RSUs – awards of large blocks of stock that vest over time upon certain conditions, including the achievement of EBITDA targets – in advance of the IPO. Murphy and Sexton each received 701,963 RSUs and Klejna received 350,981 RSUs (¶ 591). Audit Committee Defendants O'Kelley, Breitman and Gantcher each received 20,000 RSUs, and were the only Board members to receive such awards (¶ 592); and

- the Officer Defendants' desire to receive bonuses under the Senior Management Bonus Pool Plan, which bonuses were subject to performance criteria based on EBIDTA and thus created an incentive to conceal, rather than write off, uncollectible receivables (¶ 593).

Moreover, Plaintiffs allege as motive the Officer Defendants' and Audit Committee Defendants' determination and resolute commitment to ensure that Refco had a successful IPO, which would allow each of them to reap huge financial rewards from their ownership stakes in the Company. ¶¶ 588, 590 ("the five guys who were running the company were all hooked into the IPO"). Plaintiffs allege that Defendants had opportunity to commit fraud by virtue of the fact that they each prepared, reviewed and/or approved Refco's financial statements and other documents containing the materially false and misleading statements and omissions. ¶ 594.

Defendants characterize the multiple benefits outlined above as being common to all executives, tantamount to executive compensation, and as being too generalized to demonstrate scienter. Sexton Mem. at 13; Murphy/Sherer Mem. at 19, 21; THL/Audit Comm. Mem. 26. This argument is without merit as Plaintiffs' allegations establish that the benefits described

above were not part of these Defendants' compensation packages and arose only by virtue of the unique circumstances surrounding Refco's LBO and IPO.

Defendants further argue that the "mere" ownership of stock is insufficient to establish scienter and that they must have actually sold their shares to incur liability. There are two significant flaws with this argument. First, courts in this District have held that the receipt of shares can constitute motive. *Marcus v. Frome*, 329 F. Supp. 2d 464, 473 (S.D.N.Y. 2004) (plaintiffs adequately alleged motive and opportunity by showing the defendants would personally benefit from fraud through receipt of shares for themselves and family members). Second, Defendants *were not able* to sell their shares of Refco following the IPO because there was a "lock up" agreement in place preventing any sales for 180 days, and within that period the Company spiraled quickly into bankruptcy upon revelation of the massive fraud. ¶ 586. Accordingly, the fact that Defendants did not sell all of their Refco shares does not negate motive.[78]

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[78] Certain Officer Defendants (*i.e.,* Klejna and Sherer) and the Audit Committee Defendants argue for a negative inference of scienter due to their purchase of some Refco shares one day after the IPO. Klejna Mem. at 16; Murphy/Sherer Mem. at 20; THL/Audit Comm. Mem. at 27. However, such arguments cannot be resolved absent discovery and are inappropriate on a motion to dismiss. *See, e.g., In re Cardinal Health Inc. Sec. Litigs.*, 426 F. Supp. 2d 688, 731 (S.D. Ohio 2006) ("'the calculus is clearly more complicated'") (quoting *Microstrategy*, 115 F. Supp. 2d at 646). This is especially true in this case because of the highly suspicious fact that four out of the five Defendants at issue (Klejna, Sherer, O'Kelley and Breitman) bought exactly the same number of shares (2,900) at the same price ($22) on the same day (August 11, 2005). Klejna Mem. at 16; Murphy/Sherer Mem. at 20; THL/Audit Comm. Mem. at 27. Indeed, Defendant Maggio purchased even more Refco shares on August 11, 2005 (12,500 shares) and he has not even filed a motion to dismiss, which is not surprising given his extensive role in the fraud. *See* ¶¶ 397-99, 402-05, 482-84. Similarly, Sexton's and Murphy's efforts to point to pre-IPO "investments" in Refco of $1 million and $500,000, respectively, to negate any inference of scienter are improper at this stage and should await discovery (including discovery regarding the actual facts and circumstances surrounding the complex, multi-party series of pre-IPO transactions involved in, and concurrent with, the LBO – from which these Defendants also received substantial benefits).

3. Plaintiffs Have Pleaded Loss Causation With Respect to Their Section § 10(b) Claim Against Grant Thornton for Plaintiffs' Damages After October 10, 2005

Of the twenty-seven Defendants moving to dismiss all or part of the Complaint, only Grant Thornton raises any argument for dismissal on the ground of a purported failure to plead loss causation. According to Grant Thornton, only a small portion of the losses suffered by Plaintiffs and the Class could be recoverable against Grant Thornton, because on October 10, 2005, Refco announced that its audited financial statements should no longer be relied upon. GT Mem. at 18. Based upon this disclosure alone, which Grant Thornton itself concedes was incomplete according to the allegations of the Complaint (GT Mem. at 20; ¶¶ 199-204), Grant Thornton argues that none of the losses suffered on or after October 11, 2005 are recoverable from Grant Thornton because it cannot be considered the "cause" of those losses. GT Mem. at 18-20. Thus, Grant Thornton would have the Court significantly limit Plaintiffs' damages on a motion to dismiss "as a matter of law" based on its assertions – contrary to the facts alleged in the Complaint and in the absence of any discovery to date – that "any artificial inflation in the price of Refco's securities that was arguably traceable to Grant Thornton was extinguished on October 10." *Id.* This argument is not only premature at this stage of the litigation, but it is not supported by the cases that Grant Thornton cites and is completely at odds with the facts alleged in the Complaint.

In *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336 (2005), the Supreme Court adopted a pragmatic, common-law tort approach to loss causation in securities litigation. Expressly endorsing loss causation as it has been defined in the *Restatement (Second) of Torts* and the Second Circuit, the Supreme Court held that the element of loss causation requires a plaintiff to show that the misrepresentation "proximately caused the plaintiff's economic loss." 544 U.S. at 344-46. The Court did not suggest that all securities fraud claims must be

characterized by one corrective disclosure followed by a single large stock price decline; to the contrary, the Court explained that loss may be caused if the investor sells after "the relevant truth begins to leak out" (*id.* at 342), thus recognizing that some cases may involve a series of adverse disclosures and stock price declines.

Among the decisions cited with approval by the Supreme Court in *Dura* was the Second Circuit's decision in *Emergent Capital Investment Management, LLC v. Stonepath Group, Inc.*, 343 F.3d 189 (2d Cir. 2003). In *Emergent Capital*, the Second Circuit held that proximate cause in a securities case exists when "damages suffered by plaintiff [are] a foreseeable consequence of any misrepresentation or material omission." *Id.* at 197. *See also Restatement (Second) of Torts* § 548A cmt. B (1977) (causation is established if the losses can "reasonably be expected to result from the misrepresentation"); *Lentell v. Merrill Lynch & Co.*, 396 F.3d 161, 173 (2d Cir. 2005), *cert. denied*, 126 S. Ct. 421 (2005) ("a misstatement or omission is the 'proximate cause' of an investment loss if the risk that caused the loss was within the zone of risk *concealed* by the misrepresentations and omissions alleged by a disappointed investor); *In re Initial Public Offering Sec. Litig.*, 399 F. Supp. 2d 261, 266 n.23 (S.D.N.Y. 2005) (Second Circuit's loss causation standard was "undisturbed by *Dura.*").

In terms of Plaintiffs' pleading burden to allege loss causation in a securities fraud complaint, the Supreme Court in *Dura* "assumed" that plaintiffs would only be required, pursuant to Rule 8(a), to plead "a short and plain statement of the claim." 544 U.S. at 346. *See also id.* at 347 ("it should not prove burdensome for a plaintiff who has suffered an economic loss to provide defendant with some indication of the loss and the causal connection that the plaintiff has in mind."). Following *Dura,* courts have agreed that plaintiffs need only satisfy liberal Rule 8 notice pleading requirements for loss causation. *See, e.g., In re Marsh &*

McLennan Cos., Inc. Sec. Litig., MDL No. 1744, 2006 WL 2057194, at *32 (S.D.N.Y. July 20, 2006); *In re NYSE Specialists Sec. Litig.*, 405 F. Supp. 2d 281, 315 (S.D.N.Y. 2005). When viewed against these standards, Grant Thornton's efforts to cut off a material portion of Plaintiffs' damages in this case as a pleading matter should be rejected.

First, the allegations of the Complaint, which must be accepted as true for purposes of Defendant's motion, are unambiguous. Plaintiffs allege that Refco's October 10, 2005 disclosure of a previously unreported $430 million receivable owed by Bennett to Refco was not a complete disclosure of Defendants' fraud, but merely the first of a number of adverse disclosures during the period from October 10 through October 17, 2005, all of which were a direct result of Defendants' fraud. *See* ¶¶ 199-211. In fact, as alleged in the Complaint, while Refco's October 10, 2005 press release stated that Bennett had repaid the newly-disclosed receivable, it failed to disclose that Bennett had obtained the funds from BAWAG or any of the facts related to Refco's relationship with BAWAG. Refco also downplayed the impact of the newly-released information on Refco's ongoing business and publicly stated, on October 11, 2005, that it had "adequate liquidity to run the business in the ordinary course." ¶ 205. This assertion was directly contradicted by Refco's disclosure, on October 13, 2005, that the Company's capital markets subsidiary no longer had sufficient liquidity to operate its business, which – until trading was halted by the New York Stock Exchange – led to another material decline in the price of Refco common stock. ¶¶ 207, 208. When trading was finally resumed on October 18, 2005, after Refco announced its intention to seek bankruptcy protection, the price of Refco common stock traded down to just 65 cents per share. ¶ 209. Refco bonds (which were not halted from trading) declined to as low as 16% of par following Refco's October 13, 2005 disclosure, losing at least 80% of their value in just four days. ¶ 208. Thus, it is simply not

accurate for Grant Thornton to assert that all of the previously undisclosed facts were made public on October 10, 2005. As set forth in the Complaint, they were not.

Nor can Grant Thornton argue that Refco's October 10, 2005 disclosure "necessarily removed any artificial inflation in the price of Refco securities that could have been attributed to Grant Thornton." GT Mem. at 19. Neither Refco nor Grant Thornton provided full disclosure of the previously misstated or omitted facts on October 10, 2005. In fact, as of October 10, 2005, Grant Thornton's clean audit opinion for Refco remained issued and outstanding. As alleged in the Complaint, the true facts, including Refco's inability to operate as a going concern, continued to be revealed in the days that followed, causing the price of Refco common stock and bonds to lose nearly all value.

Second, Grant Thornton cannot be heard to argue on a motion to dismiss that the SEC's investigation of Refco (¶ 205), the arrest of Bennett (¶ 206), or the liquidity crisis that was triggered at Refco in response to the October 10, 2005 disclosure (¶ 207) were not foreseeable consequences of Defendants' misrepresentations and material omissions (including the misrepresentations in Grant Thorton's clean audit opinions). Indeed, these are precisely the sort of events that Grant Thornton should have expected to occur upon the revelation of fraud at Refco. *See, e.g., Suez Equity Investors, L.P. v. Toronto-Dominion Bank*, 250 F.3d 87, 97 (2d Cir. 2001) ("it would have been foreseeable to defendants that facts concealed [regarding bankruptcy, tax liens, delinquent credit history and civil litigation related to Group's founder and principal] . . . would have indicated [the executive's] inability to run the Group, and would have forecast its (eventually fatal) liquidity problems"); *In re Parmalat Sec. Litig.*, 375 F. Supp. 2d 278, 305-07 (S.D.N.Y. 2005) (Parmalat's disclosure of a liquidity crisis and resulting stock price

decline was a foreseeable consequence of defendants' materially misstated financial statements and audit opinions).

Grant Thornton argues, in essence, that the adverse disclosures which followed Refco's October 10, 2005 disclosure were not foreseeable consequences of Defendants' fraud, but rather separate, intervening events that somehow broke the chain of causation. Those arguments are "a matter of proof at trial and not to be decided on a Rule 12(b)(6) motion to dismiss." *Emergent Capital*, 343 F.3d at 197.[79] Moreover, for Grant Thornton to succeed with this factual defense at trial it would have to demonstrate that the SEC investigation, arrest of Bennett, and the liquidity crisis at Refco were all separate events with "no connection" to the alleged prior misstatements and omissions, and that they were the result of "unforeseeable" events. *See, e.g., Castellano v. Young & Rubicam, Inc.*, 257 F.3d 171, 190 (2d Cir. 2001) (intervening events are "external and unforeseeable factors" unrelated to alleged fraud); *Restatement (Second) of Torts* § 548A cmt. B (1977) (described intervening event as having "no connection" to alleged fraud, for example, a stock decline caused by the sudden death of a corporation's leading officer).[80] While these

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[79] *See also Exxon Co., U.S.A. v. Sofec, Inc.*, 517 U.S. 830, 840-41 (1996) ("The issues of proximate causation and superseding cause involve application of law to fact, which is left to the factfinder, subject to limited review"); *In re Tyco Ltd. Sec. Litig.*, 2005 U.S. Dist. LEXIS 19154, at *46 (D.N.H. Sept. 2, 2005) ("even if…there had been an intervening event that interrupted the chain of causation, such a determination is a matter of proof after discovery, either at summary judgment or at trial, and is not to be decided here on a Rule 12(b)(6) motion to dismiss") (citing *Lentell*, 396 F.3d at 174).

[80] *See also Caremark, Inc. v. Coram Healthcare Corp.,* 113 F.3d 645, 649-50 (7th Cir. 1997) (loss causation adequately pled and not "negated by [plaintiff] having mentioned in the complaint other causes that could have contributed to the fall in the value of the notes…. [I]t is possible for more than one cause to affect the price of a security and, should the case survive to that point, a trier of fact can determine the damages attributable to the fraudulent conduct") (citation omitted); *Miller v. Asensio & Co., Inc.*, 364 F.3d 223, 232 (4th Cir. 2004) (to establish loss causation plaintiff is not required "to prove that the defendant's fraud was the *sole* cause of the plaintiff's loss."); *Semerenko v. Cendant Corp.*, 223 F.3d 165, 186-87 (3d Cir. 2000) (plaintiff adequately pled loss causation by alleging that defendant's misrepresentations "directly or proximately caused, or were a *substantial contributing cause of*, the damages sustained by plaintiff" and "so long as the alleged misrepresentations were a substantial cause of the inflation in the price of a security and in its subsequent decline in value, other contributing forces will not bar recovery") (emphasis added); *In re Daou Sys., Inc. Sec. Litig.*, 411 F.3d 1006, 1025 (9th Cir.

(Cont'd)

issues of proof are premature at this juncture, it is hard to imagine any scenario where Grant Thornton could carry its burden of proof to demonstrate that the additional adverse disclosures which followed Refco's October 10, 2005 disclosure were entirely unrelated to that disclosure. Accordingly, Grant Thornton's attempt to "extinguish" Plaintiffs' losses suffered after October 10, 2005 at this early pre-discovery stage of the litigation as a "matter of law" should be rejected.

B. The Complaint Adequately Pleads Claims for Control Person Liability Under § 20(a) (Counts XI, XII and XIII)

Defendants Refco Holdings, the Bennett Trust, the THL Defendants, the Audit Committee Defendants, Murphy, Sherer, Trosten, Grant, Sexton, Silverman and Klejna move to dismiss the claims asserted against them under § 20(a) of the Exchange Act (Counts XI, XII and XIII). They argue that these claims should be dismissed because the Amended Complaint fails to adequately allege either "control" or "culpable participation." *See* Bennett Mem. at 16-18; THL/Audit Comm. Mem. at 40-46; Murphy/Sherer Mem. at 31-36; Trosten Mem. at 22; GT Mem. at 17-22; Sexton Mem. at 17-20; Silverman Mem. at 5-14; Klejna Mem. at 24-30. As discussed below, because the Complaint adequately alleges both of these elements, the § 20(a) claims asserted against these Defendants should be sustained.

2005), *cert. denied*, 126 S. Ct. 1335 (2006) (plaintiffs were not required to show that a "misrepresentation was the *sole* reason" for stock's decline in value in order to establish loss causation, and so long as the misrepresentation is "one substantial cause of the investment's decline in value, other contributing forces will not bar recovery under the loss causation requirement"); *In re Enron Corp. Sec., Deriv. & ERISA Litig.*, 2005 U.S. Dist. LEXIS 41240 (S. D. Tex. Dec. 22, 2005) ("Plaintiff's loss need not be caused exclusively by the defendant's fraud.") (citations omitted); *Schuster v. F.H. Anderson Company, P.C.*, 413 F. Supp. 2d 983, 1014 (N.D. Iowa 2005) ("Thus, a plaintiff must prove that the pecuniary injury is directly attributable to the wrongful conduct. However, it does not need to be the exclusive or even primary cause. Rather, it is enough to show 'some causal nexus' between [the defendant's] improper conduct and plaintiff's losses . . . .") (internal citation omitted); *In re UnumProvident Corp. Sec. Litig.*, 396 F. Supp. 2d 858, 898 (E.D. Tenn. 2005) ("A plaintiff need not allege the defendant's misrepresentations were the sole cause of the plaintiff's loss, only that they were a substantial contributing cause") (citations omitted).

1. The Complaint Adequately Alleges Defendants' Control of Persons Primarily Liable Under the Exchange Act

It is well-established that the liberal pleading standards of Rule 8 apply to allegations of "control" under § 20(a). *See In re Global Crossing Ltd. Sec. Litig.*, No. 02 Civ. 910, 2006 WL 1628469, at *11 (S.D.N.Y. June 13, 2006) (because Rule 8(a) applies to allegations of control under both Section 15 of the Securities Act and Section 20(a) of the Exchange Act, "even if the facts alleged do not, by themselves, permit an inference of control, 'dismissal is improper as long as it is at least plausible that plaintiff could develop some set of facts that would pass muster'") (quoting *In re Global Crossing Ltd. Sec. Litig.*, 2005 WL 2990646, at *8 (S.D.N.Y. Nov. 7. 2005)). In contending that the Complaint fails adequately to allege "control" for purposes of § 20(a), these Defendants simply re-hash the same arguments they raised to challenge the control person claims asserted against them for violations of § 15 of the Securities Act. As discussed above, the allegations of the Complaint are sufficient to state a claim under § 15. For these same reasons, the element of "control" has been adequately pled for purposes of § 20(a). *See Global Crossing,* 2006 WL 1628469, at *11.

2. The Complaint Adequately Alleges Culpable Participation

Defendants argue that, even if "control" is adequately alleged, the Complaint fails to set forth sufficient particularized allegations of their "culpable participation" in the Refco fraud. This argument should be rejected.[81]

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[81] While Lead Plaintiffs recognize that this Court adheres to the line of cases in this Circuit that applies the PSLRA's heightened pleading requirements to the "element" of culpable participation, Lead Plaintiffs note that a separate line of cases in this Circuit holds that culpable participation is an affirmative defense under § 20(a) and, therefore, it need not be pled with specificity, if at all. *See In re Initial Public Offering Sec. Litig.,* 241 F. Supp. 2d 281, 385 (S.D.N.Y. 2003); *In re WorldCom, Inc. Sec. Litig.,* 294 F. Supp. 2d 392, 414-16 (S.D.N.Y. 2003).

a. The Complaint's Scienter Allegations Satisfy the Pleading Requirements For Culpable Participation Against the Audit Committee Defendants, Trosten, and the Officer Defendants

This Court recognizes that the pleading requirements for "culpable participation" are satisfied by allegations that satisfy the "similar" pleading requirements for scienter. *Global Crossing*, 2006 WL 1628469, at *11. Accordingly, Plaintiffs' allegations regarding the scienter of Trosten, the Officer Defendants, and the Audit Committee Defendants also satisfy the pleading requirements for culpable participation.

b. The Bennett Shell Entities

Refco Holdings and the Bennett Trust move to dismiss the § 20(a) claims asserted against them (Refco Holdings in Counts XI, XII and XIII and the Bennett Trust in Count XII). Remarkably, however, Refco Holdings does not contest that scienter is adequately alleged against it with respect to its alleged violations of Rule 10b-5(a) and (c) (Count X). It is wholly inconsistent for Refco Holdings to concede, on one hand, that the Complaint adequately alleges its scienter, but argue on the other that it fails to allege its culpable participation.

Moreover, the Complaint alleges in detail that both Refco Holdings and the Bennett Trust are simply instrumentalities of Defendant Bennett himself, and that Bennett used them during the Class Period as vehicles to exercise control over Refco by holding up to 60% (Refco Holdings) and 40% (the Bennett Trust) of Bennett's equity interest in the Company. ¶ 261(b). The Complaint alleges that "Refco Holdings and the Bennett Trust were instrumentalities of Defendant Bennett, wholly dominated and controlled by Bennett, with no ability to take any action independent of Bennett." ¶ 261(a); *see also* ¶¶ 28, 261(b)-(e). Consistent with these allegations, Refco Holdings repeatedly states in its Answer to the Complaint that "defendant Phillip R. Bennett is the only known individual representative of [Refco Holdings] capable of

responding on its behalf . . . ." *See* Answer of Defendant Refco Holdings at ¶¶ 1, 2, 4, 6, 8, 10-12, 16, 17.[82] Given Plaintiffs' specific allegations concerning Bennett's direct participation in, and knowledge of, the Refco fraud (*see* ¶¶ 393-97, 472-502, 568) – allegations which Bennett concedes are sufficient to allege his scienter and culpable participation – the allegations that Bennett used these shell entities as his instrumentalities and that they "had control of Refco by virtue of Defendant Bennett's pervasive control of the Company … which was at all times exercised through Refco Holdings and/or the Bennett Trust" (¶ 261(a)) satisfy the culpable participation element of § 20(a).

In addition, Refco Holdings' assertion that "Plaintiffs do not allege that [Refco Holdings] . . . played any role in the alleged fraudulent scheme" (Bennett Mem. at 18), is simply incorrect. The Complaint contains more than 145 pages of allegations describing – in what the THL Defendants characterize as "painstaking detail" (THL/Audit Comm. Mem. at 43) – Refco Holdings' direct involvement in the fraud at Refco. Specifically, the Complaint alleges that Bennett and others transferred to Refco Holdings as much as $970 million in uncollectible receivables owed to Refco and, at each financial period end, concealed these receivables through a series of fraudulent transactions that were used "to temporarily pay down the receivable owed to Refco from Refco Holdings." ¶ 399; *see also id.* ¶¶ 380-524. As the Complaint makes abundantly clear, Refco Holdings was directly involved in these fraudulent transactions. *See* ¶¶ 517, 518 (charts showing Refco Holdings' involvement). This type of direct involvement is the very definition of culpable participation. Accordingly, culpable participation is adequately pleaded against Refco Holdings and the Bennett Trust.

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[82] The Answer of Defendant Refco Holdings uses "RGHI" to refer to Refco Holdings. *See* Answer of Defendant Refco Holdings at ¶ 1.

c. The THL Partner Defendants and the THL Individual Defendants

The THL Partner and THL Individual Defendants assert that the culpable participation allegations against them amount to nothing more than a claim that they "should have guessed that Bennett and his co-conspirators were engaged in a fraud." THL/Audit Comm. Mem. at 43-44. Based on this assertion, they argue that the § 20(a) claim against them should be dismissed. This argument should be rejected because it: (i) attempts to minimize the detailed factual allegations of the Complaint by drawing inferences in favor of the THL Defendants; (ii) addresses the allegations in a piecemeal fashion instead of viewing them in their entirety as required; and (iii) wrongly suggests that Lead Plaintiffs can only plead culpable participation through allegations of actual knowledge, when the law is clear that allegations of recklessness will suffice.

First, the Complaint contains a wealth of detailed allegations about the THL Defendants, including that the THL Partners acquired a 57% ownership interest in the Company at the start of the Class Period, and at all times thereafter exercised control over Refco through this ownership interest by, among other things, designating the THL Individual Defendants to serve on Refco's Board. ¶¶ 46, 263(a)-(b). As alleged in the Complaint, the THL Partner Defendants were "deeply involved in the day-to-day management of Refco." ¶ 263; *see also* ¶¶ 264-68, 687(a)-(i).[83] Indeed, the Offering Memorandum acknowledges that the THL Partner Defendants had "the ability to control all aspects of [the Company's] business." ¶ 263(c). THL Partners entered into a Management Agreement with Refco pursuant to which THL Partners received

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[83] Far from "clump[ing]" the THL Individual Defendants together (THL/Audit Comm. Mem. at 45), the Complaint separately describes the roles of these individuals. *See, e.g.*, ¶¶ 265-68.

compensation for its "special skills and management advisory services" they provided to Refco. ¶ 263(d).

In addition to these and other allegations of insider access to information at the Company, the Complaint alleges in detail the unusual and significant motives possessed by the THL Defendants to ignore the fraud at Refco.[84] These motives were coupled with the THL Defendants' reckless failure to see obvious indicators of this fraud, such as: (i) the massive size of the fraud – up to 3,045% of the Company's net income for certain quarters (¶ 560); (ii) the recurring and unusual nature of the transactions (¶¶ 561, 562); and (iii) the detailed line item records of the round-trip transactions that were available to – but apparently ignored by – the THL Defendants and others (¶ 567(a)-(c)). *See Microstrategy,* 115 F. Supp. 2d at 635 ("the number, size, timing, nature, frequency and context of the misapplication or restatement are taken into account" in considering whether a complaint adequately pleads scienter.).

The THL Defendants respond to these allegations by mislabeling them as "status allegations" and allegations of "generalized economic motive." THL/Audit Comm. Mem. at 44. This response, however, ignores the Complaint's detailed allegations, including unique motives that go beyond a run-of-the-mill desire to profit from increases in Refco's stock price. *See* ¶¶ 587, 589, 687(h). Likewise, the THL Defendants' access to insider information, which is alleged in detail in the Complaint, put the THL Defendants in the unique position of being involved in "day-to-day" management of the Company by virtue of the Management Agreement,

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[84] *See* ¶ 687(h) (incentive to complete IPO and cash out investment); *id.* (handsome profit of $210 million on IPO while retaining 38% stake in Company); ¶ 687(i) ("strong incentive to maintain a high demand . . . in order to trigger the 'green shoe' option and benefit [by] nearly $43 million as a result"); ¶ 587 (same); ¶ 589 ("A successful IPO would also provide additional benefits to the THL Defendants because they were in the process of marketing a new private equity fund . . . the THL Defendants could 'leverage' the publicity provided by a high-profile IPO of Refco by touting the quick profits they and their co-investors had realized…").

as well as being 57% owners of pre-IPO Refco. ¶ 263(d). As discussed above, the Complaint alleges that the THL Defendants had unfettered access to Refco's inside information, including numerous records that would have alerted them to the fraud.

Second, the THL Defendants ask the Court to engage in the discredited practice of scrutinizing Plaintiffs' allegations in isolation to see if – standing alone – any single fact is adequate to demonstrate culpable participation. *See* THL/Audit Comm. Mem. at 44. However, even under the heightened pleading requirements of the PSLRA, the Court should consider the Complaint's allegations in the aggregate. *See Phillips v. Scientific Atlanta, Inc.*, 374 F.3d 1015, 1017 (11th Cir. 2004) ("we readily join the courts that have interpreted the PSLRA to permit the aggregation of facts to infer scienter").

Third, the THL Defendants argue that "there is no allegation that the THL Partner or Individual Defendants were aware of these transactions." THL/ Audit Comm. Mem. at 44. But this misses the point. It is well-established that allegations of recklessness can satisfy the element of culpable participation. Indeed, this Court has held that "section 20(a) requires that plaintiffs plead with particularity facts giving rise to a strong inference that the controlling person knew *or should have known*" of the fraud. *See Global Crossing*, 2006 WL 1628469, at *11 (emphasis added) (citing *In re Global Crossing Ltd. Sec. Litig.*, 322 F. Supp. 2d 319, 349 (S.D.N.Y. 2004)). Thus, it is no answer to respond, as the THL Defendants do, that the Complaint fails to allege their actual knowledge of the fraud. Because Plaintiffs have alleged detailed facts giving rise to a strong inference that these Defendants were, at a minimum, reckless, their culpable participation is adequately alleged at the pleading stage.

d. <u>Grant</u>

Defendant Grant asserts that the Complaint fails to sufficiently allege his "culpable participation" for purposes of the § 20(a) claim asserted in Count XI. Grant Mem. 20-22. In this

regard, Grant contends that the "entirety of Plaintiffs 'culpability' allegations" against Grant are contained in paragraph 668 of the Complaint. *Id.* at 21. Grant is mistaken. While ¶ 668 does contain significant allegations of Grant's culpability – including his involvement in Refco's management and the hundreds of millions of dollars he received as part of the LBO (¶ 668) – Grant simply ignores additional allegations that, coupled with ¶ 668, give rise to a "strong inference" of culpability. *In re Global Crossing*, 2005 WL 2990646, at *9.

The Complaint alleges that, prior to the LBO, Grant and Bennett were co-owners of Refco Holdings (¶ 41), which was involved in *all aspects* of the fraud at Refco. *E.g.,* ¶¶ 517-18. Not only did Refco Holdings assume the huge uncollectible receivables that Refco's customers were unable to pay in or about 1999 (*i.e.,* while Grant was a co-owner of Refco Holdings) (¶¶ 395-97), but it was also involved in *every single one* of the yearly and quarterly sham transactions whereby hundreds of millions of dollars were transferred between Refco Holdings, third-parties, and Refco in order to conceal the uncollectible receivables. *See* ¶¶ 517-18. Grant could not have been one of only two owners of Refco Holdings, as well as the former CEO of Refco itself, and been unaware of the fraud taking place at the two companies. Indeed, between February 2000 and June 2004 – when Grant remained a co-owner of Refco Holdings – nearly *$4 billion* worth of fraudulent loans were cycled through Refco Holdings as part of the fraudulent scheme described in the Complaint. *See* ¶ 515. This fact alone gives rise to a strong inference of Grant's culpability, particularly when coupled with the fact that these inflows and outflows coincided with the end of Refco's fiscal reporting periods – which Grant, as former CEO of Refco, indisputably knew. Indeed, the fact that huge sums of money were flowing through Refco Holdings should have been an obvious red flag for Grant because Refco Holdings did not have any real business operations and was simply a holding company for Bennett's and Grant's

equity interests in Refco. ¶ 28. Accordingly, there was no conceivable legitimate business purpose for hundreds of millions of dollars to flow between Refco Holdings, Refco and third parties each year.

In short, when taken together, the allegations of the Complaint are sufficient to demonstrate Grant's culpable participation.

C. The Complaint Adequately Pleads Claims Under § 20A (Count XIV)

1. The Complaint Adequately Alleges Bennett's Contemporaneous Sales

In moving to dismiss Count XIV, Bennett contends that the Complaint fails to allege that his stock sale and Plaintiff RH Capital's purchase of Refco stock in the August 2005 IPO occurred "contemporaneously." Bennett Mem. at 21-23. This argument is inexplicable.[85]

Because allegations of contemporaneous trading are "at most, tangential to the underlying fraud aspect" of a § 20A claim, they are subject to the notice pleading requirements of Rule 8(a) of the Federal Rules of Civil Procedure. *Qwest Commc'ns Int'l, Inc.*, 396 F. Supp. 2d at 1201. Furthermore, Plaintiffs' § 20A claim "is not subject to dismissal for failure to plead contemporaneous trades unless it appears beyond doubt that [Plaintiffs] can prove no set of facts in support of their claim that would entitle them to relief." *Id.* (citation omitted).

The Complaint alleges that Bennett sold at least 5.375 million shares of Refco common stock in the IPO, which commenced on or about August 10, 2005. ¶¶ 166, 710. Plaintiff RH Capital and other class members purchased Refco stock in that IPO, with RH Capital's purchases commencing on August 11, 2005. *See* ¶¶ 166, 362; Cplt. Ex. 3. At most, then, Bennett's sales preceded RH Capital's first purchase by a single day, and it is likely that they occurred on the

[85] The THL Partner Defendants, who also sold their Refco stock in the August 2005 IPO and on the same date as Bennett, do not challenge the issue of contemporaneity.

same day. In *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith,* 495 F.2d 228 (2d Cir. 1974), the Second Circuit upheld the district court's finding of insider trading liability against defendants who sold stock between one and four days prior to the plaintiffs' purchases. *See id.* at 232-33 (the defendants sold between June 20 and June 23, and the plaintiffs purchased between June 21 and June 24). Courts in this District have uniformly found transactions even more than one day apart to be contemporaneous for purposes of an insider trading claim. *See, e.g.*, *Oxford Health Plans*, 187 F.R.D. at 144 (transactions five trading days apart were contemporaneous); *O'Connor & Assocs. v. Dean Witter Reynolds, Inc.*, 559 F. Supp. 800, 805 n.5 (S.D.N.Y. 1983) (trades within a seven-day period were contemporaneous).[86] Plaintiffs' allegations are therefore sufficient to state a § 20A claim against Bennett.[87]

2. The Complaint Adequately Pleads § 20A Claims Against the THL Partner Defendants

The THL Partner Defendants argue that: (1) the Complaint does not sufficiently allege a predicate violation of the Exchange Act; and (2) the Complaint does not sufficiently allege that the THL Partner Defendants possessed material nonpublic information. THL/Audit Comm. Mem. at 46-47. Both arguments are without merit.

To state a claim under § 20A, a complaint must allege an independent violation of "this chapter or the rules and regulations thereunder." 15 U.S.C. § 78t-1(a). The statute does not distinguish which sections of the Exchange Act must be alleged to have been violated. *Id.*

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[86] Other courts have reached the same conclusion. *See, e.g.*, *In re Engineering Animation Sec. Litig.*, 110 F. Supp. 2d 1183, 1196 (S.D. Iowa 2000) (three-day gap); *In re Cypress Semiconductor Litig.*, 836 F. Supp. 711, 714 (N.D. Cal. 1993) (five-day gap); *In re Verifone Sec. Litig.*, 784 F. Supp. 1471, 1489 (N.D. Cal. 1992) (interval between trades "could be as short as a few days, but no longer than a month").

[87] Bennett cites *Neubronner v. Millken*, 6 F.3d 666, 671 (9th Cir. 1993) for the proposition that contemporaneousness must be pled with particularity. Bennett Mem. at 23. However, *Neubronner*, involved facts and circumstances vastly different than this case, including allegations of a three-year period of contemporaneous trading. *Id*.

Defendants offer no support for their contention that allegations of a violation of § 20(a) cannot constitute the predicate violation required to state a claim under § 20A. THL/Audit Comm. Mem. at 46-47. As set forth above, the Complaint sufficiently pleads a claim against the THL Partner Defendants pursuant to § 20(a). Accordingly, the Complaint sufficiently alleges a predicate violation of § 20A.

Section 20A also requires that a defendant must have "possession of material, nonpublic information." 15 U.S.C. § 78t-1(a). By their own admission, in a complaint filed in this District on November 14, 2005, styled *Thomas H. Lee Equity Fund V., L.P., et al v. Phillip R. Bennett, et al.*, No. 05 Civ. 9608 (S.D.N.Y.) (the "THL Complaint", referenced at ¶ 119 of the Complaint), the THL Partner Defendants had access to and were in possession of extensive material nonpublic information. For example, highlighting their due diligence, the THL Partner Defendants allege that they conducted:

> review and analysis of extensive additional financial information provided by … Bennett … including historical models, balance sheets, accounts payable and asset information, daily management reports, expense breakouts, customer analysis, audited subsidiary account, investment and data concerning its business units.

THL Complaint ¶ 22(d).[88] The THL Complaint continues at length describing their insider status and access to material nonpublic information. *See, e.g.,* THL Complaint ¶ 22(h) (numerous meetings with Bennett, Maggio and other members of management); *id.* ¶ 22(i) (visits to Refco data room that contained all material contracts and agreements); *id.* ¶ 22(l) (regular and repeated contact with Bond Underwriter Defendants regarding their due diligence); *id.* ¶ 24 (access to unaudited financial statements). In light of these allegations by the THL Partner Defendants,

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[88] A copy of the THL Complaint is attached as Exhibit D to the Coffey Decl. *See also* ¶¶ 119, 572 (referencing the THL Complaint).

they cannot now seriously challenge their insider status and possession of material nonpublic information.

CONCLUSION

For the reasons set forth herein, Defendants' motions to dismiss should be denied in all respects.

Dated: New York, New York
September 15, 2006

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EXHIBIT 1

Chart of Claims[1]

KEY

A…………….defendant has answered, and/or otherwise not moved to dismiss the claim
P……………...defendant has moved to dismiss the claim only in part
M…………….defendant has moved to dismiss the claim

Count	**I**	**II**	**III**	**IV**	**V**	**VI**	**VII**	**VIII**	**IX**	**X**	**XI**	**XII**	**XIII**	**XIV**	**XV**
Officer Defendants															
Bennett	M	M	A	M	A	M		M	A		M	M	M	M	
Sherer				A	A	A		A	M			M	M		
Sexton		M	P	M		M		M	M		M	M	M		
Maggio		M	M	M		M		M	M		M	M	M		
Murphy		M	A	M		M		M	M		M	M	M		
Silverman		M	M						M		M	M	M		
Klejna			M	M		M		M	M			M	M		
Bennett Shell-Entity Defendants															
Refco Holdings		M		M		M		M		A	M	M	M		
Bennett Trust				M		M		M				M	M		
Audit Committee Defendants															
O'Kelley			P	M	A	A		A	M			M	M		
Breitman			P	M	A	A		A	M			M	M		
Gantcher			P	M	A	A		A	M			M	M		
THL Defendants															
THL Partner Defendants	M	A		A		A		A			M	M	M	M	
Lee		M	P	M	A	A		A			M	M	M		
Harkins			P	M	A	A		A				M	M		
Jaeckel	M		P	M	A	A		A				M	M		
Schoen			P	M	A	A		A				M	M		
Other Defendants															
Stock Underwriter Defendants					A		A								
Bond Underwriter Defendants	M		M												
Trosten	M	M							M		M	M			
Grant Thorton			M		M				M						
Grant		M									M				

Securities Act

Count I Section 12(a)(2) (144 A Bonds)
Count II Section 15 (144 A Bonds)
Count III Section 11 (Registered Bonds)
Count IV Section 15 (Registered Bonds)
Count V Section 11 (IPO)
Count VI Section 15 (IPO)
Count VII Section 12(a)(2) (IPO)
Count VIII Section 15 (IPO)

Exchange Act

Count IX Section 10b-5(b)
Count X Section 10b-5(a) and (c)
Count XI Section 20(a) (144 A Bonds)
Count XII Section 20(a) (Bonds between Bond Offering and IPO)
Count XIII Section 20(a) (Bonds or Stock after IPO)
Count XIV Section 20A (Stock)
Count XV Section 10b-5(a) and (c)

[1] The chart excludes claims against Defendants who are inactive due to bankruptcy filings or who have reached proposed settlements.

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

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	:	
	:	05 Civ. 8626 (GEL)
In re REFCO, INC. SECURITIES LITIGATION	:	
	:	
	:	
--	x	

CERTIFICATE OF SERVICE

I hereby certify that on September 15, 2006, a copy of the foregoing **Lead Plaintiffs' Memorandum of Law In Opposition to Defendants' Motions to Dismiss the First Amended Consolidated Class Action Complaint** was filed electronically. Notice of this filing will be sent to all parties by operation of the Court's electronic filing system.

/s/ John P. Coffey
John P. Coffey