Proposed Federal Legislation Seeks to Overturn Supreme Court Limits on Aiding and Abetting Liability in Certain Securities Cases

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Under recently-introduced legislation, a company's bankers, auditors, business partners, and outside lawyers could be held liable in civil actions under Section 20 of the Securities Exchange Act of 1934 ("1934 Act") if they provide "substantial assistance" in violation of the statute. According to Senator Arlen Specter's statement accompanying Senate Bill 1551, the Liability for Aiding and Abetting Securities Violations Act of 2009, "[t]he massive frauds involving Enron, Refco, Tyco, Worldcom, and countless other lesser-known companies during the past decade have taught us that a stock issuer's auditors, bankers, business affiliates, and lawyers—sometimes called 'secondary actors'—all too often actively participate in and enable the issuer's fraud."[1] According to Senator Specter, the amendment would overturn two prior Supreme Court decisions holding that the 1934 Act does not allow private plaintiffs to sue alleged violators who did not themselves commit an act in violation of the statute even if they allegedly aided and abetted others to violate the law.[2]

I. The 1933 and 1934 Acts

The Securities Act of 1933 ("1933 Act") regulates initial distributions of securities, while the 1934 Act for the most part regulates post-distribution trading.[3] Certain bad actors can be subject to civil liability under either express statutory rights or private rights of action that courts have implied under § 10(b) and § 14(a) of the 1934 Act.[4] In addition to the private litigation available under the Acts, the Securities and Exchange Commission ("SEC") can bring actions and injunctive proceedings.

Section 10(b) of the 1934 Act makes it unlawful for any person:

> *directly or indirectly*, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange — . . .
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, . . . any *manipulative or deceptive* device or contrivance in contravention of such rules and regulations as the [SEC] may prescribe as necessary or appropriate in the public interest or for the protection of investors.[5]

Rule 10b-5, in turn, provides that:

> It shall be unlawful for any person, *directly or indirectly*, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.[6]

II. Supreme Court First Says No Aiding and Abetting Liability Under § 10(b) in *Central Bank*

In *Central Bank of Denver, N.A. v. First Interstate Bank of Denver*, the Supreme Court considered whether a private plaintiff may maintain an aiding and abetting suit under § 10(b) against those who do not engage in a manipulative or deceptive practice.[7] In a 5-4 decision, the Court said no.

The Colorado Springs-Stetson Hills Public Building Authority ("Authority") had issued millions of dollars in bonds to finance public improvements at a planned development.[8] Central Bank served as indenture trustee for the bond issues.[9] Landowner assessment liens, in turn, secured the bonds.[10] The bond covenants required that the land subject to the liens be worth at least 160% of the bonds' outstanding principal and interest and required the developer to give Central Bank an annual report containing evidence that the 160% test was met.[11]

After the Authority defaulted on the bonds, bond purchasers sued the Authority and others directly.[12] They also contended that Central Bank was "secondarily liable" under § 10(b) for aiding and abetting the alleged fraud.[13] Central Bank allegedly agreed to delay an independent review of the land appraisal after one appraisal showed the land values nearly unchanged and Central Bank's in-house appraiser indicated the values listed appeared optimistic, among other things.[14] The court of appeals in *Central Bank*, as well as other federal courts, had previously allowed private aiding and abetting actions under § 10(b).[15]

The Supreme Court's reasoning for rejecting private aiding and abetting liability included:

- The Court "[a]dhere[d] to the text" of § 10(b).[16] The Court noted that "the language of Section 10(b) does not in terms mention aiding and abetting."[17] "Because the text of § 10(b) does not prohibit aiding and abetting, we hold that a private plaintiff may not maintain an aiding and abetting suit under § 10(b)."[18]
- The Court rejected the argument that § 10(b)'s textual use of the phrase "directly or indirectly" covers aiding and abetting, noting that aiding and abetting liability extends beyond persons who engage "even indirectly" in a proscribed activity.[19]

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• The Court noted that the "directly or indirectly" language is used elsewhere in the 1934 Act in a way that does not impose aiding and abetting liability.[20]

• The Court noted that in other statutes Congress has explicitly imposed aiding and abetting liability when it chose to do so.[21]

• The Court analyzed the express causes of action in the 1933 Act and the 1934 Act and concluded that none of the express causes of action in the 1934 Act further imposes liability on one who aids or abets a violation.[22] "From the fact that Congress did not attach private aiding and abetting liability to any of the express causes of action in the securities Acts, we can infer that Congress likely would not have attached aiding and abetting liability to § 10(b) had it provided a private § 10(b) cause of action. There is no reason to think that Congress would have attached aiding and abetting liability only to § 10(b) and not to any of the express private rights of action in the Act."[23]

• The Court found that its reasoning was confirmed by the fact that imposing aiding and abetting liability under Rule 10b-5 would result in liability when at least one element critical for recovery under 10b-5 is missing: reliance. A plaintiff must show reliance on the defendant's statement or omission to recover under Rule 10b-5.[24]

• The Court also rejected a congressional "intent" argument. While there is a general aiding and abetting statute applicable to all federal criminal offenses, Congress has not enacted a general civil aiding and abetting statute.[25]

• The Court rejected the SEC's policy argument that aiding and abetting liability should be allowed because it deters secondary actors from contributing to fraudulent activities and ensures that "plaintiffs are made whole," stating that "[p]olicy considerations cannot override our interpretation of the text and structure of the Act."[26] The Court also noted that liability for aiders and abetters exacts costs that may undermine the goals of efficiency and fair dealing in securities because of the danger of vexatious litigation, which may make it difficult for newer and smaller companies to get advice from professionals.[27]

Justice Stevens, writing for a four-member dissent in *Central Bank*, noted that in numerous prior judicial and administrative proceedings, the courts and the SEC had previously concluded that § 10(b) and Rule 10b-5 allow for aiding and abetting liability.[28] The dissent emphasized that the statute was passed in an era when courts commonly read statutes broadly to accord with their remedial purposes.[29] The dissent also noted Congress' failure to amend the statute after prior court and administrative decisions that allowed for aiding and abetting liability.[30]

III. The Supreme Court Reaches a Similar Result of No Liability for Secondary Liability in Stoneridge

In *Stoneridge Inv. Partners v. Scientific-Atlanta, Inc.*, the Supreme Court last year again declined to extend secondary actor liability under § 10(b). Specifically, the Court found that a company's vendors and customers could not be liable as secondary actors under § 10(b).[31]

The plaintiffs in *Stoneridge* sought to impose liability on entities that allegedly agreed to arrangements that allowed Charter Communications, Inc. ("Charter") to mislead its auditor and issue a misleading financial statement affecting Charter's stock price.[32] The Court held that the implied right of action under § 10(b) of the 1934 Act did not reach entities that were suppliers, and later customers, of Charter because the investors did not rely upon these entities' statements or representations.[33]

According to the complaint, Charter allegedly decided to alter its existing arrangements with Scientific-Atlanta and Motorola to mislead Charter's auditor, Arthur Andersen.[34] The complaint asserted that Charter arranged to overpay $20 for each converter set top box that Charter furnished to its customers until the end of the year, with the understanding that Scientific-Atlanta, Inc. and Motorola, Inc. would return the overpayment by purchasing advertising from Charter.[35] Thus, the transactions allegedly had no economic substance but allowed Charter to record the advertising purchases as revenue and capitalize its purchase of the set top boxes.[36] The deals allegedly misled Charter's auditor into approving a financial statement showing Charter met projected revenue and operating cash flow numbers.[37] According to the complaint, to hide the link between the increased payments for the boxes and the advertising purchases, the companies drafted documents to make the transactions appear unrelated and in the ordinary course and also backdated the supplier agreements.[38]

Although Scientific-Atlanta and Motorola had no role in preparing or disseminating Charter's financial statements, the complaint alleged that they knew or recklessly disregarded Charter's intention to use the transactions to inflate Charter's revenues and knew that investors and research analysts would rely on the resulting financial statements that Charter issued.[39] The complaint claimed that by participating in the transactions Scientific-Atlanta and Motorola violated § 10(b) and Rule 10b-5.[40]

Again, the Supreme Court rejected the notion that secondary actors could be subject to civil liability under those provisions. The Court noted that in *Central Bank* it had determined that § 10(b) liability did not extend to aiders and abettors and that § 10(b)'s text limits its scope, and the text fails to mention aiding and abetting liability.[41] The Court explained that the *Central Bank* decision led to calls for new legislation to expressly provide for aiding and abetting liability within the 1934 Act, but Congress chose not to pass such legislation.[42]

In rejecting the aiding and abetting claim in this case, the Court stated that "[r]eliance by the plaintiff upon the defendant's deceptive acts is an essential element of the § 10(b) private cause of action. It ensures that, for liability to arise, the requisite causal connection between a defendant's misrepresentation and a plaintiff's injury exists as a predicate for liability."[43] The Court found that a rebuttal presumption of reliance did not apply because Scientific-Atlanta and Motorola had no duty to disclose and their deceptive acts were not communicated to the public.[44]

The Court rejected arguments that the financial statement that Charter released was a natural and expected consequence of the deceptive acts and that without Scientific-Atlanta's and Motorola's alleged assistance Arthur Andersen would not have been misled.[45] That causal link, the lead plaintiff argued, was sufficient to invoke the presumption of reliance.[46] The Court stated:

> In effect petitioner contends that in an efficient market investors rely not only upon the public statements relating to a security but also upon the transactions those statements reflect. Were this concept of reliance to be adopted, the implied cause of action would reach the whole marketplace in which the issuing company does business; and there is no authority for this rule . . . . In all events we conclude respondents' deceptive acts, which were not disclosed to the investing public, are too remote to satisfy the requirement of reliance. It was Charter, not respondents, that misled its auditor and filed fraudulent financial statements; nothing respondents did made it necessary or inevitable for Charter to record the transactions as it did."[47]

The Court also noted that Congress specifically responded to *Central Bank* in § 104 of the Private Securities Litigation Reform Act of 1995 ("PSLRA") to provide for aiding and abetting liability in SEC actions but not for a private party in litigation.[48] The Court found that the amendment supports the conclusion that there is no liability under the current scheme.[49]

The Court pointed out that secondary actors are already subject to certain *criminal* penalties under another provision, as well as civil enforcement by the SEC, which can include disgorgement and penalties, much of which is for distribution to investors, along with state securities laws.[50] In addition, the Court explained that another provision allows for a private right of action against accountants and underwriters in some cases, and secondary actors who commit primary violations can be liable under *Central Bank*.[51]

Writing for the dissent in *Stoneridge* as in *Central Bank* (this time a three-member dissent), Justice Stevens determined that the respondents' alleged fraud was "itself a 'deceptive device'" prohibited by § 10(b) and that Charter could not have inflated its revenues absent the conduct of Scientific-Atlanta and Motorola.[52] The dissent distinguished *Central Bank* because the bank did not engage in any deceptive act and therefore did not itself violate § 10(b).[53] The dissent also disagreed with the majority's reliance analysis. The dissent argued that a correct view of causation coupled with the fraud on the market presumption would allow reliance to be pled.[54] As to the intervening passage of the PSLRA, the dissent argued that history provided no support for immunizing "actual violators" of § 10(b) from liability in private litigation.[55]

IV. Senate Bill 1551 Would Legislatively Overrule *Central Bank* and *Stoneridge*

In his remarks introducing the Liability for Aiding and Abetting Securities Violations Act of 2009, Senator Specter argued that the legislation "would overturn two errant decisions of the Supreme Court," *Central Bank* and *Stoneridge*, by amending the 1934 Act to authorize a private right of action for aiding and abetting liability.[56] In sponsoring the legislation, Senator Specter asserted that when Congress debated the legislation that led to the PSLRA, Congress was urged to overturn *Central Bank* but declined to do so, and, as a result, the PSLRA authorized only the SEC to bring aiding and abetting enforcement litigation.

V. Current Status

The legislation, which has three co-sponsors, is now pending in the Senate Judiciary Committee. On September 17, 2009, the Senate Subcommittee on Crime and Drugs held its first hearing on the bill. Two organizations, Change to Win (an alliance of unions and workers) and the North American Securities Administrators Association, testified in favor of the bill. Professor John C. Coffee, Jr. of Columbia University Law School testified in favor of the concept of the bill, but his testimony was conditioned on an amendment to the bill. He recommended a ceiling on damages of $2 million in the case of a natural person, and $50 million in the case of a public corporation, such as an investment bank or a ratings agency.

Both at the hearing and since then, opponents to the bill have raised concerns that its passage would result in a potential undue expansion of liability and result in unforeseen, and problematic, consequences. At the hearing, Robert J. Giuffra, Jr., a partner at Sullivan & Cromwell LLP and former Chief Counsel of the U.S. Senate Banking Committee (1995-1996), and Adam C. Pritchard, Professor of Law of the University of Michigan, testified against the bill. They argued that the legislation would expand potential liability as well as increase defense costs of third parties from whom plaintiffs would be able to exact significant settlements. Indeed, the enormity of potential damages could render the merits of a lawsuit merely a secondary consideration in a company's decision whether or not to settle. Professor Pritchard opined that aiding and abetting liability, and the associated increased costs of settlement, would not benefit shareholders because third parties, such as insurers, would demand compensation for bearing the costs of liability, and these costs ultimately would be borne by shareholders. Both witnesses also testified that, because companies already fear the enormous expense of discovery in the U.S. legal system, the bill's expansion of liability, and the attendant costs of litigation and settlement, would hurt the competitiveness of both the U.S. capital markets and financial centers by further driving up the cost of doing business in the United States.

In addition to concerns articulated during the hearing, practitioners have expressed their concern that the bill, at the very least, could raise difficult questions about an attorney's ethical and legal obligations regarding attorney-client confidentiality. The bill, if adopted, could potentially impose liability on an attorney who participated in a challenged disclosure, and otherwise complied with all ethical and legal obligations. The attorney would be faced with an impossible option: avoid aiding and abetting liability only by revealing client confidences in violation of his or her duties to the client.

Similarly, concerns have been raised that passage of the bill would enable a private plaintiff to maintain a securities action against nearly any person or company that transacts business

with a public company. Potential defendants would encompass a company's outside professionals—such as accountants, investment banks, securities analysts, credit rating agencies, and lawyers—undoing the *Stoneridge* Court's rejection of such an expansive scope of liability. As the Court previously found, "[w]ere [plaintiff's] concept of reliance to be adopted, the implied *cause of action would reach the whole marketplace in which the issuing company does business*."[57] Such concerns warrant careful analysis with regard to the pending legislative efforts.

Endnotes

1 155 Cong. Rec. S8564 (daily ed. July 30, 2009) (statement of Sen. Specter).

2 *See id.*; Central Bank of Denver, N.A. v. First Interstate Bank of Denver, 511 U.S. 164 (1994); Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., 552 U.S. 148 (2008).

3 *See Central Bank*, 511 U.S. at 171.

4 *See id.*

5 15 U.S.C. § 78j (emphasis added).

6 7 C.F.R. § 240.10b-5 (2009) (emphasis added).

7 *See Central Bank*, 511 U.S. at 167.

8 *Id.*

9 *Id.*

10 *Id.*

11 *See id.*

12 *Id.* at 168.

13 *Id.*

14 *Id.* at 168-69.

15 *See id.* at 169.

16 *See id.* at 174.

17 *Id.* at 175 (quotation omitted).

18 *Id.* at 191.

19 *See id.* at 176.

20 *See id.*

21 *See id.* at 176-77.

22 *See id.* at 179.

23 *Id.* at 179-80 (internal citation and quotation omitted).

24 *See id.* at 180 (citing Basic Inc. v. Levinson, 485 U.S. 224, 243 (1988)).

25 *See id.* at 180-82.

26 *See id.* at 188.

27 *See id.* at 188-89.

28 *Id.* at 192 (Stevens, J. dissenting).

29 *See id.* at 195-96.

30 *See id.* at 196-98.

31 *See Stoneridge*, 552 U.S. at 766.

32 *Id.*

33 *Id.*

34 *Id.*

35 *Id.*

36 *Id.*

37 *See id.*

38 *Id.* at 767.

39 *Id.*

40 *Id.*

41 *See id.* at 768.

42 *See id.* at 768-69.

43 *Id.* at 769 (quotation omitted).

44 *See id.*

45 *See id.* at 770.

46 *See id.*

47 *Id.*

48 *See id.* at 771.

49 *See id.*

50 *See id.* at 771, 773.

51 *See id.* at 773-74.

52 *See id.* at 774 (Stevens, J. dissenting).

53 *See id.* at 775.

54 *See id.* at 775-77.

55 *See id.* at 778-79.

56 *See* 155 Cong. Rec. S8565 (daily ed. Jul. 30, 2009) (statement of Sen. Specter).

57 *Stoneridge*, 552 U.S. at 770 (emphasis added).