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Phone: +1 212 537 6331 | Fax: +1 212 537 6371 | customerservice@portfoliomedia.com

# Congress Mulling Aiding And Abetting Legislation

*Law360, New York (November 13, 2009)* -- On July 30, 2009, Sen. Arlen Specter, D-Pa., introduced legislation that would establish a private right of action for aiding and abetting violations of the Securities Exchange Act of 1934 ("Exchange Act").

Entitled the "Liability for Aiding and Abetting Securities Violations Act of 2009", the bill (S. 1551) would "allow for a private civil action against a person that provides substantial assistance in violation of [the Exchange Act]."[1]

If enacted, the bill would largely (though not entirely) restore the law regarding the liability of secondary actors for participating in alleged securities frauds to what it was prior to the Supreme Court's decision in Central Bank of Denver v. First Interstate Bank of Denver.[2]

The proposed legislation would thus significantly expand the pool of persons potentially liable for a company's violations of Section 10(b) of the Exchange Act and Rule 10b-5. Whether S. 1511 would in fact open the floodgates to litigation against secondary participants such as investment banks and accountants is uncertain.

However, this concern may well be overstated in view of (i) the heightened pleading requirements to which such claims would be subject under the Private Securities Litigation Reform Act ("PSLRA"); and (ii) the cap on the damages that may be recovered from secondary defendants that has been proposed by Professor John Coffee.

## The Proposed Legislation

The Liability for Aiding and Abetting Securities Violations Act of 2009 would amend Section 20(e) of the Exchange Act, 15 U.S.C. § 78t(e), by adding the following provision:

(2) PRIVATE CIVIL ACTIONS. For purposes of any private civil action implied under this title, any person that knowingly or recklessly provides substantial assistance to another person in violation of this title, or of any rule or regulation issued under this title, shall be deemed to be in violation of this title to the same extent as the person to whom such assistance is provided.[3]

S. 1551 would, as Sen. Specter characterized it in his accompanying statement, "overturn two errant decisions of the Supreme Court….," i.e., Central Bank and Stoneridge Investment Partners LLC v. Scientific Atlanta Inc.[4]

In Central Bank, the Supreme Court held that "because the text of § 10(b) does not prohibit aiding and abetting, … a private plaintiff may not maintain an aiding and abetting suit under § 10(b)."[5] Prior to Central Bank, numerous courts of appeal had recognized private rights of action for aiding and abetting Section 10(b)/Rule 10b-5 violations. See, e.g., IIT v. Cornfeld, 619 F. 2d 909 (2d Cir. 1980); Monsen v. Consolidated Dressed Beef Co., 579 F. 2d 793 (3d Cir. 1978).

The Central Bank court concluded that Section 10(b) "prohibits only the making of a material misstatement (or omission) or the commission of a manipulative act …." and that such "proscription does not include giving aid to a person who commits a manipulative or deceptive act."[6]

In Stoneridge, the Supreme Court rejected "scheme liability" as a basis for holding a secondary actor liable under Section 10(b). The Court held that the alleged participation by an issuer's vendors and customers in sham transactions that improperly inflated the issuer's reported operating revenues and cash flow did not give rise to a Section 10(b) violation because the plaintiff investors did not rely upon any of the alleged deceptive acts by the vendors and customers.[7]

Sen. Specter observed that Congress debated whether to restore civil liability for aiding and abetting when it considered the PSLRA in 1995 but that it ultimately declined to do so, authorizing only the U.S. Securities and Exchange Commission ("SEC") to prosecute persons for aiding and abetting Exchange Act violations. See 15 U.S.C. § 78t(e) (2009).

Sen. Specter pointed to some of the more notorious securities frauds which have transpired since Central Bank and the passage of the PSLRA as justifying the proposed legislation: "It is time for us to revisit that judgment. The massive frauds involving Enron, Refco, Tyco, Worldcom, and countless other lesser-known companies during the last 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."[8]

Sen. Specter added that "[t]he immunity from suit that Central Bank confers on secondary actors has removed much needed incentives for them to avoid complicity in

and even help prevent securities fraud, and all too often left the victims of fraud uncompensated for their losses."[9]

Sen. Specter also noted that SEC enforcement authority is inadequate to serve as a deterrent: "Enforcement actions by the SEC have proved to be no substitute for suits by private plantiffs. The SEC's litigating resources are too limited for the SEC to bring suit except in a small number of cases, and even when the SEC does bring suit, it cannot recover damages for the victims of fraud."[9]

Sen. Specter pointed out that aiding and abetting claims under S. 1551 would be subject to the same PSLRA requirements that apply to claims against primary defendants, observing that "[a]ny suit brought under my proposed amendment would, of course, be subject to the heightened pleading standards, discovery-stay procedures, and other defendant-protective features of the PSLRA."[9]

The Senate Judiciary Committee's subcommittee on crime and drugs held a hearing on S. 1551 on Sept. 17, 2009.[10] Among the persons who testified in favor of the proposed legislation was Professor John Coffee of Columbia University Law School. Professor Coffee testified that restoring civil liability for aiding and abetting Exchange Act violations is justified on deterrence grounds:

"[R]estoring private liability for aiding and abetting violations makes sense because (1) the critical gatekeepers of the capital markets -- accountants, investment banks, securities analysts, credit rating agencies and sometimes law firms -- will not otherwise face liability and will remain underdeterred in most instances, and (2) these gatekeepers can be more easily deterred than the primary violator because they do not stand to receive the same gain as the primary violator. In contrast, the primary violator may be essentially undeterrable by civil penalties.

"Moreover, gatekeepers are critical actors without whom many corporate and securities transactions cannot be completed unless they do give their approval (for example, the law firm's opinion, the accountant's certification or the credit rating agency's investment grade rating may be a legal precondition to the transaction). Hence, if the gatekeepers are adequately deterred, they will block transactions, even though the primary violator would willingly proceed with them. Thus, to give these gatekeepers immunity from private liability is to abandon what logically is the most efficient technique for deterrence: namely, to focus on the party who has both the ability to block the illicit transaction and the weakest incentive to engage in it."[11]

Professor Coffee echoed Sen. Specter's sentiment that SEC enforcement actions cannot adequately deter secondary actors from participating in securities frauds:

"Although private enforcement has its flaws, it is entrepreneurially motivated and thus will pursue secondary participants with predictable zeal. Given the severity of the current financial crisis, the only possible justification for not unleashing private enforcement is the belief that adequate deterrence can come from public enforcement

alone. But can it? To pose this question in a more pointed fashion, does anyone really believe today, in this post-Madoff world, that the SEC, by itself, can adequately deter most secondary participants in securities frauds?"[11]

Professor Coffee rejected the "open floodgates" argument that restoring civil liability for aiding and abetting would expose "secondary participants…to a flood of frivolous litigation," testifying that the PSLRA's reforms "have amply protected — indeed insulated — secondary participants…." through the statute's heightened pleading requirements and proportionate liability scheme.[11]

He cautioned, however, that while "the time has come for legislative reexamination of the immunity given secondary participants[,] a balance needs to be struck" and that "this balance is best stuck by restoring private aiding and abetting liability, but with a ceiling on damages."[11]

Professor Coffee cited several reasons for imposing a ceiling on the damages recoverable from a secondary actor, including that: (i) "[b]ecause secondary defendants typically stand to make only a small portion of the gain that the primary defendant expects, they can be deterred more easily and do not need to face exposure to multibillion dollar liabilities"; and (ii) "a ceiling on liability would mean that professional firms could not be extorted into settling by the threat of potential billion dollar liability."[11]

Professor Coffee proposed capping aiding and abetting damages at $2 million for an individual and $50 million for a corporation..

Testifying in opposition to S. 1551, Adam Pritchard, director of the Empirical Legal Studies Center at the University of Michigan, opined that the bill would have a deleterious effect on the United States capital markets:

"The goal of the bill is to rope in more "deep pocket" defendants to feed the plaintiffs' bar's lucrative class action machine… By offering up additional targets to the class action bar, S. 1551 promises to worsen the fundamental problems that make America's securities class action regime so dysfunctional and destructive of shareholder wealth. Securities class actions are already an enormous drain on America's capital markets. S. 1551 would make a bad situation worse."[12]

Pritchard testified that establishing a private right of action for aiding and abetting Exchange Act violations would impose substantial burdens on the capital markets that will ultimately be borne by the shareholders that the legislation purports to protect:

"Giving the plaintiffs' bar aiding-and-abetting authority would offer class action lawyers one more weapon with which to shake down settlements. Here the obvious targets would be available deep pockets with some contractual connection to the corporation, such as accountants, lawyers, and banks. The demise of Arthur Andersen suggests that increasing the liability burden of these third party professionals is fraught with risks for

the capital markets… Professionals providing services to public corporations will demand compensation for bearing the risks of liability. Moreover, these advisors will begin more aggressively monitoring statements in order to protect themselves from litigation risk… Shareholders will bear those costs…."[12]

Pritchard disagreed with the assessment that restoring civil liability for aiding and abetting would have a deterrent effect, commenting that "[p]rivate class actions move a lot of money around, but add little to deterrence at the margin."[12] Pritchard also pointed out that secondary actors are liable for their own misstatements:

"[E]ven in private actions, secondary defendants do not enjoy immunity from liability under current law. If they make misrepresentations upon which investors rely (such as certifying false financial statements or hyping a security with inflated prospects), secondary defendants can and will be held liable. Central Bank and Stoneridge only exclude liability when secondary defendants have made no false statement themselves. That is hardly a startling principle. The basic purpose of securities law is to protect investors who reasonably rely on information. If the accountant, investment banker, or lawyer has made no statement, then investors have not relied on that person in making their investment decisions. On the other hand, current law already provides that if the secondary defendants have induced reliance by investors, they will be on the hook."[12]

Pritchard concluded that the better approach is to change the Rule 10b-5 damages remedy to focus on disgorgement by the corporate executives responsible for the fraudulent misstatement, observing that with a disgorgement model:

"Deterrence is maximized by sanctioning the person who is most at fault for the fraud, so turning the sights of the class action bar on the culpable individuals would give us substantially more deterrent bang for our class action buck. And reducing the potential dollar figures involved would eliminate the ability of plaintiffs' lawyers to extract nuisance settlements in weak cases. If defendants believe they can prevail at trial, a small probability of losing an enormous judgment will no longer tip the balance in favor of settlement..."[12]

**Analysis**

If enacted, the Liability for Aiding and Abetting Securities Violations Act of 2009 would represent a major change in the legal landscape for securities litigation that has existed since Central Bank and the passage of the PSLRA.

It is too early in the legislative process to predict what the prospects are for passage of S. 1551. The Madoff and Stanford Ponzi schemes, Refco fraud and other recent financial scandals that have resulted in multibillion dollar losses to shareholders have, however, made Congress more receptive to consideration of aiding and abetting legislation than it has been previously.

If the bill were to be enacted, the fact that aiding and abetting claims would be subject to the heightened pleading requirements and proportionate liability of the PSLRA would arguably reduce the risk of an onslaught of aiding and abetting litigation against secondary actors, especially if the legislation were amended to include a cap on recoverable damages, such as the one suggested by Professor Coffee.

--By David J. Libowsky, Bressler Amery & Ross PC

*David J. Libowsky, Esq. is a shareholder and director of Bressler Amery & Ross PC. He works out of New York and New Jersey.*

*The opinions expressed are those of the author and do not necessarily reflect the views of Portfolio Media, publisher of Law360.*

[1] S. 1551, 111th Cong., 1st Sess., 155 Cong. Rec. S8564 (July 30, 2009)

[2] 511 U.S. 164, 114 S. Ct. 1439 (1994)

[3] S. 1551, 111th Cong., 1st Sess. (July 30, 2009). S. 1551 was referred to the Senate Committee on the Judiciary and is now before the Subcommittee on Crime and Drugs.

[4] 552 U.S. 148, 128 S. Ct. 761 (2008)

[5] Central Bank, 511 U.S. at 191

[6] Central Bank, 511 U.S. at 177-78

[7] Stoneridge, 128 S. Ct. at 770-74

[8] 155 Cong. Rec. S8564 (July 30, 2009) (Statement of Senator Specter)

[9] 155 Cong. Rec. S8565 (July 30, 2009) (Statement of Senator Specter)

[10] 155 Cong. Rec. D1056 (Daily Digest Sept. 17, 2009)

[11] Aiding and Abetting Securities Violations: Hearings on S. 1551 Before the Subcomm. on Crime and Drugs of the Senate Comm. on the Judiciary, 111th Cong., 1st Sess., 2009 WL 2974863 at 3 (Sept. 17, 2009) (testimony of Professor John Coffee)

[12] Aiding and Abetting Securities Violations: Hearings on S. 1551 Before the Subcomm. on Crime and Drugs of the Senate Comm. on the Judiciary, 111th Cong., 1st Sess., 2009 WL 2974875 at 2 (Sept. 17, 2009) (testimony of Adam Pritchard)