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In this issue … Senator Arlen Specter moves to thwart* Stoneridge*.

THE STRUGGLE OVER AIDER AND ABETTOR LIABILITY MOVES FROM THE SUPREME COURT TO CONGRESS

The Supreme Court decision on *Stoneridge*, which we discussed in our September 2007 (pdf) and March 2008 (pdf) newsletters, was not expected to be the last word on the fractious subject of aider and abettor liability. While the court closely adhered to its own precedents in rejecting the claims against secondary accomplices to securities fraud, the court itself suggested that a remedy might be found through federal legislation: "The decision to extend the cause of action is for Congress, not for us." Since then, the issue of liability for those who assist primary violators of securities laws has continued to make news in at least one notable case—that of Refco, a former financial services company that specialized in commodities.

The Refco case: *Stoneridge* cited but not embraced

So far, consequences of the fraud perpetrated by Refco executives include a sixteen-year prison sentence for the company's former CEO, bankruptcy of the company, and securities class action settlements.

However, attempts by plaintiffs to snare the law firm of Mayer Brown have proved unsuccessful. Notwithstanding the extent of Mayer Brown's alleged involvement with their client Refco's fraudulent activities, the *Stoneridge* decision that rejected aider and abettor liability effectively foreclosed plaintiffs' recourse under federal securities laws.

In an opinion (pdf) handed down on March 17, 2009 by the U.S. District Court for the Southern District of New York, Judge Gerard E. Lynch reluctantly granted the motion to dismiss the plaintiffs' case against the law firm. Governed by the directives of *Stoneridge*, Judge Lynch conceded that Mayer Brown had consistently operated behind the scenes purely as a secondary participant in the fraud, a participant on whose actions there had been no reliance by the plaintiff class, and as such was afforded protection under the *Stoneridge* decision:

> *However significant a role the Mayer Brown Defendants may have played in assisting Refco's management to engage in these transactions, and however culpable they may have been to do so with the knowledge that the transactions were ultimately designed as part of a scheme to defraud and practice deceit upon Refco's shareholders … the liability that attaches to those acts is liability for aiding and abetting Refco's schemes and manipulation, not principal liability for executing schemes of the Mayer Brown Defendants' own.*

But in a final footnote to the opinion, Judge Lynch fired off a parting shot at what he felt was the inequity of the situation:

> *It is perhaps dismaying that participants in a fraudulent scheme who may even have committed criminal acts are not answerable in damages to the victims of the fraud. However, as the [Supreme] Court noted in* Stoneridge*, the fact that the plaintiff-investors have no claim is a result of a policy choice by Congress … . This choice may be ripe for legislative re-examination.*

Senate Bill S. 1551: Sen. Specter picks up the gauntlet

On July 30, 2009, some four and a half months after Judge Lynch's opinion, Senator Arlen Specter of Pennsylvania introduced a bill to amend Section 20 of the Securities Act of 1934. The short title given to the

measure is the “Liability for Aiding and Abetting Securities Violations Act of 2009.” The core of the proposed change is to add a paragraph to Section 20 that addresses 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.*

Initial Reactions

The U.S. Chamber of Commerce quickly came out against the proposed legislation. Speaking for the Chamber, Lisa S. Rickard issued a statement encouraging Congress “… to reject S. 1551. Instead, Congress should support and fund the effective enforcement of existing laws, because expanding the current lawsuit system will ultimately impose excessive costs on innocent shareholders while producing too little for injured investors."

Consumer groups have been slower to formally respond, but the measure is in the early stages. The plaintiff investors in the *Stoneridge* case attracted an unusually large number of supporters, united in wanting to remove the historic protection for secondary accomplices in securities fraud. It would be surprising if similar support for S.1551 failed to materialize.

The Bill’s progress

On September 17, 2009, the Senate Committee on the Judiciary’s Crime and Drugs Subcommittee held its first hearing. A statement was made by the Chairman of the full Senate Judiciary Committee, Senator Patrick Leahy, showing where his sympathies lie: “With this ruling [Stoneridge], the Supreme Court has left everyday Americans with nowhere to go for redress. … We should … make sure that those who aid in fraudulent behavior are caught and held fully accountable.”

Witness testimony followed from speakers who generally support the measure:

- Professor John C. Coffee Jr. of Columbia Law School: “I support the concept but urge that it be coupled with a ceiling on damages for such secondary defendants.”

- Tanya Solov, speaking for the North American Securities Administrators Association: “This legislation is a positive step in restoring accountability and the integrity of the U.S. markets.”

- Patrick J. Szymanski, speaking for Change to Win (“an alliance of unions and six million workers”): “We believe that S.1551 adequately and appropriately addresses the artificial and inexplicable result in *Stoneridge*.”

and from those who oppose it:

- Professor Adam C. Pritchard of the University of Michigan Law School: “Securities class actions are already an enormous drain on America’s capital markets. S.1551 would make a bad situation worse.”

- Robert J. Giuffra, Jr., a partner at law firm Sullivan & Cromwell: “In my view, S.1551 would hurt the competitiveness of U.S. capital markets and financial centers and vastly expand the potential liability and defense cost of innocent third parties that do business with public companies.”

The likely next step (pdf) is for the Senate Subcommittee members to “mark-up” the bill, meaning they meet to discuss and maybe amend the proposed bill, finally voting on whether or not to advance the bill to the full Senate. (A Subcommittee vote for the bill to proceed is known as “reporting” the bill.) However, because of the current legislative log-jam, there may be no room in the schedule for the Senate to consider the bill until next year. An alternative possibility is for the bill to be tacked on to a larger finance-related measure.

Comment

If S.1551 or similar measure is enacted, it is likely to have a considerable impact on the providers of professional services to businesses. These would include law firms, accounting firms and banks. No longer protected from securities class action lawsuits filed by investors in their clients' companies, these professional groups would confront significantly increased exposure and potential liability.

Moreover, the effect would probably extend beyond these immediate areas; the defendant in *Stoneridge* — Scientific-Atlanta, Inc.— was not a professional-services provider but a supplier of equipment to Charter Communications, a supplier that willfully engaged in a strategy with Charter to falsify sales numbers. The subsequent effect on professional and D&O insurance coverage could be far-reaching. Professional liability carriers would face the prospect of their policyholders defending securities class action lawsuits as possible aiders and abettors, while D&O carriers could see a whole new front of plaintiff attacks open up, which, even if they proved to be without merit, would mean incurring substantial defense costs.

Footnote

Interested readers can track the progress of Senate bill S.1551 by clicking this link and registering (free).

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