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Bright Line Protects Secondary Actors From Civil Liability In Securities Fraud Actions

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[Author's note: As I finished this article, the U.S. Senate was voting to approve the provisions of S.3217, the "Restoring American Financial Stability Act." I had been following closely the progress of an amendment to the Act submitted by Senators Arlen Specter and Jack Reed. The amendment was intended to nullify several decisions by the Supreme Court and by the Second Circuit, including the decision I discuss here.]

In a carefully reasoned opinion, the Second Circuit has drawn a bright line which continues the judicial protection of law firms, accounting firms, and other "secondary actors" from civil liability in actions by third parties for securities fraud. In *Pacific Investment Company v. Mayer Brown*, (09-1619-cv, April 28, 2010), Judge Jose A. Cabranes followed the reasoning of the Supreme Court in *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.* 552 U.S. 148 (2008).

> We hold that a secondary actor can be held liable for false statements in a private damages action for securities fraud only if the statements are attributable to the defendant at the time the statements are disseminated. We further hold that plaintiff's claims that defendants participated in a scheme to defraud investors are not meaningfully distinguishable from the claim at issue in Stonebridge and, therefore, were properly dismissed.

Plaintiffs Pacific Investment ("Pacific") and RH Capital Associates LLC claimed in their complaint that Mayer Brown ("Mayer") and one of its senior partners, Joseph P. Collins, had violated federal securities laws in their representation of Refco, Inc., a bankrupt brokerage firm whose demise prompted the title "the Refco Scandal." Pacific claimed that (1) the Mayer defendants had facilitated fraudulent transactions between Refco and third parties with the intent of concealing the extent of Refco's uncollectible debt, and (2) they had drafted portions of Refco's security-offering documents which contained false information. Joseph P. Collins, Refco's principal outside counsel, was convicted by a federal jury of five counts – two counts of securities fraud, one count of conspiracy and two counts of wire fraud.

At the time of their dissemination, all of the false statements to which Mayer had contributed were attributed to Refco, not to Mayer. As we shall see, the terms "dissemination" and "attribution" are at the heart of the opinion by Judge Cabranes.

Judge Cabranes placed Mayer in the role of "secondary actor". He defined secondary actors as "lawyers, such as Mayer, accountants, 'or other parties who are not employed by the issuing firm whose securities are the subject of allegations of fraud.'" The firm's bank, for example, would also qualify as a secondary actor.

For purposes of the Appeal, the Court accepted as true the allegations by Pacific against Mayer. These included (1) that Mayer had participated in seventeen "sham" loan transactions involving Refco, another company controlled by Refco's CEO, and third-parties who served as accommodation borrowers and lenders in the transactions between Refco and the other company. According to Pacific, Mayer had

negotiated the terms of the loans, had drafted and revised the loan documents, had distributed the documents to the participants, and had retained copies of the documents.

False Statements in Refco Documents

Further, Mayer was responsible for false statements in three Refco documents: (1) an offering memorandum for an unregistered bond offering; (2) a Registration Statement for another bond offering; and (3) an IPORegistration Statement for Refco's initial public offering of common stock in August 2005. (By October 10, 2005, only two months later, the Refco Scandal had erupted). Each of these documents failed to disclose Refco's financial condition.

Mayer's contribution to the preparation of these documents was extensive. Its lawyers participated in the creation of false statements in each of the documents. They reviewed and drafted replies to comment letters from the SEC. They were directly involved in reviewing the SEC comments to the IPORegistration Statement.

In all of this, however, Mayer was mentioned as Refco's attorney only in the Offering Memorandum and the IPORegistration Statement. The Registration Statement did not mention Mayer. Nor did any of the documents specifically attribute any of the information cited in them to Mayer.

Plaintiff Pacific purchased its interest in Refco during the period in which Mayer was allegedly participating in the Refco fraud. Pacific and other investors sued Mayer following the Refco bankruptcy. They relied on Mayer's violation of Section 10(b) of the Exchange Act and of the underlying Rule 10b-5, and on the "control person" provisions of Section 20(a) of the Exchange Act.

Text of Rule 10b-5

Section 10(b) makes it unlawful "for any person, directly or indirectly, …[t]o use or employ, in connection with the purchase or sale of any security…, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [Securities and Exchange] Commission may prescribe." Rule 10b-5 provides:

> Rule 10b-5: Employment of Manipulative and Deceptive Practices:
>
> 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 the 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.

Judge Cabranes began his analysis of the facts by framing two cardinal issues:

This appeal raises primarily two issues regarding the scope of Rule 10b-5 liability in private actions: (1) whether defendants can be liable under Rule 10b-5 for false statements that they allegedly drafted, but which were not attributed to them at the time the statements were disseminated; and (2) whether the allegations in the complaint are sufficient to state a claim for "scheme liability" under 10b-5(a) and (c).

History of Actions Claiming Civil Fraud

The notion that persons who aid and abet the primary actor in securities fraud may nevertheless escape civil liability to third parties was first enunciated by the Supreme Court in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994). A public housing authority had issued a series of bonds. Plaintiff Bank alleged that Defendant Bank had aided and abetted the fraud of the issuer by agreeing to delay an independent appraisal of the real property securing the bonds.

The Supreme Court reviewed the text and history of Section 10(b) and concluded that "the 1934 [Exchange] Act does not itself reach those who aid and abet a §10(b) violation." As the Supreme Court explained, a contrary view would "impose… liability when at least one element critical for recovery under 10b-5 is absent: reliance."

In *Shapiro v. Cantor*, 123 F. 3d 717 (1997), the Second Circuit following the decision in *Central Bank*, and held that plaintiff had failed to state a claim for primary violation of securities laws against the accounting firm Deloitte & Touche. The plaintiff had alleged complicity by the firm in the deceptive conduct of a limited partnership. Judge Cabranes quoted the *Shapiro* Court:

> (a)llegations of "assisting," "participating in," "complicity in" and similar synonyms used throughout the complaint all fall within the prohibition in Central Bank. Aclaim under §10(b) must allege a defendant has made a material misstatement or omission indicating an intent to deceive or defraud in connection with the purchase or sale of a security.

In 1998, the Second Circuit decided *Wright v. Ernst & Young*, LLP, 152 F.3d 169. For the first time, the Court articulated the principle that *Central Bank* requires **the attribution of a false statement to the defendant at the time the statement is disseminated** (emphasis added). Wright involved the allegation that Ernst & Young had orally approved a client's false and misleading financial statements, which were subsequently disseminated to the public by the client. As Judge Cabranes explained:

Wright also made clear that attribution is necessary to satisfy the reliance element of a private damages action under Rule 10b-5. Because the misrepresentations on which plaintiff's claims were based were not attributed to Ernst and Young, we held that the complaint failed to state a claim under Rule 10b-5.

But, as Judge Cabranes acknowledged, some of the cases which followed *Wright*, "may have created uncertainty or ambiguity with respect to when attribution is required." In *In Re Scholastic Corp. Securities Litigation*, 252 F. 3d at 75-76, for example, the Court imposed civil liability on a corporate officer for misrepresentations made by the corporation, although none of the statements had been attributed to him. The opinion in the *Scholastic* matter did not rely on or even cite *Wright or Central Bank*, nor did it discuss the difference between primary liability under Rule 10b-5 and the liability of "secondary actors" who aid and abet.

Following *Scholastic*, the district courts "struggled to reconcile its holding with our earlier holding in *Wright*." In *Lattanzio v. Deloitte & Touche*, 476 F. 3d at 151-52 (2007), however, the Second Circuit retook the high ground and confirmed the importance of attribution for claims against secondary actors. *Lattanzio* involved misrepresentations in the quarterly statements of a public company. According to the complaint, the accounting firm of Deloitte & Touche had reviewed and approved the statements. The Court refused to impose civil liability on the accounting firm. It held:

> …to state a §10b claim against an issuer's accountant, a plaintiff must allege a misstatement that is attributed to the accountant 'at the time of its dissemination,' and cannot rely on the accountant's alleged assistance in the drafting or compilation of a finding (quoting *Wright*)…. Under Central Bank, Deloitte is not liable for merely assisting in the drafting and filing of the quarterly statements.

Creator Standard v. Attribution Standard

Plaintiff Pacific and the SEC (in its amicus brief) urged the Court to adopt a "Creator" standard in its ruling. By this standard, courts would be required to impose civil liability on defendants who "created" a false statement that investors relied on, whether or not the statement was attributed to the defendant at the time of dissemination.

Judge Cabranes made it clear that the creator standard did not satisfy the Court.

> According to the SEC, the creator standard would extend liability to secondary actors who supplied the writer with false or "misleading information or cause a false or misleading statement to be made" – even if the statement disseminated to the public made no mention of the defendant. … however, a "[p]ublic understanding that [a secondary actor] is at work behind the scenes does not create an exception to the requirement that an actionable misstatement be made by the [secondary actor]". …Insofar as a creator standard would impose liability on secondary actors, such as defendants here, for their role in drafting and editing false documents on behalf of an issuing firm, it would mark a radical departure from our precedents.
>
> An attribution requirement makes clear – to secondary actors and investors alike -- that those who sign or otherwise allow a statement to be attributed to them expose themselves to liability. Those who do not are beyond the reach of Rule 10b-5's private right of action. A creator standard establishes no clear boundary between primary violators and aiders and abettors, and it is uncertain what level of involvement might expose an individual to liability. Even the SEC struggles to define the precise contours of the creator standard, noting that a person "would arguably not cause a misstatement where he merely gave advice to another person regarding what was required to be disclosed and then that person made an independent choice to follow the advice."
>
> For the foregoing reason, we conclude that even if Wright and Lattanzio were not read explicitly to require attribution in every case, an attribution requirement is most consistent with our Circuit's preference for a bright line approach to the question of secondary actor liability. Accordingly, we reject the creator standard advanced by plaintiffs and the SEC and we reaffirm our jurisprudence. … namely, that "a secondary actor cannot incur primary liability under [Rule 10b-5] for a statement not attributed to that actor at the time of the dissemination." ("Under Central Bank, [a secondary actor] is not liable for merely assisting in the drafting and filing of [allegedly false statements].").

Pacific's Claims of "Scheme Liability"

The District Court had dismissed Plaintiff's claim that defendant Mayer had engaged in "Scheme Liability" as that term is defined by Rule 10b-5(a) and 5(c). Relying on *Stoneridge*, Judge Cabranes agreed with the decision of the lower court. (The decision can be found at *In re Refco*, 609 F. Supp. 2d at 314-19.) In *Stoneridge*, two companies had participated in sham transactions that allowed a securities issuer to overstate its revenues. The Court found that the conduct of the companies was deceptive and that it had enabled the issuer to conceal the misstatements in its financial statements, but it also found that the essential element of reliance was missing.

> …[defendants'] deceptive acts were not communicated to the public. No member of the investing public had knowledge, either actual or presumed, of [defendants'] deceptive acts during the relevant times. [Plaintiffs] as a result, cannot show reliance upon any [defendants'] actions except in an indirect chain that we find too remote for liability.

Judge Cabranes concluded his opinion by rejecting "control person" liability by Mayer. "Any claim for 'control person' liability under §20(a) must be predicated on a primary violation of securities law. Because we hold that plaintiffs failed to state a claim for a primary violation against the defendants, we also hold that the District Court properly dismissed their §20(a) claim against Mayer Brown."

In a concurring opinion, Judge Barrington D. Parker praised Judge Cabranes for "an admirable job with a formidable task – distilling a theory of Rule 10(b) liability for secondary actors from our precedents." Nevertheless, Judge Parker expressed a fear "that our Circuit's law in this area is far from a model of clarity."

He pointed out that in *In re Scholastic*, which followed *Wright*, the Court had asserted liability against a corporate vice president without imposing the requirement for attribution against him. In other decisions by the Second Circuit, the meaning of "attribution" had become clouded and confused.

At the same time, the courts in other Circuits had reached different decisions on the need for attribution.

Judge Parker referred to the amicus brief filed in *Pacific* by the SEC. He cited the Commission's arguments:

(1) Adoption of a creator status is fully consistent with Central Bank of Denver.
(2) An attribution requirement will prevent the securities laws from deterring individuals who make false statements anonymously or through proxies.
(3) Private citizens who seek to establish liability by secondary parties already face significant hurdles to recovery.
(4) A result cannot be sustained that shields Mayer Brown from damages when the partner responsible was convicted criminally.

Judge Parker pointed to the opportunity afforded by *Pacific*, "to provide our full Court, as well as, perhaps, the Supreme Court, with an opportunity to clarify the law in this area."

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[Author's Note: The amendment submitted by Senators Specter and Reed read:

> **Private Civil Actions**.--For purposes of any private civil action implied under this title, any person that knowingly 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. For purposes of this paragraph, a person acts knowingly only if the person has actual knowledge of the conduct underlying the violation described in the preceding sentence.

The amendment was clearly meant to undo the decision of the Supreme Court in *Stoneridge*, supra. It was backed by several Senators and by a petition reciting the names of many firms and unions. They said:

> Those who know they are aiding someone in the commission of a securities fraud – sometimes referred to as secondary actors – are actually highly culpable participants in illegal enterprises. They are no different and should not be distinguished from one who drives the getaway car in a bank robbery. Without their knowing, reckless and active participation, many frauds, including those involving Enron and, more recently, those involving misleading balance sheets and taking both sides in a transaction with investors, simply could not have happened.

I was informed this morning by a member of the staff in the office of Senator Dodd that the amendment was dropped from the bill before the Senate voted.]

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