

A New Class of Securities Defendants? Extending 10b-5 Liability to Secondary Actors



By Vincent Caracciolo and Tara Cummins

Alleged Aiders and Abettors, Beware!

Despite, or perhaps in response to criticism over its failure to detect certain Ponzi schemes, the Securities and Exchange Commission (SEC) has recently stepped up enforcement endeavors, opening roughly 10% more investigations and nearly 30% more actions compared to the same period in 2008.¹ Though the recent spike in credit-related securities class actions is waning, the plaintiff's bar appears to remain hungry. History shows that while filings may ebb and flow, they sustain historical norms that equate to significant judgment, settlement and defense costs dollars. Accordingly, a current proposal by Senator Arlen Specter (D-PA) to extend 10b-5 liability beyond its current borders is particularly relevant to directors and officers with an interest in securities litigation.

Secondary Actors and Central Bank

The anti-fraud provisions of Section 10b of the Securities Exchange Act of 1934 and SEC Rule 10b-5 promulgated thereunder have long been used with modulating frequency to bring class action lawsuits against companies and individuals. The SEC Rule imposes, inter alia, civil liability on those who commit a manipulative or deceptive act in connection with the purchase or sale of securities. It is purportedly designed to ensure that investors may rely on information when purchasing and trading securities:

"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.

(Sec. 10; 48 Stat. 891; 15 U.S.C. 78j)

Enforcement of rules such as 10b-5 rests primarily with the SEC, which is authorized to bring actions against individuals and companies who violate securities laws. As part of that mandate, the Private Securities Litigation Reform Act of 1995 ("PSLRA") extends the SEC's authority to prosecute "persons who aid and abet violations." On a practical level, securities laws essentially establish two classes of securities defendants: those who directly violate the law (so-called "primary violators") and those who aid and abet that violation, commonly referred to as "secondary actors."

¹ [Remarks Before the New York City Bar: My First 100 Days as Director of Enforcement Robert Khuzamii, Director, Division of Enforcement, U.S. Securities and Exchange Commission, August 5, 2009](#) (Last Accessed 9/10/09)

This distinction is important because the SEC has broader powers of enforcement than private citizens. While both the SEC and individuals may bring actions against primary violators, at present only the SEC may bring an action against aiders and abettors. This precedent was established in 1994 by the landmark Supreme Court opinion in *Central Bank*:

“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). The absence of § 10(b) aiding and abetting liability does not mean that secondary actors in the securities markets are always free from liability under the securities Acts. Any person or entity, including a lawyer, accountant, or bank, who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator under 10b-5, assuming *all* of the requirements for primary liability under Rule 10b-5 are met” (*Central Bank of Denver NA v. First Interstate Bank of Denver NA*, 511 U.S. 164, 191 1994).

Thus, secondary actors whose conduct does not rise to the level of a primary violation of Rule 10b-5 are shielded from such private right of action liability, because there is no recognized private right of action against “aiders and abettors.” Secondary actors, such as lawyers, accountants, consultants, and actuaries, however, will lose such “protected status” if and when they morph into “primary violators.”

Scheme Liability and *Stoneridge*

Central Bank did not delineate precisely the boundaries of primary liability. Accordingly, plaintiffs became creative in their attempts to establish secondary actors as primary violators to keep them as defendants in securities class action litigation. In broad terms, plaintiffs have tried to pursue theories whereby knowledge of the fraud by secondary actor defendants amounted to deceptive practices. Lower courts reached varying conclusions on the viability of this so-called “scheme liability” theory and the issue reached its apex before the Supreme Court in another landmark securities case, *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.* (552 U.S. 148, 2008).

In *Stoneridge*, a company called Charter was allegedly engaged in a scheme whereby it overpaid vendors (Scientific Atlanta and Motorola) who, in turn, funneled those excess monies back to Charter by way of advertising fees. This arrangement inflated Charter’s revenue by about \$17 million in a single quarter, which helped the company meet analysts’ expectations.

Plaintiffs argued that the vendors’ knowledge of the fraudulent scheme amounted to more than aiding abetting, and therefore the claim was actionable. However, the Supreme Court disagreed, finding that plaintiffs failed to meet the preconditions for §10(b) liability. In particular, the court held that plaintiffs failed to establish a required element of the violation, “reliance,” because:

"Respondents had no duty to disclose; and their deceptive acts were not communicated to the investing public during the relevant times."²

Congressional Action?

The Supreme Court's refusal to grant a private right of action against aiders and abettors in part rested on the absence of such a specific grant in the PLSRA:

"The decision to extend the cause of action is for Congress, not for us. Though it remains the law, the §10(b) private right should not be extended beyond its present boundaries."³

As if picking up the gauntlet from the Supreme Court, Senator Arlen Specter (D-PA), joined by Jack Reed (D-RI) and Edward Kaufman (D-DE), are now pushing to legislatively overturn the effects of both *Central Bank* and *Stoneridge* with a proposed law called "The Liability for Aiding and Abetting Securities Violations Act of 2009" (S. 1551). The bill seeks to amend the Securities Exchange Act of 1934 to authorize a private right of action for aiding-and-abetting liability.

Specter's proposed legislation modified Section 20(3) of the Securities Exchange Act as follows:

e) Actions Against Prosecution of persons who aid and abet violations
~~For purposes~~
 (1) ACTIONS BROUGHT BY COMMISSION - For Purposes of any action brought by the Commission under paragraph (1) or (3) of section 78u(d) of this title, any person that knowingly or recklessly provides substantial assistance to another person in violation of a provision of this chapter, or of any rule or regulation issued under this chapter, shall be deemed to be in violation of such provision to the same extent as the person to whom such assistance is provided.
(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 to the same extent as the person to whom such assistance is provided."

Specter's proposal arises from his perceived need to supplement enforcement efforts by private plaintiffs. A relevant quote by Specter from the Senate floor:

"The 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. Enforcement actions by the SEC have proved to be no substitute for suits by private plaintiffs. The SEC's litigating resources are too limited for the SEC to

² *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.* (552 U.S. 148, 8,2008)

³ *Ibid* at 14.

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.”⁴

Potential Impact

If *The Liability for Aiding and Abetting Securities Violations Act of 2009* becomes law, it will likely include an element of “back to the future.” Before *1994 and the Central Bank* decision, 10b claims were routinely brought in private litigation against alleged “aiders and abettors” of securities violations. Those “aiding and abetting” defendants not surprisingly spent money defending the allegations, at times enjoyed an early dismissal from the litigation, and often spent large amounts resolving the matters through settlement.

Law firms, investment banks, consultants, professional advisors, actuaries, and auditors of the company whose stock is allegedly at issue for securities violations could be more regularly dragged into securities class actions as defendants, and remain as defendants for a longer and more expensive time frame. The relationship between a company and its outside professional service providers will be stressed and tested, potentially with challenging cross claims across defense lines.

Another aspect of Senator Specter’s bill implicates the much broader based affect on securities litigation exposure to anyone that does business with public corporations. Taking Stoneridge as a model, it may be argued that the outside “aider or abettor” need not be an outside professional of the company, but rather anyone that enters into a transaction with the company. Customers become potential defendants, and the securities laws may be implicated in ordinary commercial transactions. This chilling effect could significantly raise the cost of doing business with U.S. publicly traded companies, and spur risk shifting and indemnity agreements to try to address unanticipated legal expenses.

Management Liability insurance, including Directors and Officers liability policies, evolve in response to perceived risks and developments in the law. Underwriters may seek greater understanding of trading partners of accounts and adjust insuring appetite or premium based on perceived aiding and abetting risks. They may also view outside professionals as greater risks for securities claims and a “deep pocket” target to a disgruntled client’s shareholder. Plus, underwriters may seek to restrict or limit policy language to exposure to claims of securities violations in an Insured’s own securities and try to exclude entity coverage for securities allegations implicating others securities.

⁴ Arlen Specter, Statements on Introduced Bills and Joint Resolutions (Senate, 7/30/2009), p. S8565.

Prudent Review

In light of continually evolving exposures, it is prudent to review regularly your risk management strategies. Re-examining the terms and conditions of your executive liability policies within the context of new developments can help identify potential challenges to be addressed. At Integro, our Claims and Coverage Counsel analyze coverages and exposures through all stages of work with our clients. We are pleased to discuss this new legislation and other developing trends with you at any time.

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