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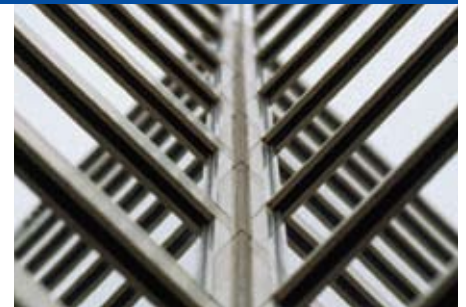
May 2010

Proposed Amendment to Financial Reform Bill, if Enacted, Will Revive Aiding and Abetting Liability for Securities Fraud

On May 3, 2010, Senator Arlen Specter of Pennsylvania submitted an amendment¹ to the Restoring American Financial Stability Act of 2010,² the financial reform bill currently under debate in the United States Senate. If incorporated into the bill and passed, this amendment would overturn the US Supreme Court's 2008 ruling in *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*³ and revive aiding and abetting exposure for those who advise on or assist in structuring securities transactions and who have actual knowledge of securities fraud.⁴

The Proposed Amendment

The amendment would allow for aiding and abetting liability in civil suits based on Section 10(b) of the Securities and Exchange Act of 1934 (the "1934 Act") and Rule 10b-5, but only as to any person that "knowingly provides substantial assistance to another person in violation of" the 1934 Act.⁵ To "knowingly" provide assistance a person must have "actual knowledge of the conduct underlying the violation."⁶ Thus, secondary liability will depend on a plaintiff's ability to plead and prove that a defendant actually knew of the alleged securities fraud in providing substantial assistance to that fraud.



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1. S. AMDT. 3776, 111th Cong. (2010).

2. Restoring American Financial Stability Act of 2010, S. 3217, 111th Cong. (2010). As of May 10, 2010, the amendment has not yet been proposed for consideration.

3. 552 US 148 (2008). *Stoneridge* held that private securities fraud claims under federal law may not assert aiding and abetting claims. See also Owen C. Pell, *Supreme Court Further Limits Securities Claims Against Non-Issuers Important Ruling for Financial Institutions*, White & Case LLP Client Alert, Jan. 22, 2008, http://www.whitecase.com/alert_litigation_0108/.

4. S. AMDT. 3776 § 929D.

5. *Id.* (emphasis added). The amendment states, in relevant part:

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. *Id.*

6. *Id.* (emphasis added).

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Prior Efforts to Overrule *Stoneridge*

While potentially increasing significantly the scope of liability in securities actions, the proposed Specter amendment does represent a shift from earlier bills aimed at reversing the *Stoneridge* decision. Prior proposals had set a lower bar on the knowledge required to support a claim, posing a substantially greater risk to financial institutions and other advisors. For example, in July 2009, Senator Specter proposed the Liability for Aiding and Abetting Securities Violations Act of 2009.⁷ This bill would have imposed liability on persons that “knowingly or recklessly” provided substantial assistance to another person in violation of the 1934 Act.⁸ On May 5, 2010, Senator Robert Menendez of New Jersey submitted an amendment to the financial reform bill containing identical language.⁹ Standards of recklessness or reckless disregard would allow plaintiffs to assert that even if financial institutions did not know of a fraud, they should have known based on some standard of care or alleged “red flags.” While recklessness is a higher standard than simple negligence, such a standard would have encouraged claims, and financial institutions and other advisors would be exposed to hindsight-based allegations of what they should have known about companies they advised or for whom they structured transactions.

The Current Heightened Pleading Standards Help Minimize Potential Liability

If enacted, the Specter amendment would be applied in a difficult pleading environment for plaintiffs seeking to plead class action securities fraud claims under the 1934 Act. Over the last several years, the Supreme Court has made it more difficult for plaintiffs

to plead claims generally. For example, the rulings in *Ashcroft v. Iqbal*¹⁰ and *Bell Atlantic Corp. v. Twombly*¹¹ now require a plaintiff to state “a claim to relief that is plausible on its face.”¹² A “claim has facial plausibility when the plaintiff pleads factual content that allows the court to draw the reasonable inference that the defendant is liable for the misconduct alleged.”¹³ In *Dura Pharmaceuticals, Inc. v. Broudo*,¹⁴ the Court held that securities fraud plaintiffs must allege and prove that the fraud was the proximate cause of the claimed economic loss¹⁵ and *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*¹⁶ held that plaintiffs must prove a strong, “more than merely ‘reasonable,’” inference of scienter, or the intent to defraud. Under these cases, the lower federal courts must perform a balancing test, and a securities fraud complaint will only survive a motion to dismiss if the inference of scienter and the other elements of the claim are at least or more compelling than nonculpable explanations for the defendant’s conduct.¹⁷

The Specter amendment is an improvement for public company advisors as compared to earlier versions of the bill because pleading actual knowledge should be challenging. By focusing on actual knowledge, the Specter amendment would appear to protect advisors whose sole fault was allegedly to miss certain red flags which may have surrounded an issuer or its transactions. The actual knowledge standard may evidence Congress’ sensitivity to the idea, endorsed by the Supreme Court in the decisions cited above, that targeting parties who were actually complicit in wrongdoing should be done in a way that does not open other parties up to weak or unfounded claims that nonetheless carry the threat of huge class action liability exposure. On the other hand, a number of significant interests, including the US Chamber of Commerce and certain stock

7. S. 1551, 111th Cong. (2009). No action has been taken on this bill since hearings were held in September 2009.

8. *Id.* at Section 2. Other bills with similar, if not identical, language were also submitted. All were referred to committee and have not advanced. See, e.g., Liability for Aiding and Abetting Securities Violations Act of 2010, H. R. 5042, 111th Cong. (2010) (“any person that knowingly or recklessly provides substantial assistance to another person in violation of [the 1934 Act]”); Investors Rights and Corporate Accountability Act of 2009, S. 2813, 111th Cong. (2009) (“[a]ny person that provides substantial assistance to another person with reckless disregard for whether the substantial assistance is in violation of [the 1934 Act]”); Wall Street Reform and Consumer Protection Act of 2009, H. R. 4173, 111th Cong. (2009) (“any person that knowingly or recklessly provides substantial assistance to another person in violation of [the Securities Act of 1933]”; “any person that knowingly or recklessly provides assistance to another person in violation of a provision of [the Investment Company Act of 1940]”; and amending Section 20(e) of the 1934 Act by inserting “or recklessly” after “knowingly”). H.R. 4173 was passed by the House and referred to the Senate in January 2010.

9. S. AMDT. 3818 § 992, 111th Cong. (2010). Like H.R. 4173, this amendment addresses the 1934 Act, Securities Act of 1933, Investment Company Act of 1940 and Investment Advisors Act.

10. 129 S.Ct. 1937 (2009).

11. 55 US 544 (2007).

12. 129 S.Ct. at 1940 (2009).

13. *Id.* at 1949.

14. 544 US 336 (2005).

15. *Id.* at 346; White & Case LLP, US Supreme Court: In Securities Fraud Cases, Must Show Fraud Caused Loss, *Financial Services Advisory Update*, Vol. 2, No. 4 (May 2005), available at http://www.whitecase.com/files/FileControl/486a537d-c24b-4b50-830a-03253b85fd0e/7483b893-e478-44a4-8fed-f49aa917d8cf/Presentation/File/FSAU_December_05_2.pdf.

16. 551 US 308 (2007).

17. *Id.* at 324 (2007) (“A complaint will survive...if a reasonable person would deem the inference of scienter cogent and at least as compelling as any opposing inference one could draw from the facts alleged.”). Bills designed to overturn *Iqbal* have not advanced in either chamber of Congress.

exchanges, submitted an opposition to the bill on May 10, arguing that knowledge of the underlying transaction alone will suffice, and that the “provision would thus subject defendants to liability whether or not they have any idea that the conduct they are assisting is wrongful.”¹⁸ Although their interpretation of the bill as not requiring knowledge of the fraud is questionable, it at a minimum highlights the risk that courts may interpret the bill, if enacted, broadly. Indeed, the opposition itself can be cited as part of the legislative history reflecting the intended scope of the law, subject to further clarifications and submissions (including a response denying the interpretation is intended).

Irrespective of how broadly it is interpreted, a statutory revival of aiding and abetting liability would almost certainly increase significantly the number of securities fraud cases brought against third parties who under *Stoneridge* would not otherwise have been targeted.

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18. Letter from Am. Fin. Servs. Ass’n et al. to Sen. Harry Reid, Majority Leader, US Senate and Sen. Mitch McConnell, Minority Leader, US Senate (May 10, 2010) (on file with author).