Debating "Scheme Liability"

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For years, Congress, the courts and the Securities & Exchange Commission have struggled to balance the rights of shareholders and companies in securities fraud cases. The latest battle, over whether courts should recognize so-called "scheme liability," is headed to the Supreme Court this fall in a highly-anticipated case called *Stoneridge Investment Partners LLC v. Scientific-Atlanta, Inc., et al.*

At issue: whether a plaintiff-shareholder should be allowed to recover not only from a company that commits securities fraud, but also from a third party that participates in a fraudulent scheme. A 1994 Supreme Court decision known by lawyers as *Central Bank* barred plaintiffs from recovering against a third party alleged to have "aided and abetted" a securities fraud. Since then, lower courts have divided over whether third parties should be held liable for playing a more central role in a fraud.

The SEC has urged the Bush Administration to file a brief with the Supreme Court supporting "scheme liability." The Treasury Department has taken the opposite stance. The battle lines are drawn.

Plaintiffs lawyer Sean Coffey and defense lawyer Robert Giuffra, both high-profile securities lawyers, recently exchanged views on "scheme liability" and the *Stoneridge* case.

The Participants

Sean Coffey

Sean Coffey is a partner in the New York office of Bernstein Litowitz Berger & Grossmann LLP, which prosecutes class and private actions on behalf of individual and institutional clients. Mr. Coffey served as lead counsel in the *WorldCom Inc.* securities class action against a handful of defendants, a case that yielded a $6.15 billion recovery, and currently serves as court-appointed lead counsel representing investors in the *HealthSouth Corp.*, *Merck & Co.*, *Refco Inc.*, and *Delphi Corp.* securities cases. Mr. Coffey is a graduate of the United States Naval Academy and the Georgetown University Law Center.

Robert Giuffra

Robert Giuffra is a litigation partner at Sullivan & Cromwell LLP in New York. He coordinates S&C's securities litigation practice and is a member of the firm's management committee. He currently represents clients in government investigations and securities class actions involving *Enron Corp.*, *HealthSouth Corp.*, and NYSE specialist trading. He served as chief counsel of the Senate Banking Committee from 1995 to 1996 and was a primary drafter of the Private Securities Litigation Reform Act of 1995 ("PSLRA"). He clerked for Chief Justice William Rehnquist and is a graduate of Princeton and Yale Law School.

Sean Coffey

Where should courts draw the line between third-party conduct that "merely" aids and abets a fraud, and conduct that puts the third party in the thick of the fraud as a direct participant? That is the question the Supreme Court has agreed to tackle next term in *Stoneridge Investment v. Scientific-Atlanta.*

To clear up any confusion: the question is not whether there should be aiding and abetting liability — that issue was settled by the Court's 1994 *Central Bank* decision, in which the Court held that investors could not sue third parties (be they bankers or lawyers or business partners) that had "aided and abetted" an act of securities fraud by a "principal" (typically a publicly traded company and/or its senior managers, who may have fudged the company's financial statements in order to boost the stock price).

Here's an example of the type of conduct that many investors think should subject a third-party to liability: Let's say a company is concerned about coming up short at year end on its cash flow. So senior management arranges to obtain $100 million in cash from Bank A on December 31, the last day of the fiscal year. But rather than paper it as a loan, the company and Bank A arrange for A to pay the $100 million to "buy" a warehouse of widgets that the company has in inventory (which the bank never inspects), and simultaneously execute a side letter requiring the company to "buy" that same inventory back from the bank in a month — after the books have closed for the year — for $105 million.

Bank A knows that the company intends to add the $100 million to its cash flow number even though this transaction is in fact a loan, not a legitimate sale. I respectfully submit that Bank A has participated in a scheme to commit securities fraud and (like the company) should be held accountable to those whom it was foreseeable would be harmed by that scheme — investors.

It is deceptive conduct like this that the theory of "scheme liability" is intended to reach. And it finds its legal roots in an SEC rule called Rule 10b-5, which makes it illegal to engage in "any" scheme to defraud another in connection with the purchase or sale of securities.

A number of hysterical arguments are being thrown about that, in effect, predict the end of capitalism as we know it if "scheme liability" is endorsed by the Court. Since nobody I know makes these arguments better and more persuasively than my friend Bob Giuffra, let me turn it over to Bob.

Bob Giuffra

Well, Sean, there you go again. You pick a troubling fact pattern — a Wall Street bank's alleged involvement in a phony sale of assets to prop up corporate cash flow — to argue for the rewriting of the securities laws.

We both know that if the plaintiffs' bar somehow can persuade the Supreme Court (and I doubt the justices will) to adopt so-called "scheme liability," plaintiffs will be able to extract millions, if not billions, from innocent investment banks, accountants, vendors and maybe even law firms (yikes!) whenever a company's stock drops. As a securities defense lawyer, the creation of amorphous "scheme liability" may be good for my narrow practice, but it will be a disaster for our economy, especially in New York. I'm sure the Mayor of London is rooting for you.

Let's review some history. The plaintiffs' bar was never happy with the Supreme Court's decision in *Central Bank,* which held that rule 10b-5 imposes liability only on defendants who themselves make a false statement relied on by investors. The Court's ruling was based on a careful reading of the language of Section 10(b) — the statute that gave the SEC authority to create rule 10b-5 — and the dangerous "ripple effects" of imposing "ad hoc" liability on third parties. After *Central Bank*, the plaintiffs bar asked Congress to create so-called "aiding and abetting" liability, but Congress said no, granting the authority to sue for "aiding and abetting" only to the SEC in the Private Securities Litigation Reform Act of 1995 ("PSLRA"). The PSLRA, as you'll remember, passed with the support of many Democrats, including Ted Kennedy.

After this, the ever-resourceful plaintiffs bar dreamed up "scheme liability," little more than a new name for "aiding and abetting" liability for private plaintiffs. In a few cases involving massive investor losses, most notably *Enron*, the plaintiffs' bar managed to convince a few sympathetic federal judges to accept "scheme liability," and thereby rewrite the securities laws. Ultimately, the Fifth Circuit reversed the *Enron* district judge, but only after several Wall Street banks had paid billions in settlements to avoid the risk of a trial in which Bill Lerach likely would have asked a jury to "punish" those banks for the sins of Enron's corrupt executives. (As you and I both know, virtually all securities class action settle because defendants can't run the risk of a runaway jury in cases in which plaintiffs are seeking billions of dollars in damages.)

Sean, if Congress originally intended to impose "scheme liability" on third parties, such as banks, why did it take almost 70 years for the plaintiffs' bar to discover this "theory?" The bottom line is that Congress writes the laws in our democracy, and if "scheme liability" is good policy (and, it's not), then Congress is where the battle should be fought, not in the courts. In 1995, Congress decided that the SEC (and the SEC alone) should have the power to prosecute banks that aid and abet securities fraud. Congress clearly did not want to give the plaintiffs bar the enormous leverage of an open-ended theory of liability to extract huge settlements from the supposedly "deep pockets" of those who deal with public companies.

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DEBATING SCHEME LIABILITY

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Sean Coffey

Thanks Bob for your concession that Bank A's conduct in my hypothetical was "troubling." That had to hurt. The question that investors would like to have you (and the Chamber of Commerce) answer is: do you think Bank A should get a pass for what it did in the (not so) hypothetical? Or is Bank A an "innocent" third party that should be beyond the reach of defrauded investors?

Your response suffers from several flaws. Most notably, it fails to acknowledge all of the hoops that an investor would have to jump through to obtain a recovery from our hypothetical Bank A even if "scheme liability" were a viable theory — hoops that give comfort even to the most flagrant wrongdoers.

Thanks to the PSLRA, before investors can recover a dime for their losses due to securities fraud they must file a complaint significantly more detailed than those required in typical civil actions. They have to allege a "cogent and compelling" portrait of an intent to commit fraud, and link specific stock drops to the fraud itself, all without the benefit of any discovery from the defendant's files (a right that civil litigants get in every other kind of case). Furthermore, if the case survives a motion to dismiss and a jury eventually concludes that investors proved their case, the award against any particular defendant is reduced to the share of the blame the jury concludes the defendant deserves.

These and other mechanisms were put in place a dozen years ago to reduce frivolous securities litigation and the threat of "runaway" verdicts against honest business people. And guess what? It worked. Filings are down; dismissals are up; and the cases where investors get real money back have names like *WorldCom, Cendant, Enron, Nortel,* etc.

Bob Giuffra: "If Congress originally intended to impose 'scheme liability' on third parties, such as banks, why did it take almost 70 years for the plaintiffs' bar to discover this 'theory?"

As for the history lesson, please recall that before the 1994 *Central Bank* decision (which, based on your description of the holding, I think you ought to re-read), circuit courts covering virtually the entire country believed that investors could bring aiding and abetting claims, so the need to invoke "scheme liability" was absent. "Scheme liability" isn't some "new" fad cooked up by the plaintiffs bar since 1994; Rule 10b-5 (including the scheme provisions of subsections (a) and (c)) was put in place by the SEC in 1942.

Let me put it right out on the table. "Scheme liability" is invoked more these days partly because more third parties feel emboldened to participate in such schemes. They feel they can make money doing shady things they wouldn't do if there were a chance they'd have to pay for their transgressions. In my world, Bank A would be sufficiently concerned about "scheme liability" that it would think twice about papering a loan as a bogus purchase so a company could cook its books.

But the SEC can go after them, you say? Please. I'm sure you would be comfortable having the present SEC leadership "protecting" investors. My clients aren't (although they, like me, admire the career, rank and file enforcement staff).

I happen to believe that the vast majority of corporate officers, lawyers, bankers, and yes, even auditors try to earn their keep honestly and act in an ethical manner. The conduct that scheme liability seeks to address is that (hopefully) very narrow band of conduct that is by its nature deceptive and fraudulent — fabricating loans, setting up bogus round-trip revenue deals, and the like. If corporate America feels that outlawing that type of conduct would have a material adverse effect on how it does business, then maybe I ought to move to London.

Bob Giuffra

Sean, you're right that the PSLRA has done much to improve securities class actions. Now, plaintiffs lawyers have real clients — at least in the big cases like *Enron*. And, post-PSLRA, it's harder to bring a strike suit based on flimsy allegations. But too many frivolous cases still get past motions to dismiss, and defendants still pay millions to settle weak cases.

You gloss over my point that Congress makes the laws, not the courts. In the PSLRA, Congress expressly refused to enact "aiding and abetting" liability. Having lost in Congress, the plaintiffs' bar now wants the Supreme Court to rewrite Section 10(b) to create "scheme liability," which is — sorry — just another version of "aiding and abetting" liability. There's no way around that.

In reciting some of the elements of a Section 10(b) violation, you studiously ignore the requirement that investors must rely on the allegedly false statement to state a legal claim. In your hypothetical, the company (not Bank A) made the allegedly false statements to investors; investors can sue the company or perhaps its accountants for any false statements they made.

The plaintiffs bar wants to use "scheme liability" to write the "reliance requirement" out of Section 10(b). You want to say that if the issuer made a misstatement to the market as part of the "scheme" (and the investors relied on the statement through the so-called fraud on the market presumption), then the bank is responsible for this misstatement as a co-schemer, even though the bank didn't make the statement. This

sounds a lot like conspiracy, and Congress has refused to turn Section 10(b) into a conspiracy law. Sorry.

Our debate is not about Bank A. It's about whether the plaintiffs bar should collect big fees by suing innocent third parties. And it's about whether those innocent third parties should be forced to pay millions simply because they did business with a public company that suffered a big stock drop.

Sean Coffey

Bob, I take your unremarkable point that Congress makes laws, not the courts, but please remember also that Congress empowered the SEC to promulgate rules to effectuate the purposes of Section 10(b), and it did so over 60 years ago with Rule 10b-5. That rule — which the PSLRA did not disturb when it overhauled the securities laws in 1995 — has three subsections, only one of which (subsection (b)) deals with false statements. As any good strict constructionist should agree, the other two subsections (which deal with scheme and deceptive practices, not statements) must mean something. That is what investors are relying on in pressing "scheme liability" claims. You haven't gotten around to dealing with that yet and I invite you to do so.

Finally, I agree that there is still too much frivolous litigation in this area. But my observation is that the majority of it is practiced by defendants who have their lawyers deny the obvious, file every motion that can be filed regardless of merit and engage in every dilatory tactic that can be made. (Not you though, Bob.)

Bob Giuffra

Sean, the SEC can't adopt a regulation that exceeds the statutory language of Section 10(b), and the statute says nothing — not a word— about "scheme liability." And the SEC hasn't interpreted Section 10(b), or even Rule 10b-5, to permit the sort of amorphous "scheme liability" that plaintiffs' lawyers want to use to leverage big settlements from innocent third parties. And remember, the Supreme Court in *Central Bank* rejected as inconsistent with the statutory text the SEC's then-reading of Section 10(b) to permit "aiding and abetting" liability, and Congress refused to create such liability in the PSLRA.

Sean Coffey: "Let me put it right out on the table. 'Scheme liability' is invoked more these days partly because more third parties feel emboldened to participate in such schemes. They feel they can make money doing shady things they wouldn't do if there were a chance they'd have to pay for their transgressions."

Our dispute is all about the standards governing pre-trial motions. We both know that almost every case settles if defense motions are denied. Armed with the weapon of open-ended "scheme liability," plaintiffs lawyers easily could survive such motions and then use trumped-up damages theories to bludgeon banks and other third parties into multi-million and, as in *Enron*, even billion dollar settlements.

There's no doubt that the present system benefits lawyers, not investors. We spend millions of dollars on litigation, and even in the most egregious cases, investors recover only a small fraction of their losses. Almost every public company faces business risks that even the most diligent banker may not spot. And, yes, sometimes corporate executives are crooks who deceive their bankers. But turning banks into insurers for their clients' losses will weaken the U.S. capital markets.

Sean Coffey

Yikes, Bob. Let me focus quickly on your statement that the SEC hasn't interpreted the law the way I have described. That's wrong. The SEC is on record stating its view that private investors can assert "scheme liability" claims, and even filed a "friend of the court" brief laying out the basis for "scheme liability" in a recent 9th Circuit case. In fact, the SEC voted to submit a brief in support of "scheme liability" in *Stoneridge*, but the Justice Department's Solicitor General (who has final say on whether to file briefs for the government) nixed the idea. Remarkably, there have been reports that the President took the unusual step of reaching out to tell the SG not to file the brief, but I'm confident this White House doesn't interfere with internal DOJ workings, aren't you Bob?

Bob Giuffra

Sean, I was referring to the completely open-ended theory of "scheme liability" whereby even the making of a plain vanilla loan can be the basis for liability. In the Ninth Circuit case, the SEC advocated some limits, saying that "scheme liability" shouldn't apply just because a bank makes a loan knowing that a company will use the proceeds to keep a fraud afloat. In regard to the *amicus* brief in *Stoneridge*, let's wait and see, but hopefully the SG will come down on the side of the U.S. capital markets and not the plaintiffs bar.

It's been fun, Sean. See you in court. ■