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Before the Subcommittee on Crime and Drugs of the
United States Senate Committee on the Judiciary

September 17, 2009

Hearing on
"Evaluating S.1551: The Liability for Aiding and Abetting Securities Violations Act of 2009"

226 Dirksen Senate Office Building

Chairman Specter, and Fellow Senators:

I am honored to be before this Committee to discuss the proposed "Liability for Aiding and Abetting Securities Violations Act of 2009." I support the concept but urge that it be coupled with a ceiling on damages for such secondary defendants.

Introduction

For a century (since 1909), it has been a criminal offense under federal law to knowingly aid or abet persons committing a federal crime with the intent to facilitate that crime.[1] Indeed, aiding and abetting can be traced back to the English criminal law of the 1700s.[2] In the civil law, the Restatement of Torts has long provided to similar effect that an actor is liable for harm resulting to a third person as a result of the tortous conduct of another "if he . . . knows that the other's conduct constitutes a breach of duty and gives substantial assistance or encouragement to the other."[3]

In the securities law context, the idea also has a considerable history. Prior to the Supreme Court's decision in Central Bank of Denver, N.A. v. First Interstate Bank of Denver, 511 U.S. 164 (1994), Justice Stevens observed (in his dissenting opinion in that case) that:

> "In hundreds of judicial and administrative proceedings in every Circuit in the federal system, the courts and the SEC have concluded that aiders and abettors are subject to liability under §10(b) and Rule 10b-5."[4]

Thus, we are not dealing with a novel concept where there has been no prior experience. Civil liability for aiding and abetting securities violations was well established prior to 1994, and securities class actions were by then already well developed. No evidence suggests that such

[1] See 18 U.S.C. §2, 35 Stat. 1152 (Act of March 4, 1909).
[2] See 1 M. Hale, Pleas of the Crown, 615 (1736); for a general discussion, see United States v. Peoni, 100 F.2d 401, 402 (2d Cir. 1938).
[3] See Restatement (Second) of Torts, §876(b) (1977). See also 1 T. Cooley, Law of Torts, 244 (3d ed. 1906) ("All who actively participate in any manner in the commission of a tort, or who command, direct, advise, encourage, aid or abet its commission, are jointly and severally liable therefor"). To be sure, not every state follows the Restatement of Torts, but many do.
[4] 511 U.S. 164, 192.

liability resulted in major failures or bankruptcies or that it drove firms out of the industry. This is not to say that safeguards are not needed (and I will suggest one shortly), but predictions of doom and disaster from restoring private civil liability seem unfounded given the considerable prior experience with aiding and abetting actions against secondary participants in securities transactions.

Nor, if it restored aiding and abetting liability, would Congress be challenging the Supreme Court with respect to a matter primarily reserved to it by the Constitution. This is not a Constitutional issue, and the Supreme Court in Central Bank was only interpreting the intent of Congress with respect to the implied private cause of action under Rule 10b-5.

Thus, the real issue is not whether Congress can restore aiding and abetting liability but whether it should. In this brief memorandum, I will address (1) the arguments for restoring aiding and abetting liability; (2) the claim that it will open the floodgates to frivolous or abusive litigation; (3) the case for a ceiling on the damages applicable to secondary defendants; and (4) a modest drafting revision that I would recommend so that the intent of the proposed statute is better realized.

I. The Case for Aiding and Abetting Liability

To say the least, it is anomalous that one could be criminally liable for aiding a securities law violation, but not civilly liable for the same conduct in a private suit. Yet, that has been the state of the law since 1994. The consequences need to be assessed along two different dimensions: deterrence and compensation.

a. Compensation. Frequently, the primary violator in a securities case will become bankrupt at or about the time the fraud is discovered. This is often the case in initial public offerings ("IPOs"), but it was also true in Enron and WorldCom. In those two cases, the settling

secondary participants (primarily investment banks) contributed approximately $7.3 billion and $6.5 billion, respectively, to fund the settlements (these cases remain the record securities class action settlements). However, in the case of Enron, this liability was based on a "scheme" theory of liability that was subsequently overturned in Stoneridge Investment Partners LLC v. Scientific Atlanta, 552 U.S. 148 (2008), and the remaining Enron defendants who had not settled escaped liability when the class action was decertified. The point here is simply that secondary defendants do represent a significant source of compensation for injured investors if a cause of action for aiding and abetting is recognized.

Many commentators (including this author[5]) have criticized the typical securities class action as being incapable of achieving compensatory relief because of its circularity. That is, when the corporation pays damages in a secondary market case (which is the typical securities class action), this payment is borne by its shareholders. Thus, shareholders who purchased or sold within the class period win (at least if they file claims), whereas those shareholders who fall outside the class period lose. But because most shareholders are diversified, they fall into both camps, sometimes winning and sometimes losing. The net result is a series of pocket-shifting wealth transfers that in the aggregate leave shareholders worse off (particularly after the deduction of the legal costs of both sides).

Valid as this critique may sometimes be, it does not apply to litigation against secondary participants. Recoveries obtained from secondary participants do not come from the issuer corporation and thus are not indirectly borne by its shareholders. Pocket-shifting wealth transfers do not occur. Thus, in a very real sense, recoveries from secondary participants uniquely provide compensation to shareholders, while recoveries from issuer corporations may seldom do so.

[5] See Coffee, Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation, 106 Colum. L. Rev. 1534 (2006).

b. Deterrence. Most recent academic commentary has viewed deterrence as the best rationale for the securities class action. From this perspective, restoring private liability for aiding and abetting violations makes sense because (1) the critical gatekeepers of the capital markets – accountants, investment banks, securities analysts, credit rating agencies, and sometimes law firms – will not otherwise face liability and will remain underdeterred in most instances, and (2) these gatekeepers can be more easily deterred than the primary violator because they do not stand to receive the same gain as the primary violator. In contrast, the primary violator may be essentially undeterrable by civil penalties. To visualize this point, recall Enron and Arthur Andersen. Because Arthur Andersen received only accounting fees and consulting income from Enron, it did not share in the massive stock price inflation or in the proceeds of numerous offerings that benefitted Enron and its officers. Thus, it can be more easily deterred. But Enron and its officers were virtually beyond deterrence through civil penalties.

Moreover, gatekeepers are critical actors without whom many corporate and securities transactions cannot be completed unless they do give their approval (for example, the law firm's opinion, the accountant's certification or the credit rating agency's investment grade rating may be a legal precondition to the transaction). Hence, if the gatekeepers are adequately deterred, they will block transactions, even though the primary violator would willingly proceed with them. Thus, to give these gatekeepers immunity from private liability is to abandon what logically is the most efficient technique for deterrence: namely, to focus on the party who has both the ability to block the illicit transaction and the weakest incentive to engage in it. This was precisely the strategy that Congress adopted in Section 11 of the Securities Act of 1933 when it imposed a form of negligence liability on both accountants and other experts in connection with registered public offerings of securities.

Put differently, it may not always be possible to deter the primary violator because it regularly may face a choice between bankruptcy or engaging in a fraud. In these circumstances, the most realistic means to prevent misconduct may be to seek to deter those who have less to gain and also the ability to block the transaction by withholding their consent. It was precisely this more feasible form of deterrence that the Central Bank decision denied investors.

If we look at the last decade's experience in the U.S. capital markets, it is difficult to avoid the conclusion that there has been inadequate deterrence. A high-tech bubble burst in 2000; a wave of accounting restatements (which began in the late 1990s) peaked in 2001-2002 with the collapse of both Enron and WorldCom amidst egregious accounting irregularities; and, in 2007-2008, the principal gatekeeper of the debt markets – the credit rating agencies – clearly failed investors and deserve much of the blame for the collapse of asset-backed securitizations. In response to these evident gatekeeper failures, Congress passed the Sarbanes-Oxley Act in 2002, and a year later a global settlement was reached between regulators and securities analysts. Basically, these reforms increased criminal penalties, administrative controls, and the SEC's powers. But the one obvious step that has not been taken was to focus private enforcement on delinquent gatekeepers. Although private enforcement has its flaws, it is entrepreneurially motivated and thus will pursue secondary participants with predictable zeal.

Given the severity of the current financial crisis, the only possible justification for not unleashing private enforcement is the belief that adequate deterrence can come from public enforcement alone. But can it? To pose this question in a more pointed fashion, does anyone really believe today, in this post-Madoff world, that the SEC, by itself, can adequately deter most secondary participants in securities frauds? As the Madoff debacle, itself, shows, the SEC has been reluctant (at least in the recent past) to pursue prominent persons aggressively and has

rarely sued major accounting or law firms (arguably both because of cost considerations and because of fears of political retaliation). Nor has it sued any of the credit rating agencies for their failures. This week, a federal court in New York criticized the SEC for its illusory settlement in the SEC's action against the Bank of America and suggested that too often the SEC enters into weak settlements that penalize the shareholders, rather than protecting them. Against this backdrop, adding private enforcement to backstop public enforcement is a failsafe protection. The plaintiff's bar would not be similarly constrained by the desire to obtain public relations victories; it wants money.

Recently, in the Stoneridge decision, which found "scheme to defraud" liability to be outside the scope of Rule 10b-5, the Court's majority wrote that it would not extend Rule 10b-5 to reach secondary participants because this "would undermine Congress' determination that this class of defendants should be pursued by the SEC and not by private litigants."[6] The "class of defendants" here referred to were essentially those secondary participants who had not themselves made public attributed statements upon which the market had relied. Today, it seems less likely that Congress really wants to rely exclusively on the SEC to police misconduct by such a broad class of persons. Inevitably, the SEC is cost constrained, has limited personnel and a large backload of cases, and sometimes it misses for years frauds (such as the Madoff and Stanford Ponzi schemes) that others had begun to suspect and would have been motivated to pursue if they could.

My sense that it no longer seems wise to rely exclusively upon the SEC has been recently confirmed by the comments of a prominent federal judge (who has been recently nominated by the President for appointment to the Second Circuit). In In re Refco Securities Litigation,[7] United

[6] Stoneridge Investment Partners LLC v. Scientific Atlanta, 128 S. Ct. 761, 771.
[7] 609 F. Supp. 2d 304 (S.D.N.Y. 2009).

States District Judge Gerald Lynch was confronted with a case in which it appeared that a law firm, which was highly familiar with the company's operations, had participated in 17 rounds of "round-trip" loan transactions pursuant to which certain "receivables were periodically made to disappear from Refco's books."[8] The partner at the law firm supervising the client was later criminally convicted of securities fraud. Yet, Judge Lynch concluded that he had no choice but to dismiss the case against the law firm in light of Central Bank and its progeny of follow-up decisions in the Second Circuit. In dicta, he observed:

> "It is perhaps dismaying that participants in a fraudulent scheme who may even have committed criminal acts are not answerable to the victims of the fraud . . . In 1995, in reaction to the Supreme Court's decision in Central Bank, Congress authorized the SEC – but not private parties – to bring enforcement actions against those who "knowingly provide . . . substantial assistance to another person in violation of the federal securities laws . . ." This choice may be ripe for legislative re-examination. While the impulse to protect professionals and other marginal actors who may too easily be drawn into securities litigation may well be sound, a bright line between principals and accomplices may not be approximate."[9]

Essentially, I agree with the judge that the time has come for legislative re-examination of the immunity given secondary participants; a balance needs to be struck. As I suggest below, this balance is best struck by restoring private aiding and abetting liability, but with a ceiling on damages.

II. The Open Floodgates Argument: Will Secondary Participants Be Exposed to a Flood of Frivolous Litigation?

The predictable response to any proposal to restore aiding and abetting liability will be that it would expose professionals to frivolous litigation. Once, back at the time that Central Bank was decided in 1994, this might have been a valid concern. But the next year, Congress passed the Private Securities Litigation Reform Act of 1995 ("PSLRA"), and its reforms have

[8] 609 F. Supp. 2d at 307.
[9] Id. at 318 n. 15.

amply protected – indeed, insulated – secondary participants. The key PSLRA safeguard is a pleading requirement: under §21D(b)(2) ("Required State of Mind") of the Securities Exchange Act of 1934, the action cannot go forward, and the plaintiff cannot obtain discovery, unless and until the plaintiff can plead "with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind" (i.e., an intent to defraud in the case of Rule 10b-5 cases). In the case of the primary violator, this requisite level of intent can often be shown without the benefit of discovery (for example, the CEO may have suddenly sold most of his stock after he learned of undisclosed negative information). But in the case of a secondary participant (such as accountant or law firm), it is extremely difficult to plead such facts without discovery. A plaintiff cannot simply allege that the lawyer or investment banker serving as an advisor to the CEO counseled fraud or illegality; rather, the plaintiff must plead such a claim with particularity before it can obtain any discovery. This is one of the primary reasons that credit rating agencies have never been held liable for securities fraud. Erroneous and inflated as some of their ratings may have been, such errors do not by themselves show with particularity an intent to defraud.

Other PSLRA provisions also provide protections that uniquely shelter secondary defendants. For example, the proportionate liability provision of Section 21D(f) of the Securities Exchange Act replaces the traditional "joint and several" liability rule with a proportionate liability rule that is designed to reduce the liability that can be imposed on less culpable defendants (such as secondary defendants).

The net result is that secondary defendants in most cases will be able to obtain early dismissals at the motion to dismiss stage and will be protected by the proportionate liability standard so that they can settle well within their insurance coverage.

III. Aiding and Abetting Liability Should Be Accompanied By a Ceiling on Damages for Secondary Defendants

Restoring aiding and abetting liability will be controversial. A solid phalanx of professions – law firms, accounting firms, investment banks, and the credit rating agencies – will unite to oppose such a restoration. Although I am hardly an expert on the political odds on its passage, those odds would be improved if restoration of aiding and abetting liability were packaged with a ceiling on liability for secondary defendants. Independently, such a ceiling, particularly for gatekeepers, makes good sense for a number of reasons:

(1) Because secondary defendants typically stand to make only a small portion of the gain that the primary defendant expects, they can be deterred more easily and do not need to face exposure to multi-billion dollar liabilities;

(2) A number of markets for gatekeeper services are highly concentrated (for example, there are only four major accounting firms and three major credit rating agencies). The failure of one of these firms would be as disruptive to the capital markets as that of Arthur Andersen.

(3) A ceiling on damages would permit professional firms that cannot now obtain liability insurance to obtain such coverage, thus averting their potential collapse.

(4) It is fundamentally unfair and undesirable that any professional firm become insolvent and fail because of the conduct of just one individual. Essentially, this is the Arthur Andersen scenario, and it could reoccur; and

(5) A ceiling on liability would mean that professional firms could not be extorted into settling by the threat of potential billion dollar liability.

What would a reasonable ceiling on damages for secondary defendants look like? Because secondary participants come in all sizes and shapes, neither a fixed dollar amount nor a

fixed percentage (whether of net worth or market capitalization or income) will work well. The goal should be to devise a penalty that is sufficiently painful to deter, but not so large as to threaten insolvency. Because some secondary participants are publicly held and some are not, one must use a variety of measures: e.g., market capitalization or net worth for public companies, revenues or income for private ones. Some outer fixed ceiling seems necessary so that a billion dollar penalty is not within the ceiling in the case of public company. Hence, on this basis, I would propose a ceiling as set forth below:

> "The maximum penalty that may be imposed in one or more actions (whether filed in state or federal court and whether the result of a judgment or a settlement in a filed action) relating to the same transaction or conduct shall not exceed the greater of:
>
> (A) in the case of a defendant who is not a natural person,
>
> (1)[10]% of the defendant's average annual income over its last three fiscal years;
>
> (2) [10]% of the defendant's net worth (as determined by its latest audited financial statements);
>
> (3) [10%] of the defendant's market capitalization at the close of its latest fiscal year if its securities are traded in a securities exchange;
>
> (B) in the case of a defendant who is a natural person, $2,000,000;
>
> but in no event shall any such defendant be liable for an amount greater than $[50,000,000]."

In the case of a natural person, the ceiling would thus be $2,000,000; in the case of a public corporation (such as an investment bank or a rating agency), the maximum ceiling would be $50,000,000. If this latter maximum ceiling seems high at first glance, it should be understood that accounting firms have recently settled securities fraud class actions for amounts in excess of $300 million. Moreover, the real impact of a ceiling is to induce the parties to settle for an amount beneath the ceiling (because few, if any, will settle for an amount equal of their maximum exposure to liability).

IV. A Drafting Suggestion

Proposed Section 20(e)(2) follows the existing language of §20(e) of the Securities Exchange Act of 1934. But there is a problem with that language. Its key limiting phrase – "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" (emphasis added) – probably requires that the secondary participant have itself engaged in a deceitful or manipulative act that would violate an SEC rule (most likely, Rule 10b-5). Thus, this language would not reach persons who provide substantial assistance without themselves engaging in a deceit or manipulation. Consider the lawyer in the earlier noted Refco case who knowingly advises his client on how to structure a transaction to avoid disclosure of material information. Hence, to remove this ambiguity, I would suggest redrafting Section 20(e)(2) to read as follows:

> "For purposes of any private civil action implied under this title, any person who knowingly or recklessly provides substantial assistance to another person enabling such person to violate this title, or 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."

Use of the word "enabling" also connotes that some causal linkage is required (i.e., helping to incorporate a subsidiary or assisting on an unrelated matter is not sufficient). Finally, the legislative history should make clear that when the proposed language uses the phrase "to the same extent as the person to whom such assistance is provided," it does not seek to overrule the proportionate liability damages rule of §21D(f) of the Securities Exchange Act. That is, the secondary participant would be liable, but the measure of damages to be awarded against such person would be determined under §21D(f).