Testimony of Patrick J. Szymanski

**Before the Senate Judiciary Committee,
Subcommittee on Crime and Drugs**

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

Chairman Specter, Ranking Member Graham and members of the subcommittee, thank you for inviting me to testify concerning S. 1551 which addresses liability for aiding and abetting violations of the Securities Exchange Act and, in particular, would correct the result reached by the United States Supreme Court in *Stoneridge Investment Partners LLC v. Scientific-Atlanta Inc.*, 552 U.S. 148, 128 S. Ct. 761 (2008).

My name is Patrick Szymanski, and I am General Counsel to Change to Win. Change to Win ("CtW") is an alliance of unions and six million workers, united to build a new movement of working people that can meet the challenges of the global economy and restore the American Dream: a paycheck that can support a family, affordable health care, a secure retirement and dignity on the job. Our partner unions include the International Brotherhood of Teamsters, Laborers' International Union of North America, Service Employees International Union, United Farm Workers of America, and the United Food and Commercial Workers International Union.

The CtW Investment Group was established in February 2006 to monitor corporate activity, to protect the interests of Change to Win workers in pension funds sponsored by unions affiliated with Change to Win, and, in particular, to enhance long-term shareholder returns through active ownership. Members of CtW affiliates participate in Taft-Hartley plans with more than $200 billion in assets. Because these funds are responsible for supporting the retirement benefits of their participants, they are diversified, are focused on long-term appreciation, and are particularly concerned with corporate governance issues, including the prevention of securities fraud, as a means of achieving reliable long-term results. In short, these funds are the paradigmatic "institutional investors" to whom Congress entrusted the presumptive leadership of private securities litigation.

Change to Win and the CtW Investment Group filed amicus briefs in *Stoneridge* and *Tellabs, Inc. v. Makor Issues & Rights Ltd.*, 551 U.S. 308, 127 S. Ct. 2499 (2007), and have similarly supported the interests of our funds, workers, investors and shareholders before Congress and the Securities and Exchange Commission.

In recent years, and particularly as a result of last year's economic meltdown, our funds have lost tens of billions of dollars, in some cases as much as 25-30 percent of their assets. These losses were not the result of poor management by fund administrators – the vast majority of pension funds have adopted investment policies that significantly limit investments in the highly complex and poorly understood financial products at the heart of the meltdown. Rather, the losses sustained by our funds were the result of financial misconduct by firms like Enron and WorldCom and, more recently, by the 2008 economic debacle that directly resulted from the lack of meaningful regulation in the financial sector, particularly with regard to complex and poorly understood derivatives and the so-called "shadow financial markets."

While our funds' conservative investment policies thankfully prevented them from investing in such products to the degree of many Wall Street investors, pension funds have nonetheless suffered massive losses as the fallout from out-sized risks taken by Wall Street executives that rippled out into virtually every corner of the capital markets. The lack of regulation in the shadow financial markets meant that there was little to no way for the funds to determine how much risk their portfolios contained – something the banks themselves were apparently unable to accurately gauge. This was true even for pension funds' investments in publicly traded investment and commercial banks, which saw their market capitalization crash when the full extent of their exposure to unregulated and ultimately toxic investments became clear. As a result, the retirement security of millions of hard-working American families has been severely shaken due to the gambles taken by Wall Street executives.

Unfortunately, this is not new. William O. Douglas accurately described the inherent problems in the financial markets in an address delivered at the University of Chicago in 1937 ("Forces of Disorder," SEC

Historical Society, http://www.sechistorical.org/collection/ papers/1930/ 1936_1027_Douglas_Forces.pdf):

> Of the many forces which breed insecurity, perhaps the most dangerous are the exploitation and dissipation of capital at the hands of what is known as "high finance." The reality of such waste and leakage comes forcibly home when one sees the tottering ruins of industry in bankruptcy or receivership.

Then Chairman of the SEC, Mr. Douglas went on to describe "financial termites" that "destroy the legitimate function of finance and become a common enemy of investors and business."

> Enterprises ostensibly secure collapse as a consequence of their subtle operations. Their mysterious and destructive work has ruined many fine businesses. And at times the first warning which security holders have had that these termites were at work was the disastrous collapse of the company.

And Mr. Douglas well understood that the purpose of the SEC and the Government is to protect investors, both the "institutional buyer of stock" and "people of small income," from the adverse effects of these inherent problems.

The recent financial crisis has highlighted the necessity of a legal and regulatory framework that properly and adequately protects investors from corporate fraud. The Securities and Exchange Commission must of course take a leading role, as it did when Mr. Justice Douglas was its Chairman. But the markets and the problems have grown beyond what anyone imagined in the 1930s. The SEC cannot be the sole cop on the beat. It simply has not the necessary resources. As with any market system, the capital markets will function most efficiently and fairly if investors themselves have the legal tools necessary to hold accountable those who knowingly or recklessly put their investments at risk.

Nowhere could this be more true than in the case of corporate actors who make fraudulent or misleading statements to investors *and* those who would knowingly or recklessly aid in deceiving the investing public. The

Supreme Court's ruling in *Stoneridge* insulates from accountability those who aid in the dissemination of such fraudulent or misleading statements regarding the financial health of publicly-traded companies – companies in which our funds and our workers' retirement security are heavily invested. In the wake of the scandals of the Enron and WorldCom era and following the worst financial crisis since the Great Depression, it is exactly the wrong way to protect investors in a dis-intermediated, market based financial system.

Stoneridge and other recent decisions have contributed to the problem. They are inconsistent with the fundamental purpose of protecting investors from financial misconduct. *Stoneridge* virtually immunizes banks, brokers, accountants, law firms, and others from liability in many cases. The view that those crafty enough to benefit from participating in a securities fraud can escape liability by carefully avoiding a public statement directly conflicts with the broad language and purposes of the antifraud provisions. Indeed, it is precisely with respect to such secret schemes that the antifraud provisions are needed the most. The federal securities laws cannot be allowed to reward the most cunning at the expense of the honest and hard working and the institutional investors entrusted with holding and managing their funds for their future benefit and retirement.

We need a general overhaul of federal financial regulation, and the Administration has promised to lead that effort. The overhaul must reinvigorate the private enforcement of the securities laws and, to accomplish that end, must remove two significant barriers to investor claims. The first, resulting from the Supreme Court's decision in *Tellabs*, concerns the requirement that securities fraud claims be dismissed unless investors can without discovery allege evidentiary facts demonstrating a "strong inference of scienter." The second is the *Stoneridge* rule that those who knowingly or recklessly facilitate another's fraud must be immune to liability because they are mere "aiders and abettors."

We believe that S. 1551 adequately and appropriately addresses the artificial and inexplicable result in *Stoneridge*, and we discuss below many of the cases that show the need for just such a correction. But before we address the *Stoneridge* aiding-and-abetting issue, we briefly note the need to also correct the initial barrier to legitimate claims imposed in *Tellabs*.

Requiring Investors to Demonstrate "a Strong Inference" of Scienter

The Private Securities Litigation Reform Act of 1995 (PSLRA) requires plaintiffs in securities cases to state with particularity both the facts constituting the alleged violation and the facts establishing "scienter," i.e., the defendant's intention "to deceive, manipulate, or defraud." *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 194 & n.12 (1976). In particular, PSLRA §21D(b)(2) requires plaintiffs to "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." 15 U.S.C. §78u–4(b)(2). Congress left the key term "strong inference" undefined. Many courts, as did the court of appeals in *Tellabs* itself, had held that the "strong inference" standard would be met if the complaint "allege[d] facts from which, if true, a reasonable person could infer that the defendant acted with the required intent." *Makor Issues & Rights, Ltd. v. Tellabs, Inc.*, 437 F.3d 588, 602 (7th Cir. 2006). But the Supreme Court ruled in *Tellabs* that courts faced with securities claims must go beyond this common sense pleading requirement to assess the defendant's state of mind by "engag[ing] in a comparative evaluation; it must consider, not only inferences urged by the plaintiff, as the Seventh Circuit did, but also competing inferences rationally drawn from the facts alleged." *Tellabs,* 551 U.S. at 314. This standard is ambiguous, subjective, unworkable and fatal to many meritorious securities actions.

WorldCom stands as one of the most notorious frauds of the past century. But when investors first filed suit against WorldCom and its top executives, CEO Bernard J. Ebbers and Scott D. Sullivan, in federal court in Mississippi, their case was dismissed – and the U.S. Court of Appeals for the Fifth Circuit affirmed on the ground that investors could not allege either Ebbers or Sullivan acted with scienter – even though Sullivan was by then under indictment. *See Goldstein v. MCI WorldCom,* 340 F.3d 238 (5th Cir. 2003). Both Ebbers and Sullivan ultimately received prison sentences. As the magnitude of their fraud became public, investors managed to plead claims that were permitted to proceed in federal court in New York. Still, the investors who first identified WorldCom as a fraudulent operation had their case thrown out of court – on account of a ridiculously demanding pleading requirement.

Many other cases get terminated forever because plaintiffs cannot plead enough facts to demonstrate a strong inference of fraudulent intent or recklessness. Along with the correction embodied in S. 1551, Congress should also correct the *Tellabs* result by returning the law to the commonsense requirement that plaintiffs be required to "allege facts from which, if true, a reasonable person could infer that the defendant acted with the required intent." *Tellabs*, 551 U.S. at 323 (quoting decision below).

Central Bank and Stoneridge: A Free Pass for Aiders and Abettors

We turn to the cases that demonstrate the need to correct the *Stoneridge* rule. Our criminal law long ago "'abolishe[d] the distinction between principals and accessories and [made] them all principals.'"[1] Indeed, the rule that one who aids and abets another's crime or fraud shall be punished as a principal has been codified in 18 U.S.C. §2, which states: "Whoever commits an offense against the United States or aids, abets, counsels, commands, induces or procures its commission, is punishable as a principal."

Thus, in *Nye & Nissen v. United States*, 336 U.S. 613, 618-20 (1949), the Supreme Court held that one who aids and abets fraud is himself guilty as a principal perpetrator of that fraud. *Id*. The rule is sound. For a scheme to defraud typically involves multiple parties who conspire with, or aid and abet, one another in order to perpetrate the fraudulent scheme. "[A]ll members" of such a scheme, the Supreme Court holds without hesitation in criminal cases, "are responsible." *Pinkerton v. United States*, 328 U.S. 640, 647 (1946) (mail fraud).

When Congress enacted §10(b) it understood that such a statute, making securities fraud illegal, would also make aiding and abetting securities fraud illegal. Federal courts and the SEC readily concluded that

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[1] *Standefer v. United States*, 447 U.S. 10, 19 (1980), quoting *Hammer v. United States*, 271 U.S. 620, 628 (1926) (*Standefer*'s brackets); *see United States v. Pino-Perez*, 870 F.2d 1230, 1233 (7th Cir. 1989) (en banc); *United States v. Oates*, 560 F.2d 45, 55 (2d Cir. 1977).

aiding and abetting a violation of the federal securities laws is itself a violation of those laws.[2]

From the very beginning, the same rule applied to civil liability in private actions under §10(b). The first two decisions recognizing an implied private right of action for violations of §10(b) imposed liability for conspiracy to defraud,[3] and for aiding and abetting a violation of §10(b).[4] Following those early cases, the circuit courts uniformly concluded that aiding and abetting securities fraud was a violation of §10(b) and Rule 10b-5 for which investors could sue. "Under §10(b) and Rule 10b-5 knowing assistance of or participation in a fraudulent scheme," the Tenth Circuit held in *Kerbs v. Fall River Indus.*, 502 F.2d 731, 740 (10th Cir. 1974), "gives rise to liability equal to that of the perpetrators themselves." When auditors assisted a client's fraud, the Ninth Circuit declared: "Aiding and abetting is itself a violation of section 10(b) and Rule 10b-5." *Roberts v. Peat, Marwick, Mitchell & Co.*, 857 F.2d 646, 652 (9th Cir. 1988). The other Circuits agreed that those who aid and abet securities fraud should face liability to their foreseeable victims.[5]

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[2] *See, e.g., SEC v. Scott Taylor & Co.*, 183 F. Supp. 904, 909 n.12 (S.D.N.Y. 1959); *SEC v. Timetrust, Inc.*, 28 F. Supp. 34, 43 (N.D. Cal. 1939), appeal dismissed, 118 F.2d 718 (9th Cir. 1941); *Matter of Burley & Co.*, 23 S.E.C. 461, 468 n.11 (1946) (Exchange Act Release No. 3838).

[3] *Kardon v. National Gypsum Co.*, 69 F. Supp. 512, 513 (E.D. Pa. 1946) (Kirkpatrick, J.) (sustaining a complaint that "in substance, charges a conspiracy, participated in by the three defendants").

[4] *Fry v. Schumaker*, 83 F. Supp. 476, 478 (E.D. Pa. 1947) (Kirkpatrick, J.) (recognizing liability for either "rendering service essential to or participating in a scheme to defraud").

[5] *See, e.g., Cleary v. Perfectune, Inc.*, 700 F.2d 774, 772-77 (1st Cir. 1983); *IIT v. Cornfeld*, 619 F.2d 909, 922 (2d Cir. 1980); *Monsen v. Consolidated Dressed Beef Co.*, 579 F.2d 793, 799 (3d Cir. 1978); *Schatz v. Rosenberg*, 943 F2d 485, 496-97 (4th Cir. 1991); *Fine v. American Solar King Corp.*, 919 F.2d 290, 300 (5th Cir. 1990); *Herm v. Stafford*, 663 F.2d 669, 684 (6th Cir. 1981); *Carroll v. First National Bank*, 413 F.2d 353, 357

But the Supreme Court changed the rules in *Central Bank v. First Interstate Bank*, 511 U.S. 164 (1994), by overturning many decades of settled precedent holding that aiders and abettors of a fraud may be liable under §10(b). The Court went even further in *Stoneridge Investment Partners LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148, 128 S.Ct. 761 (2008), when it held that third parties who conspire to generate phony financial results for another company to report cannot be held liable – because they have merely aided and abetted another's fraud. The consequences for the victims of sophisticated fraudulent schemes have been disastrous.

Stoneridge: Freedom to Generate Phony Financial Results

Stoneridge itself presents a compelling example of why the proposed amendment is needed – for it exempted from liability companies that knowingly entered into sham transactions in order to generate the phony financial results that Charter Communications, a cable-television provider, wanted to report to investors.

Investors alleged that when Charter executives saw that their company would miss projected operating cash-flow numbers by $15 to $20 million, they sought the help of Scientific-Atlanta, Inc., and Motorola, Inc., to gin up the phony numbers needed to meet the projections. Scientific-Atlanta and Motorola supplied Charter with the digital cable converter (set top) boxes that Charter furnished to its customers. So Charter executives arranged to conceal the company's cash-flow shortfall by arranging to overpay Scientific-Atlanta and Motorola "$20 for each set top box it purchased until the end of the year, with the understanding that [they] would return the overpayment by purchasing advertising from Charter," which it would then report as revenues, while improperly capitalizing the added expense of the set-top boxes. *Stoneridge*, 128 S.Ct. at 766.

Charter investors alleged that Motorola and Scientific-Atlanta were knowing participants in this fraudulent scheme to falsify Charter's financial results by misleading both Charter's auditors and the investors who

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(7th Cir. 1969); *Metge v. Baehler*, 762 F.2d 621, 624 (8th Cir. 1985); *Little v. Valley National Bank*, 650 F.2d 218, 222-23 (9th Cir. 1981); *Woods v. Barnett Bank*, 765 F.2d 1004, 1009 (11th Cir. 1985).

ultimately would rely upon its audited financial statements. As the Supreme Court's opinion explains:

> To return the additional money from the set top box sales, Scientific-Atlanta and Motorola signed contracts with Charter to purchase advertising time for a price higher than fair value. The new set top box agreements were backdated to make it appear that they were negotiated a month before the advertising agreements. The backdating was important to convey the impression that the negotiations were unconnected, a point Arthur Andersen considered necessary for separate treatment of the transactions. Charter recorded the advertising payments to inflate revenue and operating cash flow by approximately $17 million. The inflated number was shown on financial statements filed with the Securities and Exchange Commission (SEC) and reported to the public.

Stoneridge, 128 S. Ct. at 767.

Motorola and Scientific-Atlanta booked the transactions as a wash, given their lack of real economic substance. But by entering the transactions and backdating documents, they knowingly facilitated the generation of the phony results that Charter desired to report. In short, they participated in a scheme to defraud, that they could expect would injure investors who purchased Charter securities in reliance on the bogus financial results that they helped to generate.

The Supreme Court applied *Central Bank*, to hold them immune to liability under §10(b), on the rationale that they had merely aided and abetted Charter's fraud. "Respondents had no duty to disclose," the Supreme Court explained, "and their deceptive acts were not communicated to the public" – only the deceptive results of those acts were reported by Charter. *Stoneridge*, 128 S. Ct. at 769.

The Court wrote that "[i]n effect petitioner contends that in an efficient market investors rely not only upon the public statements relating to a security but also upon the transactions those statements reflect." *Stoneridge*, 128 S. Ct. at 770. This, the Supreme Court held, went too far. It held that "respondents' deceptive acts, which were not disclosed to the

investing public, are too remote to satisfy the requirement of reliance," even if they knowingly entered sham transactions in order to generate the phony financial results that Charter sought to report, and backdated documents to hide the impropriety from Charter's auditors. *Id*. That Charter reported those results (as all involved surely expected) somehow constituted an intervening cause: "It was Charter, not respondents, that misled its auditor and filed fraudulent financial statements; nothing respondents did made it necessary or inevitable for Charter to record the transactions as it did." *Id*.

The Court cited *Central Bank*, and Congress' response to it as the basis for denying investors relief from the very entities that had worked to advance Charter's fraud. The Court explained that after *Central Bank* had done away with civil aiding-and-abetting liability,

> Congress amended the securities laws to provide for limited coverage of aiders and abettors. Aiding and abetting liability is authorized in actions brought by the SEC but not by private parties. See 15 U.S.C. §78t(e). Petitioner's view of primary liability makes any aider and abettor liable under §10(b) if he or she committed a deceptive act in the process of providing assistance. [citation omitted] Were we to adopt this construction of §10(b), it would revive in substance the implied cause of action against all aiders and abettors except those who committed no deceptive act in the process of facilitating the fraud; and we would undermine Congress' determination that this class of defendants should be pursued by the SEC and not by private litigants.

Stoneridge, 128 S. Ct. at 771. Thus, said the Court, "we give weight to Congress' amendment to the Act restoring aiding and abetting liability in certain cases but not others," by denying relief to the victims of the fraud. *Id*. at 772.

The time has come for Congress to restore to victims the right to be made whole, by restoring their right to recover from those who knowingly or recklessly facilitate financial fraud. The sad consequences of the *Central Bank/Stoneridge* rule can be seen in many cases, where investors are being denied relief from perpetrators of criminal acts.

One such case is *In re Adelphia Communications Corp. Sec. & Deriv. Litig.*, No. 03-MDL-1523 (LMM), 2009 WL 1740035 (S.D.N.Y. June 17, 2009), where purchasers of Adelphia securities alleged that the *Stoneridge* defendants Scientific-Atlanta and Motorola had engaged in precisely the same kind of transactions to inflate Adelphia's financial results as they had with Charter. Adelphia "negotiated and entered into supplemental agreements with Motorola and Scientific-Atlanta to buy cable boxes at the original contract price plus a premium," while "Motorola and Scientific-Atlanta agreed to pay Adelphia an amount equivalent to the premium as 'marketing support payments.'" *Adelphia*, 2009 WL 1740035, at *1. As in *Stoneridge*, these "deals were in essence 'wash' transactions," whose "only impact was to make Adelphia's financial performance look better from an accounting standpoint, by artificially inflating Adelphia's" apparent financial results. *Id.* Though they were repeat players in such schemes, Motorola and Scientific-Atlanta avoided liability again, just as they had in *Stoneridge*.

As serious as these frauds may be, *Stoneridge* and *Adelphia* provide only a hint of how bad the problem is. The largest and most egregious frauds are the ones where immunity for aiders and abettors has its most serious effect.

Enron: Poster Child for Reform

The case of Enron, perhaps the most notorious of all financial frauds, starkly illustrates why aiders and abettors cannot be permitted to avoid liability under §10(b). Boiled down to its essence, Enron's financial fraud consisted of using bogus transactions to hide the company's debt and generate phony revenues. Enron's investment banks, including Credit Suisse, Merrill Lynch, and Barclays Bank, structured and executed the transactions that accomplished this – producing the raw data underlying the false financial statements on which investors and the market relied.

Yet the Fifth Circuit held that the very entities who effected the fraud – by executing the sham transactions that hid Enron's debt and generated the phony financial results that it reported – were immune to liability under §10(b). They were, the Fifth Circuit held, merely aiders and abettors of Enron's fraud, because they had no independent duty to report the bogus financial data they generated to investors, and because it was Enron, in the

end, that filed the false financial statements reporting the results that they had worked to generate.

Under *Central Bank*, the Fifth Circuit ruled, "the factual probability that the market relied on the banks' behavior and/or omissions does not mean that plaintiffs are entitled to the legal presumption of reliance," when they purchased Enron securities on the basis of the false data that the banks had generated for Enron. *Regents*, 482 F.3d at 383. The banks' carefully structured bogus transactions were, the Fifth Circuit reasoned, "not misrepresentative because the market had no right to rely on them." *Id.* And reliance on Enron's financial statements, which were based upon them, did not count – because it was too remote. *Id.*

"Presuming plaintiffs' allegations to be true," the Fifth Circuit explained, "Enron committed fraud by misstating its accounts, but the banks only aided and abetted that fraud by engaging in transactions to make it more plausible; they owed no duty to Enron's shareholders." *Regents*, 482 F.3d at 386. The federal appeals court accordingly held that "what the banks are alleged to have done, namely engage in transactions elsewhere that gave a misleading impression of the value of Enron securities that were already on the market," was quite simply beyond the law's reach because, under *Central Bank*, they were merely aiders and abettors of the fraud that they had structured and executed. *Regents*, 482 F.3d at 391.

This, the Fifth Circuit acknowledged, ran contrary to common-sense constructions of §10(b) and Rule 10b-5. For §10(b) purports to reach "any person" who "directly or indirectly" employs "any manipulative or deceptive device or contrivance in contravention of such rules and regulation as the Commission may prescribe." 15 U.S.C. §78j(b). And Rule 10b-5 says it reaches "any person" who "directly or indirectly" employs "any device, scheme, or artifice to defraud," who makes "any untrue statement of a material fact," or omits facts "necessary to make the statements made, in light of the circumstances under which they were made, not misleading," or who engages "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." 17 C.F.R. §240.10b-5.

The investment banks' conduct – structuring bogus transactions in order to mislead creditors and investors – surely seemed to fit within the

natural meaning of the statute and rule, as deceptive contrivances designed to deceive investors as part of a clearly fraudulent scheme. But the Fifth Circuit held that it was "by ascribing natural, dictionary definitions to the words of the rule, that the district court and likeminded courts have gone awry." *Regents*, 482 F.3d at 387. The Fifth Circuit concluded that the statute's natural meaning had to fall, and that under *Central Bank* the investment banks were immune to liability as mere aiders and abettors of the fraudulent scheme that they helped to design, and in which they knowingly participated.

To be sure, Enron investors managed to collect more than $7 billion in settlements before the Fifth Circuit so ruled. But the Fifth Circuit's interpretation of *Central Bank denied* investors any further relief. And a week after issuing its opinion in *Stoneridge*, the Court denied the Enron petition for certiorari and allowed the decision to stand.[6]

Refco: Criminals Owing No Duty to Their Victims

Another egregious example of the effect of *Stoneridge* is found in the Refco securities-fraud litigation, where investor claims against Refco's outside counsel were dismissed with prejudice, despite allegations that the lawyers were intimately and knowingly involved in the company's fraud. "Although the Complaint alleges facts that, if true, would make the Mayer Brown Defendants guilty of aiding and abetting the securities fraud that harmed the plaintiffs," the district court observed in dismissing the claims, "the Supreme Court and Congress have declined to provide a private right of action for victims of securities fraud against those who merely – if otherwise substantially and culpably – aid a fraud that is executed by others." *In re Refco, Inc., Sec. Litig.*, 609 F. Supp. 2d 304, 306 (S.D.N.Y. 2009); *see also Thomas H. Lee Equity Fund V, L.P. v. Mayer Brown, Rowe & Maw LLP*, 612 F. Supp. 2d 267 (S.D.N.Y. 2009).

"Prior to Refco's spectacular collapse," the district court's opinion explains, "it was among the world's largest providers of brokerage and

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[6] *Regents of the Univ. of Cal. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, __ U.S. __, 128 S. Ct. 1120 (January 22, 2008) (denying petition for a writ of certiorari).

clearing services in the international derivatives, currency, and futures markets." *Refco*, 609 F. Supp. 2d at 306. "Refco's business model involved extending credit to its customers so that they could trade on margin and leverage their capital into larger trades, for which Refco could again extend credit," thereby generating "substantial commissions, revenues, and profits." *Id.* Over time, however, "Refco began making loans without adequately assessing customers' credit-worthiness or the risks associated with trading activities," so that when customers suffered massive trading losses in the late 1990s, the loans "became 'uncollectible receivables' that Refco's customers were unwilling or unable to repay." *Id.*

"Rather than write off or disclose these uncollectible receivables – the revelation of which would have had dire financial consequences for the company – Refco's management allegedly devised a scheme to conceal them from the public and Refco's investors." *Refco*, 609 F. Supp. 2d at 306. The district court's opinion describes its operation:

> First, they transferred the loans onto the books of Refco Group Holdings, Inc. ("RGHI"), an entity owned and controlled by Phillip R. Bennett ("Bennett"), Refco's President, CEO, and Chairman. As a result of these transfers, [RGHI] owed hundreds of millions of dollars to Refco, but RGHI had no liquid assets and no operational functions, and thus it had no conceivable means of repaying the "loans."
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> Next, to avoid the disclosure of large "related-party" receivables - the sum of which dwarfed Refco's net income – a series of fraudulent transactions were arranged by which the RGHI receivables were periodically made to disappear from Refco's books through so-called "round-trip loans" in which the receivables owed to Refco from RGHI were replaced with receivables purportedly owed by a third-party customer.
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> These loans, which straddled the end of each fiscal year from 2000 through 2005 and at the end of several fiscal quarters as well, all worked in essentially the same way. First, several days before Refco closed its books for each financial period, Refco Capital Markets Ltd. ("RCM"), a Refco subsidiary, would loan hundreds of millions of dollars to a third-party

> customer who then, through its account at Refco, simultaneously loaned the same amount to RGHI. The loan agreements between the third party and RCM – which were done on a book basis (the principal never changed hands) – were meticulously structured so that they were essentially risk-free to the third-party customers; the customers' loans to RGHI were guaranteed by Refco and the customers profited for their participation in the "loans" through interest earned on their loans to RGHI, which by design exceeded the interest they were charged by RCM. RGHI, in turn, used the loans from the customers to pay down the money it owed to Refco for its uncollectible receivables. The net effect of these transactions was that at the close of each reporting period, Refco's books would show "loans" to third-party customers and the RGHI receivables would be gone. Then, just days after the financial period closed, the transactions were unwound – the "loans" repaid, and the uncollectible receivables from RGHI were returned to Refco's books. Thus, these transactions enabled Refco to lend money to itself, through third parties, to conceal its grim, multi-hundred million dollar losses from the public and from its investors.

Refco, 609 F. Supp. 2d at 306-07 (citations omitted); *see id.* at 315-16.

You might imagine that lawyers were needed to structure and execute this elaborate scheme of manipulative transactions. Indeed, the law firm of "Mayer Brown was familiar with Refco's operations and finances and participated in seventeen rounds of the round-trip loan transactions between 2000 and 2005 by which Refco's uncollectible receivables were concealed." *Refco*, 609 F. Supp. 2d at 307. "Specifically, the role of the Mayer Brown Defendants was to explain the structure and terms of the transactions to potential third-party participants, negotiate the loans, draft and revise the documentation for the transactions including the relevant loan agreements, promissory notes, guarantees and indemnification letters, transmit documents to the participants, distribute executed copies of the documents, and mark the third-party customers' promissory notes to RCM as 'paid in full' when the transaction was unwound." *Id.* at 307-08.

With Refco's financial difficulties thus concealed by its attorneys, Refco insiders began to cash out of the company as they issued securities to unsuspecting public investors – beginning with a $600-million bond offering in 2004, and a $670-million initial public offering ("IPO") of stock in 2005. *Refco*, 609 F. Supp. 2d at 308. Refco's lawyers from Mayer Brown "participated in drafting the documents that were filed with the Securities and Exchange Commission ('SEC') in order to induce investors to purchase Refco's Bonds and, later, to effectuate the IPO. The lawyers took part "in drafting and disseminating the Offering Memorandum" for the bonds, "which state that Mayer Brown represented Refco in connection with the offering." *Id*. at 308. "The portions of the memorandum drafted by the Mayer Brown Defendants included the Management's Discussion & Analysis ('MD&A') and Risk Factors portions, which discussed Refco's business and financial conditions in a way that, given Mayer Brown's involvement in the round-trip loan transactions and knowledge of the RGHI receivables, the Mayer Brown Defendants knew to be false." *Id.* at 308-09.

The lawyers also "played a significant role in drafting and reviewing the IPO Registration Statement," which similarly "misrepresented Refco's financial condition and failed to disclose multi-hundred million dollar receivables that were concealed through the round-trip loans that the Mayer Brown Defendants helped facilitate." *Refco*, 609 F. Supp. 2d at 309.

The lawyers thus had "'design[ed] and implement[ed] sham transactions used by Refco to fraudulently transfer uncollectible debt and design[ed] and participat[ed] in blatantly fraudulent sham loan transactions.'" *Refco*, 609 F. Supp. 2d at 316. And these allegations raised a strong inference of the lawyers' scienter, "that is, that the Mayer Brown Defendants knew or acted in reckless disregard of Refco's intention to use the transactions to inflate its revenues, and knew or should have known that the resulting financial statements issued would be relied upon by research analysts and investors." *Refco*, 609 F. Supp. 2d at 316. The lawyers then transmitted information that they knew to be false to investors through false offering documents that they helped to draft and disseminate. *See id*.

But Judge Lynch felt compelled to dismiss the claims of the defrauded investors against the dishonest lawyers, holding that "the Supreme Court's decision in *Stoneridge* forecloses this theory of liability." *Refco*, 609 F.

Supp. 2d at 314. He explained that the allegations "if proven true, are adequate to establish liability for aiding and abetting securities fraud, but are not enough to establish civil liability as a ***primary*** actor. As was the case in Stoneridge, it was Refco, not the Mayer Brown Defendants, 'that . . . filed fraudulent financial statements; nothing [the Mayer Brown Defendants] did made it necessary or inevitable for [Refco] to record the transactions as it did.'" *Refco*, 609 F. Supp. 2d at 316 (quoting *Stoneridge*, 128 S. Ct. at 770).

The lawyers might be criminally liable – indeed, the government had indicted one of them – but their victims had no claim for relief: "However significant a role the Mayer Brown Defendants played in assisting Refco's management to engage in these transactions, and however culpable they may have been to do so with the knowledge that the transactions were ultimately designed as part of a scheme to defraud and practice a deceit upon Refco's shareholders – indeed even if the acts of Collins were, as the Government has charged, criminal – the liability that attaches to those acts is liability for aiding and abetting Refco's schemes and manipulation, not principal liability for executing schemes of the Mayer Brown Defendants' own." *Refco*, 609 F. Supp. 2d at 316.

Judge Lynch found it "perhaps dismaying that participants in a fraudulent scheme who may even have committed criminal acts are not answerable in damages to the victims of the fraud. However, as the Court noted in *Stoneridge*, the fact that the plaintiff-investors have no claim is the result of a policy choice by Congress," in 1995, when it "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." *Refco*, 609 F. Supp. 2d at 318 n.15.

"This choice may be ripe for legislative re-examination," Judge Lynch declared, observing that "in the criminal context when the Godfather orders a hit, he is only an accomplice to murder – one who 'counsels, commands, induces or procures' but he is nonetheless liable as a principal for the commission of the crime." *Refco*, 609 F. Supp. 2d at 318 n.15 (quoting 18 U.S.C. §2).

The time is indeed ripe for legislative re-examination when the criminals who orchestrated frauds like that of Refco may face prison

sentences – but are utterly immune from liability to their victims, who on account of *Central Bank* and *Stoneridge*, may never be made whole.

Homestore.com: Generating Revenues Through Sham Transactions

Litigation on behalf of investors defrauded by Homestore.com's false financial results also is instructive. *See In re Homestore.com, Inc. Sec. Litig.*, 252 F. Supp. 2d 1018 (C.D. Cal. 2003), *aff'd in part and remanded sub nom. Simpson v. AOL Time Warner Inc.*, 452 F.3d 1040 (9th Cir. 2006), *vacated and remanded sub nom., Avis Budget Group, Inc. v. Cal. State Teacher' Ret. Sys.*, 128 S. Ct. 1119 (U.S. Jan. 22, 2008), *and vacated sub nom. Simpson v. Homestore.com*, 519 F. 3d 1041 (9th Cir. 2008).

The case involved sham transactions that had no real economic substance and whose sole purpose was to inflate the revenues of each involved company in the structured triangular wash transactions. As a duly-appointed lead plaintiff on behalf of a class of investors who had purchased Homestore stock, the California State Teachers' Retirement System ("CalSTRS") alleged that Homestore and its business partners – including AOL Time Warner – had devised and executed a scheme to mislead public investors by means of accounting contrivances that were designed to, and did, produce phony revenues. CalSTRS alleged, for example, that the structure of triangular deals entered into between Homestore and AOL in order to falsify Homestore's reported revenues was "jointly developed" and "concocted by [Homestore CEO Peter] Tafeen and [AOL's Eric] Keller, with the knowledge and approval of [AOL's David] Colburn." (Complaint ¶1, ¶¶174, 331). CalSTRS averred that further deals, with defendants L90 and Cendant, were similarly designed and executed to mislead Homestore investors by generating phony revenues. (Complaint ¶¶174, 331).

That fraud was committed was beyond dispute. Seven Homestore executives had entered guilty pleas for what they did. AOL Time Warner and Cendant's role in perpetrating financial fraud with them was plainly alleged, and in great detail. CalSTRS averred that defendant AOL, through its employees Keller and Colburn, devised and successfully executed the scheme to mislead Homestore investors. Several of Homestore's other "business partners" knowingly participated in Homestore's massive financial

fraud, entering into transactions with Homestore with the very purpose of generating fabricated revenues.

In related securities-fraud litigation against AOL Time Warner, moreover, it was similarly "alleged that Keller was the architect of sixteen separate sham transactions with Homestore in which the two companies generated bogus advertising revenue through the use of three-legged 'round-trip' deals involving third parties." *AOL*, 2004 U.S. Dist. LEXIS 7917, at *80. The *AOL* plaintiffs alleged that "Keller and Colburn agreed with Homestore executives not to document the secret leg of these transactions in order to avoid detection." *Id*. If these allegations are proved, the *AOL* district court had held, then these defendants "engaged in a prohibited act as defined by Rules 10b-5(a) and (c)." *Id*. at *82-*83 (Keller); *see id*. at *89 n.38 (Colburn).

But when Homestore investors sued Homestore's partners in fraud – AOL, Cendant, and L90 – the district court held that even if they had deliberately fabricated transactions to generate Homestore's phony revenues, under *Central Bank* they could face no securities fraud liability to purchasers of Homestore's securities. Applying *Central Bank*, it held that by generating phony revenues to mislead investors, AOL and the other "third-party" defendants did not engage in any "manipulative or deceptive device or contrivance" within the meaning of §10(b), 15 U.S.C. §78j(b), or in a "scheme" to defraud prohibited by Rule 10b-5(a), or even in conduct calculated to "operate as a fraud or deceit upon any person" as prohibited by Rule 10b-5(c). 17 C.F.R. §240.10b-5(a), (c).[7]

Ruling on appeal that the investors should at least be permitted to amend their complaint, the Ninth Circuit held "that to be liable as a primary violator of §10(b) for participation in a 'scheme to defraud,' the defendant must have engaged in conduct that had the principal purpose and effect of creating a false appearance of fact in furtherance of the scheme." *Simpson v. AOL Time Warner, Inc.*, 452 F.3d 1040, 1048 (9th Cir. 2006) Should the

[7] As originally promulgated by the SEC, Rule 10b-5's subparagraphs are numbered, (1) through (3). As codified in the C.F.R., the subparagraphs are lettered, (a)-(c). *See* 17 C.F.R. §240.10b-5(a)-(c).

plaintiff investors be able to meet this standard, the Ninth Circuit ruled, the case might proceed.

But the Supreme Court vacated the Ninth Circuit's decision just one week after it issued *Stoneridge*, remanding to the Ninth Circuit with directions to reconsider its decision "in light of *Stoneridge*." *Avis Budget Group, Inc. v. Cal. State Teachers' Ret. Sys.*, 128 S. Ct. 1119 (Jan. 22, 2008). On remand the Ninth Circuit complied by vacating its prior opinion, and remanding to the district court "for further proceedings which are consistent with the opinion of the Supreme Court." *Simpson v. AOL Time Warner Inc.*, 519 F.3d 1041, 1041 (9th Cir. 2008).

Though the fraudulent transactions had involved multiple parties, *Stoneridge* appeared to bar liability.

Pugh v. Tribune Co.: Deliberate Criminal Fraud, with No Relief to Investors

Investors value stock on the basis of the money that a company can legitimately be expected to make. Thus, even the common law recognized that a company commits securities fraud if its reported financial results come, in material part, from a fraud upon its customers. "The reasonable interpretation of a representation that a company is making dividends and profits is that it is making lawful dividends and profits; and if, instead of this, the company is stealing from some one money with which to declare fictitious dividends and profits, the representation is untrue." *Boggs v. Wann*, 58 F. 681, 686 (Cir. Ct. N.D. Ohio 1893) (Taft, Circuit Judge).

In *Pugh v. Tribune Co.*, 521 F.3d 686 (7th Cir. 2008), employees of the Tribune Co.'s *Newsday* subsidiary deliberately falsified circulation numbers for *Newsday* and *Hoy*, and reported revenues obtained by practicing a fraud upon its advertisers. "The true circulation of *Newsday* and *Hoy* was roughly 80 percent and 50 percent, respectively, of what was reported." *Id.* at 691. Investigations launched after advertisers filed suit to get their money back required the Tribune Co. to take a $90 million charge and produced legal actions – criminal prosecutions by the federal government and

securities-fraud and ERISA class actions filed on behalf of Tribune Co. investors and pension-plan beneficiaries.

The criminal prosecutions produced "guilty pleas by nine former *Newsday* and *Hoy* employees, including four of the five *Newsday* and *Hoy* employees named as defendants in [the] securities case." *Pugh v. Tribune Co.*, 521 F.3d at 691 n.1. A Justice Department press release reported that "each defendant faces a maximum sentence of 20 years imprisonment, three years supervised release, and a $250,000 fine (or twice the gross gain or loss as a result of the offense)."[8] A subsequent Department of Justice press release "reported that *Newsday* and *Hoy* agreed to forfeit $15 million to the United States pursuant to an agreement that resolves its criminal investigation."[9]

But defrauded investors and pension funds got no relief at all, not even from the fraudulent scheme's "mastermind," Louis Sito, who at relevant times was *Newsday*'s vice president for circulation, *Hoy*'s president, publisher, and chief executive, and the Tribune Co.'s vice president for

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[8] *Press Release: Nine Former Employees and Contractors of* Newsday *and* Hoy *Plead Guilty to Scheme to Defraud Newspaper Advertisers* (May 30, 2006) (available online: http://www.usdoj.gov/usao/nye/pr/2006/2006may30.html). It appears that, in the end, Sito actually served no prison time, receiving instead a sentence of five years probation. *See* Stephanie Cohen, *Newsday Circ Scandal Execs Sentenced,* New York Post, August 30, 2008 ("Louis Sito, a former vice president of *Newsday* and *Hoy*'s former publisher; Robert Brennan, Newsday's former circulation director; Richard Czark, Hoy's former senior vice president for circulation; and Robert Garcia, a circulation manager at *Newsday* and *Hoy*, were each given five years probation and fined.").

[9] *Pugh v. Tribune Co.*, 521 F.3d at 691 n.1; *see DOJ Press Release: Newsday and Hoy Agree to Resolve Criminal Inquiry into Scheme to Defraud Newspaper Advertisers – Newspapers Admit Responsibility for Circulation Reporting Fraud and Agree to Forfeit $15 Million* (December 18, 2007) (available online at http://www.usdoj.gov/usao/nye/pr/2007/007dec18b.html).

Hispanic Media – and whose guilty plea to criminal charges of fraud "admitted to directing *Newsday* and *Hoy* employees to falsely inflate paid circulation data." *Pugh v. Tribune Co.*, 521 F.3d at 693 n.4, 696. Even as to Sito, the Seventh Circuit held, "the plaintiff's allegations of 'scheme liability' are insufficient under the Supreme Court's recent decision in *Stoneridge*." *Id.* at 696.

"Like the defendants in *Stoneridge*," the Seventh Circuit explained, "Sito participated in a fraudulent scheme but had no role in preparing or disseminating Tribune's financial statements of press releases." *Pugh v. Tribune Co.*, 521 F.3d at 697. That Sito's fraudulent conduct was designed to – and in fact operated to – mislead investors was beside the point:

> Sito may have foreseen (or even intended) that the advertising scheme would result in improper revenue for Newsday and Hoy, which would eventually be reflected in Tribune's revenues and finally published in its financial statements. But *Stoneridge* indicates that an indirect chain to the contents of false public statements is too remote to establish primary liability.

Pugh v. Tribune Co., 521 F.3d at 697.

Sito, who orchestrated and executed the fraud, could not be held liable under *Stoneridge*, because he did not frame or file the Tribune Co.'s financial statements communicating to investors the fraudulently inflated revenues that his scheme was designed to produce. *Id.* The Tribune Co., in turn, was insulated from liability, because "the corporate scienter inquiry must focus on 'the state of mind of the individual corporate official or officials who make or issue the statement . . . rather than generally to the collective knowledge of all the corporation's officers and employees acquired in the course of their employment,'" and because "misconduct of employees at a corporate subsidiary is not normally attributed to its corporate parent." *Pugh v. Tribune Co.*, 521 F.3d at 697 (citation omitted).

The Seventh Circuit thus concluded that although the Tribune's financial results had been deliberately falsified, and although investors who purchased its securities were injured, no one was accountable to them. Sito

was accountable as a felon under criminal law, but under *Stoneridge,* his investor victims were not entitled to even a penny of relief.

Conclusion

There are other decisions that demonstrate the injustice of *Central Bank* and *Stoneridge*, but these are the principal and most egregious ones. And, if not corrected, there will be more as lawyers in accord with *Stoneridge* tell clients that they are free from liability so long as they make no public statement to investors. S. 1551 makes the appropriate and necessary correction by extending liability for violations to "any person that knowingly or recklessly provides substantial assistance to another person in violation of this title."

Thank you again for the opportunity to testify. I welcome your questions.