

Evolving Theories of Scheme Liability

Does Your D&O Policy Cover Guilt By Association?

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Secondary actor liability—frequently labeled as “aiding and abetting” liability—is a hot topic in the securities litigation world. Although the Supreme Court abolished “aiding and abetting” liability in civil litigation brought under Rule 10b-5(b) in its landmark 1994 opinion in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, courts have struggled mightily in recent days over how to define the scope of primary Rule 10b-5(b) liability for secondary actors—such as underwriters, accountants, attorneys and others.

The unprecedented collapses of WorldCom, Global Crossing, Enron and others have provided new stimuli for plaintiffs’ lawyers to seek to hold secondary actors liable for alleged securities fraud or other forms of civil liability. Banks, corporate strategic partners (or even ordinary business partners), accountants and legal counsel for publicly traded companies (or those seeking to go public) would be well-served to take a step back, review the current state of the law and analyze appropriate best practices to address an increasing secondary liability exposure. Indeed, the list of those within the crosshairs of secondary liability may now extend beyond traditional “secondary actor” accounting, investment banking and law firm defendants.

Those who bear responsibility for securing appropriate corporate insurance coverage in today’s market should also take

account of this trend in order to ensure that their business is appropriately considering the exposure to potential secondary liability.

The Securities Exchange Act of 1934

Before this discussion goes any further, we should acquaint ourselves with the laws at hand.

Section 10(b) of the Securities Exchange Act of 1934 provides as follows:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange -

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, or any securities-based swap agreement (as defined in section 206B of the Gramm-Leach-Bliley Act), any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Pursuant to its authority granted by Congress in the Ex-

change Act, the SEC promulgated Rule 10b-5 as follows:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,

(a) to employ any device, scheme, or artifice to defraud,

(b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

The Post-Central Bank of Denver Calm

In its 1994 landmark decision, the United States Supreme Court held that no private right of action exists under the federal securities laws against secondary actors—including lawyers, accountants, banks and underwriters—for “aiding and abetting” a primary actor’s violation of the federal securities laws. Specifically, the Court concluded in that opinion that Congress never intended to impose secondary liability under Section 10(b) of the 1934 Exchange Act. The 5-4 decision, however, left open the door for these professionals to be held liable as primary violators of the securities laws. Since then, plaintiffs’ lawyers, as well as defense lawyers and secondary actors, have sought to identify the line of demarcation between actions that give rise to primary liability versus non-actionable secondary activities.

Recent debate over the degree of conduct and participation required for a secondary actor to take on primary 10b-5(b) liability has increased. Some federal appellate courts continue to require that, in order for a secondary actor to incur liability, an alleged mis-

representation by or on behalf of a public company must be publicly attributable to the secondary actor. Other appellate courts, however, require only that the secondary actor be a substantial participant with others in making a material misrepresentation in violation of the securities laws in order to incur potential liability. Yet, some observers believe there may be a growing trend in the courts allowing the expansion of 10b-5 theories of liability, permitting claims under Rule 10b-5(a) and (c) against so-called secondary actor participants for their roles in alleged fraudulent schemes, notwithstanding the absence of any misrepresentation attributable to the secondary actor. It appears that the plaintiffs’ bar is more aggressively pursuing such claims.



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Then Comes Enron

This public discourse has taken on renewed vigor since the trial court presiding over the securities class action litigation filed against Enron Corporation and its investment bankers, accountants, lawyers and others issued an opinion in December 2002 denying many of the secondary actor defendants’ motions to dismiss the plaintiffs’ claims. Notably, the Securities and Exchange Commission filed an *amicus curiae* memorandum in that litigation advocating its view that when a person or entity participates in the creation of a misleading statement for distribution to investors in a public company—but is not identified to the investors as having so participated—primary liability on that secondary actor’s part may nonetheless arise under Rule 10b-5(a) or (c) if that actor meets the requirements of primary liability.

Judge Melinda Harmon rejected the bright line test followed in several federal circuits and adopted the test urged by the SEC that “when a person, acting alone or with others, creates a misrepresentation [on which investor-plaintiffs relied], the person can be liable as a primary violator...if ...he acts with the requisite scienter.”¹

Judge Harmon further emphasized, however, that liability for securities fraud under 10(b) and Rule 10b-5 is not limited to circumstances of affirmative misrepresentations or omissions. Subsections (a) and (c) of Rule 10b-5 do not require a specific misrepresentation or omission as a precondition to liability, but rather, specifically expose liability to any defendant “who, with scienter, participated in a ‘course of business’ or a ‘device, scheme or artifice’ that operated as a fraud’ on sell-

ers or purchasers of stock even if these defendants did not make a materially false or misleading statement or omission.”²

Thus, the court’s reemphasis of 10b-5(a) and (c) as viable avenues of recovery underscores the possibility that a secondary actor may incur liability for deceptive acts, contrivances, schemes, or engaging in a course of business which operates as a fraud, notwithstanding the lack of any clear misrepresentation or omission attributable to the secondary actor.³

Indeed, shareholder plaintiffs asserted such claims against numerous bank underwriters in both WorldCom and Enron shareholder litigation resulting in record-breaking settlements. Recently reported settlements by various investment banks in the WorldCom litigation have exceeded \$6 billion collectively. J.P. Morgan settled such claims in the WorldCom, and Enron securities litigation for \$2 billion and \$2.2 billion, respectively. Meanwhile, Citigroup agreed to pay nearly \$2.6 billion in WorldCom, and \$2 billion in Enron, to settle its alleged liability.

Other Theories of Secondary Liability

Of course, the Supreme Court's prohibition of "aiding and abetting" claims in *Central Bank* only limited private litigants from prosecuting such claims. If any doubt existed, the 1995 Private Securities Litigation Reform Act confirmed the SEC's authority to prosecute claims for aiding and abetting violations of the securities laws.

In the aftermath of Enron and several other spectacular corporate collapses, the SEC—as well as some state prosecutors—are aggressively bringing such claims. Recent examples have even implicated the insurance industry. For example, the SEC recently filed aiding and abetting charges against a former senior executive of a reinsurance company for allegedly aiding and abetting a prominent insurer in structuring two sham reinsurance transactions, that purportedly enabled the insurer to improperly boost reported loss reserves for the sole purpose of meeting analyst expectations.

The SEC clearly takes "aiding and abetting" very seriously. One SEC director was recently quoted in *Insurance Journal* as saying that "[t]hese cases send a message that [the SEC] will hold accountable those who knowingly help to create the contractual building blocks on which a securities fraud is built."

Additional secondary liability may also attach under federal and state securities laws to any person or entity alleged to have controlled, directly or indirectly, a primary violator. Moreover, above and beyond new Rule 10b-5 theories under the federal securities laws or SEC exposure, additional aiding and abetting liability exposure may exist under state securities laws. Some state securities laws may expressly provide for private claims of aiding and abetting otherwise prohibited under the federal securities laws by the Supreme Court's ruling in *Central Bank*.

So What Happens Now?

In the wake of such apparent renewed judicial and governmental scrutiny of secondary liability, the plaintiffs' bar has set out to determine just how far the pool of vulnerable deep pockets can be expanded by utilizing allegations under subsection (a) and (c) of Rule 10b-5, in addition to the traditional focus on subsection (b).

For example, in securities class action litigation filed against Homestore.com and Charter Communications, Inc., plaintiffs asserted claims against third-party companies alleging that they participated in fraudulent schemes based upon ordinary business transactions where one party to the transaction allegedly engaged in improper accounting.

Against Homestore.com, the plaintiffs sought to impose liability on third parties for engaging in service barter transactions—sometimes referred to as "round-tripping"—with Homestore.com. In these barter transactions, Homestore.com would provide services in exchange for services provided by the third party. However, Homestore.com allegedly failed to properly account for these transactions, and as a result, the plaintiffs sued the third party for its role in aiding and abetting the alleged wrongdoing.

Against Charter Communications, Inc., the plaintiffs asserted claims against the manufacturer of digital cable converters for engaging in co-marketing agreements to jointly increase cable subscriptions for Charter and sales of the third party's digital cable boxes. Charter allegedly accounted for these co-marketing transactions improperly so as to artificially boost its revenue and cash flow. The plaintiffs, however, also sued the third party under a secondary liability theory. Although the claims against the business partners in both cases were dismissed, the effort to expand the pool of potentially

liable secondary actors is unmistakable.

Moreover, the potential reach of such efforts is significant. Banks, for example, may be sued for alleged fraud in underwriting a co-defendant's securities. Likewise, parent companies may be sued in connection with a spin-off of a subsidiary. Venture capital firms and other large shareholders may be sued in connection with their alleged control of or investment in other companies. Or a company may be sued merely because of its business relationship with other perceived primary violators.

For example, many securities class actions include allegations of accounting irregularities, including improper revenue recognition schemes or alleged "channel stuffing." Channel stuffing occurs when a company induces retailers along its distribution channel to substantially increase their purchases before they would, in the normal course, otherwise purchase products from a company. It has the result of shifting earnings into earlier quarters, quite likely to the detriment of earnings in later quarters. In *re Trex Co., Inc. Sec. Lit.*, 212 F. Supp. 2d 596, 599 (W.D. Va. 2002).]

Another potential scenario for the assertion of expanded secondary actor liability claims could be allegations that a company or venture capital group participated in a fraudulent scheme based upon nothing more than the purchase of some asset from a party who subsequently is accused of improperly accounting for the transaction. An aggressive plaintiffs' lawyer might allege that the deal was intentionally designed to facilitate the improper accounting treatment, and that the purchaser knowingly or recklessly aided and abetted such securities fraud.

Historically, plaintiffs have asserted claims against the company and individuals directly engaged in the

accounting shenanigans and not against the business partners involved in the underlying transactions at issue. It is not that difficult to envision scenarios today, however, where the buyers of allegedly “stuffed” inventory are alleged to have been aware that the sales were for an improper purpose. A few carelessly worded e-mails exchanged near the end of a financial quarter discussing the timing of a large purchase order raises a spectre of litigation challenges for a buyer of products today that just five years ago would have seemed unlikely.

Coverage Implications, Needs and Concerns

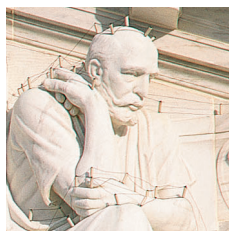
First, the good news: in most instances, coverage for individual director and officer insureds is not limited to claims arising out of the purchase or sale of their employer company’s securities. On the contrary, so long as the alleged wrongdoing occurred while the insured acted in the capacity as a covered insured under the policy, coverage generally exists subject to the policy’s other terms, conditions and exclusions.

In other words, under a typical D&O policy, an individual director or officer sued by shareholders of another company for participating in a scheme to defraud with that company and its directors and corporate insiders, may find coverage under his or her D&O policy so long as the individual is being sued in his or her capacity as a covered director or officer.

One caveat exists, however, even for individual directors and officers: if your policy includes a professional services exclusion (typically included in D&O policies issued in service industries such as healthcare, software/technology, insurance, and banking)

and the alleged wrongdoing occurs in the context of rendering professional services to the co-defendants, coverage may be otherwise excluded. Companies that purchase both D&O and errors and omissions (“E&O”) coverage may thus face unique challenges in the structure and negotiation of coverage to address third party scheme liability.

Where the D&O policy contains a “professional services” exclusion, securities claims arising out of the rendering of professional services to third parties may be excluded. At the same time, the E&O policy may include a shareholder exclusion eliminating coverage for such shareholder claims altogether. Risk managers should carefully review



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any “professional services” exclusions contained in their policies to confirm whether coverage for securities claims asserting secondary actor theories of liability falls within their purview.

While individual directors and officers may find D&O coverage for “aiding and abetting” theories of liability, other corporate employees and the company itself may not be so fortunate. Most public companies today purchase D&O insurance that extends coverage to all employees and the entity for “securities claims.” Such companies may incorrectly assume that their D&O coverage protects them from all claims asserted under the federal and state securities laws. To the contrary, for many companies, the “securities claim” definition does not extend to secondary actor theories of liability.

In many D&O policy forms

today, the “securities claim” definition extends only to alleged securities claims arising out of the purchase or sale of the insured company’s securities. Under such definitions, coverage may not exist for “secondary actor” securities violations arising out of the purchase or sale of a co-defendant or other company’s securities. Many D&O policies issued today limit entity coverage and coverage afforded to non-director or officer employees to claims arising out of the purchase or sale of a covered entity’s securities, or to claims otherwise asserted by shareholders of such corporate insureds with respect to their security interests.

Risk managers should closely scrutinize the “securities claim” definition in their D&O policies to confirm whether coverage applies to all claims alleging that the company violated a federal or state securities law, or is limited to claims arising solely out of the purchase or sale of securities issued by the company.

While some insurance purchasers may not wish to dilute the coverage provided to individual directors and officers by broadening the “securities claim” definition to include all alleged violations of state and federal securities laws, at least two major D&O insurers today include such a broad “securities claim” definition in their primary D&O policy form.

Addressing the Exposure

In the current claim environment, federal and state regulators, as well as the plaintiffs’ bar, are taking a closer look at any and all parties associated with alleged securities fraud. Consider the following steps to address secondary liability exposure:

Analyze where and how plaintiffs’ lawyers or regulators may scrutinize your industry, and your business in particular, for sec-

ondary actor liability. Corporate executives and directors need to understand whether and in what form such liability may arise for them and their company.

Businesses can no longer casually enter into business transactions without any regard to why the party on the other side of the table wants the deal. If a transaction appears to lack substance and offers unusually high benefits or incentives to your company, it may be a red flag of future trouble for your business. The

more complex or unusual the transaction, the more caution you should employ.

Assess the insurance implications of secondary liability. Corporate executives and directors need to understand whether and at what cost coverage may exist for themselves and for the company under the company's existing D&O policy or under a future policy. As with all such insurance coverage, the cost of the policy itself may or may not exceed the potential corporate benefit. ■

¹ In re *Enron Corp. Securities, Derivative and ERISA Litig.*, 235 F.Supp.2d 549, 588 (S.D. Tex. 2002).

² Id. at 577.

³ In April 2003, Judge Harmon granted the motions to dismiss filed by other alleged secondary actors, including the corporate general counsel of Enron and the former chief executive officer of an Enron subsidiary. In re *Enron Corp. Securities, Derivative & ERISA Litig.*, No. MDL-1446, Civ.A. H-01-3624, 2003 WL 21418157 (S.D. Tex. April 24, 2003).

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