



COMMERCIAL DIVISION UPDATE

BY GEORGE BUNDY SMITH AND THOMAS J. HALL

After 'Stoneridge': Securities Liability Scheme

In its much discussed opinion in *Stoneridge v. Scientific-Atlanta*, the U.S. Supreme Court sharply curtailed the availability of federal securities laws to hold accountants, lawyers, banks and other third parties involved with securities transactions liable to investors. The Court held that third parties who do not themselves make fraudulent statements cannot be liable under Rule 10b-5 even where they assisted the public company that issued fraudulent statements affecting stock price. Before *Stoneridge*, these federal "scheme liability" claims were plaintiffs' favored vehicle for pursuing third parties.

While *Stoneridge* represents a significant setback to the plaintiffs' bar, it does not close the door completely on third-party liability arising from securities fraud. Indeed, the *Stoneridge* opinion itself noted the continued availability of state law claims to harmed investors.¹ As such, in the absence of federal law claims, the post-*Stoneridge* era will likely see a spike in the number of state law claims brought for scheme liability. Unless federal diversity jurisdiction exists, these claims in New York will largely be litigated in the Commercial Division.

The most likely scheme liability claims under New York law are aiding and abetting fraud, aiding and abetting breach of fiduciary duty and conspiracy. Like pre-*Stoneridge* scheme liability claims under Rule 10b-5, these causes of action would permit suit against third parties that have not made false statements but somehow assisted a public company in making such statements. As discussed below, significant obstacles exist under New York law to employing these theories which, though not insurmountable, place a heavy burden on plaintiffs at both the pleading and evidentiary stages.

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Actual Knowledge

Among the chief obstacles faced by plaintiffs asserting scheme liability claims under New York state law is showing that the third party had requisite knowledge of the underlying fraud. In actions for both aiding and abetting fraud and aiding and abetting breach of fiduciary duty, the plaintiff must plead and prove that the defendant had actual knowledge of the underlying wrong committed by the primary violator. Constructive knowledge of the fraud or breach of fiduciary duty is insufficient. Likewise, the mere fact that third parties were privy to information that should have made them suspicious of actions taken by the primary violator does not satisfy the actual knowledge standard.²

Similarly, a plaintiff asserting civil conspiracy to commit fraud must show that the defendant was not merely an unwitting participant but rather an actual member of the conspiracy to defraud investors.³ Civil conspiracy requires "proof of an agreement to engage in a common scheme or plan to deprive plaintiff of his property."⁴

The considerable difficulty in proving actual knowledge or the existence of a conspiracy agreement is demonstrated by *Albion Alliance Mezzanine Fund, L.P. v. State Street Bank and Trust Co.*, decided by Justice Herman Cahn. *Albion* arose out of the collapse of Sharp International Corporation. The plaintiffs were institutional investors who alleged that State Street, the defendant bank, had participated in the fraud in which Sharp misstated its financial figures to entice plaintiffs to purchase \$26 million of subordinated notes from Sharp, funds that were used to repay Sharp's loan to State Street. Plaintiffs

asserted claims for aiding and abetting fraud and conspiracy against State Street.

Plaintiffs alleged that prior to their purchase of Sharp subordinated notes, State Street had placed Sharp under scrutiny and commenced an investigation into its business operations. The results of these investigations suggested there was erroneous information in Sharp's financial reporting, including information concerning its customers, accounts receivables and levels of cash disbursements. State Street, however, did not reveal these findings to the plaintiff investors prior to their investment in Sharp.

Though State Street had at least a strong suspicion that there was fraud in Sharp's financials, Justice Cahn dismissed the aiding and abetting claim on summary judgment in part because the plaintiff investors' evidence established only that State Street had constructive knowledge of Sharp's fraud. The court noted that State Street's investigations had not conclusively revealed fraud. Further, the court observed, "while the other inaccuracies in Sharp's account information certainly gave the bank reason to be highly suspicious of its veracity, such suspicions cannot be equated with actual knowledge."⁵

The court also dismissed the plaintiff investors' conspiracy to defraud claim because there was no showing that State Street had entered into an agreement with Sharp to defraud plaintiffs. Rather, plaintiffs conceded "that the bank did not discuss any fraud with Sharp... and in fact declined to confront the company with its suspicions."⁶

Justice Cahn's opinion suggests that the knowledge requirement would have been satisfied had Sharp's financial records investigated by State Street conclusively shown a fraud. This is consistent with other New York opinions that have found the actual knowledge requirement satisfied where plaintiffs have shown that, under the circumstances, third parties "must have known" of the underlying fraud.⁷ Nonetheless, the *Albion* opinion demonstrates the considerable knowledge requirement that must be pled and proven for liability to attach.

Role in Underlying Wrong

Another major obstacle faced by plaintiffs is demonstrating that the third parties played a significant role in the underlying wrong. Both of the aiding and abetting causes of action require

the plaintiff to demonstrate that the third party provided “substantial assistance” to the primary violator.⁸ This substantial assistance requirement is satisfied where “(1) a defendant affirmatively assists, helps conceal, or by virtue of failing to act when required to do so enables the fraud to proceed, and (2) the actions of the aider/abettor proximately caused the harm on which the primary liability is predicated.”⁹

Although “helping to conceal” fraud can constitute substantial assistance, a third party’s mere failure to disclose a fraud or breach of fiduciary duty does not. To the contrary, New York law is clear that “the mere inaction of the alleged aider and abetter constitute[s] substantial assistance only if the defendant owes a fiduciary duty directly to the plaintiff.”¹⁰ Though certain cases have established that a duty to disclose may arise from one party’s superior knowledge, the context of such holdings “has invariably involved direct negotiations between parties to a business transaction.”¹¹ As accountants, banks and other third-party advisors generally do not have independent duties to plaintiffs asserting scheme liability, and their liability cannot be predicated on their failure to disclose the existence of fraud or breach of fiduciary duty.¹²

Thus, in *In re Sharp Int’l Corp.*, the Second Circuit Court of Appeals, considering the same types of allegations found in *Albion*, concluded that plaintiffs failed to state a claim for aiding and abetting under New York law because their claims were based on defendant’s failure to act.¹³ Plaintiffs in *Sharp* alleged that the defendant bank substantially assisted the underlying fraud by deliberately concealing knowledge of the fraud, by electing not to foreclose on its own loan to the company, and by avoiding investors’ attempts to discuss the company’s financial situation. As the Second Circuit stated: “Artful pleading aside, all of these allegations come down to omissions or failures to act: i.e., not revealing what State Street knew and suspected, not foreclosing, not responding to inquiries. As such they are not ‘substantial assistance,’ as that term is elucidated in [New York case law] Absent a duty to act, the only action prescribed is not to ‘affirmatively assist’ or to ‘help conceal,’ which is another form of assistance and is likewise affirmative in nature [A] company in a position to thwart or expose a breach of fiduciary duty may protect its interests by doing neither, sitting tight, and being quiet. No doubt, State Street was hoping to be replaced by a less cautious lender, and had no intention of precipitating its own loss, but silence and forbearance did not assist the fraud affirmatively.”¹⁴

Similarly, a third party’s failure to act typically cannot form the basis of conspiracy. Under New York law, “the defendant’s participation in furtherance of the plan must consist of specific wrongful acts constituting independent torts in furtherance of the conspiracy.”¹⁵ Failing to disclose the existence of a fraudulent scheme, in the absence of some independent duty to do

so, will rarely satisfy the requirement.

For instance, in *Glenn v. SBPartners LLC*, Justice Stephen Bucaria in Nassau County dismissed a conspiracy claim brought by an investor against out-of-state accountants and legal counsel who allegedly conspired with a company in the issuance of a fraudulent prospectus.¹⁶ On defendants’ motion to dismiss for lack of personal jurisdiction, the plaintiff alleged that the court could exercise “conspiracy jurisdiction” over the defendants based on an act in furtherance of the alleged fraud committed by an alleged conspirator in New York. Specifically, the plaintiff alleged that by allowing their names to appear in the prospectus, these third parties gave “credibility” to the prospectus and assumed a duty to investigate the truthfulness of the statements made therein.

The court, however, held that the plaintiff failed to establish defendants’ participation in a conspiracy to defraud the plaintiff, noting that the plaintiff “simply failed to offer any evidence to contradict the specific evidence submitted by [the third parties]...which has established that they were not involved in the drafting, review, revision or editing of any documents distributed” by the company.¹⁷

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scheme liability claims face
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Plaintiffs must plead and prove that the third parties took affirmative actions to facilitate or conceal the underlying wrong. While it is difficult to draw meaningful generalizations given the myriad ways that third parties can assist in perpetrating a fraud, it appears that substantial assistance requires direct and sustained participation in the fraud.

For instance, the court in *Sharp* rejected the argument that State Street had substantially assisted the fraud by providing its contractually required consent to plaintiff investors’ purchase of notes from Sharp, holding that State Street “did no more than remove a contractual impediment that was reserved to State Street to invoke or not in its own interest.”¹⁸ By contrast, a financial services provider did substantially assist a company to commit tax fraud and participate in a conspiracy to defraud where it consulted with tax shelter promoters, reviewed opinion letters and other transaction documents prior to the transaction, and facilitated the transfer of funds.¹⁹

Intent to Harm

Deeply connected with the difficulty of showing actual knowledge is the burden of pleading and proving that the third party acted with the intent to harm the plaintiff. Plaintiffs asserting scheme liability under state law must clearly demonstrate an intent to cause harm on the part of the third-party defendant. For instance, ordinary scienter is insufficient to establish liability for aiding and abetting. Instead, as Justice Cahn noted in *Sterling Nat’l Bank v. Ernst & Young LLP*, “a high degree of scienter is necessary to extend fraud liability under an aiding and abetting theory.”²⁰

The distinction between ordinary scienter and a “high degree of scienter,” according to the *Sterling* opinion, is as follows: While ordinary scienter encompasses both intentional as well as reckless conduct, reckless conduct is insufficient for aiding and abetting. Plaintiffs in *Sterling* alleged that Ernst & Young had aided and abetted a company to commit bank, mail and wire fraud by giving a “clean” opinion of the company’s financials. Scienter was satisfied, according to plaintiffs, because they had alleged that Ernst & Young had acted recklessly in issuing the “clean” opinion.

The court, however, rejected this argument and dismissed the allegation, finding that basing liability on reckless conduct would be incompatible with the “knowing participation” requirement of aiding and abetting. Because Ernst & Young knew only that the audit was not properly conducted, but was unaware of the underlying tax fraud scheme, the required “high degree of scienter” was not established.²¹

Likewise, an intent to injure the plaintiff is an essential element of civil conspiracy.²² For instance, in *Williams v. Sidley Austin Brown & Wood*, Justice Bernard Fried initially dismissed a complaint lodged by investors against the law firm, financial institution and accounting firm that allegedly assisted the company, in which the plaintiffs had invested, to commit a massive tax fraud. In dismissing the conspiracy claim, the court held that even though the defendants’ actions facilitated the fraud, the plaintiffs had failed to allege that the defendants acted with a “shared perfidious purpose.” As the court stated, “the mere fact that a defendant’s otherwise lawful activities may have assisted another in pursuit of guileful objectives is not a sufficient basis for a finding that they conspired to defraud.”²³

Pleading Requirements

A further challenge to plaintiffs seeking to pursue scheme liability claims under state law is that, while the evidence necessary to establish knowledge, intent and active participation will typically be obtainable only through discovery, the plaintiff must initially plead facts allowing the inference that the third party knew of and intended to assist the underlying fraud.²⁴ For instance, allegations that a fraud occurred and

that the third party should have known of the alleged wrongdoing, because it had unfettered access to the primary violator's files and papers, has been found insufficient to plead conspiracy or aiding and abetting.²⁵

Likewise, "mere allegations, in conclusory form, that the moving defendants participated in or assisted in the commission of a fraud are insufficient to state a cause of action."²⁶ Thus, plaintiffs in state law scheme liability claims face much the same problem as plaintiffs asserting federal securities law claims—how to meet heightened pleading requirements without the aid of discovery.

One potential solution for plaintiffs' counsel, though limited in its application, is to piggyback off federal and state enforcement actions.²⁷ For instance, following Justice Fried's dismissal of the allegations in *Williams v. Sidley Austin Brown & Wood*, plaintiffs supplemented their complaint with admissions contained in a deferred prosecution agreement entered into by one of the defendants following a U.S. Department of Justice investigation.²⁸ As Justice Fried noted in his opinion, which declined to dismiss the supplemented complaint, "the deferred prosecution agreement supplies the element of scienter and a shared 'perfidious purpose' found lacking in plaintiffs' amended complaint," as the agreement contained admissions showing that defendants must have known that the tax shelter transactions were fraudulent and that defendants were deeply involved in facilitating the fraud.²⁹

Conclusion

Though the *Stoneridge* decision represents a victory for corporate advisors, it is likely to result in a significant increase in the number of scheme liability claims based on state law theories. While establishing liability under one of these state law theories is hardly impossible, New York law prescribes the circumstances under which third parties can be held liable. New York law narrowly limits the application of aiding and abetting and conspiracy to instances where third parties have knowingly, intentionally and actively helped to perpetrate the fraud. Knowledge of the underlying wrong will be inferred only where the circumstances render the inference inescapable, and liability generally cannot be premised on the third parties' failure to investigate or act on well-grounded suspicions that a fraud has occurred.



1. *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, 127 U.S. ____ (decided January 15, 2008).

2. See *Albion Alliance Mezzanine Fund, L.P. v. State St. Bank & Trust Co.*, 8 Misc. 3d 264, 273, 797 N.Y.S.2d 699, 707 (N.Y. Co. 2003) (Cahn, J.), aff'd, 2 A.D.3d 162, 767 N.Y.S.2d 619 (1st Dep't 2003); *Bullmore v. Ernst & Young Cayman Islands*, 45 A.D.3d 461, 464, 846 N.Y.S.2d 145, 148 (1st Dep't 2007) (for aiding and abetting breach of fiduciary duty "actual knowledge as opposed to merely constructive knowledge, is required and a plaintiff may not merely rely on conclusory or sparse allegations that the aider or abettor knew or should have known about the primary breach of fiduciary duty").

3. See *Glenn v. SBPartners LLC*, 2008 WL 239524, at *7 (Nassau Co. Jan. 16, 2008) (Bucaria, J.).

4. *Albion Alliance Mezzanine Fund*, 8 Misc. 3d at 273, 797 N.Y.S.2d at 707 (no civil conspiracy claim where bank did not discuss the fraud and declined to confront the company with its suspicions).

5. Id. at 273, 797 N.Y.S.2d at 707.

6. Id. at 273, 797 N.Y.S.2d at 707.

7. See, e.g., *Williams v. Sidley Austin Brown & Wood, L.L.P.*, 38 A.D.3d 219, 220, 832 N.Y.S.2d 9, 11 (1st Dep't 2007) (investor stated claim for aiding and abetting against law firm where firm "must have known that the loans were sham based on the rapid timetable for the completed transaction" and designed to perpetrate tax fraud).

8. *Williams*, id. at 220, 832 N.Y.S.2d at 11; *Egnovich v. Katten Muchin Zavis & Roseman LLP*, 2008 WL 199757, at *10 (N.Y. Co. Jan. 23, 2008).

9. *UniCredito Italiano SPA v. JPMorgan Chase Bank*, 288 F. Supp. 2d 485, 502 (S.D.N.Y. 2003).

10. *Parklex Assoc.*, 15 Misc. 3d 1125(A), ____, 2007 WL 1203617, at *6 (Kings Co. Apr. 23, 2007) (quoting *Kaufman v. Cohen*, 307 A.D.2d 113, 126 (4th Dep't 2003) (Demarest, J.)).

11. *Albion*, 8 Misc. 3d at 269-70, 797 N.Y.S.2d at 704 (noting also that "a bank ordinarily does not have an obligation to disclose information regarding a borrower to the borrower's investors").

12. See id. at 269-71, 797 N.Y.S.2d at 704-05.

13. *In re Sharp Int'l Corp.*, 403 F.3d 43, 51-52 (2d Cir. 2005).

14. Id. at 51-52.

15. *Shalam v. KPMG LLP*, 13 Misc. 3d 1205(A), ____, 2006 N.Y. Slip Op. 51697(U), at *9 (N.Y. Co. Sep. 8, 2006).

16. See *Glenn*, 2008 WL 239524, at *7.

17. Id.

18. *In re Sharp*, 403 F.3d at 52.

19. See *Williams*, 38 A.D.3d at 220, 832 N.Y.S.2d at 11.

20. *Sterling Nat'l Bank v. Ernst & Young LLP*, 2005 WL 3076341, at *7 (N.Y. Co. Jan. 7, 2005) (Cahn, J.) (quoting *National Westminster Bank USA v. Weksel*, 124 A.D.2d 144, 150, 511 N.Y.S.2d 626,

630 (1st Dep't 1987)).

21. Id.

22. See 20 N.Y. Jur. 2d Conspiracy § 3 (West 2008); *Rosen v. Brown & Williamson Tobacco Corp.*, 11 A.D.3d 524, 525, 781 N.Y.S.2d 795, 795 (2d Dep't 2004) ("a civil conspiracy cause of action requires a showing of intentional conduct, negligence cannot serve as the underlying tort").

23. *Williams v. Sidley Austin Brown & Wood, L.L.P.*, 2006 WL 684599, at *4 (N.Y. Co. Mar. 13, 2006) (Fried, J.).

24. See *National Westminster Bank USA v. Weksel*, 124 A.D.2d 144, 147, 511 N.Y.S.2d 626, 629 (1st Dep't 1987).

25. See id. at 149-50, 511 N.Y.S.2d at 630.

26. *Gramazio v. Borda, Wallace & Witty*, 181 A.D.2d 428, 429, 580 N.Y.S.2d 344, 345 (1st Dep't 1992).

27. Perpetrators of securities fraud may be subject to civil or criminal enforcement by the Securities Exchange Commission and the Justice Department. Similarly, New York's Martin Act permits the Attorney General to prosecute securities fraud violations and to seek penalties against anyone who assists in securities fraud. See N.Y. Gen. Bus. Law § 352 (McKinney 1996).

28. In a deferred prosecution agreement, a business entity agrees to admit its wrongdoing and enact reform policies in exchange for a promise by the Justice Department not to seek an indictment as long as the business lives up to its agreement.

29. *Williams v. Sidley Austin Brown & Wood, L.L.P.*, 2006 WL 2739013, at *3 (N.Y. Co. Sep. 22, 2006)

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