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No Securities Fraud Liability for Persons Who Merely Participate in Drafting False or Misleading Statements if Those Statements Are Not Attributed to Them

The United States Court of Appeals for the Second Circuit recently issued a defendant-friendly decision that helps keep the door slammed firmly shut against plaintiffs who seek to bring Rule 10b-5 securities fraud claims against “secondary actors” — persons such as law firms, investment banks, and other professionals who have not made any allegedly false or misleading public statements themselves, but rather were merely involved in preparing public financial disclosure and offering documents that contained such statements. The Court held that such secondary actors cannot be held liable for misleading statements in the documents unless the statements were “explicitly attributed” to those secondary actors at the time when the statements were made. *Pacific Investment Management Company LLC v. Mayer Brown LLP*, No. 09-1619-cv, 2010 WL 1659230 (2d Cir. Apr. 27, 2010).

In reaching this decision, the Court rejected plaintiffs’ attempts to make an end-run around the U.S. Supreme Court’s decision in *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148 (2008), that rejected attempts to hold secondary actors liable in a private securities fraud actions on the basis of so-called “scheme liability,” i.e., that their supporting roles made them part of the overall “scheme.” (See Jan. 15, 2008 Chadbourne & Parke LLP Client Alert, “[Supreme Court in Stoneridge v. Scientific-Atlanta Deals Severe Blow to ‘Scheme Liability’ in Securities Fraud Litigation.](#)”)

Background

Pacific Investment arose out of the 2005 collapse of Refco Inc. in the wake of revelations that the company had engaged in sham transactions designed to conceal hundreds of millions of dollars in uncollectible debt. Plaintiffs sued one of the law firms that represented Refco and a former partner at that firm, alleging that they committed securities fraud under Rule 10b-5 by (i) facilitating fraudulent transactions between Refco and third parties that concealed the debt, and (ii) drafting portions of Refco’s offering memorandum and registration statements that contained false statements. Although these lawyer defendants allegedly created the false statements in the sense of having drafted them, those statements were attributable only to Refco—and not the firm or the partner—at the time when they were publicly disseminated.

The district court granted these defendants’ motion to dismiss the claims, holding that none of the false or misleading statements in the offering documents were attributed to them. The district court held that the plaintiffs’ claims based on participation in drafting the documents in question were simply the kind of “scheme liability” claims foreclosed by *Stoneridge*. On appeal, the Second Circuit affirmed.

The Second Circuit's Decision

The Second Circuit held that secondary actors who merely participate in the drafting of documents are not themselves making actionable “statements” for purposes of Rule 10b-5. Thus, such persons cannot be held liable in a private securities action unless the statements are “explicitly” attributed to those actors at the time of dissemination. The “mere identification of a secondary actor as being involved in a transaction, or the public’s understanding that a secondary actor ‘is at work behind the scenes,’” said the Court, are themselves insufficient to establish liability.

What the law requires, according to the Second Circuit, is that a claim against a secondary actor “must be based on that actor’s own ‘articulated statement,’ or on statements made by another that have been *explicitly* adopted by the secondary actor” (emphasis in original). In so holding, the Second Circuit rejected a “creator standard” for liability, which would have imposed liability on a secondary actor for creating a false statement even if not explicitly attributed to that actor when disseminated.

The Second Circuit held that claims based upon mere participation in drafting the misleading documents were nothing more than “scheme liability” claims foreclosed by *Stoneridge*. In *Stoneridge*, the Supreme Court held that secondary actors who had made no public statements themselves, but had participated in business dealings that assisted a public company’s misrepresentations, could not be held liable in a private Rule 10b-5 securities action.

The *Stoneridge* Court noted that the defendants’ conduct in that case did not make it “necessary or inevitable” that false statements would be disseminated to the public, and further noted that the deceptive transactions “took place in the marketplace for goods and services, not in the investment sphere.” Attempting to find an opening in the reasoning of *Stoneridge*, the *Pacific Investment* plaintiffs tried to distinguish the two cases on their facts by arguing that, unlike the transactions at issue in *Stoneridge*, the *Pacific Investment* defendants’ deceptive conduct was actually communicated to the public in the form of Refco’s financial statements.

The Second Circuit rejected this distinction. It held that it did not matter whether the sham transactions allegedly facilitated by the law firm defendants were “reflected” in Refco’s financial statements in order for liability to be foreclosed. Indeed, the Court recognized that after *Stoneridge* “it is somewhat unclear how the deceptive conduct of a secondary actor could be communicated to the public and yet remain ‘deceptive.’”

Plaintiffs also sought to distinguish *Stoneridge* on the grounds that the law firm defendants’ conduct made it “necessary or inevitable” that Refco would mislead investors. The Second Circuit disagreed, finding that “as was the case in *Stoneridge*, it was Refco, not the [lawyer] Defendants, that filed fraudulent financial statements; nothing the [lawyer] Defendants did made it necessary or inevitable for Refco to record the transactions as it did.” Indeed, “unlike in *Stoneridge*,” the lawyer defendants “were not even the counterparty to the fraudulent transactions; they merely participated in drafting the documents to effect those transactions.”

Finally, the Second Circuit stated that it was “not dispositive or materially relevant” that the lawyer defendants’ conduct arguably occurred in the “investment sphere.” *Stoneridge*, explained the Second Circuit, “was primarily focused on whether investors were aware of, and relied on, the defendant’s own conduct,” and not on the “sphere” in which the conduct occurred.

Conclusion

As our legal system increasingly confronts frauds and bankruptcies of such enormous dimensions that no single defendant or small group of defendants could possibly cover the damages sustained by all the victims, plaintiffs have increasingly been seeking out creative means to hold “deep pocket” parties — like law firms, accounting firms, investment banks and other professionals — as potential sources of recovery under securities fraud theories, based on their involvement in preparation of offering and financial disclosure documents. In a series of notable decisions in recent years, the legal system has pushed back against many of the avenues plaintiffs have attempted for doing so. *Pacific Investment* represents the latest of these responses by the courts, confirming the difficulties such plaintiffs face in finding a way to charge such secondary actors with securities fraud liability when no allegedly misleading statements were attributed to those persons at the time the statements in question were made.

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