

E-ALERT | Securities Litigation

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SECOND CIRCUIT LIMITS FEDERAL SECURITIES FRAUD LIABILITY OF INVESTMENT BANKS, ACCOUNTANTS, AND LAWYERS

On April 27, 2010, the U.S. Court of Appeals for the Second Circuit, clarifying a 12-year-old line of appellate decisions, sharply restricted the availability of private federal securities fraud actions for damages against lawyers, accountants, banks, and others who are not employed by securities issuers. The court ruled that such “secondary actors” can be liable for securities fraud *only* if allegedly false or misleading statements were attributed to them when made. In affirming this bright-line attribution test, the Second Circuit sought to reduce uncertainty in this area of the law, which it found may have increased the cost of doing business and raising capital, and may have made it difficult for newer and smaller companies to obtain professional advice. Covington joined with several other law firms to file an *amicus* brief urging the court to embrace this clear legal standard.

The case, *Pacific Investment Management Company LLC v. Mayer Brown LLP*, involved allegations that a law firm and one of its partners violated Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 by participating in sham loan transactions and creating false statements in three securities offering documents on behalf of Refco, Inc., a now-defunct brokerage firm. Although two of the offering documents noted that the law firm represented Refco in the transactions, no statement in any of the documents was attributed to the law firm or the attorney. The lower court had dismissed the case, and the Second Circuit affirmed, holding that, absent attribution, the plaintiffs could not demonstrate that they had relied on the lawyers’ statements and not on statements conveyed to the public by someone else.

Notably, the Second Circuit rejected the “creator” standard proposed by the SEC, which participated in the appeal as an *amicus curiae*. The creator standard would have extended liability to a secondary actor who supplies false or misleading information or causes a false or misleading statement to be made, regardless of whether the statement disseminated to the public linked the “creator” to the statement. Unlike the bright-line attribution rule, the creator standard would set no clear boundaries and would generate uncertainty regarding the level of involvement that could expose a secondary actor to liability.

Although this decision is good news for banks, accountants, and securities lawyers, it applies only to cases filed in federal courts in the Second Circuit, which includes New York, Connecticut, and Vermont. Secondary actors could still face liability for statements not publicly attributed to them in actions brought in other federal courts or under state common law. The Second Circuit’s decision also would not limit the scope of federal securities fraud charges brought by the SEC or the Department of Justice, which unlike private plaintiffs can bring aiding-and-abetting charges under the federal securities laws.

This ruling is not likely to be the last word on this issue. One of the three judges who handed down the decision also wrote a separate concurring opinion inviting further review by the full Second Circuit or the Supreme Court. And Congress is currently considering legislation that, if enacted, would effectively overrule the decision by restoring aiding-and-abetting liability in private securities fraud actions. Stay tuned.

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