Should Professionals Be Concerned?

Aiding and Abetting Liability Under State Securities Statutes

By Peter D. Hawkes

Broader liability in many states makes it critical to understand the laws that are applicable to the transactions involved.

In *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148 (2008), the U.S. Supreme Court firmly closed the door on plaintiffs seeking to sue on the basis of aiding and abetting for federal securities fraud under Section 10(b) of the Securities Exchange Act of 1934. Building on an earlier decision in which it held that Section 10(b) did not impose aiding and abetting liability, *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164 (1994), the Court clarified that secondary actors involved in securities transactions cannot be held liable based on the "scheme liability" theory. The *Stoneridge* decision was tremendously comforting to many professionals involved in securities transactions, such as attorneys and accountants, who had much to fear from an expansion of potentially devastating civil liability for federal securities fraud.

However, while *Stoneridge* has shielded lawyers, accountants, and others involved in securities transactions from *federal* liability initiated through private lawsuits alleging federal securities fraud, most *state* securities statutes *do* permit plaintiffs to sue for aiding and abetting securities fraud. Although many states limit that liability to certain classes of persons, such as employees of sellers or brokers materially involved in the fraudulent transactions, others do not. Through legislation or judicial interpretation, a number of state securities statutes around the country extend joint and several liability to virtually anyone with a material role in a securities transaction—including lawyers and accountants who merely provided professional services to clients. Moreover, many of these state statutes do not require a plaintiff to prove that a secondary actor had a culpable state of mind. Instead, a secondary actor is required to prove not only that he or she did not know of the fraud, but also that he or she could not have known of it with the exercise of reasonable care. Professionals involved in securities transactions and their counsel should, therefore, understand the securities fraud laws in states in which these transactions occur, and they should take steps to minimize their liability exposure.

No Liability for Aiding and Abetting Securities Fraud Under Federal Law

In *Central Bank*, the Supreme Court, in

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a 5–4 decision written by Justice Kennedy, held that Section 10(b) the Securities Exchange Act and SEC Rule 10b-5 did not permit private plaintiffs to sue aiders and abettors for federal securities fraud. 511 U.S. 164 (1994). The Court relied primarily on the text of the statute, which does not mention aiding and abetting liability, finding that "It is inconsistent with settled methodology in §10(b) cases to extend liability beyond the scope of conduct prohibited by the statutory text." *Central Bank*, 511 U.S. at 177. The Court also noted that public policy did not necessarily favor recognizing private aiding and abetting federal lawsuits for good reasons. For one, because "the rules for determining aiding and abetting liability are unclear,… entities subject to secondary liability as aiders and abettors may find it prudent and necessary, as a business judgment, to abandon substantial defenses and to pay settlements in order to avoid the expense and risk of going to trial." *Id.* at 188–89. The Court further characterized 10b-5 litigation as particularly vexatious litigation that had "ripple effects," such as making it difficult for newer and smaller companies "to obtain advice from professionals," who might fear that companies might not survive, leaving these professionals vulnerable to secondary liability, and indirectly driving up costs for investors. *Id.* at 189.

Unable to reach lawyers, accountants, and others indirectly involved in securities transactions based on aiding and abetting theory under federal law, plaintiffs' attorneys took a new tack, relying on the concept of "scheme liability." Under this theory, every "secondary actor" that engages in conduct that furthers a "scheme" to mislead investors can be held primarily liable to the investors. In *Stoneridge*, the Supreme Court rejected that theory as well. 552 U.S. 148 (2008). In *Stoneridge*, digital cable converter box suppliers engaged in "wash" transactions of no economic substance with a cable provider that enabled the cable provider to mislead its accountants regarding its revenue and operating cash flow and to file misleading financial statements with the SEC. 552 U.S. at 153–55. Justice Kennedy, writing for the 5–3 majority, concluded that the "wash" transactions, "which were not disclosed to the investing public, were too remote to satisfy the requirement of reliance." *Id.* at 161. The Court found that Section 10(b) "does not reach all commercial transactions that are fraudulent and affect the price of a security in some attenuated way." *Id.* at 162. The Court observed that a contrary conclusion "would revive in substance the implied cause of action against all aiders and abettors except those who have committed no deceptive act in the process of facilitating the fraud," which would diverge from the Court's holding in *Central Bank* and Congress' legislative response to it. *Id.* at 162–63.

After *Stoneridge*, it seemed clear that courts would consider private lawsuits alleging civil liability for aiding and abetting under Section 10(b) of the Securities Exchange Act non-starters, in theory making it easier for lawyers, accountants, and other professionals involved in securities transactions to do their jobs without fear of protracted litigation and crushing civil liability. But, as mentioned above, plaintiffs' attorneys have increasingly turned to state securities statutes to bring secondary actors into securities fraud cases, effectively thwarting federal policy.

Many State Statutes Are Broader than Federal Law

In enacting the Securities Act of 1933 and the Securities Exchange Act of 1934, Congress deliberately chose not to preempt the existing "Blue Sky" laws already in place in many of the states, which left an overlapping regulatory structure. The vast majority of states today have enacted one form or another of the Uniform Securities Act, which was first introduced in 1956 and later revised in 1985 and 2002.

All three versions of the Uniform Securities Act provide that certain secondary actors can be held jointly and severally liable for aiding and abetting a person who sells securities by means of a material misstatement or omission. These include "an individual who is an employee of or associated with a person [primarily] liable… [or] a broker-dealer, agent, investment advisor, or investment advisor representative" if that person "materially aids the conduct giving rise to liability." Unif. Securities Act (2002) §509(g)(3)–(4), 7C U.L.A. 165 (2006); *see also* Unif. Securities Act (1985) §605(d), 7C U.L.A. 297 (an employee, broker-dealer, or sales representative who "materially aids in the act, omission, or transaction constituting the violation" is secondarily liable); Unif. Securities Act (1956) §410(b), 7C U.L.A. 888 (an employee, broker-dealer, or agent "who materially aids in the sale" is secondarily liable). These secondary actors need not have acted with knowledge of the fraud to be held liable; instead, they must prove as an affirmative defense that they "did not know, and in the exercise of reasonable care could not have known," of the facts constituting the underlying fraud. *Id.* Thus, while the Uniform Securities Act has a fairly aggressive form of aiding and abetting liability, it is limited to a fairly narrow group of people—employees of the seller and securities intermediaries—thereby limiting its harsh effect.

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However, a handful of state legislatures have modified the language of the Uniform Securities Act to cast the net of aiding and abetting liability over a much broader group, including lawyers and accountants providing professional services in connection with securities transactions. In Oregon, for example, "every person who participates or materially aids in the sale" can be held jointly and severally liable for the seller's securities fraud. Or Rev. Stat. §59.115(3). In Iowa, any person "who materially aids in the act or transaction constituting the violation" is jointly and severally liable. Iowa Code Ann. §502.509(7)(c). Similarly, in Oklahoma, "Any other person who materially aids in the conduct giving rise to the liability" is equally liable. Okla. Stat. Ann. 71 §1-509(G)(5).

Unsurprisingly, courts have held that such broad statutes can reach persons who merely provided professional services to other persons found liable for securities fraud. In *Prince v. Brydon*, 307 Or. 146, 148, 764 P.2d 1370 (Or. 1988), for example, the Oregon Supreme Court held that an attorney could be liable for "preparing documents and performing other legal services for the partnership," if those services materially aided in the sale of an unregistered limited partnership interest. The court explained that "Whether one's assistance in the sale is 'material'… depends on the importance of one's personal contribution to the transaction. Typing, reproducing, and delivering sales documents may all be essential to a sale, but they could be performed by anyone; it is a drafter's knowledge, judgment, and assertions reflected in the contents of the documents that are 'material' to the sale." *Id.* at 149.

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Even in some states that have enacted the aiding and abetting language of the Uniform Securities Act almost word-for-word, judicial interpretation has broadened it to encompass professionals who were only indirectly involved in securities transactions. In *Powell v. H.E.F. Partnership*, 835 F. Supp. 762, 765 (D. Vt. 1993), for instance, the U.S. District Court in Vermont interpreted the term "agent" in the former version of the Vermont Securities Act, Vt. St. Ann. 9 §4225, to include "its ordinary meaning," in addition to its more limited definition elsewhere in the statute. The court found that "an attorney acting on behalf of a client does so as the client's agent," and that "While it does not appear that [the attorney] actively 'peddled' the securities or met individually with any potential purchasers of securities, by drafting the offering documents it aided [the issuer's] efforts to sell the securities" and could be held liable as an "agent" under the statute. *Id.* The current version of the Vermont Securities Act continues to provide that an "agent… that materially aids the conduct giving rise to liability" is jointly and severally liable. *See* Vt. St. Ann. 9 §5509(g)(4).

Similarly, in *Arthur Young & Co. v. Reves*, 937 F.2d 1310, 1325–26 (8th Cir. 1991), the Eighth Circuit implicitly found that the seller's accountant was an "agent" under Arkansas' securities statute, Ark. Code Ann. §23-42-106(c), when it found that the accountant could be held liable for "materially aiding" in a sale that violated Arkansas's securities statute.

These cases stand in stark contrast to the court's interpretation of the same term in the Wisconsin securities statute in *Rendler v. Markos*, 154 Wis. 2d 420, 431, 453 N.W.2d 202 (Wis. Ct. App. 1990). In *Rendler*, the court observed that the term "agent" in Wis. Stat. Ann. §551.59(4) was specifically defined elsewhere in the statute as covering "persons who assist directly in offering securities for sale, soliciting offers to buy, or performing the sale, but who do not fit the definition of broker-dealer." *Id.* The court concluded that the term "agent" was "not intended to cover professionals such as attorneys engaging in their traditional advisory functions," and specifically "does not include attorneys who merely render legal advice or draft documents for use in securities transactions." *Id.* Wisconsin has subsequently amended its law to adopt the 2002 Uniform Securities Act, but the language interpreted in *Rendler* has remained unchanged. *See* Wis. Stat. Ann. §551.509(7)(d).

Rendler presents the best-reasoned view—and certainly the view more in keeping with the obvious intent of the Uniform Securities Act's drafters—and will hopefully prove persuasive in states that have yet to determine the scope of the term "agent" in secondary securities liability provisions.

Another way that courts have found that state securities statutes encompassed persons rendering professional services has been by expansively interpreting a "seller" of securities—and thus those potentially *primarily* liable for securities fraud. The Washington State Securities Act, as that of most states based on the Uniform Securities Act, provides that "Any person who… sells a security" can be held liable for securities fraud. Wash. Rev. Code §21.20.430(1). However, under Washington law, any person who is a "substantial contributing factor" in a fraudulent securities sale is considered a statutory "seller"—a test that has been held to include professionals such as independent auditors who had roles in preparing offering materials for the public. *See In re Metropolitan Securities Litigation*, 532 F. Supp. 2d 1260, 1300–01 (E.D. Wash. 2007) (refusing to dismiss state securities fraud claims against an independent auditing and accounting firm and an investment banking firm). This form of aiding and abetting liability is particularly troubling, because secondary actors do not even have the affirmative defense that they did not know and could not have known of the alleged fraud. *Compare* Wash. Rev. Code §21.20.430(3) (setting forth affirmative defense for other persons secondarily liable for securities fraud); *see also Kittilson v. Ford*, 93 Wn. 2d 223, 608 P.2d 264 (Wash. 1980) (holding that a securities fraud claim under Washington law does not require proof of scienter).

Other states have taken a more moderate approach. While they have allowed aiding and abetting liability for securities fraud to apply to a broad range of persons, they have strictly limited it to situations in which a secondary actor was an active and knowing participant in the fraud, and they have required plaintiffs to prove that a the secondary actor had a culpable states of mind. The South Carolina Uniform Securities Act, for instance, provides that "a person who, *with actual knowledge that a person is committing acts* [constituting securities fraud], nonetheless *intentionally furthers the violation* with *actual awareness* that the person is rendering substantial assistance to the person committing the violation…, thereby becomes an aider and abettor of the violation,… however, this subsection… does not require any due diligence investigation nor impose liability for failure to perform any due diligence investigation otherwise required." S.C. Code 1976 §35-1-509(g)(5) (emphasis added). Texas' Blue Sky law—which is not based on the Uniform Securities Act—also provides for aiding and abetting liability for persons who "materially aid" a seller or issuer, but only if the secondary actor acted "with intent to deceive or defraud or with reckless disregard for the truth or the law…" Texas Rev. Civ. Stat. Ann. art. 581-33(F)(2). The Texas Supreme Court has interpreted the scope of this aiding and abetting liability quite narrowly, holding that the "reckless disregard" standard means that "an aider must be aware of the primary violator's improper activities before it may be held liable for assisting in the securities violation," which requires "subjective awareness." *Sterling Trust Co. v. Adderley*, 168 S.W.3d 835, 841 (Tex. 2005). California—which also has not adopted the Uniform Securities Act—imposes liability on those who "materially assist" in the sale of securities by means of a material misstatement or omission, but only if the secondary actor acted "with intent to deceive or defraud." Cal. Corp. Code §25504.1.

Finally, at least one state does not impose aiding and abetting liability—or *any* civil liability—for securities fraud. In New York, it is a misdemeanor to make or cause to be made any material misrepresentation affecting the value of a security or concerning the financial condition of an issuer with the intent to deceive, or to make a false statement to induce a securities sale that the speaker knew or should have known was false, but without *civil* liability or any form of aiding and abetting liability. N.Y. Gen. Bus. Law §339-a and §352-c. A secondary actor can be held civilly liable for aiding and abetting *common-law* fraud in connection with the sale of securities, but only if that secondary actor knew of the fraud and substantially assisted in achieving it. *UniCredito Italiano SPA v. JPMorgan Chase Bank*, 288 F. Supp. 2d 485, 502 (S.D.N.Y. 2003).

Prevention Is the Best Cure

As the above survey demonstrates, the scope of state law based civil liability for aiding and abetting securities fraud varies widely around the country. To proactively advise clients who provide professional services in connection with securities transactions to protect against the numerous pitfalls, counsel should pursue the recommendations that follow.

Know Which Securities Statutes Potentially Apply

Inform your clients that they could potentially face liability in *any* state in which the securities in question are bought or sold—*not* just in the state in which they rendered their professional services. Even small securities offerings and transactions frequently cross state lines, and the scope of potential liability can differ radically in neighboring jurisdictions. If possible, professionals should find out in which state securities sales will occur before rendering their services so that you and they can become familiar with the risks presented by each jurisdiction and make an informed decision about whether to undertake particular engagements.

Perform—and Document—Due Diligence on Your Clients and All Securities

In most states in which professionals could face exposure for aiding and abetting securities fraud, they will have the affirmative defense that they did not know and, in the exercise of reasonable care, could not have known, of the facts underlying the fraud. Accordingly, advise professionals to reasonably investigate *their* clients and the specific securities involved in proposed transactions to assure themselves that they have no basis for believing fraudulent activity is afoot. Professionals should also create a clear paper trail documenting the efforts that they made to determine the truth and accuracy of the representations made in these securities transactions.

Take into Account Broad Definitions of "Securities"

Be aware that courts may define as securities some things that you or your clients *would not* necessarily think of as securities. The definition of a "security" under the Uniform Securities Act and most state statutes is quite broad, and courts have interpreted it to apply to numerous transactions that do not fit paradigmatic stock or bond transactions. Interests in entities other than corporations, such as partnerships and limited liability companies, tenant-in-common interests in real property, viatical settlements, and standard promissory notes, have all been found by courts to constitute securities in certain circumstances. Even professionals who do not consider themselves "securities" practitioners may find themselves facing claims under state securities laws based on their rendering of professional services. Professionals should consider the potential implications of state securities statutes when they perform services in connection with any business transaction and ensure that they protect themselves from potential liability.

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Defending a Secondary Liability Securities Claim

Civil litigators defending professional service providers from secondary liability claims under state securities statutes may have a tough road ahead, at least in some of the states mentioned above. But all is not lost. You can take several approaches to mitigate the potential for adverse judgments.

Argue for the Wisconsin Approach

In traditional Uniform Securities Law states, argue forcefully for the Wisconsin approach over the Vermont-Arkansas approach. As noted, the language of the Uniform Securities Acts limits secondary liability to a narrow group, but courts interpreting that language as adopted by at least two states—Vermont and Arkansas—have held that professionals can be held secondarily liable as "agents" of sellers if they have materially aided in the fraudulent sales. *See Powell*, 835 F. Supp. at 765; *Arthur Young & Co.*, 937 F.2d at 1325–26. If the plaintiff in your case pursues this theory of secondary liability, you should seek dismissal based on the reasoning of the Wisconsin Supreme Court in *Rendler*, which held that the term "agent" applies only to securities interme-

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diaries, not to professionals such as lawyers and accountants. *Rendler*, 154 Wis. 2d at 431. Even in Vermont and Arkansas, *federal* courts rendered the adverse opinions discussed above, and, therefore, they are not binding in those states' courts.

Assert that Your Client's Aid Was Immaterial

Focus on whether your client's aid was really "material." Even states with broadly sweeping secondary liability generally require that a secondary actor "materially" aid in the fraudulent transaction. Depending on the facts, this element may be weak in a plaintiff's case. For example, suppose that your client is an attorney who helped prepare the offering memorandum and other transactional documents in a private placement. However, the plaintiff testifies that he or she never read the documents that your client prepared, but simply relied on statements of a salesperson that were inconsistent with those documents. Was your client's role actually "material" in that situation? A jury might well conclude that it was not.

Maintain Your Affirmative Defense

Use your affirmative defense to equate your client with the plaintiff. Secondary actors generally have an affirmative defense that they did not know and, in the exercise of reasonable care, could not have known of the underlying securities fraud acts. This defense offers you an opportunity to situate your client in the same position as the plaintiff. You can argue that both were fooled by the same fraudulent seller. The jury may come to view your client as a victim as well, potentially decreasing an inclination to find liability. Of course, this approach may not always be appropriate—you may be coordinating a defense with the seller, arguing that no fraud was involved, which would obviously make demonizing the seller rather difficult.

Argue the Right of Contribution

Use the broad scope of potentially liable parties to your advantage. Keep in mind that the seller's and all secondary actors' liability are joint and several, and you have a right of contribution against all the other liable parties. To the extent that your states' rules permit, consider whether you wish to bring in other secondary actors as third-party defendants. Bringing in additional parties can dilute your client's share of liability, and further allows you to minimize your client's role in the overall transaction.

In conclusion, despite the false sense of security of *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148 (2008), you do have some tools to defend lawyers, accountants, and others involved in securities transactions against secondary liability claims under state securities statutes.