

Liability for Financial Misstatements and the “Non-speaking Actor” Dilemma

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Abstract

This paper reports on the origins of “scheme liability” doctrine and on its fall under the Supreme Court decision in Stoneridge. It discusses also the “non-speaking actor” issue that has arisen as a result, and outlines the comparative law perspective and the European regulatory policy.

Keywords: fraud, deceit, misrepresentation, “scheme liability”, shareholders, economic losses, non-speaking actors, duty to disclose, reliance, silent behaviors, inference of scienter, recklessness, securities class actions

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1. Liability for financial misstatements and the “scheme liability” doctrine.

Securities issuer is charged with specific duties to disclose and inform investors in securities markets. Those duties can be violated by him through deceptive practices and fraudulent schemes elaborated and/or implemented in cooperation with third parties (“secondary actors” like auditors, investment banks, lawyers, commercial partners).

Some kind of secondary actors can act openly with public declarations or counseling (for example auditors), some others behave silently: for example by aiding the issuer to misrepresent transactions¹.

This latter behavior turns often into severe economic losses to shareholders. Who bears such losses?

There is a high probability that shareholders will file a suit against issuer or auditors that directly carry on the disclosure process reaching huge settlements. However it results in setting free from any liability those who assist the issuer without making any public statement.

¹ For example in *Stoneridge Investment Partners, LLC v. Scientific Atlanta, Inc.* 128 S.Ct. 761 (2008), “the respondents (*Scientific-Atlanta, Inc.* and *Motorola, Inc.*) were suppliers and also became later customers of *Charter Communications, Inc.* a publicly traded company. In late 2000 the executives of *Charter* realized that the company would miss the projected revenue and cash flow. In order to meet the expectations *Charter* and the respondents arranged an overpayment for the products of the respondents with the understanding that the respondents would return the overpayment by purchasing advertising from *Charter* for a price higher than fair value. Although the transaction had no economic substance it enabled *Charter* to improve its financial statements by recording the advertising purchases as revenue and capitalizing the purchase of the overpaid products. The documents of the transactions were drafted in way that they appeared as being unrelated and conducted in an ordinary way of business. Especially the new agreement concerning the purchase of the products of the respondent were backdated so that they appeared of being negotiated one month before the advertisement agreement.” See M.C. HILGARD, S. MOCK, *Stoneridge and Its Impact on European Capital Market and Consumer Law- Is there a Sanction for Aiding and Abetting a False or Misleading Financial Statement in European Capital Market Law?* 4 *Eur. Comp. Fin. L. Rev.*, (2008) vol. 5, 454.

This paper investigates the liability of “non-speaking actors” for issuer misrepresentation in a comparative perspective.

Section 10(b) of the Securities and Exchange Act of 1934 furthers the purpose of “full disclosure” by prohibiting the use or employment of “any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the SEC may prescribe². SEC Rule 10b-5 and its three subsections effectuate this mandate³. Specifically, Rule 10b-5(b) bars *incorrect* and *incomplete* disclosure by imposing a duty on speakers to be truthful and complete—it prohibits “any untrue statement of material fact” or omission “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.”⁴

Rules 10b-5(a) & (c), in contrast, address conduct that does not involve speaking, and thus apply even where there is *no* disclosure. They prohibit “any device, scheme, or artifice to defraud” and “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 *U.S. Supreme Court*, in *Central Bank, N.A. v. First Interstate Bank, N.A.*⁵ rejected a private right of action under Section 10(b) against aiders and abettors, finding that Congress did not intend the statute to reach such conduct. The following year, Congress specifically considered including a provision in the Private Securities

² *Brief of Organization for International Investment, International Chamber of Commerce and Federation of German Industries as amici curiae in support of Respondents*, No. 06-43, In the Supreme Court of the United States, *Stoneridge Investment Partners LLC, Petitioner v. Scientific-Atlanta, Inc. and Motorola, Inc., Respondents*, August 15, 2007 (http://www.scotuswiki.com/index.php?title=Stoneridge_v._Scientific-Atlanta), 4.

³ *Ibidem*.

⁴ *Ibidem*.

⁵ *Id.*, 511 U.S. 164 (1994).

Litigation Reform Act (the “PSLRA”) which would restore aiding and abetting liability.

Ultimately, Congress concluded that only the SEC – which, unlike private plaintiffs, does not possess a profit motive and is charged with considering the market impact of its actions – should have the right to bring claims against those who aid and abet securities fraud.⁶ This is called also secondary liability to distinguish it from primary liability as the only one allowing a private right to sue⁷.

“Scheme liability” doctrine predicates a broad expansion of primary liability under Section 10(b)⁸. Under the “participation test”, anyone who takes part in a transaction that has the “purpose and effect” of creating “a false appearance of material fact in furtherance of [a] scheme” can be held jointly and severally liable⁹. “Any person who directly or indirectly engages in a manipulative or deceptive act as part of a scheme to defraud can be a primary violator of Section 10(b) and Rule 10b-5; any person who provides assistance to other participants in a scheme but does not himself engage in a manipulative or deceptive act can only be an aider and abettor.”¹⁰

According to the « participation test » secondary actors must give substantial assistance to issuer and must act with strong inference of scienter to be held liable¹¹.

⁶ *Brief of Organization for International Investment*, at 4.

⁷ See for a critical approach, R.A. PRENTICE, *Locating That “Indistinct” and “Virtually Nonexistent” Line Between Primary and Secondary Liability Under Section 10(b)*, 75 *N. C. L. Rev.* (1997), 727-28.

⁸ See E. BERRY, *Stoneridge and the Short-Lived Experiment of Scheme Liability*, vol. 4, *NYU Journ. of Law and Business*, (2007), 355: “Scheme liability is a theory of liability in which secondary actors could be liable as primary violators for their role in furthering a fraudulent scheme.” See also T.S. SOUZA, *Freedom to Defraud: Stoneridge, Primary Liability, and the need to Properly Define Section 10(b)*, 57 *Duke L.J.* (2008), 1179 ff.

⁹ *Simpson v. AOL Time Warner, Inc.*, 452 F.3d 1040 (9th Cir. 2006).

¹⁰ *Ibidem*.

The same goal is achieved by a similar test when the participant is proved not to be an innocent victim of issuer machination but conscious creator of misrepresentation himself (as the « creator of misrepresentation test »).

An intensive discussion started in 2008 about “scheme liability” which brought the “Stoneridge case” to the U.S. Supreme Court¹². The decision, a negative response¹³, is considered extremely relevant because of its systemic impact on the global economy and its influence on the future behavior of many commercial actors and institutional investors.

The U.S. Supreme Court, in *Stoneridge Investment Partners v. Scientific Atlanta*, 552 U.S. 148 (2008) held that liability even for

¹¹ If an investment bank engages in the creation of a sham entity as part of the services to arrange the financing, the investment bank may be a primary violator if it acted with scienter. The investment bank itself engaged in a deceptive act. If a third party engages with the corporation in a transaction whose principal purpose and effect is to create a false appearance of revenues, intending to deceive investors in the corporation’s stock, it may be a primary violator. See *Brief of Securities and Exchange Commission, Amicus Curiae in support of Positions that favour Appellant*- No. 04-55665, *In the United States Court of Appeal for the Ninth Circuit, T. Jeffrey Simpson v. Homestore.Com, Inc.*, October 21, 2004, 20.

¹² J. A. GRUNDFEST, *Is There an Express Section 10(b) Private Right of Action? A Response to Professor Prentice*, 8 (Stanford Law Sch., Working Paper No. 352, Dec. 2007), available at <http://www.ssrn.com/abstract=1077437>; B. BLACK, *Stoneridge Investment Partners v. Scientific-Atlanta (8th Cir. 2006) What makes It the Most Important Securities Case in a Decade?* (University of Cincinnati College of Law. Public Law & Legal Theory Research Paper Series No. 07-21, October 15 2007); R. A. EPSTEIN, *Primary and Secondary Liability Under Securities Law: The Stoneridge Investment Saga* (University of Chicago Law School Faculty Blog, October 08, 2007); R.A. PRENTICE, “Scheme Liability”, *Federal Securities Fraud, and Jhon Wayne’s i-Pod* (McCombs School of Business- Research Paper Series, September 2007 at <http://ssrn.com/abstract=1014658>).

¹³ Stoneridge “rejects an expansion of liability under section 10(b) premised on a broad conception of scheme liability.” See *In re DVI Securities Litigation* 249 F.R.D. (E.D. Pa. 2008): “Lead Plaintiffs have not overcome the objection that investors in DVI did not rely upon the allegedly deceptive conduct of [the Layers].”

active aiding and abetting of a fraud is not permitted under the Securities and Exchange Commission Act of 1934, 15 U.S.C. §§ 78a et seq., and the SEC’s Rule 17 C.F.R. § 240.10b-5 which supports a tort remedy for securities fraud.¹⁴ It states that although *Central Bank* prompted calls for creation of an express cause of action for aiding and abetting, Congress did not follow this course. Instead, in §104 of the Private Securities Litigation Reform Act of 1995, it directed the SEC to prosecute aiders and abettors.

2. Critical Arguments

2.1 The open floodgates argument.

The “floodgates argument” constitutes a critical issue powerfully confirmed by the S.C. in *Stoneridge*.

Class actions in aiding and abetting cases could introduce an unpredictable and potentially arbitrary mechanism for determining liability. These kinds of outsized damages claims almost inevitably result in huge settlements, regardless of the substantive merits of the case.¹⁵ A hostile litigation environment materially increases the risks of litigation abuses and “deep pocket” assaults. Furthermore, this measure exaggerates the social harm caused by fraud on the market

¹⁴ See, *Testimony of J. C. COFFEE, Jr.* (Adolf A. Berle Professor of Law Columbia University Law School) *Before the Subcommittee on Crime and Drugs of the United States Senate Committee on the Judiciary*, September 17, 2009 Hearing on “Evaluating S.1551: The Liability for Aiding and Abetting Securities Violations Act of 2009”.

¹⁵ See *Brief of Organization for International Investment*, at 12, and see, e.g., *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*, 547 U.S. 71, 80-81 (2006) (citing *Blue Chip Stamps v. Manor Drug Stores* for the proposition that “litigation under Rule 10b-5 presents a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general.”).

because it fails to account for the gains of equally innocent shareholders who sold at the inflated price¹⁶.

Although this kind of cost-benefit analysis is fashionable, the same reasons could be adopted for questioning the liability of the primary violator. This approach could lead to an aggravation of the actual financial crisis. It doesn't take into account that an extension of liability to "non-speaking actors" could drive beneficial effects on transaction costs allocation. Above all it makes clear that courts often act as economic policy makers. Economic analysis of law must take very seriously the decline of the "new economy" model and the recent fall of the reputation of securities markets.

As underlined by Prof. Coffe, there is no stronger case for judicial recognition of an implied cause of action than when a statute declares a wrong. Aiding and abetting a fraud has been a crime for 100 years. 18 U.S.C. § 2 (Principals) declares: "*(a) Whoever commits an offense against the United States or aids, abets, counsels, commands, induces or procures its commission, is punishable as a principal*"

That substantial aid to a fraudulent scheme is actionable has been declared « In hundreds of judicial and administrative proceedings in every Circuit in the federal system, the courts and the SEC have concluded that aiders and abettors are subject to liability under §10(b) and Rule 10b-5. »¹⁷ Recognition of a private cause of action in tort is an elementary proposition. It is followed by the Restatement of Torts (2d) which declares, in § 876 (b) that an actor is liable for harm resulting to a third person as a result of the tortious conduct of another

¹⁶ See Statement of A.C. PRITCHARD (Frances and George Skestos Professor of Law Director, Empirical Legal Studies Center University of Michigan), *Before the Committee on the Judiciary, Subcommittee on Crime and Drugs United States Senate*, September 17, 2009, *Evaluating S. 1551: The Liability for Aiding and Abetting Securities Violations Act of 2009*, 6. See also R. EPSTEIN, (above, nt. 12).

¹⁷As Justice Stevens observed (dissenting) in *Central Bank of Denver Central Bank of Denver, N.A. v. First Interstate Bank of Denver*, 511 U.S. 164 (1994).

“if he . . . knows that the other’s conduct constitutes a breach of duty and gives substantial assistance or encouragement to the other.”¹⁸ The Restatement did not speak of aiding and abetting as a form of secondary liability¹⁹.

2.2 Political economy argument.

The practical effect of “scheme liability” would be that any company that enters into a general commercial transaction could be held liable to a counterparty’s shareholders under Section 10(b) if its counterparty misreports the transaction on its own financial statements. This result would obtain even though the “non-speaking” company correctly accounted for the transaction in its own financial statements and neither made representations nor owed any duties to the counterparty’s shareholders.

“Scheme liability” could expose those who engage in commercial transactions with U.S. issuers to liability for the issuer’s misrepresentations. It also increases the likelihood that the silent counterparty could be held jointly and severally liable for scheme-wide damages. This change could turn into a hostile U.S. litigation environment that will deter foreign companies from doing business with U.S. companies.

“scheme liability” differs widely from strict liability as in the first plaintiffs have to comply with burdensome allegations²⁰. So not all

¹⁸ See: *Testimony of Professor John C. Coffee*.

¹⁹ See R.A. PRENTICE, *Scheme Liability: does it have a Future After Stoneridge?* (2009), *Wisconsin Law Rev.* 376 ff.

²⁰ “A plaintiff cannot simply allege that the lawyer or investment banker serving as an advisor to the CEO counseled fraud or illegality; rather, the plaintiff must plead such a claim with particularity before it can obtain any discovery. This is one of the primary reasons that credit rating agencies have never been held liable for securities fraud.” See *Testimony of Professor John C. Coffee*, at 8. On credit rating agencies liability see, R. VON SCHWEINITZ, *Rating Agencies. Their Business, Regulation and Liability*,

commercial partners of a misrepresentative issuer could be drawn in hostile litigation environment, but only those who sciently participate in a deceptive scheme. The market's ability to avoid information asymmetries due to moral hazard is a long-term issue and the legal issues goal is to prevent a short-term systemic impact through deterrence. Financial crisis critics have already demonstrated how much legal issues can be affected by some political-economic doctrines²¹.

2.3 Bright line test (reliance).

According to the “bright line test” the extension of private right of action to aiders and abettors falls on the plaintiff's reliance upon a material misrepresentation or omission by the defendant.

Supporting a highly formalistic reasoning the S.C. applies the “bright line test” excluding “scheme liability”.

In § 10b-5 “antifraud provision”, reliance is presumed in two circumstances (as a “rebuttable presumption”). First, if there is an omission of a material fact by one who owns a duty to disclose. Non-speaking-actors have no duty to disclose but only a general duty to not aid and abet violations of such duty.

Second, under the “fraud-on-the-market” doctrine, reliance is presumed when the statements at issue become public. In *Basic Inc.*²², the S.C held that the “fraud-on-the-market” theory provides adequate support for a presumption in private securities actions that

Bloomington, Indiana, 2007; S. SICA, *Controllo e responsabilità delle società di rating in Italia*, in *Rapports suisses présentés au 17. Congrès international de droit compare: Utrecht, 16 au 22 juillet, 2006-Institut Suisse de droit compare, Genève, Schultess, 2006.*

²¹ On the recent U.S. political economy impact on global financial markets, J.K. GALBRAITH, *The Economics of Innocent Fraud. Truth for Our Time*, Boston-New York, 2004; J. STIGLITZ, *Capital market liberalization, globalization, and the IMF*, (2004) *Oxford Rev. of economic policy*, 57.

²² *Basic Inc. v. Levinson*, 485 U.S. 224, (1988) at 247.

shareholders (or former shareholders) in publicly traded companies rely on public material misstatements that affect the price of the company's stock.²³

The S.C. decision is paradoxical when stating deceptive acts were not communicated to the investing public during the relevant times and so the petitioner, as a result, cannot show reliance upon any of the respondent's actions except in an indirect chain that is too remote for liability. The argument adopts a logical-formalistic view that sounds like *a contradictio in adiecto*.

How should fraudulent schemes, whose fulfillment is based upon secrecy, be communicated to the public without contradicting its intrinsic reason?

3. Comparative argument: statutory liability for financial misstatements does not extend to third parties

"Scheme liability" doctrine, as a typical creation of some U.S. academics, was imported in case law by the ninth Circuit Court of Appeal decision in *Simpson v. AOL Time Warner*²⁴ and by other courts²⁵. This theory doesn't find any correspondence in other countries of the "western legal tradition" (U.K., Germany, Canada, Italy etc.).

Securities laws generally provide for liability in the context of misrepresentations made in other "secondary market" materials, such as annual or quarterly filings and certain press releases.

Liability is charged only upon the parties directly involved in

²³See R.A. PRENTICE, at 248.

²⁴*Simpson v. AOL Time Warner, Inc.*, 452 F.3d 1040 (9th Cir. 2006).

²⁵J.B. APOLINSKY, *Is There Any Viability to Scheme Liability for Secondary Actors after Stoneridge Investment Partners, LLC v. Scientific Atlanta, Inc.?* 2 *Catholic Univ. L. Rev.*, vol. 58, (2009), 411.

disclosure process, as the misrepresenting issuer, along with the responsible officers, directors and auditors²⁶.

For example, the U.K. Financial Services and Markets Act of 2000 (“FSMA”) contains provisions akin to Section 10(b) that impose civil liability for untrue or misleading statements made in offering documents, publicly disclosed financial reports or statements, and other documents that an issuer must make publicly available. Under Section 90B of FSMA, introduced by S. 1270 of the 2006 Companies Act, issuers, as well as directors or other persons discharging managerial responsibilities in relation to such issuers, may be liable for any false or misleading statements contained in these documents.

The European “market abuse” provisions, which focus on insider trading and market manipulation in relation to listed securities, might be applicable to secondary actors²⁷.

For example, Subsection 118 (8) of the English FSMA provides that “market abuse” is behavior that: a) is likely to give a regular user of the market a false or misleading impression of the supply of, or demand for a price or value of, qualifying investments; or b) would be, or would be likely to be, regarded by a regular user of the market as behavior that would distort, or would be likely to distort, the market in such an investment...”.

However, Section 118 of FSMA does not expressly create a statutory tort and a private right of action to recover compensation for its breach, rather, S. 383 of the FSMA grants the Financial Services

²⁶ The liability for false or misleading financial statement is currently addressed in several harmonization directives as Annual Accounts Directive (art. 50b, Directive 2006/46/EC), the Transparency Directive (art. 7, Directive 2004/109/EC), the Market Abuse Directive (art. 5, Directive 2003/6/EC). See M. IRIBARREN BLANCO, *Responsabilidad civil por la información divulgada por las sociedades cotizadas*, Madrid, 2008; HILGARD, MOCK, at 465 ff.

²⁷ The common frame is provided by Directive 2003/6/EC (art. 6). On mandatory disclosure regulation see E. AVGOULEAS, *The Mechanics and Regulation of Market Abuse*, Oxford, 2005, 173.

Authority (FSA) standing to apply to the courts for “restitution orders” upon contravention of S. 118²⁸. The proceeds become payable to investors who have suffered loss as a result of such contravention²⁹. Securities regulation in Canada is a matter of provincial law³⁰. However the overwhelming majority of corporations subject to Canadian securities law are subject to Ontario’s *Securities Act*³¹. Like the primary market regime, the secondary market regime is limited to certain actors: the issuer; in the case of a misrepresentation in an oral statement, the person who made the statement; every director of the issuer; every officer of the issuer, if they “authorized, permitted or acquiesced” to the misrepresentation or failure to disclose; every influential person who knowingly influenced the misrepresentation or failure to disclose, where an influential person is, essentially, a person with control over the issuer, an insider or, if the issuer is a mutual fund, a fund manager; and experts (accountants, auditors, lawyers and the such) where the misrepresentation made is included in their report, that report is included or summarized in a document containing

²⁸ See D. WALTER, *Developments in US Litigation: The Decision in Stoneridge Investment Partners v Scientific Atlanta*, [2008] *J.I.B.L.R.*, Issue 5, 270: “It seems reasonably arguable that a person who enters into agreements with a securities issuer, which that person understands will, or likely will, result in investors developing a false or misled impression of the value of the issuer’s securities, has engaged in “market abuse” for purposes of s. 118 (8) of the Financial Services and Markets Act.”; see also HILGARD, MOCK, at 465 ff..

²⁹ *Ibidem*. See in Italy, art. 187-ter, c. 1°, D.lgs. n. 58, 24.1.1998 as modified by L. n. 62, 18.4.2005. In a recent case the Consob (the Italian equivalent of FSA) decided to impose a financial penalty on a lawyer in respect of breaches of art. 187-ter. The Lawyer was found liable for assisting the issuer to draft a manipulative press release. See C. App. Torino, 23.1.2008, I, *Nuova Giur. Civ. Comm.*, 2008, 1330. For a critical perspective, see V. ZENO ZENCOVICH, *La responsabilità dell’avvocato nell’attività di consulenza Avanti le autorità di regolamentazione del mercato*, II, *Nuova Giur. Civ. Comm.*, 2008, 361 ff.

³⁰ See *Brief of Organization for International Investment*, at 20.

³¹ *Ibidem*.

misrepresentations, and the expert consented, in writing, to the use of the report³².

The German Securities Trading Act (the “Wertpapierhandelsgesetz” as “WpHG”) contains the principal statutory provisions governing capital markets activity in Germany.³³ Similar to their counterparts in the UK and Canada, these provisions limit liability for misstatements to the issuer and, potentially, certain directors and officers of the issuer. WpHG, Section 37(b), (c) does not provide for claims against silent third-parties to commercial transactions that the issuer misreports. Its goal, like most other countries’ legislations, is to improve full disclosure.

The abovementioned statutes reached a U.S. “fraud-on-the market” model to facilitate the proof of causal link between misrepresentations and economic losses³⁴. For example, Section 90A(5) of U.K. Financial Services Markets Act replaces ‘intended reliance’, as a common law prerequisite, with a requirement that the recipient’s reliance should be reasonable in the circumstances. This change facilitates the bringing of fraud actions³⁵.

4. Coexistence between liability for financial misstatements and liability of “non-speaking actors”

³² *Ibidem*.

³³ *Id.*, at 21.

³⁴ “Further, the existing statutory regime makes fraud claims easier to bring than at present at common law, because the claimant need only show that his own reliance on the misstatement was reasonable and not also that the issuer intended that he should rely on it.” see DAVIES, at 4; E. GOTTSCHALK, *Die persönliche Haftung der Organmitglieder für fehlerhafte Kapitalmarktinformationen de lege lata und de lege ferenda*, 5 *Der Konzern*, 2005, 285; *contra*, see BGH v. 15.2.2006-II ZR 246/04, ZIP 2007, 679.

³⁵ See Prof. DAVIES, at 18.

This statutory trend doesn't mean, as affirmed in the Brief of Organization for International Investment, International Chamber of Commerce and Federation of German Industries as *amici curiae* in support of Respondents³⁶, an implied exclusion of silent counterparties liability for financial misstatements.

These countries have not yet established clear lines for civil liability under their securities laws, because “transparency legislation” is too recent and there were only a few claims decided in courts.³⁷

Although liability is not imposed by statute or regulation on third parties that enter into transactions with the issuer which the issuer then misreports, a joint and several liability might be applied when fraud and dishonesty are involved in a tortious conduct³⁸.

A legal dictionary in use at the time of Section 10(b)'s enactment defined “deception” as follows: “The act of deceiving, intentional misleading by falsehood spoken or acted.”³⁹ The semantic origin of “deceit” comes from the Latin expression “deceptio” as a part of

³⁶*Id.*, at 21.

³⁷See O. FLEISCHER, at 271: “Eine verbreitete Auffassung in der Literatur ordnet die §§ 37b, c WpHG als gesetzliche Vertrauenshaftung ein. Zur Begründung stützt sie sich darauf, dass § 37c Abs. 1 WpHG das Vertrauen des Anlegers auf die Richtigkeit der Ad-hoc-Mitteilung ausdrücklich zur Anspruchsvoraussetzung erhebt und dass §§ 37b Abs. 3, 37c Abs. 3 WpHG einen Haftungsschluss bei Kenntnis des Anlegers vorsehen.” See V. ENGAMMARE, R. WEBER, *Transparence des sociétés à l'égard des actionnaires et des tiers: perspectives de droit européen et de droit suisse*, (2004) *La semaine judiciaire* II, 67.

³⁸ See M. COESTER, B. MARKESINIS, *Liability of Financial Experts in German and American Law: An Exercise in Comparative Methodology*, 51 *Amer. J. Comp. L.* 275 (2003). at 292-293; see the Canadian *Report of the Standing Senate Committee on Banking, Trade and Commerce*, “Joint and Several Liability and Professional Defendants: Options. Discussion Paper, October 1997, Part I, let. C (Journals of the Senate, Wednesday, October 22, 1997; R.A. PRENTICE, *Scheme Liability*, at 419: “Nearly every body of fraud law in the western legal tradition prevents fraudsters from escaping liability by hiding in the shadows when they are up to their elbows in a fraud”; P.G. MONATERI, *La responsabilità civile (Trattato di diritto civile diretto da R. Sacco)* Torino, 1998. 787.

dolus malus doctrine⁴⁰. A similar concept can be found in the legal systems countries like *bedingter Vorsatz* in Germany (§ 826 BGB)⁴¹, “dolo” in the Italian civil code (art. 2043 c.c. and art. 185 c.p.)⁴².

Tort of deceit needs the proof of reliance that involves normally a preexisting relationship between victim and tortfeasor. How long this conduct must correspond *directly* to a misstatement is strongly disputed.

As Prof. Davies noticed “the tort of deceit is a form of wrongdoing developed by the common law *specifically* to deal with misstatements.” (emphasis added)⁴³. The speaking-actor must either know that the statement is false or not care whether it is true or false; and a genuine belief in the truth of the statement would be a defence to liability.⁴⁴ At common law, besides knowing that the statement is

³⁹ See *Black’s Law Dictionary* 529 (3d ed. 1933). See also 37 *Am. Jur.2d Fraud and Deceit* § 38 (2004): “Fraud may consist of the creation of a false impression by words or acts”.

⁴⁰ “Dolus malus est machinatio quaedam alterius *decipiendi* causa, cum aliud simulatur et aliud agitur” (*Ulp. l. 1 § 2 D. de dolo malo 4, 3*, emphasis added); about *dolus-malus* in *emptio-venditio*, see Cicero, *De Officiis*, III, XIV.

⁴¹ See FLEISCHER, *Zur zivilrechtlichen Teilnehmerhaftung für fehlerhafte Kapitalmarktinformation nach deutschem und US-amerikanischem Recht*, 8 *Die Aktiengesellschaft* (2008), 265; D. ECKNER, *Die Haftung für fehlerhafte Kapitalmarktinformation in Deutschland und den U.S.A.*, (2008) *Freiburg Law Students Journal*, 3, 8.

⁴² See P. CENDON, *Il dolo nella responsabilità extracontrattuale*, Torino, 1976; See Trib. Milano, 14.2.2004, *Foro it.*, 2004, I, 1567; G. ALPA, *Atipicità dell’illecito*, Napoli, 1979, the last chapter; see also Cass. Sez. V, 17.2.2004, n. 13989, (*Guida al Diritto*, 2004, 23, 90) affirming that a damage for “loss of chance” can be caused by a fraudulent conduct, although the latter offends primarily a public interest.

⁴³ Prof. DAVIES at 10: “As laid down by the House of Lords over a century ago in the case of *Derry v Peek*, a person is liable in this tort only if he or she knew the statement being made was false or did not care whether it was true or false” See *Derry v. Peek* (1889) 14 App. Cas. 337. For a detailed analysis see J CARTWRIGHT, *Misrepresentation, Mistake and Non-Disclosure*, (London: Sweet and Maxwell, 2007), para. 5.13 ff.

⁴⁴ DAVIES, at 16.

false or being reckless in this regard, the maker of the statement is liable only if he or she intended the recipient for the statement (or a class of person of whom the recipient was one) to rely on it.⁴⁵

In a seminal English case *Scott v Brown, Doering, McNab & Co*, [1892] 2 Q.B. 724 (C.A.)⁴⁶ is stated: “an agreement to cheat the public by leading them to believe the shares had a value, which the plaintiffs and defendants knew they had not, and thus inducing them to become purchasers. Is such a transaction illegal? I am of opinion that it is, and might be made the subject of an indictment for conspiracy.”⁴⁷ In this Opinion it was irrelevant that the deception had been carried out by deeds, rather than words: “I can see no substantial distinction between false rumours and false and fictitious acts; the price of the shares in this case was artificial, and the premium unreal and nominal, to the knowledge of all parties concerned, put forward to induce the public to take shares, with which otherwise they would have had nothing to do.”⁴⁸

⁴⁵ *Ibidem*.

⁴⁶ *Scott v. Brown, Doering, McNab & Co.*, [1892] 2 Q.B. 724, 730 (C.A.) recognized that “manipulation can occur without the dissemination of false statements”, quoted approvingly in *Schreiber v. Burlington Northern, Inc.*, 472 U.S. 1, 7 n.4 (1985). See also *Berkowitz v. Lyons*, 119 A. 20, 22 (N.J. 1922) which involved the fraudulent sale of a stolen automobile: “want of ownership and actual misrepresentations of fact are not the sole basis of actionable fraud, since the deceit and fraud practiced can as well effectuate its baneful purpose by conduct as it can by words.” 119 A; see *Pennebaker v. Kimble*, 269 P. 981, 984 (1928); 269 P.2d at 984: “To communicate a representation, it is not necessary that the party should speak words or write a message. The desired result may be accomplished oft times by conduct.”; see *Brief of the American Association for Justice as Amicus Curiae in support of Petitioner, No. 06-43, In the Supreme Court of the United States, Stoneridge Investment Partners LLC, Petitioner v. Scientific-Atlanta, Inc. and Motorola, Inc., Respondents*, June 11, 2007 (http://www.scotuswiki.com/index.php?title=Stoneridge_v._Scientific-Atlanta), at 13.

⁴⁷ *Id.* at 730 (Lopes, L.J.).

⁴⁸ *Id.* at 730-31.

The House of Lords has recently reaffirmed the authority of *Scott v. Brown, Doering in Norris v. United States of America*, a price-fixing agreement case⁴⁹. The *Norris* opinion outlined that advancing one's own commercial interests by false and fictitious acts is not sufficient to be held liable for fraud. It needs the aggravating features of the malicious or wrongful objective of injuring the plaintiff. Far from any exclusion of any non-speaking actors liability, the problem is the positive allegation of such requirements.

The German BGB supplies a joint and several liability for tortfeasor collaboration, assistance and encouragement in his *Mittäterhaftung* (§ 830 BGB). Section 830, par. 2 constitutes a general basis for joint and several liability in tort. According to the German tort system, recovery for pure economic losses requires a subjective right infringement (§ 823 BGB) or an intentional harm *contra bonos mores*, as a conscious violation of normal business practices (§ 826 BGB *sittenwidrigen Schädigung*)⁵⁰. Liability of secondary actor does not

⁴⁹*Id.* [2008], UKHL, 16, at 6, the case involved the distinction between strict liability and fraud. On the subtle boundary dividing the two concepts, M. COESTER, B. MARKESINIS, *Liability of Financial Experts in German and American Law: An Exercise in Comparative Methodology*, 51 *Amer. J. Comp. L.* 275 (2003). The House of Lords has underlined in *Norris* case the authority of *Mogul Steamship Co Ltd v McGregor, Gow & Co* [1892] AC 25: it was accepted that the defendants had acted to advance their own commercial interests, and with no malicious or wrongful object of injuring the plaintiff company, although their gain was inevitably its loss. In the absence of any aggravating feature such as misrepresentation, compulsion, intimidation, violence, molestation or inducement of breach of contract, the defendants' conduct would not have been unlawful if done by a single independent party and was not rendered unlawful by their combination. Even if a restraint of trade, the defendants' agreement was at most void and unenforceable, not actionable or indictable.

⁵⁰ P. CATALA, A. WEIR, *Delict and Torts: A Study in Parallel*, (1965) 39 *Tul. L. Rev.* 701, 780; M. REIMANN, in: M. BUSSANI, V.V. PALMER (eds.), *Pure Economic Loss in Europe* (2003), p. 200 ff. The role played by Codes of Conduct (adopted by listed companies) in determining the good practices is investigated by GOULDING, MILES, SCHALL, *Judicial Enforcement of Extra-legal Codes in U.K. and Germany Company Law*, (2005) *Eur. Comp. Fin. L. Rev.*, 2005, I, 49 ff..

require the evidence of his exact knowledge of potential damages or victims but a general awareness of the unlawful goal shared by the parties involved in the scheme is sufficient. Although the correctness of both solutions (§ 823 or § 826 BGB) is discussed, the last one seems more appropriate than the first; as the majority of commentators observed, German Securities Trading Act (“WpHG”) improved full disclosure as a public interest, not as a “subjective right” to financial transparency.

In the application of § 826 BGB German courts are strongly influenced by criminal law doctrines⁵¹. As a result, since the third party in *Stoneridge* consciously promoted unlawful activities or participated in scheme implementation, its behavior could be considered substantially equivalent to issuer misrepresentation⁵².

5. Aiders and abettors liability: a new matter for Congress

Following the recent U.S. Supreme Court ruling *Stoneridge Investment Partners v. Scientific-Atlanta*,⁵³ U.S. Senator Arlen Specter (D-PA) introduced *S. 1551: Liability for Aiding and Abetting Securities Violations Act of 2009*⁵⁴. It would amend the Section 20 of Securities Exchange Act of 1934 to subject to liability in a private

⁵¹About *Deliktsrechtliche Täterschaft und Teilnahme*, see O. FLEISCHER, at 268.

⁵²This conclusion is reached by O. FLEISCHER, at 273; N. BRUTTI, *Responsabilità per danni agli investitori e “scheme liability”*, 9, *Resp. civ. Prev.*, (2008), 1943; the damages suffered by defrauded investors are consistent with “pure economic loss” doctrine, see E.K. BANAKAS (ed.), *Civil Liability for Pure Economic Loss* London, The Hague, Boston, 1996; M. BUSSANI, V.V. PALMER (eds.), *Pure Economic Loss in Europe*, Cambridge, 2003.

⁵³ See also *Ashcroft v. Iqbal*, 556 U.S., 129 S. Ct. 1937 (2009), a case in which the United States Supreme Court held that top government officials were not liable for the actions of their subordinates absent evidence that they ordered the allegedly discriminatory activity.

⁵⁴Senator Patrick Leahy (D-VT), chairman of the Senate Committee on the Judiciary, submitted a statement that clearly suggests that he is in favor of a change in the law. Among other things, his statement declared:

civil action any person that knowingly or recklessly provides substantial assistance to another person (aids and abets) in violation of such Act.

The measure would overturn *Stoneridge* and embrace a private cause of action against those who knowingly aid and abet a fraud - whether law firms, accountants, or investment advisors.

At a hearing September 17, 2009 held by the Senate Judiciary subcommittee on crime and drugs Columbia, Professor John Coffee, Jr. supported the measure albeit urging caps on damages for secondary tortfeasors. In fact, the fairness and justice of a legal rule must be questioned when its effect is to place full liability on a defendant who may have been only marginally at fault, and to provide full compensation to a plaintiff who is able to find one on whom to fix the blame for the loss.⁵⁵

Giving the plaintiffs' bar aiding-and-abetting authority would offer class action lawyers one more weapon with which to shake down settlements⁵⁶.

"Today's hearing focuses on yet another case where the Supreme Court has misinterpreted the clear intent of Congress. This important hearing will examine laws designed to deter and punish those who assist and participate in fraud schemes. In the wake of scandals like Enron, the Madoff case, and the widespread financial fraud that contributed to our current economic crisis, we need to start holding those who take part in fraud accountable. I have long supported efforts to ensure that we give our Federal agencies the tools they need to help address fraud. The Supreme Court has made this issue more difficult to address in the wake of their divided decision in *Stoneridge v. Scientific Atlanta*." See *Liability For Aiding And Abetting Securities Violations – Will Congress Act?* Submitted by S. MEYEROWITZ, 12 Oct. 2009, (www.financialfraudlaw.com).

⁵⁵ Australia, *Inquiry into the Law of Joint and Several Liability*, Report of Stage Two, January 1995, p. 33 quoted by *Report of the Standing Committee on Banking, Trade and Commerce- Joint and Several Liability and Professional Defendants: Options. Discussion Paper*. October 1997, Part. II, in *Journals of the Senate*, October 22, 1997.

⁵⁶See, Statement of Prof. A.C. PRITCHARD, *Before the Committee on the Judiciary, Subcommittee on Crime and Drugs United States Senate, Evaluating S. 1551: The Liability for Aiding and Abetting Securities Violations Act of 2009*, September 17, 2009,

The desirability of a limitation of liability (cap provision or proportionate liability) is demonstrated by the *Stoneridge* case. Here, although respondents participated in transactions representing less than 4% of the artificial inflation alleged, the petitioners seek to hold respondents liable for all alleged shareholder losses – approximately \$7 billion⁵⁷.

For this reason defendants might be afforded some protection by proportionate liability, 15 U.S.C. but the effect of that provision is reduced substantially by the exceptions for intentional fraud and the insolvency of other defendants⁵⁸.

6. Myths of transparency: against a formalistic approach

As fictitious acts and transactions were traditionally used to create a false appearance of insolvency to defraud creditors, the same goal is achieved in modern securities markets by creating a false appearance of prosperity through schemes and manipulations to defraud shareholders.⁵⁹

The securities trading laws' fundamental purpose is to promote full disclosure. This aim is pursued principally through a special statutory liability regime that charges certain actors with mandatory disclosure, without precluding tort remedies⁶⁰. When transparency purpose can easily be circumvented through polymorphous machinations,

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⁵⁷ See, *Brief of Organization for International Investment*, at 12.

⁵⁸ See, A.C. PRITCHARD, at 4. See *PSLRA*, 15 U.S.C. § 78u-4(f)(2)(A).

⁵⁹ See for a historical perspective, C. ROSS, *Elizabethan Literature and the Law of Fraudulent Conveyance*, Aldershot, 2003; see also F. FERRARA, *Della simulazione dei negozi giuridici*, 1922, Roma, 149 ss.; M. BARBERIS, *L'azione di dolo e il concorso della responsabilità di terzi*, (*Il Diritto Commerciale*, 1911, Vol. III, s. 2, n. 8); A. GAMBARO, *Revocatoria fallimentare e simulazione del prezzo*, *II Riv. Dir. Comm.*, 1979, 71 ss..

excluding other legal means could turn into a lack of protection for disgruntled investors. Furthermore, this statutory interpretation might sound like a misunderstood (somehow mythicized) financial transparency⁶¹.

Is it possible that investors rely on something unknown? The answer might be positive, since a scheme to defraud shareholders must not come into light, but needs to be kept secret. Otherwise it would be a nonsense.

However, leaving investors to their rights in the tort of deceit is a ineffective solution; indeed bringing successfully an action against non-speaking-actors and demonstrating their liability seems extremely difficult.⁶² A better solution is represented by a statutory tort provision that introduces liability (maybe capped or proportional) for aiders and abettors. Its success depends widely on the introduction of strong

⁶⁰ See O. FLEISCHER, at 273: “Empfindliche Schutzlücken werden durch die Verneinung einer Dritthaftung nicht aufgerissen, weil Ansprüche aus vorsätzlichen unerlaubten Handlungen nach §§ 37b, Abs. 5, 37 c Abs. 5 WpHG unberührt bleiben. Dazu gehören namentlich Ansprüche gegen Anstifter und Gehilfen nach §§ 826, 830 Abs. 2 BGB.” See BGH v. 11.7.1988-II ZR 243/87, BGHZ 105,121 (134)=AG 1988, 331; in Italy, see Trib. Milano, 14.2.2004, *Foro it.* 2004, I, 1567 (granting investors’ claims for damaged suffered by insider trading practices); Trib. Napoli 2.4.2003, n. 2953 (www.adusbef.it/consultazione.asp?Id=680&T=S) on bank (and officers) liability for artificial inflation of securities price.

⁶¹For a critical approach to the new “authoritative transparency” as ineffective, see P. SALIN, M. LAINE, *Les myth de la transparence imposée*, *JCP E. Semaine Juridique*, n° 45-46, 2003, 1800-1805; about cognitive shortcomings and bounded rationality, see C.R. SUNSTEIN, R. THALER, *Libertarian Paternalism*, in C.R. SUNSTEIN, *Laws of Fear. Beyond the Precautionary Principle*, Cambridge, 2005, 182: “We have seen that people use heuristics that lead them to make systematic blunders, and they make different choices depending on the framing of the problem.”

⁶² “Moreover in the European Union the Member States can still impose a private cause of action against aidors and abettors for the violation of the respective provisions of the applicable directives in their national law...Due to the limited approach of the applicable directives both problems cannot be solved under the current European capital market law regime.” HILLGARD, MOCK, at 569.

inference of scienter (or recklessness) requirement, fraud-on-the market doctrine and class action suit⁶³.

⁶³ See HILGARD, MOCK, at 569 ff.: “Core features of the U.S. system such as class actions, punitive damages and discovery are not known in Europe”; on deterrence function, see also PRITCHARD, at 6: “A better damages rule would focus on deterrence rather than compensation. Instead of making defendants liable for all losses resulting from misstatements, we should instead force defendants to disgorge their gains (or expected gains, for those who fail in their scheme) from the fraud.”