Testimony of
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on
Barriers to Justice and Accountability: How the Supreme Court's Recent Rulings Will Affect Corporate Behavior

My name is James D. Cox. I am Brainerd Currie Professor of Law, School of Law, Duke University where my research and teaching focuses on securities and corporate law. Prior to joining the Duke faculty in 1979, I taught at Boston University, University of San Francisco, University of California, Hastings College of the Law, and Stanford University School of Law. I am currently a member of the Standing Advisory Group of the Public Company Accounting Oversight Board, the Committee of Corporate laws of the Business Law Section of the American Bar Association and, in the past, I was a member of the New York Stock Exchange Legal Advisory Committee and the National Association of Securities Dealers Legal Advisory Board. Among my publications are Securities Regulations: Cases and Materials (6th ed. Aspen 2009)(with Langevoort and Hillman), which has been adopted in approximately two-thirds of American law schools, and a multi-volume award winning treatise, The Law of Corporations (3d ed. 2010)(with Hazen).

I submit this statement and appear before the Senate Judiciary Committee on behalf of no organization and the costs incurred in connection with my appearing before this committee are being borne entirely by me. The views expressed in this statement and my testimony are my own and are not on behalf of any of the above-named organizations.

I. Perverse Consequences

No principle is more ingrained in western civil and criminal law than that individuals and entities that wrongfully and proximately harm another should bear the consequences of their misconduct. The principle of responsibility to others is drilled into first year law students in their standard courses of study- torts, property, criminal law and contracts. Thereafter, the link between duty and proximate harm is a linchpin for much of our daily applications of the law whether in private or public settings. However, a perusal of law reports reflects that this principle does not apply when the misconduct is securities fraud. A few cases (each influenced by *Central Bank* and *Stoneridge*) illustrate this outlier characteristic.

> Corporations whose executives knowingly prepared false documents to conceal from their customer's auditors that $17 million dollars in the customer's revenues were fraudulent "roundtrip transactions" and did so to retain the customer as a client are not responsible to investors who purchased the customer's shares at prices inflated due to the fraudulent roundtrip transactions. *Stoneridge Investment Partners, LLC. v. Scientific-Atlanta, Inc.*, 552 U.S. 148 (2008).

> The president of a newspaper subsidiary who fraudulently inflates the number of subscribers and revenues for the subsidiary is not liable to those who purchased the

parent company's shares at prices inflated as a consequence of the president's reporting chicanery having been incorporated into the consolidated financial statements issued by the parent. *Pugh v. Tribune Co.*, 521 F.3d 686 (7th Cir. 2008).

The outside lawyer who on 17 different occasions engineered on behalf of the client (Refco) fraudulent sham transactions for the purpose of concealing in various offering documents that the client firm had massive trading losses and was unable to repay millions of dollars due on margin was not liable as a primary participant to investors who suffered significant losses upon the ultimate bankruptcy of Refco. *Pacific Investment Management Company LLC v. Mayer Brown* LLP, 603 F.3d 144 (2010).

The CEO who falsely represents facts in a letter to the firm's auditor so as to prevent the auditor from pursuing confirmations that would have uncovered the chain of defalcations carried out by the CEO, so that the auditor, in reliance on the CEO's letter, issued an unqualified opinion, is not liable to the investors for their losses when the CEO's fraudulent acts were disclosed and the stock became worthless. *In re Nature's Sunshine Products Sec. Litig.*, [2008 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,846 (D. Utah 2008).

The above cases are leading cases in this area, but they are not aberrations. Indeed, each of the above cases is consistent with this month's Supreme Court decision, *Janus Capital Groups, Inc., v. First Derivative Traders,* 2011 WL 2297762 (S. Ct. 2011). The issue in *Janus Capital* was whether the investment advisor who prepared the prospectus issued by Janus

Investment Fund was responsible for misstatements contained in the prospectus. The divided (5 to 4) court held that the advisor 'did not "make" any of the statements in the Janus Investment Fund prospectus.' The court supports its conclusion with the analogy to the relationship of speechwriter and a speaker where the court concludes that "[e]ven when a speechwriter drafts a speech, the content is entirely within the control of the person who delivers it. And, it is the speaker who takes credit – or blame – for what is ultimately said." However, the analogy fails. When a speech is delivered it is delivered by a human being; a corporation is not such a being and can only act through individuals and then can act only through the symbiosis of the entity structure or structures by which the entity operates. Thus, financial reports pass through multiple individuals, each of which provides the voice to the inanimate corporate entity. The reasoning of *Janus Capital* is that none of these actors makes a statement as the statement can only be understood to have been made by the entity, which, of course, is powerless to make any statement.

II. How Did We Get Here?

Central Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164 (1994), stunned the securities and litigation bar in holding that aiding and abetting liability did not exist under the securities law antifraud provision, section 10(b) and Rule 10b-5. Prior to *Central Bank* every circuit not only had recognized aiding and abetting liability, but had done so for decades! Indeed, the petition seeking Supreme Court review did so not on the broad question of whether there was aiding and abetting liability, but on the narrower question of whether there could be *reckless* aiding and abetting liability for *inaction.* In granting certiorari petition for review, the court asked the parties to brief the broader question, whether there was aiding and abetting liability.

Central Bank likely reflects the wisdom of the observation, "bad cases make bad law." *Central Bank* dealt with a complaint that a bond trustee was reckless in failing to provide an updated appraisal of real estate values securing the indenture. The plaintiffs alleged that, had the appraisal been undertaken earlier than it was, the indenture covenants would have prevented further issuances of the bonds, and the investors who purchased the bonds would not have suffered the loss that ultimately occurred when the commercial venture failed. *Central Bank* was therefore a case where the alleged "assistance" to the primary violator was through *inaction* not affirmative steps of assistance. Inaction aiding and abetting cases were always problematic and more so when the inaction was alleged to be reckless. *See e.g.,* David Ruder, Multiple Defendants in Securities Law Fraud Cases: Aiding and Abetting, In Pari Delicto, Indemnification, and Contribution, 120 U. Pa. L. Rev. 597 (1972).

As decided, *Central Bank,* even though rejecting aiding and abetting, nonetheless appeared relatively open ended stating that the ultimate prohibition of the antifraud provision reached "the making of a material misstatement (or omission) or the commission of a manipulative act." One passage of *Central Bank* suggests some breadth to this inquiry by observing:

> The absence of §10(b) aiding and abetting does not mean that secondary actors in the securities markets are always free from liability under the securities acts. Any person or

entity, including a lawyer, accountant, or bank, who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable.

However, both *Stoneridge* and *Janus* relied on a passage of *Central Bank* where the court reasoned that a critical link to defining who is a primary participant under the antifraud provision is through the causation requirement of reliance, i.e., a central element of an antifraud case is an allegation of reliance on the statement made by the defendant. As applied in *Stoneridge* and *Janus*, as well as the other cases set forth in the cases summarized above, the major constraint for determining whether a party "makes" a false statement is not whether the statement is one relied on by the investor but rather whether the investor has relied on the *defendant as the maker* of that statement. If the false statement is conceived and drafted by the defendant, but does not bear the defendant's name or otherwise identify the defendant cleanly *as its maker*, the defendant is not a primary participant and, hence, has no responsibility to the defrauded investor.

III. What are the Consequences of *Stoneridge* and *Janus*?

In the wake of *Stoneridge* and *Janus,* executives and their counselors who cook the books and defraud investors avoid personal responsibility so long as the product of their chicanery does not bear their name (even though it bears their footprints). Vendors, such as those in *Stoneridge,* who cooperate in their client's fraud so as to retain the client's business escape responsibility for the losses their complicity caused investors. If they seek the advice of their counsel or others whether to participate in a fraudulent roundtrip scheme, such as occurred in *Stoneridge*, their advisors can correctly advise that the consequences of liability under the securities laws are nonexistent so long as their names are not directly linked to the falsely inflated revenues. This hardly adds to the deterrent effects of the antifraud provision. Similarly, the CEO or CFO who needs to "meet the street's expectations" or wishes to pump up her bonus or option's value has much less concern for retribution via private suits if the means to this end is cooking the books. Stated simply, but correctly, *Stoneridge* and *Janus* severely reduce the deterrent effects of the antifraud provision.

IV. Further Perverse Effects

By providing a pass to those who engineer and carryout the fraud, *Stoneridge* and *Janus Capital* create additional public policy concerns. First, there is the so-called "circularity problem" that is more prevalent when the defendant company enjoys a large institutional ownership. Circularity refers to the fear that when securities fraud settlements are paid entirely by the company itself that there is no net gain to the class members since the funds they receive in the settlement flows from the very company in which the institutions (and other investors) continue to maintain an ownership interest. Circularity does not arise, however, when funds flow from individuals, e.g., officers, directors, counselors, auditors, and other entities. However, to the extent (and it is substantial as we have seen) that *Stoneridge* and *Janus Capital* each make personal responsibility unavailable, this creates the concerns that securities class actions entail circularity and, therefore, are not optimal because these decisions enhance the risk of circularity by removing individuals from the scope of liability. A second concern arises from contribution claims. The corporation issuing the false report is the most entity most likely to be held liable under *Stoneridge* and *Janus Capital.* However, its ability to obtain contribution from the wrongful actors is compromised by the narrow definition of primary participant embraced by *Stoneridge* and *Janus Capital.* The party more likely to be aggrieved by this lack of contribution claim is the firm's accountants who cannot obtain contribution through the antifraud provision if the senior management is shielded by *Stoneridge* and *Janus Capital.* Again, we see that the unduly and unreasonable definition of primary participants leads to unacceptable results, namely *Stoneridge* and *Janus Capital* do not permit responsibility to be cleanly and logically placed upon those who are responsible for defrauding investors. The shield thus provided substantially weakens, if not totally eviscerates, the deterrent effect of the antifraud provision.