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Dusting Off the Common Law

Plaintiffs turn to agency and respondeat superior in an attempt to hold 'non-speakers' liable for securities fraud.

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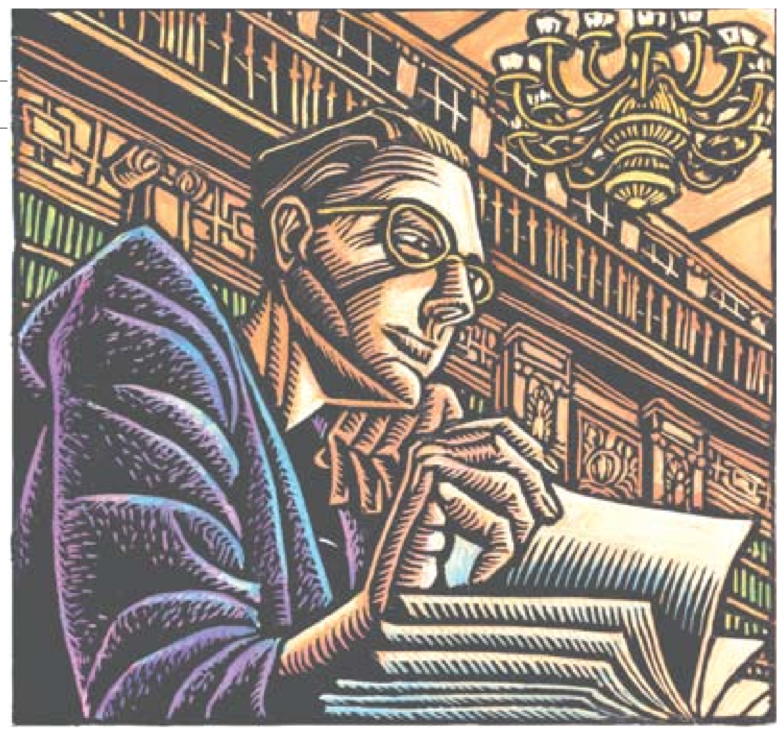

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WITH INCREASING frequency, plaintiffs in federal securities fraud cases have been dusting off and employing traditional common law agency and respondeat superior theories in an attempt to reach defendants who are not otherwise alleged to have made any misleading statements or omissions. According to this theory, notwithstanding the U.S. Supreme Court's seminal decision in *Central Bank*—which eliminated aiding and abetting liability in securities cases—a "non-speaking" defendant may potentially be held liable under the federal securities laws for the statements of another individual or entity if the plaintiff can show that the speaker was an agent of the non-speaker.

In several recent cases plaintiffs have invoked these theories in asserting federal securities claims against entities that had designated or elected individuals to another corporation's board of directors, arguing that the false or misleading statements allegedly made by the designated directors should be attributed under common law agency principles to the entity that designated the directors.

This issue, therefore, has broad implications for entities, including private equity funds and corporations, that elect or designate directors—often their own directors or high-level officers—to the boards of directors of former portfolio companies or subsidiaries that have gone public. This article discusses recent developments in this area and several recent decisions addressing this topic.

Background

Under §10(b) of the Securities Exchange Act of 1934 (Exchange Act), an d Rule 10b-5(b) promulgated under the Exchange Act, in order for a plaintiff to recover in a private securities fraud action, the plaintiff must allege that the defendant made a materially false statement or omission in connection with the purchase or sale of a security, with scienter (i.e., an intent to defraud), and that the plaintiff's reliance on the defendant's statement or omission caused injury to the plaintiff.

Prior to the Supreme Court's 1994 holding in *Central Bank*[1] that §10(b) and Rule 10b-5(b) reaches only "primary violators," and not individuals who aid and abet the violation,

According to this theory, notwithstanding 'Central Bank,' a 'non-speaking' defendant may potentially be held liable for the statements of another individual or entity if the plaintiff shows that the speaker was an agent of the non-speaker.

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virtually every federal circuit accepted some version of agency or respondeat superior liability in the federal securities context.

In essence, under traditional common law principles, a master may be held liable for the acts of its agent where the master controls the actions of the agent. Likewise, under the common law doctrine of respondeat superior, an employer may be held liable for any wrongful acts committed by its employee, if such acts were undertaken within the scope of the employee's employment.

Thus, if an agent or an employee made a false or misleading statement that otherwise met the elements of a §10(b) claim, and such statement was made within the scope of his agency relationship or employment, the master or the employer could potentially be liable under §10(b) for the agent's or employee's misleading statement.

In the wake of the *Central Bank* holding there was some initial uncertainty as to whether common law theories of agency and respondeat superior liability were still available under §10(b) and Rule 10b-5(b).[2] In particular, several courts questioned whether such theories could be squared with *Central Bank*'s apparent mandate that "a defendant must actually make a false or misleading statement in order to be held liable under Section 10(b) [and] [a]nything short of such conduct is merely aiding and abetting."[3]

The prevailing (but not definitive) view today is that these common law theories may still be applied to securities fraud cases, and plaintiffs are pursuing such claims as one avenue to reach deep pockets.[4]

But Why Use Agency Claims?

A plaintiff asserting securities fraud claims under common law agency principles must establish that the master controlled the alleged agent. Thus, at first blush, one may question why a plaintiff would pursue such claims when the control person provisions of the federal securities laws appear already to provide for similar liability.

In particular, §20 of the Exchange Act and §15 of the Securities Act of 1933 (Securities Act) each provide an express cause of action against any entity or individual that controls any person liable under any provision of the Exchange Act or under §§11 and 12 of the Securities Act, respectively.

The answer apparently lies in the differing standards for pleading federal control person claims versus agency-based securities claims.

Specifically, numerous federal courts have held that control person claims under §20 of the Exchange Act generally require a showing (and, at the pleading stage, well-pled allegations suggesting) that the alleged controlling person or entity was in "some meaningful sense a culpable participant" in the underlying misconduct of the controlled person or entity.[5]

Moreover, many of these courts hold that culpable participation must be pled with the heightened specificity required for claims of fraud under both Rule 9(b) of the Federal Rules of Civil Procedure (FRCP) and the heightened standards for pleading fraud under the Private Securities Litigation Reform Act of 1995 (PSLRA).

In contrast, plaintiffs proceeding on common law agency or respondeat superior theories of securities fraud have, at least in some cases, been required simply to plead a short and plain statement of a theory upon which a fact-finder could conclude that the agents or employees were acting within the scope of their alleged agency or employment at the time the allegedly fraudulent statements were made. In other words, at least according to some courts, the pleading standards of Rule 8 of the FRCP, and not the stricter pleading requirements of Rule 9(b) and the PSLRA, will govern the agency-based allegations, unless the allegations of the agency are so intertwined with the allegations of the fraud that the agency relationship is itself part of the fraud.

Additionally, the control person provisions of the federal securities laws provide affirmative defenses that may not necessarily be available where a plaintiff pursues an agency-based claim for securities fraud.

In particular, under §20(a) of the Exchange Act, a controlling person is absolved of any liability if the controlling person "acted in good faith and did not directly or indirectly induce" violation of the securities laws.[6] Similarly, §15 of the Securities Act eliminates control person liability if "the controlling person had no knowledge of or reasonable ground to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist."[7]

Thus, it is possible that by bypassing the conventional control person provisions of the federal securities laws, and instead pursuing agency-based securities claims, plaintiffs may avoid these affirmative defenses.

Recent Cases

As several recent decisions demonstrate, even if the heightened pleading standards of FRCP Rule 9(b) and the PSLRA do not apply to agency-based securities claims, plaintiffs seeking to apply these common law theories to federal securities fraud may have difficulty pleading (and at trial proving) that the alleged agent or employee was in fact acting within the scope of the alleged agency or employment relationship.

In that regard, several courts in recent decisions have evinced a reluctance simply to accept conclusory allegations that the speaker of allegedly misleading statements was acting as an agent or employee of another entity or individual. Rather, courts are requiring concrete factual allegations suggesting control over the alleged agent by the principal.

For example, in *In re Global Crossing Securities Litigation* (*Global Crossing I*), plaintiffs claimed that Microsoft Corporation and Softbank Corporation should be held vicariously liable under the federal securities laws for several allegedly false statements made by various directors appointed, respectively, by Microsoft and Softbank to the board of directors of a Global Crossing subsidiary, Asia Global Crossing.[8]

The *Global Crossing* plaintiffs theorized that because a corporation can act only through its human agents, the appointed directors' statements should be attributed to the corporations who had appointed them. This theory depended, however, on the notion that when the allegedly false statements were made, the appointed directors were acting within the scope of their employment by the corporation that had appointed them, and not acting independently as directors.

Judge Gerard Lynch found in *Global Crossing I* that the allegations against Microsoft and Softbank did not sufficiently plead facts showing that the appointed directors were acting as the agents of Microsoft or Softbank when they were performing their duties as directors of Asia Global Crossing. And, recognizing the principle that directors are presumed to be acting independently of the particular shareholder who nominated or appointed them—particularly given that a director's fiduciary duties run to all shareholders and not just the shareholder that appointed the director—the court rejected the notion that the mere appointment of employees as directors of another company sufficed to allege control over those individuals acting in their capacity as directors. Thus, the court concluded that there was no basis upon which to allow the agency-based claims to survive the motion to dismiss.

The *Global Crossing* plaintiffs also brought agency-based securities law claims against Canadian Imperial Bank of Commerce (CIBC) and CIBC World Markets. Citing its decision in *Global Crossing I*, the court in a subsequent decision (*Global Crossing II*) applied its earlier analysis and rejected the plaintiffs' attempt to hold CIBC and CIBC World Markets liable on a respondeat superior theory for allegedly false and misleading statements signed by CIBC's designees on the Global Crossing board of directors.[9]

In particular, the court once again gave credence to the presumption that directors are independent of the person who nominated or appointed them. Notably, while Judge Lynch found the particular allegations before him wanting, the court did not dismiss the agency theory out of hand, but rather found that such a theory would require specific factual allegations to establish the agency relationship, essentially requiring allegations sufficient to overcome the presumption that the directors were acting as directors on behalf of all Global Crossing shareholders, and not as employees of CIBC, at the time the allegedly fraudulent statements were made.

In another recent case in the Southern District of New York, the plaintiffs in *In re Alstom SA Securities Litigation* advanced an agency theory in the context of a claim for securities fraud liability.[10] The *Alstom* plaintiffs claimed that the defendant Alstom and several of its officers fraudulently concealed millions of dollars of costs incurred by a subsidiary (ATI) in connection with contracts to build train cars, including for New Jersey Transit.

In an earlier decision, the *Alstom* court, noting that principals may be held liable under the federal securities laws for the acts of their agents, had rejected the plaintiffs' effort to plead such an agency claim because of the plaintiffs' failure to plead sufficiently any agency relationship between Alstom, ATI, and another Alstom subsidiary, Alstom USA, Inc. (Alstom USA).

In an amended complaint, the *Alstom* plaintiffs alleged that Alstom and Alstom USA should be held liable for ATI's fraud under an agency or respondeat superior theory on the basis of allegations that Alstom and Alstom USA dominated and controlled ATI, including by, for instance, disregarding corporate formalities.

Examining the substance of plaintiffs' allegations, the court found that the plaintiffs' allegations of dominance and control actually stated a veil-piercing, or alter ego, theory of liability, as opposed to any agency or respondeat superior claim. In so doing, the court rejected the defendants' arguments that agency principles cannot be applied in the securities law context.

The court also considered and rejected the defendants' contention that use of these agency principles would allow plaintiffs to bypass required inquiry into the principal's scienter as well as the argument that theories of agency liability impermissibly conflict with the control person provisions of the Exchange Act.[11]

Settlement Issues

The theory upon which a plaintiff elects to pursue a securities fraud claim against a non-speaker can also have implications for settlement of the underlying claims against the alleged agent or employee. A recent *Global Crossing* decision (*Global Crossing III*) illustrates this point.[12]

The *Global Crossing* plaintiffs reached a settlement with the individual employees who had been appointed directors of Asia Global Crossing by Microsoft and Softbank. While the settlement agreement fully released all claims against the employees, it expressly reserved all rights against the non-settling defendants, including Microsoft and Softbank. When the *Global Crossing* plaintiffs then sought leave to amend their allegations against Microsoft and Softbank, the court did not permit them to do so as to the securities claims based on respondeat superior.

Applying the common law rule that settlement with an employee extinguishes the liability of the employer on a respondeat superior theory, the court rejected what it characterized as the plaintiffs' attempt to ignore the limits of the common law doctrines they sought to import into the context of the federal securities laws.

The court held that where, as in the respondeat superior claim, Microsoft's and Softbank's liability was entirely derivative of their employees' alleged liability, the settlement of the underlying claims left no claim against the principals. As the court explained, the rationale for this result is that "the employee and the employer are treated as a single unit for the assignment of responsibility among the alleged tortfeasors."

The court further noted the significance of this in the context of the federal securities laws, where the PSLRA's judgment reduction and proportionate share rules apply. After the employee settles, there is no longer any share of responsibility that could be attributed to the non-settling employer.

Thus, the release of the claims against the employees was a de facto release of the claims against the employers, at least as to the respondeat superior claims. However, where the companies were alleged to have been independently liable to the plaintiffs, as in the statutory control person claims, the settlement of the underlying claims did not prohibit the further pursuit of control person claims against the principals.

Conclusion

While it is often desirable from a business perspective to appoint directors to another company's board, care should be taken to avoid even the appearance of control over the actions of the appointed directors when they are acting in their director capacity.

Although directors are allowed to "wear two hats" in many situations, such appointments are not risk-free to the company appointing such directors. Adherence to the strictures of director independence, and avoidance of even the appearance of a conflict, will stand both the appointed directors and the appointing party in good stead.

1. *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994).

2. See *ESI Montgomery County, Inc. v. Montenay Int'l Corp.*, 1996 WL 22979, at *3 (S.D.N.Y. Jan. 23, 1996) (holding that respondeat superior liability was no longer available under Section 10(b) in light of *Central Bank*).

3. *Wright v. Ernst & Young LLP*, 152 F.3d 169, 175 (2d Cir. 1998) (internal quotations omitted) (summarizing *Central Bank*).

4. See, e.g., *Suez Equity Investors L.P. v. Toronto-Dominion Bank*, 250 F.3d 87, 101 (2d Cir. 2001) (indicating that allegations that a principal acted fraudulently through an agent remain a viable basis for primary liability after *Central Bank*).

5. See *Boguslavsky v. Kaplan*, 159 F.3d 715, 720 (2d Cir. 1998).

6. 15 U.S.C.A. §78t(a) (West 2006).

7. 15 U.S.C.A. §77o (West 2006).

8. *In re Global Crossing Sec. Litig.*, 2005 WL 1907005 (S.D.N.Y. Aug. 8, 2005) (*Global Crossing I*).----

9. *In re Global Crossing Sec. Litig.*, 2005 WL 2990646 (S.D.N.Y. Nov. 7, 2005) (*Global Crossing II*).

10. *In re Alstom SA Sec. Litig.*, 2006 WL 2819588 (S.D.N.Y. Sept. 29, 2006).

11. On a related note, plaintiffs in the *In re Parmalat Securities Litigation*, 375 F. Supp. 2d 278 (S.D.N.Y. 2005), presented an agency theory of vicarious liability of certain accounting firms for the allegedly fraudulent acts of their Italian affiliates. The *Parmalat* court found that the plaintiffs had successfully pled an agency relationship, and declined to reach plaintiffs' alter ego theory.

12. See *In re Global Crossing Sec. Litig.*, 2006 WL 1628469, at *4 (S.D.N.Y. June 13, 2006) (*Global Crossing III*).