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Senate Judiciary Committee Considers Two Bills That May Benefit Plaintiffs in Private Civil Litigation

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While most of the country focuses its attention on the national healthcare debate, Senator Arlen Specter (D-PA) recently proposed two new pieces of legislation that seek to roll back defense-friendly protections provided in several different United States Supreme Court opinions. These proposals are worthy of note because, if passed, the combined effect of this legislation may result in plaintiffs being able (1) to bring innocent parties into securities cases and (2) to maintain expensive lawsuits against these parties with only a paucity of factual detail.

Imposing Primary Liability upon Secondary Actors

The first such bill—the Liability for Aiding and Abetting Securities Violations Act of 2009 (S. 1551)—takes aim at *Stoneridge Investment Partners LLC v. Scientific-Atlanta Inc.* and *Central Bank of Denver v. First Interstate Bank of Denver*.[1] Until *Central Bank*, private litigants could sue aiders and abettors under Section 10(b) of the 1934 Securities Exchange Act.[2] After *Central Bank* and continuing with *Stoneridge*, the United States Supreme Court placed constraints on the parties against whom plaintiffs may file a civil securities litigation lawsuit, holding that plaintiffs may not maintain such lawsuits against "secondary actors" like auditors, bankers, business affiliates, and lawyers.[3]

The Senate Judiciary Committee is still reviewing S. 1551, but if Congress passes the bill, it will amend section 20 of the Securities Exchange Act of 1934 to authorize a private right of action against any individual or entity that "knowingly or recklessly provides substantial assistance" to securities fraud perpetrators.[4] This, in turn, may result in plaintiffs in securities fraud cases naming as defendants every possible secondary actor whom plaintiffs consider as accomplices (*i.e.*, aiders and abettors) to the alleged fraud.[5]

Although how the Senate will ultimately vote on the bill is unclear, Senator Specter's proposal is certain to generate a hotly contested political debate. Indeed, since the introduction of S. 1551, numerous individuals, including law professors, attorneys from the plaintiff and defense bars, and state regulators have expressed opinions both in support of and in opposition to the bill.

Building a Case in Support of S. 1551

Not surprisingly, state regulators have come out in support of S. 1551. A representative of the North American Securities Administrators Association testified at a recent Judiciary Committee hearing that the bill would effectively restore the ability of investors to seek damages from all parties that may have participated significantly in a fraud.

Attorneys who represent plaintiffs in securities cases also support S. 1551, calling it an important development for investors.

Espousing what he deems a midpoint compromise that may increase the bill's chances for success, securities law professor John Coffee has argued in support of the bill because of its deterrent effects, but he proposes establishing a ceiling on damages for any imposition of private liability upon third parties. Coffee testified that secondary defendants who stand to gain less than primary perpetrators might be deterred more easily without the threat of exposure to multi-billion dollar liabilities.

Efforts to Prevent S. 1551's Passage

Considerable opposition has emerged to S. 1551, including the U.S. Chamber of Commerce, which urged lawmakers to reject the bill because it would benefit securities class action plaintiffs at the expense of ordinary investors. Moreover, according to the President of the U.S. Chamber's Institute for Legal Reform, S. 1551 "will only slow our economic recovery, drag down investors' portfolios and retirement accounts, and delay the creation of much needed new jobs."

Other critics of S. 1551 also warn that the bill creates the potential to inject the securities laws into a wide range of ordinary commercial transactions, which, among other drawbacks, could deter overseas firms with no other exposure to U.S. securities laws from doing business here.

Adam Pritchard, a securities law professor at the University of Michigan, expressed concern during his testimony to the Judiciary Committee that passage of S. 1551 will hurt the competitiveness of U.S. capital markets and financial centers and expand the potential liability and litigation costs for third parties. Pritchard predicted that S. 1551 would lead to a sharp spike in securities class actions because it may incentivize plaintiffs to sue third parties with perceived deep pockets, with the hopes of extracting a huge settlement from someone. Indeed, even if a third party is successful at getting a case dismissed later for a lack of merit, this often only happens after spending considerable sums of money moving to dismiss the complaint or otherwise defending against the allegations.

Many defense attorneys oppose S. 1551, also arguing that its passage could hurt the competitiveness of U.S. markets by subjecting parties such as bankers, accountants, lawyers, and auditors to scores of frivolous lawsuits merely for doing business with or being connected to a company that is accused of securities fraud. Imposing the threat of liability for securities fraud on a third-party business partner based on another party's conduct creates an unworkable scenario for business relationships—indeed, investors cannot expect companies to examine the internal controls of every other company with which they do business.

Additionally, auditors have complained that the proposal seeks to impose obligations on accountants far beyond what is required in the profession under GAAP.

S. 1551 also suffers from drafting flaws. Nowhere in the proposal is the phrase "substantial assistance" defined, thereby opening the door to more litigation around that issue. Interpreted broadly, plaintiffs may argue that the phrase could encompass acts such as drafting public disclosures for company filings, opining on audited financial statements, and even entering into routine business contracts.

Despite all of its inherent flaws and the substantial opposition that has aligned against S. 1551, the current political and economic climates increase its chance of success. Of course, even if Congress passes S. 1551, any lawsuit brought under this amended provision of the Securities Exchange Act will

be subject to heightened pleading standards, the automatic discovery stay, and other features of the Private Securities Litigation Reform Act of 1995.

A Return to Notice Pleading

Senator Specter's other proposal—aimed at *Bell Atlantic Corp. v. Twombly* and *Ashcroft v. Iqbal*, U.S. Supreme Court cases released in the last two years—has generated far less discussion. Nevertheless, S. 1504—the Notice Pleading Restoration Act of 2009—threatens to have a far broader impact because it would apply to all civil lawsuits, not just private securities class actions.[6]

In *Iqbal*, the U.S. Supreme Court made it easier for defendants to terminate lawsuits before getting to discovery, often the most costly pre-trial exercise, by holding that plaintiffs must include in their initial pleadings substantial, not "threadbare," factual assertions that give "facial plausibility" to their claims.[7] The *Iqbal* decision built upon the Court's prior decision in *Twombly*, in which the Court first started shifting away from the traditional "notice pleading" standard that required only a short statement of the case against the defendant, to one requiring "plausible" factual detail.[8] *Twombly* rejected "notice pleading" as unworkable, reasoning that this loose standard subjected defendants to costly and burdensome discovery on the basis of little more than conclusory allegations.[9] Combined, these decisions toughened the standard plaintiffs must meet to prevent their claims from being dismissed at the pleadings stage.

When Senator Specter introduced S. 1504, he accused the U.S. Supreme Court of doing an "end run" around Congress to amend the Federal Rules of Civil Procedure with its opinions in *Twombly* and *Iqbal*.[10] If passed, S. 1504 may make it easier for plaintiffs to survive a motion to dismiss because it would return the pleading standards to the pre-*Twombly* status, *i.e.*, the simple "notice" pleading standard provided under Rule 8 of the Federal Rules of Civil Procedure and outlined by the U.S. Supreme Court in *Conley v. Gibson*.[11]

Supporters of S. 1504 argue that the *Twombly* and *Iqbal* decisions create a scenario under which courts will dismiss what could be meritorious claims based on subjective judgments about the evidence at the pleading stage. Indeed, courts have already cited the *Iqbal* decision close to 2,300 times, and the opinion has resulted in the early dismissal of innumerable lawsuits.

Moreover, proponents of S. 1504 argue that it is necessary because they are unable to gain access to enough facts to meet the heightened pleading standards the *Iqbal* and *Twombly* decisions impose. Plaintiffs complain that this thwarts their ability to file lawsuits that will withstand motions to dismiss.

Noted civil procedure expert Arthur Miller also supports S. 1504, calling the *Iqbal* decision "one of the biggest deals" he has ever seen. Even Justice Ginsberg has criticized the decisions, stating that the Supreme Court has "messed up the federal rules" governing pleading.

Opponents of S. 1504 believe the *Iqbal* and *Twombly* opinions should be left as is because they set the appropriate pleading standard and thereby weed out weak or frivolous lawsuits. No longer may plaintiffs file hollow lawsuits based on conclusory allegations in hopes that a company will settle the case rather than pay expensive discovery costs. Indeed, defense counsel report already that the *Iqbal* decision has slowed the filing of abusive lawsuits against corporate defendants.

Moreover, the *Iqbal* decision provides the secondary benefit of reducing the already overburdened federal court caseloads by purging frivolous lawsuits from the docket earlier. The Senate Judiciary Committee is currently reviewing S. 1504.

Paul Hastings will continue to monitor both S. 1551 and S. 1504's progress, and we will publish an update if Congress passes either bill.

If you have any questions concerning these developing issues, please do not hesitate to contact either of the following Paul Hastings Los Angeles lawyers:

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1 Senator Arlen Specter introduced S. 1551 on July 30, 2009; Sens. Edward Kaufman (D-DE), John Reed (D-RI), and Sheldon Whitehouse (D-RI) are co-sponsors of the bill.

2 511 U.S. 164 (1994).

3 522 U.S. 148 (2008).

4 S. 1551 would amend 15 U.S.C. § 78t(e) to include a new subsection (2), which would provide: "Private Civil Actions— For purposes of any private civil action implied under this title, any person that knowingly or recklessly provides substantial assistance to another person in violation of this title, or of any rule or regulation issued under this title, shall be deemed to be in violation of this title to the same extent as the person to whom such assistance is provided."

5 The Private Securities Litigation Reform Act of 1995 currently authorizes only the SEC to bring enforcement actions against aiders and abettors. Senator Specter argues that the SEC has proved to be no substitute for suits by private plaintiffs.

6 Senator Arlen Specter introduced S. 1504 on July 22, 2009; Senator Russell Feingold (D-WI) is the co-sponsor of the bill.

7 129 S. Ct. 1937 (2009).

8 550 U.S. 544 (2007).

9 Id.

10 S. 1504 would provide: "Except as otherwise expressly provided by an Act of Congress or by an amendment to the Federal Rules of Civil Procedure which takes effect after the date of enactment of this Act, a Federal court shall not dismiss a complaint under rule 12(b)(6) or (e) of the Federal Rules of Civil Procedure, except under the standards set forth by the Supreme Court of the United States in Conley v. Gibson, 355 U.S. 41 (1957)."

11 355 U.S. 41 (1957).

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