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### **Looney & Grossman** Practice Areas:

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### ONE YEAR AFTER REFCO: THE CONTINUING PROTECTION FOR LAWYERS AS “SECONDARY ACTORS” UNDER THE FEDERAL SECURITIES LAWS

By: Joseph S. Berman, Esq.

A recurring theme in the law of professional liability is whether lawyers are responsible for the misconduct or false statements of their clients. The issue arises in securities actions and has taken on more visibility in the wake of the Madoff scheme and similar scandals in the real estate market. In 2009, a federal court in New York held that secondary actors, such as attorneys, are not liable for “aiding and abetting” violations of federal securities statutes. In re Refco, Inc. Sec. Litig., 609 F. Supp. 2d 304 (S.D.N.Y. 2009). In the year since Refco, other courts have continued to insulate lawyers as “secondary actors.”

The Refco case continues a trend begun sixteen years ago. In Central Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164, 191 (1994), the Supreme Court held that “there is no private aiding and abetting liability under § 10(b)” of the Securities Act of 1934. The Court’s decision in Central Bank was predicated on a strict textual analysis of the statute where, the Court determined, Congress conscientiously decided not to provide a private cause of action against those who merely “aided and abetted” a manipulative or deceptive act within the meaning of § 10(b), such as where Central Bank allowed investors to rely on information that it knew to be suspicious.

The Court affirmed this position in Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., 552 U.S. 148 (2008), refusing to impose § 10(b) liability against defendants, Scientific-Atlanta and Motorola, who agreed to structure sham deals with a failing cable operator, Charter Communications, that were used to trick Charter’s auditor into believing that Charter had more revenue than it really did. In Stoneridge, unlike Central Bank, defendants took more affirmative steps contributing toward a material misstatement. Still, the Court insulated the defendants from a private right of action under § 10(b) because investors could not have been found to rely upon any statements (or misstatements) by the defendants themselves.

Refco was the next major case to address the issue, albeit at the trial court level on a motion to dismiss. Applying the doctrine to a law firm, a judge in the Southern District dismissed Mayer Brown from a § 10(b) action even though the complaint alleged that the lawyers had knowledge of their client’s fraud, but drafted the loan documents and SEC filings necessary to perpetuate the scheme. Refco was in the business of extending credit to customers trading on margin in the international derivatives and futures markets. After years of success, Refco began making loans without properly assessing the customer’s credit risk. Following global financial setbacks in the late 1990s, many of Refco’s customers suffered enormous losses and were unable to pay back their Refco loans. Rather than write off or disclose these losses Refco transferred all the defunct loans off their books and onto a sham entity created to hide the loss named Refco Group Holdings, Inc. (“RGHI”). To avoid making certain necessary “related-party” financial disclosures regarding the huge sum owed by RGHI, Refco “loaned” money to third-party customers who then loaned that money to RGHI which would then re-pay its “loans” to Refco prior to the close of each reporting period. The aggregate effect of these “round-trip loans” gave the appearance that Refco had good loans out to credit-worthy third parties and was receiving substantial payments on its loans to RGHI,

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**There is a dichotomy between Massachusetts state law and federal securities law in the responsibilities of lawyers who convey information on behalf of their clients. Ironically, the federal cases provide more protection to lawyers than state common law.**

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thus masking its terminal financial status. Lawyers at Mayer Brown drafted SEC filings and offering memoranda for a \$600MM public bond offering and a \$670MM initial public stock offering. The complaint alleged that the lawyers knew that the documents contained false statements.

Dismissing the lawyers, the judge held that Section 10(b) imposes liability only on a person who makes a material misrepresentation and that Central Bank insulates “aiders and abettors” from liability. To rise to a level of a “primary violation,” a secondary actor must not only make a material misrepresentation, but the “misrepresentation must be attributed to the specific actor at the time of the public dissemination.” In other words, the plaintiffs would have to allege that they relied on the lawyers’ “misstatements,” and not the “misstatements” of the clients, where the attorneys were simply conduits for the information. Because the documents mentioned the law firm only once – when they identified the firm as Refco’s counsel – the judge held that the documents did not attribute their contents to the law firm. To the contrary, the comments were attributed to management. Most significantly, the court rejected plaintiffs’ argument that the lawyers’ involvement in drafting documents provided a basis to hold them primarily liable. “Even if [Mayer Brown] played a substantial role in drafting the statements at issue, plaintiffs have offered no reason why [the law firm’s] status as counsel for Refco would be understood by investors as an endorsement of the accuracy of Refco’s assertions about its financial condition.” Refco at 313-314. The motion judge suggested that only in the instance where defendants allegedly controlled the client’s misleading communications, could plaintiffs have a possible path to establishing civil liability. Id at 317.

In the year since Refco, other federal courts have followed this application with respect to attorneys. See Thomas H. Lee Equity Fund v. Mayer Brown, 612 F.Supp. 2d 267 (S.D.N.Y. 2009) (no liability where statements were made directly from defendant law firm to plaintiff investor, but attributed at the time to client); accord Wilson v. Dalene, 2010 U.S. Dist. LEXIS 30138 (E.D.N.Y. 2010) (dismissing case against defendant law firm that allegedly knew of client’s false statements yet failed to correct them).

The federal securities cases are at odds with Massachusetts appellate courts. In Kirkland Constr. Co. v. James, 39 Mass. App. Ct. 559 (1995), the Appeals Court created an exception to the general rule that a lawyer owes no duty to a non-client. Lawyers may be liable if the plaintiff could prove that it “sought assuring information from the lawyers about their client”...and that the lawyer provided the information, intending for the plaintiff to rely on it. Rather than affirming the protection afforded lawyer-defendants in private securities cases, the Kirkland court held that it was error for the motion judge to dismiss the law firm even if the attorney were merely parroting his client’s position, since the complaint alleged that the attorney “knew or should have known” that the information was false. Id at 564. And, in May, 2010, the Appeals Court relied on the Kirkland case when it noted that “[i]n certain circumstances, a lawyer may owe a duty of care to a nonclient for the knowing or negligent provision of false information.” Nova Assignments, Inc. v. Kunian, 77 Mass. App. Ct. 34, 38 (2010).

Thus, there is a dichotomy between Massachusetts state law and federal securities law in the responsibilities of lawyers who convey information on behalf of their clients. Ironically, the federal cases provide more protection to lawyers than state common law. In response to a suit under state law, it may be useful to analogize to the federal decisions to limit exposure to non-clients. On the other side, I expect that federal suits may include state common law claims in addition to federal securities counts.

*To discuss your situation, and to learn how Looney & Grossman may be able to assist you, please contact Joseph S. Berman, Esq. at (617) 951-2800 or jberman@lgllp.com.*