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# Locating That Indistinct and Virtually Nonexistent Line between Primary and Secondary Liability under Section 10(b)

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**LOCATING THAT “INDISTINCT” AND  
“VIRTUALLY NONEXISTENT” LINE BETWEEN  
PRIMARY AND SECONDARY LIABILITY  
UNDER SECTION 10(b)**

**ROBERT A. PRENTICE\***

*The 1994 Supreme Court case Central Bank of Denver v. First Interstate Bank of Denver, seemed to portend momentous change in the jurisprudence of securities fraud. In ruling that there is no aiding and abetting liability under Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934, the Court overturned thirty years of precedent and seemingly freed securities professionals from a kind of statutory sword of Damocles. Professor Prentice, however, contends that Central Bank should have a negligible effect on the liability of lawyers, accountants, investment bankers and other professionals in securities fraud cases. This is because much of what has been characterized as secondary liability can and should be treated as primary liability. After briefly revisiting the pre-Central Bank world and suggesting that the scope of Section 10(b) and Rule 10b-5 should be generously construed, Professor Prentice offers three basic conclusions about post-Central Bank collateral defendant liability. First, securities professionals will remain liable for their own fraudulent statements. Second, collateral participants should be held primarily liable for the statements of others under a “participation” standard. Third, whistleblower liability will continue its demise with little help from Central Bank. The primary focus of the Article is the second conclusion, and Professor Prentice demonstrates how the participation standard historically was sufficient to impose primary liability and remains so today.*

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## INTRODUCTION

On April 19, 1994, the United States Supreme Court, in *Central Bank of Denver v. First Interstate Bank of Denver*,<sup>1</sup> ruled that there is no cause of action for aiding and abetting under Section 10(b)<sup>2</sup> and Rule 10b-5<sup>3</sup> of the Securities Exchange Act of 1934.<sup>4</sup> Securities industry professionals such as attorneys, accountants, and investment bankers breathed a collective sigh of relief, for they had been substantially hectored by such lawsuits. Consider accountants. In 1992 alone, the Big Six accounting firms paid more than a third of a billion dollars (\$373.8 million) in Section 10(b)/Rule 10b-5 claims.<sup>5</sup>

1. 511 U.S. 164 (1994).

2. 15 U.S.C. § 78j(b) (1994) [hereinafter Section 10(b)]. This section provides: It shall be unlawful for any person, directly or indirectly, by use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

....

To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

*Id.*

3. 17 C.F.R. § 240.10b-5 (1996) [hereinafter Rule 10b-5]. This rule provides: It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit 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, or

(c) To engage in 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.

*Id.*

4. See *Central Bank*, 511 U.S. at 191. The Supreme Court's ruling was, in many ways, a tribute to the prescience of Professor Fischel, who argued thirteen years earlier that "the theory of secondary liability is no longer viable in light of recent Supreme Court decisions strictly interpreting the federal securities laws." Daniel R. Fischel, *Secondary Liability Under Section 10(b) of the Securities Act of 1934*, 69 CAL. L. REV. 80, 82 (1981).

5. See Karen Donovan, *Quick Fallout Likely From Central Bank*, NAT'L L.J., May 2, 1994, at B1.

Those same firms claim to have been facing more than \$30 billion in such claims in 1993. See Marianne Lavelle, *Lawyers and Accountants Hail Dodd-Domenici Bill*, NAT'L L.J., May 9, 1994, at B1. Judgments, settlements, and litigation expenses cost the Big Six firms approximately 12% of their annual audit and accounting revenue after insurance reimbursement. See Lee Berton, *Big Accounting Firms Weed Out Risky Clients*, WALL ST. J., June 26, 1995, at B1.

Because the majority opinion (a) overturned thirty years of settled precedent confirmed by literally hundreds of lower court cases;<sup>6</sup> (b) eliminated what was by far the most frequently invoked avenue of Section 10(b)/Rule 10b-5 redress against collateral participants in private damages actions;<sup>7</sup> and (c) by its reasoning also clearly rendered extinct (i) aiding and abetting claims by the SEC<sup>8</sup> and (ii) other secondary theories of liability, such as conspiracy,<sup>9</sup> *Central Bank* ap-

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6. See *Central Bank*, 511 U.S. at 192-94 (Stevens, J., dissenting) ("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. . . . [The Court has] reach[ed] out to overturn a most considerable body of precedent." (footnote and citations omitted)).

7. See Lewis D. Lowenfels, *The Knowledge Requirement in Aider and Abettor Collateral Liability*, 21 REV. SEC. & COMMOD. REG. 191, 191 (1988) (aiding and abetting was "[t]he most widely utilized legal theory under the federal securities laws upon which to base actions against collateral or secondary parties by plaintiffs who are not in privity with these parties"); Claudia MacLachlan, *High Court Hears Case on Private Securities Lawsuits*, NAT'L L.J., Dec. 13, 1993, at 17 (quoting plaintiffs' attorney Edward Labaton as saying that "[v]irtually all the cases against accountants are aiding and abetting cases").

8. In his *Central Bank* dissent, Justice Stevens reasoned that the majority opinion's logic eliminated SEC authority to impose secondary liability. See 511 U.S. at 200-01 (Stevens, J., dissenting). However, Congress later partially restored SEC power to impose liability for knowingly aiding and abetting in the Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67 Title I, § 104(2), 109 Stat. 737, 757 (codified at 15 U.S.C.S. § 78t(f) (Law. Co-op. 1983 & Supp. 1996)).

9. See, e.g., *In re Glenfed, Inc. Sec. Litig.*, 60 F.3d 591, 592 (9th Cir. 1995) (holding that *Central Bank* renders conspiracy nonactionable); *Phillips v. Kidder, Peabody & Co.*, 933 F. Supp. 303, 316 (S.D.N.Y. 1996) (same); *Van De Velde v. Coopers & Lybrand*, 899 F. Supp. 731, 738 (D. Mass. 1995) (same); *In re MTC Elec. Tech. Shareholders Litig.*, 898 F. Supp. 974, 981-82 (E.D.N.Y. 1995) (same); *Upton v. McKerrow*, 887 F. Supp. 1573, 1580 (N.D. Ga. 1995) (same); *In re Medimmune, Inc. Sec. Litig.*, 873 F. Supp. 953, 964 n.8 (D. Md. 1995) (same); *In re Syntex Corp. Sec. Litig.*, 855 F. Supp. 1086, 1098 (N.D. Cal. 1994) (same). But see *In re Towers Fin. Corp. Noteholders Litig.*, 936 F. Supp. 126, 129-30 (S.D.N.Y. 1996) (distinguishing between conspiracy and aiding and abetting and refusing to hold that *Central Bank*, which did not involve a conspiracy claim, necessarily dooms such claims).

There are very strong reasons to hold that *respondeat superior* liability, unlike conspiracy liability, should be treated differently than aiding and abetting liability and should survive *Central Bank*. A full discussion of that issue is outside the scope of this Article, but I strongly believe that a recent case, *ESI Montgomery County, Inc. v. Montenay International Corp.*, No. 94 CIV 0119 (RLC), 1996 U.S. Dist. LEXIS 592, at \*7 (S.D.N.Y. Jan. 23, 1996), which held that *respondeat superior* liability had been abolished by *Central Bank*, was wrongly decided. See *AT&T Co. v. Winback & Conserve Prod., Inc.*, 42 F.3d 1421, 1429-32 (3d Cir. 1994) (holding in Lanham Act case that (a) aiding and abetting was not strongly established in civil common-law practice, but *respondeat superior* liability was, and (b) *Central Bank* evidenced Supreme Court's wariness of the nature of aiding and abetting liability itself, and was not concerned with issue of upon whose shoulders to place responsibility for conduct "indisputably proscribed" by the relevant statute); *Tranchina v. Howard, Weil, Labouisse, Friedrichs, Inc.*, No. CIV.A.95-2886 c/w 95-3165, 1996 U.S. Dist. LEXIS 8110, at \*11 (E.D. La. June 7, 1996) (holding that *respondeat superior* liability survives *Central Bank*); *Pollack v. Laidlaw Holdings, Inc.*, [1995 Transfer

parently had the potential to effect a sea of change in the jurisprudence of securities fraud litigation. Indeed, many proclaimed just such an effect. No less an authority than Joel Seligman pronounced *Central Bank* "the most important federal securities law decision in several years."<sup>10</sup> Roberta Karmel pronounced it "a watershed in federal securities law jurisprudence."<sup>11</sup> David Ruder commented that the decision "marked a dramatic event in the history of the interpretation of Rule 10b-5."<sup>12</sup> Thomas O. Gorman suggested that after *Central Bank*, "it may be the SEC and plaintiffs who need 'litigation reform' and legislative assistance."<sup>13</sup>

Realizing that Supreme Court decisions mean only what the lower courts say they mean, Donald Langevoort has predicted that lower court inertia will prevent the pendulum from swinging quite as far away from the pre-*Central Bank* body of law as might be surmised from the tenor of the Supreme Court's opinion,<sup>14</sup> which was obviously quite hostile to securities fraud litigation. He predicted that, since secondary liability theories are no longer available in such cases, lower courts will be fairly generous in delineating the scope of primary liability in order to help reestablish the legal equilibrium that was disrupted by *Central Bank's* abrupt departure from precedent.<sup>15</sup>

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Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,741, at 92,509 (S.D.N.Y. May 2, 1995) (holding that *respondeat superior* survived *Central Bank* because "[u]nlike aiding and abetting liability, . . . liability of a principal based upon apparent authority has long been recognized by federal courts" in many settings and such traditions should not be lightly cast aside); see also William H. Kuehne, *Secondary Liability Under the Federal Securities Laws—Aiding and Abetting, Conspiracy, Controlling Persons, and Agency: Common-Law Principles and The Statutory Scheme*, 14 J. CORP. L. 313, 348, 351-54 (1988) (noting that (a) aiding and abetting and conspiracy liability are keyed to defendant's relationship with the plaintiff, whereas *respondeat superior* liability turns on defendant's relationship with the primary wrongdoer, and (b) the 1934 Act's "control liability" provision, § 20(a), was meant to supplement, not replace, preexisting *respondeat superior* liability); Donald C. Langevoort, *Words from on High About Rule 10b-5: Chiarella's History, Central Bank's Future*, 20 DEL. J. CORP. L. 865, 893-96 (1995) (noting that "[t]here is a substantial difference between the aiding and abetting and *respondeat superior* issues" and suggesting that recasting claims from the traditional *respondeat superior* to primary liability will not be unduly difficult).

10. Joel Seligman, *The Implications of Central Bank*, 49 BUS. LAW. 1429, 1430 (1994).

11. Roberta S. Karmel, *Implications of the Central Bank of Denver Case*, N.Y.L.J., June 16, 1994, at 3.

12. David S. Ruder, *The Future of Aiding and Abetting and Rule 10b-5 After Central Bank of Denver*, 49 BUS. LAW. 1479, 1479 (1994).

13. Thomas O. Gorman, *Who's Afraid of 10b-5? The Scope of a Section 10(b) Cause of Action After Central Bank of Denver*, 22 SEC. REG. L.J. 247, 248 (1994).

14. See Langevoort, *supra* note 9, at 865-67, 885-97.

15. See *id.* at 897.

I offer a third view.<sup>16</sup> It is my thesis that *if* the lower courts do their job properly, *Central Bank* will be nearly a nonevent, an almost otiose exercise of Supreme Court prerogative. It will have little impact upon its subject matter area—the Section 10(b)/Rule 10b-5 liability of attorneys, accountants, investment bankers, and other collateral defendants in securities fraud cases. To be more specific, I offer three primary conclusions about the proper status of collateral defendant liability in the post-*Central Bank* world.

First, and uncontroversially, accountants, lawyers, investment bankers, and others will remain liable for their own fraudulent statements (and omissions) in the sale of securities. Such liability has, in recent years, often been characterized as secondary.<sup>17</sup> However, it was, and remains, more accurately treated as primary liability.

Second, and quite controversially, these collateral participants should remain liable for the fraudulent statements of others (usually their clients) in at least two important sets of circumstances. In other words, many of the numerous attempts of plaintiffs' attorneys to recast what before *Central Bank* would have been denominated aiding and abetting claims as claims of primary liability<sup>18</sup> under Section 10(b)/Rule 10b-5 should succeed. Unfortunately, many lower court opinions have already held to the contrary, totally eliminating Section 10(b)/Rule 10b-5 liability for the misstatements (and omissions) of others.<sup>19</sup> I hope to establish that these rulings are ill-founded and that there remain significant legitimate avenues for imposing primary

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16. I do so without disagreeing with Langevoort's equilibrium theory, which I believe to be generally accurate. However, he may have underestimated the pent-up hostility to securities fraud litigation among Reagan and Bush appointees to the bench.

Professor Coffee is also on record as doubting that *Central Bank* will make a huge difference, at least for accountants. See John C. Coffee Jr., *For Accountants, the Supreme Court's Central Bank Decision is Likely to be the Victory that Wasn't; for Lawyers, the Result is More Ambiguous*, NAT'L L.J., July 11, 1994, at B4.

17. See *infra* notes 58-60 and accompanying text.

18. See, e.g., *In re Ivan F. Boesky Sec. Litig.*, 36 F.3d 255, 264 (2d Cir. 1994) (attempt to replead unsuccessful); *Vosgerichian v. Commodore Int'l*, 862 F. Supp. 1371, 1378 (E.D. Pa. 1994) (primary liability not alleged in original complaint). See generally Edward Brodsky, *Aiding and Abetting Claims Under Rule 10b-5*, N.Y.L.J., June 14, 1995, at 3 (discussing the blurred line that inconsistent lower court decisions have created between primary and secondary liability).

19. See, e.g., *Anixter v. Home-Stake Prod. Co.*, 77 F.3d 1215, 1227 (10th Cir. 1996); *In re JWP, Inc. Sec. Litig.*, 928 F. Supp. 1239, 1256 (S.D.N.Y. 1996); *Lycan v. Walters*, 904 F. Supp. 884, 901 n.12 (S.D. Ind. 1995); *O'Neil v. Appel*, 897 F. Supp. 995, 1000 (W.D. Mich. 1995); *Cascade Int'l Sec. Litig.*, 894 F. Supp. 437, 442 (S.D. Fla. 1995); *Stamatios v. Hurco Co., Inc.*, 885 F. Supp. 1180, 1185 (S.D. Ind. 1995); *Kendall Square Research Corp. Sec. Litig.*, 868 F. Supp. 26, 28 (D. Mass. 1994); *Vosgerichian v. Commodore Int'l*, 862 F. Supp. 1371, 1378 (E.D. Pa. 1994).

Section 10(b)/Rule 10b-5 liability upon defendants for the statements of others.

This is the most contentious and important area of post-*Central Bank* controversy and I give it the most attention. I will show that significant “participation” in a fraud, even if one is not the speaker: (a) was sufficient to impose primary fraud liability at common law;<sup>20</sup> (b) was sufficient to impose primary Section 10(b)/Rule 10b-5 liability before the advent of aiding and abetting liability under Section 10(b)/Rule 10b-5;<sup>21</sup> (c) was in many jurisdictions sufficient to impose primary liability, as well as aiding and abetting liability, during the heyday of the Section 10(b)/Rule 10b-5 aiding and abetting cases;<sup>22</sup> and (d) has twice been suggested by the Supreme Court as the appropriate standard for primary liability under Section 10(b) and Rule 10b-5.<sup>23</sup> Therefore, a “participation” standard is certainly appropriate for determining the scope of Section 10(b)/Rule 10b-5 primary liability of defendants in the aftermath of *Central Bank*.

My third basic conclusion is that *Central Bank* should have little impact upon a third category of cases—those involving the whistleblower scenario. Rather, *Central Bank* merely hastens a preexisting trend toward the demise of most whistleblower liability for securities law professionals.

I do not wish to be too bold. As noted, many lower courts have already botched the job of properly describing the parameters of post-*Central Bank* primary liability under Section 10(b)/Rule 10b-5. If those courts get the upper hand, my predictions, and much of Section 10(b) and Rule 10b-5 jurisprudence, are out the window. Also, *Central Bank* could prove to be an extremely significant case if it emboldens the Supreme Court to continue to overturn settled law in order to pursue the majority’s apparent goal of blunting a perceived torrent of securities fraud litigation.

Nonetheless, I will argue that if the lower courts *properly* locate what has been called that “indistinct and, in the minds of some courts, virtually nonexistent”<sup>24</sup> line between primary and secondary liability under Section 10(b)/Rule 10b-5, then *Central Bank* will be remembered as a pebble, rather than a boulder, tossed into a calm

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20. See *infra* notes 263-69 and accompanying text.

21. See *infra* notes 52-57 and accompanying text.

22. See *infra* notes 74-75 and accompanying text.

23. See *infra* notes 294-300 and accompanying text.

24. Alan R. Bromberg & Lewis D. Lowenfels, *Aiding and Abetting Securities Fraud: A Critical Examination*, 52 ALB. L. REV. 637, 640 (1988).



lake of established law.<sup>25</sup> In Part I of the Article, I briefly trace the history of aiding and abetting liability up through *Central Bank* in order to provide a context for analysis.<sup>26</sup> In Part II, I attempt to gently remind the courts that the scope of primary liability under Section 10(b)/Rule 10b-5 should be generously construed.<sup>27</sup> In Part III, I get down to the specifics of supporting the three conclusions drawn above.<sup>28</sup>

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25. Even if I am correct about *Central Bank's* turning into a dud, there is still good news on the horizon for collateral Section 10(b)/Rule 10b-5 defendants. Among those positive developments are:

The Supreme Court's decision in *Reves v. Ernst & Young*, 507 U.S. 170 (1993), by requiring that a defendant actually participate in the operation or management of the criminal enterprise, *see id.* at 185, largely eliminated the liability of accountants, attorneys, and investment bankers under the Racketeer Influenced Corrupt Organizations Act (RICO), 18 U.S.C. §§ 1961-68 (1994). This, coupled with the provisions of the Private Securities Litigation Reform Act of 1995 (PSLRA), Pub. L. No. 104-67, 109 Stat. 737 (codified in scattered sections of 15 U.S.C.), largely eliminates securities fraud as a predicate act under RICO. The logic of *Central Bank* could further constrict RICO's application. *See* Taurie M. Zeitzer, *In Central Bank's Wake, RICO's Voice Resonates: Are Civil Aiding and Abetting Claims Still Tenable?*, 29 COLUM. J.L. & SOC. PROB. 551, 570-83 (1996) (arguing that the logic of *Central Bank* dooms aiding and abetting theories under RICO). However, most courts still recognize aiding and abetting under RICO. *See, e.g., Jaguar Cars Inc. v. Royal Oaks Motor Car Co.*, 46 F.3d 258, 270 (3d Cir. 1995).

The Supreme Court's decisions regarding § 12 of the 1933 Securities Act, including *Pinter v. Dahl*, 486 U.S. 622 (1988), which, by requiring that a defendant actually "solicit" sales in order to be liable, *see id.* at 654, largely eliminated attorney and accountant liability under § 12 of the 1933 Securities Act, and *Gustafson v. Alloyd Co.*, 115 S. Ct. 1061 (1995), which limited the scope of § 12(2) to public offerings of securities only, and not to private offerings or to secondary market trading. *See id.* at 1073-74.

The Supreme Court's adoption of a conservative statute of limitations for Section 10(b)/Rule 10b-5 cases. *See Lampf, Pleva, Lipkind, Prupis & Pettigrow v. Gilbertson*, 501 U.S. 350, 362 (1991).

The influential California Supreme Court's adoption of a relatively narrow standard for accountants' third-party liability in negligence cases. *See Bily v. Arthur Young & Co.*, 834 P.2d 745, 768-73 (Cal. 1992) (adopting "Restatement approach").

Successful lobbying for state tort reform legislation to modify or eliminate joint and several liability and otherwise improve the lot of deep pocket defendants. *See generally* Dan L. Goldwasser, *State Legislative Initiatives on Behalf of the Accounting Profession*, in ACCOUNTANTS' LIABILITY 1994, at 143 (PLI Litig. Course Handbook Series No. H-506, 1994) (discussing the opportunities for favorable legislation for the accounting profession).

Most important is passage of the PSLRA which, in addition to the change in RICO noted above, made some extremely important changes in the 1933 and 1934 securities acts. For a detailed background on this Act, see John W. Avery, *Securities Litigation Reform: The Long and Winding Road to the Private Securities Litigation Reform Act of 1995*, 51 BUS. LAW. 335 (1996). For a summary of the PSLRA's more important provisions, see *infra* note 96.

26. *See infra* notes 30-91 and accompanying text.

27. *See infra* notes 92-116 and accompanying text.

28. *See infra* notes 117-389 and accompanying text.

Whether I am right or wrong, the subject under discussion is the most important issue currently facing courts, lawyers, and parties in the realm of Section 10(b)/Rule 10b-5 jurisprudence. As one court recently stated: “[D]istinctions in conduct between primary and secondary liability are elusive. Prior to *Central Bank of Denver* the distinction was academic. Now it is pivotal.”<sup>29</sup>

## I. A SUMMARY OF THE PRE-CENTRAL BANK WORLD

### A. *Elements of a Section 10(b) Cause of Action*

In order to state a claim for *primary liability* under Section 10(b)/Rule 10b-5, a plaintiff must show, according to one popular formulation, that the defendant (a) made a misstatement or omission, (b) of a material fact, (c) with scienter, (d) in connection with the sale or purchase of securities, (e) upon which the plaintiff relied, and (f) that reliance proximately caused (g) damages to the plaintiff.<sup>30</sup>

As is well known, the private right of action for damages under Section 10(b)/Rule 10b-5 was first implied by the *Kardon* case<sup>31</sup> in 1946 and gained official Supreme Court acquiescence at least by 1983.<sup>32</sup> Many current members of the Supreme Court clearly regret that acquiescence and the fact that the substantial body of Section 10(b)/Rule 10b-5 jurisprudence represents a “judicial oak which has grown from little more than a legislative acorn.”<sup>33</sup>

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29. *Anixter v. Home-Stake Prod. Co.*, 77 F.3d 1215, 1230 (10th Cir. 1996).

30. See *Stransky v. Cummins Engine Co.*, 51 F.3d 1329, 1331 (7th Cir. 1995). For a general discussion of these elements as applied in a particular context (false statements regarding technological breakthroughs), see generally Robert A. Prentice & John H. Langmore, *Beware of Vaporware: Product Hype and the Securities Fraud Liability of High-Tech Companies*, 8 HARV. J.L. & TECH. 1, 20-62 (1994).

This formulation is arguably too narrow in that it focuses on only the two primary forms of Section 10(b)/Rule 10b-5 violation—misrepresentations and omissions in corporate communications. Perhaps it unfairly omits reference to other acts that are barred by Rule 10b-5, including “devices,” “contrivances,” “schemes,” “artifices,” and “acts,” “practices,” or “courses of business” that operate as a fraud or deceit. Nonetheless, the Supreme Court has tended to lump all deceptive activity not involving misrepresentations or omissions into the “manipulation” category, and then held that “manipulation” is a virtual term of art for practices such as wash sales, matched orders, or rigged prices that are intended to mislead investors. See *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 472-74 (1977); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 199 (1976).

31. See *Kardon v. National Gypsum Co.*, 69 F. Supp. 512, 513-14 (E.D. Pa. 1946).

32. See *Herman & MacLean v. Huddleston*, 459 U.S. 375, 380 (1975) (recognizing that 35 years of accumulated lower court decisions implying a private cause of action under Section 10(b)/Rule 10b-5 rendered its existence “simply beyond peradventure”).

33. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 737 (1975).

## B. Elements of Aiding and Abetting Liability

One of the larger branches of the Section 10(b)/Rule 10b-5 judicial oak came to be represented by aiding and abetting liability. As Section 10(b) jurisprudence flowered in the 1960s,<sup>34</sup> aiding and abetting liability for Section 10(b) violations was initially recognized in *Brennan v. Midwestern United Life Insurance Co.*<sup>35</sup> and was eventually embraced by every circuit in multitudes of cases,<sup>36</sup> although some courts did express mild misgivings about the solidity of the doctrine's foundation.<sup>37</sup>

The historical evolution of aiding and abetting liability under Section 10(b)/Rule 10b-5 has been explored in detail elsewhere<sup>38</sup> and

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34. In 1972, David Ruder noted "[t]he explosive growth of securities law fraud litigation during the last decade under federal statutes and rules." David S. Ruder, *Multiple Defendants in Securities Law Fraud Cases: Aiding and Abetting, Conspiracy, In Pari Delicto, Indemnification, and Contribution*, 120 U. PA. L. REV. 597, 598 (1972).

35. 259 F. Supp. 673, 681 (N.D. Ind. 1966), *aff'd*, 417 F.2d 147, 154 (7th Cir. 1969). Actually, *Brennan* was the first major case to apply aiding and abetting theory to a private Rule 10b-5 action for damages, but as early as 1939, the theory had been recognized in an SEC action brought under § 17(a) of the 1933 Securities Act. *See SEC v. Timetrust, Inc.*, 28 F. Supp. 34, 43 (N.D. Cal. 1939). Still, *Brennan* is the seed from which thousands of Section 10(b)/Rule 10b-5 aiding and abetting actions grew, playing a comparable role to that of *Kardon*.

36. *See, e.g.*, *Farlow v. Peat, Marwick, Mitchell & Co.*, 956 F.2d 982, 986 (10th Cir. 1992); *Akin v. Q-L Invs.*, 959 F.2d 521, 525-27 (5th Cir. 1992); *Schatz v. Rosenberg*, 943 F.2d 485, 495 (4th Cir. 1991); *Robin v. Arthur Young & Co.*, 915 F.2d 1120, 1123-24 (7th Cir. 1990); *Moore v. Fenex, Inc.*, 809 F.2d 297, 303 (6th Cir. 1987); *Zoelsch v. Arthur Anderson & Co.*, 824 F.2d 27, 35-36 (D.C. Cir. 1987); *Rudolph v. Arthur Anderson & Co.*, 800 F.2d 1040, 1045-46 (11th Cir. 1986); *Cleary v. Perfectune, Inc.*, 700 F.2d 774, 778-79 (1st Cir. 1983); *SEC v. Seaboard Corp.*, 677 F.2d 1301, 1311 (9th Cir. 1982); *IIT v. Cornfeld*, 619 F.2d 909, 922-25 (2d Cir. 1980); *Monsen v. Consolidated Dressed Beef Co.*, 579 F.2d 793, 799-801 (3d Cir. 1978).

37. *See, e.g.*, *Seaboard Corp.*, 677 F.2d at 1311 n.12.

38. *See, e.g.*, Bromberg & Lowenfels, *supra* note 24, at 643-751; Joel S. Feldman, *The Breakdown of Securities Fraud Aiding and Abetting Liability: Can a Uniform Standard Be Resurrected?*, 19 SEC. REG. L.J. 45 (1991); Ralph C. Ferrara & Diane Sanger, *Derivative Liability in Securities Law: Controlling Person Liability, Respondeat Superior, and Aiding and Abetting*, 40 WASH. & LEE L. REV. 1007 (1983); Sally Totten Gilmore & William H. McBride, *Liability of Financial Institutions for Aiding and Abetting Violations of Securities Laws*, 42 WASH. & LEE L. REV. 811 (1985); William C. Humphreys, Jr., *Aiding and Abetting Liability of Accountants in Securities Fraud Cases*, 17 SEC. REG. L.J. 375 (1990); Kuehne, *supra* note 9; Patrick J. McNulty & Daniel J. Hanson, *Liability for Aiding and Abetting by Silence or Inaction: An Unfounded Doctrine*, 29 TORT & INS. L.J. 14 (1993); Ruder, *supra* note 34; Lawrence R. Bard, Note, *A Distinct-Responsibility Approach to Accountants' Primary Liability Under Rule 10b-5*, 61 GEO. WASH. L. REV. 193 (1992); Clyde A. Billings, Jr., Note, *The Private Action Against a Securities Fraud Aider and Abettor: Silent and Inactive Conduct*, 29 VAND. L. REV. 1233 (1976); Mary T. Doherty, Note, *Aiding and Abetting Securities Fraud*, 25 IND. L. REV. 829 (1992); John H. Karnes, Jr., Comment, *Lenders' Liability for Aiding and Abetting Rule 10b-5 Violations: The Knowledge Standard*, 41 SW. L.J. 925 (1988); Jeffrey Farley Keller, Comment, *Aiding and*

need not be repeated here. To summarize briefly, however, the lower courts developed two primary approaches to aiding and abetting liability.<sup>39</sup> The majority approach was based on a three-part test which was variously stated but typically provided that to establish aiding and abetting a plaintiff had to prove: (a) a primary violation by another party; (b) that the defendant had "knowledge" of the wrong and of his role in furthering it; and (c) that the defendant substantially assisted the violation.<sup>40</sup> Most courts applied a "sliding-scale" analysis that required actual intent to aid the fraud if the aiding and abetting defendant owed no fiduciary duty to plaintiff.<sup>41</sup> Indeed, many courts spoke of the requirement that defendant act with "high conscious intent" in order to be liable in the absence of a duty to speak.<sup>42</sup> "High conscious intent," several courts stressed, required more motivation by accountants or lawyers than the simple desire to be paid or to retain a client.<sup>43</sup> And, according to several other courts, mere performance of "grist of the mill" services by attorneys, accountants and underwriters was usually insufficient to constitute

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*Abetting Liability Under Securities Exchange Act Section 10(b) and SEC Rule 10b-5: The Infusion of a Sliding-Scale, Flexible-Factor Analysis*, 22 LOY. L.A. L. REV. 1189 (1989); Don J. McDermott, Jr., Note, *Liability for Aiding and Abetting Violations of Rule 10b-5: The Recklessness Standard in Civil Damage Actions*, 62 TEX. L. REV. 1087 (1984); Timothy M. Metzger, Comment, *Abandoning Accountants' Liability for Aiding and Abetting 10b-5 Securities Fraud*, 87 NW. U.L. REV. 1374 (1993); Cheryl L. Pollak, Note, *Rule 10b-5 Liability after Hochfelder: Abandoning the Concept of Aiding and Abetting*, 45 U. CHI. L. REV. 218 (1977); Elizabeth Sager, Comment, *The Recognition of Aiding and Abetting in the Federal Securities Laws*, 23 HOUS. L. REV. 821 (1986); John T. Vangel, Note, *A Complicity-Doctrine Approach to Section 10(b) Aiding and Abetting Civil Damages Actions*, 89 COLUM. L. REV. 180 (1989); Edward Brodsky, *Aiding and Abetting*, N.Y.L.J., Dec. 8, 1993, at 3.

39. A more detailed summary of these exact points, but pertaining only to lawyer defendants, is contained in Donald C. Langevoort, *Where Were the Lawyers? A Behavioral Inquiry Into Lawyers' Responsibility for Clients' Fraud*, 46 VAND. L. REV. 75, 84-89 (1993).

40. See, e.g., *Seaboard Corp.*, 677 F.2d at 1311; *Woodward v. Metro Bank of Dallas*, 522 F.2d 84, 94-95 (5th Cir. 1975) (citing *SEC v. Coffey*, 493 F.2d 1304, 1316 (6th Cir. 1974)).

41. See, e.g., *Camp v. Dema*, 948 F.2d 455, 459 (8th Cir. 1991); *Metge v. Baehler*, 762 F.2d 621, 624 (8th Cir. 1985); *Sirota v. Solitron Devices, Inc.*, 673 F.2d 566, 575 (2d Cir. 1982). However, some courts held that recklessness satisfied the scienter requirement for aiding and abetting even if defendant did not owe a fiduciary duty to plaintiffs. See, e.g., *Ingram Indus., Inc. v. Nowicki*, 502 F. Supp. 1060, 1066-67 (E.D. Ky. 1980).

42. See, e.g., *IIT v. Cornfeld*, 619 F.2d 909, 925 (2d Cir. 1980) (citing *Woodward*, 522 F.2d at 97); *Schick v. Ernst & Whinney*, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,764, at 98,666-67 (S.D.N.Y. Jan. 18, 1991).

43. *National Union Fire Ins. Co. v. Turtur*, 892 F.2d 199, 207 (2d Cir. 1989); *In re Westinghouse Sec. Litig.*, [1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶97,750, at 97,600 (W.D. Pa. July 27, 1993); *Ernst & Whinney*, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. at 98,667.

“substantial assistance” or to provide evidence of scienter.<sup>44</sup>

However, if something approximating a fiduciary duty was established, then the collateral defendant could be liable for aiding and abetting on the basis of mere recklessness.<sup>45</sup> For collateral defendants, many courts focused the matter of the existence of a duty upon whether the asserted aider and abettor could reasonably have foreseen that the plaintiff would rely on its actions.<sup>46</sup>

A minority approach, pioneered by the Seventh Circuit, functionally eliminated aiding and abetting liability by requiring that defendant breach a duty owed to plaintiffs before aiding and abetting liability could be imposed.<sup>47</sup> This line of cases basically required plaintiffs to establish all the elements of Section 10(b)/Rule 10b-5 primary liability, except that the defendant was a purchaser or seller, before collateral participants such as lawyers or accountants could be held liable as aiders and abettors. Although the analysis underlying the holdings in these cases was suspect,<sup>48</sup> the ultimate outcomes now look prescient in light of *Central Bank*.

### C. Observations Regarding Pre-Central Bank Litigation

A few pertinent lessons can be drawn from an analysis of the rather confused pre-*Central Bank* body of aiding and abetting jurisprudence.

(1) The lower courts' creation of an aiding and abetting theory of

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44. See, e.g., *Ockerman v. May Zima & Co.*, 785 F. Supp. 695, 704-05 (M.D. Tenn. 1992).

45. See *Akin v. Q-L Invs.*, 959 F.2d 521, 526-27 (5th Cir. 1992); *In re AM Int'l Sec. Litig.*, 606 F. Supp. 600, 606 (S.D.N.Y. 1985).

Bromberg & Lowenfels put it this way:

[A] majority of cases hold that there must be a duty, sometimes described as a fiduciary duty, running from the alleged aider and abettor to the plaintiff for recklessness to satisfy the second requirement of aiding and abetting. If there is no such duty running from the alleged aider and abettor to the plaintiff, then the knowledge required on the part of the alleged aider and abettor scales upward from recklessness to full scienter, approximating intent to defraud.

Bromberg & Lowenfels, *supra* note 24, at 678.

46. See, e.g., *In re Storage Tech. Corp. Sec. Litig.*, 630 F. Supp. 1072, 1076 (D. Colo. 1986); *Fund of Funds, Ltd. v. Arthur Andersen & Co.*, 545 F. Supp. 1314, 1356 (S.D.N.Y. 1982); *In re Investors Funding Corp. of New York Sec. Litig.*, 523 F. Supp. 550, 558-59 (S.D.N.Y. 1980); *Oleck v. Fischer*, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,898, at 95,690 (S.D.N.Y. June 8, 1979), *aff'd*, 623 F.2d 791 (2d Cir. 1980); *Competitive Assocs., Inc. v. Laventhol, Krekstein, Horwath & Horwath*, 478 F. Supp. 1328, 1341 (S.D.N.Y. 1979).

47. See *DiLeo v. Ernst & Young*, 901 F.2d 624, 628 (7th Cir. 1990); *Barker v. Henderson, Franklin, Starnes & Holt*, 797 F.2d 490, 495-96 (7th Cir. 1986).

48. See *infra* notes 64-71 and accompanying text.

liability under Section 10(b)/Rule 10b-5 led to no hue and cry from its potential targets. Although over time summary and analysis of the first case to adopt the theory, *Brennan v. Midwestern United Life Insurance Co.*,<sup>49</sup> became a standard feature of every law review article discussing secondary liability, it was not a matter of significant concern at the time. At least two reasons are obvious:

(a) There simply was not much securities fraud litigation under Section 10(b)/Rule 10b-5 or any other theory at the time. The huge body of law that currently exists was only beginning to develop.<sup>50</sup> The fad of almost always suing a wrongdoing company's accountants and attorneys was also in its nascent stages.

(b) By the time that the Seventh Circuit affirmed *Brennan* in 1969, becoming the first circuit court of appeals to accept aiding and abetting as a theory of Section 10(b)/Rule 10b-5 liability, there were already plenty of cases on the books finding collateral defendants such as attorneys, accountants, and investment bankers *primarily* liable for just the sort of acts that later came to be characterized as alleged aiding and abetting. In other words, the "knowing" provision of "substantial assistance to the effectuation of a fraud," which is the essence of the majority formulation of aiding and abetting, also constitutes in most cases "participation" in that fraud which, at common law and under pre-*Brennan* Section 10(b)/Rule 10b-5 litigation, had been sufficient to establish primary liability. I will talk about the common law in more detail later,<sup>51</sup> but in pre-*Brennan* Section 10(b)/Rule 10b-5 jurisprudence, attorneys had already been told by the Second Circuit that they could be primarily liable for passing on their clients' communications, knowing those communications were inaccurate, even when the attorneys claimed that they had acted as "mere scriveners."<sup>52</sup> Corporate directors had already been held primarily liable for playing an "integral role" in the fraudulent communications of others.<sup>53</sup> Securities firms had already been held primarily liable under Section 10(b)/Rule 10b-5 for failing to stop correspondents from stealing from their customers.<sup>54</sup> Supervisors of

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49. 259 F. Supp. 673 (N.D. Ind. 1966), *aff'd*, 417 F.2d 147 (7th Cir. 1969).

50. Professor Conard has traced the securities fraud "litigation explosion" to *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968), the opinion which first revealed the broad potential for § 10(b) liability. See Alfred F. Conard, *Enterprise Liability and Insider Trading*, 49 WASH. & LEE L. REV. 913, 929 (1992).

51. See *infra* notes 263-69 and accompanying text.

52. See *SEC v. Frank*, 388 F.2d 486, 489 (2d Cir. 1968).

53. See *Sprayregen v. Livingston Oil Co.*, 295 F. Supp. 1376, 1378 (S.D.N.Y. 1968).

54. See *Hawkins v. Merrill, Lynch, Pierce, Fenner & Beane*, 85 F. Supp. 104, 122 (W.D. Ark. 1949).

securities sales representatives had already been held primarily liable for the lies of those sales representatives.<sup>55</sup> Broker-dealers had already been warned that they could be held primarily liable for passing a newspaper report to customers knowing that it contained misrepresentations, even though the misrepresentations were those of the newspaper.<sup>56</sup> Similarly, stock brokers had already been held primarily liable for "participating" in another's fraudulent scheme.<sup>57</sup> In later years, such claims would almost always be brought as aiding and abetting claims, but by the time *Brennan* was decided by the Seventh Circuit, there was substantial precedent on the books that such actions constituted primary violations of Section 10(b)/Rule 10b-5. Thus, *Brennan's* main effect was simply to add a new theory for imposing liability for activities that were already actionable under established law.

(2) Given that the formulation of aiding and abetting liability brought very little conduct under the liability blanket of Section 10(b)/Rule 10b-5 that was not already there and punishable as primary conduct, the lower courts seldom troubled themselves to draw any sort of a line between primary liability on the one hand, and aiding and abetting liability on the other.<sup>58</sup> If both theories punished virtually the same conduct, there was no reason to draw such a distinction.<sup>59</sup>

(3) In many cases where aiding and abetting terminology was used and liability was found, primary liability could obviously have been found as well. Indeed, some courts merely held that all elements of primary liability appeared to be present and therefore, of necessity, the criteria for aiding and abetting liability also had to be

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55. See *SEC v. Broadwall Sec., Inc.*, 240 F. Supp. 962, 968 (S.D.N.Y. 1965).

56. See *SEC v. Franklin Atlas Corp.*, 154 F. Supp. 395, 399 (S.D.N.Y. 1957).

57. See *Fry v. Schumaker*, 83 F. Supp. 477, 478 (E.D. Pa. 1947).

58. See, e.g., *Molecular Tech. Corp. v. Valentine*, 925 F.2d 910, 917-18 (6th Cir. 1991) (holding that attorney's assistance in drafting a false offering circular constituted both primary and secondary wrongdoing); *Fine v. American Solar King Corp.*, 919 F.2d 290, 297, 301 (5th Cir. 1990) (same conduct held to constitute both primary and aiding and abetting violations); *Buttrey v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 410 F.2d 135, 144 (7th Cir. 1969) (upholding claims of both primary and aiding and abetting liability based on same conduct); *Ross v. Licht*, 263 F. Supp. 395, 410 (S.D.N.Y. 1967) (holding insiders primarily liable and "equally liable" with aiders and abettors).

59. Indeed, even plaintiffs' attorneys often failed to clarify whether they were claiming defendants were liable as primary or secondary violators, although this occasionally brought criticism from the courts. See *The Limited, Inc. v. McCrory Corp.*, 645 F. Supp. 1038, 1043 (S.D.N.Y. 1986) (stating that one element of every well-pled complaint is a statement regarding whether defendant is being sued as a primary or secondary violator); *Decker v. Massey-Ferguson, Ltd.*, 534 F. Supp. 873, 882 (S.D.N.Y. 1981) (complaining that complaint failed to draw the distinction).

met.<sup>60</sup>

(4) That there was little or no difference between pre-*Brennan* primary liability and post-*Brennan* aiding and abetting liability is vividly illustrated by the futile efforts of the courts over thirty years to draw any sort of meaningful distinction between the two. As noted above, most courts just did not bother to delineate between primary and secondary liability. Those that did try typically ended up terribly frustrated. Their efforts to draw a distinction between primary and secondary liability have been aptly described as “erratic.”<sup>61</sup> A reading of the Fifth Circuit’s opinion in *Akin v. Q-L Investments, Inc.*,<sup>62</sup> is instructive in this regard. In surveying aiding and abetting law, the court found that precedent in the circuit created three different paths to Section 10(b)/Rule 10b-5 liability, each more circuitous than the other, and noted that the aiding and abetting “‘theory’ of liability is mushy and difficult to apply. Were we writing on a clean slate, it would give us pause.”<sup>63</sup>

The Seventh Circuit had even greater problems. Preceding the Supreme Court by several years in its overt hostility to federal securities fraud litigation and its determination to overturn established precedent in an attempt to blunt such lawsuits,<sup>64</sup> the Seventh Circuit held that in order to establish aiding and abetting liability, plaintiff had to establish all the elements of primary liability. Having pronounced that aiding and abetting liability on the one hand and primary liability on the other required proof of the same elements, the Seventh Circuit felt constrained to conjure up a distinction between the two. It did so by ruling that “primary and secondary liability differ in that one may be held secondarily liable without having actually purchased or sold a security,”<sup>65</sup> implying that one

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60. See, e.g., *Lerch v. Citizens First Bancorp., Inc.*, [1992-1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,258, at 95,172 (D.N.J. Feb. 2, 1992); *Bernstein v. Crazy Eddie, Inc.*, 702 F. Supp. 962, 978 (E.D.N.Y. 1988) (stating that because primary liability was adequately pled, “[i]t follows that the complaint adequately pleads aiding and abetting”).

61. Pollak, *supra* note 38, at 243.

62. 959 F.2d 521 (5th Cir. 1992).

63. *Id.* at 526; see also *Mirotnick v. Sensney, Davis & McCormick*, 658 F. Supp. 932, 941 (W.D. Wash. 1986) (admitting that jurisdiction’s differentiation between primary and aiding and abetting liability may be “more semantic than real” where defendant’s involvement is minimal).

64. See Sherry R. Sontag, *Harder to Sue*, NAT’L L.J., June 17, 1991, at 1.

65. *National Union Fire Ins. Co. v. Wilkins-Lowe & Co. Inc.*, 29 F.3d 337, 340 n.4 (7th Cir. 1994) (quoting *Renovitch v. Kauffman*, 905 F.2d 1040, 1045 n.7 (7th Cir. 1990)); see also *Robin v. Arthur Young & Co.*, 915 F.2d 1120, 1123-24 n.4 (7th Cir. 1990) (“Secondary liability . . . differs from primary liability in that secondary liability can attach to one who has not actually purchased or sold a security.”); *LHLC Corp. v. Cluett*,



cannot be primarily liable under Section 10(b) unless they purchased or sold securities.

This was clearly very wide of the mark. Nothing in the wording of Section 10(b) limits primary liability to sellers, and Congress knows how to limit liability to sellers if it wants to do so.<sup>66</sup> The lower courts have long held non-sellers to be liable for their misrepresentations and omissions under Section 10(b) and Rule 10b-5.<sup>67</sup> And several Supreme Court cases have addressed Section 10(b)/Rule 10b-5 liability regarding non-seller defendants without ever mentioning that only sellers can be liable under the provision.<sup>68</sup> *Central Bank* would have been the perfect opportunity for the Supreme Court to declare that only sellers could be liable under Section 10(b)/Rule 10b-5;<sup>69</sup> instead, as noted earlier, the Court expressly declared that

Peabody & Co., 842 F.2d 928, 932 (7th Cir. 1988) (“[A] party other than a purchaser or seller of securities faces liability as an aider and abettor . . . only if it would have been primarily liable had it purchased or sold the securities.”).

66. See *McGann v. Ernst & Young*, 95 F.3d 821, 825 (9th Cir. 1996); *Adam v. Silicon Valley Bancshares*, 884 F. Supp. 1398, 1402 (N.D. Cal. 1995) (quoting *Spear v. Ernst & Young*, [1994-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,399, at 90,743 (D.S.C. 1994)).

67. See, e.g., *SEC v. Seaboard Corp.*, 677 F.2d 1301, 1312 (9th Cir. 1982) (holding accountant liable as primary violator); *Competitive Assocs. v. Laventhol, Krekstein, Horwath & Horwath*, 516 F.2d 811, 815 (2d Cir. 1975) (finding “in connection with” requirement satisfied regarding non-selling accountant defendant); *Fund of Funds, Ltd. v. Arthur Andersen & Co.*, 545 F. Supp. 1314, 1351 n.18 (S.D.N.Y. 1982) (holding accountant liable as primary violator) (collecting cases); *Seiffer v. Topsy’s Int’l, Inc.*, 487 F. Supp. 653, 663, 667 (D. Kan. 1980) (finding “in connection with” element satisfied in case against accountant); *Lingenfelter v. Title Ins. Co. of Minn.*, 442 F. Supp. 981, 993 (D. Neb. 1977) (holding that “defendant need not be a ‘seller’ to be liable” under Section 10(b)/Rule 10b-5); *Bredehoeft v. Cornell*, 260 F. Supp. 557, 559 (D. Or. 1966) (holding that defendant need not be a “purchaser” to be liable); *Miller v. Bargain City, U.S.A., Inc.*, 229 F. Supp. 33, 38 (E.D. Pa. 1964) (same); *New Park Mining Co. v. Cranmer*, 225 F. Supp. 261, 266 (S.D.N.Y. 1963) (stating that a purchaser, seller, or third person may be liable); see also ROBERT J. HAFT, LIABILITY OF ATTORNEYS AND ACCOUNTANTS FOR SECURITIES TRANSACTIONS § 3.05, at 3-26 (1994-1995) (criticizing Seventh Circuit’s holding in *Robin*); Kuehnle, *supra* note 9, at 318 (criticizing Seventh Circuit approach). Fortunately, at least one post-*Central Bank* case has rejected the notion that *Central Bank* limits Section 10(b)/Rule 10b-5 liability to sellers only. See *Spear*, [1994-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 90,743.

68. See, e.g., *Herman & MacLean v. Huddleston*, 459 U.S. 375 (1983) (accountant defendant); *Aaron v. SEC*, 446 U.S. 680 (1980) (stock broker defendant); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976) (accountant defendant).

69. One could, of course, argue that *Central Bank* was not the “perfect opportunity” to make such a declaration because this was not the issue before the Court. However, as has been widely noted, the Supreme Court itself didn’t decide the issue that the parties had raised (the particulars of aiding and abetting liability), but a different issue (its very existence). See Lisa Klein Wager & John E. Failla, *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.—The Beginning of an End, Or Will Less Lead to More?*, 49 BUS. LAW. 1451, 1452-53 (1994).

there are often multiple violators of this antifraud rule.<sup>70</sup> Because there can be only one seller, non-sellers must be included among those "multiple violators." Indeed, as noted above, the Court itself said that "[a]ny person or entity, including a lawyer, accountant, or bank . . . who makes a material misstatement . . . may be liable as a primary violator" of Section 10(b)/Rule 10b-5 if all the elements of the offense are present, thereby clearly indicating that defendant's identity as a seller (or purchaser) is *not* an element of the offense.<sup>71</sup>

The Seventh Circuit's holdings in this area are so tortured and so plainly wrong that they stand as testament to the difficulty of finding any principled distinctions between primary and secondary liability under Section 10(b)/Rule 10b-5.<sup>72</sup>

(5) Most aiding and abetting cases fell into one of three categories.

(a) First, many of the claims framed as aiding and abetting involved misleading communications by the collateral defendants themselves, often complicated by a failure to correct.<sup>73</sup> There should have been no doubt before *Brennan* and there should be no doubt after *Central Bank* that one's liability for one's own misrepresentations and omissions is primary, not secondary.

(b) Many aiding and abetting cases attempted to impose liability upon collateral defendants for the misstatements (or omissions) of others. Even in the post-*Brennan*, pre-*Central Bank* period when aiding and abetting liability was in its prime, several lower courts con-

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70. See 511 U.S. 164, 191 (1994).

71. *Id.*

72. The Seventh Circuit completed its embarrassment in this area by issuing an opinion *three months after Central Bank* was decided that assumed the continued viability of aiding and abetting liability. See *National Union Fire Ins. Co. v. Wilkins-Lowe & Co.*, 29 F.3d 337, 340-41 & n.4 (7th Cir. 1994).

73. See, e.g., *Akin v. Q-L Indus.*, 959 F.2d 521, 531 (5th Cir. 1992) (holding that the same conduct, preparing reports that omitted crucial information, constituted both a primary and secondary violation by accountant); *Fine v. American Solar King Corp.*, 919 F.2d 290, 300-01 (5th Cir. 1990) (holding that issuance of a false audit opinion may constitute both primary and secondary violations); *In re Sahlen & Assocs. Sec. Litig.*, 773 F. Supp. 342, 351-60 (S.D. Fla. 1991) (holding that certifying false financial statements constitutes both aiding and abetting and a primary violation); *Gutfreund v. Christoph*, 658 F. Supp. 1378, 1385-86 (N.D. Ill. 1987) (holding that issuing a false projection can constitute aiding and abetting); *Summer v. Land & Leisure, Inc.*, 571 F. Supp. 380, 386 (S.D. Fla. 1983) (holding that certifying an inaccurate financial statement and failing to correct it constitute aiding and abetting); *Fund of Funds, Ltd. v. Arthur Andersen & Co.*, 545 F. Supp. 1134, 1356 (S.D.N.Y. 1982) (holding that a misstatement can constitute a primary violation or aiding and abetting); *Resnick v. Touche Ross & Co.*, 470 F. Supp. 1020, 1023 (S.D.N.Y. 1979) (holding that certification of false financial statements by accountant can constitute both a primary violation and aiding and abetting).

tinued to hold collateral defendants such as accountants *primarily* liable for the communications of others if their participation in the misleading communication was "direct" and other elements of Section 10(b)/Rule 10b-5 liability were met. For example, the Sixth Circuit developed a "direct contact" test holding that collateral parties' direct contact with investors gave rise to an affirmative obligation to disclose what their clients or others had omitted.<sup>74</sup> Many other courts had a lower standard of liability, holding collateral defendants liable for simply "participating" in the drafting of their clients' misleading documents.<sup>75</sup> These will be the most controversial post-*Central Bank* cases.

(c) Many other cases involved the failure of attorneys or accountants to "blow the whistle" on their clients' fraud.<sup>76</sup> Most courts

74. See *Molecular Tech. Corp. v. Valentine*, 925 F.2d 910 (6th Cir. 1991) The court noted:

This court applies a "direct contact" test for determining whether a defendant is liable as a primary violator.

"[O]nly those individuals who had an *affirmative obligation* to reveal what was allegedly omitted can be held as primary participants in the alleged deception . . . [.] A person undertaking to furnish information which is misleading because of a failure to disclose a material fact is a primary participant. Conversely, a person who does not undertake to furnish any information, and who is not aware of what information has been furnished, is under no duty to disclose material information in his possession."

*Id.* at 917 (quoting *SEC v. Washington County Util. Dist.*, 676 F.2d 218, 223 (6th Cir. 1982)). The court affirmed the liability of an attorney who helped draft and edit communications of his client that he knew were misleading. See *id.* at 918. However, the court's opinion carries no indication that there was actually "direct contact" between the defendant attorney and the plaintiff investors. Liability was imposed primarily because the attorney worked on misleading documents that he knew would be shown to investors. See *id.* at 919; see also *SEC v. Coffey*, 493 F.2d 1304, 1314 (6th Cir. 1974) (holding defendant liable where he "knew or should have known that the omitted information was significant").

75. See, e.g., *Breard v. Sachnoff & Weaver, Ltd.*, 941 F.2d 142, 143-44 (2d Cir. 1991) (imposing primary liability apparently because of the defendant attorney's participation in the drafting of a client limited partnership's misleading offering memorandum); *Moore v. Fenex, Inc.*, 809 F.2d 297, 305 (6th Cir. 1987) (stating that direct participation is key to being primary violator); *SEC v. Seaboard Corp.*, 677 F.2d 1301, 1312 (4th Cir. 1982) (ruling that accountant may be primarily liable "if its participation in the misrepresentation is direct"); *In re Rospatch Sec. Litig.*, 760 F. Supp. 1239, 1247 (W.D. Mich. 1991) (similar); *Mercer v. Jaffe, Snider, Raitt & Heuer*, 713 F. Supp. 1019, 1025 (W.D. Mich. 1989); *SEC v. Electronic Warehouse, Inc.*, 689 F. Supp. 53, 60 (D. Conn. 1988); *Lubin v. Sybedon Corp.*, 688 F. Supp. 1425, 1449 (S.D. Cal. 1988); *Union Carbide Corp. Consumer Prod. Business Sec. Litig.*, 676 F. Supp. 458, 467-69 (S.D.N.Y. 1987) (holding that investment banker's participation in preparing client's fraudulent announcements leads to primary liability under Rule 10b-5(a) and (c)). Although the *Breard* approach has generally been regarded as imposing liability for a lesser degree of misconduct than *Molecular Technology's* "direct contact" test, factually the cases seem nearly indistinguishable.

76. See, e.g., *Roberts v. Peat, Marwick, Mitchell & Co.*, 857 F.2d 646, 653 (9th Cir.

declined to impose such a duty,<sup>77</sup> meaning that failure to blow the whistle leads to neither primary nor secondary liability. Although most courts did not expressly so recognize, if a duty to “blow the whistle” does exist, failure to do so is properly characterized as leading to primary liability rather than mere secondary liability in the form of aiding and abetting or conspiracy.

If one were to graphically represent primary and aiding and abetting liability under Section 10(b)/Rule 10b-5, it would be useful to draw two concentric circles. The inner circle would represent primary liability. The outer circle would represent aiding and abetting liability, but it would be only the tiniest fraction larger than the inner circle because in theory and in application the two areas of fraudulent conduct covered by the two theories are nearly coextensive. Any space in the outer circle not covered by the inner circle should probably be filled with question marks, because during the thirty-year existence of the aiding and abetting theory, no court or commentator ever clearly established exactly what is covered by aiding and abetting liability that is not covered by primary liability. I will suggest that the question marks might be replaced by cases finding aiding and abetting liability in what have been called “standing around” liability cases and some closely-related whistleblowing cases.<sup>78</sup>

#### D. Central Bank and Its Implications

As with the pre-*Central Bank* state of the law, there has been copious summary and analysis of the *Central Bank* opinion<sup>79</sup> that will

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1988); *Rudolph v. Arthur Andersen & Co.*, 800 F.2d 1040, 1045-46 (11th Cir. 1986) (holding that an accounting firm can aid and abet by substantially assisting a cover-up); *Gilmore v. Berg*, 761 F. Supp. 358, 373 (D.N.J. 1991) (same). Although most cases of failure to “blow the whistle” involved lawyers or accountants, similar aiding and abetting claims were lodged against brokers for handling stock transactions. See, e.g., *Rolf v. Blyth, Eastman, Dillon & Co.*, 570 F.2d 38, 48 (2d Cir. 1978); *Martin v. Pepsi-Cola Bottling Co.*, 639 F. Supp. 931, 935 (D. Md. 1986). Other claims were lodged against banks for lending money. See, e.g., *Metge v. Baehler*, 762 F.2d 621, 626-30 (8th Cir. 1985); *Monsen v. Consolidated Dressed Beef Co.*, 579 F.2d 793, 797-99 (3d Cir. 1978).

77. See *infra* notes 314-25 and accompanying text.

78. See *infra* notes 326-33 and accompanying text.

79. See, e.g., *Brodsky*, *supra* note 18; *Gorman*, *supra* note 13; *Karmel*, *supra* note 11; *Langevoort*, *supra* note 9; *Ann Maxey, Competing Duties: Securities Lawyers' Liability After Central Bank*, 64 *FORDHAM L. REV.* 2185 (1996); *James D. Redwood, Toward a More Enlightened Securities Jurisprudence in the Supreme Court? Don't Bank on It Anytime Soon*, 32 *HOUS. L. REV.* 3 (1995); *Ruder*, *supra* note 12; *Seligman*, *supra* note 10; *Marc I. Steinberg, The Ramifications of Recent U.S. Supreme Court Decisions on Federal and State Securities Regulation*, 70 *NOTRE DAME L. REV.* 489 (1995); *Wager & Failla*, *supra* note 69; *John F. Olson et al., The End of the Section 10(b) Aiding and Abetting Li-*

not be supplemented here.<sup>80</sup> The *Central Bank* majority opinion has been properly criticized (a) for bringing an unduly stunted and formalistic dictionary-style analysis to federal securities laws;<sup>81</sup> (b) for being unfairly selective in its application of that analysis;<sup>82</sup> (c) for disingenuously mischaracterizing the history of Section 10(b)/Rule 10b-5 analysis;<sup>83</sup> (d) for being unduly influenced by unsubstantiated

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*ability Fiction*, INSIGHTS, June 1994, at 3; David J. Baum, Comment, *The Aftermath of Central Bank of Denver: Private Aiding and Abetting Liability Under Section 10(b) and Rule 10b-5*, 44 AM. U. L. REV. 1817 (1995); Sean G. Blackman, Note, *An Analysis of Aider and Abettor Liability Under Section 10(b) of the Securities Exchange Act of 1934: Central Bank of Denver v. First Interstate Bank of Denver*, 27 CONN. L. REV. 1323 (1995); Stephen J. Brown, Note, *Central Bank: The End of Secondary Liability Under Section 10(b) of the Securities Exchange Act of 1934*, 46 MERCER L. REV. 1515 (1995); Nathan F. Coco, Comment, *Has Legislative History Become History?: A Critical Examination of Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 20 J. CORP. L. 555 (1995); Craig J. Concannon, Note, *Central Bank of Denver v. First Interstate Bank: The End of Aiding and Abetting Liability Under Section 10(b) of the Securities Exchange Act of 1934*, 14 ST. LOUIS. U. PUB. L. REV. 679 (1995); Carrie E. Goodwin, Note, *Central Bank v. First Interstate Bank: Not Just the End of Aiding and Abetting Under Section 10(b)*, 52 WASH. & LEE L. REV. 1387 (1995); Nicole Miller, Note, *The Judicial Rejection of Aiding and Abetting Civil Liability Under Section 10(b): Will Central Bank of Denver Spell the End of the Implied 10(b) Cause of Action?*, 1995 UTAH L. REV. 913; Scott M. Murray, Note, *Central Bank of Denver v. First Interstate Bank of Denver: The Supreme Court Chops a Bough From the Judicial Oak: There is no Implied Remedy to Sue for Aiding and Abetting Under Section 10(b) and SEC Rule 10b-5*, 30 N. ENG. L. REV. 475 (1996); JoErin O'Leary, Note, *Securities Regulation—Central Bank, Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 33 DUQUESNE L. REV. 1053 (1995); Susan E. Springer, Note, *Central Bank v. First Interstate Bank and the Demise of Section 10(b) Private Aiding and Abetting Liability: Opting for a Rule of Economic Efficiency*, 4 GEO. MASON L. REV. 213 (1995); John F. X. Peloso & Stuart M. Sarnoff, *What Now for Aider and Abettor Liability?*, N.Y.L.J., June 16, 1994, at 3.

80. A brief glance at the majority opinion in *Central Bank* discloses that it held that there is no aiding and abetting liability under Section 10(b) because: (a) the statutory text does not mention such secondary liability, see 511 U.S. at 170-78; (b) no express liability provision in the 1933 or 1934 securities acts includes an aiding and abetting cause of action, see *id.* at 178-80; (c) post-1934 legislative developments do not definitively indicate that Congress intended aiding and abetting liability to exist, see *id.* at 185-90; (d) policy arguments do not show that elimination of aiding and abetting liability would lead to results so "bizarre" as to override the supposed clarity of the statutory text, see *id.* at 190-92; and (e) imposition of aiding and abetting liability cannot be based on the general federal criminal aiding and abetting statute, 18 U.S.C. § 2, see *id.* at 190.

81. See Alan R. Bromberg, *Aiding and Abetting: Sudden Death and Possible Resurrection*, 27 SEC. & COMMODITIES REG. 133, 139 (1994) (arguing that the *Central Bank* holding was "simplistic" and "overly literal"); Redwood, *supra* note 79, at 7 (suggesting that the Supreme Court should do more than thumb through the dictionary).

82. See Redwood, *supra* note 79, at 16 n.50 (pointing out that the Supreme Court in quoting Section 10(b) actually left out its final words which, significantly, are "as necessary or appropriate in the public interest or for the protection of investors").

83. The Court stated that in determining the scope of Section 10(b)'s grant of rule-making authority, it had limited its analysis to the text of the statute, whereas in determining the elements of liability within that proper scope it had used broader means of statutory interpretation. See *Central Bank*, 511 U.S. at 173-74. In fact, the Court has

policy claims that should have been essentially irrelevant to its stated mode of analysis;<sup>84</sup> (e) for failing to give deference to the SEC's interpretations pursuant to the *Chevron*<sup>85</sup> doctrine;<sup>86</sup> (f) for ignoring evidence that Congress has implicitly approved the existence of Section 10(b)/Rule 10b-5 aiding and abetting liability;<sup>87</sup> (g) for underemphasizing the importance of investor protection<sup>88</sup> and of ethical behavior and its role in creating an efficient capital market system;<sup>89</sup> and (h) for being inconsistent with a strong modern trend in both civil and criminal law to recognize "that those who play a substantial role in a harm are subject to liability."<sup>90</sup>

Such criticisms are at this point essentially water under the bridge.<sup>91</sup> The key question now is the impact of the decision. In the long run, the ultimate impact of *Central Bank* will depend upon how broad the lower courts determine the scope of primary liability under Section 10(b)/Rule 10b-5 to be.

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often used the broader tools of statutory construction to determine scope-type questions. See Bromberg, *supra* note 81, at 136 n.28.

84. See Seligman, *supra* note 10, at 1433. For a collection of sources that support the *Central Bank* majority's jaundiced view of securities litigation, see Blackman, *supra* note 79, at 1359-68.

85. In *Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 843-45 (1984), the Supreme Court ruled that courts should defer to agencies' interpretations of the statutes they administer so long as (a) the statutory language does not clearly resolve the issue, and (b) the agency's interpretation is not manifestly unreasonable.

86. See Nat Stern, *The Constitutionalization of Rule 10b-5*, 27 RUTGERS L. REV. 1, 27-28 (1995).

87. See Langevoort, *supra* note 9, at 887.

88. See Gorman, *supra* note 13, at 260 (arguing that *Central Bank* weakens the deterrent effect of federal securities laws and unintentionally chills investor confidence in markets); Kuehnle, *supra* note 9, at 316 (arguing pre-*Central Bank* that in light of (a) the existence of secondary liability in the common-law scheme pre-dating passage of the 1933 Securities Act and 1934 Securities Exchange Act, and (b) Congress's clear intention to provide investors protections at least as strong as those existing at common law, persons who took the position that "controlling person" liability was the exclusive form of secondary liability available under the federal securities laws "have a heavy burden to establish that Congress meant something that it easily could have said, but failed to say").

89. See O'Leary, *supra* note 79, at 1071.

90. Langevoort, *supra* note 9, at 887.

91. And, they are not unique to *Central Bank*. Similar criticisms can be made regarding most of the Supreme Court's decisions in Section 10(b)/Rule 10b-5 cases over the past two decades. See generally Stern, *supra* note 86 (criticizing the Supreme Court's decisions regarding Section 10(b) as "inconsistent" and involving poor statutory interpretation).

## II. A GENTLE REMINDER THAT THE BOUNDARIES OF SECTION 10(B)/RULE 10B-5 PRIMARY LIABILITY SHOULD BE GENEROUSLY DESCRIBED

It is important to remember that *Central Bank* itself does not in any way directly address the proper scope of primary liability under Section 10(b)/Rule 10b-5. Indeed, the *Central Bank* majority itself stressed that the scope of Section 10(b) liability on the one hand, and the particulars of its recognized existence on the other, are two completely different questions requiring different modes of analysis.<sup>92</sup> *Central Bank* merely holds that there is no basis in the statute's language for recognizing the existence of secondary liability. A holding that there is no secondary liability does not necessarily carry any implications for the proper scope of primary liability. True, the majority did engage in some gratuitous bashing of securities fraud litigation,<sup>93</sup> but that, at least according to the *Central Bank* majority, is essentially irrelevant to determination of the correct parameters of primary liability.<sup>94</sup>

To the extent that such policy matters are considered anyway, there is also substantial evidence casting doubt upon the "litigation crisis" mentality that apparently motivated the *Central Bank* majority.<sup>95</sup> In any event, passage of the Private Securities Litigation Reform Act of 1995 (PSLRA) substantially undermines any "litigation crisis" rationale<sup>96</sup> and should allow courts to recall that

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92. See 511 U.S. at 172-76.

93. See *id.* at 189 (referring to securities fraud litigation's "danger of vexatiousness" and to the "ripple effects" from "uncertainty and excessive litigation").

94. If the majority is correct, and the wording of the statute is the only determinant of the scope of Section 10(b)/Rule 10b-5 liability, see *id.* at 173, then policy considerations regarding the pros and cons of federal securities class actions and their impact on innovation and capital formation are irrelevant.

95. See, e.g., Janet Cooper Alexander, *The Lawsuit Avoidance Theory of Why Initial Public Offerings Are Underpriced*, 41 UCLA L. REV. 17, 33 n.59 (1993) (noting that although "hundreds" of securities class actions are filed every year, many of these relate to the same alleged offense and are eventually consolidated into a single suit); Baruch Lev, *Disclosure and Litigation*, 37 CAL. MGMT. REV., Spring 1995, at 8, 9 (suggesting a detailed empirical study that responsible communications with investors do not generate frivolous securities fraud litigation); Seligman, *supra* note 10, at 1434 ("[L]ess than one percent of the 17,400 companies that filed with the SEC in 1993 have been subject to [securities] litigation in any given year.")

96. Among other things, the PSLRA (a) placed significant limitations on the "professional plaintiffs" supposedly behind most federal securities law class actions, see 15 U.S.C.A. § 78u-4(a) (West Supp. 1996); (b) created a "safe harbor for forward-looking statements," thereby codifying defendants' "bespeaks caution doctrine" defense, see *id.* § 77z-2(c)(1); (c) altered in a pro-defendant fashion the requirements of loss causation, see *id.* § 77l(b); (d) heightened plaintiffs' pleading requirements, see *id.* § 78u-4(b); (e)

Section 10(b) is a remedial statute with broad remedial purposes<sup>97</sup> that should be flexibly and liberally construed to effectuate its compensatory purposes.<sup>98</sup> In its more generous moments, even the Supreme Court has recognized the investor protection policies that underlay much of Congress's motivation in passing the Securities Exchange Act of 1934.<sup>99</sup>

The main goal of the 1934 Act was to eliminate to the extent possible fraudulent securities transactions.<sup>100</sup> The 1934 Act's investor

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provided rules for discovery disputes that greatly benefit defendants, *see id.* § 78u-4(a)(3)(iv), (b)(3); (f) discourages litigation by sanctioning "abusive" suits, *see id.* § 78u-4(c); and, most importantly perhaps, (g) did much to eliminate collateral defendants' joint and several liability, *see id.* § 78u-4(g)(2)(B)(ii).

In the six weeks before the PSLRA was passed, forty-four Section 10(b)/Rule 10b-5 class action lawsuits were filed against accounting firms. In the four months following passage of the PSLRA, no such suits were filed. *See* Karen Donovan, *Bean Counters in a Bind: Trade-Off Expands Duties*, NAT'L L.J., Apr. 29, 1996, at B1. However, plaintiffs and plaintiffs' attorneys being the resourceful creatures that they are, state court securities fraud filings have increased dramatically since passage of the PSLRA, and federal filings have made a comeback as well. *See* Mike France, *Bye, Fraud Suits. Hello, Fraud Suits*, BUS. WK., June 24, 1996, at 127; Dean Starkman, *Securities Class-Action Suits Seem Immune to Effects of New Law*, WALL ST. J., Nov. 12, 1996, at B7.

97. *See* Tcherepnin v. Knight, 389 U.S. 332, 336 (1967) (Section 10(b) is remedial legislation); Kerbs v. Fall River Indus., 502 F.2d 731, 739 (10th Cir. 1974) (remedial purpose); Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228, 235 (2d Cir. 1974); Arpet, Ltd. v. Homans, 390 F. Supp. 908, 910 (W.D. Pa. 1975) (remedial purpose); Ingenito v. Bermec Corp., 376 F. Supp. 1154, 1178 (S.D.N.Y. 1974) (remedial purpose).

98. *See* Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 12 (1971) (flexible interpretation); *In re* American Continental Corp./Lincoln S&L Sec. Litig., 49 F.3d 541, 543 (9th Cir. 1995) (read flexibly in order to effect remedial purposes); International Controls Corp. v. Vesco, 490 F.2d 1334, 1345 (2d Cir. 1974) (interpret flexibly, not technically and restrictively); Herpich v. Wallace, 430 F.2d 792, 806 (5th Cir. 1970) (interpret broadly).

99. *See, e.g.*, Bateman Eichler, Hill Richards, Inc. v. Berner, 472 U.S. 299, 315 (1985) (concluding that the objective of securities laws was "protection of the investing public and the national economy through the promotion of 'a high standard of business ethics'"); Santa Fe Indus. v. Green, 430 U.S. 462, 475-76 (1977) ("[The] cases forcefully reflect the principle that '§ 10(b) must be read flexibly, not technically and restrictively' and that the statute provides a cause of action for any plaintiff who 'suffer[s] an injury as a result of deceptive practices touching its sale [or purchase] of securities . . .'" (citations omitted)); Affiliated Ute Citizens v. United States, 406 U.S. 128, 151 (1972) (stating that the main purpose of the 1934 Act was "to substitute a philosophy of full disclosure for the philosophy of *caveat emptor*"); *Superintendent of Ins.*, 404 U.S. at 12; SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186 (1963) (noting that the fundamental purpose of securities laws "is to substitute a philosophy of full disclosure for the philosophy of *caveat emptor* and thus to achieve a high standard of business ethics in the securities industry").

Admittedly, the current Supreme Court is not likely to stress these numerous holdings, but to respond as in *Aaron v. SEC*, 446 U.S. 680, 695 (1980), that "generalized references" to the securities laws' "remedial purposes" are not enough justification to construe a securities statute liberally.

100. *See* S. REP. NO. 73-792, at 1-5 (1934); *see also* Brennan v. Midwestern United Life



protection goals have been under significant assault lately by a wave of financial fraud accompanied by audit and other failures,<sup>101</sup> so it is a particularly inappropriate time to ignore the Act's basic purposes. Furthermore, the SEC "does not have the resources to investigate every instance in which a public company's disclosure is questionable . . . [and would not] even if the Commission's resources were substantially increased."<sup>102</sup> Therefore, the SEC encourages private enforcement of the securities laws and urged the Supreme Court in *Central Bank* to recognize aiding and abetting liability in both private actions and SEC enforcement actions. The Supreme Court has, in earlier Rule 10b-5 decisions, noted the importance of not undermining the congressional policy favoring private damage actions as an important mode of enforcing federal securities statutes.<sup>103</sup> A broad reading of the scope of Section 10(b)/Rule 10b-5 primary liability would help minimize fraud in the markets and thereby bolster investor confidence in those markets and make them more efficient as well.<sup>104</sup>

Furthermore, Section 10(b) was patterned, roughly, upon the common law of fraud and deceit.<sup>105</sup> To the extent that Congress in-

Ins. Co., 259 F. Supp. 673, 680 (N.D. Ind. 1966), *aff'd*, 417 F.2d 147 (7th Cir. 1969) (1934 Act "is directed toward the creation and maintenance of a post-issuance securities market that is free from fraudulent practices").

101. See Diana B. Henriques, *Business Fraud of the '90s: Falsifying Corporate Data*, N.Y. TIMES, Sept. 21, 1992, at A1 (there seems to be a sharp resurgence of fraud rooted in the way public companies are managed); Anthony Lewis, *Maintain Laws Against Securities Fraud*, HOUS. CHRON., May 23, 1995, at 16 ("It is a peculiar time to weaken legal protections: a time of spectacular financial frauds.").

It is also a time when a recent survey indicates that 47% of top executives are willing to misstate financial records, see Arthur P. Brief et al., *What's Wrong with the Treadway Commission Report? Experimental Analyses of the Effects of Personal Values and Codes of Conduct on Fraudulent Financial Reporting*, 15 J. BUS. ETHICS 183, 190 (1996), and where companies are increasingly outsourcing their internal audit functions away from the internal employees who have been uncovering most of the frauds to outside auditors who have failed to uncover the frauds. See Lee Berton, *Who is Going to Audit the Auditors?*, WALL ST. J., Mar. 5, 1996, at B1. This outsourcing in and of itself creates serious questions about the ability of outside auditors to adequately check their own work. See *id.*

102. *Securities Fraud Hearings Before the Subcomm. of the Senate Comm. on Banking, Housing & Urban Affairs*, 103d Cong. 113 (1993) (statement of William R. McLucas).

103. See *Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299, 307 (1985); see also *Pinter v. Dahl*, 486 U.S. 622, 636-37 (1988) (same in 1933 Act case).

104. See John A. MacKerron, *The Price Integrity Cause of Action Under Rule 10b-5: Limiting and Expanding the Use of the Fraud on the Market Theory*, 69 OR. L. REV. 177, 181-82 (1990).

105. See *Harris v. American Inv. Co.*, 523 F.2d 220, 224 (8th Cir. 1975) (common-law fraud concepts underlie the securities laws and provide guidance as to their reach and application); *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 855 (2d Cir. 1968) (Section 10(b) "should be interpreted as an expansion of the common law [in order] to effectuate

tended to alter the common law, it intended to make it *easier, not more difficult*, for securities law plaintiffs to recover under Section 10(b)/Rule 10b-5 than it had been under the common law,<sup>106</sup> because Congress realized “that the common law and state legislation afforded the public insufficient protection against plain fraud both in the issuance of securities and in post-issuance trading.”<sup>107</sup> The Supreme Court has concluded that Congress intended provisions such as Section 10(b) to “rectify perceived deficiencies in the available common-law protections,”<sup>108</sup> and to add to those protections.<sup>109</sup> This conclusion is justified by the legislative history, because the House Report on the 1934 Act indicated:

If investor confidence is to come back . . . the law must advance. As a complex society so diffuses and differentiates the financial interests of the ordinary citizen that he has to trust others and cannot personally watch the managers of all his interests as one horse trader watches another, it becomes a condition of the very stability of that society that its rules of law and of business practice recognize and protect that ordinary citizen's dependent position.<sup>110</sup>

Professor Loss has also noted that “[b]ecause of the legislative background it seems reasonable to assume at the very least that the most liberal common law views on these questions should govern under the statutes.”<sup>111</sup> Courts should bear this in mind as they establish

[its] broad remedial [purpose]”).

106. See *Bateman Eichler, Hill Richards, Inc.* 472 U.S. at 310 (stating that the Supreme Court has “eschewed rigid common-law barriers in construing the securities laws”); *Harris*, 523 F.2d at 224-28 (observing that Rule 10b-5 offers greater protection to plaintiffs than does the common-law tort of fraud); *Resort Car Rental Sys., Inc. v. Chuck Ruwart Chevrolet, Inc.*, 519 F.2d 317, 321 (10th Cir. 1975) (same); *James v. Gerber Prod. Co.*, 483 F.2d 944, 946 (6th Cir. 1973) (noting that Rule 10b-5 plaintiff does not face same limits to recovery as common-law fraud plaintiff); *Kubik v. Goldfield*, 479 F.2d 472, 476 n.6 (3d Cir. 1973) (stating that plaintiffs need not prove all elements of common-law fraud to recover under 10b-5); *SEC v. Manor Nursing Ctrs., Inc.*, 458 F.2d 1082, 1096 (2d Cir. 1972) (same).

107. LOUIS LOSS & JOEL SELIGMAN, *SECURITIES REGULATION* 27-28 (3d ed. 1989).

108. *Herman & MacLean v. Huddleston*, 459 U.S. 375, 389 (1983) (citing *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 186 (1963)).

109. See *Basic Inc. v. Levinson*, 485 U.S. 224, 244 n.22 (1988) (“Actions under Rule 10b-5 are distinct from common-law deceit and misrepresentation claims and are in part designed to add to the protections provided investors by the common law.” (citations omitted)).

110. H.R. REP. NO. 73-1383, at 5 (1934), reprinted in 5 LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934, at 5, n.158, item 18 (J.S. Ellenberger & Ellen P. Mahar eds., 1973).

111. LOUIS LOSS, *FUNDAMENTALS OF SECURITIES REGULATION* 812 (1983); see also 1 ALAN R. BROMBERG & LEWIS D. LOWENFELS, *SECURITIES FRAUD & COMMODITIES FRAUD* § 2.7(1), at 55 (1992) (“When it turned its attention to securities legislation, Con-

the boundary between actionable primary and nonactionable secondary liability under Section 10(b)/Rule 10b-5.

If in deciding the scope of primary liability the courts interpret Section 10(b)/Rule 10b-5 "so as to prevent fraud,"<sup>112</sup> the concept of primary liability will be given a broad range and the remedial and antifraud purposes of the legislation will be served. Nothing in *Central Bank* forbids this. After all, even the *Central Bank* majority opinion admitted that there is room for primary liability for collateral defendants under Section 10(b)/Rule 10b-5:

The absence of § 10(b) aiding and abetting liability 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 as a primary violator under 10b-5, assuming all of the requirements for primary liability under Rule 10b-5 are met. In any complex securities fraud, moreover, there are likely to be multiple violators; in this case, for example, respondents named four defendants as primary violators.<sup>113</sup>

In summary, although one reads the *Central Bank* opinion in vain trying to find even the slightest hint that the majority realizes it, it nonetheless remains true that Section 10(b)/Rule 10b-5 constitute a broadly remedial measure meant to give purchasers and sellers of securities more, not less, protection than they received from common-law theories of fraud and deceit. This gentle reminder to the Court unfortunately seems necessary in light of its decision in *Mer-*

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gress plainly expressed its wish that injured investors have an easier time [than at common law]."); Margaret V. Sachs, *The Relevance of Tort Law Doctrines to Rule 10b-5: Should Careless Plaintiffs Be Denied Recovery?*, 71 CORNELL L. REV. 96, 138 (1985) ("Congress's determination that common law protections were deficient suggests that in the face of divided common law opinions, the most liberal common law views of 1934 should govern.").

112. *Resort Car Rental Sys., Inc. v. Chuck Ruwart Chevrolet, Inc.*, 519 F.2d 317, 321 (10th Cir. 1975).

113. 511 U.S. at 191 (citations omitted). The dissent chimed in on this point:

Indeed, the [majority] anticipates that many aiders and abettors will be subject to liability as primary violators. For example, an accountant, lawyer, or other person making oral or written misrepresentations (or omissions, if the person owes a duty to the injured purchaser or seller) in connection with the purchase or sale of securities may be liable for a primary violation of § 10(b) and Rule 10b-5.

*Id.* at 199 n.10 (Stevens, J., dissenting) (citations omitted).

*tens v. Hewitt Associates*.<sup>114</sup> The *Mertens* Court, faced with an ambiguous statute, strained the statutory language to reach a conservative result that was outrageously at odds with the undeniably remedial purpose of the statute.<sup>115</sup> Although *Mertens* involved a totally different statute and issues that are distinguishable, its holding was an uncomfortable reminder of what a conservative court can do when it starts picking lexicographical nits in disregard of obvious legislative intent.<sup>116</sup>

### III. THE PROPER SCOPE OF PRIMARY LIABILITY UNDER SECTION 10(B)/RULE 10B-5

As noted earlier, analysis of primary liability can be broken down into three broad categories: (a) defendants' responsibility for their own misstatements (or omissions); (b) defendants' responsibility for the misstatements (or omissions) of others in which they participated; and (c) defendants' responsibility for the misstatements (or omissions) of others regarding which they did not "blow the whistle." I shall address these *seriatim*.

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114. 508 U.S. 248 (1993).

115. The *Mertens* majority held that the Employee Retirement Income Security Act of 1974 (ERISA) did not authorize suits for money damages against nonfiduciaries who knowingly *participate* in a fiduciary's breach of fiduciary duty. See 508 U.S. at 251-63. This holding was based on extremely vague and contradictory statutory language and ignored five basic points made by the dissenters: (a) the language at issue authorizing plaintiffs to seek "appropriate equitable relief" plausibly means relief which was available in courts of equity for a breach of trust; (b) compensatory money damages were in fact available in the equity courts for breach of trust; (c) nonfiduciaries who knowingly participated in another's breach of trust were liable for such damages at common law; (d) ERISA was grounded in the common-law experience and to be guided by the principles of trust law; and (e) ERISA was meant to provide more *protection* for plaintiffs than had the common law while the majority's interpretation clearly provided them with less. See *id.* at 263 (White, J., dissenting).

116. See, e.g., Maria Linda Cattafesta, Note, *Mertens v. Hewitt Associates: Nonfiduciary Liability for Money Damages Under ERISA*, 43 CATH. U. L. REV. 1165, 1175 (1994) (suggesting that "the *Mertens* decision will result in a level of protection for plan participants and beneficiaries who are victims of fiduciary breaches that is lower than that formerly available to such victims under the common law of trusts prior to ERISA's enactment, a result that directly counters ERISA's purpose"); Gregory A. Hewett, Note, *Should Non-Fiduciaries Who Knowingly Participate in a Fiduciary Breach Be Liable for Damages Under ERISA?*, 71 WASH. U. L.Q. 773, 800 (1993) (stating that "the Court in *Mertens* disregarded ERISA's fundamental purpose and accepted a strained interpretation of the statute that has left plan participants and beneficiaries with less protection than the common law provided").

A. *Primary Liability for One's Own Misrepresentations (or Omissions)*

This is an easy one. In *Central Bank*, the majority accepted the universal rule that Section 10(b) and Rule 10b-5 impose an obligation upon persons not to defraud investors through affirmative misrepresentations.<sup>117</sup> Not just corporations, but all actors (accountants, attorneys, underwriters, etc.) have a duty<sup>118</sup> not to tell lies in settings where they can reasonably foresee that investors will be misled and consequently injured.<sup>119</sup>

For example, false statements in a bank's opinion letter,<sup>120</sup> or an attorney's tax or bond opinion letter<sup>121</sup> can lead to primary Section 10(b)/Rule 10b-5 liability when all other statutory elements are present. When an accounting firm certifies a financial statement, it will be primarily liable for inaccuracies that occur therein, assuming the other elements of Section 10(b) liability are present,<sup>122</sup> because such

117. See Fischel, *supra* note 4, at 108 (“[T]he making of misrepresentations which distort the transmission of accurate information is the core conduct which Section 10(b) and Rule 10b-5 are meant to deter. That such misrepresentations are made by accountants or lawyers should not provide a shield from liability.”).

118. The “duty” element is one of the key requirements of Section 10(b)/Rule 10b-5 liability. In cases involving affirmative misrepresentations and half-truths, existence of a duty running to investors is generally presumed. See *Deutschman v. Beneficial Corp.*, 841 F.2d 502, 506 (3d Cir. 1988). Where the asserted wrong is a mere failure to speak, such a duty may be more difficult to locate. See *infra* notes 128-29 and accompanying text.

119. See *Akin v. Q-L Invs.*, 959 F.2d 521, 531-32 (5th Cir. 1992).

120. See *Herskowitz v. Nutri/System, Inc.*, 857 F.2d 179, 184-85 (3d Cir. 1988).

121. See, e.g., *Kline v. First W. Gov't Sec., Inc.*, 24 F.3d 480, 486-88 (3d Cir. 1994); *Ackerman v. Schwartz*, 947 F.2d 841, 846-47 (7th Cir. 1991); *Eisenberg v. Gagnon*, 766 F.2d 770, 776 (3d Cir. 1985); *Cronin v. Midwestern Okla. Dev. Auth.*, 619 F.2d 856, 862 (10th Cir. 1980); *SEC v. Spectrum, Ltd.*, 489 F.2d 535, 540-41 (2d Cir. 1973); *Gilmore v. Berg*, 761 F. Supp. 358, 371 (D.N.J. 1991); *Stevens v. Equidyne Extractive Indus.*, 694 F. Supp. 1057, 1064 (S.D.N.Y. 1988); *Bush v. Rewald*, 619 F. Supp. 585, 598 (D. Haw. 1985).

122. See, e.g., *Akin*, 959 F.2d at 531-32; *Arthur Young & Co. v. Reves*, 937 F.2d 1310, 1330-31 (8th Cir. 1991), *aff'd sub nom. Reves v. Ernst & Young*, 507 U.S. 1066 (1993); *Fine v. American Solar King Corp.*, 919 F.2d 290, 295-97 (5th Cir. 1990); *Manufacturers Hanover Trust v. Drysdale Sec. Corp.*, 801 F.2d 13, 20 (2d Cir. 1986); *Herzfeld v. Laventhol, Krekstein, Horwath & Horwath*, 540 F.2d 27, 33-37 (2d Cir. 1976); *In re Sahlen & Assoc. Sec. Litig.*, 773 F. Supp. 342, 351-60 (S.D. Fla. 1991); *Quantum Overseas, N.V. v. Touche Ross & Co.*, 663 F. Supp. 658, 666 (S.D.N.Y. 1987), *order rev'd*, 762 F.2d 930 (2d Cir. 1984); *Chemical Bank v. Arthur Andersen & Co.*, 552 F. Supp. 439, 454 (S.D.N.Y. 1982) (“ ‘Accountants may be primary wrongdoers when they [prepare and certify financial statements that] contain misrepresentations or omit to state facts necessary to make what is said not misleading [because] [f]inancial statements certified by an accountant for presentation to investors give rise to a direct duty to the public.’ ” (quoting *Seiffer v. Topsy's Int'l, Inc.*, 487 F. Supp. 653, 667 (D. Kan. 1980) (alterations in original)); *Resnick v. Touche Ross & Co.*, 470 F. Supp. 1020, 1022 (S.D.N.Y. 1979).

This is well settled despite the accounting profession's early insistence that figures in a certified financial statement were not representations by the auditor since they were

a certification is equivalent to any misrepresentation made in a business transaction in that it supplies information naturally and justifiably relied upon by others to make investment decisions.<sup>123</sup> This liability extends to misstatements of an issuer where the lawyer or accountant also happens to be a principal of that issuer, such as a director or important officer.<sup>124</sup> Although there exists an ongoing controversy regarding the scope of accountants' and attorneys' liability for negligent statements,<sup>125</sup> there is near unanimity in both state law and federal law, which can be traced back to the *Ultramares* case,<sup>126</sup> that a speaker's liability on fraud-related theories (such as Section 10(b)/Rule 10b-5) extends to all reasonably foreseeable

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prepared primarily by the client. See T.J. Fafilis, *Current Problems of Accountants' Responsibilities to Third-parties*, 28 VAND. L. REV. 31, 62 & n.110 (1975).

123. See *Fine*, 919 F.2d at 298 (stating that accounting firm potentially primarily liable for its own misstatements); *DiLeo v. Ernst & Young*, 901 F.2d 624, 628 (7th Cir. 1990) (noting that although it is difficult to distinguish primary from secondary liability, "[w]hen an accountant certifies that a firm's financial statements 'present fairly' its financial position . . . it is certifying the absence of materially misleading omissions, a source of primary liability. If it acts with the necessary mental state, the case for direct liability is complete."); *Chemical Bank v. Arthur Andersen & Co.*, 552 F. Supp. 439, 454-55 (S.D.N.Y. 1982); *Seiffer*, 487 F. Supp. at 667; *Fischer v. Kletz*, 266 F. Supp. 180, 186 (S.D.N.Y. 1967).

This liability can attach even if there was no direct communication from defendant to plaintiff. See *Anixter v. Home-Stake Prod. Co.*, 77 F.3d 1215, 1226 (10th Cir. 1996); see also *Humphreys*, *supra* note 38, at 383-84 ("If the alleged misrepresentation or omission occurred in the context of financial statements reported on by the accountant, there is no need to analyze aiding and abetting liability, the accountant's duty to disclose or the accountant's relationship to the investing public. The inquiry should be limited to whether there was a materially misleading omission or misrepresentation in those statements resulting from the accountant's fraudulent conduct."); *Metzger*, *supra* note 38, at 1391-92 (discussing duties and responsibilities of accountants).

124. See, e.g., *Wilson v. Great Am. Indus.*, 855 F.2d 987, 995 (2d Cir. 1988) (holding lawyer who was also director, secretary, and shareholder liable for company's misrepresentations); *Pucci v. Santi*, 711 F. Supp. 916, 925-26 (N.D. Ill. 1989) (same); *Felts v. National Account Sys. Ass'n*, 469 F. Supp. 54, 68 (N.D. Miss. 1978) (same). The relatively controversial "group published" theory extends primary liability for disclosure deficiencies in corporate communications to those officers actively involved in the corporation's affairs. See, e.g., *Wool v. Tandem Computers Inc.*, 818 F.2d 1433, 1440 (9th Cir. 1987).

125. See generally Brian K. Kirby & Thomas L. Davies, *Accountant Liability: New Exposure for an Old Profession*, 36 S.D. L. REV. 574 (1991) (examining developing theories of accountant liability and their impact on the accounting profession); Gary Lawson & Tamara Mattison, *A Tale of Two Professions: The Third-Party Liability of Accountants and Attorneys for Negligent Misrepresentation*, 52 OHIO ST. L.J. 1309 (1991) (describing legal standards used by courts in cases of third-party claims of negligent misrepresentation and reviewing trends of the last two decades).

126. In *Ultramares*, Judge Cardozo was careful to distinguish between mere negligence, regarding which he was concerned about sheltering accountants from indeterminate liability to an indeterminate number of persons for an indeterminate time, and fraud, as to which he was determined not to "emancipate accountants from the consequences." *Ultramares Corp. v. Touche, Niven & Co.*, 174 N.E. 441, 448 (N.Y. 1931).

plaintiffs.<sup>127</sup>

Of course, a distinction is typically drawn between active misrepresentation cases, where it is universally recognized that injured third-parties may sue for fraud, and nondisclosure cases, where the common law typically did not impose liability. Notwithstanding this bifurcation, the common law recognized numerous situations where a duty to disclose did arise vis-à-vis third-parties. The Supreme Court has acted in recent years as though there was only one such exception—the fiduciary duty exception.<sup>128</sup> But, in point of fact, the common law has recognized multiple exceptions to the traditional *caveat emptor* rule.<sup>129</sup> Because the 1934 Exchange Act was passed to

127. See, e.g., *Ackerman v. Schwartz*, 947 F.2d 841, 847 (7th Cir. 1991) (applying rule to author of tax investment letter); *FDIC v. Hudson*, 758 F. Supp. 663, 670 (D. Kan. 1991) (citing the rule generally); *In re Investors Funding Corp. of N.Y. Sec. Litig.*, 523 F. Supp. 550, 558 (S.D.N.Y. 1980) (same); *Oleck v. Fischer*, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,898, at 95,699 (S.D.N.Y. June 8, 1979), *aff'd*, 623 F.2d 791 (2d Cir. 1980) (holding that accountant who is reckless is liable to parties whose reliance upon the false document is reasonably foreseeable); *Bily v. Arthur Young & Co.*, 834 P.2d 745, 753 (Cal. 1992) (applying rule to auditors), *rev'd on other grounds*, 834 P.2d 745 (Cal. 1992); *Fidelity & Deposit Co. of Md. v. Atherton*, 144 P.2d 157, 161 (N.M. 1943) (applying rule to county-employed auditors); *Haberman v. Washington Pub. Power Supply Sys.*, 744 P.2d 1032, 1070 (Wash. 1987) (noting that rule may be applied to professionals other than accountants). See generally RESTATEMENT (SECOND) OF TORTS § 531, *illus.* 4 (1977) (illustrating accountants' liability to third-party relying on his or her report); W. PAGE KEETON ET AL., PROSSER AND KEETON ON THE LAW OF TORTS § 107, at 744-45 (5th ed. 1984) (noting that reliance by third-parties on information need merely be foreseeable); Bonita A. Daly & John M. Gibson, *The Delineation of Accountants' Legal Liability to Third-parties: Bily and Beyond*, 68 ST. JOHN'S L. REV. 609, 618 (1994) (“[A]ccountants may be held liable not only to their clients but also to reasonably foreseeable third-parties for intentional fraud . . .”).

128. A duty to speak obviously arises where there is a fiduciary relationship or some other relationship of trust and confidence. See *Chiarella v. United States*, 445 U.S. 222, 228 (1980).

129. The Supreme Court's seeming presumption that the fiduciary relationship situation is the only one imposing a duty to speak is woefully inconsistent with the common law. Numerous other exceptions exist to the general rule, which is fortunate, since the general rule reflects “dubious business ethics.” See KEETON ET AL., *supra* note 127, § 106, at 737. These exceptions are now so numerous that it is at least plausible to argue that they have swallowed the traditional rule of *caveat emptor*. As one commentator has noted, “[t]here are . . . occasional modern cases which have held that so long as one adversary does not actively mislead another he is perfectly free to take advantage, no matter how unfair, of ignorance . . . . These are surely singularly unappetizing cases.” *Id.* § 106, at 737-38. Even a partial listing of these exceptions is lengthy.

For example, a second exception arises from the rule that even if a defendant does speak truthfully, he must say enough not to mislead. In other words, silence can lead to liability for half-truths. See *Dennis v. Thomson*, 43 S.W.2d 18, 23 (Ky. 1931); *Smith v. Pope*, 176 A.2d 321, 324-25 (N.H. 1961); *Uptegraft v. Dome Petroleum Corp.*, 764 P.2d 1350, 1353 (Okla. 1988) (duty to speak may arise from partial disclosure); *Palmiter v. Hackett*, 185 P. 1105, 1106 (Or. 1920).

Third, one who speaks truthfully and then learns either that (a) he was mistaken at the time he spoke, or (b) the facts have changed since he spoke so as to make his statement inaccurate, must speak out. Silence in such situations constitutes fraud. See *Fitzgerald v. McFadden*, 88 F.2d 639, 642 (2d Cir. 1937); *Loewer v. Harris*, 57 F. 368, 373 (2d Cir. 1893); *Mammas v. Oro Valley Townhouses*, 638 P.2d 1367, 1369 (Ariz. App. 1981); *Tempo Tamers, Inc. v. Crow-Houston Four, Ltd.*, 715 S.W.2d 658, 669 (Tex. App. 1986).

Fourth, a duty to speak out may be imposed when one party realizes that the other is acting under a misapprehension. See *Tyra v. Cheney*, 152 N.W. 835, 835 (Minn. 1915); *Shea v. H.S. Pickrell Co.*, 748 P.2d 980, 982 (N.M. Ct. App. 1987).

Fifth, a duty to speak out is often imposed when one party has such a superior position, perhaps because of training, education or professional experience, that it is natural for the other party to rely. See *First Ala. Bank of Montgomery, N.A. v. First State Ins. Co.*, 899 F.2d 1045, 1057 (11th Cir. 1990) (superior expertise); *Mancini v. Gorick*, 536 N.E.2d 8, 9-10 (Ohio Ct. App. 1987) (noting that defendant's position may lead to natural reliance).

Sixth, a duty to speak out can be imposed in situations where one party has superior knowledge or access to information. See *FDIC v. W.R. Grace & Co.*, 877 F.2d 614, 619 (7th Cir. 1989); *Kociemba v. G. D. Searle & Co.*, 707 F. Supp. 1517, 1526 (D. Minn. 1989); *Posner v. Davis*, 395 N.E.2d 133 (Ill. App. Ct. 1979); *Irons v. Community State Bank*, 461 N.W.2d 849, 854 (Iowa Ct. App. 1990) (ruling that duty to speak can arise from inequality of condition and knowledge); *Silva v. Stevens*, 589 A.2d 852, 857 (Vt. 1991).

Seventh, a duty to speak out may arise if a party actively conceals material facts. See *American-Traders' Nat'l. Bank v. Henderson*, 133 So. 36, 37 (Ala. 1931); *Nicolet, Inc. v. Nutt*, 525 A.2d 146, 149 (Del. Super. 1987); *Moser v. DeSetta*, 589 A.2d 679, 682 (Pa. Super. 1989).

Eighth, a duty to speak out can be imposed in situations where the elements of estoppel apply. See *Stambovsky v. Ackley*, 169 A.2d 254, 260 (N.Y. App. Div. 1991) (because seller had told the public of ghosts in her house, "she may be said to owe no less a duty to her contract vendee").

Ninth, courts often impose duties to speak out in cases of latent or hidden defects that the buyer is unlikely to discover through a reasonable inspection. See *Schnell v. Gustafson*, 638 P.2d 850, 852 (Colo. Ct. App. 1981); *Harton v. Harton*, 344 S.E.2d 117, 119 (N.C. App. 1986).

Tenth, courts often impose a duty to speak in contracts of *uberrima fides*, of utmost good faith. See *Jewish Center of Sussex County v. Whale*, 397 A.2d 712, 715-16 (N.J. Super. 1978); *Connecticut Gen. Life Ins. Co. v. Chase*, 47 A. 825, 826 (Vt. 1900).

Eleventh, where one is in a position where her silence will convey a misleading impression, a duty to disclose may arise. See *Atwood v. Chapman*, 68 Me. 38, 42 (1877).

Twelfth, a duty to disclose arises whenever one couples silence with any artifice or trick designed to lull the other party into a sense of false security. See *First Nat. Bank v. Elam*, 258 P. 892, 898 (Okla. 1927).

Thirteenth, there have been numerous modern cases that impose a duty to disclose where failure to do so would strike a normal person as unethical. See *KEETON ET AL.*, *supra* note 127, § 106, at 739; see also *Hand v. Dayton-Hudson*, 775 F.2d 757, 759 (6th Cir. 1985) (speaking of "equitable duty" of disclosure); *Southern Land Dev. Co. v. Meyer*, 159 So. 245, 246 (Ala. 1935) ("good faith" standard); *Berger v. Security Pac. Info. Sys., Inc.*, 795 P.2d 1380, 1383 (Colo. Ct. App. 1990) ("in equity or good conscience" test); *Weintraub v. Krobatsch*, 317 A.2d 68, 71 (N.J. 1974) ("conscience and duty" test); *George Cohen Agency, Inc. v. Donald S. Perlman Agency, Inc.*, 114 A.D. 930, 932 (N.Y. App. Div. 1985) (holding that disclosure is required where necessary for "good faith"); *Ollerman v. O'Rourke Co., Inc.*, 288 N.W.2d 95, 107 (Wis. 1980) (using "reasonable expectation of honesty in the marketplace" standard).



eliminate the philosophy of *caveat emptor* and to raise the level of ethics in the stock marketplace,<sup>130</sup> those exceptions should be expanded, not minimized, in Section 10(b)/Rule 10b-5 jurisprudence. Some lower courts had already invoked these non-fiduciary duty common law exceptions as a basis for primary liability before *Brennan* introduced aiding and abetting liability.<sup>131</sup>

Liability for one's own misstatements (or omissions) was often characterized as aiding and abetting liability before *Central Bank* was decided.<sup>132</sup> However, it was really primary liability and it remains so today. Of this, there should be no doubt, although tangential questions regarding duties to correct and to update will remain.<sup>133</sup> The post-*Central Bank* cases are having no difficulty with such situations.<sup>134</sup>

### B. Primary Liability for the Misstatements (or Omissions) of Others

The most important and controversial question that arises following *Central Bank* is this: Can one owe (and breach) a duty to the investing public, and therefore be viewed as primarily liable, based on *another's* misstatement? Most often the issue will be whether accountants, lawyers, investment bankers or others can become so involved in their clients' communications that they should be held

130. See *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 186 (1963) (concluding that fundamental purpose of securities laws is "to substitute a philosophy of full disclosure for the philosophy of *caveat emptor* and thus to achieve a high standard of business ethics in the securities industry").

131. See *Fischer v. Kletz*, 266 F. Supp. 180, 184-85 (S.D.N.Y. 1967) (invoking "change of facts" exception).

132. See *supra* notes 58-60 and accompanying text.

133. See *IIT v. Cornfeld*, 619 F.2d 909, 927 (2d Cir. 1980) (holding that accountants have duty to correct misstatements they discover upon which they know public is relying); *Mishkin v. Peat, Marwick, Mitchell & Co.*, 658 F. Supp. 271, 273 (S.D.N.Y. 1987) (ruling that accounting firms have duty to correct); *In re AM Int'l Sec. Litig.*, 606 F. Supp. 600, 607 (S.D.N.Y. 1985) (concluding that accounting firm has "a duty to take reasonable action to disclose errors or to correct financial statements for which it previously gave its opinion"); *Summer v. Land & Leisure, Inc.*, 571 F. Supp. 380, 385 (S.D. Fla. 1983) (duty to correct).

134. See, e.g., *McGann v. Ernst & Young*, 95 F.3d 824, 828 (9th Cir. 1996) (holding accounting firm directly liable for issuing a false audit opinion with knowledge that the opinion would be made public); *Trust Co. of La. v. N.N.P., Inc.*, 92 F.3d 341, 350-53 (5th Cir. 1996) (affirming verdict against attorney who wrote misleading letters to potential investors); *Knapp v. Ernst & Whinney*, 90 F.3d 1431, 1436-38 (9th Cir. 1996) (affirming verdict against accounting firm for statements it made in financial statements); *Anixter v. Home-Stake Prod. Co.*, 77 F.3d 1215, 1226-27 (10th Cir. 1996) (holding accountants liable for statements directly attributable to them); *In re MTC Elec. Tech. Shareholders Litig.*, 898 F. Supp. 974, 987 (E.D.N.Y. 1995) (holding underwriters liable for research report they prepared).

primarily liable for affirmative misrepresentations contained therein. The two lines of cases that have developed in *Central Bank's* wake are nearly polar opposites.

## 1. The Post-*Central Bank* Cases Summarized

### a. The Narrow View

In the wake of *Central Bank*, several lower courts have adopted a narrow view of what activity can constitute a primary violation of Section 10(b)/Rule 10b-5. This narrow view asserts that if a defendant did not make a particular false statement, the defendant cannot be liable for the false statement. No amount of participation or assistance to the maker of the statement can convert the defendant into anything more than an aider and abettor. Under this view, lawyers, accountants, and underwriters cannot be primarily liable for statements issued under the names of their clients.<sup>135</sup>

For example, in *In re Kendall Square Research Corp. Securities Litigation*,<sup>136</sup> the trial court allowed investors to sue Kendall Square's auditor over its statements in an unqualified opinion issued regarding certain of Kendall Square's financial statements. The court correctly viewed the opinion as a representation by the accounting firm which, if it contained intentionally false misstatements or omissions, could be the basis for primary liability under Section 10(b)/Rule 10b-5.<sup>137</sup> However, the court refused to allow plaintiffs to pursue a claim based upon the auditor's mere review and approval of other financial statements and prospectuses. These communications were the client's, not the auditor's. At most, the auditor substantially assisted the client in making the communication, and that was deemed insufficient for liability after *Central Bank*.<sup>138</sup> The court also held that the

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135. Several pre-*Central Bank* cases took this same point of view. For example, in *Friedman v. Arizona World Nurseries Ltd.*, 730 F. Supp. 521 (S.D.N.Y. 1990), *aff'd*, 927 F.2d 594 (2d Cir. 1991), the court refused to hold a law firm liable for drafting an offering memorandum that contained false statements that were not attributed to the law firm itself. *See id.* at 533-34. The only portions of the offering memorandum that were attributed to the law firm—a legal opinion and a tax assistance letter—did not contain false statements. *See id.* at 533-34.

And in *Schatz v. Rosenberg*, 943 F.2d 485 (4th Cir. 1991), the court held that “a lawyer or law firm cannot be held liable for the representations of a client, even if the lawyer incorporates the client's misrepresentations into legal documents or agreements necessary for closing the transaction.” *Id.* at 495.

136. 868 F. Supp. 26 (D. Mass. 1994).

137. *See id.* at 27-28.

138. *See id.* at 28 (“Because Price Waterhouse did not actually engage in the reporting of the financial statements and prospectuses, but merely reviewed and approved them,

auditor's involvement in structuring many of the client's improperly recognized transactions did not make the subsequent improper reporting the auditor's communication rather than the client's.<sup>139</sup>

Coopers & Lybrand was the collateral defendant on the hot seat in *In re Cascade International Securities Litigation*.<sup>140</sup> Coopers had been hired to audit two of Cascade's numerous subsidiaries and to provide other accounting advice to Cascade. Levy was Cascade's auditor. Plaintiffs alleged, in part, that Coopers gave tax advice to Cascade and to Levy and gave advice regarding whether Cascade should consolidate its financial statements with those of its numerous subsidiaries. The court held that "[t]his advice did not act as a statement by Defendant Coopers & Lybrand upon which the public relied, and, at the most, could only be considered as aiding or abetting the fraud being committed by Cascade which is not actionable under *Central Bank*."<sup>141</sup>

The narrow view stands for the proposition that a defendant's "substantial assistance" to another's misrepresentations cannot lead to primary liability,<sup>142</sup> and is consistent with many cases decided by

the statements *are not attributable to Price Waterhouse* and thus Price Waterhouse cannot be found liable for *making* a material misstatement." (emphasis added)).

139. *See id.* at 28 n.1 ("[T]he participation in the 'structuring' does not constitute the making of a material misstatement; rather, it is the improper reporting of the 'structured' transactions by the Company in its quarterly statements that constitutes the alleged Section 10(b) violation.").

Other courts addressing accountants' Section 10(b) liability have accepted the distinction drawn by *Kendall Square*. For example, in *O'Neil v. Appel*, 897 F. Supp. 995 (W.D. Mich. 1995), the court held that an accounting firm that issues an unqualified audit report that it knows is false and will be attached to an SEC filing can be primarily liable, but that same firm is not liable for merely reviewing and approving documents of the client. *See id.* at 1000; *see also* *Stamatio v. Hurco Co.*, 885 F. Supp. 1180, 1185 (S.D. Ind. 1995) (appearing to hold that primary liability attaches only to those who misrepresent or omit a material fact); *Vosgerichian v. Commodore Int'l*, 862 F. Supp. 1371, 1378 (E.D. Pa. 1994) (holding that issuance of a false "clean" audit report would be actionable, but not advising, concurring, guiding, approving, and otherwise directly and substantially assisting a client's fraudulent treatment of items on its financial statements).

140. 894 F. Supp. 437 (S.D. Fla. 1995).

141. *Id.* at 442.

142. *See Anixter v. Home-Stake Prod. Co.*, 77 F.3d 1215, 1226 (10th Cir. 1996) ("[W]e conclude that in order for accountants to 'use or employ' a 'deception' actionable under the antifraud law, they must themselves make a false or misleading statement (or omission) that they know or should know will reach potential investors.").

In a case involving manipulation rather than false statements, a court recently held that a stock trader could, with full knowledge of a manipulative plot and with intent to profit, assist that plot by executing trades that he knew were wash sales and other manipulative devices and yet be only an aider and abettor not reachable by Section 10(b)/Rule 10b-5. *See SEC v. U.S. Envtl.*, 929 F. Supp. 168, 171-72 (S.D.N.Y. 1996). According to the court, unless the defendant "controlled" the manipulative scheme, he was merely an aider and abettor. *See id.* at 171.

the lower courts both before<sup>143</sup> and after<sup>144</sup> *Central Bank*.

Although courts taking this narrow view are not unanimous regarding all possible scenarios,<sup>145</sup> the purest version of this view is summarized in the following words of one court:

[I]f *Central Bank* is to have any real meaning, a defendant must actually make a false or misleading statement in order to be held liable under Section 10(b). Anything short of such conduct is merely aiding and abetting, and no matter how substantial that aid may be, it is not enough to trigger liability under Section 10(b).<sup>146</sup>

### b. The Broad View

Not all lower courts are following the narrow view. Some have held that under proper circumstances Section 10(b)/Rule 10b-5 collateral defendants can indeed be held liable for statements made by others. For example, in *In re ZZZZ Best Securities Litigation*,<sup>147</sup> plaintiffs challenged thirteen public statements made by the client

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143. See, e.g., *Abell v. Potomac Ins. Co.*, 858 F.2d 1104, 1125-26 (5th Cir. 1988), *vacated on other grounds sub nom. Fryar v. Abell*, 492 U.S. 914 (1989); *Friedman v. Arizona World Nurseries Ltd.*, 730 F. Supp. 521, 533 (S.D.N.Y. 1990), *aff'd*, 927 F.2d 594 (2d Cir. 1991); *Buford White Lumber Co. Profit Sharing & Sav. Plan & Trust v. Octagon Properties Ltd.*, 740 F. Supp. 1553, 1570 (W.D. Okla. 1989).

Langevoort, quite correctly, calls these holdings "troubling" if the attorneys were actively involved in preparing the client's fraudulent communication, "for when the lawyer bears such primary responsibility for the misinformation, there is no need to invoke secondary liability. The very idea of aiding-and-abetting liability is to reach those who only assist, rather than commit, a primary violation." Langevoort, *supra* note 39, at 86 n.40.

144. See, e.g., *Klein v. Boyd*, No. 95-5410, 1996 U.S. Dist. LEXIS 19153, at \*80-82 (E.D. Pa. 1996) (law firm held not to be liable for false statements and omissions in two documents that it prepared for its client because the firm's name did not appear on the document); *In re JWP, Inc. Sec. Litig.*, 928 F. Supp. 1239, 1256 (S.D.N.Y. 1996) (holding that members of audit committee could not be liable for statements they did not make); *Lycan v. Walters*, 904 F. Supp. 884, 901 n.12 (S.D. Ind. 1995) (rejecting the notion that an attorney could be primarily liable under Section 10(b) for circulating a client's statement that he knows to be false); see also *Brown v. Benchmark Power Corp.*, No. 95-35578, 1996 U.S. App. LEXIS 20523, at \*10 (9th Cir. 1996) (stating cryptically in opinion not for publication or citation that for an auditor to be liable it must do more than merely audit and fail to publicly blow the whistle on client's wrongdoing—"There must also be some sort of public statement or other affirmative act" (emphasis added)).

145. For example, in *Walco Investments, Inc. v. Thenen*, 881 F. Supp. 1576, 1582-83 (S.D. Fla. 1995), the court took the narrow view that an underwriter could not be liable for statements it did not make, yet hedged the ruling by suggesting that primary liability could be based on disseminating false statements made by others, which other narrow view cases, such as *In re MTC Electronic Technology Shareholders Litigation*, 898 F. Supp. 974, 987 (E.D.N.Y. 1995), appear to reject.

146. *In re MTC Elec. Tech. Shareholders Litig.*, 898 F. Supp. at 987.

147. 864 F. Supp. 960 (C.D. Cal. 1994).

company in press releases and SEC filings, none of which attributed its existence to the company's auditor or even hinted that the auditor might be involved in its issuance. However, based on plaintiffs' claims that the auditor was "intricately involved" in the creation, review, or issuance of the misleading statements, the court held that the statements might well be attributable to the auditor and that the auditor could be *primarily* liable for their inaccuracies. The court rejected the auditor's claim that these were the client's communications and that the most it had done was aid and abet their making.<sup>148</sup>

Similarly, in *In re Software Toolworks Inc.*,<sup>149</sup> the Ninth Circuit held that underwriters who joined with other professionals in drafting a client's letter to the SEC and accountants who reviewed, discussed, edited, and helped draft letters to the SEC were both potentially *primarily* liable.<sup>150</sup>

Several other courts have found the approaches of *ZZZZ Best* and *Software Toolworks* to be persuasive and have held, consequently, that under proper circumstances collateral Section 10(b)/Rule 10b-5 defendants could be *primarily* liable for their "involvement,"<sup>151</sup> "central involvement,"<sup>152</sup> or for being "primary actors"<sup>153</sup> or for "actively participating"<sup>154</sup> in the "preparation"<sup>155</sup> of fraudulent communications of others even after *Central Bank*.<sup>156</sup>

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148. See *id.* at 966-72.

149. 38 F.3d 1078 (9th Cir. 1994).

150. See *id.* at 1087 (underwriters) & 1090 n.3 (accountants).

151. See *Adam v. Silicon Valley Bancshares*, 884 F. Supp. 1398, 1401-02 (N.D. Cal. 1995) (regarding accounting firm that was "involved" in preparation of client's prospectus, interim financial statements, and press releases which were part of an overall scheme to defraud).

152. See *Cashman v. Coopers & Lybrand*, 877 F. Supp. 425, 432 (N.D. Ill. 1995) (holding accountants potentially *primarily* liable because they played "a central role in the drafting and formation of the alleged misstatements" which client incorporated into its prospectus).

153. See *Employees Ins. of Wausau v. Musick, Peeler & Garrett*, 871 F. Supp. 381, 389 (S.D. Cal. 1994) (citing *Software Toolworks* for the view that one who plays a "significant role" in the preparation of a fraudulent communication is a "primary actor" who can be *primarily* liable under Section 10(b)/Rule 10b-5).

154. See *Phillips v. Kidder, Peabody & Co.*, 933 F. Supp. 303, 316 (S.D.N.Y. 1996) (holding underwriter potentially "responsible" and therefore *primarily* liable for "actively participat[ing] in formulating the language of the prospectus" even though the prospectus was issued in the client's name).

155. See *Whirlpool Fin. Corp. v. GN Holdings, Inc.*, 873 F. Supp. 111, 119 (N.D. Ill. 1995) (noting Rule 10b-5's "wide-open language" in holding liable all those who prepared a false memorandum issued in a corporation's name).

156. See also *In re MTC Elec. Tech. Shareholders Litig.*, 898 F. Supp. 974, 980 (E.D.N.Y. 1995) (expressing tentative belief that corporate officers can be *primarily* liable for statements for which they were not personally responsible); *In re U.S.A. Classic*

## 2. The Post-Central Bank Cases Analyzed

Before I set forth what I believe to be the viable post-*Central Bank* theories for imposing primary liability upon some defendants for statements issued under the names of others, let me emphasize why the courts taking what I have denominated as the “narrow view” of this issue have erred.

The “narrow” view, premised on the notion that one cannot ever be liable for statements made by another, does create a “bright-line” test. Such tests have their advantages, primarily those that stem from having a clear rule that people can count on in planning their activities and having a rule that is easily and (relatively) inexpensively litigated.<sup>157</sup> With the narrow view, participants in the securities industry know that if their name is not on the report as author, the chances of their being held liable for damages in a Section 10(b)/Rule 10b-5 private damages action are virtually nil. Accountants and lawyers know that they can respond, when called upon by clients for assistance in editing, drafting, and even circulating documents to investors, without the risk of incurring Section 10(b)/Rule 10b-5 liability. But that advantage, admittedly important to the *Central Bank* majority,<sup>158</sup> is outweighed by the narrow view’s weaknesses.

The principal weakness of the narrow approach lies in its potential to allow egregious wrongdoing to go unpunished<sup>159</sup> and serious

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Sec. Litig., [1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,837, at 93,046 (S.D.N.Y. June 16, 1995) (holding issuer, corporate officers, and underwriter all potentially primarily liable as “direct participants” in fraudulent scheme).

On the other hand, if collateral defendants assist a primary wrongdoer’s scheme in ways that do not involve false representations or omissions, it does not seem that they have done anything more than aid and abet. See, e.g., *Primavera Familienstiftung v. Askin*, No. 95-8905, 1996 U.S. Dist. LEXIS 12683, at \*20 (S.D.N.Y. 1996) (drawing such a distinction).

157. Cf. *Anixter v. Home-Stake Prod. Co.*, 77 F.3d 1215, 1227 (10th Cir. 1996) (noting that while the rule in *Central Bank* is “far from a bright line,” it “provides more guidance to litigants than a rule allowing liability to attach to an accountant or other outside professional who provided ‘significant’ or ‘substantial’ assistance to the representations of others”).

158. The majority stated that one of the primary problems with recognition of aiding and abetting liability was that “the rules for determining aiding and abetting liability are unclear, in ‘an area that demands certainty and predictability.’” 511 U.S. at 188 (quoting *Pinter v. Dahl*, 486 U.S. 622, 652 (1988)). How the Supreme Court squared its decision to overturn 30 years of settled law with the need for “certainty and predictability” is not exactly clear.

159. Depending on how lower courts (and, perhaps ultimately, the Supreme Court) shape the outlines of primary liability in post-*Central Bank* jurisprudence, bad actors in the securities industry could have a field day. Redwood has predicted: “After the Supreme Court’s decision, aiders and abettors have nothing to fear from the violations, even if known and approved by them, of others with whom they associate in a securities trans-

fraud-inflicted injuries to go uncompensated.<sup>160</sup> Lower courts adopting the narrow view have held that an accounting firm, for example, is not primarily liable if it reviews a client's false financial statements,<sup>161</sup> approves a client's false financial statements,<sup>162</sup> structures transactions that the clients can report in a misleading fashion,<sup>163</sup> gives advice on their erroneous reporting,<sup>164</sup> assists in drafting false letters to the SEC,<sup>165</sup> or takes a client's statement that it knows is false and shows it to potential investors on the client's behalf.<sup>166</sup>

Given the narrow view's bright-line test, a collateral defendant could do *all* these things in a single case yet still not be considered a primary violator of Section 10(b)/Rule 10b-5. Indeed, a defendant could do all these things even in a situation where the defendant (a) profited from the fraud, and (b) owed a fiduciary duty to the plaintiff and still not face a private damages action under Section 10(b)/Rule 10b-5, according to this bright-line test. It is silly to conclude, in a case in which an accountant (or lawyer or investment banker) has this level of involvement, scienter, and motivation, that the communication is solely the client's simply because it is issued under the client's name.<sup>167</sup>

Consider a hypothetical example. Under the narrow view, a

action that injures public investors." Redwood, *supra* note 79, at 28-29.

Hewing closely to a narrow view of *Central Bank* leaves courts saying: "Yes, it's unethical. Yes, it's immoral. But, golly, we can't seem to do anything about it." See *United States v. O'Hagan*, 92 F.3d 612, 628 (8th Cir. 1996) (rejecting "misappropriation" theory of insider trading), *cert. granted*, 65 U.S.L.W. 3505 (U.S. Jan. 17, 1997) (No. 96-842).

160. Of course, there are many situations where Section 10(b)/Rule 10b-5 defendants should not be liable for the statements of others. For example, corporations should not be held liable for statements in newspapers over which they had no control, even if those articles contain references to unidentified sources supposedly inside the corporations. See, e.g., *In re Time Warner Inc. Sec. Litig.*, 9 F.3d 259, 264 (2d Cir. 1993); *In re Kidder Peabody Sec. Litig.*, [1995-1996 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,030, at 94,097 (S.D.N.Y. Oct. 4, 1995); *Hershfang v. Citicorp.*, 767 F. Supp. 1251, 1255 (S.D.N.Y. 1991).

161. See, e.g., *O'Neil v. Appel*, 897 F. Supp. 995, 1000 (W.D. Mich. 1995); *In re Kendall Square Research Corp. Sec. Litig.*, 868 F. Supp. 26, 28 (D. Mass. 1994).

162. See, e.g., *O'Neil*, 897 F. Supp. at 1000; *In re Kendall Square Research Corp. Sec. Litig.*, 868 F. Supp. at 28; *Vosgerichian v. Commodore Int'l*, 862 F. Supp. 1371, 1378 (E.D. Pa. 1994).

163. See, e.g., *In re Kendall Square Research Corp. Sec. Litig.*, 868 F. Supp. at 28.

164. See, e.g., *Cascade Int'l Sec. Litig.*, 894 F. Supp. 437, 442 (S.D. Fla. 1995); *Vosgerichian*, 862 F. Supp. at 1378.

165. See, e.g., *Walco Inv., Inc. v. Thenen*, 881 F. Supp. 1576, 1583 (S.D. Fla. 1995).

166. See, e.g., *Lycan v. Walters*, 904 F. Supp. 884, 901 n.12 (S.D. Ind. 1995).

167. See Richard W. Painter, *The Moral Interdependence of Corporate Lawyers and Their Clients*, 67 S. CAL. L. REV. 507, 508 (1994) ("If conduct results from concerted action by both [client and lawyer], attributing responsibility for that conduct to only one would not make sense.").

lawyer could conceive of the idea of a fraudulent press release, write the release in its entirety, induce the client to issue it in the client's name, then personally show it widely to unsuspecting investors to whom he owed a fiduciary relationship, and pocket some of the proceeds, and yet not be deemed a primary violator of Section 10(b)/Rule 10b-5. A rule that produces this result is clearly inconsistent with the spirit that animated passage of the 1934 Securities Exchange Act<sup>168</sup> and promulgation of Rule 10b-5.<sup>169</sup> It is inconsistent with professional rules of ethics,<sup>170</sup> with the common law of fraud and deceit, and with the pre-*Brennan* Section 10(b)/Rule 10b-5 case law regarding primary liability. Perhaps any bright-line test carries the potential to be attacked via a "parade of horrors" posed by imaginative opponents. But this parade of horrors is neither imaginary nor hypothetical—it is based on real cases decided since *Central Bank*.

If a "bright-line" rule that one entity can never be responsible for another's statements were adopted, puppeteers who manipulate fraudulent schemes from behind the scenes by pulling the strings and making others talk will go unpunished.<sup>171</sup> If such a test were adopted, an important line of cases based on *Elkind v. Liggett & Myers, Inc.*<sup>172</sup> would be senselessly overruled. Most cases relevant to this discussion involve the liability of collateral participants for statements of their clients, the issuing companies. But consider the converse situation—the liability of a company for statements of others, say, stock analysts. *Elkind* held that a company may be held *primarily* liable under Section 10(b)/Rule 10b-5 for false statements issued by a stock analyst if the company has so "entangled itself" with the issuance of the analyst's report that the statements contained therein may fairly be attributed to the company.<sup>173</sup>

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168. This is true notwithstanding the Supreme Court's attempt in *Central Bank* to read investor protection goals out of the 1934 Act's legislative history (which history the Court, in turn, attempted to read out of the process of statutory interpretation). See *supra* notes 100, 105-13, 130.

169. See *infra* note 402 and accompanying text.

170. An attorney who discovers that a client is engaged in fraud is not to assist that fraud but may instead have to withdraw from the representation. See MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.2 cmt. (1983).

171. See *Cashman v. Coopers & Lybrand*, 877 F. Supp. 425, 433-34 (N.D. Ill. 1995) (preserving "puppeteer" liability).

172. 635 F.2d 156 (2d Cir. 1980).

173. See *id.* at 163 ("We have no doubt that a company may so involve itself in the preparation of reports and projections by outsiders as to assume a duty to correct material errors in those projections. This may occur when officials of the company have, by their activity, made an implied representation that the information they have reviewed is true



Plaintiffs in *In re ICN/Viratek Securities Litigation*<sup>174</sup> alleged that officials of the defendant company reviewed the full text of a stock analyst's report immediately before its issuance and made several changes and additions to it while failing to correct other inaccuracies that they knew existed in the report. Judge Kimba Wood rejected defendants' assertion that *Central Bank* had overruled the *Elkind* line of cases and that, therefore, they could not under any circumstances be liable for another's misstatements. Emphasizing that *Central Bank* addressed only the existence of a secondary liability theory under Section 10(b)/Rule 10b-5 and did not in any way attempt to establish the parameters of primary liability,<sup>175</sup> Judge Wood held that the *Central Bank* ruling had no implications for *Elkind's* holding regarding the scope of primary liability. She noted:

Here, plaintiffs' claim may be characterized as an aiding and abetting claim, but it may just as easily be characterized as a claim of primary liability, pled on the theory that defendants used PaineWebber as their agent to make false or misleading statements to the market. If claims of agency such as these did not give rise to primary liability under *Elkind*, then a corporation, acting with scienter, could use an analyst, acting without scienter, as its agent to make false statements to the market, and neither the analyst nor the corporation would be liable under § 10(b) . . . . My view is that neither the Second Circuit, in *Elkind*, nor the Supreme Court, in *Central Bank*, intended this result.<sup>176</sup>

Related to the pre-publication entanglement theory of *Elkind*, assume that Company A, which had nothing to do with preparation of a stock analyst's report it knows to be unduly optimistic, circulates that report to many potential investors. Courts have held that when companies knowingly *recirculate* the inaccurate statements of analysts, they should be liable even though the statements are clearly identified as the communications of the analysts, not of the company which had no role in preparing them.<sup>177</sup> No reasoning in *Central*

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or at least in accordance with the company's views."). See generally Frank Placenti, *When Securities Analysts are Brought 'Over the Wall' to Conduct Due Diligence in IPOs, Their Research Reports Risk Improper Disclosure of Nonpublic Information*, NAT'L. L. J., Sept. 2, 1996, at B6, B8.

174. [Current Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,213, at 95,084 (S.D.N.Y. Apr. 4, 1996).

175. See *id.* at 95,086.

176. *Id.* But see *In re MTC Elec. Tech. Shareholders Litig.*, 898 F. Supp. 974, 984-87 (E.D.N.Y. 1995) (holding directly contrary).

177. See *Stack v. Lobo*, 903 F. Supp. 1361, 1373-74 (N.D. Cal. 1995); *In re Cypress Semiconductor Sec. Litig.*, 891 F. Supp. 1369, 1377-78 (N.D. Cal. 1995); *Strassman v.*

*Bank* undermines this line of cases, yet the narrow view that one can never be liable under Section 10(b)/Rule 10b-5 for the statements of others is inconsistent with its continued existence and opens up a great opportunity for fraudulent behavior.

The bright-line, narrow approach is not only terribly unfair and disruptive of existing precedent, but it cannot be justified as a matter of statutory interpretation either. As noted earlier, there is no doubt that there will be at least some primary liability for ancillary defendants—both the *Central Bank* majority and the dissenters agreed on that point. The narrow view, as applied by most courts, ignores the language of the statute, certainly something the *Central Bank* majority would not countenance. As others have pointed out, Section 10(b) and Rule 10b-5 both condemn those who “employ[] a manipulative device or make[] a material misstatement” and “it seems certain that more than one person can ‘employ’ a device or ‘make’ a misstatement.”<sup>178</sup> As the majority noted in *Central Bank*, “[i]n any complex securities fraud, moreover, there are likely to be multiple violators . . . .”<sup>179</sup>

Furthermore, the view that one can be liable only for one’s own statements arguably ignores the fact that both Section 10(b) and Rule 10b-5 condemn those who employ devices or make misstatements “directly or indirectly.” Those who make statements commit fraud directly. If others are to be liable for “indirectly” committing fraud, then liability must extend beyond the speakers themselves.<sup>180</sup> In *Central Bank*, the majority opinion held that the term “indirectly” did not encompass aiders and abettors who do not do the prohibited acts at all,<sup>181</sup> but made no effort to indicate what the term does mean. The majority specifically noted that the term was included in the

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Fresh Choice, Inc., No. 95-20017, 1995 U.S. Dist. LEXIS 19343, at \*30-33 (N.D. Cal. Dec. 7, 1995); *In re Rasterps Corp. Sec. Litig.*, [1994-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,467, at 91,195 (N.D. Cal. Oct. 31, 1994).

178. Thomas L. Riesenber, *Fraud Claims Against Professionals After Central Bank*, INSIGHTS, Feb. 1995, at 9, 13. Cases involving “manipulation” make up a relatively small percentage of Section 10(b)/Rule 10b-5 cases and receive little attention in this Article. However, the same questions and controversies exist in manipulation cases as in misstatement cases. For example, in *SEC v. U.S. Environmental, Inc.*, 929 F. Supp. 168 (S.D.N.Y. 1996), the court held that one who knowingly participates in “manipulation” is not primarily liable under Rule 10b-5 unless he had a manipulative purpose. *See id.* at 170-71. In other words, if A has a scheme to manipulate, she can recruit B and C to help her with the scheme and they will not incur Rule 10b-5 liability even if they knowingly assist the law violation with the intent to profit. This is another unseemly hole in the anti-fraud shield that Congress meant to erect.

179. 511 U.S. at 191.

180. *See Riesenber, supra* note 178, at 13.

181. *See* 511 U.S. at 175-76.

statute, but then construed the statute (and the rule) as if the term were not there. This is hardly sound statutory interpretation.<sup>182</sup> But if the language means anything (other than that aiding and abetting is covered by the statute),<sup>183</sup> it must mean that persons can primarily violate Section 10(b)/Rule 10b-5 without speaking themselves. Speaking lies themselves would be a direct misrepresentation.

Central Bank's reply brief argued that the "indirectly" language was simply Congress's method of making corporations responsible for the actions of their agents.<sup>184</sup> There is no real evidence of this, and the argument makes it extremely anomalous that some courts are now holding that *Central Bank* eliminated just such *respondeat superior* liability.<sup>185</sup> As Langevoort has pointed out, the very nature of fraud tends to be sneaky, behind-the-scenes, and indirect,<sup>186</sup> and it is more logical to conclude that Congress was trying to prevent and punish that type of activity. *Respondeat superior* liability was already firmly established at common law<sup>187</sup> and Congress probably assumed that it would continue to be so.

Even attorneys for the major accounting firms admit that the narrow view is unjustifiable.<sup>188</sup> Among all its other problems, it fails to appreciate how lawyers, accountants, and investment bankers can become pragmatically and, even morally, responsible for their clients' transactions as well as communications.<sup>189</sup>

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182. Cf. *Association of Bituminous Contractors, Inc. v. Andrus*, 581 F.2d 853, 862 (D.C. Cir. 1978) (interpreting the Federal Coal Mine Health and Safety Act of 1969 in a way that gave meaning to the terms "lessee" and "owner") (citing 2A JABEZ GRIDLEY SUTHERLAND, STATUTORY CONSTRUCTION §46.06 (4th ed. C. Sands 1973)).

183. It must mean, at the very least, that *respondeat superior* liability must exist under Sec. 10(b). See John J. Musewicz, *Vicarious Employer Liability and Section 10(b): In Defense of the Common Law*, 50 GEO. WASH. L. REV. 754, 778 (1982) ("A reasonable interpretation . . . is that an employer who employs someone who commits a securities fraud in violation of the 1934 Act has indirectly violated rule 10b-5.").

184. See Reply Brief for Petitioner at 2, *Central Bank* (No. 92-854).

185. See *supra* note 9.

186. See Langevoort, *supra* note 9, at 889.

187. See, e.g., *AT&T Co. v. Winback & Conserve Program, Inc.*, 42 F.3d 1421, 1431 (3d Cir. 1994) (discussing origins of *respondeat superior* liability under federal common law).

188. See Riesenbergh, *supra* note 178, at 13. Riesenbergh is counsel for Ernst & Young.

189. See, e.g., Painter, *supra* note 167, at 543-45 (explaining how lawyers, for example, become involved in structuring their clients' deals and gain financial and egotistical incentives to ensure that the transactions are completed); Robert J. Giuffra, Jr., Note, *Investment Bankers' Fairness Opinions in Corporate Control Transactions*, 96 YALE L.J. 119, 135-41 (1986).

### 3. A Suggested Regime

It is clear that the narrow view is wrong-headed. Primary liability for the misstatements (or omissions) of others must exist in some situations. But what are those situations? The broad post-*Central Bank* view of primary Section 10(b)/Rule 10b-5 liability, as explicated by the lower courts and summarized earlier in this Article, has its strengths and weaknesses. If “intricate involvement,” “substantial participation,” or some similar standard is applied, what does it mean exactly? How and where do we draw the lines? If drafting a client’s fraudulent press release constitutes a primary violation but merely being a client’s auditor (and having nothing to do with a specific fraudulent statement) does not, where on the continuum between those two activities do we draw the line and say mere aiding and abetting has ended and primarily liability begun?

These are troubling questions. Still, if defensible and workable lines can be drawn, a liberal view of primary liability is much more justifiable than the narrow, bright-line approach. I believe that the role of accountants, attorneys, and other collateral participants must obviously involve more than simply “standing around.”<sup>190</sup> Collateral participants in securities transactions should not become potential Section 10(b)/Rule 10b-5 defendants simply by the fact that their serving as professionals hired by a client lends a patina of respectability to what turns out to be a fraudulent operation. Some level of actual involvement (with scienter) in the false communication should be required in order to satisfy all the elements of Section 10(b)/Rule 10b-5 primary liability. I suggest two primary avenues for liability, without ruling out others.

#### a. Implied Representations

First, I suggest that there are situations where, by their visible and significant participation in a client’s communications, securities professionals impliedly represent to the investing public that, at the very least, they know of no fraudulent misrepresentations or omissions in those communications. Where these collateral defendants

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190. Accountants have for many years complained about “standing around” liability—being sued, even though they had done nothing wrong, because they were “deep pockets” located in the vicinity of their failing clients. See, e.g., Philip R. Lochner, Jr., *Black Days for Accounting Firms*, WALL ST. J., May 22, 1992, at A10; Shaun F. O’Malley, *Legal Liability is Having a Chilling Effect on the Auditor’s Role*, 7 ACCT. HORIZONS, June 1993, at 82; Walter P. Schuetze, *The Liability Crisis in the U.S. and Its Impact on Accounting*, 7 ACCT. HORIZONS, June 1993, at 88; Lawrence A. Weinbach, *The \$30bn Question Behind US “Litigation Crisis,”* FIN. TIMES, Sept. 23, 1993, at 27.

do, in fact, know of such fraud, they are implicitly lying to the investing public and should be held primarily liable for Section 10(b)/Rule 10b-5 violations. To allow lawyers,<sup>191</sup> accountants, investment bankers and others to transmit the statements of others that they know are inaccurate and that they know will be relied upon by investors, and yet escape Section 10(b)/Rule 10b-5 liability, is to allow them to make implicit misrepresentations in connection with securities transactions with impunity.<sup>192</sup>

In a pre-*Central Bank* article, Professor Langevoort argued regarding attorneys specifically that they should be liable for clients' misstatements so long as their role is so significant that the primary elements of reliance and causation can be established:

Under both state and federal law, the duty of truthfulness is triggered when the lawyer comes into sufficiently direct

191. At least regarding the lawyer as a "letter carrier," this is an area of intense controversy. For example, in the famous *Kaye, Scholer* proceeding, members of the law firm had allegedly forwarded to the FHLBB various files and documents which they knew were false and misleading. See generally Howell E. Jackson, *Reflections on Kaye, Scholer: Enlisting Lawyers to Improve the Regulation of Financial Institutions*, 66 S. CAL. L. REV. 1019, 1025-37 (1993) (discussing the aftermath of the *Kaye, Scholer* enforcement action).

Such an act, according to the ethically economical view of Professor Fried, is perfectly fine:

[C]learly in such instances it is not the lawyer who lies, it is not the lawyer who asks that the lie be believed. He is like the letter carrier who delivers the falsehood, and whether he is free to do that is a matter more of legal than of personal ethics.

CHARLES FRIED, *RIGHT AND WRONG* 193 (1978). The better view is expressed by Professor Painter:

The falsehoods may have been those of Charles Keating and Lincoln [Savings], but they were forwarded to the FHLBB by no ordinary letter carrier, rather by one of New York City's most prominent law firms, and in at least one instance, by the firm's managing partner himself. Even absent any additional representations by *Kaye, Scholer*, this in itself was a representation to the FHLBB about the quality of the information being furnished and about the monitoring process from which it had come. Clients pay a substantial premium to employ firms like *Kaye, Scholer* in part because of their value as "reputational intermediaries." For a law firm to deny responsibility for forwarding false documents to regulators is to deny responsibility for using reputation to facilitate a misrepresentation.

Painter, *supra* note 167, at 573-74 (footnote omitted).

192. Compare this to the situation in *Elkind v. Liggett & Myers, Inc.*, 635 F.2d 156, 163 (2d Cir. 1980), discussed *supra* notes 172-73 and accompanying text, wherein the Second Circuit held that companies may become so involved in the preparation of statements by outsiders as to become legally responsible for the accuracy of those statements when "by their activity, officials of the company have, made an implied representation that the information they have reviewed is true or at least in accordance with the company's views." This is exactly the point being made about the involvement of auditors, lawyers, underwriters and others in the preparation of a company's statements.

communication with the third-parties so as to bear primary responsibility for the flow of information. So long as victims of fraud can establish reliance and causation they may recover against the attorney under both state and federal securities law.<sup>193</sup>

He went on to argue that:

[P]rimary liability is appropriate when the lawyer's involvement in the disclosure materials is such that a reasonable investor would rely directly on her skill, diligence and expertise, in evaluating its contents. That would take into account both the extent of the involvement and, more important, how much information was communicated to investors about the attorneys' role.<sup>194</sup>

Per Langevoort, a proper rule would give rise to primary liability when a defendant *participates significantly in the preparation or communication of another's misleading statement (or omission) under circumstances in which it would be reasonable for third persons to rely upon the defendant in accepting the truthfulness of the representations made.*

Consider the hypothetical example noted in Part III.B.2.—a lawyer (or accountant, or investment banker) conceives of a false representation, drafts it, induces the client to issue it, and then communicates it to potential investors. The *duty* not to speak falsely arises from the substantial participation in a false communication under circumstances in which the attorney can foresee that the communication,<sup>195</sup> and the lawyer's role in preparing it, will be relied upon by investors. I believe that in such cases the securities professionals are not simply "failing to act." Rather, by their visible participation in the fraudulent scheme, they are impliedly representing that they know of no fraud being committed. If collateral defendants act with scienter, and if they do know that a fraud is occurring and that they are advancing it by drafting, editing, or communicating their client's lies to persons who know of their roles in the activity, then they are themselves misleading those third-parties<sup>196</sup> and should be liable to them.

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193. Langevoort, *supra* note 39, at 83 (footnote omitted).

194. *Id.* at 83 n.30.

195. Pre-*Central Bank* cases often stressed that professionals, such as lawyers, must realize that their statements will be relied upon by third-parties before they could be liable to those investors under Section 10(b)/Rule 10b-5. See, e.g., *Ackerman v. Schwartz*, 947 F.2d 841, 848 (7th Cir. 1991); *Rose v. Ark. Valley Env. & Util. Auth.*, 562 F. Supp. 1180 (W.D. Mo. 1983).

196. See *Roberts v. Peat, Marwick, Mitchell & Co.*, 857 F.2d 646, 653 (9th Cir. 1988)

A recent article broke down pre-*Central Bank* Section 10(b)/Rule 10b-5 cases against attorneys into three categories depending on the defendant's level of involvement: (a) merely revising or reviewing client documents; (b) preparing and drafting client documents based on client-supplied information; and (c) issuing an attorney opinion letter based on client-supplied information.<sup>197</sup> The article argued that there should be no post-*Central Bank* primary liability for the attorney in either (a) or (b) because the attorney is not speaking.<sup>198</sup> This seems wrong. If an attorney takes client-supplied information that she knows is false and either revises documents or drafts them in toto and then allows them to be issued knowing they will be relied upon by investors, "speaking" has occurred. Any reasonable investor, seeing the attorney's role in these transactions would conclude that the attorney is "saying" that she believed the documents to be fraud-free.<sup>199</sup> It takes a very cynical view of the role of attorneys, accountants, and investment bankers in our commercial world to believe that such an implied representation is not being made.

In *SEC v. Universal Major Industries Corp.*,<sup>200</sup> defendant general counsel wrote 118 letters to debenture holders who exercised a conversion privilege in connection with his company's stock.<sup>201</sup> In each letter, the counsel included a statement that he rendered no opinion as to the legality of the conversion of stock, but relied upon an attached letter of special counsel that the conversion did not violate the Securities Act.<sup>202</sup> The trial court rejected this "obvious attempt to avoid a personal commitment," finding "that the letters could reasonably have been understood by their recipients as an expression of appellant's own opinion concerning the legality of the issuances which they covered."<sup>203</sup> The appellate court affirmed.<sup>204</sup> I believe that, at a minimum, the defendant general counsel was stating that he

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("Investors can reasonably be expected to assume that an accounting firm would not consent to the use of its name on reports and offering memoranda it knew were fraudulent.").

197. See Scott M. Herpich, Note, *Relying on Client-Supplied Information: An Attorney's Liability Exposure Under Rule 10b-5*, 43 U. KAN. L. REV. 661, 661-62 (1995).

198. See *id.* at 671.

199. The logic here that silence in such cases is tantamount to an implicit affirmative representation is the same as in the many cases that hold that silence, when there is a duty to speak out, is as much a fraud as an actual affirmative misrepresentation. See, e.g., *Wade v. Thomasville Orthopedic Clinic, Inc.*, 306 S.E.2d 366, 368 (Ga. App. 1983).

200. 546 F.2d 1044 (2d Cir. 1976).

201. See *id.* at 1045-46.

202. See *id.* at 1046.

203. *Id.*

204. See *id.* at 1054.

had no real reason to disbelieve the attached conclusion of the special counsel.<sup>205</sup>

The biggest stumbling block to a plaintiff's recovery in such cases might be the reliance element. As phrased, the test requires both reliance upon the actual false statement and reliance upon the collateral defendant's visible role in the preparation and/or communication of that false statement. Only with this visibility can it be concluded that the collateral defendants have indeed made an implied representation to the plaintiffs.

Reliance has been called "the subjective counterpart to the objective element of materiality."<sup>206</sup> The Tenth Circuit has suggested that reliance is the "critical element separating primary from aiding and abetting violations."<sup>207</sup> Indeed, the Supreme Court in *Central Bank* faulted plaintiffs for attempting to impose 10b-5 liability when the reliance element was missing,<sup>208</sup> and commentators have suggested that the reliance element will be plaintiffs' biggest stumbling block in attempting to recast aiding and abetting claims as primary liability claims because accountants and others who act behind the scenes in preparing and editing prospectuses, for example, are not directly relied upon by investors.<sup>209</sup>

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205. In *Schatz v. Rosenberg*, 943 F.2d 485 (4th Cir. 1991), the court held that "lawyers do not vouch for the probity of their clients when they draft documents reflecting their clients' promises, statements, or warranties." *Id.* at 495. As far as this statement goes, I agree. I believe that the attorney is not saying, "What my client says is true." But I do believe that the attorney is impliedly representing: "I do not know that what my client says is false." If the attorney does, with scienter, help his client draft or transmit a communication to investors that the attorney knows is false, and may do so with legal impunity, then heaven help the legal profession and heaven help investors.

The better decisions hold that "[a] lawyer has no privilege to assist in circulating a statement with regard to securities which he knows to be false simply because his client has furnished it to him." *In re Rospatch Sec. Litig.*, 760 F. Supp. 1239, 1249 (W.D. Mich. 1991) (quoting *SEC v. Frank*, 388 F.2d 486, 489 (2d Cir. 1968)).

The better view also holds that when the underlying client-supplied materials on their face appear to be unreliable, the attorneys' or accountants' failure to investigate further indicates that they had no genuine belief upon which they could predicate their opinions. See *Eisenberg v. Gagnon*, 766 F.2d 770, 776 (3d Cir. 1985); *McLean v. Alexander*, 599 F.2d 1190, 1198 (3d Cir. 1979).

206. *Abell v. Potomac Ins. Co.*, 858 F.2d 1104, 1117 (5th Cir. 1988), *vacated on other grounds sub nom. Fryar v. Abell*, 492 U.S. 914 (1989).

207. *Anixter v. Home-Stake Prod. Co.*, 77 F.3d 1215, 1225 (10th Cir. 1996). This seems wrong because attorneys or accountants who are actively and visibly involved in preparing or communicating a client's statement to potential investors are making the implied representation that they know of no fraudulent representations contained therein.

208. See *Central Bank of Denver v. First Interstate Bank*, 511 U.S. 164, 180 (1994).

209. See *Wager & Failla, supra* note 69, at 1461.



*i. Non-efficient Markets*

In cases involving non-efficient markets, plaintiffs will often have difficulty establishing reliance. In the suggested scheme, it is important that the attorney's (or accountant's or underwriter's) role be sufficiently visible that it is reasonable for the plaintiffs to rely upon the defendant as vouching in some sense for the truthfulness of the representation. For example, when an accountant visibly plays a major role in writing and editing a communication to be filed with the SEC and the SEC is told to consult the accountant if it has any questions, the reliance element would appear to be easily satisfied.<sup>210</sup> Who would conceive, in such a case, that the accountant knew the communication was riddled with lies? If it turns out that such scientist did exist, the accountant should be liable.

When an attorney hands her client's communication to a potential investor knowing that the communication is inaccurate and that the investor is going to rely upon it, the reliance element is easily met. As noted earlier, such an attorney is making an implied representation: "Here is what my client says and I have no strong reason to believe that it is not true." Similarly, when issuers become intimately involved in the pre-publication drafting of an analyst's descriptions of the companies' prospects or in the post-publication recirculation of copies of those descriptions, while knowing that they are false, the reliance requirement is easily met. In such cases, the reader of those reports can clearly and justifiably reason that the companies are representing their accuracy even though they are not technically the companies' communications.

In these cases where plaintiffs are informed as to the specific roles that accountants, attorneys or other collateral participants play in certain communications issued by their clients (or vice versa), the reliance element is easily established. The more difficult question is whether plaintiffs should be allowed to establish reasonable reliance in the absence of information about a defendant's specific involvement in company communications. Should they be allowed to assume that the collateral defendants are playing the normal role that such defendants play in similar transactions?<sup>211</sup> After all, prominent law firms, accounting firms, and underwriters all lend reputational

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210. See, e.g., *In re Software Toolworks, Inc.*, 38 F.3d 1078, 1090-111 (9th Cir.), *modified on other grounds*, 50 F.3d 1078 (9th Cir. 1994).

211. The typical roles played by attorneys and accountants in such transactions are easily identified. See generally Lawson & Mattison, *supra* note 125, at 1312-17 (outlining the duties of accountants and attorneys in typical corporate transactions).

capital to their clients. They are handsomely compensated for doing so. Investors and lenders rely on that reputation as a matter of course. For that reason, it seems proper to apply some fairly liberal assumptions regarding what is reasonable reliance by plaintiffs.<sup>212</sup>

(a) Accountants

Consider the role of accountants. Section 10(b)/Rule 10b-5 liability arises from either the primary or the secondary securities markets. The accounting profession's reputational capital plays a major role in the workings of each.

Regarding primary markets, companies going public for the first time typically do not have an established track record and the market knows relatively little about them. It is critical that they signal the market regarding, among other things, the reliability of their financial statements.<sup>213</sup> A primary method of doing so is to hire a "Big Six"

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212. This Article addresses primarily the liability of collateral participants in securities transactions, such as lawyers and accountants. However, a strict application of the narrow view of primary Section 10(b)/Rule 10b-5 liability might also allow officers and directors who "participate" in their company's fraudulent communications to escape liability. After all, the statement typically is issued in the company's name, not in the name of any of the officers and directors. The reasoning of the narrow view which exonerates lawyers and accountants from their clients' false statements can also be used to exonerate officers and directors, especially in light of the potential demise of the *respondeat superior* doctrine in Section 10(b)/Rule 10b-5.

This, of course, would be another tragic and silly result of *Central Bank* were it to come to pass. No court has specifically reached such a conclusion, but the logic of the narrow view justifies it. Officers and directors of companies who are actively involved in drafting and communication of their firms' fraudulent statements should be, and prior to *Central Bank* were, primarily liable. Most jurisdictions even applied a "group published" presumption to assist plaintiffs in the pleading stage. That presumption basically allowed courts to assume that officers and directors who were active in the corporation bore some responsibility for its fraudulent statements. See, e.g., *In re Glenfed, Inc. Sec. Litig.*, 60 F.3d 591, 593 (9th Cir. 1995); *Serabian v. Amoskeag Bank Shares, Inc.*, 24 F.3d 357, 367-68 (1st Cir. 1994); *Wool v. Tandem Computers, Inc.*, 818 F.2d 1433, 1440 (9th Cir. 1987); *Picard Chem. Inc. Profit Sharing Plan v. Perrigo Co.*, Nos. 1:95-CV-141, 1:95-CV-290, 1996 U.S. Dist. LEXIS 11804, at \*12, \*57 (W.D. Mich. July 25, 1996); *Golden v. Terre Linda Corp.*, No. 95-C0657, 1996 U.S. Dist. LEXIS 10672, at \*16 (N.D. Ill. Jan. 26, 1996); *Degulis v. LXR Biotechnology, Inc.*, 928 F. Supp. 1301, 1311-12 (S.D.N.Y. 1996); *In re Newbridge Networks Sec. Litig.*, 926 F. Supp. 1163, 1174-75 (D.D.C. 1996). The narrow view is arguably inconsistent with the "group published" doctrine and with the very notion of holding directors and officers liable for their participation in the false communications of their employers.

213. See Krishnagopal Menon & David D. Williams, *Auditor Credibility and Initial Public Offerings*, 66 ACCT. REV. 313, 316 (1991). Concomitantly, investors and others must devise surrogates for determining the (difficult to ascertain) quality of audits and size of firms is a reasonable surrogate. See Linda E. DeAngelo, *Auditor Size and Audit Quality*, 3 J. ACCT. & ECON. 183, 186 (1981).

accounting firm.<sup>214</sup> The mere fact that a firm doing an initial public offering (IPO) has a Big Six firm as its auditor provides credibility,<sup>215</sup> attracts more investors,<sup>216</sup> and allows the issuer to charge more for its shares than it otherwise could.<sup>217</sup> The Big Six firm is paid for its work but receives a premium for its reputation as well.<sup>218</sup> In part, this is true because informational asymmetries make it very difficult for shareholders and creditors to assess the accuracy of any given audit,<sup>219</sup> so the auditor's reputation must serve as a proxy for the quality of any given audit.<sup>220</sup>

In secondary markets, "name brand" accounting firms offer

214. Studies indicate that this is a common method of signaling the market. See, e.g., Charles G. Carpenter & Robert H. Strawser, *Displacement of Auditors When Clients Go Public*, 131 J. ACCT. 55, 58 (1971); Menon & Williams, *supra* note 213, at 330-31; Sheridan Titman & Brett Trueman, *Information Quality and the Valuation of New Issues*, 8 J. ACCT. & ECON. 159, 170 (1986); Robert Wilson, *Auditing: Perspectives from Multi-Person Decision Theory*, 58 ACCT. REV. 305, 308 (1983).

Companies undergoing IPOs are advised to hire prestigious accounting firms to give the impression of reliability to their financial statements. For example, Sutton and Benedetto advise:

One key consideration is which accounting firm to hire. Many investment bankers insist that one of the "Big Eight" [now "Big Six"] accounting firms be used. While this may not seem necessary, to the underwriter it is. The major accountants have been through the process many times before and are less likely to miss some important aspect of reporting. *Perhaps the most important aspect, however, is that of image. A financial statement audited by a reputable, well-known accounting firm carries more weight than an unknown one.*

DAVID P. SUTTON & M. WILLIAM BENEDETTO, *INITIAL PUBLIC OFFERINGS: A STRATEGIC PLANNER FOR RAISING EQUITY CAPITAL* 32 (1988) (emphasis added).

215. See Menon & Williams, *supra* note 213, at 330 (noting that firms going public often replace smaller auditors with large national firms and "credibility is the reason").

216. See *id.* at 317.

217. See DAN A. SIMUNIC & MICHAEL T. STEIN, *PRODUCT DIFFERENTIATION IN AUDITING: AUDITOR CHOICE IN THE MARKET FOR UNSEASONED NEW ISSUES* 1 (1987); Ronald J. Balvers et al., *Underpricing of New Issues and the Choice of Auditor as a Signal of Investment Banker Reputation*, 63 ACCT. REV. 605, 620 (1989); Randolph P. Beatty & Ivo Welch, *Issuer Expenses and Legal Liability in Initial Public Offerings*, 39 J.L. & ECON. 545, 597 (1996); Randolph P. Beatty, *Auditor Reputation and the Pricing of Initial Public Offerings*, 64 ACCT. REV. 693, 708 (1989); Carpenter & Strawser, *supra* note 214, at 58; DeAngelo, *supra* note 213, at 194.

218. See Jere R. Francis & Daniel T. Simon, *A Test of Audit Pricing in the Small-Client Segment of the U.S. Audit Market*, 62 ACCT. REV. 145, 155 (1987); Zoe-Vonna Palmrose, *Audit Fees and Auditor Size: Further Evidence*, 24 J. ACCT. RES. 97, 108 (1986); Titman & Trueman, *supra* note 214, at 162. A critical factor in the ability of any accountant to exploit the role of reputational intermediary is its own reputation as being independent. See Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 607 n.166 (1984).

219. See SIMUNIC & STEIN, *supra* note 217, at 18.

220. See Nicholas Dopuch & Dan A. Simunic, *Competition in Auditing: An Assessment*, in *FOURTH SYMPOSIUM ON AUDITING RESEARCH* 443-44 (1982).

similar reputational value, which may account for the fact that the Big Six audit 494 of the Fortune 500 and 90% of publicly-traded companies in the U.S.<sup>221</sup> As Gilson and Kraakman have pointed out, “[a]n issuer can internalize some of the economies of scale and scope of outside auditors by conducting a substantial portion of its audits internally, but it can never internalize their reputational role.”<sup>222</sup> Indeed, for public corporations it has been argued that “[t]he key attribute of the audit service is likely to be its *credibility* as perceived by the shareholders.”<sup>223</sup> Current shareholders, as well as potential investors and lenders, rationally believe that a credible auditor’s clean opinion regarding financial statements reduces the likelihood that management is hiding self-serving behavior.<sup>224</sup> As a consequence, firms choosing Big Six auditors have higher firm value, *ceteris paribus*, than those choosing less credible auditors.<sup>225</sup>

Clients are well aware of the concept of reputational capital and use it to great effect, often to assist their fraudulent activities. Consider the infamous PTL case, where televangelist Jim Bakker repeatedly solicited funds from viewers, pleading in his telecasts that his books were continually subject to the scrutiny of Big Six accounting firms and, therefore, he must be credible and on the level.<sup>226</sup>

221. See *Accounting Firms Predict Dim Future If Joint and Several Liability Remains*, Sec. Law Daily (BNA) (June 16, 1993), available in LEXIS, BNA Library, BNASLD File.

222. Gilson & Kraakman, *supra* note 218, at 609 n.166. Indeed, the trend is to outsource internal audit work to the Big Six as well, creating potential conflict of interest situations. See Lee Berton, *Who Is Going to Audit the Auditors?*, WALL ST. J., Mar. 5, 1996, at B1.

223. SIMUNIC & STEIN, *supra* note 217, at 9.

224. See Dopuch & Simunic, *supra* note 220, at 407.

225. See SIMUNIC & STEIN, *supra* note 217, at 60.

226. See generally GARY L. TIDWELL, ANATOMY OF A FRAUD: INSIDE THE FINANCES OF THE PTL MINISTRIES 243-44 (1993). Tidwell cites three different statements by Bakker that illustrate his use of his auditors’ reputational capital to advance his fraud. On January 31, 1986, Bakker told his TV audience: “We are accountable. We have been audited by Deloitte, Haskins and Sells for many years, and now, by Laventhol and Horwitz [sic], and here is the audit for 1977. How many ministries can say this? 1978, complete audit. 1979, 1980, 1981, 1982, 1983, 1984, and 1985.” *Id.* at 243. On February 6, 1986, Bakker responded to allegations of PTL abuses by telling his audience:

In fact, I’m having an audit firm now—an outside audit firm come in to audit that because they don’t want to take any of our word, even though they can see the checks, they can see the statements, they are still going to go through this audit and have someone outside of PTL come in and look at it that knows bookkeeping and can-and can say, yes this is exactly how it was done.

*Id.* at 244. Finally, on April 18, 1986, during a telethon, Bakker told viewers:

We don’t mind letting you know that we print audits of this ministry. We have done it for, what, ten years now, and we go through an audit almost a hundred percent of the time.

An outside auditing firm, one of the big audit firms of America, is in here at

## (b) Underwriters

Underwriters also lend reputational capital to their clients. For example, it is well known that initial public offerings are often substantially underpriced.<sup>227</sup> There are several theories regarding the reasons for this underpricing,<sup>228</sup> none apparently conclusive. But what is known is that underwriters with strong reputations underprice less than other underwriters.<sup>229</sup> In other words, an issuer that hires a top underwriter is able to charge more for its shares. In large part,

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all times auditing this ministry at our own expense, thousands of dollars, tens of thousands of dollars, to be responsible. And we are going to go forward, but it's time God's people say enough is enough.

*Id.* See generally *Teague v. Bakker*, 35 F.3d 978 (4th Cir. 1994) (civil lawsuit), *cert. denied*, 115 S. Ct. 1107 (1995); *U.S. v. Bakker*, 925 F.2d 728 (4th Cir. 1991) (criminal action).

227. Several studies have indicated that IPOs are generally underpriced between five and twenty percent. See, e.g., Robert Hansen, *Evaluating the Costs of a New Equity Issue*, 4 MIDLAND CORP. FIN. J. 42, 42 (1986) (noting underpricing of 15 to 20%); Roger G. Ibbotson, *Price Performance of Common Stock New Issues*, 2 J. FIN. ECON. 235, 254 (1975) (finding underpricing to be 11.4%); Robert E. Miller & Frank K. Reilly, *An Examination of Mispricing, Returns, and Uncertainty for Initial Public Offerings*, 16 FIN. MGMT. 33, 34 (1987) (finding underpricing of 9.87%); Jay R. Ritter, *The "Hot Issue" Market of 1980*, 57 J. BUS. 215, 218 (1984) (finding underpricing around 19%); Clifford W. Smith, Jr., *Investment Banking and the Capital Acquisition Process*, 15 J. FIN. ECON. 3, 20-21 (1986) (finding underpricing to exceed 15%); Clifford W. Smith, Jr., *Raising Capital: Theory and Evidence*, 4 MIDLAND CORP. FIN. J. 6, 18 (1986) (finding underpricing of 15% or more).

228. Professor Tinic has posited one of the most interesting theories for underpricing, reckoning that underwriters underprice in order to reduce the likelihood of securities fraud litigation and to put a cap on recovery. See Seha M. Tinic, *Anatomy of Initial Public Offerings of Common Stock*, 43 J. FIN. 789, 790 (1988). There is substantial reason, however, to disbelieve this explanation for underpricing. See generally Alexander, *supra* note 95, *passim* (1993) (arguing that the lawsuit avoidance theory only accounts for a small portion of underpricing and suggesting alternative explanations for underpricing); John H. Langmore & Robert A. Prentice, *Contribution Under Section 12 of the Securities Act of 1933: The Existence and Merits of Such a Right*, 40 EMORY L.J. 1015, 1082-89 (1991) (arguing that Tinic's theory only accounts for a portion of the underpricing).

229. See Randolph P. Beatty & Jay R. Ritter, *Investment Banking, Reputation, and the Underpricing of Initial Public Offerings*, 15 J. FIN. ECON. 213, 217 (1986); Richard Carter & Steven Manaster, *Initial Public Offerings and Underwriter Reputation*, 45 J. FIN. 1045, 1057 (1990) ("The reputation variable provides more explanatory power than any other variable."); Dennis E. Logue, *On the Pricing of Unseasoned Equity Issues: 1965-1969*, 8 J. FIN. & QUANTITATIVE ANALYSIS 91, 98-102 (1973); Brian M. Neuberger & Carl T. Hammond, *A Study of Underwriters' Experience with Unseasoned New Issues*, 9 J. FIN. & QUANTITATIVE ANALYSIS 165, 172-73 (1974); Brian M. Neuberger & Chris A. LaChapelle, *Unseasoned New Issue Price Performance on Three Tiers: 1975-1980*, 12 FIN. MGMT. 23, 27 (1983). But see James M. Johnson & Robert E. Miller, *Investment Banker Prestige and the Underpricing of Initial Public Offerings*, 17 FIN. MGMT. 19, 28 (1988) (arguing that IPO underpricing is unrelated to underwriter prestige).

Therefore, other things being equal, firms choosing underwriters with good reputations will be worth more than those that do not. See Balvers et al., *supra* note 217, at 620; Titman & Trueman, *supra* note 214, at 171.

this is because the aura of respectability lent to the client by the underwriter translates into more willing investors happy to pay a higher price.<sup>230</sup> In the words of Gilson and Kraakman, “[i]n essence, the investment banker rents the issuer its reputation.”<sup>231</sup> In turn, such underwriters are able to charge higher fees and commissions to the issuers.<sup>232</sup> By paying more to hire underwriters with strong reputations, sellers signal the market that they have confidence in the information they are providing.<sup>233</sup>

(c) Attorneys

Attorneys play a similar role in lending reputation to clients. Gilson and Kraakman have written extensively regarding the role of attorneys (as well as accountants and investment bankers) as “reputational intermediar[ies],” which they define as “someone paid to verify another party’s information.”<sup>234</sup> Although there is not the extensive body of literature regarding the reputational role of attorneys in IPOs as there is for accountants and underwriters, the effect is likely similar.<sup>235</sup> As Gilson explains:

[L]awyers and accountants commonly play the role of reputational intermediary. And once we think of them as being in the business of selling—more accurately, renting—their reputations, a number of examples readily come to mind in which this phenomenon seems to be at work. Practicing lawyers will recall instances when, having been advised that they were to represent their client in a transaction with an unfamiliar party on the other side, their initial question to their client concerned the identity of the other side’s lawyers. Implicit in the question is that the identity of the lawyer conveyed information about the lawyer’s client; i.e.,

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230. See Alexander, *supra* note 95, at 67.

231. Gilson & Kraakman, *supra* note 218, at 620.

232. See Giuffra, *supra* note 189, at 126 n.49 (“Leading investment banks command premium fees for rendering fairness opinions; investors trust the monitoring abilities of these investment banks and expect a bank’s prospects for future premiums to deter carelessness or corruption.”).

233. The reputation of investment bankers plays a similar role in mergers and acquisitions. See Gilson & Kraakman, *supra* note 218, at 604 n.159; Ronald J. Gilson, *Seeking Competitive Bids Versus Pure Passivity in Tender Offer Defense*, 35 STAN. L. REV. 51, 58-59 (1982).

234. Ronald J. Gilson, *Value Creation by Business Lawyers: Legal Skills and Asset Pricing*, 94 YALE L.J. 239, 289 (1984).

235. See Maxey, *supra* note 79, at 2218 (“In the context of a public offering, fees paid to independent securities lawyers may represent, in effect, a purchase of the imprimatur of the securities lawyers whose opinions provide comfort to the underwriter and who lend their reputations in dealing with the SEC and the market.”).

a reputable business lawyer would not risk his reputation by representing an untrustworthy client.<sup>236</sup>

Langevoort makes a complementary point regarding the role of lawyers as the "financial engineers" of their clients' deals:

Law firms frequently utilize their reputational capital to overcome lingering suspicions by opposing parties. It is thus too quick to say that lawyers are not a proximate cause of a tainted transaction simply because their role was limited to advice and drafting.<sup>237</sup>

Gilson points out that opinion letters issued by lawyers often specifically provide that the firm has made no independent investigation of the facts, yet the letter still carries weight *because of the law firm's reputation*.<sup>238</sup> This reputation effect allows law firms with good and widely-known reputations to charge higher fees than equally-competent but lesser known firms.<sup>239</sup>

Thus, the evidence is strong that collateral defendants such as accountants, underwriters, and attorneys do serve as reputational intermediaries. The very fact that they represent their client adds credibility to the client. This enables the client to do deals it could not otherwise do and to charge prices that it could not otherwise charge. In turn, the accountants, underwriters, and attorneys are able to charge higher fees than they would otherwise charge if they did not serve the role of reputational intermediary. It also earns them dismissal from time to time when courts accept the argument of prestigious accounting or law firms that they certainly would never risk as valuable a commodity as their reputation simply in order to earn a fee from a dishonest client.<sup>240</sup>

236. Gilson, *supra* note 234, at 290-91 (footnote omitted); accord Ronald J. Gilson & Robert H. Mnookin, *Sharing Among the Human Capitalists: An Economic Inquiry into the Corporate Law Firm and How Partners Split Profits*, 37 STAN. L. REV. 313, 367-68 (1985).

237. Langevoort, *supra* note 39, at 88; see also Painter, *supra* note 167, at 548 ("[C]lients may take advantage of credibility they gain from lawyers to make misrepresentations in negotiations while their lawyer 'reputational intermediaries' stand by and do nothing.").

238. See Gilson, *supra* note 234, at 293.

239. See Gilson & Mnookin, *supra* note 236, at 368.

240. This argument has been repeatedly accepted in the Seventh Circuit. See, e.g., *Barker v. Henderson, Franklin, Starnes & Holt*, 797 F.2d 490, 495 (7th Cir. 1986). There is considerable reason to believe, however, that the argument is seriously flawed. See Langevoort, *supra* note 39, at 112-13 (arguing that the threat of reputational harm alone may not be likely to force lawyers to be more careful in dealing with their clients); Giuffra, *supra* note 189, at 127-28 (arguing that investment bankers rarely suffer harm to their reputations unless legal liability is imposed).

Given the very strong evidence that the typical Section 10(b)/Rule 10b-5 collateral defendants (accountants, attorneys, investment bankers) do serve as reputational intermediaries upon which third-parties such as investors and lenders reasonably rely, how is the reliance element to be applied? To ignore the reputational intermediary role altogether allows accountants, underwriters, and attorneys to profit substantially from renting their reputations to clients, and then to simultaneously deny that injured plaintiffs have any right to rely on those same reputations. On the other hand, to allow plaintiffs to assert no more than: "Hey, defendant is a prestigious accountant (or underwriter or attorney) so I assumed its client's communications were all legitimate!" casts too wide a net.

The answers to two key questions will shape the proper application of this rule. First, is plaintiff investor entitled to assume that accountants or lawyers or other collateral participants played their normal role in preparing or distributing the client's communications, or must the investor prove that the specific defendant participated significantly in this particular communication? Only requiring actual proof of significant participation eliminates the threat of "standing around" liability. Therefore, such proof must be required. An accountant or attorney usually has no obligation to "blow the whistle" on a client's fraudulent representation if she had no significant role in preparing or communicating it. Professionals have no free floating duty to monitor all of their clients' communications for accuracy. Rather, they should be liable only where their visible role in preparation or communication of the client's inaccurate statement that they knew would be shown to investors indicated that they vouched for its credibility.

Second, what is meant by "relying upon the defendant"? Assume that an investor relies upon a misleading statement issued by Company A. He knows at the time that Company A has auditor X and outside counsel Y. Only later does the investor learn that auditor X and outside counsel Y participated significantly in preparing the communication. The investor is able to prove the collateral defendants' significant participation, but does this establish the reliance requirement? Or should plaintiff be required to prove that he or she knew of the roles of the auditor and outside counsel at the time he or she evaluated the credibility of the client's statement?

In non-efficient markets, the better view is that the plaintiff should be required to show pre-existing knowledge of the defendant's role in the participation, although this is a difficult call. Only with such proof can plaintiff reasonably claim that she understood that the



defendant had made an implied representation regarding the client's statement's accuracy.

*ii. Efficient Markets*

In cases involving securities traded in efficient markets,<sup>241</sup> plaintiffs should be allowed to utilize the fraud-on-the-market theory<sup>242</sup> to establish the reliance element somewhat more easily than plaintiffs in non-efficient markets. The fraud-on-the-market theory allows plaintiffs to establish the reliance element of a Section 10(b)/Rule 10b-5 claim even though they may not have read or even seen the misrepresentations of which they complain. The Supreme Court adopted the theory in *Basic, Inc. v. Levinson*,<sup>243</sup> and explained its rationale by quoting the following passage from *Peil v. Speiser*:<sup>244</sup>

"The fraud on the market theory is based on the hypothesis that, in an open and developed securities market, the price of a company's stock is determined by the available material information regarding the company and its business. . . . Misleading statements will therefore defraud purchasers of stock even if the purchasers do not directly rely on the misstatements. . . . The causal connection between the defendants' fraud and the plaintiffs' purchase of stock in such a case is no less significant than in a case of direct reliance on misrepresentations."<sup>245</sup>

In explaining the mechanics of the theory, the Court said:

241. The fraud-on-the-market theory is, in turn, based on the Efficient Capital Market Hypothesis (ECMH), which, in its "semi-strong" form "states that, at any point in time, market prices are an unbiased forecast of future cash flows that fully reflect all publicly available information." RONALD J. GILSON & BERNARD S. BLACK, (SOME OF) THE ESSENTIALS OF FINANCE AND INVESTMENT 136 (1993). Neither the ECMH nor the fraud-on-the-market theory applies in non-efficient markets, see *Gruber v. Price Waterhouse*, 776 F. Supp. 1044, 1052 (E.D. Pa. 1991); *In re MDC Holdings Sec. Litig.*, 754 F. Supp. 785, 804 (S.D. Cal. 1990), although some courts have recognized a more limited fraud-created-the-market theory for these non-efficient markets. See, e.g., *Ross v. Bank South, N.A.*, 885 F.2d 723, 729-30 (11th Cir. 1989); *Shores v. Sklar*, 647 F.2d 462, 469-72 (5th Cir. 1981); *Wiley v. Hughes Capital Corp.*, 746 F. Supp. 1264, 1293 (D.N.J. 1990).

The courts have developed at least some rough criteria for judging the difference when the market for a particular security is efficient and when it is not. See generally Michael W. Prozan & Michael T. Fatale, *Revisiting "Truth in Securities": The Use of the Efficient Capital Market Hypothesis*, 20 HOFSTRA L. REV. 687 (1992) (surveying court approaches). A particularly popular formulation is contained in *Cammer v. Bloom*, 711 F. Supp. 1264, 1285-87 (D.N.J. 1989).

242. For an excellent discussion of the early development of the fraud-on-the-market theory, see Note, *The Fraud-on-the-Market Theory*, 95 HARV. L. REV. 1143 (1982).

243. 485 U.S. 224, 247 (1988).

244. 806 F.2d 1154, 1160-61 (3d Cir. 1986).

245. 485 U.S. at 241-42 (quoting *Peil v. Speiser*, 806 F.2d at 1160-61).

The modern securities markets, literally involving millions of shares changing hands daily, differ from the face-to-face transactions contemplated by early fraud cases, and our understanding of Rule 10b-5's reliance requirement must encompass these differences.

In face-to-face transactions, the inquiry into an investor's reliance upon information is into the subjective pricing of that information by that investor. With the presence of a market, the market is interposed between seller and buyer and, ideally, transmits information to the investor in the processed form of a market price. Thus the market is performing a substantial part of the valuation process performed by the investor in a face-to-face transaction. The market is acting as the unpaid agent of the investor, informing him that given all the information available to it, the value of the stock is worth the market price.<sup>246</sup>

If the fraud on the market theory can be used by plaintiffs to establish the reliance element vis-à-vis communications they have never seen, it should be equally available to establish reliance upon the substantial participation of defendants in those communications when that substantial participation has been visible to the market, even though perhaps not to the particular plaintiffs.<sup>247</sup> As noted in the discussion above,<sup>248</sup> the market does take into account the reputational role of accountants, attorneys, underwriters and others in assessing the market price of an issuer's securities. That information is embedded in the market price established for shares traded on an efficient market.<sup>249</sup> Plaintiffs who buy those shares implicitly rely upon the efficient market to value those shares accurately and are misled when it does not. Given that, in cases involving efficient markets where the fraud-on-the-market theory applies, there seems no reason why plaintiffs should not be able to invoke it to establish the reliance element in a primary Section 10(b)/Rule 10b-5 claim. In *In re ZZZZ Best*,<sup>250</sup> the court seemed to rely upon elements from the

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246. *Id.* at 243-44 (quoting *In re LTV Sec. Litig.*, 88 F.R.D. 134, 143 (N.D. Tex. 1980)).

247. To be clear, the defendants' significant participation in their client's misleading statements is not being presumed. Plaintiffs must prove that element. However, if plaintiffs succeed in showing, for example, that an issuer's accountant knowingly participated in a major way in the client's issuance of a materially false representation, plaintiffs' reliance on that statement should be presumed.

248. See *supra* notes 217, 229 and accompanying text.

249. See *supra* note 246 and accompanying text.

250. *In re ZZZZ Best Sec. Litig.*, 864 F. Supp. 960 (C.D. Cal. 1994).

fraud-on-the-market theory in holding:

While the investing public may not be able to reasonably attribute the additional misstatements and omissions to [ZZZZ Best's accountant] E & Y, the securities market still relied on those public statements and anyone intricately involved in their creation and the resulting deception should be liable under Section 10(b)/Rule 10b-5.<sup>251</sup>

### iii. Disclaimers

A discussion of the reliance element is not complete without examining the question of whether plaintiff investors could *reasonably* assert the reliance element in a situation where an attorney, accountant, or underwriter had disclaimed responsibility for facts conveyed on grounds that they were merely the representations of clients. In other words, the collateral participant attempts to disclaim any implied representations of her own regarding the accuracy of the client's communications. Although the courts have disagreed,<sup>252</sup> the trend appears to be to give legal effect to such disclaimers.<sup>253</sup>

Certainly there is every reason to give effect to disclaimers in some circumstances. For example, a disclaimer that informs potential investors or lenders that an accountant has performed a mere review rather than a full-blown audit properly gives the readers of the disclaimer an accurate picture of the accountant's activities and informs them of the limits of sensible reliance upon the reviewed financial statements.<sup>254</sup> However, when disclaimers are invoked to protect collateral defendants who have knowingly promulgated clients' statements that they knew were false, or based conclusions upon client-provided assumptions that they knew were inaccurate, fraud is encouraged.

Unfortunately, the modern trend is ill-reasoned. Proper treatment of such disclaimers is exemplified by the controversial case

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251. *Id.* at 970.

252. *See, e.g.,* Gilmore v. Berg, 761 F. Supp. 358, 370 (D.N.J. 1991) (denying disclaimer defense).

253. *See, e.g.,* Fortson v. Winstead, McGuire, Sechrest & Minick, 961 F.2d 469, 475 (4th Cir. 1992); Moorhead v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 949 F.2d 243, 245-46 (8th Cir. 1991); Friedman v. Arizona World Nurseries Ltd., 730 F. Supp. 521, 541 (S.D.N.Y. 1990), *aff'd*, 927 F.2d 594 (2d Cir. 1991); Buford White Lumber Co. v. Octagon Properties, Ltd., 740 F. Supp. 1553, 1562-63 (W.D. Okla. 1989); Andreo v. Friedlander, Gaines, Cohen, Rosenthal & Rosenberg, 651 F. Supp. 877, 881 (D. Conn. 1986).

254. *See, e.g.,* William Iselin & Co., Inc. v. Landau, 513 N.Y.S.2d 3, 4 (App. Div. 1987) (dismissing negligence claim).

*Kline v. First Western Government Securities, Inc.*,<sup>255</sup> wherein the defendant law firm argued that its opinion letters contained disclaimers explicitly indicating that (a) the representations were based on assumed facts supplied by the client, and (b) the law firm had undertaken no independent investigation as to the accuracy of the statements.<sup>256</sup> Given this, the law firm argued that no investor could have reasonably relied upon the law firm's representations in the opinion letter.<sup>257</sup> Although many courts would apparently agree with the law firm, fortunately the Third Circuit did not. Such a disclaimer should only be a defense if the law firm, not having undertaken an independent investigation, truly has no substantial reason to believe that the client's factual representations are inaccurate. But where, as alleged in *Kline*, the lawyers do in fact know or have very strong reason to know that the client-represented facts are simply not true, enforcement of such a disclaimer would be unjust and improper. Disclaimers for negligence are usually enforceable, but attempts to disclaim liability for fraud and other intentional torts must fail.<sup>258</sup> Investors who see such a disclaimer are put on notice that the opinion is based on client-supplied information and that the law firm has undertaken no independent investigation of its own. They are not reasonably put on notice that the law firm is passing along facts that, despite not having undertaken an independent investigation, it knows to be materially misleading.

Fortunately, the *Kline* court did not give effect to the disclaimer. The court, instead, judged the reasonableness of the plaintiffs' reliance by weighing five factors: "(1) the existence of a fiduciary relationship; (2) plaintiffs' opportunity to detect the fraud; (3) the sophistication of the plaintiffs; (4) the existence of long-standing business or personal relationships; and (5) access to the relevant in-

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255. 24 F.3d 480 (3d Cir. 1994).

256. *See id.* at 486.

257. *See id.* at 488.

258. *See, e.g.,* Turkish v. Kasenez, 27 F.3d 23, 28 (2d Cir. 1994) (parties may not "use contractual limitation of liability clauses to shield themselves from liability for their own fraudulent conduct"); Arnold v. National Aniline & Chem. Co., 20 F.2d 364, 370 (2d Cir. 1927) (same); Reece v. Finch, 562 So. 2d 195, 199 (Ala. 1990) ("A disclaimer cannot be used to insulate a party from liability for an intentional tort."); Banks v. Public Storage Mgmt., 585 So. 2d 467, 477 (Fla. Dist. Ct. App. 1991); Hussain v. Side, No. 90-2632, 1991 Fla. App. LEXIS 9146, at \*6 (Fla. Dist. Ct. App. 1991); Burton v. Linotype Co., 556 So. 2d 1126, 1127 (Fla. Dist. Ct. App. 1990) ("'Fraud is an intentional tort and thus not subject to the cathartic effect of the exculpatory clauses found in contracts.'" (quoting L. Luria & Sons, Inc. v. Honeywell, Inc., 460 So. 2d 521, 523 (Fla. Dist. Ct. App. 1984)); Hardage Enter. v. Fidesys Corp., 570 So. 2d 436, 439 (Fla. Dist. Ct. App. 1990); LaFrenz v. Lake County Fair Bd., 360 N.E.2d 605, 608 (Ind. Ct. App. 1977).

formation.”<sup>259</sup> Because factors (2), (3), and (5) all weighed for plaintiffs, the Third Circuit refused to rule as a matter of law that plaintiffs’ reliance on the facts contained in the law firm’s opinion letter was unreasonable.<sup>260</sup>

Contrary to the suggestion of critics of *Kline* that it “creates a conflict of interest between an attorney and his or her client because it requires an attorney to investigate and verify each and every fact supplied by the client,”<sup>261</sup> *Kline* imposes no duty to investigate. Rather, it merely prevents lawyers, accountants, and underwriters from representing client-supplied representations as true in situations where, with or without the benefit of an investigation, the professionals have learned that the representations are inaccurate.<sup>262</sup>

#### b. Participation

A second major situation in which collateral defendants should be liable for the misrepresentations (or omissions) of their clients arises when they are *participants* in their clients’ fraud. This is a broader liability provision than suggested in the previous section. There, the defendants’ participation *plus visibility* led to an implied

259. *Kline*, 24 F.3d at 488 (citing *Straub v. Vaisman & Co.*, 540 F.2d 591, 598 (3d Cir. 1976)).

260. *See id.* at 488.

261. *See* Herpich, *supra* note 197, at 684 (citing Brief Amici Curiae of Business and Financial Lawyers and of The National Association of Bond Lawyers in Support of Petitioner, filed with *cert. petition* in *Arvey, Hodes, Costello & Burman v. Kline*, *cert. denied*, 115 S. Ct. 613 (1994)).

262. A similar disclaimer was raised by an accountant in *United States v. Benjamin*, 328 F.2d 854, 861 (2d Cir. 1964). The accountant argued that he could not be held liable for false statements in a financial statement because he had labeled it “pro forma.” The court responded aptly:

It would be insulting an honorable profession to suppose that a certified public accountant may take the representations of a corporation official as to companies it proposes to acquire, combine their balance sheets without any investigation as to the arrangements for their acquisition or suitable provision reflecting payment of the purchase price, and justify the meaningless result by an applique of two Latin words.

*Id.*; *see also* *Ackerman v. Schwartz*, 947 F.2d 841, 843 (7th Cir. 1991) (rejecting as a defense disclaimer that attorney had not made an attempt to independently verify the various representations of client when facts made it clear that attorney simply did not care if representations were accurate or not); *In re American Continental Corp./Lincoln S&L Sec. Litig.*, 794 F. Supp. 1424, 1448-49 (D. Ariz. 1992) (auditor may not protect itself by making highly qualified representations concerning client whom it suspects of wrongdoing).

Numerous persuasive reasons for discounting such disclaimers appear in a recent article. *See* Donald C. Langevoort, *Selling Hope, Selling Risk: Some Lessons for Law from Behavioral Economics About Stockbrokers and Sophisticated Customers*, 84 CAL. L. REV. 627 *passim* (1996).

misrepresentation by the collateral defendants for which they were naturally liable. In other words, it was a hybrid situation where defendants were held liable for implicitly making misrepresentations about others' statements. Their duty to injured parties arose from their having made an implied misrepresentation.

In this section, I argue that the broad liability view embodied in such cases as *ZZZZ Best* and *Software Toolworks* is essentially valid and should be adopted. In other words, collateral defendants who significantly participate in their clients' misrepresentations should be liable even when they hide behind the scenes not because they can be said to have impliedly vouched for the accuracy of the clients' lies, but simply because they participated in them. Their knowing participation in a fraud in a situation where they know that investors will be injured creates a duty to those injured investors. Everyone has a duty not to defraud or participate in the defrauding of others. Nowhere in the common law or pre-*Brennan* Section 10(b)/Rule 10b-5 jurisprudence were plaintiffs limited to suing only persons who had not only defrauded them but also simultaneously breached a fiduciary duty to them. Everyone owes a duty not to defraud other persons, even if those others are total strangers.

And, it is clear, one can be a party to a fraud without necessarily being the person who speaks a specific misrepresentation. At common law, there were multiple situations where persons could be liable for the fraudulent statements of others.<sup>263</sup> *At common law, mere participation in a fraud was clearly sufficient to impose primary liability.* The general rule for common-law fraud liability, as stated in the 1943 *Corpus Juris Secundum*, is this:

One who, by fraudulent representations, induces another to act to his damage is liable for the damages suffered, and it is not essential that there should have been privity of contract

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263. This was clearly the case in 1934. See, e.g., *Lewis v. McClure*, 16 P.2d 166, 170 (Cal. App. 1932) (several defendants involved in fraud who all told plaintiffs separate lies for their own reasons held liable for other defendants' lies even though no conspiracy was alleged); *Jacobsmeier v. Frank J. Falzone & Co.*, 260 S.W. 764, 766 (Mo. App. 1924) (trust held liable for fraudulent statements of its 100% owner); *King v. Shawver*, 30 S.W.2d 930, 933 (Tex. App. 1930) (A held liable for B's lies after telling plaintiff that B was trustworthy); see also MELVILLE M. BIGELOW, *THE LAW OF FRAUD* 378 (1877) ("[W]here a man has combined and conspired with others to cheat and defraud the plaintiff in the sale of certain property, by fraudulent concealments and misrepresentations, and the fraud has been perpetrated accordingly, though by some other member or members of the company, he will be liable, even where he has not himself made any of the misrepresentations complained of." (emphasis added)).

More recent cases agree. See, e.g., *Vikse v. Flaby*, 316 N.W.2d 276, 284 (Minn. 1982); *Kopperud v. Agers*, 312 N.W.2d 443, 445 (Minn. 1981).

or personal dealings; but a person cannot be held liable for a fraudulent misrepresentation unless he made it himself or authorized another to make it for him *or in some way participated therein*.<sup>264</sup>

*American Jurisprudence* concurs in the participation standard,<sup>265</sup> as do a plethora of cases both on the books at the time the 1934 Act was passed<sup>266</sup> and decided since.<sup>267</sup>

At common law, all participants were jointly and severally liable, not just the wrongdoer who had direct contact with the victim.<sup>268</sup> All

264. 37 C.J.S. *Fraud* § 61, at 346 (1943) (emphasis added).

265. See 37 AM. JUR. 2D *Fraud and Deceit* § 305, at 403 (1968) ("A person may not be held liable for fraudulent representations not made, authorized, or *participated in* by him." (emphasis added)).

266. See, e.g., *Lewis*, 16 P.2d at 170 (plaintiffs could recover against each defendant shown to have participated in the fraud); *Purdum v. Edwards*, 141 A. 550, 553-54 (Md. 1928) (participants in deceit acting in different ways held jointly liable); *Powers v. American Traffic Signal Corp.*, 209 N.W. 16, 17 (Minn. 1926) (whoever participates in a fraud is liable); *Orlann v. Laederich*, 92 S.W.2d 190, 194 (Mo. 1936) ("Any one or more of several persons participating in the perpetration of an actionable fraud becomes a fraud-feasor and . . . is liable."); *Leimkuehler v. Wessendorf*, 18 S.W.2d 445, 452 (Mo. 1929) (all persons participating in fraud are liable); *Hotaling v. A.B. Leach & Co.*, 214 N.Y.S. 452, 458 (N.Y. Mun. Ct. 1926) (all promoters, officers, and directors who participated in preparing and circulating corporation's false prospectus held liable); *King v. Cliett*, 31 S.W.2d 350, 353 (Tex. App. 1930) (all those who participated liable to defrauded party).

267. See, e.g., *IIT v. Cornfeld*, 619 F.2d 909, 918 (2d Cir. 1980) (a participant in fraud is liable as a principal even if it was not his idea); *FDIC v. Hudson*, 758 F. Supp. 663, 670 (D. Kan. 1991) (Kansas law) (active participation sufficient for liability of corporate officer or director); *Stratton v. Miller*, 113 B.R. 205, 211 (D. Md. 1989) (Maryland law) (willfully aiding fraud sufficient for liability), *aff'd sub nom. In re First American Mortg. Co., Inc.*, 900 F.2d 255 (4th Cir. 1990); *Beaver v. Union Nat'l Bank & Trust Co.*, 414 N.E.2d 1339, 1341 (Ill. App. Ct. 1980) (to be liable for fraud one must have participated in it or at least had some knowledge of it); *Boisdore v. Bridgeman*, 502 So. 2d 1149, 1155 (La. Ct. App. 1987) (knowing participation leads to fraud liability); *Nye v. Oates*, 385 S.E.2d 529, 531 (N.C. App. 1989) (one who "facilitated" fraud is liable); *Pumphrey v. Quillen*, 141 N.E.2d 675, 680 (Ohio Ct. App. 1955) ("All of those who actively participate, by cooperation or request, in a tortious act to defraud which results in damage, or who lend aid to the wrongdoer, or ratify or adopt the acts done for their benefit, are equally liable."), *aff'd*, 135 N.E.2d 328 (Ohio 1956); *Crisp v. Southwest Bancshares Leasing Co.*, 586 S.W.2d 610, 615 (Tex. App. 1979) (all who participate in fraud are liable); *Galloway v. Afco Dev. Corp.*, 777 P.2d 506, 508 n.3 (Utah Ct. App. 1989) (parties who participate in fraud are jointly liable); *Israel Pagen Estate v. Cannon*, 746 P.2d 785, 792 (Utah Ct. App. 1987) (party cannot be liable for fraud unless he participated in it); *Kaas v. Privette*, 529 P.2d 23, 29 (Wash. Ct. App. 1974) (every participant in fraud is liable).

268. See RESTATEMENT (SECOND) OF TORTS § 876 cmt. on Clause (b) (1979) ("If the encouragement or assistance is a substantial factor in causing the resulting tort, the one giving it is himself a tortfeasor and is responsible for the consequences of the other's act."). Interestingly, the case that started it all, *Brennan v. Midwestern United Life Insurance Co.*, 286 F. Supp. 702 (N.D. Ind. 1968), *aff'd*, 417 F.2d 147 (7th Cir. 1969), used section 876's language to develop the notion that one who renders substantial assistance to a fraud is liable for aiding and abetting. See 286 F. Supp. at 708. However, the Re-

participants were equally at fault. No conspiracy was requisite for the imposition of joint and several liability upon all the participants.<sup>269</sup>

The common law was very clear in holding that participants in fraudulent schemes are liable to the schemes' victims. If all participants to a fraud were primarily (and jointly and severally) liable at common law, they should also be primarily liable under Section 10(b)/Rule 10b-5 which, as noted above, should be applied in a more pro-plaintiff fashion than was the common law. It is therefore clear that the post-*Central Bank* cases like *ZZZZ Best* and *Software Toolworks* which have applied simple participation tests, however phrased, have quite properly followed established common-law precedent. This is not only permissible, but is exactly the right course of action.

Langevoort has strongly argued in favor of this common-law standard, pointing out:

There is little sense, however, in limiting fraud liability to those whose involvement is public and direct. The vast bulk of securities law makes clear that behind the scenes involvement in fraudulent disclosure (or actionable nondisclosure), as opposed to mere participation in the fraud, by no means absolves the participant from culpability. The very nature of securities fraud often involves obscuring the source and interests of its authors. People can have a significant influence on how fraudulent disclosure is packaged, and hence how effective it is, without being identifiable to the victim.<sup>270</sup>

There is much to be said for Langevoort's view. Assume that A (a) conceives of a plan to defraud an old lady; (b) induces B, a friend of the victim, to go to her with a false story concocted by A about the value of A Company's stock (which is actually worthless); and (c) takes the bulk of the proceeds from the fraud once it is accomplished. Is Langevoort not correct in concluding, as he no doubt would, that A is a defrauder, rather than a mere aider and abettor, even though the communication was B's? That conclusion is consistent with the common law. For example, in the 1926 case of *Hotaling v. A. B. Leach & Co.*,<sup>271</sup> the court held promoters, officers, and directors of a company primarily liable for the company's false prospectus "if they

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statement section never mentions aiding and abetting; it describes the common-law parameters of primary liability.

269. See, e.g., *Lewis*, 16 P.2d at 170.

270. Langevoort, *supra* note 9, at 889.

271. 214 N.Y. 452 (Mun. Ct. 1926).



participated in the preparation and circulation of it."<sup>272</sup> Langevoort's position is also, as noted above,<sup>273</sup> consistent with pre-*Brennan* Section 10(b)/Rule 10b-5 jurisprudence. It is also, Langevoort believes, consistent with "a moderate reading" of *Central Bank*,<sup>274</sup> although it may not be consistent with *Central Bank's* vitriolic dicta attacking securities fraud litigation.<sup>275</sup>

Riesenberg, an attorney for accountants, argues that there is no statutory basis for the participation approach because the words "participate" and "involvement" are not in the statute.<sup>276</sup> There are two problems with Riesenberg's argument. First, he proposes to derive a test from the "seller" jurisprudence under § 12(2) of the 1933 Act,<sup>277</sup> thereby committing the same alleged error—basing the standard on words that are not in the statute. Second, he ignores the language of Rules 10b-5(a) and (c), which, respectively, seek to punish those who "employ any device, scheme, or artifice to defraud," and who "engage in any act . . . which operates or would operate as a fraud or deceit upon any person."<sup>278</sup> To "take part in" is a synonym for both "participate"<sup>279</sup> and "engage in."<sup>280</sup> Indeed, "participate" is one of the accepted meanings of "engage."<sup>281</sup> This is very broad language,<sup>282</sup> and Riesenberg's attempt to read it narrowly is unconvincing.<sup>283</sup>

272. *Id.* at 458.

273. See *infra* notes 51-57 and accompanying text.

274. Langevoort, *supra* note 9, at 889 ("Nothing in any moderate reading of *Central Bank* precludes imposing liability on key participants.").

275. See *id.* at 892 ("How faithful this relatively broad approach is to *Central Bank's* dicta is debatable.").

276. See Riesenberg, *supra* note 178, at 13.

277. Under § 12(2), the Supreme Court has held that only "sellers" are liable and that the term "seller" includes only those who transfer title or "solicit" a sale. See *Pinter v. Dahl*, 486 U.S. 622, 642-43 (1988). See generally Robert A. Prentice, *Section 12 of the 1933 Act: Establishing the Statutory Seller*, 40 ALA. L. REV. 417, 443-70 (1989) (criticizing the Supreme Court's opinion as inconsistent with congressional intent).

278. 17 C.F.R. § 240.10b-5 (1996). Admittedly, the Supreme Court has noted that the scope of Rule 10b-5 "cannot exceed the power granted the Commission by Congress under § 10(b)." *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 214 (1976). But no court, including the Supreme Court, has held or hinted that subsections (a) and (c) of Rule 10b-5 are beyond the scope of congressional authorization.

279. WEBSTER'S NEW WORLD THESAURUS 548 (revised ed. 1985).

280. *Id.* at 244.

281. THE AMERICAN HERITAGE DICTIONARY OF THE ENGLISH LANGUAGE 610 (3d ed. 1992).

282. See *Molecular Tech. Corp. v. Valentine*, 925 F.2d 910, 917 (6th Cir. 1991) ("Section 10(b)/Rule 10b-5 is not limited to claims based on misrepresentations and omissions but, rather, has been applied to a wide variety of fraudulent schemes . . .").

283. Riesenberg would apparently also require that the defendant have a direct finan-

In *ZZZZ Best*, the court noted that the Supreme Court has often held that Section 10(b)/Rule 10b-5, including these provisions, must be construed to eliminate “the full range of ingenious [fraudulent] devices,”<sup>284</sup> “any manipulative or deceptive device,”<sup>285</sup> and “all fraudulent schemes,”<sup>286</sup> concluding:

Thus, the terms of the statute and rule extend liability to all participants in any scheme or device that operates as a fraud on investors. In *Affiliated Ute Citizens v. United States*, the Supreme Court observed that “the second subparagraph of the rule [10b-5(b)] specifies the making of an untrue statement of a material fact and the omission to state a material fact,” but that “[t]he first and third subparagraphs [10b-5(a) and (c)] are not so restricted.” The Supreme Court held in *Affiliated Ute* that the defendants violated Section 10(b) and Rule 10b-5 when they participated in “a ‘course of business’ or a ‘device, scheme or artifice’ that operated as a fraud”—even though these defendants had not themselves said anything that was false or misleading.<sup>287</sup>

Admittedly, a “participation” standard sets a fairly low threshold for liability. One dictionary defines “participate” as “[t]o take part.”<sup>288</sup> In a variety of situations, courts have adopted a similar

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cial interest in the transaction before primary liability could arise. See *Riesenberg, supra* note 178, at 14. There is no basis for this requirement in either statutory language, court precedent, or policy. Furthermore, it ignores how closely aligned with the interests of their clients the interests of attorneys, bankers, and accountants already are. The desire to have their fees (sometimes contingency fees) paid and the desire for future streams of income provide a plentiful direct financial interest for collateral participants in the transactions of their clients. See *Painter, supra* note 167, at 545 (lawyers want their clients’ deals to get done so that they get paid and their work isn’t wasted). Additionally, the language of *Central Bank* seems to reject such a requirement. See *Coffee, supra* note 16, at B4.

284. *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 477 (1977).

285. *Herman & MacLean v. Huddleston*, 459 U.S. 375, 386 (1983).

286. *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 11 n.7 (1971).

287. *In re ZZZZ Best Sec. Litig.*, 864 F. Supp. 960, 971-72 (C.D. Cal. 1994) (citations omitted). *ZZZZ Best* also cited *In re Union Carbide Corporation Consumer Products Business Securities Litigation*, 676 F. Supp. 458, 467 (S.D.N.Y. 1987), for the proposition that even if an accountant could not be held liable under Rule 10b-5(b) because the false statements were not fairly attributable to it, the accountant could still be liable under subsections (a) and (c). See *ZZZZ Best*, 864 F. Supp. at 972; see also *In re U.S.A. Classic Sec. Litig.*, [Current Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,837, at 93,048 (S.D.N.Y. June 16, 1995) (holding issuer and underwriter and corporate officials potentially liable for issuer’s false statements because they all allegedly participated in a scheme to defraud and were therefore direct participants with primary liability); *Alter v. DBLKM, Inc.*, 840 F. Supp. 799, 808 (D. Colo. 1993) (holding that all who “were involved in the [fraudulent] scheme” owed a duty to plaintiff investors).

288. *THE AMERICAN HERITAGE DICTIONARY OF THE ENGLISH LANGUAGE* 955 (New College ed. 1979).

meaning.<sup>289</sup> But isn't it true that one who intentionally takes part in a fraud should be punished and should have to compensate the innocent victim? Actions such as drafting false communications, editing false communications, and transmitting false communications are clearly sufficient for liability if done knowingly by the client in whose name the communications are issued. Because it has never been a requirement that one actually be the speaker to be liable in a fraudulent scheme, these same acts, if knowingly done by a collateral defendant such as an attorney or accountant, must also lead to liability.

Certainly, the term "to participate" is vague and confusion can arise from various formulations of the test ("significant participation," "significant involvement," "intricate involvement," etc.). Does drafting a client's communication satisfy the test? Does partial drafting? How about editing? Proofreading? These are troubling questions, especially given how far they run from the Supreme Court's desired bright line. Still, I am not convinced any great effort needs to be expended developing a bright-line test for defining "participation." After all, so long as the people being sued have actually acted with the requisite element of scienter to help formulate or communicate a false representation that they know will be relied upon by investors, a relatively low level of participation should justify, both morally and legally, imposition of liability.<sup>290</sup>

Nonetheless, Langevoort has suggested a somewhat more specific approach,<sup>291</sup> and I am happy to embrace it. He suggests:

289. See, e.g., *Bayersdorfer v. Massachusetts Protective Ass'n*, 20 F. Supp. 489, 491 (S.D. Ohio. 1937), *aff'd*, 105 F.2d 595 (1939); *Burrell v. Ford Motor Co.*, 192 N.W.2d 207, 211 (Mich. 1965); *Key Life Ins. Co. of South Carolina v. Tharp*, 179 So. 2d 555, 557 (Miss. 1965); *Bew v. Travelers' Ins. Co.*, 112 A. 859, 860 (N.J. 1921); *Lee v. Guardian Life Ins. Co. of America*, 46 N.Y.S.2d 241, 246 (N.Y. Sup. Ct.), *aff'd*, 48 N.Y.S.2d 800 (N.Y. App. Div. 1944); *McConnell v. Ray*, 71 P.2d 975, 978 (Okla. 1937); *Lloyds of Texas v. Webb*, 150 S.W.2d 181, 184 (Tex. Civ. App. 1941), *rev'd*, 152 S.W.2d 1096 (1941).

Other courts have noted that "participation" requires "action, effort, or direction." See, e.g., *Prinsen v. Travelers Protective Ass'n of America*, 65 F.2d 841, 842 (10th Cir. 1933), *rev'd*, 291 U.S. 576 (1934). This requirement does, and should, eliminate mere "standing around" liability.

290. In a post-*Central Bank* setting, *Brennan*, the original aiding and abetting case, should also result in primary liability for the alleged aider and abettor which, consistent with its own self-interest, adopted a mechanism for responding to investor complaints about the primary wrongdoer that actually assisted the wrongdoer in identifying and mollifying those customers most likely to turn him in to the authorities. See *Brennan v. Midwestern United Life Ins. Co.*, 286 F. Supp. 702, 723 (N.D. Ind. 1968), *aff'd*, 417 F.2d 147 (7th Cir. 1969).

291. In general, Professor Langevoort opposes writing undue specificity into Rule 10b-5. See Donald C. Langevoort, *Rule 10b-5 as an Adaptive Organism*, 61 *FORDHAM L.*

that the notion of participation or involvement in these cases be redefined in terms of proximate causation or a broad notion of "co-authorship." Any person who plays a significant role in the formulation of a disclosure document or other form of publicity that contains a material misstatement or omission should be liable as a primary violator if he or she acted with the requisite degree of scienter and all the other requirements for Rule 10b-5 liability are met. A significant role is one in which the person is invited, expected, or is otherwise in a position to affect the form or content of the disclosure—where the person has the ability to influence its capacity to deceive. This could take the form of drafting, editing, or providing information.<sup>292</sup>

The common law managed for several hundred years without this specific a standard, but this particular one is neither inconsistent with the common law nor objectionable on other grounds. I am happy with it because it seems unlikely to impinge upon the long-established discretion of judges and juries to impose liability upon those who knowingly participate in a significant way to advance a fraudulent scheme.<sup>293</sup>

Finally, it must be noted that the Supreme Court itself has sug-

REV. S7, S19 (1993).

292. Langevoort, *supra* note 9, at 892 (footnote omitted).

293. One final point relating to the reliance element of a cause of action must be stressed. The reliance that a plaintiff must establish to recover on a Section 10(b)/Rule 10b-5 participation claim is reliance upon the false representation, not upon any particular defendant's role in preparing it. Indeed, it is irrelevant that the plaintiff, at the time of reliance upon the misrepresentation, does not know the identities of all who had a significant role in preparing it. At common law and in pre-*Brennan* Section 10(b)/Rule 10b-5 jurisprudence, all who played a substantial role in the preparation were potentially primarily liable, even if their identities did not become known until after the transaction. *Central Bank* has been read as holding that:

[I]t is not enough for a person who, throwing in his lot with other wrongdoers, engages behind the scene in acts that are then packaged by the seller and sold to deceive investors. Regardless of how reprehensible the defendant's conduct, the issue becomes whether the plaintiff is entitled to rely on that conduct.

Maxey, *supra* note 79, at 2210-11.

Any such holding would be erroneous, but it appears that the Supreme Court did not so hold. What the majority said was simply that "[a] plaintiff must show reliance on the defendant's misstatement or omission to recover under Rule 10b-5." *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164, 180 (1994) (emphasis added). The majority did not require reliance on defendant's conduct. If the misstatement or omission is attributable to defendant, as it should be if the defendant participated substantially in its preparation or communication, then the defendant is liable to a plaintiff who relied upon the misstatement or omission regardless of whether plaintiff knew of defendant's role at the time of the transaction. Any other holding would, inconsistent with the common law of fraud and deceit, reward those who can successfully cover their tracks, at least for a time.

gested that "participation" is the proper standard for Section 10(b)/Rule 10b-5 liability for both defendants and for plaintiffs facing *in pari delicto* defenses. In *Herman & MacLean v. Huddleston*,<sup>294</sup> the Court explained that one of the reasons that Section 10(b) should be construed as providing a cumulative remedy supplementing that provided by Section 11 of the 1933 Securities Act was that Section 11 did not reach certain collateral defendants, including "lawyers not acting as 'experts,' and accountants with respect to parts of a registration statement which they are not named as having prepared or certified."<sup>295</sup> The Court refused to hold that Section 11 provided the exclusive remedy in public offerings because absent the availability of a remedy under Section 10(b)/Rule 10b-5, injured investors

would have no recourse against such individuals [as lawyers and accountants] even if the excluded parties engaged in fraudulent conduct while *participating* in the registration statement. The exempted individuals would be immune from federal liability for fraudulent conduct even though § 10(b) extends to 'any person' who engages in fraud in connection with a purchase or sale of securities.<sup>296</sup>

Thus, the Supreme Court clearly indicated in *Huddleston* that collateral defendants such as lawyers and accountants who participate in another's fraudulent statement are to be held liable under Section 10(b)/Rule 10b-5. Any other holding would provide a bitter irony in light of the Supreme Court's holdings regarding the *in pari delicto* defense. In both *Bateman Eichler, Hill Richards, Inc. v. Berner*<sup>297</sup> and *Pinter v. Dahl*,<sup>298</sup> the Supreme Court borrowed common-law doctrine to fill out the interstices of the federal securities laws, just as I am suggesting here. In both cases, the Court held that defendants in federal securities litigation (*Bateman Eichler* was a 10b-5 insider trading case and *Pinter* was a '33 Act case) may raise the common-law defense of *in pari delicto*.<sup>299</sup> In *Pinter*, Justice Blackmun rejected a "duty" standard, and selected a *participation* standard, holding that a plaintiff could be barred from recovery from a wrongdoing defendant if the plaintiff was "an active, voluntary *par-*

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294. 459 U.S. 375 (1983).

295. *Id.* at 386 n.22.

296. *Id.* (emphasis added).

297. 472 U.S. 299, 306-11 (1985).

298. 486 U.S. 622, 633-35 (1988).

299. *In pari delicto melior est conditio defendentis* means "[w]here the parties are equally at fault, the situation of the defendant is the more favorable." BALLENTINE'S LAW DICTIONARY 631 (3d ed. 1969).

participant in the unlawful activity.”<sup>300</sup> Notwithstanding that the word “participant” did not appear in the relevant statute, the Supreme Court selected that standard and rejected a competing “duty” standard.<sup>301</sup> Given that one of the main purposes of the federal securities laws is to protect investors, it would be a vicious irony indeed if injured plaintiffs were barred from recovery by their “participation” in a fraud, whereas collateral defendants’ equal “participation” would exonerate them because they were not the “speakers” of the particular misrepresentation.<sup>302</sup>

### C. Primary Liability for Failing to “Blow the Whistle”

Collateral defendants should clearly be primarily liable for their own fraudulent misstatements. That liability, I have argued, should extend to situations (a) where defendants, by their visible and significant participation in preparing or communicating statements of others, impliedly vouch for the accuracy of statements that they know are fraudulent;<sup>303</sup> and (b) where defendants knowingly and significantly participate in a fraud, even behind-the-scenes.<sup>304</sup>

I now address the potential liability of such a collateral defendant for the client’s communications which the defendant knew were false, but did not play a role in writing, editing, reviewing, or transmitting. For example, assume that an accounting firm audits and certifies a financial statement that is contained in a prospectus. The financial statement is accurate in all respects. However, in the post-effective period, it comes to the attention of the accounting firm that the issuer is accompanying prospectuses with “free-writing” materials that contain information that the accounting firm knows is false, even though the firm played no role in preparing the materials. The accounting firm would not have any Section 11 liability,<sup>305</sup> but could it

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300. 486 U.S. at 636 (emphasis added) (citing *Woolf v. S.D. Cohn & Co.*, 515 F.2d 591, 604 (5th Cir. 1975), *vacated and remanded on other grounds*, 426 U.S. 944 (1976)).

301. See generally Robert A. Prentice, *Section 12 of the Securities Act of 1933: The Case of the Overly Eager Investor*, 23 NEW ENG. L. REV. 697, 721-23 (1988-89) (preferring duty test in that context).

302. The fact that the Supreme Court itself has twice suggested that the “participation” standard is the appropriate one to apply in this context provides the best hope that it will not in this area do what it did in *Mertens v. Hewitt Assoc.*, 508 U.S. 248 (1993). See *supra* notes 114-16 and accompanying text (discussing *Mertens* decision). As noted earlier, the *Mertens* Court, in the face of ambiguous statutory language, selected an extremely conservative standard that led to a result Congress could not possibly have intended.

303. See *supra* notes 191-262 and accompanying text.

304. See *supra* notes 263-302 and accompanying text.

305. See *Ahern v. Gaussoin*, 611 F. Supp. 1465, 1483 (D. Or. 1985).

be primarily liable under Section 10(b)/Rule 10b-5 for failing to "blow the whistle" on the client's fraud?

The whistleblowing area is one where it can reasonably be argued that aiding and abetting liability could apply where primary liability would not. There was no liability for failing to blow the whistle at common law, unless a fiduciary duty existed between plaintiff and defendant.<sup>306</sup> Yet, it is arguable, for example, that an accounting firm renders "substantial assistance" and thereby aids and abets a client's fraud in which it did not participate by its act of failing to notify investors of the fraud. Therefore, here is one area where *Central Bank* seemingly has the potential to reduce the scope of collateral defendants' liability.

In this section, I will (a) survey the pre-*Central Bank* case law to demonstrate that the duty to blow the whistle on a client was embraced by some courts but was definitely a minority view;<sup>307</sup> (b) conclude that *Central Bank* does seem to spell the end of any free-standing duty by collateral participants in securities transactions to blow the whistle;<sup>308</sup> and (c) argue that there remain a couple of situations in which a whistleblowing duty might just survive.<sup>309</sup>

### 1. Pre-*Central Bank* Case Law

As noted earlier, when one makes affirmative misrepresentations and tells half-truths, a duty to those the speaker can foresee will rely upon these misstatements arises.<sup>310</sup> But failing to blow the whistle on a client's fraud involves neither affirmative misrepresentations nor half-truths. The Supreme Court, following the common law, has made it abundantly clear that mere silence, in the absence of a duty to speak, is not actionable.<sup>311</sup>

Before *Central Bank*, the key question, with which the courts struggled mightily, was whether silence by collateral defendants could meet the "substantial assistance" element of an aiding and abetting claim.<sup>312</sup> But this was faulty analysis. If a duty to blow the

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306. See 37 C.J.S. *Fraud* § 61(b)(3) (1943) ("Mere silence in the face of a third person's fraud will not render defendant liable unless there is a duty to speak.").

307. See *infra* notes 314-33 and accompanying text.

308. See *infra* notes 334-39 and accompanying text.

309. See *infra* notes 340-89 and accompanying text.

310. See *Deutschman v. Beneficial Corp.*, 841 F.2d 502, 506 (3d Cir. 1988).

311. See, e.g., *Dirks v. SEC*, 463 U.S. 646, 654 (1983); *Chiarella v. United States*, 445 U.S. 222, 235 (1980); *Shaw v. Digital Equip. Corp.*, 82 F.3d 1194, 1202 (1st Cir. 1996).

312. *Humphreys*, *supra* note 38, at 399 ("The most difficult issue arising in aiding and abetting cases is the duty to disclose consideration of the substantial assistance element.").

whistle did exist, a breach of that duty should have been deemed to give rise to *primary* liability. Notwithstanding that error, the issue of whether such a duty did exist was very controversial.<sup>313</sup>

a. Narrow View: No Duty to Blow the Whistle

Before *Central Bank*, most courts held that mere silence or inaction could not give rise to even aiding and abetting liability, not to mention primary liability.<sup>314</sup> A leading case is *DiLeo v. Ernst & Young*,<sup>315</sup> in which plaintiffs charged fraud in violation of Section 10(b)/Rule 10b-5 by Continental Bank and alleged that the bank's accounting firm aided and abetted that fraud by "lending its name to the financial statements and keeping its mouth shut about what was really going on."<sup>316</sup> Under plaintiff's theory, Ernst & Young could be liable even though all the financial statements it certified were accurate (and even though Ernst & Young had not participated in any

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313. See McNulty & Hanson, *supra* note 38, at 16-17, 39-50 (arguing that if there is no duty to speak up or "blow the whistle" on a securities law violator, there should be no liability for failing to do so).

314. See, e.g., Schatz v. Rosenberg, 943 F.2d 485, 490-94 (4th Cir. 1991); Robin v. Arthur Young & Co., 915 F.2d 1120, 1125-26 (7th Cir. 1990); DiLeo v. Ernst & Young, 901 F.2d 624, 628-29 (7th Cir. 1990); Latigo Ventures v. Laventhol & Horwath, 876 F.2d 1322, 1327 (7th Cir. 1989); LHLC Corp. v. Cluett, Peabody & Co., 842 F.2d 928, 932-33 (7th Cir. 1988); Windon v. Third Oil & Gas Drilling Partnership v. FDIC, 805 F.2d 342, 347 (10th Cir. 1986); Barker v. Henderson, Franklin, Starnes & Holt, 797 F.2d 490, 496 (7th Cir. 1986); Strong v. France, 474 F.2d 747, 752 (9th Cir. 1973); Wessel v. Buhler, 437 F.2d 279, 283 (9th Cir. 1971) (fearing that imposing liability on a defendant solely for "inaction" would lead to "serious mischief"); Leoni v. Rogers, 719 F. Supp. 555, 565-66 (E.D. Mich. 1989); Gutfreund v. Christoph, 658 F. Supp. 1378, 1385 (N.D. Ill. 1987); Mendelsohn v. Capital Underwriters, Inc., 490 F. Supp. 1069, 1086-87 (N.D. Cal. 1979); Gold v. DCL, Inc., 399 F. Supp. 1123, 1127-28 (S.D.N.Y. 1973).

However, other courts disagreed. The foundation Section 10(b)/Rule 10b-5 case was an inaction case. See Brennan v. Midwestern United Life Ins. Co., 259 F. Supp. 673, 681-82 (N.D. Ind. 1966) (motion to dismiss), 286 F. Supp. 702, 728 (N.D. Ind. 1968) (trial on merits), *aff'd*, 417 F.2d 147 (7th Cir. 1970); see also Blakely v. Lisac, 357 F. Supp. 255, 246-67 (D. Or. 1972) (holding defendants liable for failing to make duly diligent inquiry into accuracy of prospectuses); Anderson v. Francis I. duPont Co., 291 F. Supp. 705, 709 (D. Minn. 1968) ("An aider and abettor may be liable for damages even though his assistance of the scheme consists of mere silence or inaction."); Ross v. Licht, 263 F. Supp. 395, 408 (S.D.N.Y. 1967) (holding insiders liable where silence influences outsider not to make a sale).

Commentators similarly disagreed. Compare David B. Isbell, *An Overview of Accountants' Duties and Liabilities Under the Federal Securities Laws and a Closer Look at Whistle-Blowing*, 35 OHIO ST. L.J. 261, 278 (1974) ("[T]here is no legal obligation on an accountant to report to the [SEC] or other governmental authority his client's errors, omissions, and misdeeds."), with Billings, *supra* note 38, at 1269 ("The policies of the securities acts are served by sanctioning aiding and abetting—active and passive.").

315. 901 F.2d 624 (7th Cir. 1990).

316. *Id.* at 628.



way in the client's fraud), if it failed to blow the whistle on its client's fraudulent activities.<sup>317</sup>

The Seventh Circuit began by noting a very important point that I have tried to emphasize: Although plaintiffs' claim against Ernst & Young was framed as aiding and abetting, it actually attempted to state a cause for primary liability. If a duty to blow the whistle on a client *did* exist, the court concluded, failure to live up to that duty would constitute a *primary* violation of Section 10(b)/Rule 10b-5.<sup>318</sup> Professor Ruder has also made this point:

[M]ere inaction should not give rise to liability under rule 10b-5 in the absence of an independent duty to make disclosure of the primary wrong. If such a duty does exist, liability for nondisclosure will be based upon direct breach of a duty to disclose rather than upon an aiding and abetting theory.<sup>319</sup>

However, the Seventh Circuit quickly ruled that no such duty exists because, it thought, the federal "securities laws do not impose general duties to speak."<sup>320</sup> Furthermore, the only other potential source of such duties, state law,<sup>321</sup> was viewed as unavailing to plaintiffs because Illinois law imposed no obligation on accountants to "search and sing."<sup>322</sup> In so ruling, the court cited many policy arguments consonant with the Supreme Court's fears, articulated in *Central Bank*, about the adverse effects of securities fraud litigation.<sup>323</sup>

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317. *See id.*

318. *See id.* ("An accountant's liability for aiding and abetting is hard to distinguish from primary liability. After all, the securities laws forbid material omissions that render misleading what has been stated.")

319. Ruder, *supra* note 34, at 644 (emphasis added).

320. *DiLeo*, 901 F.2d. at 628 (citing *Basic, Inc. v. Levinson*, 485 U.S. 224, 239 & n.17 (1988)).

321. *See id.* (relying on *Barker v. Henderson, Franklin, Starnes & Holt*, 797 F.2d 490, 495 (7th Cir. 1986)).

322. *Id.* at 629 (citing *Latigo Ventures v. Laventhol & Horwath*, 876 F.2d 1322, 1327 (7th Cir. 1989)).

323. *See id.* The court explained:

Such a duty [to blow the whistle] would prevent the client from reposing in the accountant the trust that is essential to an accurate audit. Firms would withhold documents, allow auditors to see but not copy, and otherwise emulate the CIA, if they feared that access might lead to destructive disclosure-for even an honest firm may fear that one of its accountant's many auditors would misunderstand the situation and ring the tocsin needlessly with great loss to the firm. Duties to disclose or pay damages would raise the costs of all audits, as accountants increased fees to cover anticipated liabilities. Honest enterprises would pay these fees no less than dishonest (for until the audit ended, an accountant could not tell which was which). So firms would purchase less accounting service, and investors in all firms would lose at both ends: the price would go up as the amount

The court in *In re Cascade International Securities Litigation*<sup>324</sup> took a similar view, holding:

[I]f an accountant does not issue a public opinion about a company, although it may have conducted internal audits or reviews for portions of the company, the accountant cannot subsequently be held responsible for the company's public statements issued later merely because the accountant may know those statements are likely untrue. It follows therefore that an accountant who has not publicly expressed support for the company's financial statements upon which the public relied in connection with the sale or purchase of securities has no duty to alert the public to the content, even if inaccurate, of those statements in the future.<sup>325</sup>

b. Broad View: A Duty May Exist

The leading cases for the pre-*Central Bank* minority view that a duty to blow the whistle might exist relied upon a flexible duty test arising apparently out of federal law in order to arguably "invent" a duty by lawyers and accountants to blow the whistle on their clients' fraud.

One set of criteria was explicated in *Rudolph v. Arthur Andersen & Co.*<sup>326</sup> In *Rudolph*, a limited partnership's auditor issued various reports and memos that it believed were accurate at the time they were included in the limited partnership's private placement memorandum. However, plaintiffs alleged that thereafter auditor Arthur Andersen learned (or recklessly failed to learn) that the general partner planned to divert the funds invested for purposes other than those stated in the memorandum. Plaintiffs claimed that Arthur Andersen's failure to blow the whistle constituted assistance of a cover-up and, consequently, aiding and abetting of the general partner's Section 10(b)/Rule 10b-5 violation. As noted above, however, if there is indeed a duty to blow the whistle, failure to do so constitutes a *primary violation*, not mere aiding and abetting. Unlike the Seventh Circuit in *DiLeo*, the Eleventh Circuit in *Rudolph* recognized the possibility of such a duty:

The rule that an accountant is under no duty to disclose ordinary business information, unless it shows a previous report to have been misleading or incorrect when issued, is a

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of oversight went down.

*Id.*

324. 894 F. Supp. 437 (S.D. Fla. 1995).

325. *Id.* at 443.

326. 800 F.2d 1040, 1043-45 (11th Cir. 1986).

sensible one. It would be asking too much to expect accountants to make difficult and time-consuming judgment calls about the nature of routine facts and figures turned up after a report has been completed. *The situation is quite different, however, where the issue is disclosure of actual knowledge of fraud. Standing idly by while knowing one's good name is being used to perpetrate a fraud is inherently misleading.* An investor might reasonably assume that an accounting firm would not permit inclusion of an audit report it prepared in a placement memo for an offering the firm knew to be fraudulent, and that such a firm would let it be known if it discovered to be fraudulent an offering with which it was associated.<sup>327</sup>

Under what circumstances does an accountant owe a duty to blow the whistle on a client's fraud? The Eleventh Circuit held that it exists "where [a] the accountant's information is obviously superior to that of the investor, [b] the cost to the accountant of revealing the information is minimal, and [c] the cost to investors of the information remaining secret [is] potentially enormous."<sup>328</sup> In such cases, "standing around" liability can attach, according to *Rudolph*.

A similar five-part test has perhaps been more commonly applied. In *Roberts v. Peat, Marwick, Mitchell & Co*,<sup>329</sup> an aiding and abetting claim was again involved, but the court held that the accountant's alleged knowledge of its client's misrepresentation while allowing the use of its name in the client's offering memoranda "may be sufficient to create a duty to disclose."<sup>330</sup> As noted above, if a duty to disclose does exist and is not performed, a primary violation occurs, not mere aiding and abetting. The test invoked by the Ninth Circuit involved five non-exclusive factors:

1. the relationship of the defendant to the plaintiff;
2. the defendant's access to information as compared to the plaintiff's access;
3. the benefit that the defendant derives from the relationship with the plaintiff;
4. the defendant's awareness of plaintiff's reliance; and

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327. *Id.* at 1044 (emphasis added).

328. *Id.*; see also *In re American Continental Corp./Lincoln S&L Sec. Litig.*, 794 F. Supp. 1424, 1443 (D. Ariz. 1992) (quoting *Rudolph* while holding that an auditor may not stand by and withhold knowledge of client's fraud from the SEC); *In re Rospatch Sec. Litig.*, 760 F. Supp. 1239, 1251 (W.D. Mich. 1991) (adopting *Rudolph* approach).

329. 857 F.2d 646 (9th Cir. 1988).

330. *Id.* at 653.

5. the defendant's activity in initiating the securities transaction in question.<sup>331</sup>

Several courts have applied this five-factor test in deciding whether or not a Section 10(b)/Rule 10b-5 defendant owed a duty to disclose.<sup>332</sup> Like *Rudolph* and *Roberts*, many of these cases involved claims of aiding and abetting, but the analysis for an asserted primary violation should be the same.<sup>333</sup>

## 2. The Implications of *Central Bank* for the Whistleblowing Duty

It seems very unlikely that any whistleblowing duty can survive *Central Bank* in light of the fact that the majority opinion thrice cited Daniel Fischel's law review article in which he stated clearly that the " 'whistle blowing' theory of liability does not survive the abolition of secondary liability proposed in this Article."<sup>334</sup> Hansen and Garrison argue that there is no whistle-blowing duty in light of *Central Bank* because (a) the text of Section 10(b) imposes no such duty; (b) the auditor has no independent duty to investors arising under contract or professional standards;<sup>335</sup> and (c) the auditor's duty to the public extends only to the audit engagement, not to matters arising outside the audit engagement.<sup>336</sup> They suggest that *Central Bank* dramatically undermines the rationale in *Rudolph*, because *Central Bank* suggests that an auditor has no duty to blow the whistle on client fraud unless

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331. *Id.* at 653-54. These factors appear to be drawn from the common-law rules on duty to speak discussed *supra* note 129.

332. *See, e.g.,* *Camp v. Dema*, 948 F.2d 455, 460 (8th Cir. 1991); *Arthur Young & Co. v. Reves*, 937 F.2d 1310, 1330-31 (8th Cir. 1991), *aff'd sub nom. Reves v. Ernst & Young*, 507 U.S. 170 (1993); *Pegasus Fund, Inc. v. Laraneta*, 617 F.2d 1335, 1340 (9th Cir. 1980); *First Va. Bankshares v. Benson*, 559 F.2d 1307, 1314 (5th Cir. 1977).

333. The Ninth Circuit is fairly schizophrenic in its use of this flexible duty test. It appeared to jettison the requirement in *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1570 (9th Cir. 1990). The court reasoned that this was too much of a negligence-based test that had already been rejected by the Supreme Court in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 n.12 (1976). Yet the court continues to apply it from time to time. *See, e.g.,* *Paracor Finance v. General Elec. Capital Corp.*, 79 F.3d 878, 884-85 (9th Cir. 1996).

334. Fischel, *supra* note 4, at 103.

335. In any event, professional ethics rules as promulgated by state bar and accounting associations have been rejected as providing the basis for federal securities law violations. *See* *Schatz v. Rosenberg*, 943 F.2d 485, 492 (4th Cir. 1991) (refusing to impose Rule 10b-5 liability on attorneys even though plaintiffs had obtained an ethics ruling from the Maryland State Bar Committee that under the alleged facts an attorney would have an obligation to disclose client's fraud or withdraw from representing the client); *Tew v. Arky, Freed, Stearns, Watson, Greer, Weaver & Harris*, 655 F. Supp. 1573, 1573-74 (S.D. Fla. 1987), *aff'd mem.*, 846 F.2d 753 (11th Cir.) (same).

336. *See* James D. Hansen & Michael J. Garrison, *The Significance of 'Central Bank' on Auditor Liability*, 54 OHIO CPA J., June 1995, at 20, 21-23.

professional auditing standards require that disclosure.<sup>337</sup>

Thus, it seems clear that the *Rudolph/Roberts* line of whistleblower cases is unlikely to survive *Central Bank*.<sup>338</sup> However, because most courts had already rejected the whistleblower theory as a means of imposing aiding and abetting liability even before *Central Bank*, the overall impact on Section 10(b)/Rule 10b-5 jurisprudence will be somewhat limited.

I suggest that the *Central Bank* impact is further minimized by the fact that there are at least two limited situations in which primary liability for failing to blow the whistle may actually survive *Central Bank*.<sup>339</sup>

### 3. Post-*Central Bank* Whistleblowing Duty

#### a. Fiduciary Duty Situations

The Supreme Court has held that a duty to disclose will exist if there is "a fiduciary or other similar relation of trust and confidence between" plaintiff and defendant.<sup>340</sup> Therefore, at the very least, accountants and other collateral defendants owe a duty to blow the whistle to warn third parties of their clients' fraud when they owe a fiduciary duty to those third parties. Such situations will seldom arise, however.

Accountants occasionally owe fiduciary duties to their clients,<sup>341</sup>

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337. *See id.* at 23.

338. Professor Maxey has suggested some other routes by which courts might develop a duty of disclosure, such as state common law, state securities statutes, and professional rules of conduct, *see* Maxey, *supra* note 79, at 2224-32, but these do not seem particularly promising.

339. If I had my druthers, there would be a broader-based whistleblower duty. However, it seems extremely unlikely that I will be in possession of my druthers any time soon, and this section is written from a realistic perspective. However, all hope is not lost. Although no whistleblower duty for attorneys is likely to survive *Central Bank*, members of the American Law Institute working on a proposed Restatement of the Law Governing Lawyers, recently approved a section permitting attorneys to reveal a client's past, present, or intended fraudulent conduct in order to prevent fraud or rectify its financial consequences. *See* Corporate Counsel Daily (BNA) (June 21, 1996), available in LEXIS, BNA Library, BNACCD File. This development indicates that even the law profession itself realizes that the courts are setting a scandalously low standard for the conduct of corporate attorneys and that something needs to be done to begin raising the level of expected behavior.

340. *Chiarella v. United States*, 445 U.S. 222, 228 (1980) (quoting RESTATEMENT (SECOND) OF TORTS § 551(2)(a) (1976)). I noted earlier, *supra* note 129, that the Supreme Court has unfortunately chosen to ignore a raft of other common-law situations where a duty to speak up was imposed.

341. *See generally* M. Thomas Arnold, *Breach of Fiduciary Duty*, in ACCOUNTANTS'

but only rarely will they develop the kind of sustained personal relationship with third parties typically necessary to give rise to a relationship of trust and confidence.<sup>342</sup> Therefore, seldom will a situation arise where an accountant has a duty to blow the whistle on a client in favor of a third-party investor or lender.<sup>343</sup>

Lawyers are even less likely to owe fiduciary duties to third parties.<sup>344</sup> It is not simply a coincidence that *Rudolph* and *Roberts* (as well as *DiLeo* and *Cascade*) involve accountant-defendants. Plaintiff investors should realize that an issuer's attorneys owe a such strong fiduciary duty to their client<sup>345</sup> that communications from the client to the attorneys are typically confidential<sup>346</sup> and privileged,<sup>347</sup> and that the law mandates that the attorneys serve the client's interests first.<sup>348</sup> All of these factors lead most courts to conclude that even when they act as underwriters' counsel, attorneys do not owe public investors a special duty to ferret out and disclose fraud.<sup>349</sup> According to most courts, attorneys do not typically owe duties of disclosure to noncli-

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LIABILITY 341 *passim* (PLI Litig. & Admin. Practice Course Handbook Series No. H-506, 1994) (examining situations in which accountants may owe fiduciary duties).

342. See, e.g., *Farlow v. Peat, Marwick, Mitchell & Co.*, 956 F.2d 982, 988 (10th Cir. 1992) (noting that accountants generally have no duty to report a client's wrongdoing); *Ackerman, Jablonski, Porterfield & DeTure v. Aldhadeff*, [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,756, at 93,684-86 (W.D. Wash. Apr. 16, 1986) (stating that attorneys owe no fiduciary duty to a clients' potential investors); *Fund of Funds, Ltd. v. Arthur Andersen & Co.*, 545 F. Supp. 1314, 1356 (S.D.N.Y. 1982) (finding that accountants do not owe a duty to client's shareholders); *Mendelsohn v. Capital Underwriters, Inc.*, 490 F. Supp. 1069, 1087 (N.D. Cal. 1979) (observing that accountants typically owe no duty to third parties to blow the whistle).

343. In *Wagenheim v. Alexander Grant & Co.*, 482 N.E.2d 955, 963 (Ohio App. 1983), an accounting firm which did blow the whistle by telling one group of clients about the financial difficulty of another client was held liable to the latter client for breaching its duty of confidentiality.

344. See *Maxey*, *supra* note 79, at 2186.

345. Attorneys are bound to represent their clients "zealously within the bounds of the law." MODEL CODE OF PROFESSIONAL RESPONSIBILITY EC 7-1 (1986).

346. An attorney may disclose only when necessary "to prevent the client from committing a criminal act that the lawyer believes is likely to result in imminent death or substantial bodily harm." MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.6(b)(1) (1995).

347. See *Pratt v. State*, 387 A.2d 779, 782 (Md. App. 1978), *aff'd*, 398 A.2d 421 (Md. 1979) (discussing theory behind creation of attorney-client privilege).

348. See MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.7(b) (1995); see also *Page v. Frazier*, 445 N.E.2d 148, 153 (Mass. 1983) (stating that a client's interest takes precedence over that of a non-client).

349. See, e.g., *Fortson v. Winstead, McGuire, Sechrest & Minick*, 961 F.2d 469, 474-75 (4th Cir. 1992); *Schatz v. Rosenberg*, 943 F.2d 485, 490-95 (4th Cir. 1991); *Abell v. Poto-mac Ins. Co.*, 858 F.2d 1104, 1124-26 (5th Cir. 1988), *cert. granted and judgment vacated on other grounds sub nom. Fryar v. Abell*, 492 U.S. 914 (1989); *Barker v. Henderson, Franklin, Starnes & Holt*, 797 F.2d 490, 497 (7th Cir. 1986).

ents<sup>350</sup> and will rarely be liable to third parties for their legal work unless “[they] prepared a signed ‘opinion’ letter designed for the use of a third party.”<sup>351</sup> A common view is that expressed by the Fourth Circuit in *Schatz v. Rosenberg* that “[t]he better rule—that attorneys have no duty to ‘blow the whistle’ on their clients—allows clients to repose complete trust in their lawyers.”<sup>352</sup> It is perhaps unfortunate that a lawyer’s theoretical duty to justice<sup>353</sup> and to the public good has been so totally overwhelmed by the duty of loyalty to a client, but this seems unlikely to change any time soon.

Investors can make only a slightly stronger case for whistle-blowing by underwriters in a public offering,<sup>354</sup> and for most other collateral defendants other than accountants, investors cannot reasonably expect whistle-blowing.<sup>355</sup> Therefore, the fiduciary relationship scenario should be recognized, but will remain of limited

350. See, e.g., *Bush v. Rewald*, 619 F. Supp. 585, 590 (D.C. Haw. 1985); *Quintel Corp. v. Citibank*, 589 F. Supp. 1235, 1245 (S.D.N.Y. 1984). Typically, such courts have erroneously failed to distinguish between a duty not to defraud and a duty to blow the whistle on another’s fraud. As stressed repeatedly above, one party need not owe a fiduciary duty to another in order to be under a legal duty not to participate in a scheme to defraud that other person.

351. *Abell*, 858 F.2d at 1125 (5th Cir. 1988); accord *Schatz v. Rosenberg*, 943 F.2d 485, 491 (4th Cir. 1991) (quoting *Abell*).

352. 943 F.2d at 493; see also *Camp v. Dema*, 948 F.2d 455, 463 (8th Cir. 1991) (stating that neither lawyers nor accountants need to report their clients’ wrongdoing absent a fiduciary duty); *Barker v. Henderson, Franklin, Starnes & Holt*, 797 F.2d 490, 497 (7th Cir. 1986) (same); *Alter v. DBLKM, Inc.*, 840 F. Supp. 799, 808 (D. Colo. 1993) (holding that attorney has no duty to “tattle” on client).

This is not to say that there have not been occasional cases hinting that a higher standard of whistleblowing conduct should be imposed on attorneys. Two classic cases in the securities area are *SEC v. National Student Marketing Corp.*, 457 F. Supp. 682, 712-14 (D.D.C. 1978), in which the SEC argued strongly, only to have the court basically avoid the issue, that attorneys have a duty to disclose fraud to others than their own client, and *In re Carter*, [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,847, at 84,169-73 (SEC Feb. 28, 1981), an SEC proceeding in which the SEC hinted at a lawyer’s duty to go to the board of directors and/or the independent directors to insure that their clients’ disclosures of financial difficulties were not inadequate.

353. See *Langevoort*, *supra* note 39, at 78 (expressing this fear).

354. Underwriters have been characterized, like accountants, as owing some type of duty to the investing public and therefore serving a role characterized as “adverse” to their clients. Unlike attorneys, they do not owe a fiduciary duty to their clients. See *Escott v. BarChris Constr. Corp.*, 283 F. Supp. 643, 696-97 (S.D.N.Y. 1968) (“In a sense, the positions of the underwriter and the company’s officers are adverse. It is not unlikely that statements made by company officers to an underwriter to induce him to underwrite may be self-serving . . . unduly enthusiastic . . . [or], on occasion, be deliberately false.”).

355. In addition, these other collateral defendants, such as banks, are much less likely than accountants, attorneys, or underwriters to have participated in the preparation of the issuer’s misleading communications. Their liability has tended to be of the “standing around” variety and will not survive *Central Bank*. See *Maxey*, *supra* note 79, at 2209.

impact. Collateral defendants' fiduciary duties tend to run to their clients, not to third-party investors or lenders.

b. Accountants and the PSLRA

The strongest case for a whistleblowing duty has always existed against accountants, particularly because of the Supreme Court's statements in *United States v. Arthur Young & Co.*,<sup>356</sup> where the Court, while denying a federal law privilege for the workpapers of an independent auditor, stated:

An independent certified public accountant performs a different role [than an attorney whose job is to serve the client]. By certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a *public* responsibility transcending any employment relationship with the client. The independent public accountant performing this special function *owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public*. This "public watchdog" function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust.<sup>357</sup>

The SEC has echoed this duty, contrasting it with the role of attorneys in securities law:

Though owing a public responsibility, an attorney in acting as the client's advisor, defender, advocate and confidant enters into a personal relationship in which his principal concern is with the interests and rights of his client. The requirement of the [1934 Securities Exchange] Act of certification by an independent accountant, on the other hand, is intended to secure for the benefit of public investors the detached objectivity of a disinterested person.<sup>358</sup>

Given that an independent auditor owes a duty not to the client but to the investing public, it is certainly more than reasonable for an investor to assume that an auditor will blow the whistle on the fraud of the party to whom it does not owe a duty (the client) in order to prevent substantial monetary loss to the party to whom it does owe a duty (the investor). Nonetheless, as noted above, it is extremely unlikely that cases such as *Roberts* and *Rudolph* can survive *Central Bank*, even though they probably should.

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356. 465 U.S. 805 (1984).

357. *Id.* at 817-18 (second emphasis added).

358. *In re American Fin. Co.*, 40 S.E.C. 1043, 1049 (1962).



However, the story does not end there. The PSLRA of 1995<sup>359</sup> created a limited federal statutory duty for accountants, but not other collateral defendants, to blow the whistle on the fraudulent acts of their clients. This reform act, pushed heavily by the accounting profession's potent lobby, contained many pro-defendant provisions which are quite favorable to accountants. However, it also contained a new Section 10A amending the 1934 Exchange Act to require accountants, in some cases, to report detected illegal acts directly to the SEC.

This portion of the PSLRA was introduced in Congress independently as early as 1985. Its original proponent was Representative Wyden, and through various iterations it was generally known as the Financial Fraud Detection Act or the Financial Fraud Detection and Disclosure Act. During the summer of 1995 it was suddenly married to the bills that became the PSLRA.

*i. The Mechanics of New Section 10A*

In essence, the new Section 10A provides that each audit required by the 1934 Act is to include procedures designed to provide reasonable assurance of detecting illegal acts that would have a direct and material effect on the determination of financial statement amounts.<sup>360</sup> If, during the audit, the accountant becomes aware of information indicating illegal activity (whether or not material), then the accountant is obligated to

(A) (i) determine whether it is likely that an illegal act has occurred; and

(ii) if so, determine and consider the possible effect of the illegal act on the financial statements of the issuer, including any contingent monetary effects, such as fines, penalties, and damages; and

(B) as soon as practicable, inform the appropriate level of the management of the issuer and assure that the audit committee of the issuer,<sup>361</sup> or the board of directors . . . is adequately informed . . . .

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359. Pub. L. No. 104-67, 109 Stat. 737, 737-65 (codified as amended in scattered sections of 15 U.S.C.). The discussion of Section 10A refers to Title III, § 10A which is codified at 15 U.S.C.A. § 78 j-1 (West Supp. 1996) and adds a new section, 10A, to the Securities Exchange Act of 1934.

360. See Pub. L. No. 104-67, § 10A(a)(1), 109 Stat. at 762-64. The audit is also to include procedures designed to identify material related-party transactions and an evaluation of whether there is substantial doubt about the issuer as a going concern. See *id.* § 10A(a)(2)-(3).

361. *Id.* § 10A(b)(1).

If senior management does not take timely and appropriate remedial action, then the auditors must report to the board of directors if they believe the illegal act will have a material impact on the financial statement and that the failure to take such action is reasonably expected to warrant departure from a standard report of the auditor or, when made, warrant resignation from the audit engagement.<sup>362</sup>

When the board of directors receives such a report, it should inform the SEC within one business day and provide a copy of the notice to the accountant. If the accountant fails to receive a copy of this notice it shall on the following business day "(A) resign from the engagement; or (B) furnish to the [SEC] a copy of its report . . . not later than [one] business day following such failure to receive notice."<sup>363</sup> Even if the auditor chooses to resign, it shall nonetheless, within one business day following the issuer's failure to inform the SEC, furnish the SEC with a copy of its report.<sup>364</sup>

To shelter the auditor somewhat, the law provides that "[n]o independent public accountant shall be liable in a private action for any finding, conclusion, or statement expressed in a report made to [the issuer or the SEC]."<sup>365</sup> However, if an auditor willfully violates these requirements, including the duty to blow the whistle to the SEC, the SEC may impose a civil penalty under Section 21B.<sup>366</sup>

### ii. *The Impact of New Section 10A*

Although the accounting profession argues that this new provision simply codifies preexisting professional norms,<sup>367</sup> it seems clear that the new rule has the potential to alter in a fundamental way the relationship between auditors and their public company clients.<sup>368</sup> In the words of one commentator, the new provisions "represent a meaningful enhancement of the auditor's duty to report wrongdoing."<sup>369</sup>

The auditor's pre-PSLRA obligation to detect and report poten-

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362. *See id.* § 10A(b)(2).

363. *Id.* § 10A(b)(3).

364. *See id.* § 10A(b)(4).

365. *Id.* § 10A(c).

366. *See id.* § 10A(d).

367. *See Donovan, supra* note 95, at B1 (quoting accounting industry lawyers).

368. *See Harvey L. Pitt et al., More Than "Classical GAAS": Audits and Corporate Illegality Under the Litigation Reform Act*, in 1 SWEEPING REFORM: LITIGATING AND BESPEAKING CAUTION UNDER THE NEW SECURITIES LAW 513, 516 (PLI Corporate Law & Practice Course Handbook Series No. B-923, 1995).

369. Robert Sidorsky, *Auditor's Duty to Blow the Whistle Under the Litigation Reform Act*, N.Y.L.J., Feb. 9, 1996, at 1.

tially fraudulent conduct was contained primarily in Statements on Auditing Standards (SAS) No. 53, entitled "The Auditor's Responsibility to Detect and Report Errors and Irregularities."<sup>370</sup> While this provision acknowledged, for the first time in accounting industry standards, that auditors have a duty to detect fraud that would materially impact the client's financial statements, it also stands for the proposition that the auditor has no duty to disclose fraudulent conduct to parties other than the client. SAS No. 54 addresses detection of illegalities, but imposes no real duty on auditors to detect them.<sup>371</sup>

If the auditor detects problems with errors, irregularities, or illegalities under SAS No. 53 and No. 54, and if the client declines to take action, the strongest responsibility for the auditor is not to report to the SEC or to third parties, but simply to withdraw from the engagement.<sup>372</sup> Pursuant to Item 304 of Regulation S-K, this will give rise to a duty to the client to explain to the SEC why it has changed auditors, but that is all.<sup>373</sup>

While it is arguable that the only impact of the PSLRA is to ensure that the information surrounding the alleged illegality or impropriety gets to the SEC sooner than it would have under the client's self-reporting requirement of Regulation S-K, it is clear that now the information may well come from a different source—the auditor. Before, only the company had the duty to report this information. Now the auditor has such a duty and breach of a duty typically gives rise to liability.

Before the PSLRA was enacted, it was predicted that passage of an earlier version of this portion of the Act would "increase the auditor's exposure to liability under the federal securities laws."<sup>374</sup> It was reasoned that the new provision "imposes a new affirmative duty on independent auditors to establish a system for detecting and report-

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370. CODIFICATION OF STATEMENTS ON AUDITING STANDARDS, Statement of Auditing Standards No. 1, § 316.03 (American Inst. of Certified Pub. Accts. 1995).

371. See *id.* § 317.08. See generally Michael S. Rabb, *Detecting and Preventing Financial Statement Fraud: The Roles of the Reporting Company and the Independent Auditor*, 5 YALE L. & POL'Y REV. 514 *passim* (1987) (examining proposed reforms of financial reporting); James L. Costello, Note, *The Auditor's Responsibilities for Fraud Detection and Disclosure: Do the Auditing Standards Provide a Safe Harbor?*, 43 ME. L. REV. 265 *passim* (1991) (examining the role of auditors in fraud detection).

372. See Sidorsky, *supra* note 369, at 1.

373. See Item 304 of Regulation S-K, 17 C.F.R. § 229.304 (1996) (requiring the issuer to report a change of accountants and any "disagreements" with its former accountant and to report four additional "reportable events").

374. Sidney H. Stein & Beth E. Goldman, *The Wyden Legislation and Its Likely Effect on CPA Liability*, in ACCOUNTANTS' LIABILITY 35, 53 (PLI 1993) (speaking of the "Wyden bill" which was the genesis for this provision of the PSRLA).

ing illegal activity. With additional duties comes additional liability.”<sup>375</sup>

Section 10(b)/Rule 10b-5 renders actionable a misleading omission where there is a duty to speak. New Section 10A creates an enhanced duty to speak or to blow the whistle. The provision imposes a duty on auditors that arguably runs to investors.<sup>376</sup> Therefore, it seems reasonable to argue that breach of a duty to blow the whistle under Section 10A will give rise to Section 10(b)/Rule 10b-5 liability.<sup>377</sup>

Yet, two arguments can be lodged against imposing Section 10(b)/Rule 10b-5 liability here. The *first* argument is based on the existence of a “safe harbor” provision in Section 10A. It has been argued that “the statutory language is sufficiently broad to allow auditors to maintain that they are not liable in *any* private action in which the allegations pertain to matters disclosed or discussed in the auditor’s report.”<sup>378</sup> However, the language of the safe harbor is clearly limited. It provides that “[n]o independent public accountant shall be liable in a private action for any finding, conclusion or statement expressed in a report made pursuant to”<sup>379</sup> the PSLRA’s requirements. So, the language provides a safe harbor from litigation brought by clients only for reports that are made by the auditors. It provides no safe harbor against litigation brought by investors for reports that should have been filed, but were not. A lawsuit claiming

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375. *Id.* at 56. This position is supported by the fact that passage of the PSLRA prompted the AICPA to issue new, stronger rules on fraud detection in audits. See Elizabeth McDonald, *CPA Institute Tightens Rules to Find Fraud*, WALL ST. J., Nov. 13, 1996, at A6.

376. In one of the hearings regarding the Financial Fraud Detection Act, one of its sponsors, Rep. Wyden, testified that the Act would, “for the first time, require accountants to report publicly when companies are ripping off investors. When this bill passes, fraudulent managers will know that accountants will stick up for investors, not cover up for the company . . . . [A]uditors are supposed to inform the public when they see companies committing fraud.” *Financial Fraud Detection: Hearings Before the Subcomm. on Telecommunications and Fin. of the Comm. on Energy and Commerce, House of Representatives*, 103d Cong. 12-13 (1993) (statement of Rep. Wyden).

377. See Elizabeth McDonald, *Auditors Are Ending Up Between a Rock and a Hard Place over Securities Law*, WALL ST. J., Dec. 24, 1996, at C1 (quoting lawyers asserting that PSLRA requirements that auditors detect fraud could increase their liability); Sidor-sky, *supra* note 369, at 1 (“[I]t can now be argued that . . . the auditor ha[s] a legal obligation to notify the directors and make sure that the directors notif[y] the SEC . . . [and, therefore, the PSLRA] could expose auditors to increased litigation for failure to discover and disclose illegal acts other than management fraud.”).

378. Pitt et al., *supra* note 368, at 517 n.10.

379. Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, § 10A(c) 109 Stat. 737, 762 (1995) (codified at 15 U.S.C.A. § 78j-1(c) (West Supp. 1996) (emphasis added)).

a failure to file such a report at all (in other words, failure to blow the whistle), would not be based on "any finding, conclusion, or statement expressed in a report."<sup>380</sup>

The legislative history underlying the safe harbor provision indicates that it was not "intended to circumscribe in any way the existing rights of private individuals to sue accountants with respect to other matters *including with respect to any failure by the auditor to file such reports* or any failure by the auditor to comply with GAAS."<sup>381</sup> A House Report on an earlier version of this provision stated that the "safe harbor" was intended to protect auditors from litigation "based on the content of their direct reports to the Commission."<sup>382</sup> In a 1993 hearing on the provision, one of its sponsors, Representative Markey of Massachusetts, stated that the safe harbor provision was "designed to protect auditors *that comply* with the reporting requirements of the bill from exposure to private litigation."<sup>383</sup> The purpose of the safe harbor was to increase the odds that auditors would blow the whistle on fraud by taking into account the fact that under the current system they might be reluctant to do so in "that their client or its shareholders might sue them if it turned out that they were wrong about the fraud."<sup>384</sup> Auditors who do not comply with the reporting requirements are given no protection at all.

A *second* argument that could be lodged is that Congress intended the potential punishment it imposed for failure to blow the whistle—civil fines imposed pursuant to section 21B—to be the exclusive remedy. Furthermore, the text of the PSLRA provides that nothing in the Act shall be deemed to create or ratify any implied right of action.<sup>385</sup> On the other hand, although the Act expressly provides for SEC-imposed civil penalties should an auditor willfully fail to file a required report,<sup>386</sup> nothing in the Act implies that such penal-

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380. *Id.*

381. JOHN D. DINGLE, FINANCIAL FRAUD AND DISCLOSURE ACT, H.R. REP. NO. 102-890, at 25 (1992).

382. *Id.* at 15.

383. *Financial Fraud Detection: Hearings Before the Subcomm. on Telecommunications and Fin. of the House Comm. on Energy and Commerce, House of Representatives*, 103d Cong. 2 (1993) (statement of Rep. Markey). Later in the hearings, Rep. Markey made the same point, noting that "we create a whistle blower safe harbor for the auditor as he or she goes to the SEC so that they don't feel as though they are going to be necessarily exposing themselves to additional legal ramifications *if they do so.*" *Id.* at 85.

384. *Id.* at 76 (statement of Rep. Markey).

385. Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, § 203, 109 Stat. 737, 762 (1995) (codified at 15 U.S.C.A. § 78j-1 (West Supp. 1996)).

386. *See id.* § 10A(d) (codified at 15 U.S.C.A. § 78j-1(d) (West Supp. 1996)).

ties are exclusive. Furthermore, the fact that nothing in the Act is meant to create an implied right of action does not mean that anything in the Act is meant to eliminate the preexisting implied right of action based on Section 10(b)/Rule 10b-5. Nothing in the PSLRA or its legislative history supports elimination of this firmly established implied right of action. Rather, the Act makes changes in how the cause of action should be implemented, for example, by altering the circumstances in which joint and several liability will arise, thereby clearly placing Congress's stamp of approval upon its continued existence. Indeed, the Conference Report accompanying the bill that became the PSLRA expressly stated that "[p]rivate securities litigation is an indispensable tool with which defrauded investors can recover their losses without having to rely upon government action."<sup>387</sup> And a House Report on an early version (H.R. 4313) of the Financial Fraud Detection and Disclosure Act specifically stated that the safe harbor

is not intended to circumscribe in any way the existing rights of private individuals to sue accountants with respect to other matters, including with respect to any failure by the auditor to file such reports or any failure by the auditor to comply with GAAS (including any auditing procedures the Commission may establish pursuant to [this new section]) while conducting an audit or preparing other statements or reports provided to the Commission.<sup>388</sup>

Congress appears to have made a judgment, albeit only regarding accountant defendants, that a limited duty to blow the whistle is justified.<sup>389</sup> And breach of that duty appears to be actionable.

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387. COMMITTEE ON ENERGY AND COMMERCE, SECURITIES LITIGATION REFORM, H.R. REP. Nos. 104-369, at 31 (1995).

388. H.R. CONF. REP. NO. 102-890, at 25 (1992).

389. In so doing, Congress has implicitly rejected arguments that such a duty would deal a fatal blow to the accountant-client relationship. Cf. Metzger, *supra* note 38, at 1412 (discussing arguments that liability for failure to disclose would lead to "the complete erosion of the accountant-client relationship"). The Supreme Court had already dealt that view a blow in *United States v. Arthur Young & Co.*, 465 U.S. 805 (1984), where it held:

By certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a *public* responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public. This "public watchdog" function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust.

*Id.* at 817-18.

Congress also implicitly rejected the argument that imposing such a duty puts ac-

## CONCLUSION

In *Central Bank*, Justice Kennedy rejected the argument that aiding and abetting liability should be recognized because Section 10(b)'s language speaks of those who "directly or indirectly" violate the rules.<sup>390</sup> Kennedy pointed out that "aiding and abetting liability reaches persons who do not engage in the proscribed activities at all."<sup>391</sup> Therefore, all *Central Bank* really did was eliminate Section 10(b)/Rule 10b-5 liability for those "who do not engage in the proscribed activities at all."<sup>392</sup> Only those who are merely "standing around" near a fraud or who are so far away from it that they do not participate in misrepresentations or omissions should escape post-*Central Bank* liability (assuming that scienter and all other elements of liability are present).<sup>393</sup>

On the other hand, those who (a) make false representations or omissions themselves; (b) by their visible and substantial participation in another's communications impliedly vouch for the accuracy of those statements; (c) participate substantially in another's false statements (or omissions) knowing that they are false and will be shown to investors who will rely upon them; and (d) fail, in very limited circumstances, to blow the whistle on fraud when they have a duty to do so, all do engage in the proscribed activities and should be held primarily liable for Section 10(b)/Rule 10b-5 violations.<sup>394</sup>

The "participation" standard is the most controversial aspect of my suggestions. Therefore, it bears repeating that "participation" in a fraud, even if one is not the speaker, was sufficient to impose pri-

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countants in a "no-win" situation. Cf. Humphreys, *supra* note 38, at 405 (discussing the test for an accountant's duty to disclose as formulated by the Eleventh Circuit and stating that "the accountant's duty to disclose never ends for his audit clients."); Metzger, *supra* note 38, at 1413 (describing the argument). The related argument that a whistleblowing firm will lose business "for no company would hire an accounting firm so willing to turn its back on its client," Metzger, *supra* note 38, at 1413, is not ultimately persuasive. First, accounting firms have "blown the whistle" in the past, *see, e.g.,* Wagenheim v. Alexander Grant & Co., 482 N.E.2d 955, 960 (Ohio Ct. App. 1983), and still had lots of customers. Second, the argument underestimates the value to firms of having a Big Six firm as an auditor. *See supra* notes 214-25 and accompanying text. Given the PSLRA's new requirements, all of the Big Six firms will, sooner or later, blow the whistle on their clients; realistically, those clients have nowhere else to go. As noted, the Big Six firms have a virtual monopoly on the business of auditing large public companies.

390. 511 U.S. at 175-76.

391. *Id.* at 176.

392. *Id.*

393. Professor Maxey suggests that remote collateral participants, like banks, who cannot be linked to an issuer's misrepresentations or omissions will not be liable under Section 10(b)/Rule 10b-5 following *Central Bank*. *See* Maxey, *supra* note 79, at 2209.

394. *See supra* notes 2, 3 (quoting Section 10(b) and Rule 10b-5).

mary fraud liability at common law, was sufficient to impose primary Section 10(b)/Rule 10b-5 liability before the advent of aiding and abetting liability under the statute, was sufficient in several jurisdictions to impose primary liability, as well as aiding and abetting liability, during the heyday of Section 10(b)/Rule 10b-5 aiding and abetting cases, and has been chosen by the Supreme Court as the proper standard for both imposing primary liability upon collateral defendants and barring recovery by plaintiffs facing *in pari delicto* defenses. Clearly, a "participation" standard is appropriate for determining the scope of Section 10(b)/Rule 10b-5 primary liability of defendants post-*Central Bank*.

Setting these parameters on the scope of primary liability, even though they are broader than many others have argued for, is unlikely to lead to excessive litigation of the type decried in *Central Bank* because (a) any private damages plaintiff must establish *all* the elements of liability, especially scienter and reliance, in order to recover;<sup>395</sup> (b) the PSLRA establishes new pleading requirements which will realistically prevent many, many plaintiffs from ever crossing the first of many hurdles that must be surmounted in order to recover;<sup>396</sup>

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395. For example, in a whistleblower case, McNulty & Hanson suggest that "[a] plaintiff will have to prove that he or she reasonably relied on the defendant to blow the whistle about another's wrongdoing and that, if made, the disclosure would have prevented him or her from entering into a transaction and sustaining a loss." McNulty & Hanson, *supra* note 38, at 49. While their point is generally well taken, they are wrong in this particular. If there is, indeed, a duty to "blow the whistle," plaintiffs will have a rather easier time establishing reliance because, regarding actionable omissions, reliance is *presumed*. See *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 153-54 (1972).

396. Even before the PSLRA was passed, many courts viewed Rule 9(b)'s strictures on pleading specificity as "especially designed to protect the reputation of accountants and other professionals from injury caused by unsubstantiated charges of fraud." Griffin v. McNiff, 744 F. Supp. 1237, 1248 (S.D.N.Y. 1990), *aff'd*, 996 F.2d 303 (2d Cir. 1993); *In re Union Carbide Corp. Consumer Prods. Bus. Sec. Litig.*, 666 F. Supp. 547, 557 (S.D.N.Y. 1987). The courts had already taken it upon themselves to screen out deficient claims at the pleadings stage and were granting more motions to dismiss than ever before. See Jonathan Eisenberg, *Beyond the Basics: 50 Defense Doctrines that Every Securities Litigator Needs to Know*, in AMERICAN CONFERENCE INSTITUTE, SECURITIES LITIGATION AND ENFORCEMENT: NEW DEVELOPMENTS AND RECENT TRENDS 49, 49 (May 1995) (courts are dismissing far more cases than in the past); Joel Seligman, *The Merits Do Matter: A Comment on Professor Grundfest's "Disimplying Private Rights of Action Under the Federal Securities Laws; The Commission's Authority"*, 108 HARV. L. REV. 438, 446 (1996) (indicating that a substantial percentage of cases were dismissed before trial in 1992).

The PSLRA substantially heightened pleading standards by, among other things, codifying a standard for pleading state of mind based on the most stringent rules then in existence. See Avery, *supra* note 25, at 357. Those rules had been developed by the Second Circuit. See *Ross v. A.H. Robins Co.*, 607 F.2d 545, 558 (2d Cir. 1979).

Professor Langevoort has pointed out, even before passage of the PSLRA, that it will



and (c) joint and several liability, the chief bugaboo of collateral defendants that has long been accused of forcing them to settle nonmeritorious "strike" suits, has been largely eliminated by the PSLRA.<sup>397</sup>

Setting broad parameters of liability should reduce fraud,<sup>398</sup> increase fairness,<sup>399</sup> improve the accuracy of financial reporting, and,

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be rare when a plaintiff at the pleadings stage will have access to evidence that directly implicates an issuer's attorneys absent some prior SEC proceedings and journalistic investigation. See Langevoort, *supra* note 39, at 93. Now that the PSLRA is on the books, private plaintiffs will truly face very serious obstacles to ever seeing the inside of a courtroom.

397. See generally Avery, *supra* note 25, at 362-63 (indicating that henceforth, defendants guilty of only recklessness will usually not face joint and several liability).

398. Auditors' judgments are heavily influenced by their incentive structures. See Karl Hackenbrack & Mark W. Nelson, *Auditors' Incentives and Their Application of Financial Accounting Standards*, 71 ACCT. REV. 43, 54 (1996) ("[A]uditors tend to make the reporting decisions favored by their incentives . . ."). Therefore, it stands to reason that if the legal structure is modified substantially to alter the incentive structure for auditors, and presumably other collateral defendants, by dramatically reducing their liability for fraud, the accuracy of corporate reporting in America would suffer. There is evidence that increased liability exposure for auditors has increased the quality of their work. See, e.g., Ellen Benoit, *A Gentleman's Game: Why the SEC is Thinking about Tougher Disclosure Rules for Public Companies That Change Auditors*, FIN. WORLD, Sept. 22, 1987, at 18 (noting that "litigation would seem to be the only thing that can really force auditors to be tough"); E.P. Minnis, *Professional Liability after Hedley Byrne*, in ACCOUNTANTS' LIABILITY IN THE 1980s: AN INTERNATIONAL VIEW 26, 31 (E.P. Minnis & C.W. Nobes eds., 1985) (British expert Paul Rutteman "sees the improvement in [audit] quality control in recent years as a direct by-product of the legal problems [of accountants]"); C.W. Nobes, *Summary and Highlights of Chapters Four to Seven*, in *id.* at 37 ("One response to increasing litigation has been a growing emphasis on quality."); David E. Wallin, *Legal Recourse and the Demand for Auditing*, 67 ACCT. REV. 121, 122 (1992) ("[T]he threat of lawsuit will cause less frequent fraudulent reports.").

In many transactions, lawyers' fees are dependent on deals going through. Attorneys "may use 'premium billing' for successful transactions or merely know that they will have to reduce their fees if transactions fail to close." Painter, *supra* note 167, at 552. Such arrangements give attorneys an incentive to assist fraud that will assist closure of transactions, making useful a liability counterweight.

Perhaps no professionals are better known for producing conclusions that aid their own self-interest than investment bankers. See generally Robert A. Prentice & John H. Langmore, *Hostile Tender Offers and the "Nancy Reagan Defense": May Target Boards "Just Say No"? Should They Be Allowed To?*, 15 DEL. J. CORP. L. 377, 468-472 (1990) (noting that courts often view incentive-driven investment bankers' opinions as nearly worthless). Again, a broad view of "primary liability" which would help better align the investment bankers' interests with those of investors seeking accurate information would be useful. See Bill Shaw & Edward J. Gac, *Fairness Opinions in Leveraged Buy Outs: Should Investment Bankers Be Directly Liable to Shareholders?*, 23 SEC. REG. L.J. 293, 319 (1995) (arguing that increased liability for investment bankers might restore the "fairness" to fairness opinions); Giuffra, *supra* note 189, at 140-41 ("[L]iability will encourage [investment bankers] to render opinions with greater diligence.").

399. See Seligman, *supra* note 10, at 1441-42 ("[I]f a business corporation commits fraud in the sale of securities and then goes bankrupt, who should ultimately bear the loss?"). Should it be the innocent investors who were deceived? Or should it be those

thereby, improve the efficiency of our financial markets consonant with the goals established by Congress for the 1934 Act. Participation liability is firmly established at the common law and if Section 10(b)/Rule 10b-5 were read to unduly narrow that standard, it would be very unfortunate. If professionals participate in clients' fraud, they should be held liable, plain and simple. Any serious opposition to this point is, at bottom, probably based on a fear that the "recklessness" standard of liability has been loosened too far and will result in professionals being held liable for their clients' fraud which they truly did not know was occurring. That is a separate issue. But assuming the lower courts adopt my view of primary liability, if *Central Bank* ultimately has any major impact, it likely will be because it emboldened the Supreme Court to hold at some later date that recklessness is insufficient as a standard for fraud liability,<sup>400</sup> or perhaps that the "in connection with" requirement must be dramatically tightened.<sup>401</sup>

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who significantly participated, visibly or behind the scenes, in perpetrating the fraud? See *id.* In terms of equity, this is not a difficult question to answer.

400. Some have observed that the reasoning of the *Central Bank* majority "seems to ring a death knell for recklessness." Wager & Failla, *supra* note 69, at 1460. Fortunately, in my opinion, the lower courts have tended to disagree. See, e.g., *In re Leslie Fay Co., Inc. Sec. Litig.*, 871 F. Supp. 686, 693-94 (S.D.N.Y. 1995) (recklessness is still a viable standard); *In re Phar-Mor, Inc. Sec. Litig.*, 892 F. Supp. 676, 685-86 (W.D. Pa. 1995) (same).

401. Section 10(b) prohibits fraud "in connection with the purchase or sale" of securities. See *supra* note 2. The "in connection with" requirement may present difficulties for some plaintiffs. Courts have applied different tests depending on whether the misrepresentation was a relatively private one made by defendants to individual plaintiffs or a relatively public one made by defendants to the market at large. See Prentice & Langmore, *supra* note 30, at 56-60. In the former situation, most courts have been split among three possible views. The narrowest view is that an affirmative misrepresentation is "in connection with" the purchase or sale of a security only if it relates directly to the value of the security or the consideration offered therefor. See, e.g., *Gurwara v. LyphoMed, Inc.*, 937 F.2d 380, 383 (7th Cir. 1991). A slightly more liberal approach requires that there be a "nexus" between the defendant's fraudulent misrepresentation and plaintiff's investment decision, focusing on whether the policies underlying Section 10(b) and Rule 10b-5 would be advanced by applying it to the particular transaction. See, e.g., *Brown v. Ivie*, 661 F.2d 62, 65 (5th Cir. 1981). The most pro-plaintiff view is that the "in connection with" requirement is largely a restatement of the transaction causation requirement and therefore adds no additional element to the plaintiff's burden of proof. See *Superintendent of Ins. of N.Y. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 10 n.7 (1971).

In cases of public misrepresentations, courts generally hold that the "in connection with" requirement is met when the affirmative misrepresentations are made in a setting reasonably calculated or reasonably expected to influence the investing public. See Prentice & Langmore, *supra* note 30, at 60. On the other hand, if the defendant did not expect the statements to be communicated to the investing public, the "in connection with" requirement is not met. So, if accountants or attorneys, for example, provide opinions or representations to the clients with the expectation that they will be used only internally, yet the clients transmit the documents to investors, those opinions or representations are

When the decision was made to promulgate Rule 10b-5, Commissioner Sumner Pike commented, "Well, we are against fraud, aren't we?"<sup>402</sup> If we are still against fraud, primary liability under Section 10(b)/Rule 10b-5 must be applied broadly as I have argued above.

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not "in connection with" investment decisions later made by investors. *See, e.g., Zoelsch v. Arthur Andersen & Co.*, 824 F.2d 27, 34 (D.C. Cir. 1987) (private statements to German accounting firm were not transmitted to the public so the "in connection with" requirement was not met even though they were included in the latter's report which was used by German investors); *Wessel v. Buhler*, 437 F.2d 279, 281-82 (9th Cir. 1971) (financial statements prepared for client company's internal use only held not "in connection with" investor's subsequent purchase).

But at least one post-*Central Bank* case has used that opinion's reasoning to drastically alter the meaning of the "in connection with" requirement, holding that a false statement by a collateral defendant such as an accountant in a publicly-filed document is not "in connection with" secondary market trading. *See McGann v. Ernst & Young*, No. SA CV 93-814 AHS, 1995 U.S. Dist. LEXIS 11116, at \*25 (C.D. Cal. June 2, 1995), *rev'd*, 95 F.3d 821 (9th Cir. 1996). Such false statements, this trial court held, are actionable only if they are contained in "selling documents." *See id.* This view is clearly erroneous in that (among other things) it totally ignores the efficient market hypothesis which the Supreme Court adopted lock, stock, and barrel in the *Basic* case. *See Basic, Inc. v. Levinson*, 485 U.S. 224, 241-47 (1988) (recognizing efficient markets hypothesis as basis for adoption of "fraud on the market" theory of reliance). Fortunately, the case was reversed and better reasoned opinions have rejected the "selling documents" restriction. *See Adam v. Silicon Valley Bancshares*, 884 F. Supp. 1398, 1402 (N.D. Cal. 1995); *In re Leslie Fay Cos., Inc. Sec. Litig.*, 871 F. Supp. 686, 697-98 (S.D.N.Y. 1995); *Spear v. Ernst & Young*, [1994-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶98,399, at 90,743-44 (D.S.C. Aug. 15, 1994).

402. Remarks of Milton Freedman on Administrative Procedures (Nov. 18 & 19, 1966), in *Conference on Codification of the Federal Securities Laws*, 22 BUS. LAW. 793, 922 (1967).