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NOTES

THE STATEMENT SOMEONE ELSE MAKES MAY BE YOUR OWN: PRIMARY LIABILITY UNDER SECTION 10(b) AFTER *CENTRAL BANK*

The Supreme Court's elimination of aiding and abetting actions in *Central Bank of Denver v. First Interstate Bank of Denver*¹ overturned thirty years of federal common law which had provided private plaintiffs with remedies against secondary participants in fraudulent securities transactions. Prior to *Central Bank*, investors could recover from secondary actors, such as lawyers and accountants, who provided only substantial assistance to the primary actor in violation of section 10(b).² In the wake of *Central Bank*, however, investors who suffer loss due to securities fraud must scramble to find other remedies.

In *Central Bank*, the Supreme Court held that “[b]ecause the text of [section] 10(b) does not prohibit aiding and abetting ... a private plaintiff may not maintain an aiding and abetting suit

¹ 511 U.S. 164 (1994).

² See, e.g., *Harmsan v. Smith*, 693 F.2d 932, 943 (9th Cir. 1982) (recognizing aiding and abetting cause of action under section 10(b) where defendant has knowledge of independent primary wrong and substantially assists in furtherance of that wrong); *ITT v. Cornfeld*, 619 F.2d 909, 922 (2d Cir. 1980); *SEC v. Coffey*, 493 F.2d 1304, 1316 (6th Cir. 1974) (recognizing aiding and abetting cause of action under section 10(b) where another person violated securities law and accused “had general awareness that his role was part of an overall activity that [was] improper, and ... knowingly and substantially assisted the violation”); *Brennan v. Midwestern Life Ins. Co.*, 259 F. Supp. 673, 680 (N.D. Ind. 1966) (holding that absent clear expression of contrary legislative intent, courts must be flexible in their application of section 10(b) to ensure proper implementation of its purposes and policies), *aff'd*, 417 F.2d 147 (7th Cir. 1969).

under [section] 10(b).³ Nevertheless, the Court expressly recognized that the absence of aiding and abetting does not mean that secondary actors are completely free from liability—secondary actors can potentially still be held liable as primary violators.⁴ In response, private plaintiffs have tried to recharacterize what were once aiding and abetting violations as primary violations.

Ultimately, the fundamental question left unanswered by *Central Bank* is what actions of secondary actors in Rule 10b-5 violations constitute primary violations. With little guidance to be found within the *Central Bank* decision, several lower courts have struggled to define the boundaries of primary liability.

This Note attempts to determine the limits of primary liability. Part I outlines the provisions of the securities laws at issue in *Central Bank*. Part II discusses the decision in *Central Bank* and the Private Securities Litigation Reform Act of 1995. Part III discusses the fundamental distinctions between primary and secondary liability. Part IV introduces the post-*Central Bank* decisions which have addressed the limits of primary liability. Finally, Part V analyzes the post-*Central Bank* authority in order to define the primary violation after *Central Bank* and its effect on the jurisprudence of securities enforcement under section 10(b)/Rule 10b-5.

I. OVERVIEW OF INSIDER TRADING PRIOR TO *CENTRAL BANK*

A. *Section 10(b)/Rule 10b-5*

The Securities Act of 1933⁵ (the "Securities Act") and the Securities Exchange Act of 1934⁶ (the "Securities Exchange Act"),

³ *Central Bank*, 511 U.S. at 191.

⁴ *See id.*

⁵ 15 U.S.C. § 77(a)-(bbb) (1994 & Supp. 1995). The Securities Act has two basic objectives: (1) to provide investors with information, financial or otherwise, concerning the sale of securities to the public; and (2) to prohibit fraudulent sales of securities. *See Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 195 (1976); *SEC v. Southwest Coal & Energy Co.*, 624 F.2d 1312, 1318 (5th Cir. 1980). The scope of the Securities Act is strictly limited to jurisdiction established through some use of the mails or of interstate facilities to commit a prohibited act. 15 U.S.C. § 77(a)-(bbb) (1994 & Supp. 1995); *accord, e.g., United States v. Robertson*, 181 F. Supp. 158, 164 (S.D.N.Y. 1959).

⁶ 15 U.S.C. § 78(a)-(kk) (1994 & Supp. 1995). The Securities Exchange Act also has two fundamental objectives: (1) to provide for full disclosure; and (2) to prevent fraud in the sales of securities. *Id.*; *see Ernst & Ernst*, 425 U.S. at 195.

enacted in the wake of the 1929 stock market crash and in response to widespread abuses in the securities industry, are the primary federal securities laws dealing with fraud in the purchase and sale of securities. "The [Securities Act] regulates initial distributions of securities, [while the Securities Exchange Act] for the most part regulates post-distribution trading."⁷ Section 10(b)⁸ of the Securities Exchange Act is a "catchall provision"⁹ designed to deal with abuses of the securities laws and has thus been described as the general anti-fraud provision.¹⁰ Rule 10b-5¹¹ was promulgated by the Securities and Exchange Commission (the "SEC") in 1942 under section 10(b)'s grant of authority to the SEC to prescribe rules prohibiting any person from using or employing any manipulative or deceptive device in

⁷ *Central Bank*, 511 U.S. at 170-71 (citing *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 752 (1975)). The Acts taken together, "embrace a fundamental purpose ... 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." *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 151 (1972) (first alteration in original) (quoting *SEC v. Capital Gains Research Bureau*, 375 U.S. 180, 186 (1963)).

⁸ 15 U.S.C. § 78(j) (1994 & Supp. 1995). Section 10(b) 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—

...

(b) 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 [SEC] may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Id.

⁹ *Chiarella v. United States*, 445 U.S. 222, 235 (1980).

¹⁰ See *Central Bank*, 511 U.S. at 171.

¹¹ 17 CFR § 240.10b-5 (1997). Rule 10b-5 states:

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 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.

connection with the purchase or sale of any security.¹²

While neither section 10(b) nor Rule 10b-5 provide an express private remedy,¹³ federal courts have implied the existence of a private right of action for violations of Rule 10b-5.¹⁴ This private right of action was reaffirmed by the Supreme Court in *Herman & MacLean v. Huddleston*,¹⁵ where the Court held that the availability of an express remedy under other sections of the securities laws did not preclude defrauded investors from maintaining actions under section 10(b).¹⁶

Consistent with a broad interpretation of the securities laws and the willingness of the courts to imply a private right of action for violations of Rule 10b-5, the courts interpreted the securities laws to impose liability on secondary actors for aiding and abetting.

B. *Aiding and Abetting and Pre-Central Bank Application*

Aiding and abetting imposes liability on secondary parties who do not directly participate in an alleged wrongdoing, but

¹² 15 U.S.C. § 78(j) (1994 & Supp. 1995). Rule 10b-5 is the chief enforcement mechanism for section 10(b) of the Securities Exchange Act. The substance of Rule 10b-5 was taken from Section 17(a) of the 1933 Act. See George M. Duff, Jr., Remarks, *Conference on Codification of the Federal Securities Laws*, 22 BUS. LAW. 793, 885 (1967). The drafters of Rule 10b-5 intended to supplement the SEC's enforcement capacity under section 17(a). See Milton Freeman, Remarks, *Conference on Codification of the Federal Securities Laws*, 22 BUS. LAW. 793, 921-23 (1967).

¹³ See *supra* notes 8 & 11.

¹⁴ Because Congress did not provide investors with an express remedy against violation of the "catchall" securities provision, the cause of action and its scope were created by the courts. This private remedy for a violation of Rule 10b-5 was first implied in *Kardon v. National Gypsum Co.*, 73 F. Supp. 798 (E.D. Pa. 1947). See Freeman, *supra* note 12, at 922. For the past 50 years, the federal courts have sustained private actions of investors deceived in connection with the purchase or sale of a security. See, e.g., *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 196 (1976) (citing *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 730 (1975)); *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 150-54 (1972); *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 13-14 (1971) (holding section 10(b) should be read more liberally to provide private right of action).

¹⁵ 459 U.S. 375 (1983). "The existence of this implied remedy is simply beyond peradventure." *Id.* at 380.

¹⁶ *Id.* at 386-87. In so holding, the Court noted that "[t]he effectiveness of the broad proscription against fraud in [section] 10(b) would be undermined if its scope were restricted by the existence of an express remedy under [section] 11." *Id.* at 386. Nevertheless, the Court expressly reserved the issue of the existence of aider and abettor liability as the Court had previously done in *Ernst & Ernst*, 425 U.S. at 191-92 n.7. See *Herman & MacLean*, 459 U.S. at 379 n.5.

who have played a substantial part in the fraudulent activity.¹⁷ Historically, aiding and abetting was used by private plaintiffs as well as the SEC to bring actions against accountants, lawyers, and others who assisted in violations of the securities laws.¹⁸

Congress did not expressly provide for aiding and abetting liability under section 10(b).¹⁹ As with the creation of any express private remedy,²⁰ the concept of an aiding and abetting securities violation was derived from civil common law and criminal law doctrines.²¹ The leading case recognizing secondary liability for aiding and abetting was *Brennan v. Midwestern United Life Insurance Co.*²² The *Brennan* court held Midwestern, the defendant corporation, liable under Rule 10b-5 for aiding and abetting the fraudulent scheme of a securities broker.²³ With knowledge of the fraudulent activity, Midwestern permitted the activities to continue by failing to report the broker.²⁴ Acknowledging that nothing in the statute or legislative history indicated congressional intent to impose such liability, the court, relying on section 876 of the Restatement of Torts,²⁵ nonetheless stated

¹⁷ See *supra* note 2.

¹⁸ See *supra* note 2 and accompanying text.

¹⁹ See *supra* notes 8, 11 & 13 and accompanying text.

²⁰ See *supra* notes 14-16 and accompanying text.

²¹ In 1909, Congress enacted a general aiding and abetting statute applicable to all federal criminal offenses. See 18 U.S.C. § 2 (1994 & Supp. 1995). The statute requires that a defendant, in order to aid and abet another to commit a crime must, "in some sort associate himself with the venture, that he participate in it as in something that he wishes to bring about, that he seek by his action to make it succeed." *United States v. Peoni*, 100 F.2d 401, 402 (2d Cir. 1938); accord *United States v. Harris*, 441 F.2d 1333, 1336 (10th Cir. 1971) (stating that in order to be liable, one need not have active stake in crime, but must merely participate).

²² 259 F. Supp. 673 (N.D. Ind. 1966).

²³ *Id.* at 682 (holding that trial would be necessary to determine whether "the defendant's alleged 'silence and inaction' was sufficient assistance or encouragement to constitute an aiding and abetting of [the broker's] alleged violation of the statute and rule").

²⁴ The broker was trading Midwestern stock but was not transferring the stock to the buyers. See *id.* at 675. Acting as its own transfer agent, Midwestern received complaints about this from the purchasers but simply transferred the complaints back to the broker. See *id.* These complaints occurred over a lengthy period of time during which Midwestern had various conversations with the broker concerning this problem. See *id.* Allegedly, Midwestern's officers decided not to report the broker because of fear that this might depress Midwestern's stock price. See *id.*

²⁵ Section 876 of the RESTATEMENT (SECOND) OF TORTS provides:

For harm resulting to a third person from the tortious conduct of another, one is subject to liability if he ... (b) knows that the other's conduct constitutes a breach of duty and gives substantial assistance or encouragement to the other so to conduct himself, or (c) gives substantial assistance to the

that "general principles of law should continue to guide the development of federal common law remedies under Section 10(b) and Rule 10b-5."²⁶ Thus, the court in *Brennan* held that an aider or abettor could be jointly liable for participation in fraudulent activity even though the participants did not act in concert.²⁷

A number of courts soon followed *Brennan*.²⁸ While the standards for the cause of action differed, all eleven federal circuits had recognized a private cause of action against aiders and abettors.²⁹ Prior to *Central Bank*, courts did not make a manipulative or deceptive act on the part of the aider and abettor a requirement for liability under section 10(b), but rather, required "an independent, illegal act ... to which the alleged aider and abettor [could] be attached."³⁰ These cases, however, contained virtually no discussion with respect to this requirement because once any independent illegal act was found, attention shifted to the other elements of aiding and abetting.³¹ As such, the cause of action for aiding and abetting continued to be applied in this manner until *Central Bank*.³²

other in accomplishing a tortious result and his own conduct, separately considered, constitutes a breach of duty to the third person.

RESTATEMENT (SECOND) OF TORTS § 876 (1979).

²⁶ *Brennan*, 259 F. Supp. at 680.

²⁷ *Id.* at 682. Implying liability for aiding and abetting based upon common law tort principals, in the court's view, was nothing more than a "logical and natural complement" to the implication of a private right of action under Rule 10b-5, which was also developed from general principles of tort law. *Id.* at 680. The court noted:

Such liability was there rested upon the maxim, *Ubi jus, ibi remedium*—Where there is a right, there is a remedy. This is the rationale upon which the *Kardon* doctrine has been adopted by the court of appeals. Appropriate general principles of law should continue to guide the development of federal common law remedies under Section 10(b) and Rule 10b-5.

Id. (citations omitted).

²⁸ See, e.g., *DiLeo v. Ernst & Young*, 901 F.2d 624, 628 (7th Cir. 1990); *Cleary v. Perfectune, Inc.*, 700 F.2d 774, 777 (1st Cir. 1983); *Kerbs v. Fall River Indus., Inc.*, 502 F.2d 731, 740 (10th Cir. 1974). See generally Alan R. Bromberg & Lewis D. Lowenfels, *Aiding and Abetting Securities Fraud: A Critical Examination*, 52 ALB. L. REV. 637 (1988) (discussing versions and elements of aiding and abetting action).

²⁹ See *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164, 192 n.1 (1994) (Stevens, J., dissenting). The Supreme Court, however, had twice reserved ruling on the issue of the existence of an action for aiding and abetting under section 10(b) and Rule 10b-5. See *Herman & MacLean v. Huddleston*, 459 U.S. 375, 379 n.5 (1983); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 191-92 n.7 (1976).

³⁰ Bromberg & Lowenfels, *supra* note 28, at 669.

³¹ See *id.* at 670; see *infra* note 67 and accompanying text for elements of the aiding and abetting cause of action.

³² See generally Carrie E. Goodwin, *Central Bank v. First Interstate Bank: Not Just the End of Aiding and Abetting Under Section 10(b)*, 52 WASH. & LEE L. REV.

II. THE *CENTRAL BANK* DECISION AND THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995

A. *The Central Bank Decision*

In 1994, in *Central Bank of Denver v. First Interstate Bank of Denver*,³³ the Supreme Court rejected the existence of secondary liability for aiders and abettors.³⁴ In *Central Bank*, the Colorado Springs–Stetson Hills Public Building Authority issued bonds in 1986 and 1988, secured by landowner assessment liens, to finance public improvements in a planned development.³⁵ Central Bank served as the indenture trustee for the bond issues.³⁶ Under the indenture, the bonds were to be secured by landowner assessment liens with an appraised value of at least 160 percent of the bonds' outstanding principal and interest.³⁷

In 1988, Central Bank received an updated appraisal of the land securing the 1986 bonds, showing that land values had remained unchanged.³⁸ Upon review of the appraisal, the underwriter for the bond issue as well as Central Bank's in-house appraiser informed Central Bank that the appraisal did not appear to be reliable due to recent declines in property values.³⁹ Central Bank nevertheless postponed an independent review of the appraisal until after the bonds were issued.⁴⁰ The bonds were issued in June 1988 and shortly thereafter the Authority defaulted on the 1988 bonds.⁴¹ Upon default, purchasers of the 1988 bonds, First Interstate et al., brought suit against, among others, Central Bank for violation of section 10(b) of the Securities Exchange Act.⁴² The complaint alleged that Central Bank was "secondarily liable under [section] 10(b) for its conduct in aiding

1387 (1995) (discussing aider and abettor liability prior to and following *Central Bank*).

³³ 511 U.S. 164 (1994).

³⁴ *Id.* at 191.

³⁵ *Id.* at 167.

³⁶ *See id.*

³⁷ *See id.* The bond covenants required the developer to give Central Bank evidence that the 160 percent was met by submitting annual reports to the trustee. *See id.*

³⁸ *See id.*

³⁹ *See id.*

⁴⁰ *See id.*

⁴¹ *See id.* at 167-68.

⁴² *See id.* at 168.

and abetting the fraud.'"⁴³

While the issue initially presented to the Court was whether recklessness is sufficient to satisfy the scienter requirement under Rule 10b-5,⁴⁴ the Court instead decided to address a threshold issue not raised or addressed by the lower courts: "Whether there is an implied private right of action for aiding and abetting violations of [section] 10(b) ...[.]"⁴⁵ While acknowledging difficulty in defining the elements of a section 10(b) cause of action because Congress had not created the private remedy,⁴⁶ the Court nonetheless followed a strict textual construction that it had employed in earlier decisions.⁴⁷ The Court simply concluded that because Congress had not used the words "aiding and abetting" in the statute, liability could not extend beyond the scope of conduct prohibited by the statute.⁴⁸

The Court also held that "aiding and abetting" was not embodied in the "directly or indirectly" language of section 10(b).⁴⁹ The Court reasoned that the inclusion of general aiding and abetting in the federal criminal code⁵⁰ suggested that Congress knew how to impose aiding and abetting liability and had simply

⁴³ *Id.* (citation omitted). Plaintiff's counsel expressly conceded that Central Bank of Denver had not itself committed a manipulative or deceptive act. *See id.* at 191.

⁴⁴ *See id.* at 169. In *Ernst & Ernst v. Hochfelder*, the Supreme Court held that the existence of scienter was a necessary element in establishing a private cause of action under section 10(b) and Rule 10b-5. 425 U.S. 185, 214 (1976).

⁴⁵ *See Central Bank*, 508 U.S. at 959 (granting certiorari). In fact, the Court did not even mention the eleven federal circuit court opinions and the other numerous district court decisions that found aiding and abetting liability under section 10(b).

⁴⁶ *See id.* at 173.

⁴⁷ *See Chiarella v. United States*, 445 U.S. 222, 234 (1980); *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 472 (1977); *Ernst & Ernst*, 425 U.S. at 200-01. *But see* Melvin Aron Eisenberg, *Strict Textualism*, 29 LOY. L.A. L. REV. 13, 14 (1995) (arguing strict textual construction is "intellectually incoherent").

⁴⁸ *See Central Bank*, 511 U.S. at 177. "We reach the uncontroversial conclusion, accepted even by those courts recognizing a [section] 10(b) aiding and abetting cause of action, that the text of the 1934 Act does not itself reach those who aid and abet a [section] 10(b) violation." *Id.* The Court also observed that "litigation under Rule 10b-5 presents a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general." *Id.* at 189 (quoting *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 739 (1975)). *But cf. Central Bank*, 511 U.S. at 196 (Stevens, J., dissenting) ("A policy of respect for consistent judicial and administrative interpretations leaves it to elected representatives to assess settled law and to evaluate the merits and demerits of changing it.").

⁴⁹ *See Central Bank*, 511 U.S. at 176.

⁵⁰ *See* 18 U.S.C. § 2 (1994 & Supp. 1995).

chosen not to impose it under section 10(b).⁵¹

In its opinion, the Supreme Court focused on the basic requirement for section 10(b) liability: a deceptive material misstatement (or omission) or the commission of a manipulative act on the part of the defendant.⁵² The Court recognized that "aiding and abetting liability extends beyond persons who engage, even indirectly, in a proscribed activity; aiding and abetting liability reaches persons who do not engage in the proscribed activities at all, but who give a degree of aid to those who do."⁵³ Thus, noting that aider and abettor liability as it had been previously defined by the lower courts did not meet the minimum requirements for liability under section 10(b), the Supreme Court held that a person could not be liable under section 10(b)/Rule 10b-5 for merely aiding a primary violation of the provisions.⁵⁴

The Supreme Court's elimination of liability for aiding and abetting abolished approximately thirty years of federal common law. While, as we will see, this action clearly limited the reach of private remedies against lawyers and others who provide services in connection with the offering of securities,⁵⁵ the decision also created uncertainty as to the SEC's ability to use aiding and abetting as a theory of liability. For this reason, the SEC urged Congress to enact legislation addressing the *Central Bank* decision.

B. *The Private Securities Litigation Reform Act of 1995*

On December 22, 1995, the U.S. Senate overrode a Presidential veto to enact the Private Securities Litigation Reform Act

⁵¹ See *Central Bank*, 511 U.S. at 176-77.

⁵² See *id.* at 177.

⁵³ *Id.* at 176. Underscoring the Court's conclusion was the recognition that aiding and abetting created liability without reliance by the plaintiff on the aider and abettor's acts, see *id.* at 180, which was expressly rejected in *Basic, Inc. v. Levinson*, 485 U.S. 224, 243 (1988).

⁵⁴ See *Central Bank*, 511 U.S. at 175. The Court noted that section 10(b)/Rule 10b-5 is "an area that demands certainty and predictability." *Id.* at 188 (quoting *Pinter v. Dahl*, 486 U.S. 622, 652 (1988)). The rules for determining aiding and abetting had led to ad hoc determination, offering little predictive value to participants in the securities business. See *id.* The Court further noted "[s]uch a shifting and highly fact-oriented disposition of the issue of who may [be liable for] a damages claim for violation of Rule 10b-5' is not a 'satisfactory basis for a rule of liability imposed on the conduct of business transactions.'" *Id.* (alterations in original) (quoting *Blue Chip Stamps*, 421 U.S. at 755).

⁵⁵ See *infra* notes 141-42 and accompanying text.

of 1995 (the "PSLRA").⁵⁶ The PSLRA explicitly grants authority to the SEC to bring actions for aiding and abetting under the Securities Exchange Act.⁵⁷ However, the PSLRA limits the SEC's authority to actions where the aider or abettor knowingly provides substantial assistance to the primary violator.⁵⁸

Consequently, the PSLRA's express provision of authority for the SEC to bring actions for aiding and abetting is, significantly, a clear indication by Congress of the approval of the elimination of the cause of action of aiding and abetting for private plaintiffs.⁵⁹ As a result of *Central Bank* and the PSLRA, investors who suffer a loss as a result of securities fraud may seek a remedy only by alleging a primary violation of section 10(b)/Rule 10b-5.⁶⁰

III. PRIMARY V. SECONDARY LIABILITY

An anticipated response to the *Central Bank* decision was the attempt to expand the limits of primary liability under section 10(b) and Rule 10b-5. In *Central Bank*, the Supreme Court noted:

The absence of [section] 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

⁵⁶ Pub. L. No. 104-67, 1996 U.S.C.C.A.N. (109 Stat. 737) (codified in various sections of 15 U.S.C.). The PSLRA contains amendments to various sections of the Securities and Exchange Act. The amendments include both procedural and substantive changes as well as penalties to deter meritless litigation. *See id.* § 101. Additionally, the amendments provide for safe-harbors for forward looking statements, *see id.* § 102, and proportionate liability for defendants who do not commit securities violations with actual knowledge; *see id.* § 201.

⁵⁷ *See* PSLRA, 15 U.S.C. § 78t(f) (adding subsection (f) to section 20 of the Securities Exchange Act). Section 78t(f) provides:

For purposes of any action brought by the Commission ... any person that knowingly provides substantial assistance to another person in violation of a provision of this chapter, or of any rule or regulation issued under this chapter, shall be deemed to be in violation of such provision to the same extent as the person to whom such assistance is provided.

Id.

⁵⁸ *See id.*

⁵⁹ *See* 141 CONG. REC. S17933, S17937 (daily ed. Dec. 5, 1995) (statement of Sen. Sarbanes) ("This bill, unfortunately, restores only the SEC's ability to go after aiders and abettors of violations of the securities laws.")

⁶⁰ *See* Broady R. Hodder, *Central Bank v. First Interstate Bank and its Aftermath: Securities Professionals' Ever-Changing Liabilities*, 39 ARIZ. L. REV. 343, 357 (1997).

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 In any complex securities fraud, moreover, there are likely to be multiple violators⁶¹

While the decision undermined the law that had been created under Rule 10b-5, it also raised a number of issues. The most important question the Court left open was what actions of secondary actors in Rule 10b-5 violations would be deemed to constitute primary violations.⁶² Clearly inviting litigation of this issue, the decision in *Central Bank* did not indicate or lend guidance to the specific actions that could be sustained as primary violations;⁶³ and as a result, the lower courts began to address this issue.⁶⁴

Prior to *Central Bank*, the courts had noted differing degrees of culpability between primary and secondary wrongdoing. This culpability distinction was, nevertheless, insignificant; because liability for primary and secondary actors was joint and several, the courts were not required to distinguish between the two types of liability.⁶⁵ Instead, courts focused their attention on the aider and abettor's state of mind and whether substantial assistance was given to the primary violator.

In *Central Bank*, the Supreme Court stated that the elements set forth by the Court of Appeals of the section 10(b) aiding and abetting cause of action consisted of: (1) a primary violation of section 10(b); (2) recklessness by the aider and abettor as to the existence of the primary violation; and (3) substantial as-

⁶¹ *Central Bank*, 511 U.S. at 191. The dissenting opinion noted: "Indeed, the Court 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 ...) in connection with the purchase or sale of securities may be liable for a primary violation of [section] 10(b) and Rule 10b-5." *Id.* at 199 n.10 (Stevens, J., dissenting).

⁶² Commentators have long recognized the unclear limits between primary and secondary liability. See generally Daniel R. Fischel, *Secondary Liability Under Section 10(b) of the Securities Act of 1934*, 69 CAL. L. REV. 80, 103-11 (1981); 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, 600 (1972).

⁶³ See Gareth T. Evans & David S. Floyd, *Secondary Liability Under Rule 10b-5: Still Alive and Well After Central Bank*, 52 BUS. LAW. 13, 14 (1996).

⁶⁴ See *id.*

⁶⁵ See Hodder, *supra* note 60, at 344.

sistance given to the primary violator by the aider and abettor.⁶⁶ A primary violation for section 10(b), in contrast, is generally understood to include the following elements: (1) the making by the defendant of a material misrepresentation or omission; (2) an intent to manipulate, deceive or defraud (scienter); (3) reliance by the plaintiff on the defendant's misrepresentation or omission; (4) causation; and (5) damages.⁶⁷ Additionally, if the primary violation is predicated upon the defendant's failure to disclose material information, as in an omission case, the plaintiff must prove that the defendant had assumed an affirmative duty to disclose.⁶⁸

Since *Central Bank*, plaintiffs have alleged primary liability against professionals and financial institutions in many contexts where secondary liability previously applied. Consequently, courts have grappled with the distinctions between primary and secondary liability.⁶⁹

In any complex securities transaction where fraud has occurred, there are likely to be multiple violators.⁷⁰ Therefore, any person or entity, including, among others, a lawyer, accountant, or bank, employing a manipulative device or making a material misstatement or an omission on which a purchaser or seller of securities relies, may be liable as a primary violator under Rule

⁶⁶ *Central Bank*, 511 U.S. at 168 (citing *First Interstate Bank of Denver, N. A. v. Pring*, 969 F.2d 891, 898-903 (10th Cir. 1992)).

⁶⁷ Prior to *Central Bank*, it was unclear what minimum level of scienter was required to sustain a cause of action for aiding and abetting. Although the Supreme Court has stated that scienter is a necessary element of the cause of action under section 10(b), see *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 194 n.12 (1976), the Court has nonetheless, on two occasions, declined to issue a decision on the question of whether a showing of reckless conduct is sufficient to satisfy the scienter requirement, see *Aaron v. SEC*, 446 U.S. 680, 690-91 (1980); *Ernst & Ernst*, 425 U.S. at 193-94; *Aaron v. SEC*, 446 U.S. 680, 690-91 (1980).

The majority of both district and circuit courts have stated that some level of recklessness is sufficient to support a cause of action under section 10(b). See, e.g., *Eisenberg v. Gagon*, 766 F.2d 770 (3d Cir. 1985); *Huddleston v. Herman & MacLean*, 640 F.2d 534, 544-45 (5th Cir. 1981), *aff'd in part, rev'd in part on other grounds*, 459 U.S. 938 (1982); *Sunstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033, 1044 (7th Cir. 1977). For a discussion of the scienter requirement under section 10(b) and Rule 10b-5, see Kevin R. Johnson, *Liability for Reckless Misrepresentations and Omissions Under Section 10(b) of the Securities Exchange Act of 1934*, 59 U. CIN. L. REV. 667 (1991).

⁶⁸ See *Dirks v. SEC*, 463 U.S. 646 (1983); *Chiarella v. United States*, 445 U.S. 222, 231 (1980).

⁶⁹ See *Evans & Floyd*, *supra* note 63, at 14.

⁷⁰ See *Central Bank*, 511 U.S. at 191.

10b-5 provided all of the requirements for primary liability under Rule 10b-5 are met.⁷¹

IV. POST *CENTRAL BANK* ANALYSIS

While *Central Bank* clearly eliminated secondary liability for securities fraud for private plaintiffs, the Supreme Court did little to resolve the confusion surrounding primary liability. As a result, the lower courts, relying on the Supreme Court's express statement that secondary actors still may be held primarily liable for violations of section 10(b) and Rule 10b-5,⁷² have struggled to define the limits of primary liability.⁷³ Not surprisingly, the lack of Supreme Court guidance has led to some inconsistencies.

The issue of who makes a material misrepresentation is one of the first issues the courts have been called upon to address. One of the first significant cases to analyze the *Central Bank* decision was *In re ZZZZ Best Securities Litigation*.⁷⁴ In *ZZZZ Best*, the plaintiffs argued that the defendant accounting firm, Ernst & Young, should be held primarily liable for securities fraud resulting from the firm's involvement in the "creation, review, or issuance" of publicly released fraudulent statements, despite the fact that Ernst & Young did not itself release the statements.⁷⁵ Relying on *Central Bank*, Ernst & Young moved for summary adjudication claiming that because the statements were not released by the firm, the plaintiffs' claims were, at best, aiding and abetting allegations no longer actionable as violations of section 10(b)/Rule 10b-5.⁷⁶ The plaintiffs, however, asserted that anyone who actively participates in the creation of a mis-

⁷¹ See *id.*

⁷² See *supra* text accompanying note 61.

⁷³ See Evans & Floyd, *supra* note 63, at 14.

⁷⁴ 864 F. Supp. 960 (C.D. Cal. 1994).

⁷⁵ *Id.* at 964. In addition to approximately 13 publicly released statements, including press releases, a Form 10-Q quarterly report, and a Form 8-K report, Ernst & Young prepared a Review Report on interim financial information which consisted of an explanation of the system for preparing interim financial information, the application of analytical review procedures to financial data, and conducting inquiries of persons responsible for financial accounting matters. See *id.* at 964 n.2.

⁷⁶ See *id.* at 965. Ernst & Young contended that *Central Bank*, "eliminate[s] claims brought against all those alleged to have 'participated' in the primary wrongdoer's statement but not to have made a statement' to the public directly," *id.* at 968 (quoting E & Y Supp. Mem. of P's & A's, at 9), so that even if Ernst & Young had reviewed, edited or approved the statements, no liability could attach, see *id.* at 966.

representation should be held primarily liable.⁷⁷

The *ZZZZ Best* court began its analysis by outlining the distinctions between secondary aiding and abetting liability and primary liability.⁷⁸ The court noted that under the former aiding and abetting test, there was no requirement that the defendant actually commit a deceptive act;⁷⁹ however, in order for primary liability to attach, there must be a deceptive misrepresentation on the part of the defendant.⁸⁰ Relying on *Central Bank*, the court emphasized that the Supreme Court made it clear that mere knowing assistance with the underlying fraudulent scheme is insufficient to support a primary liability claim.⁸¹ Rather, the plaintiff must allege that the defendant's own statements are deceitful.⁸²

The court characterized *ZZZZ Best* as a "close call," but ultimately relied on pre-*Central Bank* authority to find that there was sufficient evidence to suggest that Ernst & Young's participation in the third party misrepresentations was "extensive enough" to attribute these misrepresentations to Ernst & Young

⁷⁷ See *id.* The plaintiffs asserted that Ernst & Young was "actively involved" in the creation and review of the various financial reports and press releases that were provided by *ZZZZ Best* to the public. See *id.* The plaintiffs contended that *Central Bank* had held simply that a secondary actor who merely assisted another in committing a manipulative or deceptive act was not liable under section 10(b)/Rule 10b-5. See *id.*

⁷⁸ See *id.* at 967-68.

⁷⁹ See *id.* The court also noted that in the Ninth Circuit, prior to *Central Bank*, the only requirements for aider and abettor liability were an independent primary wrong, actual knowledge or reckless disregard of the wrong and of the aider and abettor's role in furthering the wrong, and substantial assistance in furthering the wrong. See *id.* at 967 (citations omitted).

⁸⁰ See *id.* "[A]iding and abetting liability reaches persons who do not engage in the proscribed activities at all, but who give a degree of aid to those who do." *Central Bank*, 511 U.S. at 176.

⁸¹ See *ZZZZ Best*, 864 F. Supp. at 969. The Supreme Court, however, did not decide the issue of affirmative assistance in a section 10(b)/Rule 10b-5 action because the plaintiffs had not alleged a primary violation of section 10(b). See *id.* at 969 n.11; cf. *McGann v. Ernst & Young*, 95 F.3d 821, 825 (9th Cir. 1996) (concluding that language in section 10(b) requires positive action), *cert. denied*, 117 S. Ct. 1463 (1997).

⁸² See *ZZZZ Best*, 864 F. Supp. at 969 (stating that in absence of "manipulation," plaintiffs must prove some other form of deception on part of defendant pursuant to Rule 10b-5); see also *McGann*, 95 F.3d at 826 (concluding that in order for accountants to be liable for deception under securities laws, "they must themselves make a false or misleading statement (or omission) that they know or should know will reach potential investors") (quoting *Anixter v. Home-Stake Prod. Co.*, 77 F.3d 1215, 1226 (10th Cir. 1996)).

itself.⁸³ Quoting *SEC v. Seaboard*,⁸⁴ the court stated that “[a]n accountant may be liable for direct violation of ... [Rule 10b-5] if its participation in the misrepresentation is direct and if it knows or is reckless in not knowing that the facts reported in the prospectus materially misrepresent the condition of the issuer.”⁸⁵ Similarly, the court relied on *In re Union Carbide Corp. Consumer Business Securities Litigation*⁸⁶ to conclude that if the defendant “fully participate[s] in the fraud,” misrepresentations made by a third party could be attributed to the defendant.⁸⁷

Interestingly, the *ZZZZ Best* court noted, in a lengthy footnote, that primary liability was not alleged or addressed in *Central Bank*.⁸⁸ Despite the *Central Bank* plaintiff's concession that the defendant did not itself commit a deceptive act, the *ZZZZ*

⁸³ *ZZZZ Best*, 865 F. Supp. at 970 (“While this case creates a close call and perhaps one of first impression, this Court agrees with Plaintiffs’ position.”). The court acknowledged that plaintiffs had not submitted any evidence that indicated defendants had prepared or received the public statements. Nevertheless, the court agreed with the plaintiff's position that there was sufficient evidence from which to infer that Ernst & Young was “intricately involved” in the creation of these statements. *See id.* The court inferred that by publicly dispersing a prospectus that names them, the defendants assumed responsibility for the statements contained therein, even though they were not directly involved in its preparation. *See id.*; *see also* Alan Goudiss & Steven M. Simpson, *Federal and State Securities Law Litigation: Fundamentals and Recent Developments*, PRAC. L. INST. (1997), available in WESTLAW at 560 PLI/LIT 187, 195.

⁸⁴ 677 F.2d 1301 (9th Cir. 1982) (holding that an accountant may be culpable for direct breach of securities laws if directly involved in misrepresentation and knows or is reckless in failing to know that prospectus materially misrepresents state of issuer).

⁸⁵ *ZZZZ Best*, 864 F. Supp. at 970 (alterations in original) (emphasis omitted) (quoting *Seaboard*, 677 F.2d at 1312). Although the court conceded, in a footnote, that the accountants in *Seaboard* had certified the financial statements, the court agreed with the Ninth Circuit's statement that adequate proof of participation in the public statements of others can “cause the statements to be attributed to the participator.” *Id.* at 970 n.12.

⁸⁶ 676 F. Supp. 458, 468 (S.D.N.Y. 1987) (holding that an independent professional accounting firm's formulation of misleading forecasts or arrangement of “raw data” for those formulations can comprise direct involvement in misrepresentation and lead to primary securities fraud liability).

⁸⁷ *ZZZZ Best*, 864 F. Supp. at 970. In *Union Carbide*, the court held that a financial forecast issued by Union Carbide could be attributed to the accountants, Morgan Stanley, because “Morgan Stanley prepared the financial projections and fully participated in the fraud....” *Id.* (citing *Union Carbide*, 676 F. Supp. at 467-69). The *Union Carbide* court stated that “[p]reparation of misleading projections or provision of the raw data for such projections can constitute direct participation in a misrepresentation, and lead to primary 10b-5 liability as was held in *Seaboard*.” *Union Carbide*, 676 F. Supp. at 468-69.

⁸⁸ *See ZZZZ Best*, 864 F. Supp. at 969 n.11.

Best court suggested that a primary liability claim was actionable.⁸⁹ Turning to policy considerations, the court reasoned that if the securities market relied on certain public misrepresentations, then "anyone intricately involved in their creation and the resulting deception should be liable under Section 10(b)/Rule 10b-5."⁹⁰

Within weeks of the *ZZZZ Best* decision, the Court of Appeals for the Ninth Circuit, in *In re Software Toolworks, Inc.*,⁹¹ without analyzing the issue, concluded in a footnote that an ac-

⁸⁹ See *id.* ("While it might be argued that the Supreme Court could not have ignored the facts of that case and therefore intended to send the message that such affirmative assistance did not rise to the level of a primary violation, such an inference will not be made by this Court.")

⁹⁰ *Id.* at 970; accord *McGann v. Ernst & Young*, 95 F.3d 821, 828 (9th Cir. 1996) (stating that natural meaning of section 10(b) imposes liability on all whose misrepresentations are "reasonably calculated to influence the investing public").

⁹¹ 50 F.3d 615 (9th Cir.), *cert. denied*, *Montgomery Secs. v. Dannenberg*, 116 S. Ct. 274 (1995). The Ninth Circuit reversed the trial court's grant of summary judgment in favor of the accountant defendants. See *In re Software Toolworks, Inc.*, 38 F.3d 1078, 1083 (9th Cir. 1994).

In *Software Toolworks*, a producer of software for personal computers conducted a public offering of common stock. See *id.* at 1082. After the offering, the market price of the stock steadily declined and approximately 3 months later, Toolworks announced substantial losses. See *id.* Several investors initiated a class action suit alleging that Toolworks, auditor Deloitte & Touche, and underwriters Montgomery Securities and Paine Webber, Inc., had:

- (1) falsified audited financial statements by reporting as revenue sales to manufacturers with whom Toolworks had no binding agreements,
- (2) fabricated large consignment sales to meet financial projections, and
- (3) lied to the SEC in response to inquiries made before the registration became effective.

Id. Moreover, plaintiffs argued that the prospectus was misleading because it stated that revenues for Nintendo Software products had remained constant when, in fact, revenues had dropped within days of the offering due to substantial returns of the products. See HAROLD S. BLOOMENTHAL, 3B SECURITIES & FEDERAL CORPORATE LAW, §§ 8.26, 9C.08[2] (1997).

With respect to the SEC inquiries, the plaintiffs alleged that Deloitte had violated section 10(b) by participating in the drafting of two letters sent to the SEC. See *In re Software Toolworks Inc.*, 38 F.2d at 1090. In response to a draft prospectus, the SEC instructed Toolworks to disclose second quarter financial information. Toolworks informed the SEC that this information was not available, but did acknowledge to others participating in the offering that some data for the quarter was available. See *id.*

A second letter to the SEC stated that it "was prepared after extensive review and discussions with ... Deloitte" and referred the SEC to two Deloitte partners for more information. *Id.* at 1090 n.3 (alteration in original). The plaintiffs alleged that this letter was false and misleading because a "model" agreement attached to the letter differed materially from the agreements Toolworks actually used. *Id.* at 1090-91.

countant's "significant role" in the mere drafting and editing of an SEC letter containing misrepresentations was sufficient to support a claim for a primary violation of section 10(b)/Rule 10b-5.⁹² Thus, the Ninth Circuit has established a clear proposition that primary liability of a secondary actor may be based upon misrepresentations of a third party when the secondary actor's participation has been sufficient enough such that the third party misrepresentations are actually attributed to the secondary actor.⁹³ Naturally, what constitutes sufficient participation is unclear.

The *ZZZZ Best* court set a standard of "intricate involvement" in the creation of a misrepresentation to satisfy the sufficient participation requirement.⁹⁴ It is worth noting, however, that the facts of the *ZZZZ Best* case are particularly egregious. Indeed, the representations that *ZZZZ Best* made were not only false, but impossible.⁹⁵ For instance, *ZZZZ Best* represented that

⁹² *Id.* at 1090 n.3. In holding that the plaintiff had established a cause of action, the court simply noted, "[d]espite *Central Bank*, we nevertheless consider this issue because the plaintiffs' complaint clearly alleges that Deloitte is primarily liable under section 10(b) for the SEC letters This evidence is sufficient to sustain a primary cause of action under section 10(b) and, as a result, *Central Bank* does not absolve Deloitte on these issues." *Id.*

⁹³ *See id.*; *McGann*, 95 F.3d at 828 (concluding that accountants who received, discussed, and helped draft letters to SEC were potentially primarily liable).

⁹⁴ *ZZZZ Best*, 864 F. Supp. at 970; *see supra* note 83.

⁹⁵ The facts of *ZZZZ Best* were described in Edward Labaton, *The Gatekeepers are Still Accountable Even After Central Bank and the Contract With America*, PRAC. L. INST. (1996), available in WESTLAW at 958 PLI/CORP 847, 850-52.

According to Mr. Labaton, *ZZZZ Best* had portrayed itself as a growing business enjoying rapidly increasing earnings. *See id.* at 850. The company represented that its business was derived from residential carpet cleaning and the restoration of commercial office buildings damaged by fire or water. Most of *ZZZZ Best*'s revenues were alleged to come from its restoration business which, in actuality, did not exist, and, therefore, the revenues attributable to the restoration business also did not exist. *See id.*

Mr. Labaton states that before the registration statement became effective, the lawyers and accountants retained by *ZZZZ Best* knew that:

- (1) *ZZZZ Best* was headed by a twenty-year-old chief executive officer.
- (2) *ZZZZ Best* was reporting phenomenal earnings.
- (3) *ZZZZ Best* claimed a 30% to 40% profit margin on restoration work for which *ZZZZ Best* was supposedly bidding at the time.
- (4) *ZZZZ Best*, to cover up for the non-existent restoration work, used cashiers checks to pay its purported supplier.
- (5) The multi-million dollar restoration contracts contained no specific details or addresses because such information was supposedly secret.
- (6) All of the contracts were with one entity, Interstate Appraisal Services, to which *ZZZZ Best* was purportedly extending millions of dollars of credit,

it had a contract to clean 800,000 square feet of carpet in a single eight story building in San Diego. However, the largest building in the city while twenty-five stories tall, comprised only 510,000 square feet.⁹⁶ Under such circumstances, it is not difficult to see why a court would be reluctant to dismiss claims of aggrieved investors.

Software Toolworks, however, may signal the Ninth Circuit's willingness to permit a much looser standard. As compared with the "intricate involvement" standard announced in *ZZZZ Best*, the *Software Toolworks* court announced a "significant role" standard.⁹⁷ In *Software Toolworks*, the plaintiffs alleged, and the court allowed to stand, primary liability claims based upon the defendant's mere participation in the drafting of two letters sent to the SEC.⁹⁸ Notably, the court never expressly recognized that the two letters were actually the representations of a third party and not of the defendant.⁹⁹

This trend in the Ninth Circuit toward an expansive reading

in the form of labor, service, and material, while Interstate's credit report, on file with the accountants, showed Interstate's credit rating to be fifty dollars.

(7) The accountants were told that Interstate acted on behalf of insurance companies whose identities were also a secret.

Id. at 851. As lawyers and accountants, the defendants should have questioned some of these representations. *See id.* at 850-51.

In addition, the accountants also knew that before the *ZZZZ Best* statement became effective in November, 1986, the CEO of *ZZZZ Best* had allowed the attorneys and accountants to see a "job site." *Id.* at 851. Mr. Labaton stated that the accountants:

were taken on a tour of a high rise office building in Sacramento on a Sunday when no one else was in the building. On the tour it was explained to them that *ZZZZ Best* had restored the building which had supposedly been damaged by massive flooding. Of course, there had been no flood and *ZZZZ Best* had done no work at the site.

... Prior to taking the tour, [*ZZZZ Best's* CEO] had the lawyers and accountants sign letter agreements whereby they agreed not to disclose the address of the supposed job site to any other members of their respective firms and not to make any follow-up telephone calls to the building owner or others about any information that had been provided to them. Both the lawyers and accountants signed those letters.

Id.

⁹⁶ *See id.* at 963. "The Chrysler Building in New York contains approximately 1,200,000 square feet of interior space." Labaton, *supra* note 95, at 852.

⁹⁷ *In re Software Toolworks Inc.*, 38 F.3d at 1090 n.3 (noting that evidence presented by plaintiffs illustrated defendant's "significant role" in drafting and editing letter at issue).

⁹⁸ *See id.*

⁹⁹ *See id.* at 1090-91.

of primary liability continued with *Employers Insurance of Wausau v. Musick, Peeler, & Garrett*.¹⁰⁰ *Wausau*, addressing both attorney and accountant liability under section 10(b)/Rule 10b-5, relied on *Software Toolworks* and pre-*Central Bank* authority to conclude that a secondary actor may be held primarily liable when the secondary actor's "participation in the misrepresentation is direct."¹⁰¹ Specifically, with respect to accountant liability, the defendant maintained that an accountant may be held primarily liable only for misrepresentations made in a report certified by the accountant.¹⁰² The court disagreed, stating that "most courts apply a much more flexible test to determine if an accountant has been sufficiently involved in an offering to be considered a primary actor"¹⁰³ The defendant accounting firm in *Wausau Insurance*, unlike in *Software Toolworks*, was not even named in the document containing the misrepresentations. Nevertheless, the court refused to recognize a "rigid rule that an accountant must actually be named in a document to be liable as a primary actor."¹⁰⁴

While the Ninth Circuit has been willing to recognize primary liability of a secondary actor by attributing misrepresentations of a third party to the secondary actor, other courts have refused to impose primary liability for representations that the defendant does not actually make. These courts have adopted a bright line rule approach.

In *In re MTC Electronic Technologies Shareholders Litigation*,¹⁰⁵ the Eastern District of New York addressed whether third party statements are actionable as primary liability.¹⁰⁶ The court recognized that there appeared to be two distinct approaches: the Ninth Circuit approach, focusing on the level of participation

¹⁰⁰ 871 F. Supp. 381 (S.D. Cal. 1994) (considering case remanded by Supreme Court that resolved circuit split by permitting cause of action for contribution is under section 10(b)).

¹⁰¹ *Wausau*, 871 F. Supp. at 389 (quoting *SEC v. Seaboard*, 677 F.2d 1301, 1312 (9th Cir. 1982)).

¹⁰² *See id.* The complaint alleged that "the attorneys and accountants were the actual architects of the prospectus and registration statements, and that these documents contained material misrepresentations and omissions." *Id.* at 384.

¹⁰³ *Id.* at 389.

¹⁰⁴ *Id.* at 389-90.

¹⁰⁵ 898 F. Supp. 974 (E.D.N.Y. 1995).

¹⁰⁶ *See id.* at 985. Specifically, the court addressed the question remaining after *Central Bank's* elimination of aiding and abetting liability under section 10(b) and stated, "where is the line between secondary and primary liability?" *Id.*

by the defendant in the misrepresentation; and a bright line rule approach, dictating that a defendant who did not actually make the misrepresentation cannot be held liable regardless of the level of involvement or assistance given.¹⁰⁷ After considering both theories, the court rejected the Ninth Circuit approach, preferring to adopt a bright line rule.¹⁰⁸ The court stated that "if *Central Bank* is to have any real meaning," the defendant itself must actually make the misrepresentation.¹⁰⁹ "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)."¹¹⁰

Following *MTC Electronic*, the Court of Appeals for the Tenth Circuit decided *Anixter v. Home-Stake Production Co.*¹¹¹ *Anixter*, a securities fraud case that first began in 1973,¹¹² was the first appellate case to actually analyze the primary liability/secondary liability distinctions.¹¹³ After reviewing the elements of the respective causes of action,¹¹⁴ the court stated:

The critical element separating primary from aiding and abetting violations is the existence of a representation, either by statement or omission, made by the defendant, that is relied upon by the plaintiff. Reliance only on representations made by others cannot itself form the basis of liability.¹¹⁵

In a footnote, the *Anixter* court reviewed and rejected the Ninth Circuit approach, including both *Software Toolworks* and *ZZZZ Best* expressly.¹¹⁶ The court stated that permitting claims to stand based upon misrepresentations made by someone other than the defendant merely reformulated the "substantial assistance" element of aiding and abetting liability into primary liability and was thus inconsistent with *Central Bank*.¹¹⁷

¹⁰⁷ See *id.* at 986 (noting that "[u]pon closer scrutiny ... these different approaches start to blur").

¹⁰⁸ See *id.* at 987.

¹⁰⁹ *Id.*

¹¹⁰ *Id.*

¹¹¹ 77 F.3d 1215 (10th Cir. 1996).

¹¹² *Id.* at 1218.

¹¹³ *Id.* at 1224.

¹¹⁴ See *supra* notes 66-68 and accompanying text.

¹¹⁵ *Anixter*, 77 F.3d at 1225 (citing *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164, 177 (1994)).

¹¹⁶ *Id.* at 1226 n.10.

¹¹⁷ See *id.* The court stated, "[t]o the extent these cases allow liability to attach without requiring a representation to be made by defendant, and reformulate the

The *Anixter* court, although conceding that a secondary actor does not have to communicate a misrepresentation directly to the plaintiff before primary liability may attach, concluded that, according to *Central Bank*, in order for secondary actors to be held primarily liable under the anti-fraud law, the secondary actors must themselves make a false or misleading statement (or omission) that they know or should know will reach potential investors.¹¹⁸ Interestingly, the court characterized this approach as “far from a bright line [rule].”¹¹⁹ Nevertheless, by expressly rejecting the Ninth Circuit approach, particularly *ZZZZ Best*,¹²⁰ the Tenth Circuit clearly refuses to permit third party misrepresentations to be attributed to a defendant, regardless of the level of the defendant’s involvement in the misrepresentation—a somewhat bright line.

V. ZZZZ BEST REPRESENTS THE BEST APPROACH

Regardless of its wisdom, the *Central Bank* decision overruled several decades of case law recognizing aiding and abetting liability in securities fraud.¹²¹ Specifically, the Supreme Court held that the proscription under section 10(b) does not include giving aid to a person who commits a manipulative act.¹²² As the Court noted, the problem with aiding and abetting, as it had developed, was that liability could reach persons who engaged only indirectly in a proscribed activity.¹²³ Thus, in theory, a person could be held liable for aiding and abetting without actually committing an affirmative action in furtherance of a fraud.¹²⁴

‘substantial assistance’ element of aiding and abetting liability into primary liability, they do not comport with *Central Bank of Denver*.” *Id.*

¹¹⁸ *Id.* at 1226.

¹¹⁹ *Id.* at 1227. The court held that rule 10b-5 “provides more guidance to litigants than a rule allowing liability to attach to an accountant or other outside professional” *Id.* (citing *Central Bank*, 511 U.S. at 188). The court also noted the need for “certainty and predictability” for participants in the securities industry. *See id.*; *see also Central Bank*, 511 U.S. at 188; *Pinter v. Dahl*, 486 U.S. 622, 652 (1988).

¹²⁰ *See Anixter*, 77 F.3d at 1224-27, 1226 n.11. By declining to follow *ZZZZ Best*, the *Anixter* court adopted *Central Bank*’s holding that conduct of many third-party actors falls outside of the intended scope of section 10(b) and Rule 10b-5, and indicated that the court should carefully scrutinize the extent to which a defendant participates in the fraud. *Id.*

¹²¹ *See Central Bank*, 511 U.S. at 192 (Stevens, J., dissenting).

¹²² *See id.* at 176.

¹²³ *See id.*

¹²⁴ By analogy to criminal law, liability for aiding and abetting can attach without the requirement of an actus reus. In general, crimes must have two components, the “actus reus, the physical or external portion of the crime[] and the ‘mens rea,’

Arguably, though not expressly characterized as such in *Central Bank*, the main flaw with aiding and abetting liability for securities violations was that secondary actors were held jointly and severally liable as if they were primarily culpable.¹²⁵ Thus, those persons held responsible for their involvement in a proscribed activity were equally liable regardless of their respective levels of culpability.¹²⁶

This problem can best be illustrated through analogy by examining the differences between common law criminal accomplice and aiding and abetting liabilities. Under criminal law jurisprudence, accomplice liability provides that "a person who does not personally commit a proscribed harm may [nonetheless] be held accountable for the conduct of [a third] person with whom he has associated himself."¹²⁷ Accomplice liability focuses on the secondary party's liability for the primary party's acts¹²⁸ and is derivative in nature.¹²⁹ Thus, an accomplice is not guilty of an independent offense of "aiding and abetting," but rather, "derives his liability from the primary party with whom he has associated himself."¹³⁰

Accomplice liability in criminal law is widely accepted and

the mental feature." JOSHUA DRESSLER, UNDERSTANDING CRIMINAL LAW § 9.01[A], at 69 (1995); see LAFAYE & SCOTT, CRIMINAL LAW § 3.2 (2d ed. 1986). In criminal law, "the actus reus of an offense consists of (1) a voluntary act ... ; (2) that causes; (3) social harm." DRESSLER, *supra*, § 9.01[A] at 69.

Under aiding and abetting, a person could be held liable without the actus reus: the making of a material misstatement. Cf. *United States v. Teffera*, 985 F.2d 1082, 1086 n.3 (D.C. Cir. 1983) (noting that elements of federal crime of aiding and abetting include: "(1) the specific intent to facilitate the commission of crime by another; (2) 'guilty knowledge' by alleged abettor; (3) commission of the substantive offense by someone else; and (4) assistance or participation in the commission of the offense").

¹²⁵ See, e.g., *In re Ivan F. Boesky Secs. Litig.*, 36 F.3d 255, 263 (2d Cir. 1994) (holding that in light of Supreme Court's ruling in *Central Bank*, aiders and abettors can no longer be held jointly and severally liable).

¹²⁶ See *supra* notes 17-31 and accompanying text.

¹²⁷ DRESSLER, *supra* note 124, § 30.01, at 427. Once it is determined that the accomplice has assisted in the harmful conduct, the degree of aid is "immaterial." *Id.* § 30.04(B)(1), at 437.

¹²⁸ See *id.* § 30.02, at 428; Sanford H. Kadish, *Complicity, Cause, and Blame: A Study in the Interpretation of Doctrine*, 73 CAL. L. REV. 323 (1985).

¹²⁹ See DRESSLER, *supra* note 124, § 30.02(B), at 429 ("In criminal law, an accomplice is held accountable for the conduct of the primary party because, by intentionally assisting the primary party, the accomplice voluntarily identifies himself with the other.").

¹³⁰ *Id.* § 30.02(A)(2), at 428. "An accomplice is a person who, with the requisite *mens rea*, assists the primary party in committing an offense." *Id.* § 30.04(A)(1), at 435.

has been defended by analogy to agency law.¹³¹ Under agency principles, a person may be held liable for the actions of another if he "consent[s] to be bound by the actions of his agent, whom he vests with authority for this purpose."¹³² Once a person is determined to be an accomplice of another, "his identity as a person subject to criminal punishment is subsumed in that of the primary party."¹³³ On the other hand, as such, an aider and abettor is not liable to the same extent as the primary actor.¹³⁴ For example, in New York, criminal facilitation, which is analogous to common law aiding and abetting,¹³⁵ varies in classification from a class B felony to a class A misdemeanor.¹³⁶ Nevertheless, in all cases criminal facilitation punishes a lesser level of culpability than that of the predicate felon, and accordingly, the penalties for criminal facilitation are always less severe.¹³⁷

The *ZZZZ Best* court apparently recognized this difference in culpability when it emphasized that *Central Bank* requires a defendant's own statements to be deceitful as opposed to mere "knowing assistance"¹³⁸ in the underlying fraud where the defendant's own actions were not necessarily deceitful. Yet, the cases rejecting the *ZZZZ Best* approach, and perhaps even those cases adopting *ZZZZ Best*, have failed to recognize this fundamental distinction.

Indeed, in *In re JWP Inc., Securities Litigation*,¹³⁹ decided

¹³¹ See *id.* § 30.02(B), at 428.

¹³² *Id.* (alteration in original) (quoting Kadish, *supra* note 128, at 354).

¹³³ *Id.* "The intention to further the acts of another, which creates liability under the criminal law, may be understood as equivalent to manifesting consent to liability under the civil law." Kadish, *supra* note 128, at 354-55.

¹³⁴ Cf. *Enmond v. Florida*, 458 U.S. 782 (1982) (holding that when accomplice does not kill, intend to kill, or attempt to kill victim, Eighth Amendment does not permit death penalty to be imposed).

¹³⁵ See LAFAYE & SCOTT, *supra* note 124, § 6.7(d), at 584 (proposing knowing assistance as a distinct criminal offense that would provide a "means whereby such persons, clearly less culpable than those directly participating ... could be subjected to lesser and different penalties"). New York defines criminal facilitation as "providing means or opportunity for the commission of a crime by another person. No 'intent' by the facilitator to commit the prospective crime is required." N.Y. PENAL LAW § 115.00, Practice Commentary (McKinney 1975).

¹³⁶ See N.Y. PENAL LAW §§ 115.00-115.08 (McKinney 1997).

¹³⁷ See *id.* (outlining various degrees of criminal facilitation and their respective felony class).

¹³⁸ *In re ZZZZ Best Secs. Litig.*, 864 F. Supp. 960, 972 (C.D. Cal. 1994). The concept of "knowing assistance" has developed from criminal law. See LAFAYE & SCOTT, *supra* note 124, § 6.7(d), at 582-84.

¹³⁹ 928 F. Supp. 1239 (S.D.N.Y. 1996).

four months after *Anixter*, the Southern District of New York summarized the post-*Central Bank* case law addressing primary liability under section 10(b).¹⁴⁰ The court noted that *Anixter* as well as *MTC Electronic* had held that a defendant may not be held primarily liable unless the defendant actually made a misrepresentation.¹⁴¹ Comparing *ZZZZ Best* and *Software Toolworks*, the court also stated that, “[c]ertain courts in the Ninth Circuit ... have held that a defendant’s substantial participation ... in the preparation of misrepresentations that are actually made by someone else are sufficient to ground primary liability under [section] 10(b).”¹⁴² The court, rejecting the stated Ninth Circuit approach, ultimately held in favor of the defendants, stating that the defendants did not themselves make the alleged misrepresentations.¹⁴³

This distinction from the Ninth Circuit drawn by *Anixter* and *JWP, Inc.* is, however, not necessarily correct. Although *Anixter* expressly noted the critical element separating primary liability from aiding and abetting liability is the existence of a representation made by the defendant,¹⁴⁴ the *ZZZZ Best* approach is nevertheless entirely consistent with the *Anixter* court’s interpretation of *Central Bank*. *ZZZZ Best* emphasized that is a threshold to liability.¹⁴⁵ Other courts have failed to recognize that *ZZZZ Best* stands for the proposition that although a defendant may not have made the actual precise fraudulent statement that the plaintiff relied upon, once the defendant has engaged in some deceitful act, the defendant may be deemed to have itself made the relied upon fraudulent statement if that defendant was “intricately involved” in the creation of the fraudu-

¹⁴⁰ *Id.* at 1256.

¹⁴¹ *See id.*

¹⁴² *Id.* (citations omitted).

¹⁴³ *See id.* In *JWP, Inc.*, the company’s independent auditors, among others, were sued under section 10(b). *Id.* at 1246. The court noted that the alleged misrepresentations that the audit committee defendants made did not include any statements not directly authorized by *JWP, Inc.*’s Board of Directors. *See id.* at 1256. Therefore, the court held that the defendants were “entitled to summary judgment dismissing the plaintiffs’ [section] 10(b) claims to the extent that those claims [were] based on alleged misrepresentations that the audit committee defendants did not make.” *Id.*

¹⁴⁴ *Anixter v. Home-Stake Prod. Co.*, 77 F.3d 1215, 1225 (10th Cir. 1996); *see also Central Bank*, 511 U.S. at 177.

¹⁴⁵ *See In re ZZZZ Best Secs. Litig.*, 864 F. Supp. 960, 967 (C.D. Cal. 1994).

lent statement.¹⁴⁶ Essentially, the *ZZZZ Best* approach refuses to absolve a defendant's wrongdoing through the use of semantics once the defendant has crossed the threshold of deceit.

Additionally, the *ZZZZ Best* approach is consistent with the congressional interpretation of the scope of section 10(b). In arguing against the creation of a private cause of action for aiding and abetting during a debate on the PSLRA Senator D'Amato stated:

Of course, if someone has knowingly, intentionally[] misled investors or *been involved in committing fraud*, they are no longer just aiders and abettors, and can be held liable for their actions. ... [P]eople who commit fraud will be treated as primary wrongdoers, as the culpable party, and can be held jointly and severally.¹⁴⁷

While not advocating the return of aiding and abetting liability, Senator D'Amato's comments indicate some degree of congressional recognition of at least some level of involvement in the commission of a fraud that should potentially lead to liability as a primary actor.

Accordingly, the *ZZZZ Best* approach is entirely consistent with the holding of *Central Bank* and the intent of Congress. *ZZZZ Best* recognizes that there is a threshold level of activity in which a defendant must engage to be primarily liable under section 10(b)/Rule 10b-5. *ZZZZ Best* holds that this liability is predicated not on substantial participation, but rather on a party's intricate involvement such that a third party's statements are actually attributed to the defendant. This holding is also entirely consistent with the common law roots of primary accomplice liability and provides that primary liability attaches only for primary culpability. Thus, *ZZZZ Best* represents the best approach to establishing primary liability after *Central Bank*.

VI. CONCLUSION

The Supreme Court's abolition of aiding and abetting liability for violations of section 10(b)/Rule 10b-5 of the federal securities laws has forced the federal bench to reassess the contours

¹⁴⁶ See *supra* notes 72-93 and accompanying text (discussing *ZZZZ Best* holding).

¹⁴⁷ 141 CONG. REC. S9111 (June 27, 1995) (emphasis added).

of federal securities fraud violations. One of the major issues perplexing the courts is whether a secondary actor can be held primarily liable for a fraudulent misrepresentation actually made by someone other than that secondary actor. Not surprisingly, courts have taken divergent views in resolving this issue.

In *In re ZZZZ Best Securities Litigation*, the Ninth Circuit held that although a defendant may not make the actual fraudulent statement relied upon by the plaintiff, once the defendant engages in some deceitful act, the defendant may be deemed to have made the fraudulent statement if the defendant was "intricately involved" in the creation of the statement.¹⁴⁸ Other courts, particularly the Court of Appeals for the Tenth Circuit in *Anixter v. Home-Stake Production Co.*,¹⁴⁹ rejected the *ZZZZ Best* approach and concluded that permitting claims to stand based upon misrepresentations actually made by others was merely a reformulation of the "substantial assistance" analysis for aiding and abetting liability that the Supreme Court had been expressly abrogated.¹⁵⁰

Nevertheless, *Anixter* and the other courts decisions that have rejected the *ZZZZ Best* approach have failed to recognize the true fundamental holding of *ZZZZ Best*. *ZZZZ Best* recognized that there is first a threshold level of wrongdoing that a defendant must engage in before being held primarily liable under section 10(b)/Rule 10b-5. Once a defendant engages in a deceitful act, and only then, will a defendant potentially be held liable for misrepresentations of a third party. The defendant still must be "intricately involved" in the creation of the misrepresentation before the third party statement will be attributed to the defendant, leading to primary liability. This holding provides that primary liability attaches only for primary culpability and, as such, is consistent with the common law root of accomplice liability.

Even under the *ZZZZ Best* approach, the Supreme Court's elimination of the aiding and abetting cause of action will clearly limit the number of parties that were previously caught under the net of traditional securities fraud. While this Note does not address the social impact of the removal of aiding and abetting liability, at the very least, it does not seem unreasonable that a

¹⁴⁸ *ZZZZ Best*, 864 F. Supp. at 967.

¹⁴⁹ 77 F.3d 1215 (10th Cir. 1996).

¹⁵⁰ *Id.* at 1226.

party's level of liability should equate with his or her level of culpability: a theory that was absent under the aiding and abetting liability scheme.

One thing is clear: aiding and abetting liability for private plaintiffs is gone. Before the swell of criticism becomes too great, it would be prudent to consider a plaintiff's motivation for trying to hold a "secondary" actor liable in the first instance. Stripping away the legalese, the motivation for finding secondary actors liable is perhaps nothing more than the search for a deep pocket.¹⁵¹ This motivation is completely inconsistent with the fundamental objectives of the securities laws and, as such, the elimination of aiding and abetting does not seem so unreasonable after all.

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¹⁵¹ See generally Joseph A. Grundfest, Commentary, *Why Desimplify?*, 108 HARV. L. Q., 727, 745-46 (1995) (discussing defendants' objection to joint and several liability's unfair financial burden); Joseph A. Grundfest, *Desimplifying Private Rights of Action Under the Federal Securities Laws: The Commission's Authority*, 107 HARV. L. REV. 963 (1994) (advocating SEC involvement in Rule 10b-5 debate so that causes of action with merit can be distinguished from fraudulent claims and claims based solely on a "deep pocket" theory).

