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## The Ebb and Flow of Section 10(b) Jurisprudence: An Analysis of Central Bank

S. Scott Luton

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THE EBB AND FLOW OF SECTION 10(b) JURISPRUDENCE:  
AN ANALYSIS OF *CENTRAL BANK*

S. Scott Luton\*

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I. INTRODUCTION

A. Overview

On April 19, 1994, the United States Supreme Court decided

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*Central Bank v. First Interstate Bank.*<sup>1</sup> In *Central Bank*, Justice Kennedy, writing for a 5-4 majority,<sup>2</sup> overturned established case law in the jurisdictions of all eleven United States circuit courts of appeals and ruled that private civil liability under section 10(b) of the Securities Exchange Act of 1934<sup>3</sup> ("Exchange Act") does not extend to those "who do not engage in the manipulative or deceptive practice but who [only] aid and abet the violation."<sup>4</sup> The Court based its decision on the express text of the statute, declaring that "[t]he issue . . . is not whether imposing private civil liability on aiders and abettors is good policy but whether aiding and abetting is covered by the statute."<sup>5</sup>

The Court's decision in *Central Bank* places all theories of secondary liability under the Exchange Act in jeopardy, and some authorities argue the decision is likely to slant the playing field in the securities litigation arena sharply in favor of those professionals who have traditionally been its targets, at the expense of defrauded investors.<sup>6</sup> However, the lower federal courts have historically tempered

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1. 114 S. Ct. 1439 (1994).

2. Justice Kennedy delivered the opinion of the Court, in which Chief Justice Rehnquist and Justices O'Connor, Scalia, and Thomas joined. Justice Stevens filed a dissenting opinion in which he was joined by Justices Blackmun, Souter, and Ginsburg. 114 S. Ct. at 1455 (Stevens, J., dissenting). It appears that Justice Kennedy holds the swing vote in interpreting whether specific implied causes of action under the federal securities laws exist and in the determination of the methodology employed by the Court. Justice Kennedy seemingly switched to the more restrictive methodology in *Central Bank* as compared to the position he took in *Virginia Bankshares, Inc. v. Sandberg*, 501 U.S. 1083 (1991), where he wrote in his concurring and dissenting opinion, "If the analysis adopted by the Court today is any guide, Congress and those charged with enforcement of the securities laws stand forewarned that unresolved questions concerning the scope of those causes of action are likely to be answered by the Court in favor of defendants." *Id.* at 1115 (Kennedy, J., concurring in part and dissenting in part).

3. 15 U.S.C. § 78j(b) (1988).

4. 114 S. Ct. at 1443.

5. *Id.* at 1448.

6. See Testimony of Arthur Levitt, Chairman, United States Securities and Exchange Commission concerning the *Central Bank* decision, before the Subcommittee on Securities, Committee on Banking, Housing and Urban Affairs, United States Senate (hereinafter Subcommittee), May 12, 1994 (hereinafter *Levitt Testimony*); Testimony of United States Senator Howard M. Metzenbaum, Ohio, before the Subcommittee, May 12, 1994 (hereinafter *Metzenbaum Testimony*); Testimony of Mark J. Griffin, Director, Division of Securities, Utah Department of Commerce, on behalf of the North American Securities Administrators Association (NASAA), before the Subcommittee, May 12, 1994 (hereinafter *NASAA Testimony*); Testimony of Christopher J. Dodd, Connecticut, Chairman, Subcommittee, May 12, 1994 (hereinafter *Dodd Testimony*); Testimony of David S. Ruder, Professor of Law, Northwestern University School of Law, before the Subcommittee, May 12, 1994 (hereinafter *Ruder Testimony*); Testimony of Harvey J. Goldschmid, Professor of Law, Columbia

the harshness of the Supreme Court's strict statutory approach by adopting alternative theories of recovery.<sup>7</sup> This antithetic relationship between the courts has created an ebb and flow of section 10(b) jurisprudence, both expanding and restricting the scope of liability under the provision.<sup>8</sup> In the wake of *Central Bank*, the lower federal courts are likely to modify the restrictive effect of the Court's decision by expanding primary liability under the term "indirectly" contained within the text of section 10(b). Whether this expansion can broaden the scope of liability to pre-*Central Bank* boundaries is yet to be seen.<sup>9</sup>

This article briefly summarizes the requirements for sustaining an action under section 10(b) and analyzes the Supreme Court's decision in *Central Bank*. In the analysis, it discusses the appropriate standard of culpability, the effect of the opinion on SEC enforcement actions, and the various aspects of secondary liability under the Exchange Act, including the definition, historical development, and status of the doctrines of aider and abettor liability, conspiracy, controlling person liability, and liability under common law agency principles. Also, the article analyzes the concept of "indirect" liability under section 10(b) of the Exchange Act and discusses the scope of conduct covered by such liability. Finally, the article includes an analysis of the possibility of congressional response to the Court's decision in *Central Bank*.

## B. The Rule 10b-5 Claim

Section 10(b) is the general anti-fraud provision in the Exchange Act.<sup>10</sup> It states:

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University School of Law, before the Subcommittee, May 12, 1994 (hereinafter *Goldschmid Testimony*); Testimony of Donald C. Langevoort, Professor of Law, Vanderbilt University, before the Subcommittee, May 12, 1994 (hereinafter *Langevoort Testimony*). But see Testimony of Eugene I. Goldman, Partner in the Washington, D.C. office of McDermott, Will & Emery, before the Subcommittee, May 12, 1994 (hereinafter *Goldman Testimony*); Testimony of Stuart J. Kaswell, Senior Vice President and General Counsel, Securities Industry Association ("SIA"), before the Subcommittee, May 12, 1994 (hereinafter *SIA Testimony*).

7. See *Langevoort Testimony*, *supra* note 6, at 1-2.

8. *Id.*

9. *Id.* at 3. Restricting the scope of liability under Rule 10b-5 will most likely have little effect on the volume of actions filed. As of June 1993, the number of securities fraud class actions had tripled since 1988. Furthermore, the number of suits filed in 1990 alone was virtually equivalent to the number of suits filed in 1987, 1988, and 1989 combined. See Testimony of William R. McLucus, Director, Division of Enforcement, Securities and Exchange Commission, before the Subcommittee, June 17, 1993.

10. Section 10(b) is an omnibus provision drafted to parallel the language in 15

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 . . . .

Subsequent to the Exchange Act's passage the Securities and Exchange Commission ("SEC") promulgated Rule 10b-5<sup>11</sup> which parallels the statutory proscription. It states that:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate

U.S.C. § 77q(a) (1988), otherwise known as § 17(a) of the Securities Act of 1933, as amended ("Securities Act"). Section 17(a) is the comparable antifraud provision under the Securities Act and provides:

It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly,

- (1) to employ any device, scheme, or artifice to defraud, or
- (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state material facts necessary in order to make the statements made, in light of the circumstances under which they are made, not misleading, or
- (3) to engage in any transactions, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

*Id.* Before the passage of § 17(a) there was no way for the government to police securities fraud except for prosecuting defendants criminally. Several provisions were available: 18 U.S.C. § 1341 (1988) allowed for prosecution for mail fraud; 18 U.S.C. § 371 (1988) allowed for prosecution for conspiring to commit mail fraud; and 39 U.S.C. § 3005 (1988) allowed for entry of a so-called "fraud order" by the Postmaster General, by which the Postal Service could forbid the payment of a money order or postal note made out to the person who was the subject of the "fraud order." See LOUIS LOSS, *FUNDAMENTALS OF SECURITIES REGULATION* 799 (1983).

11. 17 C.F.R. § 240.10b-5 (1942). In May 1942, the SEC, acting under the authority of § 10(b), promulgated Rule 10b-5, which was originally designated X-10B-5. The rule merely copies the language of § 17(a) of the Securities Act of 1933, except that the reference to "obtain money or property by means of" an untrue statement in subsection (2) was replaced with the phrase "in connection with the purchase or sale of any security." Rule 10b-5 was adopted in response to the SEC's desire to investigate and obtain injunctive relief against insiders who were buying their companies' stock. See Loss, *supra* note 10, at 820-822. Although the SEC did not envision or intend private litigation under the rule when it was passed, the federal courts have used the rule as a "catch-all" provision to remedy fraudulent conduct not expressly proscribed under more precise provisions of the federal securities laws. In the words of Chief Justice Rehnquist, Rule 10b-5 is a "judicial oak which has grown from little more than a legislative acorn." *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 737 (1975).

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.

In 1947, the United States District Court for the Eastern District of Pennsylvania was the first to recognize an implied private right of action under section 10(b) in *Kardon v. National Gypsum Co.*<sup>12</sup> Although this implied right has been uniformly adopted throughout the federal court system, critics remain.<sup>13</sup> The United States Supreme Court first recognized a private right of action under Rule 10b-5 in 1971.<sup>14</sup>

Section 10(b) and Rule 10b-5 have been often criticized for promoting vexatious and unmeritorious litigation against persons who innocently provide services to market participants.<sup>15</sup> Nevertheless, the successful prosecution of a 10b-5 claim requires proof of an appreciable amount of culpability. Professor Jacobs, in his authoritative treatise, generally describes the elements of a violation of the rule by stating: "Rule 10b-5 is violated when, by the use of jurisdictional means and in connection with the purchase or sale of any security, any person performs a prohibited act."<sup>16</sup> The statement parallels the

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12. 69 F. Supp. 512 (E.D. Pa. 1946).

13. *E.g.*, *Virginia Bankshares, Inc. v. Sandberg*, 501 U.S. 1083 (1991). "I think the federal cause of action at issue here was never enacted by Congress . . . and hence the more narrow we make it (within the bounds of rationality) the more faithful we are to our task." *Id.* at 1110 (Scalia, J., concurring) (citations omitted).

14. *Superintendent of Ins. v. Banker's Life & Cas. Co.*, 404 U.S. 6 (1971); see also *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 150-54 (1972).

15. See *Goldman Testimony*, *supra* note 6, at 1; see also *SIA Testimony*, *supra* note 6, at 8. The SIA argues that securities litigation has created confusion about the potential liability of accountants, attorneys, banks, and securities firms because these professionals are most likely to be drawn into cases under secondary theories of liability. As a consequence, the SIA argues, "[T]he cost of these professionals' services rise, with higher costs likely to be passed on to public companies and their shareholders." See Mednick and Peck, *Proportionality: A Much-Needed Solution to the Accountants Legal Liability Crisis*, 28 VAL. U. L. REV. 867 (1994). Mednick and Peck argue that "[b]y mandating joint and several liability, federal securities laws . . . encourage suits against 'deep pocket' defendants, such as accounting firms, for the sole purpose of extracting settlements from those parties, regardless of their actual responsibility, if any, for the losses suffered." *Id.* at 867.

16. 5B ARNOLD JACOBS, LITIGATION AND PRACTICE UNDER RULE 10b-5 § 36, at 2-5 to 2-6.

express language of the rule itself. However, through judicial interpretation of the implied right of action under section 10(b) and Rule 10b-5, the Supreme Court has gradually narrowed the scope of liability under the rule by imposing additional requirements of proof. In order to recover under section 10(b) and Rule 10b-5 the plaintiff must prove:

- (1) a use of jurisdictional means by the defendant;<sup>17</sup>
- (2) the plaintiff was a "purchaser or seller"<sup>18</sup> of securities;<sup>19</sup>

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17. Courts have had no difficulty in finding a jurisdictional means to invoke the protection of Rule 10b-5. An interstate telephone call has been deemed sufficient. *Matheson v. Armbrust*, 284 F.2d 670, 673 (9th Cir. 1960), *cert. denied*, 365 U.S. 870 (1961). The use of the word "of" before "interstate commerce," rather than "in" interstate commerce as it is defined in § 17(a) of the Securities Act, has led some courts to hold that "the communication itself must be interstate" under § 17(a) while "intrastate use of the [interstate] facility is all that is required" under Rule 10b-5. *United States v. DeSapio*, 299 F. Supp. 436, 448 (S.D.N.Y. 1969). For example, courts have held that an intrastate telephone call is sufficient since the telephone itself is an instrumentality of interstate commerce. *Loverage v. Dregoux*, 678 F.2d 870, 873-74 (10th Cir. 1982) (citing *Kerbs v. Fall River Indus., Inc.*, 502 F.2d 731 (10th Cir. 1974)); *Alley v. Miramon*, 614 F.2d 1372, 1379 (5th Cir. 1980).

18. 15 U.S.C. § 78c(a)(13) (1988). Section 3(a)(13) of the Exchange Act defines the terms "buy" and "purchase" to include "any contract to buy, purchase, or otherwise acquire." *Id.* Section 3(a)(14) defines "sale" and "sell" to include "any contract to sell or otherwise dispose of." 15 U.S.C. § 78c(a)(14) (1988). The definitions are of little help, but are to be construed broadly. *Northland Capital Corp. v. Silver*, 735 F.2d 1421, 1427 (D.C. Cir. 1984); *see Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 8-9 (1971) (holding that sale occurs when a person exchanges title to security for something of value); *First Nat'l Bank v. Estate of Russell*, 657 F.2d 668, 674 n.18 (5th Cir. 1981) (holding that sale occurred notwithstanding fact that delivery of securities had not taken place). For unorthodox transactions, courts have sought review of whether there was "some surrendering of control, change in ownership, or change in the fundamental nature of an investment." *Sacks v. Reynolds Sec., Inc.*, 593 F.2d 1234, 1240 (D.C. Cir. 1978); *see also* 5B ARNOLD JACOBS, LITIGATION AND PRACTICE UNDER RULE 10b-5 § 38.02[b], at 2-121 to 2-122.

19. 15 U.S.C. § 78c(a)(10) (1988). The term security is defined in § 3(a)(10) of the Exchange Act. It provides:

The term "security" means any note, stock, treasury stock, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or in general, any instrument commonly known as a "security;" or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof

- (3) the defendant misstated a material fact or omitted to state a material fact or otherwise engaged in manipulative or deceptive conduct;<sup>20</sup>
- (4) the defendant's misstatement or omission was "in connection with" the purchase or sale of securities;<sup>21</sup>
- (5) the defendant acted with scienter (an intent to deceive or reckless disregard for the truth);<sup>22</sup>
- (6) the plaintiff reasonably relied upon the defendant's misstatement or omission;<sup>23</sup>

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the maturity of which is likewise limited.

*Id.* At least with respect to unusual kinds of securities, the Supreme Court looks at the "economic reality" rather than the form. *SEC v. W. J. Howey Co.*, 328 U.S. 293, 298 (1946); *see also* *United Housing Found., Inc. v. Forman*, 421 U.S. 837, 848 (1975); *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967). The term "investment contract" found within the definition of "security" has been a vehicle used to expand the reach of the economic realities test. *See Arthur Young & Co. v. Reves*, 856 F.2d 52, 54 (8th Cir. 1988) (including an investment contract within the definition of "security" when it was "(1) an investment, (2) in a common venture, (3) premised on a reasonable expectation of profits, (4) to be derived from the entrepreneurial or managerial efforts of others"), *cert. denied*, 112 S. Ct. 1165 (1992), and *aff'd* 113 S. Ct. 1163 (1993).

20. *See* 5B ARNOLD JACOBS, LITIGATION AND PRACTICE UNDER RULE 10b-5 § 39, at 2-414. Professor Jacobs divides the proscribed conduct under Rule 10b-5 into seven major categories: "(1) misrepresentations and concealments when the defendant trades; (2) misstatements and omissions when he does not buy and sell; (3) mismanagement; (4) manipulation; (5) tipping; (6) tender offers and exchange offers; and (7) activities of broker-dealers and other fiduciaries." *Id.* The majority in *Central Bank* concluded that § 10(b) "prohibits only the making of a material misstatement (or omission) or the commission of a manipulative act." *Central Bank v. First Interstate Bank*, 114 S. Ct. 1439, 1448 (1994).

21. The words "in connection with" serve three functions. First, they define the scope of the rule. *See Jett v. Sunderman*, 840 F.2d 1487, 1494 (9th Cir. 1988) (requiring a nexus between the fraud and the purchase or sale of securities); *Financial Corp. of America Shareholder Litig. v. Anderson & Co.*, 796 F.2d 1126, 1130 (9th Cir. 1986); *Angelastro v. Prudential-Bache Sec. Inc.*, 764 F.2d 939, 943-44 (3d Cir. 1985), *cert. denied*, 474 U.S. 935 (1985). Second, "in connection with" defines the class of persons protected by the rules. *See Deutschman v. Beneficial Corp.*, 841 F.2d 502, 506 (3d Cir. 1988) (holding that plaintiff need not be in privity with the defendant), *cert. denied*, 490 U.S. 1114 (1989); *Ruefenacht v. O'Halloran*, 737 F.2d 320, 334 (3d Cir. 1984) (holding that protected class is not limited to investors), *aff'd sub nom.* *Gould v. Ruefenacht*, 471 U.S. 701 (1985); *cf.* *Crane Co. v. American Standard, Inc.*, 603 F.2d 244, 250 & n.13 (2d Cir. 1979) (holding that plaintiff must be an investor to be protected). Third, the words "in connection with" determine who has standing to sue. *See Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975) (limiting standing to a buyer or seller of the security), *reh'g denied*, 423 U.S. 884 (1975).

22. *See Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 214 (1976) (holding that negligence would not suffice for a cause of action under Rule 10b-5, but rather scienter was required; the Court left unresolved whether "recklessness" was sufficient); *see infra* pp. 60-64.

23. *See Basic Inc. v. Levinson*, 485 U.S. 224, 241-42 (1988). "The fraud on the



- (7) the plaintiff was damaged;<sup>24</sup> and
- (8) the defendant's conduct caused the plaintiff's damages.<sup>25</sup>

Securities fraud litigation, and more precisely section 10(b) and Rule 10b-5, has proven to be an intensely complex challenge for securities lawyers. The complexity derives from the application of numerous concepts and doctrines of liability in the context of multiple defendants.<sup>26</sup> In every case of securities fraud there are persons who,

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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 . . . ." *Id.* (quoting *Peil v. Speiser*, 806 F.2d 1154, 1160-61 (3d Cir. 1986)); *see also* *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375 (1970) (adopting a rule of constructive reliance); *Huddleston v. Herman & MacLean*, 640 F.2d 534, 548 (5th Cir. 1981) (distinguishing between a subjective "reasonable reliance" concept versus an objective "justifiable reliance" concept); *Chris-Craft Indus. v. Piper Aircraft Corp.*, 480 F.2d 341, 399 (2d Cir. 1973) (holding that subjective reliance is still the appropriate test to the extent that constructive reliance has pre-empted its application), *cert. denied*, 414 U.S. 910 (1973).

24. Several measures of general damages have been adopted by courts. *See* *Randall v. Loftsgaarden*, 478 U.S. 647, 661-62 (1986) (citing *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 155 (1972)) (adopting "out-of-pocket" damages); *Chasins v. Smith, Barney & Co.*, 438 F.2d 1167, 1173 (2d Cir. 1970) (adopting resale-price damages); *John R. Lewis, Inc. v. Newman*, 446 F.2d 800, 805 (5th Cir. 1971) (adopting benefit of the bargain damages). *But cf.* *Harris v. American Inv. Co.*, 523 F.2d 220, 225 n.4 (8th Cir. 1975) (holding that benefit of the bargain damages are never appropriate under Rule 10b-5), *cert. denied*, 423 U.S. 1054 (1976).

25. *Schlick v. Penn-Dixie Cement Corp.*, 507 F.2d 374, 380-81 (2d Cir. 1974). The plaintiff must usually prove "transaction causation" (fraud caused the plaintiff to enter into the transaction) and "loss causation" (transaction caused loss to the plaintiff). Causation requires a nexus between the defendant's conduct and the plaintiff's damage. *Id.* at 381. Courts have applied various tests of causation. *See* *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 154 (1972) (requiring an "obligation to disclose and . . . [a] withholding of a material fact . . ."); *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375, 385 (1970) (requiring "a finding of materiality . . . [and] . . . the proxy solicitation itself, . . . was an essential link in the accomplishment of the transaction"); *Ward v. Succession of Freeman*, 854 F.2d 780, 790 (5th Cir. 1988) (using a proximate causation test); *Manufacturers Hanover Trust Co. v. Drysdale Sec. Corp.*, 801 F.2d 13, 20-21 (2d Cir. 1986), *cert. denied sub nom.* *Arthur Andersen & Co. v. Manufacturers Hanover Trust Co.*, 479 U.S. 1066 (1987) (using a foreseeability of injury test); *List v. Fashion Park, Inc.*, 340 F.2d 457, 462 (2d Cir. 1965), *cert. denied sub nom.* *List v. Lerner*, 382 U.S. 811 (1965) (using a substantial factor test).

26. *See* 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, 598-601 (1972). It has been claimed that the record number of named defendants in a securities fraud suit is over 700 in *In re Washington Pub. Power Supply Sys. Litig.*, 823 F.2d 1349 (9th Cir. 1987).

either directly or indirectly, participate in the fraudulent conduct. These persons are primary violators of section 10(b). There are others who do not actively participate in the conduct, but who are involved peripherally with the transaction. Historically, courts have imposed secondary liability on these persons, usually lawyers and accountants, under theories of aider and abettor liability, conspiracy, controlling person liability, or liability under general agency principles.<sup>27</sup> With the lower courts' reliance on implied remedies of secondary liability, little or no emphasis has been placed on the distinction between primary and secondary liability under section 10(b) and Rule 10b-5.<sup>28</sup> It has been stated that the distinguishing feature between the two theories is that the primary violator either directly or indirectly participates in the conduct proscribed by the statute, while the secondary violator assists the primary violator's act, or is liable for the act, based upon a relationship with the primary violator.<sup>29</sup> This is simply stated, but the practical application is imponderable. Some have argued that the distinction is illusory.<sup>30</sup> Nevertheless, in light of *Central Bank* the lower federal courts will be asked to draw this distinction, which, in some instances, will determine the liability of the defendant.

## II. THE CENTRAL BANK DECISION

### A. Introduction

Central Bank of Denver, N.A. ("Central Bank") served as the indenture trustee on two bond issues brought to market in 1986 and 1988 on behalf of the Colorado Springs-Stetson Hills Public Building Authority ("Authority").<sup>31</sup> The issues aggregately totalled

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27. See Ruder, *supra* note 26, at 600. Although these theories of secondary liability have produced much litigation, liability under Rule 10b-5 is usually imposed because the defendant has been a principal participant in the proscribed conduct or has breached an independent duty. *Id.*

28. See generally 5B ARNOLD JACOBS, LITIGATION AND PRACTICE UNDER RULE 10b-5 § 40.0. See also William H. Kuehnle, *Secondary Liability Under the Federal Securities Laws - Aiding and Abetting, Conspiracy, Controlling Person, and Agency: Common-Law Principles and The Statutory Scheme*, 14 J. CORP. L. 313, 318 (1988); *Langevoort Testimony*, *supra* note 6, at 2.

29. See *Langevoort Testimony*, *supra* note 6, at 2; Daniel R. Fischel, *Secondary Liability Under Section 10(b) of the Securities Act of 1934*, 69 CAL. L. REV. 80, 80 n.4 (1981).

30. 4 ALAN R. BROMBERG & LEWIS D. LOWENFELS, SECURITIES FRAUD AND COMMODITIES FRAUD § 8.5, at 600 (1991).

31. *Central Bank v. First Interstate Bank*, 114 S. Ct. 1439, 1443 (1994).

\$26,000,000.00, and the proceeds were used to fund improvements at Stetson Hills, a planned residential and commercial development located in Colorado Springs.<sup>32</sup> Both issues were secured by landowner assessment liens, with 250 acres being pledged for the 1986 issue and 272 acres pledged for the 1988 issue.<sup>33</sup> Covenants in the indenture required that the real estate subject to the liens have a market value of at least 160% of the total outstanding principal and interest for both issues.<sup>34</sup> The covenants required the developer of Stetson Hills, Amwest Development ("Amwest"), to deliver an annual report to Central Bank evidencing compliance with the 160% test.<sup>35</sup>

In January of 1988, five months prior to the issuance of the 1988 bonds, the annual report delivered by Amwest showed little change in the market value of the real estate since 1986.<sup>36</sup> Subsequent to this report, Central Bank received a letter from the senior underwriter for the 1986 issue in which the underwriter expressed concern that the 160% test was not being met, noting that the appraisal in the 1988 report was over sixteen months old and that property values in Colorado Springs had declined over that period of time.<sup>37</sup>

Central Bank requested that its in-house appraiser review the 1988 report. The in-house appraiser determined that the market values for the real estate listed in the report were "optimistic" in light of the Colorado Springs real estate market and suggested that an independent appraiser be retained to conduct a review of the 1988 report.<sup>38</sup> However, Central Bank decided to delay an independent review until the end of the year, six months after the 1988 bond issue was closed in June.<sup>39</sup> An independent review was never conducted

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32. *Id.* The 1986 bond issue totaled approximately \$11 million, while the 1988 issue totaled approximately \$15 million. See *First Interstate Bank v. Pring*, 969 F.2d 891, 894 (10th Cir. 1992).

33. 114 S. Ct. at 1443.

34. *Id.*

35. *Id.*

36. *Id.*

37. *Id.* The letter suggested that the Authority may have provided "false or misleading certifications" evidencing compliance with the restrictive covenants in the bond indenture. *Id.* After receiving the updated appraisal, the 1986 underwriter wrote a second letter to Central Bank questioning the outdated real estate values. See 969 F.2d at 894-95.

38. 114 S. Ct. at 1443. In a letter dated March 22, 1988, Central Bank requested review of the appraisal by an independent appraiser citing its reasons as: "(1) [T]he comparable sales data was outdated; (2) the methodology did not consider a bulk sale in a forced liquidation context; and (3) considering the local real estate market the values appeared unjustifiably optimistic." 969 F.2d at 894-95.

39. 969 F.2d at 895. Central Bank did require that roughly two million dollars of property be pledged as additional collateral as security for the 1986 issue. *Id.* at 895, 904.

because the Authority defaulted on the 1988 issue prior to the end of that year.<sup>40</sup>

First Interstate Bank of Denver, N.A. ("First Interstate") and Jack Naber purchased \$2.1 million of the 1988 issue.<sup>41</sup> After the Authority defaulted, First Interstate and Naber sued the Authority, the 1988 underwriter, a junior underwriter, and an Amwest director for primary liability under section 10(b) of the Exchange Act.<sup>42</sup> First Interstate and Naber also alleged that Central Bank was "secondarily liable under section 10(b) for its conduct in aiding and abetting this fraud."<sup>43</sup>

The United States District Court for the District of Colorado granted Central Bank's motion for summary judgment.<sup>44</sup> The Tenth Circuit Court of Appeals ("Tenth Circuit") reversed and remanded the case for trial. The Tenth Circuit set forth the elements for an aiding and abetting claim as follows: "(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 assistance given to the primary violator by the aider and abettor."<sup>45</sup> The court found that Central Bank was aware of the concerns regarding the accuracy of the 1988 appraisal, that it knew that the sale of the 1988 bonds was forthcoming, and that it knew investors would rely upon the 1988 appraisal to evaluate the collateralization of the bonds.<sup>46</sup> The court then ruled that these facts supported a finding of an extreme departure from the standard of ordinary care and that First Interstate had established a genuine issue of material fact with respect to the recklessness element of aiding and abetting liability.<sup>47</sup>

Central Bank filed a writ of certiorari to the United States Supreme Court seeking review of "whether an indenture trustee could be found liable as an aider and abettor . . . based only on a showing

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40. *Id.* at 895.

41. *Id.*

42. *Id.* The plaintiffs alleged that the 1988 issue was sold as a part of a fraudulent scheme in that the official statement was materially false and misleading by (1) representing that the updated appraisal was correct, and (2) failing to disclose that an Amwest director, Pring, would receive almost \$2 million from the issuance. *Id.*

43. *Id.*

44. *Id.* at 899. With respect to the aiding and abetting allegation the district court granted Central Bank's motion for summary judgment on the ground that "silence and inaction are not bases to establish substantial assistance absent an additional fiduciary duty to disclose." *Id.*

45. *Central Bank v. First Interstate Bank*, 114 S. Ct. 1439, 1443 (1994) (citing 969 F.2d at 898-903).

46. 969 F.2d at 904.

47. *Id.* The Tenth Circuit also found a genuine issue of material fact with respect to the element of substantial assistance, holding that if Central Bank had required an independent review the deficient collateral would have been discovered and the bondholders' losses avoided. *Id.*

of recklessness.”<sup>48</sup> Instead of directly responding to the question presented, the Court *sua sponte* directed the parties to address the more fundamental question of “whether private civil liability under section 10(b) extends as well to those who do not engage in the manipulative or deceptive practice but who [only] aid and abet the violation.”<sup>49</sup>

## B. The Decision

Writing for the Court, Justice Kennedy stated that the plain text of the statute controlled the decision determining the scope of conduct proscribed by section 10(b).<sup>50</sup> Traditionally, the Court has resorted to strict construction in deciding cases involving section 10(b).<sup>51</sup> In *Central Bank*, the Court reemphasized its adherence to strict statutory construction of section 10(b).<sup>52</sup> It declared that Congress knew how to impose liability on those who aid and abet the proscribed conduct, but did not impose it in the context of section 10(b).<sup>53</sup> Justice Kennedy wrote, “We cannot amend the statute to create liability for acts that are not themselves manipulative or deceptive within the meaning of the statute.”<sup>54</sup>

First Interstate and the SEC argued that the phrase “directly or indirectly” in section 10(b) includes aiding and abetting.<sup>55</sup> The Court reasoned, however, that aiding and abetting liability extends beyond mere indirect participation in proscribed conduct and imposes liability on those persons who do not themselves engage in any prohibited activity.<sup>56</sup> The Court further reasoned that Congress has used the phrase “directly or indirectly” in several provisions of the Exchange Act in a way that does not impose aiding and abetting liability.<sup>57</sup>

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48. 114 S. Ct. at 1457.

49. *Id.* at 1443.

50. *Id.* at 1446.

51. See *Dirks v. SEC*, 463 U.S. 646 (1983); *Aaron v. SEC*, 446 U.S. 680 (1980); *Chiarella v. United States*, 445 U.S. 222 (1980); *Santa Fe Indus. v. Green*, 430 U.S. 462 (1977); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976).

52. 114 S. Ct. at 1446. The Court stated that “not every instance of financial unfairness constitutes fraudulent activity under § 10(b).” *Id.* (citing 445 U.S. at 232).

53. 114 S. Ct. at 1452; see *Pinter v. Dahl*, 486 U.S. 622, 650 (1988); *Touche Ross & Co. v. Redington*, 442 U.S. 560, 572 (1979); *Fischel*, *supra* note 29, at 96-98.

54. 114 S. Ct. at 1448. The Court declared, “When a statute speaks so specifically in terms of manipulation and deception. . . we are quite unwilling to extend the scope of the statute.” *Id.* (quoting 425 U.S. at 214).

55. 114 S. Ct. at 1447.

56. *Id.*

57. *Id.*; see 15 U.S.C. § 78g(f)(2)(C) (1988) (direct or indirect ownership of stock); 15 U.S.C. § 78i(b)(2)-(3) (1988) (direct or indirect interest in derivative security); 15 U.S.C. § 78m(d)(1) (1988) (direct or indirect ownership of securities); 15 U.S.C. § 78p(a) (1988) (direct or indirect ownership of securities); 15 U.S.C. § 78t(a)-(b) (1988) (direct or indirect control of person violating the Exchange Act).

Therefore, the Court concluded that the term “indirectly” fails to support First Interstate’s suggestion that the language of the statute itself proscribes aiding and abetting.<sup>58</sup>

Moreover, the Court stated that even if the text of section 10(b) did not control, it would have reached the same conclusion by speculating how the 1934 Congress would have addressed the issue had it expressly included a private right of action under section 10(b).<sup>59</sup> The Court took note that none of the express private causes of action in the federal securities law in existence at that time imposed aider and abettor liability. Therefore, it concluded that Congress probably would not have included such liability in a private right of action in section 10(b).<sup>60</sup>

First Interstate and the SEC further argued that Congress intended to make aiding and abetting liability part of the Exchange Act because it was well established in both civil and common law and would naturally have been included.<sup>61</sup> Justice Kennedy noted that Congress chose to impose certain types of secondary liability, but not others, thus indicating a choice deliberately made by Congress “with which courts should not interfere.”<sup>62</sup> The Court held that “it is not plausible to interpret the statutory silence as tantamount to an implicit congressional intent to impose section 10(b) aiding and abetting liability.”<sup>63</sup>

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58. 114 S. Ct. at 1448.

59. *Id.* The Court examined the express causes of action in the securities acts, reasoning, “Had the 73rd Congress enacted a private § 10(b) right of action, it likely would have designed it in a manner similar to the other private rights of action in the securities Acts.” *Id.*

60. *Id.* at 1449. The Court further reasoned that to impose aider and abettor liability under § 10(b) would circumvent the requirement that the plaintiff have relied upon the aider and abettor’s statements or actions. *Id.* at 1450.

61. *Id.* at 1450.

62. *Id.* at 1452. Congress has imposed civil aiding and abetting liability in several instances. See 26 U.S.C. § 6701 (1988 & Supp. IV 1992) (Internal Revenue Code); 7 U.S.C. § 25(a)(1) (1988 & Supp. IV 1992) (Commodity Exchange Act); 12 U.S.C. § 93(b)(8) (1988 & Supp. IV 1992) (National Bank Act); 12 U.S.C. § 504(h) (1988 & Supp. IV 1992) (Federal Reserve Act); 7 U.S.C. § 192(g) (1988) (Packers and Stockyards Act). Also there are several express provisions in the securities acts imposing civil liability for aiding and abetting. See *infra* pages 67-69.

63. 114 S. Ct. at 1452. At the time Congress passed the Exchange Act, eleven states and the territory of Hawaii had enacted provisions within their blue sky laws to impose liability upon a person who aided in fraudulent sale of securities. See Douglas E. Abrams, *The Scope of Liability Under Section 12 of the Securities Act of 1933: “Participation” and the Pertinent Legislative Materials*, 15 FORDHAM URB. L.J. 877, 945-46 & n.423 (1987).

In support of their claim to define notions of congressional intent broadly, First Interstate and the SEC also argued that Congress acquiesced in the existence of aider and abettor liability, citing the 1983 and 1988 committee reports that referred to section 10(b) aider and abettor liability coupled with a failure to amend the statute to deny such liability.<sup>64</sup> Central Bank made a competing argument that Congress intended to exclude aider and abettor liability based upon Congress's failure to pass 1957, 1959, and 1960 bills expressly creating such liability.<sup>65</sup> The Court ruled that both arguments deserved little weight in the interpretative process and that neither argument pointed to a definitive answer. Therefore, the Court rejected both arguments.<sup>66</sup>

The SEC put forth various policy positions arguing that aider and abettor liability deters secondary actors from assisting the fraudulent conduct and insures that defrauded investors are made whole.<sup>67</sup> The Court held that these policy arguments cannot supersede the plain text of the statute, because adherence to the statute's text and structure would not lead to such a bizarre result that Congress could not have intended it.<sup>68</sup> The Court stated that "litigation under Rule 10b-5 presents a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general" and requires secondary actors to incur larger costs even for pretrial defense and negotiation of settlements.<sup>69</sup> The Court declared that if aider and abettor liability is readily available to plaintiffs, then professionals that incur litigation expenses associated with such claims will pass the costs on to their clients, who in turn will pass the expense on to their investors, the intended beneficiaries of the statute.<sup>70</sup>

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64. 114 S. Ct. at 1452; *see also* H.R. REP. NO. 910, 100th Cong., 2d Sess. 27-28 (1988); H.R. REP. NO. 355, 98th Cong., 1st Sess. 10 (1983). The House Report accompanying the Insider Trading Sanctions Act of 1983 contained the following reference: "[J]udicial application of the concept of aiding and abetting liability to achieve the remedial purpose of the securities laws." *Id.*

65. 114 S. Ct. at 1453; *see also* S. 2545, 85th Cong., 1st Sess. § 20 (1957); S. 1179, 86th Cong., 1st Sess. § 22 (1959); S. 3770, 86th Cong., 2d Sess. § 20 (1960).

66. 114 S. Ct. at 1453.

67. *Id.*

68. *Id.* at 1453-54; *see* *Demafest v. Manspeaker*, 498 U.S. 184, 191 (1991); *Pinter v. Dahl*, 486 U.S. 622, 654 (1988); *Santa Fe Indus. v. Green*, 430 U.S. 462, 477 (1977).

69. 114 S. Ct. at 1454 (quoting *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 739 (1975)); *see* 138 CONG. REC. S12605 (daily ed. Aug. 12, 1992) (remarks of Sen. Sanford) (asserting that in 83% of 10b-5 cases major accounting firms pay \$1 in claims for every \$8 paid in legal fees).

70. 114 S. Ct. at 1454; *see* *Frivolous Lawsuits Hurt Shareholders*, HARTFORD COURANT, Apr. 11, 1994, at C8. In the *Hartford Courant*, one editorialist noted,

Finally, the Court rejected the SEC's argument that private civil liability under section 10(b) for aiding and abetting could be based on 18 U.S.C. § 2, a general aiding and abetting provision applicable to all federal crimes.<sup>71</sup> The Court reasoned that although an aider and abettor can be criminally liable under any provision of the Exchange Act, it does not follow that a civil action lies as well.<sup>72</sup> The logical consequence of this approach would be the creation of implied civil damages for every criminal provision enacted for the benefit of a particular class of persons.<sup>73</sup> The Court stated that such an approach would cause a significant and unacceptable shift in established interpretive principles.<sup>74</sup>

Justice Stevens wrote the dissenting opinion in *Central Bank* stating that "the majority gives short shrift to a long history of aider and abettor liability under section 10(b) and Rule 10b-5 . . . and its rationale imperils other well established forms of secondary liability not expressly addressed in the securities laws."<sup>75</sup> The dissent argued that the aiding and abetting theory is grounded in general principles of tort law and is a "logical and natural complement" to the private section 10(b) action that furthers the Exchange Act's purpose of "creation and maintenance of a post-issuance securities market that is free from fraudulent practices."<sup>76</sup> Justice Stevens wrote that there is a "risk of an anachronistic error" in applying the Court's strict statutory interpretation approach to a statute enacted in 1934, given the fact that the Court, shortly before passage of the Exchange Act, instructed that such "remedial legislation should receive a broader and more liberal interpretation than that to be drawn from mere dictionary definitions of the words employed by Congress."<sup>77</sup>

The dissent argued that the "subtle construction of an important federal statute should not be disturbed unless and until Congress so decides."<sup>78</sup> Furthermore, Justice Stevens wrote that the evidence suggests

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"These frivolous lawsuits discredit the legal profession, distract companies from their main tasks, discourage or retard the development of new, cutting-edge businesses and ultimately harm the interests of all shareholders." *Id.*

71. 114 S. Ct. at 1454-55.

72. *Id.* at 1455.

73. *Id.*

74. *Id.*

75. *Id.* at 1456 (Stevens, J., dissenting).

76. *Id.* (quoting *Brennon v. Midwestern United Life Ins. Co.*, 259 F. Supp. 673, 680 (N.D. Ind. 1966)); see also *Pettit v. American Stock Exch.*, 217 F. Supp. 21, 28 (S.D.N.Y. 1963).

77. 114 S. Ct. at 1457 (quoting *Piedmont & N. Ry. v. ICC*, 286 U.S. 299, 311 (1932)).

78. *Id.* at 1458 (Stevens, J., concurring) (quoting *Reves v. Ernst & Young*, 494 U.S. 56, 74 (1990)).



that Congress was in favor of aider and abettor liability. Justice Stevens based this conclusion on the fact that when Congress comprehensively amended the Exchange Act in 1975 it left undisturbed the large body of case law imposing private civil liability for aiding and abetting under section 10(b) and Rule 10b-5.<sup>79</sup> Furthermore, Justice Stevens was concerned that not only private parties may be barred from bringing suit against aiders and abettors, but also that the SEC may be left powerless in civil enforcement actions.<sup>80</sup>

### C. Analysis of *Central Bank*

#### 1. *Standard of Culpability*

The majority in *Central Bank* recognized that determining liability under the aider and abettor doctrine has exacted costs via vexatious litigation that "disserv[es] the goals of fair dealing and efficiency in the securities markets."<sup>81</sup> The Court's restrictive decision was aimed at reducing the uncertainty and unpredictability in the application of Rule 10b-5 and eliminating frivolous and unmeritorious claims thereunder.<sup>82</sup> Although the Court was given the opportunity, it declined to address the issue that has spawned a flood of litigation and has yet to be definitely resolved under the federal securities laws: the standard of culpability.<sup>83</sup> As expressed in Justice Stevens's dissenting

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79. *Id.*

80. *Id.* at 1459-60.

81. *Id.* at 1454.

82. *Id.* The Court stated that the rules for determining liability for aiding and abetting are unclear and because of this uncertainty defendants who may be subjected to secondary liability under the aider and abettor concept may find it necessary, "as a business judgment, to abandon substantial defenses and to pay settlements in order to avoid the expense and risk of going to trial." *Id.*; see Douglas M. Branson, *Collateral Participant Liability Under State Securities Laws*, 19 PEPP. L. REV. 1027 (1992). Professor Branson describes a typical securities fraud lawsuit where the plaintiff utilizes a tactical device called the "prisoner's dilemma." The plaintiff will isolate one or more peripheral defendants offering a settlement that cannot be refused compared to the costs of litigation and adverse publicity. This puts money in the plaintiff's war chest and allows the plaintiff to proceed against the primary violators. *Id.* at 1035.

83. See *Goldschmid Testimony*, *supra* note 6, at 10. Goldschmid argues that a Supreme Court requirement including a showing of willful or intentional conduct for a violation of § 10(b) would provide accountants, attorneys, and directors with incentives "to simply ignore red flags suggesting fraud or egregious disclosure failures," because such professionals would be vulnerable to liability only if it could be proven they actually intended the fraud. *Goldschmid Testimony*, *supra* note 6, at 10. Goldschmid further argues that "recklessness" is the appropriate standard under §10(b) and Rule 10b-5 for the predication of liability. *But see Goldman Testimony*, *supra* note 6, at 6. Goldman argues that the recklessness standard is arbitrary, resembles negligence too closely, and ignores the requirement of a duty of disclosure. *Goldman Testimony*, *supra* note 6, at 6.

opinion, Central Bank sought review only of the question of "whether it could be held liable as an aider and abettor based only on a showing of recklessness."<sup>84</sup> The Court never reached the issue of culpability in *Central Bank* because it invalidated the underlying cause of action altogether.

In a famous footnote, the Court left the issue of aiding and abetting liability unresolved in *Ernst & Ernst v. Hochfelder*<sup>85</sup> where the Court determined that scienter was required to state a cause of action under Rule 10b-5, and that negligent conduct would not suffice.<sup>86</sup> While the Court clarified that intentional or willful deception will satisfy the scienter requirement, it did not decide whether recklessness was sufficient.<sup>87</sup> Consequently, the lower federal courts swiftly began applying recklessness as a sufficient standard of culpability under section 10(b).<sup>88</sup>

The lower courts, however, have found it difficult to draw a clear line between mere negligence and recklessness, with some courts indicating support for a sliding scale of culpability inversely related to whether the defendant had a duty to disclose the misstatement or omission.<sup>89</sup> Several courts have followed the Seventh Circuit Court of Appeals ("Seventh Circuit") in applying a stringent test to the recklessness standard.<sup>90</sup> The Seventh Circuit has held:

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84. 114 S. Ct. at 1457 (Stevens, J., dissenting). By way of footnote, Justice Stevens stated, "As I have said before, the adversary process functions most effectively when we rely on the initiative of lawyers, rather than the activism of judges, to fashion the questions for review." *Id.* at 1457 n.4.

85. 425 U.S. 185, 193-94 n.12 (1976).

86. *Id.*

87. *Id.* The Court stated:

In this opinion the term "scienter" refers to a mental state embracing intent to deceive, manipulate, or defraud. In certain areas of the law recklessness is considered to be a form of intentional conduct for purposes of imposing liability for some act. We need not address here the question whether, in some circumstances, reckless behavior is sufficient for civil liability under § 10(b) and Rule 10b-5.

*Id.*

88. See *Backman v. Polaroid Corp.*, 910 F.2d 10 (1st Cir. 1990); *McDonald v. Alan Bush Brokerage Co.*, 863 F.2d 809 (11th Cir. 1988); *Dirks v. SEC*, 681 F.2d 824 (D.C. Cir. 1982), *cert. granted*, 459 U.S. 1014 (1982), *rev'd*, 463 U.S. 646 (1983); *Hackbart v. Holmes*, 675 F.2d 1114 (10th Cir. 1982); *Huddleston v. Herman & MacLean*, 640 F.2d 534 (5th Cir. 1981) *aff'd in part, rev'd in part*, 459 U.S. 375 (1983); *Pegasus Fund, Inc. v. Laraneta*, 617 F.2d 1335 (9th Cir. 1980); *Rolf v. Eastman Dillon & Co.*, 570 F.2d 38 (2d Cir. 1978), *cert. denied*, 439 U.S. 1039 (1978); *Coleco Indus., Inc. v. Berman*, 567 F.2d 569 (3d Cir. 1977), *cert. denied*, 439 U.S. 830 (1978); *Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033 (7th Cir. 1977), *cert. denied*, 434 U.S. 875 (1977); *Sanders v. John Nuveen & Co.*, 554 F.2d 790 (7th Cir. 1977), *cert. denied*, 450 U.S. 1005 (1981).

89. See *Sirota v. Solitron Devices, Inc.*, 673 F.2d 566, 575 (2d Cir. 1982), *cert. denied*, 459 U.S. 838 (1982).

90. See *Broad v. Rockwell Int'l. Corp.*, 614 F.2d 418, 440 (5th Cir. 1981), *reh'g*

In view of the Supreme Court's analysis in *Hochfelder* of the statutory scheme of implied private remedies and express remedies, the definition of "reckless behavior" should not be a liberal one lest any discernable distinction between "scienter" and "negligence" be obliterated for these purposes. We believe "reckless" in these circumstances comes closer to being a lesser form of intent than merely a greater decree of ordinary negligence.<sup>91</sup>

However, not all courts have followed the Seventh Circuit's approach. For instance, the Second Circuit Court of Appeals ("Second Circuit") has declared that *Hochfelder* did not establish a standard of specific intent to defraud unless a fiduciary relationship exists between the plaintiff and defendant.<sup>92</sup> Furthermore, the Second Circuit has ruled that reckless behavior signifies "carelessness approaching indifference" which connotes a standard closer to negligence than intent.<sup>93</sup> As the Sixth Circuit Court of Appeals ("Sixth Circuit") put it, "[T]he standard falls somewhere between intent and negligence."<sup>94</sup>

Although the Court refrained from addressing the culpability issue directly in *Central Bank*, the Court did seem to be sending mixed signals regarding the validity of a recklessness standard of culpability in establishing civil liability. Some insight may be gleaned from the Court's declaration that "the rules for determining aiding and abetting liability are unclear" when the nature of the securities business requires certainty.<sup>95</sup> Therefore, the Court reasoned, establishing such liability on a theory of aiding and abetting would result in "ad hoc" decisions "offering little predictive value" to business participants.<sup>96</sup> The Court declined adopting a theory of liability that yielded such results.<sup>97</sup> This language clearly manifests the Court's

granted, 618 F.2d 396 (1980), *reh'g*, 642 F.2d 929 (1981), *cert. denied*, 454 U.S. 965 (1981); 617 F.2d at 1340-41; 554 F.2d at 793.

91. 554 F. 2d at 793; *see also* *Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033 (7th Cir. 1977), *cert. denied*, 434 U.S. 875 (1977). There, the Seventh Circuit defined reckless conduct as:

A highly unreasonable omission, involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it.

553 F.2d at 1045.

92. *Edwards & Hanly v. Wells Fargo Sec. Clearance Corp.*, 602 F.2d 478, 485 (2d Cir. 1979).

93. *Id.*

94. *Mansbach v. Prescott, Ball & Turben*, 598 F.2d 1017, 1025 n.36 (6th Cir. 1979).

95. *Central Bank v. First Interstate Bank*, 114 S. Ct. 1439, 1454 (1994).

96. *Id.* (quoting *Pinter v. Dahl*, 486 U.S. at 652 (1988)).

97. *Id.*

skeptical view of a recklessness standard in imposing civil liability. It should be noted, however, that the Court seemingly buttressed its rejection of the SEC's argument that 18 U.S.C. § 2 implies a civil aiding and abetting cause of action under section 10(b), by contrasting the standards of culpability between civil and criminal liability under the Exchange Act.<sup>98</sup> The Court noted the inconsistency in the SEC's argument by stating that "recklessness, not intentional wrongdoing, is the theory underlying the aiding and abetting allegations in the case before us."<sup>99</sup> Although the Court did not expressly adopt a recklessness standard for civil liability, the use of the standard to contradict the SEC's argument impliedly suggests that the Court may recognize its validity.

However, because the standard of culpability applied can help determine the scope of conduct prohibited by section 10(b), the Court will limit its analysis to the text of section 10(b). As the Court stated in *Hochfelder*, "[T]he words 'manipulative or deceptive' used in conjunction with 'device or contrivance' strongly suggest that section 10(b) was intended to proscribe 'knowing or intentional misconduct.'"<sup>100</sup> This reference to a "knowing" standard signifies proscription of "knowing misconduct" apart from "intentional misconduct." Furthermore, the reference implies the Court's acceptance of this lesser form of intent as appropriate under section 10(b).

The Court in *Hochfelder* suggested that recklessness may be sufficient "in some circumstances."<sup>101</sup> This language is more restrictive than the liberal test employed by the Second Circuit, which seemingly would hold that reckless behavior is always sufficient to violate section 10(b).<sup>102</sup> The question becomes: In what circumstance, if any, does reckless behavior constitute manipulative or deceptive conduct within the meaning of section 10(b)? A plain reading of the words "manipulative," "device," and "contrivance" seem to reject any standard that falls below knowing misconduct.<sup>103</sup> In light of the Court's

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98. *Id.* at 1454-55.

99. *Id.* at 1455.

100. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 197 (1976).

101. *Id.* at 193 n.12.

102. *Edwards & Hanley v. Wells Fargo Sec. Clearance Corp.*, 602 F.2d 478 (2d Cir. 1979).

103. Justice Stevens, in his dissenting opinion in *Central Bank*, declared that the text of § 10(b) "should receive a broader and more liberal interpretation than that to be drawn from mere dictionary definitions of the words employed by Congress." 114 S. Ct. at 1457 (Stevens, J., dissenting) (quoting *Piedmont & N. Ry. v. ICC*, 286 U.S. 299, 311 (1932)). However, a series of footnotes in *Ernst & Ernst v. Hochfelder* illustrates that the Court may cling to the definitional meaning of the words "device," "contrivance," and "manipulate" in determining whether reckless

restrictive approach in *Central Bank* and its jurisprudential attention to the doctrine of fault,<sup>104</sup> the continued validity of a recklessness standard under section 10(b) may be in doubt.<sup>105</sup>

## 2. Effect on SEC Enforcement Actions

Justice Stevens, in the dissenting opinion, expressed concern that the Court's ruling would not only prohibit private plaintiffs from bringing aiding and abetting claims, but also would apply to SEC enforcement actions.<sup>106</sup> The majority in *Central Bank* left some doubt as to whether the Court's ruling would extend to SEC civil enforcement actions, but not much. The Court relied upon the text of section

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behavior is sufficient under § 10(b). Footnotes 19, 20, and 21 provide, in pertinent part:

<sup>19</sup> "To let general words draw nourishment from their purpose is one thing. To draw on some unexpressed spirit outside the bounds of the normal meaning of words is quite another. . . . After all, legislation when not expressed in technical terms is addressed to the common run of men and is therefore to be understood according to the sense of the thing, as the ordinary man has a right to rely on ordinary words addressed to him."

<sup>20</sup> Webster's International Dictionary (2d ed. 1934) defines "device" as "[t]hat which is devised, or formed by design; a contrivance; an invention; project; scheme; often, a scheme to deceive; a stratagem; an artifice," and "contrivance" in pertinent part as "[a] thing contrived or used in contriving; a scheme, plan, or artifice." In turn, "contrive" in pertinent part is defined as "[t]o devise; to plan; to plot . . . [t]o fabricate . . . design; invent . . . to scheme . . . ."

<sup>21</sup> Webster's International Dictionary, *supra*, defines "manipulate" as "to manage or treat artfully or fraudulently; as to *manipulate* accounts . . . ."

425 U.S. at 19 nn. 19-21. If the Court employs a strict definitional methodology, as it did in *Hochfelder*, it would be difficult to argue that one has schemed, plotted, designed, or planned without exhibiting "knowing misconduct." *Id.*

104. See *Ruder Testimony*, *supra* note 6, at 13. In expressing his opposition to the applicability of the doctrine of respondeat superior under Rule 10b-5, Ruder states there has been extensive legislative and jurisprudential attention to the doctrine of fault in federal securities laws. *Rader Testimony*, *supra* note 6, at 13.

105. See *Goldschmid Testimony*, *supra* note 6, at 10. Professor Goldschmid implored Congress to enact legislation confirming the recklessness standard under § 10(b) stating "Congress could perform no greater service to the nation in the business law area." *Goldschmid Testimony*, *supra* note 6, at 10. The Court in *Central Bank* stated, "When the text of § 10(b) does not resolve a particular issue, we attempt to infer 'how the 1934 Congress would have addressed the issue had the 10b-5 action been included as an express provision in the 1934 Act' . . . . For that inquiry we use the express causes of action in the Securities Acts as the primary model for the § 10(b) action." *Id.* at 1448 (citation omitted). Section 9(e) of the Exchange Act is a more precise fraud provision dealing with the purchase or sale of a security on a national securities exchange as well as transactions relating to puts, calls, straddles, or options. The express use of the term "willful" in § 9(e) further casts doubt on the validity of the recklessness standard under § 10(b).

106. 114 S. Ct. at 1460.

10(b) to determine that an action for aiding and abetting would not lie.<sup>107</sup> When the Court has taken a “text-only” approach in the past it has found no reason why its ruling should not equally apply to both public and private plaintiffs. For example, in *Hochfelder* the Court ruled that a private plaintiff could not maintain an action under Rule 10b-5 absent an allegation of scienter.<sup>108</sup> The Court expressly reserved the question of whether its ruling would extend to an SEC action for injunctive relief under Rule 10b-5.<sup>109</sup>

However, the Court took up the reserved question in *Aaron v. SEC*<sup>110</sup> and held that the scienter requirement for bringing a Rule 10b-5 action applies to the SEC as well as to private plaintiffs.<sup>111</sup> Likewise, nothing in the majority’s analysis in *Central Bank* limits the holding to private plaintiffs. The Court clearly held that the proscription in section 10(b) “does not include giving aid to a person who commits a manipulative or deceptive act.”<sup>112</sup> Because the SEC derives its enforcement authority from the statute itself,<sup>113</sup> any effort by the SEC to pursue defendants under Rule 10b-5 as aiders and abettors is ultra vires. Subsequent to the Court’s decision in *Central Hudson*, Arthur Levitt, Chairman of the SEC, publicly stated that although an argument can be made that the Court did not intend to restrict the SEC’s ability to pursue aiders and abettors, the SEC “will generally refrain, at this time, from asserting aiding and abetting theories of liability where the statute does not expressly provide for such claims.”<sup>114</sup>

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107. *Id.* at 1447.

108. 425 U.S. at 197.

109. *Id.* at 193-94 n.12.

110. 446 U.S. 680 (1980).

111. *Id.* at 691. The Court stated that “the rationale of *Hochfelder* ineluctably leads to the conclusion that scienter is an element of a violation of § 10(b) and Rule 10b-5, regardless of the identity of the plaintiff or the nature of the relief sought. Two of the three factors relied upon in *Hochfelder*—the language of § 10(b) and its legislative history—are applicable whenever a violation of § 10(b) or Rule 10b-5 is alleged, whether in a private cause of action for damages or in a Commission injunctive action . . . .” *Id.*

112. 114 S. Ct. at 1448.

113. 15 U.S.C. § 78j (1988).

114. See *Levitt Testimony*, *supra* note 6, at 8. It is possible that to the extent that *Central Bank* holds that a defendant cannot be enjoined for aiding and abetting a violation of § 10(b), it is in direct conflict with Rule 65(d) of the Federal Rules of Civil Procedure. Rule 65(d) provides that a preliminary injunction “is binding only upon parties to the action, their officers, agents, servants, employees and attorneys, and upon those persons in active concert or participation with them who receive actual notice of the order by personal service or otherwise.” FED R. Civ. P. 65(d). This provision has been interpreted to be binding upon aiders and abettors even if such persons are not named parties to the proceeding. See *Regal Knitwear*

It is unclear what affect the *Central Bank* decision will have on the SEC enforcement actions. Chairman Levitt stated that "of the 420 pending [SEC] cases, we have identified about 80 cases in which the Commission has asserted an aiding and abetting claim not expressly provided by statute."<sup>115</sup> The Chairman added that in most of these cases the defendant is also charged as a primary violator, but cautioned, "In at least 25 . . . injunctive actions, however, one or more defendants are charged solely under an aiding and abetting theory of liability."<sup>116</sup>

Even without the ability to pursue defendants under an implied theory of aider and abettor liability under Rule 10b-5, the SEC is not likely to be hamstrung in its enforcement efforts. The SEC may still enjoin primary violators under Rule 10b-5,<sup>117</sup> including persons

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Co. v. NLRB, 324 U.S. 9, 14 (1945); *Roe v. Operation Rescue*, 919 F.2d 857, 871 (3d Cir. 1990); see also 2 JAMES W. MOORE ET AL., *MOORE'S FEDERAL PRACTICE* ¶ 65.13 (2d ed. 1994).

115. *Levitt Testimony*, *supra* note 6, at 8.

116. *Levitt Testimony*, *supra* note 6, at 8.

117. Section 21(d) of the Exchange Act, 15 U.S.C. § 78u(d) (1988 & Supp. V 1993). Section 21(d) provides, "Whenever it shall appear to the [SEC] that any person is engaged or is about to engage in acts or practices constituting a violation of any provision of this chapter . . . it may in its discretion bring an action in the proper district court . . . to enjoin such acts or practices . . ." *Id.* The primary purpose of injunctive relief against violators of federal securities laws is to deter future violations and not to punish violators. *SEC v. Kora Corp. Indus.*, 575 F.2d 692 (9th Cir. 1978). The grounds for which an injunction will be granted has garnered considerable controversy. Judge Friendly reflected the current judicial attitude toward SEC injunctions in *SEC v. Commonwealth Chem. Sec.*, 574 F.2d 90, 99-100 (2d Cir. 1978), where he stated:

It is fair to say that the current judicial attitude toward the issuance of injunctions on the basis of past violations at the SEC's request has become more circumspect than in earlier days. Experience has shown that an injunction, while not always a "drastic remedy" as appellants contend, often is much more than the "mild prophylactic" described by the dissenters in this court in *SEC v. Capital Gains Research Bureau, Inc.*, 306 F.2d 606, 613 (2d Cir. 1962), a phrase quoted by the Supreme Court at 375 U.S. 180, 193 (1963). In some cases the collateral consequences of an injunction can be very grave. The Securities Act and the Securities Exchange Act speak, after all, of enjoining "any person [who] is engaged or about to engage in any acts or practices" which constitute or will constitute a violation. Except for the case where the SEC steps in to prevent an ongoing violation, this language seems to require a finding of "likelihood" or "propensity" to engage in the future violations. As said by Professor Loss, "[t]he ultimate test is whether the defendant's past conduct indicates . . . that there is a reasonable likelihood of further violation in the future." Our recent decisions have emphasized, perhaps more than older ones, the need for the SEC to go beyond the mere facts of past violations and demonstrate a realistic likelihood of recurrence. See *SEC v. Universal Major Indus.*, 546 F.2d 1044, 1048 (2d Cir. 1976), *SEC v. Parklane Hosiery*, 558 F.2d 1083 (2d Cir. 1977), and *SEC v. Bausch & Lomb, Inc.*, 565 F.2d 8, 18 (2d Cir. 1977),

who “indirectly” violate the rule, and furthermore, may impose civil monetary penalties against such violators of up to \$100,000 for a natural person and up to \$500,000 for any other person.<sup>118</sup> It has the power, through administrative proceedings, to discipline investment advisors,<sup>119</sup> broker-dealers,<sup>120</sup> and government and municipal securities dealers,<sup>121</sup> as well as suspend, revoke, or restrict the right of an attorney or accountant to appear before the SEC for any violation of the securities laws.<sup>122</sup>

Congress, in 1990, greatly enhanced the SEC’s enforcement authority with the passage of the Securities Enforcement Remedies and Penny Stock Reform Act (“Remedies Act”).<sup>123</sup> The Remedies Act added section 21C to the Exchange Act and gave the SEC the authority to issue a cease-and-desist order against any person who violates any provision of the Exchange Act or who is “a cause of the violation, due to an act or omission the person knew or should have known would contribute to a violation.”<sup>124</sup> By employing this “negligence-sounding standard,” the SEC can reach a person who causes securities law violations as long as he “should have known” that an act or omission would contribute to a violation, even if that person is neither a primary violator nor an aider and abettor. The SEC can also order accounting and disgorgement of the violator’s illegal profits,<sup>125</sup> and if the cease-and-desist order is violated may seek civil money penalties.<sup>126</sup>

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where the court went so far as to say “[T]he Commission cannot obtain relief without positive proof of a reasonable likelihood that past wrongdoing will recur.”

574 F.2d at 99-100.

118. Section 21(d)(3) of the Exchange Act, 15 U.S.C. § 78u(d)(3) (1988 & Supp. V 1993). Section 21(d)(3) provides: “Whenever it shall appear to the [SEC] that any person has violated any provision of this chapter, the rules or regulations thereunder, . . . the [SEC] may bring an action in a United States district court . . . to seek . . . a civil penalty to be paid by the person who committed such violation.” *Id.*

119. Section 203(i) of the Investment Advisers Act of 1940, 15 U.S.C. § 80b-3(i) (1988 & Supp. V 1993).

120. Section 15(b) of the Exchange Act, 15 U.S.C. § 78o(b) (1988 & Supp. V 1993).

121. Section 15B of the Exchange Act, 15 U.S.C. § 78o-4 (1988 & Supp. V 1993); Section 15C of the Exchange Act, 15 U.S.C. § 78o-5 (1988 & Supp. V 1993).

122. Rule 2(e) of the Securities and Exchange Commission Rules of Practice, 17 C.F.R. § 201.2(e) (1994).

123. Securities Enforcement Remedies and Penny Stock Reform Act of 1990, 15 U.S.C. § 77h-1 (Supp. V 1993).

124. Section 21C of the Exchange Act, 15 U.S.C. § 78u-3 (1988 & Supp. V 1993); *see also* Section 8A of the Securities Act, 15 U.S.C. § 77h-1 (1988 & Supp. V 1993).

125. 15 U.S.C. § 78u-3(e) (1988 & Supp. V 1993).

126. 15 U.S.C. § 78u(d)(3) (1988 & Supp. V 1993).



The Remedies Act also grants the SEC the authority to impose sanctions on any broker-dealer who willfully violates or willfully aids and abets a violation of federal securities law.<sup>127</sup> In this case, Congress expressly provided for the imposition of sanctions, including the revocation or denial of registration, on those broker-dealers who aid and abet a federal securities law violation.<sup>128</sup> Furthermore, the Remedies Act gives the SEC the authority to impose sanctions upon persons, even if unassociated with the broker-dealer, who participate in the distribution of a penny stock and who aid and abet a violation of federal securities law.<sup>129</sup> The SEC's authority to pursue aiders and abettors in this context is clear.

The SEC may also impose administrative sanctions on investment advisors for willfully aiding and abetting a violation of federal securities law.<sup>130</sup> Moreover, the Investment Company Act gives the SEC authority to bar a person from serving in any capacity for an investment company if that person aided and abetted a violation of the same laws.<sup>131</sup> Furthermore, the Remedies Act supplemented SEC authority under the foregoing provisions by authorizing the imposition of civil monetary penalties against such broker-dealers, investment advisors, and persons affiliated with investment companies who willfully aid and abet a violation.<sup>132</sup> Also, Rule 2(e) of the SEC's Rules of Practice gives the SEC authority to bar an attorney or accountant from practicing before the SEC if such person, among other things, has willfully aided or abetted violators of the federal securities laws.<sup>133</sup>

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127. Section 15(b)(4)(E) of the Exchange Act, 15 U.S.C. § 78o(b)(4)(E) (1988).

128. *Id.*; see also *Central Bank v. Interstate Bank*, 114 S. Ct. 1439, 1451 (1994).

129. Section 15(b)(6)(A)(i) of the Exchange Act, 15 U.S.C. § 78o(b)(6)(A)(i) (1988 & Supp. V 1993).

130. Section 203(e)(4)-(5) of the Investment Advisors Act of 1940, 15 U.S.C. § 80b-3(e)(4)-(5) (1988 & Supp. V 1993).

131. Section 9(b)(2)-(3) of the Investment Company Act of 1940, 15 U.S.C. § 80a-9(b)(2)-(3) (1988 & Supp. V 1993).

132. Section 21B of the Exchange Act, 15 U.S.C. § 78u-2 (1988 & Supp. V 1993); Section 9(d) of the Investment Company Act, 15 U.S.C. § 80a-9(d) (1988 & Supp. V 1993); Section 203(i) of the Investment Advisors Act, 15 U.S.C. § 80b-3(i) (1988 & Supp. V 1993).

133. See 17 C.F.R. § 201.2(e) (1994). Rule 2(e) provides:

The [SEC] may deny, temporarily or permanently, the privilege of appearing or practicing before it in any way to any person who is found by the Commission after notice of and opportunity for hearing in the matter (i) not to possess the requisite qualifications to represent others, or (ii) to be lacking in character or integrity or to have engaged in unethical or improper professional conduct, or (iii) to have willfully violated, or willfully aided and abetted the violation of any provision of the Federal securities laws (15 U.S.C. §§ 77a—80b-20 (1988)), or the rules and regulations thereunder.

As can be seen, the expressed prohibitions on aiding and abetting in all of the aforementioned acts require a “willful” violation. What this term means in the context of the federal securities laws is unsettled and is sure to achieve greater emphasis after *Central Bank*.

Some authorities have argued that the loss of the ability to enjoin aiders and abettors will adversely affect the SEC’s enforcement program.<sup>134</sup> However, the most likely effect is a shift in SEC resources to its disciplinary and cease-and-desist authority and a recasting of allegations in terms of indirect primary liability rather than aiding and abetting liability. As Chairman Levitt stated, “The Commission’s preliminary assessment is that its enforcement program can continue to operate effectively under these circumstances. The Commission believes that some enforcement remedy will continue to be available against most defendants that . . . would have [been] pursued on an aiding and abetting theory.”<sup>135</sup>

### 3. Status of Secondary Liability

#### a. Aider and Abettor Liability.

The existence and validity of a private right of action under section 10(b) was originally based upon the tort law maxim, *Ubius, ibi remedion* — where there is a right, there is a remedy.<sup>136</sup> Courts have borrowed from tort law the aiding and abetting theory of liability under securities fraud. The leading case establishing the doctrine under section 10(b) was *Brennan v. Midwestern United Life Insurance Co.*,<sup>137</sup> when, in 1968, a federal district court in Indiana held that the general concept of aiding and abetting “has been formulated in a most helpful

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134. See *Langevoort Testimony*, *supra* note 6, at 5. Langevoort argues that Congress has recognized, as evidenced by the passage of the Remedies Act, that effective sanctions are needed to combat securities fraud and the inability to pursue aiders and abettors would be a significant loss. *Langevoort Testimony*, *supra* note 6, at 5.

135. See *Levitt Testimony*, *supra* note 6, at 2. Chairman Levitt expressed concern that in some cases the SEC will pursue principal violators in federal court to obtain civil penalties and simultaneously pursue secondary violators in administrative actions. *Levitt Testimony*, *supra* note 6, at 2-3.

136. Fischel, *supra* note 29, at 80; see also *Kardon v. National Gypsum Co.*, 69 F. Supp. 512, 513 (E.D. Pa. 1946).

137. 259 F. Supp. 673 (N.D. Ind. 1966) (motion to dismiss denied); *Brennan v. Midwestern United Life Ins. Co.*, 286 F. Supp. 702 (N.D. Ind. 1968) (on the merits after trial), *aff’d* 417 F.2d 147 (7th Cir. 1969), *cert. denied*, 397 U.S. 989 (1970).

manner in the Restatement of Torts § 876.”<sup>138</sup> Section 876 of the Restatement of Torts provides:

876. Persons Acting in Concert

For harm resulting to a third person from the tortious conduct of another, a person is liable if he

- (a) does a tortious act in concert with the other or pursuant to a common design with him, or
- (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 other in accomplishing a tortious result and his own conduct, separately considered, constitutes a breach of duty to the third person.<sup>139</sup>

The United States District Court for the Northern District of Indiana reasoned that “[i]n the absence of a clear legislative expression to the contrary, . . . [section 10(b)] must be flexibly applied so as to implement its policies and purposes.”<sup>140</sup> Since *Brennan* in 1966, all federal circuit courts of appeals have recognized the aiding and abetting doctrine and have generally fashioned a test after section 876.<sup>141</sup> The Tenth Circuit in *First Interstate Bank* set forth the elements as (1) a primary violation of section 10(b); (2) recklessness by the aider and abettor as to the existence of a primary violation; and (3) substantial assistance given to the primary violator by the aider and abettor.<sup>142</sup> The Supreme Court, prior to *Central Bank*, had not reached the issue directly, but nevertheless the Court's decision in *Hochfelder* suggested

138. 286 F. Supp. at 708; see Ruder, *supra* note 26, at 621.

139. RESTATEMENT OF TORTS § 876 (1939).

140. 259 F. Supp. at 680-81.

141. See, e.g., *Farlow v. Peat, Marwick, Mitchell & Co.*, 956 F.2d 982, 986 (10th Cir. 1992); *Schatz v. Rosenberg*, 943 F.2d 485, 496 (4th Cir. 1991); *K&S Partnership v. Continental Bank*, 952 F.2d 971, 977 (8th Cir. 1991); *Levine v. Diamanthuset, Inc.*, 950 F.2d 1478, 1483 (9th Cir. 1991); *Fine v. American Solar King Corp.*, 919 F.2d 290, 300 (5th Cir. 1990); *Schlifke v. Seafirst Corp.*, 866 F.2d 935, 949 (7th Cir. 1989); *Schneberger v. Wheeler*, 859 F.2d 1477, 1480 (11th Cir. 1988); *Moore v. Ferex, Inc.*, 809 F.2d 297, 303 (6th Cir. 1987), *cert. denied sub nom. Moore v. Frost*, 483 U.S. 1006 (1987); *Cleary v. Perfectune, Inc.*, 700 F.2d 774, 777 (1st Cir. 1983); *IIT v. Cornfeld*, 619 F.2d 909, 922 (2d Cir. 1980); *Monsen v. Consolidated Dressed Beef Co.*, 579 F.2d 793, 799-800 (3d Cir. 1978). *But see Robin v. Arthur Young & Co.*, 915 F.2d 1120, 1123 (7th Cir. 1990) (requiring an aider and abettor to commit one of the manipulative or deceptive acts, virtually eliminating the secondary liability count).

142. *First Interstate Bank v. Pring*, 969 F.2d 891, 898 (10th Cir. 1992). However, under the traditional analysis the aider and abettor must have known of the wrongful conduct. See *Landy v. FDIC*, 486 F.2d 139, 162 (3d Cir. 1973). The knowledge requirement is consistent with § 876(b) of the Restatement of Torts.

that it might not recognize any of the various forms of secondary liability, including aider and abettor liability.<sup>143</sup> In *Hochfelder*, the Court ruled that an accounting firm could not be held liable under section 10(b) and Rule 10b-5 absent a showing of scienter. By way of a footnote, the Court stated:

In view of our holding that an intent to deceive, manipulate, or defraud is required for civil liability under section 10(b) and Rule 10b-5, we need not consider whether civil liability for aiding and abetting is appropriate under the section and the Rule . . . .<sup>144</sup>

The Court looked to the word “manipulative” within section 10(b), stating that it “connotes intentional or willful conduct designed to deceive or defraud.”<sup>145</sup> Under a strict aiding and abetting theory it makes no difference whether the aider and abettor engaged in “intentional or willful conduct.” Some argued that this strict statutory approach implicitly invalidated the doctrine.<sup>146</sup>

After *Hochfelder*, courts began questioning the validity of the aiding and abetting theory.<sup>147</sup> Recently, both the Fifth and Seventh Circuit Courts of Appeals heightened the confusion concerning the doctrine. The Fifth Circuit Court of Appeals (“Fifth Circuit”) stated:

[I]t is now apparent that open-ended readings of the duty stated by Rule 10b-5 threaten to rearrange the congressional scheme. The added layer of liability . . . for aiding and abetting . . . is particularly problematic . . . . There is a powerful argument that . . . aider and abettor liability should not be enforceable by private parties pursuing an implied right of action.<sup>148</sup>

The Seventh Circuit, in effect, invalidated aider and abettor liability by holding that a defendant must actively commit a manipulative or

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143. See Fischel, *supra* note 29, at 82, 87. Fischel argued that in light of the Supreme Court’s strict statutory approach and emphasis on the text of federal securities statutes, all forms of secondary liability under those statutes are no longer viable. In the aftermath of the Court’s decision in *Central Bank*, Fischel’s prognostication has proven to be quite accurate.

144. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 191 n.7.

145. *Id.* at 199; see *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 868 (2d Cir. 1968) (Friendly, J. concurring), *cert. denied sub nom. Coates v. SEC*, 394 U.S. 976 (1969); Loss, *supra* note 10, at 884.

146. See Fischel, *supra* note 29, at 88.

147. See, e.g., *Benoay v. Decker*, 517 F. Supp. 490, 495 (E.D. Mich. 1981), *aff’d*, 735 F.2d 1363 (6th Cir. 1984) (stating that it was “doubtful that a claim for ‘aiding and abetting’ . . . will continue to exist under § 10(b)”)”; see also *Little v. Valley Nat’l Bank*, 650 F.2d 218, 220 n.3 (9th Cir. 1981) (declaring that the “status of aiding and abetting as a basis for liability under the securities laws is in some doubt”).

148. *Akin v. Q-L Invs., Inc.*, 959 F.2d 521, 525 (5th Cir. 1992).

deceptive act to be liable under section 10(b).<sup>149</sup> In addition, the Ninth Circuit Court of Appeals ("Ninth Circuit") raised serious questions about the doctrine's validity in light of the Supreme Court's adherence to strict statutory construction of the securities laws by noting:

[A]iding and abetting and other 'add-on' theories of liability have been justified by reference to the broad policy objectives of the securities acts . . . . The Supreme Court has rejected this justification for an expansive reading of the statutes and instead prescribed a strict statutory construction approach to determining liability under the acts.<sup>150</sup>

It has been suggested that the Court's decision in *Central Bank* may have been a response to the questions posed by the various circuit courts.<sup>151</sup>

Although the Court invalidated aiding and abetting liability only under section 10(b), the use of the doctrine under other provisions where courts have recognized implied private remedies is now in jeopardy. Courts have applied the doctrine with respect to violations of section 5 of the Securities Act (illegal sale of unregistered stock),<sup>152</sup> section 12(2) of the Securities Act (materially misleading prospectus),<sup>153</sup> section 17 of the Securities Act (comparable anti-fraud provision),<sup>154</sup> and Rule 14a-9 (materially misleading proxy statement).<sup>155</sup> The "text-only" approach applied in *Central Bank* would likely invalidate aiding and abetting liability under these provisions as well. As the Court in *Central Bank* noted, the statutory text controls the definition of conduct, and this "bodes ill" for the imposition of aider and abettor

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149. See, e.g., *Barker v. Henderson*, Franklin, Starnes & Holt, 797 F.2d 490, 495 (7th Cir. 1986).

150. *SEC v. Seaboard Corp.*, 677 F.2d 1301, 1311 n.12 (9th Cir. 1982).

151. See Claudia MacLachlon, *High Court Hears Case on Private Securities Lawsuits*, 16 NAT'L L.J. 17 (1993).

152. See, e.g., *SEC v. Universal Major Indus. Corp.*, 546 F.2d 1044 (2d Cir. 1976), cert. denied, 434 U.S. 834 (1977); *Stern v. American Bankshares Corp.*, 429 F. Supp. 818 (E.D. Wis. 1977).

153. See, e.g., *Mabon, Nugent & Co. v. Borey*, 127 B.R. 727 (Bankr. S.D.N.Y. 1991); *Hill v. Equitable Bank*, 599 F. Supp. 1062 (D. Del. 1984). *But cf.* *Frymire v. Peat, Marwick, Mitchell & Co.*, 657 F. Supp. 889 (N.D. Ill. 1987) (holding that § 12(2) imposes liability only on sellers of securities); *Harrison v. Enventure Capital Group, Inc.*, 666 F. Supp. 473 (W.D.N.Y. 1987); *Farlow v. Peat, Marwick, Mitchell & Co.*, 666 F. Supp. 1500 (W.D. Okla. 1987), *aff'd*, 956 F.2d 982 (10th Cir. 1992); *Hagert v. Glickman, Lurie, Eiger & Co.*, 520 F. Supp. 1028 (D. Minn. 1981).

154. See, e.g., *Cleary v. Perfectune*, 700 F.2d 774 (1st Cir. 1983); *Little v. Valley Nat'l Bank*, 650 F.2d 218 (9th Cir. 1981); *SEC v. Cooper*, 402 F. Supp. 516 (S.D.N.Y. 1975).

155. See, e.g., *Lazzarro v. Manber*, 701 F. Supp. 353 (E.D.N.Y. 1988); *Leff v. CIP Corp.*, 540 F. Supp. 857 (S.D. Ohio 1982).

liability under the above-referenced provisions, for the language of those provisions does not mention aiding and abetting.

#### b. Conspiracy Liability

Conspiracy is a doctrine borrowed from the criminal and tort law that the federal courts have applied to fraud claims under section 10(b).<sup>156</sup> In fact, *Kardon v. National Gypsum Co.*,<sup>157</sup> where a private right of action under section 10(b) was first recognized, involved an allegation of conspiracy. Used primarily in the "sale of control" cases, conspiracy is a form of secondary liability that reaches peripheral defendants if they "conspired" with the primary violator.<sup>158</sup> Conspiracy can be distinguished from aiding and abetting by the former's prerequisite of an agreement.<sup>159</sup> To prove conspiracy the plaintiff must present evidence showing an agreement by two or more persons to engage in the proscribed conduct and that at least one overt act has been committed in furtherance of the agreement.<sup>160</sup> Any person who is a party to the conspiracy is legally responsible for the acts taken by co-conspirators in furtherance of the conspiracy.<sup>161</sup>

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156. See Fischel, *supra* note 29, at 85; Kuehnle, *supra* note 28, at 343.

157. 69 F. Supp. 512 (E.D. Pa. 1946).

158. See Kuehnle, *supra* note 28, at 343. Kuehnle notes that some plaintiffs have confused conspiracy with other substantive violations such as a "scheme." This concept is best illustrated in *United States v. Read*, 658 F.2d 1225 (7th Cir. 1981), where the Seventh Circuit stated:

A scheme to defraud and conspiracy embrace analogous, but not identical, concepts . . . . The elements of the offenses are, however, different. The predicate for liability for conspiracy is an agreement . . . . Mail and securities fraud, on the other hand, punish the *act* of using the mails or the securities exchanges to further a scheme to defraud . . . . As an aider and abettor, Spiegel need not agree to the scheme. He need only associate himself with the criminal venture and participate in it.

*Id.* at 1239-40 (citation omitted).

It has been argued that a "scheme to defraud" may be within the scope of a "deceptive device or contrivance" in the text of § 10(b) and, therefore, may be a viable alternative to impose liability on peripheral actors who, prior to *Central Bank*, were found liable under the aiding and abetting theory. See Harold S. Bloomenthal, 16 Sec. & Fed. Corp. L. Rep. (Clark Boardman), No. 8, at 149 (August 1994).

159. See Ruder, *supra* note 26, at 627. Ruder discusses conspiracy in the criminal context and relies upon *Pinkerton v. United States*, 328 U.S. 640 (1946), where Justice Rutledge distinguished conspiracy from aiding and abetting by stating:

The gist of conspiracy is the agreement; that of aiding, abetting or counseling is in consciously advising or assisting another to commit particular offenses, and thus becoming a party to them; that of substantive crime, going a step beyond mere aiding, abetting, counseling to completion of the offense.

328 U.S. at 649.

160. See Kuehnle, *supra* note 28, at 346.

161. See Kuehnle, *supra* note 28, at 346.

Liability for the acts of co-conspirators can enlarge the scope of damages beyond that imposed by aider and abettor liability because a defendant can be held liable for acts that occurred prior to his joining the conspiracy.<sup>162</sup> Likewise, a defendant can be held liable for the acts of others even after the commission of the defendant's last act.<sup>163</sup> If the statute of limitations has run on the defendant's act, he still may be liable for the acts of his co-conspirators.<sup>164</sup> For example, in the context of a "sale of control" case, the Seventh Circuit held that the defendant, who had resigned as a director and sold his stock prior to a fraudulent merger, was nevertheless liable as a conspirator.<sup>165</sup> The court stated:

[The Defendant's] sale of his stock and his resignation as a director were allegedly two of the overt acts done by him in furtherance of the conspiracy. Thus, having allegedly joined the conspiracy and taken steps to assure its success, [the Defendant] is responsible for the acts of his co-conspirators in furtherance of said conspiracy.<sup>166</sup>

To date, the conspiracy theory under section 10(b) has been used relatively seldom, primarily due to the wide acceptance of aider and abettor liability.<sup>167</sup> Given the Court's restrictive approach in *Central Bank*, the conspiracy theory is not likely to be a viable alternative to aiding and abetting liability. Neither the text nor the legislative history of section 10(b) refer to conspiracy liability; therefore, it appears that the concern expressed by the dissent in *Central Bank* that the Court's decision "would sweep away the decisions recognizing that a defendant may be found liable . . . for conspiring to violate section 10(b) . . ."<sup>168</sup> is well-founded.

### c. Controlling Person Liability

Section 15 of the Securities Act<sup>169</sup> and section 20(a) of the Exchange Act<sup>170</sup> expressly provide for the imposition of liability upon those

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162. Kuehnle, *supra* note 28, at 344 n.175; see, e.g., *In re Nissan Motor Corp. Antitrust Litig.*, 430 F. Supp. 231, 233 (S.D. Fla. 1977).

163. Kuehnle, *supra* note 28, at 344 n.175.

164. See, e.g., *United States v. Read*, 658 F.2d 1225, 1231-40 (7th Cir. 1981).

165. *Dasho v. Susquehanna Corp.*, 380 F.2d 262 (7th Cir. 1967), *cert. denied*, 389 U.S. 977 (1967).

166. *Id.* at 267 n.2.

167. See *Langevoort Testimony*, *supra* note 6, at 4. But see *U.S. Indus. v. Touche Ross & Co.*, 854 F.2d 1223, 1231 (10th Cir. 1988); *SEC v. Coffey*, 493 F.2d 1304, 1316 (6th Cir. 1974); *Ferguson v. Omnimedia, Inc.*, 469 F.2d 194, 197-98 (1st Cir. 1972); *Shell v. Hensley*, 430 F.2d 819, 827 n.13 (5th Cir. 1970).

168. *Central Bank v. First Interstate Bank*, 114 S. Ct. 1439, 1460 n.12 (1994) (Stevens, J., dissenting).

169. Section 15 of the Securities Act, 15 U.S.C. § 77o (1988), provides:

persons who “control” the person who violates any provision of each respective act. Section 15 of the Securities Act imposes vicarious liability on those persons who “control” a person who substantively violates section 11 (misrepresentations in a registration statement),<sup>171</sup> section 12(1) (unlawful sale of unregistered securities),<sup>172</sup> section 12(2) (materially misleading prospectus),<sup>173</sup> as well as other provisions in the Securities Act. Section 20(a) of the Exchange Act imposes vicarious liability on the person who “controls” a person who substantively violates Rule 10b-5 (fraud using means of interstate commerce),<sup>174</sup> Rule 14a-9 (fraud in connection with proxy solicitations),<sup>175</sup> and section 18(a) of the Exchange Act (misrepresentations in documents filed with the SEC).<sup>176</sup>

In *Lanza v. Drexel & Co.*,<sup>177</sup> the Second Circuit attempted to define the boundaries of who is a “controlling person” under section 20(a) in the context of whether a certain board member was culpable for the conduct of a corporate officer. The court imposed liability on the director and in doing so held that absent direct participation in the fraud, liability can only be imposed on persons “who in some meaningful sense are culpable participants in the fraud perpetrated.”<sup>178</sup>

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Every person who, by or through stock ownership, agency or otherwise, or who, pursuant to or in connection with an agreement or understanding with one or more persons by or through stock ownership, agency, or otherwise, controls any person liable under Section 11 or 12 . . . shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person had no knowledge of or reasonable ground to believe in the existence of facts by reason of which the liability of the controlled person is alleged to exist.

*Id.*

170. Section 20(a) of the Exchange Act, 15 U.S.C. § 78t(a) (1988), provides: Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.

*Id.*

171. 15 U.S.C. § 77k (1988).

172. 15 U.S.C. § 77l(1) (1988).

173. 15 U.S.C. § 77l(2) (1988).

174. 17 C.F.R. § 240.10b-5 (1994).

175. 17 C.F.R. § 240.14a-9 (1994).

176. 15 U.S.C. § 78r (1988).

177. 479 F.2d 1277 (2d Cir. 1973).

178. *Id.* at 1299. The Second Circuit must have intended something less than actual participation, the existence of which would eliminate the necessity of relying upon



The Ninth Circuit, in *Hollinger v. Titan Capital Corp.*,<sup>179</sup> seemingly commingled the “culpable participant” standard with the underlying consideration of control, holding absolutely that a “broker-dealer is a controlling person under section 20(a) with respect to its registered representatives.”<sup>180</sup> However, the Seventh Circuit has positioned itself somewhere in the middle of the Second and Ninth Circuits, interpreting the “culpable participant” standard to require that the defendant exercise some degree of control over the principal violator.<sup>181</sup> The Seventh Circuit overruled a lower court which applied the “culpable participant” standard, observing that “the district court used a test we have never approved, a test, the rigors of which contravene our prior holdings.”<sup>182</sup> Moreover, the court added, “nor have we construed [the determination of who is a controlling person under Section 20(a)] as broadly as the court in *Hollinger*.”<sup>183</sup>

Both section 15 and section 20(a) contain affirmative defenses to liability and although courts construe the defenses similarly, the provisions, at least technically, can be distinguished.<sup>184</sup> The section 15 defendant can avoid liability by affirmatively asserting and proving that “he had no knowledge of or reasonable ground[s] to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist.”<sup>185</sup> Under section 20(a) the controlling person can elude liability by proving that he didn’t induce the acts of the primary violators, either directly or indirectly, and that he acted in good faith.<sup>186</sup> A distinction can be drawn between the two provisions in that the section 15 defendant must prove that he was not negligent, while the section 20(a) defendant must prove that he acted in good faith. Courts have struggled with giving a definition to the “good faith” standard and, to date, the issue has not been resolved by the Supreme Court.<sup>187</sup> However, in *G. A.*

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§ 20(a) for the imposition of liability. See Harold S. Bloomenthal, *The Implications of Central Bank*, 16 Sec. & Fed. Corp. L. Rep. (Clark Boardman), No. 6, at 134 (June 1994).

179. 914 F.2d 1564 (9th Cir. 1990), *cert. denied*, 499 U.S. 976 (1991).

180. *Id.* at 1573.

181. *Harrison v. Dean Witter Reynolds, Inc.*, 974 F.2d 873 (7th Cir. 1992), *cert. denied*, 113 S. Ct. 2994 (1993).

182. *Id.* at 877.

183. *Id.* at 881.

184. See Bloomenthal, *supra* note 178, at 134.

185. 15 U.S.C. § 77o (1988).

186. 15 U.S.C. § 78t (1988).

187. The Court has used Section 20(a) to illustrate a state-of-mind requirement that is greater than negligence. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 208 n.26, *reh'g denied*, 425 U.S. 986 (1976).

*Thompson & Co. v. Patridge*,<sup>188</sup> the Fifth Circuit declared that “a negligence standard is inappropriate” and held that “recklessly” failing to supervise or monitor the conduct of the principal violator is actionable.<sup>189</sup>

Several circuit courts have concluded that section 20(a)'s controlling person liability is not exclusive and does not preclude the imposition of liability under section 10(b) and Rule 10b-5 pursuant to the common law tort doctrine of respondeat superior.<sup>190</sup> These courts have viewed section 20(a) as inadequate when the controlling person has acted in good faith but nevertheless put the primary violator in a position to commit fraud.<sup>191</sup> In light of *Central Bank*, the future application of the common law doctrine of respondeat superior is questionable.

The Fifth Circuit relied heavily on policy considerations in *Paul F. Newton & Co. v. Texas Commerce Bank*,<sup>192</sup> holding that section 20(a) was not the exclusive form of secondary liability under the Exchange Act. The Court noted that neither the legislative history of section 15 nor section 20(a) reveals whether Congress “intended to supplant common law agency principles for determining secondary liability or simply to expand the group of persons secondarily liable for violations of the Securities Act by imposing liability on certain

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188. 636 F.2d 945 (5th Cir. 1981).

189. *Id.* at 959-60.

190. See, e.g., *Hollinger v. Tital Capital Corp.*, 914 F.2d 1564, 1576-77 (9th Cir. 1990), *cert. denied*, 499 U.S. 976 (1991); *In re Atlantic Fin. Mgmt., Inc.*, 784 F.2d 29, 31 (1st Cir. 1986), *cert. denied sub nom. AZL Resources, Inc. v. Margaret Hall Found., Inc.*, 481 U.S. 1072 (1987); *Commerford v. Olson*, 794 F.2d 1319, 1323 (8th Cir. 1986); *Marbury Mgmt., Inc. v. Kohn*, 629 F.2d 705, 713 (2d Cir. 1980), *cert. denied*, 449 U.S. 1011 (1980); *Paul F. Newton & Co. v. Texas Commerce Bank*, 630 F.2d 1111, 1118-19 (5th Cir. 1980), *reh'g denied*, 634 F.2d 1355 (5th Cir. 1980); *Hollaway v. Howerdd*, 536 F.2d 690, 694-95 (6th Cir. 1976); *Carras v. Burns*, 516 F.2d 251, 259 (4th Cir. 1975); *Fey v. Walston & Co.*, 493 F.2d 1036, 1052-53 (7th Cir. 1974); *Kerbs v. Fall River Indus., Inc.*, 502 F.2d 731, 740-41 (10th Cir. 1974). The Third Circuit has recognized the application of the doctrine in certain circumstances. *Compare Rochez Bros. v. Rhoades*, 527 F.2d 880, 885-86 (3d Cir. 1975), *cert. denied*, 425 U.S. 993 (1976) with *Sharp v. Coopers & Lybrand*, 649 F.2d 175, 180-84 (3d Cir. 1981), *cert. denied*, 455 U.S. 938 (1982). The common law doctrine of respondeat superior holds employers strictly liable for the acts of their employees if those acts were committed within the scope of employment. *RESTATEMENT (SECOND) OF AGENCY* § 257 (1958); 502 F.2d at 740-41.

191. See *Langevoort Testimony*, *supra* note 6, at 4. *Langevoort* argues that respondeat superior may have continued validity after *Central Bank* in part because “[r]espondeat superior is a central tenant of tort law, in contrast to the insignificant status the Court found for aiding and abetting [in] the common law scheme.” *Langevoort Testimony*, *supra* note 6, at 4.

192. 630 F.2d 1111, 1115 (5th Cir. 1980), *reh'g denied*, 634 F.2d 1355 (5th Cir. 1980).

'controlling persons' who might not be liable under common law principles."<sup>193</sup>

Although the Court in *Central Bank* stated that "the interpretation given by one Congress . . . to an earlier statute is of little assistance in discerning the meaning of that statute,"<sup>194</sup> support for the incorporation of respondeat superior can be found in the legislative history of the Insider Trading and Securities Fraud Enforcement Act of 1988 ("Insider Trading Act").<sup>195</sup> Congress expressly excluded respondeat superior liability in two provisions in the Insider Trading Act regarding the liability of employers resulting from the trading of securities by their employees.<sup>196</sup> However, Congress stated in the legislative history that "the legislation does not effect the applicability of the respondeat superior theory in [SEC] action or under the federal securities laws generally."<sup>197</sup> Furthermore, the Exchange Act does include a savings clause that states: "The rights and remedies provided by this subchapter shall be in addition to any and all other rights and remedies that may exist at law or in equity."<sup>198</sup> This provision arguably illustrates Congress's rejection of the notion that the express remedies of the securities laws would preempt all other rights of action<sup>199</sup> and supports the recognition of respondeat superior liability under section 10(b).

Nevertheless, given the fact that the doctrine of respondeat superior is not expressed within the text of section 10(b) and because application of the doctrine is seemingly inconsistent with the expressed language of section 20(a), the validity of the doctrine is in doubt. A textual argument can be made, however, that section 10(b)'s reference to any "person" expressly includes "companies" as well as natural persons via the definition of the term in section 3(a)(9) in the Exchange Act.<sup>200</sup>

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193. *Id.*

194. *Central Bank v. First Interstate Bank*, 114 S. Ct. 1439, 1452 (1994) (quoting *Public Employees Retirement Sys. v. Betts*, 492 U.S. 158, 168 (1989)); See *Weinberger v. Rossi*, 456 U.S. 25, 35 (1982).

195. Pub. L. No. 100-704, 102 Stat. 4677 (1988). The Insider Trading Act added new § 20A (15 U.S.C. § 78t-1 (1988)) and § 21A (15 U.S.C. § 78u-1 (1988)) to the Exchange Act. Section 20A provides that any person who trades a security while in possession of material nonpublic information regarding that security is liable to any person who was "contemporaneously" trading the security on the other side of the market. Section 21A authorizes the SEC to seek civil penalties against such person in amount equal to three times the amount of profit realized or loss avoided by the trade.

196. See 15 U.S.C. § 78t-1(b)(3) (1988); 15 U.S.C. § 78u-1(b)(1) (1988).

197. H.R. REP. NO. 910, 100th Cong., 2d Sess. 27 n.23 (1988) (citations omitted).

198. Section 28(a) of the Exchange Act, 15 U.S.C. § 78bb(a) (1988).

199. *Herman & MacLean v. Huddleston*, 459 U.S. 375, 383 (1983).

200. See *Langevoort Testimony*, *supra* note 6, at 4.

By implication, it can be argued that Congress must have intended some form of agency ascription in order to give effect to the definition of "person." This argument, however, is not likely to prevail. The majority in *Central Bank* held that with respect to the "scope of conduct prohibited by section 10(b), the text of the statute controls our decision."<sup>201</sup> The terms "deceptive" or "manipulative" in section 10(b) have been interpreted by the Court as requiring some degree of fault.<sup>202</sup> Respondeat superior, as traditionally applied, is a doctrine that imposes strict liability on the principal apart from the showing of any culpability.<sup>203</sup> Therefore, the doctrine is substantively inconsistent with the express language of the statute. Furthermore, the recognition of the doctrine by lower federal courts has effectively read section 20(a) out of the Exchange Act, which undoubtedly was not the intent of Congress. Therefore, it is reasonable to conclude that the term "person" as it is defined in section 3(a)(9) was merely intended to expand the category of persons that could be held primarily liable under section 10(b) and not to impose vicarious liability on persons who have not engaged in conduct proscribed by the statute. As the Court in *Central Bank* stated, Congress knew how to impose aider and abettor liability when it wanted. So also does Congress know how to impose respondeat superior liability, and it did not do so within the text of section 10(b).

#### 4. Scope of Conduct

There is no doubt that the scope of conduct proscribed by section 10(b) was restricted in *Central Bank*. However, the impact this restriction will have on litigation under section 10(b) is not clear. For almost two decades the Supreme Court, applying a strict statutory approach, has restricted the scope of conduct under section 10(b), only to have the lower federal courts expand the scope under different theories or standards.<sup>204</sup> For example, in *Hochfelder*, the Court held a showing of scienter was required to sustain an action under section 10(b).<sup>205</sup> The lower courts expanded the use of "recklessness" to satisfy this requirement.<sup>206</sup> In *Santa Fe Industries v. Green*,<sup>207</sup> the Court held that

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201. 114 S. Ct. at 1446.

202. See *Ruder Testimony*, *supra* note 6, at 13. Ruder states: "In view of the extensive legislative and jurisprudential attention to the doctrine of fault or culpability in the federal securities laws, the doctrine of respondeat superior should not be applicable under Rule 10b-5." *Rader Testimony*, *supra* note 6, at 13.

203. *Rader Testimony*, *supra* note 6, at 13.

204. See *Langevoort Testimony*, *supra* note 6, at 1.

205. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976).

206. See *supra* notes 85-91 and accompanying text.

207. 430 U.S. 462 (1977).

“breaches of fiduciary duty by a majority against minority shareholders without any charge of misrepresentation or lack of disclosure” does not violate section 10(b).<sup>208</sup> The lower courts expanded the scope of conduct under the theory that fiduciary breaches were actionable as long as the breach was concealed from shareholders and could have been remedied in state court.<sup>209</sup> In *Chiarella v. United States*, the Court required an independent duty of disclosure for insider trading liability.<sup>210</sup> The lower courts countered with a misappropriation theory of liability.<sup>211</sup>

Again, the path is clear for the lower courts to moderate the ruling in *Central Bank*. The phrase “directly or indirectly” in the text of section 10(b) could be the lower courts’ cornerstone to expand the scope of conduct to cover those defendants once charged with aiding and abetting.<sup>212</sup> Even the majority in *Central Bank* concluded that the scope of conduct covered by section 10(b) need not be narrow, stating:

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 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 section 10(b), assuming *all* of the requirements for primary liability under Rule 10b-5 are met.<sup>213</sup>

Courts have given little attention to the distinction between “indirect” primary and secondary liability under section 10(b).<sup>214</sup> The

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208. *Id.* at 470 (quoting *Green v. Santa Fe Indus.*, 533 F.2d 1283, 1287 (2d Cir. 1976)).

209. *See, e.g.,* *Goldberg v. Meridor*, 567 F.2d 209, 225 (2d Cir. 1977), *cert. denied*, 434 U.S. 1069 (1978) (Meskill, J., concurring in part and dissenting in part) Judge Meskill stated:

Those who breach their fiduciary duties seldom disclose their intentions ahead of time. Yet under the majority’s reasoning the failure to inform stockholders of a proposed defalcation gives rise to a cause of action under 10b-5. Thus, the majority has neatly undone the holdings of *Green . . .* by creating a federal cause of action for a breach of fiduciary duty that will apply in all cases, save for those rare instances where the fiduciary denounces himself in advance.

*Id.*

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

211. *See, e.g.,* *Carpenter v. United States*, 484 U.S. 19 (1987); *SEC v. Materia*, 745 F.2d 197 (2d Cir. 1984), *cert. denied*, 471 U.S. 1053 (1985).

212. *See Goldschmid Testimony*, *supra* note 6, at 6.

213. 114 S. Ct. at 1455.

214. *See* 5B ARNOLD JACOBS, LITIGATION AND PRACTICE UNDER RULE 10b-5 § 40 (rev. ed. 1993); *see also Langevoort Testimony*, *supra* note 6, at 2.

line between the two has been characterized as “indistinct” and “virtually nonexistent.”<sup>215</sup> In fact, the Fifth Circuit recently stated that the imposition of aiding and abetting liability in some cases has been illusory, declaring that the defendant’s conduct is better described in terms of primary liability.<sup>216</sup> Although the Court in *Central Bank* indicated that not every allegation of aiding and abetting could be recast in terms of primary liability, the relatively few lower court decisions addressing the issue show that “indirect” primary liability could potentially have an exceedingly broad scope.<sup>217</sup>

Clearly, any person who makes a material misstatement directly to investors may be a primary violator of section 10(b).<sup>218</sup> For example, the accountant who certifies an issuer’s financial statements or the attorney who writes an opinion that he knows contains materially false information may be primarily liable. In each instance the investor relies not only on the financial statements or opinion but upon the credibility of the source.<sup>219</sup>

The more complex issue requiring a finer distinction is the availability of imposing primary liability on those participants who merely prepare the issuer’s disclosure documents. Consider the Ninth Circuit’s decision in *Wool v. Tandem Computers, Inc.*,<sup>220</sup> where the court found that a group of corporate officers were primary violators of section 10(b), reasoning that through concerted action the officers caused the issuer to disseminate a materially misleading press release.<sup>221</sup> The distinction was also analyzed in *Molecular Technology Corp. v. Valentine*,<sup>222</sup> where the Sixth Circuit found an attorney primarily liable

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215. See *supra* note 28 and accompanying text.

216. See *supra* note 148 and accompanying text.

217. *Goldschmid Testimony*, *supra* note 6, at 6. Goldschmid states that courts will be confronted, at best, with years of wasteful litigation before “indirect” primary liability recaptures the ground once occupied by aider and abettor liability. *Goldschmid Testimony*, *supra* note 6, at 6. Some courts have determined that under Section 5 of the Securities Act (i.e., 15 U.S.C. § 77e (1988)), the defendant must be a “necessary and substantial” participant in an unregistered sale of securities to be liable as a primary violator. See, e.g., *SEC v. Holschuh*, 694 F.2d 130, 139-42 (7th Cir. 1982). Some courts may employ this test in the context of § 10(b) also.

218. See *Langevoort Testimony*, *supra* note 6, at 2.

219. See, e.g., *Ackerman v. Schwarts*, 947 F.2d 841 (7th Cir. 1991) (holding that investors in a tax shelter scheme could proceed with § 10(b) claim against an attorney who wrote opinion letter for the offering literature); see also *Commercial Discount Corp. v. Lincoln First Commercial Corp.*, 445 F. Supp. 1263 (S.D.N.Y. 1978) (allowing a § 10(b) action against accountants based upon plaintiffs’ reliance on unqualified certification of bankrupt company’s books).

220. 818 F.2d 1433 (9th Cir. 1987).

221. *Id.* at 1440.

222. 925 F.2d 910, 917-18 (6th Cir. 1991).

for merely reviewing and editing disclosure materials of the issuer.<sup>223</sup>

What about corporate insiders, attorneys, accountants, or bankers who play no role in the preparation of disclosure materials, but who are aware of their falsity and otherwise assist the issuer? Are these persons primarily liable under section 10(b)? Possibly, if they owe an affirmative duty to disclose the false information to investors. Several courts have found that such a duty exists when it is shown that the investors have reasonably relied upon these peripheral actors for the truth.<sup>224</sup> In *Chiarella*, the Supreme Court stated that nondisclosure of a material fact is actionable only if "such liability is premised upon a duty to disclose arising from a relationship of trust and confidence . . . ."<sup>225</sup> In *Arthur Young & Co. v. Reves*,<sup>226</sup> the Eighth Circuit Court of Appeals ("Eighth Circuit"), citing *Chiarella*, held:

A relationship for purposes of Rule 10b-5 liability . . . requires neither a "physical presence nor face to face conversation." Rather, whether a relationship exists that gives rise to a duty to disclose depends on the circumstances of the individual case. The Fifth, Ninth, and Eleventh Circuits have established a number of factors to be used in evaluating those circumstances, including (1) the parties' relative access to the information; (2) the benefit the defendant derives from . . . [the transaction]; (3) the defendant's awareness of the plaintiff's reliance on the defendant in making investment decisions; and (4) the defendant's role in initiating the sale. In addition, the Eleventh Circuit also considers (5) the extent of the defendant's knowledge; (6) the significance of the nondisclosure; and (7) the extent of the defendant's participation in the fraud.<sup>227</sup>

Such a test could easily be applied to peripheral actors who remain silent in the face of the securities fraud of their associates. However, the courts' increased emphasis on culpability when the defendant is remote from the fraud will likely remain. Even under the pre-*Central Bank* scheme, aiders and abettors often incurred liability only when

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223. *Id.*; see also *Breard v. Sachnoff & Weaver Ltd.*, 941 F.2d 142 (2d Cir. 1991); *In re Rospach Sec. Litigation*, 802 F. Supp. 110 (W.D. Mich. 1992), *aff'd sub nom.* *Atlantis Group, Inc. v. Warner, Norcross & Judd*, 28 F.3d 1213 (6th Cir. 1994).

224. See, e.g., *Arthur Young & Co. v. Reves*, 937 F.2d 1310, 1329-31 (8th Cir. 1991), *cert. denied*, 112 S. Ct. 1165 (1992).

225. *Chiarella v. United States*, 445 U.S. 222, 230 (1980).

226. 937 F.2d 1310 (8th Cir. 1991), *cert. denied*, 112 S. Ct. 1165 (1992).

227. *Id.* at 1329-31 (citations omitted).

“engage[d] in conduct that intentionally misleads or lulls . . . [the] victim.”<sup>228</sup>

It is clear that the majority in *Central Bank* was concerned about the uncertainty and excessiveness of litigation under Rule 10b-5, asserting that “the rules for determining aiding and abetting liability are unclear, in ‘an area that demands certainty and predictability.’”<sup>229</sup> However, from a practical standpoint, the Court has exacerbated the uncertainty of liability under the provision. The distinction between being “indirectly” engaged in proscribed conduct and merely aiding another party’s proscribed conduct is sure to create a vast vacuum that aggressive plaintiffs’ counsel and some lower courts are sure to fill. Consequently, the prediction that the scope of conduct covered under section 10(b) and Rule 10b-5 will be greatly restricted is unwarranted. The decision is more likely to only alter the form and language in which liability is cast.<sup>230</sup>

### III. THE RESPONSE TO CENTRAL BANK

#### A. The Court’s Invitation

The reaction to the Court’s decision in *Central Bank* was either one of euphoria or despair, depending upon one’s perspective. Some believe that the decision is likely to draw a response from Congress.<sup>231</sup> The Court clearly invited congressional review by stating:

To be sure, aiding and abetting a wrongdoer ought to be actionable in certain instances. The issue however, is not whether imposing private civil liability on aiders and abettors is good policy but whether aiding and abetting is covered by the statute.<sup>232</sup>

One major law firm sent out a memo to its clients three days after the decision warning:

There are reports that legislation will be introduced in Congress in response to the Court’s decision. Therefore, those clients who

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228. IX LOUIS LOSS & JOEL SELIGMAN, *SECURITIES REGULATION* 4486 (3d ed. 1992); see also *K&S Partnership v. Continental Bank*, 952 F.2d 971, 980 (8th Cir. 1991), cert. denied, 112 S. Ct. 2993 (1992).

229. 114 S. Ct. at 1454 (quoting *Pinter v. Dahl*, 486 U.S. 622, 652 (1988)).

230. Instead of pleading that a defendant aided and abetted the securities fraud, complaints will be cast in terms alleging that the defendant, himself, indirectly participated in the securities fraud.

231. See Marianne Lavelle, *Lawyers and Accountants Hail Dodd-Domenici Bill; After the Central Bank Decision, Lobbying Heats Up for a Law Aimed at Curbing Some Investor Securities Suits*, NAT’L L.J., May 9, 1994, at B1.

232. 114 S. Ct. at 1448 (citation omitted).



are defendants in Section 10(b) cases involving private claims that allege aiding and abetting should *immediately* seek a final judgment dismissing those claims to minimize the impact of new legislation.<sup>233</sup>

Indeed, prior to *Central Bank*, Senators Dodd<sup>234</sup> and Domenici<sup>235</sup> had already introduced a reform bill, the Private Securities Litigation Reform Act of 1994 ("Act"),<sup>236</sup> which some view as being "dressed up in anti-lawyer rhetoric [but] more accurately . . . seen as anti-investor in nature."<sup>237</sup>

On May 12, 1994, the Senate Subcommittee on Securities, a subcommittee of the Senate Committee on Banking, Housing, and Urban Affairs, held a hearing concerning the *Central Bank* decision. Several experts testified as to the alternatives Congress should consider in determining whether to respond to the decision.<sup>238</sup> Opinions were mixed, but most agreed that Congress should not pursue a "quick fix" by passing piecemeal legislation aimed only at addressing *Central Bank*. Instead, Congress should comprehensively review the entire liability scheme.<sup>239</sup> It appears that Congress will do so in the context of debate over the Act. The Act, in its present form, does not contain a provision to overrule the Court's decision in *Central Bank*. At the hearing, Senator Metzenbaum<sup>240</sup> stated that language to that effect had already been drafted, but that he would refrain from offering it as an amendment until the effects of *Central Bank* could be fully evidenced.<sup>241</sup> However, Senator Metzenbaum cautioned against

233. See *Metzenbaum Testimony*, *supra* note 6, at 2.

234. Senator Christopher J. Dodd is a Democrat from Connecticut. He was elected in 1980 and is the Chairman of Subcommittee on Securities of the Committee on Banking, Housing and Urban Affairs. He is also a member of Budget, Foreign Relations, Labor and Human Resources, and Rules and Administrative Committees.

235. Senator Pete V. Domenici is a Republican from New Mexico. He was elected in 1972 and is a member of Subcommittee on Securities of the Committee on Banking, Housing and Urban Affairs. He is also a member of Appropriations, Budget, Energy and National Resources, and Select Indian Affairs Committees.

236. S. 1976, the "Private Securities Litigation Reform Act of 1994" [hereinafter "*The Act*"], introduced on March 24, 1994, by Senators Dodd and Domenici.

237. See *NASAA Testimony*, *supra* note 6, at 6.

238. See *supra* note 6.

239. See *SIA Testimony*, *supra* note 6, at 15; *Langevoort Testimony*, *supra* note 6, at 7; *Goldman Testimony*, *supra* note 6, at 1-2. But see *NASAA Testimony*, *supra* note 6, at 10 ("NASAA respectfully encourages Congress to enact limited legislation to reverse the Supreme Court's Central Bank Decision."); *Goldschmid Testimony*, *supra* note 6, at 8 ("Congress should, as expeditiously as practicable — legislatively overrule *Central Bank* . . .").

240. Senator Howard M. Metzenbaum is a Democrat from Ohio. He was elected in 1976 and is a member of Environment and Public Works, Judiciary, Labor and Human Resources, and Select Intelligence Committees.

241. On July 21, 1994, Senator Metzenbaum introduced Senate Bill S. 2306, the

procrastination stating, “[D]elay can be so costly that I will find a legislative vehicle if this committee does not see fit to act promptly.”<sup>242</sup>

Following is a brief overview of some of the Act’s controversial provisions, a description of the substantive law the Act would modify, and the possible consequences of the Act’s passage.<sup>243</sup>

## B. Private Securities Litigation Reform Act of 1994

### 1. Joint and Several Liability

Under existing law, each defendant in a Rule 10b-5 action, whether primarily or secondarily responsible for violating the Rule, is jointly and severally liable for damages resulting from the violation.<sup>244</sup> In theory, the effect of joint and several liability under Rule 10b-5 has been offset somewhat by the Court’s recognition of a right of contribution in *Musick, Peeler & Garret v. Employers Ins. of Wausau*.<sup>245</sup> However, in reality, the key fraudulent actor is often defunct or bankrupt, and the plaintiff is left pursuing peripheral actors, such as attorneys, accountants, and other professionals, for recovery.<sup>246</sup>

As expressed by opponents of the Act, the rationale supporting the imposition of joint and several liability is that the fraud would have failed if one of the actors revealed its existence; therefore, all

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“Securities Fraud Fairness Act.” Section 2 of the Act would amend Section 10(b) of the Exchange Act by inserting “or to aid and abet the use or employment of any manipulative or deceptive device or contrivance,” before “in contravention” within the text of Section 10(b).

242. See *Metzenbaum Testimony*, *supra* note 6, at 3.

243. The Act contains several provisions not discussed in this Article. These provisions include, but are not limited to, the elimination of certain abusive practices (i.e., prohibition on the receipt of referral fees by broker-dealers, prohibition on the receipt of attorney’s fees paid from SEC disgorgement funds, limitations on attorney’s fees from private litigation settlement funds, prohibition on disproportionate share of recovery by the named plaintiff in a class action suit, and provisions for the disqualification of attorneys with conflicts of interest). The Act also contains an alternative dispute resolution procedure, a provision to establish guardians ad litem and class action steering committees, a safe-harbour provision for forward looking statements, and a section regarding fraud detection and disclosure. Furthermore, the Act would establish the Public Auditing Self-Disciplinary Board which would be charged with overseeing the regulation of public accounting firms.

244. See 5D ARNOLD JACOBS, LITIGATION AND PRACTICE UNDER RULE 10b-5 § 260.03(j) (rev. ed. 1993).

245. 113 S. Ct. 2085 (1993).

246. See Jennifer H. Arlen & William J. Carney, *Vicarious Liability For Fraud on Securities Markets: Theory and Evidence*, 1992 U. ILL. L. REV. 691. Arlen and Carney illustrate that securities fraud has a tendency of occurring in “final period” settings when management fears possible insolvency and job loss, and as a consequence are willing to assume greater legal risks.

actors are equally culpable if the fraud succeeds.<sup>247</sup> This concept is derived from common law tort tenets as illustrated by the Third Circuit Court of Appeals in *Gould v. American-Hawaiian Steamship Co.*<sup>248</sup> In that case, the court held directors jointly and severally liable where they failed to fully and fairly disclose material facts in proxy materials and declared:

Where two or more persons fail to perform a common duty each is liable for the entire harm resulting from the breach . . . . As joint tortfeasors they are jointly and severally liable for the plaintiffs' entire damage which they have inflicted . . . and this is true even though one of the tortfeasors held liable has received no benefit from his wrongdoing.<sup>249</sup>

The Act restricts the imposition of joint and several liability to persons who are either "primary wrongdoers" or who commit "knowing securities fraud." A "primary wrongdoer" is defined as any "issuer, registrant, purchaser, seller, . . . underwriter of securities, marketmaker . . . specialist in securities, clearing agency, securities information processor or government securities dealer if such person breached a direct statutory or regulatory obligation . . . ." <sup>250</sup> "Knowing securities fraud" can only be established if it is proven that a person "makes a material representation with *actual* knowledge that, as a result of the omission, one of the material representations is false" and "knows that the other persons are likely to rely on that misrepresentation or omission."<sup>251</sup> Consequently, the Act would codify a standard of culpability for attorneys and accountants more strict than even the Seventh Circuit's standard of recklessness.<sup>252</sup> An attorney's or accountant's extreme deviation from the standard of care would not

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247. See *NASAA Testimony*, *supra* note 6, at 6.

248. 535 F.2d 761 (3d Cir. 1976).

249. *Id.* at 778; see W. PAGE KEETON ET AL., *PROSSER AND KEETON ON THE LAW OF TORTS* § 52, at 345 (5th ed. 1984).

250. See *The Act*, *supra* note 236. Section 203(a) of the Act would add a proposed § 41(b)(2) which would define "primary wrongdoer."

251. See *The Act*, *supra* note 236. Section 203(a) would amend the Exchange Act by adding § 41. Proposed § 41(b)(2) defines "knowing securities fraud." Sections 41(b)(2)(A) and (B)(ii) contain provisions declaring that persons are either "primary wrongdoers" or persons engaging in "knowing securities fraud" if they "intentionally rendered substantial assistance to the fraudulent conduct," "with knowledge [of the conduct and] that such conduct was wrongful." These definitional sections presume the validity of aider and abettor liability. Yet, the Act does not amend § 10(b) to provide for such liability. This can be explained by the fact that the Act was introduced on March 24, 1994, while the Court did not decide *Central Bank* until April 19, 1994.

252. See *supra* text accompanying note 149.

suffice for the imposition of joint and several liability, but would subject such person only to proportionate liability "linked to degree of fault."<sup>253</sup>

The liability scheme proposed by the Act would shift the financial exposure from attorneys and accountants to the investing public. Competing arguments can be made for or against this shift in policy. The National Association of Securities Administrators Association (NASAA),<sup>254</sup> joined by various groups, most notably the American Association of Retired Persons, has argued, "If forced to choose between innocent investors who are victimized in a scheme and professionals who have knowingly or recklessly assisted the fraud by failing to meet professional standards, the risk of financial loss rightfully is borne by the professionals, and not the innocent victims."<sup>255</sup> However, Stuart J. Kaswell, the Senior Vice President and General Counsel of the Securities Industry Association, expressed a differing view in response to the *Central Bank* decision by stating, "[M]oreover, secondary liability, coupled with the securities laws' application of joint and several liability, could result in peripheral and incidental actors unfairly bearing the entire liability for the intentional fraud of others."<sup>256</sup>

Regardless of the hierarchy one places on these competing policy positions, the underlying rationale of imposing joint and several liability on peripheral participants under Rule 10b-5, as mentioned earlier, has been that the participant failed to reveal the existence of the fraud. Therefore, a requirement that the participant actually knew of the fraudulent scheme is entirely consistent with this rationale. Moreover, a continuation of joint and several liability may make it difficult for smaller and newer companies to attract and obtain competent legal and accounting services. As the Court stated in *Central Bank*, "[a] professional may fear that a newer or smaller company may not survive and that business failure would generate securities litigation against the professional, among others."<sup>257</sup>

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253. See Lavelle, *supra* note 231, at B1; see also *The Act*, *supra* note 236, § 203(d) (proposing revisions to § 41(d) of the Exchange Act).

254. NASAA has described itself as "the national voice of the 50 state securities agencies responsible for investor protection and the efficient functioning of the capital markets at the grassroots level." See Background Brief of NASAA, "Key Flaws in S. 1976, Proposed Securities Litigation Reform Bill," June 1994 (hereinafter *Brief of NASAA*).

255. See *Brief of NASAA*, *supra* note 254, at 7.

256. See *SIA Testimony*, *supra* note 6, at 8. Kaswell states that the present securities fraud class action system equates to a "litigation tax" on capital formation, which "drains funds that would otherwise be available to produce new products, expand plants, or hire more workers." *SIA Testimony*, *supra* note 6, at 6.

257. 114 S. Ct. at 1454. The National Venture Capital Association released a

## 2. Statute of Limitations.

Because there is no express statute of limitations within section 10(b), courts traditionally borrowed the statute of limitations from the most analogous state law. This limitation period was usually borrowed from the state's blue sky law fraud action.<sup>258</sup> In *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*,<sup>259</sup> the Supreme Court rejected that practice and held that the statute of limitations applicable to a private right of action under section 10(b) and Rule 10b-5 was one year after discovery of the facts constituting the violation, but within a maximum of three years after the violation occurred.<sup>260</sup>

The Act would extend the statute of limitations under section 10(b) to five years after the violation, but would impose a two-year limitation from the point in time the violation was discovered "or should have been discovered through the exercise of reasonable diligence."<sup>261</sup>

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survey of 212 publicly traded companies in March 1994, where it was found that more than one in six newer companies had been defendants in securities fraud suits. As of March 9, 1994, the suits had generated an average of 1,055 hours of management time each and \$692,000 in legal fees. See Brent Bowers & Vdayan Gupta, *Shareholder Suits Beset More Small Companies*, WALL ST. J., Mar. 9, 1994.

258. See, e.g., *Bath v. Bushkin*, Gains, Gains and Jonas, 913 F.2d 817 (10th Cir. 1990); *Smith v. Duff & Phelps, Inc.*, 891 F.2d 1567 (11th Cir. 1990); *Jensen v. Snellings*, 841 F.2d 600 (5th Cir. 1988); *Semegen v. Weidner*, 780 F.2d 727 (9th Cir. 1985); *Gurley v. Documentation Inc.*, 674 F.2d 253 (4th Cir. 1982); *Carothers v. Rice*, 633 F.2d 7 (6th Cir. 1980), *cert. denied*, 450 U.S. 998 (1981); *Cook v. Avien, Inc.*, 573 F.2d 685 (1st Cir. 1978); *Forrestal Village, Inc. v. Graham*, 551 F.2d 411 (D.C. Cir. 1977); *Vanderboom v. Sexton*, 460 F.2d 362 (8th Cir. 1972). *But see In re Data Access Sys. Sec. Litig.*, 843 F.2d 1537 (3d Cir. 1988) (holding that §§ 9(e) and 18(a) of the Exchange Act provide a closer analogy and adopted a statute of limitations one year from discovery and in no event more than three years from the violation of the statute), *cert. denied*, 488 U.S. 849 (1988). *In re Data Access* was followed by the Second Circuit in *Ceres Partners v. GEL Assocs.*, 918 F.2d 349 (2d Cir. 1990), and the Seventh Circuit in *Short v. Belleville Shoe Mfg. Co.*, 908 F.2d 1385 (7th Cir. 1990), *cert. denied*, 501 U.S. 1250 (1991).

259. 501 U.S. 350 (1991), *reh'g denied*, 501 U.S. 1277 (1991).

260. *Id.* at 364. However, on December 19, 1991, Congress amended the Exchange Act by adding § 27A, codified at 15 U.S.C. § 78aa-1(a) (Supp. V 1993), which limits the *Lampf* decision to proactive application by stating, "The limitation period for any private civil action implied under § 10(b) or this Act that was commenced on or before June 19, 1991 shall be the limitation period provided by the laws applicable in the jurisdiction, including principles of retroactivity, as such laws existed on June 19, 1991."

261. See *The Act*, *supra* note 236. Subsection 102(b) of the Act would amend the Exchange Act by adding § 37(a) which would create a new limitations period for private litigation under § 10(b). Several courts have judicially adopted a reasonable diligence or constructive notice standard regarding the tolling of the statute of limitations. See *Brumbaugh v. Princeton Partners*, 985 F.2d 157 (4th Cir. 1993); *Corwin v. Marney, Orton Invs.*, 843 F.2d 194 (5th Cir. 1988), *cert. denied*, 488 U.S.

As a matter of course, this constructive notice or reasonable diligence standard will be asserted by attorneys defending Rule 10b-5 cases. Instead of abrogating excessive and vexatious litigation, the reasonable diligence standard is sure to initiate even more litigation. The Supreme Court reiterated in *Central Bank* that litigation under section 10(b) “demands certainty and predictability.”<sup>262</sup> A “reasonable diligence” standard would demand a highly fact-oriented disposition and would exacerbate the costs of litigating section 10(b) claims. Former SEC Chairman Richard Breeden expressed opposition to the standard by saying, “A ‘reasonable diligence’ standard is unfair to fraud victims because almost every defendant can allege that a plaintiff ‘should have’ discovered a fraud earlier. Thus, this requirement would prompt a considerable amount of needless litigation to resolve subtle shadings of what an investor could or might have done.”<sup>263</sup>

The issues that arise with a reasonable diligence standard are potentially endless. Is the standard to be applied similarly to investors regardless of experience, sophistication, intellect or, education? Will courts develop differing standards for professionals? Will experts emerge to testify when the professional investor should have discovered the fraud? What qualifications must an expert possess? Will the courts always be required to hold a separate hearing on the statute of limitations? Seemingly, this trial within a trial, in the context most likely of a summary judgment proceeding, would be necessary because the defendant would be required to argue that fraud existed and that the plaintiff should have discovered it. In an area that demands certainty and predictability, the enactment of such an equivocal standard is sure to create a morass of litigation which is neither desirable nor in furtherance of the Act’s purpose. Regardless of the time period attributed to statute of limitations, a bright-line rule appears to be more prudent.

### 3. *Concept of “Financial Means-Testing”*

Under existing law, the financial wealth of the plaintiff has no relevance to securities fraud litigation under section 10(b) and Rule 10b-5. However, the Act departs from this tenet by applying the concept of “financial means-testing” to determine whether a plaintiff has standing under section 10(b) or to determine whether a plaintiff is entitled to the imposition of joint and several liability.

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924 (1988); *Norris v. Wirtz*, 818 F.2d 1329 (7th Cir. 1987), *cert. denied*, 484 U.S. 943 (1987); *Robertson v. Seidman & Seidman*, 609 F.2d 583 (2d Cir. 1979); *Grahan v. Taubman*, 610 F.2d 821 (9th Cir. 1979).

262. 114 S. Ct. at 1454 (quoting *Pinter v. Dahl*, 486 U.S. 622, 652 (1988)).

263. See *Brief of NASAA*, *supra* note 254, at 9.

The Act would impose a means-testing scheme upon three key areas. First, it would require that plaintiffs desiring to be certified as representatives of a class must have aggregately owned, at the time the action occurred, the lesser of \$10,000 market value or one percent of the securities in question.<sup>264</sup> Second, the Act would create a system directing cases to alternative dispute resolution (ADR).<sup>265</sup> Any party to the case could object to ADR as the method of disposition or object to the outcome of an ADR proceeding and litigate the case in federal court.<sup>266</sup> However, if a person objects on one of these bases and the court renders a judgment against the person ruling that the person's claim was not "substantially justified," the Act would require the court to award attorneys fees and costs against that person.<sup>267</sup> This shifting of fees and costs would always be applicable to attorneys, but would apply to the named plaintiff only if that plaintiff owned more than \$1 million of the securities.<sup>268</sup> Third, the Act would preserve joint and several liability only for those plaintiffs who are natural persons with net worth of less than \$200,000 and who have incurred damages of more than 10% of their net worth.<sup>269</sup>

The system of means-testing proposed by the Act is a radical deviation from existing law. The basis of the financial test regarding standing is apparently to eliminate the so-called "professional plaintiff" and to assure that class representatives protect the rights and interests of investors rather than acquiesce to the unscrupulous tactics of some plaintiffs' counsel.<sup>270</sup> Furthermore, the fee-shifting provision is

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264. See *The Act*, *supra* note 236. Subsection 101(c) of the Act would amend § 21 of the Exchange Act by adding several new provisions, including § 21(o), which would provide the standing requirements for class representatives. The requirement for standing is similar to that required under 17 C.F.R. § 240.14a-8 to place a shareholder proposal on an issuer's proxy statement, except Rule 14a-8 requires only \$1,000 market value owned and contains other minimum holding period requirements.

265. See *The Act*, *supra* note 236. Subsection 102(a) of the Act would amend the Exchange Act by adding § 36 which would create an alternative dispute resolution ("ADR") procedure for securities litigation. Any party could offer to proceed to ADR, which would be voluntary and nonbinding, within the time period for answering the complaint, or in cases where a class has been certified, within 30 days after a steering committee or guardian ad litem had been appointed by the Court.

266. See *The Act*, *supra* note 236, § 102(a).

267. See *The Act*, *supra* note 236, § 102(a).

268. See *the Act*, *supra* note 236. Presumably the fee shifting provision would always be applicable to a named defendant.

269. See *The Act*, *supra* note 236. Section 203(a) would amend the Exchange Act to add § 41(d), which provides that each defendant that has not committed knowing securities fraud and is not a primary wrongdoer is liable only for the portion of the judgment that corresponds to that defendant's degree of fault. However, if upon motion made by the plaintiff's counsel not later than six months after the final judgment is entered, the court determines that all or part of a defendant's share is uncollectible, the remaining defendants are jointly and severally liable, but only to those plaintiffs who met the financial means test.

270. See, e.g., *Shields v. Smith*, 1991 WL 319032, at \*4 (N.D. Cal. 1991) (stating

apparently aimed at reducing the caseload of an already over-burdened federal court system by deterring unmeritorious claims with the threat of fees and costs. However, the provision retaining joint and several liability for small investors is presumably political in nature.

Regardless of the merit of the policy objectives advanced in support of these provisions, the concept that justice would be based on the financial standing of the plaintiff is an antithesis to fair-minded thinking. Moreover, the fee-shifting provision may have a chilling effect on the representation of fraud victims, since the provision is always applicable to the plaintiff's counsel. More poignant, however, is that the provision restricting the imposition of joint and several liability for the benefit of only small investors is questionable on due process and equal protection grounds and undoubtedly will spur litigation challenging its constitutionality.<sup>271</sup>

Furthermore, there are also practical concerns to consider if such a standard is enacted. What happens if none of the investors meets the standard to represent the class? Is the class action mechanism unavailable? Must each plaintiff individually pursue the defendants? This surely would deny access to many defrauded investors. What if a class consists of several thousand investors, some entitled to the imposition of joint and several liability and some not? Does this invalidate the commonality requirement of the class?<sup>272</sup> If not, are the federal courts charged with the responsibility of sorting out who is entitled to what recovery? Apparently, the drafters have exhibited little foresight regarding the potential consequences of instituting the proposed provisions.

#### 4. *Standards for Fraud Pleadings*

Rule 9(b) of the Federal Rules of Civil Procedure requires a plaintiff to plead fraud with particularity, meaning that particular

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that due to a "consistent pattern of purchasing a few shares in troubled companies [and] plaintiff's involvement in over two dozen lawsuits . . . the Court finds clear evidence that plaintiff's purchasing stock in troubled companies to possibly pursue litigation is a serious defense likely to become the focus of the litigation to the detriment of the class").

271. The Supreme Court will uphold legislative actions which burden persons of a class based on wealth or lack thereof under the equal protection or due process guarantee if the actions have any rational relationship to a legitimate end of government. *See, e.g., Douglas v. California*, 372 U.S. 353 (1963); *Harper v. Virginia Bd. of Educ.*, 383 U.S. 663 (1966); *Boddie v. Connecticut*, 401 U.S. 371 (1971).

272. *See FED. R. CIV. P. 23(a)*. Rule 23(a) provides:

One or more members of a class may sue or be sued as representative parties on behalf of all only if (1) the class is so numerous that joinder of all members is impracticable, (2) there are questions of law or fact common to the class, (3) the claims or defenses of the representative parties are typical of the claims or defenses of the class, and (4) the representative parties will fairly and adequately protect the interests of the class.



fraudulent acts or statements must be attributed to a particular defendant.<sup>273</sup> The Ninth Circuit Court of Appeals, in *Wool v. Tandem Computers, Inc.*,<sup>274</sup> recognized an exception to this rule where the alleged misstatement or omission can be attributed to a group. If the members of the group are involved in the day-to-day management of those parts of the corporation involved in the fraud the allegations may be pleaded generally.<sup>275</sup> The court declared, "In cases of corporate fraud where the false or misleading information is conveyed in prospectuses, registration statements, annual reports, press releases, or other 'group published information,' it is reasonable to presume that these are the collective actions of the officers."<sup>276</sup>

The Act would impose much stricter pleading standards and would directly overrule Rule 9(b) and the "group pleading doctrine."<sup>277</sup> In order to state a cause of action, a plaintiff would have to set forth specific facts explaining why the plaintiff believes that each defendant acted with intent.<sup>278</sup> Furthermore, a plaintiff who alleges the making of a material misstatement or omission would be required to specify each statement believed to be misleading, the facts upon which the plaintiff's belief is based, and why the statement is misleading.<sup>279</sup>

If adopted, the new pleading standards may prove to be significant obstacles for plaintiffs who may not have the requisite information until discovery has been initiated or concluded. This is especially true with respect to information regarding the defendant's state of mind.<sup>280</sup> This seemingly impracticable standard puts the cart before the horse and will either force plaintiff's counsel to fill in the gaps where the facts are not yet known, often in anticipation of amending the complaint if facts previously pleaded are either fallacious or not

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273. FED. R. CIV. P. 9(b). Rule 9(b) provides:

In all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity. Malice, intent, knowledge, and other condition of mind of a person may be averred generally.

274. 818 F.2d 1433 (9th Cir. 1987).

275. *Id.* at 1439.

276. *Id.* at 1440.

277. See *Brief of NASAA, supra* note 254, at 11-12. Section 104 would amend the Exchange Act by adding § 39 which would set forth the pleading requirements for implied private actions under § 10(b).

278. See *The Act, supra* note 236, § 104(a). Proposed § 39 of the Exchange Act would require the plaintiff to plead that the defendant "acted with some level of intent." This requirement is substantially inconsistent with the adoption of the recklessness standard under § 10(b). If passed in its present form, § 39(a) may be fertile ground from which to harvest an argument for the abrogation of the recklessness standard.

279. See *The Act, supra* note 236, § 104(b).

280. See FED. R. CIV. P. 9(b) ("[M]alice, intent, knowledge, and other condition of mind of a person may be averred generally.").

apposite to the claim, or to drop the case altogether fearing possible sanctions under Rule 11.<sup>281</sup> Admittedly, reducing or eliminating frivolous claims under Rule 10b-5 is salutary, but to accomplish this by prohibiting the meritorious claims of investors because the malefactors refuse to disclose how the fraud was perpetuated is simply unjustifiable.

#### IV. CONCLUSION

Embodied within the Exchange Act is a careful balance between the desire to provide whole compensation to damaged investors and the facilitation of fair and efficient markets. This is evidenced by the coordination of the remedies and defenses in the Exchange Act. Nevertheless, over the last quarter of a century the Supreme Court has clung to a strict statutory approach and restricted the scope of liability under section 10(b) and Rule 10b-5. However, there has been a certain ebb and flow to section 10(b) jurisprudence. Each time the Supreme Court has handed down an opinion that limits the scope of liability under section 10(b), the lower federal courts have adroitly embraced an alternative theory that takes back the ground previously lost. Consequently, the boundaries of the scope of liability under section 10(b) have been capricious. This fact has given rise to criticism by attorneys and accountants who are the primary targets of expanded liability.

The Court's decision in *Central Bank* once again restricts the outward expansion of liability under section 10(b) by repudiating aider and abettor liability. However, the path toward expansion of primary liability under the phrase "indirectly" is clear. Needless to say, the extent of that expansion is not absolute, but considering the track record of the lower federal courts the term "indirectly" will most likely cover the vast majority of defendants (i.e., attorneys and accountants) that were previously held liable under the aiding and abetting theory.

After the Court's decision, many cried out for Congressional repudiation. However, if Congress responds to *Central Bank*, it will probably not come in piecemeal fashion, but rather in the context of a broader bill. Passage of the bill presently under consideration in the Senate Securities Subcommittee would constitute an unmitigated reversal in policy, shifting financial risk of loss from professionals who provide services in the securities business to the investing public.

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281. See FED. R. CIV. P. 11 (imposing sanctions on attorneys who sign a pleading, written motion, or "other paper" which has been filed for an improper purpose, or is otherwise frivolous or unsupported by the evidence).

The 73rd Congress enacted the Exchange Act with an overriding policy objective to replace the doctrine of caveat emptor with one of full disclosure. Although the proposed bill would leave untouched the extensive body of law requiring full disclosure with respect to a purchase or sale of securities, it would strip the Exchange Act of its teeth to enforce those requirements.