Roger Williams University Law Review

Volume 6 | Issue 1 Article 10

Fall 2000

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Recommended Citation
Marsella, Russell P. (2000) "Who's Primarily to Blame? The Quest for the Better Test of Section 10(b) Liability," *Roger Williams University Law Review*: Vol. 6: Iss. 1, Article 10.
Available at: http://docs.rwu.edu/rwu_LR/vol6/iss1/10

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Who's Primarily to Blame? The Quest for the Better Test of Section 10(b) Liability

I. Introduction

Investors filed a class action suit against an accounting firm[1] in the United States District Court for the Southern District of New York[2] alleging false representations in violation of Section 10(b) of the Securities Exchange Act of 1934[3] and Securities and Exchange Commission Rule 10b-5.[4] The accounting firm moved that the case be dismissed for failure to state a claim on which relief could be granted.[5] The court granted the motion but also granted plaintiffs leave to replead.[6] The investors declined to re-plead and instead filed an appeal to the Second Circuit, asserting that the claim adequately stated a cause of action for violation of federal securities law.[7] The Second Circuit concluded that in circumstances where persons have purchased stock in a company that issued a press release containing false and misleading financial information, with a notation that the information is unaudited and without mention of its outside auditor, they cannot recover from the auditor for false or misleading statements contained in the press release attributed to the auditor.[8]

Among the duties of the Securities and Exchange Commission is to keep the public stock markets free from fraud and abuse.[9]

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1. The accounting firm was acting as an independent auditor for a corporation which had recently sold stock in an initial public offering.
2. *See* Wright v. Ernst & Young LLP, No. 97 Civ. 2189(SAS), 1997 WL 563782 (S.D.N.Y. Sept. 10, 1998).
3. 15 U.S.C. § 78j(b) (1994).
4. 17 C.F.R. § 240.10b-5 (1993).
5. *See Wright*, 1997 WL 563782, at *1.
6. *See id.* at *4.
7. The action under appeal is Wright v. Ernst & Young LLP, 152 F.3d 169 (2d Cir. 1998).
8. *See Wright*, 152 F.3d at 178.
9. *See* Brennan v. Midwestern United Life Ins. Co., 259 F. Supp. 673, 680 (N.D. Ind. 1966).

One of the most powerful tools in doing so is Section 10(b) of the Securities Exchange Act of 1934. That Section and Rule 10b-5, promulgated by the Securities Exchange Commission, prohibit the use of any scheme to defraud or the making of any untrue statements of a material fact or omission thereof in connection with the sale of securities.[10]

For many years the enforcement of this regulation was divided into two components: primary and secondary liability.[11] Primary liability existed where one acts directly contrary to the statute.[12] Secondary liability resulted from aiding and abetting a direct violation, which generally consisted of acting (or omitting to act) when under the duty to correct an error of which one knew.[13]

When the question of whether aiding and abetting was enough to meet the standard of primary liability was finally presented to the United States Supreme Court in the case of *Central Bank of Denver v. First Interstate Bank of Denver*,[14] it ruled that an aiding and abetting cause of action is not supported by the text of the statutes in question.[15] The Supreme Court also explained that while there was no longer a concept of secondary liability, many of the situations formerly thought of as secondary actually met the threshold test for primary liability.[16]

While the concern used to be to determine if a cause of action met the elements of primary or secondary liability, the result of this decision is that the concern has now shifted to exactly where the cutoff exists as to meeting the elements of primary liability. Different tests have arisen among the United States' Circuit Courts to determine whether an activity meets the threshold of primary liability.

This casenote will examine the recent case of *Wright v. Ernst & Young*.[17] In doing so, it will examine the two main tests being employed, which have become known as the bright line test and

10. *See* 15 U.S.C. § 78j(b) (1994) and 17 C.F.R. § 240.10b-5 (1993). The relevant part of these sections are quoted later in this paper.

11. *See Wright*, 152 F.3d at 170-75 (discussing the history and development of the theories of liability growing from the wording of the statutes).

12. *See id.* at 179-81.

13. *See id.*

14. 511 U.S. 164 (1994).

15. *See id.* at 191.

16. *See id.*

17. 152 F.3d 169 (2d Cir. 1998).

the substantial participation test. Finally, this casenote will suggest reasons why one test is the preferable test, with the recommendation that it be the standard test in determining primary liability in Section 10(b) and Rule 10b-5 actions.

II. HISTORICAL BACKGROUND OF THE SECURITIES EXCHANGE ACT § 10(B) AND RULE 10B-5

After the stock market crash of 1929, and the resulting depression, it became evident that regulation and control of speculation in the securities markets would be essential to try to prevent future recurrences.[18] Congress enacted two pieces of legislation to address this issue.[19] The first became known as the Securities Exchange Act of 1933, and dealt mainly with the initial distributions of securities.[20] The second was the Securities Exchange Act of 1934, and was aimed mainly at the regulation of post-distribution trading, most notably being the publicly traded stock markets, but also at trading of non-registered stock.[21]

Together, the Acts create an extensive scheme of civil liability.[22] They "embrace a fundamental purpose . . . to substitute a philosophy of full disclosure for the philosophy of caveat emptor."[23] Violators are not only subject to proceedings brought by the Securities and Exchange Commission, but also proceedings brought by private plaintiffs who sue under the express private rights of action contained in the Acts.[24] Of the many actions, the most common private action takes place under the general antifraud provision of the 1934 Act, which is Section 10(b).[25] The Securities and Exchange Commission adopted Rule 10b-5 several years later, which mirrors the doctrine of the 1934 Act.[26]

The general theme of Section 10(b) and Rule 10b-5 is to prohibit the use of any manipulation or deception in the sale of securities. The fundamental purpose of the 1934 Act is to implement a

18. *See Central Bank,* 511 U.S. at 170.
19. *See id.* at 170-71.
20. *See id.* at 171.
21. *See id.*
22. *See id.*
23. Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128, 151 (1972).
24. *See Central Bank,* 511 U.S. at 171.
25. *See id.*
26. 17 C.F.R. § 240.10b-5 (1993).

"philosophy of full disclosure."[27] Specifically, Section 10(b) of the Securities Exchange Act of 1934 provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange. . .(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.[28]

Similar in nature and in wording, Securities and Exchange Rule 10b-5 makes unlawful any provision "that would cause reasonable investors to rely thereon, and, in connection therewith, so relying, cause them to purchase or sell a corporation's securities."[29] The Rule provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
> (a) To employ any device, scheme, or artifice to defraud,
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.[30]

The fact that both statutes contain the phrase "directly or indirectly" seems to be the root of the doctrine of secondary liability, or at least has led some to suggest it.[31] The thought behind secondary liability, or aider and abettor liability as it was more commonly called, was that it required a minimum of committing one of the "manipulative or deceptive" acts under Section 10(b) and Rule

27. Basic, Inc. v. Levinson, 485 U.S. 224, 230 (1988).
28. 15 U.S.C. § 78j(b) (1994).
29. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 860 (2d Cir. 1968).
30. 17 C.F.R. § 240.10b-5 (1993).
31. *See* Wright v. Ernst & Young LLP, 152 F.3d 169, 175-76 (2d Cir. 1998) (discussing and rejecting the notion of the wording "indirectly" in relation to secondary liability).

10b-5, with the same degree of scienter that primary liability requires.[32] It was understood that liability under Rule 10b-5 could be imposed not only on persons who made fraudulent misrepresentations, but also on those who had knowledge of the fraud and assisted in its perpetration.[33] This liability has extended to lawyers and accountants.[34]

III. FACTS OF WRIGHT v. ERNST & YOUNG

Wright v. Ernst & Young was filed after BT Office Products Corporation (BT) sold a public offering of common stock.[35] Its accounting firm was alleged to have known that potentially misleading statements were being communicated to investors.[36] The plaintiffs viewed this as action that would constitute primary liability.[37] The accounting firm did not issue the financial statement, but rather it came from BT's management, making this an example of indirect liability.[38] This is a case that would almost certainly have been brought on secondary liability grounds in the pre-*Central Bank* days. In fact, the defendant's defense was that their action amounted to no more than aiding and abetting, which was specifically not enough to impose liability under *Central Bank*.[39]

A. *Factual and Procedural History*

As BT expanded its business, but prior to their initial public offering, it acquired a company called Summit Office Supply (Summit).[40] BT had hired the accounting firm of Ernst & Young as outside auditor of the company's financial records.[41] Ernst & Young issued audit opinions as to the accuracy of BT's financial

32. *See* Robin v. Arthur Young, 915 F.2d 1120, 1123 (7th Cir. 1990).
33. *See* IIT Int'l Inv. Trust v. Cornfeld, 619 F.2d 909, 927 (2d Cir. 1980).
34. *See IIT Int'l*, 619 F.2d 909 (holding that accountants have a "duty to take reasonable steps to correct misstatements they have discovered in previous financial statements on which they know the public is relying"); SEC v. Frank, 388 F.2d 486, 489 (2d Cir. 1968) (holding that a lawyer "has no privilege to assist in circulating a statement with regard to securities which he knows to be false simply because his client has furnished it to him").
35. *See Wright*, 152 F.3d at 171.
36. *See id.*
37. *See id.* at 171-72.
38. *See id.* at 172.
39. *See id.*
40. *See id.* at 171.
41. *See Wright*, 152 F.3d at 171.

statements for the years of 1993 and 1994.[42] Later, in July, 1995, it reissued the 1994 audit opinion for use in BT's initial public offering prospectus, which included a statement of BT's first quarter 1995 results.[43] The audit included a full scope audit of most of BT's business, but only a limited review of the recently acquired Summit business.[44]

Later in the year, Ernst & Young began a full scope audit of the Summit business.[45] While working on this effort, it discovered an under-accrual of Summit's accounts payable, which would have a negative effect on the financial statements, and alerted BT management of the findings.[46] Upon further consideration, it decided the problem was not material[47] and signed off on the 1995 financial statements, knowing that they would be used by investors in evaluating the BT stock offering.[48]

Based on oral assurances from Ernst & Young, BT issued a press release in early 1996, announcing the 1995 financial results and speaking of strong growth during the year.[49] The press release did note that the figures were unaudited, however, and made no mention of Ernst & Young.[50]

A few months later, it became clear to both BT and Ernst & Young that the under-accrual problem was more serious than previously thought.[51] After analyzing the information, BT announced that it was restating its 1995 results from a $1.5 million profit to a

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42. *See id.*

43. *See id.* at 171-72.

44. *See id.* at 172. A limited review is a less intense version of audit which would assume more corporate records as correct without the independent verification done under a full scope audit. Generally when an audit opinion is issued it is assumed that a full scope audit has been conducted, following the Generally Accepted Auditing Principles.

45. *See id.*

46. *See id.* An under-accrual of accounts payable would indicate that more money was owed to creditors than was reflected on the financial reports. An adjusting entry would cause an amount equal to that shortfall to reduce the net earnings, which in this case eliminated profits completely and caused a loss to be shown on the income statement.

47. Though the auditors recognized that a problem existed, by deciding that it was not material they were in essence saying that any impact from such a problem would have little if any impact on the overall financial picture of the company.

48. *See Wright*, 152 F.3d at 172.

49. *See id.*

50. *See id.*

51. *See id.*

$200,000 loss.[52] With that announcement, BT's stock dropped 25%, injuring Wright and other stockholders who joined the class action.[53]

This class action was filed in the district court, claiming the accounting firm "recklessly failed to detect various acts of financial malfeasance committed by employees of BT Office Products."[54] The district court held that "the Complaint fails to allege the essential elements of a Rule 10b-5 claim."[55]

B. *Treatment of the Case by the Second Circuit*

The Second Circuit must have felt pulled by the strong leash of *Central Bank*.[56] They noted the Tenth Circuit's requirement that the defendant must directly communicate misrepresentations to investors for primary liability to attach.[57] However, the lack of any reference to Ernst & Young in the violating communications made the stretch just too tenuous for the court to accept.[58] The lack of any mention of Ernst & Young made the Second Circuit feel that the accountants neither directly nor indirectly communicated misrepresentations to investors.[59] Because of that premise, the court could not find that Ernst & Young made a material misstatement on which an investor would rely.[60]

The court concluded that holding Ernst & Young primarily liable in this situation would be effectively reviving aiding and abetting liability under a different name.[61] It went on to affirm the decision of the district court in dismissing the claim for failure to state a claim on which relief could be granted.[62]

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52. *See id.*
53. *See id.*
54. Wright v. Ernst & Young LLP, No. 97 Civ. 2189(SAS), 1997 WL 563782, at *4 (S.D.N.Y. Sept. 10, 1998).
55. *Id.*
56. *See Wright*, 152 F.3d 169 at 173, (stating "[w]e conclude that Wright's arguments are foreclosed by *Central Bank*").
57. *See* Anixter v. Home-Stake Prod. Co., 77 F.3d 1215, 1226-27 (10th Cir. 1996).
58. *See Wright*, 152 F.3d at 175.
59. *See id.*
60. *See id.*
61. *See id.*
62. Fed. R. Civ. P. 12(b)(6).

IV. AIDING AND ABETTING

Since the Securities and Exchange Acts have been promulgated, it became settled law that aider and abettor liability existed under Section 10(b) and Rule 10b-5.[63] This did not remove all ambiguity and confusion from the section, however. This confusion resulted from the language of the section, which stated that it was a violation to mislead either directly or indirectly, which seemed to indicate that it could, yet decisions were being handed down that hinted that they could not.[64]

The concept of aiding and abetting has come into the securities arena from its origin in tort law.[65] At the time just after the Securities and Exchange Acts became law the Restatement of Torts viewed liability for aiding and abetting where there is:

> harm resulting to a third person from the tortious conduct of another, a person is liable if he
> (b) knows that the other's conduct constitutes a breach of duty and gives substantial assistance or encouragement to the other so to conduct himself, or
> (c) gives substantial assistance to the other in accomplishing a tortious result and his own conduct, separately considered, constitutes a breach of duty to the third person.[66]

Central Bank noted that "[t]he first and leading case to impose [private aiding and abetting actions] was *Brennan v. Midwestern United Life Ins. Co.*"[67] In fact, the provisions of Section 10(b) and Rule 10b-5 were applied to aiders and abettors even before the first case recognizing civil liability under that statute and rule.[68] The first case to deal with the applicability of Section 10(b) and Rule

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63. *See Robin* v. Arthur Young, 915 F.2d 1120, 1123 (7th Cir. 1990) (stating "[o]ur recognition of aider and abettor liability is rooted in 20 + years' [sic] precedent").

64. *See generally* Santa Fe Indus., Inc. v. Green, 430 U.S. 462 (1977) (discussing Congress' intention with regard to the scope of Rule 10(b)); Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976) (defining scope of Rule 10(b) with close attention to statutory text).

65. *See Central Bank* of Denver v. First Interstate Bank of Denver, 511 U.S. 164, 181 (1994) (discussing how aiding and abetting has its origin in criminal law doctrine, and has worked its way into torts as a concert of action principle).

66. Restatement (First) of Torts § 876 (1939).

67. *Central Bank*, 511 U.S. at 169.

68. *See* Brennan v. Midwestern United Life Ins. Co., 259 F. Supp. 673, 676 (N.D. Ind. 1966).

10b-5 to aiders and abettors was *SEC v. Timetrust, Inc.*,[69] which involved a suit by the SEC for an injunction against alleged principal violators and certain aiders and abettors. The complaint against the aiders and abettors was upheld on a motion to dismiss.[70] The district court cited the criminal provisions making aiders and abettors responsible as principals and stated, "[n]o good reason appears why this same rule should not apply in an injunctive proceeding to restrain a violation of the same statute."[71]

Behind the growth of this doctrine was the idea that since knowing assistance of or participation in a fraudulent scheme under Section 10(b) gives rise to liability equal to that of the perpetrators themselves, the facts alleged by the (plaintiff) trustees, if proven, would permit recovery under Section 10(b).[72]

This has led to a search of the legislative history to find the intent of Congress. At that time, the securities industry wanted to limit the liability of aiders and abettors, and the SEC would have been satisfied with a provision limited to a confirmation of its own powers.[73] The SEC developed a proposed amendment which was modified in the Senate Committee on Banking and Currency as suggested by the New York Stock Exchange.[74] The bill, favorably reported out of committee but never passed by Congress, would have amended Section 21(e) of the Securities Exchange Act of 1934 as follows:

> Whenever it shall appear to the Commission * * * that any person is aiding, abetting, counseling, commanding, inducing, or procuring, or is about to aid, abet, counsel, command, induce, or procure such a violation, it may in its discretion bring an action * * * to enjoin such acts or practices and to enforce compliance with this title. * * * The Commission may transmit such evidence as may be available concerning such acts or practices to the Attorney General, who may, in his discretion, institute the necessary criminal proceedings under this title.[75]

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69. 28 F. Supp. 34 (N.D. Cal. 1939).
70. *See id.*
71. *Id.* at 43.
72. *See* Pettit v. American Stock Exchange, 217 F. Supp. 21, 28 (S.D.N.Y. 1963).
73. *See Brennan*, 259 F. Supp. at 679.
74. *See id.*
75. *Id.* (quoting S. 3770, 86th Cong. § 20 (1960)).

This amendment was not enacted by Congress.[76] The courts have wisely and consistently refused to draw such speculative inferences from Congressional non-action.[77] When considering a legislative history strikingly similar to that urged upon this court by the defendant in *Brennan*, the Supreme Court stated "[w]e draw, therefore, no inference in favor of either construction of the Act—from the Department's request for legislative clarification, from the congressional committee's willingness to consider it, or from Congress' failure to enact it."[78]

The *Brennan* court then went back to the philosophy and goals of the Securities and Exchange Acts to determine the case at hand.[79] It is hardly a question that investors can be harmed when an issuer of stock fails to disclose information of its own improper activities affecting the value of its stock.[80] When a brokerage firm dealing heavily in the issuer's stock does roughly the same thing, the results are not that different.[81] The heart of the matter is that the loss to the investor may be the same. This made the court realize that while it is not to say that there is no distinction between the two types of situations, they are quite closely related.[82] The court therefore emphasized that a statute with a broad and remedial purpose such as the Securities Exchange Act of 1934 should not easily be rendered too weak to deal with new and unique situations within the scope of the evils intended to be eliminated.[83] In the absence of a clear legislative expression to the contrary, the statute must be flexibly applied so as to implement its policies and purposes.[84] The above described reasoning led the court to hold that it was improper to say that civil liability for damages, established under the Securities Exchange Act of 1934, may never, under any circumstances, be imposed upon persons who do no more than aid and abet a violation of Section 10(b) and Rule 10b-5.[85]

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76. *See id.*
77. *See id.*
78. Wong Yang Sung v. McGrath, 339 U.S. 33, 47-48 (1950).
79. *See Brennan*, 259 F. Supp. at 680.
80. *See id.*
81. *See id.*
82. *See id.*
83. *See id.*
84. *See id.* at 680-81.
85. *See Brennan,* 259 F. Supp. at 681.

Aside from the legislative history, the defendant in *Brennan* points out that there is nothing in the statute indicating a Congressional intent to impose civil liability on persons aiding and abetting violations of Section 10(b) and Rule 10b-5.[86] But, likewise, "one can search the statute in vain for language indicating that a violator of Section 10(b) and Rule 10b-5 should be liable in a civil action for damages. Such liability was developed by the courts on general principles of tort law."[87] In the years following *Brennan*, other courts have taken the same position.[88]

V. Impact of Central Bank of Denver v. First Interstate Bank of Denver

On at least two occasions, the United States Supreme Court reserved a decision on whether those who aid or abet were subject to civil liability.[89] Finally, in 1994, a case reached the United States Supreme Court in which the court attempted to clear up the confusion regarding secondary liability.[90] In the late 1980's, a municipal building authority issued $26 million in bonds to finance public improvements at a planned residential and commercial development.[91] Central Bank of Denver served as the trustee for the bond issues.[92] These bonds were secured by landowner assessment liens, and had covenants that required that the land subject to the liens be worth at least 160% of the bonds' outstanding prin-

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86. *See id.*

87. *Id.* at 681.

88. *See generally* Cleary v. Perfectune, Inc., 700 F.2d 774 (1st Cir. 1983) (holding that same standards should be applied in determining aider and abettor liability under § 17(a) of the Securities Act, assuming that there is a private right of action thereunder); Kerbs v. Fall River Indust., Inc., 502 F.2d 731 (10th Cir. 1974) (holding that knowing assistance and participation in a fraudulent scheme in contravention of 10(b) of the statute and Rule 10b-5 were sufficient for liability).

89. *See generally* Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976) (holding that private cause of action will not lie under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 in the absence of an allegation of intent to deceive, manipulate or defraud); Herman & MacLean v. Huddleston, 459 U.S. 375 (1983) (holding that the availability of an express remedy under the 1933 Securities Act against one who includes falsehood or misleading information in registration statement does not preclude defrauded purchaser of stock from maintaining an action).

90. *See Central Bank* of Denver v. First Interstate Bank of Denver, 511 U.S. 164, 167 (1994).

91. *See id.* at 167.

92. *See id.*

cipal and interest.[93] The covenants required the developer to give Central Bank an annual report containing evidence that the 160% test was met.[94]

In early 1988, the developer provided Central Bank with an updated appraisal of the land, showing land values almost unchanged from an appraisal done nearly two years earlier.[95] Shortly after, Central Bank received a letter from the underwriter of one set of the bonds, expressing concern that property values in the area were declining, and that this report, which was being used for another round of bond issues, was based on an appraisal that was sixteen months old.[96] Central Bank asked its in-house appraiser to review the developer's appraisal, and their conclusion was that the values appeared optimistic.[97] They recommended that an independent, outside firm be asked to provide an opinion.[98] Central Bank then decided to hold off on that until late in the year (which would be six months after the second round of bond financing).[99] Before the review was ever completed, the building authority had defaulted on the new set of bonds.[100]

Some of the purchasers, including First Interstate Bank of Denver and Jack Naber, who had purchased $2.1 million of the bonds, sued Central Bank and others, alleging a violation of Section 10(b).[101] The District Court for the District of Colorado granted summary judgment to Central Bank, but the Court of Appeals for the Tenth Circuit reversed.[102] The Supreme Court granted certiorari to resolve the confusion over the existence and scope of the Section 10(b) aiding and abetting action.[103]

Ultimately, the Court held the statutory language of the Act did not reach those who aid and abet a section 10(b) violation.[104] However, they went on to say that the absence of aiding and abetting liability does not mean that secondary actors in the securities

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93. *See id.*
94. *See id.*
95. *See id.*
96. *See Central Bank*, 511 U.S. at 167.
97. *See id.*
98. *See id.* at 168.
99. *See id.*
100. *See id.*
101. *See id.*
102. *See Central Bank*, 511 U.S. at 168.
103. *See id.* at 170.
104. *See id.* at 177.

markets are always free from liability under the securities Acts.[105] Any person or entity, including a lawyer, accountant or bank, who employs a manipulative device or makes a material misstatement (or omission) may be liable as a primary violator under Rule 10b-5, assuming all the requirements for primary liability under that rule are met.[106]

Central Bank thus elevated the distinction between primary and secondary liability to critical importance by its elimination of secondary liability under Section 10(b).[107] More precisely, the Court in *Central Bank* held "contrary to the established law in every federal circuit, that Congress had never imposed such liability."[108]

VI. ANALYSIS

A. *The Second Circuit's Bright Line Test*

Despite the attempt to add clarity through the *Central Bank* decision, in actuality what happened was that the area of unknown shifted from the area of secondary liability to the boundaries of primary liability.[109] Thus, the difficulty after *Central Bank* lies in determining the circumstances under which a party can be said to have indirectly engaged in the conduct referenced by Section 10(b) and Rule 10b-5.[110] "Unfortunately, deciding when conduct constituting aiding and abetting rises to the level of prohibited primary conduct is not well settled."[111] The circuit courts have started using different standards to come up with a definition as to the threshold required for a secondary actor's conduct to implicate primary liability in the cases they have heard since *Central Bank.*[112]

105. *See id.* at 191.

106. *See id.*

107. *See In re* MTC Elec. Technologies S'holders Litig. 898 F. Supp. 974, 985 (E.D.N.Y. 1995).

108. *Id.*

109. *See generally MTC Elec.*, 898 F. Supp. at 974, 987 (stating "[i]n short, *Central Bank* has generated a fair amount of confusion in the lower courts both in identifying the line between primary and secondary liability").

110. *See* Lawton v. Nyman, No. Civ.A. 98-288-T, 1999 WL 669837, at *3 (D.R.I. Aug. 24, 1999).

111. Anixter v. Home-Stake Prod. Co., 77 F.3d 1215, 1224 (10th Cir. 1996).

112. As will be discussed, the circuit courts have broken into two main tests, the bright line test and the substantial participation test, as well as some hybrids of the two.

The plaintiffs in *Wright* were attempting to show primary liability in three ways.[113] First, they wanted to bar the use of the "bespeaks caution doctrine," where a disclaimer serves a warning on the contents of a report.[114] Second, they wanted a more broad interpretation of what the market would implicitly understand by a company's release of financial results and an accountant's role in that release.[115] Third, they wanted a more narrow view in giving effect to the word 'unaudited' when such a disclaimer cannot negate the auditor's own conduct in causing the dissemination of false financial results.[116] Even further, they wanted to bar the auditor from being able to hide behind the word 'unaudited.'[117]

The bright line test[118] stands for the philosophy that to be primarily responsible, there must be a showing that the person knew or should have known that the representation would be communicated to investors.[119] While there are examples of decisions within the Second Circuit finding liability against this general view, they are definitely the exception, and not the rule.[120] In the case of *In re MTC Electronic Technologies,*[121] it was noted:

> [I]f *Central Bank* is to have any real meaning, a defendant must actually make a false or misleading statement in order to be held liable under Section 10(b). Anything short of such conduct is merely aiding and abetting, and no matter how substantial that aid may be, it is not enough to trigger liability under Section 10(b).[122]

The Second Circuit also noted that words such as "assisting," "participating in," and "complicity in," as well as similar synonyms, all fall within the bar of *Central Bank*.[123]

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113. *See Wright*, 152 F.3d at 176-78.

114. *See id.* at 176.

115. *See id.*

116. *See id.*

117. *See id.*

118. The name bright line test is somewhat of any oxymoron, as there is no easy bright line, like other 'bright line' tests in different areas of law.

119. *See Anixter*, 77 F.3d at 1226.

120. *See* SEC v. First Jersey Sec., Inc., 101 F.3d 1450 (2d Cir. 1996) (holding the president of a brokerage firm primarily liable for orchestrating the manipulative acts of multiple branch offices in the sale of securities at excessive prices).

121. 898 F. Supp. 974 (E.D.N.Y. 1995).

122. *Id.* at 987.

123. *See* Shapiro v. Cantor, 123 F.3d 717, 720 (2d Cir. 1997).

The scope of the view behind the bright line test is well captured in the following:

> [I]n a situation in which the accountant 'gives an opinion or certifies statements' about a company—statements which the accountant later discovers may not have been accurate . . . then the accountant has a duty to disclose the fraud to the public . . . . Conversely, if an accountant does not issue a public opinion about a company, although it may have conducted internal audits or reviews for portions of the company, the accountant cannot subsequently be held responsible for the company's public statements issued later merely because the accountant may know those statements are likely untrue.[124]

The apparent reason for this reasoning is this court's view of the holding in *Chiarella v. United States.*[125] In that case the Supreme Court held that the duty to disclose arises when one party has information that the other party is entitled to know because of a fiduciary or other similar relation of trust and confidence between the parties.[126]

In speaking of the bright line test, it is important to note that in *Wright*, not only did the Second Circuit find that Ernst & Young was not primarily liable, it agreed with the district court's holding.[127]

B. *The Ninth Circuit's Substantial Participation Test*

Whereas the bright line test stands for the finding that primary liability only exists where the party was directly involved in making the communication, the substantial participation test takes a more flexible view. Here, third party defendants can be primarily liable for statements made by others where the defen-

124. *Id.* at 721 (quoting *In re* Cascade Int'l Sec. Litig., 894 F. Supp 437, 443 (S.D. Fla. 1995)). *But cf.* ZZZZ Best Securities Litig, 864 F. Supp. 960 (C.D. Cal. 1994); *In Re* Software Toolworks, 38 F.3d 1078 (9th Cir. 1994).

125. 445 U.S. 222, 228 (1980).

126. *See id.* at 228.

127. Wright v. Ernst & Young LLP, 152 F.3d 169, 178 (2d Cir. 1998). The district court's holding was that "[h]olding E[rnst] & Y[oung] primarily liable under Rule 10b-5 in spite of its clearly tangential role in the alleged fraud would effectively revive aiding and abetting liability under a different name, and would therefore run afoul of the Supreme Court's holding in *Central Bank.*" Wright v. Ernst & Young LLP, No. 97 Civ. 2189(SAS), 1997 WL 563782, at *3 (S.D.N.Y. Sept. 10, 1998).

dant substantially participated in preparing the statement.[128] This would seem to allow accountants to be found liable more easily.

Shortly after the *Central Bank* decision, the case of *In re ZZZZ Best Securities Litig.*[129] put the question of primary and secondary liability before the District Court for the Central District of California. A short history of the ZZZZ Best Company legacy is not only entertaining and almost unbelievable, but worth explaining as background to the litigation. It may even provide insight into why the court developed the substantial participation test. ZZZZ Best Company was a carpet-cleaning and building restoration company founded by Barry Minkow when he was just 16 years old.[130] Just five years later the company was publicly traded, reporting sales of over $50 million and a market capitalization of $200 million.[131] Shortly thereafter it was discovered that the whole company was actually nothing more than a giant Ponzi scheme,[132] which ultimately cost investors and lenders more than $100 million.[133]

In 1986, just before the company was to go public, the Ernst & Young[134] partner in charge of this account began an audit.[135] He noticed that the company had a $7 million contract to restore a damaged building in Sacramento.[136] Questioning the validity of the contract, the auditor demanded to see the building.[137] As the contract was fictitious, the company needed to remedy the problem and sent representatives to Sacramento to scope out a building to

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128. *See In re* Software Toolworks, 38 F.3d 1078, 1078 n.3 (9th Cir. 1994):

> Despite *Central Bank*, we nevertheless consider this issue because the plaintiffs' complaint clearly alleges that [defendant] is primarily liable under section 10(b) for the SEC letters. . .This evidence is sufficient to sustain a primary cause of action under section 10(b) and, as a result, *Central Bank* does not absolve [defendant] on these issues.

Id.

129. 864 F. Supp. 960 (C.D. Cal. 1994).

130. *See* Daniel Akst, *How Barrry Minkow Fooled the Auditors*, Forbes, Oct. 2, 1989, at 126, *available at* LEXIS, News Library, Forbes File.

131. *See id.*

132. The Ponzi scheme is named after the swindler Charles A. Ponzi. This type of scheme is an investment swindle in which earlier investors are paid off with money put in by later investors in order to encourage more and bigger risks.

133. *See* Akst, *supra* note 130.

134. The firm that did the audit was Ernst & Whinney, but Ernst & Young is the successor firm following a merger.

135. *See* Akst, *supra* note 130.

136. *See id.*

137. *See id.*

suit its purposes.[138] Upon arriving in Sacramento, the company representatives found only one building in the city large enough to have sustained $7 million worth of damage: the Capital Mall building.[139] They then went to the building owners and expressed interest in leasing a large amount of space, and stated that their investor could only come on a weekend.[140] In reality, they didn't want the auditors to bump into anyone who might torpedo their plan.[141] They then set up a phony property management company to tour them around, as dealing with the real one would be too dangerous to the hoax.[142] The day of the tour, they drove to the building and posted ZZZZ Best signs wherever they could, left a ZZZZ Best T-shirt in an empty room, and stole a set of blue prints to carry around for effect.[143] The plan was a great success, with the Ernst & Young partner saying that "[t]he tour was beneficial in gaining insight as to the scope of the damage that had occurred and the type of work that the Company can do."[144] In other words, ultimately, the plan worked.

The public offering took place, and the company received not only the proceeds, but also a loan from a bank.[145] The auditor, perhaps suspicious of some of the happenings of the company, demanded to see another building.[146] He was told that they had an $8.2 million contract in National City, a suburb of San Diego.[147] When his executives went there to reenact the Sacramento ploy, they discovered that there weren't any buildings in National City that could even remotely pass for a structure in the midst of an $8.2 million facelift.[148] Undaunted, they rented a warehouse in National City, filled it with $168,000 of the cheapest carpet they could find, and concocted a story that the supplies were in National City, but the job was actually in San Diego.[149] Company representatives then located a building (which happened to be a brand

138. *See id.*
139. *See id.*
140. *See id.*
141. *See* Akst, *supra* note 130.
142. *See id.*
143. *See id.*
144. *Id.*
145. *See id.*
146. *See id.*
147. *See* Akst, *supra* note 130.
148. *See id.*
149. *See id.*

new office building, just taken over by the Federal Savings & Loan Insurance Corp.), obtained the keys with the same weekend story, put up ZZZZ Best signs and phony contractor permits, and took down any "For Rent" signs.[150] After another successful scam, the careful auditor later demanded to see the same building with the work completed.[151] This forced the company to take a seven-year lease on the entire building so they could give the follow-up tour.[152] Later, the same day of the follow-up tour, they flew the auditor to Dallas to view a warehouse full of carpet (the same carpet he had seen in National City/San Diego on his earlier trip).[153] All of this planning paid off, as the auditor's note to the file indicated that the "[j]ob looks very good."[154]

Ultimately, after the sham fell apart, injured investors filed suit against Ernst & Young. They alleged that the first quarter financial information from 1986, which was included in ZZZZ Best's offering prospectus, gave the company a clean audit.[155] Despite the company's efforts to dupe the auditors as described above, plaintiffs alleged that Ernst & Young did know of major discrepancies in internal accounting procedures and that the figures released by ZZZZ Best were not accurate.[156] Thus, the plaintiffs alleged that by issuing this report, Ernst & Young knowingly engaged in a fraudulent scheme which contained misrepresentations and/or omissions that directly affected the purchase of the company's initial stock offering.[157]

The defendants in the case countered that because of the Supreme Court's elimination of aider and abettor liability, the plaintiffs could not base their case on Section 10(b) and Rule 10b-5, and they therefore sought summary judgment.[158] They contended that all of the financial reports, press releases and prospectus documents were released to the public by ZZZZ Best and would therefore not be attributable to Ernst & Young.[159]

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150. *See id.*
151. *See id.*
152. *See id.*
153. *See* Akst, *supra* note 130.
154. *Id.*
155. *See In re* ZZZZ Best Securities Litig., 864 F. Supp. 960, 964 (C.D. Cal. 1994).
156. *See id.*
157. *See id.*
158. *See id.* at 965.
159. *See id.* at 966.

The court immediately noted that under *Central Bank*, there is "a significant change in Section 10(b)/Rule 10b-5 liability."[160] They then summarized *ZZZZ Best* by stating that the "real issue presented by this motion is whether *Central Bank's* prohibition of aider and abettor liability also limits the scope of primary liability under Section 10(b)/Rule 10b-5."[161] It is still generally understood that a party may violate Section 10(b) even though that party did not directly commit the manipulative or deceptive act in question.[162] To aid in the decision, the court looked to the three elements that the Ninth Circuit stated in *Levine v. Diamanthuset, Inc.*[163] These elements are: 1) conduct as outlined in the statutes; 2) a purchase or sale of securities connected to this conduct; and 3) resulting damages.[164]

The plaintiffs countered defendant's claims that additional statements (beyond the report in the prospectus) could not be attributed to Ernst & Young because no evidence had been offered to show that these statements indicated preparation or review by the auditors claiming there was sufficient evidence to show Ernst & Young's participation.[165] The court, noting that the case was a close call and perhaps one of first impression, relied on two earlier circuit court holdings and agreed with plaintiffs.[166]

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160. *Id.* at 967.

161. *In re ZZZZ Best*, 864 F. Supp. at 968.

162. *See* Lawton v. Nyman, No. Civ.A. 98-288-T, 1999 WL 669837, at *3 (D.R.I. Aug. 24, 1999).

163. 950 F.2d 1478, 1485 (9th Cir. 1991). This was a case in which investors in a diamond investment scheme brought a class action against a diamond investment corporation and its officers, banks, trust company, counsel for corporation, and firms with which counsel was affiliated, alleging violations of securities laws, RICO, and various state laws. The district court held that confirmations of deposits sent by bank and trust company to investors did not constitute "securities," that allegations of fraud were not stated with sufficient particularity to state a claim for primary liability under § 10(b) and rule 10b-5, as well as holding on two issues outside the scope of this paper on RICO and California Corporations Code.

164. *See id.*

165. *See In re ZZZZ Best*, 864 F. Supp. at 970.

166. *See generally* SEC v. Seaboard, 677 F.2d 1301 (9th Cir. 1982) (holding that "[a]n accountant may be liable for direct violation of [Rule 10(b)] if its participation in the misrepresentation is direct and if it knows or is reckless in not knowing that the facts reported in the prospectus materially misrepresent the condition of the issuer"). *See also* Union Carbide Corp. Cons. Prod. Bus. Sec. Lit., 676 F. Supp. 458 (S.D.N.Y. 1987) (holding that an accountant's "[p]reparation of misleading projections or provision of the raw data for such projections can constitute participation in a misrepresentation, and lead to primary 10b-5 liability").

On the issue of omissions of information, it is well settled that failure to act does not give rise to a Section 10(b) claim unless the plaintiffs establish that defendants have a specific relationship which creates such a duty.[167] The significance of the *Dirks* holding is that if Ernst & Young is found at trial to have sufficiently participated in the preparation of the additional misstatements or omissions such that they are attributed to themselves, then they will likewise be found to have a duty to disclose or correct these previously released misrepresentations.[168]

In summarizing their logic as to what has now become known as the substantial participation test, the *ZZZZ Best* court made a statement which most courts seem to miss:

> While the investing public may not be able to reasonably attribute the additional misstatements and omissions to E & Y, *the securities market still relied on those public statements and anyone intricately involved in their creation* and the resulting deception should be liable under Section 10(b)/Rule 10b-5.[169]

The court reaffirmed the Ninth Circuit's finding in *Blackie v. Barrack*[170] that "'Rule 10b-5 liability is not restricted solely to isolated misrepresentations or omissions; it may also be predicated on a practice, or course of business which operates . . . as a fraud.'"[171]

C. *Other Circuits' Views*

Though the Ninth Circuit's substantial participation and the Second Circuit's bright line tests have come forward as the leading tests, other circuits and the district courts within their jurisdictions have not been totally silent on the issue. The Northern District of Illinois seems to lean toward the substantial participation test in *Cashman v. Coopers & Lybrand*.[172] In that case, they note that an accountant can be held primarily liable under Rule 10b-5 for material misstatements or omissions in connection with the sale of a security.[173] They also state that in their circuit, primary liability under Section 10(b) requires an accountant's misstate-

167. *See* Dirks v. SEC, 463 U.S. 646, 654 (1983).
168. *See In re ZZZZ Best*, 864 F. Supp. at 971.
169. *Id.* at 970 (emphasis added).
170. 524 F.2d 891 (9th Cir. 1975).
171. *In re ZZZZ Best*, 864 F. Supp. at 972 (citation omitted).
172. 877 F. Supp. 425 (N.D. Ill. 1995).
173. *See id.* at 432.

ment to be certified, audited, prepared or reported.[174] In dictum, they note that under Section 10(b), a misstatement is as actionable as an omission.[175] They further note that defendants, Coopers and Lybrand, may be held primarily liable for any misstatements in the prospectus which can be attributed to statements made in the financial statements or other certified reports issued to the partnership at issue.[176]

The Eastern District of Pennsylvania also leans toward substantial participation, but perhaps not as far along the continuum as the Eastern District of Illinois.[177] In the case of *Vosgerichian v. Commodore Int'l,*[178] a decision rendered just months after *Central Bank*, the Eastern District of Pennsylvania Court dismissed claims that an accountant advising and guiding a client in making allegedly fraudulent misrepresentations as insufficient.[179] It would not dismiss the plaintiff's claim that the accounting firm committed securities fraud by issuing a clean opinion however, because it found that to be a statement made directly by defendant Arthur Andersen.[180] The court thus concluded that this was not affected by *Central Bank*.[181]

More toward the bright line end of the continuum, the District Court of Massachusetts commented in *In Re Centennial Tech. Litig.*[182] that the United States Supreme Court (in *Central Bank*) was "not willing to read into Section 10(b) a cause of action for conduct that did not amount to what the text of the statute prohibited—fraudulent or manipulative conduct."[183] The Massachusetts District Court felt that *Central Bank's* goal was to "constrict the ambit of private actions under Section 10(b) and to thereby reduce

174. *See id.*

175. *See id* at 433.

176. *See id.*

177. *See generally In re* MTC Elec. Technologies S'holders Litig., 898 F. Supp. 974, 985 (E.D.N.Y. 1995) (discussing the two main tests). MTC seems to be the first case where the names of the tests are discussed. It also states how "[a]t first blush, these cases seem to suggest two distinct approaches," but that "[u]pon closer scrutiny, however, these different approaches start to blur." *Id.* at 986.

178. 862 F. Supp. 1371 (E.D. Penn. 1994).

179. *See id.* at 1378.

180. *See id.*

181. *See id.*

182. 52 F. Supp. 2d 178 (D. Mass. 1999).

183. *Id.* at 185.

the number of parties implicated by that statute."[184] It went on to say that "[o]nly those primary violators, i.e., those who make a material misstatement or omission or commit a manipulative act, are subject to private suit under Section 10(b)."[185] The court ruled that Price Waterhouse, the accounting firm involved in *Kendall Square*, had reviewed and approved the quarterly financial statements and the prospectuses, but this did not constitute the making of a material misstatement.[186] The logic behind the finding was that because Price Waterhouse did not actually engage in the reporting of the financial statements and prospectuses, but only reviewed and approved them, the statements are not attributable to Price Waterhouse and it cannot therefore be found liable for making a material misstatement.[187] Note, however, that this decision is directly opposite to the similar Ninth Circuit case of *In re Software Toolworks,*[188] which reached the opposite conclusion under substantial participation. Plaintiffs in *Software Toolworks* pointed to *ZZZZ Best* for support of their position of accountant/auditor liability, but the court noted "[t]o the extent *ZZZZ Best* provides such support, the court declines to follow that decision, relying instead on the Supreme Court's emphatic conclusion in *Central Bank* that 'Section 10(b) prohibits only the making of a material misstatement. . .'"[189]

The Massachusetts District Court (which decided *Kendall Square*) also noted that the law imposes a broader liability for affirmative misrepresentations, and that a company will be found liable under Rule 10b-5 for affirmatively misleading investors into purchasing its stock by providing materially false or incomplete information.[190] The court goes even further to note that a viable Section 10(b) claim can be pled without alleging the existence of a fiduciary relationship.[191]

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184. *In re* Kendall Square Research Corp., 868 F. Supp. 26, 28 (D. Mass. 1994).

185. *Id.*

186. *See id.* See also note 1 in the decision, explaining how "structuring" of transactions is different than making of material misstatements.

187. *See id.* at 28.

188. 38 F.3d 1078 (9th Cir. 1994).

189. *In re* Kendall, 868 F. Supp. at 28 n.2.

190. *See In re* Fidelity/Micron Securities Litig., 964 F. Supp 539, 545 (D. Mass. 1997).

191. *See id.*

The Tenth Circuit, which has adopted the bright line test, observed clearly and succinctly:

> Reading the language of § 10(b) and 10b-5 through the lens of *Central Bank of Denver*, we conclude that in order for accountants to "use or employ" a "deception" actionable under the antifraud law, they must themselves make a false or misleading statement (or omission) that they know or should know will reach potential investors. In addition to being consistent with the language of the statute, this rule, though far from a bright line, provides more guidance to litigants than a rule allowing liability to attach to an accountant or other outside professional who provided "significant" or "substantial" assistance to the representations of others.[192]

D. *The Better Test*

Though the bright line test may be easier to administer,[193] its lower accuracy could be harmful to the markets over time. The very circuit which advances this test in *McMahan & Co. v. Wherehouse Entertainment, Inc.*[194] notes that "[s]ome statements, although literally accurate, can become, through their context and manner of presentation, devices which mislead investors. For that reason, the disclosure required by the securities laws is measured not by literal truth, but by the ability of the material to accurately inform rather than mislead prospective buyers."[195] The statement captures the idea that the markets look to information at face value, meaning that today's investors have an expectation of accuracy of the reports that get released in connection with public companies. Perhaps because of the very success of the Securities Exchange Acts and the SEC, there is somewhat of a presumption of truth to information in our markets. And showing just how narrow that tolerable range of accurate information can be, the Fifth

192. Anixter v. Home-Stake Prod. Co., 77 F.3d 1215, 1226-27 (10th Cir. 1996).

193. One must question how much easier these decisions are in consideration of *Anixter*. Though subscribing to the bright line test, "[t]his securities fraud case, first filed in 1973, already has been the subject of four published opinions by this court. Over the past four years it has been ordered dismissed, reinstated, remanded, and now, appealed once more." *Id.* at 1218. Twenty three years later it was remanded yet again. Admittedly, most of the delay was not due to the decision of primary liability.

194. 900 F.2d 576 (2d Cir. 1990).

195. *Id.* at 579.

Circuit in *Isquith v. Middle South Utilities, Inc.*[196] noted that "emphasis and gloss can, in the right circumstances, create liability."[197]

The courts applying the bright line test appear rather naïve regarding the communication of financial information disseminated to the stock market and its investors. While it may be true that some financial statements may not directly state the name of the firm that prepared or audited them, sophisticated investors trading on the major exchanges expect that such reports have been created in collaboration with an accounting firm. This should be enough to at least bring in the *Chiarella* duty of having that company's firm issue a statement to the contrary if they have not assisted in the preparation of reports that are communicated by others.

Another key indicator to substantial participation is that subsequent to *Central Bank*, Congress passed a law authorizing the SEC to bring enforcement actions against those who "knowingly provide substantial assistance to another person" in violation of the federal securities laws.[198] This legislation, the Private Securities Litigation Reform Act of 1995, is not available for a private party who seeks redress. It seems incongruent to have the Securities Exchange Act of 1934 available to both the SEC and private parties in an attempt to ensure efficient administration of the securities markets, and to then deny private parties the same rights under this act. Instead, courts should allow private parties redress via the substantial participation test.

When all is said and done, the true issue becomes how one defines the term "indirectly." Clearly, the concept of indirect action was intended to create liability in some instances, as the term is used in both Section 10(b) and Rule 10b-5. Yet the other boundary becomes the decision in *Central Bank*, claiming that "it is not plausible to interpret the statutory silence [on aiding and abetting] as tantamount to an implicit congressional intent to impose § 10(b) aiding and abetting liability."[199] Yet even *Central Bank* acknowledges that while aiding and abetting may not be enough for liabil-

196. 847 F.2d 186 (5th Cir. 1988).

197. *Id.* at 203.

198. 15 U.S.C. § 78t(f) (1994).

199. *Central Bank* of Denver v. First Interstate Bank of Denver, 511 U.S. 164, 185 (1994).

ity, the "absence of § 10(b) aiding and abetting liability does not mean that secondary actors in the securities markets are always free from liability under the securities Acts."[200] As a conclusion on this area of the decision, the Court in *Central Bank* notes that "[a]ny person or entity, including a lawyer, accountant, or bank, who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator under 10b-5. . . ."[201]

To resolve this issue, it is necessary to strike a balance between adequately protecting investors, yet stopping before giving them scapegoats to sue every time they lose money. It seems an odd strategy to allow one to shirk all liability by simply marking exhibits as 'unaudited.' This is because the markets have an expectation that companies do an annual audit of financial statements, but that interim statements are likely unaudited. Thus, there is a connotation attached to usual procedures that even though an audit may not have been conducted, the accounting firm is still involved to some degree. This gives weight to the substantial participation test. For example, in *Wright*, it is not contested that the communications were not made directly from the auditors.[202] Instead, one of the complaints was that Ernst & Young, by electing to perform only a limited review of the acquired Summit business, "did not uncover the massive 'accounting and financial reporting irregularities' at BT-Summit."[203] Thus, it appears auditors are expected to do more than issue some reports. This shows how the markets are relying on more than direct communications from these third parties.

VII. CONCLUSION

Perhaps the substantial participation test evolved because the court deciding *ZZZZ Best* felt behavior that outrageous should not be allowed to slip through the cracks. Regardless of whether the court considered this, it is definitely something that should be given thought. Trying to put a muzzle on the information expectations of market investors serves no fruitful purpose.

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200. *Id.* at 191.

201. *Id.*

202. *See* Wright v. Ernst & Young LLP, 152 F.3d 169, 175 (2d Cir. 1998).

203. *See id.* at 172.

If a case such as *Wright* were subjected to the substantial participation test as opposed to its own bright line test, it is rather unlikely to yield a different result.[204] The flip-side, however, is where the danger lies. Subjecting *ZZZZ Best* to the bright line test would likely not show any liability[205].

If the purpose of Section 10(b) and Rule 10b-5 are to prevent fraud, perhaps a hard line needs to be taken, saying that despite an auditor's being duped by a rather elaborate hoax, such an outrageous scheme should not have gone undetected. Further, it is a second atrocity where an auditor becomes aware of information contrary to that which they have participated in preparing, reviewing, etc., and they do not disseminate a correction to the market that is relying on it. If this became a trend, our markets, respected throughout the world for the integrity in information yielded, would be no safer than that of many lesser developed nations.

Further, the Second Circuit fully appreciated the fact that markets use and make assumptions about information that comes from companies at the stage of a corporation's life where they are about to become a public company. If it is too easy for an accountant, auditor, or other professional to walk away from statements that, while technically might have been made by a third party, would be attributed to the professional by reasonable investors, we lose our corporate checks and balances.

To conclude, the substantial participation test is the best alternative to promote the goals of Section 10(b) and Rule 10b-5. Using a lower threshold would soon have American stock markets selling more than just securities short.

Russell P. Marsella

204. This is more than pure conjecture. In its opinion, the Second Circuit noted that "even under the 'substantial participation' test, we would be hard pressed to conclude that the amended complaint alleged an actionable misrepresentation within the meaning of § 10(b)." *Id.* at 176.

205. In *ZZZZ Best*, the auditors were duped into signing off on the finances of the company. However, even so, this would likely be viewed as aiding and abetting, which doesn't rise to the threshold necessary for primary liability.