

LAWYERS, OTHER CORPORATE ADVISERS FACE EXPOSURE TO SECURITIES CLAIMS

by

Steven S. Scholes

Prior to the United States Supreme Court's 1994 decision in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994), lawyers, accountants, investment bankers and other corporate advisers faced substantial exposure in private litigation under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder. This exposure arose in significant part from theories that the secondary actors "aided and abetted"¹ or "conspired"² with the primary violator, or were otherwise responsible for the primary violation on *respondeat superior* or other common law agency principles.³ In *Central Bank*, the Supreme Court gave some measure of relief to professionals in holding that no cause of action exists for aiding and abetting a violation of Rule 10b-5: "[T]he text of the 1934 Act does not itself reach those who aid and abet a § 10(b) violation . . . [T]he statute prohibits only the making of a material misstatement (or omission) or the commission of a manipulative act." 511 U.S. at 177. "The proscription does not include giving aid to a person who commits a manipulative or deceptive act." *Id.*

¹*Central Bank*, 511 U.S. at 191.

²See, e.g., *U.S. Industries, Inc. 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, 197-198 (1st Cir. 1972); *Shell v. Hensley*, 430 F.2d 819, 827, n.13 (5th Cir. 1970); *Dasho v. Susquehanna Corp.*, 380 F.2d 262, 267, n.2 (7th Cir.), *cert. denied sub nom. Bard v. Dasho*, 389 U.S. 977 (1967). See generally William H. Kuehnle, *Secondary Liability Under the Federal Securities Laws*, 14 J. CORP. L. 313, 343-348 (1989).

³See, e.g., *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1576-1577, and n. 27 (CA9 1990) (en banc) (citing and following decisions to this effect from six other Circuits). See generally Kuehnle, *supra* note 2, at 350-376.

Steven S. Scholes is a partner in the Trial Department of the law firm McDermott, Will & Emery, resident in its Chicago office, and co-chair of the Firm's Securities Litigation Practice Group, as well as its SEC Defense Group.

Central Bank not only put an end to private aiding and abetting claims,⁴ but it has been construed to bar other theories of secondary liability, such as conspiracy theories.⁵ While *Central Bank* ended the ability of private plaintiffs to reach professionals under Rule 10b-5 on aiding and abetting claims, the government may bring such claims in both criminal prosecutions and civil enforcement proceedings, and private litigants have other avenues for reaching professionals for violations of the federal securities laws.

Exposure to Claims of Secondary Liability by the Government. Under Section 32(a) of the Exchange Act, any willful violation of the act or any rule or regulation thereunder may be prosecuted criminally, except that no person is subject to criminal prosecution for the violation of a rule or regulation if the person had no knowledge of the rule or regulation. 15 U.S.C. § 78ff(a) (2003). Moreover, 18 U.S.C. § 2 expressly provides that it is a crime to aid and abet the commission of a crime by another: “Whoever commits an offense against the United States or aids, abets, counsels, commands, induces or procures its commission, is punishable as a principal.” 18 U.S.C. § 2(a) (2003).⁶ Because a violation of Rule 10b-5 can constitute a crime under § 32(a) of the Exchange Act, aiding and abetting a criminal violation of Rule 10b-5 can constitute a crime under 18 U.S.C. § 2. Thus, the Justice Department may prosecute criminally anyone who aids and abets a primary violation of Rule 10b-5, or any other provision of the federal securities laws. Ironically, because there is no civil analog to this provision, it is possible for the government to prosecute a person criminally for aiding and abetting a violation of Rule 10b-5, even though a private party could not recover damages through a private action against the same person on the same theory, due to *Central Bank*.

In addition, the year following the *Central Bank* decision, Congress passed the Private Securities Litigation Reform Act of 1995, which expressly provides the SEC with authority to institute enforcement proceedings in federal district courts against those who “knowingly provide [] substantial assistance to another person in violation of” the 1934 Act, including Section 10(b) and Rule 10b-5.⁷ See

⁴See *Teague v. Bakker*, 35 F.3d 978 (4th Cir. 1994); *Melder v. Morris*, 27 F.3d 1097 (5th Cir. 1994); *In re Software Toolworks Inc. Securities Litigation*, 50 F.3d 615 (9th Cir. 1994); *Anixter v. Home-Stake Production Co.*, 77 F.3d 1215 (10th Cir. 1996).

⁵It would be “beyond logic to maintain that although *Central Bank* prohibits aiding and abetting liability it permits plaintiffs to maintain the same cause of action by labeling it a conspiracy.” *Van De Velde v. Coopers & Lybrand*, 899 F. Supp. 731, 738 (D. Mass. 1995) (quoting *In re Ross Systems Securities Litigation*, No. C-94-0017-DLJ, 1994 U.S. Dist. LEXIS 21263 (N.D.Cal. July 21, 1994)). See also *Snap-on Inc. v. Ortiz*, No. 96 C 2138, 1996 U.S. Dist. LEXIS 16045 (N.D.Ill. Oct. 24, 1996).

⁶In addition, subsection (b) of 18 U.S.C. Section 2 provides:

Whoever willfully causes an act to be done which if directly performed by him or another would be an offense against the United States, is punishable as a principal.

⁷Section 20(e) of the Exchange Act provides:

For purposes of any action brought by the Commission under paragraph (1) or (3) of section 21(d), any person that knowingly provides substantial assistance to another person in violation of a provision of this title, or of any rule or regulation issued under this title, shall be deemed to be in violation of such provision to the same extent as the person to whom such assistance is provided.

15 U.S.C. § 57b-1(e) (2003). Sections 21(d)(1) and (3) authorize the Commission to bring actions for injunctions and civil money penalties in federal court. 15 U.S.C. § 78u(d)(1) (2003).

Exchange Act § 20(e), 15 U.S.C. § 77t(e) (2003). Section 20(e) provides that aiders and abettors are “deemed to be in violation . . . to the same extent as” the primary violator.⁸ *Id.*

The SEC also may pursue secondary actions in administrative proceedings. The SEC may issue an administrative cease-and-desist order against any person, whether or not that person is subject to administrative regulation by the SEC. Such an order may issue against any person who is a mere “cause” of a violation “due to an act or omission the person knew or should have known would contribute to such violation.” See Exchange Act § 21C, 15 U.S.C. § 78u-3 (2003). There is no heightened state of mind requirement for the issuance of a cease-and-desist order. Not even a finding of willfulness is necessary, even though “willfulness” has been interpreted to mean only that the respondent intentionally committed the act that constituted the violation. See *Tager v. SEC*, 344 F.2d 5 (2d Cir. 1965). Mere negligence is all that is required. See *In re Graham*, Admin. Proc. File No. 3-8511, 1995 SEC LEXIS 3457 at *72 (Dec. 28, 1995); *In re Haynes*, Admin. Proc. File No. 3-8512, 1995 SEC LEXIS 3134 at *84 (Nov. 24, 1995); *In re Kulak*, Admin. Proc. File No. 3-8509, 1995 SEC LEXIS 2481 at *70 (Sept. 26, 1995). In addition, under Section 21B(a)(2), the Commission may impose a civil money penalty in an administrative proceeding against any person who willfully aids and abets a violation of the Exchange Act, or several other specifically delineated acts. 15 U.S.C. § 78u-2(a)(2) (2003).

Thus, secondary actors are subject to criminal prosecution and SEC civil enforcement based solely on claims that the secondary actor aided and abetted another’s violation of the federal securities laws.

Exposure to Claims of Secondary Liability by Private Parties. While *Central Bank* expressly eliminated any claim for aiding and abetting in private litigation, and implicitly eliminated other secondary liability claims such as conspiracy claims, secondary actors still face significant liability exposure not only to the government but also to private parties. First, given the *Central Bank* decision, plaintiffs’ lawyers struggle mightily, sometimes successfully, to cast secondary actors as primary violators. *Central Bank* does not preclude securities claims for primary liability against parties generally considered to play secondary roles in transactions (such as accountants or lawyers). See, e.g., *In re Enron Corp. Securities Derivative & ERISA Litigation*, 235 F. Supp. 2d 549, 588-91, 687 (S.D. Tex. 2002); *In re Worldcom, Inc. Securities Litigation*, 2003 WL 212/9049 at *8 (S.D.N.Y. 2003) *Sullivan v. Rilling*, 94 C 539, 1999 U.S. Dist. LEXIS 4746 (N.D. Ill. Mar. 31, 1999); *Van De Velde*, *supra* note 5; *O’Neil v. Appel*, 897 F. Supp. 995, 999–1000 (W.D. Mich. 1995). For example, some post-*Central Bank* cases have held that secondary defendants can be liable for statements made by others if they “substantially participated” in preparing the statements.⁹

⁸*Central Bank* did not affect the express aiding and abetting provision in Section 15(b)(4)(E) of the Exchange Act, which subjects broker-dealers to having their registrations suspended or revoked for willfully aiding or abetting any provision of the Exchange Act and other specifically delineated acts. 15 U.S.C. § 78o(b)(4)(e) (2003).

⁹See, e.g., *In re Software Toolworks Inc. Securities Litigation*, 50 F.3d 615, 628 n.3 (9th Cir. 1994) (accountant may be primarily liable based on “significant role” in drafting letter client sent to SEC); *In re ZZZZ Best Securities Litigation*, 864 F. Supp. 960, 970 (C.D. Cal. 1994) (accounting firm that was “intricately involved” in creating false documents published by client was primary violator); *Cashman v. Coopers & Lybrand*, 877 F. Supp. 425, 432 (N.D. Ill. 1995) (primary liability attached when accountant was charged with playing “central role in the drafting and formation of the alleged misstatements” that were incorporated into prospectus). However, other courts use a “bright line” test and restrict liability to those who actually make the representation on which plaintiffs claim to have relied. See *Ziemba v. Cascade International*, 256 F.3d

Moreover, there is substantial exposure to a purely secondary actor on several theories, even absent any contention that the person should be held responsible as a primary violator. One such theory is that the secondary actor was a “control person” of the primary actor and thus is liable jointly and severally with the primary actor under Section 20(a) of the Exchange Act. This liability attaches “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.” 15 U.S.C. § 78t(a).¹⁰

Similarly, under Section 20(b) of the Exchange Act, it is “unlawful for any person, directly or indirectly, to do any act or thing which it would be unlawful for such person to do under the provisions of this title or any rule or regulation thereunder through or by means of any other person.” 15 U.S.C. § 77t(b) (2003). While Section 20(b) has historically not been invoked often by plaintiffs’ lawyers, the holding in *Central Bank* precluding implied civil aiding and abetting claims under Rule 10b-5 has no impact on the rights statutorily established in Section 20(b).

Other theories which plaintiffs may pursue against secondary actors notwithstanding *Central Bank* include the theory that a person participated in a “scheme to defraud,” which is expressly prohibited by the text of Rule 10b-5, even though the person made no misrepresentation or omission in connection with the purchase or sale of a security. See *SEC v. Zandford*, 535 U.S. 813 (2002); *In re Enron Corp. Securities, Derivative & ERISA Litigation*, 235 F. Supp. 2d 549, 577 (S.D. Tex. 2002). However, in *In re Homestore.com*, 252 F. Supp. 2d 1018 (C.D. Cal. 2003), the court held that an action asserting that several companies participated with *Homestore.com* in a scheme to create illusory revenue by entering into questionable transactions was barred by *Central Bank*. Likewise, some courts have held that a principal is responsible for violations of Rule 10b-5 by the principal’s agent, even though the principal did not directly violate the rule. See *Suez Equity Investors, L.P. v. Toronto-Dominion Bank*, 250 F.3d 87 (2d Cir. 2001); *In re Centennial Technologies Litigation*, 52 F. Supp. 2d 178 (D. Mass. 1999).

Finally, Section 10(b) and Rule 10b-5 proscribe violations both “directly and indirectly.” 15 U.S.C. § 78j(b) (2003); 17 C.F.R. § 240.10b-5 (2003). Courts have not relied greatly on this language in adjudicating Rule 10b-5 claims and thus have not delineated the differences either between actionable direct violations and actionable indirect violations, or between actionable indirect violations and inactionable aiding and abetting claims. While *Central Bank* does not limit the reach of Rule 10b-5 to direct violations, *Central Bank* expressly holds that the “directly or indirectly” language of Rule 10b-5 does not imply a cause of action for civil aiding and abetting. *Central Bank*, 511 U.S. at 176.

Conclusion. While the Supreme Court’s decision in *Central Bank* certainly precluded the assertion of many claims against persons historically viewed as secondary actors, numerous theories for holding such persons responsible for primary violations are available to both the federal government and private litigants. Clearly, accountants, lawyers, investment bankers and others similarly situated should exercise a high degree of caution in their relationships with their public company clients, in view of their own potential for liability under Rule 10b-5 and other provisions of the federal securities laws.

1194 (11th Cir. 2001); *Wright v. Ernst & Young, LLP*, 152 F.3d 169 (2d Cir. 1998); *Anixter v. Home-Stake Production Co.*, 77 F.3d 1215 (10th Cir. 1996).

¹⁰The Securities Act of 1933 contains a substantially similar provision in Section 15. 15 U.S.C. § 77o (2003).