

RETHINKING ATTORNEY LIABILITY UNDER RULE
10b-5 IN LIGHT OF THE SUPREME COURT'S DECISIONS
IN *TELLABS* AND *STONERIDGE*

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INTRODUCTION

“Mr. Gorbachev, tear down this wall!”¹ On June 12, 1987, former President Ronald Reagan issued this famous exhortation to Mikhail Gorbachev during a speech at the Brandenburg Gate of the Berlin Wall.² Heralded by many as President Reagan’s most memorable speech, the Berlin Wall Address (as it famously has come to be known) was authored, at least in part, by the president’s speech writer at the time, Peter Robinson.³ Although it is no secret that presidents have speech writers, who are responsible for drafting or assisting in the preparation of the president’s public addresses, the public nonetheless attributes the words written by presidential speech writers to the president himself.

Like presidential speech writers, lawyers historically have played a significant role in drafting or otherwise assisting in the preparation of their clients’ public disclosure documents, including SEC filings, securities offering documents, and other communications made to the investing public.⁴ Notwithstanding the fact that lawyers are seldom identified by name or appear as signatories in their clients’ disclosure documents, lawyers play a crucial role in the public disclosure process.⁵

Assume, for a moment, that an SEC filing or other public communication made by a company contains materially misleading or false statements (or omissions) on which investors have relied in connection with the purchase or sale of a security. Should the attorneys who assisted in drafting those public disclosures be liable for fraud to third-party investors for material misrepresentations contained in their clients’ public disclosure docu-

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¹ President Ronald Reagan, Remarks at the Brandenburg Gate (June 12, 1987) (transcript available at <http://www.reaganlibrary.com/reagan/speeches/wall.asp>).

² *Id.*

³ See Peter Robinson, *Tearing Down That Wall*, THE WKLY. STANDARD, June 23, 1997, at 8, 8.

⁴ Lisa H. Nicholson, *A Hobson’s Choice For Securities Lawyers in the Post-Enron Environment: Striking a Balance Between the Obligation of Client Loyalty and Market Gatekeeper*, 16 GEO. J. LEGAL ETHICS 91, 100 (2002).

⁵ See *id.* (“Federal regulators and the investing public increasingly expect securities lawyers to ensure their clients’ compliance with the federal securities laws.”).

ments? The parade of horrors at Enron, WorldCom, Tyco, and most recently at Refco has heightened the urgency to find acceptable approaches to complex issues concerning the scope of secondary actor liability for securities fraud.⁶

Following the Supreme Court's abolition of aiding and abetting liability in *Central Bank of Denver v. First Interstate Bank of Denver*,⁷ a schizophrenic jurisprudence developed over whether attorneys (and other secondary actors) should be liable for securities fraud when their clients' public filings and other public communications contain material misstatements.⁸ The post-*Central Bank* jurisprudence has produced vastly different judicial standards of secondary actor liability.⁹ On one end of the spectrum exists a desire to limit meritless litigation against deep-pocket defendants such as lawyers by severely restricting the reach of existing anti-fraud liability. On the other end exists an acknowledgment of the potential for unabated, secondary actor fraud if the interpretation of the current standard of liability remains unchanged. The lawyer's role as a behind-the-scenes scrivener complicates an already-pitched debate surrounding the appropriate interpretation of existing anti-fraud legislation as well as the practicable scope of a potentially new regime of secondary actor liability for securities fraud. This debate has only become more complicated after the Supreme Court's recent decision in *Stoneridge Investment Partners v. Scientific-Atlanta, Inc.*¹⁰

This Article begins with a description of the *In re Enron Corp. Securities, Derivative & ERISA Litigation*,¹¹ which, because of the allegations made against Enron's primary outside law firm, brought the issue of attorney liability for securities fraud to center stage.¹² Part II of the Article sets forth the provisions of Section 10(b) of the Securities Exchange Act of 1934 (the "1934 Act")¹³ and Rule 10b-5¹⁴ promulgated thereunder, which, together, establish the existing parameters of securities fraud liability. Part

⁶ Professor Daniel Fischel has defined secondary actor liability as "judicially implied civil liability which has been imposed on defendants who have not themselves been held to have violated the express prohibition of the securities statute at issue, but who have some relationship with the primary wrongdoer." Daniel R. Fischel, *Secondary Liability Under Section 10(b) of the Securities Act of 1934*, 69 CAL. L. REV. 80, 80 n.4 (1981).

⁷ 511 U.S. 164 (1994).

⁸ See Taavi Annus, *Scheme Liability Under Section 10(b) of the Securities Exchange Act of 1934*, 72 MO. L. REV. 855, 859-61 (2007) ("[C]ourts have adopted three theories in order to delineate when the decisions have been 'made' by the secondary actors and when the secondary actors only assist in making the statements, thus being at most aiders and abettors Reliance on Rule 10b-5(b) has thus produced a clear split between different jurisdictions.").

⁹ *Id.*

¹⁰ 128 S. Ct. 761 (2008).

¹¹ 235 F. Supp. 2d 549 (S.D. Tex. 2002) (detailing the allegations of Vinson & Elkins's role in Enron's collapse).

¹² See *id.* at 656-69.

¹³ 15 U.S.C. §§ 78a-mm (2000).

¹⁴ 17 C.F.R. § 240.10b-5 (2008).

III discusses the Supreme Court's landmark decision in *Central Bank* as well as the decision's implications for the substantive reach of Section 10(b) and Rule 10b-5 liability to secondary actors. Part III also sets forth the heightened pleading requirements of the Private Securities Litigation Reform Act of 1995 (the "PSLRA")¹⁵ and their impact on the standards for pleading Section 10(b) claims. Part IV of the Article juxtaposes the judicial standards of secondary actor liability—the bright line, substantial participation, and creator standards—that emerged in the post-*Central Bank* era. Part V explores the benefits and disadvantages of each standard as well as some of the pragmatic concerns associated with the application of each standard in the secondary actor context. Part VI of the Article examines recent Supreme Court developments, including the Court's interpretation of the PSLRA's heightened pleading standards in *Tellabs Inc. v. Makor Issues & Rights, Ltd.*¹⁶ as they relate to allegations of scienter in Section 10(b) claims, and the Court's recent consideration of the parameters of secondary actor liability in *Stoneridge* under a new doctrinal analysis called scheme liability. Finally, Part VII of the Article prescribes a workable construction of Section 10(b) liability that, by incorporating the heightened pleading standards of the PSLRA, sets forth a sensible regime of secondary actor liability that effectuates the remedial purposes of the federal securities laws and balances the competing concerns outlined above.

I. THE ENRON SECURITIES CLASS ACTION

A. *Vinson & Elkins's Role as Enron's Primary Outside Counsel*

After the collapse of Enron, purchasers of Enron securities filed a securities fraud class action lawsuit against Enron, its officers and directors, a number of financial institutions, and Enron's outside advisers, including its law firm, Vinson & Elkins LLP ("V&E"), after suffering allegedly more than \$40 billion in losses.¹⁷ Preceding its spectacular collapse, Enron Corp., a Houston-based energy company and the seventh-largest company in the country, employed approximately 21,000 people, commanded \$60 billion in assets, and generated \$100 billion in revenue.¹⁸ From the mid-1980s to

¹⁵ Pub. L. No. 104-67, 109 Stat. 737 (codified as amended at 15 U.S.C. §§ 77z-1, 77z-2, 78j-1, 78u-4, 78u-5 (2000)).

¹⁶ 127 S. Ct. 2499 (2007).

¹⁷ *In re Enron Corp. Sec., Derivative & ERISA Litig.*, 235 F. Supp. 2d 549, 611, 656-69 (S.D. Tex. 2002); Carrie Johnson & Robert Barnes, *Court Declines Enron Investors' Appeal*, WASH. POST, Jan. 23, 2008, at D1.

¹⁸ Enron Corp., Annual Report (Form 10-K) (Apr. 2, 2001), available at <http://www.sec.gov/Archives/edgar/data/1024401/000102440101500010/ene10-k.txt>; Douglas M. Branson, *Enron—When*

2002, V&E served as Enron's primary outside counsel.¹⁹ In the five years preceding the Enron conflagration, V&E had generated over \$160 million in fees from Enron.²⁰ In 2001 alone, Enron accounted for more than seven percent of V&E's \$450 million in revenue.²¹ Over the course of their long-standing relationship, V&E advised Enron on more than 800 transactions, including numerous related-party transactions.²²

B. *Vinson & Elkins's Role in the LJM Transactions*

Specifically, V&E advised Enron on the formation of LJM1 and LJM2—private investment limited partnerships controlled by Andrew Fastow, Enron's Chief Financial Officer ("CFO").²³ Characterized as "the main engines of the Enron fraud," the LJM related-party transactions allegedly were part of a scheme that generated "hundreds of millions of dollars of phony profits" for Enron and improperly housed many of Enron's liabilities in the LJM entities as well as other off-balance sheet entities.²⁴ From June

All Systems Fail: Creative Destruction or Roadmap to Corporate Governance Reform?, 48 VILL. L. REV. 989, 996 (2003).

¹⁹ Nicholson, *supra* note 4, at 97.

²⁰ Nathan Koppel, *Executives on Trial: Lay Says 'Classic run on Bank' Ruined Enron; Energy Firm's Outside Counsel Sits in the Cross Hairs of Lerach, Securities Class-Action Kingpin*, WALL ST. J., Apr. 25, 2006, at C1. Vinson & Elkins billed Enron for \$35.6 million in 2001, or 7.8% of its revenue, and between \$35 million and \$40 million in other years. Gary McWilliams & John R. Emshwiller, *Executives on Trial: Skilling Testimony May Come Today*, WALL ST. J., Apr. 6, 2006, at C3; Ellen Joan Pollock, *Limited Partners: Lawyers for Enron Faulted Its Deals, Didn't Force Issue—Vinson & Elkins Rejects Idea Firm Should Have Taken Doubts to Client's Board—Face to Face With Fastow*, WALL ST. J., May 22, 2002, at A1.

²¹ Mike France et al., *One Big Client, One Big Hassle: Vinson & Elkins' heavy reliance on Enron is now a potential liability for the law firm*, BUS. WK., Jan. 28, 2002, at 38, 38. By contrast, Enron represented less than one percent of its now-defunct auditor Arthur Andersen's revenues. See Jonathan Macey & Hillary A. Sale, *Observations on the Role of Commodification, Independence, and Governance in the Accounting Industry*, 48 VILL. L. REV. 1167, 1170 (2003). And yet, ironically, Arthur Andersen lays in the dust pile of Enron's ashes, while V&E marshals on, albeit hobbled by the negative press coverage it received relating to its former role as Enron's primary outside counsel. Neither V&E nor any of its attorneys have been sanctioned by the SEC, raising significant questions regarding the agency's willingness to bring enforcement actions against lawyers.

²² See *In re Enron*, 235 F. Supp. 2d at 656-69. Although other firms provided legal services to Enron, V&E was known to third parties as Enron's "go-to" law firm. See Pollock, *supra* note 20.

²³ Plaintiffs' Opposition to Motion to Dismiss Filed by Vinson & Elkins LLP at 9, *In re Enron*, 235 F. Supp. 2d 549 (No. H-01-3624) [hereinafter *In re Enron* motion], available at http://securities.stanford.edu/1020/ENE01/2002610_r05x_013624.pdf.

²⁴ *In re Enron* motion, *supra* note 23, at 2-4. See *In re Enron*, 235 F. Supp. 2d at 659 ("Similarly, Vinson & Elkins participated in the creation of both LJM partnerships and knew the reason for their establishment, i.e., so that Enron could effectuate transactions that it could not otherwise do with an independent entity, such as purchasing Enron assets that Enron otherwise was unable to sell at prices it would never otherwise receive.").

1999 through September 2001, Enron or Enron affiliates entered into twenty-four business transactions with LJM1 or LJM2.²⁵ These transactions included, among others: (1) sales of Enron assets to LJM2; (2) sales of LJM2 assets to Enron; (3) purchases of debt or equity interests by LJM1 or LJM2 in Enron-sponsored special purpose entities; (4) purchases of debt or equity interests by LJM1 or LJM2 in Enron affiliates or other entities in which Enron invested; and (5) purchases of equity investments by LJM1 or LJM2 in special purpose entities in order to mitigate market risk in Enron's investments.²⁶ According to court filings, V&E knew from the time of these entities' formation that Andrew Fastow was the managing agent of both LJM1 and LJM2, and that his arrangement with the LJM entities created a potential significant conflict of interest as it was unclear in any LJM/Enron transaction as to whether Fastow would serve Enron's interests as its CFO or LJM's interests as its managing agent.²⁷ V&E also understood that Enron's Board of Directors had implemented a number of safeguards to ensure that any transactions between Enron and the LJM entities were conducted on an arm's-length basis.²⁸

C. *Vinson & Elkins's Role in the Disclosure of the LJM Transactions*

During the course of V&E's representation of Enron, V&E advised on and drafted, at least in part, many of Enron's quarterly and annual reports on Forms 10-Q and 10-K, respectively, as well as all of its proxy statements, which contained particular emphasis on Enron's related-party disclosures.²⁹ In those public disclosures, Enron identified LJM as a related

²⁵ Enron Corp., Current Report (Form 8-K), at 10 (Nov. 8, 2001), available at <http://www.sec.gov/Archives/edgar/data/1024401/000095012901503835/h91831e8-k.txt>.

²⁶ *Id.* at 11. The court noted that "LJM2 was one of the primary manipulative devices to misrepresent Enron's financial results, was also secretly controlled by Enron, and was used to create a number of SPEs, including the Raptors, which in turn served to falsely inflate Enron's profits and conceal its debts." *In re Enron*, 235 F. Supp. 2d at 659.

²⁷ *In re Enron* motion, *supra* note 23, at 9-12.

²⁸ *The Financial Collapse of Enron—Part 2: Hearing Before the Subcomm. on Oversight and Investigations of the Comm. on Energy and Commerce*, 107th Cong. 106-10 (2002) (statement of Herbert S. Winokur, Jr., Chairman, Finance Comm., Board of Directors, Enron Corp.); S. REP. NO. 107-70, at 10, 30 (2002); Matthew J. Barrett, *Enron, Accounting and Lawyers*, NOTRE DAME LAW., Summer 2002, at 14, 17.

²⁹ The district court itself relied upon allegations from the Consolidated Complaint that the disclosures on which V&E worked concealed that the "transactions were not true commercial, economic transactions comparable to those with independent third parties . . . [;] failed to disclose Fastow's actual financial interest in or compensation from the LJM partnerships"; and were materially misleading because they "gave the impression that each transaction was fair to the company, not contrived, but made at arm's length as it would have been if made with an independent third party." *In re Enron*, 235 F. Supp. 2d at 661-62; WILLIAM C. POWERS, JR. ET AL., ENRON CORP., REPORT OF INVESTIGATION BY THE

party and stated that Enron's transactions with the LJM entities were at arm's length and on terms no more favorable than similar arrangements with unrelated third parties.³⁰ From LJM's inception in 1999, however, V&E became concerned that the transactions between LJM and Enron were not at arm's-length when V&E attorneys learned of a potential side agreement Enron had entered into with Mr. Fastow guaranteeing that LJM would not lose money on a particular deal.³¹ By 2000, V&E received further indication that the transactions between Enron and the LJM entities were not at arm's-length when it discovered that LJM2 had earned an outstanding \$41 million within one month in connection with the early settlement of an option.³² Despite V&E's alleged knowledge of the conflict of interest that Mr. Fastow had as CFO of Enron and managing agent of the LJM limited partnership investment vehicles, V&E itself allegedly added language to the related-party disclosures of Enron's public filings stating that the LJM transactions "involved dispositions of interests in the ordinary course of Enron's business and were negotiated on an arm's length basis with senior officers [of Enron] other than Mr. Fastow."³³ During the class period, V&E continued to assist Enron in drafting public disclosures that included this arm's-length language.³⁴

By November 2001, unable to further obfuscate financial results due to the declining stock market, Enron restated its earnings from 1997 through 2001.³⁵ Many of the liabilities that had been improperly housed in the LJM entities and other off-balance sheet vehicles were returned to Enron's balance sheet.³⁶ On December 2, 2001, Enron filed for bankruptcy.³⁷ Investors

SPECIAL COMMITTEE OF THE BOARD OF DIRECTORS OF ENRON CORP. 17, 25-26 (2002) [hereinafter POWERS REPORT], available at <http://i.cnn.net/cnn/2002/LAW/02/02/enron.report/powers.report.pdf>.

³⁰ *In re Enron*, 235 F. Supp. 2d at 660-61 ("The disclosures consistently misrepresented that terms of Enron's transactions with related third parties were representative of terms that could have been obtained from independent third parties.").

³¹ Appellees' Brief Responding to Merrill Lynch, Credit Suisse and Vinson & Elkins Appeals at 126-27, *In re Enron*, No. 07-20051, 2008 WL 2689248, at *1 (5th Cir. July 10, 2008) [hereinafter *Appellees' Response*], available at http://www.enronfraud.com/pdf/fifth_circuit_response_brief_122906.pdf; POWERS REPORT, *supra* note 29, at 134-35; Alexei Barrionuevo, *Warning on Enron Recounted*, N.Y. TIMES, Mar. 16, 2006, at C1; Pollock, *supra* note 20.

³² See POWERS REPORT, *supra* note 29, at 100-07. "V&E learned that early settlement of the put in Raptor I had returned to LJM2 its entire investment (\$30 million) plus a 30% rate of return (\$11 million, for a total of \$41 million) within one month." *Appellees' Response*, *supra* note 31, at 141 n.179.

³³ *Appellees' Response*, *supra* note 31, at 141.

³⁴ See *In re Enron*, 235 F. Supp. 2d at 662; *Appellees' Response*, *supra* note 31, at 111; POWERS REPORT, *supra* note 29, at 25-26.

³⁵ See Enron Corp., Current Report (Form 8-K), at 1 (Nov. 8, 2001), available at <http://www.sec.gov/Archives/edgar/data/1024401/000095012901503835/h91831e8-k.txt>.

³⁶ *Id.*; Robert W. Hamilton, *The Crisis in Corporate Governance: 2002 Style*, 40 HOUS. L. REV. 1, 10 (2003).

³⁷ Peter Behr, *Ailing Enron Files for Chapter 11 Bankruptcy Protection*, WASH. POST, Dec. 3, 2001, at A7.

lost billions of dollars.³⁸ Assuming V&E drafted or otherwise assisted in the preparation of knowingly false and materially misleading public disclosures for its client, Enron, what, if any, liability should have attached to V&E for securities fraud? Should investors who relied on those false or misleading disclosures in purchasing or selling Enron securities have been allowed to bring suit against V&E even though they had no information prior to Enron's collapse about V&E's specific role in drafting Enron's public disclosures?

Before exploring these questions, it is important to understand the current landscape of secondary actor liability. The following Part sets forth the anti-fraud provisions of Section 10(b) and Rule 10b-5 of the 1934 Act as well as pre-*Central Bank* law on aiding and abetting liability.

II. SECTION 10(b) OF THE SECURITIES EXCHANGE ACT OF 1934

A. *Section 10(b), Rule 10b-5, and the Elements of a Cause of Action Thereunder*

Following the stock market crash of 1929, Congress enacted two pieces of landmark securities legislation in an effort to resurrect public confidence in the capital markets: the Securities Act of 1933 (the "1933 Act")³⁹ and the 1934 Act (together with the 1933 Act, the "Acts").⁴⁰ Collectively the Acts form the basis of federal securities law by setting forth a system of mandatory, periodic disclosure designed to remedy the unscrupulous market practices that had preceded the stock market's collapse.⁴¹ Rather than embrace an intrusive federal role in the operation of the capital markets, the Acts' disclosure-minded orientation sought to correct the informational asymmetries that public shareholders typically experienced vis-à-vis company insiders and other market professionals.⁴² "More generally, Congress sought to substitute a philosophy of full disclosure for the philosophy of

³⁸ Steven Pearlstein & Peter Behr, *At Enron, the Fall Came Quickly; Complexity, Partnerships Kept Problems from Public View*, WASH. POST, Dec. 2, 2001, at A1.

³⁹ The Securities Act of 1933, Pub. L. No. 73-22, 48 Stat. 74 (codified as amended at 15 U.S.C. §§ 77a-77aa (2000)).

⁴⁰ See Steve Thel, *The Original Conception of Section 10(b) of the Securities Exchange Act*, 42 STAN. L. REV. 385, 410-15 (1990).

⁴¹ *Id.* at 390.

⁴² See *id.* See also André Douglas Pond Cummings, "Ain't No Glory in Pain": *How the 1994 Republican Revolution and the Private Securities Litigation Reform Act Contributed to the Collapse of the United States Capital Markets*, 83 NEB. L. REV. 979, 995 (2005) ("The 1933 Securities Act, 1934 Securities Exchange Act, and the battery of federal regulations that were put into place by President Roosevelt and the New Deal Congress for the express purpose of protecting U.S. investors sought to strike a delicate balance between investor protection and enhancement of capital formation by U.S. corporations.").

caveat emptor and thus to achieve a high standard of business ethics in the securities industry.”⁴³ To that end, the 1933 Act makes disclosure mandatory during the initial offering of a security,⁴⁴ while the 1934 Act continues to enforce this disclosure as the security is being publicly traded.⁴⁵

An essential tool for promoting the “informational integrity” of the capital markets is Rule 10b-5, promulgated by the Securities and Exchange Commission (“SEC”) under the authority granted to it by Congress in Section 10(b) of the 1934 Act.⁴⁶ Section 10(b) generally prohibits fraud in connection with the sale or purchase of a security. Under Section 10(b), it is unlawful for any person, directly or indirectly, to:

[U]se or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [Securities and Exchange Commission] may prescribe as necessary or appropriate in the public interest or for the protection of investors.⁴⁷

Rule 10b-5 states, in relevant part, that:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

- (a) To employ any device, scheme, or artifice to defraud,
- (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or
- (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.⁴⁸

Section 10(b) and Rule 10b-5 are co-extensive.⁴⁹ If Section 10(b) does not give rise to liability, *a fortiori*, Rule 10b-5 does not either.⁵⁰

⁴³ SEC v. Zandford, 535 U.S. 813, 819 (2002) (citations and internal quotation marks omitted) (quoting *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 151 (1972)).

⁴⁴ James C. Spindler, *IPO Liability and Entrepreneurial Response*, 155 U. PA. L. REV. 1187, 1188 (2007) (“Sellers of securities—such as founding entrepreneurs—are required under the Securities Act of 1933 to make full and complete disclosure to purchasing investors (the public shareholders) in public offerings.”).

⁴⁵ Robert M. Lawless et al., *The Influence of Legal Liability on Corporate Financial Signaling*, 23 J. CORP. L. 209, 218 (1998) (“[T]he 1934 Act governs the trading of securities in the secondary markets, such as the New York Stock Exchange or the NASDAQ.”).

⁴⁶ JAMES D. COX ET AL., SECURITIES REGULATION 701 (3d ed. 2001).

⁴⁷ 15 U.S.C. § 78j(b) (2000).

⁴⁸ 17 C.F.R. § 240.10b-5 (2007).

It is well-established that under Rule 10b-5, investors have an implied private right of action for securities fraud.⁵¹ To state a claim for relief, a plaintiff must prove: (1) that the defendant made an untrue statement (or omission); (2) of a material fact; (3) that the plaintiff relied on the untrue statement (or omission); (4) that the plaintiff sustained damages as a proximate result of the untrue statement (or omission);⁵² (5) that the defendant made the untrue statement (or omission) with scienter; and (6) that the conduct occurred in connection with the sale or purchase of a security.⁵³

The making of an untrue statement or the failure to disclose information (an omission) is actionable only if the untrue statement (or omission) is material. The standard for materiality is whether “there is a substantial likelihood that a reasonable shareholder would consider [a fact or omission] important” when making an investment decision.⁵⁴ Put another way, the materiality threshold is satisfied if the untrue statement (or omission) sig-

⁴⁹ See *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164, 173 (1994) (“We have refused to allow [private] 10b-5 challenges to conduct not prohibited by the text of the statute.”); see also *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 213-14 (1976) (stating that the scope of Rule 10b-5 “cannot exceed the power granted the Commission by Congress under § 10(b)”).

⁵⁰ See Jeanne L. Schroeder, *Envy and Outsider Trading: The Case of Martha Stewart*, 26 CARDOZO L. REV. 2023, 2046 (2005) (“Although the language of Rule 10b-5 is broader than that of § 10(b), under the basic principles of administrative rulemaking, the rule should not be read more expansively than the statute under which it is promulgated.”).

⁵¹ See *Ernst & Ernst*, 425 U.S. at 196 (citing *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 730 (1975)); *In re Parmalat Sec. Litig.*, 376 F. Supp. 2d 472, 494 (S.D.N.Y. 2005) (noting that the implied private right of action under Rule 10b-5 has been recognized in the lower courts since 1946 and acknowledged by the Supreme Court in 1971). Consistent with the Acts’ goals, meritorious private securities actions deter wrongdoing by those entrusted with important gatekeeping functions, and in so doing, promote public confidence in the integrity and honesty of the capital markets. *SEC v. Zandford*, 535 U.S. 813, 819 (2002) (quoting *United States v. O’Hagan*, 521 U.S. 642, 658 (1997)) (stating that the securities laws embrace a philosophy of full and accurate disclosure in order to protect investors against fraud and promote honesty and fair dealing).

⁵² To establish proximate causation under Section 10(b), plaintiffs must prove “that they would not have suffered a loss on their investment if the facts were as they believed them to be at the time they purchased the securities.” *In re VMS Sec. Litig.*, 752 F. Supp. 1373, 1399 (N.D. Ill. 1990) (citing *LHLC Corp. v. Cluett, Peabody & Co.*, 842 F.2d 928, 931 (7th Cir. 1988)). See also Elizabeth A. Nowicki, *A Response to Professor John Coffee: Analyst Liability Under Section 10(b)*, 72 U. CIN. L. REV. 1305, 1331 (2004) (discussing how loss causation becomes “more difficult to establish with respect to non-issuers in part because causation is one step removed with respect to non-issuers. It is easier to see how actions by an issuer caused a loss to investors than it is to see how actions by a third party—an analyst, an underwriter, an accountant, a lawyer—caused a loss.”).

⁵³ See *Adams v. Kinder-Morgan, Inc.*, 340 F.3d 1083, 1095 (10th Cir. 2003) (citing *Grossman v. Novell, Inc.*, 120 F.3d 1112, 1118 (10th Cir. 1997)); *SEC v. Rana Research, Inc.*, 8 F.3d 1358, 1362-64 (9th Cir. 1993) (quoting *SEC v. Clark*, 915 F.2d 439, 449 (9th Cir. 1990)).

⁵⁴ *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976) (defining materiality in the context of proxy statements and Rule 14a-9); see also *Basic, Inc. v. Levinson*, 485 U.S. 224, 232 (1988) (“expressly adopt[ing] the *TSC Industries* standard of materiality for the § 10(b) and Rule 10b-5 context”).

nificantly alters the “total mix” of information made available to a reasonable investor.⁵⁵

Plaintiffs in a securities fraud lawsuit must also establish the requisite causal link between the defendant’s misrepresentation (or omission) and plaintiffs’ injury. To do so, plaintiffs must show that, in making their investment decision, plaintiffs *relied* on the information that the defendant provided to them.⁵⁶ To establish the requisite reliance, plaintiffs must prove that “defendants’ conduct caused [them] ‘to engage in the transaction in question.’”⁵⁷ As discussed in greater detail in Part IV, the current reliance debate juxtaposes two conflicting views on reliance for the establishment of

⁵⁵ *TSC Indus., Inc.*, 426 U.S. at 449. Omissions of material fact do not constitute Rule 10b-5 violations, however, unless there is a preexisting fiduciary duty to disclose such material information. *Schatz v. Rosenberg*, 943 F.2d 485 (4th Cir. 1991), is instructive on the courts’ reluctance to impose an affirmative duty to disclose outside of a fiduciary relationship. In that case, plaintiffs sold their business to a buyer who later declared bankruptcy and defaulted on payment. *Id.* at 488. Plaintiffs claimed that the law firm representing the buyer knew of the buyer’s imminent insolvency but failed to disclose it to plaintiffs, thereby committing fraud. *Id.* at 489. The Fourth Circuit affirmed the trial court’s dismissal of the complaint, holding that the law firm did not make any misrepresentations and that the law firm also had no legal duty to disclose the buyer’s bankruptcy under the federal securities laws. *Id.* at 492. *Rubin v. Schottenstein, Zox & Dunn*, 143 F.3d 263 (6th Cir. 1998), however, provides a useful contrast to the *Schatz* case. In *Rubin*, the lawyer for the company informed investors that everything was “fine” with the transaction even though the attorney knew that plaintiffs’ investments in the company would constitute a default under the company’s existing loan agreement with the bank. *Id.* at 266. Reversing the lower court’s summary judgment ruling in favor of the company’s attorney, the Sixth Circuit held that the plaintiffs had shown sufficient facts to merit a trial on their claims. *Id.* at 268. According to the court, had the attorney never made an affirmative disclosure regarding the propriety of the transaction, even if he knew of the problems surrounding the company’s loan agreement with the bank, he would not have been liable under Section 10(b). *Id.* at 267. This ruling is consistent with Rule 10b-5’s imposition of liability for omissions in those circumstances where there is a duty to disclose in order to make statements made, in light of the circumstances under which they were made, not misleading. *See, e.g., Basic*, 485 U.S. at 239 n.17 (noting that “[s]ilence, in the absence of an affirmative duty to disclose, is not [actionable] under Rule 10b-5”); *Fortson v. Winstead, McGuire, Sechrest & Minick*, 961 F.2d 469, 475 (4th Cir. 1992) (citing *DiLeo v. Ernst & Young*, 901 F.2d 624, 629 (7th Cir. 1990) (arguing that “[a]n omnipresent duty of disclosure” compromises the attorney-client privilege and “destroy[s] incentives for clients to be forthcoming with their attorneys and would artificially inflate the cost of involving legal counsel in commercial ventures”)).

⁵⁶ *Stoneridge Inv. Partners v. Scientific-Atlanta*, 128 S. Ct. 761, 769 (2008) (“Reliance by the plaintiff upon the defendant’s deceptive acts is an essential element It ensures that, for liability to arise, the ‘requisite causal connection between a defendant’s misrepresentation and a plaintiff’s injury’ exists as a predicate for liability.” (quoting *Basic*, 485 U.S. at 243)).

⁵⁷ *Newton v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 259 F.3d 154, 174 (3d Cir. 2001) (quoting *Robbins v. Koger Props., Inc.*, 116 F.3d 1441, 1447 (11th Cir. 1997)); *see Basic*, 485 U.S. at 243. Often, the reliance element of a Rule 10b-5 claim is difficult to prove. It becomes even more difficult to prove in the context of secondary actor liability. Unlike issuers whose actions can be directly tied to the losses suffered by the plaintiff, secondary actors (non-issuer defendants) such as underwriters, accountants, and lawyers are typically one step removed from the specific misrepresentation (or omission) on which the plaintiff relied and which caused the plaintiff’s injury. Nowicki, *supra* note 52, at 1331.

a Rule 10b-5 claim: reliance on a particular speaker who made a misrepresentation and reliance on the misrepresentation itself.

Furthermore, plaintiffs must sustain the burden of showing loss causation. Consistent with the Supreme Court's recent decision in *Dura Pharmaceuticals, Inc. v. Broudo*,⁵⁸ plaintiffs must prove that any losses resulted from the fraud itself and not other market forces such as investor expectations, market conditions, or developments within the company.⁵⁹ While a misrepresentation may play a role in bringing about a future loss, "[t]o 'touch upon' a loss is not to *cause* a loss, and it is the latter that the law requires."⁶⁰ In that case, Dura Pharmaceuticals misrepresented that FDA approval of its new asthmatic spray was imminent.⁶¹ Plaintiffs alleged that the company's misrepresentation caused an artificial spike in the purchase price of the company's stock.⁶² Rejecting this premise, the Supreme Court held that plaintiffs must establish a direct correlation between any loss incurred and the allegedly false or misleading statement.⁶³

Lastly, plaintiffs must establish that the defendant made the untrue statement (or omission) with scienter, or with the "intent to deceive, manipulate, or defraud."⁶⁴ As a check against abusive litigation in private secu-

⁵⁸ 544 U.S. 336 (2005).

⁵⁹ *See id.* at 343.

⁶⁰ *Id.*

⁶¹ *See id.* at 339.

⁶² *See id.* at 339-40 (noting that "the complaint says the following (and nothing significantly more than the following) about economic losses attributable to the spray device misstatement: '*In reliance on the integrity of the market, [the plaintiffs] . . . paid artificially inflated prices for Dura securities' and the plaintiffs suffered 'damage[s]' thereby.*").

⁶³ *See id.* at 346 ("The statute thereby makes clear Congress' intent to permit private securities fraud actions for recovery where, but only where, plaintiffs adequately allege and prove the traditional elements of causation and loss. By way of contrast, the Ninth Circuit's approach would allow recovery where a misrepresentation leads to an inflated purchase price but nonetheless does not proximately cause any economic loss. That is to say, it would permit recovery where these two traditional elements in fact are missing."). Thus, under the Court's decision, a plaintiff must be able to plead and demonstrate that the plaintiff suffered an economic loss that was caused by a fall in market price once the news of the alleged fraud was disseminated to the market.

⁶⁴ *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976). The federal appellate courts have ruled that severe recklessness is sufficient to establish the necessary state of mind. *See id.* at 193 n.12. To prove that the defendant acted recklessly, the plaintiff must show that the defendant's disregard for the truth or falsity of a statement was "highly unreasonable" and "represent[ed] an extreme departure from the standards of ordinary care." *SEC v. McNulty*, 137 F.3d 732, 741 (2d Cir. 1998) (quoting *Rolf v. Blyth, Eastman Dillon & Co.*, 570 F.2d 38, 46 (2d Cir. 1978)). *See also* *Fin. Acquisition Partners LP v. Blackwell*, 440 F.3d 278, 287 (5th Cir. 2006) (citing *Nathenson v. Zonagen, Inc.*, 267 F.3d 400, 408 (5th Cir. 2001)); *In re Software Toolworks Inc. Sec. Litig.*, 50 F.3d 615, 626 (9th Cir. 1994) ("[R]ecklessness' is conduct '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.'" (quoting *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1569 (9th Cir. 1990) (en banc))). Proof of the defendant's negligence therefore is insufficient to trigger liability under Rule 10b-5.

rities fraud actions, Congress enacted the PSLRA in 1995, which included, among other things, exacting pleading requirements for allegations of scienter in Rule 10b-5 claims.⁶⁵ As set forth in Section 21D(b)(2) of the PSLRA, plaintiffs must “state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.”⁶⁶ Specifically, the PSLRA requires plaintiffs to state with particularity the facts constituting the alleged violation of Rule 10b-5, including each statement alleged to have been misleading and the reason or reasons why the statement is misleading.⁶⁷

B. *Pre-Central Bank Jurisprudence*

Until the Supreme Court drew a jurisprudential “line in the sand” in *Central Bank*, the federal judiciary recognized a private right of action against aiders and abettors of Rule 10b-5 violations.⁶⁸ Prior to *Central Bank*, the elements of a Rule 10b-5 cause of action for aiding and abetting were: (1) a primary violation by another party; (2) the defendant’s knowledge of (or recklessness as to) the violation; and (3) the defendant’s substantial assistance in furthering the violation.⁶⁹ The most critical element separating a primary violation of Rule 10b-5 and an aiding and abetting violation of the same is proof of reliance on the statement or conduct of the aider and abettor.⁷⁰ By eliminating aiding and abetting liability, therefore, the Supreme Court’s decision in *Central Bank* provided a windfall to sec-

⁶⁵ 15 U.S.C. § 78u-4(b)(1) and (2) (2000). Prior to the passage of the PSLRA, Rule 9(b) of the Federal Rules of Civil Procedure governed the pleading standards for securities fraud. In its current form, the rule provides that “[i]n alleging fraud or mistake, a party must state with particularity the circumstances constituting fraud or mistake. Malice, intent, knowledge, and other conditions of a person’s mind may be alleged generally.” FED. R. CIV. P. 9(b). The PSLRA further enhanced the standards for averring fraud in a securities action.

⁶⁶ 15 U.S.C. § 78u-4(b)(2).

⁶⁷ 15 U.S.C. § 78u-4(b)(1). If the complaint does not satisfy these requirements, the PSLRA provides that “the court shall, on the motion of any defendant, dismiss the complaint” 15 U.S.C. § 78u-4(b)(3)(A).

⁶⁸ See, e.g., *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164, 194 (1994) (Stevens, J., dissenting); *In re Parmalat Sec. Litig.*, 376 F. Supp. 2d 472, 494 (S.D.N.Y. 2005) (stating that civil liability for aiding and abetting violations was recognized in the 1960s and subsequently became a common feature of Section 10(b) private lawsuits) (footnotes omitted) (citing *Brennan v. Midwestern United Life Ins. Co.*, 259 F. Supp. 673, 680-81 (N.D. Ind. 1966)).

⁶⁹ See *Landy v. FDIC*, 486 F.2d 139, 162-63 (3d Cir. 1973); see also David J. Baum, *The Aftermath of Central Bank of Denver: Private Aiding and Abetting Liability Under Section 10(b) and Rule 10b-5*, 44 AM. U. L. REV. 1817, 1826-27 (1995) (setting forth the elements of an aiding and abetting 10b-5 claim under pre-*Central Bank*).

⁷⁰ See, e.g., *Central Bank*, 511 U.S. at 180 (“Our reasoning is confirmed by the fact that respondents’ argument would impose 10b-5 aiding and abetting liability when at least one element critical for recovery under 10b-5 is absent: reliance.”).

ondary actors.⁷¹ Having generally not made the statement or engaged in the conduct that would have formed the basis of a primary violation of Rule 10b-5 and established the critical reliance element of such violation, secondary actors traditionally had been found liable as aiders and abettors.⁷²

The following Part discusses the *Central Bank* decision and examines its impact on the substantive reach of Section 10(b) to secondary actors such as lawyers, accountants, and other non-issuer defendants. Part III also sets the stage for the doctrinal ambiguity that emerged and has persisted in the wake of *Central Bank*.

III. *CENTRAL BANK*

A. *Background*

In *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*,⁷³ the Supreme Court considered whether liability extends to those who do not directly make a material misstatement but who instead aid and abet a Section 10(b) violation.⁷⁴ There, a bond issuer hired Central Bank of Denver to serve as indenture trustee for its issuance of \$26 million of secured bonds to finance public improvements at a planned residential and commercial development.⁷⁵ The bond covenants required that the land subject to the liens be worth, at a minimum, 160 percent of the bonds' outstanding principal and interest and that the developer of the land provide the bank with evidence that the 160 percent requirement was being satisfied.⁷⁶ Despite indications that the land would not meet the 160 percent test, Central Bank of Denver failed to get an updated appraisal of the land until after the closing of the bond issue.⁷⁷ Following the issuer's default on the bonds, purchasers filed suit against Central Bank of Denver and other participants in the issue, alleging aiding and abetting violations of Section 10(b).⁷⁸ Although Central Bank of Denver itself did not make any misrepresentation concerning the value of the land securing the bonds, it delayed an appraisal

⁷¹ Elizabeth A. Nowicki, *10(b) or Not 10(b)?: Yanking the Security Blanket for Attorneys in Securities Litigation*, 2004 COLUM. BUS. L. REV. 637, 639 (“[*Central Bank*] was a windfall for attorneys and other non-issuer defendants such as accountants, analysts, and underwriters who had historically been brought into Section 10(b) lawsuits as aiders and abettors. [And its] implications . . . were huge: the attorney conspirators who were critical to effectuating fraudulent transactions now appeared to be almost unreachable by defrauded investors.”).

⁷² *See id.*

⁷³ 511 U.S. 164 (1994).

⁷⁴ *Id.* at 167.

⁷⁵ *Id.*

⁷⁶ *Id.*

⁷⁷ *Id.* at 167-68.

⁷⁸ *Id.* at 168.

of the land until after the consummation of the bond offering, which would have put the bond purchasers on notice that the bonds were inadequately secured.⁷⁹

The district court granted summary judgment in favor of Central Bank of Denver.⁸⁰ Reversing the lower court's holding, the Tenth Circuit held that there was a genuine issue of material fact concerning Central Bank of Denver's awareness of the inadequacy of the land's value and its substantial assistance in furthering the issuer's fraud by delaying the land's appraisal.⁸¹ The Supreme Court granted Central Bank of Denver's petition for certiorari.⁸²

B. *Supreme Court's Decision*

Based on a literal reading of the statutory text and an interpretation of congressional intent, the Supreme Court held that a private right of action for aiding and abetting is not cognizable under Section 10(b).⁸³ The Court reasoned that the statutory text did not explicitly provide a cause of action against a secondary actor who had assisted another in violating Section 10(b).⁸⁴ The Court also asserted that "it is not plausible to interpret the statutory silence as tantamount to an implicit congressional intent to impose § 10(b) aiding and abetting liability."⁸⁵

In addition, the Court rejected the argument that the statute's prohibition on "direct or indirect" violations of the securities laws extended liability to those who aid and abet Section 10(b) violations.⁸⁶ In the respondent's view, the "direct or indirect" language was "intended to reach all persons who engage, even if only indirectly, in [a] proscribed activit[y]."⁸⁷ The Court, however, stated that such a reading of the text would impermissibly impose liability on those secondary actors who "do not engage in the proscribed activities at all, but who give a degree of aid to those who do."⁸⁸ Synthesizing its prior decisions, the Court concluded that "[a]s in earlier cases considering conduct prohibited by § 10(b), . . . the statute prohibits only the *making* of a material misstatement (or omission) or the commission of a manipulative act. The proscription does not include giving aid to a

⁷⁹ *Central Bank*, 511 U.S. at 168.

⁸⁰ *Id.* at 168-69.

⁸¹ *Id.* at 169.

⁸² *Id.* at 170.

⁸³ *Id.* at 191.

⁸⁴ *Id.* at 177.

⁸⁵ *Central Bank*, 511 U.S. at 184.

⁸⁶ *Id.* at 175-76.

⁸⁷ *Id.* at 176.

⁸⁸ *Id.*

person who commits a manipulative or deceptive act.”⁸⁹ After surveying other provisions of the securities laws, the Court also concluded that the absence of a private right of action for aiding and abetting pointed to a specific congressional intent not to provide such a right.⁹⁰ Because Congress had not attached aiding and abetting liability to other express causes of action in the securities laws, the Court inferred that Congress specifically intended not to attach aiding and abetting liability to Section 10(b).⁹¹

Furthermore, the Court maintained that a theory of liability based on aiding and abetting would impermissibly remove a critical element of a Section 10(b) cause of action, reliance.⁹² Were it to allow aiding and abetting liability, a defendant could be found liable “without any showing that the plaintiff relied upon the aider and abettor’s statements or actions.”⁹³ In the Court’s view, reliance on a misstatement necessarily entails knowledge of the speaker’s identity.⁹⁴ In the absence of attribution to the aider and abettor as the author or co-author of a specific misrepresentation in most instances, however, plaintiffs cannot establish the requisite reliance element of a Section 10(b) cause of action. *Central Bank* thus announced that liability under Section 10(b) is limited to those who *themselves* make a material misstatement or violate a duty to disclose.⁹⁵

Lastly, the Court reasoned that because the federal securities laws create an extensive scheme of liability, which includes the power of the SEC to bring administrative actions and injunctive proceedings against aiders and abettors of federal securities law violations, the abolition of a private right of action for aiding and abetting did not completely eviscerate the enforce-

⁸⁹ *Id.* at 177 (emphasis added) (citations omitted) (citing *Santa Fe Indus. v. Green*, 430 U.S. 462, 473 (1977)).

⁹⁰ *Id.* at 179-80 (“[I]t would be just as anomalous to impute to Congress an intention in effect to expand the defendant class for 10b-5 actions beyond the bounds delineated for comparable express causes of action.” (quoting *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 736 (1975))).

⁹¹ *Central Bank*, 511 U.S. at 170, 180 (rejecting an “expansive reading of the statutes and instead prescrib[ing] a strict statutory construction approach to determining liability” (quoting *SEC v. Seaboard Corp.*, 677 F.2d 1301, 1311 n.12 (9th Cir. 1982))).

⁹² *Id.* at 180 (“A plaintiff must show reliance on the defendant’s misstatement or omission to recover under 10b-5.” (citing *Basic Inc. v. Levinson*, 485 U.S. 224, 243 (1988))).

⁹³ *Id.* (arguing that “[a]llowing plaintiffs to circumvent the reliance requirement would disregard the careful limits on 10b-5 recovery mandated by our earlier cases”).

⁹⁴ See *Wright v. Ernst & Young LLP*, 152 F.3d 169, 175 (2d Cir. 1998) (interpreting *Central Bank* to require that a misrepresentation “be attributed to that specific actor at the time of public dissemination, that is, in advance of the investment decision” (citing *In re Kendall Square Research Corp. Sec. Litig.*, 868 F. Supp. 26, 28 (D. Mass. 1994))).

⁹⁵ *Central Bank*, 511 U.S. at 177; *Wright*, 152 F.3d at 175 (“[A] secondary actor cannot incur primary liability under the Act for a statement not attributed to that actor at the time of its dissemination.”). In the context of secondary actors, the sort of liability-producing conduct envisioned by the Court would be an accountant’s certification of misleading financial statements or an attorney’s preparation of false opinion letters. See *Wright*, 152 F.3d at 178. Such a misstatement by the secondary actor would allow the plaintiff to prove reliance on *that defendant’s* statements.

ability of such liability.⁹⁶ The Court envisioned that the SEC, rather than private plaintiffs, would enforce the prohibition against aiding and abetting under the statutory authority granted to the SEC.⁹⁷

Following its seemingly irrefutable pronouncement of the absence of a private cause of action for aiding and abetting, the Supreme Court cautioned that its holding did not immunize secondary actors from liability under the securities laws.⁹⁸ To the contrary:

Any person or entity, including a *lawyer*, accountant, or bank, who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator under 10b-5, assuming *all* of the requirements for primary liability under Rule 10b-5 are met. In any complex securities fraud, moreover, there are likely to be multiple violators.⁹⁹

C. *Fallout from Central Bank*

These cautionary words have spurred over a decade's worth of ambiguity and judicial uncertainty regarding the exact parameters of secondary actor liability under Section 10(b) and Rule 10b-5.¹⁰⁰ Without providing any guidance on what it means to "make" a material misstatement in violation of Section 10(b), the Supreme Court's decision has muddied more than clarified the landscape of secondary actor liability.¹⁰¹ In the vague borders between primary and secondary liability following *Central Bank*, the federal courts have struggled with ascribing liability to attorneys (as well as other secondary actors) without running afoul of the Supreme Court's prohibition on aiding and abetting liability.¹⁰² This struggle has, in part, produced vastly different judicial standards of secondary actor liability under

⁹⁶ See *Central Bank*, 511 U.S. at 183 (noting that "various provisions of the securities laws prohibit aiding and abetting, although violations are remediable only in actions brought by the SEC").

⁹⁷ See *id.* This has not been the case, however, as the SEC has not brought any enforcement actions against V&E or any of the law firms involved in the Enron scandal.

⁹⁸ *Id.* at 191.

⁹⁹ *Id.* (emphasis added) (citation omitted).

¹⁰⁰ See Cecil C. Kuhne, III, *Expanding the Scope of Securities Fraud? The Shifting Sands of Central Bank*, 52 *DRAKE L. REV.* 25, 27-28 (2003) ("This small linguistic concession has emboldened some courts and commentators to promote a more liberal interpretation of the act—one that allows a secondary actor to be held liable as a primary violator for 'participation' in the making of a material misstatement—even though that individual was never identified in any way to the public.").

¹⁰¹ See Annus, *supra* note 8, at 877.

¹⁰² See *id.* at 859 (commenting that in the Rule 10b-5(b) context, "courts have adopted three theories in order to delineate when the decisions have been 'made' by the secondary actors and when the secondary actors only assist in making the statements, thus being at most aiders and abettors" (footnote omitted)). The lower courts have "come to different conclusions regarding the scope of scheme liability" under Rule 10b-5 (a) and (c). See *id.* at 877. To resolve this split, the Supreme Court granted certiorari in *Stoneridge Investment Partners v. Scientific-Atlanta, Inc.*, 128 S. Ct. 761 (2008), and recently issued an opinion in that case.

the federal securities laws, including the “bright line” standard, the “substantial participation” standard, and the “creator” standard.

IV. THE JUDICIAL STANDARDS FOR SECONDARY ACTOR LIABILITY UNDER RULE 10b-5(b)

A. *The Bright Line Standard*

With the demise of aiding and abetting liability after *Central Bank*, the federal courts have grappled with the question of what constitutes the “making” of a material misrepresentation in connection with the sale or purchase of a security.¹⁰³ The Second, Tenth, and Eleventh Circuits have applied a “bright line” test when determining whether the statements or actions of a secondary actor rise to the level of a primary violation of Section 10(b) and Rule 10b-5.¹⁰⁴ Under the bright line test, the secondary actor must actually publish a material misstatement or omission, rather than merely participate in its creation.¹⁰⁵ In other words, a law firm or other secondary actor can be primarily liable for a misrepresentation *only* if it signs the document containing the misrepresentation or is otherwise identified to investors at the time of the misrepresentation’s dissemination to the public.¹⁰⁶ As courts that have applied the bright line test have noted, only in those limited circumstances could a plaintiff establish the necessary reliance on the defendant’s misrepresentation.¹⁰⁷

Of the three Circuits that have adopted the bright line standard, however, only the Eleventh Circuit Court has applied the bright line test to Section 10(b) and Rule 10b-5 claims brought against attorneys for securities fraud. In *Ziemba v. Cascade International, Inc.*,¹⁰⁸ plaintiff shareholders in then-bankrupt Cascade International, Inc. (“Cascade”), a company engaged

¹⁰³ See Kathy Patrick, *The Liability of Lawyers for Fraud under the Federal and State Securities Laws*, 34 ST. MARY’S L.J. 915, 922-23 (2003).

¹⁰⁴ See *Ziemba v. Cascade Int’l, Inc.*, 256 F.3d 1194, 1205 (11th Cir. 2001); *Wright v. Ernst & Young LLP*, 152 F.3d 169, 175 (2d Cir. 1998); *Anixter v. Home-Stake Prod. Co.*, 77 F.3d 1215, 1226-27 (10th Cir. 1996).

¹⁰⁵ See, e.g., *Ziemba*, 256 F.3d at 1205; *Wright*, 152 F.3d at 175; *Anixter*, 77 F.3d at 1226-27.

¹⁰⁶ See, e.g., *Wright*, 152 F.3d at 175 (“[A] secondary actor cannot incur primary liability under the Act for a statement not attributed to the actor.”); see also *Shapiro v. Cantor*, 123 F.3d 717, 720 (2d Cir. 1997) (“[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).” (quoting *In re MTC Elec. Techs. S’holders Litig.*, 898 F. Supp. 974, 987 (E.D.N.Y. 1995))).

¹⁰⁷ See, e.g., *Wright*, 152 F.3d at 175; see also Mary M. Wynne, *Primary Liability Amongst Secondary Actors: Why the Second Circuit’s “Bright Line” Standard Should Prevail*, 44 ST. LOUIS U. L.J. 1607, 1628 (2000) (“[U]nder the Second Circuit’s ‘bright line’ standard, reliance on the part of the plaintiff, an essential element of primary liability, remains intact.”).

¹⁰⁸ 256 F.3d 1194 (11th Cir. 2001).

in the manufacture and retail sale of women's apparel and cosmetics, brought suit against the officers and directors of the company, its independent auditors, its accounting firm, and its law firm alleging, among other things, violations of Section 10(b) and Rule 10b-5 in connection with various misstatements of assets, revenues, and profits as well as unauthorized issuances of stock.¹⁰⁹ In reference to the company's law firm, Gunster, Yoakley & Stewart, P.A. ("GY&S"), plaintiffs claimed that: (1) GY&S knew of inaccuracies in Cascade's financial statements and press releases; (2) GY&S advised on and drafted a memorandum for Cascade's CEO that refuted statements made by a stock service that Cascade had financial difficulties; (3) GY&S drafted an opinion letter in which it justified the non-consolidation of one of Cascade's subsidiaries on its financial statements even though GY&S knew the subsidiary was merely being reorganized and should have been consolidated; (4) GY&S discouraged stock analysts from questioning Cascade's financial health; and (5) GY&S generally deflected, in letters and otherwise, negative publicity Cascade was receiving relating to its financial prospects.¹¹⁰

The district court dismissed plaintiffs' claims against GY&S relying heavily on the fact that GY&S did not make any direct statements to investors.¹¹¹ On appeal, plaintiffs argued that although "no statements attributable to GY&S were made directly to the plaintiffs," the law firm's "significant role in drafting, creating, reviewing or editing allegedly fraudulent letters or press releases" nonetheless formed the basis for GY&S's Section 10(b) liability.¹¹² The Eleventh Circuit affirmed the lower court's ruling and reasoned that "for the defendant to be primarily liable under § 10(b) and Rule 10b-5, the alleged misstatement or omission upon which a plaintiff relied must have been publicly attributable to the defendant at the time that the plaintiff's investment decision was made."¹¹³ The Court noted that, based on plaintiffs' allegations of substantial assistance in Cascade's alleged fraud, to permit plaintiffs' lawsuit against the law firm to go forward would allow plaintiffs to circumvent the reliance requirement necessary to state a claim under Rule 10b-5 and "would 'effectively revive aiding and abetting liability under a different name.'"¹¹⁴

Although other Circuits have adopted the bright line test, they have not used it in the context of attorneys. Instead, they have applied the bright line test to Section 10(b) claims asserted against other secondary actors, includ-

¹⁰⁹ *Id.* at 1197-98.

¹¹⁰ *Id.* at 1199-1200.

¹¹¹ *Id.* at 1202.

¹¹² *Id.* at 1202-03.

¹¹³ *Id.* at 1205.

¹¹⁴ *Ziemba*, 256 F.3d at 1206 (quoting *Wright v. Ernst & Young LLP*, 152 F.3d 169, 175 (2d Cir. 1998)).

ing auditors. For instance, in *Wright v. Ernst & Young LLP*,¹¹⁵ the Second Circuit refused to impose liability on BT Office Products' ("BT") outside auditor, Ernst & Young ("E&Y"), in connection with BT's issuance of a press release, which contained allegedly fraudulent financial statements.¹¹⁶ The complaint averred that E&Y violated the anti-fraud provisions of the 1934 Act by orally approving BT's financial statements even though it knew or, at a minimum, should have known that those statements were materially false and misleading.¹¹⁷ A purchaser of BT's common stock sued for losses resulting from a 25 percent decline in BT's common stock after the company's true financial picture was disclosed.¹¹⁸ Noting that the press release expressly indicated that BT's financial results were unaudited and that E&Y's name was never mentioned in the press release, the court applied the bright line test and concluded that the imposition of liability on E&Y would violate the Supreme Court's prohibition against aiding and abetting liability.¹¹⁹ The Second Circuit found that the material misstatement must be "attributed to the defendant at the time of its dissemination" and that reliance on a misstatement necessarily entails knowledge of the speaker's identity.¹²⁰ Without specific attribution to E&Y in the company's press release, the 10b-5 claim was facially deficient because plaintiff could not establish reliance on any misrepresentation made by E&Y.¹²¹

¹¹⁵ 152 F.3d 169 (2d Cir. 1998).

¹¹⁶ *Id.* at 171.

¹¹⁷ *Id.* The court did not reach the issue of whether E&Y was liable for its alleged failure to correct materially false and misleading statements contained in the company's press release because that claim was not alleged in the complaint. *Id.* at 178 ("In this case, however, although the amended complaint alleges that the prospectus contained false statements (*i.e.*, the inaccurate 1994 results) in 1995, it does *not* allege the misrepresentation claim that Wright presses on appeal—namely, that Ernst & Young made a false statement (by omission) in 1996 as a result of its duty and subsequent failure to correct those statements. In fact, an alleged duty to correct does not appear anywhere in the amended complaint and did not enter the case until Wright mentioned it for the first time in her opposition memoranda to the motion to dismiss.").

¹¹⁸ *Id.* at 172.

¹¹⁹ *Id.* at 172-73 (observing that E&Y's "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*").

¹²⁰ *Wright*, 152 F.3d at 175.

¹²¹ *Id.* ("[A] secondary actor cannot incur primary liability under the Act for a statement not attributed to that actor at the time of its dissemination."). In *Shapiro v. Cantor*, the Second Circuit also addressed the issue of auditor liability under Section 10(b)—this time within the context of an auditor's failure to disclose material information (an omission). 123 F.3d 717, 721 (2d Cir. 1997). The court held that a party "cannot be liable for failure to disclose material information under § 10(b) unless it was under a duty to do so." *Id.* (citing *Chiarella v. United States*, 445 U.S. 222, 228 (1980)). However, the Court recognized that when an accountant issues a certified opinion (which was not alleged in this case), it creates the required special relationship with the investor. *Id.* at 722 & n.3 (citing *IIT v. Cornfield*, 619 F.2d 909, 925 (2d Cir. 1980)).

The Tenth Circuit has followed the same approach. In *Anixter v. Home-Stake Production Co.*,¹²² plaintiffs sued Home-Stake Production Company (“Home-Stake”) and its independent outside auditor for losses incurred in connection with interests (in the form of securities) purchased in the company’s oil and gas programs.¹²³ Plaintiffs alleged that the auditor participated in the preparation and filing of the company’s registration statements and prospectuses and that the auditor’s certifications and opinion letters verifying Home-Stake’s financial health were made with knowledge (or reckless disregard) of the false statements contained therein.¹²⁴ According to the court, a misrepresentation is actionable under Section 10(b) only if a party communicates that statement to investors:

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.¹²⁵

Consistent with the Second Circuit’s test for primary liability, the court also indicated that plaintiff’s proof of reliance was dependent upon a defendant actually making the false statement to the public either by signing the document containing the false statement or otherwise having the statement directly attributed to it.¹²⁶

Reflecting a more nuanced theory of secondary actor liability under Section 10(b) than the bright line standard, the Ninth Circuit has adopted a vastly different standard. The following section discusses the Ninth Circuit’s substantial participation test.

B. *The Substantial Participation Standard*

Under the Ninth Circuit’s standard, a secondary actor who participates in the preparation of materially false or misleading statements may be liable

¹²² 77 F.3d 1215 (10th Cir. 1996).

¹²³ *Id.* at 1218-19.

¹²⁴ *Id.*

¹²⁵ *Id.* at 1226 (citing *Frymire-Brinati v. KPMG Peat Marwick*, 2 F.3d 183, 189-90 (7th Cir. 1993); *Akin v. Q-L Invs., Inc.*, 959 F.2d 521, 526-27 (5th Cir. 1992); *Zoelsch v. Arthur Andersen & Co.*, 824 F.2d 27, 34-35 (D.C. Cir. 1987)). The Tenth Circuit mandated a new trial to determine the auditor’s liability based on a supervening change in the law of aiding and abetting (the Supreme Court’s *Central Bank* decision). *Id.* at 1233.

¹²⁶ *See id.* at 1225 (“Reliance only on representations made by others cannot itself form the basis of liability.”).

for a primary violation of Section 10(b) and Rule 10b-5.¹²⁷ Unlike the bright line rule, the substantial participation standard does not require that the secondary actor sign the document containing the misrepresentation, distribute the misrepresentation to investors, or otherwise be identified to investors.¹²⁸ The substantial participation standard thus sets forth a theory of liability based, not on the identified authors of deceptive statements, but on the secondary actor's knowing participation in the preparation of material misrepresentations for inclusion in its client's public disclosures.¹²⁹

The substantial participation standard was applied in *In re ZZZZ Best Securities Litigation*.¹³⁰ In that case, dissatisfied investors brought suit against ZZZZ Best Co. ("Z Best") and its accounting firm, Ernst & Young ("E&Y"), alleging securities fraud violations in connection with the public offering and trading of Z Best stock.¹³¹ Plaintiffs alleged that at least thirteen of Z Best's public disclosure documents (including its Form 10-Qs, Form 8-Ks, and a supplement to the offering prospectus issued by Z Best) contained materially false and misleading statements about Z Best's finances, its management, and its future business prospects.¹³² According to plaintiffs, E&Y had substantially participated in the drafting, issuance, and review of Z Best's public disclosures and, even though none of those public disclosures were attributed to E&Y, E&Y should still be liable under Section 10(b).¹³³

Rejecting the argument that liability attaches for material misrepresentations only if those misrepresentations are attributed to the defendant, the court held that if the secondary actor's participation in preparing the misstatements is substantial enough that the statements rightfully could be attributed to it, a secondary actor could be liable under Section 10(b) and Rule 10b-5.¹³⁴ The court added that, even if investors could not reasonably attribute the misstatements 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."¹³⁵

¹²⁷ See, e.g., *In re Software Toolworks Inc. Sec. Litig.*, 50 F.3d 615, 628 n.3 (9th Cir. 1994); *Employers Ins. of Wausau v. Musick, Peeler & Garrett*, 871 F. Supp. 381, 388-89 (S.D. Cal. 1994) (citing *In re ZZZZ Best Sec. Litig.*, 864 F. Supp. 960, 970 (C.D. Cal. 1994)).

¹²⁸ Kuhne, *supra* note 100, at 37 (noting that "[t]he Ninth Circuit has been the most vocal proponent of expanding liability to secondary actors under the guise of a substantial participation test").

¹²⁹ See *In re Software Toolworks Inc. Litig.*, 50 F.3d at 628 n.3 (finding plaintiffs had a primary cause of action when accounting firm played a "significant role in drafting and editing" the letter that misled the plaintiffs).

¹³⁰ 864 F. Supp. 960, 967-68 (C.D. Cal. 1994).

¹³¹ *Id.* at 964.

¹³² *Id.* at 964-65.

¹³³ *Id.* at 965 (noting that none of the statements "included any public indication within them that E & Y had anything to do with their existence").

¹³⁴ *Id.* at 970.

¹³⁵ *Id.*

What mattered, in the Ninth Circuit's view, is that investors relied on misinformation transmitted to the market—not that they knew who actually made the statements.¹³⁶ Thus, the court concluded that all of the requirements for a primary violation of Rule 10b-5, including reliance, had been satisfied.¹³⁷

The position taken by the courts that have followed the bright line standard, on the one hand, and courts applying the substantial participation standard, on the other hand, are at the opposite ends of the spectrum as they relate to proof of reliance under a Rule 10b-5 claim. Whereas the Second, Tenth, and Eleventh Circuits (the bright line circuits) require that the plaintiff know the identity of the speaker/author of a particular misrepresentation, the Ninth Circuit (the substantial participation circuit) requires that the plaintiff prove only that he or she relied on the misrepresentation, regardless of whether there is attribution to a specific speaker/author. In the Ninth Circuit's view, this interpretation of reliance is consistent with the Supreme Court's decision in *Central Bank*, which despite rejecting aiding and abetting liability for failure to establish reliance, was narrowly circumscribed to discussions of reliance in that context only.¹³⁸

In an effort to balance the need to impose liability on nameless fraudsters without casting too broad a net, the SEC proposed its own middle-ground standard of liability for secondary actors. The SEC's creator standard attempted to forge a compromise between the bright line standard's limited attribution rule and the specter of unlimited liability arguably inherent in the application of the substantial participation standard.

C. *The Creator Standard*

The theory that lawyers can be held liable as primary violators of the securities laws for material misrepresentations made by their clients in public disclosure documents (after *Central Bank*) was first articulated by the

¹³⁶ See *Z Best*, 864 F. Supp. at 970 (“While the investing public may not be able to reasonably attribute the additional misstatements and omissions to [the defendant], 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.”).

¹³⁷ See *id.* Several courts have followed the rationale set forth in *Z Best*. See, e.g., *McNamara v. Bre-X Minerals, Ltd.*, 57 F. Supp. 2d 396, 429 (E.D. Tex. 1996) (holding that “if a defendant played a ‘significant role’ in preparing a false statement actually uttered by another, primary liability will lie”); *Cashman v. Coopers & Lybrand*, 877 F. Supp. 425, 432 (N.D. Ill. 1995) (ruling that primary liability may be established against accountants centrally involved in preparing allegedly false information for inclusion in prospectuses and promotional material distributed to investors).

¹³⁸ See *In re Software Toolworks Inc. Sec. Litig.*, 50 F.3d at 628 n.3; Tarik J. Haskins, Comment, *Holding Secondary Actors Liable: Defining Primary Liability Under Section 10(b)*, 71 U. CIN. L. REV. 1093, 1101-02 (2003) (discussing the Ninth Circuit's substantial participation test).

SEC in an amicus brief submitted to the Third Circuit in *Klein v. Boyd*.¹³⁹ In that case, an investor in Mercer L.P. (“Mercer”), a limited partnership securities brokerage business, brought suit against Mercer, Mercer’s general partner, founder, and its primary outside law firm, Drinker Biddle & Reath (“Drinker”), for securities fraud violations under Section 10(b) and Rule 10b-5.¹⁴⁰ According to the complaint, Drinker drafted Mercer’s partnership and subscription agreements as well as many of its initial disclosure statements.¹⁴¹ Although Mercer and its principals had a lengthy history of securities fraud-related violations and sanctions—of which Drinker allegedly was aware—the disclosure documents failed to include this material information.¹⁴²

Adopting the SEC’s proposed liability standard, the Third Circuit held that Drinker could be found primarily liable under the securities laws for allegedly misleading statements (or omissions) contained in its client’s offering documents despite the fact that the investment community was unaware of Drinker’s participation in the drafting of those public disclosures.¹⁴³ The Third Circuit panel stated:

[A] lawyer who can fairly be characterized as an author or a co-author of a client’s fraudulent document may be held primarily liable to a third-party investor under the federal securities laws for the material misstatements or omissions contained in the document, even when the lawyer did not sign or endorse the document and the investor is therefore unaware of the lawyer’s role in the fraud.¹⁴⁴

The Third Circuit panel also opined that a lawyer who prepares a document knowing that it will be given to investors “has elected to speak to the investors, even though the document may not be facially attributed to the lawyer.”¹⁴⁵ Distinguishing its holding from *Central Bank*’s disavowment of aiding and abetting liability, the Third Circuit panel added:

We do not suggest that a lawyer who merely provides “substantial assistance” to a client may be liable under Section 10(b) and Rule 10b-5. Such a holding would be inconsistent with the Supreme Court’s rejection of a private cause of action for aiding and abetting. Rather, we believe that a person may be liable for a primary violation of [S]ection 10(b) and Rule 10b-5 when the person’s participation in the creation of a statement containing a misrepresentation or omission of a material fact is sufficiently significant that the statement can properly be attributed to the person as its author or co-author. At that point, the person has done more than

¹³⁹ Brief for the SEC as Amicus Curiae at 17-18, *Klein v. Boyd*, [1998 Supp. Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 90,136 (3d Cir. Feb. 12, 1998) (Nos. 97-1143; 97-1261), available at <http://www.sec.gov/pdf/klein.pdf> [hereinafter SEC Amicus Brief].

¹⁴⁰ *Klein v. Boyd*, [1998 Supp. Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 90,136, at ¶ 90,318 (3d Cir. Feb. 12, 1998), vacated on reh’g en banc, 1998 U.S. App. LEXIS 4121 (3d Cir. Mar. 9, 1998).

¹⁴¹ *Id.* ¶¶ 90,319-20.

¹⁴² *Id.*

¹⁴³ *Id.* ¶ 90,324.

¹⁴⁴ *Id.* ¶ 90,318.

¹⁴⁵ *Id.* ¶ 90,325.

provide mere substantial assistance; the person has become a primary violator of [S]ection 10(b) and Rule 10b-5, assuming that the other requirements of [S]ection 10(b) and Rule 10b-5 are satisfied. This is true even if the investor is unable to attribute the statement to the person at the time of the transaction.¹⁴⁶

Under the SEC's proposed creator standard, a secondary actor is primarily liable to a third-party investor when it, acting alone or with others, *creates* a misrepresentation even if the misrepresentation is not publicly attributed to it.¹⁴⁷ Pursuant to this standard, a plaintiff must prove: (1) that the secondary actor knew (or was reckless in not knowing) that the statement would be relied on by investors; (2) that the secondary actor was aware (or was reckless in not being aware) of the material misstatement; (3) that the secondary actor played such a significant role in the creation of the misrepresentation that he or she could fairly be characterized as the author or co-author of the misrepresentation; and (4) that the other requirements for primary liability have been satisfied.¹⁴⁸

The creator standard proposed by the SEC and adopted by a panel of the Third Circuit in *Klein v. Boyd* regained momentum recently with a decision issued by the Southern District of Texas in *In re Enron Corp. Securities, Derivative & ERISA Litigation*.¹⁴⁹ In reviewing the alleged conduct of Vinson & Elkins outlined above in Section I.C, the district court found that the allegations made against Enron's primary outside counsel, V&E, were sufficient to state a Rule 10b-5(b) claim against it.¹⁵⁰ Plaintiffs alleged that V&E knew there were side deals to a number of transactions between Enron and related third parties (e.g., the LJM entities) and subsequently drafted false and misleading language of proposed disclosures concerning those transactions that were included in Enron's 10-Ks, 10-Qs, and proxy

¹⁴⁶ *Klein*, [1998 Supp. Transfer Binder] Fed. Sec. L. Rep. (CCH) at ¶ 90,325 (citation omitted). Shortly after the panel issued its decision, the Third Circuit granted rehearing en banc, but the case was settled and the suit dismissed before the en banc court had an opportunity to address the parameters of secondary actor liability in this context. *In re Enron Corp. Sec., Derivative & ERISA Litig.*, 235 F. Supp. 2d 549, 585-86 (S.D. Tex. 2002) (noting that *Klein v. Boyd* was pending in the Third Circuit, but "settled before that appellate court could review the issue *en banc* [sic]"). Arguably, however, the Third Circuit panel's decision failed to address how an investor could prove a necessary element of a Section 10(b) claim—reliance—if the investor is unaware of the law firm's specific role in drafting the public disclosures; particularly in light of the Supreme Court's seeming admonition that reliance necessarily incorporates knowledge of the identity of a speaker who makes a misstatement.

¹⁴⁷ *Carley Capital Group v. Deloitte & Touche, L.L.P.*, 27 F. Supp. 2d 1324, 1334 (N.D. Ga. 1998).

¹⁴⁸ *In re Enron* motion, *supra* note 23, at 50.

¹⁴⁹ 235 F. Supp. 2d 549, 588 (S.D. Tex. 2002) ("Because § 10(b) expressly delegated rule-making authority to the agency, which it exercised inter alia in promulgating Rule 10b-5, this Court accords considerable weight to the SEC's construction of the statute since the Court finds that construction is not arbitrary, capricious or manifestly contrary to the statute."); *id.* at 590-91 ("This Court finds that the SEC's approach to liability under § 10(b) and Rule 10b-5 is well reasoned and reasonable, balanced in its concern for protection for victimized investors as well as for meritlessly harassed defendants . . .").

¹⁵⁰ *Id.* at 704-05.

statements.¹⁵¹ Based on these allegations, the court reasoned that “when a person, acting alone or with others, creates a misrepresentation [on which the investor-plaintiffs relied], the person can be liable as a primary violator . . . if . . . he acts with the requisite scienter.”¹⁵² The court’s application of the creator test to the conduct of V&E on the high-profile Enron securities class action highlighted the viability of the creator test as a standard of secondary actor liability.¹⁵³

V. ADVANTAGES AND DISADVANTAGES OF EACH STANDARD

Given the different standards of secondary actor liability that have been adopted by the courts, it is important to understand the advantages and disadvantages of each before reaching a conclusion as to whether any (or none) of these standards strikes the right balance between curbing meritless litigation against deep-pocket defendants and imposing obligations on attorneys and other secondary actors to act in the best interests of their clients and as gatekeepers for the investing public.¹⁵⁴

¹⁵¹ *Id.* at 663-64.

¹⁵² *See id.* at 587, 705 (“Vinson & Elkins was not merely a drafter, but essentially a co-author of the documents it created for public consumption concealing its own and other participants’ actions. Vinson & Elkins made the alleged fraudulent misrepresentations to potential investors, credit agencies, and banks . . . [and] deliberately or with severe recklessness directed those public statements toward them in order to influence those investors to purchase more securities, credit agencies to keep Enron’s credit high, and banks to continue providing loans to keep the Ponzi scheme afloat.”).

¹⁵³ Pre-Enron, the Northern District of Georgia adopted the creator test in *Carley Capital Group v. Deloitte & Touche L.L.P.*, 27 F. Supp. 2d 1324 (N.D. Ga. 1998). In that case, the shareholders of Medaphis Corporation (“Medaphis”) brought a class action lawsuit against Medaphis’s accountants, Deloitte, in connection with alleged material misstatements related to Medaphis’s financial results for the years 1995 and 1996. *Id.* at 1328-29. Acknowledging the split that had developed among the circuit courts regarding the appropriate analysis for determining the primary liability of secondary actors under Section 10(b) and Rule 10b-5, the court refused to follow the bright line or the substantial participation standards. *Id.* at 1334. After criticizing the bright line standard for its excessively restrictive interpretation of primary liability, the court also expressed reluctance at imposing liability for “mere participation, complicity, or assistance,” thereby rejecting the Ninth Circuit’s “substantial participation” test. *See id.* Instead, the court adopted the SEC’s creator standard and focused its inquiry on what the secondary actor did in “creating” the misrepresentation that violated Section 10(b). *Id.* The court held that a “secondary actor can be primarily liable when it, acting alone or with others, creates a misrepresentation even if the misrepresentation is not publicly attributed to it.” *Id.*

¹⁵⁴ *See Haskins, supra* note 138, at 1096 (Attorneys “are gatekeepers in the sense that they have some control over many statements and reports before they are given to investors and they can deter fraud before it affects the investing public”).

A. *The Bright Line Standard*

1. Advantages of the Bright Line Standard

The bright line standard of liability provides certainty to securities professionals, including lawyers, who advise clients on securities transactions as well as draft or otherwise assist in the preparation of their clients' public disclosure documents.¹⁵⁵ Under the bright line standard, a lawyer, accountant, or other secondary actor knows that unless a misrepresentation is (or can be) directly attributed to him or her at the time of its dissemination to the public, he or she will not be subject to Section 10(b) liability.¹⁵⁶ In addition to the predictive value offered by the bright line standard, another potential benefit is that its attribution rule limits meritless or vexatious litigation against deep-pocket defendants.¹⁵⁷ In a bright line jurisdiction, plaintiffs have little incentive to sue all of the secondary actors involved in a securities transaction unless the claims against them are truly meritorious because the odds of winning against, or extracting a substantial settlement from, a secondary actor defendant are small.¹⁵⁸ Accordingly, by removing from the scope of liability those who merely provide a degree of assistance to the actual perpetrators of the fraud, but who are not themselves engaging

¹⁵⁵ See *id.* at 1107 (“A securities professional working under the narrow standard knows exactly when she will be liable for a Section 10(b) violation, because liability can be found for misrepresentations attributable to the secondary actor only.”); but see Rodney D. Chrisman, “*Bright Line*,” “*Substantial Participation*,” or *Something Else: Who is a Primary Violator Under Rule 10b-5?*, 89 KY. L.J. 201, 212 (2000) (commenting that the bright line test provides “no additional guidance to the investment community beyond what the Supreme Court provided in *Central Bank of Denver*. Accordingly, a standard is needed for determining when a secondary actor has actually made the misstatement or omission and should therefore be subject to liability under rule 10b-5.”).

¹⁵⁶ See *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164, 188 (1994) (noting that this is “an area [of law] that demands certainty and predictability” (quoting *Pinter v. Dahl*, 486 U.S. 622, 652 (1988))); Wynne, *supra* note 107, at 1628 (stating that the substantial participation test might create “confusion among those who provide services to issuers”).

¹⁵⁷ See Wynne, *supra* note 107, at 1629 (adopting the bright line test “would eliminate unnecessary litigation by plaintiffs who are merely searching for deep pockets”); *Central Bank*, 511 U.S. at 189 (“uncertainty and excessive litigation can have ripple effects”).

¹⁵⁸ See *Central Bank*, 511 U.S. at 189 (“Because of the uncertainty of the governing rules, entities subject to secondary liability as aiders and abettors may find it prudent and 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.”). In contrast, aiding and abetting liability “presents a danger of vexatiousness different in degree and kind,” and “requires secondary actors to expend large sums even for pretrial defense and the negotiation of settlements.” *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 739 (1975); *Central Bank*, 511 U.S. at 189. See *Virginia Bankshares, Inc. v. Sandberg*, 501 U.S. 1083, 1106 (1991) (“The issues would be hazy, their litigation protracted, and their resolution unreliable. Given a choice, we would reject any theory . . . that raised such prospects . . .”).

in proscribed activities, the bright line standard of liability eases the burden on the judiciary and simplifies securities class action lawsuits.¹⁵⁹

Despite arguments to the contrary (explained below), proponents of the bright line standard also maintain that it tracks the language and rationale of *Central Bank*, providing appropriate deference to the precedential value (i.e., *stare decisis*) of the Supreme Court's decision.¹⁶⁰ In their view, if *Central Bank* is to have any real meaning, a defendant must actually *make* a false or materially misleading statement to be found liable under Section 10(b).¹⁶¹ Anything short of that constitutes aiding and abetting and is insufficient to trigger liability under Section 10(b) regardless of any purported "unjust" result that flows from this reading of *Central Bank*.¹⁶² Because secondary actors, such as lawyers, rarely *make* statements to the public, they are, at worst, non-actionable aiders and abettors of their clients.¹⁶³

Moreover, proponents of the bright line test contend that insulating secondary actors from liability under the securities laws operates to the benefit of the investing public.¹⁶⁴ The removal of the looming specter of liability enables companies and their attorneys (or other secondary actors) to exchange information freely and for attorneys to provide unencumbered

¹⁵⁹ See Nowicki, *supra* note 71, at 653 ("But it is more difficult to pursue the attorney who drafted the materially misleading prospectus at the specific direction of the senior officers because the attorney's role in the fraud is one step removed from those who actually conveyed the materially misleading statements to the public. It is much easier to argue that the attorney aided and abetted a Section 10(b) violation. Suing 'secondary actors' as 'primary violators' has therefore been a less desirable course of action for plaintiffs.").

¹⁶⁰ See Wynne, *supra* note 107, at 1631 ("The Second Circuit's 'bright line' standard, unlike the Ninth Circuit's 'substantial participation' or 'intricate involvement' standard, encompasses all five traditional elements of primary liability. *Central Bank* did nothing to change the elements of primary liability under Section 10(b), it merely eliminated the aiding and abetting cause of action as means of imposing liability.").

¹⁶¹ See *In re MTC Elec. Techs. S'holders Litig.*, 898 F. Supp. 974, 987 (E.D.N.Y. 1995) ("[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).").

¹⁶² As explained in more detail *infra* at Part V.B.1, opponents of the bright line test contend that although *Central Bank* eliminated aiding and abetting as a theory of liability under Section 10(b), it expressly indicated that secondary actors were not immune from liability under the statute.

¹⁶³ See Wynne, *supra* note 107, at 1629 ("The 'bright line' standard, which would not impose liability upon the accounting firm absent a finding that it actually made a material misstatement or omission and that it could be attributed to the firm at the time of dissemination, prevents such an unjust result.").

¹⁶⁴ See *id.* (reasoning that if the bright line standard were not applied, "secondary actors such as lawyers or accountants are at risk of being held primarily liable for substantial participation or intricate involvement in their client's statements containing material misstatements or omissions to the shareholders, then such secondary actors will likely step back from the process. Not only will the outside investors, who benefit from the involvement of outside professionals in the preparation process, be harmed if this results, but so too will the clients.").

disclosure advice to their clients.¹⁶⁵ Under these circumstances, counsel is in a better position to ensure the informational integrity of their clients' public disclosure documents without charging risk premiums for their services.¹⁶⁶ This standard of liability is advantageous both to the corporation, which is the recipient of expertised advice of counsel, and the shareholder who, as owner of the corporation, benefits from the company's full and accurate disclosures and the decreased potential for corporate liability for securities law violations.¹⁶⁷

2. Disadvantages of the Bright Line Standard

Although the bright line standard provides more certainty than a standard that requires the exercise of judgment, critics note that ease of application is no excuse for ignoring the fundamental remedial purposes of the federal securities laws and Congress's policy decisions.¹⁶⁸ The purpose of the federal securities laws is to foster openness in the capital markets and to ensure that the public receives full and accurate information before making investment decisions.¹⁶⁹ Given this backdrop, any approach that designates a single fact or occurrence (i.e., whether the identity of a secondary actor is disclosed to the investing public) as determinative of an inherently fact-oriented inquiry, such as whether a defendant took part in making false or materially misleading statements, is necessarily over-inclusive or under-inclusive.

¹⁶⁵ See *id.* ("Ironically, it is the shareholders who will ultimately pay the price for increased legal and accounting fees if attorneys and accountants are forced to 'over-lawyer' and 'over-account' disclosure advice.").

¹⁶⁶ See *id.*

¹⁶⁷ See Nowicki, *supra* note 71, at 695-96 ("One might argue that broader application of Section 10(b) to attorneys will harm the attorney-client relationship by making the attorney more likely to be a deal killer and the client therefore less likely to make full disclosure to the attorney.").

¹⁶⁸ See *id.* at 689 ("The Supreme Court has said that Section 10(b) should be flexibly applied to promote its broad prophylactic purpose. The Court's retreat from this position in *Central Bank* betrays the investing public.").

¹⁶⁹ See 15 U.S.C. § 78b (2000) ("[T]ransactions in securities . . . are affected with a national public interest which makes it necessary to provide for regulation and control of such transactions . . . and to insure the maintenance of fair and honest markets in such transactions The prices established and offered in such transactions are generally disseminated and quoted throughout the United States . . . and constitute a basis for determining and establishing the prices at which securities are bought and sold"); see also U.S. Sec. and Exchange Commission, *The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation*, <http://www.sec.gov/about/whatwedo.shtml> (last visited Aug. 21, 2008) ("[A]ll investors . . . should have access to certain basic facts about an investment prior to buying it, and so long as they hold it. To achieve this, the SEC requires public companies to disclose meaningful financial and other information to the public. This provides a common pool of knowledge for all investors to use to judge for themselves whether to buy, sell, or hold a particular security. . . . The result of this information flow is a far more active, efficient, and transparent capital market").

Opponents of the bright line standard further contend that nothing in *Central Bank* indicates that when the Supreme Court used the word “makes,” it meant that only persons who sign documents or are otherwise identified to investors can be primarily liable under Section 10(b).¹⁷⁰ Such an interpretation would be inconsistent with the language of Section 10(b), which makes it unlawful “for any person, directly or indirectly . . . [t]o use or employ . . . any manipulative or deceptive device or contrivance.”¹⁷¹ According to these opponents, *Central Bank* gives no indication that the Supreme Court considers the revelation of a defendant’s identity as a prerequisite for liability and, conversely, that the absence of such is a free pass to co-author falsehoods to investors.¹⁷² Thus, it can be viewed that the Supreme Court did not set forth a bright line rule for liability, much less one that turns on whether the defendant has signed the relevant disclosure or otherwise been identified to the investing public.¹⁷³

Furthermore, according to critics, the justification for the bright line standard on the basis of a global informational benefit to the capital markets warrants further scrutiny.¹⁷⁴ This argument presupposes that the removal of the threat of liability will provide incentives for secondary actors to have frank and open discussions with their clients that result in the drafting or preparation of accurate public disclosures.¹⁷⁵ Without discounting entirely the plausibility of a scenario in which optimal behavior flows from the ab-

¹⁷⁰ See Nowicki, *supra* note 71, at 677-78 (“Yet even if one concedes that Section 10(b) is clear in that it does not speak to aiding and abetting liability, the statute is clear about little else. The specific parameters of what is unlawful under Section 10(b) are not defined in the statute, but were left to the SEC’s discretion.”).

¹⁷¹ 15 U.S.C. § 78j(b) (2000) (emphasis added).

¹⁷² See Nowicki, *supra* note 71, at 684 (asking “[w]hat [] it mean[s] to ‘make’ an untrue statement in violation of Rule 10b-5(b)? In the context of a disclosure document drafted by an attorney, for example, does ‘make’ mean simply ‘draft’ or does ‘make’ mean draft and then release to the public, with attribution to the scrivener attorney himself?”). Moreover, contrary to arguments that *Central Bank*’s prohibition on aiding and abetting liability precluded the imposition of primary liability on secondary actors, the fact that a lawyer or other secondary actor makes a misstatement within the course of employment by a client is no defense—or the Supreme Court’s admonition that secondary actors, including lawyers, could be held liable, would amount to nothing. For a lawyer’s work, by definition, is done for a client.

¹⁷³ See *id.*

¹⁷⁴ See *id.* at 698 (“There are, however, reasons to believe that the threat to attorneys of primary liability for securities fraud will not erode the confidential attorney-client relationship. . . . [T]here is no historical evidence that this [Section 10(b)] liability significantly impacted disclosure by clients to attorneys.”).

¹⁷⁵ See Wynne, *supra* note 107, at 1629 (stating that under the Ninth Circuit’s substantial participation standard, if “secondary actors . . . are at risk of being held primarily liable for substantial participation or intricate involvement in their client’s statements containing material misstatements or omissions . . . then such secondary actors will likely step back from the process”). See also *id.* at 1625 (stating that under the Ninth Circuit’s standard, “lawyers, although advisors by nature, may be hesitant to offer advice to clients . . . [or] to enter into transactions with a client involved in the sale or purchase of securities, for fear of facing primary liability . . .”).

sence of legal liability, the potential for a perverse incentive regime in which the removal of the threat of legal sanctions encourages sub-optimal, or even outright dishonest, behavior on the part of secondary actors is also plausible.¹⁷⁶ Critics maintain that the bright line standard would allow those who deliberately defraud to escape liability simply by having others disseminate their statements without attribution, thereby eliminating a powerful incentive for securities professionals to create disclosures that are in fact truthful and accurate.¹⁷⁷ In fact, as the SEC has commented, the bright line test may very well “place a premium on concealment and subterfuge rather than on compliance with the federal securities laws.”¹⁷⁸ These critics conclude that, at worst, the bright line standard allows lawyers and other secondary actors to participate, albeit behind-the-scenes, in their clients’ fraud, and that, at best, it gives lawyers and other secondary actors license to turn a blind eye to ongoing fraud and, in so doing, subvert their traditional roles as gatekeepers of the securities markets.¹⁷⁹ Such a standard seemingly neither serves the best interests of the investing public nor effectuates the remedial purposes of the 1934 Act.

B. *The Substantial Participation Standard*

1. Advantages of the Substantial Participation Standard

Supporters of the substantial participation standard maintain that it is the only standard of liability that both promotes the securities laws’ goals of accurate and continuous disclosure and enforces secondary actors’ traditional roles as gatekeepers of the securities market.¹⁸⁰ With the looming

¹⁷⁶ See Nowicki, *supra* note 71, at 707-08 (“The ethical obligation to the corporation itself appears to not always be compelling enough when weighed against the opportunity for an attorney to generate huge fees by acceding to the wishes of a corporate manager. The threat of Section 10(b) liability can be a useful counterbalance to the sometimes overwhelming desire of the attorney to line his pockets with gold at the expense of the faceless investor.”).

¹⁷⁷ See *In re Global Crossing, Ltd. Sec. Litig.*, 322 F. Supp. 2d 319, 333 (S.D.N.Y. 2004) (noting that the “requirement of public attribution would allow those primarily responsible for making false statements to avoid liability by remaining anonymous, and thus ‘would place a premium on concealment and subterfuge rather than on compliance with the federal securities laws’” (quoting *In re Enron Corp. Sec., Derivative & ERISA Litig.*, 235 F. Supp. 2d 549, 587 (S.D. Tex. 2002))).

¹⁷⁸ SEC Amicus Brief, *supra* note 139, at 13.

¹⁷⁹ See Susan Koniak, *Corporate Fraud: See, Lawyers*, 26 HARV. J.L. & PUB. POL’Y 195, 195-97 (2003) (“Lawyers can [participate in corporate scandals] with virtually no risk. There is no real prospect of criminal prosecution, SEC enforcement actions or discipline, or state bar sanctions. . . . [In the Enron scandal,] these were not situations where . . . lawyers were merely following the advice of the accountants, but rather it was the lawyers who made the accountants feel comfortable about the way some of the Enron transactions were to be booked.”).

¹⁸⁰ See Haskins, *supra* note 138, at 1096.

threat of liability for misstatements contained in their clients' public disclosure documents, attorneys will have incentives to verify the accuracy of their clients' public filings before approving them or drafting any portion of them.¹⁸¹

Proponents of the substantial participation standard also contend that it sets forth the only theory of secondary actor liability that is consistent with the "directly or indirectly" language of Section 10(b), which points to congressional intent "to reach all persons who engage, even if only indirectly, in proscribed activities connected with securities transactions."¹⁸² In connection with this interpretation of Rule 10b-5, these proponents also assert that a standard of liability that shields any secondary actor who is not specifically identified to investors at the time of a misstatement's dissemination to the public does not comport with the Supreme Court's decision in *Central Bank*.¹⁸³ In *Central Bank*, the Supreme Court stated that any person, including a lawyer, accountant, or other secondary actor, could be liable for fraud under Section 10(b).¹⁸⁴ Notwithstanding the Court's elimination of a private cause of action for aiding and abetting, any interpretation of *Central Bank* that precludes the imposition of primary liability on secondary actors, such as the ones specifically named by the Court, would render the language from the decision meaningless.¹⁸⁵ Far from portending an end to secondary actor liability, the Supreme Court's decision embraced the continued existence of secondary actor liability, albeit outside the framework of aiding and abetting.¹⁸⁶ To the extent, therefore, that *Central Bank* abolished

¹⁸¹ See *id.* at 1102 (stating that the substantial participation test "ensures that secondary actors will perform their functions as gatekeepers and deter companies from providing misinformation to investors").

¹⁸² See Brief for the SEC as Amicus Curiae in Support of Respondents at 8, *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164 (1994) (No. 92-854), 1993 WL 13006275. The Supreme Court in *Central Bank* rejected this argument noting that the "respondents' interpretation of the 'directly or indirectly' language fails to support their suggestion that the text of § 10(b) itself prohibits aiding and abetting." *Central Bank*, 511 U.S. at 176; see also *id.* at 198 (stating that "we have read this 'broad' language 'not technically and restrictively, but flexibly to effectuate its remedial purposes'" (quoting *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 151 (1972))).

¹⁸³ See Nowicki, *supra* note 71, at 649 ("*Central Bank* does not preclude a lawsuit against a lawyer for primary liability under Section 10(b).").

¹⁸⁴ *Central Bank*, 511 U.S. at 191 ("Any person or entity, including a lawyer, accountant, or bank, who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator under 10b-5, assuming *all* of the requirements for primary liability under Rule 10b-5 are met.").

¹⁸⁵ Nowicki, *supra* note 71, at 649; Wynne, *supra* note 107, at 1631 ("In the end, it appears that the real answer to the question of what type of activity constitutes primary liability amongst secondary actors can be found in *Central Bank* itself.").

¹⁸⁶ Wynne, *supra* note 107, at 1631 ("*Central Bank* did nothing to change the elements of primary liability under Section 10(b), it merely eliminated the aiding and abetting cause of action as means of imposing liability. If plaintiff cannot prove a secondary actor defendant has met all five of the elements,

aiding and abetting liability without completely eviscerating secondary actor liability, proponents maintain that the substantial participation standard is consistent with the Supreme Court's decision.¹⁸⁷

2. Disadvantages of the Substantial Participation Standard

Unlike the bright line standard, however, the substantial participation standard adds uncertainty to an area of the law that demands predictability, particularly as it relates to the conduct of business transactions.¹⁸⁸ Through a shifting and highly fact-oriented disposition of what activities constitute "substantial participation," courts applying the standard make decisions "on an ad hoc basis, offering little predictive value to those who provide services to participants in the securities business."¹⁸⁹ Consequently, the substantial participation standard heightens the potential for frivolous strike lawsuits against deep-pocket defendants, which, at a minimum, requires those defendants to expend large sums of money in pretrial defense and settlement negotiations.¹⁹⁰

In addition, opponents of the substantial participation standard contend that the application of Section 10(b) liability to attorneys for their participation in drafting false or misleading disclosures for their clients has the unintended adverse consequence of chilling attorney-client communications.¹⁹¹ Attorneys may seek to insulate themselves from material discussions with

then the plaintiff has no cause of action under Section 10(b)/Rule 10(b)(5), regardless of whether defendant is a primary or secondary actor.").

¹⁸⁷ See *id.*

¹⁸⁸ See *supra* notes 158-59 and accompanying text.

¹⁸⁹ See *Central Bank*, 511 U.S. at 188 (quoting *Pinter v. Dahl*, 486 U.S. 622, 652 (1988)).

¹⁹⁰ See *supra* notes 160-61 and accompanying text; *but see* Kuhne, *supra* note 100, at 41 ("The courts advocating the substantial participation standard also note that its abuse is unlikely because third-party defendants are still substantially protected from frivolous suits by the requirement that plaintiffs plead and ultimately prove all other elements of a section 10(b) claim, including, perhaps most importantly, scienter."). Vague tests for liability expose secondary actors to Section 10(b) liability whenever plaintiffs can plausibly allege substantial participation in the making of a material misstatement. Such allegations—often made in hindsight—may be too readily made, particularly in a business environment where transactions are complicated, constantly evolving, and the subject of numerous judgment calls. The courts that have applied the substantial participation test, however, maintain that the risk of frivolous litigation remains low because plaintiffs must still plead and prove all of the elements of a Section 10(b) claim, including scienter and reliance, both of which are difficult to prove and "that a defendant who participates in a scheme to defraud will be liable for damages caused by the other participants, because the Private Securities Litigation Reform Act provides for joint and several liability only if the defendant is found to have knowingly committed the fraud; otherwise, the defendant who is found to have acted recklessly is liable only for the percentage of his or her proportionate responsibility for the fraud." *Id.* (citing 15 U.S.C. § 78u-4(f) (2000)).

¹⁹¹ Nowicki, *supra* note 71, at 695-96 (noting that some have contended that "broader application of Section 10(b) to attorneys will harm the attorney-client relationship by making the attorney more likely to be a deal killer and the client therefore less likely to make full disclosure to the attorney").

their clients and confine their role to that merely of a proofreader of their clients' public disclosures.¹⁹² Similarly, corporate clients may withhold material, and potentially damaging, information from their attorney to avoid the attorney's possible "tattling" to the company's board of directors or other objections from counsel who is concerned about limiting his or her own exposure to liability.¹⁹³ According to critics of the substantial participation standard, attorneys' increased exposure to liability would likely undermine the ethos of openness and frankness, which has traditionally characterized the attorney-client relationship, and encourage instead a new culture of secrecy and concealment.¹⁹⁴ Ironically, a standard intended to promote the system of accurate and continuous disclosure as well as enforce attorneys' gatekeeping function could theoretically compromise the effectiveness of outside counsel.¹⁹⁵

The foregoing discussion assumes that attorneys will continue to provide disclosure advice to their corporate clients despite enhanced liability provisions for secondary actors. However, recognizing their increased vulnerability to Section 10(b) liability under a substantial participation standard, it is possible that attorneys may no longer offer securities advice to their clients or participate in the preparation of their clients' public disclo-

¹⁹² See *id.*; see also *United States v. Chen*, 99 F.3d 1495, 1500 (9th Cir. 1996) ("This valuable social service of counseling clients and bringing them into compliance with the law cannot be performed effectively if clients are scared to tell their lawyers what they are doing, for fear that their lawyers will be turned into government informants.").

¹⁹³ Nowicki, *supra* note 71, at 696 ("Corporate officers will be less forthcoming with their outside counsel, the argument goes, to avoid objections from counsel, to avoid being 'tattled on' to the board of directors, and to avoid closer scrutiny.").

¹⁹⁴ See Nicholson, *supra* note 4, at 129 ("It is believed that lawyers will more likely be able to provide better legal counsel that may include advice tending to dissuade clients from their improper conduct where clients are able to speak freely. Clients would otherwise be less candid about their conduct and intentions, thereby affording lawyers fewer opportunities to counsel them against pursuing unlawful courses of action.").

¹⁹⁵ See *id.*; Scott A. Crist, *Walking on Thin Ice: The Changing Liability of Attorneys in the Securities Area*, 27 J. MARSHALL L. REV. 909, 938 (1994) (enhanced liability under Section 10(b) for securities lawyers would "render the securities lawyer incapable of maintaining a traditional attorney-client relationship"). To be fair, some in the corporate law arena question the extent to which the substantial participation standard or any other enhanced liability standard will erode attorney-client communications. Nowicki, *supra* note 71, at 696-98. As discussed above, during the period preceding the Supreme Court's decision in *Central Bank* (from the mid-1960s to 1994), private causes of action for aiding and abetting were permitted. *Id.* at 698. Although lawyers and other secondary actors typically were sued as aiders and abettors because it was often difficult to prove their active engagement in their clients' fraud, anecdotal evidence pointing to chilled attorney-client communications during that period is limited. *Id.* Likewise, there is scant evidence that communications by corporate officers to outside counsel became more open after the Supreme Court's abolition of aiding and abetting liability in *Central Bank*. *Id.* at 700. Moreover, a corporate officer's own fear of liability may mitigate against the potential chilling effect on attorney-client communications. *Id.* Corporate officers rely on the expertise of outside counsel, particularly as it relates to disclosure issues concerning securities transactions. *Id.*

sure documents.¹⁹⁶ Particularly, as noted in the *Central Bank* decision, attorneys may be unwilling to provide securities advice to start-up and/or small companies due to these companies' increased potential for business failure, which could generate securities litigation against their outside advisers.¹⁹⁷ This scenario—although unlikely (because of the fees lawyers charge for disclosure and other securities advice)—would deprive corporate officers of the expertise and often liability-insulating advice of outside counsel.¹⁹⁸ A more likely scenario is that those attorneys who choose to provide disclosure advice would increase their liability insurance or raise their fees to offset higher premiums as well as bill more time to due diligence to minimize potential litigation and settlement costs.¹⁹⁹ These increased costs, in turn, would be passed on to their client companies and ultimately to the company's shareholders—ironically, the intended beneficiaries of the statute—in the form of decreased available capital surplus and decreased annual earnings.²⁰⁰

¹⁹⁶ See Nowicki, *supra* note 71, at 713-14. The SEC recently adopted what are called “reporting up” rules which could have, but have not yet been proven to have, adverse consequences on attorney-client communications. See *id.* at 701. Pursuant to Section 307 of the Sarbanes-Oxley Act of 2002, Congress instructed the SEC to set forth “minimum standards of professional conduct for attorneys appearing and practicing before the Commission in any way in the representation of issuers. . . .” Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 307, 116 Stat. 745, 784 (codified at 15 U.S.C.A. § 7245 (West 2008)). Under these standards, an attorney appearing before the SEC in connection with the representation of an issuer must report evidence of corporate misconduct to the company's chief legal officer or chief executive officer, and if the company fails to provide an appropriate response, to the board of directors or an appropriate subcommittee thereof. Nowicki, *supra* note 71, at 701-02. Despite the potential benefits of SEC regulation of corporate lawyers, some commentators were concerned that broad, externally-imposed regulations would compromise the attorney-client relationship. See, e.g., Bruce G. Vanyo, *The Sarbanes-Oxley Act of 2002: A Securities Litigation Perspective*, 1332 PLI/CORP. 89, 114-16 (2002). The consensus, however, among corporate law scholars is that the “reporting up” rules do not damage the attorney-client relationship—at least not any more than most states' existing rules of professional conduct. Nowicki, *supra* note 71, at 702-04.

¹⁹⁷ *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164, 189 (1994) (“[N]ewer and smaller companies may find it difficult to obtain advice from professionals. 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.”).

¹⁹⁸ In addition, companies derive significant benefits by discussing complicated issues and, in particular, disclosures with outside counsel—given that outside counsel can provide insulation from liability. See Nowicki, *supra* note 71, at 700 (“Realistically, a corporate officer will be loath to reveal too few of the relevant facts pertaining to a transaction or disclosure to outside counsel because this might expose the officer personally to greater liability.”).

¹⁹⁹ *Id.* at 711-12 (“Attorneys who view themselves as increasingly vulnerable under Section 10(b) might (a) increase their liability insurance and raise their fees to offset the higher premiums, (b) bill more time for due diligence, or (c) stop being corporate and securities attorneys (such that the limited number of corporate and securities attorneys who remain in the field can demand higher fees).”).

²⁰⁰ Wynne, *supra* note 107, at 1629; Nowicki, *supra* note 71, at 712 (“[I]ncreased attorney liability could raise the corporation's outside legal counsel costs and therefore could directly impact shareholders by decreasing the available capital surplus for dividends, by decreasing annual earnings, or by generally increasing the cost of capital.”).

Moreover, opponents of the substantial participation standard assert that the Ninth Circuit's approach to secondary actor liability is squarely opposed to *Central Bank* as well as decades of Supreme Court jurisprudence firmly establishing a clear rule limiting liability under Section 10(b) to only those persons who themselves make a material misstatement.²⁰¹ The exact conduct that was previously denominated as aiding and abetting—providing substantial assistance to a primary violator—could in every case be labeled substantial participation.²⁰² Accordingly, some have argued that the distinction between pre-*Central Bank* aiding and abetting theories of liability and the Ninth Circuit's substantial participation test for primary liability is purely semantic.²⁰³

C. *The Creator Standard*

1. Advantages of the Creator Standard

In contrast to the bright line standard of liability, the SEC's creator test does not allow secondary actors to avoid liability merely by not being identified to the investing public.²⁰⁴ The SEC's creator standard imposes liability on nameless, clever fraudsters and ensures that injured investors will be compensated for meritorious claims, regardless of whether the fraudster is identified to the public.²⁰⁵ Distinguishing its test from the Ninth Circuit's substantial participation test, however, the SEC does not support the imposition of liability on those secondary actors who provide "substantial assistance" to their clients.²⁰⁶ In the SEC's view, a person has done more than

²⁰¹ See, e.g., Wynne, *supra* note 107, at 1629 ("[U]nder the Ninth Circuit's standard, *Central Bank* could be rendered toothless by permitting a plaintiff, who essentially drafted an aider/abettor complaint, to simply amend the complaint on the same set of facts to allege primary liability.").

²⁰² See *id.*

²⁰³ See Chrisman, *supra* note 155, at 217, 224-25 (noting that "the 'substantial participation' test seems to be aiding and abetting liability in primary violator's clothing" and concluding that "the 'substantial participation' test . . . is little more than aiding and abetting liability under a different name").

²⁰⁴ Haskins, *supra* note 138, at 1110 (commenting that "this approach, unlike the narrow one will not allow an entity to escape liability by simply concealing its identity"); see also Barbara Black, *Tattlers and Trail Blazers: Attorneys' Liability for Clients' Fraud*, 46 WASHBURN L.J. 91, 95-96 (2006) ("[If] the attorney plays a substantial role in the creation of a document that is disseminated to investors, he can be considered its author or co-author if he knows (or is reckless in not knowing) that investors will rely on the statement and is aware (or is reckless in not being aware) that the document contains a material misstatement or omission.").

²⁰⁵ See Haskins, *supra* note 138, at 1110.

²⁰⁶ See *In re Enron Corp. Sec., Derivative & ERISA Litig.*, 235 F. Supp. 2d 549, 586, 588 (S.D. Tex. 2002); John C. Coffee, Jr., *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 B.U. L. REV. 301, 337-38 (2004) (noting that the district court in the *Enron Securities Litigation* adopted the position urged by the SEC in an amicus curiae brief, which was similar to a SEC amicus brief filed in *Klein*, see *supra* note 139); see also *Shapiro v. Cantor*, 123 F.3d 717, 720 (2d Cir.

provide substantial assistance—or aid and abet—when his or her involvement in the *creation* of a material misrepresentation is sufficiently significant that he or she can properly be deemed the author or co-author of the misrepresentation.²⁰⁷ To the extent that the SEC’s creator standard removes from the scope of liability mere aiders and abettors, therefore, some proponents view it as an improvement over the potentially broad scope of the Ninth Circuit’s substantial participation test.²⁰⁸

Without drifting into the so-called expansive waters of the substantial participation standard, the creator test attempts to establish a more limited framework for imposing liability on secondary actors. For example, in the *In re Enron Securities, Derivative & ERISA Litigation*, the Southern District of Texas applied the creator test to V&E’s conduct.²⁰⁹ Because V&E allegedly had worked on the underlying LJM transactions and later authored the precise language that was included in Enron’s public disclosures relating to those transactions, the district court denied V&E’s motion to dismiss.²¹⁰ The court’s adoption of the creator test provided it with legal footing on which to deny V&E’s motion to dismiss despite the fact that investors were unaware of V&E’s specific role in drafting the materially false and misleading disclosures at issue.²¹¹ Although the district court’s decision is incompatible with the bright line attribution rule, proponents of the creator standard maintain that it sets forth an appropriately circumscribed framework for imposing liability on unidentified secondary actors

1997) (describing how “allegations of ‘assisting,’ ‘participating in,’ ‘complicity in’ and similar synonyms used throughout the complaint all fall within the prohibitive bar of *Central Bank*”).

²⁰⁷ See SEC Amicus Brief, *supra* note 139, at 10 (setting forth the broad view that “[a] person who creates a misrepresentation, but takes care not to be identified publicly with it, ‘indirectly’ uses or employs a deceptive device or contrivance and should be liable”).

²⁰⁸ See *In re Enron Corp.*, 235 F. Supp. 2d at 590-91 (“This Court finds that the SEC’s approach to liability under § 10(b) and Rule 10b-5(b) is well reasoned and reasonable, balanced in its concern for protection for victimized investors as well as for meritlessly harassed defendants (including businesses, law firms, accountants and underwriters), in addition to the policies underlying the statutory private right of action for defrauded investors and the PSLRA.”).

²⁰⁹ See *id.* at 591 (finding that because the creator test “is consistent with the language of § 10(b), Rule 10b-5, and *Central Bank* . . . the SEC’s proposed test is a reasonable interpretation of the text of the statute and serves its underlying policies, the Court adopts and applies it in this litigation to claims under § 10(b) and rule 10b-5(b)”).

²¹⁰ *Id.* at 705 (“Moreover in light of its alleged voluntary, essential, material, and deep involvement as a primary violator in the ongoing Ponzi scheme, Vinson & Elkins was not merely a drafter, but essentially a co-author of the documents it created for public consumption concealing its own and other participants’ actions.”).

²¹¹ See *id.* (“Vinson & Elkins made the alleged fraudulent misrepresentations to potential investors, credit agencies, and banks, whose support was essential to the Ponzi scheme, and Vinson & Elkins deliberately or with severe recklessness directed those public statements toward them in order to influence those investors to purchase more securities, credit agencies to keep Enron’s credit high, and banks to continue providing loans to keep the Ponzi scheme afloat.”).

(like V&E for its Enron-related work) who knowingly facilitate their clients' fraud.²¹²

2. Disadvantages of the Creator Standard

However, the line-drawing that is necessary to determine when a person has “created” a misrepresentation generates a great deal of uncertainty for litigants. By not clearly demarcating the parameters of Section 10(b) liability, the SEC’s creator test—like the substantial participation standard—may provide incentives for plaintiffs to bring suit against all parties involved in drafting a public disclosure.²¹³ Although the creator standard arguably offers more protection to defendants from liability for minimal assistance or complicity in a fraud than the substantial participation standard, the uncertainty surrounding its application could encourage frivolous litigation.²¹⁴

Furthermore, critics contend that the SEC’s creator test fails to account for the modern realities of the disclosure process. Most public disclosures result from the combined efforts of a number of people, including the company’s senior management, its in-house legal, accounting, and finance personnel, as well as its outside law firm, accounting firm, and other outside advisers.²¹⁵ To ascribe the title of “creator” to any or all of these individuals or institutions oversimplifies the nuanced and often complex process by which public disclosures are crafted.²¹⁶ Consider, for a moment, the following scenarios. Suppose an attorney was instructed on what to include in a prospectus or proxy statement by the CEO of the client company and subsequently drafted a false disclosure at the direction of the CEO. Should the attorney be liable under Section 10(b) if she knew (or was reckless in not knowing) that portions of the disclosure statement were false but still turned a blind eye to the fraud? Arguably, under the SEC’s creator standard, the

²¹² See Kimberly Brame, Comment, *Beyond Misrepresentations: Defining Primary and Secondary Liability Under Subsections (a) and (c) of Rule 10b-5*, 67 LA. L. REV. 935, 941 (2007) (“[The creator test] achieves a workable test for liability under Rule 10b-5(a), (b), and (c).”).

²¹³ Haskins, *supra* note 138, at 1110 (finding that the creator test “provides an incentive to plaintiffs to bring suit against all parties involved in a securities transaction, which could result in meritless litigation”).

²¹⁴ See *id.*

²¹⁵ For example, many different parties participated in drafting Enron’s disclosures. See POWERS REPORT, *supra* note 29, at 181 (“Enron’s related-party disclosures in its proxy statements, as well as in the financial statement footnotes in its periodic reports, resulted from collaborative efforts among Enron’s Senior Management, employees in the legal, accounting, investor relations, and business units, and outside advisors at Andersen and Vinson & Elkins.”).

²¹⁶ See *id.*; see also Andrew S. Gold, *Reassessing the Scope of Conduct Prohibited by Section 10(b) and the Elements of Rule 10b-5: Reflections on Securities Fraud and Secondary Actors*, 53 CATH. U. L. REV. 667, 687 (2004) (criticizing the SEC’s creator standard as “implausible” in the context of the realities of the disclosure process).

attorney, a mere behind-the-scenes scrivener, could escape Section 10(b) liability because she was not the “creator” of the misrepresentation. An equally difficult question concerns what happens when one person proposes a false or materially misleading statement, a second person comments on it, a third edits it, a fourth approves it, and a fifth signs the document containing the false and misleading statement. Who, if anyone, would be considered the “creator” of the false statement in this scenario and thus liable for fraud under Section 10(b)? Where the lines of liability should be drawn and on what basis when disclosure results from the collaborative efforts of a number of people are complex questions to which the SEC’s creator standard fails to provide a workable framework for analysis. Lastly, the creator standard arguably could be viewed as under-inclusive in its application. In applying this standard, courts exempt conduct that is fraudulent, but perhaps not “creatively” fraudulent, in the sense that a public disclosure was not created per se by a secondary actor.²¹⁷

VI. RECENT DEVELOPMENTS

A number of recent developments are likely to have a significant effect on the scope of secondary actor liability. The Supreme Court, in *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, recently issued a seminal ruling on the requirements of pleading scienter for a Rule 10b-5 claim pursuant to the PSLRA.²¹⁸ In addition, the Supreme Court granted certiorari and then issued a decision in *Stoneridge Investment Partners v. Scientific-Atlanta, Inc.* on the parameters of “scheme liability”—a new doctrinal analysis for Rule 10b-5(a) and (c) claims against secondary actors—in an attempt to resolve a circuit split.²¹⁹ Finally, a major securities class action was recently initiated against a prestigious law firm (Mayer Brown) under Rule 10b-5(a), (b), and (c) for its involvement in the Refco scandal.²²⁰

²¹⁷ Proponents of the bright line standard would also note that many of the legal problems/disadvantages set forth *supra* in Part V.B.2 as to the substantial participation standard apply with equal force to the creator standard (e.g., the lack of reliance). *See, e.g.*, Gold, *supra* note 216, at 686 (noting that “the reliance requirement is fatal to this theory because creation of a misrepresentation alone does not cause deception. In the context of a misrepresentation case, the misrepresentation itself is the deceptive device. The rough draft of the misrepresentation as such, no matter if every word were written by a secondary actor, is not a deceptive device.”).

²¹⁸ *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499 (2007).

²¹⁹ *Stoneridge Inv. Partners v. Scientific-Atlanta, Inc.*, 128 S. Ct. 761 (2008).

²²⁰ Class Action Complaint Against Mayer Brown LLP and Joseph P. Collins ¶¶ 1-3, *In re Refco, Inc. Secs. Litig.*, (S.D.N.Y.) (No. 05 Civ. 8626), available at <http://www.refcosecuritieslitigation.com/courtbox/2007-10-01-RefcoClassComplaint-MayerBrown&Collins.pdf> [hereinafter “*Refco Complaint*”].

A. *The Supreme Court's Decision in Tellabs*

In June 2007, the Supreme Court interpreted what it means to create a “strong inference” of scienter under the PSLRA’s heightened pleading requirements.²²¹ In *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, shareholders of Tellabs, a manufacturer of specialized equipment for fiber optic networks, filed a class action lawsuit against Tellabs and its chief executive officer, Notebaert, alleging securities fraud in violation of Section 10(b).²²² Plaintiffs claimed that, during the class period extending from December 2000 until June 2001, Notebaert (1) made various false statements regarding its products; and (2) falsely represented Tellabs’s financial results and overstated its revenue projections for the fourth quarter of 2000.²²³ On June 19, 2001, Tellabs disclosed that demand for its products had dropped significantly and simultaneously lowered its revenue projections for the second quarter of 2001.²²⁴ The following day, the price of Tellabs’s stock plunged to a low of \$15.87 after having reached a high of \$67 during the class period.²²⁵

The *Tellabs* Court set forth a three-step process for evaluating motions to dismiss Section 10(b) claims for failure to adequately plead scienter.²²⁶ First, a court must accept all allegations in the complaint as true.²²⁷ Second, a court must consider “whether *all* of the facts alleged, taken collectively, give rise to a strong inference of scienter”²²⁸ Third, and finally, in order to qualify as a “strong inference” within the meaning of Section 21D(b)(2) of the PSLRA, “an inference of scienter must be more than merely plausible or reasonable—it must be cogent and at least as compelling as any opposing inference of nonfraudulent intent.”²²⁹ To determine whether plaintiffs’ allegations of scienter survive threshold inspection for sufficiency, a court must undertake a comparative evaluation that considers both “plausible non-culpable explanations for the defendant’s conduct, as well as inferences favoring the plaintiff.”²³⁰ “The inference that the defendant acted with scienter need not be irrefutable, *i.e.*, of the ‘smoking-gun genre,’” but it must be “more than merely ‘reasonable or permissible’—it

²²¹ *Tellabs*, 127 S. Ct. at 2504-05.

²²² *Id.* at 2505.

²²³ *Id.*

²²⁴ *Id.*

²²⁵ *Id.*

²²⁶ *Id.* at 2509-10.

²²⁷ *Tellabs*, 127 S. Ct. at 2509.

²²⁸ *Id.* (“The inquiry, as several Courts of Appeals have recognized, is whether *all* of the facts alleged, taken collectively, give rise to a strong inference of scienter, not whether any individual allegation, scrutinized in isolation, meets that standard.”).

²²⁹ *Id.* at 2504-05. The *Tellabs* Court also noted that “Congress required plaintiffs to plead with particularity facts that give rise to a ‘strong’—*i.e.*, a powerful or cogent—inference.” *Id.* at 2510.

²³⁰ *Id.*

must be . . . strong in light of other explanations.”²³¹ Accordingly, the Supreme Court mandated that a Section 10(b) claim can only survive a motion to dismiss “if a reasonable person would deem the inference of scienter cogent and at least as compelling as any opposing inference one could draw from the facts alleged.”²³²

Preceding its decision in *Tellabs*, the Supreme Court granted certiorari in the *Stoneridge* case. The Supreme Court’s decision in *Stoneridge*, together with its interpretation of the meaning of scienter for the pleading of Section 10(b) claims, has important ramifications for the application of Section 10(b) liability to secondary actors and will impact the framework of analysis for the establishment of a regime of secondary actor liability for Rule 10b-5(b) claims.

B. *The Supreme Court’s Decision in Stoneridge*

Stoneridge represented a critical decision in the Supreme Court’s securities law jurisprudence because, in *Stoneridge*, the Court considers whether

²³¹ *Id.* Consistent with the Supreme Court’s interpretation of the PSLRA’s pleading requirements, the Fifth Circuit affirmed dismissal of a class action securities fraud lawsuit against an electrical contracting services company, Integrated Electrical Services (“IES”), and several of its officers because the complaint did not meet the PSLRA’s particularity requirement as to scienter. *Central Laborers’ Pension Fund v. Integrated Elec. Servs.*, 497 F.3d 546, 549, 556 (5th Cir. 2007). *Central Laborers’ Pension Fund (“CLPF”)*, a stockholder in IES, claimed that IES and several of its executive officers made a number of false or misleading statements about the company’s financial condition resulting in the artificial inflation of the company’s stock. *Id.* at 549. To establish a strong inference of scienter, the plaintiff pointed to, among other things, statements made by confidential sources relating to the company’s lack of internal accounting controls and a pervasive culture of financial manipulation. *Id.* at 551-52. Concluding that the confidential source statements lacked sufficient detail to form the basis for a strong inference of scienter, the Court dismissed the plaintiff’s complaint. *Id.* at 552, 555.

²³² *See Tellabs*, 127 S. Ct. at 2510. In *Tellabs*, neither the Northern District of Illinois nor the Seventh Circuit had the opportunity to consider whether the plaintiffs’ allegations warranted a strong inference of scienter. *Id.* at 2513. Thus, the Supreme Court remanded the case for a determination consistent with its construction of Section 21D(b)(2). *Id.* The leading post-*Tellabs* case is *Higginbotham v. Baxter International Inc.*, 495 F.3d 753 (7th Cir. 2007). In *Higginbotham*, the Seventh Circuit affirmed dismissal of federal securities claims against an issuer that had restated earnings to correct errors created by fraud at a foreign subsidiary, and in doing so, announced a number of principles emanating from *Tellabs*’s new standard. *Id.* at 755, 761. First, restated financial statements—and the decision to hire an auditor to strengthen financial controls—do not establish a strong inference of scienter. *Id.* at 760. Second, the court rejected the notion that the initiation of an internal investigation into possible fraud gives rise to a compelling inference of scienter. *Id.* at 758. Third, failure to correct a misstatement immediately upon learning of it does not give rise to a compelling inference of scienter because it is reasonable, and often prudent, to investigate what went wrong before taking remedial action. *Id.* at 761. Fourth, allegations of scienter based on confidential or anonymous sources must be “discounted” because they cannot be subject to the requisite weighing of the plaintiff’s favored, non-culpable inference in comparison to other possible inferences. *Id.* at 756-57. Finally, scienter cannot be based on public charges of problems at the company. *Higginbotham*, 495 F.3d at 758-59.

the express acknowledgment of secondary actor liability in *Central Bank* can be reconciled doctrinally with its abolition of aiding and abetting liability, which presents the seminal question in the debate over the substantive reach of Section 10(b) to secondary actors. The Eighth Circuit's decision in *Charter Communications*, the lower court's decision that led to the Supreme Court's decision in *Stoneridge*, provides a useful example of how courts disposed of plaintiffs' efforts to make an end-run around *Central Bank*'s abolition of aiding and abetting liability in the post-*Central Bank* era.²³³ Recasting aiding and abetting liability as scheme liability under Rule 10b-5(a) and (c), plaintiffs in that case—shareholders who purchased Charter Communications, Inc. stock between November 8, 1999 and August 16, 2002—alleged that Charter, one of the nation's largest cable television providers, had engaged in a “pervasive and continuous fraudulent scheme intended to artificially boost the Company's reported financial results.”²³⁴ This scheme allegedly involved the delayed disconnection of customers no longer paying their bills, the improper capitalization of labor costs, and the execution of sham transactions with two equipment vendors (the “Vendors”) that improperly inflated Charter's reported operating revenues and cash flow.²³⁵ Plaintiffs argued that the Vendors, with whom Charter had firm contracts to purchase set-top boxes at a set price, agreed to receive an additional \$20 per set-top box from Charter in exchange for returning those additional payments to Charter in the form of advertising fees.²³⁶ In addition, plaintiffs maintained that the Vendors entered into these sham transactions knowing that the transactions were “contrived to inflate Charter's operating cash flow . . . in order to meet the revenue and operating cash flow expectations of Wall Street analysts.”²³⁷ Significantly, because plaintiffs in *Charter Communications* did not allege that the Vendors prepared or disseminated Charter's fraudulent financial statements and/or press releases to the investing public, the Vendors' conduct did not fall under a Rule 10b-5(b) violation for the making of false or materially misleading statements.²³⁸ Instead, plaintiffs characterized the Vendors' conduct as participation in a “scheme to defraud” arguably covered by Rule 10b-5(a) and (c) for knowingly giving substantial assistance to a party committing a fraud.²³⁹ By

²³³ *In re Charter Commc'ns, Inc., Sec. Litig.*, 443 F.3d 987 (8th Cir. 2006), *cert. granted sub nom. Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 127 S. Ct. 1873, *aff'd*, 128 S. Ct. 761 (2008).

²³⁴ *Id.* at 989.

²³⁵ *Id.*

²³⁶ *Id.*

²³⁷ *Id.* at 989-90.

²³⁸ *Id.* at 990, 992.

²³⁹ *Charter Commc'ns*, 443 F.3d at 991. The Supreme Court has stated that Section 10(b)'s prohibition on “manipulative” conduct is “virtually a term of art” which “refers generally to practices, such as wash sales, matched orders, or rigged prices, that are intended to mislead investors by artificially affecting market activity.” *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 476 (1977) (citation omitted) (quoting *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 199 (1976)). Wash sales are fake sales of publicly traded

framing the Vendors' conduct in terms of a "scheme to defraud," plaintiffs attempted to eschew *Central Bank's* prohibition on aiding and abetting liability.²⁴⁰

Relying on *Central Bank*, however, the district court granted the Vendors' motion to dismiss.²⁴¹ The Eighth Circuit affirmed the district court, finding that the allegations against the Vendors were merely claims of aiding and abetting disguised as scheme liability and no longer cognizable after *Central Bank*.²⁴² The Eighth Circuit was reluctant to impose liability on a business that entered into an arm's-length transaction with an entity that then used the transaction to publish false and materially misleading statements to its investors.²⁴³ According to the Eighth Circuit, to impose

securities that involve no change in beneficial ownership but create the impression of active trading in the security. *Ernst & Ernst*, 425 U.S. at 205 n.25; see also *SEC v. U.S. Envtl., Inc.*, 155 F.3d 107, 109 (2d Cir. 1998). Matched orders, having the same purpose as wash sales, are orders for the sale or purchase of a security "that are entered into with the knowledge that orders of substantially the same size, at substantially the same time and price, have been or will be entered by the same or different persons for the sale/purchase of such security." *Ernst & Ernst*, 425 U.S. at 205 n.25. Price-rigging refers to a scheme to set the price of a security at other than the free market price. *Santa Fe Indus.*, 430 U.S. at 476. The lower courts have routinely followed the Supreme Court's arguably restrictive construction of Section 10(b), and in that regard, have been reluctant to impose Rule 10b-5(a) or (c) liability on attorneys for using or employing manipulative devices or otherwise engaging in schemes to defraud. In general, cases in which a lawyer, as distinct from his or her client, incurs liability for using or employing a deceptive device in connection with a securities offering are rare because the client typically is the one using the deceptive device (e.g., disclosure documents) in the selling process. See Patrick, *supra* note 103, at 930; see also *Hundahl v. United Benefit Life Ins. Co.*, 465 F. Supp. 1349, 1360 (N.D. Tex. 1979) (Section 10(b)'s prohibition on manipulative conduct refers to "practices in the marketplace which have the effect of either creating the false impression that certain market activity is occurring when in fact such activity is unrelated to actual supply and demand or tampering with the price itself . . ."); *Schreiber v. Burlington N., Inc.*, 568 F. Supp. 197, 202 (D. Del. 1983) (manipulative practices consist of "artificial acts of stimulative trading designed to mislead investors into believing there was a heavy market demand for the stock" (quotation omitted)), *aff'd*, 731 F.2d 163 (3d Cir. 1984), *aff'd*, 472 U.S. 1 (1985); *In re Commonwealth Oil/Tesoro Petroleum Sec. Litig.*, 484 F. Supp. 253, 267 (W.D. Tex. 1979) (defining manipulative conduct to include activities that interfere with the market's proper functioning). Given that lawyers generally do not actively employ disclosure documents for their own benefit in the securities selling process, the imposition of Rule 10b-5(a) and (c) liability on attorneys for disclosure advice rendered in connection with a securities offering is rare. See Patrick, *supra* note 103, at 930. To that extent, this Article focuses on the liability of lawyers under Rule 10b-5(b) for the making of material misstatements. The gravamen of a Rule 10b-5(b) claim is for misrepresentations, not conduct.

²⁴⁰ *In re Charter Commc'ns, Inc.*, 443 F.3d at 991-92.

²⁴¹ *Id.* at 992 ("Like the district court, we reject Stoneridge's narrow interpretation of *Central Bank*.").

²⁴² *Id.* ("[A]ny defendant who does not make or affirmatively cause to be made a fraudulent misstatement or omission, or who does not directly engage in manipulative securities trading practices, is at most guilty of aiding and abetting and cannot be held liable under § 10(b) or any subpart of Rule 10b-5.").

²⁴³ *Id.* at 992-93 ("[W]e are aware of no case imposing § 10(b) or Rule 10b-5 liability on a business that entered into an arm's length non-securities transaction with an entity that then used the transaction to publish false and misleading statements to its investors and analysts. The point is significant. To

liability on a party to an arm's-length transaction because that party knew or should have known that the other party would use the transaction to mislead investors would introduce far-reaching duties and uncertainties for those engaged in day-to-day business activities, and the court noted that such decisions should be made by Congress.²⁴⁴

On October 9, 2007, the Supreme Court heard oral arguments in *Charter*,²⁴⁵ and on January 15, 2008, the Court issued its decision.²⁴⁶ Closely following its ruling in *Central Bank*, the Supreme Court held that the Vendors were not liable to Charter's investors.²⁴⁷ The Court explained that "[r]eliance by the plaintiff upon the defendant's deceptive acts is an essential element of the § 10(b) private cause of action."²⁴⁸ Accordingly, the third-party Vendors:

[H]ad no duty to disclose . . . and their deceptive acts were not communicated to the public. No member of the investing public had knowledge, either actual or presumed, of respondents' deceptive acts during the relevant times. [Stoneridge], as a result, cannot show reliance upon any of the respondents' actions except in an indirect chain that we find too remote for liability.²⁴⁹

Notably, the Supreme Court rejected the Eighth Circuit's decision to the extent that it could be "read to suggest there must be a specific oral or written statement before there could be liability under §10(b) or Rule 10b-5"²⁵⁰ The Court found that "[c]onduct itself can be deceptive" and provide the basis for liability.²⁵¹ This language leaves in doubt the exact contours of Rule 10b-5(b) liability for the making of materially misleading or false statements. Significantly, however, under *Stoneridge*, it is possible that participating in a scheme to defraud may be sufficient deception as long as the participation of the defendant is disclosed to investors. For example, if the transactions of the *Stoneridge* third-party Vendors had been publicly disclosed because they were significant drivers of the issuer's cash flow, the reliance element under Section 10(b) might be satisfied. Although *Stoneridge* assists in framing the issues for third-party liability under a new

impose liability for securities fraud on one party to an arm's length business transaction in goods or services other than securities because that party knew or should have known that the other party would use the transaction to mislead investors in its stock would introduce potentially far-reaching duties and uncertainties for those engaged in day-to-day business dealings." (citation omitted).

²⁴⁴ *Id.* at 993 ("Decisions of this magnitude should be made by Congress.").

²⁴⁵ The case caption is now *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.* See *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 127 S. Ct. 1873 (2007).

²⁴⁶ *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 128 S. Ct. 761 (2008).

²⁴⁷ *Id.* at 771, 774.

²⁴⁸ *Id.* at 769.

²⁴⁹ *Id.*

²⁵⁰ *Id.*

²⁵¹ *Id.*

framework of analysis called scheme liability (pursuant to Rule 10b-5(a) and (c)), in casting doubt on the notion that there must be a specific oral or written statement attributable to the defendant, the decision does not resolve the doctrinal ambiguity that emerged in the post-*Central Bank* era concerning the precise requirements of Rule 10b-5(b) liability, particularly as it applies to secondary actors, such as lawyers and accountants, who prepare statements (public disclosure and financial) for publication to investors.

C. *The Refco Securities Class Action*

The issue of the scope of Rule 10b-5(b) liability to secondary actors remains particularly salient as the Southern District of New York now considers the liability of lawyers in connection with the Refco, Inc. (“Refco”) securities class action.²⁵² The *In re Refco, Inc. Securities Litigation* case arose from the collapse of Refco, a previously prominent brokerage, following the revelation that the company had been secreting hundreds of millions of dollars of uncollectible receivables with a related party controlled by the company’s Chairman and CEO, Philip R. Bennett (“Bennett”).²⁵³ As a result, Refco filed the fourth largest bankruptcy in U.S. history.²⁵⁴ On October 1, 2007, plaintiffs, purchasers of Refco securities during the period from August 5, 2004 through October 17, 2005, added Mayer Brown LLP (“Mayer Brown”) and Mayer Brown senior partner Joseph P. Collins (“Collins”) as named defendants in the class action.²⁵⁵

According to the complaint, Mayer Brown, Collins, and other lawyers at Mayer Brown worked extensively with Refco in devising, documenting, and concealing the fraudulent scheme that resulted in Refco’s false financial statements.²⁵⁶ In particular, plaintiffs alleged that Refco, in conjunction with Collins and Mayer Brown, structured end-of-period loan transactions, whereby at the end of each financial period, millions of dollars would be loaned by Refco to third parties, which would then simultaneously loan the same amount to an entity controlled by Bennett.²⁵⁷ That entity would use the proceeds to pay down a receivable it owed to Refco, leaving an apparently collectible receivable from a bona fide third party on Refco’s books at the end of the period.²⁵⁸ After the close of each financial period, however, the transaction would be unwound and the receivable returned to Refco’s books.²⁵⁹

²⁵² See generally *Refco* Complaint, *supra* note 220.

²⁵³ *Id.* ¶ 4.

²⁵⁴ William Neuman, A ‘Gift’ From Refco’s Former C.E.O., N.Y. TIMES, Jan. 29, 2006, at C2.

²⁵⁵ *Refco* Complaint, *supra* note 220, ¶¶ 19-22.

²⁵⁶ *Id.* ¶ 3.

²⁵⁷ *Id.* ¶ 7.

²⁵⁸ *Id.*

²⁵⁹ *Id.*

Plaintiffs alleged Rule 10b-5(a) and (c) (scheme liability) claims—whose viability is in doubt following *Stoneridge*—against Mayer Brown and Collins for their involvement in, among other things, structuring sham entities in furtherance of a scheme to defraud investors by misstating Refco’s financial statements as well as Rule 10b-5(b) claims based on materially false and misleading statements that were included in an offering memorandum, bond registration statement, and IPO registration statement issued by Refco.²⁶⁰ Regardless of the Supreme Court’s ruling in *Stoneridge* on the reach of Rule 10b-5(a) and (c) liability to secondary actors under the “scheme to defraud” rubric, the district court will have to determine whether viable Rule 10b-5(b) claims exist against Mayer Brown using the analytical framework set forth in this Article.

VII. PROPOSAL

In the more than ten years since the Supreme Court’s landmark decision in *Central Bank*,²⁶¹ the legal and political climate has shifted as a result of substantive changes in the law as well as mounting public outrage over a string of corporate scandals. On the legal front, the heightened pleading requirements of the PSLRA (as interpreted in *Tellabs*)²⁶² have minimized some policy concerns (e.g., nuisance filings, the targeting of deep-pocket defendants, vexatious discovery requests, and manipulation by class action lawyers to extract large settlements) that motivated, at least in part, the Court’s decision in *Central Bank*.²⁶³ As one court aptly stated, the analysis required by *Tellabs* at the motion to dismiss stage “is akin to holding a mini-trial on the merits of the case based only on the complaint.”²⁶⁴ In addition, the seemingly endless parade of corporate scandals has provoked widespread public outrage over the alleged participation of secondary ac-

²⁶⁰ *Id.* ¶¶ 218-39. The complaint asserted that Mayer Brown, Collins, and other partners and employees of Mayer Brown drafted portions of those public disclosures and reviewed and commented on drafts of these disclosures before they were publicly issued. *Refco* Complaint, *supra* note 220, ¶ 230. According to plaintiffs, Collins and other lawyers at Mayer Brown disregarded that these disclosures were materially false and misleading, yet allowed them to be issued to the public and allowed Mayer Brown to be identified as counsel to Refco in the offering memorandum and IPO registration statement. *Id.* ¶¶ 230-31. The complaint went on to allege that Collins and Mayer Brown were responsible for making the allegedly false statements by virtue of having prepared, reviewed, and approved the public disclosures that contained the untrue statements and that the false statements were made either knowingly, intentionally, or in such an extremely reckless manner as to constitute willful deceit and fraud. *Id.* ¶¶ 233-35.

²⁶¹ 511 U.S. 164 (1994).

²⁶² 127 S. Ct. 2499 (2007).

²⁶³ *Central Bank*, 511 U.S. at 188-91 (“Policy considerations cannot override our interpretation of the text and structure of the Act, except to the extent that they may help to show that adherence to the text and structure would lead to a result ‘so bizarre’ that Congress could not have intended it.”).

²⁶⁴ *In re Proquest Sec. Litig.*, 527 F. Supp. 2d 728, 747 (E.D. Mich. 2007).

tors—namely lawyers and accountants—in orchestrating and/or perpetuating large-scale frauds that resulted in the loss of billions of dollars for investors and the demise of several corporate behemoths, including Enron.²⁶⁵ Accordingly, a liability regime that imposes culpability only on primary actors for the *making* of false or materially misleading statements consistent with the bright line standard (and *Central Bank*) has become increasingly unpalatable even as the Supreme Court itself acknowledged in *Stoneridge*.²⁶⁶

The following section of the Article prescribes a construction of Section 10(b) and Rule 10(b)-5(b) liability that moves away from *Central Bank*. Instead, the proposed standard adopts the fundamental tenets of the substantial participation test, but supports the enforcement of the heightened pleading requirements of the PSLRA to provide a sensible framework of secondary actor liability under Rule 10(b)-5(b) that accomplishes the seemingly competing goals of limiting frivolous litigation while still preserving investors' ability to recover on meritorious claims.

A. *Central Bank Is Obsolete*

The tension between the Supreme Court's Section 10(b) jurisprudence and the imposition of secondary actor liability is undeniable. Even before *Central Bank*, Professor Daniel Fischel, a leading corporate law scholar, commented on this tension in one of the most influential articles written on the scope of secondary actor liability.²⁶⁷ Professor Fischel concluded that the Supreme Court's Section 10(b) precedents established that "defendants can be held liable, if at all, only if they have engaged in a 'manipulative or deceptive practice' prohibited by [S]ection 10(b)," and that "in order to fall within this statutory prohibition, a defendant, acting with scienter, must *make* a material misrepresentation or wrongfully fail to disclose despite a fiduciary duty to do so in connection with the purchase or sale of a security,

²⁶⁵ See, e.g., Ben Stein, *Enron, the Supreme Court and Shareholders on the Brink*, N.Y. TIMES, Apr. 29, 2007, § 3, at 6 ("This is a potential golden moment for the stockholders—or another step down the dreary alley toward extinction of the rights of those poor whipped dogs: the actual owners of America's public companies. It is up to the Supreme Court to right the ship.").

²⁶⁶ See *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 128 S. Ct. 761, 769 (2008) ("The Court of Appeals concluded petitioner had not alleged that respondents engaged in a deceptive act within the reach of the § 10(b) private right of action, noting that only misstatements, omissions by one who has a duty to disclose, and manipulative trading practices (where 'manipulative' is a term of art) are deceptive within the meaning of the rule. If this conclusion were read to suggest there must be a specific oral or written statement before there could be liability under § 10(b) or Rule 10b-5, it would be erroneous. Conduct itself can be deceptive, as respondents concede. In this case, moreover, respondents' course of conduct included both oral and written statements, such as the backdated contracts agreed to by Charter and respondents." (citations omitted)).

²⁶⁷ Fischel, *supra* note 6, at 102-03.

or engage in a manipulative practice designed to mislead investors by artificially affecting market activity.”²⁶⁸ Professor Fischel’s conclusion was later validated in *Central Bank*. By eliminating aiding and abetting liability on the premise that aiders and abettors do not actually *make* statements to the investing public, the Supreme Court’s decision imperiled the continued viability of secondary actor liability.²⁶⁹ Other than those situations where, for example, attorneys provide false opinion letters or accountants certify false financial statements—instances in which a secondary actor actually *makes* a false statement which is directly attributable to it at the time of the statement’s dissemination to the market—the imposition of secondary actor liability will be, in almost every instance, seemingly incompatible with the Supreme Court’s abolition of aiding and abetting liability. Rather than trivializing *Central Bank*’s import, characterizing its reasoning as dicta, or describing its holding as limited, the decision in *Central Bank*, as recently acknowledged in *Stoneridge*, effectively abolished aiding and abetting liability and immunized secondary actors from Section 10(b) liability in most instances.²⁷⁰

Given what has transpired over the past decade, however, *Central Bank* has proven itself to be an unmitigated failure in deterring the participation of secondary actors in corporate malfeasance. It is, therefore, time to revisit the Court’s holding, especially in light of the Supreme Court’s recent decision in *Stoneridge*, and provide an alternative analysis and standard that accomplishes the securities laws’ fundamental remedial purposes.

B. *The Substantial Participation Standard Is the Best Alternative*

Among the standards of liability under Rule 10b-5(b) discussed in this Article, the substantial participation standard best promotes the securities laws’ goals of accurate and continuous disclosure and enforces secondary actors’ traditional roles as gatekeepers of the securities market.²⁷¹ Because the substantial participation standard imposes liability for participation or assistance in the making of a fraudulent statement (regardless of whether there is attribution to the secondary actor), secondary actors will have incentive to ensure the informational integrity of issuers’ disclosure documents in order to avoid liability. Beyond providing incentive due to liability concerns, the substantial participation standard will enhance the legal profession’s role in the public disclosure process and enable attorneys to act as gatekeepers of the securities markets.

²⁶⁸ *Id.* (emphasis added).

²⁶⁹ See *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164, 177 (1994).

²⁷⁰ See *Stoneridge Inv. Partners*, 128 S. Ct. at 769 (“The § 10(b) implied private right of action does not extend to aiders and abettors.”).

²⁷¹ See Haskins, *supra* note 138, at 1102.

The substantial participation standard is also superior to the creator test. Although the creator test sets forth a more sophisticated and nuanced approach to liability than the bright line standard's one-size-fits-all approach, its amorphous framework for defining who is a "creator" of a disclosure fails to accommodate the complexities of the modern disclosure process. As explained *supra*, most companies employ a collaborative disclosure process. The creator test is unworkable in that context because it would make the establishment of liability for particular, allegedly false words contained in public disclosure documents difficult, if not impossible. For this reason, the creator test results in a standard of liability that is, or at least can be, applied almost as under-inclusively as the bright line rule.

The failure of the SEC to bring enforcement actions against attorneys and other secondary actors, including V&E for its role in the Enron scandal and Mayer Brown in Refco, provides further support for the implementation of a substantial participation standard of liability.²⁷² Motivating the Supreme Court's rationale in *Central Bank* for the abolition of a private right of action for aiding and abetting was the fact that the SEC, under the authority granted to it by 15 U.S.C. § 78t(e) could bring enforcement proceedings against aiders and abettors, thereby relieving private plaintiffs from having to act as their own ombudsmen to enforce the securities laws.²⁷³ Since *Central Bank*, this notion has formed one of the primary underpinnings for the application of the bright line standard of liability to secondary actors. However, given the SEC's demonstrated failure to police attorneys and/or law firms, this policy argument for the continued application of the bright line standard is increasingly without merit.

Despite possible resistance to the abolition of the bright line standard, the Supreme Court's decision in *Tellabs* should impact the conventional thinking of proponents of the bright line test. One of the main reasons proponents of the bright line test support its application is concern over the initiation of frivolous litigation against deep-pocket secondary actors.²⁷⁴ With *Tellabs*, however, if plaintiffs fail to meet the heightened scienter

²⁷² See *id.* at 1096 (commenting on the lack of resources available to the SEC to police the markets). Even though the SEC has not successfully policed attorneys and/or law firms, the SEC has collected over \$10 billion in disgorgement and penalties since September 30, 2002. See U.S. SEC. AND EXCHANGE COMMISSION, 2007 PERFORMANCE AND ACCOUNTABILITY REPORT 26, available at <http://www.sec.gov/about/secpar/secpar2007.pdf>.

²⁷³ See *Central Bank*, 511 U.S. at 183; see also *Stoneridge Inv. Partners*, 128 S. Ct. at 768-69 ("The decision in *Central Bank* led to calls for Congress to create an express cause of action for aiding and abetting within the Securities Exchange Act. Then-SEC Chairman Arthur Levitt, testifying before the Senate Securities Subcommittee, cited *Central Bank* and recommended that aiding and abetting liability in private claims be established. Congress did not follow this course. Instead, in § 104 of the Private Securities Litigation Reform Act of 1995, it directed prosecution of aiders and abettors by the SEC." (citations omitted)).

²⁷⁴ See Wynne, *supra* note 107, at 1629 (stating that adopting the bright line test "would eliminate unnecessary litigation by plaintiffs who are merely searching for deep pockets").

standard at the motion to dismiss stage, they will not be permitted to embark on a fishing expedition to substantiate vaguely-pleaded claims brought against lawyers (or other secondary actors). As a result, lawyers (and other secondary actors) will not have to endure the expense and hassle of costly discovery. On the other hand, if plaintiffs satisfy the heightened standard (which they should only be able to do in the most egregious cases, like Enron and Refco), lawyers (and other secondary actors) will be exposed to liability for substantially assisting their clients in the preparation of fraudulent disclosures even if the lawyer is not attributed by name or otherwise identified to the public at the time the false disclosure is made.

To the extent that concerns surrounding the application of the substantial participation standard—such as the increased potential for frivolous litigation and the decreased efficacy of the attorney-client relationship—persist, the PSLRA's heightened pleading requirements as defined by *Tellabs* should alleviate these concerns. Although the substantial participation standard sets forth a highly fact-oriented framework for determining liability under Section 10(b) (similar to the creator standard), which theoretically heightens the potential for lawyer-driven, class action lawsuits, the PSLRA's pleading standards, particularly as they relate to allegations of scienter, reduce the risk of frivolous litigation. With a heavy burden on plaintiffs to plead with particularity why a party has acted with the requisite scienter in a securities fraud class action lawsuit, courts will have the ability to employ the heightened pleading standards to weed out most meritless lawsuits against lawyers, allaying the policy concern expressed by the Supreme Court in *Central Bank* that secondary actors should not have to defend vaguely pleaded complaints brought against them.

Furthermore, contrary to arguments expounded by its opponents, the substantial participation standard does not compromise the attorney-client relationship, especially when applied together with the heightened pleading standards of the PSLRA. Although some opponents contend that attorneys may insulate themselves from material discussions with their corporate clients in order to limit their role to that merely of a behind-the-scenes scrivener, that argument has little weight.²⁷⁵ Despite this argument's appeal in the pre-*Central Bank* era when concerns over frivolous litigation were particularly salient, the enactment of the PSLRA has significantly reduced its potency. After *Tellabs*, only those attorneys who knowingly provide substantial assistance in drafting a materially false public disclosure would have any concern regarding liability. In fact, these are the precise actors that the securities laws are intended to capture. Thus, the substantial participation standard, together with the application of the PSLRA's pleading requirements, presents a satisfactory balance that allows plaintiffs to bring claims against lawyers and other secondary actors that have knowingly as-

²⁷⁵ See, e.g., Nowicki, *supra* note 71, at 696-98.

sisted their clients with the preparation of fraudulent public disclosures, without opening the floodgates of liability.

C. *The Substantial Participation Standard Satisfies the Element of Reliance Under Section 10(b)*

A discussion of the substantial participation standard would not be complete without an acknowledgment of the fact that the standard, at least in a technical sense, eschews the reliance requirement under Section 10(b). The inability to establish reliance on the conduct of an aider and abettor was one of the primary reasons the *Central Bank* Court rejected aiding and abetting liability.²⁷⁶ The application of the substantial participation standard to secondary actors, therefore, would have to be consistent with *Stoneridge*'s recent explanation of the reliance requirement²⁷⁷ as well as its instruction that “[c]onduct itself can be deceptive” and provide the basis for liability.²⁷⁸ Two recent cases have provided a viable, alternative interpretation of reliance in the context of Rule 10b-5(a) and (c) that is consistent with *Stoneridge* and that can be applied to Rule 10b-5(b) liability.

In re Parmalat Securities Litigation considered allegations of scheme liability against Citigroup Inc., Citibank, N.A., Bank of America, and Banca Nazionale del Lavoro (collectively, the “Bank Defendants”).²⁷⁹ In that case, plaintiffs asserted that defendants violated Rule 10b-5(a) and (c) as a result of their participation in two fraudulent schemes: one involving loans disguised as equity transactions and the other involving the securitization of phony receivables for the purpose of improperly inflating Parmalat’s reported earnings.²⁸⁰ With the exception of Bank of America, none of the defendants were alleged to have participated in the creation of false statements or omissions in violation of Rule 10b-5(b).²⁸¹

Straying from the Supreme Court’s interpretation of reliance in *Central Bank*, the *Parmalat* court acknowledged that, in the absence of a false statement made by the Bank Defendants, plaintiffs “cannot be said to have relied on the banks.”²⁸² However, the district court sidestepped the reliance

²⁷⁶ See *Central Bank*, 511 U.S. at 180 (arguing that “[a]llowing plaintiffs to circumvent the reliance requirement would disregard the careful limits on 10b-5 recovery mandated by our earlier cases”).

²⁷⁷ It is important to note that, according to *Stoneridge*, to establish reliance, the deceptive acts of the defendant must be disclosed to the investors; it does not suffice only if they were incorporated into the price of the security through the efficient market theory. See *Stoneridge Inv. Partners*, 128 S. Ct. at 770 (“In all events we conclude respondents’ deceptive acts, which were not disclosed to the investing public, are too remote to satisfy the requirement of reliance.”).

²⁷⁸ *Id.* at 769.

²⁷⁹ See *In re Parmalat Sec. Litig.*, 376 F. Supp. 2d 472, 481-89 (S.D.N.Y. 2005).

²⁸⁰ *Id.* at 504-05.

²⁸¹ *Id.* at 487.

²⁸² *Id.* at 509.

issue by positing that it was inapplicable to claims under Rule 10b-5(a) and (c).²⁸³ According to the court, the reliance requirement operates as a proxy for causation—a way “to certify that the conduct of the defendant actually caused the plaintiff’s injury.”²⁸⁴ In the absence of a false statement or omission on which a plaintiff could rely, the court maintained that the reliance requirement could nonetheless be satisfied by evidence that the defendant’s conduct was a “substantial, i.e., a significant contributing cause” of plaintiff’s injury.²⁸⁵

Likewise, in *In re Lernout & Hauspie Securities Litigation*,²⁸⁶ plaintiffs brought claims under Rule 10b-5(a) and (c) against Lernout & Hauspie (“L&H”) and the owners of certain “strategic partner” entities.²⁸⁷ The “strategic partner” entities were start-up software companies that entered into software licensing agreements with L&H.²⁸⁸ According to plaintiffs’ allegations, the “strategic partner” entities were shams owned by undisclosed related third parties that were used to improperly enhance L&H’s reported earnings.²⁸⁹ Acknowledging that the case law on scheme liability is “slender,” the district court nonetheless was persuaded that business associates of L&H who were owners of the “strategic partners” could be liable as primary violators of Rule 10b-5 if they “substantially participat[ed] in a manipulative or deceptive scheme by directly or indirectly employing a manipulative or deceptive device (like the creation or financing of a sham entity) intended to mislead investors, even if a material misstatement by another person creates the nexus between the scheme and the securities market.”²⁹⁰ On the issue of reliance, the court found that a plaintiff could establish reliance on the conduct of a secondary actor in a scheme liability case based upon the plaintiff’s reliance on the transactions at issue “as a whole.”²⁹¹

Both *Parmalat* and *Lernout & Hauspie* challenge *Central Bank*’s premise that reliance cannot be established in the absence of a statement made by a speaker identified to the public, which leaves both decisions consistent with the language used by the Supreme Court in the *Stoneridge* decision. Recasting defendants’ conduct in those district court cases as participation in a deceptive or fraudulent scheme pursuant to Rule 10b-5(a) and (c) (scheme liability), both courts essentially did away with *Central Bank*’s arguably restrictive view of reliance. By distinguishing between reliance on

²⁸³ *Id.*

²⁸⁴ *Id.* (citing *List v. Fashion Park, Inc.*, 340 F.2d 457, 462 (2d Cir. 1965)).

²⁸⁵ *Parmalat*, 376 F. Supp. 2d at 509 (citing *Wilson v. Comtech Telecomms. Corp.*, 648 F.2d 88, 92 (2d Cir. 1981)).

²⁸⁶ 236 F. Supp. 2d 161 (D. Mass. 2003).

²⁸⁷ *Id.* at 165-66.

²⁸⁸ *Id.* at 166.

²⁸⁹ *Id.*

²⁹⁰ *Id.* at 171-73.

²⁹¹ *Id.* at 174.

a misstatement made by a particular speaker and reliance on the conduct as a whole, *Parmalat* and *Lernout & Hauspie* provide further legal support for the Ninth Circuit's interpretation of reliance. With this distinction in mind, the reliance argument in *Parmalat* and *Lernout & Hauspie* can be extrapolated to the Rule 10b-5(b) context to include reliance on the misstatement itself, rather than on any particular speaker who may have made the misstatement. This interpretation of reliance is both appropriate and necessary, especially given the investing public's experience with corporate misconduct over the past decade. Without a view of reliance consistent with *Parmalat* and *Lernout & Hauspie*, the imposition of Rule 10(b)-5 liability on secondary actors would be impossible in nearly every instance.

CONCLUSION

The past decade has witnessed a seemingly endless parade of corporate scandals. Following *Central Bank's* abolition of aiding and abetting liability and the adoption of the bright line attribution rule, secondary actors such as lawyers, accountants, and underwriters became nearly impervious to liability under Section 10(b). Although the bright line rule provides certainty, which is a significant benefit to the conduct of business transactions, the ease of application of such a rule is no excuse for ignoring the fundamental remedial purposes of the federal securities laws and Congress's policy decisions. Given that the bright line rule has failed to deter corporate malfeasance and that the policy concerns expressed in *Central Bank* have been addressed by the PSLRA's pleading requirements as interpreted by the Supreme Court in *Tellabs*, the bright line rule's effectiveness and propriety as a standard of secondary actor liability is in serious doubt.

Notwithstanding certain limitations, including a highly fact-oriented disposition of liability, the substantial participation test sets forth a standard of liability that both promotes the securities laws' goals of accurate and continuous disclosure and enforces secondary actors' traditional roles as gatekeepers of the securities market. In moving away from the formalistic approach adopted by the Supreme Court in *Central Bank* and adopting the suggested basis for liability announced by the Court in *Stoneridge*, the standard prescribed in this Article adopts the fundamental tenets of the substantial participation standard for Rule 10b5-(b) liability, but by enforcing the heightened pleading requirements of the PSLRA based on the Supreme Court's recent decision in *Tellabs*, provides for a sensible framework of secondary actor liability that accomplishes the seemingly conflicting goals of curbing frivolous litigation while still preserving investors' ability to recover on meritorious claims.