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PRIMARY LIABILITY UNDER THE FEDERAL SECURITIES LAW EVEN WHEN YOU DO NOT "MAKE" A STATEMENT – THE AFTERMATH OF CENTRAL BANK

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INTRODUCTION

The recent avalanche of massive accounting frauds at once venerable companies such as Enron and Lernout & Hauspie has resulted in renewed scrutiny of the United States Supreme Court decision in Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164 (1994). In Central Bank, the Court held a private party could not maintain an action for aiding and abetting liability under Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act"). Now courts seek to reconcile Central Bank with claims brought against secondary actors such as banks, law firms and accountants who participated or perpetuated a corporate defendant's fraud. This article addresses: (i) the Supreme Court's decision in Central Bank, (ii) liability under Section 10(b) and Rule 10b-5 for engaging in a fraudulent scheme or course of business; (iii) the two competing standards for determining a secondary actor's liability for "making" a material misstatement or omission; and (iv) Congress's response to Central Bank.

In enacting Section 10(b), Congress sought to "'substitute a philosophy of full disclosure for the philosophy of *caveat emptor* and thus to achieve a high standard of business ethics in the securities industry.'" Affiliated Ute Citizens v. United States, 406

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U.S. 128, 150 (1972), (quoting SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186 (1963)). The statute should be "construed 'not technically and restrictively, but flexibly to effectuate its remedial purposes.'" Affiliated Ute, 406 U.S. at 151, (quoting Capital Gains, 375 U.S. at 195).

I. CENTRAL BANK'S ELIMINATION OF "AIDING AND ABETTING" LIABILITY

From 1966 until 1994, a private party could maintain an action under Section 10(b)[2] against a person or entity for aiding and abetting another in committing a manipulative or deceptive act in connection with the purchase or sale of securities. In 1994, the Supreme Court, in a 5-4 decision, eviscerated that right.[3] Central Bank, 511 U.S. at 191. Prior to the Supreme Court's decision in Central Bank, all eleven federal Courts of Appeal had recognized the existence of a private right of action against the aiders and abettors under Section 10(b) and Rule 10b-5.[4] See id. at 192 (dissenting

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[2] Section 10(b) of the Exchange Act states in relevant part:

> It shall be unlawful for any person, directly or indirectly . . . (b) to use 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 [SEC] may proscribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78j(b).

[3] Justice Kennedy delivered the opinion of the Court, in which Chief Justice Rehnquist and Justices O'Connor, Scalia, and Thomas joined. Justices Blackmun, Souter and Ginsburg joined Justice Steven's dissenting opinion.

[4] SEC Rule 10b-5 provides in relevant part:

> 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,

opinion) (noting courts and the SEC had concluded aiders and abettors are liable under Section 10(b) and Rule 10b-5 in "hundreds of judicial and administrative proceedings").[5]

In Central Bank, the Colorado Springs-Stetson Hills Public Building Authority ("Authority") held two bond offerings, one in 1986 and a second in 1988. The Authority issued the bonds to finance public improvements relating to a planned residential and commercial development in Colorado Springs. Id. at 167. Central Bank of Denver ("Central Bank") served as indenture trustee for the bond issues. Id. The bonds were secured by landowner assessment liens. Id. The bond covenants required that the land subject to the liens remain worth at least 160% of the bonds outstanding principal and interest. The developer of the project, AmWest Development ("AmWest"), was responsible for providing the bank with an annual report demonstrating that the worth requirement was met. Id.

In 1988, Central Bank learned that property values had declined and that its latest appraisal for the land may be overly optimistic. Id. Nonetheless, Central Bank agreed to delay an independent review of the appraisal until after the Authority issued additional

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(a) To employ any device, scheme, or artifice to defraud,
(b) To make any untrue statement of 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.

17 C.F.R. § 240.10b-5. "The scope of Rule 10b-5 is coextensive with the coverage of § 10(b)." SEC v. Zandford, 535 U.S. 813, 122 S. Ct. 1899, 1901 n.1 (2002).

[5] The earlier decisions borrowed from tort law in formulating aiding and abetting liability under Section 10(b).

bonds in June 1988. Id. at 168. Before the independent review was complete, but after the bond sale, the Authority defaulted on the 1988 bonds.

First Interstate Bank of Denver and Jack N. Naber (collectively, "respondents") purchased $2.1 million in bonds issued in the 1988 closing. After the Authority defaulted on the bonds, respondents sued the Authority, the AmWest directors and certain underwriters of the bonds. In addition, respondents sued Central Bank for its conduct in aiding and abetting the fraud.[6] Id.

On appeal, a majority of the Supreme Court employed rules of statutory construction to determine that Section 10(b) failed to support a cause of action for aiding and abetting liability. The Central Bank Court first determined that the plain language of the statute did not provide for aiding and abetting liability. The Court disagreed that the words "directly or indirectly" in the statute stretched to cover aiders and abettors. Id. at 176 (reasoning phrase applied to those engaged in proscribed activity while aiding and abetting reaches even those persons who do not engage in the prohibited activity). The Central Bank Court feared that recognizing aiding and abetting liability would permit plaintiffs to circumvent the reliance requirement of Rule 10b-5 because the aider and

[6] The United States District Court for the District of Colorado granted summary judgment to Central Bank after determining no genuine issues of material fact existed. The United States Court of Appeals for the Tenth Circuit reversed the lower court's decision upon finding that plaintiffs had established genuine issues of material fact regarding the recklessness element of aiding and abetting liability and that a reasonable fact-finder could conclude the bank had rendered substantial assistance. First Interstate Bank, of Denver N.A. v. Pring, 969 F.2d 891, 904 (10th Cir. 1992), rev'd, Central Bank, N.A. v. First Interstate Bank, N.A., 511 U.S. 164 (1994).

abettor could be liable without any showing that the plaintiff relied upon the aider and abettor's statements or actions.[7] Central Bank, 511 U.S. at 168.

The majority also rejected arguments that Congress intended to include liability for aiding and abetting within the meaning of the statute. See id. at 180-85. The Court found the text of the statute failed to support that interpretation. Id. at 183-85. Finally, the Court concluded that Central Bank could not be secondarily liable under Section 10(b) for aiding and abetting. Id. at 191-92.

In Central Bank, plaintiffs conceded that the bank did not commit a manipulative or deceptive act within the meaning of Section 10(b), thus the Court constrained itself to analyzing the bank's liability as an aider and abettor.[8] Id. at 191. The Court recognized, however, that despite the absence of aiding and abetting liability, secondary actors were not immune from liability under Section 10(b). The Central Bank Court stated that any person or entity, including "a lawyer, accountant and 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." Central Bank, 511 U.S. at 191.

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[7] "Reliance . . . generally requires that the plaintiff have known of the particular misrepresentation complained of, have believed it to be true and because of that knowledge and belief purchased or sold the security in question." Nathenson v. Zonagen Inc., 267 F.3d 400, 413 (5th Cir. 2001).

[8] At least one court has pointed out that an examination of the underlying facts of Central Bank reveal that plaintiffs did allege that the bank committed the affirmative act of intentionally delaying the new property appraisal until after the bonds had issued. Thus, plaintiffs might have been able to allege this act was a manipulative or deceptive device under Section 10(b). In re ZZZZ Best Sec. Litig., 864 F. Supp. 960, 969 n.11 (C.D. Cal. 1994).

The Supreme Court's recognition that the absence of aiding and abetting liability does not shield secondary actors from liability under Section 10(b) has served as the cornerstone for courts seeking to uphold claims against secondary actors for their role in the fraud. See, e.g., Cooper v. Pickett, 137 F.3d 616, 624 (9th Cir. 1997) (relying on the statement in Central Bank that the absence of aiding and abetting liability did not mean secondary actors were free from liability); In re Enron Corp. Sec., Derivative & ERISA Litig., 235 F. Supp. 2d 549, 582 (S.D. Tex. 2002) (recognizing that Central Bank did not immunize secondary actors from liability); In re ZZZZ Best Sec. Litig., 864 F. Supp. 960, 967-68 (C.D. Cal. 1994) (quoting Central Bank as justification for analyzing accounting firm's liability as primary violator); see also Brief of the Securities and Exchange Commission, Amicus Curiae, Klein v. Boyd, (3d Cir. Apr. 1998) (Nos. 97-1143, 97-1261) ("SEC Amicus Brief, Klein v. Boyd") at 9. Consequently, some courts have declined to allow secondary actors, like banks, law firms and accountants, to use Central Bank to escape liability.

II. LIABILITY UNDER RULE 10b-5 FOR ENGAGING IN A FRAUDULENT SCHEME OR COURSE OF BUSINESS

While much attention and litigation has focused on liability under subsection (b) of Rule 10b-5, which concerns the making of a material misstatement (or omission), recent cases have breathed new life into subsections (a) and (c). Subsections (a) and (c) impose liability on persons or entities engaging in any device, scheme or artifice to defraud or engaging in an act, practice or course of business which operates as a fraud.[9] The Supreme Court has consistently espoused the view that "it [is not] sound to dismiss a

[9] Liability under subsection (a) of Rule 10b-5 is generally referred to herein as engaging in a "scheme" and liability under subsection (c) is generally referred to as engaging in a "course of business".

complaint merely because the alleged scheme does not involve the type of fraud that is 'usually associated with the sale or purchase of securities.' . . . § 10(b) and Rule 10b-5 prohibit *all* fraudulent schemes in connection with the purchase or sale of securities, whether the artifices employed involve a garden type variety of fraud, or present a unique form of deception." Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 11 (1971); see Ernst & Ernst v. Hochfelder, 425 U.S. 185, 199 (1976) (market manipulation defined as conduct "designed to deceive or defraud investors by controlling or artificially affecting the price of securities."). The Court recently reiterated its position that neither it nor the SEC "has ever held that there must be a misrepresentation about the value of a particular security in order to run afoul of the Act." SEC v. Zandford, 535 U.S. 813, 122 S. Ct. 1899, 1903 (2002) (interpreting securities broker's liability under § 10(b) for engaging in a fraudulent scheme to defraud a client).

The Ninth Circuit and the United States District Courts for the District of Massachusetts and the Southern District of Texas have recently grappled with the issue of determining liability of certain secondary actors for engaging in a fraudulent scheme or course of business under subsections (a) and (c) of Rule 10b-5. No. 84 Employer-Teamster Joint Counsel Pension Trust Fund v. America West Holding Corp., No. 01-16725, 2003 WL 328998 at *8-9 (9th Cir. Feb. 13, 2003); In re Lernout & Hauspie Sec. Litig., 236 F. Supp. 2d 161, 170-74 (D. Mass. 2003); Enron, 235 F. Supp. 2d at 577 (recognizing liability under subsections (a) and (c) for fraudulent schemes or course of business).

In America West, the plaintiffs had appealed the dismissal of their class action complaint against America West Airlines, Inc., its two largest shareholders during the

class period and certain other individual officers and directors. The two largest shareholders consisted of a group of companies collectively referred to by the court as "TPG" and Continental Airlines ("Continental"). In 1994, America West had filed for bankruptcy protection under Chapter 11 and reorganized. In the reorganization, TPG obtained 49% of America West's Class A stock and Continental held 8.3% of the Class A stock. Pursuant to a "lock up" provision, TPG and Continental retained two shares of publicly traded Class B stock for every Class A stock until May 20, 1998. Beginning in 1997, plaintiffs alleged that TPG and Continental influenced America West to inflate the value of its stock by May 20, 1998 by denying the existence of operational problems and misrepresenting the reasons for the purportedly improved financial results. Defendants' conduct resulted in the stock reaching an all-time high of $31 5/16 by April 21, 1998. On May 28, 1998, TPG sold approximately 99% of its Class B stock at $27 3/4. On June 22, 1998, Continental sold all of its Class B stock at $28 1/8 per share.

On appeal, TPG and Continental both contended that plaintiffs failed to specifically plead defendants' involvement in the fraud and thus, could not be liable under Section 10(b) and Rule 10b-5. These two large shareholders also relied on the fact that they did not make any of the allegedly false and misleading statements. The Ninth Circuit reversed the decision of the lower court and upheld the claims against TPG and Continental. The court noted that liability under the statute and rule was not limited to misrepresentations or omissions of material fact. Rather, liability could attach for employing any device, scheme or artifice to defraud and that trading on material, nonpublic information constituted a deceptive device under Section 10(b). America West, 2003 WL 328998 at *13 (citing United States v. O'Hagan, 521 U.S. 642, 652

(1997) (holding that person who trades on confidential information for personal gain in breach of a fiduciary duty violates Section 10(b) and Rule 10b-5)). Accordingly, the America West court held that the fact that defendants did not make statements did not shield TPG and Continental from liability.

In Lernout, plaintiffs alleged defendants Flanders Language Valley Fund c.v.a. ("FLV"), Mercator and Noordstar, N.V. ("Mercator") and an individual defendant, Louis H. Verbeke, participated in a scheme and course of business to defraud investors of Lernout & Hauspie ("L&H") by "setting up, funding and operating sham entities." These entities or "strategic partners" would enter into bogus software licensing agreements with L&H, which would result in boosting L&H's profits. In return, FLV, Mercator and Verbeke benefited from the scheme. Mercator and Verbeke benefit in part because of their personal stake in L&H. The inflated profits led to an increased stock price, which increased the value of defendants' holdings.

Defendants moved to dismiss claiming Central Bank precludes all private actions under Section 10(b) and Rule 10b-5 whose actions do not directly impact the securities market. Defendants argued that only L&H directly interacted with the market by disseminating financial statements that misstated revenues from the strategic partners. Thus, according to defendants, plaintiffs could have relied only on L&H's fraud.

The Lernout court first distinguished Central Bank in finding that the Supreme Court never reached the extent of primary liability under Section 10(b). Lernout, 236 F. Supp. 2d at 171. While recognizing the dearth of post-Central Bank case law on fraudulent schemes, the court determined that primary liability under Section 10(b) and Rule 10b-5 extends to "any person who substantially participates 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." Id. at 171-73. In keeping with Central Bank's concern for maintaining the reliance requirement, the Lernout court further held that to demonstrate reliance, plaintiffs must show defendants substantially participated in a fraudulent scheme and when viewed as a whole, plaintiffs relied on the scheme.[10] Id. at 174.

The SEC adheres to the same view as the America West and Lernout courts. This position is consistent with the Supreme Court's interpretation of Section 10(b), which does not restrict liability to the making of a misrepresentation or omission. In its brief to the United States Court of Appeals for the Fourth Circuit, the SEC criticized the United States District Court for the Southern District of West Virginia for holding Section 10(b) and Rule 10b-5 applied only to misleading statements or omissions. The SEC argued that the lower court ignored the plain language of the statute and rule which prohibits any deceptive device, contrivance, act or practice. SEC Brief, United States v. Bryan, 58 F.3d 933 (4th Cir. 1995). The SEC made the same argument in its brief to the Supreme Court in United States v. O'Hagan, 521 U.S. 642 (1997). See Bryan Brief at 10-11.

III. LIABILITY FOR "MAKING" A STATEMENT UNDER RULE 10b-5(b) – THE BRIGHT-LINE STANDARD VERSUS THE SUBSTANTIAL PARTICIPATION STANDARD

Unlike subsections (a) and (c) of Rule 10b-5, liability under subsection (b) is restricted to the making of an untrue statement or omitting a material fact. See ZZZZ Best, 864 F. Supp. at 971-72 (distinguishing between the sweeping reach of liability for a

[10] The Lernout Court cautioned that in addition to showing substantial participation, plaintiffs must still satisfy the scienter requirement. Lernout, 236 F. Supp. 2d at 175.

scheme or course of business versus restricted reach of subsection (b)).[11] Since Central Bank, two divergent tests have developed to determine whether a secondary actor is liable under Section 10(b) for "making" any untrue statement or omission under Rule 10b-5(b). The two tests, known as the "bright-line" standard and the "substantial participation" standard differ on what must be shown before liability will attach to a secondary actor for violation of Section 10(b). The more stringent bright-line standard has come under fire by various courts and the SEC because of its rigid and narrow application.

1. The Bright-Line Standard

The "bright-line" standard requires secondary actors to make a material misstatement or omission that the actor knows or should know will be disseminated to investors, although the actor need not directly communicate the misrepresentation to the investors. See Shapiro v. Cantor, 123 F.3d 717, 720 (2d Cir. 1997); Anixter v. Home-Stake Production, Co., 77 F.3d 1215, 1225-26 (10th Cir. 1996) (requiring accountants to make false or misleading statement and omission that they know or should know will reach investors); see also In re Kendall Square Research Corp. Sec. Litig., 868 F. Supp. 26, 28 (D. Mass. 1994) (1994) (determining Price Waterhouse could not be liable under

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[11] Despite the facial distinctions, an overlap of liability exists among the three prongs for liability under Rule 10b-5. See Peil v. Speiser, 806 F.2d 1154, 1162 (3d Cir. 1986) (recognizing "uncertainty surrounding the differences and overlap among the three clauses of Rule 10b-5"); ZZZZ Best, 864 F. Supp. at 969-72 (denying summary judgment for auditor under all three subsections because allegations established primary violation auditor participated in creating, reviewing or issuing its clients' fraudulent public statements); see also Lernout, 236 F. Supp. 2d at 173 (outlining plaintiffs' argument that scheme or course of business under Rule 10b-5(a) and (c) can include misleading financial statements that may qualify as basis for liability under (b)). The Peil court distinguished between subsection (b) and subsections (a) and (c), however, in that

Section 10(b) for merely reviewing and approving quarterly financial statements and prospectuses). Unlike the Tenth Circuit, the Eleventh and Second Circuits also require that the false or misleading statement be attributed to the defendant at the time of its publication. See Ziemba v. Cascade Int'l, Inc., 256 F.3d 1194, 1205 (11th Cir. 2001) (following Second Circuit precedent and concluding plaintiffs must have relied upon a misstatement or omission publicly attributable to the defendant); Wright v. Ernst & Young LLP, 152 F.3d 169, 175 (2d Cir. 1998) (requiring misrepresentation be attributed to specific actor at time of publication to avoid circumventing reliance requirement), cert. denied, 525 U.S. 1104 (1999).

The Second Circuit adopted the bright-line standard in Shapiro. In that case, several persons formed seven limited partnerships to develop and operate a chain of video stores. Id. at 718. These principals then held three private placement offerings and obtained investments from a number of limited partners. These limited partners subsequently brought suit claiming they were fraudulently induced to invest in the limited partnerships in violation of the federal securities laws, including Section 10(b) of the Exchange Act. Shapiro, 123 F.3d at 718. The plaintiffs named as a defendant the accounting firm of Touche Ross and Co. and its successor-in-interest Deloitte & Touche (collectively, "Deloitte"). Id. at 719. Plaintiffs claimed Deloitte participated in defendants' fraudulent scheme by assisting with the preparation of the offering memorandum. Id.

On appeal, the Court of Appeals for the Second Circuit affirmed the district court's dismissal of the complaint for failure to state a claim. Id. at 720. Against the

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liability under subsection (b) may arise from a single fraudulent action, while (a) and (c) require a "scheme" to defraud. Peil, 806 F.2d at 1162.

backdrop of Central Bank, the Court held that accountants "must themselves make a false or misleading statement (or omission) that they know or should know will reach potential investors in order to be held liable under § 10(b)." Shapiro, 123 F.3d at 720. The Court reasoned that this approach over one which analyzed whether the outside professional had substantially assisted in the fraud provided guidance to litigants. Id. Consequently, the Shapiro Court concluded that the complaint alleged that Deloitte had merely aided and abetted defendants and could not be sustained.[12]

In adhering to Shapiro, the Wright court determined that the accounting firm of Ernst & Young could not be held liable for approving a corporate defendant's financial statements. The statements were contained in a press release which were disseminated to the public. The company's press release stated that the results were "unaudited" and failed to mention Ernst & Young. Wright, 152 F.3d at 175. Moreover, the press release warned that no audit has been completed. Thus, the plaintiff could not show that she relied on any statement made by Ernst & Young. Id.

Similarly, in Ziemba, the Eleventh Circuit also focused on Central Bank's discussion of the reliance requirement. The court refused to hold a corporate defendant's law firm and auditor liable where plaintiffs failed to allege the law firm or auditor made any misstatements upon which plaintiffs relied in making their investment decision. Ziemba, 256 F.3d 1205-06. Plaintiffs alleged only that the law firm played a role in "drafting, creating, reviewing or editing allegedly fraudulent letters or press releases." Id. at 1205. The plaintiffs alleged the auditor provided advice to the corporation. Id. at

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[12] The Shapiro Court deemed the allegations in the complaint containing the words "assisting in, participating in, complicity in" and similar synonyms pled only aiding and abetting liability and ran afoul of Central Bank. Shapiro, 123 F.3d at 721 (internal quotations omitted).

1207. The circuit court deemed these allegations pled only "substantial participation" and could not serve as a basis as liability under Central Bank. Ziemba, 256 F.3d at 1205, 1207.

In choosing the bright-line standard over the substantial participation standard, the courts have reasoned that this standard gives effect to Central Bank. Shapiro, 123 F.3d at 720 (deciding that if Central Bank is to have "real meaning", defendant must actually make a false or misleading statement). The Eleventh and Second Circuits have deemed the bright-line standard as the better way of ensuring plaintiffs cannot forgo establishing reliance, a primary concern of Central Bank. The Anixter court criticized the substantial participation test as "reformulating" the substantial assistance element of aiding and abetting liability into primary liability. See Anixter, 77 F.3d at 1226 n.10.

2. The Substantial Participation Standard

The substantial participation standard provides for primary liability where the secondary actor substantially participates or is intricately involved in the preparation of fraudulent statements "even though that participation might not lead to the actor's actual making of the statements." Howard v. Everex Sys. Inc., 228 F.3d 1057, 1061 n.5 (9th Cir. 2000); see also In re Software Toolworks Inc. Sec. Litig., 50 F.3d 615, 628-29 (9th Cir. 1994) (reversing grant of summary judgment for auditor for its significant role in preparing false and misleading letters to the SEC); Cashman v. Coopers & Lybrand, 877 F. Supp. 425, 432 (N.D. Ill. 1995) (determining accountant liable when "centrally involved" in preparing, certifying or reporting misstatements).

In Lernout, plaintiffs alleged KPMG US prepared the fraudulent L&H statements issued from L&H headquarters in Burlington, Massachusetts and worked extensively on

the audit report issued by KPMG Belgium. Although not the auditor, KPMG US was listed in L&H's annual report to its shareholders. The court determined that KPMG US played a significant role in drafting the financial statements and that its role was publicly disseminated to shareholders. Thus, the court held that KPMG's actions, taken together, satisfied the misrepresentation prong of Rule 10b-5. The Lernout court reasoned that "in 1998 and 1999 investors could reasonably have attributed the statements in the quarterly and annual financial statements to KPMG US." Lernout, 230 F. Supp. 2d at 167.

In analyzing plaintiffs' claim against KPMG UK, the Lernout court noted that KPMG UK also allegedly played a substantial role in conducting audits of L&H. Unlike, KPMG US, however, KPMG UK's role was never disclosed to investors. Nonetheless, the court deemed absolving "an auditor who prepares, edits and drafts a fraudulent financial statement knowing it will be publicly disseminated simply because an affiliated auditor with which it is working under a common trademark is the one to actually sign it, would stretch Central Bank's holding too far." Id. at 168-69. Accordingly, the court determined that KPMG UK's role in preparing an annual report triggered primary liability.[13] Id.

Defendants in Lernout and Enron argued that absent any alleged misstatement by a defendant, plaintiffs could not meet the reliance requirement of their securities fraud claim. This exact argument was rejected by the Supreme Court in Affiliated Ute, by the SEC and by the Lernout and Enron courts. "Under the circumstances of this case, involving primarily a failure to disclose, positive proof of reliance is not a prerequisite to

[13] The Lernout Court, however, ultimately dismissed the claim against KPMG UK because the allegations failed to show that it had acted with the requisite scienter. Id. at 169.

recovery. All that is necessary is that the facts withheld be material in the sense that a reasonable investor might have considered them important in the making of this decision." See Affiliated Ute, 406 U.S. at 153-54; see also ZZZZ Best, 864 F. Supp. at 970 ("While the investing public may not be able to reasonably attribute the additional misstatements and omissions to [the auditors], the securities market still relied on those public statements and anyone intricately involved in their creation and the resulting deception should be liable under § 10(b)/Rule 10b-5.").

3. The SEC's position

The SEC has criticized courts that require a defendant to be identified as the author of the misrepresentation before liability can attach (a view espoused by some courts applying the bright-line standard). The SEC has declared 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." See SEC Amicus Brief, Klein v. Boyd at 10-11.[14] As the SEC forcefully asserted in Klein,

> Creators of misrepresentation could escape liability as long as they concealed their identities.[15] Not only outside lawyers would benefit from

[14] The SEC has stated repeatedly that "private actions under the federal securities laws serve an important role, both because they provide compensation for investors who have been harmed by securities law violations and because, as the Supreme Court has repeatedly recognized, they 'provide "a most effective weapon in the enforcement" of the securities laws and are "a necessary supplement to Commission action."'" SEC Amicus Brief, Klein v. Boyd, at 2 (citing Bateman Eichler, Hill Richards, Inc. v. Berner, 472 U.S. 299, 310 (1985)) (quoting J. I. Case Co. v. Borak, 377 U.S. 426, 432 (1964)); see also Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 730 (1975). Further, an amicus brief filed by the SEC "reflect[s] the agency's considered judgment on that matter in question" and is entitled to extreme difference. See Hertzberg v. Dignity Partners, Inc., 191 F.3d 1076, 1082 (9th Cir. 1999) (citations omitted).

[15] "Controlling persons" of those publicly identified as responsible for the misrepresentation would be liable under § 20(a) of the Exchange Act, 15 U.S.C. 78t(a). Yet, a person can be a creator of a misrepresentation without controlling the person in whose name the misrepresentation is issued.

> such a rule; others who are retained to prepare information for dissemination to investors, including accountants and public relations firms, could immunize themselves by remaining anonymous . . . . In sum, by providing a safe harbor for anonymous creators of misrepresentations, a rule that imposes liability only when a person is identified with a misrepresentation would place a premium on concealment and subterfuge rather than on compliance with the federal securities laws.

SEC Amicus Brief, Klein v. Boyd, at 11; see also SEC v. First Jersey Sec., 101 F.3d 1450, 1471 (2d Cir. 1996) ("Primary liability may be imposed 'not only on persons who made fraudulent misrepresentation but also on those who had knowledge of the fraud and assisted in its preparation.'") (citation omitted), cert. denied, 522 U.S. 812 (1997). In addressing the issue of reliance, the SEC argued that the identity of the author of the misrepresentation is a nonfactor. In particular, the SEC noted:

> The reliance a plaintiff in a securities fraud action must plead is reliance on a misrepresentation, not on the fact that a particular person made a misrepresentation. The Supreme Court stated in Central Bank that liability exists where "[a]ny person or entity, including a lawyer, accountant, or bank . . . makes a material misstatement (or omission) on which a purchaser or seller of securities relies." 511 U.S. at 191. Thus, the Court placed the focus on the misrepresentation, not on the fact that a particular person made it.

SEC Amicus Brief, Klein v. Boyd, at 13.

In Enron, the court eschewed the bright-line approach and adopted the SEC's proposed rule for primary liability of a secondary actor under Section 10(b): " '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.'" Enron, 235 F. Supp. 2d at 588, 591 (quoting SEC's amicus brief).

IV. CONGRESS'S RESPONSE TO CENTRAL BANK

In enacting the Private Securities Litigation Reform Act of 1995 ("PSLRA"), Congress ensured the SEC's authority to bring actions against aiders and abettors for violations of Section 10(b). 15 U.S.C. 78t(f). The shocking number of large accounting frauds over the past couple of years, however, has compelled two congressmen to revisit the matter. Representatives Edward Markey and Bart Stupak have each submitted bills which would reinstate liability for aiding and abetting.

1. "Stop Enablers of Fraud Act"

On October 10, 2002, Rep. Markey of Massachusetts introduced bill number H.R. 5625 - "Stop Enablers of Fraud Act" to the 107th Congress. The bill was officially titled "To restore aiding and abetting liability under the Federal securities laws." If passed, the Act would have amended the Securities Act of 1933, the Exchange Act, the Investment Company Act of 1940 and the Investment Advisors Act of 1940 to impose liability for recklessly or knowingly providing substantial assistance towards aiding and abetting violations.[16]

In introducing the bill to Congress, Rep. Markey deemed reinstating aiding and abetting liability and overturning Central Bank as the best way to protect the interest of shareholders and the marketplace:

> The Stop Enablers of Fraud Act responds to the series of corporate scandals that have illuminated the integral, albeit supporting, role that professional services firms sometimes play in the design, implementation

[16] The amendments to the Securities Act and Exchange Act would allow prosecution of "any person who knowingly or recklessly provides substantial assistance to another person in the violation of a provision of this title, or of any rule or regulation hereunder, shall be deemed to violate such provision to the same extent as the person to whom such assistance is provided. No person shall be liable under this subsection based on an omission or failure to act unless such omission or failure constituted a breach of a duty owed by such person."

> and validation of fraudulent activities conducted by their clients. In their responses to the consolidated complaint in the pending Enron litigation, professional services firms frequently have cited the Central Bank precedent as they seek to have the charges against them dismissed, arguing that aiders and abettors are immune from liability for fraud alleged in private suits.

148 Cong. Rec. E1831-01 (daily ed. Oct. 11, 2002) (statement of Rep. Markey), 2002 WL 31275023.

Rep. Markey warned that the SEC, who could pursue secondary actors for aiding and abetting, could not keep up with the caseload because of its limited resources and heavy workload. In citing statistics, he noted that between August 2001 and May 2002, the SEC had filed or instituted forty initial actions for aiding and abetting violations of the federal securities laws. Twenty-two of the matters were concluded as of May 2002. Only four resulted in disgorgement of illegal profits. The amount disgorged totaled approximately $321,369. Rep. Markey emphasized that this amount pales in comparison to the losses suffered by shareholders on the open market. In Enron alone, state pension plans suffered an estimated loss of $3 billion.

The House referred the bill to the subcommittee on Crime, Terrorism and Homeland Security on November 12, 2002. The bill died in committee. To date, Rep. Markey has not reintroduced the legislation to the 108th Congress.

2. "Shareholders and Employee Rights Restoration Act of 2003"

On February 5, 2003, Rep. Stupak of Michigan introduced a bill to the 108th Congress titled the "Shareholders and Employee Rights Restoration Act of 2003." While more extensive than Rep. Markey's bill, it includes a similar provision which would restore aiding and abetting liability under the Exchange Act, Securities Act, the Investment Company Act of 1940 and the Investment Advisors Act of 1940. Through his

legislation, Rep. Stupak also seeks to repeal many provisions of the PSLRA. In particular, he seeks to reinstitute joint and several liability, enable defrauded investors to gain access to discovery at the beginning of the case and repeal the safe harbor provisions for corporate predictions. On February 27, 2003, the bill was referred to the subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises.

CONCLUSION

The controversy over the reach of Central Bank is far from over. Nonetheless, a few points arising from the debate have been made clear. First, Central Bank did not eliminate primary liability for secondary actors under Section 10(b) and Rule 10b-5, only aiding and abetting liability. Second, liability under Section 10(b) and Rule 10b-5 encompasses more than the mere making of a misrepresentation or omission of material fact, but includes fraudulent schemes and courses of business. Third, the recent accounting scandals involving multiple players and complicated schemes suggest that a more flexible approach than the bright-line standard is needed to ensure secondary actors involved in the fraud do not escape liability. The substantial participation standard, espoused by various courts, or the SEC's test, provide the requisite flexibility without sacrificing the element of reliance.