

# JUST DESERTS FOR ACCOUNTANTS AND ATTORNEYS AFTER *BANK OF DENVER*

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Why did God create accountants? To be sued under section 10(b), or so it would seem from reading the testimony<sup>1</sup> that accompanied the enactment of the Private Securities Litigation Reform Act.<sup>2</sup> This legislation became a part of the new Republican Congress' "Contract with America" and reflected the widely-shared belief that securities litigation had unjustly pilloried professionals, such as accountants, attorneys and investment bankers. Attorneys were not the champions of this legislation, a fact no doubt explained by the infrequency with which they have been held liable in private actions under the antifraud provision and, unlike accountants, the legal profession is not benefited by less litigation. On the other hand, accounting firms were great supporters of the legislation, since they have suffered greatly from the status quo, and any change would likely benefit the accounting profession.

Though accountants and attorneys do not benefit equally from the Reform Act, each profession reaps the same marginal gains with the Supreme Court's holding in *Central Bank of Denver v. First Interstate Bank of Denver*,<sup>3</sup> that neither the language of section 10(b) nor the legislative scheme of the securities laws supports the long-held view of aiding and abetting liability in private litigation under the antifraud provision.<sup>4</sup> In reaching this conclusion,

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1. See, e.g., *Hearings Before the Subcomm. on Securities of the Comm. on Banking, Housing, and Urban Affairs*, 103d Cong., 1st Sess. 347-48 (July 21, 1993) (statement of Jake L. Netterville, Chairman of Board, American Institute of Certified Public Accountants, stating that \$30 billion in damage claims were then pending against public accounting firms); *id.* at 351-53 (statement of A.A. Sommer, Jr., Chairman, Public Oversight Board of the SEC Practice Section of the AICPA, stating that accountants are too frequently the target of securities fraud actions). The National Association of Securities and Commercial Law Attorneys reports that since 1991, the Big Six accounting firms have paid \$1.7 billion in fines, settlements and jury verdicts in connection with securities fraud actions. 27 Sec. Reg. & L. Rep. (BNA) No. 42, at 1723 (1995). *Staff Report on Private Securities Litigation, Hearings Before the Subcomm. on Securities of the Comm. on Banking, Housing, and Urban Affairs*, 103d Cong., 2d Sess. 98-114 (1994).

2. Act of Dec. 22, 1995, Pub. L. No. 104-67, 109 Stat. 737 (1995).

3. 114 S. Ct. 1439 (1994).

4. Aiding and abetting has three distinct requirements: "(1) the existence of an independent wrong, (2) actual knowledge by the alleged aider and abettor of the wrong and of his or her role in furthering it, and (3) substantial assistance in the wrong." *Roberts v. Peat, Marwick, Mitchell & Co.*, 857 F.2d 646, 652 (9th Cir. 1988) (quoting *Jett v. Sunderman*, 840 F.2d 1487, 1495 (9th Cir. 1988)), *cert. denied*, 493 U.S. 1002 (1989). Authority existed in all

the Court emphasized that section 10(b) proscribes "the making of a material misstatement (or omission) or the commission of a manipulative act."<sup>5</sup> The Court further reasoned that because the aider and abettor is not one who has engaged in such a proscribed act, but merely assisted in its commission, to permit recovery against such a defendant would allow the plaintiff to circumvent the reliance requirement which the Court has repeatedly held was a part of the plaintiff's case. The Court concluded that if aiding and abetting liability existed a "defendant could be liable without any showing that the plaintiff relied upon the aider and abettor's statements or actions."<sup>6</sup> The Court also supported this conclusion by reference to liability provisions, in which Congress clearly expressed its intent to impose secondary liability, with the implication that the absence of such language in section 10(b) necessarily forecloses expanding liability beyond the fraudulent act's primary participants. In passing, the Court also emphasized the harmful commercial effects of vexatious litigation involving professionals who are collateral participants in various types of securities transactions.<sup>7</sup> On this point, the narrow majority of the Court joined the crest of sentiment that has propelled the Reform Act through Congress.

This Article examines the continuing scope of liability of collateral participants after *Bank of Denver* with special attention given to accountants and attorneys. In Parts I and II the author reasons that the many approaches to defining the scope of liability under section 10(b) that existed prior to *Bank of Denver* should continue to be applicable after the decision. The author reasons in Part III that because the Reform Act expressly recognizes aiding and abetting authority for SEC enforcement actions in the courts, the Congress assured the regulatory flexibility that was at the heart of its earlier augmentation of the SEC's enforcement powers in the Securities Enforcement Remedies and Penny Stock Reform Act of 1990.<sup>8</sup> But as will be seen in Part III, the assured regulatory harmony for the SEC poses grave uncertainty for private litigants who reasonably fear that an unintended consequence of the SEC's authority to reach aiders and abettors is a narrowing of the scope of primary participant liability in private litigation. In Part IV the author places *Bank of Denver* in the larger context, arguing there is a need to change the rhetoric that surrounds the antifraud action so that deterrence is more frequently emphasized; with the antifraud provision so viewed, *Bank of Denver* is out of step with prior decisions and the philosophy of proportionate liability as now embraced in the Reform Act.

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the circuits recognizing aiding and abetting liability. *Cleary v. Perfectune, Inc.*, 700 F.2d 774 (1st Cir. 1983); *Hirsch v. duPont*, 553 F.2d 750 (2d Cir. 1977); *Landy v. FDIC*, 486 F.2d 139 (3d Cir. 1973), *cert. denied*, 416 U.S. 960 (1974); *Schatz v. Rosenberg*, 943 F.2d 485 (4th Cir. 1991), *cert. denied*, 112 S. Ct. 1475 (1992); *Woodward v. Metro Bank*, 522 F.2d 84 (5th Cir. 1975); *SEC v. Coffey*, 493 F.2d 1304 (6th Cir. 1974), *cert. denied*, 420 U.S. 908 (1975); *Hochfelder v. Midwest Stock Exch.*, 503 F.2d 364 (7th Cir. 1974), *cert. denied*, 419 U.S. 875 (1974); *Stokes v. Lokken*, 644 F.2d 779 (8th Cir. 1981); *Strong v. France*, 474 F.2d 747 (9th Cir. 1973); *Kerbs v. Fall River Indus., Inc.*, 502 F.2d 731 (10th Cir. 1974); *Woods v. Barnett Bank*, 765 F.2d 1004 (11th Cir. 1985); *Investors Research Corp. v. SEC*, 628 F.2d 168 (D.C. Cir. 1980), *cert. denied*, 449 U.S. 919 (1980).

5. 114 S. Ct. at 1448.

6. *Id.* at 1450.

7. *Id.* at 1454.

8. Pub. L. No. 101-429, 104 Stat. 931 (1990).

## I. THE DIRECT CONTACTS TEST

A good deal of litigation has already ensued after *Bank of Denver* over the scope of primary participant liability. The cause of litigation is not the indeterminacy of the scope of primary participant liability, but that the overbreadth of the courts' construction of the earlier aiding and abetting standard prevented any clear development of the scope of primary participant liability. With the well-received aiding and abetting standard of proof that the defendant knowingly assisted another's violation, it was possible to avoid the question whether that assistance itself was a violation. The broad scope of aiding and abetting liability, therefore, carried its own mischief; just as a giant tree's canopy prevents younger, healthier trees from developing, so did the all-encompassing aiding and abetting standard stunt the development of a rich jurisprudence for the scope of primary participant liability. Thus, many earlier aiding and abetting cases clearly were cases where professionals were themselves primary participants.<sup>9</sup> This past practice will prove mischievous if courts blindly use past precedents holding accountants, attorneys and others to be aiders and abettors to conclude that after *Bank of Denver* such participation is beyond the scope of the antifraud provision. A far wiser approach is to understand that most pre-*Bank of Denver* aiding and abetting decisions' treatment of the accountant's or attorney's liability as aiding and abetting was a misnomer because the professional committed her own misrepresentations.<sup>10</sup>

There is reason to believe that after *Bank of Denver* courts will reconsider the liability of professionals as primary participants, even though prior to *Bank of Denver* their liability was customarily regarded as that of an aider and abettor to their client's violation. This result will arise, in part, because, as Professor Langevoort has suggested, the lower courts will over time temporize *Bank of Denver's* sweeping rejection of aiding and abetting liability.<sup>11</sup> Proceeding from the foundation that *Bank of Denver* draws conclusions not compelled by conventional approaches to statutory construction, either of the language of section 10(b) or the legislative scheme, and the lower courts' strong propensity to shelter investors from fraudulent practices, Professor Langevoort concludes that interpretations of standards, such as the direct contacts approach, will yield results comparable to those that occurred in aiding and abetting cases prior to *Bank of Denver*.<sup>12</sup> This no doubt will be the case for accountants and attorneys, whose liability under aiding and abetting standards was fairly routinely limited to instances in which they at least had

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9. See, e.g., *Fine v. American Solar King Corp.*, 919 F.2d 290 (5th Cir. 1990) (accountants were aiders and abettors where it was alleged that financial statements did not comply with GAAP); *Competitive Assocs., Inc. v. Laventhol, Krekstein, Horwarth & Horwarth*, 516 F.2d 811 (2d Cir. 1975) (same); *SEC v. Scherm*, 854 F. Supp. 900 (N.D. Ga. 1993) (accountants were aiders and abettors because they issued false reports to conceal broker's misappropriations); *In re Sahlen & Assocs.*, 773 F. Supp. 342 (S.D. Fla. 1991) (accountant's disregard of auditing standards rendered accountant liable as both primary participant and aider and abettor); *Schaps v. R.A. Transp. Servs., Inc.*, No. 86 C 4582, 1987 WL 12178 (N.D. Ill., June 9, 1987) (attorney was aider and abettor where through letters he misrepresented the client's financial status); *Mishkin v. Peat Marwick, Mitchell & Co.*, 658 F. Supp. 271 (S.D.N.Y. 1987).

10. See *Akin v. Q-L Invs., Inc.*, 959 F.2d 521, 526 (5th Cir. 1992).

11. See Donald C. Langevoort, *Words from on High About Rule 10b-5: Chiarella's History*, *Central Bank's Future*, 20 DEL. J. CORP. L. 865 (1995).

12. *Id.* at 867-69.

committed a misrepresentation in their own documents. Even where professionals do not commit misrepresentations in their own documents, courts will likely temporize *Bank of Denver* by considering the client's representation to also be that of the professional under the direct contacts test.

Because of the expansive scope of aiding and abetting liability, there has been little need for a crisp definition of primary participant liability prior to *Central Bank of Denver*. The few pre-*Bank of Denver* decisions that considered who was a primary participant generally invoked the "direct contacts" approach under which:

[O]nly those individuals who had an affirmative obligation to reveal what was allegedly omitted can be held as primary participants in the alleged deception.... A person undertaking to furnish information which is misleading because of a failure to disclose a material fact is a primary participant. Conversely, a person who does not undertake to furnish any information, and who is not aware of what information has been furnished, is under no duty to disclose material information in his possession.<sup>13</sup>

Thus, under the above formulation of the direct contacts test, Snyder, an attorney, was held to be one of the primary participants in a fraudulent scheme.<sup>14</sup> The plaintiffs purchased convertible bond debentures that were privately placed through a misleading offering circular. The first draft of the offering circular had been prepared by the issuer's general counsel, and Snyder reviewed that draft, making several additions and editorial changes. Among the facts known to Snyder, but not disclosed in the circular, were significant unrecorded liabilities and that real estate listed as the issuer's assets was owned by an unrelated entity.<sup>15</sup> An even broader consideration was that the issuer had been created by the merger of a failing company into an existing shell corporation to raise money from investors, and that Snyder had been deeply involved in effecting that merger. The court held the facts were sufficient for a jury to conclude that Snyder owed a disclosure duty to the bond's purchasers.<sup>16</sup>

The direct contacts approach to defining responsibility under section 10(b) is consistent with the reasoning invoked by the majority in *Bank of Denver*. The Supreme Court's emphasis that the defendant must commit a deceptive or manipulative act relied upon by the plaintiffs is subsumed within the above quoted standard for primary participant liability; the direct contacts test focuses upon whether the defendant has *furnished* misleading information to the investor.<sup>17</sup> Although there may be important questions of fact, as there were in the case involving Snyder, regarding the degree of a particular defendant's involvement and whether that involvement crosses the threshold of the defendant being among the suppliers of the misleading information, the

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13. SEC v. Washington County Util. Dist., 676 F.2d 218, 223 (6th Cir. 1982) (interpreting and quoting in part SEC v. Coffey, 493 F.2d 1304, 1315 (6th Cir. 1974), cert. denied, 420 U.S. 908 (1975)).

14. Molecular Technology Corp. v. Valentine, 925 F.2d 910 (6th Cir. 1991).

15. *Id.* at 918.

16. *Id.* See also Bread v. Sachnoff & Weaver, Ltd., 941 F.2d 142 (2d Cir. 1991) (attorney was primary participant because of reckless preparation of offering circular).

17. See quote in text accompanying *supra* note 13.

overall standard remains true to *Bank of Denver's* limiting private liability to those whose conduct is proscribed by section 10(b).<sup>18</sup>

Post-*Bank of Denver* decisions have invoked the direct contacts approach in resolving pretrial motions as to whether certain defendants should be dismissed from the case. Thus, the Ninth Circuit has held that liability was sufficiently pleaded against accountants through allegations that they had a significant role in drafting, reviewing and editing the allegedly misleading financial reports.<sup>19</sup> Similarly, an accounting firm was denied summary judgment, because the court believed there was a substantial question of fact under the direct contacts approach as to whether the accountants were "intricately involved" in the preparation of financial reports that falsely represented ZZZZ Best as a solid investment.<sup>20</sup> On the other hand, accountants who are not closely linked to their client's misrepresentations are easily dismissed from the action.<sup>21</sup> Similarly, an attorney whose misrepresentations are not in connection with the securities that are the subject of the suit is not liable.<sup>22</sup>

*Bank of Denver* unquestionably invites a good deal of uncertainty and litigation on the close factual distinction between one who *assists* in the making of a false statement and one who *makes* such a statement. More troubling are decisions that gloss over this important distinction to conclude that no level of involvement with a client's communications is sufficient to make those communications also the accountant's or attorney's.<sup>23</sup> Such decisions appear to

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18. In contrast, in *Bank of Denver* the aider and abettor was not involved in any false representation to investors. Central Bank of Denver was the indenture trustee for bonds held by the plaintiffs who alleged the bank recklessly failed to undertake a timely appraisal of real estate to determine whether there was a breach of the indenture covenant that required that the real estate serving as security for the bonds have an appraised value of not less than 160% of outstanding indebtedness. 114 S. Ct. 1439, 1443 (1994).

19. *In re Software Toolworks, Inc.*, 38 F.3d 1078, 1090 n.3 (9th Cir. 1994). See also *Anixter v. Home-Stake Prod. Co.*, 77 F.3d 1215 (10th Cir. 1996) (accountant is a primary participant when he knows his representations will be communicated to investors); *Kline v. First W. Gov't Sec., Inc.*, 24 F.3d 480 (3d Cir. 1994) (attorney denied summary judgment where alleged facts charged he was reckless in preparing opinion letter, even though opinion letter stated only the client could rely on the opinion expressed therein).

20. *In re ZZZZ Best Sec. Litig.*, 864 F. Supp. 960, 970 (C.D. Cal. 1994).

21. See *In re Cascade Int'l Sec. Litig.*, No. 91-8652-CIV-NESBITT, 1995 U.S. Dist. LEXIS 10061 (S.D. Fla. June 27, 1995); *McGann v. Ernst & Young*, No. SA CV 93-814 AHS, 1995 U.S. Dist. LEXIS 11116 (C.D. Cal. May 30, 1995). In contrast, attorneys who draft solicitation documents alleged to be misleading can through those documents be linked to the misrepresentation and have encountered difficulty in being dismissed from the action on the basis of the pleadings, at least until further discovery is accorded the plaintiff. See *Walco Invs. v. Thenen*, 881 F. Supp. 1576, 1583 (S.D. Fla. 1995). See also *Employers Ins. v. Musick, Peeler & Garrett*, [1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,700 (N.D. Cal. 1994) (attorney who drafted entire misleading prospectus can be a primary participant); *Cashman v. Coopers & Lybrand*, [1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,732 (N.D. Ill. 1995) (accountant held to be primary participant because of substantial participation in preparing misleading statements).

22. See *In re Towers Fin. Corp. Noteholders Litig.*, Fed. Sec. L. Rep. (CCH) ¶ 98,905 (S.D.N.Y. 1995) (attorneys who made misrepresentations in connection with rescission offer made to holders of 1986 notes were not primary violators as to purchasers of subsequent issue of notes which would not have been purchased had the earlier misrepresentations not occurred).

23. See *In re Kandall Square Research Corp. Sec. Litig.*, 868 F. Supp. 26, 28 (D. Mass. 1994) (accountant not liable if she merely reviewed the quarterly reports that were not attributable to the accountants); *Vosgerichian v. Commodore Int'l*, 862 F. Supp. 1371 (E.D. Pa. 1994). See generally *Edward Brodsky, Aiding and Abetting Claims Under Rule 10b-5*, N.Y.L.J., June 14, 1995, at 3.

conclude that the professional's involvement in the client's communications never constitutes more than "assistance," unless the misleading communication occurs under the professional's name or signature.<sup>24</sup> In contrast, more liberal applications of *Bank of Denver* subject professionals to primary liability for drafting and editing misleading offering materials with knowledge of their falsity even if they are not identified in the materials.<sup>25</sup> *Bank of Denver* is consistent with the view that professionals can be primary participants through their professional involvement in their clients' communications.<sup>26</sup> One can resolve this division in the cases by considering how a corporate entity itself becomes a primary violator. Corporate violators of the antifraud provision become such only through the actions of individuals whose conduct at least qualifies as assistance to their corporate employer—the corporate entity depends on the actions of natural persons for it to act. Just as the corporation's agents can themselves be primary violators, along with their employer corporation, it would appear consistent to hold responsible the corporation's accountants, attorneys and others who contribute to the corporation by making a false representation where the involvement is equal to that necessary to hold the corporation's agents liable.

A further possible limitation of the direct contacts test is whether courts will require privity, or something bordering on it, between a plaintiff and a defendant for the latter to be deemed a primary violator.<sup>27</sup> Though cases thus far have applied the test solely in terms of requiring the defendant to have some direct linkage to the misrepresentation itself, it is possible that the lower courts will require that the defendant have dealt directly with the plaintiff or otherwise have some relationship with the plaintiff. This narrower interpretation would complement the thesis advanced by some that disclosure obligations arise from a pre-existing relationship between the plaintiff and the defendant.<sup>28</sup> After all, *Bank of Denver* did emphasize the defendant's remoteness from the plaintiff. However, the Court qualified its concern for the defendant's proximity to the plaintiff through its equal emphasis of the plaintiff's reliance upon the fraudulent act giving rise to the plaintiff's loss. Furthermore, the Court's treatment of the "direct or indirect" language of section 10(b) supports the view that the critical focus is the role of the misrepresentation in the plaintiff's investment decision. That is, the "directly or indirectly" language, though not a basis to expose one not linked directly to the

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24. Brodsky, *supra* note 23, at 3.

25. See, e.g., *Employers Ins. v. Musick, Peeler & Garrett*, 871 F. Supp. 381, 390 (S.D. Cal. 1994).

26. Justice Kennedy in his opinion of the majority invites consideration of professionals being treated as primary participants:

The absence of 10(b) aiding and abetting liability does not mean that secondary actors in the securities markets are always free from liability under the securities Acts. 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* the requirements for primary liability under Rule 10b-5 are met.... In any complex securities fraud, moreover, there are likely to be multiple violators.

114 S. Ct. 1439, 1455 (1994).

27. For an advocate of this view, see Daniel R. Fischel, *Secondary Liability Under Rule 10(b) of the Securities Exchange Act of 1934*, 69 CAL. L. REV. 80, 108 (1981) (accountants and attorneys liable for misrepresentations in their statements and opinions).

28. This subject is discussed in the text accompanying *infra* notes 40-48.

false statement to liability, is nevertheless available to impose liability on one who indirectly perpetrated the false statement relied on by the plaintiff.<sup>29</sup>

One area where the direct contacts approach may possibly include accountants within section 10(b), as they were included prior to *Bank of Denver*, are those instances in which the accountant's certification is not itself misleading, but the accountants are nonetheless aware at the time of their certification that they are facilitating a fraudulent scheme. For example, in *Roberts v. Peat, Marwick, Mitchell & Co.*,<sup>30</sup> the purchasers of oil and gas limited partnership interests included as a defendant in their complaint the accounting firm that certified the financial statements for the misleading offering brochure. Though the financial statements were not misleading,<sup>31</sup> the plaintiff successfully argued that the accountants aided and abetted their client's fraud, because they provided their certification with knowledge that the proposed oil technologies were unproven and that many of the properties to be explored had been purchased from the promoters at inflated prices. The court upheld the complaint that the accounting firm aided and abetted the promoters' fraudulent scheme, reasoning that the accountants had knowingly assisted the scheme by lending their name to the offering.<sup>32</sup>

After *Bank of Denver*, no longer will it be sufficient to merely allege that the accountants lent their good name to the fraudulent promoter's solicitation. The focus will be on issues such as whether the accountants have themselves committed a misrepresentation by their unqualified audit opinion stating that the firm's financial statements fairly present the financial condition of the firm.<sup>33</sup> Such a statement is likely to subject the accountants to liability in situations where the accountants are aware that the promoters have not otherwise sufficiently disclosed their precarious financial condition.<sup>34</sup> It is therefore intriguing that the Reform Act includes a provision imposing a disclosure obligation on accountants who learn that their audit clients have engaged in an illegal act that will have a material impact on the company's

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29. Cf. *Harden v. Raffensperger, Hughes & Co.*, 65 F.3d 1392 (7th Cir. 1995) ("directly or indirectly participates" in underwriting interpreted to include within the definition of underwriter one who did not sell for or purchase from the distributing issuers).

30. 857 F.2d 646 (9th Cir. 1988), cert. denied, 493 U.S. 1002 (1989).

31. It is quite likely that *Roberts* would, after *Bank of Denver*, be litigated differently so that the financial statements certified by the accountants would be alleged to be misleading in failing, among other factors, to record assets at their true, rather than inflated, values, failing to report the promoter's secret profits as a type of compensation, or failing to reveal a material contingency due to the reasonable likelihood that investors would have a claim of fraud against the corporation. A cause of action plead on any of these grounds would focus on the misrepresentation made by the accountants.

32. 857 F.2d at 646, 653. In contrast, the law firm that prepared certain closing documents, such as various title opinions, was not viewed to have lent its name to the offering and thus was dismissed from the action. *Id.* at 654.

33. For an earlier case holding that accountants had a duty to disclose their client's fraud, even though the accountant was not linked to preparing the false representations committed by his clients, see *In re Cascade Int'l Sec. Litig.*, 840 F. Supp. 1558 (S.D. Fla. 1993).

34. See *supra* note 31. See also *Adam v. Silicon Valley Bancshares*, 884 F.2d 1398 (N.D. Cal. 1995). More difficult would be the case where the accountants are charged with knowledge that the promoters intended to embezzle or otherwise misapply the offering's proceeds. In such a case, should the accountant's opinion that the financial statements fairly present the firm's financial position be qualified by knowledge that continued solvency depended on offering proceeds being applied to liquidate existing debts rather than to provide capital for expanding production?

financial statements.<sup>35</sup> In such a case, the accountants must report their conclusions to the audit committee or the board of directors<sup>36</sup> and, if the committee or board does not inform the SEC within one day of such a report, the accountants must report their knowledge to the SEC.<sup>37</sup> The effect of this provision, certainly if the duties it embodies give rise to private enforcement, would be to more systematically shape the accountants' obligations to investors than would likely occur under probable applications of the direct contacts test.<sup>38</sup> Even if this accountants' reporting provision itself does not directly create a duty to investors, after the provision takes effect investors may fairly interpret the auditor's unqualified opinion as embodying an implicit representation that the auditor is not aware of any material illegal contingent liability that requires qualification in the opinion. It would be a small step, therefore, to conclude that the auditor's failure to fulfill its statutory obligation when it learns of such a contingency constitutes a false certification of the financial statements such that the auditor is a primary violator.<sup>39</sup>

## II. BEYOND THE DIRECT CONTACTS TEST

The Supreme Court has yet to consider what standard appropriately identifies who is a primary participant. Certainly the boldness with which the Court in *Bank of Denver* swept away the universal recognition of aiding and abetting liability cautions litigants and the lower courts against continuing to view uncritically approaches long recognized within the circuits. Nevertheless, the direct contacts standard appears to fulfill *Bank of Denver's* emphasis on the defendant being one on whose deceptive or manipulative acts the plaintiff has relied. There remains, however, the question of whether other theories and approaches are equally consistent with the Court's narrow interpretation of the activity proscribed by section 10(b).

### A. The Role of a Pre-Existing Relationship

Some early commentators have suggested an even narrower construction than the direct contacts test. Drawing on the reasoning that underlies the Supreme Court's earlier narrowing of the proscription against insider trading in *Chiarella v. United States*,<sup>40</sup> pre-*Bank of Denver* decisions sometimes

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35. Securities Exchange Act § 10A, 15 U.S.C.A. § 78j-1 (Supp. 1996).

36. *Id.* § 10A(b)(1), 15 U.S.C.A. § 78j-1(b)(1).

37. *Id.* § 10A(b)(3), 15 U.S.C.A. § 78j-1(b)(3).

38. *But see Twiss v. Kury*, 25 F.3d 1551 (11th Cir. 1994) (recovery under state securities law but not Rule 10b-5 for failure of broker-dealer to fulfill its duty under state securities statute to report that broker had been fired for defrauding customers when that broker subsequently defrauds plaintiffs while employed by another broker-dealer).

39. Also, it would appear that the legislation sweeps in a wider range of considerations regarding the obligations of accountants than is likely to result in future applications of the direct contact test. For example, accountants who learn that their audit clients will embezzle the proceeds of an offering would appear to be subject to the disclosure obligations of the Reform Act, but it is more doubtful under the direct contacts standard whether their certification of the firm's financial statements bears on a future misapplication of funds. *See Rudolph v. Arthur Andersen & Co.*, 800 F.2d 1040, 1042 (11th Cir. 1986) (accountants assisted embezzlement by allowing their name to be used in offering brochure).

40. 445 U.S. 222 (1980).

[O]ne who fails to disclose material information prior to the consummation of a transaction commits fraud only when he is under a duty to do so. And the duty to disclose arises when one party has information "that the other [party] is entitled to



reasoned there was no misrepresentation absent a special relationship between the plaintiff and the defendant. Thus, in *Schatz v. Rosenberg*,<sup>41</sup> an attorney who prepared the closing documents in furtherance of a fraudulent scheme was held to owe no disclosure duty to the defrauded investors, because the attorney had no fiduciary or other confidential relationship to third party investors.<sup>42</sup> On the basis of such decisions, some commentators have concluded that accountants and attorneys are inappropriate candidates for primary participant liability because their duty does not run to their client's investors.<sup>43</sup>

A focus on the defendant's duty should be seen as a useful supplement to the direct contacts test, but not an indispensable requirement for primary participant liability for deceptive or manipulative practices.<sup>44</sup> *Bank of Denver* is the strongest statement the Supreme Court has made regarding the objectives of the antifraud provision. The Court's emphasis on the need for a false or manipulative act that is relied upon by the plaintiff necessarily includes such acts regardless of there being a pre-existing relationship between the investor and the defendant. Indeed, it would be an anomalous situation if only those with such a pre-existing relationship were under a duty to disclose; such a result would, for example, accord sellers of shares much greater protection than it would initial purchasers of the shares of a fraudulent venture because the former, through their ownership, could more easily establish the requisite pre-existing relationship whereas the latter would not.<sup>45</sup>

More generally, there appears to be no practical reason to distinguish results on the basis of the presence or absence of a pre-existing relationship if the false statement attributable to the defendant has indeed been relied upon by the plaintiff.<sup>46</sup> It would appear that the relevance of a fiduciary relationship goes more to the question of whether the plaintiff did in fact rely, as well as

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know because of a fiduciary or other similar relation of trust and confidence between them.

*Id.* at 228. See also *United States v. Chestman*, 947 F.2d 551 (2d Cir. 1991) (en banc) (fiduciary relationship is indispensable antecedent to wrongful misappropriation of confidential information).

41. 943 F.2d 485 (4th Cir. 1991). One post-*Bank of Denver* decision distinguishes *Schatz* as a case involving an attorney who did not prepare the misleading prospectus and where the only alleged fraud was failing to disclose material facts. *Employers Ins. v. Musick, Peeler & Garrett*, 871 F. Supp. 381, 389 (S.D. Cal. 1994). The court therefore concluded that a pre-existing duty is necessary for omission but not affirmative misstatement cases. *Id.*

42. 943 F.2d at 490-92. Furthermore, the court held that the attorney's obligations under Maryland's Rules of Professional Conduct imposed no such duty or relationship for the benefit of the investors.

43. See *Lisa K. Wager & John E. Failla, Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.—The Beginning of an End, Or Will Less Lead to More?*, 49 BUS. LAW. 1451, 1456-57 (1994). See also *Camp v. Dema*, 948 F.2d 455 (8th Cir. 1991) (attorney for buyer had no duty to seller of stock to disclose there was another buyer); *Abell v. Potomac Ins. Co.*, 858 F.2d 1104 (5th Cir. 1988) (no duty of underwriter's lawyer to correct disclosures in issuer's offering materials). But see *Woods v. Homes & Structures, Inc.*, 489 F. Supp. 1270, 1283 (D. Kan. 1980) (attorney for issuer may owe duty to bond purchasers).

44. Quite apart from this statement, the author remains unconvinced that the courts' emphasis in insider trading cases on the defendant's fiduciary relationship accomplishes anything more than begging the question regarding the purpose of regulating insider trading.

45. At one time such a distinction existed in insider trading cases. See *Strong v. Repide*, 213 U.S. 419 (1909).

46. See *Employers Ins. v. Musick, Peeler & Garrett*, [1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,700 (N.D. Cal. 1994) (pre-existing duty to disclose not a prerequisite for primary participant liability on part of attorneys who prepared allegedly false prospectus).

whether such reliance was justified. The role of a pre-existing fiduciary relationship can even be expanded to define the scope of primary participant responsibility. If the investor's fiduciary knowingly assists in, for example, a fraudulent promotion, but does not herself commit an overt misrepresentation to the plaintiff, the pre-existing fiduciary relationship should be a separate basis for the fiduciary's responsibility under section 10(b). Though deception continues to be the hallmark for such liability, it is easily satisfied through the fiduciary's failure to speak to protect the beneficiary of that relationship, and any need for reliance to be established would appear more than satisfied by the relationship itself.<sup>47</sup> That is, the requirement of a pre-existing relationship is most justified in those cases where the professional has not participated in making the misleading communication—the pure nondisclosure case. In such an instance, the professional's breach under Rule 10b-5 is failing to fulfill a duty to speak or to warn, a duty that arises from the antecedent fiduciary relationship.<sup>48</sup> It would also appear that such analysis is consistent with *Bank of Denver's* concern for not broadening the scope of liability to parties with only a collateral relationship to the transaction and the plaintiffs.

### B. Conspiracy to Defraud

After *Bank of Denver*, there is much more doubt that primary participant liability can be established using the conspiracy analysis applied in earlier cases.<sup>49</sup> Conspiracy, although overlapping with aiding and abetting liability, has very different requirements. Conspiracy requires an agreement among the co-conspirators to carry out a violation, and generally no defendant is liable unless *one or more of the conspirators* commits a violation in furtherance of the conspiracy.<sup>50</sup> In contrast, no agreement, either express or tacit, is necessary for one to be an aider or abettor; the focus of aiding and abetting is the defendant's knowing assistance in furtherance of the offense. Because of the difficulty in establishing the existence of an agreement to commit a securities violation, conspiracy is generally seen as demanding more than is required under the standard elements for aiding and abetting liability so that few securities law violations have been premised on conspiracy.<sup>51</sup> The

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47. To rule otherwise would overrule the Supreme Court's decision in *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972) (market makers failed to inform Native Americans whose tribal assets were in corporate form that their shares could be sold in the secondary market at a higher price than the defendants were arranging for their sale).

48. See, e.g., *Arthur Young & Co. v. Reves*, 937 F.2d 1310, 1329-31 (8th Cir. 1991) (seven factors weighed to determine accountant's liability for non-disclosure).

49. See, e.g., *Van de Velde v. Coopers & Lybrand*, Fed. Sec. L. Rep. (CCH) ¶ 98,840 (D. Mass. 1995) (*Bank of Denver* also bars theory defendant is liable as a co-conspirator); *SEC v. U.S. Envtl., Inc.*, 490 F. Supp. 117 (S.D.N.Y. 1995) (SEC foreclosed by *Bank of Denver* from pursuing defendant on a conspiracy theory); *In re Syntex Sec. Litig.*, 855 F. Supp. 1086 (C.D. Cal. 1994).

50. See *Halberstam v. Welch*, 705 F.2d 472, 477 (D.C. Cir. 1983). On the element of an overt act, there is no need for that act to be criminal or even unlawful. *United States v. Eisenberg*, 773 F. Supp. 662 (D.N.J. 1991) (making of telephone calls between conspirators in a securities fraud conspiracy).

51. See generally IX LOUIS LOSS & JOEL SELIGMAN, *SECURITIES REGULATION* 4488-90 (3d ed. 1992); William H. Kuehnle, *Secondary Liability Under the Federal Securities Laws—Aiding and Abetting, Conspiracy, Controlling Person, and Agency: Common Law Principles and the Statutory Scheme*, 14 J. CORP. L. 313, 343-48 (1988); David Ruder, *Multiple Defendants in Securities Law Fraud Cases: Aiding and Abetting, Conspiracy, In Pari Delicto, Indemnification, and Contribution*, 120 U. PA. L. REV. 597, 638-41 (1972).

limited role that conspiracy has played has prompted Professor Seligman to conclude that if *Bank of Denver* forecloses conspiracy liability, "this would not appear to be a particularly significant loss" because so few securities cases have been prosecuted under a conspiracy theory.<sup>52</sup> On the other hand, the paucity of conspiracy cases is due to the overbreadth of the aiding and abetting standard; after *Bank of Denver*, conspiracy should assume greater importance in defining the scope of responsibility. This observation makes all the more important the concern over whether conspiracy theory survives *Bank of Denver*.<sup>53</sup>

Unlike the criminal offense of conspiracy, in which the crime is the agreement to commit an unlawful act,<sup>54</sup> the civil applications invoke the conspiratorial agreement not as the offense itself but as a means to place responsibility on a particular defendant because of the tortious conduct of her co-conspirators.<sup>55</sup> A use of conspiracy under section 10(b) that is equal to that in other civil settings seems hardly beyond the scope of the antifraud provision. The logic is irresistible that Congress is unlikely to have, on the one hand, prohibited the direct commitment of a fraudulent act by an individual and, on the other hand, that Congress would have approved that same act's commission through a jointly planned agreement.

Sound reasons exist for concluding that conspiracy theory is not superfluous to determining who is a primary participant in a fraudulent scheme. The language of Rule 10b-5 invites just such an inquiry through its proscription of "any...scheme...to defraud." A "scheme" refers to a plan of action that can involve more than one person with each person performing very different tasks toward carrying out the end objective.<sup>56</sup> The violation is not committed solely by the conspirator that draws the duty of performing the manipulative or deceptive act. It is violated by each of the participants in the conspiracy. And, though the enabling language of section 10(b) does not refer to a "scheme," it would appear that a knowing scheme to engage in a manipulative or deceptive act is clearly within the scope of the enabling language, so that the language of Rule 10b-5 reflects the many ways that a

52. Joel Seligman, *The Implications of Central Bank*, 49 BUS. LAW. 1429, 1435 (1994).

53. See Wager & Failla, *supra* note 43, at 1463.

54. See 2 WAYNE R. LAFAVE & AUSTIN W. SCOTT, JR., SUBSTANTIVE CRIMINAL LAW § 6.4, at 61 (substantive offense is the agreement whether or not the purpose was achieved). The abuse of the conspiracy offense has long been feared, and the procedural and substantive advantages for the prosecution to invoke a charge of conspiracy are such that Learned Hand aptly referred to conspiracy as "the darling of the modern prosecution's nursery." Harrison v. United States, 7 F.2d 259, 263 (2d Cir. 1925). An example of a prosecutorial advantage of alleging a conspiracy is an exception to the hearsay rule that permits hearsay if "made by the coconspirator of a party during the course and in furtherance of the conspiracy." FED. R. EVID. 801(d)(2). See *Bourjaily v. United States*, 483 U.S. 171 (1987) (hearsay statement can be used both to establish conspiracy and the speaker's participation therein). For critical assessments of criminal conspiracy, see Phillip E. Johnson, *The Unnecessary Crime of Conspiracy*, 61 CAL. L. REV. 1137 (1973); Paul Marcus, *Criminal Conspiracy Law: Time to Turn Back from an Ever Expanding, Ever More Troubling Area*, 1 WM. & MARY BILL OF RIGHTS J. 1 (1992).

55. See Kuehnle, *supra* note 51, at 347.

56. "Scheme" is defined as "a plan, design or program of action to be followed; project." RANDOM HOUSE DICTIONARY OF THE ENGLISH LANGUAGE (unabridged ed. 1971). Thus, in *SEC v. National Bankers Life Ins. Co.*, 324 F. Supp. 189, 195 (N.D. Tex. 1971), *aff'd*, 448 F.2d 652 (5th Cir. 1971), the court viewed "scheme" as used in Rule 10b-5 as synonymous with conspiracy. The court however, did not find an agreement, and thus also considered whether there was evidence of aiding and abetting.

manipulative or deceptive act or contrivance can occur. As such, the language of Rule 10b-5 further proscribes the SEC's power through enforcement to delineate the substantive scope of section 10(b).<sup>57</sup>

Courts should understand that a pre-existing conspiracy to violate the securities laws can play an important role in defining the scope of primary liability and is not beyond the scope of section 10(b). The sine qua non for primary participant liability after *Bank of Denver* is the defendant's commission of a manipulative or deceptive act relied upon by the plaintiff. Thus, Bank of Denver escaped liability because it proffered no representation that was relied upon by the plaintiff. The role of a conspiratorial agreement is to attribute to each conspirator the making of the fraudulent act.<sup>58</sup> Through the conspirators' agreement to commit a misleading or manipulative act, it is an easy, and logical step to conclude that the violation that results from the conspiracy is committed by each of the conspirators.

Evidence of a conspiracy assumes relevance because it links each conspirator to the proscribed act such that through the conspiracy each co-conspirator's responsibility can be addressed under the direct contacts standard discussed earlier. This result is not merely pouring aiding and abetting wine into a new bottle.<sup>59</sup> As seen, the essence of aiding and abetting is knowing assistance, whether or not there was tacit agreement to violate the securities law, and whether or not the representation or manipulation could be linked to the assistance provided by the aider and abettor. A conspiracy does not exist merely on proof that the defendant assisted another's unlawful act.<sup>60</sup> To be responsible as a conspirator for a violation of the antifraud provision, there must be an agreement to make a false representation or manipulative act.<sup>61</sup> Hence, there are very different levels of involvement between, on the one hand, aiders and abettors, and, on the other hand, conspirators. A conspirator is not a participant in another's scheme; the conspirator is a participant in his own misrepresentation or manipulative act.<sup>62</sup> Because the agreement links the

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57. For a review of the Commission's powers to define the scope of the antifraud provision's prohibitions, both to contract and expand its scope, see Joseph A. Grundfest, *Disimplying Private Rights of Action Under the Federal Securities Laws: The Commission's Authority*, 107 HARV. L. REV. 963, 976-99 (1994).

58. *First Fin. Sav. Bank, Inc. v. American Bankers Ins. Co.*, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,016 (E.D.N.C. 1991) (aspect of conspiracy is joint and several liability for acts committed pursuant to the common scheme and in furtherance of the conspiracy). On the criminal consequences of a conspirator's responsibility, consider the landmark case of *Pinkerton v. United States*, 328 U.S. 640 (1946) (conspirator deemed to have committed offense though he was in prison when his coconspirator carried out the act in furtherance of their earlier agreement). *But see* MODEL PENAL CODE §§ 1.01-2.13 (A.L.I. 1985) (conspiratorial agreement rejected as sole basis of accomplice responsibility in favor of considerations such as whether the defendant also aided or assisted in offense's commission or solicited its commission).

59. For a case where a conspiracy was found, but aiding and abetting was not, see *Mays v. Ridenhour*, 811 P.2d 1220 (Kan. 1991).

60. *See, e.g.*, *United States v. Falcone*, 319 U.S. 703 (1943) (supplying yeast and other products with knowledge it would be used by moonshiners did not make one a conspirator—they must otherwise promote the venture as such and make it as their own). *See* MODEL PENAL CODE § 503 commentary at 420 (A.L.I. 1985) (mere aid in furtherance of crime does not make one a conspirator).

61. *See* *Roses v. Arkansas Valley Envtl. & Util. Auth.*, 562 F. Supp. 1180, 1200 (W.D. Mo. 1983).

62. For example, state blue sky laws impose a harsher sanction for those who "sell" securities without registration as contrasted with those who merely "assist" such a sale, and the

conspirator to the representation, *Bank of Denver's* concern for the investor's reliance upon the conspirator's representation is satisfied. Thus, had there been an agreement between the bond's issuer and Bank of Denver that the bank would withhold its appraisal for the purpose of concealing the issuer's default on the bonds, that agreement would have linked Bank of Denver to the ongoing representations of the issuer's financial responsibility. It should be underscored that the violation is not the conspiracy, for a conspiracy to violate the securities laws is not proscribed as such;<sup>63</sup> the violation is the act of the conspirators.

A conspiracy can be by tacit agreement,<sup>64</sup> albeit more is required than mere willfulness or reckless failure to act.<sup>65</sup> Thus, in the first aiding and abetting case, *Brennan v. Midwestern United Life Insurance Co.*,<sup>66</sup> a company's officers were held to have aided and abetted a broker who was promoting the company's shares to his clients, but failed to deliver their share certificates following the purchase. His failure to deliver the shares was because he pledged his clients' shares in order to obtain funds that he then used to purchase more shares of the company's stock to further manipulate the price of the company's shares. The company officers suspected the broker was misappropriating his clients' funds for the purpose of manipulating officers' company's shares.<sup>67</sup> The officers warned him that if they received another complaint they would alert the state securities commissioner. However, when the company became the object of a possible merger, and it was therefore in the company's and officer's interest to maintain the price of the company's shares, an artificially high price because of the broker's fraudulent promotion, the officers changed their approach.<sup>68</sup> The officers then warned the broker they would raise their concerns with complaining investors only if the broker's customers reported to the officers that the customers' requests to the broker for their shares were unsatisfied. The court concluded that the officers had aided and abetted the

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courts have applied a conspiracy approach to hold officers and others as sellers rather than as merely assisting in the sale. *See, e.g., Mosley v. Unruh*, 95 P.2d 537 (Kan. 1939); *Cook v. Pepco, Inc.*, [1987-88 Transfer Binder] Blue Sky L. Rep. (CCH) ¶ 72,694, 72,900 (Okla. Dist. Ct. 1986).

63. *Halberstam v. Welch*, 705 F.2d 472, 479 (D.C. Cir. 1983). Therefore, one post *Bank of Denver* decision barred the SEC from proceeding on the theory that the defendant was a conspirator. The court appears to have interpreted the SEC's case as merely charging the defendant with entering into a conspiracy to violate the securities laws and not with any substantive violation of the securities laws. *See SEC v. U.S. Envtl. Inc.*, 897 F. Supp. 117 (S.D.N.Y. 1995).

64. *See Roberts v. Heim*, 670 F. Supp. 1466, 1484-85 (N.D. Cal. 1987) (pleading sufficient if it links professional defendant to violation with allegation "defendant[] reached an understanding to conduct an illegal scheme to defraud," but mere performance of wrongful act does not create a conspiracy). LAFAVE & SCOTT, *supra* note 54, at 71.

It is possible for various persons to be parties to a single agreement (and thus one conspiracy) even though they have no direct dealings with one another or do not know the identity of one another, and even though they are not all aware of the details of the plan of operation or were not all in on the scheme from the beginning.

*Id.* The agreement serves the twin purposes of identifying the parties and the object they wish to achieve. *Id.* at 96.

65. *See SEC v. Cooper Co., Inc.*, 402 F. Supp. 516, 521-24 (S.D.N.Y. 1975).

66. *Brennan v. Midwestern United Life Ins. Co.*, 417 F.2d 147 (7th Cir. 1969), *cert. denied*, 397 U.S. 989 (1970).

67. *Id.* at 150.

68. *Id.* at 152-53.

fraudulent broker by communicating that the officers would take steps to stop his fraudulent scheme only if the broker failed to provide certificates to those few customers who pressed their claims to the company.<sup>69</sup> If *Brennan* were decided today, the officers would be shielded by *Bank of Denver*. A closer question, however, arises if there were proof that the broker and the officers had attracted investors to the company's shares by manipulating the share prices.<sup>70</sup> Certainly, if an agreement is found between the officers and the brokers to manipulate share prices, the act of one should be treated as the act of the others. The only question is the willingness of the courts to find such an agreement circumstantially.<sup>71</sup>

### C. Agency Principles and Control Person Liability

The Supreme Court may well conclude that it is far more consistent with the structure of the securities laws to rely exclusively on the control person liability provision of the Securities Exchange Act than to invoke the concept of conspiracy when examining the scope of an officer's or other participant's responsibility in a fraudulent scheme.<sup>72</sup> One reason for viewing control person and conspiracy as one and the same is that the very factors that the courts customarily consider to determine control person status for a fraudulent scheme could also establish whether a conspiracy existed.<sup>73</sup> Once a common scheme is established, it is a small and irresistible step to conclude that each conspirator had the power, albeit unexercised, to stop the furtherance of the common objective. Certainly the requirements for establishing a conspiracy appear much more precise than the contemporary standards for a control person relationship.<sup>74</sup>

There appear to be several reasons why supplanting a conspiracy approach with control person liability is ill-advised. First, it disserves the

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69. *Id.* at 153.

70. *See, e.g.*, *First Fin. Sav. Bank, Inc. v. American Bankers Ins. Co.*, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,016 (E.D.N.C. 1991) (court examines facts for circumstantial evidence of a tacit agreement to conspire to violate the securities laws, concluding there is no evidence of such an agreement).

71. There is also the additional question whether the officers have a duty to disclose to the investors in their company's shares their knowledge that their corporation's shares are being manipulated.

72. This ominous possibility that the majority's reasoning would curtail forms of secondary liability such as that based on conspiracy or respondeat superior liability was noted by Justice Stevens in his dissent in *Bank of Denver*. *Central Bank v. First Interstate Bank*, 114 S. Ct. 1439, 1460 (1994) (Stevens, J., dissenting).

73. There are a variety of approaches used to establish control. Frequently one's status defines whether they are a control person. *See Dowling v. Narragansett Capital Corp.*, 735 F. Supp. 1105, 1122 (D.R.I. 1990) (directors are presumptively control persons); *American Gen. Ins. Co. v. Equitable Gen. Corp.*, 493 F. Supp. 721, 752 (E.D. Va. 1980) (directors control persons because position confers power to direct management). Other courts emphasize whether the defendant had the power or ability to influence the conduct of the primary participant; this standard varies from the control by status standard because there is no presumption of control because of one's position. *See, e.g., Rochez Bros., Inc. v. Rhoades*, 527 F.2d 880, 890-91 (3d Cir. 1975). Finally, other courts seek evidence of actual control over the primary participant. *See, e.g., Metge v. Baehler*, 762 F.2d 621, 630-31 (8th Cir. 1985) (to be a control person lender must actually have participated generally in its borrower's operations and must be shown to have had the power to control the specific transaction giving rise to the violation). But the ambiguities of this inquiry abound. *See Wool v. Tandem Computers, Inc.*, 818 F.2d 1433, 1441 n.9 (9th Cir. 1987).

74. *See supra* note 73.

purpose of control person liability to hold nonactive co-conspirators as merely control persons. Control person liability is a form of vicarious liability designed to expand responsibility to those in a supervisory capacity who cannot establish their good faith. Even in the minority of the circuits that have read "good faith" to require evidence that the controlling person was a "culpable participant,"<sup>75</sup> the control person standard entails a lower showing than is required for a conspiracy. The culpable participation standard requires proof that the control person had knowledge of the violation or meaningfully participated in the violation.<sup>76</sup> The distinction between a co-conspirator and a control person lies in the observation that a control person is appropriately treated as one who is secondarily responsible for the fraud, and hence less culpable, than a primary participant in the fraudulent scheme. The relative fault between controlling persons and co-conspirators assumes significance under a proportional fault standard, discussed later. In contrast, a co-conspirator is correctly viewed as having the same level of responsibility as any other actor. And, when one of the conspirators has a special relationship with the plaintiff there is reason to assign to that conspirator an even higher level of responsibility for the plaintiff's loss. In any case, one who is responsible solely because of the standards imposed on her by the Securities Exchange Act's control person provision has a lower level of culpability than does one who is an active participant in a scheme to defraud investors.

Second, and most importantly, any abandonment of conspiracy in favor of control person responsibility would be based on the misguided belief that Congress' provision of control person liability meant it intended to supplant auxiliary theories of responsibility that exist under traditional agency principles. Such a result would, just as casting off all the circuits' acceptance of aiding and abetting liability, sweep aside the universal view that control person liability is additive, and not exclusive. More important than the popularity of agency doctrines such as respondeat superior liability is the core commitment to investor and market protection that is embodied in control person liability. Certainly, as enacted in the Securities Act of 1933, control person liability was the Congressional vehicle to impose responsibility on those controlling the issuer's public offering and was designed not to allow issuers to hide behind "dummy directors."<sup>77</sup> By so imposing liability on control persons, the quest was to subject them to the same responsibilities as nominal directors in order to assure, after reasonable investigation, that there was a reasonable basis to believe (as well as an actual belief) that the registration statement was free of material misrepresentations. The Exchange Act's control person provision was modeled on section 15 of the Securities Act, and in both instances Congress

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75. See, e.g., *Sharp v. Coopers & Lybrand*, 649 F.2d 175 (3d Cir. 1981); *Carpenter v. Harris, Upham & Co.*, 594 F.2d 388 (4th Cir. 1979). A majority of the courts defer to the language of the statute under which the lack of knowledge and good faith are defenses. See, e.g., *Donohoe v. Consolidated Operating & Prod. Corp.*, 30 F.3d 907, 911-12 (7th Cir. 1994); *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1575 (9th Cir. 1990); *G.A. Thompson & Co. v. Partridge*, 636 F.2d 945, 958 (5th Cir. 1981). But see *Abbott v. Equity Group, Inc.*, 2 F.3d 613, 619-20 (5th Cir. 1993) (noting inconsistency in decisions after *Partridge* regarding whether circuit invokes culpable participant standard).

76. See, e.g., *Gordon v. Burr*, 506 F.2d 1080, 1086 (2d Cir. 1974). See also *Carpenter v. Harris, Upham & Co.*, 594 F.2d 388 (4th Cir. 1979) (culpability greater than mere failure to discover or deter the primary violation).

77. See *Paul F. Newton & Co. v. Texas Commerce Bank*, 630 F.2d 1111, 1115 (5th Cir. 1980).

sought to impose liability on those shareholders,<sup>78</sup> directors<sup>79</sup> and officers,<sup>80</sup> who would not otherwise be within the reach of ordinary common law agency principles.<sup>81</sup> The more sweeping range of primary responsibilities, and broader range of possible control persons under the Exchange Act, has caused that provision to be interpreted variously depending upon the context in which control person liability is sought to be imposed. Nevertheless, the thrust of responsibility has a distinct deterrence orientation by seeking to impose liability on those who are not themselves the actors in the wrongdoing but who could have prevented the harm had they not turned a blind eye toward the violation. To interpret conspiracy theory as consistent or otherwise in conflict with control person liability would, therefore, seriously misread and constrict Congress' intent in expressly imposing control person liability.

The most common use of agency principles under the antifraud provision is to impose vicarious liability on an entity for the misrepresentations of its agents pursuant to the doctrine of respondeat superior.<sup>82</sup> Traditional agency principles, however, can serve a broader function than merely identifying possible control person or vicarious respondeat superior liability. Agency principles can link the nonspeaker directly to the statements relied upon by the plaintiff. The classic illustration of this is the means by which the corporate employer becomes liable for the misstatements of its employees. In a leading case, *In re Atlantic Financial Management, Inc.*,<sup>83</sup> then Judge Breyer reasoned that the theory of apparent authority was among the common law agency principles that coexist with control person liability by which the corporation is accountable for its employee's misrepresentations. Judge Breyer reasoned that such an interpretation is consistent with the "direct or indirect" language of section 10(b) and also gives substance to the Exchange Act by including corporations within its definition of "person."<sup>84</sup> The importance of the latter is that since corporations act only through the efforts of natural persons, agency

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78. See, e.g., *Partridge*, 636 F.2d at 958 (ownership of large block of shares and substantial involvement in business equate to shareholder having substantial influence for control person liability).

79. See *In re PAR Pharmaceutical, Inc. Sec. Litig.*, 733 F. Supp. 668, 680 (S.D.N.Y. 1990) (directors who delegated power to other directors are control persons if they retained authority to control contents of disclosures). Outside directors, however, appear to have less exposure to control person liability. See *In re Sahlen & Assocs. Sec. Litig.*, 773 F. Supp. 342, 363 (S.D. Fla. 1991).

80. Even lawyers, with sufficient involvement, can be control persons of their client corporation and its officers. See *In re Rospatch Sec. Litig.*, 1991 U.S. Dist. LEXIS 6419 (W.D. Mich. 1991) (long relationship representing corporate client and membership on board prevented grant of the lawyer-defendant's motion for summary judgment).

81. See S. REP. NO. 47, 73d Cong., 1st Sess. 5-6 (1933); H.R. REP. NO. 1838, 73d Cong., 2d Sess. 42 (1934). See also FED. SEC. CODE § 793 & cmt. 3(b) (A.L.I. 1978).

82. *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 154 (1972) (bank's liability "is coextensive with that of [its employees]"); *Commerford v. Olson*, 794 F.2d 1319 (8th Cir. 1986) (employer bound by acts of its agent); *Lewis v. Walston & Co.*, 487 F.2d 617 (5th Cir. 1973) (broker's misdeeds are in scope of employment so that employer is liable).

83. *In re Atlantic Fin. Management, Inc.*, 784 F.2d 29, 31-32 (1st Cir. 1986) (the other bases were that the corporation had actually authorized the false statement and the respondeat superior liability of employers).

84. Securities Exchange Act § 3(a)(9), 15 U.S.C. § 77(b)(2) (1994).



principles must necessarily be resorted to if corporations are to be subject to liability under the antifraud provisions like other "persons."<sup>85</sup>

Agency principles such as ratification should also be available to link natural persons to the misrepresentations uttered by others. This is the approach taken outside the securities laws where the courts have attributed the misrepresentations of others to the defendant because of the defendant's failure to correct those misrepresentations.<sup>86</sup> Moreover, there is no apparent reason why such reasoning should not apply to link misrepresentations to one who does not herself utter the statements, but whose conduct otherwise links that person to the statement such that the plaintiff relies on the false representation. For example, in *Kerbs v. Fall River Industries, Inc.*, Kerbs successfully recovered against Fall River Industries, Inc. (FRI) on the theory that FRI's president, Thompson, had knowingly assisted and participated in a scheme to defraud Kerbs.<sup>87</sup> The fraud occurred when Dial, a close friend of Thompson, transferred stock certificates in FRI to Kerbs in the presence of Thompson. Just prior to the transfer, Thompson was introduced to Kerbs as FRI's president; and despite his knowledge that the FRI stock certificates were forged, Thompson said nothing. The court concluded that by his presence and acquiescence Thompson lent an appearance of legitimacy to an otherwise fraudulent deal and was thus liable as a participant.<sup>88</sup>

*Kerbs* is consistent with a wide range of common law cases that impose liability on the basis that through active conduct or mere acquiescence the defendant has ratified the misrepresentation of others. Responsibility so based links the defendant directly to the false representation in a way that is consistent with *Bank of Denver's* emphasis that the defendant commit a representation upon which the plaintiff relied. Thus, in one recent decision, the primary participants were individuals who purposely withheld information from the corporation's spokesperson for the purpose of assuring that the misinformation would thereby be released by the spokesperson.<sup>89</sup> *Kerbs* should survive *Bank of Denver*. It survives not solely because its reasoning is consistent with the direct contacts approach discussed earlier. The import of *Kerbs* is that the principles of the law of agency enable the courts to fully consider Thompson's role so that ultimately his liability can be fully rationalized within the concerns emphasized in *Bank of Denver*. It would appear mischievous to interpret *Bank of Denver* as

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85. 784 F.2d at 33-34. The court also relied upon the legislative history, discussed in text following *supra* note 77, that added the control person provisions to the Securities Act and the Exchange Act. 784 F.2d at 33.

86. See, e.g., *Aetna Ins. Co. v. Eisenberg*, 294 F.2d 301 (8th Cir. 1961) (insurer estopped to deny insurance coverage where it allowed furrier to display its sign with assurances to customers that their furs were fully insured); *SEI Corp. v. Norton & Co.*, 631 F. Supp. 497 (E.D. Pa. 1986) (affirmation of unauthorized statements by failure to repudiate the statements); *Scheuer v. Central States Pension Fund*, 358 F. Supp. 1332 (E.D. Wis. 1973) (silent acceptance of payments constitutes ratification of misleading statements); *Ragsdale v. Life Ins. Co. of N. Am.*, 60 So. 2d 465 (Ala. 1994) (question of fact whether city employee was representative of private insurer where employee made representations regarding scope of insurance coverage).

87. 502 F.2d 731 (10th Cir. 1974).

88. *Id.* at 740. Fall River Industries was held liable on the theory that Thompson acted with "apparent authority." *Id.* at 741. See also *Irving v. Walker*, No. 88 C 7540, 1991 WL 133686 (N.D. Ill. July 12, 1991) (attorney's participation implicitly represented validity of many of the documents).

89. *LB Partners, L.P. v. Neutrogena Corp.*, Fed. Sec. L. Rep. (CCH) ¶ 98,913 (C.D. Cal. 1995).

broadly enjoining the lower courts' consideration of traditional principles of agency law, for to do so would rob the courts of a useful and rigorous framework with which to consider the responsibility of all participants in complex fraudulent schemes.

### III. AIDING AND ABETTING IN SEC ENFORCEMENT ACTIONS

It is a predictable reaction to reason that *Bank of Denver* restrains SEC enforcement actions under section 10(b) just as it does private actions. The Supreme Court's emphasis on the language of section 10(b) and the scheme of the federal securities laws leaves little room to suggest that different language and a different scheme apply to SEC enforcement actions. Thus, it would appear that history was about to repeat itself. Just as nearly twenty years earlier, in the wake of *Ernst & Ernst v. Hochfelder*,<sup>90</sup> the SEC argued that scienter was not required in SEC enforcement actions under section 10(b),<sup>91</sup> shortly after *Bank of Denver* the SEC's general counsel reasons that aiding and abetting remains a viable consideration in SEC enforcement actions under section 10(b).<sup>92</sup> Among his arguments is the interconnectiveness of conduct constituting a violation, and conduct that requires prospective judicial proscription either to cure the violation or to prevent its recurrence.<sup>93</sup> Even conceding that *Bank of Denver* limits the former, he reasons that aiding and abetting survives for remedial purposes. That is, the remedial purposes of government enforcement actions permit injunctive relief against nonviolators who, for example, would otherwise retain any ill-gotten gains of the violator's misconduct or whose conduct, if not proscribed in the future, will contribute to future violations.<sup>94</sup> Moreover, under this analysis, it would be appropriate for the court to enjoin specific types of conduct that contributed to or otherwise assisted in a violation.<sup>95</sup> Such an order appears clearly within the scope of remedial relief permissible to government agencies.<sup>96</sup>

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90. 425 U.S. 185 (1976). See James D. Cox, *Ernst & Ernst v. Hochfelder: A Critique and an Evaluation of Its Impact upon the Scheme of the Federal Securities Laws*, 28 HASTINGS L.J. 569, 589-92 (1977) (predicting the Court's reasoning would apply equally to SEC enforcement actions and concluding this would not seriously impact investor protection).

91. The Supreme Court, however, concluded otherwise. *Aaron v. SEC*, 446 U.S. 680 (1980).

92. See Simon M. Lorne, *Central Bank of Denver v. SEC*, 49 BUS. LAW. 1467 (1994).

93. *Id.* at 1473-74.

94. One approach offered by a court in responding to the SEC's arguments that *Bank of Denver* does not apply to SEC enforcement actions is that Rule 65(d) of the Federal Rules of Civil Procedure permits orders against nonviolators so long as such persons are given notice as required by the rule. *SEC v. U.S. Envtl., Inc.*, Fed. Sec. L. Rep. (CCH) ¶ 98,912, at 93,399 (S.D.N.Y. 1994).

More frequently the question is the power to cause nonviolators to disgorge the fruits of the securities law violation. See, e.g., *SEC v. Cherif*, 933 F.2d 403 (7th Cir. 1991); *International Controls Corp. v. Vesco*, 490 F.2d 1334, 1354 (2d Cir. 1974).

95. Mr. Lorne paints somewhat more broadly than this, reasoning that the true distinction in *Bank of Denver* is between who is liable for a violation in a private action versus who is liable in a government prosecution. See Lorne, *supra* note 92, at 1476. The argument above is narrower because the emphasis is on the steps necessary to prevent a future recurrence of a violation or to provide appropriate remedial relief under the facts without formerly labeling the aider and abettor as either a violator or being responsible for such a violation.

96. The uncertainty in this approach arises under Securities Exchange Act § 21(d)(1), 15 U.S.C. § 78u(d)(1) (1994). Though § 21(d)(1) authorizes SEC injunctive actions in the federal

But history has not quite repeated itself. The Reform Act confirms the SEC's authority to judicially prosecute *knowing* aiders and abettors,<sup>97</sup> and thus restores much of the reach of SEC enforcement authority and orders to their pre-*Bank of Denver* state.<sup>98</sup> Not to have so acted would have seriously undercut the regulatory balance Congress had recently created within the SEC enforcement arsenal and thereby would have led to perverse enforcement choices and to sanctions that were inappropriate for the offense.

The SEC has the power to impose money penalties in an administrative action on aiders and abettors.<sup>99</sup> However, this authority only applies in actions initiated pursuant to the Commission's authority to enforce its rules against broker-dealers and their associates, municipal securities dealers, government securities dealers, and clearing agents.<sup>100</sup> If *Bank of Denver* barred the SEC from obtaining injunctive relief against aiders and abettors, the Commission's enforcement powers would, under the express language of the Act, be broader in actions brought in an administrative proceeding against a broker-dealer than if the same action were initiated in the district court. The anomaly would have continued with respect to the Commission's cease and desist authority. This authority reaches not only violators<sup>101</sup> but also: "[A]ny other person that is, was or would be a cause of the violation, due to an act or omission the person knew or should have known would contribute to such violation...."<sup>102</sup> Against such a person, the SEC can issue an order requiring the respondent to cease and desist from committing or causing the commission of a violation as well as requiring such person to comply, or take steps to effect compliance, with the statute, rules and regulations of the Act.<sup>103</sup>

A gateway concept in the Commission's exercise of its cease and desist powers against collateral participants in fraudulent schemes is the meaning of "cause" in the above quoted provision. In its enforcement actions, the Commission has successfully equated cause with conduct that could equally be regarded as aiding and abetting. For example, a registrant's general counsel who knowingly created a paper trail of fictitious documents to support the

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courts against "any person...engaged or about to engage in acts or practices constituting a violation," the section if read literally would limit relief to an order "to enjoin *such* acts or practices." This is essentially the argument that has been raised against Mr. Lorne's argument. See Edward C. Brewer III & John L. Latham, *SEC v. Central Bank: A Draft Opinion for the Court's Conference*, 50 BUS. LAW. 19, 39-46 (1994). The case law, however, supports the view that § 21(d) is a jurisdictional provision and not a substantive or procedural limitation on SEC enforcement powers. Thus, a wide range of ancillary remedies are recognized as appropriate in SEC enforcement actions. See James R. Farrand, *Ancillary Remedies in SEC Enforcement Suits*, 89 HARV. L. REV. 1779 (1976). Moreover, disgorgement remedies are upheld against individuals against whom injunctive relief was not obtained because there was no likelihood of recurrence, and whose only fault was knowing participation and enrichment in another's fraudulent scheme. See, e.g., *SEC v. Commonwealth Chem. Sec., Inc.*, 574 F.2d 90 (2d Cir. 1978) (spouse of promoter of an "all or nothing" underwriting required to disgorge gains on shares purchased to create appearance that all offered shares had been fully subscribed).

97. Securities Exchange Act § 20(f), 15 U.S.C.A. § 78(t)(f) (Supp. 1996).

98. What is not restored is reckless aiding and abetting such as that argued to have been committed in *Bank of Denver*.

99. Securities Exchange Act § 21B(a)(2), 15 U.S.C. § 78u-2(a)(2) (1994).

100. *Id.* § 21B(a), 15 U.S.C. § 78u-2(a).

101. Or more precisely and broadly, "any person is violating, has violated, or is about to violate, any provision of this chapter, or any rule or regulation thereunder...." Securities Exchange Act § 21C(a), 15 U.S.C. § 78u-3a (1994).

102. *Id.*

103. *Id.*

misleading representations in the registrant's filings with the Commission was deemed the cause of that disclosure violation.<sup>104</sup> Overall, cause, as interpreted by the SEC, appears to include within any organization those who, though not the source of the false representation to the defrauded investors, have failed to take action that could have prevented the fraud.<sup>105</sup> In a decision applying this analysis to an outside counsel, the Commission held that the attorney was the cause of his client's failure to register securities because the attorney persisted in his erroneous belief that foreign exchange bearer certificates to be sold through the State Bank of Pakistan were not required to be registered under the federal securities laws.<sup>106</sup> The attorney maintained his opinion even though securities work was not his area of specialization and after he had been informed by an employee of the Bank that an SEC staff attorney stated the certificates were securities and should be registered. The breadth and clarity of the Commission's cease and desist powers over collateral participants permitted it to avoid pressing the issue of whether *Bank of Denver* circumscribes its enforcement actions in the courts because it can proceed administratively against violators.<sup>107</sup>

If *Bank of Denver* applied to SEC injunctive actions, it would have required attributing to Congress the intent to limit severely who could be the targets of Commission enforcement actions in the courts while simultaneously broadening the range of who is a violator in administrative actions. This approach would result in turning the Securities Enforcement Remedies and Penny Stock Reform Act of 1990<sup>108</sup> on its head. In the Enforcement Remedies Act, Congress augmented the panoply of SEC enforcement sanctions so that the Commission could better match the sanction to the degree of fault and prospective threat to investors. The legislation's Congressional history is replete with the philosophy that balancing fault with the sanction not only serves the public interest but also avoids too draconian a sanction being imposed on the defendant.<sup>109</sup> Moreover, by providing wider sanctioning powers to the SEC in administrative proceedings, including against collateral participants, Congress implicitly recognized the circuits' universal recognition of aiding and abetting liability. Simply stated, the express provision for aiding and abetting liability for the Commission's newly received cease and desist authority can be fairly interpreted as the Congress' awareness that the SEC could also reach aiders and abettors in injunctive actions. That is, Congress, in light of the contemporary case law, unquestionably designed the newly created SEC enforcement powers to complement the same range of violators that then were recognized in the rich case law that surrounded section 10(b) and other sections of the securities laws. If *Bank of Denver* were to bar enforcement of the antifraud provisions against aiders and abettors, not only would this lead to increased administrative

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104. See *In re Kaczmarek*, 57 SEC Docket 1762 (1994).

105. See, e.g., *In re Anderson*, 52 SEC Docket 1738 (1994).

106. *In re Feldman*, 55 SEC Docket 9 (1993).

107. See *Hearings Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing, and Urban Affairs*, 103d Cong., 2d Sess. 46, 49 (1989) (testimony of Arthur Levitt, SEC Chairman).

108. Pub. L. No. 101-429, 104 Stat. 931 (1990) (codified as amended in scattered sections of 15 U.S.C.).

109. See COMM. ON BANKING, HOUSING, AND URBAN AFFAIRS, THE SECURITIES LAW ENFORCEMENT REMEDIES ACT OF 1990, S. REP. NO. 337, 101st Cong., 2d Sess. 5-9 (June 26, 1990).

proceedings against such violators, but that result would in many cases disturb the regulatory harmony sought in the 1990 Enforcement Remedies Act.

The anomaly is compounded when one considers, as does the SEC's General Counsel, the clear availability of aiding and abetting responsibility in criminal actions.<sup>110</sup> That is, the general proscription of aiding and abetting in the United States Code<sup>111</sup> assures that aiders and abettors are subject to Exchange Act's criminal liability provision.<sup>112</sup> Thus, without including aiding and abetting within civil enforcement actions, not only would the purpose of the 1990 securities enforcement legislation be seriously conflicted, but the strange anomaly arises of a defendant being subject to more serious criminal sanctions than would be available civilly. The Commission and the defendant would each face the choice of a sanction that was either too harsh or too light for the offense.<sup>113</sup>

The Reform Act, by expressly authorizing SEC judicial enforcement of the antifraud provision against aiders and abettors, avoids the anomalies and regulatory disharmony only with respect to "knowing" misconduct. To the extent the SEC's administrative sanctions also reach reckless aiding and abetting, the uncertainty ushered in by *Bank of Denver* continues. Even more troubling, however, is the threat to the scope of primary participant liability in private litigation that lurks in the shadows of the Reform Act which bestows on the SEC authority to prosecute knowing aiding and abetting.

As seen earlier, a good many pre-*Bank of Denver* cases were prosecuted on a theory of aiding and abetting liability when violators were, under one of the approaches examined in Parts I and II, primary participants. Because the jurisprudence developed through public prosecutions informs private enforcement actions, the SEC can no longer enjoy the luxury of proceeding against accountants, attorneys and other professionals as aiders and abettors where they have themselves "made" misleading statements. The private litigants' worst nightmare is that while they seek to establish a workable definition of primary participant liability, the SEC labors will perpetuate the ambiguity between primary participant and aiding and abetting standards. Precedents in SEC enforcement actions that mischaracterize primary participants as aiders and abettors will be used defensively to dismiss accountants, attorneys and others because they have merely "assisted" in the violation. Thus, though the SEC has received in the Reform Act clear authority to proceed against knowing aiders and abettors, its responsibility is now much greater than it was before *Bank of Denver*. To meet this responsibility, the SEC should carefully define through its administrative and judicial actions who is an aider and abettor. In doing so, it must keep its eye on the important role that private litigation plays in the overall compliance and enforcement of the federal

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110. See Lorne, *supra* note 92, at 1474-75.

111. 18 U.S.C. § 2(a) (1994) ("Whoever commits an offense...or aids, abets, counsels, commands, induces, or procures its commission, is punishable as a principal.").

112. Securities Exchange Act § 32, 15 U.S.C. § 78ff (1994).

113. On the general topic of the Commission exercising flexibility by invoking its discretion to proceed with a cease and desist action rather than injunctive action, see Bruce A. Hiler & Neil K. Gilman, *The SEC's Use of Its Cease-and-Desist Authority: A Survey*, 23 SEC. REG. L.J. 235 (1995). For example, the authors discuss the Commission's decision, because of the respondents' youth, to invoke its cease and desist powers rather than to seek the harsher sanction of a permanent injunction. *Id.* at 259-60 (citing *In re Conway*, 52 SEC Docket 2158 (1992)).

securities laws.<sup>114</sup> The challenge facing the SEC is to carry out its enforcement mission without constricting the scope of primary participant liability. This challenge requires the enforcement staff to avoid the easier road of proceeding against accountants, attorneys and others as aiders and abettors, which generally would be the easier charge to prove, when such persons can be reached under the direct contacts test or other approach as a primary participant. Even if the enforcement staff could avoid the sirens of the aiding and abetting standard, there continues to be a significant likelihood that courts will themselves opt for the broader and more malleable standard of aiding and abetting liability in finding a violation of the antifraud provision. In doing so, the courts unwittingly restrict the development of primary participant liability standards along the lines reasoned to be possible in Parts I and II above. If this occurs, an unintended consequence of the Reform Act's clarification of SEC authority to reach aiders and abettors is narrowing the scope of liability in private actions for would be primary participants.

#### IV. THE VALUE OF AIDING AND ABETTING IN AN ERA OF PROPORTIONATE FAULT

*Bank of Denver* must be placed in its contemporary legal and political context to fully understand its reasoning. Though the substantive arguments invoked by the Court focused on the language of section 10(b) and the inferences drawn from the legislative scheme, these conclusions are not persuasive.<sup>115</sup> It is quite likely that absent the national rhetoric on the avalanche of securities litigation and the social and commercial costs of such vexatious litigation, the decision in *Bank of Denver* would have been otherwise.<sup>116</sup> *Bank of Denver* and the Reform Act jointly stand as milestones marking not simply the continuing conservatism within the nation, but more importantly the public mood that the greater good lies in nurturing commercial interests over the

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114. There is yet another approach, namely, the SEC could through rulemaking define primary participant liability and aiding and abetting so as to clarify their respective scope and also embrace the permissible scope of primary participant liability along the lines reasoned in Parts I and II of this article. See generally Grundfest, *supra* note 58, at 1015-20. This would, of course, require some political courage by the SEC commissioners greater than that demonstrated in the final hours of the Reform Act's passage.

115. The purpose here is not to critique *Bank of Denver*, but to examine the consequences of its decisions. However, to summarize the problems with the Court's analysis, one need only state that the Court commits the same errors it did nearly 20 years earlier in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), in holding that the language of § 10(b) and the legislative history foreclosed negligence as a basis of liability under the antifraud provision. For example, the language of § 10(b) is most definitely impact rather than conduct oriented, such that it should not matter within the scope of the enabling statute whether that conduct occurred as a result of negligence or scienter, or by a primary or collateral participant. See Cox, *supra* note 90. For example, the absence of aiding and abetting language in § 10(b) and its presence in other enforcement provisions is easily explained by the fact that the provisions in which express aiding and abetting language is found are those enacted after aiding and abetting had been accepted for actions brought under the antifraud provision. See discussion in text accompanying *supra* note 108. Similarly, any inferences to be drawn from the legislative scheme must be understood in the context of likely Congressional intent in enacting enforcement statutes when the contemporary legal climate recognized both the SEC's and private litigant's power to reach aiders and abettors. And more pragmatically, there is no evidence that the aiding and abetting standard in application was pernicious or unwieldy. To repeat a wise saying, "If it ain't broke, don't fix it."

116. Examples of such rhetoric are found in Congressional hearings on the frequency of securities class action litigation. See *supra* note 1.

interests of individual citizens harmed in the expansion of our economy. If a preoccupation with "vexatious" litigation is indeed the cause for the majority's narrow construction of section 10(b) and the scheme of the federal securities laws,<sup>117</sup> we may question whether casting aside aiding and abetting liability achieved very much in the battle against a "flood of litigation."

The correlative to joint and several liability is proportionate liability.<sup>118</sup> Aiders and abettors abhor joint and several liability because their more minimal involvement subjects them to liability for the total harm caused by the fraudulent scheme, even though most of the blameworthiness lies with the scheme's promoters. Not surprisingly, the plaintiff's bar champions joint and several liability as necessary to compensate those harmed by the fraud because the promoters and their venture are judgment proof; thus they seek to enter the deep pocket of the aider and abettor whose five percent moral fault subjects it to 100% financial responsibility, either amount being greatly disproportionate to the benefits derived from the engagement with the promoted venture or that defendant's overall blameworthiness. A further consideration is that the true aider and abettor was the wayward employee of the law firm or accounting firm, who like the promoter has insufficient assets to satisfy the plaintiff class; her employer is the true target of the action, either through controlling person or respondeat superior liability. And, that employer's blameworthiness may be no more than a lack of sufficient supervision, hiring poorly or just bad luck.

Prior to *Bank of Denver*, courts were moving at an ever-increasing pace to confine joint and several liability, if not ultimately reject its application beyond the fraudulent promoters. This trend arose first in courts substituting various formulae for determining relative fault for the more mechanical per capita approach when determining contribution rights among defendants.<sup>119</sup> More recently, courts have increasingly resolved the contribution rights of nonsettling defendants against settling defendants through a mechanism that limits the plaintiff's recovery against a nonsettling defendant to the particular defendant's relative fault.<sup>120</sup> Because the confinement of joint and several liability was limited to disputes involving the contribution rights among co-defendants, especially where the plaintiffs had entered into a settlement with

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117. For a close analysis of the data on both sides of the issue of whether the public interest is not served by securities fraud class actions, see Joel Seligman, *The Merits Do Matter*, 108 HARV. L. REV. 438 (1994). One of the Reform Act's sponsors indicated the inconclusiveness of the conflicting data marshaled by both sides when he observed at the close of the hearings that there was "no agreement on whether there is in fact a problem, the extent of the problem, or the solution to the problem." *Hearings, supra* note 1, at 280 (statement of Senator Dodd).

118. See Ronald A. Dabrowski, *Proportionate Liability in 10b-5 Reckless Fraud Cases*, 44 DUKE L.J. 571 (1994).

119. See, e.g., *Smith v. Mulvaney*, 827 F.2d 558 (9th Cir. 1987) (rejecting pro rata method as inappropriate in securities fraud action involving multiple defendants with varying levels of involvement in the fraud; to not distinguish among the defendants would defeat the equitable principle upon which contribution rests in the first place); *McLean v. Alexander*, 449 F. Supp. 1251, 1276 (D. Del. 1978), *rev'd on other grounds*, 599 F.2d 1190 (3d Cir. 1979) (divided defendants into two groups, finding that one group was 90% liable, and assigning that share to the individual members of that group on a pro rata basis).

120. See, e.g., *Franklin v. Kaypro Corp.*, 884 F.2d 1222, 1231 (9th Cir. 1989) (jury asked at trial to determine total damages suffered by the plaintiffs and the percentage of culpability of each defendant, settling as well as nonsettling; plaintiff is limited to a verdict equal to the nonsettling defendant's portion of the total damages suffered), *cert. denied*, 498 U.S. 1064 (1990).

some of the defendants, the state of the law when *Bank of Denver* was decided was ripe with interesting choices for both plaintiffs and defendants to "game" the settlement process. For example, under the approach whereby nonsettling defendants' liability is limited by their proportionate fault, the plaintiff is a substantial risk taker in entering any settlement. Under this approach to the plaintiff's rights against nonsettling defendants, a settlement that is small vis-a-vis the settling defendant's relative fault ultimately means the plaintiff will recover from all defendants, settling and nonsettling, less than the total losses she suffered.<sup>121</sup>

It is within the debate over whether joint and several liability should be the rule that the two sometimes conflicting philosophies for civil actions under the antifraud provision are most apparent. On the one hand, joint and several liability's justification lies in providing greater assurance that the injured class members will recover their full damages. By holding each participant in the fraudulent scheme responsible for the total damages caused by all the scheme's participants, the deficiencies in any one of the defendant's assets can be overcome by a disproportionate recovery against defendants whose assets are more substantial. That joint and several liability may thereby lead to damage awards against defendants far exceeding either the benefits they derived from the fraudulent scheme or their relative blameworthiness is overcome by compensatory benefits to the class members. On the other hand, proportionate liability is consistent with the deterrence rationale for responsibility. By capping any defendant's liability through considerations of the benefits derived from the particular transaction and the relative role, including the degree of scienter in carrying out the scheme, the sanctions are more closely tailored to the breaching conduct. Thus, the aim is not a blind adherence to making the class members whole, but rather seeking a sanction whose adequacy is measured not by the plaintiffs' losses but its probable impact in discouraging others from stepping across the line.

The Reform Act modestly embraces proportionate liability—modest because proportionate liability exists only for nonknowing violations of the Exchange Act's antifraud provision.<sup>122</sup> The vast number of fraud actions involve knowing violations by most of the defendants and therefore fall outside the proportionate liability provision introduced by the Reform Act. Moreover, within this narrow band of nonknowing violators, joint and several liability exists against certain "small" investors,<sup>123</sup> and the proportionate liability of defendants is increased by a maximum of fifty percent to cover the liability of any defendant whose assets are insufficient to satisfy his share of the plaintiffs' damages. Thus, it would seem that Congress, through the Reform Act's provisions for limited proportionate fault, has embraced a strong philosophy of

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121. Contrast *Singer v. Olympia Brewing Co.*, 878 F.2d 596 (2d Cir. 1989), *cert. denied*, 493 U.S. 1064 (1990), where the risk is placed on the nonsettling defendants because they remain liable for the plaintiff's total damages, reduced by the amount the plaintiffs recovered through earlier settlements.

122. Securities Exchange Act § 21D(g), 15 U.S.C. § 78u-4 (1994). The provision also reaches outside directors who have breached their obligations to undertake a reasonable investigation of the registration statement under § 11 of the Securities Act. *Id.*

123. The so-called small investor is one whose net worth is less than \$200,000 (determined the date before the investor's purchase or sale that is the subject of the suit) and whose recoverable damages are greater than 10% of his net worth. Securities Exchange Act § 21D(g)(4), 15 U.S.C. 78u-4 (1994).



compensation over deterrence.<sup>124</sup> One can also speculate whether the philosophy of the Reform Act will have broader repercussions on judicial developments that turn on the choice between the compensation and deterrence mission of the securities fraud class action.

The contemporary antifraud jurisprudence lends itself to a deterrence orientation for open market frauds such that it remains possible that the rhetoric that surrounds the antifraud provisions' application to open market frauds can assume a deterrence orientation. For example, because materiality determinations do not require proof that the investor or shareholder relied in fact on the omitted or misstated fact,<sup>125</sup> there is a bias within class actions involving open market frauds. That bias means that class recoveries include many more members than were in fact induced to trade or vote because of a particular material omission or misstatement. This occurs because of a presumption of reliance from the materiality in proxy solicitations,<sup>126</sup> or that the misrepresentation involved an omission for which proof of reliance, is at best problematic.<sup>127</sup> The result in either case is nevertheless to include within the recovering class members who would not have changed their investment decision even if the misrepresentation had not occurred. The full effects of the over inclusiveness of materiality as a surrogate for causation appear in the "fraud on the market" approach to causation. By permitting class members to recover for misrepresentations the defendant committed upon an efficient market without the necessity of individual class members proving their reliance or even awareness of the particular misrepresentation, the fraud on the market approach facilitates recovery by nonrelying investors.<sup>128</sup> At one level, the fraud on the market theory reflects the realities of any economically efficient market, namely that the average investor is a "price taker" and not a "price maker." So viewed, the question under the fraud on the market approach is not the more subjective one of whose trading in fact moved the individual stock to a new equilibrium point, and on what information that trader reacted. The focus under the fraud on the market approach is the more trustworthy<sup>129</sup> one of whether an allegedly misleading statement had a material effect on the stock's price.

Thus, the Supreme Court's own formulation to key elements in private litigation—materiality and causation—embraces a distinct deterrence

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124. Though the Reform Act does not embrace proportionate fault for all offenders, regardless of scienter, the Reform Act does embrace standards for contribution among settling and nonsettling defendants that extend proportionate responsibility even to knowing violators. Securities Exchange Act § 21D(g)(8), 15 U.S.C. 78u-4 (1994).

125. See *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976) (materiality "does not require proof of a substantial likelihood that disclosure of the omitted fact would have caused the reasonable investor to change his vote.")

126. *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375, 385 (1970) (not necessary to prove the omission or misstatement actually influenced how shareholders voted; only necessary to prove that proxy solicitation itself was an "essential link" to the approved transaction).

127. *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 153-54 (1972):

Under the circumstances of this case, involving primarily a failure to disclose, positive proof of reliance is not a prerequisite to 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.

128. *Basic Inc. v. Levinson*, 485 U.S. 224 (1988).

129. This focus is more trustworthy than relying upon the individual plaintiff's bald assertion of reliance, which, for powerful reasons of self interest, may be questioned. See *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975).

orientation. This occurs because neither its standard of materiality nor the fraud on the market theory (and relatedly, causation inquiry in omission cases) is designed to award damages only to those induced by the defendant's conduct to trade. In each such case, there is a bias toward over-compensation because each standard is defined to permit recovery by nonrelying plaintiff members. The focus then shifts to the defendant's relative fault and responsibility which can be adjudged by the total harm to the market rather than to particular investors.

Though the overbreadth of the materiality standard and the accompanying fraud on the market approach to causation can be justified by the expediency of facilitating resolution of cases involving mass frauds,<sup>130</sup> each doctrine is also consistent with the view that the objective of the antifraud rule's application in open market fraud cases is to deter blameworthy conduct and not provide sharp measurement of the plaintiffs' damages. Or, stated conversely, each doctrine brushes aside the notion that recoveries presumptively lie only for those who can affirmatively prove that the defendant's misrepresentation induced the plaintiff to trade. So viewed, the relevant questions for the Congressional hearings that preceded enactment of the Reform Act were not the "recoverable" losses suffered by the class members and what percentage of such recoverable claims were recouped through class action securities litigation. These questions do not bear on the role of private litigation in deterring securities violations. Far more relevant are the questions probing the deterrent effect of the frequency of suits, the availability of insurance and the overall size of settlements in deterring open market frauds or disclosing the voluntary release of information.

There also is a need to ask relevant questions outside of Congressional hearings. Thus, under a deterrence orientation to open market fraud cases, it is important to inquire as to the commercially practical and socially desirable role that should be imposed on the various participants in business transactions. For example, in *Bank of Denver*, it would have been consistent with a deterrence orientation to resolve whether Bank of Denver should be bound by a duty to the bond's investors and the appropriate remedy for breaching that duty. In this inquiry, the probable reliance, if any, investors placed on the Bank of Denver's role in assuring the public of the solvency of the securities' issuer would have been an important, if not definitive, finding in considering the responsibility of Bank of Denver.

*Bank of Denver* and the Reform Act each discourage a shift in the rhetoric for open market fraud cases. It would have been far more consistent with its prior decisions for the Supreme Court to uphold aiding and abetting liability in private litigation, especially with the qualification that such liability could not co-exist with joint and several liability. If both proportional fault and aiding and abetting liability applied to private open-market fraud cases, a much purer description of the orientation to private liability would have resulted. The overbreadth in the pre-*Bank of Denver* jurisprudence was not in the

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130. In this regard, consider then Justice Rehnquist's reasoning that the purchaser-seller requirement for standing in private actions would necessarily mean that some truly injured by the defendant's misconduct could not recover under section 10(b), but that the requirement was nevertheless desirable to facilitate the district court's handling of securities actions (and would also avoid having much depend in such cases on the plaintiff's uncorroborated assertion of reliance). See *id.* at 738-44.

proscription of who was an aider and abettor, but rather in the propriety of holding any collateral participant to joint and several liability. That is, aiding and abetting liability provided a useful approach, well developed in the case law, for determining the scope of blameworthy conduct under the antifraud provision. A far sounder approach, and one more in step with the Court's earlier decisions and now the Reform Act, would have been to affirm the existence of aiding and abetting liability in private actions, but to have recognized the desirability of proportionate fault in open market fraud cases.

## V. CONCLUSION

Even if the scope of the collateral participants' liability is not exactly as broad as it was before *Bank of Denver*, there is ample reason to believe that *Bank of Denver* is one of the least significant interpretations of the scope of the antifraud provisions. As discussed in Parts I and II, *Bank of Denver* changes very little in terms of whether those formerly held to be aiders and abettors will now escape responsibility when alleged to have been a primary participant, a co-conspirator, or bound by another's misdeed within the scope of their agency or business arrangement. But this will take time, and much uncertainty will exist during the years in which decisions are meted out on such issues. What is most remarkable about *Bank of Denver* is its poor timing. The Supreme Court discarded a doctrine that had not only been accepted by all the circuits but had matured and become predictable, and there was no evidence the doctrine had created mischief in its wake. Moreover, *Bank of Denver* was decided at a time when doctrine was cautiously evolving toward a proportionate fault standard. Minimally, the Court's elimination of defendants who are not liable under one of the approaches discussed in Parts I and II has removed from securities litigation defendants who, under a proportionate fault standard, have very little liability. Whatever one's view of the desirability of private enforcement of the securities laws, *Bank of Denver* has made a very small contribution, if any, to the cause of rationalizing and strengthening the private cause of action.

