THE GATEKEEPERS ARE STILL ACCOUNTABLE EVEN AFTER *CENTRAL BANK* AND THE CONTRACT WITH AMERICA

Edward Labaton*

If from a defrauded investor's view there is any silver lining in the *Central Bank*[1] decision it is the penultimate paragraph of the Court's opinion. There, Justice Kennedy, speaking for the five-justice majority, said:

> 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* of the requirements for primary liability under Rule 10b–5 are met. [citation omitted] In any complex securities fraud, moreover, there are likely to be multiple violators...."[2]

Some four months after the *Central Bank* case, a District Court judge citing the language quoted above, delivered an opinion[3] which held that there could be primary liability for an accountant even though it issued no statement, if in fact it participated in the preparation of misleading statements disseminated by others or otherwise participated in a fraudulent scheme.

The *ZZZZ Best* case[4] illustrates the need for a broad interpretation of primary liability. ZZZZ Best was a notorious fraud which cost investors tens of millions of dollars and resulted in several prison sentences, including that of Barry Minkow, the twenty-year old promoter of the scheme.

The Securities and Exchange Commission brought no proceedings against the then Big–8[5] accounting firm whose review report on the three-month stub period financials was essential to the ZZZZ Best public offering in December 1986 and whose retention thereafter as ZZZZ Best's auditors gave the company an air of legitimacy. Nor did the SEC bring any proceeding against the national law firm which represented ZZZZ Best from the time of the public offering until its collapse in June 1987.

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* BBA, City College of New York, 1952; LLB, Yale University, 1955. Partner in the firm of Goodkind Labaton Rudoff & Sucharow LLP.

1. Central Bank of Denver v. First Interstate Bank, 114 S. Ct. 1439 (1994).
2. *Id.* at 1455.
3. *In re* ZZZZ Best Sec. Litig., 864 F. Supp. 960, 967–68 (C.D. Cal. 1994).
4. In the interest of full disclosure, I was actively engaged throughout the litigation representing plaintiffs in the ZZZZ Best Consolidated Class Action.
5. The Big–8 accounting firms are, of course, the eight largest accounting firms in the world. The firm referenced in this article subsequently merged with another Big–8 firm and is now one of the Big–6.

The litigation against these accountants and lawyers, and others including investment bankers and lawyers for the underwriters was recently concluded.[6] As a result of several consolidated class action litigations against these professionals, investors will recover, after allowance for attorneys' fees, more than fifty cents on the dollar.

The conduct of the Big–8 accountants and the lawyer defendants demonstrates the importance of a broad reading of the standard by which primary liability will be determined. It also demonstrates the need for the courts to properly apply the proportional liability requirements of the 1995 Act in a manner which will protect defrauded investors.

In 1986 and until its collapse in June 1987, ZZZZ Best portrayed itself in glowing terms as having enjoyed rapidly growing revenues and earnings. The company said it was engaged in two lines of business: (a) residential carpet cleaning, and (b) restoring commercial office buildings damaged by fire or water disasters. Most of the revenues and earnings supposedly came from the restoration business which, in fact, never existed. Millions of dollars of revenues that ZZZZ Best attributed to its sham restoration business were entirely fake. ZZZZ Best nonetheless sold securities to investors pursuant to a public offering in December 1986. ZZZZ Best's auditor on the registration statement was a one-man shop operating out of New Jersey (this for a company based in Los Angeles and claiming to do no business whatever east of the Mississippi). The underwriter, however, required the prestige of a Big–8 accounting firm, and a Big–8 firm agreed to lend its name to the prospectus providing a review report on the three-month stub period ending July 31, 1986. ZZZZ Best also agreed to retain the Big–8 firm as auditors for the next fiscal year. Just seven months later, the fraud was revealed, the company went bankrupt and investors lost tens of millions of dollars.

Before the Registration Statement became effective, the lawyers and Big–8 accountants retained by ZZZZ Best knew the following:

(1) ZZZZ Best was headed by a twenty-year-old chief executive officer—namely, Minkow.

(2) ZZZZ Best was reporting phenomenal growth in earnings and revenues.[7]

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6. Discovery was stayed for almost five years pending dispositive motions, which for the most part were denied, and the class was certified. (*See In re* ZZZZ Best Sec. Litig., [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,485 (C.D. Cal. May 19, 1989) and [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,416 (C.D. Cal. July 23, 1990). Although the investors ultimately recovered a substantial portion of their damages, the delay illustrates one of the shortcomings of the Private Securities Litigation Reform Act of 1995 (hereinafter the "1995 Act"), § 101(b) of which states: "all discovery and other proceedings shall be stayed...during the pendency of any motion to dismiss, unless the court finds...that particularized discovery is necessary to preserve evidence or to prevent undue prejudice...." Pub. L. No. 104–67, 1995 U.S.C.C.A.N. (109) Stat. 737 (to be codified at 15 U.S.C. §§ 77a et seq.). The latter qualification may permit courts, so inclined, to prevent defendants from abusing motion practice merely to delay discovery.

7. In the three months covered by the stub period, ZZZZ Best's growth appeared exponential. It reported revenues of $5.4 million in the first quarter of fiscal 1987 (May 1 to July 31, 1986) compared to $638,000 in the comparable quarter in fiscal 1986, and $4.8 million in the entire fiscal year ended April 30, 1986. Its reported (fictitious) income also soared to almost seven times that recorded in the comparable fiscal 1986 quarter.

(3) Even though it supposedly was competitively bidding for restoration work, ZZZZ Best claimed that it earned a thirty to forty percent profit margin on that work.

(4) ZZZZ Best regularly used cashier's checks to pay its purported suppliers. (This was done to cover up the fact that ZZZZ Best had no suppliers for the restoration work because that business did not exist.) Minkow claimed that he used cashier's checks to buy carpeting cheaply, which purportedly explained the company's high profit margins.

(5) The contracts for multi-million dollar insurance restoration jobs consisted of a single sheet of paper written on the same printed form that the company used for $100 residential carpet cleaning jobs. The contracts contained no specific details (such as quality of carpet, time of completion, etc.), and did not even provide the addresses of the job sites. When asked by the accountants, lawyers and underwriters where the jobs were located, Minkow explained that the addresses were a secret, and the professionals accepted that absurd explanation.

(6) All of the contracts were with an entity known as Interstate Appraisal Services. The Big–8 accountants recognized that Interstate was the only party, other than ZZZZ Best, bound by the one-page "contract" pursuant to which ZZZZ Best was purportedly extending credit in the form of millions of dollars in labor, service and materials. The Big–8 accounting firm had in its file a Dun & Bradstreet report showing that Interstate was formed in 1985 by Tom Padgett, and had a high credit rating of *Fifty* Dollars ($50). Padgett, like Minkow, was convicted and imprisoned for his part in the fraud.

(7) The Big–8 accountants were told that Interstate acted on behalf of large insurance companies. When asked if they could contact the insurance companies to verify information he provided to them, Minkow explained that their identities were also a secret. Of course, the jobs did not really exist and no insurance companies had authorized the hiring of ZZZZ Best.

(8) In November 1986, shortly before the effective date of the ZZZZ Best registration statement, Minkow was finally prevailed upon to allow the attorneys and accountants to visit a "job" site. They were taken on a tour of a high rise office building in Sacramento on a Sunday when no one else was in the building. On the tour it was explained to them that ZZZZ Best had restored the building which had supposedly been damaged by massive flooding. Of course, there had been no flood and ZZZZ Best had done no work at the site.

(9) Prior to taking the tour, Minkow had the lawyers and accountants sign letter agreements whereby they agreed not to disclose the address of the supposed job site to any other members of their respective firms and not to make any follow-up telephone calls to the building owner or others about any information that had been provided to them. Both the lawyers and accountants signed those letters. Shortly thereafter, the securities offering went forward and ZZZZ Best raised $13.2 million from the investing public.

The Review Report covering the three-month stub period ending July 31, 1986 was the last report issued by the Big–8 accounting firm but they continued to be retained as ZZZZ Best's accountants and they worked on two abortive audits: one for the nine months ended January 31, 1987 and the other for the year ended April 30, 1987.

In connection with those engagements the accountants wanted to look at another site and they signed another confidentiality agreement. The contract, for $8,262,160.52, was on one sheet of paper and referred to a San Diego office building. (A copy of that contract is annexed to this article.[8]) It called for removal and replacement of 610,000 square feet of carpeting and cleaning of another 172,000 square feet (or a total of almost 800,000 square feet of carpeted space).

The Big-8 firm partner in charge of the audit visited the building in February 1987. The building he walked through and which he described in a memorandum was eight stories high. He testified that each floor was about 15,000 square feet. To further illustrate how red the flag was, the largest office building in San Diego in 1987 was about twenty-five stories high and comprised 525,000 square feet (including hallways, bathrooms, elevators, and other uncarpeted areas). The Chrysler Building in New York City comprises approximately 1,200,000 square feet of interior space. In other words, the Big-8 accounting firm, by February, had hard evidence that ZZZZ Best was a massive fraud, yet it did nothing; and for another four months investors paid millions of dollars for worthless stock. Indeed, in the two months following the San Diego visit, the market price for ZZZZ Best common stock doubled (going from $8 to more than $16) and investors who bought in that period sustained millions of dollars in losses.

Shortly after the *Central Bank* decision came down, the Big-8 defendant in *ZZZZ Best* moved for partial summary judgment with respect to the period following the Registration Statement,[9] contending that its conduct in that period, as alleged in the complaint, constituted aiding and abetting and that the accounting firm would not be primarily liable under Rule 10b-5 as to any period in which it issued no reports.

The court denied the motion on three separate grounds:

1. Participation in reviewing or preparing reports (such as the 10-Q statement) issued by ZZZZ Best itself may have been extensive enough to attribute misstatements in, or omissions from, such reports to the Big-8 firm.

2. The Big-8 firm had an affirmative duty to correct misstatements which it previously made.

3. The conduct of the Big-8 firm in assisting ZZZZ Best in the preparation of additional public statements after December 1986, as alleged in the complaint, was actionable under subsections (a) and (c) of Rule 10b-5 as deceptive devices, schemes, practices and a course of business.

While some courts have more narrowly construed primary liability,[10] the *ZZZZ Best* decision represents a sound approach toward squaring *Central Bank* with the need to hold accountants and other professionals accountable for

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8. The contract varied slightly in form from that used prior to the public offering but the level of detail was essentially the same.

9. The Big-8 accounting firm also moved for summary judgment on the earlier period, arguing that its Review Report "bespoke caution." The court, holding that the bespeaks caution doctrine applies only to forward looking statements and not to misstatements and omissions relating to historical facts, denied that aspect of the motion. *In re* ZZZZ Best Sec. Litig., 864 F. Supp. at 974-75.

10. *See, e.g., In re* Kendall Square Research Corp. Sec. Litig., 868 F. Supp. 26 (D. Mass. 1994).

damage that they cause when they fail to fulfill the gatekeeper role which is essential to maintaining the trustworthiness of our securities markets.

In the course of the motion practice and depositions the Big–8 accountants claimed that they were victims of Minkow's fraud. They claimed never to know that they were abetting a fraud. Hence, it is arguable[11] whether under the 1995 Act the Commission could bring an aiding and abetting claim for such conduct. The 1995 Act provides that the Commission may prosecute aiders and abettors defined as

> any person that *knowingly* provides substantial assistance to another person in violation of a provision of this title, or of any rule or regulation issued under this title, shall be deemed to be in violation of such provision to the same extent as the person to whom such assistance is provided.[12]

The Bill provides for no private right of action against aiders and abettors. It is difficult to understand a good faith rationale for that omission. Surely public policy should allow civil recovery against one who has aided and abetted a fraud.

PROPORTIONATE LIABILITY

The new legislation eliminates joint and several liability except for those found to have "knowingly committed a violation of the securities laws"[13] and establishes a system of proportionate liability for all other defendants. But that system would not relieve accountants and lawyers who acted recklessly from liability for a major portion of the losses sustained in a ZZZZ Best (or even less egregious) scenario.

Section 201 of the Act provides that a defendant who did not knowingly violate the securities laws is liable solely for the portion of the judgment that corresponds to the percentage of responsibility of that defendant as determined under paragraph (3) of the section.[14]

Does this mean that under the 1995 Act, Minkow, clearly more than ninety percent culpable, would be liable for most of the damages and the Big–8 firm would only be responsible for a minuscule share of damages? Not so. The Statute provides that two factors are to be considered in determining the percentage of responsibility of a defendant:

(a) the nature of his or her conduct in causing or contributing to the loss, and

(b) the nature and extent of the *causal relationship between the conduct of each of the defendants and the damages incurred by the plaintiffs.*[15]

11. It is not clear what the word "knowingly" modifies. Does it mean that an aider and abettor must have knowledge that the primary violator is in violation of Rule 10b–5? Or is it sufficient that he or she is aware that they are assisting someone, without actual knowledge that such person is violating this law?

12. Pub. L. No. 104–67, § 104, 1995 U.S.C.C.A.N. (109 Stat.) 737, 757.

13. Although a jury could infer knowing misconduct in many circumstances, establishing a knowing violation could be a Pyrrhic victory for plaintiffs who would then be faced with the certainty of denial of insurance coverage by the defendants' carrier.

14. Pub. L. No. 104–67, § 201, 1995 U.S.C.C.A.N. (109 Stat.) 737, 758–59.

15. *Id.* at 759.

This language in sub-section (b) came out of a staff report dated May 17, 1994 at the direction of Senator Dodd, whose bill in the last Congress formed the basis of the 1995 Act:

> relative culpability may not always be the only appropriate indicator of responsibility in the case of egregious securities fraud. For example, an issuer may perpetrate a knowing fraud, while the issuer's agents, such as its independent auditors or law firm or financial adviser may contribute to the harm through less egregious conduct. Although the conduct of the agents may be less blameworthy than that of the primary violator, the agent's responsibility for harm to investors may nonetheless be considerable. The market may place far greater reliance on the judgment of an independent auditor, law firm, or investment bank than on the issuer, and the agent's actions may be more critical in causing injury to investors. *Any attempt to fashion a system of proportionate liability should therefore consider both a defendant's degree of culpability and the causal connection between the defendant's role and the harm caused.*[16]

Summing up, I believe that accountants and lawyers will still be liable in 10b–5 cases where they participate, even indirectly, in fraudulent conduct; and because the investing public places great reliance on the gatekeeping role of these professionals, they will derive less comfort than they hoped for from the elimination of joint and several liability.

16. STAFF OF SENATE COMM. ON BANKING, HOUSING & URBAN AFF., SUBCOMM. ON SECURITIES, REPORT ON PRIVATE SECURITIES LITIGATION 130 (May 17, 1994) (prepared at the direction of Senator Christopher J. Dodd) (copy on file with *Arizona Law Review*).

APPENDIX

INTERSTATE APPRAISAL SERVICES

5430 VAN NUYS BOULEVARD
SUITE 308
VAN NUYS, CALIFORNIA 91401

TELEPHONE
(818) 785-9021

Mr. Barry Jay Minkow
ZZZZ Best Co., Inc.
7040 Darby Avenue #201-210
Reseda CA 91335

12-2-86

Dear Mr. Minkow;

In regards to contract number 0147 submitted to this office on December 1st 1986 we have reviewed your contract and have accepted your bid for the damaged property located in San Diego, California. The work will commence on December 10th and our first material inspection will be December 16th.

All workman must have I.D. badges on the job site at all times and all workmans compensation insurance must be current and up to date. No unauthorized suppliers, workers, or personnel are allowed on the job site at any time.

ZZZZ Best will be disbursed funds in the following matter:

March - 30th - $2,500,000.00
April - 27th - 2,500,000.00
May - 25th 3,259,660.12 (upon completion)

If any of these payments are to be assigned, this office must receive written verification no later than 12-5-86.

Thank you for your cooperation and concern and we look forward to a very successful completion.

With Highest Regards;

Tom Padgett

PROMPT PROFESSIONAL SERVICE

APPENDIX

WATER RESTORATION SERVICE STATEMENT 0147

NAME INTERSTATE APPRAISEL SERVICES PHONE (810)785-9021

ADDRESS 5430 VAN NUYS BLVD #308

INSURANCE COMPANY AGENT REPRESENTING INSURANCE AGENT ATTENTION: GREG MORGAN

INSURANCE ADDRESS NATIONAL CITY, SAN DIEGO PHONE # (818)785-9021

POLICY # A-084661X DEDUCTIBLE 2,500.00 STARTED 12-15-86 FINISHED ESTIMATED May 1987

	SERVICES RENDERED	CHARGES
	Service Call Water Damage 610,000 sq. feet Pipe/Plumbing & Water Heater Explosion	
	Water Extraction Throughout entire damage. Pull up Removal, Disposal	1,738,500.00
	(Aqua Sensor Test @ S ____ Each Per ____ Days (SIXTEEN) }	
	(Porta Dryers @ S ____ Each/Day X ____ Days X ____ Dryers ____ }	
	(Dehumidifiers @ S ____ Each/Day Times ____ Days X ____ Dehumid }	326,841.20
	Deodorizing @ S ____ Each/Day Times ____ Days	
4	Furniture Moving Relate to number "nine" Storage, Repair, Clean, Scotchguard	See line "9"
2	Carpet Pull-Up See Line One 610,000 square feet	
3	Pad Removal & Disposal See line #1 2.85 per square feet	
5	New Pad @ S 1 5 lb Per Yard Times 2.75 Yards 67,777.00	186,386.75
6	Carpet Reinstallation Better Grade, Code "SY" 17.25 per yd time 67,777.00 yds	1,169,153.25
	Seams Included in Reinstall	
	New Tack Strips Included in Reinstall	
	Doorway Strips (Metal) Included in Reinstall	
7	Carpet Steam Cleaning In areas not replaced 172,000 sq.ft. 21 cents per	36,120.00
8	Carpet Disinfecting	
9	Furniture Dried & Cleaned Various Appliances, Chains, Sofas, Love Seats, Desks, Table	1,797,488.50
	Drapes Dried & Cleaned Not applicable to ZZZZ Best	
10	Miscellaneous Ceramic Tile on ceiling and on Flooring 86,000 sq.ft.	1,548,000.00
11	Miscellaneous Scotchguarding of all necessary areas	579,671.20
12	Miscellaneous Baseboards, Crown, Molding, Bathrooms repaired	877,499.22
	Type Of Water Damage Piping/Plumbing & Problem and water heaters explosion	
	TOTAL CHARGES	8,259,660.12
	DEDUCTIBLE RECEIVED	2,500.00
	TOTAL DUE	[illegible]

US ATT 029310

Carpet Furniture . . . . . .