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COMMENT

PRIMARY LIABILITY AMONGST SECONDARY ACTORS: WHY THE SECOND CIRCUIT'S "BRIGHT LINE" STANDARD SHOULD PREVAIL

I. INTRODUCTION

In today's widely traded securities market, the need for fair and honest disclosure is imperative. The investing public has a right to such disclosure and often relies on federal regulation to ensure it. Nonetheless, there are, unfortunately, times when such honesty is compromised. When this occurs, those at fault should be held liable, whether they are primary or secondary actors.

Section 10(b) and Rule 10(b)(5) of the 1934 Securities Exchange Act prohibit any person from making deceptive, untrue or inaccurate statements or failing to disclose necessary information in connection with the purchase or sale of any security.[1] Even in light of Section 10(b) and Rule 10(b)(5), however, courts have disagreed about the appropriate standard of liability to be imposed upon secondary actors such that they will be found primarily liable when such unfortunate circumstances arise. In fact, a definite split in the circuits has developed. The Ninth Circuit has adopted the broad standard of imposing liability upon secondary actors based upon their "substantial participation."[2] The Second Circuit, rather, has adopted a bright line standard,

1. Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j(b) (1997); Rules and Regulations, Securities Exchange Act of 1934, 17 C.F.R. § 240.10b-5 (1998).

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

only imposing liability on secondary actors when the secondary actors make a misstatement or omission attributable to them.[3]

Section II of this Note discusses the elimination of secondary liability, namely the abolition of aider and abettor liability, as well as conspiracy liability. Section III goes on to examine what remained after the Supreme Court's decision in *Central Bank v. First Interstate Bank*[4] and provides an overview of the Ninth and Second Circuit split regarding what type of conduct constitutes primary liability amongst secondary actors. Section IV provides an explanation of the differences between the Ninth Circuit's "substantial participation" or "intricate involvement" standard and the Second Circuit's "bright line" standard. Furthermore, Section IV establishes the superiority of the Second Circuit's standard. Section V examines policy considerations which demonstrate the preeminence of the Second Circuit's "bright line" standard. Finally, the Note concludes in Part VI, stating that while *Central Bank* may already provide the real answer to what type of activity constitutes primary liability amongst secondary actors, it will take another Supreme Court case to eliminate the current circuit split.

II. THE END OF SECONDARY LIABILITY

Although the need for securities regulation may be obvious today, such was not always the case.[5] It was not until the beginning of the 20th century that "[t]he idea that the general public ha[d] an interest in the operations and performance of the stock market sufficient to justify public control of the exchanges" came into fruition.[6] A want of federal regulations and a lack of uniformity in state legislation prior to this point provided breeding grounds for fraudulent and deceptive securities transactions.[7] However, it was not until after the problem came to a head with the "Great Crash" of October 1929 that the necessary federal securities legislation came about.[8]

3. *See, e.g.*, *In re* MTC Elec. Tech. Shareholders Litig., 898 F.Supp. 974 (E.D.N.Y. 1995); *In re* JWP Inc. Sec. Litig., 928 F.Supp. 1239 (S.D.N.Y. 1996); Phillips v. Kidder, Peabody & Co., 933 F.Supp. 303 (S.D.N.Y. 1996), *aff'd*, 108 F.3d 1370 (2d Cir. 1997); Shapiro v. Cantor, 123 F.3d 717 (2d Cir. 1997); Wright v. Ernst & Young, 152 F.3d 169 (2d Cir. 1998).

4. Central Bank v. First Interstate Bank, 511 U.S. 164 (1994).

5. *See generally* Steve Thel, *The Original Conception of Section 10(b) of the Securities Exchange Act*, 42 STAN. L. REV. 385, 394 (1990).

6. *Id*.

7. Kyle M. Globerman, *The Elusive and Changing Definition of a Security: One Test Fits All*, 51 FLA. L. REV. 271, 277 (1999) (Globerman noted the problems of the securities market prior to federal legislation, stating: "The absence of federal regulations and disparity in state legislation provided fertile ground for fraudulent and deceptive trading in securities leading to illusory market strength.").

8. *Id*. at 278-80.

On May 27, 1933, the Securities Act[9] was passed "to protect investors during the initial offering of a security."[10] The purpose of the Act was twofold: "to provide the investor with enough information to make a sound economic decision in purchasing a security, and to hold the issuers liable for any misstatements or any other fraudulent activities in the issuance of securities."[11]

Shortly thereafter, the Securities Exchange Act of 1934 ("Act")[12] was passed to regulate the trading of securities on the secondary market.[13] Section 10(b) of the Securities Exchange Act of 1934 provides, in pertinent part, that it shall be unlawful for any person to directly or indirectly "use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe."[14] Rule 10(b)(5) promulgated thereunder provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.[15]

The original purpose of the 1934 Act was to regulate market manipulation and speculation.[16] Today, the 1934 Act is the primary federal securities law to deal with fraud in the purchase and sale of securities. With the investing public as the intended beneficiaries of the 1934 Act, Section 10(b) of the Act, and Rule 10(b)(5) promulgated thereunder, were implemented to "proscribe[] knowing and intentional misconduct designed to deceive or defraud investors."[17] Due to the "extensive scheme of civil liability"[18] created by the

9. Securities Act of 1933, 15 U.S.C. § 77(a) (1994).
10. Globerman, *supra* note 7, at 279.
11. *Id*.
12. Securities Exchange Act of 1934, 15 U.S.C. § 78(a) (1994).
13. *See* Globerman, *supra* note 7, at 280.
14. Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j(b) (1994).
15. Rules and Regulations, Securities Exchange Act of 1934, 17 C.F.R. § 240.10(b)(5) (1998).
16. *See* Globerman, *supra* note 7, at 280.
17. Thel, *supra* note 5, at 386-87.
18. Central Bank v. First Interstate Bank, 511 U.S. 164, 171 (1994).

Act, Section 10(b) and Rule 10(b)(5) were to serve as "catchall"[19] provisions. While neither Section 10(b) nor Rule 10(b)(5) provide an express remedy for private causes of action, federal courts have implied the existence of a private remedy for violations thereof.[20]

A. *The Elimination of Aider and Abettor Liability*

In 1994, the Supreme Court, in *Central Bank v. First Interstate Bank*, eliminated the private plaintiff's aiding and abetting cause of action for securities fraud under Section 10(b).[21] This holding frustrated the previously routine practice of suing the so-called "primary" violators of the statute, such as the issuers, officers or underwriters, as well as naming other professionals, such as accountants and lawyers, as aiders, abettors or co-conspirators.[22] *Central Bank* stated that although a private plaintiff may not maintain an aiding and abetting cause of action under Section 10(b), the absence of such liability does not mean that secondary actors in the securities market are "always free from liability under the securities Acts."[23] The Court noted that secondary actors may be held liable as primary violators, stating "[a]ny 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 [Rule] 10b-5, assuming all of the requirements for primary liability under Rule 10b-5 are met."[24]

Furthermore, in 1995, Congress passed the Private Securities Litigation Reform Act ("PSLRA"), which explicitly gave the Securities Exchange Commission ("SEC") authority to bring actions for aiding and abetting under the Securities Exchange Act.[25] Such legislation evidences Congress's approval of the elimination of the aider/abettor cause of action for private plaintiffs. Thus, it appears that as a result of both *Central Bank* and the PSLRA,[26] the

19. *Id.* at 174 (quoting Chiarella v. U.S., 445 U.S. 222, 234-35 (1980), where the court stated: "Section 10(b) is aptly described as a catchall provision, but what it catches must be fraud.").

20. *Id.* at 171.

21. *See id.* at 164.

22. Irwin J. Sugarman, *Lawyers & Accountants Liability After Central Bank*, G-79 A.B.A. CENTER FOR CONTINUING LEGAL EDUC. NAT'L INST. (1998).

23. *Central Bank*, 511 U.S. at 191.

24. *Id*.

25. Private Securities Litigation Reform Act, Pub. L. No. 104-67, 109 Stat. 737 (codified in scattered sections of 15 U.S.C.).

26. Arthur Levitt, former Chairman of the U.S. Securities and Exchange Commission, stated in his October 21, 1997, address before the Subcommittee on Finance and Hazardous Materials, that in the two years since implementation of the Private Securities Litigation Reform Act of 1995, the Staff Report had made various preliminary observations. One such observation was that "[s]econdary defendants, such as accountants and lawyers, were being named much less

only remedy that remains available for private investors who have suffered a loss as a result of securities fraud is to allege a primary violation of Section 10(b) or Rule 10(b)(5).[27] The following sections explore the confusing question of what constitutes a "primary violation" amongst secondary actors.

B. No Aiding and Abetting Also Means No Conspiracy

Following *Central Bank*, private plaintiffs have attempted to hold secondary actors liable under Section 10(b) by alleging conspiracy charges, as opposed to aiding and abetting in the fraudulent misstatement or omission.[28] For example, in the class action suit of *Dinsmore v. Squadron, Ellenoff, Plesent, Sheinfeld & Sorkin,* plaintiffs alleged that the defendant law firm conspired to violate Section 10(b) and Rule 10(b)(5) by allegedly making material misstatements and omissions to the SEC during its representation of their client, Towers, and by drafting an offer of rescission to the plaintiffs on the client's behalf.[29] The Second Circuit refused to extend liability for conspiracy to violate Section 10(b) or Rule 10(b)(5), stating that "the reasoning leading to the Supreme Court's rejection of aiding and abetting liability . . . also applies to conspiracy."[30] Furthermore, the court held that when the requirements for primary liability are not independently met, "they may not be

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frequently in federal securities class actions. It is unclear, however, whether this decline can be attributed primarily to the Reform Act or to the Supreme Court's 1994 decision in the Central Bank of Denver case, which eliminated private liability for aiding and abetting in actions under Section 10(b) of the Securities Exchange Act of 1934." *Testimony of Arthur Levitt*, 1997 WL 757725 (S.E.C.), at *3.

27. It is interesting to note that since *Central Bank* and the passage of the 1995 Private Securities Litigation Reform Act, litigation involving secondary actors has seemed to decline overall. *Id*. at *10 n.4.

> The staff's review of complaints in the 105 class actions filed in 1996 revealed that accounting firms have been named in six cases, corporate counsel in no cases, and underwriters in 19 cases. By contrast, a report of the Big Six accounting firms concluded that the number of audit-related suits filed both in state and federal court against these firms for the years 1990 to 1992, was 192, 172, and 141 respectively, . . . although these numbers were not limited to securities class actions. Moreover, this report concluded that during these same years the number of cases either settled or dismissed against the Big Six firms which involved claims under Section 10(b) was 18, 35, and 58 respectively. . . . A study by the National Economic Research Associates reported that during the period 1991 through June 1996, accountants were defendants in 52 reported settlements (as opposed to complaints), underwriters were defendants in 80, and law firms were defendants in seven.

Id.

28. *See* Dinsmore v. Squadron, Ellenoff, Plesent, Sheinfeld & Sorkin, 135 F.3d 837 (2d Cir. 1998); *In re* GlenFed, Inc. Sec. Litig., 60 F.3d 591 (9th Cir. 1995); Van de Velde v. Coopers & Lybrand, 899 F.Supp. 731 (D. Mass. 1995); Faleck & Margolies, Ltd. v. Margolies, No. 89 Civ. 8548 (S.D.N.Y. Jan. 30, 1995).

29. *Dinsmore*, 135 F.3d at 839.

30. *Id*. at 842.

satisfied based solely on one's participation in a conspiracy in which other parties have committed a primary violation."[31] Other attempts by plaintiffs alleging conspiracy to violate Section 10(b) have also been unsuccessful.[32]

III. PRIMARY LIABILITY UNDER SECTION 10(B)/ RULE 10(B)(5)

A. *What Constitutes Primary Liability?*

With aiding and abetting and conspiracy causes of action eliminated, the only remaining option for private plaintiffs seeking a remedy for violations of Section 10(b) and Rule 10(b)(5) is to allege a primary violation.[33] However, just what constitutes a primary violation is far from settled. Although the general elements of primary liability are accepted throughout the circuits,[34] the Ninth and Second Circuits have split when defining the type of conduct that constitutes a primary violation amongst secondary actors. There are also

31. *Id*. at 843.

32. *See GlenFed*, 60 F.3d at 592 ("The Court's rationale [in Central Bank] precludes a private right of action for 'conspiracy' liability."); *Van de Velde*, 899 F.Supp. at 738 ("To the extent that this constitutes a distinct claim for conspiracy to violate the securities laws, defendant is correct that this claim is barred by Central Bank."); *In re* MTC Elec. Tech. Shareholders Litig., 898 F.Supp. 974, 982 (E.D.N.Y. 1995) ("[E]very reason cited by the Supreme Court, in rejecting the implied right of action for aiding and abetting also applies to actions alleging conspiracies."); *Faleck & Margolies*, 1995 WL 33631 at *12 ("Since neither § 10(b), nor any other express cause of action under the 1934 Act, contains any statutory language making conspiracy to violate § 10(b) a violation of the 1934 Act, the Supreme Court's holding in Central Bank precludes such an action by plaintiffs" and "[t]o permit a private plaintiff to maintain an action for conspiracy to violate Rule 10b-5 would make Central Bank of Denver meaningless, since virtually every aiding and abetting claim can be alleged as a conspiracy claim.").

33. *See Central Bank*, 511 U.S. at 191 ("Because the text of § 10(b) does not prohibit aiding and abetting, we hold that a private plaintiff may not maintain an aiding and abetting suit under § 10(b). . . . Yet, [a]ny person or entity. . .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."); *see also Dinsmore*, 135 F.3d at 842 ("We emphasize that, while we decline to imply a cause of action for conspiracy to violate § 10(b) and Rule 10b-5, secondary actors who conspire to commit such violations will still be subject to liability so long as they independently satisfy the requirements for primary liability.").

34. The generally accepted elements of primary liability under Section 10(b)/Rule 10(b)(5) are:

(1) a misrepresentation or omission,
(2) of a material fact,
(3) made with scienter,
(4) that plaintiff relied upon, and
(5) causing the plaintiff injury.

See, e.g., Wright v. Ernst & Young, 152 F.3d 169, 177 (2d Cir. 1998); Anixter v. Home-Stake Prod. Co., 77 F.3d 1215, 1225 (10th Cir. 1996); Trust Co. of La. v. N.N.P., Inc., 104 F.3d 1478, 1490 (5th Cir. 1997).

several other decisions outside of these two circuits which espouse one standard or the other, or some hybrid thereof. A discussion of these varying standards and the cases that developed them follows.

B. The Ninth Circuit's "Substantial Participation" or "Intricate Involvement" Standard

Some courts, particularly those in the Ninth Circuit, have held that "substantial participation"[35] or "intricate involvement"[36] in the preparation of misrepresentations or omissions that are actually made or omitted by someone else is sufficient to create liability.[37]

In one of the earliest Ninth Circuit cases to address this issue after *Central Bank*, the court in *In re ZZZZ Best Securities Litigation*,[38] imposed liability upon a secondary actor who was "intricately involved" in the creation of the primary actor's misstatements and in the "resulting deception."[39] In *ZZZZ Best*, investors brought a Section 10(b) and Rule 10(b)(5) securities fraud suit against the accounting firm of Ernst & Young, which prepared a Review Report and allegedly reviewed, created or issued several other statements related to the *ZZZZ Best* fraudulent scheme.[40] The *ZZZZ Best* court extended liability despite the fact that the alleged misstatements "included [no] public

35. "Substantial participation," as it relates to a secondary actor's liability for misrepresentations or omissions made by the primary violator, is usually phrased in terms of the secondary actor's "significant role" or "central role" in the misrepresentation or omission. *See, e.g.*, *In re* Software Toolworks Inc. Litig., 50 F.3d 615, 628 n.3 (9th Cir. 1994) (stating that accounting firm could be held liable based on the "significant role [they played] in drafting and editing" a letter); Cashman v. Coopers & Lybrand, 877 F.Supp. 425, 432 (N.D. Ill. 1995) (stating that accountants may be primarily liable under Section 10(b) if they played a "central role in drafting and formation of the alleged misstatements"). Interestingly, "substantial" participation or assistance was also a phrase commonly used when determining aider/abettor liability prior to its elimination. *See Central Bank*, 511 U.S. at 181.

36. The term "intricate involvement" was first introduced in the case of *In re* ZZZZ Best Sec. Litig., where primary liability was imposed upon the defendant accounting firm, who prepared a review report and reviewed other statements of the primary violator, which according to the court, made the accounting firm "intricately involved" in the creation of misstatements made by the primary violator. *In re* ZZZZ Best Sec. Litig. 864 F.Supp. 960, 970 (C.D. Cal. 1994).

37. *See Software Toolworks*, 50 F.3d at 628 n.3 (stating that plaintiff's complaint "clearly alleges" primary liability under Section 10(b) for the "significant role" the defendant accounting firm played in drafting and editing letters to the SEC which contained material misrepresentations and omissions); Adam v. Silicon Valley Bancshares, 884 F.Supp. 1398 (N.D. Cal. 1995) (Defendant accounting firm held primarily liable under Section 10(b) for misrepresentations made by the primary violator issuer in their financial statements and reports.); *ZZZZ Best*, 864 F.Supp. at 970 (Defendant accounting firm, a secondary actor, found primarily liable because "anyone intricately involved in their creation [the fraudulent material misrepresentations and omissions of the primary violator] . . . should be liable under Section 10(b)/Rule 10b-5").

38. *ZZZZ Best*, 864 F.Supp. at 960.

39. *Id*. at 970.

40. *Id*. at 964.

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indication within them that [Ernst & Young] had anything to do with their existence."[41] The court held that "liability under Section 10(b)/Rule 10b-5 is not limited to the making of materially false and misleading statements or omissions,"[42] and imposed liability on Ernst & Young whose activity was "extensive enough."[43] The court noted, however, that the case "create[d] a close call."[44]

Shortly after the *ZZZZ Best* decision, the Ninth Circuit, in *In re Software Toolworks Inc. Litig.,*[45] again imposed liability on an accounting firm for the "significant role" it played in participating in the preparation of its client's allegedly misleading letter to the SEC. [46] Although the court only discussed the issue of primary liability in a footnote, defendant Deloitte & Touche was "not absolve[d]"[47] of the issue of primary liability despite the fact that they only provided "extensive review and discussion"[48] of letters their client sent to the SEC .

The trend towards a broad reading of primary liability for secondary actors continued in the Ninth Circuit with *Employers Ins. of Wausau v. Musick, Peeler, & Garrett*.[49] In *Employers Ins.*, the court held both the accountants and the attorneys who participated in drafting their client's prospectus liable.[50] In finding the defendant attorneys liable, the court stated that "a secondary actor may be primarily liable under section 10(b) when the actor's alleged participation consists mainly of drafting and editing an offering document."[51] Furthermore, a secondary actor "may be liable for direct violation of the rule if its participation in the misrepresentation is direct."[52] In holding the accountants liable, the court paid no attention to the fact that the reports made were

41. *Id.* at 965. The court went on to state that "[n]one of these additional [mis]statements attributes its existence to E & Y or even hints that E & Y might have been involved in the issuance of any of those [mis]statements." Furthermore, "Plaintiff's complaint does not specifically identify which of the numerous defendants made which of the alleged misrepresentations alluded to in the complaint. Thus, it is difficult to determine, based only on the complaint, exactly what E & Y alone is accused of doing." *Id.* at n.5. Finally, "Plaintiffs essentially concede in their opposition papers that E & Y did not itself release the additional statements to the public." *Id.* at n.7.

42. *Id*. at 972.

43. *ZZZZ Best*, 864 F.Supp. at 970.

44. *Id*.

45. *In re* Software Toolworks Inc. Litig., 50 F.3d 615 (9th Cir. 1994).

46. *See id*. at 628.

47. *Id*. at 628 n.3.

48. *Id*.

49. Employers Ins. of Wausau v. Musick, Peeler, & Garett, 871 F.Supp. 381 (S.D. Cal. 1994).

50. *See id*. at 388-89.

51. *Id*. at 389.

52. *Id*. (quoting S.E.C. v. Seaboard Corp., 677 F.2d 1301, 1312 (9th Cir. 1982)).

uncertified, stating a "more flexible test,"[53] as opposed to a "rigid rule,"[54] was needed to "determine if an accountant has been sufficiently involved in an offering to be considered a primary actor under section 10(b)."[55]

Expanding the standard yet again, a district court in California held that the defendant accountants had satisfied the "in connection with"[56] requirement of Section 10(b), such that they could be held primarily liable, simply by their involvement in the misrepresentations made by their issuer client.[57] In *Adam v. Silicon Valley Bancshares*, defendant Deloitte & Touche never made a fraudulent misrepresentation or omission itself,[58] rather, plaintiffs alleged that Deloitte & Touche violated Section 10(b) by permitting Silicone Valley Bancshares to issue misleading financial statements and not "expand[ing] its audit procedures to accommodate"[59] Silicone Valley Bancshares' "critical weaknesses"[60] in their internal controls and loan portfolio. In sum, the *Adam* court concluded that accountants could be held liable under Section 10(b) for their involvement in representations made by their client, even though it was claimed that *Central Bank* authorized a narrow interpretation of the "in connection with" the sale of securities requirement,[61] so as to limit accountants exposure to certified financial statements contained in prospectuses.[62]

In *McGann v. Ernst & Young*,[63] the Ninth Circuit continued the practice of an expansive reading by again finding the defendant accounting firm liable for

53. *Employers Ins.*, 871 F.Supp. at 389.

54. *Id*. ("[T]he court [will] not . . . create the rigid rule that an accountant must actually be named in a document to be liable as a primary actor.").

55. *Id*. at 389.

56. *See supra* note 15. Section 10(b) provides that it shall be unlawful for any person to "use or employ, *in connection with* the purchase or sale of any security. . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission my prescribe." Securities Exchange Act of 1934, 15 U.S.C. § 78(j)(b) (emphasis added). The "in connection with" requirement of Section 10(b), as it relates to primary liability amongst secondary actors, comes into play when determining what statements or omissions, or the documents that house them, can be considered to be issued in connection with the purchase or sale of securities. *See* Adam v. Silicon Valley Bancshares, 884 F.Supp. 1398, 1401-02 (N.D. Cal. 1995).

57. *See Adam*, 884 F.Supp. at 1398.

58. *See id*. at 1401.

59. *Id*. at 1399.

60. *Id*.

61. *Id*. at 1402. The *Adam* court rejected the argument Deloitte & Touche advanced to limit their liability that "after Central Bank, the only documents which can be the basis for accountant liability are 'selling documents,' i.e. documents used by either sellers or purchasers of securities to effect a particular sales transaction." The *Adam* court instead "adhere[d] to the interpretation of the 'in connection with' requirement previously held by the Ninth Circuit. . . .[under which] the non-Prospectus statements satisfy the "in connection with" requirement and may be a basis for holding [Deloitte & Touche] primarily liable under 10(b)." *Id.*

62. *See Adam*, 884 F.Supp. at 1401-02.

63. McGann v. Ernst & Young, 102 F.3d 390 (9th Cir. 1996).

violating Section 10(b). There, the defendant, "E[rnst] & Y[oung,] knew that [their client] would include its audit opinion"[64] in its annual report. The court went on to state that "[w]hile an outside accounting firm might be blameless where it had no reason to know that its clients would use its audit report to sell securities, or where it instructed its client not to release the report to the public," such was not the case at hand.[65]

The very role of the secondary actor, inherent in his or her profession, at times plays a part in the comprehensive standard the Ninth Circuit espouses.[66] In *Flecker v. Hollywood Entertainment Corp.*, the district court of Oregon found that plaintiffs had established a claim for primary liability under Section 10(b) against the underwriters of the defendant corporation, not based upon any particular act or omission, but upon the relationship the underwriters had with the primary violator.[67] The court found "that the defendants' roles as analysts, investment bankers and business advisors with extensive contacts with Hollywood defendants, superior access to non-public information and participation in both drafting and decision-making is sufficient to establish a triable primary liability claim under [Section] 10(b)."[68] Similarly, in *Cooper v. Pickett*,[69] the defendant accounting firm of Deloitte & Touche was held liable under Section 10(b) and Rule 10(b)(5) because they knowingly certified false and misleading financial statements of their client Merisel.[70] In *Cooper*, the court held that plaintiff stock purchasers adequately stated a securities fraud claim against Deloitte & Touche based on the allegation that the accountants "knowingly certified financial statements including the false revenue figures."[71] Furthermore, the court held the defendant underwriters and their analysts liable for Section 10(b) violations of making false statements in light of their purported access to inside information arising from their close relationship with the issuer.[72] Finally, the *Cooper* court expanded the standard for imposing primary liability upon secondary actors by accepting plaintiff's complaint which alleged that defendants participated in a direct scheme to defraud.[73] Differentiating this scheme to defraud from conspiracy, the court noted that securities fraud liability may be "based on allegations that a group of defendants acted together to violate the securities law, as long as each

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64. *Id*. at 397.

65. *Id*.

66. *See* Flecker v. Hollywood Entertainment Corp., 1997 WL 269488 (D.Or. Feb. 12, 1997); Cooper v. Pickett, 137 F.3d 616 (9th Cir. 1997).

67. *Flecker*, 1997 WL 269488, at *7.

68. *Id*. at *9.

69. *Cooper*, 137 F.3d at 616.

70. *See id*. at 629.

71. *See id*.

72. *See id*.

73. *Id.* at 624.

defendant committed a manipulative or deceptive act in furtherance of the scheme."[74]

C. The Second Circuit's "Bright Line" Standard

Unsatisfied with the expansive scope of liability espoused by the Ninth Circuit, other courts, primarily those in the Second Circuit, have adopted a more limited standard of liability.[75] This "bright line"[76] standard imposes liability on secondary actors only when they have actually made a fraudulent misstatement or omission and such a misstatement or omission can be attributed to them.[77]

In one of the earlier cases to come out of the Second Circuit, *In re MTC Elec. Tech. Shareholders Litig.* ("MTC"),[78] a class of shareholders filed suit against the underwriters and accountants of the primary defendant, MTC Electronic Technologies Co., Ltd., for violations of Section 10(b) and Rule 10(b)(5).[79] The *MTC* court refused to impose primary liability upon the underwriters for the misrepresentations made in the MTC prospectus, where

74. *Cooper,* 137 F.3d at 624. The *Cooper* court stated: "The complaint does not allege a conspiracy, however, as a separate cause of action. Instead, it alleges a "scheme" in which Merisel and the other defendants directly participated, tracking the language of Rule 10(b)(5)(a), which makes it unlawful for any person "[t]o employ any device, scheme, or artifice to defraud." *Id.*

75. *See e.g., In re* MTC Electronic Tech. Shareholders Litig., 898 F.Supp. 974, 987 (E.D.N.Y. 1995) ("[I]f *Central Bank* is to have any real meaning, a defendant must actually make a false or misleading statement in order to be held liable under Section 10(b)."); *In re* JWP Inc. Sec. Litig., 928 F.Supp. 1239 (S.D.N.Y. 1996); Phillips v. Kidder, Peabody & Co., 933 F.Supp. 303 (S.D.N.Y. 1996), *aff'd*, 108 F.3d 1370 (2d Cir. 1997); Shapiro v. Cantor, 123 F.3d 717 (2d Cir. 1997); Wright v. Ernst & Young, 152 F.3d 169 (2d Cir. 1998).

76. The "bright line" terminology was first introduced in *Anixter v. Home-Stake Prod. Co.*, 77 F.3d 1215 (10th Cir. 1996), a case outside of the Second Circuit which espoused the idea that primary liability may only be imposed upon secondary actors when the secondary actor "themselves [made] a false or misleading statement (or omission) that they know or should know will reach potential investors." *Id.* at 1227. Interestingly, the *Anixter* court characterized this approach as "far from a bright line," but expressly rejected the standard adopted in the Ninth Circuit stating the Second Circuit's rule "provides more guidance to litigants than a rule allowing liability to attach to an accountant or other outside professional who provided "significant" or "substantial" assistance to the representations of others." *Id.* at 1227. Since the time of the *Anixter* decision, the standard adopted by the Second Circuit has commonly been referred to as a "bright line" rule.

77. *See, e.g.*, Shapiro, 123 F.3d at 720 (quoting *MTC Elec.*, 898 F.Supp. at 987, where the court stated that "if Central Bank is to have any real meaning, a defendant must actually make a false or misleading statement in order to be held liable under Section 10(b)."). *See also* Wright v. Ernst & Young, 152 F.3d at 175 ("[A] secondary actor cannot incur primary liability under the Act for a statement not attributed to the actor.").

78. *MTC Elec*., 898 F.Supp. at 974.

79. *Id*. at 978.

the underwriters had only participated in its drafting and circulation.[80] Cognizant of the two approaches towards imposing liability that had developed after *Central Bank*, the court stated:

> [I]f *Central Bank* is to have any real meaning, a defendant must actually make a false or misleading statement in order to be held liable under Section 10(b). Anything short of such conduct is merely aiding and abetting, and no matter how substantial that aid may be, it is not enough to trigger liability under Section 10(b).[81]

While the *MTC* court held the defendant accountant liable for a primary violation of Section 10(b), it did so only because the accountant was personally responsible for certain misstatements and omissions.[82] The court found that plaintiffs had sufficiently stated a claim against the accountant as a primary violator, after alleging the accountant had "materially misstated MTC's results of operations and net income, outstanding shares and options and the nature and extent of its business, and that [the accountant] materially misrepresented that it had performed its audit in accordance with generally accepted auditing standards."[83]

Shortly after the *MTC* decision, two district courts in the Second Circuit reinforced the bright line standard by holding that accountants and underwriters are only primarily liable for the misrepresentations that they actually make under Section 10(b).[84] First, the *In re JWP Inc. Sec. Litig.* court refused to impose liability upon the accountants and granted the audit committee defendants summary judgment "dismissing the plaintiff's" §10(b) claims to the extent that those claims are based on alleged misrepresentations that the audit committee defendants did not make."[85] Second, in *Phillips v. Kidder, Peabody & Co.*, the court refused to extend liability upon the defendant underwriter, finding that an underwriter who participates in drafting the prospectus may be held liable under Section 10(b) only if the underwriter "made" the fraudulent misrepresentations contained in the prospectus.[86]

In the first case on point to reach the Second Circuit Court of Appeals, *Shapiro v. Cantor*,[87] the court reinforced the findings of the lower courts and in doing so furthered the application of the bright line standard.[88] In *Shapiro*,

80. *Id*. at 987.

81. *Id*.

82. *Id.* at 988. ("[Defendant's] claim that the plaintiffs have not alleged that it made any materially false and misleading statements is incorrect.").

83. *MTC Elec.,* 898 F.Supp. at 988.

84. *In re* JWP Inc. Sec. Litig., 928 F.Supp. 1239 (S.D.N.Y. 1996); Phillips v. Kidder, Peabody & Co., 933 F.Supp. 303 (S.D.N.Y. 1996), *aff'd*, 108 F.3d 1370 (2d Cir. 1997).

85. *JWP Inc.*, 928 F. Supp at 1256.

86. *Phillips*, 933 F. Supp at 324.

87. Shapiro v. Cantor, 123 F.3d 717 (2d Cir. 1997).

88. *Id*. at 720.

investors in a limited partnership sued the accounting firm of Touche Ross and Co., and its successor in interest, Deloitte & Touche, for violations of Section 10(b).[89] Plaintiff's claims were "based primarily on the defendant's failure to disclose that David Greenberg—one of the principals—was a convicted felon,"[90] yet there was "no allegation that the projections [made by defendant] misrepresented any financial fact."[91] The court concluded that the defendant accounting firm was under no duty to disclose material information under Section 10(b) and, therefore, could not be held liable.[92] Furthermore, plaintiff's amended complaint alleged that Touche Ross's specific "participating" role in selling interests of their client was only in providing financial projections included in the offering memoranda.[93] As such, the court refused to extend liability stating that "because this is consistent with the role of an accountant, and because the plaintiffs otherwise fail to articulate a 'fiduciary or other similar relation of trust and confidence'. . . Touche Ross had no duty to disclose."[94] In sum, the court reasoned that plaintiff's allegations essentially constituted aiding and abetting principles and that "[a]llegations of 'assisting,' 'participating in,' 'complicity in' and similar synonyms used throughout the complaint all fall within the prohibitive bar of *Central Bank*."[95]

More recently, the Second Circuit Court of Appeals decided *Wright v. Ernst & Young*,[96] further contracting the standard of liability applicable to secondary actors by specifying the time frame within which the misstatement or omission must be attributed to the secondary actor in order to hold them liable.[97] In *Wright*, a class of investors brought a securities fraud action under Section 10(b) against the accounting firm of Ernst & Young, alleging that Ernst & Young had violated Section 10(b) by orally approving their client's materially false and misleading financial statements. The client, BT Office Products ("BT"), disseminated the statements to the public through a press release.[98] The press release, however, stated that the figures contained in the financial statements were unaudited and made no reference to Ernst &

89. *Id*. at 718-19.

90. *Id.* at 721.

91. *Id.*

92. *Shapiro,* 123 F.3d at 721.

93. *Id*. at 722.

94. *Id. But cf*. Flecker v. Hollywood Entertainment Corp., 1997 WL 269488 at *9 (D.Or. Feb. 12, 1997) (This Ninth Circuit case also took into account the very role of the secondary actor, inherent in his profession, but used it to impose primary liability, stating "defendant's roles as analysts, investment bankers and business advisors with extensive contacts with Hollywood defendants, superior access to non-public information, and participation in both drafting and decision-making is sufficient to establish a triable primary liability claim under Section 10(b).").

95. *Shapiro*, 123 F.3d at 720.

96. Wright v. Ernst & Young, 152 F.3d 169 (2d Cir. 1998).

97. *Id*. at 175.

98. *Id*. at 171.

Young.[99] The court concluded that plaintiffs did not allege primary liability against Ernst & Young because Ernst & Young did not directly or indirectly communicate misrepresentations to the investors upon which they would have relied in making their investment decision.[100]

The *Wright* court noted that although there is "no requirement that the alleged violator directly communicate misrepresentations to [investors] for primary liability to attach,"[101] a "secondary actor cannot incur primary liability under the Act [of 1934] for a statement not attributed to the actor at the time of its dissemination."[102] Thus, in order for liability to attach, the misrepresentation must be attributed to that specific actor at the time of public dissemination, in advance of the investment decision, which was not present in the case at hand.[103] Additionally, the court reaffirmed the "bright line" notion that secondary actors may not be held primarily liable under Section 10(b) unless they made the material misstatement or omission on which the purchaser or seller of securities relies. Furthermore, the *Wright* court reaffirmed that the secondary actor "may no longer be held primarily liable under §10(b) for mere knowledge and assistance in the fraud."[104]

D. Decisions Outside of the Ninth and Second Circuits

Although the primary split between the standards exists in the Ninth and Second Circuits, courts throughout all circuits have had to address the issue of what type of conduct constitutes a primary violation of Section 10(b) amongst secondary actors.[105] No single standard has been adopted by any particular circuit, and, in fact, the decisions seem to coincide with either the Ninth Circuit's standard,[106] that of substantial participation," or with the Second Circuit's standard,[107] that the secondary actor make a misstatement or omission attributable to him or her. A discussion of these cases follows.

99. *Id*. at 172.

100. *Id.* at 173-74.

101. *Wright,* 152 F.3d at 175 (quoting Anixter v. Home-Stake Prod. Co., 77 F.3d 1215, 1226 (10th Cir. 1996)).

102. *Id*.

103. *Id.* at 172 ("The press release also stated . . . that the figures were 'unaudited' and it made no mention of Ernst & Young.").

104. *Id.* at 176.

105. *See, e.g.*, Dublin Sec., Inc. v. Hurd, 197 B.R. 66 (S.D. Ohio), *aff'd*, 133 F.3d 377 (6th Cir. 1997); *Anixter*, 77 F.3d at 1215; Trust Co. of La. v. N.N.P., Inc., 104 F.3d 1478 (5th Cir. 1997).

106. *See, e.g.*, Cashman v. Coopers & Lybrand, 877 F.Supp. 425 (N.D. Ill. 1995); *Dublin Sec.*, 197 B.R. at 66.

107. *See, e.g.*, *Anixter*, 77 F.3d at 1215; Vosgerichian v. Commodore Int'l, 862 F.Supp. 1371 (E.D. Pa. 1994); *In re* Kendall Square Research Corp. Sec. Litig., 868 F.Supp. 26 (D. Mass. 1994); Trust Co. of La. v. N.N.P., Inc., 104 F.3d 1478 (5th Cir. 1997).

1. Decisions Coinciding with the Ninth Circuit's Standard

Shortly after the *Central Bank* decision, a district court in Illinois was faced with the issue of what type of conduct constitutes primary liability amongst secondary actors, and more particularly, amongst accountants.[108] In *Cashman v. Coopers & Lybrand*, shareholders and debenture holders brought a Section 10(b) action against the accounting firm of Coopers & Lybrand. Plaintiffs alleged that Coopers & Lybrand concealed and misrepresented material facts of their client, Stotler Group, Inc. ("Stotler"), during Stotler's transition from a partnership to a public corporation.[109] The *Cashman* court concluded that plaintiffs' allegations, most of which were framed in terms of the "substantial participation"[110] by Coopers & Lybrand in the scheme to defraud, were sufficient to allege "that Coopers played a central role in the drafting and formation of the alleged misstatements which the Stotler Partnership incorporated into its Prospectus."[111] Thus, in many respects, the *Cashman* decision mirrored the *ZZZZ Best* and *Software Toolworks* decisions in the Ninth Circuit because in all three cases, liability was framed according to the defendant's "substantial participation" or "central role" in the primary violator's misstatements or omission.

In the Sixth Circuit, attorneys may be held liable for primary violations under Section 10(b) for their participation in securities fraud where their direct involvement was in the management and control of the company when the alleged fraud occurred.[112] The *In re Dublin Sec. Inc*. court held that "the defrauded investors . . . have direct avenues of relief against the defendant attorneys"[113] despite the fact that the only allegation was that "the attorney defendants knew or should have known of the illegal nature of the activities of Dublin Securities, but failed to advise Dublin Securities of the illegality of the activities."[114] The reasoning behind the court's imposition of liability in *Dublin* is reminiscent of the *Flecker* and *Cooper* rationale that one's role or relationship with a client is a substantial factor in determining liability under the comprehensive standard espoused by the Ninth Circuit. Just as the *Dublin* court imposes primary liability upon the defendant attorneys due, at least in

108. Cashman v. Coopers & Lybrand, 877 F.Supp. 425 (N.D. Ill. 1995).

109. *See id*. at 429.

110. *Id*. at 432-33 ("During its substantial participation in the preparation of the Prospectus, Coopers recklessly misrepresented to the partners . . . [the] particular results [that] would follow from the "taking public" Transaction. Coopers' substantial participation consisted of: (1) issuing reports/statements of financial condition and financial statement schedules for the Stotler Partnership . . . and (2) allowing the Stotler Partnership to rely on these reports . . . .").

111. *Id*. at 432.

112. *See* Dublin Sec. Inc. v. Hurd, 197 B.R. 66 (S.D. Ohio 1996), *aff'd* 133 F.3d 377 (6th Cir. 1997).

113. *Id*. at 73.

114. *Id*. at 69.

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part, to their role as managers of the primary violator, so too did the *Flecker* and *Cooper* courts impose primary liability upon the secondary actor defendants due to their role or relationship with the primary violator client.[115]

2. Decisions Coinciding with the Second Circuit's Standard

An important case espousing the Second Circuit's standard and in fact relied upon in many of the more recent decisions handed down in the Second Circuit, is *Anixter v. Home-Stake Prod. Co*.[116] In *Anixter*, the Tenth Circuit Court of Appeals articulated the bright line standard, stating that in order for accountants to be held liable under Section 10(b) "they must themselves make a false or misleading statement (or omission) that they know or should know will reach potential investors."[117] In addition, the Tenth Circuit expressly rejected the Ninth Circuit's standard, stating that "to the extent these [Ninth Circuit] cases allow liability to attach without requiring a representation to be made by [a] defendant, and reformulate the 'substantial assistance' element of aiding and abetting liability into primary liability, they do not comport with Central Bank of Denver."[118] Finally, the court stated that the standard *Anixter* adopted "provides more guidance to litigants than a rule allowing liability to attach to an accountant or other outside professional who provided 'significant' or 'substantial' assistance to the representations of others."[119]

In *Vosgerichian v. Commodore Int'l*, a district court in Pennsylvania refused to extend primary liability upon the defendant auditing firm of Arthur Andersen. The firm allegedly assisted its client, a computer manufacturing firm, in perpetrating securities fraud by advising or concurring, guiding and approving the manufacturer's decisions regarding the alleged misrepresentations.[120] The court concluded that "plaintiff's allegations . . . [we]re insufficient to support any claim other than one for aider and abettor liability, which has now been abolished."[121] Thus, the court's finding stated that an accounting or auditing firm that merely advises or gives guidance to a client, who in turn allegedly makes a fraudulent misrepresentation, is

115. *Id*. at 66. *See* Flecker v. Hollywood Entertainment Corp., 1997 WL 269448, at *9 (D.Or. Feb. 12, 1997), where the defendant underwriters were held liable due to their "role as analysts, investment bankers and business advisors with extensive contacts with Hollywood defendants"; *see also* Cooper v. Pickett, 137 F.3d at 629 (9th Cir. 1997), where the defendant underwriters were held liable due to their purported access to inside information and close relationship with the primary violator issuer.

116. Anixter v. Home-Stake Prod. Co., 77 F.3d 1215 (10th Cir. 1996).

117. *Id*. at 1226.

118. *Id*. at 1226 n.10.

119. *Id*. at 1227.

120. *See* Vosgerichian v. Commodore Int'l, 862 F.Supp. 1371, 1378 (E.D. Pa. 1994) (Plaintiff's allegations included that "Commodore 'consulted Arthur Andersen' and that 'AA advised or concurred with Commodore's decision[s]. . . .").

121. *Id*. at 1378.

insufficient for imposing Section 10(b) liability.[122] Such a holding is clearly in accordance with the Second Circuit's bright line standard.

Another instance of a court applying the Second Circuit's bright line standard is *In re Kendall Square Research Corp. Sec. Litig.*[123] The *Kendall Square* court refused to impose liability upon the defendant accounting firm of Price Waterhouse, whose only role was to review and approve the client's financial statements and prospectuses.[124] The court stated that the "activities do not rise to the level of actionable conduct set forth by the Supreme Court in Central Bank. . . ."[125] The court reiterated an important aspect of the bright line standard, that of attribution, by stating "[b]ecause Price Waterhouse did not actually engage in the reporting of the financial statements and Prospectuses, but merely reviewed and approved them, the statements are not attributable to Price Waterhouse and thus Price Waterhouse cannot be found liable for making a material misstatement."[126]

Although the Second Circuit's standard is narrower than the Ninth Circuit's, it does not follow that secondary actors are always free from liability under such a standard.[127] In the Fifth Circuit Court of Appeals case, *Trust Co. of La. v. N.N.P. Inc*., the court applied the Second Circuit bright line standard, yet held an attorney primarily liable for violations of Section 10(b) and Rule 10(b)(5).[128] In *Trust Co.*, an attorney, who was the supposed custodian of collateralized certificates, made a material fraudulent omission by not disclosing that he did not hold the certificates, but only the assignments of interests in the certificates.[129] The court, in finding the defendant attorney liable, stated that the attorney "made material misstatements in connection with the purchase of a security. [Plaintiffs] justifiably relied on those material misstatements and that reliance proximately caused injury to [the plaintiff]."[130]

122. The *Vosgerichian* court summarized this proposition best by stating that "Plaintiff's allegations against [defendant] do not go beyond allegations that [defendant] assisted [primary violator] in perpetrating securities fraud and are thus not cognizable." *Vosgerichian*, 862 F.Supp. at 1378.

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

124. *Id*. Recognizing that defendant's sole role was to provide review and approval, the *Kendall Square* court stated "[t]he Court rules that the CAC's allegations that Price Waterhouse reviewed and approved the quarterly financial statements and the Prospectuses do not constitute the making of a material misstatement; at most, the conduct constitutes aiding and abetting and is thus not cognizable under Section 10(b)." *Id.* at 28.

125. *Id*.

126. *Id*.

127. *See e.g.*, *In re* MTC Elec. Tech. Shareholders Litig., 898 F.Supp. 974, 988 (E.D. N.Y. 1995) (defendant accountants held primarily liable for misrepresentations and omissions they personally made).

128. Trust Co. of La. v. N.N.P., Inc., 104 F.3d 1478 (5th Cir. 1997).

129. *Id*. at 1482.

130. *Id*. at 1491.

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As can be seen, both the Ninth and Second Circuits' standards have received support and application from other courts. However, this Note will argue in the following sections that should the Supreme Court chose to eliminate the split in the circuits, the Second Circuit's standard should prevail.

IV. ANALYSIS OF THE NINTH AND SECOND CIRCUIT STANDARDS

A. *The Ninth Circuit's Standard: A Lack of Culpability, Reliance, and Objectivity*

The Ninth Circuit's standard, imposing primary liability upon secondary actors for their "intricate involvement" or "substantial participation" in the material misstatement or omission of the primary violator, is entirely too broad. Under such a standard, secondary actors playing only a minor role, such as consultant or auditor, are subject to the same consequences as primary violators, responsible for actually making the fraudulent misstatement or omission. Thus, there exists a great degree of disparity in terms of culpability.

For example, the accounting firm defendant in *Software Toolworks*, who only "reviewed" and "discussed" their client's letters, containing the alleged fraudulent misstatements, could, like the primary violator, be held primarily liable under Section 10(b).[131] Ultimately it is the primary violator who made the misrepresentation, and as such, it is he or she who should have to pay the price. It is important to remember that in the real world of securities disclosure counseling, ultimately the decisions and risks concerning what to disclose and how to disclose it belong not to the attorney or accountant, but to the client. In the end, it is the client, as issuer, who makes the disclosure containing the alleged misstatement or omission. Additionally, the administrative feasibility of the secondary actor sifting through every aspect of their client's business in order to detect potentially omitted facts would be difficult, if not impossible.

Another major problem with the Ninth Circuit's standard is that it essentially disregards an essential element of primary liability—that of reliance on the part of the plaintiff.[132] To illustrate, in *ZZZZ Best*, the defendant was held primarily liable despite the fact that the documents containing the alleged misstatements included no indication that defendant Ernst & Young had anything to do with them.[133] How could the plaintiff investors have relied upon Ernst & Young's substantial participation or intricate involvement in the alleged misrepresentation if they did not even know Ernst & Young was involved? Although secondary actors, by the very nature of their role, are

131. *See supra* note 48 and accompanying text.

132. *See supra* note 34. To reiterate, the generally accepted elements of primary liability under Section 10(b)/Rule 10b-5 are: (1) a misrepresentation or omission, (2) of a material fact, (3) made with scienter, (4) that plaintiff relied upon, and (5) caused the plaintiff injury.

133. *See supra* note 41 and accompanying text.

generally "behind the scenes" participants in the sale and issuance of securities, that does not mean that their activities can never result in reliance on the part of the plaintiff. However, absent the secondary actor actually making the misrepresentation or omission himself, reliance on the part of the plaintiff will be difficult to find.

Along the same lines, the very role of the secondary actor, inherent in his or her profession, seems to play a part in the overly-broad standard the Ninth Circuit espouses. In *Flecker v. Hollywood Entertainment Corp*., the defendant underwriters were held primarily liable based upon their relationship with the primary violator client and their role as investment bankers and business advisors, as opposed to participation in any particular misrepresentation or omission.[134] Similarly, in both *Cooper v. Picket*[135] and *In re Dublin Sec. Inc.,*[136] the defendants' relationship with the primary violator client was a major consideration in imposing primary liability. The problem with allowing a secondary actor's role or relationship with the client to factor into the determination of whether or not to impose primary liability is that it will likely have the adverse effect of discouraging the secondary actor from performing their function in an appropriate manner. Furthermore, the imposition of liability based upon a professional's degree of involvement may have the practical effect of punishing him or her for professionally responsible behavior. The very purpose of engaging securities professionals is to obtain their assistance in the preparation of the required disclosure documents, yet a professional, assisting the client in preparation of such documents, may thereby be subject to liability under the Ninth Circuit's standard. Consequently, lawyers, although advisors by nature, may be hesitant to offer advice to clients. Worse yet, lawyers may even hesitate to enter into transactions with a client involved in the sale or purchase of securities, for fear of facing primary liability under Section 10(b)/Rule 10(b)(5). Likewise, accountants may be apprehensive to properly audit or even enter into an audit relationship with clients they fear are at risk for committing a fraudulent misrepresentation or omission. In the end, this will only disserve the investing public, the intended target of protection under Section 10(b).

A final flaw in the "substantial participation" or "intricate involvement" standard is that it lacks objectivity, a concern the *Central Bank* court expressly deemed undesirable.[137] Under such a loose standard there is no threshold amount of involvement or participation necessary before imposing primary liability upon secondary actors. For example, in *Software Toolworks Inc.*, the defendants were held liable for merely "review and discussion" of the

134. *See supra* notes 67 and 68 and accompanying text.

135. *See supra* note 72 and accompanying text.

136. *See supra* note 114 and accompanying text.

137. Central Bank v. First Interstate Bank, 511 U.S. 164, 188 (1994).

materials containing the alleged misstatements.[138] At the other end of the spectrum, the defendant accounting firm in *Cooper v. Pickett* was held primarily liable for knowingly certifying false and misleading financial statements of their client.[139]

These seemingly inconsistent impositions of liability provide secondary actors with no gauge of what type or amount of participation or involvement confers liability. For example, an attorney, assisting a client in preparing disclosure documents, would have no way of knowing whether his or her efforts amounted to such a substantial or intricate role in the creation of the disclosure that the attorney would be primarily liable, rather than just an advisor or scrivener. Furthermore, under the Ninth Circuit's standard, *Central Bank* could be rendered toothless by permitting a plaintiff, who essentially drafted an aider/abettor complaint, to simply amend the complaint on the same set of facts to allege primary liability.

Despite all of its problems, there are some benefits to the Ninth Circuit's standard. For instance, the wide standard of liability it imposes undoubtedly alerts secondary actors to the possibility of primary liability, which may, in turn, lead to better and more thorough disclosure from the client to the investing public. Additionally, the expansiveness of the Ninth Circuit's standard would likely allow a greater number of aggrieved plaintiffs to get their day in court. Unfortunately, however, the benefits of the "substantial participation" or "intricate involvement" standard are far outweighed by the standard's flaws, which are not present in the Second Circuit's standard.

B. The Second Circuit's Standard: A Bright Line

The Second Circuit's standard, though not infallible, seems to alleviate the aforementioned problems related to the Ninth Circuit's standard. By imposing primary liability upon secondary actors only when they have actually made the material misstatement or omission and such misstatement or omission is attributed to them at the time of dissemination, the problems regarding culpability, reliance and lack of objectivity disappear.

The "bright line" standard espoused by the Second Circuit imposes primary liability upon secondary actors in the same fashion it imposes liability upon primary actors— that is both may be found liable under Section 10(b)/Rule 10(b)(5) if they make a material misstatement or omission.[140] For example, not only was the primary violator liable in *In re MTC Elec. Tech.*

138. *In re* Software Toolworks Inc. Litig., 50 F.3d at 628 n.3; *see also* note 48 and accompanying text and note 131 and accompanying text.

139. *See supra* note 71 and accompanying text.

140. When both primary and secondary actors are held liable for the material misstatement or omission, the difficulty of determining who actually made the disclosure is eliminated, thereby decreasing the chances of a "he said, she said" argument.

Shareholders Litig., but the accountant who had personally made material misstatements was also held liable.[141]

On the contrary, if only the primary actor made the material misstatement or omission, while the secondary actor merely participated in some other facet of the transaction without making the misstatement or omission, the primary violator will be subject to liability and the secondary actor will not. For instance, while the primary violator in *Kendall Square* was found liable under Section 10(b), defendant Price Waterhouse, who "merely reviewed and approved" the financial statements housing the alleged misstatements, was not.[142] Thus the disparity in culpability found in the application of the Ninth Circuit's standard is not present under the Second Circuit's standard.

Directly related to the culpability issue is the issue of objectivity. Under the "bright line" standard, a secondary actor is primarily liable under Section 10(b)/Rule 10(b)(5) when he or she makes a material misstatement or omission, and such misstatement or omission can be attributed to the secondary actor at the time of dissemination. Thus, whether the secondary actor makes one misstatement or one thousand misstatements, he or she will be subject to primary liability, assuming the misstatement is attributable to the actor at the time of dissemination. There is no minimum threshold determination involved in the Second Circuit's standard— if a secondary actor made a misstatement or omission, not participated in making one or was intricately involved in the making of one, he or she may be subject to liability.

Unlike the Ninth Circuit's standard, subjectivity does not enter into the imposition of liability under the "bright line" rule. Furthermore, the Second Circuit's standard provides predictability for secondary actors. To reiterate, it is irrelevant whether the secondary actor "substantially participated" in making his own misstatement or was "intricately involved" in making it. If the secondary actor made a misstatement, substantially, intricately or otherwise, he is subject to liability under Section 10(b)/Rule 10(b)(5).

Furthermore, the second prong of the standard, "attributable to the actor at the time of dissemination," abates any doubts regarding reliance on the part of the plaintiff. Similar to the facts in *ZZZZ Best,*[143] the documents containing the alleged misstatement in *Wright v. Ernst & Young* made no reference to the secondary actor defendant Ernst & Young.[144] Unlike *ZZZZ Best*, however, the *Wright* court refused to impose liability upon Ernst & Young, recognizing that plaintiff investors could not have possibly relied upon the alleged misstatements, which moreover, were made by the primary rather than

141. *See supra* notes 82 and 83 and accompanying text.

142. *See supra* notes 124-26 and accompanying text.

143. *See supra* note 133.

144. *See supra* note 99 and accompanying text.

secondary actor.[145] The *Wright* court concluded "a secondary actor cannot incur primary liability under the Act for a statement not attributed to the actor at the time of its dissemination."[146] Thus, under the Second Circuit's "bright line" standard, reliance on the part of the plaintiff, an essential element of primary liability, remains intact.

Finally, the Ninth Circuit's practice of using the secondary actor's role or relationship with the client as a factor in determining primary liability is nonexistent in the Second Circuit's standard. In one of the few Second Circuit cases that mentions the secondary actor's role, *Shapiro v. Cantor,*[147] it worked to the secondary actor's benefit, not detriment, as it would in the Ninth Circuit. In *Shapiro*, the court refused to impose liability upon the defendant accountants. Plaintiff's allegations were not that the defendant had actually made a material misstatement or omission, but rather that liability should be imposed based upon defendant's specific "participating" role in selling interests of their clients, despite the fact that defendant's only role was in providing financial projections included in the offering memoranda.[148] The court reasoned that "because [defendant's actions were] consistent with the role of an accountant,"[149] imposing primary liability would not be proper.

V. POLICY CONSIDERATIONS IN SUPPORT OF THE SECOND CIRCUIT'S STANDARD

Not only does the Second Circuit's standard alleviate the aforementioned problems associated with the "substantial participation" or "intricate involvement" standard, it also proves to be superior to the Ninth Circuit's standard under policy considerations.

The Ninth Circuit's standard for imposing primary liability, which does not substantially differ from the now nonexistent standard formerly used to impose secondary liability upon aiders and abettors, presents many of the same policy concerns *Central Bank* addressed when eliminating aider and abettor liability.[150] Similar to the standard previously employed for imposing secondary liability upon aiders and abettors, the Ninth Circuit's standard "exacts costs that may disserve the goals of fair dealing and efficiency in securities markets."[151] As explained earlier, these costs might derive from the creation of confusion among those who provide services to issuers "in an area

145. *See supra* notes 99-102 and accompanying text.

146. Wright v. Ernst & Young, 152 F.3d 169, 175 (2d Cir. 1998).

147. *See supra* notes 94 and 95 and accompanying text.

148. *See supra* note 93.

149. Shapiro v. Cantor, 123 F.3d 717, 722 (2d Cir. 1997).

150. These policy concerns, as identified in *Central Bank*, include the lack of predictability, the settlement pressures imposed by fact based liability standards, and the risk of vexatious litigation. *See* Central Bank v. First Interstate Bank, 511 U.S. 164, 188-89 (1994).

151. *Central Bank*, 511 U.S. at 188.

of law that demands certainty and predictability."[152] Furthermore, adherence to the Ninth Circuit's standard would expose a myriad of parties to the danger of vexatious litigation "different in degree and kind from that which accompanies litigation in general."[153]

Adopting the more stringent standard that the Second Circuit espouses would eliminate unnecessary litigation by plaintiffs who are merely searching for deep pockets. The unfortunate motivation for some plaintiffs seeking to impose primary liability upon secondary actors is merely a search for deep pockets. Assume, for instance, that a start-up company, with little capital, made a fraudulent misrepresentation or omission in their initial public offering documents. An aggrieved plaintiff, aware of the fact that they will be afforded little relief from the financially infirm primary violator, may look to impose primary liability upon the secondary actor, say a "Big Five," financially sound, accounting firm. The accounting firm that did not actually make the misstatement or omission itself, may be held liable under a looser standard than that which the Second Circuit imposes, and thus allow the plaintiff to reach into its deep pockets.[154] The "bright line" standard, which would not impose liability upon the accounting firm absent a finding that it actually made a material misstatement or omission and that it could be attributed to the firm at the time of dissemination, prevents such an unjust result.

Furthermore, the Second Circuit's standard would decrease unnecessary litigation overall, because it does not allow plaintiffs to name as defendant every secondary actor involved in a transaction where fraud is present in connection with the sale and purchase of securities. Only when the plaintiffs relied upon the secondary actor's misstatement or omission at the time of dissemination can such an actor be legitimately named a defendant subject to primary liability under Section 10(b)/Rule 10(b)(5).

Additionally, if, as under the Ninth Circuit's standard, secondary actors such as lawyers or accountants are at risk of being held primarily liable for substantial participation or intricate involvement in their client's statements containing material misstatements or omissions to the shareholders, then such secondary actors will likely step back from the process. Not only will the outside investors, who benefit from the involvement of outside professionals in the preparation process, be harmed if this results, but so too will the clients. Ironically, it is the shareholders who will ultimately pay the price for increased legal and accounting fees if attorneys and accountants are forced to "over-lawyer" and "over-account" disclosure advice.

152. *Id*. (quoting Pinter v. Dahl, 486 U.S. 622, 652 (1988)).

153. *Id*. (quoting Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 755 (1975)).

154. All of this relates to the court's worry in *Central Bank* that creating Rule 10(b)(5) liability for professionals in such cases would make it difficult for "newer and smaller companies" to obtain advise from professionals. *See Central Bank*, 511 U.S. at 189.

On the other hand, under the "bright line" standard, secondary actors such as lawyers and accountants will not constantly have the threat of liability hanging over their head. The predictability that the Second Circuit's standard provides secondary actors— that is, they need not worry that they will face Section 10(b)/Rule 10(b)(5) liability unless they actually make a material misstatement or omission— will not impair their ability to participate in the disclosure process. This will ultimately result in better and more thorough disclosure, which benefits the intended targets of Section 10(b), the investors.

A final point in favor of the Second Circuit's "bright line" standard, which essentially argues that the scope of liability for secondary actors should be drawn narrowly, is that it is aligned with the current trend to limit securities fraud litigation overall. For example, the Private Securities Litigation Reform Act ("PSLRA"),[155] passed in 1995 over President Clinton's veto, contains a variety of procedural and substantive reforms designed to reduce the volume of private securities fraud litigation, mainly class actions, and to curb litigation abuse.[156] Such reforms include a heightened pleading standard, a safe harbor provision for forward looking statements, and the creation of a lead plaintiff to monitor litigation decision making.[157] Additionally, the Securities Litigation Uniform Standards Act of 1998 limited securities fraud litigation in the federal courts and tangentially in state courts.[158] The effect of the statute was to preempt state law causes of action for fraud and essentially leave federal liability as the exclusive remedy for investors. While the Second Circuit's standard seems to intimate this trend to decrease securities fraud litigation, it does not follow that meritorious claims will be overlooked. Rather, the "bright line" standard will capture wrongdoers and impose liability in proportion to culpability. When the secondary actor has actually made a material misstatement or omission and it is attributable to him or her at the time of dissemination, liability will be imposed.

VI. CONCLUSION

The permissible scope of professional liability for secondary actors will continue to be tested under a variety of factual circumstances in the coming years. Unfortunately, until a case arises in which the Supreme Court grants certiorari to determine which standard for imposing primary liability upon secondary actors should endure, the split between the Ninth and Second

155. Private Securities Litigation Reform Act, Pub. L. No. 104-67, 109 Stat. 737 (codified in scattered sections of 15 U.S.C.).

156. *See supra* note 25 and accompanying text.

157. *Id.*

158. Securities Litigation Uniform Standards Act of 1998, Pub. L. No.105-353, 112 Stat. 3227 (codified in scattered sections of 15 U.S.C.).

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Circuits will remain. Yet when the time comes for the issue to be finally determined, the Second Circuit's "bright line" standard should prevail.

One of the expressed goals of the Supreme Court in *Central Bank* was to end the confusion and uncertainty inherent in the concept of secondary liability for securities fraud violations.[159] This goal can only be achieved by imposing liability while staying within the confines of primary liability. The Second Circuit's "bright line" standard, which deters secondary actors from participating in fraudulent activities, serves this goal better than the Ninth Circuit's "intricate involvement" or "substantial participation" standard. Judge Gleeson, in *In re MTC Elec. Tech. Shareholders Litig.*, summed up the superiority of the "bright line" standard best by stating that if *Central Bank* is to have any meaning at all, "a defendant must actually make a false or misleading statement in order to be held liable under Section 10(b). Anything short of such conduct is merely aiding and abetting, and no matter how substantial that aid may be, it is not enough to trigger liability under Section 10(b)."[160]

In the end, it appears that the real answer to the question of what type of activity constitutes primary liability amongst secondary actors can be found in *Central Bank* itself. To state a claim for securities fraud under Section 10(b)/Rule 10(b)(5), the plaintiff must plead that each defendant, secondary actor or otherwise, committed all the traditional elements of the wrong: (1) a misrepresentation or omission, (2) of a material fact, (3) made with scienter, (4) that plaintiff relied upon, (5) causing injury to the plaintiff.[161] The Second Circuit's "bright line" standard, unlike the Ninth Circuit's "substantial participation" or "intricate involvement" standard, encompasses all five traditional elements of primary liability. *Central Bank* did nothing to change the elements of primary liability under Section 10(b), it merely eliminated the aiding and abetting cause of action as means of imposing liability. If plaintiff cannot prove a secondary actor defendant has met all five of the elements, then the plaintiff has no cause of action under Section 10(b)/Rule 10(b)(5), regardless of whether defendant is a primary or secondary actor.

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159. *See* Central Bank v. First Interstate Bank, 511 U.S. 164, 165 (1994).

160. *In re* MTC Elec. Tech. Shareholders Litig., 898 F.Supp. 974, 987 (E.D.N.Y. 1995).

161. *See supra* notes 34 and 132. Although the court in *Central Bank* did not spell out the generally accepted elements of securities fraud under Section 10(b)/Rule 10(b)(5), the court did state that "[a]ny person or entity, including a lawyer, accountant, or bank, who employs a manipulative devise or makes a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator under 10b-5, assuming all of the requirements for primary liability under Rule 10b-5 are met." *Central Bank*, 511 U.S. at 191 (1994).

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