

AIDING AND ABETTING LIABILITY UNDER SECTION 10(b):

***Can Plaintiffs “Scheme” a Way Around
Central Bank under Subsections (a) and (c) of Rule 10b-5?***

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INTRODUCTION

In 1994, the United States Supreme Court surprised many securities practitioners by ruling in *Central Bank*¹ that there is no private cause of action for aiding and abetting an alleged securities fraud under Section 10(b) of the Securities Exchange Act of 1934. That decision was welcomed by secondary players in the market, such as lawyers, investment bankers and accountants, whose professional roles to public companies (and deep pockets) made them frequent targets for aider and abettor claims. While abolishing aiding and abetting liability under Section 10(b), the *Central Bank* Court nonetheless reaffirmed that secondary actors could still be found liable as primary violators under Section 10(b).

Subsequent to *Central Bank*, the lower courts have divided as to how to interpret the scope of primary liability under Section 10(b) and Rule 10b-5(b) in cases where the allegations involve misleading misstatements or omissions. Under the stricter “bright line” test, a secondary actor cannot be held liable as a primary violator unless the misleading statement is attributable to him. The less demanding “substantial participation” test permits liability if the secondary actor had some significant participation in the preparation of the misstatement.

With the difficulties of pleading a primary violator claim for misrepresentations under Rule 10b-5(b) against secondary actors, there has been a recent effort by plaintiffs to expand primary liability by asserting claims under subsections (a) and (c) of Rule 10b-5 for alleged

¹ *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164, 177 (1994).

“schemes to defraud” and other “fraudulent practices.” Although this effort is being led by plaintiffs, the Securities and Exchange Commission (“SEC”) has also entered the fray. At the end of last year, the SEC filed an *amicus* brief in the *Homestore.com* appeal pending in the Court of Appeals for the Ninth Circuit.² The SEC argues in its brief that the Ninth Circuit should adopt a broad definition of primary liability for persons who engage in deceptive conduct as part of a scheme to defraud. If the Ninth Circuit, which is expected to hear oral arguments in May, adopts the SEC’s proposed definition, it could effectively wind back the clock to the pre-*Central Bank* days, when the professional conduct of lawyers, accountants and bankers could form the basis for liability under the federal securities laws.

AIDING AND ABETTING LIABILITY PRIOR TO *CENTRAL BANK*

To understand the significance of the ongoing battle over the scope of primary liability under Section 10(b), one must have some appreciation for the aiding and abetting landscape before and after *Central Bank*. Prior to the Supreme Court’s ruling in *Central Bank*, there was a general consensus among the federal courts that Section 10(b) and Rule 10b-5 reached not only those persons who actually made a material misstatement, but also those persons who aided and abetted such a violation.³ Some commentators even remarked that the concept of secondary liability was so widely accepted prior to *Central Bank* that “all 11 federal circuits had approved the concept of liability under Rule 10b-5 for aiding and abetting a primary violation of the securities laws.”⁴ While that may be a slight overstatement, the overwhelming majority of

² See *Simpson v. Homestore.com, Inc.*, Appeal No. 04-55665 (9th Cir.).

³ See, e.g., *First Interstate Bank of Denver v. Pring*, 969 F.2d 891, 904 (10th Cir. 1992); *Brennan v. Midwestern United Life Ins. Co.*, 417 F.2d 147 (7th Cir. 1969); *Cleary v. Perfectune, Inc.*, 700 F.2d 774, 777 (1st Cir. 1983); *Kerbs v. Fall River Indus., Inc.*, 502 F.2d 731, 740 (10th Cir. 1974). But see *Barker v. Henderson, Franklin, Starnes & Holt*, 797 F.2d 490, 495 (7th Cir. 1986).

⁴ Daniel L. Brockett, *Line Between Primary and Secondary Liability Still Blurred in Securities Cases*, 50 *Federal Lawyer* 29, 29 (Aug. 2003).

courts did take the view that “[i]n the absence of a clear legislative expression to the contrary, [the 1934 Act] must be flexibly applied so as to implement its policies and purposes.”⁵

Because the 1934 Act does not expressly disapprove aiding and abetting claims under Section 10(b), most federal courts concluded that private litigants were entitled to bring aiding and abetting claims, provided the elements could be met. In order to allege a Section 10(b) aiding and abetting claim, plaintiffs had to show that there was: (1) a primary violation of Section 10(b); (2) actual knowledge (or at least a general awareness) by the aider and abettor as to the existence of the primary violation; and (3) substantial assistance given to the primary violator by the aider and abettor.⁶

THE *CENTRAL BANK* DECISION

So well settled was the question of aiding and abetting liability under Section 10(b) that neither the parties nor the lower courts in the *Central Bank* lawsuit even raised the issue. Rather, it was the Supreme Court that instructed the parties to address the issue of whether there was civil liability for aiding and abetting a violation of Section 10(b).

The *Central Bank* case involved a typical claim of liability against a secondary actor where the actor did not make a misleading statement, but engaged in conduct related to the issuer’s misrepresentation. In that case, a public housing authority issued bonds to finance public improvements. The bonds were secured by land assessment liens and the bond covenants required that the land be valued at 160% of the value of the bonds. Six months before closing, the indenture trustee for the bonds, Central Bank, became concerned that the 160% requirement would not be met in light of decreasing land values. Central Bank delayed, however, ordering an outside appraisal of the land until after the bond closing. When the housing authority

⁵ *Brennan v. Midwestern United Life Ins. Co.*, 259 F. Supp. 673, 680-81 (N.D. Ind. 1966), *aff’d*, 417 F.2d 147 (7th Cir. 1969).

⁶ *See, e.g., Levine v. Diamantheset, Inc.*, 950 F.2d 1478, 1493 (9th Cir. 1991).

subsequently defaulted on the bonds, Central Bank was sued for its acquiescence as an aider and abettor of the primary violators, the housing authority and the underwriters.⁷

In deciding whether there was a private cause of action against Central Bank for aiding and abetting a Section 10(b) violation, the Supreme Court focused on the statutory text of the 1934 Act. Neither that Act nor the Securities Act of 1933 expressly provides for aider and abettor liability. The Court concluded, based on the statutory text, that Congress intended that only primary violators could be liable under Section 10(b) and that the Act “does not itself reach those who aid and abet . . . [but] prohibits only the making of a material misstatement (or omission) or the commission of a manipulative act.”⁸ The Court also expressed the concern that authorizing a Section 10(b) cause of action based on aiding and abetting would circumvent the reliance requirement of Rule 10b-5 by allowing a plaintiff to recover damages without having to show that he “relied upon the aider and abettor’s statements or actions.”⁹

The Court did not hold, however, that secondary actors are always free from liability under the 1934 Act. Rather, the Court cautioned that “[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 10b-5, assuming *all* of the requirements for primary liability under Rule 10b-5 are met.”¹⁰

⁷ *Central Bank*, 511 U.S. at 167.

⁸ *Id.* at 177. The Court reached this conclusion despite the position asserted by the SEC in its *amicus* brief that aiding and abetting liability should be permitted under § 10(b). Those who would argue that the SEC’s interpretations are entitled to great deference under *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984) should take note of this fact. See also Andrew S. Gold, *Reassessing the Scope of Conduct Prohibited by § 10(b) and the Elements of Rule 10b-5: Reflections on Securities Fraud and Secondary Actors*, 53 *Cath. U. L. Rev.* 667 (2004).

⁹ *Central Bank*, 511 U.S. at 180; see also *Basic, Inc. v. Levinson*, 485 U.S. 224, 243 (1988) (rejecting liability under Rule 10b-5 without reliance).

¹⁰ *Central Bank*, 511 U.S. at 191.

Thus secondary actors, freed from aiding and abetting liability under Section 10(b), could still be found liable as primary violators. Not presented with such a claim, however, the *Central Bank* Court did not provide any guidance on what actions or statements by secondary actors could amount to a primary violation of Section 10(b).

POST *CENTRAL BANK*

Subsequent to *Central Bank*, claims against secondary actors were largely relabeled as “primary” violations instead of aiding and abetting claims. This, in turn, led to a split among the federal courts over how to define the contours of a primary liability claim against secondary actors under Section 10(b). Under the “bright line” test, adopted by a majority of the circuit courts addressing the issue, a secondary actor can violate Section 10(b) only by directly or indirectly making a false statement (or omission).¹¹ The “substantial participation” test, on the other hand, imposes primary liability on a secondary actor based on her “substantial participation” or “intricate involvement” in the preparation of misstatements by others.¹² Interestingly, the two federal circuits that historically have seen the most securities lawsuit filings -- the Second and Ninth -- have come down on opposite sides of the primary liability divide.¹³

¹¹ See *Wright v. Ernst & Young LLP*, 152 F.3d 169, 175 (2d Cir. 1998); *Anixter v. Home-Stake Prod. Co.*, 77 F.3d 1215, 1225 (10th Cir. 1996); *Ziamba v. Cascade Int’l, Inc.*, 256 F.3d 1194, 1205 (11th Cir. 2001).

¹² See, e.g., *In re Software Toolworks, Inc. Sec. Litig.*, 50 F.3d 615, 628 n.3 (9th Cir. 1994) (stating that accountant may be primarily liable based on its “significant role in drafting and editing” a letter sent by the issuer to the SEC); *In re ZZZZ Best Sec. Litig.*, 864 F. Supp. 960, 970 (C.D. Cal. 1994) (ruling that accounting firm was “intricately involved” in creation of false documents and its “resulting deception” was a primary violation of § 10(b)).

¹³ In 2004, there were 233 new securities lawsuits filed in the federal courts. Sixty-four of those lawsuits were filed in the Ninth Circuit and forty-five were filed in the Second Circuit. See *Stanford Securities Class Action Clearinghouse* Press Release, available at http://securities.stanford.edu/scac_press/20050103_CR_SCAC.pdf.

**“Bright Line” Test for Misrepresentation/Omission Cases:
(Majority View -- 2d, 10th and 11th Circuits)**

In *Shapiro v. Cantor*, the first misrepresentation case that the Second Circuit Court of Appeals considered after *Central Bank*, the court adopted the “bright line” test for defining the scope of primary liability for secondary actors. The court observed:

“[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).”¹⁴

In subsequent cases, the Second Circuit developed a clear and consistent policy with regard to the standard of liability of secondary actors in misrepresentation and omission cases. To establish a primary violation in the Second Circuit, a plaintiff must show that the secondary actor actually made the false or misleading statement on which the plaintiff relied; mere “review and approval” is not enough. While the secondary actor need not directly communicate the statement to investors, the statement must be attributed to the secondary actor. For example, an accountant may not be held liable for misleading unaudited statements because those statements are not attributed to the accountant.¹⁵

¹⁴ See *Shapiro v. Cantor*, 123 F.3d 717, 720 (2d Cir. 1997).

¹⁵ See *Wright v. Ernst & Young LLP*, 152 F.3d 169, 175 (2d Cir. 1998), *cert. denied*, 525 U.S. 1104 (1999). In this case, the Second Circuit found that Ernst & Young was not a primary violator, even though it had reviewed an allegedly false press release, because the financial data in the release did not mention Ernst & Young and it was labeled as unaudited. It appears, however, that the bright line test might be fading in the lower courts of the Second Circuit. In *In re Global Crossing, Ltd. Securities Litigation*, 322 F. Supp. 2d 319 (S.D.N.Y. 2004), the plaintiffs sued Arthur Andersen for fraudulent accounting practices that enabled the company to report false earnings. Arthur Andersen, relying on the bright line test, argued that it could not be held liable for statements that were not publicly attributed to the accounting firm, even though it had assisted the company in reviewing and approving the statements. The plaintiffs claimed that Arthur Andersen’s role was so central and its role as auditor so well known that it should be subject to primary liability, even for the unaudited financials. Judge Gerard Lynch, of the Southern District of New York, agreed with the plaintiffs and admonished that “[a] strict

In 2001, the Eleventh Circuit followed the Second Circuit's lead by also adopting the bright line test in *Ziembra v. Cascade International, Inc.*¹⁶ The *Ziembra* court held that a law firm could not be held liable as a primary violator even though it had "played a significant role in drafting, creating, reviewing or editing allegedly fraudulent letters or press releases."¹⁷ The *Ziembra* court found that, in light of *Central Bank*, in order for a defendant to be primarily liable under Section 10(b), the alleged misstatement or omission that the plaintiff relied on must be publicly attributable to the defendant. The court also concluded that the outside auditors were not primary violators because they had not audited or reported on the company's financial statement, but had instead audited and reported on the financial statements of two subsidiaries.¹⁸

**"Substantial Participation" Test for Misrepresentation/Omissions Cases:
(Minority View -- 9th Circuit)**

By applying a "substantial participation" test, the Ninth Circuit Court of Appeals takes a more expanded view of primary liability for those who do not actually make an alleged misstatement. In *In re Software Toolworks Inc. Securities Litigation*, the Ninth Circuit held that the accounting firm of Deloitte & Touche LLP could be held primarily liable for falsehoods contained in two letters submitted by its client to the SEC because Deloitte had "played a significant role in drafting and editing" the letters.¹⁹ In contrast, under the bright line test,

requirement of public attribution would allow those primarily responsible for making false statements to avoid liability by remaining anonymous." *Id.* at 333.

¹⁶ 256 F.3d 1194 (11th Cir. 2001).

¹⁷ *Id.* at 1202.

¹⁸ The Tenth Circuit has also applied the bright line test to narrow the scope of primary liability for secondary actors. See *Anixter v. Home Stake Prod. Co.*, 77 F.3d 1215, 1226 (10th Cir. 1996) (finding that liability for outside professionals can only arise when they "make a false or misleading statement (or omission) that they know or should know will reach potential investors."); see also *In re Kendall Square Research Corp. Sec. Litig.*, 868 F. Supp. 26 (D. Mass. 1994); *Copland v. Grumet*, 88 F. Supp. 2d 326 (D.N.J. 1999).

¹⁹ *In re Software Toolworks Inc. Sec. Litig.*, 50 F.3d 615, 628 (9th Cir. 1994).

Deloitte would have had no primary liability for its client's letters because it neither made nor had attributed to it the misstatements.²⁰

**Expanding Liability of Secondary Actors for “Schemes”
and “Fraudulent Conduct” under Subsections (a) and (c) of Rule 10b-5**

Despite the more relaxed interpretation of the Ninth Circuit's substantial participation test, plaintiffs nonetheless faced an uphill battle in most circuits under the bright line rule. That, in combination with the Supreme Court's recent holding in *SEC v. Zandford*,²¹ has led plaintiffs to pursue a new avenue of liability.

In *Zandford*, the Supreme Court held that a stockbroker violated Rule 10b-5 when he sold his customers' securities and unlawfully pocketed the proceeds. Although there was no fraudulent statement or omission, the Court found a Rule 10b-5 violation, stating that “this Court has [n]ever held that there must be a misrepresentation about the value of a particular security in order to run afoul of the Act.”²² Even though the Court's opinion dealt primarily with the “in connection with” prong of a Section 10(b) claim, it signaled to plaintiffs the Court's possible willingness to draw upon subsections (a) and (c) of Rule 10b-5 as a source of potential liability for secondary actors who have not themselves directly made a misrepresentation or omission.

The express language of Section 10(b) is not limited simply to material misstatements and omissions. Rather, Section 10(b) makes it unlawful “for any person, directly or indirectly . .

²⁰ Although no other Circuit Court of Appeals has adopted the substantial participation test, some district courts have followed it. *See, e.g., In re ZZZZ Best Sec. Litig.*, 864 F. Supp. 960, 970 (C.D. Cal. 1994) (holding that accounting firm may be primarily liable based on being “intricately involved” in creating a client's false documents); *McNamara v. Bre-X Minerals, Ltd.*, 57 F. Supp. 2d 396, 430 (E.D. Tex. 1999) (finding that independent engineering company that played a significant role in developing allegedly false statements made by a mineral exploration company could be a primary violator); *Cashman v. Coopers & Lybrand*, 877 F. Supp. 425, 432 (N.D. Ill. 1995) (holding that accountant who played a central role in drafting alleged misstatement could be primary violator).

²¹ 535 U.S. 813 (2002).

²² *Id.* at 820.

. [t]o use or employ . . . *any manipulative or deceptive device or contrivance* in contravention of such rules and regulations as the [SEC] may prescribe as necessary or appropriate in the public interest or for the protection of investors.”²³ Building on that language, the SEC’s Rule 10b-5 prohibits three categories of conduct by making it unlawful for any person, in connection with the purchase or sale of any security, directly or indirectly:

- (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 the 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.

Thus, a material misstatement (or omission) is only one of three types of conduct prohibited by Rule 10b-5, specifically by subsection (b). Subsections (a) and (c), by contrast, prohibit “schemes to defraud” and other fraudulent “practices.” As explained below, subsections (a) and (c) of Rule 10b-5 have provided much of the support for the recent effort by plaintiffs and the SEC to expand the definition of primary liability for secondary actors.

In *In re Lernout & Hauspie Securities Litigation*,²⁴ the district court relied on subsection (a) of Rule 10b-5 (“scheme to defraud”) to deny the motions to dismiss of a venture capital fund and an insurance company. Their only role in the alleged fraud was to set up, fund and operate certain sham entities that the issuer used to book revenue from fictitious software licensing agreements. They made no misstatements and none were attributable to them. Instead, they were sued based on their allegedly fraudulent conduct and participation in the alleged scheme. Finding that no substantial participation was required in making the misstatement itself, the court

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

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

instead found that the plaintiffs had stated a claim for manipulative conduct and scheme to defraud. The court held that the “plaintiffs can satisfy the reliance requirement by alleging facts sufficient to show (1) that defendants substantially participated in a fraudulent scheme; and (2) when the scheme is viewed as a whole, the plaintiffs relied on it.”²⁵ Thus, if secondary actors substantially participate in a behind-the-scenes fraudulent scheme and have nothing to do with reviewing, approving or making the statement that actually misleads the market, they can still be primary violators under the test applied in *Lernout & Hauspie*.

The district court presiding over the *Enron* litigation applied a test falling somewhere between the bright line test and the substantial participation test for determining primary liability under Section 10(b) and Rule 10b-5.²⁶ In that case, the district court refused to dismiss the claims against the accounting firms, law firms and investment bank defendants. Adopting a so-called “creator” test proposed by the SEC,²⁷ the court held that when a person “creates a misrepresentation,” that person can be liable as a primary violator if he acts with the requisite scienter.²⁸

The *Enron* court also examined a “scheme to defraud” argument under Rule 10b-5(a) and (c) made against the investment banks. In denying the motions to dismiss of most of the banks, the court found that the defendants could be held liable under subsections (a) and (c) if they

²⁵ *Id.* at 174.

²⁶ *In re Enron Corp. Sec., Deriv. & ERISA Litig.*, 235 F. Supp. 2d 549 (S.D. Tex. 2002).

²⁷ The SEC had urged a similar test in an *amicus* brief that it filed in an earlier appeal in the Third Circuit Court of Appeals. That case involved an appeal from a district court order dismissing claims against a law firm that had helped prepare allegedly misleading statements distributed by its client to investors. *See* Brief for SEC, *Amicus Curiae* in *Klein v. Boyd*, Nos. 97-1143, 97-1261, at 14 (3d Cir. 1998). The SEC argued that the relevant test was not whether a person is identified as the author or signatory of the statement; rather, the “correct standard . . . is that when a person, acting alone or with others, *creates a misrepresentation*, the person can be liable as a primary violator.” *Id.* (emphasis added). The Third Circuit did not address this argument because the case settled while on appeal.

²⁸ *In re Enron Corp. Sec.*, 235 F. Supp. 2d at 588.

acted with scienter and employed a significant material device, contrivance, scheme or artifice that operated to defraud investors. In rejecting the defendants' argument that Enron's investors had relied on statements and not conduct, the court found that the plaintiff could meet the reliance element under the scheme to defraud prong of Rule 10b-5 by relying on the "fraud on the market" doctrine.²⁹ The court found that allegations that the defendants had used deceitful devices to paint a falsely positive picture of Enron's financial condition, and thereby artificially inflated the value of the stock, was enough to allege reliance. The district court's ruling on the motions to dismiss was a major step towards a more liberal interpretation of primary liability under Rule 10b-5 insofar that it does not require that there be a public statement attributable to the secondary actor.

Although the *Lernout & Hauspie* and *Enron* cases might suggest the beginning of a trend, other courts have been less inclined to impose primary liability on defendants who are not alleged to have made a material misstatement. In *Foss v. Bear, Stearns & Co.*,³⁰ for example, the Seventh Circuit Court of Appeals recently invoked *Central Bank's* prohibition on secondary liability in affirming the dismissal of a lawsuit against a major investment bank and one of its former employees. The plaintiff in *Foss* had alleged that a former account manager at Bear, Stearns, & Co. had helped his father-in-law abscond with millions of dollars after the father-in-law -- who had been named the administrator of a relative's estate -- found bearer stock certificates in a safe deposit box belonging to the decedent. Rather than report the certificates to the probate court, the father-in-law formed a corporation and opened an account at Bear Stearns in the corporation's name. He then asked his son-in-law to transfer ownership of the securities to the newly-formed corporation, which the son-in-law did. The father-in-law sold the securities

²⁹ *Id.* at 693.

³⁰ 394 F.3d 540 (7th Cir. 2005).

and withdrew the proceeds for his own use. After the theft came to light, the decedent's estate sued the son-in-law for securities fraud under Section 10(b) of the '34 Act and Rule 10b-5(a) and (c), and asserted that Bear Stearns was vicariously liable under Section 20(a).

The primary issue was whether the son-in-law -- who was alleged to have facilitated and knowingly assisted his father-in-law's fraud -- could be held liable as a primary violator under Rule 10b-5. The district court had ruled that he could not, inviting an appeal by the estate. In an opinion authored by Circuit Judge Frank Easterbrook, a unanimous three-judge panel of the Seventh Circuit affirmed the district court's holding. Judge Easterbrook concluded that the primary violation was committed by the father-in-law alone and that "[g]iven *Central Bank of Denver*, which knocks out private actions for aiding and abetting primary violations, there is no way that the people and firms who dealt with [the father-in-law] and the proceeds of his crimes could themselves be liable under § 10(b) in this private suit."³¹ Judge Easterbrook likened the son-in-law's conduct to fencing stolen goods, and noted that Section 10(b) is not an all-purpose remedy for misdeeds. Judge Easterbrook did not, however, specifically address subsections (a) and (c) of Rule 10b-5, even though the estate had relied on those two subsections. The closest Judge Easterbrook came to doing so was when he observed that the estate wanted the court "to call the conduct 'manipulation' rather than 'fraud'" -- an argument Judge Easterbrook summarily rejected, remarking that "[i]n securities law, manipulation is a kind of fraud; deceit remains essential."³²

³¹ *Id.* at 543.

³² *Id.* at 542.

THE *HOMESTORE* LITIGATION

The litigation involving Homestore.com provides a useful vehicle for studying the current debate over whether conduct-based scheme to defraud allegations fall within the scope of primary liability claims under Section 10(b) or are impermissible aiding and abetting claims. Homestore.com was a leading internet provider of real estate listings and moving services whose stock plummeted when the company was forced to restate its revenues for 2000 and 2001 by approximately \$190 million. The ensuing class action complaint alleged that the restatement was necessary because Homestore recognized revenue on a series of roundtrip transactions with various business partners, thus enabling Homestore to meet or exceed targets set by Wall Street analysts. The defendants in the ensuing class action lawsuit included three companies -- AOL Time Warner Inc., Cendant Corporation, and L90, Inc. -- that were Homestore's business partners in the transactions.

The plaintiff alleged that the business partner defendants had violated Section 10(b), notwithstanding that they had not made any misstatements of their own. The business partner defendants promptly moved to dismiss the complaint on the ground that, even if the allegations in the complaint were true, their conduct amounted at most to aiding and abetting and therefore the claims were precluded by *Central Bank*. The plaintiff countered that the business partner defendants had entered into a "scheme to defraud" with Homestore and thus it was of no consequence that the business partner defendants had not themselves made any misstatements.

Following extensive briefing on the issue, the district court dismissed the complaint against the business partner defendants.³³ The district court acknowledged that a defendant may be held primarily liable for participating in a scheme to defraud after *Central Bank*, but remarked that it was "unaware of any case since *Central Bank* that has ever held that outside business

³³ See *In re Homestore.com, Inc. Sec. Litig.*, 252 F. Supp. 2d 1018, 1037-42 (C.D. Cal. 2003).

partners, no matter how involved they were in fraudulent transactions with a corporation, can be held liable in a private action brought by the shareholders of that company.”³⁴ The court noted that “in every post-*Central Bank* case cited to the Court where an ‘outsider’ has been held liable as a primary violator, that outsider had some type of special relationship with the corporation, *i.e.* accountant, auditor, etc.”³⁵ The court reasoned that holding “a business partner with no special relationship with a corporation” liable would “broaden the scope of the securities acts so as to haul into court anyone doing business with a publicly traded company.”³⁶ Thus, the court held that the plaintiffs’ claims against the business partner defendants were precluded as a matter of law.

With respect to a test for liability of participants in a scheme to defraud (as compared to a misstatement), the court held that “[t]hose who actually ‘employ’ the scheme to defraud investors are primary violators, while those who merely participate in or facilitate the scheme are secondary violators.”³⁷ The court found that Homestore’s officers had designed and carried out the scheme, while the business partner defendants merely participated in the scheme.

The district court also found that the plaintiff had “suffered damage through its reliance on false or misleading statements” about Homestore’s revenues, not on the “scheme itself.” Thus, the court viewed the scheme to generate false revenues as “one step removed from the injured party.” Because the false statements were “the principal ‘wrong’ alleged,” the court reasoned that the plaintiff could not state a claim against the business partner defendants, who

³⁴ *Id.* at 1038.

³⁵ *Id.* at 1039.

³⁶ *Id.*

³⁷ *Id.* at 1040.

the district court held were not involved in the making of the false statements concerning Homestore's revenues.

Following the dismissal, the plaintiff appealed to the Ninth Circuit Court of Appeals. A short time later, the SEC entered the case as an *amicus curiae*. The SEC argues in its *amicus* brief that the Ninth Circuit should reverse the district court's decision and adopt an expansive definition of primary liability under Rule 10b-5. The SEC contends that to require a special relationship with the corporation of which the plaintiffs are shareholders would allow a person who is not in such a relationship to accomplish the same fraud, with the same state of mind, and the same effect on investors as a person in such a relationship, and nonetheless escape liability. The SEC also stresses that deceptive acts under Section 10(b) include conduct beyond the making of false statements or misleading omissions and that the district court's holding with respect to the reliance element in private actions would invite gamesmanship.

The SEC offers instead its own proposed test for determining when a defendant is a primary violator in a scheme to defraud case, as opposed to an aider and abettor under Rule 10b-5. The SEC proposes that:

Any person who directly or indirectly engages in a manipulative or deceptive act as part of a scheme to defraud can be a primary violator of Section 10(b) and Rule 10b-5; any person who provides assistance to other participants in a scheme but does not himself engage in a manipulative or deceptive act can only be an aider and abettor.³⁸

The SEC posits that this formulation provides a "meaningful distinction" between a primary violator and secondary aider and abettor. To support its point, the SEC offers the following hypothetical: A bank that makes a loan knowing the borrower will use the proceeds to commit securities fraud is at most an aider and abettor because there is nothing manipulative

³⁸ Brief of the Securities and Exchange Commission, *Amicus Curiae*, in Support of Positions that Favor Appellant at 16, *Simpson v. Homestore.com, Inc.* (9th Cir. 2004).

about making a loan. If, however, a bank creates a sham entity as part of the services to arrange the financing, then it would be a primary violator because it has engaged in a deceptive act.³⁹ This hypothetical demonstrates an important gloss on the SEC's proposed test, which is that the SEC would deem a transaction to be deceptive only if its "principal purpose" is not a valid business purpose.⁴⁰

Needless to say, the securities bar is eagerly awaiting a decision in the *Homestore* appeal. The outcome may come down to the degree of judicial deference that the Ninth Circuit extends to the SEC and its proposed test. The SEC suggests that its interpretation of Section 10(b) is entitled to deference so long as it is reasonable.⁴¹ Normally this is true. Indeed, the Supreme Court has declared on many occasions that "the well-reasoned views of the agencies implementing a statute 'constitute a body of experience and informed judgment to which courts and litigants may properly resort for guidance,'"⁴² and "[w]e have long recognized that considerable weight should be accorded to an executive department's construction of a statutory scheme it is entrusted to administer"⁴³ Deference may not be appropriate in this particular context, however, because the question is whether Rule 10b-5 and the SEC's proposed test reach conduct that is not covered by the 1934 Act, the controlling statute. As L90 points out in its brief: "[T]here is a considerable difference between granting an agency deference to interpret an ambiguous part of the statute within its area of expertise, and defining the scope of a judicially

³⁹ *Id.* at 20.

⁴⁰ *Id.* at 18 ("It is reasonable to construe § 10(b) as encompassing, within the rubric of engaging in a deceptive action, engaging in a transaction whose principal purpose and effect is to create a false appearance of revenues.").

⁴¹ Brief of the Securities and Exchange Commission, *Amicus Curiae*, in Support of Positions that Favor Appellant at 13, *Simpson v. Homestore.com, Inc.* (9th Cir. 2004) (citing *SEC v. Zandford*, 535 U.S. 813, 819-20 (2002)).

⁴² *Bragdon v. Abbott*, 524 U.S. 624, 642 (1998).

⁴³ *Chevron U.S.A. Inc. v. NRDC*, 467 U.S. 837, 844 (1984).

created private right of action.”⁴⁴ Of course, the irony is that Congress did not expressly create a private right of action under Section 10(b); rather, the body of law surrounding Section 10(b) is primarily a product of judicial lawmaking.

LEGISLATIVE ACTION REGARDING AIDING AND ABETTING LIABILITY

Because *Central Bank* involved private litigants, it left open the question whether the SEC continued to retain aiding and abetting authority under Section 10(b). The Court’s analysis of the text of Section 10(b) was arguably equally applicable to both private actions and SEC enforcement actions.

The question did not linger for long. The next year, Congress debated at length the *Central Bank* holding and its impact on SEC enforcement actions in the process of drafting the Private Securities Litigation Reform Act of 1995 (“PSLRA”).⁴⁵ The passage of the PSLRA removed any uncertainty surrounding the SEC’s enforcement power by expressly granting authority to the SEC to bring civil enforcement actions seeking damages and injunctive relief against aiders and abettors in what is now Section 20(f) of the 1934 Act.⁴⁶

⁴⁴ Brief of Defendant-Appellee L90, Inc. d/b/a Maxworldwide, Inc. at 33, *Simpson v. Homestore.com, Inc.* (9th Cir. 2004).

⁴⁵ Pub. L. No. 104-67, 109 Stat. 737 (2004).

⁴⁶ 15 U.S.C. § 78t(f). The SEC also has authority under Rule 102(e) of its Rules of Practice to bring administrative proceedings against persons who “practice” before the Commission and willfully aid and abet a primary violation. Rule 102(e) provides, in relevant part, that:

The Commission may censure a person or deny, temporarily or permanently, the privilege of appearing or practicing before it in any way to any person who is found by the Commission after notice and opportunity for hearing in the matter . . . to have willfully violated, *or willfully aided and abetted* the violation of any provision of the Federal securities laws or the rules and regulations thereunder.

SEC Rule of Practice 102(e)(1)(iii) (emphasis added).

During the PSLRA legislative process, the SEC urged Congress to overturn *Central Bank* and reinstate a private cause of action against aiders and abettors. During congressional hearings, SEC Chairman Arthur Levitt remarked that under *Central Bank*:

Persons who knowingly or recklessly assist the perpetration of a fraud may be insulated from liability to private parties if they act behind the scenes and do not themselves make statements, directly or indirectly, that are relied upon by investors. Because this is conduct that should be deterred, Congress should enact legislation to restore aiding and abetting liability in private actions.⁴⁷

Congress specifically declined, however, to overturn the holding of *Central Bank* and create an express private right of action for aiding and abetting securities fraud.

In the wake of the accounting scandals affecting Enron, WorldCom and Global Crossing, there was again a movement afoot in Congress to create a private cause of action against aiders and abettors. Although the Sarbanes-Oxley legislation covered a broad range of remedies for shareholder plaintiffs, adding an express aiding and abetting right of action against lawyers, accountants and bankers was again rejected by Congress. Instead, the Sarbanes-Oxley Act directed the SEC to study the issue and report to Congress the number of securities professionals found to have aided and abetted securities fraud in the years 1998 through 2001. Securities professionals was defined to include public accountants, public accounting firms, investment bankers, investment advisors, brokers, dealers, attorneys and other securities professionals practicing before the Commission. The SEC's report found that 1,596 securities professionals had violated and/or aided and abetted violations of the federal securities laws during the relevant

⁴⁷ *Securities Litigation Reform Proposals: Hearing on S. 240, S. 667 and H.R. 1058 Before the Subcomm. on Secs. Of the Senate Comm. On Banking, Hous., & Urban Affairs, 104th Cong. 157, at 253 (1995).*

time period.⁴⁸ Interestingly, though, despite the express enforcement powers given to the SEC by the PSLRA to bring aiding and abetting charges, only 13 of the 1,596 securities professionals were charged solely as aiders and abettors.⁴⁹

Although legislation proposing to resurrect civil aiding and abetting liability has been proposed, it has not been enacted.⁵⁰ Given the tenor of recent court holdings, it may be that any bright line test has so dimmed and blurred that secondary actors will be routinely recast as primary violators or face amorphous charges of fraudulent scheme or conduct under Rule 10b-5(a) and (c).

CONCLUSION

Although the Supreme Court's decision in *Central Bank* put an end to aiding and abetting claims in private lawsuits under Section 10(b), it has not provided the level of protection for which some secondary actors in the securities industry had initially hoped. The greatest effect has been seen in cases involving alleged misstatements because most courts have concluded that, in order for *Central Bank* to have any real meaning, liability cannot attach to secondary actors unless the alleged misstatement can be attributed to them. Other courts, however, have been less demanding and require only that the secondary actor participate substantially in the preparation of the misstatement. Because the extent to which someone participates in the creation of a misstatement is a fact-intensive question, it is unlikely that a secondary actor who finds himself in a "substantial participation" district will successfully extricate himself from a lawsuit on a Rule 12(b)(6) motion to dismiss.

⁴⁸ *Report of the Securities and Exchange Commission: § 703 of the Sarbanes-Oxley Act of 2002*, at 1 (2003).

⁴⁹ *Id.* at 10.

⁵⁰ *See, e.g.*, Investor Protection Act of 2002, S. 1933, 107th Cong. § 3(b) (2002).

As difficult as it has been to apply *Central Bank* to Rule 10b-5(b) “misstatement” cases, the more vexing application of *Central Bank* is found in cases where the plaintiffs allege that a secondary actor engaged in a scheme to defraud with the primary actor, in violation of subsection (a) or (c) of Rule 10b-5. By making such a claim, plaintiffs avoid having to demonstrate that the secondary actor made a misstatement or even participated in creating the misstatement; rather, the plaintiffs can point to conduct alone as the source of liability. If the courts, such as the Ninth Circuit in the *Homestore* appeal, accept “scheme to defraud” liability as a legitimate extension of Section 10(b), the number of claims against secondary actors under Rule 10b-5(a) and (c) will increase sharply. At that point, the impact of *Central Bank* will be largely vitiated and the old aiding and abetting moniker will no longer be needed to bring lawyers, accountants, and banks (and possibly even business partners) back into the securities class action arena.