LIABILITY FOR SECONDARY ACTORS

By Hille R. Sheppard and Brian D. Rubens

Since 1994, private plaintiffs have been barred from bringing securities fraud claims under Section 10(b) and Rule 10b-5 (or aiding and abetting claims) against defendants who did not make, author, adopt, or have attributed to them a false or misleading statement. In 2009, this prohibition, which began with the Supreme Court's decision in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994), appeared to be under serious threat of being repealed on two fronts: by appellate court interpretation at the behest of the SEC and by legislative action. First, in the First Circuit, the en banc court of appeals heard argument on October 6, 2009, in *SEC v. Tambone*, where the SEC sought to impose liability based on an "implied representation" theory that would hold the defendants liable even where the defendants did not actually utter, author, or adopt a statement or have one attributed to them. Second, in the U.S. Senate, Senator Arlen Specter (D-PA) and Senator Robert Menendez (D-NJ) each introduced bills to amend the Securities Exchange Act of 1934 to allow private civil actions against a person who provides substantial assistance in violation of that Act. If either of these efforts were successful, the scope of securities lawsuits that could potentially survive a motion to dismiss would be significantly broadened, especially for auditors, attorneys, and other groups that provide professional services to issuers.

In 2010, both trends have encountered significant setbacks. On March 10, 2010, the en banc First Circuit issued an opinion rejecting the SEC's "implied representation" theory in *SEC v. Tambone*. On March 15, 2010, Senator Menendez's bill was removed from legislation set for markup by a Senate Committee.

First Circuit Court of Appeals: Liability for Implied Representations

In *SEC v. Tambone*, the SEC sued two executives of an underwriter under Section 10(b) and Rule 10b-5 based on allegedly false statements in prospectuses, even though the defendants had not signed the prospectuses and did not author, adopt, or have attributed to them the statements in the prospectuses. The SEC argued that the defendants should be held liable on an "implied representation" theory. According to the SEC, "in light of their duties as primary underwriters—securities professionals engaged in the offer and sale of securities—[defendants] impliedly made their own statements to potential investors that they 'had reasonable basis to believe that the key representations in the prospectuses were truthful and complete.'" 550 F.3d 106, 124–25 (1st Cir. 2008).

The Panel decision concluded that this "implied representation" theory of liability was appropriate under Section 10(b) and Rule 10b-5 because of the important role of underwriters in the securities market. Despite acknowledging that the defendants did not actually make any statements, the Panel found them primarily liable for the statements made by others in the prospectuses. The First Circuit vacated the Panel's decision and granted rehearing en banc. On March 10, 2010, Judge Selya, writing for the en banc court, rejected the SEC's implied representation theory as "inconsistent with the text of the rule and with the ordinary meanings of the phrase 'to make a statement,' inconsistent with the structure of the rule and relevant statutes, and in considerable tension with Supreme Court precedent." *SEC v. Tambone*, No. 07-1384, slip op. at 3 (1st Cir. Mar. 10, 2010).

If the First Circuit had adopted, or if any future court adopts the SEC's argument in a manner similar to the *Tambone* Panel opinion, the result would be a distinct expansion of Section 10(b) and Rule 10b-5 liability beyond persons who utter, author, adopt, or have statements attributed to them. In the seven months between when the *Tambone* Panel issued its decision on December 3, 2008, and when the First Circuit vacated the opinion and granted en banc review on July 22, 2009, the implied representation theory of liability quickly gained significant use. In that short time, at least two courts followed the rhetorical lead of the First Circuit Panel in allowing securities claims to be pursued against an investment advisor and a CEO, based only on what those individuals could have "impliedly" said about another's statements. In addition, both the SEC and private plaintiffs have argued in a wide variety of cases that courts should follow the *Tambone* Panel and grant primary liability in Section 10(b) and Rule 10b-5 cases for "implied representations," including in cases against senior officers, a controller and an accountant, an internal auditor, and underwriters. In at least one of those cases, the court noted that, while it would not uphold the theory while *Tambone* was being reviewed, the SEC was free to raise the claim again if the Panel decision were upheld. In the *Tambone* briefs and other commentary on the case, authors cogently argued that if the First Circuit upheld the *Tambone* Panel opinion, there would be no obvious bar to plaintiffs bringing similar lawsuits against auditors, lawyers, underwriters, investment bankers, broker-dealers, investment advisors, and rating agencies. Under the logic in the Panel opinion, each of these parties would likely be subject to lawsuits claiming primary liability under Section 10(b) and Rule 10b-5 for statements made by others.

A Welcome Roadblock to Liability for Implied Representations

Just prior to publication of this article, the en banc First Circuit took an important step toward preventing this expansion of liability under the securities laws. The en banc court first explained that the case was "one of those happy occasions when the language and structure of a rule, the statutory framework that it implements, and the teachings of the Supreme Court coalesce to provide a well-lit decisional path," requiring that the SEC's implied representation theory of liability be rejected. *Tambone*, slip op. at 32. The court rejected the SEC's implied representation theory as against the plain language of Rule 10b-5(b), specifically noting that the "make" language in the rule could not be fairly interpreted to encompass the SEC's implied representation theory.

Supporting this clear statutory interpretation, the court explained that the SEC's implied representation theory "pose[d] a threat to the integrity of" the dichotomy established by the Supreme Court in *Central Bank* between primary and secondary liability under the securities laws. *Id.* at 13. The court noted that, unlike the SEC's interpretation, "the definition of 'make' that we propose is compatible with *Central Bank* as it holds the line between primary and secondary liability in a manner faithful to *Central Bank*." *Id.* at 20. The SEC's definition, allowing "courts to imply that 'X' has made a false statement with only a factual allegation that he passed along what someone else wrote[,] would flout a core principle that underpins the *Central Bank* decision," namely that the text of Rule 10b-5 should determine liability. *Id.* at 23. The court concluded that "[i]f *Central Bank*'s carefully drawn circumscription of the private right of action is not to be hollowed—and we do not think that it should be—courts must be vigilant to ensure that secondary violations are not shoehorned into the category reserved for primary violations." *Id.* at 21.

Concurring in the opinion, Judge Boudin, joined by Chief Judge Lynch, wrote separately to emphasize that "nothing justifies the adventure proposed by the agency." *Id.* at 38. The concurring opinion explained that the SEC's implied representation theory would have distinctly expanded liability under Section 10(b) and "[n]o one sophisticated about markets believes that multiplying liability is free of cost. And the cost, initially borne by those who raise capital or provide audit or other services to companies, gets passed along to the public." *Id.* at 39. Judge Lipez, joined by Judge Torruella, dissented from the court's decision regarding Section 10(b) and Rule 10b-5 liability, adopting the SEC's argument that "make" includes implied statements when considered in the context of the special duty of underwriters in the securities markets.

It remains to be seen whether the SEC (and other plaintiffs) will continue to pursue primary liability for implied representations in the face of the First Circuit's strong rejection of the SEC's theory.

U.S. Senate: New Private Plaintiff Cause of Action for Aiding and Abetting

Senator Specter's and Senator Menendez's bills in the Senate seek a much larger and more direct expansion of the scope of private securities litigation under Section 10(b) and Rule 10b-5. The Supreme Court concluded in *Central Bank* that there was no implied right of action for aiding and abetting under Section 10(b) or Rule 10b-5 in 1994. The next year, as part of the Private Securities Litigation Reform Act (PSLRA), Congress adopted Section 20(e), which allowed the SEC, but not private plaintiffs, to bring aiding and abetting claims against persons who provide knowing and substantial assistance to violations under the Exchange Act. Introduced July 30, 2009, Senator Specter's bill, S. 1553, would grant private plaintiffs the right to sue under Section 20(e) as well, thus essentially overturning *Central Bank*. Senator Menendez's bill, S. 2813, introduced November 30, 2009, by different means would similarly grant private plaintiffs the right to sue for aiding and abetting liability under the securities laws. Senator Christopher Dodd (D-CT), chairman of the Senate Banking, Housing, and Urban Affairs Committee, included the language from Senator Menendez's bill in his comprehensive banking and consumer protection reform legislation, entitled the "Restoring American Financial Stability Act."

The history of actions for aiding and abetting under Section 10(b) and Rule 10b-5 prior to *Central Bank*, and SEC actions under Section 20(e) since then, make clear that S. 1551 and S. 2813 would each create a broad cause of action that private plaintiffs could use against professionals who work with issuers. The key elements of aiding and abetting liability are that the defendant have actual knowledge of the primary violation and substantially assist it in some way. In *Central Bank*, the Tenth Circuit had found an indenture trustee for a bond issue liable because it "was aware of concerns about the accuracy of [an] appraisal" of the land securing the bonds, knew that purchasers were "using the 1988 appraisal to evaluate the collateral for the bonds," and delayed reviewing the appraisal. 511 U.S. 168–69. From that knowledge and delay, the Tenth Circuit concluded that there was a genuine issue of fact regarding whether the trustee had aided and abetted the issuer's violation. *Id.* at 169. Before *Central Bank*, such aiding and abetting claims were regularly successful against auditors, accountants, lawyers, and other professionals assisting issuers. *See* Loss and Seligman, Securities Regulations, §11-D-1. Moreover, since the PSLRA, the SEC has regularly brought claims of aiding and abetting Section 10(b) and Rule 10b-5 violations against executives, independent audit partners, lawyers, and many others. There can be little doubt that if the bills proposed by Senator Specter or Senator Menendez are passed, private claims against professionals working with issuers will be more common.

That possibility became somewhat less likely immediately prior to this article going to print. On March 15, 2010, on the eve of a full committee markup of the legislation, Chairman Dodd released a new version of his "Restoring American Financial Stability Act," which removed the aiding and abetting language. It remains to be seen whether the language will be returned to the legislation during the markup or as an amendment if the legislation proceeds to debate on the Senate floor, or whether Senator Specter, or Senator Menendez's bills will proceed toward adoption on their own.

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