AKIN GUMP STRAUSS HAUER & FELD LLP
Attorneys at Law

August 18, 2006

SECURITIES LITIGATION ALERT

UNSETTLED LAW OF SECONDARY ACTOR LIABILITY UNDER RULE 10b-5 RAISES CONCERNS FOR ATTORNEYS

In 1994 the U.S. Supreme Court provided some comfort to attorneys, accountants, investment bankers and other corporate advisors through its holding in *Central Bank of Denver*, which provided that the securities laws do not allow a private right of action for aiding and abetting violations of Section 10(b) of the Securities Exchange Act of 1934.[1] This decision was a relief to professionals who worried that they might be vicariously liable for fraudulent representations made by others. With the collapse of Enron and the increasing number of corporate scandals in the marketplace over the past few years, plaintiffs are attempting to circumvent the *Central Bank* decision by arguing that these secondary actors are primary violators of Section 10(b) and Rule 10b-5 promulgated thereunder.[2] In several cases courts have been persuaded by such arguments, looking not only at Rule 10b-5(b), which is the well-known rule relating to material misstatements and omissions, but also at Rules 10b-5(a) and (c), which do not require a defendant to make a false or misleading statement or omission – but rather allow a suit against a defendant who, with scienter, participated in a course of business or a device, scheme or artifice that operated as a fraud on sellers or purchasers of stock. These cases have blurred the line of liability for secondary actors, making it difficult for attorneys and other corporate advisors to know how a court will react to certain conduct and making it ever more important that attorneys and other corporate advisors be extremely careful in assisting and advising their corporate clients.

SECTION 10(b) AND RULE 10b-5 LIABILITY

Although the Supreme Court eliminated aiding and abetting liability in a private action for securities fraud in *Central Bank*, the court warned that its decision did not totally preclude

[1] *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.,* 511 U.S. 164 (1994).
[2] Rule 10b-5 was promulgated to protect persons who are deceived in securities transactions to make sure that buyers of securities get what they think they are getting. *Chemical Bank v. Arthur Andersen & Co.*, 726 F.2d 930, 943 (2d Cir. 1984). Rule 10b-5 prohibits, in connection with the purchase or sale of a security: (a) employing a device, scheme or artifice to defraud; (b) making untrue statements of material fact or failing to disclose necessary information in order to make statements misleading; and (c) engaging in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person. 17 C.F.R. §240.10b-5.

secondary actors from liability under the federal securities laws.[3] In that regard, the court stated that "any person or entity, including a lawyer, accountant or bank, who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator under Rule 10b-5, assuming all of the requirements for primary liability under Rule 10b-5 are met."[4] Therefore, based on the holding in *Central Bank*, a plaintiff must establish that an attorney's actions constitute a primary violation under Rule 10b-5 for the attorney to be liable to the third party.

RULE 10b-5(b) LIABILITY FOR MATERIAL MISSTATEMENTS OR OMISSIONS

In cases trying to establish primary liability for untrue statements or omissions of material fact under Rule 10b-5(b), courts have primarily applied the following three tests in their analysis.

"Bright Line" Test. A majority of the courts have applied a "bright line" test, holding that the secondary actor must directly or indirectly make the false statement or omission. Under this test, a legal opinion included in an offering document, such as a tax opinion included in a prospectus, can give rise to liability. However, an attorney's participation in drafting, reviewing or editing a statement attributed to others is insufficient to establish primary liability.

"Substantial Participation" Test. Another test that has emerged in some courts is the "substantial participation" test, pursuant to which "substantial participation or intricate involvement in the preparation of fraudulent statements is grounds for primary liability even though that participation might not lead to the actor's actual making of the statements."[5] Pursuant to this test, a person who participates or is otherwise involved in drafting disclosures that are untrue could be held to be a primary violator. Most courts have rejected the substantial participation standard because it is too difficult to distinguish between primary liability and aiding and abetting liability under this test. Nevertheless, this test is a viable standard in some jurisdictions, particularly the 9th Circuit, which has held that primary liability can be found against secondary actors who are part of a drafting group and who presumably have access to all available relevant information yet choose to conceal such information in a disclosure.[6]

"Creation of Misrepresentation" Test. A third test that has emerged in recent years is the "creation of misrepresentation" test, which was advocated by the Securities and Exchange Commission (SEC) in its amicus brief in the 3rd Circuit case, *Klein v. Boyd*.[7] This test was adopted by the court in *In re Enron Corp.*, whereby the court held that a secondary actor can be found primarily liable under Rule 10b-5(b) if the person, acting alone or with others,

[3] *Central Bank*, 511 U.S. at 191.
[4] *Id.* at 191.
[5] *Howard v. Everex Systems, Inc.*, 228 F.3d 1057, 1061 n. 5 (9th Cir. 2000).
[6] *In re Software Toolworks Inc. Sec. Litig.*, 50 F.3d 615 (9th Cir. 1994). In this case, the 9th Circuit reversed a grant of summary judgment for accountants and underwriters who had played a significant role in drafting and editing letters to the SEC that contained alleged misstatements.
[7] The SEC provided an amicus brief in *Klein v. Boyd* stating its position that "the correct standard…is that when a person, acting alone or with others, *creates a misrepresentation*, the person can be liable as the primary violator – assuming, of course, that he or she acts with the requisite scienter." In this case, a law firm was retained by a client with a history of violations, including securities fraud. The firm was hired to prepare disclosure packages for a private offering, which did not ultimately include disclosure of the regulatory problems the client had suffered. Although the law firm knew of the regulatory problems, it failed to make the appropriate disclosures. The district court dismissed the Section 10(b) claim against the law firm because there was no public identification of its involvement in the offering. The SEC's position is that the court should determine whether the plaintiff relied on the actual misstatement, rather than the identity of the "speaker" or the "disseminator" of the statement. Brief of the SEC, *Amicus Curiae* in *Klein v. Boyd* (3rd Cir. 1998).

creates a misrepresentation on which the investor-plaintiffs relied and acts with the requisite scienter.[8] Based on this test, the court refused to dismiss claims against Enron's law firm, Vinson & Elkins, due to its involvement in drafting and approving Enron's disclosures for public SEC filings, press releases and shareholder reports, which allegedly contained fraudulent misrepresentations regarding Enron's business and financial condition on which investors would likely rely. Because Vinson & Elkins allegedly was intimately involved in the fraudulent transactions and the concealment thereof, it could be deemed to be a co-author, as opposed to merely a drafter, of the public disclosures.[9] Consequently, Vinson & Elkins could be found to have *created* the misstatements.

RULE 10b-5(a) OR (c) "SCHEME" LIABILITY

Because of the difficulty plaintiffs have had in establishing that a secondary actor is primarily liable under Rule 10b-5(b), an increasing number of plaintiffs are looking to "scheme" liability under Rules 10b-5(a) or (c) as a possible basis for claims against secondary actors. Rule 10b-5(a) prohibits a person from employing a device, scheme or artifice to defraud, and Rule 10b-5(c) prohibits a person from engaging in any act, practice or course of business that operates or would operate as a fraud or deceit upon any person, in each case in connection with the purchase or sale of any security.[10] In many of these cases, plaintiffs allege that secondary actors are liable under Rule 10b-5(a) and/or (c) for knowingly or recklessly participating in "schemes" that allowed issuers to misstate their financial condition, thereby focusing more on the conduct of the parties than on a particular misrepresentation. Because the parties in these cases did not directly make the misleading financial statements or disclosures upon which investors relied, plaintiffs are instead trying to establish such parties' liability based on their participation in transactions that impacted the financial statements or disclosures of the issuer. Although courts have not been consistent in their rulings on these types of cases, "scheme" liability is gaining momentum, with several courts refusing to dismiss Rule 10b-5 claims against secondary actors. In *In re Enron Corp.*, the court denied the dismissal of such claims, basing its denial not only on Rule 10b-5(b) as discussed above, but also on Rules 10b-5(a) and (c). In addressing the conduct of Vinson & Elkins, the court held that plaintiffs' allegations that Vinson & Elkins participated in a fraudulent scheme through its intimate involvement in the structure of Enron's business and the negotiation and structuring of the fraudulent transactions, which had no economic purpose other than to misrepresent Enron's financial condition and defraud investors, were adequate to survive a motion to dismiss.[11]

Several other recent cases in which the "scheme" theory of liability under Rule 10b-5 has been advanced against secondary actors are discussed below. In one of these cases the court found secondary actors to be liable under the "scheme" theory of liability, while the courts rejected this approach in the other three cases. Although none of these cases involve attorneys, they signal the direction courts may go in determining the extent to which attorneys who assist clients in structuring transactions lacking a valid business purpose may become liable under Rules 10b-5(a) or (c).

In re Dynegy

In *In re Dynegy, Inc.*, plaintiffs brought claims against Dynegy, Inc., its officers and directors, underwriters and investment advisors for entering into two transactions allegedly designed to boost the appearance of Dynegy's financial

---

[8] *In re Enron Corp. Sec., Derivative & ERISA Litig.*, 235 F. Supp. 2d 549 (S.D. Tex. 2002).
[9] *Id.* at 705. Further, according to plaintiff's complaint, Vinson & Elkins did not remain silent, but rather frequently made statements to the public, including potential investors, credit agencies and banks, about Enron's business and financial situation in efforts to influence investors to purchase securities, credit agencies to keep Enron's credit high and banks to continue providing loans.
[10] 17 C.F.R. §240.10b-5.
[11] *Enron*, 235 F. Supp. at 705. The court also considered the alleged fact that as a law firm highly sophisticated in commercial matters, it should have known of the alleged illicit and fraudulent conduct.

condition.[12] The transactions involved two loans from Citigroup, one of which Dynegy allegedly disguised as an equity interest investment and one of which Dynegy allegedly disguised as cash flow from operations. Plaintiffs alleged that Citigroup violated Rules 10b-5(a) and (c) for its participation in these two loan transactions.[13]

The U.S. District Court for the Southern District of Texas held that the claim was not actionable because the plaintiffs did not allege any facts showing that Citigroup's alleged manipulative and deceptive acts coincided with the sales of Dynegy securities.[14] Citigroup only helped set up the transactions and did not take part in Dynegy's alleged improper reporting of the transactions on its financial statements. The court determined that, based on *Central Bank*, the aid that Citigroup provided Dynegy was not actionable under Section 10(b), and that plaintiffs could not invoke Rules 10b-5(a) and (c) to circumvent *Central Bank*'s limitations on liability for a secondary actor's involvement in the preparation of false and misleading statements.[15]

In re Parmalat

In *In re Parmalat*, plaintiffs sued Parmalat, several banks and other professionals under Rule 10b-5 for engaging in a web of fraudulent structured transactions allegedly designed to misrepresent Parmalat's financial position.[16] These transactions involved (1) the factoring and securitization of duplicate invoices, thereby allowing Parmalat to double count its revenues and misrepresent its financial condition, (2) loans disguised as equity investments to understate Parmalat's liabilities and (3) the issuance of convertible bonds and the subsequent transfer back of a conversion right, which allowed Parmalat to record both the conversion right and the proceeds from the bond issue as assets.[17]

The U.S. District Court for the Southern District of New York examined the three transactions under Rules 10b-5(a) and (c). The court applied the test of "whether the banks directly or indirectly used or employed any device or contrivance with the capacity or tendency to deceive." The court found that the factoring and securitization of the duplicate invoices met this test because the banks knew the invoices were worthless, but securitized them anyway. Therefore, the deception was a result of the bank's transaction and the bank was a primary violator of Rule 10b-5.[18] With respect to the loans disguised as equity investments, the court found that the banks were not primary violators because the transactions had a valid purpose and any deceit was the result of Parmalat improperly reporting the loans as equity.[19] Finally, with respect to the allegations relating to the transfer of the conversion right, the court denied the defendant's motion to dismiss because it found that the conversion right may have been similar to the duplicate invoices – but it was unable to determine from the complaint whether it was part of a deceptive act or contrivance.[20]

In re Charter Communications

In *In re Charter Communications*, Charter Communications, a cable television provider, contracted with Scientific-Atlanta, Inc. and Motorola, Inc. to purchase cable boxes.[21] Charter agreed to pay Scientific-Atlanta and Motorola an extra \$20 per box in exchange for these vendors returning the \$20 payments to Charter in the form of advertising fees. This structure allowed Charter to capitalize the extra \$20 per box and treat the returned advertising fees as immediate

---

[12] *In re Dynegy, Inc. Sec. Litig.*, 339 F. Supp. 2d 804, 819 (S.D. Tex. 2004).
[13] *Id.* at 913-914.
[14] *Id.* at 916.
[15] *Id.* at 916.
[16] *In re Parmalat Sec. Litig.*, 376 F. Supp. 2d 472, 481 (S.D.N.Y. 2005).
[17] *Id.* at 481.
[18] *Id.* at 504.
[19] *Id.* at 505.
[20] *Id.* at 505.
[21] *In re Charter Communications, Inc. Sec. Litig.*, No. 05-1974 (8th Cir. April 11, 2006).

revenue, thereby inflating Charter's operating cash flow by approximately $17 million. Purchasers of Charter securities brought suit against Charter, Scientific-Atlanta and Motorola under Rule 10b-5 based on this improper accounting. The district court held that the vendors merely aided and abetted Charter's violations, given that they neither made misstatements nor had any duty to disclose information. The plaintiffs appealed the district court's decision, claiming that the vendors were primary violators of Rule 10b-5(a) and (c) because they participated in a scheme to defraud and engaged in a course of business that operated as a fraud or deceit.

In its decision, the 8th Circuit affirmed the district court's dismissal of the claim, giving *Central Bank* a broad reading. The court held that an actor "who does not make or affirmatively cause to be made a fraudulent misstatement or omission, or who does not directly engage in manipulative securities trading practices, is at most guilty of aiding and abetting" and therefore cannot be a primary violator liable under Rule 10b-5.[22] Further, the court held that Scientific-Atlanta and Motorola could not be primary violators because (1) they did not make any misstatements to the plaintiffs, (2) they had no duty to disclose information to the plaintiffs and (3) the transaction was a supply contract and not a securities transaction.[23] The court went on to state in its decision that "to impose liability for securities fraud on one party to an arm's length business transaction in goods or services other than securities because that party knew or should have known that the other party would use the transaction to mislead investors in its stock would introduce potentially far-reaching duties and uncertainties for those engaged in day-to-day business dealings. Decisions of this magnitude should be made by Congress."[24]

In re Homestore.com

In *In re Homestore.com, Inc.*, plaintiffs alleged that Homestore entered into a series of sham transactions with various third-party vendors for products or services that Homestore did not need.[25] The third-party vendors would then contract with AOL Time Warner for advertising on Homestore's Web site and AOL would give this money back to Homestore under their advertising reseller agreement. Both the third-party vendors and AOL would keep a portion of the money as a commission. Plaintiffs sued, among others, several of Homestore's business partners, alleging they had entered into fraudulent transactions with Homestore as part of a scheme to defraud. Although the third-party business partners did not make any statements, plaintiff sought to hold them liable because the transactions were improperly recognized by Homestore and were included in financial results that Homestore ultimately had to substantially restate.

The district court dismissed the claims against the defendants, declining to expand the scope of liability under Section 10(b) to include the company's business partners where their roles were more as an aider and abettor, rather than a primary violator.[26] The court held that these business partners who participated in the scheme did not "employ" the scheme to defraud investors, and therefore were only secondary violators. Further, the court held that the plaintiff suffered damage through its reliance on false and misleading statements based on how the revenue from the transactions

---

[22] *Id.*
[23] *Id.* The court concluded that *Central Bank* and the earlier cases that it relied on stand for the following three governing principles: (1) the categorical declaration that a private plaintiff may not bring a 10b-5 suit against a defendant for acts not prohibited by the text of Section 10(b); (2) a device or contrivance is not "deceptive," within the meaning of Section 10(b) absent some misstatement or a failure to disclose by one who has a duty to disclose; and (3) the term "manipulative" in Section 10(b) has the limited contextual meaning ascribed in *Santa Fe Indus. Inc. v. Green*, 430 U.S. 462, 476-77 (1977). In that case, the court intended to limit Section 10(b) claims of unlawful manipulation (as opposed to deception) to "transactions in the [securities] marketplace, the effects of which were to prevent the market price from accurately reflecting the market's unimpeded judgment of the stock's value."
[24] *In re Charter Communications, Inc. Sec. Litig.*, No. 05-1974 (8th Cir. April 11, 2006).
[25] *In re Homestore.com, Inc. Sec. Litig.*, 252 F. Supp. 1018 (C.D. Cal. 2003).
[26] *Id.* at 1040.

was reported, not from the "scheme" itself. Because the plaintiff did not sufficiently allege that the business partner defendants substantially contributed to the statements, the court determined that the plaintiff could not state a claim against the defendants for damages resulting from reliance on misstatements or material omissions. Also, the district court ruled that a business partner with no special relationship to the issuer involved in the securities fraud action cannot be liable as a primary violator.[27]

The SEC submitted an amicus curiae brief in this case to address the question of what test is appropriate for finding a defendant to be a primary violator rather than an aider and abettor in a scheme to defraud under Rule 10b-5(a).[28] The SEC urged the court to use the following test for determining when a person's conduct as part of a scheme to defraud constitutes a primary violation:

> 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(a); 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.[29]

In addition, the SEC addressed the special relationship requirement referred to by the court. The SEC argued that requiring a special relationship with the issuer would allow a party who is not in such a relationship to accomplish the same fraud and yet escape liability. The SEC believes that "liability under Section 10(b) should be imposed on any person whose conduct comes within the proscriptions of the statute, regardless of the person's relationship with the corporation."[30]

Despite the SEC's arguments, the 9th Circuit recently affirmed the district court's decision. The 9th Circuit concluded that the element of using or employing a deceptive device was not adequately alleged, as it could not find that the transactions engaged in were completely illegitimate or in themselves created a false appearance.[31]

It is difficult to reconcile the cases discussed above and draw a line as to what conduct courts will deem to be primary violations rather than merely aiding and abetting under Section 10(b) and Rule 10b-5(a) or (c). However, in reviewing the facts of the cases, courts seem more likely to find secondary actors to be primary violators when the underlying transaction or disclosure is obviously fraudulent and the parties were aware of such fraud. In *Parmalat* and *Enron*, the courts found the transactions that the secondary actors were involved in to be fraudulent, with no true business purpose other than to skew the issuer's financial statements. In *Dynegy, Charter* and *Homestore*, the courts appeared to find some legitimacy to the transactions and found that the fraud resulted from the way the issuer reported the transaction, rather than the actual transaction itself, thereby extending some relief to the secondary actors in these cases.

SEC ENFORCEMENT ACTIONS

Although the *Dynegy, Charter* and *Homestore* decisions might provide secondary actors some comfort that they are protected from third-party fraud liability under Section 10(b), the lack of uniformity in the decisions of the courts is cause for concern. Attorneys and other corporate advisors should proceed with caution in advising their corporate clients in transactions and related public disclosure. Further, even if a secondary actor has relief from private actions for liability under Section 10(b), the SEC is not prohibited from bringing an action against such actors for aiding and

---

[27] *Id.* The court stated 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, such as an accountant or auditor.
[28] Brief of the SEC, *Amicus Curiae* in *Simpson v. Homestore.com, Inc.*, 9th Cir., No. 04-55665 (October 22, 2004).
[29] *Id.*
[30] *Id.*
[31] *Simpson v. AOL Time Warner Inc.*, 9th Cir., No. 04-55665 (June 30, 2006).

abetting liability under Section 10(b). In fact, the SEC recently charged Scientific-Atlanta, Inc. with aiding and abetting Adelphia Communications Corporation in Adelphia's violations relating to reporting, books and records, and internal controls provisions of the federal securities laws.[32] In this instance, Scientific-Atlanta entered into a marketing support agreement with Adelphia that Adelphia used to inflate its earnings by approximately $43 million. The structure of the transaction between Scientific-Atlanta and Adelphia was similar to the structure used by the parties in the *Charter* case discussed above. The complaint alleged that Scientific-Atlanta was aware of a number of facts which demonstrated that Adelphia was misusing the marketing support agreement. Scientific-Atlanta agreed to pay $20 million in settlement of these charges.[33] Therefore, although a court may dismiss a private party's claim under Section 10(b) against a secondary actor, the secondary actor may still be on the hook for its actions if the SEC brings an enforcement action.

In addition to bringing enforcement actions against secondary actors for aiding and abetting violations of Section 10(b), the SEC is bringing an increasing number of enforcement actions against attorneys for their "gatekeeper" role and related responsibilities.[34] The basis for many of the recent SEC enforcement actions includes false and misleading SEC filings, books and records violations, lying to auditors, insider trading and reckless advice, with claims often brought under Sections 10(b) and 13(a) of the Securities Exchange Act of 1934 and Rules 10b-5, 12b-20, 13a-1 and 13a-13 promulgated thereunder. Many of the SEC actions brought against attorneys involve blatant and obvious fraud and deception by the attorney. Other SEC actions, however, are more troubling to attorneys, because although the actions involved counsel who knew or should have known that their conduct was a violation of federal securities laws, the facts are much less egregious. These cases are discussed below.

In the Matter of Google, Inc.

In an SEC enforcement action brought against Google, Inc. and David Drummond, its general counsel, the SEC found that Google violated the registration provisions of the Securities Act of 1933 and that Mr. Drummond caused Google to violate those provisions.[35] Accordingly, the SEC ordered both parties to cease and desist from future violations of the registration provisions. Before Google went public, it compensated its employees and consultants with stock options, relying on the Rule 701 exemption from registration. Pursuant to this exemption, if the issuer sells securities during any 12-month period in which the amount exceeds $5 million, the issuer must deliver detailed financial statements to investors. Because Google did not want to deliver the required financial statements, and because the issuance of additional options would exceed the $5 million limit, Mr. Drummond consulted with counsel, reviewed the securities laws and subsequently determined that Google could rely on other exemptions. Mr. Drummond advised Google's board to approve the issuance of additional options, but did not disclose his legal analysis on the registration exemptions or the risks involved with the option grants. Google ultimately issued millions of dollars worth of stock options without a proper exemption or proper registration under the Securities Act. In reviewing the facts, the SEC held Mr. Drummond accountable for his business decision and related analysis and his failure to inform the board of the legal analysis and associated risks.

---

[32] SEC Litigation Release No. 19735, June 22, 2006. Accounting and Auditing Enforcement Release No. 2443, June 22, 2006. *SEC v. Scientific-Atlanta, Inc.*, Civil Action No. 06 CIV. 4823 (PKC) (S.D.N.Y.).
[33] *Id.*
[34] In general, gatekeepers are recognized as persons, including attorneys, accountants and financial advisors, who control a company's access to the capital markets. As gatekeepers, attorneys have a duty not only to their client, but also to the public markets. An attorney's "gatekeeper" role includes advising on and policing company disclosures, corporate practices and business transactions to prevent fraud and other securities law violations and to ensure compliance with laws, rules and regulations. If attorneys are successful in this role, the public markets will be stronger and investors will be better for it. As the SEC has made clear, if attorneys fail in this role, such attorneys may be exposed to liability under securities laws.
[35] *In the Matter of Google, Inc. and David C. Drummond*, Rel. No. 33-8523 (Jan. 13, 2005).

In the Matter of John E. Isselman Jr.

Another SEC enforcement action of interest was brought against John Isselman Jr., the general counsel for Electro Scientific Industries, Inc.[36] In this case, the chief financial officer eliminated certain employee benefits for certain employees of the company, which allowed Electro Scientific to record a profit for the quarter, rather than a loss. The CFO did not consult with Mr. Isselman regarding his decision to eliminate these benefits, nor was Mr. Isselman involved in any aspect of the decision. Mr. Isselman learned of the decision when the CFO presented the quarterly results to the audit committee, in which the CFO stated that the decision regarding benefits had been approved by legal. Although Mr. Isselman was unaware of any legal opinions relating to the subject, he did not question the CFO. Mr. Isselman later sought legal counsel on the elimination of benefits and was informed that the company did not take the legal steps necessary to eliminate the employee benefits. Upon learning this information, he did not immediately report it to the company's audit committee or accountants. He attempted to address his concerns at a disclosure committee meeting prior to filing the quarterly report, but the CFO cut off the discussion and the quarterly report was filed with the improper accounting transaction. Mr. Isselman later discovered that the CFO eliminated the benefits to balance out an accounting error that had a negative impact on earnings. Upon learning of this, Mr. Isselman contacted outside counsel and an investigation was conducted, causing the company to restate its earnings for the quarter. The SEC found that Mr. Isselman failed to provide important information to the company's board, audit committee and auditors regarding the accounting transaction, which caused Electro Scientific to ultimately file false financial statements with the SEC, thereby violating Section 13(a) and Rules 13a-13 and 12b-20 promulgated thereunder. Mr. Isselman's failure to speak, when he had a duty to speak, and his ultimate review and filing of the Form 10-Q, which addressed the improper accounting transaction, subjected him to securities law liability.

CONCLUSION

As discussed above, the state of law regarding secondary actors being held primarily liable under Section 10(b) and Rule 10b-5 is unclear. Although certain courts have dismissed such actions, holding that private actions for aiding and abetting liability under Section 10(b) are prohibited, plaintiffs are being more creative in persuading courts that secondary actors are primary violators of Section 10(b). The implications of secondary actors, particularly attorneys, being deemed primary violators of Section 10(b) and Rule 10b-5 are a concern for any attorney who represents a public company client. Although it is difficult to determine exactly how a court will react to certain actions, attorneys should be particularly cautious in certain circumstances to avoid primary liability, particularly when—

- making affirmative statements about an issuer client when such statements could be deemed material misstatements
- providing legal opinions or other written documentation for which a court will directly attribute statements to the law firm
- advising a client on, and drafting documents related to, a structure that has questionable business or accounting purposes.

[36] *In the Matter of John E. Isselman Jr.*, Rel. No. 34-50428 (Sept. 23, 2004).

In addition to potential liability under Section 10(b), attorneys need to be aware of the potential liability they may have for their actions under other provisions of the securities laws when representing and counseling corporate clients. Such liability seems to be growing, especially in today's business world, where companies are under increased pressure to perform in the marketplace, and attorneys are called on more and more not only to address legal issues but to serve as key advisors, counseling on non-legal issues and business decisions.

CONTACT INFORMATION

If you have questions or would like to learn more about this topic, please contact the partner who represents you, or:

Paul R. Bessette .... 512.499.6250 .... pbessette@akingump.com .... Austin

Austin	Brussels	Dallas	Dubai	Houston	London	Los Angeles	Moscow
New York	Philadelphia	San Antonio	San Francisco	Silicon Valley	Taipei	Washington, D.C.	