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Unsettled Law Of Secondary Actor Liability Under Rule 10b-5 Raises Concerns For Attorneys – Part I

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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.

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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 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 misrepresenta-

tion" 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, 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 and in Part II of this article. 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 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 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]

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[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.*

[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).*

[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.*

[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).*

[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).*