ValpoScholar
Valparaiso University Law Review

Volume 41
Number 1 *Fall 2006*

*pp.*403-454

Fall 2006

Lifting the Fog: Finding a Clear Standard of Liability for Secondary Actors Under Rule 10B-5

Mary M. Caskey

LIFTING THE FOG: FINDING A CLEAR STANDARD OF LIABILITY FOR SECONDARY ACTORS UNDER RULE 10B-5†

I. INTRODUCTION

In its first six years as a publicly traded company, Cascade reported impressive gains and profits.[1] But in August 1991, rumors began to circulate that Cascade's remarkable profits might be questionable.[2] By January of 1992, Cascade's CEO had gone missing, Cascade had declared bankruptcy, and the company faced a class action from its shareholders.[3] The ensuing lawsuit not only went after Cascade's CEO, but alleged securities fraud against Cascade's attorneys and auditors as well.[4]

The trouble had begun five months earlier when Cascade had employed an accounting firm to audit two of Cascade's largest subsidiaries.[5] During its audits, the accountants found that both entities

† Winner of the 2006 Valparaiso University Law Review's Scribes Award.

1 Ziemba v. Cascade Int'l Inc., 256 F.3d 1194, 1198 (11th Cir. 2001). In December 1985, Cascade, a women's clothing manufacturer, acquired six fashion boutique stores and in February 1989, acquired two store chains, Diana and Allison, in which Cascade planned to sell its cosmetics. *In re* Cascade Int'l Sec. Litig., 840 F. Supp. 1558, 1572 (S.D. Fla. 1993). From 1989-1991, Cascade reported record revenues and substantial financial growth in its SEC filings, press releases, and other public documents as its stock sales continued to increase. *Id*.

2 *Cascade*, 256 F.3d at 1198. A month earlier, on August 20, 1991, the SEC had written to Cascade's President and CEO, Victor Incendy, warning that it was reviewing transactions made by Cascade and requested numerous documents, including a list of all stores and cosmetic counters operated by Cascade. *Id*. Additionally, in October, 1991, "the Overpriced Stock Service ("OSS") issued a report on Cascade, in which it stated that 'the odds of trouble ahead' were 'high.'" *Id*. But, even after two class action suits were filed, Cascade maintained that there were "no negative developments" in its operations and that the suits were "without merit." *Id*.

3 *Id*. The court noted that a January 1992 SEC filing revealed assets of $8 million and liabilities of $14.5 million, in contrast to the figures in Cascade's 1991 10-K which held out assets of $65.9 million and liabilities of $17.3 million. *Id*. Also, Cascade had $6.8 million more outstanding shares of common stock than what was reported. *In re Cascade*, 840 F. Supp. at 1573. "According to a bankruptcy examiner's report and recommendations, the entire Jean Cosmetic division was nonexistent, the losses of the apparel division and Jean Cosmetics were known to Cascade's management as early as 1989 and Fran's, Swim' N Sport and J.B. Boutiques were all operating at a loss." *Id*.

4 *Cascade*, 256 F.3d at 1197. The complaint alleged violations of § 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5. *Id*. *See also infra* Part II.A (discussing § 10(b) and Rule 10b-5 of the Exchange Act).

5 *Cascade*, 256 F.3d at 1199-1200. The accountants had been hired to audit Fran's Fashions' consolidated balance sheet and its consolidated statement of operations for the fiscal year that ended June 29, 1991. *Id*. at 1200. After they were finished with their audit, the accountants issued an audit opinion asserting it had conducted its audit in accordance with GAAS. *Id*. However, plaintiffs alleged that the accountants had violated numerous

were suffering tremendous losses; in fact, the subsidiaries were in dire need of immediate funds from Cascade.[6] But when Cascade's 10-K[7] was released, the accountants learned that Cascade had failed to report the financial troubles of its subsidiaries,[8] yet they continued to reaffirm Cascade's financial well-being.[9]

Moreover, while the accountants knew of Cascade's trouble and remained silent, Cascade's attorneys took affirmative steps to improve Cascade's public image.[10] Specifically, when questions arose about Cascade, the attorneys prepared suggested statements for Cascade's CEO to issue to the public to explain Cascade's recent stock price decline.[11] One attorney even urged stock analysts to stop spreading rumors about Cascade and to stop advising people to sell the stock short.[12]

---

standards of the American Institute for Certified Public Accountants. *Id.* Plaintiffs alleged that the accounting firm did not "maintain an independence in mental attitude when conducting the audit; did not exercise due professional care in the performance of the examination and preparation of the report; did not obtain sufficient competent evidence to afford a reasonable basis for its audit opinion; and did not make reasonably adequate informative disclosures." *Id.*

6 *Id.* at 1200. The plaintiffs alleged that in auditing Fran's false statements or omissions, the accountants furthered the fraud and knew that Cascade was incapable of infusing capital into both of these subsidiaries that needed substantial capital to survive. *Id.* at 1201.

7 A Form 10-K is an annual report required of publicly traded companies by the federal securities laws. *See* Securities and Exchange Commission, Form 10-K, http://www.sec.gov/answers/form10k.htm (last visited Sept. 3, 2006). The annual report on Form 10-K "provides a comprehensive overview of the company's business and financial condition and includes audited financial statements." *Id.* Also, the Form 10-K is different from the annual report to shareholders that companies must send to shareholders when it holds an annual meeting to elect directors. *Id.*

8 *Cascade*, 256 F.3d at 1200.

9 *Id.*

10 *Id.* at 1199. In fact, Cascade's attorneys were viewed as having acted as Cascade's "hired gun" in fending off those who raised questions concerning Cascade. *In re Cascade,* 840 F. Supp. at 1572.

11 *Cascade*, 256 F.3d at 1199. The plaintiffs alleged that the attorneys had prepared the statement "without 'appropriate investigation or inquiry.'" *Id.* In fact, the law firm had never assured itself of the accuracy of the proposed statements. *Id.* Later, on October 2, 1991, the attorneys sent Incendy, at his request, an opinion letter regarding the bankruptcy status of Conston. *Id.* Despite its knowledge that the Conston's Plan of Reorganization had been confirmed in April of 1991, the attorneys concluded that there was no doubt that Conston was in bankruptcy, giving Incendy reason to justify the non consolidation of Conston's financial statements with Cascade's in 1991. *Id.*

12 *Id.* A month later, that same attorney wrote a letter to *The Miami Review* about an article that was being prepared about Cascade and claimed "there was no justification for printing such an incomplete and un-investigated article." *Id.* at 1200.

It was not until November 1991 that Cascade announced that its previous financial statements might not be accurate and it appeared that Cascade's attorneys and accountants had misinformed the public with their assuring statements.[13] Cascade then announced it was filing Chapter 11 bankruptcy and revealed that it had materially misrepresented its assets, profits, and revenues.[14] As a result, investors brought class actions not only against Cascade's CEO, but also against its attorneys, and its accountants.[15] The plaintiffs alleged that the attorneys and accountants were primary violators of § 10(b) and Rule 10b-5 ("10b-5") of the Securities Exchange Act of 1934 ("Exchange Act"),[16] because the law firm and the accountants had made "material misrepresentations or omissions" regarding Cascade's "real" financial situation.[17]

The facts from the Cascade scandal, though they are over a decade old, represent a familiar and common scenario pervasive in today's business world.[18] The players—auditors, bankers, and accountants

---

13 *Id.* at 1198. The statements in question were for the fiscal year ending June 30, 1991. *Id.* Subsequently, the National Association of Securities Dealers halted trading in Cascade stock until the company could provide the public with accurate financial statements. *Id.* Stockholders held at least $27 million, based on stock shares that became almost worthless the day after Incendy disappeared. David Altaner, *Scandal Rears Its Ugly Head*: *Three Years Later, Cascade Fraud Scheme Is Back in the News*, SUN-SENTINEL, June 4, 1995, at 1D. One investor, after learning that the Incendy had gone missing commented, "It was easy to get sucked in by the story they were telling. . . . You read a 10K . . . and you don't think they're going to lie. But now I've learned that if it seems too good to be true, it probably is." Carla Lazzareschi, *Case of Missing CEO: Cascade Investors Fear Stock Is Worthless*, LOS ANGELES TIMES, Nov. 22, 1991, at D1.

14 *Cascade*, 256 F.3d at 1198.

15 *Id.* at 1197. Plaintiffs also brought suit against Cascade's independent auditor, Bernard Levy. *Id*.

16 *See infra* Part II.A (discussing the § 10(b) and Rule 10b-5 of the Exchange Act in detail).

17 *Cascade*, 256 F.3d at 1199. Additionally, the plaintiffs alleged that during talks between Cascade and one of its subsidiaries, Conston, in the summer and fall of 1991, while the two entities were considering a deal with designer Oleg Cassini, the attorneys advised Cascade how to issue information to the public regarding the proposed deal. *Id*. However, in the fall after Cascade issued two press releases regarding a purported agreement that it and Conston had reached with Oleg Cassini, the law firm was actively involved in trying to help Cascade and Conston get out of the agreement. *Id*. However, the firm made no effort to cause Cascade to issue any press releases disclaiming the June 1991 press releases. *Id*.

18 *See, e.g., In re* Tyco Int'l, Ltd**.**, No. MDL 02-1355-B, 02-266-B 2004 WL 2348315 (D.N.H. Oct. 14, 2004); *In re* Global Crossing Ltd. Sec. Litig., 322 F. Supp. 2d 319 (S.D.N.Y. 2004); *In re* Worldcom, Inc. Sec. Litig., 346 F. Supp. 2d 628 (S.D.N.Y. 2004); *In re* Enron Corp. Sec., Derivative & ERISA Litig., 235 F. Supp. 2d 549 (S.D. Tex. 2002). *See also* Peter Elkind et al., *Judgment Day*, FORTUNE, Jan. 23, 2006, at 58 (discussing the Enron scandal's effect on the image of corporate America, and in particular, the role of CEOs Ken Lay and Jeffrey Skilling in the fraud); Stephen Labaton, *Four Years Later, Enron's Shadow Lingers as Change Comes Slowly*, N.Y. TIMES, Jan. 5, 2006, § 6, at 1 (discussing the aftermath of the Enron

(known as secondary actors)—are often sued alongside directors and officers when public representations about the health of the company turn out to be false.[19] Generally, the firm's CEOs or CFOs are publicly associated with distributing the alleged misstatements or omissions and it is often easier to sue officers since they are publicly associated with the statements.[20]

However, the scope of private suits against secondary actors under 10b-5 has been in flux since the Supreme Court's decision in *Central Bank of Denver v. First Interstate Bank of Denver*.[21] In *Central Bank*, the Supreme Court determined that there was no private right of action for aiders and abettors under § 10(b), and that if investors wanted to recover from secondary actors, investors would have to show that the secondary actors were primarily liable.[22] However, over ten years after *Central Bank*, the standard of "primary" liability for secondary actors is still in disarray.[23]

The resulting uncertainty and ambiguity surrounding § 10(b) liability for secondary actors has caused a clear and distinct split among the circuits that remains unsolved despite the wave of corporate misbehavior over recent years.[24] First, the Ninth Circuit's approach

---

scandal); Robert Trigaux, *Could the Scandals Be Over? Don't Bet*, ST. PETERSBURG TIMES, Jan. 16, 2006, at 1D (noting that Enron was the first in a large wave of corporate scandals, and summarizing the ultimate results of the downfall of companies like Global Crossing, Worldcom, and Tyco).

19 These actors are also often referred to as "gatekeepers." *See* John C. Coffee, Jr., *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 B.U. L. REV. 301 (2004). Coffee presents a discussion of the past and present role of gatekeepers. *Id*. at 308. A "gatekeeper is a reputational intermediary" who provides verification or certification services to investors. *Id*. Examples of gatekeepers include an auditor providing certification of an issuer's financial statements, an investment banker providing its "fairness opinion" as to the pricing of a merger, and a securities attorney for the issuer providing its opinion that all material information has been properly disclosed. *Id*. at 309. Coffee notes that "the professional gatekeeper essentially assesses or vouches for the corporate client's own statements about itself or a specific transaction." *Id*. Markets often depend on gatekeepers because a "gatekeeper has a lesser incentive to deceive than does its client and thus regards the gatekeeper's assurance or evaluation as more credible." *Id*.

20 *See infra* Part III.B (discussing the Bright Line test, which was utilized in the *Cascade* case).

21 511 U.S. 164 (1994). *See infra* Part II.B (discussing the Supreme Court's decision in *Central Bank*).

22 *Central Bank*, 511 U.S. at 191. More specifically, the Supreme Court stated that anyone, "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." *Id*.

23 *See infra* Part III.

24 *See infra* Part III.

imposes liability on a secondary actor when a plaintiff shows the actor's "substantial participation" in the fraud.[25] Conversely, the Second Circuit utilizes a "bright line" approach, imposing liability when an actor makes a misstatement or omission that is publicly attributable to him.[26] Similarly, the Tenth Circuit imposes liability only if an actor made a misstatement or omission that he knew or should have known would be made public.[27] The fourth and final approach is advocated by the Securities and Exchange Commission ("SEC"), and finds liability when an actor "creates" a misrepresentation.[28]

Although each of the tests has positive attributes, none of the tests adequately and effectively creates a standard of liability that serves the goals of the federal securities laws and the current interpretations of § 10(b) jurisprudence.[29] As is discussed more fully in Part IV, each of the tests suffer from a similar defect: the same attributes that make it desirable as a standard for primary liability are overshadowed by the potential harm the standard causes to the public, professionals, and the integrity of the securities market.[30] A fusion of the beneficial qualities of the tests is needed to provide certainty and predictability to professionals.[31]

Part II of this Note discusses the development of the private right of action for § 10(b) actions and the demise of the aiding and abetting action in *Central Bank*.[32] Part III examines the various approaches to primary liability for secondary actors currently taken by the circuits.[33] Then, Part IV critically examines the tests in light of their respective abilities to uphold the reliance requirement under § 10(b), comport with the

---

25 *See infra* Part III.A.
26 *See infra* Part III.B.
27 *See infra* Part III.C.
28 *See infra* Part III.D.
29 Where one approach succeeds in protecting the investor, the same approach provides a loop hole for crafty attorneys and auditors to avoid liability. *See infra* Part III.B (discussing the Bright Line test). Conversely, where one test adequately catches actors whose participation in fraud amounts to primary liability, the same test ignores the longstanding requirement that the investors have relied on the misrepresentation made by the actor. *See infra* Part III.D (discussing the Creation test).
30 *See infra* Part IV (examining the circuits' approaches to secondary actor liability in light of the reliance requirement of § 10(b), the goals of the Exchange Act, and the policies articulated in *Central Bank*).
31 *See infra* Part IV.
32 *See infra* Part II (examining § 10(b), its reliance requirement as established in the FOMT, and the decision in *Central Bank*).
33 *See infra* Part III (discussing the circuit split regarding secondary actor liability under § 10(b)).

legislative purposes of the Exchange Act, and satisfy the goals articulated by the Court in *Central Bank*.[34] Finding that none of the tests possess all the qualities desired in an adequate approach to primary liability, Part V introduces a Proposed Test, combining various qualities from current tests.[35]

II. BACKGROUND: RELIANCE AND SECONDARY ACTOR LIABILITY UNDER THE SECURITIES EXCHANGE ACT

In order to adequately assess the various approaches to secondary liability under § 10(b), a complete understanding of the purpose and elements of § 10(b) is necessary. Part II focuses on the requirement of § 10(b) that a plaintiff must have relied on an actor's material misstatement in order to proceed with a claim against a secondary actor.[36] In particular, given that the reliance requirement is the most litigated and most challenging element of § 10(b), Part II examines the development of the reliance requirement in the courts, paying particular attention to the underlying theory of the reliance requirement, the Fraud on the Market Theory ("FOMT").[37] Further, Part II examines the Supreme Court's elimination of the aiding and abetting private right of action in *Central Bank*.[38]

A. *Section 10(b) and Rule 10b-5: A Private Right of Action Under the Federal Securities Laws*

As with many provisions of the Exchange Act, Congress chose to leave the specific parameters of defining liability out of § 10(b), and instead delegated the implementation and interpretation to the SEC.[39]

---

34 *See infra* Part IV.

35 *See infra* Part V (discussing this Note's Proposed Test for secondary actor liability).

36 *See infra* Part II.A.1 (discussing the reliance requirement under § 10(b); *infra* Part II.A.2 (discussing the FOMT); *infra* Part II.A.3 (discussing *Basic v. Levinson*).

37 *See infra* Part II.A.

38 *See infra* Part II.B (discussing *Central Bank* and the elimination of aiding and abetting under § 10(b)).

39 Elizabeth A. Nowicki, *10(b) or Not 10(b)?: Yanking the Security Blanket for Attorneys in Securities Litigation*, 2004 COLUM. BUS. L. REV. 637, 677-78, 678 n.172 (2004) (noting that the vagueness and deference to agency administration was deliberate). In fact, Congress delegated the task of dealing with securities problems to the SEC in an effort to establish a specialized agency with expertise in the matters of securities regulation. *See* Joseph A. Grundfest, *Disimplying Private Rights of Action Under the Federal Securities Laws: The Commission's Authority*, 107 HARV. L. REV. 961, 1018 n.287 (1994) (noting "that Wall Street believed that it could exert greater influence over an agency devoted solely to the governance of its affairs . . . and that a new and specialized agency's understanding of capital market processes would likely be more sympathetic to business interests").

Rule 10b-5, which is similar to the wording in § 10(b)[40] of the Exchange Act, provides:

> It shall be unlawful for any person, directly or indirectly . . .
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material[41] 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, in connection with the purchase or sale of any security.[42]

---

40 15 U.S.C. § 78j (2000).

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange . . . [t]o use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Id.

41 Information is material if there is "a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976). *See also* Basic v. Levinson, 485 U.S. 224, 232 (1988) (expressly adopting the *TSC Industries* standard of materiality for the § 10(b) and Rule 10b-5 context).

42 17 C.F.R. § 240.10b-5 (2004). Rule 10b-5 is an example of the SEC's broad power to promulgate rules and courts are often required to determine what level of deference should be given to its interpretations of regulations. *See also* Chevron U.S.A., Inc. v. Natural Res. Def. Council, 467 U.S. 837, 842-43 (1984). In *Chevron*, the Court held that if the intent of Congress is clear, then both the court and the agency must give effect to the unambiguous intent of Congress. *Id*. However, if the statute is ambiguous or silent on an issue, then the court must defer to a reasonable agency interpretation of that statute, even if that interpretation is not the one which the court would have chosen. *Id*. at 843. *See also* Torrey A. Cope, *Judicial Deference to Agency Interpretations of Jurisdiction After* Mead, 78 S. CAL. L. REV. 1327, 1333 (2005). Cope looks at the modern development of deference to administrative agencies, noting that it has always "been based on the institutional competencies that agencies have when it comes to interpreting regulatory statutes: technical expertise, political accountability, and an ability to adapt their interpretations over time." *Id*. at 1331. Additionally, Cope recognizes that agencies are indirectly accountable to the electorate through the President, and therefore are more democratic than the courts. *Id*. at 1334. A third reason for judicial deference is that courts are more

However, despite Congress' strong interest in protecting the investor, neither § 10(b) nor 10b-5 explicitly provide a cause of action for plaintiffs injured by securities fraud;[43] however, an implied private right of action imposed by the courts, is well established.[44] To state a claim for

---

inflexible than agencies, because they are forced to consider statutory ambiguity on a case-by case basis. *Id*. at 1334-35. In contrast, agencies contend with everyday implementation of the statutes they administer and have a much clearer understanding of the statute's intricacies. *Id*. at 1335. *See also* Cass R. Sustein & Adrian Vermeule, *Interpretation and Institutions*, 101 MICH. L. REV. 885, 926-27 (2003) (recognizing additional advantages of agency deference and delegation, including that agencies may be able to better promote national uniformity, whereas courts are limited by their circuits); Cass R. Sustein, *Law & Administration After* Chevron, 90 COLUM. L. REV. 2071, 2072 (1990) (emphasizing that the New Deal reformers believed that modern problems "required institutions having flexibility, expertise, managerial capacity, political accountability, and powers of initiative far beyond those of the courts," and that agencies were well equipped to acquire such expertise). However, deference to administrative agencies is generally not afforded to agency interpretation of private causes of actions under statutes administered by the agency. *See, e.g.,* Adams Fruit Co., Inc. v. Barrett, 494 U.S. 638, 649 (1990) (finding that even if the Agricultural Worker Protection Act's language establishing a private right of action was ambiguous, the court would not defer to the Secretary of Labor's view of the scope of the Act because Congress had established the judiciary as the adjudicator of private rights of action). *See also* Francis J. Facciola, *When Deference Becomes Abdication*: *Immunizing Widespread Broker-Dealer Practices from Judicial Review Through the Possibility of SEC Oversight*, 73 MISS. L.J. 1, 88 (2003). Although the SEC has a directive to improve market efficiency and to protect investors, these two goals often conflict, forcing the SEC to favor one responsibility over the other. *Id*. Facciolo notes that the SEC's resources have failed to increase at a comparable rate to the growth of the securities markets. *Id*. at 89. The problem is further complicated by the involvement of the individual investor in the market, spreading SEC resources even thinner. *Id*. Consequently, Facciolo argues that the SEC's lack of resources has limited its ability to "effectively audit and study broker-dealer practices." *Id*. at 91.

43 S. REP. NO. 73-792, at 1-5 (1934) (emphasizing that Congress passed the Exchange Act in hopes that federal regulation would ensure an honest securities market and promote investor confidence). *See also* Brennan v. Midwestern United Life Ins. Co., 259 F. Supp. 673, 680 (N.D. Ind. 1966) (stating that one of the basic philosophies of the Exchange Act is disclosure and the creation and maintenance of a post-issuance securities market that is free from fraudulent practices); Scott Siamas, *Primary Securities Fraud Liability for Secondary Actors: Revisiting* Central Bank of Denver *in the Wake of Enron, Worldcom, and Arthur Andersen*, 37 U.C. DAVIS L. REV. 895 (2004) (noting that Congress believed that the public disclosure of material company information would ensure accountability and fairness in the markets, allowing investors to make knowledgeable decisions). *See generally* Peter J. Dennin, *Which Came First, the Fraud or the Market: Is the Fraud-Created-The-Market Theory Valid Under Rule 10b-5?*, 69 FORDHAM L. REV. 2611 (2001) (providing a thorough explanation of the background of the Exchange Act and its reliance requirements, as well as the presumptions based on the fraud created the market theory); Steve Thel, *The Original Conception of Section 10(b) of the Securities Exchange Act*, 42 STAN. L. REV. 385 (1990) (discussing the history behind the passage of the Exchange Act and a discussion regarding the form the Exchange Act should take).

44 *See*, *e.g.,* Herman & Maclean v. Huddleston, 459 U.S. 375, 380 (1983) (finding that "a private right of action under § 10(b) of the 1934 Act and Rule 10b-5 has been consistently recognized for more than 35 years. The existence of this implied remedy is simply beyond

relief under 10b-5 for securities fraud, a plaintiff must allege five elements: (1) scienter; (2) materiality; (3) loss causation; (4) reliance or causation; and (5) that the fraud occurred in connection with the purchase or sale of securities.[45] This Note addresses the reliance requirement because it is the most challenging and most difficult element to prove and key to any standard for secondary actor liability.[46]

1. The Development of the Reliance Requirement Under Rule 10b-5

Under Rule 10b-5, reliance requires that the plaintiff knew or should have known of the alleged misrepresentations, believed them to be true, and because of that belief, purchased or sold the security in question.[47] However, when there is an allegation of an omission, requiring a plaintiff to show a hypothetical state of facts explaining how he would have behaved if the omitted material information had been disclosed, places an unwieldy and unfair burden on the plaintiff.[48] Accordingly, in

---

peradventure"). The right was first recognized in Kardon v. Nat'l Gypsum Co., 73 F. Supp. 798, 800 (E.D. Pa. 1947). *See also* Dennin, *supra* note 43, at 2648 (noting the Exchange Act was "a catch-all clause to prevent manipulative devices") (internal citations omitted); Tarik J. Haskins, *Holding Secondary Actors Liable: Defining Primary Liability Under Section 10(b)*, 71 U. CIN. L. REV. 1093, 1096 (2003) (noting that the SEC lacks the resources to police the markets).

45 *See, e.g.*, R2 Invs. LDC v. Phillips, 401 F.3d 638, 641 (5th Cir. 2005) (finding that in order to state a claim under § 10(b) and Rule 10b-5, a plaintiff must allege, in connection with the purchase or sale of securities: (1) a misstatement or an omission; (2) of material fact; (3) made with scienter; (4) on which plaintiff relied; and (5) that proximately caused the plaintiff's injury); *see also In re* Great Atl. & Pac. Tea Co. Sec. Litig., 103 Fed. Appx. 465, 468 (3d Cir. 2004) (same); Adams v. Kinder-Morgan, Inc., 340 F.3d 1083, 1095 (10th Cir. 2003) (same).

46 *See* Robert S. De Leon, *The Fault Lines Between Primary Liability and Aiding and Abetting Claims Under Rule 10b-5*, 22 J. CORP. L. 723, 734 (1997) (emphasizing that reliance can be proven in several ways, including actual reliance on the misstatement or omission, presumed reliance based on the fraud on the market theory, and presumed reliance due to an omission of material information by a defendant who had a duty to disclose such information to the plaintiff).

47 Nathenson v. Zonagen, Inc., 267 F.3d 400, 413 (5th Cir. 2001) (quoting Abell v. Potomac, 858 F.2d 1104, 1117-18 (5th Cir. 1988)).

> The element of reliance is the subjective counterpart to the objective element of materiality. Whereas materiality requires the plaintiff to demonstrate how a "reasonable" investor would have viewed the defendants' statements and omissions, reliance requires a plaintiff to prove that it *actually* based its decisions upon the defendants' misstatements or omissions. "Reliance is *causa sine qua non*, a type of 'but for' requirement: had the investor known the truth he would not have acted."

Id.

48 Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128, 153-54 (1972). The defendants in *Ute* were two officers of the bank which was the transfer agent for a tribal

Affiliated Ute Citizens of Utah v. United States,[49] the Supreme Court created a presumption of reliance where the defendant failed to disclose material information.[50] Subsequently, the most predominant theory of reliance for § 10(b) actions, the FOMT, was later adopted in response to the special problems of proving reliance in class actions.[51]

2. The Fraud on the Market Theory

The FOMT is based on two propositions: (1) in open, secondary markets,[52] the price of stock is determined by all available information;

---

corporation that managed and distributed assets to members of the Ute Native American Tribe. *Id*. at 136. The bank officers induced tribal members to sell their stock at below-market rates, while the officers purchased a significant number of shares themselves and arranged sales to non-Native American investors, for which they received commissions. *Id*. at 147. As a result, the Court found that the Utes had the right to know that the bank officers were in a position to gain financially from the sales of the stock and that the stock was selling at a higher price in the market that the officers had developed. *Id*. at 154.

49 *Id.* The Court found that the duty to disclose and the withholding of material facts established the requisite element of causation. *Id*.

50 However, the *Affiliated Ute* presumption is limited to omissions and cannot be used to recover due to affirmative misrepresentations. *See, e.g.*, Joseph v. Wiles, 223 F.3d 1155, 1162 (10th Cir. 2000) (finding that in a case where the complaint alleges a mix of material omissions and affirmative misrepresentations, "[a] strict application of the omissions-misrepresentations dichotomy would require the trial judge to instruct the jury to presume reliance with regard to the omitted facts, [but] not to presume reliance with regard to the misrepresented facts") (citing Sharp v. Coopers & Lybrand, 649 F.2d 175, 188) (3d Cir. 1981)). Another basis for reliance, the "Fraud Created the Market" presumption, permits a plaintiff to maintain an action under § 10(b) by proving the defendant's fraud allowed securities that otherwise would have been unmarketable to come into and exit the market. *See* Shores v. Sklar, 647 F.2d 462, 470 (5th Cir. 1981). In *Sklar*, the defendants had engaged in a complicated scheme to create a bond issue so lacking in basic requirements it would have never been approved absent the massive fraud that was involved. *Id*. at 464 n.2. The court in *Sklar* indicated that the plaintiff would be entitled to a presumption of reliance if he could show "that the defendants knowingly conspired to bring securities onto the market which were not entitled to be marketed, intending to defraud purchasers." *Id*. at 469. Further, the Fifth Circuit made it clear that the plaintiff could not recover if he "proves no more than that the bonds would have been offered at a lower price or a higher rate, rather than that they would never have been issued or marketed." *Id*. at 470.

51 *See infra* Part II.A.3 (discussing the Supreme Court's adoption of the FOMT in *Basic*). *See also* Barbara Black, *Fraud on the Market: A Criticism of Dispensing with Reliance Requirements in Certain Open Market Transactions*, 62 N.C. L. REV 435, 439 (1984). Black notes that Rule 23 of Federal Rules of Civil Procedure expanded the availability of class actions and "prompted many courts to view the class action as an appropriate vehicle for adjudicating the liability of defendants whose misstatements affected many open market investors." *Id*. at 439-40. However, while some courts have held that the requirement of individual reliance made the class action inappropriate for Rule 10b-5 claims, others sought to relax or eliminate the reliance requirement in these cases. *Id*. at 440.

52 A secondary market is the market for goods or services that have previously been available for buying and selling, especially the securities market in which previously issued securities are traded among investors. BLACK'S LAW DICTIONARY 984 (8th ed. 2004).

and (2) investors rely on the integrity of market prices when making investment decisions.[53] Based on these presumptions, a plaintiff becomes injured when the market appraises the price of the plaintiff's stock based on information misrepresented by the defendant.[54] As a result, reliance under the FOMT means reliance on the integrity of the market price rather than on the challenged disclosure.[55]

Beneath the FOMT is the principle of the Efficient Capital Market Hypothesis ("ECMH"), which proposes that an efficient market[56] instantaneously assimilates available information and determines a price

---

53 *See* R. Douglas Martin, Basic Inc. v. Levinson*: The Supreme Court's Analysis of Fraud on the Market and its Impact on the Reliance Requirement of SEC Rule 10B-5*, 78 KY. L.J. 403, 418 (1990). Developing slowly over more than two decades, the FOMT appeared first in academic scholarship and then in the lower courts. Jeffrey L. Oldham, Comment, *Taking "Efficient Markets" Out of the Fraud-on-the-Market Doctrine After the Private Securities Litigation Reform Act*, 97 NW. U. L. REV. 995, 1006 (2003). The FOMT was recognized as early as 1967, in a treatise that recognized that "in open-market transactions involving thousands of investors who purchase a company's securities based on their belief in the marketplace, proving reliance upon the company's alleged misrepresentations is not only impractical, but theoretically misguided as well." *Id*. at 1006.

54 Martin, *supra* note 53, at 419. Therefore, damages arise when a buyer or seller pays a different price for the shares than if there had been no fraud. *Id*. Martin discusses the significance of the decision in *Basic v. Levinson*, addressing whether a presumption of reliance supported by the fraud on the market theory should be applied in situations involving material public misrepresentations. *Id*. at 404.

55 Daniel R. Fischel, *Symposium on the Regulation of Secondary Trading Markets, Program Trading, Volatility, Portfolio Insurance, and the Role of Specialists and Market Makers: Efficient Capital Markets, the Crash, and the Fraud on the Market Theory*, 74 CORNELL L. REV. 907, 908 (1989). As a result, a plaintiff's lack of familiarity with the particular misrepresentation becomes irrelevant and the reliance barrier to class certification is eliminated. *Id*. Instead the relevant issue is whether the market price was inflated or deflated rather than to what extent a particular investor was aware of a certain disclosure. *Id*. Additionally, because requiring that investors actually be familiar with the misstatement would create a tremendous burden on investors to satisfy the reliance requirement and make class certification a virtual impossibility, courts utilized the FOMT to accommodate Rule 10b-5 class actions. Black, *supra* note 51, at 472.

56 An "efficient market" is:

> a market where there are large numbers of rational, profit-maximizers actively competing, with each trying to predict future market values of individual securities, and where important current information is almost freely available to all participants. In an efficient market, competition among the many intelligent participants leads to a situation where, at any point in time, actual prices of individual securities already reflect the effects of information based both on events that have already occurred and on events which, as of now, the market expects to take place in the future. In other words, in an efficient market at any point in time the actual price of a security will be a good estimate of its intrinsic value.

The Efficient Market Hypothesis and the Random Walk Theory, http://www.investorhome.com/emh.htm (last visited Sept. 3, 2006).

for that security which reflects all of the available information.[57] More specifically, the most widely accepted form of the ECMH, known as the semi-strong form, suggests that the price of securities reflects all publicly available information.[58] Consequently, courts can assume that any material misrepresentations by an issuer of securities will quickly and accurately be reflected in the market price of the issuer's securities.[59] In *Basic v. Levinson,* the Supreme Court used the FOMT and the ECMH to develop a rebuttable presumption of reliance for § 10(b) actions.[60]

3. The Development of the Rebuttable Presumption Under § 10(b) in *Basic v. Levinson*

In *Basic*, former stockholders brought a class action against Basic Inc., a manufacturer of chemical refractories for the steel industry, alleging that Basic's directors had made material misstatements regarding merger discussions during 1977 and 1978.[61] In finding for the plaintiffs, the

---

[57] Oldham, *supra* note 53, at 1010-11. In fact, the ECMH has been divided into three theories of market efficiency, each based on the type of information assimilated into the market price: the weak, semi-strong, and strong. Fischel, *supra* note 55, at 911. The strong form of the ECMH asserts that all public and private information are fully reflected in the price of a stock; consequently, insider traders cannot outperform the market. *Id*. On the opposite end of the spectrum, the weak form of the hypothesis suggests that historical information is inherent in the current price of that stock; therefore, investors cannot have an edge by knowing the history of successive prices. *Id*.

[58] *See* Fischel, *supra* note 55, at 911. As a result, any efforts to acquire and analyze publicly available knowledge would not produce any different results from those who do no analysis. *Id*. at 909-11. Based on the semi-strong form of the ECMH, courts have developed the basic premise of the FOMT-that prices of securities reflect publicly available information. *Id.* at 911. Courts adopting the FOMT have alluded to empirical studies supporting the validity of the semi-strong version of the ECMH. *Id*. Specifically, market prices of actively traded securities are likely to reflect information about securities because of the "continuous buying and selling decisions of investors." *Id*. For example, "if a consensus among market professionals exists that a particular type of land owned by a publicly-traded real estate company is worth a certain amount, this consensus will be reflected in the company's stock price." *Id.* As a result, because the prices reflect publicly available information, it is reasonable for many investors to accept the market price. *Id.* Consequently, investors who purchase securities that reflect false information from disclosure defects are also harmed. *Id*. However, the weak and strong forms are supported by empirical evidence as well. *Id*.

[59] Oldham, *supra* note 53, at 1011 n.106. There is a presumption that an investor may reasonably "rely on the integrity of the market price of any such security." *Id*. Then, "because an investor who trades in a particular security can be presumed to have done so based on the market price of that security, if that market price reflects some misrepresentation made by the issuer of the security, the trader can be deemed to have relied on the misrepresentation itself." *Id*.

[60] Basic v. Levinson, 485 U.S 224, 245 (1988).

[61] *Id.* at 226-27. During 1977 and 1978, Basic made three public statements denying that it was engaged in merger negotiations, although it had in fact been approached by another

Court adopted the idea that the FOMT created a rebuttable presumption that plaintiffs relied on any public misstatements or omissions made in violation of § 10(b).[62] In its analysis, the Court reasoned that purchasers generally rely on the price of the stock as a reflection of its values.[63] Additionally, the Court noted that Congress expressly relied on the premise that information affects the securities markets and enacted legislation to facilitate an investor's reliance on the integrity of those markets.[64] Most significantly, in adopting the FOMT, the Court made

---

company regarding a merger. *Id*. However, in December 1978, Basic issued a release admitting it had been approached by another company concerning a merger and asked the New York Stock Exchange to suspend trading of its shares. *Id*. at 227-28. Consequently, the plaintiffs brought a class action against Basic and its directors, asserting that the defendants' three initial misstatements regarding the mergers were made in violation of Rule 10b-5 and § 10(b) and that as a result, the plaintiffs were injured by selling Basic shares at artificially depressed prices. *Id*. at 228.

62 *Id.* at 230-31, 245-49. To use a rebuttable presumption based on the FOMT, a plaintiff must prove: (1) that the defendant made public misrepresentations; (2) that the misrepresentations were material; (3) that the shares were traded on an efficient market; (4) that the misrepresentations would induce a reasonable, relying investor to misjudge the value of the shares; and (5) that the plaintiff traded the shares between the time the misrepresentations were made and the time the truth was revealed. *Id*. To rebut a FOMT presumption, a defendant must sever the link between the misrepresentation and the price the plaintiff paid or earned. *Id*. at 248-49. Either the defendant could show that the plaintiff knew the misrepresentation was false and did not rely on the statement or that the truth had already entered the market and altered the price of the stock based on the truth. *Id*.

63 *Id.* at 245. "There cannot be honest markets without honest publicity. Manipulation and dishonest practices of the market place thrive upon mystery and secrecy." H.R. REP. NO. 73-1383, at 11 (1934). The Court in *Basic* also emphasized that Congress "relied on the premise that securities markets are affected by information, and enacted legislation to facilitate an investor's reliance on the integrity of those markets." *Basic,* 485 U.S. at 246.

64 *Basic*, 485 U.S. at 246.

> The idea of a free and open public market is built upon the theory that competing judgments of buyers and sellers as to the fair price of a security brings *[sic]* about a situation where the market price reflects as nearly as possible a just price. Just as artificial manipulation tends to upset the true function of an open market, so the hiding and secreting of important information obstructs the operation of the markets as indices of real value.

Id. (citing H.R. REP. No. 73-1383, at 11 (1934)). As a result, the Court in *Basic* found that the presumption based on the FOMT facilitated the goals of the Exchange Act. *Id.* at 246. However Justice White and Justice O'Connor strongly disagreed with the use of the FOMT in *Basic*. *Id.* at 251-53. The Dissent offers illustrations of the dangers that arise when economic theories replace legal rules as the basis for recovery. *Id*. at 253. (White, J., dissenting). Additionally, Justice White discusses the failure of the FOMT, recognized by courts and academia alike. *Id*. at 253-54. *See also* Martin, *supra* note 53, at 426 (arguing that the FOMT runs contrary to the legislative history and purpose of the Exchange Act and the Securities Act because Congress rejected an anti-fraud provision similar to the FOMT that would have allowed plaintiff's to recover solely for showing the price of the security that had traded was affected by a misrepresentation). *Cf.* Dennin, *supra* note 43, at 2643.

clear that it was interested in the *public nature* of fraudulent misrepresentations, and not in individual reliance or knowledge of a particular misrepresentation.[65] As a result, in *Basic,* the Court clarified and solidified the reliance requirement under § 10(b) and the FOMT has become the most widely used method of proving reliance.[66]

B. *Secondary Liability Under § 10b and Rule 10b-5:* Central Bank of Denver v. First Interstate Bank of Denver

Although the Supreme Court in *Basic* expanded the private right of action under Rule 10b-5 by enabling more class actions, six years later, the Court restricted that same right.[67] In *Central Bank*, the Supreme Court eliminated the longstanding custom of investors bringing actions against secondary actors for aiding and abetting securities fraud.[68] This Part addresses the historical developments and changes regarding the ability of investors to recover against secondary actors who participated in the commission of securities fraud.[69]

Dennin notes that when the FOMT is properly applied, the FOMT "directly flows from the purpose of the Exchange Act, which is to create and maintain an honest and fair securities market." *Id*. Dennin argues that in particular, the FOMT is necessary because "disclosure is an insufficient regulatory structure" because investors cannot analyze all of the information in the marketplace and cannot evaluate investment opportunities. *Id*.

65 *Basic*, 485 U.S. at 247-49.

66 *See supra* Part II.A.2 (discussing the FOMT); *supra* Part II.A.3 (discussing the Supreme Court's adoption of the FOMT in *Basic*).

67 *See infra* notes 80–83 and accompanying text.

68 Central Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164, 185 (1994). The elements of the cause of action for aiding and abetting of a Rule 10b-5 violation were: (1) an independent disclosure violation; (2) actual knowledge, or recklessness, by the aider and abettor of the misrepresentation and his role in furthering it; and (3) the aider and abettor provided substantial assistance in the transaction giving rise to the investor's injury. Farlow v. Peat, Marwick, Mitchell & Co., 956 F.2d 982, 986 (10th Cir. 1992).

69 *See infra* notes 80–83 and accompanying text (discussing the elimination of the aiding and abetting private right of action in *Central Bank*).

Violations of 10b-5 are rarely perpetrated by a single actor.[70] As a result, for three decades, accountants, lawyers, underwriters, and banks were routinely held liable under § 10(b) for aiding and abetting their clients' violations.[71] However, due to increased uncertainty about the scope of private liability under 10b-5,[72] the Court in *Central Bank* was confronted with whether private liability under 10b-5 was actually meant to extend to aiders and abettors.[73] Focusing on the text of § 10(b),

---

70 In fact, professionals play a very important dual role in the markets. Lisa H. Nicholson, *A Hobson's Choice for Securities Lawyers in the Post-Enron Environment: Striking a Balance Between the Obligation of Client Loyalty and Market Gatekeeper*, 16 GEO. J. LEGAL ETHICS 91, 100 (2002). Nicholson discusses the professional conflict resulting from lawyers' duties to their clients and to the markets, observing that lawyers play a significant role in providing legal advice on securities transactions and actively participating in the structuring and documentation of those transactions. *Id*. More specifically, Nicholson notes that securities lawyers routinely draft and revise "transactional" and "disclosure" documents, make comments, make edits, file documents with the SEC, respond to comments by the SEC, and approve press releases and public disclosures. *Id*. Documents reviewed and prepared by lawyers include prospectuses, proxy statements, annual reports, and press releases, all of which may be relied on by investors in making investment decisions. *Id*. Conversely, securities lawyers also must involuntarily be "gatekeepers," charged with the task of "level[ing] the playing fields" of the markets. *Id*. In fact, the SEC and the investing public "increasingly *expect* securities lawyers to ensure their clients' compliance with the federal securities laws." *Id*. (emphasis added). As evidence, Nicholson notes several SEC commissioners that have emphasized the SEC's reliance on market professionals, such as lawyers and accountants, in assisting the SEC in its maintenance of market integrity and investors. *Id*. at 100-01. *See also* Hillary A. Sale, *Banks: The Forgotten(?) Partners in Fraud*, 73 U. CIN. L. REV. 139, 139-40 (2004). Sale notes that the design of the U.S. securities system is based on the existence of intermediaries, professionals who provide transparency in disclosures. *Id*. As gatekeepers, these professionals include accountants, lawyers, and investment bankers. *Id*. These professionals are "key to the assumption that disclosures are clean and accurate and, thereby, are essential to the functioning of an efficient market." *Id*.

71 Prior to 1994, every circuit recognized aiding and abetting as a violation of Rule 10b-5. *See, e.g.,* Akin v. Q-L Invs., 959 F.2d 521 (5th Cir. 1992); Farlow v. Peat, Marwick, Mitchell & Co., 956 F.2d 982 (10th Cir. 1992); Schatz v. Rosenberg, 943 F.2d 485 (4th Cir. 1991); Robin v. Arthur Young & Co., 915 F.2d 1120 (7th Cir. 1990); Zoelsch v. Arthur Andersen & Co., 824 F.2d 27 (D.C. Cir. 1987); Moore v. Fenex, Inc., 809 F.2d 297 (6th Cir. 1987); Rudolph v. Arthur Andersen & Co., 800 F.2d 1040 (11th Cir. 1986); Cleary v. Perfectune, Inc., 700 F.2d 774 (1st Cir. 1983); SEC v. Seaboard Corp., 677 F.2d 1301 (9th Cir. 1982); IIT v. Cornfeld, 619 F.2d 909 (2d Cir. 1980); Monsen v. Consol. Dressed Beef Co., 579 F.2d 793 (3d Cir. 1978).

72 Prior to the decision in *Central Bank*, many courts had begun to question the validity of the aiding and abetting action. *Central Bank,* 511 U.S. at 169-70. *See, e.g*., Benoay v. Decker, 517 F. Supp. 490, 495, *aff'd*, 735 F.2d 1363 (6th Cir. 1984) (noting it was "doubtful that a claim for 'aiding and abetting' . . . will continue to exist under 10(b)").

73 *Central Bank.*, 511 U.S. at 167. Central Bank served as a trustee for a bond issue that backed a failed residential and commercial development. *Id.* In 1986 and 1988, the Colorado Springs-Stetson Hills Public Building Authority ("Authority") issued a total of $26 million in bonds to finance public improvements at Stetson Hills, a planned residential and commercial development in Colorado Springs. *Id*. The bond covenants required that the land subject to the liens be at least 160% of the bonds' outstanding principal and

the Court found that the problem with aiding and abetting liability was that it extended liability beyond persons who "engage," even if only "indirectly," in illegal activities connected with securities transactions.[74] Further, the Court declared that Congress had chosen to impose aiding and abetting liability in other aspects of the law, and specifically used "aid" and "abet" in those statutory texts.[75] As a result, since none of the express causes of action in the Exchange Act imposes aiding and abetting liability, the Court inferred that Congress did not intend for there to be aiding and abetting liability under § 10(b).[76]

Most importantly, the Court articulated several concerns that have fueled post-*Central Bank* analysis.[77] Specifically, the Court found that the

---

interests. *Id*. The covenants also required the developer to give Central Bank an annual report showing that the 160% test was met. *Id*. When property values fell, Central Bank ignored the advice of a senior bond underwriter and its in-house appraiser to hire an outside appraiser to review the value of the bonds. *Id*. Additionally, the senior underwriter was concerned about declining property values in Colorado Springs and the fact that Central Bank was operating on an appraisal that was more than sixteen months old. *Id*. The letter suggested that the Authority may have given false certifications of compliance with the bond covenants. *Id*. In fact, Central Bank delayed the independent review until the end of the year, but by then the development had defaulted and the bonds were useless. *Id*. at 168. After the default, the plaintiffs sued Central Bank for violations under § 10(b) of the Exchange Act, alleging that Central Bank was secondarily liable for its conduct in aiding and abetting the fraud of the underwriters and the developer. *Id*.

[74] *Id.* at 176. The Court divided its precedent into two types of cases. First were cases that determined the scope of conduct prohibited by § 10(b) and followed by cases that interpreted the elements of Rule 10b-5 private liability scheme. *See* Andrew S. Gold, *Reassessing the Scope of Conduct Prohibited by Section 10(B) and the Elements of Rule 10B-5: Reflections on Securities Fraud and Secondary Actors*, 53 CATH. U. L. REV. 667, 673 (2004). Aiding and abetting falls into the scope of the conduct line of precedent, in which Congressional silence indicates that Congress did not intend to impose such liability for aiding and abetting. *Id*. at 674. Additionally, the Court found that the other sections of the Exchange Act specified the conduct for which defendants could be found liable and occasionally even provided that "any person" could be liable. *Central Bank*, 511 U.S. at 176.

[75] *Central Bank*, 511 U.S. at 176; *see also* 18 U.S.C. § 2 (2000) (general criminal aiding and abetting). However, Congress had not chosen to add such language into the Exchange Act. *Central Bank*, 511 U.S. at 176.

[76] *Central Bank*, 511 U.S. at 179. *See* Richard H. Walker & David M. Levine, *The Limits of* Central Bank's *Textualist Approach—Attempts To Overdraw the Bank Prove Unsuccessful,* 26 HOFSTRA L. REV. 1, 4 (1997). Walker and Levine note that the Court generally does not favor implied private rights of action and was likely to apply a textualist approach to limit those rights. *Id*. Also, the Court was driven by its "belief that 'litigation under Rule 10b-5 presents a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general.'" *Id*. (citing *Central Bank*, 511 U.S. at 189 (quoting Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 739 (1975))).

[77] *Central Bank*, 511 U.S. at 188. In fact, the Court rejected various policy arguments offered by the SEC in favor of the aiding and abetting private right of action. *Id*. As amicus curiae, the SEC advanced several arguments in favor of a private cause of action for aiding and abetting. *Id*. at 176. Specifically, the SEC argued that the language "directly or

rules for aiding and abetting did not meet the demands for "certainty" and "predictability" of securities laws.[78] Moreover, the Court emphasized that extra costs incurred by professionals due to litigation costs may be passed on to clients, and in turn investors, the intended beneficiaries of § 10(b).[79]

Further, and most significantly for this Note, the Court emphasized that although there was no aiding and abetting liability under § 10(b), secondary actors were not free from liability under the federal securities laws.[80] Instead, the Court determined that anyone, "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."[81] The effect of *Central Bank* was to shift the discussion of the extent of secondary liability to the unknown boundaries of primary liability for secondary actors.[82] Additionally, *Central Bank* has deeply divided the

indirectly" encompassed aiding and abetting. *Id*. Additionally, while conceding that the Exchange Act did not explicitly mention aiding and abetting, the SEC argued that Congress had intended to include the cause under § 10(b). *Id*. at 177. Finally, the SEC contended that the aiding and abetting cause of action deterred secondary actors and ensured that defrauded plaintiffs were made whole. *Id*. at 188. However, the Court held that policy considerations did not override textual interpretation. *Id*. *See also* Aegis J. Frumento, *Misrepresentations of Secondary Actors in the Sale of Securities: Does* In re Enron *Square with* Central Bank*?* 59 BUS. LAW. 975, 980 (2004) (stating that the *Central Bank* Court's policy concerns were that the liability for aiding and abetting resulted in unpredictable legal rules and gave rise to the risk of litigation exposure unrelated to the merits of cases and causing inefficiency in capital markets and the economy).

78 *Central Bank*, 511 U.S. at 188 (citing Pinter v. Dahl, 486 U.S. 552, 652 (1988)). The result was decisions made on an "ad hoc basis, offering little predictive value" to those in the securities business. *Id*.

79 *Id.* at 191. The Court also emphasized that such uncertainty could lead entities subject to aiding and abetting liability, in their business judgment, to abandon substantial defenses and pay settlements in order to avoid expensive trials. *Id*. at 189.

80 *Id*.

81 *Id.* at 191. "Modern securities fraud is seldom committed by a single person in isolation. The nature of the scam requires that investors be lulled into a sense of trust." Frumento, *supra* note 77, at 976. *See also* Nicholson, *supra* note 70, at 100 (discussing lawyers' roles in the securities markets).

82 *See, e.g.*, *In re* MTC Elec. Techs. Shareholders Litig., 898 F. Supp. 974, 987 (E.D.N.Y. 1995) ("*Central Bank* has generated a fair amount of confusion in the lower courts . . . in identifying the line between primary and secondary liability."). *See also* Russell P. Marsella, *Who's Primarily to Blame? The Quest for the Better Test of Section 10(b) Liability*, 6 ROGER WILLIAMS U. L. REV. 421, 433 (2000) (discussing the confusion after *Central Bank* regarding what primary liability was for secondary actors). However, some critics continue to debate whether a cause of action for aiding and abetting should be reinstated. *See, e.g.,* Roger C. Cramton, *Enron and the Corporate Lawyer: A Primer on Legal and Ethical Issues,* 58 BUS. LAW. 143, 182-83 (2002). Cramton argues that the private right of action for aiding and abetting should be restored for professionals who assist a client in a securities fraud. *Id*. Noting

circuits on the level of involvement required to find secondary actors liable under § 10(b).[83]

III. THE CURRENT CIRCUIT SPLIT OVER THE APPROPRIATE TEST FOR PRIMARY LIABILITY OF SECONDARY ACTORS UNDER § 10(B) OF THE SECURITIES EXCHANGE ACT

With the aiding and abetting causes of actions eliminated in *Central Bank*, the only remaining option for private plaintiffs seeking a remedy for violations of 10b-5 is to allege a primary violation.[84] However, since *Central Bank*, courts have developed four conflicting standards regarding the standard of primary liability for secondary actors.[85]

First, the Ninth Circuit has adopted a very broad standard, imposing liability on secondary actors based on their "substantial participation" in the fraud.[86] Conversely, the Second Circuit has adopted a "bright line" test, imposing liability on secondary actors only when the secondary

---

that ethics rules place limits on what a lawyer may do in terms of a prohibition on "assisting" fraudulent or illegal conduct, and because state laws routinely provide for criminal liability for someone who assists in wrongdoing, he argues the private right of action should be restored. *Id*. at 182. Also, he argues that the absence of civil liability for aiding and abetting puts pressure on courts to stretch the meaning of a primary violation. *Id*. at 182-83.

83 Additionally, the decision in *Central Bank* prompted federal securities reform. Following *Central Bank*, Congress enacted the Private Securities Litigation Reform Act ("PSLRA"). The text of the PSLRA is spread out and split up all over Title 15 of the United States Code. For a complete view of the PSLRA, see Pub. L. No. 104-67, 109 Stat. 737 (1995). In passing the PSLRA, Congress had three primary objectives: (1) to encourage voluntary disclosure of information; (2) to encourage and empower investors so that they may control litigation; and (3) to discourage frivolous lawsuits. S. REP. NO. 104-98, at 5-6 (1995). The passage of the PSLRA was evidence of Congress' approval of the elimination of the aiding and abetting cause of action for private plaintiffs by the Supreme Court in *Central Bank*. *See* Jill E. Fisch, *The Scope of Private Securities Litigation: In Search of Liability Standards for Secondary Defendants*, 99 COLUM. L. REV. 1293, 1304 (1999). Fisch offers a detailed discussion of the events and factors leading up to Congress' passing of the PSLRA. *Id*. However, the PSLRA's extension of SEC enforcement actions to cover aiding and abetting liability effectively overturned *Central Bank*'s decision of the enforcement context. *Id*.

84 *See* Mary M. Wynne, *Primary Liability Amongst Secondary Actors: Why the Second Circuit's "Bright Line" Standard Should Prevail,* 44 ST. LOUIS U. L.J. 1607, 1612 (2000) (offering criticism of the Substantial Participation test and advocated that the Supreme Court resolve the circuit split by adopting the Bright Line approach from *Wright*).

85 Specifically, it is unclear what the Court meant when it stated that one who "makes" a material misstatement could be held primarily liable. *Central Bank*, 511 U.S. at 190.

86 *See, e.g., In re* Software Toolworks Inc. Litig., 50 F.3d 615, 628 (9th Cir. 1994); *In re* ZZZZ Best Sec. Litig., 864 F. Supp. 960, 970 (C.D. Cal. 1994); *infra* Part III.A (discussing the Substantial Participation test).

actors make a misstatement or omission attributable to them.[87] Similarly, the Tenth Circuit in *Anixter v. Home Stake Production Co.* adopted a test that imposes liability if an actor knew or should have known that a misrepresentation he made would go public. [88] Finally, a district court in the Fifth Circuit has adopted a fourth approach, proposed by the SEC, which finds liability when an actor "creates" a misrepresentation.[89] Part III addresses each of these approaches.[90]

A. The Substantial Participation Test

The broadest and most far reaching of the standards for secondary actors is the Substantial Participation test, proposed by the Ninth Circuit.[91] In one of the earliest cases to address secondary actor liability after *Central Bank*, the court in *In re ZZZZ Best Securities Litigation* imposed liability on an actor who was "intricately involved" in the fraud of the primary actor.[92] In *ZZZZ Best*, investors alleged that an accounting firm prepared a report and reviewed, created, and issued several statements related to a fraudulent scheme by ZZZZ Best.[93] Even though the public had no indication that Ernst & Young had anything to do with the public statements, the court held that while the investing public may not be able to "reasonably attribute" any misstatements or

---

87 *See, e.g.*, Wright v. Ernst & Young L.L.P., 152. F.3d 169, 175 (2d Cir. 1998); *In re* MTC Elec. Tech. Shareholder Litig., 898 F. Supp. 974, 988 (E.D.N.Y. 1995); *infra* Part III.B (discussing the Bright Line test).

88 *See, e.g.*, Anixter v. Home-Stake Prod. Co., 77 F.3d 1215 (10th Cir. 1996); *infra* Part III.C (discussing the elements of the *Anixter* test).

89 *See, e.g.*, *In re* Enron Corp. Sec., Derivative & ERISA Litig., 235 F. Supp. 2d 549 (S.D. Tex. 2002); *infra* Part III.D (discussing the Creation test).

90 *See infra* Part III.

91 *See infra* notes 99–105.

92 *In re* ZZZZ Best Sec. Litig., 864 F. Supp. 960, 970 (C.D. Cal. 1994).

93 *Id*. at 970. ZZZZ Best was a large, nationally known carpet cleaning company, and was widely regarded as extremely successful prior to its sudden collapse into bankruptcy in 1987. *Id*. at 963. However, the plaintiffs had alleged that the fraud was committed through a series of misleading statements and omissions of material fact made in public statements regarding ZZZZ Best, its finances, management, and future business prospects. *Id*. The plaintiffs' claims against the accounting firm arose as a result of the firm's release of a review report on first quarter interim financial information for the three-month period ending July 31, 1986. *Id*. The report was included in ZZZZ Best's December 1986 prospectus and stated that: "we are not aware of any material modifications that should be made to the consolidated interim financial statements referred to above for them to be in conformity with generally accepted accounting principles." *Id*. at 964. However, the plaintiffs argued that the firm did know of problems with ZZZZ Best's internal accounting procedures and knew the report was inaccurate. *Id*.

omissions to the accounting firm, the securities market still relied on those statements.[94]

Shortly after *ZZZZ Best*, in *In re Software Toolworks Inc. Litigation*, the Ninth Circuit imposed liability on an accounting firm for the "significant role" it played in the preparation of a client's misleading statement to the SEC.[95] In *Software Toolworks*, the court found that accountants providing merely "extensive review and discussions" could be held primarily liable under § 10(b).[96] Additionally, in *Employers Ins. of Wausau v. Musick, Peeler, & Garrett*, the court found that attorneys and accountants who participated in drafting their client's prospectus were liable, thereby expanding the Substantial Participation test to include liability for merely drafting and editing an offering document.[97] The Ninth Circuit

---

94 *Id*. at 971. *See also* Amanda J. Aymond, Note, *You'd Better Watch What They Say: An Examination of Primary Liability for Secondary Actors Under Section 10(b),* 68 U. CIN. L. REV. 835, 857 (2000). Aymond finds that the Substantial Participation test is consistent with *Central Bank* in that it requires defendants to be primarily culpable in requiring a substantial amount of participation. *Id*. However, Aymond argues that because "substantial participation" is ambiguous, once the court has concluded that the defendant has engaged in a deceitful act, it may hold a secondary actor primarily liable for what is actually aiding and abetting. *Id*.

95 *In re* Software Toolworks Inc. Litig., 50 F.3d 615, 628 (9th Cir. 1994). In July 1990, Software Toolworks, Inc., a producer of software for personal computers and Nintendo game systems, conducted a secondary public offering of common stock at $18.50 a share, raising more than $71 million. *Id*. at 620. However after the offering, the market price of Toolworks shares declined steadily until, on October 11, 1990, the stock was trading at $5.40 a share. *Id*. At that time, Toolworks issued a press release announcing substantial losses and the share price dropped another fifty-six percent to $2.375. *Id*. The following day, investors filed a class action alleging that Toolworks, auditor Deloitte & Touche, and underwriters Montgomery Securities and PaineWebber, Inc., had all knowingly defrauded and assisted in defrauding investors in violation of § 10(b) and Rule 10b-5. *Id*. Specifically, the plaintiffs claimed that the defendants had falsified audited financial statements, fabricated sales to meet financial projections, and lied to the SEC. *Id*.

96 *Id*. at 628 n.3. However, the accountants themselves had made no affirmative misstatements. *Id*. *See also* Aymond, *supra* note 94, at 857. In *In re Software Toolworks*, the court also concluded that an accountant's "significant role" in the drafting and editing was sufficient for a primary violation, but failed to explain what a "significant role" was. *Id*. As a result, Aymond argues that the significant participation standard is too broad and ambiguous in its application, because a deceitful act may be punished as a primary violation when it is merely aiding and abetting, and therefore not actionable under *Central Bank*. *Id*.

97 *See* Employers Ins. of Wausau v. Musick, Peeler, & Garett, 871 F. Supp. 381, 388-89 (S.D. Cal. 1994). The court found the defendant attorneys liable, stating that "a secondary actor may be primarily liable under section 10(b) when the actor's alleged participation consists mainly of drafting and editing an offering document." *Id*. at 389. Additionally, the court emphasized that a secondary actor "may be liable for direct violation of the rule if its participation if the misrepresentation is direct." *Id*. (quoting S.E.C. v. Seaboard Corp., 677 F.2d 1301, 1312 (9th Cir. 1982)). As for the accountants in question, the court ignored the fact that the reports were uncertified, arguing that a flexible test was necessary to

has also indicated that an inherent role or relationship of a secondary actor to the primary violator of § 10(b) may also make the secondary actor primarily liable.[98]

However, no other circuit has adopted the Ninth Circuit's standard.[99] In fact, the Substantial Participation test is often viewed by critics as over-expansive and as having the effect of placing liability on actors having only small roles.[100] Also, the test is criticized for being too vague and as having an unstable and imprecise application.[101] Another principal criticism of the Substantial Participation test is that it does not

---

determine whether a primary violation under § 10(b) had occurred. *Musick*, 871 F. Supp. at 389.

98 In *Flecker v. Hollywood Entertainment Corp.*, the court found that the "defendants' roles as analysts, investment bankers and business advisors with extensive contacts with Hollywood defendants, superior access to non-public information and participation in both drafting and decision-making is sufficient to establish a triable primary liability claim under § 10(b)." Flecker v. Hollywood Entertainment Corp., Civil No. 95-1926-MA, 1997 U.S. Dist. LEXIS 5452, at *9 (D. Or. Mar. 7, 1997).

99 *See infra* Part III.B; *infra* Part III.C; *infra* Part III.D (discussing other approaches circuits have chosen).

100 *See* Wynne, *supra* note 84, at 1624. Wynne notes that the Substantial Participation approach has a great disparity in regards to culpability. *Id.* The ultimate decision of whether to disclose and how to disclose belongs to the client, and not to an attorney or accountant, especially when the participation involves merely reviewing or discussing statements. *Id.* Further, requiring attorneys and accountants to shift through every aspect of their client's business in order to detect omitted facts or misrepresentations is viewed as difficult if not impossible. *Id.*

101 Central Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164, 189 (1994). The Court emphasized that the uncertainty and excessive litigation caused by the aiding and abetting action could have "ripple effects." *Id.* For example, the Court noted that smaller companies could find it difficult to obtain advice from professionals because a professional may fear that a newer or smaller company may not survive, generating possible securities litigation against the professional. *Id.* In addition, the "increased costs incurred by professionals because of the litigation and settlement costs under 10b-5 may be passed on to their client companies, and in turn incurred by the company's investors, the intended beneficiaries of the statute." *Id.* (citing Ralph K. Winter, *Paying Lawyers, Empowering Prosecutors, and Protecting Managers: Raising the Cost of Capital in America*, 42 DUKE L.J. 945, 948-66 (1993)). *See also* Aymond, *supra* note 94, at 857 (noting that in some cases, it appears that the test has been defined based on its effect—whether or not the role of the players had a large or small impact). *See also* Wynne, *supra* note 84, at 1625. Wynne emphasizes that the Substantial Participation test lacks objectivity, which results in unpredictability, which was a major concern of the Court in *Central Bank*. *Id.* There is no gauge for what type of participation actually constitutes liability. *Id.* Additionally, Wynne argues that *Central Bank* will have no meaning unless affirmative acts (making or creating) are involved for the purposes of primary liability. *Id.* Additionally, the Substantial Participation test is criticized as lacking a reliance requirement because the investors did not know that the secondary actor had anything to do with the misstatement or omission. *Id.*

include the reliance requirement for § 10(b).[102] Critics note that by basing the standard of liability on a professional's level of involvement, the test may punish ethically responsible behavior or cause a decrease in professional involvement altogether.[103] Alternatively, praise for the Substantial Participation test is centered on its propensity to reach those indirectly involved.[104] However, as a whole, the Substantial

---

102 In particular, the test is criticized on the basis of a lack of reliance by investors because the investors did not know that the secondary actor had anything to do with the misstatement or omission. *See* Wynne, *supra* note 84, at 1624 (focusing on the inability of investors to rely if they do not know secondary actors had anything to do with the statement or omission). *See also* De Leon, *supra* note 46, at 734. De Leon notes that the costs of excessive litigation could be passed on to investors. Additionally, there is a conflict in the courts over whether reliance can occur when a professional's involvement with the alleged misrepresentation or omission is not known to the plaintiff or the market. *Id*. *See, e.g.*, *In re* ZZZZ Best Sec. Litig., 864 F. Supp. 960 (C.D. Cal. 1994) (recognizing that based on the FOMT, as long as the market relies upon or is affected by the alleged misstatements or omissions themselves, no separate reliance upon the professionals' conduct is needed); Employers Ins. v. Musick, Peeler & Garrett, 871 F. Supp. 387 (C.D. Cal. 1994) (finding that based on the FOMT, investors can recover damages for misstatements or omissions in documents that a third party professional allegedly helped prepare even if the professional is not named in the document and the public cannot otherwise attribute the misstatement or omissions to the professional).

103 *See* Wynne, *supra* note 84, at 1629. Wynne emphasizes that for fear of being held liable under the Substantial Participation test, lawyers may hesitate to offer advice to clients, enter into transactions with clients involved in the sale or purchase of securities, and accountants may be apprehensive to audit or enter into audit relationships with clients they fear are at risk for creating a fraudulent misrepresentation or omission. *Id*. at 1625. Further, Wynne argues that investors would lose the benefit of having outside professionals involved in the process. *Id*. Also, the investors would be the ones who ultimately pay the price for increased attorneys' and accountants' fees if attorneys have to "over-lawyer" and accountants "over-account" in order to avoid liability. *Id*. *See also* Nicholson, *supra* note 70, at 102-03. Noting that under the traditional lawyer-client structure, clients have the final say regarding whether particular public disclosures will occur, with changes in secondary liability, "enterprising and creative plaintiff's counsel" are targeting lawyers for a failure to prevent or disclose their clients' misconduct. *Id*. at 102-03. As a result, Nicholson argues that lawyers' concerns joined with ethical obligations and their roles as gatekeepers creates a "Hobson's choice" for securities lawyers. *Id*. at 103. Further, securities lawyers continue to be under the misapprehension that they could be subjected to disciplinary actions or disbarment if they reveal their clients' fraudulent activity or conduct. *Id*. In fact, securities lawyers are exposed to professional liability under the federal securities laws for maintaining client confidences if it is done with the knowledge that the clients' conduct would constitute a fraud. *Id*. As a result, lawyers must be given the discretion to disclose confidential information relating to client misconduct under the circumstances, and be able to avoid liability. *Id*.

104 *See* Marsella, *supra* note 82, at 445 (arguing that it seems to go against *Central Bank* to allow those who leave or make statements as "unaudited" to go free of liability). *But see* Gold, *supra* note 74, at 707 (arguing that § 10(b) precludes a participation theory because secondary actors that participate generally do not "use" or "employ" a deceptive device).

Participation test is the least accepted and most criticized approach to primary liability of secondary actors.[105]

B. The Bright Line Test

In contrast to the broad reach of the Substantial Participation test, the strictest and narrowest standard is the Bright Line test.[106] Adopted by the Second Circuit in *Wright v. Ernst & Young*, the Bright Line test imposes liability upon secondary actors only when they actually make a material misstatement or omission that can be attributed to them at the time the original statement was made.[107]

In *Wright*, the plaintiffs alleged that Ernst & Young, an accounting firm, provided false and misleading advice to the corporation, knowing that the advice would be passed on to investors through a press release.[108] Moreover, the plaintiffs alleged that because Ernst & Young

---

105 Currently, the Ninth Circuit is the only circuit to utilize the Substantial Participation test. *See, e.g.*, *In re ZZZZ Best*, 864 F. Supp. at 970; Flecker v. Hollywood Entertainment Corp., Civil No. 95-1926-MA, 1997 U.S. Dist. LEXIS 5452, at *9 (D. Or. Feb. 12, 1997).

106 Many jurisdictions have recognized the Bright Line test. *See, e.g.*, Ziemba v. Cascade Intl., Inc., 256 F.3d 1194 (11th Cir. 2001); Wright v. Ernst & Young, L.L.P, 152. F.3d 169 (2d Cir. 1998); S.E.C. v. Lucent Tech. Inc., 363 F. Supp. 2d 708 (D.N.J. 2005); *In re* Rural Cellular Corp. Sec. Litig., No. Civ. 02-4893PAMRLE, 2004 WL 67651 (D. Minn. Jan. 9, 2004); D.E. & J Ltd. P'ship v. Conaway, 284 F. Supp. 2d 719 (E.D. Mich. 2003); *In re* Lernout & Hauspie Sec. Litig., 230 F. Supp. 2d 152 (D. Mass. 2002); Great Neck Capital Appreciation Inv., 137 F. Supp. 2d 1114 (E.D. Wis. 2001); Copland v. Grumet, 88 F. Supp. 2d 326 (D.N.J. 1999).

107 *In re* MTC Elect. Tech. Shareholder Litig., 898 F. Supp. 974, 984 (E.D.N.Y. 1995). As a result, under this test, the standard for secondary actors is the same for primary actors. The "bright line" terminology was first used by the Tenth Circuit in *Anixter v. Home-Stake Prod. Co.*, 77 F.3d 1215 (10th Cir. 1996). Nonetheless, since *Anixter*, the standard adopted by the Second Circuit has been known as a "bright line" test. Wynne, *supra* note 85, at 1617 n.76. However, this Note concludes that the *Anixter* test should be kept separate from the Bright Line test for purposes of analysis.

108 *Wright*, 152 F.3d at 172. At all relevant times, Ernst & Young was the outside auditor for BT Office Products, Inc. ("BT"), a corporation engaged in the distribution and sale of office products. *Id.* at 171. The complaint asserted that Ernst & Young violated the antifraud provisions of the Exchange Act by orally approving BT's materially false and misleading financial statements that BT in turn disseminated to the public in a January 30, 1996 press release. *Id*. As BT expanded, its management engaged Ernst & Young to audit its year-end financial statements. *Id*. at 171. Ernst & Young issued audit opinions certifying the accuracy of BT's financial statements for the years ending December 31, 1993 and December 31, 1994. *Id*. Later, in July 1995, the firm updated and re-released the December 31, 1994 audit opinion as a "Report of Independent Auditors" for use in BT's initial public offering prospectus, which included a statement of BT's first quarter earnings for 1995. *Id*. at 171-72. Later, the firm began a new full scope review, and discovered an under-accrual of BT-Summit's accounts payable and alerted BT management. *Id*. Upon consideration, however, Ernst & Young concluded that the under-accrual was not material and advised BT that it was probably a carryover of a similar under-accrual from the year before. *Id*. Accordingly, the plaintiffs alleged that Ernst & Young signed off on BT Office

"signed-off" or approved the financial information within the press release, the market understood that the release was an implied statement by Ernst & Young that the financial information was accurate.[109] However, the Second Circuit found that not only must the actor actually make the misstatement, but the statement must be attributed to the actor at the time the statement was disseminated.[110] Otherwise, such conduct is merely aiding and abetting.[111]

As the most widely accepted test for primary liability of secondary actors, the Bright Line test has received praise for its narrow reading of

---

Products' 1995 financial statements and authorized a release of the year end results with full knowledge of the fact that the market would and did interpret the release of these figures as having been approved by Ernst & Young. *Id*. In late February and March of 1996, it became apparent to both BT and Ernst & Young that the under-accrual problem at BT-Summit was more serious than previously believed. *Id*. A further investigation revealed not only those BT-Summit employees used improper accounting techniques, but that substantial company funds had been embezzled. *Id*. In light of these discoveries, BT announced on March 28, 1996 that it was restating its 1995 financial results from a previously announced profit of $1.5 million to a loss of $200,000. *Id*. With that announcement, BT's stock lost more than 25% of its value, injuring Wright and the other class members. *Id*.

109 *Id.* at 172. The amended complaint alleged that the recklessness which caused class members to purchase stock at an artificially inflated price and later suffer injury once BT's true financial picture emerged. *Id*. As a result, the plaintiffs claimed that because the market knew and relied on the fact that these financial statements were approved by Ernst & Young, the accounting firm was liable for losses suffered. *Id*. at 171.

110 *Id.* at 173. Specifically, the court noted that the plaintiffs' arguments were foreclosed by *Central Bank* and by the Second Circuit's decision in *Shapiro v. Cantor*, 123 F.3d 717 (2d Cir. 1997). *See also Cascade,* 256 F.3d at 1205. In *Cascade,* the Eleventh Circuit followed the Second Circuit's lead and adopted the narrow version of the Bright Line test. *Id*. *See supra* notes 1-15 and accompanying text (discussing the facts from *Cascade*). Addressing the allegations against the law firm, the court found that the misrepresentations were not attributable to the law firm. *Cascade,* 256 F.3d at 1205. Instead, the plaintiffs' complaint was focused on the law firm's significant role in drafting and creating the fraudulent letters and releases, and was therefore insufficient. *Id*. As a result, the court stated that holding the law firm liable would essentially result in the finding of aiding and abetting liability. *Id*. The court also found that the law firm was not primarily liable for any alleged omissions. *Id*. at 1206. As for the accounting firm, because the plaintiffs had failed to show that any of the material misstatements or omissions were attributable to the accounting firm, the firm could not be primarily liable either. *Id*. at 1211.

111 *Wright*, 152 F.3d at 175. Specifically, the court noted that the plaintiffs' arguments were foreclosed by *Central Bank* and by the Second Circuit's decision in *Shapiro*. *Id.* Additionally, the court found that because § 10(b) and Rule 10b-5 focus on fraud made in connection with the sale or purchase of securities, a defendant must "know or should know" that his representation would be communicated to investors. *Id*. However, although the court adopts *Anixter's* language, it does not allow "knowing" or "having reason to know" to be a substitute for the requirement that the statement actually be attributed to the defendant. *Id*.

§ 10(b).[112] The test is viewed as offering great certainty and predictability in its application to professionals: if the statement or omission is publicly attributable to the defendant, he may be liable.[113] Also, proponents argue that by requiring attribution, the test upholds the reliance requirement of § 10(b).[114] However, others argue that the approach provides a "safe harbor" for defendants who can craftily avoid having their names included in the misrepresentations.[115] Nonetheless, the Bright line test remains the most popular approach in the circuits.[116]

---

112 *Cascade*, 256 F.3d at 1205; *Wright,* 152 F.3d at 175. *See also* Haskins, *supra* note 44, at 1107 (noting that this narrow reading is consistent with the current trend to narrow the scope of private securities litigation).

113 Additionally, the test ensures precision and predictability by requiring that the defendant know or should have known that the misrepresentation or omission would be communicated to investors. Frumento, *supra* note 78, at 975. *See also* Rodney D. Chrisman, Note, "*Bright Line,*" "*Substantial Participation,*" *or Something Else: Who is a Primary Violator Under Rule 10b-5*?, 89 KY. L.J. 201, 223 (2000). Chrisman argues that the Bright Line test is more faithful to the language of § 10(b) and *Central Bank*, and thus must be preferred to the Substantial Participation test, which Chrisman argues is little more than aiding and abetting liability under a different name. *Id*. However, Chrisman proposes that the Bright Line test needs to be modified in order to more clearly state what conduct is sufficient for a primary violation. *Id*. at 223-24.

114 *See* Wynne, *supra* note 84, at 1627. Specifically, Wynne emphasizes that contrary to the Substantial Participation test, which may permit liability when there are no references to secondary actors in misstatements or documents with material omissions, the Bright Line test, by requiring attribution to the actor at dissemination, fulfills the reliance requirement of § 10(b). *Id*. *See also* De Leon, *supra* note 46, at 744-45. De Leon finds that the best view of reliance is that it cannot occur unless the alleged misstatements or omissions were attributed to a third party professional. *Id*. Otherwise, neither plaintiffs nor the market will know about or be influenced by the professional's conduct. *Id*. Further, De Leon rejects the suggestion that reliance on a professional can occur when the professional helps prepare misstatements or omissions because the market is still affected by those misstatements or omissions. *Id*. Such a theory would permit findings of reliance based on conduct constituting minimal aiding and abetting of primary violations by defendants. *Id*.

115 *See* Wynne, *supra* note 84, at 1625. More specifically, actors who can keep their names off documents and therefore not publicly attributable can avoid liability entirely under the Bright Line approach, regardless of how intricately and substantially they were involved in the creation, review, or dissemination of that statement. *Id*. *See also* Robert A. Prentice, *Locating that "Indistinct and "Virtually Nonexistent" Line Between Primary and Secondary Liability Under Section 10(b),* 75 N.C. L. REV. 691, 727-28 (1997). Prentice notes that a secondary actor could approve of a client's false statements or configure transactions so that clients can misleadingly report, yet not be liable because the statement excludes the secondary actor's name. *Id*. As a result, the biggest weakness of the Bright Line approach is that it could allow egregious misconduct to go unpunished and serious injuries to go uncompensated. *Id*.

116 *See* cases cited *supra* note 106 (circuits that have recognized the Bright Line test).

C. The Anixter *Test*

The Tenth Circuit, in *Anixter v. Home-Stake Production Co.*, adopted a test that appeared to be similar to the Bright Line test, but is actually less stringent. [117] Specifically, in *Anixter*, the court did not require that the alleged misstatement be attributed to the defendant at the time of dissemination.[118] Rather, the court found that secondary actors must themselves make a false or misleading statement or omission that they "know or should know" will reach investors.[119]

---

[117] Anixter v. Home-Stake Prod. Co., 77 F.3d 1215 (10th Cir. 1996). Anixter was actually the first appellate case to discuss the distinctions between primary and secondary liability. *Id*. In fact, *Wright* cited to the language in *Anixter*, but still required actual public attribution of the misstatement to the defendant. *Wright*, 152 F.3d at 175.

[118] *Anixter*, 77 F.3d at 1225-26. Home Stake Production Company had begun offering securities in the forms of interests in oil and gas programs in the 1970s. *Id*. at 1218. The securities represented units of participation in annual oil production subsidiaries Home-Stake had established between 1964 and 1972, known as Program Operating Corporations ("Programs"). *Id*. The offerings purported to present investors both the promise of return on investment and attractive tax deductions of intangible drilling costs. *Id*. However, instead of going to oil development, the investments made in later year Programs were paid to earlier-year investors as "income" from the oil production. *Id*. Inevitably, the scheme collapsed, but only after millions of dollars had been lost. *Id*. Consequently, the first securities fraud case was filed in 1973, and had been the subject of four opinions by the 10th Circuit before 1996. *Id*. The Tenth Circuit found that because the trial court judge gave the jury an instruction on "aiding and abetting," the jury may have found liability on an invalid legal theory. *Id*. at 1218-19. In that case, the plaintiff Anixter, with others, had alleged violations of federal securities laws against Home-Stake's directors, officer, outside attorneys, auditors, and other broker-dealers who had marketed its securities. *Id*. at 1219. Plaintiffs alleged that the materials used to sell interests in the Programs contained misleading and untrue statements. *Id*. More specifically, plaintiffs alleged that the materials indicated "rosy" reports and projections to investors, when very little oil was actually being produced, and that large "royalty" payments paid out to early investors came from later investors, and not from oil production. *Id*.

[119] *Id.* at 1226. Plaintiffs alleged that Home-Stake's independent auditor was liable based on his alleged participation in the preparation and filing of the registration statements, program books, and prospectuses, and especially certification and opinion letters verifying Home-Stake's overall health, made with knowledge of the false statements contained therein, or with reckless disregard as to the truth or falsity of the statements. *Id*. Specifically, the plaintiffs alleged that the auditor's behavior had constituted fraud by other defendants, principally the top officers and directors of Home-Stake. *Id*. Specifically, typical representations include certifications of financial statements and opinion letters. *Id*. As a result, the court stated that "[a]n accountant's false and misleading representations in connection with the purchase or sale of any security, if made with the proper state of mind and if relied upon by those purchasing or selling a security, can constitute a primary violation." *Id*.

Further, the court found that the statement does not have to be made directly to the investor.[120] As a result, even though the Bright Line test was based on the *Anixter* test, two distinct tests have emerged.[121] Both versions require that secondary actors actually make the material misstatement or omission in question, but the Bright Line test from *Wright* has imposed the requirement that the action be attributed to the actor at the time the statement was disseminated, while the *Anixter* approach requires only that an actor "know or should know" that his misrepresentation or omission can reach potential investors.[122] Because the *Anixter* test is often overlooked or considered as a mere variation of the Bright Line test, there is little criticism of the test.[123]

D. The Creation Test

The final and most recent standard for primary liability to emerge is a median approach between the Bright Line, *Anixter*, and Substantial Participation standards.[124] The Creation test, proposed by the SEC and adopted by a district court in the Fifth Circuit, provides that a defendant

---

[120] *Id.* The court referenced several opinions finding that accountants have a special duty to disclose when they make statements on which they are aware the investors may rely. *Id.* at 1226-28. *See, e.g.,* United States v. Arthur Young & Co., 465 U.S. 805 (1984) (finding that an accountant who audits the financial statement of a public company has a special public responsibility, in view of the great reliance investors place on financial statements; in fact, an auditor's scrutiny of these statements is necessary to insure that the integrity of the securities markets); Rudolph v. Arthur Andersen & Co., 800 F.2d 1040, 1043-44 (11th Cir. 1986) (finding that when a public auditing firm gives an opinion or certifies statements, it assumes a role carrying a relationship of trust with the public). *But see* Shapiro v. Cantor, 123 F.3d 717, 721 n.2 (2d. Cir. 1997) (criticizing *Akin* and *Rudolph* for not clearly distinguishing between primary liability and aiding and abetting liability).

[121] *See supra* note 117 and text accompanying notes 117-23 (recognizing that *Anixter* was the first case to discuss the distinctions between primary and secondary liability and that although *Wright* cited to the language in *Anixter* in developing the Bright Line test, the court in *Wright* required actual public attribution of the misstatement to the defendant).

[122] *Anixter,* 77 F.3d at 1225-26; *Cascade,* 256 F.3d at 1205; Wright v. Ernst & Young, L.L.P., 152 F.3d 169, 175 (2d Cir. 1998). For support, the court in *Anixter* cited several cases supporting no requirement of first hand contact for liability. *See, e.g.*, SEC v. Holschuh, 694 F.2d 130, 142 (7th Cir. 1982). However, the court also emphasized that certain cases, specifically, ZZZZ *Best* and *Cashman*, that had allowed liability to attach without requiring a representation to be made by defendant, and that had reformulated the "substantial assistance" element of aiding and abetting into primary liability, were not comporting with *Central Bank*. *Anixter*, 77 F.3d at 1226.

[123] *Wright,* 152 F.3d at 175. Although the Court adopted *Anixter's* language, it did not allow "knowing" or "having reason to know" to be a substitute for the requirement that the statement actually be attributed to the defendant. *Id.* As a result, this Note treats the tests separately. *See supra* notes 112-16 and accompanying text (discussing criticisms of the Bright Line test, which are often made against the *Anixter* test as well).

[124] *See infra* notes 140-43 and accompanying text (discussing the criticisms and praise of the Creation test, finding it to be a median approach to the standards of liability).

should be liable when it "creates" a misrepresentation even if the defendant is not identified to investors.[125]

The most utilized source of the Creation test is found in an amicus brief submitted by the SEC in *Klein v. Boyd*.[126] In the *Klein* brief, the SEC proposed a test that would allow a person who "creates" a material misrepresentation, but who does not himself disseminate the misrepresentation, and whose name is not made known to investors, to be a primary violator subject to liability under § 10(b).[127] In doing so, the

[125] Brief of the Securities and Exchange Commission as Amicus Curiae at 18, *Klein v. Boyd*, [1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 90, 136 (3d Cir. Apr. 1998) (Nos. 97-1143, 97-1261) [hereinafter *Klein* Brief], *available at* http://www.sec.gov/litigation/briefs/klein.txt. In the *Klein* Brief, the SEC argued that a person who makes a material misrepresentation, while acting with the requisite scienter, but who does not himself disseminate the misrepresentation, and whose name is not made known to the public, is a primary violator subject to liability. *Id*. at 9. In *Klein*, four investors in a failed limited partnership brought suit against a law firm that represented the partnership on the basis of its role in drafting allegedly fraudulent offering documents. *Id*. The law firm was retained to advise two principals in the formation of a business entity. *Id*. However, the new entity had begun operating by soliciting and receiving investors without waiting for the firm to draft the partnership agreement and other disclosure documents. *Id*. at 9-10. The law firm then advised its client that the agreement needed to be completed, that a disclosure letter had to be provided to investors, and that the investors needed time to reaffirm or rescind their investments. *Id*. However, in the end, the disclosure materials that were distributed failed to make numerous material disclosures to the investors. *Id*. at 10-11. The Fifth Circuit adopted the Creation test in *In re Enron Corp. Sec., Derivative & ERISA Litig.,* 235 F. Supp. 2d 549 (S.D. Tex. 2002). The approach had been previously cited by *Carley Capital Group v. Deloitte & Touche, L.L.P.*, 27 F. Supp. 2d 1324 (N.D. Ga. 1998), before the decision was superseded by *Ziemba v. Cascade Int'l Inc.*, 256 F.3d 1194 (11th Cir. 2001). Additionally, the SEC brief was the basis for the decision in *Klein v. Boyd*. However, the decision in *Klein* was vacated within a month after its issuance, when an en banc panel agreed to take the case.

[126] *See* Nowicki, *supra* note 39, at 660 n.91 (noting that although *Klein* is no longer good law, the decision dealt with attorney liability in a less contrived way than the substantial participation or bright line approaches).

[127] *See* H.R. REP. NO. 104-369, at 31 (1995) ("Private securities litigation is an indispensable tool with which defrauded investors can recover their losses without having to rely upon government action. Such private lawsuits promote public and global confidence in our capital markets and help to deter wrongdoing and to guarantee that corporate officers, auditors, directors, lawyers and others properly perform their jobs."). The Supreme Court had also frequently recognized the important role private causes of action under the federal securities laws because they provide an effective weapon in the enforcement of the securities laws and are a necessary supplement to SEC action. *See, e.g.*, Bateman Eichler, Hill Richards, Inc. v. Berner, 472 US. 299, 310 (1985). The SEC also noted that Congress, in passing the PSLRA, affirmed the significance of private securities actions. *Klein* Brief, *supra* note 125, at 2; *see also* Frumento, *supra* note 77, at 985. Frumento notes that the point regarding the role of secondary actors was most clearly stated in an amicus brief submitted by the Association of the Bar of the City of New York in *Central Bank,* when it stated: "Without aiding and abetting liability, many of the experts, whose technical expertise plays a crucial role in the securities markets, and on whose credibility both buyers and sellers of

SEC argued against a rule requiring actual attribution to the defendant as a condition of liability.[128] Specifically, the SEC argued that the Court in *Central Bank* did not indicate that "make" meant that only persons who sign documents or are otherwise identified to investors can be primarily liable because such a rule would be inconsistent with the § 10(b) use of the words "directly or indirectly."[129]

Further, the SEC emphasized that the person who creates a misrepresentation for another "uses" it "indirectly" and to shield that person from liability would have the consequence of providing a "safe harbor" from liability for everyone except those identified with misrepresentations by name.[130] Additionally, the SEC noted that "makes" as used by the Court in *Central Bank* does not have a precise meaning independent of the circumstances of a particular case.[131]

securities depend, would be essentially immune from liability." *Id*. (quoting Brief Amicus Curiae of the Association of the Bar of the City of New York in Support of Respondents, Central Bank of Denver. v. First Interstate Bank of Denver, 511 U.S. 164 (1994) (No. 92-854)).

128 *Klein* Brief, *supra* note 125, at 3; *see also* Frumento, *supra* note 77, at 986 nn. 72-73 (noting that the SEC tried to limit the impact of *Central Bank* in its lobbying to get the PSLRA passed and that the SEC has long used amicus briefs to influence judicial decisions affecting the federal securities laws).

129 *Klein* Brief, *supra* note 125, at 12. *See also* Frumento, *supra* note 77, at 995. Frumento argues that the SEC incorrectly interpreted the word "make" in Rule 10(b)-5 to include the word "create." *Id*. Frumento, advocating a strict statutory analysis, compares the definitions of "create" and "make." *Id*. He concludes that when analyzing which word is consistent with the "use or employ" language of § 10(b) and Rule 10b-5, that "make" and not create is synonymous with the definition of "use," meaning to "carry out." *Id*. at 996. As a result, Frumento argues that he who "makes" a misrepresentation is he who employs it to defraud, and that he has to communicate to the victim in order to induce reliance on the statement. *Id*. Conversely, a creation of a misrepresentation, without communication to a victim, is a "non-event." *Id*.

130 *Klein* Brief, *supra* note 125, at 12. In *Central Bank*, the SEC stated that creators of misrepresentations could escape liability as long as they concealed their identities, which promoted deception rather than on compliance with federal securities laws. Brief for the Securities and Exchange Commission as Amicus Curiae in Support of Respondents at 10-11, Central Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164 (1994) (No. 92-854). In other words, if those who created misrepresentations, but took care not to be identified publicly with the statements were held not liable, any party retained to prepare information for dissemination to investors, including lawyers, accountants, and public relations firms, could immunize themselves. *Id*.

131 *Klein* Brief, *supra* note 125, at 19. *See also* Frumento, *supra* note 77, at 989. Frumento notes that the SEC's "proffer" of the Creation test had virtually the substance as the Substantial Participation rule. *Id*. Specifically, Frumento notes that "One who 'creates a representation, acting . . . with others' by definition 'participates' in the creation, and then the 'substantiality' of that participation inevitably comes back into question." *Id*. at 988-89. Additionally, Frumento notes that the SEC's primary purpose was not to have its suggested language adopted, but rather to persuade the court to reject the requirement of public attribution. *Id*.

Consequently, the SEC proposed that the standard for primary liability of secondary actors defines "make" as "create."[132]

Most recently, the SEC brief in *Klein* was the foundation for the adoption of the Creation test by the Southern District of Texas in *In re Enron Corporation Securities, Derivative & ERISA Litigation*.[133] In its decision, the district court found that a person need not initiate the misrepresentation, sign the document containing the misrepresentation, disseminate the misrepresentation, or even be identified in the document containing the misrepresentation.[134] Relying heavily on the SEC's brief, the court emphasized that *Central Bank* only required reliance on a misrepresentation, *not* that a particular person made a misrepresentation.[135] The court also rejected the Substantial Participation test because of the uncertainty as to what kind of conduct and circumstances constituted "substantial participation" or "intricate involvement."[136]

---

[132] *Klein* Brief, *supra* note 125, at 17. The SEC also emphasized that its standard would be easily applicable in situations where many parties were concerned, which frequently occurs with complex securities litigation. *Id*. at 17. *See also* Central Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164, 191 (1994) (noting that in complex securities litigation, multiple parties are often involved). Additionally, the SEC's proposed approach provided that the actor did not have to be the initiator of the misrepresentation to be primarily liable. *Klein* Brief, *supra* note 125, at 17. "[I]f he or she writes misrepresentations for inclusion in a document to be given to investors, even if the idea for those misrepresentations came from someone else," he or she may be primarily liable. *Id*. at 17-18. Conversely, if a person who prepares a truthful and complete portion of a document, he or she would not be liable as a primary violator for misrepresentations in other portions of the document; even if that person knew of the documents, he would not have created those misrepresentations and therefore would not be liable. *Id*.

[133] *See* Frumento, *supra* note 77, at 984 (noting that the *Enron* court cited the *Klein* brief for its inspiration for the creation theory).

[134] *In re* Enron Corp. Sec., Derivative & ERISA Litig., 235 F. Supp. 2d 549, 585-86 (S.D. Tex. 2002). In *Enron,* the plaintiffs, purchasers of Enron's securities, alleged that the defendants, which were accounting firms, law firms, and banks, were liable for making false statements or failing to disclose adverse facts and/or participating in a scheme to defraud purchasers of Enron's public securities. *Id*. at 564-65.

[135] *Id*. at 587-88. *See Central Bank*, 511 U.S. at 191 (allowing liability for anyone who "makes a misstatement (or omission) on which a purchaser or seller of securities relies"). Additionally, the court in *Enron* gave merit to the SEC's argument that the Bright Line test would provide a "safe harbor for anonymous creators of misrepresentations." *Enron*, 235 F. Supp. 2d at 588. The SEC also noted: "In sum, by providing a safe harbor for anonymous creators of misrepresentations, a rule that imposes liability only when a person is identified with a misrepresentation would place a premium on concealment and subterfuge rather than on compliance with the federal securities laws." *Klein* Brief, *supra* note 125, at 13.

[136] *Enron*, 235 F. Supp. 2d at 585. In fact, the *Enron* court was adopting the SEC's argument that the Substantial Participation test would encompass lesser degrees of involvement than *Central Bank* allowed. *See Klein* Brief, *supra* note 125, at 19.

Further, in assessing the validity of the SEC's approach, the court in *Enron* followed traditional administrative law principles and gave the SEC substantial deference.[137] The court found that the SEC's approach in *Klein* was balanced in its concern for defrauded investors and unnecessarily harassed defendants.[138] Nonetheless, many critics have contended that the SEC is subject to political pressures and should not be afforded such extensive deference.[139]

Because it is a median approach, the criticisms and praise for the Creation test examine how well the Creation test resolves the problems of the Bright Line, *Anixter*, and Substantial Participation approaches. The dominant praise for the Creation test is that it avoids the "safe harbor" that the Bright Line test allows.[140] Scholars have also noted that there is ample legislative history to support affording the SEC deference in regard to its interpretations of secondary actor liability.[141] In

137 *Enron*, 235 F. Supp. 2d at 588. Noting that because § 10(b) expressly delegated rule-making authority to the agency, which the SEC exercised in creating 10b-5, the court offered a great deal of deference and weight to the SEC's interpretation. *Id*. Specifically, the court notes that such deference is reasonable because the SEC's interpretation is not "arbitrary, capricious or manifestly contrary to the statute." *Id*. *See, e.g.*, Bragdon v. Abbott, 524 U.S. 624, 642 (1998) (noting that the views of administrative agencies constituted a "body of experience and informed judgment" that courts should resort to for guidance).

138 *Enron,* 235 F. Supp. 2d at 590-91. *See also* Gold, *supra* note 74, at 693. Gold discusses the interpretive problem of judicial deference to the SEC, specifically in regards to the implied private right of action and Rule 10b-5. *Id*. Gold argues that *Central Bank* was an instance of non-deference to the SEC, in which the Court rejected the SEC's arguments for a broad interpretation that would permit aiding and abetting liability. *Id*. at 696. Further, Gold notes that the extent to which the SEC's interpretation of the scope of conduct prohibited by § 10(b) merits deference is dependent on the type of action: for private securities litigation, such deference is not called for, even if it were appropriate in the enforcement context. *Id*. at 700. As a result, Gold argues that § 10(b) was meant to limit private actions, and consequently, if deference is allowed, it cannot be allowed such that private action liability would exceed the intended scope of § 10(b). *Id*.

139 Facciola, *supra* note 42, at 6. Facciolo argues that the SEC experiences political pressure when it adopts a position unpopular with the financial services industry. *Id*. As an example, he references when SEC Chairman Arthur Levitt attempted to separate the auditing and consulting functions of major accounting firms, but faltered under intense lobbying pressure by accounting firms. *Id*. The result was a weakened final version of the rules. *Id*. Facciolo also emphasizes that the SEC's budget ultimately is subject to Congressional control. *Id*.

140 *Enron*, 235 F. Supp. 2d at 587-88. *See also Klein* Brief, *supra* note 125, at 13. The SEC argued that whereas the Bright Line test requires the attribution of a statement to a particular defendant, the Creation test is broader and closes the gap by which defendants could avoid liability by strategically keeping their names removed from statements and documents. *Id.*

141 Haskins, *supra* note 44, at 1114. Basing his theory on the approach from *Carley Capital*, Haskins proposes that "an actor would be liable if, acting alone or with others, it creates a

particular, the broad delegation to the SEC allows it to reach conduct that would distort the market or affect market integrity.[142] Finally, some critics find that the Creation test is the most consistent with *Central Bank* because it holds defendants who are directly involved liable.[143]

Each approach to secondary actor liability is distinct, with different strengths and weaknesses.[144] Part IV examines the approaches to secondary actor liability in light of the reliance requirement under § 10(b), the goals of the Exchange Act, and the policies from *Central Bank*.[145]

IV. ANALYSIS: DEVELOPING A NAVIGABLE STANDARD OF LIABILITY

Clearly, the varying approaches taken by the several circuits produce significantly different results.[146] Yet the need for certainty in the field of securities litigation continues to grow.[147] In determining which test best serves the securities laws, there are several essential points of analysis.[148]

---

misrepresentation that a reasonable investor would attribute in part or in whole to the secondary actor." *Id*. Haskins advocates adding the requirement of attribution to the "Creation test" because he argues that otherwise, the reliance requirement requires that a statement must be attributable in some way to the actor involved. *Id*. As a result, he argues his theory would not hold liable individuals who were merely "standing around." *Id*.

142 *See* Thel, *supra* note 43, at 462. *See also* Haskins, *supra* note 44, at 1115 n.212. Haskins argues that his proposed approach is well within the SEC's authority and the legislative history of § 10(b), which indicates that Congress wanted to delegate broad authority to the SEC and to reach conduct that would distort the market. *Id*.

143 *See* Aymond, *supra* note 94, at 860. Aymond advocates the Creation test as articulated in *Carley Capital* because it requires more than the Substantial Participation test, which more precisely excludes aiders and abettors, while it also ensures that the creators and authors of misrepresentations are held liable. *Id*. (citing Carley Capital Group v. Deloitte & Touche, L.L.P., 27 F. Supp. 2d 1324, 1334 (N.D. Ga. 1998)). However, some scholars have made textualist arguments that "make" as used in *Central Bank*, does not mean "create." *See* Frumento, *supra* note 77, at 995. Frumento utilizes strict definitions of the words "use," "make," and "create" to argue that while "create" and "make" both suggest bringing something new into existence, only "make" can be used with "use" (as it is in § 10(b)) to mean "carry out." *Id*. at 996.

144 *See supra* Part III (discussing the various approaches to secondary actor liability).

145 *See infra* Part IV (examining the circuits' approaches to secondary actor liability in light of the reliance requirement of § 10(b), the goals of the Exchange Act, and the policies articulated in *Central Bank*).

146 *See supra* Part III.A (discussing the Substantial Participation test); *supra* Part III.B (discussing the Bright Line test); *supra* Part III.C (discussing the *Anixter* test); *supra* Part III.D (discussing the Creation test).

147 *See* Fisch, *supra* note 83, at 1304 (discussing factors leading up to Congress' passing of the PSLRA); Oldham, *supra* note 53, at 1021-22 (discussing the PSLRA).

148 *See infra* Part IV.A (discussing the relationship of the FOMT and secondary actor liability); *infra* Part IV.B (discussing the need for the secondary liability standard to protect

First, since it is generally the most litigated and most challenging aspect of private securities litigation, each test should comport with the reliance requirement of § 10(b).[149] Second, as many scholars have noted, any legitimate test for secondary actor liability must meet the purpose and goals of the Exchange Act: the test should increase market integrity and investor confidence.[150] Additionally, the SEC's proposals regarding § 10(b) are due some level of deference.[151] Finally, the goals and policies articulated by the Court in *Central Bank*—predictability of outcomes and deterrence of frivolous lawsuits—should be taken into consideration when choosing a particular standard.[152] Part IV examines how well the four tests measure up against these concerns.[153]

A. Reliance: The Fraud on the Market Theory and Secondary Actor Liability

Based on the Court's reasoning in *Basic* and the federal courts' interpretations of the FOMT, the public nature of representations is key to adequately preserving the reliance requirement under § 10(b).[154] As a result, in proving reliance on misrepresentations or omissions made by secondary actors, the preferred approach to primary liability for secondary actors should recognize that reliance is on the misrepresentation, and not on the actor himself or even the investor's knowledge of the actor's participation.[155]

---

market integrity); *infra* Part IV.C (discussing the need for the standard to provide certainty and predictability).

[149] *See infra* Part IV.A.

[150] *See also* S. REP. NO. 73-792, at 1-5 (1934) (noting that the purpose of the Exchange Act in hopes that federal regulation would ensure an honest securities market and promote investor confidence); Siamas, *supra* note 43, at 900.

[151] *See supra* notes 134-39 and accompanying text (discussing the *Enron* court's decision to give deference to the SEC in its interpretation of § 10(b)'s private right of action).

[152] *See supra* notes 77-79 and accompanying text (discussing the goals of predictability and certainty articulated in *Central Bank*).

[153] *See infra* Part IV.

[154] *See Basic*, 485 U.S. at 246 (citing H.R. REP. NO. 1383, at 11 (1934)) (quoting Congress' concern regarding the effect of public representations on investor decisions). Also, the FOMT is a widely accepted, well-grounded analysis accepted by most courts as a working analysis of the reliance requirement of 10b-5 and § 10b. *See* Oldham, *supra* note 53, at 1101 n.106 (discussing the courts' application of ECMH to the FOMT); Wynne, *supra* note 84, at 1627 (criticizing the Substantial Participation test's treatment of the reliance requirement and praising the Bright Line test for requiring attribution); *supra* Part II.B.2 (discussing FOMT); *supra* Part II.B.3 (discussing the Court's decision in *Basic v. Levinson*).

[155] This is based on the idea stated by the court in *Enron* that reliance is present in a misstatement, whether the specific individual who created it is known to the public or not. *In re* Enron Corporation Sec., Derivative & ERISA Litig., 235 F. Supp. 2d 549, 587-88 (S.D. Tex. 2002).

1. Reasonable Investors Expect that Professionals Are Involved

Reasonable investors not only know, but *expect* that outside professionals are involved in the creation and preparation of statements disseminated to the public.[156] To suggest that merely because the name of the creator and preparer of the statement is not on the document itself somehow disables the statement from affecting the market contradicts the primary assumption of the ECMH.[157] It is the misstatement itself which affects the price of the stock.[158] Further, even when the name of the attorney or accountant involved in the preparation of a document is unknown, the market reflects reasonable investors' assumptions that outside professionals were involved in the preparation and creation of the statements.[159] Such involvement is publicly known, and therefore, publicly relied on in connection with the misrepresentation.[160]

As a result, although the Bright Line test requires attribution, and is often praised for preserving the reliance requirement,[161] it fails to recognize the greater role of reliance on information in the public market.[162] In particular, the Bright Line's narrow approach focuses only on public, express reliance. It ignores the implied reliance that professionals were intricately involved in the preparation and creation of statements.[163] As a result, the Bright Line test fails to recognize that

---

156 *See also* Coffee, *supra* note 19, at 308-09 (discussing the role of gatekeepers); Sale, *supra* note 70, at 139-40 (discussing the role of professionals as intermediaries in the securities market).

157 *See generally* Fischel, *supra* note 55 and accompanying text; Thel, *supra* note 43 and accompanying text (describing the various forms of the ECMH, and focusing on how the effect of public information on the stock price is the basis for the FOMT).

158 *See* Fischel, *supra* note 55, at 908 (noting that the FOMT interprets reliance as meaning reliance on the integrity of the market price rather than on the disclosure).

159 *Id.* at 911 (describing empirical studies on the effect of the semi-strong versions of the ECMH–that indicate that market prices are likely to reflect info about securities).

160 It is contrary to common sense to suggest that the reliance is primarily on the actor whose name is attached to the statement rather than on the statement itself and the implied public assumptions that accompany it. *See supra* Part II.A (discussing the reliance requirement under § 10(b)).

161 *See* Wright v. Ernst & Young, L.L.P., 152 F.3d 169, 175 (2d Cir. 1998) (noting that courts must require attribution to an actor, because to find otherwise would circumvent the reliance requirements of the Exchange Act, as "reliance only on representations made by others cannot itself form the basis of liability"). *See also In re* ZZZZ Best Sec. Litig., 864 F. Supp. 960, 973 (C.D. Cal. 1994) (recognizing as long as the market relies on the alleged misstatements or omissions, no separate reliance upon the secondary actor is necessary); Haskins, *supra* note 44, at 1114 (arguing that reliance requires attribution).

162 Basic v. Levinson, 485 U.S. 224, 245 (1988) (discussing the role of reliance in § 10(b) actions); *Wright*, 152 F.3d at 175 (discussing the attribution requirement).

163 *See* Nicholson, *supra* note 70, at 100 (discussing professionals' involvement in creation and preparation of securities documents); Sale, *supra* note 70, at 139-40 (noting that the

information created by unknown individuals could and will affect the market.[164]

At the opposite end of the spectrum, the Substantial Participation test fails to preserve the integrity of the reliance requirement because it allows liability for individuals who may have had little contact with the representation. For example, under this test, an attorney could be liable for merely editing a document.[165] In contrast, the Creation test requires more action by secondary actors: to be liable, the actors must have made or created the misstatements even if they were able to avoid having their names attributed to their statements or omissions.[166] As a result, the reliance is on the representation made by the unnamed actor, and not on an uninvolved third party.[167]

Further, the Creation test emphasizes the significance of the public nature of misstatements.[168] In adopting the FOMT in *Basic*, the Court emphasized that all public information affects the market, so that prices reflect all publicly available information.[169] As a result, reliance under

securities system was based on the existence of professionals "charged with cleansing issuer disclosures in order to provide transparency"). Additionally, as the Court noted in *Basic*, open public markets are based on the idea that the market brings about fair prices because of the competing judgments of buyers and sellers. *Basic*, 485 U.S. at 246. Consequently, "hiding and secreting of important information obstructs the operation of the markets as indices of real value." *Id*. *See also* Prentice, *supra* note 115, at 727-28 (noting that a secondary actor could approve and draft misstatements and not be liable because the statements did not include the actor's name); Wynne, *supra* note 84, at 1625 (discussing that secondary actors' "slyness" immunizes them from liability under the Bright Line test).

164 *See supra* note 70 (emphasizing the effect of professional involvement on the market).

165 It is clear that the Substantial Participation test does not require that actors actually make the misstatement in question. *See, e.g.*, Flecker v. Hollywood Entertainment Corp., Civil No. 95-1926-MA, 1997 U.S. Dist. LEXIS 5452 (D. Or. Feb. 12, 1997) (finding liability based on defendants' roles as analysts, investment bankers, and business advisors for defendants). *But see* Anixter v. Home-Stake Prod. Co., 77 F.3d 1215 (10th Cir. 1996) (finding that the court in *ZZZZ Best*, by not requiring reliance, was finding primary liability on substantially the same grounds as aiding and abetting had once been). Further, the Substantial Participation test allows liability against actors whose participation ranges from merely reviewing a document to editing the document. *See, e.g.*, *In re* Software Toolworks Inc. Litig., 50 F.3d 615 (9th Cir. 1994) (finding liability for accountants that had only extensively reviewed and discussed a document containing misstatements).

166 *See Anixter*, 77 F.3d at 1225 (noting that courts that advocate the Bright Line test have found that *Central Bank's* conclusion that reliance only on representations made by others cannot form the basis of liability makes the Substantial Participation test not viable).

167 *In re* Enron Corp. Sec., Derivative & ERISA Litig., 235 F. Supp. 2d 549, 587-88 (S.D. Tex. 2002) (noting that *Central Bank* only required reliance on a misrepresentation, not that a particular person made a misrepresentation).

168 *See supra* Part III.D (discussing the Creation test).

169 *See* Basic v. Levinson, 485 U.S. 224, 245 (1988) (noting that market professionals generally consider most publicly announced statements about companies, thereby affecting

the FOMT assumes that the plaintiff relied on material public misrepresentations and that reasonable investors would have done the same.[170] Similarly, just as the FOMT supports the presumption that reasonable investors rely on stock prices to be a reflection of the stock's value, the same investors rely on companies to involve accountants and attorneys in the process of preparing and developing statements regarding various material aspects of the company.[171] Therefore, an attribution requirement is unnecessary.

2. Reliance Under § 10(b) Requires Knowledge that a Statement Could Go Public

The emphasis in *Basic* on the public nature of the statement indicates that the actor's knowledge that his statement would be publicly disseminated is relevant as well. First, the Substantial Participation test fails this requirement. It often reaches actors who had no intention or knowledge that their actions would lead to the dissemination of information to investors, finding liability for individuals who merely review and edit a document.[172] Similarly, the Creation test has no requirement that the creator of the document knew or should have known that the document or statements he created would go public.[173]

---

stock prices). Consequently, plaintiffs did not need to show specific reliance on any particular misstatement or omission or on any individual involved with that misstatement or omission. *Id.*

170 *Id.* at 248 n.27 (listing the factors a plaintiff must prove in order to use the FOMT, which includes that the misrepresentation must "induce a reasonable, relying investor to misjudge the value of the shares"). *See also Martin*, *supra* note 53, at 418 and accompanying text (discussing the propositions of the FOMT). Further, reasonable investors are not as concerned with the signatures and attributions on the document as much as the material representations made within the document. *See* Siamas, *supra* note 43, at 900 and accompanying text (emphasizing that the Exchange Act was passed with the belief that public disclosure of material company information would enable investors to make knowledgeable decisions, thereby implying that investors rely on the public information that is disseminated to them).

171 The FOMT and ECMH are based on the idea that prices reflect publicly available information. *See* Fischel, *supra* note 55, at 911; Martin, *supra* note 53, at 418.

172 *See infra* Part IV.B.2 (arguing that the standard for the Substantial Participation test is vague and offers no indication as to what level of participation is required for liability). *See also* Aymond, *supra* note 94, at 857 (noting that it appears the Substantial Participation test is implemented sometimes for the effect of the defendant's actions, i.e. whether or not the role of the players had a large or small impact).

173 Instead, the Creation test only requires that a person create a material misrepresentation, and has no requirement that the person know or should have known that the misrepresentation would eventually be distributed or that the public had any knowledge of the person's involvement in the creation of the misrepresentation. *See supra* Part III.C.

However, the Bright Line test's express prohibition of liability against those who knew or should have known that their statement would be made publicly known is more problematic.[174] By creating a safe harbor as discussed above, the Bright Line test effectively denies recovery against those who knew their statements would go public, but were able to keep their name and participation secret.[175] The *Anixter* test closes the safe harbor by allowing liability if the maker of the statement knew or should have known the document could be made public.[176] Because the individual making the statement knows of its purpose, intent, and use, it is likely that the maker would be aware of how, when, and to whom the document would be distributed.[177] As a result, the *Anixter* test's knowledge component effectively preserves the knowledge aspect of the reliance requirement.

As noted above, there are two primary aspects to the reliance requirement. First, reliance should be on the misrepresentation and not on the actor to whom the misrepresentation is attributed.[178] Second, a knowledge requirement, that the actor knew or should have known the misstatement would go public, is also necessary. However, specific attribution, as required by the Bright Line test, is unnecessary since it is reasonable for investors to assume that professionals are involved in the creation of such important company statements. As a result, each test currently used by the circuits needs some alteration to meet the objectives of the reliance requirement.

---

174 Wright v. Ernst & Young, L.L.P., 152 F.3d 169, 173 (2d Cir. 1998) (finding that not only must an actor actually make the misstatement, but the statement must be attributed to the actor at the time the statement was disseminated). Conversely, the *Anixter* form of the Bright Line test, by not requiring attribution, and by emphasizing the "know" or "should have known" standards, could effectively maintain the reliance requirement.

175 *See supra* Part III.B (discussing criticisms and arguments against the Bright Line test because it allows a "safe harbor" for actors who can keep their names from being publicly associated with misrepresentations).

176 *See supra* Part III.C (discussing the application of the *Anixter* test).

177 Nicholson, *supra* note 70, at 100 (discussing professionals' involvement in creation and preparation of securities documents).

178 As a result, the emphasis should be on the public nature of the misrepresentation. *Supra* Part IV.A (analyzing the standards for secondary actor liability in terms of the reliance requirement of § 10(b)).

B. Secondary Actor Liability Within the Legislative Purpose of the Exchange Act

The relative consistency of each test with the legislative purpose of the Exchange Act should also be considered.[179] More specifically, because the Exchange Act was passed to maintain a high level of integrity and to ensure protection against fraudulent schemes, common sense suggests that liability for misleading statements should exist for those predominantly involved in creating those public statements, regardless of whether or not their names are publicly associated with the misstatements.[180] As a result, denying recovery against those who perpetrate a fraud by creating a misrepresentation affects market integrity.[181]

The Bright Line and *Anixter* tests have the effect of undermining the goals of the Exchange Act by limiting recovery from those who were centrally involved in the perpetration of a fraud on the market.[182] At the other end of the spectrum, the unclear Substantial Participation test is overbroad and risks discouraging professionals from offering quality advice to their clients because of a fear of being found liable.[183] However, the Creation approach maintains market integrity by offering a clear standard of liability aimed at those centrally involved in misrepresentations to investors: professionals can carry out their duties with the awareness and knowledge of what actions could lead to

---

[179] *See* Central Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164, 173 (1994) (emphasizing the legislative history and purpose of the Exchange Act in its analysis of aiding/abetting cause of action). *See also* S. REP. NO. 73-792, at 1-5 (1934) (emphasizing that Congress passed the Exchange Act in hopes that federal regulation would ensure an honest securities market and promote investor confidence); Brennan v. Midwestern United Life Ins. Co., 259 F. Supp. 673, 680 (N.D. Ind. 1966) (stating that one of the basic philosophies of the Exchange Act is disclosure and creation and maintenance of a post-issuance securities market that is free from fraudulent practices).

[180] Dennin, *supra* note 43, at 2648 (discussing the original purpose of the Securities Acts. *See also* Brennan, 259 F. Supp. at 680 (emphasizing disclosure and creation of a market free from fraudulent practices as primary purposes of the Exchange Act); Sale, *supra* note 70, at 140 (emphasizing that the involvement of lawyers, accountants, and other bankers, is key to the assumption that disclosures are clean and accurate and lead to the functioning of an efficient market).

[181] *See* Wynne, *supra* note 84, at 1625 (discussing the implications of the safe harbor left open by the Bright Line test).

[182] This criticism applies to both tests because it's based on the "make" requirement versus the "create" requirement. In both cases, the "make" requirement is too ambiguous. *But see* Frumento, *supra* note 77, at 995 (arguing that "make" means to "use" or "carry out" and is incorrectly used by the SEC in its Creation test).

[183] *See infra* Part IV.B.2 (discussing the Substantial Participation's effect of chilling professional involvement in the securities markets).

liability.[184] Additionally, Congress created the SEC with the purpose of providing for a well-informed and specialized body to deal with the complicated matters of securities laws.[185] Some level of deference is due to SEC interpretations of § 10(b), a statute it administers, and under 10b-5, a rule it promulgated.[186]

1. The Standard for Secondary Actor Liability Should Deter Fraudulent Schemes

In order to preserve market integrity, the appropriate test for primary liability for secondary actors should deter fraudulent schemes.[187] First, the Bright Line test's failure to meet the purpose of the 1934 Act is its greatest criticism.[188] By creating a "safe harbor," whereby conniving individuals can conspire to keep their names off of documents and unassociated with various statements, the test actually encourages the fraudulent scheme behavior that the Exchange Act sought to prevent.[189] Such fraudulent schemes are more likely to develop if liability revolves around a circus act of avoiding having an attorney's or

---

184 *See infra* note Part IV.C (discussing the predictability of the outcomes generated by the Creation test).

185 *See* 15 U.S.C. § 78d (2000) (establishing the SEC); Grundfest, *supra* note 39, at 1018 (noting that Congress gave the SEC great power whenever confronted with conflict and that the SEC was created as an independent entity with its single concern being the problem of securities regulation).

186 *See In re* Enron Corp. Sec., Derivative & ERISA Litig., 235 F. Supp. 2d 549, 588 (S.D. Tex. 2002) (articulating its reasons for granting deference to the SEC's interpretation of § 10(b) and 10b-5); Nowicki, *supra* note 39, at 685-86 (arguing that the SEC's interpretation of "makes" pertains to the SEC's interpretation of its own regulation and should be adopted).

187 *See supra* Part II.A (discussing § 10(b)'s goal of deterring fraudulent schemes).

188 *See Klein* Brief, *supra* note 125, at 12-16. *See also Enron*, 235 F. Supp. 2d at 587 (agreeing with the SEC and rejecting the Bright Line test because it has the unfortunate and unwarranted consequence of providing a safe harbor from liability for everyone except those identified with the misrepresentations by name); Siamas, *supra* note 43, at 918 n.131 (advocating the Substantial Participation test because it allows the courts to punish fraud, no matter where it occurs); Aymond, *supra* note 94, at 858 (stating that Bright Line Test absolves from liability actors who use semantics to get around term "make").

189 *See* Basic v. Levinson, 485 U.S. 224, 230-31, 246 (1985) (discussing Congress' intent in passing the Exchange Act). *See also* H.R. REP. NO. 73-1383, at 11 (1934) (emphasizing that investors need honesty and honest markets). However, this criticism does not apply to the *Anixter* approach; rather, it only applies to the Bright Line test, because it requires attribution. Thel, *supra* note 43, at 427-28 (discussing the purpose of the Exchange Act, which was not to create a completely educated investor, but rather to protect investors from fraudulent schemes).

banker's name on a document that he created and manipulated for public dissemination.[190]

Consequently, the Bright Line test is clearly in contradiction with the Exchange Act's goal of increasing market integrity.[191] In contrast, because the *Anixter* test only requires knowledge that a statement would go public, and not attribution of the statement by the public to the actor, the test does not have the same adverse effect on market integrity.[192] The Creation test also closes the safe harbor left open by the Bright Line test because it does not require attribution.[193] As a result, both the Creation and *Anixter* tests avoid the likelihood that schemes and fraudulent behavior would occur, better preserving market integrity.

2. The Appropriate Test for Liability Should Provide a Navigable Standard and Predictable Outcomes

Not only should the appropriate test deter fraudulent activity, but the standard must be clearly defined and easily understandable.[194] Both the Bright Line and *Anixter* tests fail to adequately define "make," and are generally applied too narrowly, protecting those primarily responsible for the creation and preparation of misleading information meant for investors by preventing liability.[195] In contrast, the Substantial Participation test overreaches.[196] First, because the standard is vague, the Substantial Participation test may have the effect of discouraging professionals from effectively counseling their clients regarding disclosures to investors.[197] More specifically, if attorneys, accountants, and auditors are unclear as to what activities may result in liability, those professionals may choose to participate less in the securities process, thereby decreasing the quality of information passed on to investors.[198]

---

190 *See* Prentice, *supra* note 115, at 727-28 (noting that the biggest weakness of the Bright Line test is its potential to allow egregious wrongdoing).

191 *See* Central Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164, 173 (1994). *See also* Wynne, *supra* note 84, at 1625 (noting that the Bright Line approach contradicts the holding in *Central Bank* because it allows those who are centrally and fundamentally involved to go free); *supra* Part II.A (discussing the purposes of the federal securities laws).

192 *See supra* Part III.C (discussing the *Anixter* test).

193 *See supra* Part III.B (discussing the Bright Line's "safe harbor").

194 *See infra* Part IV.B.2 (discussing the need for a clear standard of liability under § 10(b) in order to encourage professional involvement).

195 *See supra* Part III.B (discussing the Bright Line's "safe harbor").

196 *See* Wynne, *supra* note 84, at 1624 (noting that the Substantial Participation approach has a degree of disparity in terms of culpability).

197 *See, e.g.*, Nicholson, *supra* note 70, at 117.

198 *See* Central Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164, 181 (1994) (emphasizing that the cost of over-lawyering might be spread to investors, the intended

Such a result would be contrary to the Exchange Act's promotion of accurate disclosure.[199]

Additionally, investors generally benefit from the involvement of outside professional consultation to companies.[200] But, the integrity of the market would be compromised as higher attorneys' fees and accountants' fees increase to cover the cost of the over-lawyering and over-accounting that could become rampant as a result of the application of the Substantial Participation test.[201] Further, allowing such a minimal standard for recovery could also discourage ethical behavior.[202] If attorneys and accountants are fearful that any affirmative action they take may later make them susceptible to liability, they may remain aloof and do a poorer job of analyzing and interpreting information presented to them by their clients.[203] Investors would suffer the loss of valuable professional services, traditionally provided by accountants and lawyers, in reviewing, editing, and adjusting statements before they are made known to the public.[204] In other words, the result would be a chilling effect on professional involvement: professionals would likely offer

beneficiaries of the Exchange Act). *See also* De Leon, *supra* note 46, at 742; Wynne, *supra* note 84, at 1624 (discussing the possibilities of excessive litigation if the Substantial Participation approach was utilized).

199 *See* Siamas, *supra* note 43, at 900 (discussing the Exchange Act's emphasis on disclosure and fairness).

200 *See* Nicholson, *supra* note 70, at 100 (discussing the important roles of gatekeepers in the securities markets). "Securities lawyers simply are not peripheral players in the securities markets. They do more than act as simple scriveners—drafting documents solely on the basis of information provided by clients, or limiting review of client documents." *Id*. at 117. Nicholson goes on to argue that the lack of a consistent rule regarding professional liability leads lawyers to ineffective representation. *Id*. at 116-17.

201 *See Central Bank*, 511 U.S. at 181 (discussing the "ripple effects" of an ambiguous standard for liability). *See also supra* note 204.

202 *See* Nicholson, *supra* note 70, at 116-17. Nicholson notes that uncertainty about the law governing professional liability makes lawyers "unnecessarily cautious" during the course of their client representations. *Id*. Additionally, the "lawyers' preoccupation with being viewed as having participated in their clients' misconduct is only heightened by the tension of balancing the lawyers' ethical duties to their clients against the obligation of market gatekeeper." *Id*.

203 Wynne, *supra* note 84, at 1624 (discussing the possible chilling effect on professional involvement caused by the Substantial Participation test).

204 Although the market wants to encourage the involvement of professionals, such as lawyers and accountants, it would be unreasonable and virtually impossible to require lawyers to review every document issued to the public by their clients in search of possible fraudulent statements. *See* Wynne, *supra* note 84, at 1624 (observing that the decision of whether to disclose and how to disclose belongs to the client and that requiring attorneys and accountants to shift through every aspect of their client's business in order to detect omitted facts or misrepresentations is viewed as difficult if not impossible). *Id*.

fewer services or charge inflated rates to cover the risk of increased liability.

In comparison, the Creation test sets out a much clearer standard for professionals by requiring that an actor "create" or "make" or "construct" a misstatement.[205] Whereas the Substantial Participation test may lead to a decrease in professional consultation and advice, the Creation test encourages such professional involvement because professionals would realize they could offer services without having to review, edit, and investigate all of their clients' documents to search for material misstatements or omissions.[206] Secondary actors would only be liable for public misstatements for which they are active creators and not for documents that they are given no opportunity to check for possible § 10(b) violations.[207]

Overall, the Substantial Participation and Bright Line tests completely fail to implement the Exchange Act's goal of preserving market integrity.[208] The tests either inhibit professional participation or allow safe harbors for improper involvement.[209] Also, the *Anixter* test, although it has no safe harbor, still leaves "make" undefined, which results in an imprecise standard.[210]

3. The SEC Deserves Some Level of Deference

Not only did Congress seek to promote market integrity and investor confidence with the Exchange Act, it also sought to create an independent agency to deal with the specific and complicated problems of the securities markets.[211] Consequently, in examining the various approaches to securities fraud under § 10(b), which the SEC administers,

---

205 This is also a benefit of the Bright Line test, but the benefit is outweighed by the "safe harbor" problem mentioned above.

206 *See supra* text accompanying notes 194-204 (discussing the Substantial Participation test and the likelihood of decreasing professional involvement).

207 This would solve the problem created by the Substantial Participation test, which has a wide range of activity for which an actor could be liable. *See supra* Part III.A (discussing the Substantial Participation test).

208 *See supra* Part IV.

209 *See supra* note 70 (noting the effect of professional involvement on the market).

210 *See supra* Part III.C.

211 Congress gave the SEC enforcement power and interpretation power to deal with the securities issues as the agency saw fit. *See* Grundfest, *supra* note 39, at 1018 (noting that Congress originally had wanted to delegate authority to the Federal Trade Commission, but decided instead to create a new entity).

the SEC's interpretation should be given some level of deference.[212] However, because the private right of action under § 10(b) is a judicially created right, traditional deference likely does not apply.[213] Nonetheless, the policies and principles behind deference, as well as the purpose and history behind the creation of the SEC, suggest that the SEC's interpretation of the right of action under § 10(b) and 10b-5 should be given some consideration.[214]

As scholars have recognized, regulation of securities is complicated and courts have frequently stepped aside to allow the SEC to resolve difficult issues of interpretation.[215] Further, the courts' policy in allowing such expansive deference was fueled by understanding the value of agency expertise and flexibility.[216] Similarly, in creating the SEC, Congress emphasized the necessity of having an entity with its "single concern" being securities regulation.[217]

The Creation test, as advocated by the SEC, comports with the congressional intent of § 10(b), and also represents the agency's

---

[212] *See supra* text accompanying note 42 (discussing judicial deference to administrative agencies).

[213] *See supra* note 42 (discussing *Chevron* deference). Since deference generally requires legislative intent or congressional delegation of authority, and because the private right of action under § 10(b) and Rule 10b-5 was judicially created, the SEC's interpretation of that right is not entitled to *Chevron* deference. *E.g.*, Crandon v. United States, 494 U.S. 152, 177 (1990) (Scalia, J., concurring) (rejecting *Chevron* deference where the statute is administered by the courts); Bowen v. Georgetown Univ. Hosp., 488 U.S. 204, 208 (1988) (finding that a congressional delegation of administrative authority is a precondition of deference). *But see In re* Enron Corporation Sec., Derivative & ERISA Litig., 235 F. Supp. 2d 549 (S.D. Tex. 2002) (finding that § 10(b) was an expressly delegated rule making authority to the agency, which it exercised *inter alia* in promulgating Rule 10b-5, and as a result, courts should give considerable weight to the SEC's construction of the statute since the SEC's construction is not arbitrary or contrary to the statute). *See also* SEC v. Zandford, 535 U.S. 813, 819-20 (2002) (noting that the SEC interpretation of the text of § 10(b) should be entitled to deference if it is reasonable). *But see* Gold, *supra* note 74, at 691-92. Gold argues that *Chevron* deference should not apply to the SEC's interpretation of the scope of conduct prohibited by § 10(b) in a private cause of action context, because such deference is based on presumed legislative intent. *Id*. at 670. Specifically, because a private right of action was not originally part of the statute, but instead was created by courts, Gold argues that courts should continue to construe the scope of prohibited conduct. *Id*. at 670-71.

[214] *See* Cope, *supra* note 42, at 1333 (discussing the rationale behind *Chevron* deference); Facciolo, *supra* note 42, at 1 (discussing various justifications courts use for deferring to agency interpretations.

[215] Facciola, *supra* note 42, at 1 (noting justifications courts used in giving deference to the SEC).

[216] Chevron U.S.A., Inc. v. Natural Res. Def. Council, 467 U.S. 837, 842-43 (1984).

[217] *See* Grundfest, *supra* note 39, at 1018 n.287 (citing courts and scholars who had affirmed the SEC's status as an agency with expertise in matters of securities regulation).

interpretation of its own rules and regulations.[218] Realizing its own limitations in regard to its enforcement efforts, the SEC has emphasized the importance of the private right action on many occasions.[219] Additionally, the SEC has an interest in the deterrence of fraudulent acts that affect investors, but the "safe harbor" left open by the Bright Line test removes that deterrent effect.[220] The SEC is also interested in keeping liability tied to public misrepresentations and acts that affect public investment.[221] As a result, the Substantial Participation test's overreach brings many defendants into the realm of liability under the Exchange Act who are beyond the desired scope of SEC power.[222] Because the interests and justifications for the SEC proposed interpretation of secondary actor liability are not only reasonable, but compelling, the SEC should be given due deference in its preferred approach to secondary actor liability.[223]

In summary, the appropriate test for secondary liability should promote market integrity by encouraging professional involvement and discouraging fraudulent schemes and practices. Additionally, because of the SEC's expertise in regards to the securities markets, the SEC's choice of the Creation test and its analysis of liability under § 10(b) is due consideration. As a result, both the Bright Line and Substantial Participation tests fail to adequately preserve these goals of the Securities Acts. The *Anixter* and Creation tests are better, but still need clarification.

C. *Predictability and Certainty: Comporting with the Goals of* Central Bank

A final analysis of the various approaches to secondary actor liability requires an inquiry into whether the goals of *Central Bank*—predictability and certainty—are met by each approach.[224] In particular, in *Central*

---

[218] *See Enron*, 235 F. Supp. 2d at 588. *See also supra* text accompanying notes 143-46 (discussing the Creation test's adherence to the legislative purpose of the Exchange Act).

[219] *See Klein* Brief, *supra* note 125, at 2. *See also* Facciolo, *supra* note 42, at 87-88 (noting the failure of SEC resources to increase comparative to litigation); Frumento, *supra* note 77, at 986 n.70 (documenting attempts by the SEC to reiterate the need for a private cause of action).

[220] *See Klein* Brief, *supra* note 125, at 12 (discussing the harmful effects of the "safe harbor" created by the Bright Line approach).

[221] *See* Securities Exchange Commission, The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation, http://www.sec.gov/about/whatwedo.shtml (last visited Sept. 3, 2006).

[222] *See supra* Part III.A (discussing criticisms of the Substantial Participation test).

[223] *See supra* Part III.D (discussing the Creation test, as applied in *Enron* and the *Klein* Brief).

[224] *See* Central Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164, 188 (1994).

Bank, the Court emphasized it wanted to avoid having unpredictable legal rules that would risk exposure to increased litigation against individuals tangentially involved.[225] Additionally, in recent years, Congress has sought to discourage frivolous suits while maintaining fair rights of action for legitimate claims.[226]

First, critics have recognized that the Bright Line test definitively offers more certainty than the other two tests regarding secondary actor liability.[227] By making the unambiguous and clear requirement that a statement must be attributed to an actor to find liability, the Bright Line test allows attorneys and accountants to clearly gauge what actions will create liability.[228] However, this same quality that provides predictability also creates a loophole for crafty actors: actors can just keep their names out of material misstatements.[229] The Bright Line approach also keeps out legitimate claims against individuals primarily or entirely responsible for the creation of misstatements and omissions.[230]

In contrast, the Substantial Participation test offers little or no compass for determining what level of activity or involvement triggers liability for secondary actors.[231] For example, the Ninth Circuit has formed liability varying from participation in the creation of a document to the mere status of a relationship. The test provides no predictability or certainty to actors as to what behavior may trigger liability under the

---

225 *Id. See also* Frumento, *supra* note 77, at 980 (stating that the Court in *Central Bank*'s concerns were that the liability for aiding and abetting resulted in unpredictable legal rules, giving rise to the risk of litigation exposure unrelated to the merits of cases and causing inefficiency in capital markets and the economy).

226 *See supra* note 83 (describing the various sections of the PSLRA).

227 *See* Haskins, *supra* note 44, at 1107.

228 *See* Wright v. Ernst & Young, L.L.P., 152 F.3d 169, 175 (2d Cir. 1998) (citing Shapiro v. Cantor, 123 F.3d 717, 720 (2d Cir. 1997)).

229 Consequently, its predictability actually harms the effectiveness of the test. *See supra* Part III.B (discussing criticisms of the Bright Line test's "safe harbor").

230 *Id.*

231 *See, e.g.*, In re Software Toolworks Inc. Litig., 50 F.3d 615, 628 (9th Cir. 1994) (finding accountants liable for playing a "significant role" in the preparation of a client's misleading statement to the SEC); Employers Ins. of Wausau v. Musick, Peeler, & Garett, 871 F. Supp. 381, 388-89 (S.D. Cal. 1994) (finding defendants liable for drafting and editing); Flecker v. Hollywood Entertainment Corp., Civil No. 95-1926-MA, 1997 U.S. Dist. LEXIS 5452, at *9 (D. Or. Feb. 12, 1997) (finding that the defendants' roles as analysts, bankers and advisors with extensive contacts with the defendants, superior access to inside information, and participation in both drafting and decision-making was sufficient to establish primary liability).

Exchange Act.[232] Additionally, the Substantial Participation test reaches individuals whose actions had a minimal effect on market integrity; consequently, the number of possible suits is indeterminate.[233] Such an expansive interpretation of the right of action directly contradicts the current trend to encourage less litigation.[234] Consequently, the Substantial Participation test is the worst at reducing litigation. Although the Bright Line test is the best at a reduction, it goes too far and removes securities fraud litigation away from the purposes of the Exchange Act.

The Creation and *Anixter* tests offer better predictability and certainty than the Bright Line and Substantial Participation tests. However, both the Creation and *Anixter* tests need clarification as to what "create" and "make" mean.[235] "Create" is unclear as to whether it includes preparation and formulization, or invention and conceptualization.[236] Nonetheless, the possibilities for the Creation and *Anixter* tests, if modified, are much better than those for the Substantial Participation and Bright Line tests.

V. A PROPOSED STANDARD OF LIABILITY FOR SECONDARY ACTORS

Although each test proposed by the circuits excels in some aspect, each test fails to offer a workable standard for primary liability of secondary actors.[237] Consequently, the best solution to the problem of primary liability left by *Central Bank* is a fusion of the best aspects of each test.

---

232 *See supra* Part III.A (discussing the application of the Substantial Participation Test). *See also* Wynne, *supra* note 84, at 1625 (noting that the Substantial Participation test lacks objectivity).

233 So far, the application of the Substantial Participation standard has ranged from allowing recovery against those who merely reviewed documents to those who actively participated in its development, creation, and dissemination. *See, e.g.*, *Musick,* 871 F. Supp. at 388-89.

234 The enactment of the PSLRA is evidence of Congress' desire to control the increasing trend of litigation in America. *See* Fisch, *supra* note 83, at 1304 (offering a detailed discussion of the events and factors leading up to Congress' passing of the PSLRA).

235 *See* Frumento, *supra* note 77, at 995. Frumento utilizes strict definitions of the words "use," "make," and "create" to argue that while "create" and "make" both suggest bringing something new into existence, only "make" can be used with "use" (as it is in § 10b) to mean "carry out." *Id*. at 996.

236 *Id.*

237 *See supra* Part IV.

A. *What Needs To Be Fixed: Text of the Proposed Test for Secondary Actor Liability*

Using the Creation test as a base format, there are two primary changes necessary to make a workable approach to secondary actor liability. First, "create" should be clarified to more adequately describe what actions are sufficient to establish liability. Second, the knowledge requirement, as stated in the *Anixter* test, should be added to enable the new test to better serve the reliance requirement under § 10(b). The result of these clarifications and additions is not merely a modified Creation test; rather, it is a new unique blend of the best aspects of the current approaches.

1. "Create" Should Be Clarified

First and foremost, the greatest obstacle to the application of the Creation test is the vague and unspecified term "create."[238] If the test is to be widely used, the term "create" must be clearly and specifically defined. As noted above, "create" is preferred to "make" because it casts a wider net around actors who take part in securities violations.[239] However, if left unclarified, the net could spread far and wide, making the Creation test a mere alternative version of the Substantial Participation test.[240]

As a result, "create" should not mean draft or review.[241] Creation requires some analytical contribution from the actor;[242] the secondary actor must put forth some original contribution to the document in order

---

[238] *See supra* text accompanying note 146 (discussing the vagueness of "create" in the Creation test). The court in *Enron* tried to clarify the Creation test. *In re* Enron Corp. Sec., Derivative & ERISA Litig., 235 F. Supp. 2d 549, 610 (S.D. Tex. 2002). The *Enron* court held that when professionals, including lawyers and accountants, take the affirmative step of speaking out, whether individually or as essentially an author or co-author in a statement or report, whether identified or not, about their client's financial condition, have a duty to third parties not in privity to not knowingly issue misleading statements on which they have reason to expect that third parties will depend. *Id.* at 610.

[239] *See supra* Part III.A (discussing the overbroad application of the Substantial Participation test); *supra* Part III.B (discussing the overly narrow application of the Bright Line Approach); *supra* Part III.C (discussing the possibility that the Creation test, if clarified, would allow recovery only against those individuals whose behavior was greater than aiding and abetting).

[240] *Supra* Part IV.C (discussing the Substantial Participation test's unpredictable outcomes).

[241] *See* Employers Ins. of Wausau v. Musick, Peeler, & Garrett, 871 F. Supp. 381, 389 (S.D. Cal. 1994) (using the Substantial Participation test to find liability for merely drafting and reviewing a document).

[242] *See infra* Part V.A.2 (discussing the need for a knowledge requirement).

to be found liable.[243] Otherwise, liability for drafting regularly used documents is aiding and abetting, which was clearly outlawed in *Central Bank*.[244] As a result, the lawyer or accountant or auditor must add or include his own thoughts, ideas, understanding, and analysis of the information provided to him in order to have a sufficient level of participation beyond mere aiding and abetting liability.[245]

2. A Knowledge Requirement Should Be Added

As discussed above, knowledge that a statement would or could go public is necessary for any test under § 10(b) to maintain the reliance requirement.[246] As stated in the *Anixter* test, the requirement that a secondary actor "know or should have known" that the misrepresentation or omission would be communicated to investors implicates the FOMT and preserves the reliance requirement of 10b-5 by preserving the public nature of the statement.[247] Furthermore, the addition of the knowledge requirement may satisfy some critics who believe that attribution is required.[248]

B. Text of the Proposed Test

This Note proposes the following test for secondary actor liability:

> *A secondary actor is a primary violator under § 10(b) if he creates a material misrepresentation by contributing his own original judgments, perceptions, or analysis of facts made known to him, while acting with the requisite scienter, even if his name was unknown to the public, if he knew or should have known that the information could or would be made public.*

---

243 *See supra* Part IV.B.1 (discussing the need for a clear standard of liability so as to encourage professional involvement and promote market integrity); *supra* Part IV.C.1 (discussing the need for predictability and certainty as to what actions would open professionals to liability under § 10(b)).

244 *See supra* Part II.C (discussing the decision in *Central Bank*).

245 *See infra* Part V.B (introducing the text of the Proposed Test).

246 *See supra* Part IV.A.2 (discussing the need for a knowledge requirement in order to adequately preserve the reliance requirement under § 10(b)).

247 *See supra* Part IV.A.2.

248 *See supra* Part III.B (discussing the Bright Line test and the necessity of an attribution requirement).

First the Proposed Test seeks to clarify the term "create" by listing a non-exhaustive list of terms that describe behavior that results in creation.[249] Specifically, creation requires that an actor's "judgments" or "perceptions" or "analysis" be "contributed" in order for the actor to be found primarily liable.[250] These words more clearly emphasize that some original input on the actor's part is required. As a result, the Proposed Test removes possible liability for drafting and reviewing by requiring affirmative action on the part of the lawyer, auditor, or accountant in the creation of the document.

Further, the Proposed Test offers the addition of the knowledge requirement articulated in the *Anixter* test. This enables the Proposed Test to more effectively serve the reliance requirement of § 10(b). Also, the addition of such language bridges the gaps between all four of the current tests, producing a median approach that is more likely to be accepted.

C. Tenets that the New Test Will Support

In analyzing the practicality and viability of the Proposed Test, the framework of the analysis is the same as the framework used in Part IV to compare the current tests.[251]

1. The Proposed Test Focuses on the Public Aspects of the Reliance Requirement

As discussed at length earlier, the key to the reliance requirement under § 10(b) is the FOMT and the public nature of misrepresentations.[252] By requiring no attribution, the Proposed Test recognizes the underlying assumption that professionals are involved in the creation and preparation of statements disseminated to the public.[253] However, by adding a knowledge requirement, the Proposed Test also recognizes that it is the public nature of statements that is significant, and knowledge that a statement will go public is necessary for the reliance requirement.[254] The Proposed Test provides a causal link between the actor and the misrepresentation by requiring enough action

---

249 *See supra* Part V.A.1 (discussing the need for a clearer definition of "create" to avoid the problems of the Substantial Participation test).

250 This avoids the over expansiveness of the Substantial Participation test. *See supra* Part III.A (discussing the wide variance in application of the Substantial Participation test).

251 *See supra* Part IV.

252 *See supra* Parts II.A.2–II.A.3.

253 *See supra* Part IV.A.1.

254 *See supra* Part III.C.

on the part of the secondary actor to move beyond aiding and abetting. The actor must make some affirmative, unique contribution to the misrepresentation.[255]

2. Market Integrity Is Protected by the Proposed Test

Part IV of this Note discussed the need for any rule of primary liability to satisfy the goals of the Exchange Act.[256] The Proposed Test serves to increase market integrity by eliminating the safe harbor left open by the Bright Line test.[257] Fewer schemes would be likely to develop under the Proposed Test because of the removal of the attribution requirement--secondary actors will not benefit from creatively avoiding having their name disclosed.[258] Additionally, the Proposed Test more clearly delineates what actions lead to liability, thereby encouraging involvement by professionals.[259] As a result, there would be no chilling effect on professional activity.

3. The SEC Is Afforded Appropriate Deference

As noted earlier, the SEC was created in an effort to have a specialized program deal with the unique problems of securities law; accordingly, the SEC deserves some deference.[260] Although the Proposed Test does not adopt the SEC's suggested test in its entirety, the Proposed Test acknowledges that the Creation test, with modification, has the ability to bridge the gap between the harsh effects of the Bright Line and Substantial Participation tests.[261] Additionally, the Proposed Test keeps the private right of action intact, enabling investors to supplement the SEC's enforcement activity.[262] However, the Proposed Test departs from the Creation test in two ways. First, it clarifies "create" to make the standard of liability less vague.[263] Second, by adding the knowledge requirement from *Anixter,* the Proposed Test

---

255 *See supra* Part II.C; *supra* Part III.A.
256 *See supra* Part IV.B.
257 *See supra* Part III.B.
258 *See supra* Part III.B.
259 *See supra* note 70.
260 *See supra* Part IV.B.2.
261 *See supra* Part III.D.
262 *See* Haskins, *supra* note 44, at 1096 (noting that the SEC lacks the resources to "comprehensively police the markets").
263 *See supra* Part V.A.1.

decreases the amount of possible litigation just the right amount--not too little, not too much.[264]

4. The Proposed Test Provides Predictability and Certainty

Finally, the Proposed Test fosters *Central Bank's* goals of predictability and certainty.[265] By clarifying the use of "create," the test more clearly delineates the type of activity that will lead attorneys, auditors, and accountants to be liable under 10b-5. Also, by more explicitly stating that an affirmative action on the part of the secondary actor is required, the Proposed Test enables professionals in the field of securities to accurately gauge what behavior they may engage in. As a result, the Proposed Test cures many of the defects of the current standards, making it a viable alternative to the approach to primary liability for secondary actors.[266]

VI. CONCLUSION

Although the circuits have battled with the issue for ten years, they have failed to reach a consensus as to what should constitute liability in the wake of *Central Bank*. Where one test succeeds at promoting investor confidence or promoting market integrity, that same test fails to preserve the reliance requirement under § 10(b). Where another test preserves the reliance requirement, it lacks a clear definition of the standard of liability, creating the likelihood that professional involvement in the securities process would be chilled. Consequently, a fusion of the currently unworkable standards is necessary.

The best approach to secondary liability is one in which "make," as used by § 10(b), is more properly defined to indicate that an affirmative or positive contribution by a professional is necessary for that person to be liable under § 10(b). Further, a requirement that the individual knew or should have known that the misstatement in question would go public is necessary to preserve the longstanding reliance requirement of § 10(b). Drawing from the strengths of each currently used test for secondary actor liability, the Proposed Test provides professionals with a clearer standard of liability to guide them.

For example, look back to the facts from the *Cascade* scandal, discussed in Part I. In *Cascade*, attorneys made affirmative, glowing

---

264 *See supra* Part IV.C.2.
265 *See supra* Part V.C.
266 *See supra* Part V.

public statements that Cascade was in excellent financial health. Under the Proposed Test, those attorneys would be liable because the statements they made to the public and distributed to Cascade officers to make to the public were unique products created by the attorneys. It would not matter that the statements were prepared by the attorneys and made public by the CEO, as long as the attorneys knew or should have known that the statements could or would go public.

Currently, there seems to be no end to the disarray surrounding secondary actor liability in the circuits. Given that four distinct tests have emerged within the circuits, it appears that the Supreme Court will likely be forced to address the issue soon to provide stability to this area of law. Until then, professionals continue to cautiously navigate through the muddled standard of liability under § 10(b).

Mary M. Caskey[*]

* J.D. Candidate 2007, Valparaiso University School of Law; B.A., English, The College of William & Mary, 2004. I give special thanks to my family, especially my husband, Bryan, for being my constant shade. Also, I thank Professor Rebecca Huss for her guidance while I was crafting this Note.