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"Bright Line," "Substantial Participation," or Something Else: Who is a Primary Violator Under Rule 10b-5?

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“Bright Line,” “Substantial Participation,” or Something Else: Who is a Primary Violator Under Rule 10b-5?

BY RODNEY D. CHRISMAN*

INTRODUCTION

Prior to the Supreme Court's landmark decision in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*,¹ secondary actors² were frequently held liable for violations of

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¹ *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994).

² Generally speaking, the issuer of a security is termed the “primary actor.” Although the term “secondary actor” can include parties such as officers, directors, and indenture trustees (among others), the term is more commonly used to refer to parties such as lawyers, accountants, underwriters, and investment bankers. For purposes of this Note, the term “secondary actors” encompasses all of these parties. These so-called “secondary actors” have traditionally been held liable under various theories of secondary liability, characterized by Professor Daniel Fischel as “judicially implied civil liability which has been imposed on defendants who have not themselves been held to have violated the express prohibition of the securities statute at issue, but who have some relationship with the primary wrongdoer.” Daniel R. Fischel, *Secondary Liability Under Section 10(b) of the Securities Act of 1934*, 69 CAL. L. REV. 80, 80 n.4 (1981).

section 10(b) of the Securities Exchange Act of 1934 ("section 10(b)")³ and Securities and Exchange Commission ("SEC") rule 10b-5 ("rule 10b-5")⁴ on a theory of aiding and abetting primary violators.⁵ In *Central Bank of Denver*, the Supreme Court ended this practice by holding that, based on the statutory language of section 10(b), there is no private aiding and abetting cause of action under rule 10b-5.⁶ With no private aiding and abetting cause of action, the Court reasoned that secondary actors can only be liable for a violation of section 10(b) and rule 10b-5 if they meet the requirements of a primary violation.⁷

Before this decision, the question whether a secondary actor was a primary violator or merely an aider and abettor was "largely academic,"⁸ because every federal circuit recognized the aiding and abetting cause of action.⁹ Accordingly, the courts had not developed a clear standard for determining when a secondary actor's conduct rose to the level of a primary violation. After *Central Bank of Denver*, however, the lower courts and commentators have struggled to define the point at which a secondary actor's conduct becomes a primary violation.¹⁰

³ 15 U.S.C. § 78j(b) (1994).

⁴ 17 C.F.R. § 240.10b-5 (2000).

⁵ See, e.g., *Akin v. Q-L Inv., Inc.*, 959 F.2d 521, 526 (5th Cir. 1992); *Camp v. Dema*, 948 F.2d 455, 459 (8th Cir. 1991); *Levine v. Diamantheset, Inc.*, 950 F.2d 1478, 1483 (9th Cir. 1991); *Ross v. Bolton*, 904 F.2d 819, 820 (2d Cir. 1990); Alan R. Bromberg & Lewis D. Lowenfels, *Aiding and Abetting Securities Fraud: A Critical Examination*, 52 ALB. L. REV. 637 (1988); William H. Kuehnle, *Secondary Liability Under the Federal Securities Laws—Aiding and Abetting, Conspiracy, Controlling Person, and Agency: Common-Law Principles and the Statutory Scheme*, 14 J. CORP. L. 313, 321-22 (1989).

⁶ *Cent. Bank of Denver*, 511 U.S. at 191.

⁷ *Id.*

⁸ *In re MTC Elecs. Tech. S'holders Litig.*, 898 F. Supp. 974, 985 (E.D.N.Y. 1995), vacated in part on reconsideration by, 993 F. Supp. 160 (E.D.N.Y. 1997).

⁹ *Cent. Bank of Denver*, 511 U.S. at 192 (Stevens, J., dissenting).

¹⁰ 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, 729-33 (1997); 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, 723-26 (1997); see, e.g., *Wright v. Ernst & Young LLP*, 152 F.3d 169, 175 (2d Cir. 1998), cert. denied, 525 U.S. 1104 (1999); *Dannenberg v. PaineWebber Inc. (In re Software Toolworks Inc. Sec. Litig.)*, 50 F.3d 615, 628 n.3 (9th Cir. 1994); *In re Kendall Square Research Corp. Sec. Litig.*, 868 F. Supp. 26, 28 (D. Mass. 1994); *Vosgerichian v. Commodore Int'l*, 862 F. Supp. 1371, 1378 (E.D. Pa. 1994); *In re ZZZZ Best Sec. Litig.*, 864 F. Supp. 960, 966 (C.D. Cal. 1994); cf.

This Note analyzes the competing theories currently used by courts and commentators to determine when a secondary actor's conduct rises to the level of a primary violation and proposes a workable and logical standard that can be used to differentiate a primary violation from mere aiding and abetting. Part I of the Note discusses the decision in *Central Bank of Denver* and the resulting dilemma that faced the lower courts in determining when a secondary actor is a primary violator.¹¹ Part II provides an analytical discussion of the emergence of two tests often used to determine whether a secondary actor is a primary violator: the "bright line" and "substantial participation" tests.¹² Finally, Part III discusses the elements of a primary violation of section 10(b) and rule 10b-5 as they relate to a secondary actor and proposes a workable and logical test to determine when a secondary actor's conduct rises to the level of a primary violation.¹³

I. *CENTRAL BANK OF DENVER* AND ITS WAKE

Central Bank of Denver was an indenture trustee¹⁴ for a bond issue by the Colorado Springs-Stetson Hills Public Building Authority ("Authority").¹⁵ The bonds required that certain land held subject to their liens be worth at least 160% of the total outstanding principal and interest on the bonds.¹⁶ AmWest Development was required to issue a written annual report to Central Bank of Denver evaluating whether the 160% test was being met.¹⁷ Following AmWest's 1988 appraisal, Central Bank of Denver learned that there was a substantial possibility that the test was not being

Fischel, *supra* note 2, at 82 (interpreting pre-1981 Supreme Court decisions as indicating "that the theory of secondary liability is no longer viable").

¹¹ See *infra* notes 14-31 and accompanying text.

¹² See *infra* notes 32-112 and accompanying text.

¹³ See *infra* notes 113-36 and accompanying text.

¹⁴ An indenture trustee can be thought of as a "third party administrator" of the debt contract (the "indenture"). 3 THOMAS LEE HAZEN, TREATISE ON THE LAW OF SECURITIES REGULATION § 16.1, at 144 (3d ed. 1995). The indenture sets out the rights and duties of all the parties involved, including the duties of the indenture trustee, which is usually a bank that acts as the agent for the individual public bond holders and whose duties often include monitoring the terms of the indenture.

¹⁵ *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 167 (1994).

¹⁶ *Id.*

¹⁷ *Id.*

met, but, on the encouragement of AmWest, waited to perform an independent review of the land value appraisals.¹⁸ Before that independent review was ever performed, however, the Authority defaulted on the bonds.¹⁹ The plaintiff bond purchasers sued Central Bank of Denver, AmWest, the Authority, and others, but the case before the Supreme Court involved primarily whether Central Bank of Denver could be held liable as an aider and abettor.²⁰

In determining whether a private cause of action existed for aiding and abetting under section 10(b) and rule 10b-5, the Supreme Court focused on the language of the statute. Section 10(b) of the 1934 Securities Exchange Act states:

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—

...

(b) To 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 [SEC] may prescribe.²¹

By its text, section 10(b) is not self-executing, but instead depends upon “such rules and regulations as the [SEC] may prescribe”²² to carry it into action. In accordance with this authority, the SEC promulgated rule 10b-5, which provides as follows:

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,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

¹⁸ *Id.* at 167-68.

¹⁹ *Id.* at 168.

²⁰ *Id.*

²¹ 15 U.S.C. § 78j(b) (1994).

²² *Id.*

(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.²³

Justice Kennedy, writing for the Court, began his analysis by stating that “[w]ith respect . . . to . . . the scope of the conduct prohibited by § 10(b), the text of the statute controls our decision.”²⁴ He went on to hold:

In § 10(b), Congress prohibited manipulative or deceptive acts in connection with the purchase or sale of securities. It envisioned that the SEC would enforce the statutory prohibition through administrative and injunctive actions. Of course, a private plaintiff now may bring suit against violators of § 10(b). But *the private plaintiff may not bring a 10b-5 suit against a defendant for acts not prohibited by the text of § 10(b)*. . . . We have refused to allow 10b-5 challenges to conduct not prohibited by the text of the statute.²⁵

Following this logic, the Court reasoned that because the text of section 10(b) does not reach aiding and abetting, there is no aiding and abetting cause of action under section 10(b).²⁶ Consequently, there could be no aiding and abetting cause of action under rule 10b-5 because the rule could not exceed the authority of the statute.²⁷

Although unnecessary to the resolution of the case, the Court proceeded to the next step in a section 10(b) analysis, which is to “attempt to infer ‘how the 1934 Congress would have addressed the issue had the 10b-5 [cause of] action been included as an express provision in the 1934 Act.’”²⁸ Under this analysis, the Court compared the implied cause of action under rule 10b-5 with the express causes of action in the 1934 Act. Based on this comparison, the Court concluded:

From the fact that Congress did not attach private aiding and abetting liability to any of the express causes of action in the securities Acts, we

²³ 17 C.F.R. § 240.10b-5 (2000).

²⁴ *Cent. Bank of Denver*, 511 U.S. at 173.

²⁵ *Id.* (emphasis added).

²⁶ *Id.* at 177 (“It is inconsistent with settled methodology in § 10(b) cases to extend liability beyond the scope of conduct prohibited by the statutory text.”).

²⁷ *Id.* at 173.

²⁸ *Id.* at 178 (quoting *Musick, Peeler & Garrett v. Employers Ins. of Wausau*, 508 U.S. 286, 294 (1993)).

can infer that Congress likely would not have attached aiding and abetting liability to § 10(b) had it provided a private § 10(b) cause of action.²⁹

Even though the Supreme Court unambiguously eliminated the private cause of action for section 10(b) aiding and abetting violations, the Court did not let secondary actors off the hook altogether. The Court reasoned:

Because the text of § 10(b) does not prohibit aiding and abetting, we hold that a private plaintiff may not maintain an aiding and abetting suit under § 10(b). The absence of § 10(b) aiding and abetting liability does not mean that secondary actors in the securities markets are always free from liability under the securities Acts. Any person or entity, including a lawyer, accountant, or bank, who employs a manipulative device or *makes a material misstatement (or omission)* on which a purchaser or seller of securities relies may be liable as a primary violator under 10b-5, assuming *all* of the requirements for primary liability under Rule 10b-5 are met. In any complex securities fraud, moreover, there are likely to be multiple violators; in this case, for example, respondents named four defendants as primary violators.³⁰

Thus, while the Court provided a definitive answer that there is no aiding and abetting cause of action under section 10(b) and rule 10b-5, its opinion raised another question that has perhaps proved more perplexing for the lower courts: when does a secondary actor's conduct rise to the level of a primary violation?³¹

II. THE EMERGENCE OF TWO TESTS TO DETERMINE WHEN A SECONDARY ACTOR'S CONDUCT RISES TO THE LEVEL OF A PRIMARY VIOLATION OF SECTION 10(B) AND RULE 10B-5 AFTER *CENTRAL BANK OF DENVER*

Following the *Central Bank of Denver* decision, commentators and lower courts have struggled to delineate the point at which a secondary

²⁹ *Id.* at 179.

³⁰ *Id.* at 191 (citations omitted) (first emphasis added).

³¹ That this question has proved more perplexing than aiding and abetting liability is illustrated by the relative difficulties that courts have encountered in answering the two questions. Prior to *Central Bank of Denver*, every federal circuit had concluded that an aiding and abetting cause of action existed under section 10(b) and rule 10b-5. *Id.* at 192 (Stevens, J., dissenting). Conversely, the federal circuits have had a much more difficult time agreeing when a secondary actor's conduct rises to the level of a primary violation. *See infra* notes 32-112 and accompanying text.

actor's conduct rises to the level of a primary violation. Courts and commentators addressing this issue have most commonly applied one of two tests:³² the "bright line" or the "substantial participation" test.³³

A. The "Bright Line" Test

Many courts have interpreted *Central Bank of Denver* to mean that, to be a primary violator under section 10(b) and rule 10b-5, the secondary actor must actually make the material misstatement or omission.³⁴ This view reflects the "bright line" test.³⁵

*In re Kendall Square Research Corporation Securities Litigation*³⁶ provides an example of the use of the "bright line" test. In *Kendall Square*, plaintiffs brought suit against several defendants, alleging "losses as a result of materially misleading statements of revenues from the sale of [Kendall Square Research Corporation's] high performance parallel computer systems."³⁷ All of the defendants settled except for Price Waterhouse, one of the "big five" accounting firms, and the company's auditor.³⁸ The complaint alleged that Price Waterhouse violated section 10(b) and rule 10b-5 by (1) reviewing and approving inaccurate financial reports for the company, (2) issuing an unqualified audit opinion³⁹ on the

³² See, e.g., *Wright v. Ernst & Young LLP*, 152 F.3d 169, 175 (2d Cir. 1998), cert. denied, 525 U.S. 1104 (1999); *Dannenberg v. PaineWebber Inc. (In re Software Toolworks Inc. Sec. Litig.)*, 50 F.3d 615, 628 n.3 (9th Cir. 1994); *In re Kendall Square Research Corp. Sec. Litig.*, 868 F. Supp. 26, 28 (D. Mass. 1994); *Vosgerichian v. Commodore Int'l*, 862 F. Supp. 1371, 1378 (E.D. Pa. 1994); *In re ZZZZ Best Sec. Litig.*, 864 F. Supp. 960, 966 (C.D. Cal. 1994); De Leon, *supra* note 10, at 729-33; Prentice, *supra* note 10, at 725.

³³ Courts and commentators have not used the same nomenclature. This Note's use of "bright line" and "substantial participation" was inspired by the Second Circuit's discussion in *Wright*, 152 F.3d at 175.

³⁴ See *id.*; *Kendall Square*, 868 F. Supp. at 28; *Vosgerichian*, 862 F. Supp. at 1378.

³⁵ See *Wright*, 152 F.3d at 175.

³⁶ *Kendall Square*, 868 F. Supp. at 26.

³⁷ *Id.* at 27.

³⁸ *Id.*

³⁹ An unqualified audit opinion is a type of audit opinion that states that the company's financial statements comply with Generally Accepted Accounting Principles ("GAAP") and that the audit was performed in accordance with Generally Accepted Auditing Standards ("GAAS") with no significant scope limitations on the audit. It is also known as a "clean" audit opinion. O. RAY WHITTINGTON & KURT PANY, *PRINCIPLES OF AUDITING* 678-79 (12th ed. 1998).

company's financial statements, and (3) reviewing and approving misleading representations made in the company's prospectuses for stock offerings.⁴⁰

The United States District Court for the District of Massachusetts refused to dismiss the claim that Price Waterhouse could be held liable as a primary violator of section 10(b) and rule 10b-5 for its unqualified audit opinion on financial statements containing material misstatements of revenues.⁴¹ Although the court failed to fully explain why it refused to dismiss the claim,⁴² it seems logical that if Price Waterhouse's statements in its unqualified audit opinion suggesting that Kendall Square's financial statements were prepared in accordance with Generally Accepted Accounting Principles ("GAAP") turned out to be false, then Price Waterhouse could be held liable as a primary violator, provided the other elements of a primary violation were present.

On the other hand, the court found Price Waterhouse immune from liability for reviewing and approving the company's quarterly financial reports and prospectuses for stock offerings, and consequently dismissed that claim.⁴³ In so holding, the court stated:

The Supreme Court's decision in *Central Bank* makes clear that the policy undergirding it is to constrict the ambit of private actions under Section 10(b) and to thereby reduce the number of parties implicated by that statute. *Only primary violators, i.e., those who make a material misstatement or omission or commit a manipulative act, are subject to private suit under Section 10(b).*

. . . The Court rules that the [complaint's] allegations that Price Waterhouse reviewed and approved the quarterly financial statements and the Prospectuses do not constitute the *making* of a material misstatement; at most, the conduct constitutes aiding and abetting and is thus not cognizable under Section 10(b). Because Price Waterhouse did not actually engage in the reporting of the financial statements and Prospectuses, but merely reviewed and approved them, the statements are not attributable to Price Waterhouse and thus Price Waterhouse cannot be found liable for *making* a material misstatement.⁴⁴

Relying on the Supreme Court's holding in *Central Bank of Denver* that section 10(b) "prohibits only the making of a material misstatement (or

⁴⁰ *Kendall Square*, 868 F. Supp. at 26-28.

⁴¹ *Id.*

⁴² *See id.*

⁴³ *Id.* at 28.

⁴⁴ *Id.* (citations omitted) (first emphasis added).

omission),”⁴⁵ the court concluded that, in order to be liable as a primary violator, the defendant must actually make a material misstatement or omission.⁴⁶ The court concluded that Price Waterhouse did not make the misstatements contained in the financial statements and prospectuses because those documents, and the misstatements contained therein, were not “attributable” to Price Waterhouse.⁴⁷ Accordingly, the court held that the plaintiffs’ claims based on the financial statements and prospectuses could not go forward.⁴⁸

In *Wright v. Ernst & Young LLP*,⁴⁹ the plaintiffs brought suit against Ernst & Young, another of the “big five” accounting firms, for an alleged primary violation of section 10(b). The violation alleged was that Ernst & Young had given “private approval of the information contained in a press release”⁵⁰ that was issued “with a notation that the information [was] unaudited and without mention of [the company’s] outside auditor.”⁵¹ The Second Circuit began by reviewing the approaches taken by several courts since the Supreme Court’s decision in *Central Bank of Denver*.⁵² After concluding that *Central Bank of Denver* mandates the use of the “bright line” test,⁵³ the court stated:

We therefore agree with the district court that holding Ernst & Young primarily liable under the Act “in spite of its clearly tangential role in the alleged fraud would effectively revive aiding and abetting liability under a different name, and would therefore run afoul of the Supreme Court’s holding in *Central Bank*.”⁵⁴

Like the district court in *Kendall Square*, the Second Circuit held that a secondary actor must actually make the material misstatement or omission

⁴⁵ *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 177 (1994).

⁴⁶ *Kendall Square*, 868 F. Supp. at 28.

⁴⁷ *Id.*

⁴⁸ *Id.*

⁴⁹ *Wright v. Ernst & Young LLP*, 152 F.3d 169 (2d Cir. 1998), *cert. denied*, 525 U.S. 1104 (1999).

⁵⁰ *Id.* at 171.

⁵¹ *Id.*

⁵² *See id.* at 174-75.

⁵³ The court so concluded because it reasoned that *Central Bank of Denver* requires that the defendant actually make the misstatement or omission to be held liable under section 10(b) and rule 10b-5. The court determined that, of the two tests, only the “bright line” test actually imposed such a requirement. *See id.*

⁵⁴ *Id.* at 175 (quoting *Wright v. Ernst & Young LLP*, No. 97 CIV. 2189(SAS), 1997 WL 563782, at *3 (S.D.N.Y. Sept. 10, 1997)).

in order for its conduct to rise to the level of a primary violation. In addition, the court concluded that “the misrepresentation must be attributed to that specific actor at the time of public dissemination”⁵⁵ before that actor could be liable as a primary violator.

While attempting to answer what it means to make a misstatement or omission, the court left unanswered another question: how does one determine whether the misrepresentation has been “attributed” to the secondary actor? To say that the misstatement or omission must be “attributed” to the secondary actor provides no more guidance than to simply reiterate that the secondary actor must actually make the misstatement or omission in order to be held liable. Again, like *Kendall Square*, the court seems to have intuitively determined which statements were actually made by the defendants without articulating a test by which it arrived at its determination.

Other courts have applied the “bright line” test. In *In re MTC Electronics Technologies Shareholders Litigation*,⁵⁶ for example, plaintiff shareholders brought suit in the United States District Court for the Eastern District of New York, alleging that MTC had made false misrepresentations.⁵⁷ Specifically, plaintiffs alleged that the company falsely stated in press statements and SEC filings that the company had secured agreements to provide cellular phone service and related equipment to customers in China.⁵⁸ When it was revealed that no such agreements existed, MTC Electronics’ stock price plummeted,⁵⁹ and those shareholders injured by the price drop sued various company officers, the underwriters for the company’s stock offerings (H.J. Meyers), and the company’s accounting firm (DBO Dunwoody).⁶⁰

The plaintiffs alleged that H.J. Meyers was a primary violator of section 10(b) and rule 10b-5 for participating in the drafting and dissemination of the company’s November 1991 prospectus for its public offering, and for disseminating a research report on the company that contained allegedly false statements made by H.J. Meyers.⁶¹ The court held

⁵⁵ *Id.*

⁵⁶ *In re MTC Elecs. Tech. S’holders Litig.*, 898 F. Supp. 974 (E.D.N.Y. 1995), vacated in part on reconsideration by, 993 F. Supp. 160 (E.D.N.Y. 1997).

⁵⁷ *Id.* at 977.

⁵⁸ *Id.* at 977-78 (noting that the price of the stock went from \$5 per share to \$30 per share after the public statements).

⁵⁹ *Id.* at 978.

⁶⁰ *Id.*

⁶¹ *See id.* at 978, 987.

that a suit could not be maintained against H.J. Meyers for having participated in the drafting and dissemination of the prospectus, but that a suit could be maintained against H.J. Meyers for its allegedly false statements made in a research report that it had disseminated.⁶² Again, like the courts in *Kendall Square* and *Wright*, the *MTC Electronics* court determined that the secondary actor must actually make the misstatement or omission to be held liable. The court did not, however, articulate a standard by which other courts and secondary actors could determine when such a statement has been made by the secondary actor.

Similarly, the court held that a suit could be maintained against DBO Dunwoody based on its issuance of an unqualified audit opinion.⁶³ Like the court in *Kendall Square*,⁶⁴ the court in *MTC Electronics* concluded that because an auditor actually makes statements in its audit opinion, the auditor can be held liable as a primary violator if those statements turn out to be false or misleading.⁶⁵

In analyzing the various claims against these parties and the confusion of the lower courts regarding what constitutes a primary violation, the court made the following statement, which has been used by courts⁶⁶ and commentators⁶⁷ to articulate the “bright line” test and the reasoning behind it:

[I]f *Central Bank* is to have any meaning, a defendant must actually make a false or misleading statement in order to be held liable under Section 10(b). Anything short of such conduct is merely aiding and abetting, and no matter how substantial that aid may be, it is not enough to trigger liability under Section 10(b).⁶⁸

Still, like *Kendall Square* and *Wright*,⁶⁹ the *MTC Electronics* court correctly asserted that the misstatement or omission must be made by the secondary actor, but failed to articulate how one determines *whether* the secondary actor made the misstatement or omission. In so doing, the court illustrated the conceptual strength and weakness of the “bright line” test.

⁶² *Id.* at 987.

⁶³ *Id.* at 988.

⁶⁴ See *supra* notes 41-42 and accompanying text.

⁶⁵ *MTC Elecs.*, 898 F. Supp. at 988.

⁶⁶ See, e.g., *Wright v. Ernst & Young LLP*, 152 F.3d 169, 175 (2d Cir. 1998).

⁶⁷ See, e.g., *Prentice*, *supra* note 10, at 725.

⁶⁸ *MTC Elecs.*, 898 F. Supp. at 987 (emphasis added).

⁶⁹ See *supra* notes 45-55 and accompanying text.

In summary, the “bright line” test is not really a test at all. Instead, it is more of a statement: In order to be a primary violator of rule 10b-5, the secondary actor must actually make the misstatement or omission in question. While that statement is correct, it provides no additional guidance to the investment community beyond what the Supreme Court provided in *Central Bank of Denver*. Accordingly, a standard is needed for determining when a secondary actor has actually made the misstatement or omission and should therefore be subject to liability under rule 10b-5.

Further, while the “bright-line” test usually arrives at the right answer, it does not provide an analytical framework that can be applied to other cases to determine whether a secondary actor’s conduct rises to the level of a primary violation of section 10(b) and rule 10b-5. For example, in *MTC Electronics*, the court stated that “a defendant must actually make a false or misleading statement in order to be [a primary violator].”⁷⁰ Further, in *Kendall Square*, the court held that “[o]nly primary violators, i.e., those who *make* a material misstatement or omission . . . are subject to private suit under Section 10(b).”⁷¹ These cases answer the first question by concluding that *Central Bank of Denver* and the language of section 10(b) require that a secondary actor must actually make the misstatement or omission in order to be held primarily liable. Nonetheless, they leave unanswered how one determines whether the secondary actor “made” the statement. Part III of this Note proposes a standard by which this question may be answered.⁷²

B. The “Substantial Participation” Test

Following *Central Bank of Denver*, a number of courts have held that, in order to be a primary violator under section 10(b) and rule 10b-5, the secondary actor need not actually make the material misstatement or omission (as in the “bright line” test), but may be held liable for participating in the fraud in some “substantial” way.⁷³ This has come to be known as the “substantial participation” test.⁷⁴

⁷⁰ *MTC Elecs.*, 898 F. Supp. at 987.

⁷¹ *In re Kendall Square Research Corp. Sec. Litig.*, 868 F. Supp. 26, 28 (D. Mass. 1994).

⁷² See *infra* notes 113-36 and accompanying text.

⁷³ See *Dannenberg v. PaineWebber Inc. (In re Software Toolworks Inc. Sec. Litig.)*, 50 F.3d 615, 628 n.3 (9th Cir. 1994); *In re ZZZZ Best Sec. Litig.*, 864 F. Supp. 960, 971 (C.D. Cal. 1994).

⁷⁴ *Wright v. Ernst & Young LLP*, 152 F.3d 169, 175 (2d Cir. 1998).

A famous case applying the “substantial participation” test is *In re ZZZZ Best Securities Litigation*,⁷⁵ which resulted from the bankruptcy of ZZZZ Best Co., Inc., once the nation’s largest carpet cleaning company. The company’s founder and largest shareholder had engaged in a scam to pass the company off as being extremely successful and was “ultimately convicted and imprisoned for fraud and embezzlement.”⁷⁶ The plaintiffs in the case sued, among many others, the company’s auditor, Ernst & Young. They alleged that Ernst & Young had violated section 10(b) and rule 10b-5 by issuing a review report⁷⁷ on certain interim financial information released by the company and by its involvement in the creation, review, and issuance of some thirteen other public statements released by the company and others.⁷⁸ These suspect statements did not contain any indication that Ernst & Young was involved in their issuance.⁷⁹

Ernst & Young conceded that it made the review report and that it could be liable as a primary violator provided the other elements were met; however, Ernst & Young argued that it did not make the other thirteen statements, and thus these statements could not lead to a primary violation.⁸⁰ The United States District Court for the Central District of California began its analysis by noting that “in *Central Bank*, the Supreme Court’s opinion makes clear that more than simply knowing assistance with the underlying fraudulent scheme is required for Section 10(b) liability.”⁸¹ However, relying on pre-*Central Bank of Denver* authority, the court disagreed with Ernst & Young’s position⁸² and held that “anyone intricately involved in [the] creation [of public statements such as those at issue] . . . should be held liable under Section 10(b)/Rule 10b-5.”⁸³

*Dannenberg v. PaineWebber Inc. (In re Software Toolworks Inc. Securities Litigation)*⁸⁴ is another case where the “substantial participation”

⁷⁵ *ZZZZ Best*, 864 F. Supp. at 960.

⁷⁶ *Id.* at 963.

⁷⁷ A review report is a report issued on some type of financial information when less than an audit has been performed. A review report provides less assurance than does an audit and accompanying opinion. See WHITTINGTON & PANY, *supra* note 39, at 719-24.

⁷⁸ *ZZZZ Best*, 864 F. Supp. at 964.

⁷⁹ *Id.* at 965, 968.

⁸⁰ *Id.*

⁸¹ *Id.* at 969.

⁸² Ernst & Young argued for an application of the “bright line” test. See *id.* at 968.

⁸³ *Id.* at 970.

⁸⁴ *Dannenberg v. PaineWebber Inc. (In re Software Toolworks Inc. Sec. Litig.)*, 50 F.3d 615 (9th Cir. 1994).

test was used. *Dannenberg* involved disappointed investors who brought suit against Deloitte & Touche (another “big-five” accounting firm), underwriters, and others for alleged violations of section 10(b) and rule 10b-5 after the company’s stock lost substantially all its value.⁸⁵ The complaint alleged that the accountants were primary violators because they had reviewed a duplicitous letter to the SEC, had consulted the company about the letter, and had drafted and edited another such letter.⁸⁶ Though both letters were issued by the company and not by Deloitte & Touche, the Ninth Circuit concluded that “[t]his evidence is sufficient to sustain a primary cause of action under section 10(b) and, as a result, *Central Bank* does not absolve Deloitte.”⁸⁷

Several other cases have also concluded that substantial participation in a primary violation constitutes a primary violation. In *Cashman v. Coopers & Lybrand*,⁸⁸ the United States District Court for the Northern District of Illinois held that Coopers & Lybrand could be liable under section 10(b) and rule 10b-5 for “play[ing] a central role in the drafting and formation of the alleged misstatements.”⁸⁹ Further, in *Phillips v. Kidder, Peabody & Co.*,⁹⁰ the United States District Court for the Southern District of New York held that the underwriter could be liable for “actively participat[ing] in formulating the language of the prospectus . . . even though the Prospectus was published in the name of the issuer.”⁹¹

The “substantial participation” test can fairly be stated as follows: a secondary actor who substantially participates in the production of documents or other materials that contain misstatements or omissions may be held liable as a primary violator of rule 10b-5. This characterization of rule 10b-5 liability is at great variance with the “bright line” test and with the Supreme Court’s opinion in *Central Bank of Denver*.

First, as to the differences between the “bright line” test and the “substantial participation” test, a comparison of *ZZZZ Best* and *Kendall Square* is instructive. The facts of *ZZZZ Best* are very similar to the facts of *Kendall Square*.⁹² In both cases, the companies’ auditors were accused

⁸⁵ See *id.* at 620.

⁸⁶ See *id.* at 627-29.

⁸⁷ *Id.* at 628 n.3.

⁸⁸ *Cashman v. Coopers & Lybrand*, 877 F. Supp. 425 (N.D. Ill. 1995).

⁸⁹ *Id.* at 432.

⁹⁰ *Phillips v. Kidder, Peabody & Co.*, 933 F. Supp. 303 (S.D.N.Y. 1996), *aff’d*, 108 F.3d 1370 (2d Cir. 1997).

⁹¹ *Id.* at 316.

⁹² Compare *supra* notes 37-40 and accompanying text with *supra* notes 75-79 and accompanying text.

of section 10(b) and rule 10b-5 violations based upon their issuance of audit or review reports and their participation in various other public statements that were not attributed to them in any way.⁹³ In both *Kendall Square* and *ZZZZ Best*, it was agreed that the reports released by the auditors could be the basis of a primary violation cause of action, provided that the other elements were met.⁹⁴ Thus, the “bright line” and the “substantial participation” tests are in agreement insofar as these types of statements can amount to a primary violation.

The rift between the two tests arises in the context of the auditors’ participation in other public statements that were in no way attributed to them. Using the “bright line” test, the court in *Kendall Square* found that after *Central Bank of Denver* a secondary actor must actually make the misstatement or omission in order to be held liable as a primary violator.⁹⁵ Conversely, the court in *ZZZZ Best* ignored the Supreme Court’s mandate that section 10(b) “prohibits only the making of a material misstatement (or omission),”⁹⁶ and concluded that a secondary actor could be held liable as a primary violator for participation in the *preparation* of company material, whether or not they were actually made by the secondary actor.⁹⁷ This decision was obviously not based on an analysis of the elements of a primary violation, but on the court’s feelings regarding fairness, which is demonstrated by the court’s statement that Ernst & Young “*should be [held] liable under Section 10(b)/Rule 10b-5.*”⁹⁸ Surely, to arrive at this conclusion the court contemplated policy considerations. However, as the Supreme Court stated in *Central Bank of Denver*, “[t]he issue . . . is not whether imposing private civil liability on aiders and abettors is good policy but whether aiding and abetting is covered by the statute.”⁹⁹

⁹³ See *In re Kendall Square Research Corp. Sec. Litig.*, 868 F. Supp. 26, 27 (D. Mass. 1994); *In re ZZZZ Best Sec. Litig.*, 864 F. Supp. 960, 964-65 (C.D. Cal. 1994).

⁹⁴ The court in *Kendall Square* held that this was the case as part of its ruling, see *Kendall Square*, 868 F. Supp. at 29, while defendant Ernst & Young conceded in *ZZZZ Best* that it could be liable if the other elements were met, see *ZZZZ Best*, 864 F. Supp. at 965.

⁹⁵ *Kendall Square*, 868 F. Supp. at 28.

⁹⁶ *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 177 (1994).

⁹⁷ See *ZZZZ Best*, 864 F. Supp. at 970.

⁹⁸ *Id.* (emphasis added). The court concluded that the defendants “should” be liable (a legislative decision) and then proceeded to find a way to hold them liable (similar to the legislature enacting a statute to remedy a perceived wrong).

⁹⁹ *Cent. Bank of Denver*, 511 U.S. at 177.

Accordingly, the *ZZZZ Best* court exceeded the bounds of the statute and the Supreme Court's opinion.

Further, the previously discussed cases demonstrate that courts using the "substantial participation" test ignore the Supreme Court's ruling in *Central Bank of Denver* and the language of the statute, thereby "reviv[ing] aider and abettor liability under a different name."¹⁰⁰ This fact is further illustrated by comparing an aiding and abetting cause of action with the "substantial participation" test.

In *Central Bank of Denver*, the Supreme Court noted that the Tenth Circuit identified the elements of an aiding and abetting cause of action as follows: "(1) a primary violation of § 10(b); (2) recklessness [or knowledge] by the aider and abettor as to the existence of the primary violation; and (3) substantial assistance given to the primary violator by the aider and abettor."¹⁰¹ For purposes of this Note, these elements will be used in comparison to the "substantial participation" test, because they are representative of the elements used in the other circuits for an aiding and abetting cause of action.¹⁰² In most cases there will be a primary violation, for example, by the issuer of the security. Further, recklessness (or knowledge) on the part of the secondary actor still needs to be shown under both aiding and abetting and primary causes of action. Accordingly, the distinction between aiding and abetting and the "substantial participation" test hinges on the difference between "substantial assistance" and "substantial participation."

¹⁰⁰ *Wright v. Ernst & Young LLP*, No. 97 CIV. 2189(SAS), 1997 WL 563782, at *3 (S.D.N.Y. Sept. 10, 1997), *aff'd*, 152 F.3d 169 (2d Cir. 1998).

¹⁰¹ *Cent. Bank of Denver*, 511 U.S. at 168 (citing *First Interstate Bank of Denver, N.A. v. Pring*, 969 F.2d 891, 898-903 (10th Cir. 1992)).

¹⁰² *See, e.g., Levine v. Diamantheset, Inc.*, 950 F.2d 1478, 1483 (9th Cir. 1991); *K & S P'ship v. Cont'l Bank, N.A.*, 952 F.2d 971, 977 (8th Cir. 1991); *Schatz v. Rosenberg*, 943 F.2d 485, 495 (4th Cir. 1991); *Fine v. Am. Solar King Corp.*, 919 F.2d 290, 300 (5th Cir. 1990); *Schlifke v. Seafirst Corp.*, 866 F.2d 935, 947 (7th Cir. 1989); *Schneberger v. Wheeler*, 859 F.2d 1477, 1480 (11th Cir. 1988); *Moore v. Fenex, Inc.*, 809 F.2d 297, 303 (6th Cir. 1987); *Cleary v. Perfectune, Inc.*, 700 F.2d 774, 777 (1st Cir. 1983); *IIT, Int'l Inv. Trust v. Cornfeld*, 619 F.2d 909, 922 (2d Cir. 1980); *Monsen v. Consol. Dressed Beef Co.*, 579 F.2d 793, 799 (3d Cir. 1978). The Federal Circuit for the District of Columbia never directly recognized aiding and abetting liability, but suggested that it would likely do so in *Zoelsch v. Arthur Andersen & Co.*, 824 F.2d 27, 35-36 (D.C. Cir. 1987). The Seventh Circuit applied a test different from those used in the other circuits in that it required that the aider and abettor "commit one of the 'manipulative or deceptive' acts prohibited under section 10(b) and rule 10b-5." *Robin v. Arthur Young & Co.*, 915 F.2d 1120, 1123 (7th Cir. 1990).

Clearly, the difference here is more a matter of semantics than legal substance. As a practical matter, juries and judges will be unable to distinguish between “assistance” and “participation,” and secondary actors once liable as aiders and abettors now become liable as “primary violators.” Surely this result is not what the Supreme Court intended in striking down aiding and abetting liability. Thus, the court in *Wright* was correct in concluding that adherence to the “substantial participation” test “would effectively revive aiding and abetting liability under a different name, and would therefore run afoul of the Supreme Court’s holding in *Central Bank*.”¹⁰³

While the “substantial participation” test seems to be aiding and abetting liability in primary violator’s clothing, many courts and commentators have been more than willing to use this test to hold secondary actors liable under section 10(b) and rule 10b-5.¹⁰⁴ This is disturbing for two reasons. First, judicial use of the less rigorous “substantial participation” test after *Central Bank of Denver* creates uncertainty for future actors. It is a fundamental principle of the American legal system that courts are bound to follow the decisions of a higher court. Without this rule, courts’ decisions cannot be relied upon as standards of conduct and actors are uncertain which actions can lead to liability and which cannot. For example, following *Central Bank of Denver*, a securities lawyer or an accountant might assume that he or she will only be liable for misstatements or omissions that he or she actually made and not misstatements or omissions made by others. However, to this person’s surprise and chagrin, it may become clear that even though the Supreme Court has held that aiding and abetting liability does not exist,¹⁰⁵ a court may still hold secondary actors liable under an “aiding and abetting”-type theory. This type of uncertainty is something the law should strive to avoid, as it causes costs to society with no reciprocal benefit. Unfortunately, this is exactly the situation that has developed following the *Central Bank of Denver* decision.

Second, courts have for the most part adopted the “substantial participation” test with very little thought or discussion,¹⁰⁶ and the com-

¹⁰³ *Wright v. Ernst & Young LLP*, 152 F.3d 169, 175 (2d Cir. 1998), cert. denied, 525 U.S. 1104 (1999) (quoting *Wright v. Ernst & Young LLP*, No. 97 CIV. 2189(SAS), 1997 WL 563782, at *3 (S.D.N.Y. Sept. 10, 1997)).

¹⁰⁴ See *supra* notes 73-91 and accompanying text.

¹⁰⁵ *Cent. Bank of Denver*, 511 U.S. at 177.

¹⁰⁶ See, e.g., *Dannenberg v. PaineWebber Inc. (In re Software Toolworks Inc. Sec. Litig.)*, 50 F.3d 615, 628 n.3 (9th Cir. 1994) (holding that “the plaintiffs’ complaint clearly alleges” a primary violation by a secondary actor without

mentators who argue for an expansive test such as the “substantial participation” test argue mainly on policy grounds¹⁰⁷—an argument that the Supreme Court specifically foreclosed in the *Central Bank of Denver* decision.¹⁰⁸ The Court explicitly stated that “[t]he issue . . . is not whether imposing private civil liability on aiders and abettors is good policy but whether aiding and abetting is covered by the statute.”¹⁰⁹

The important point here is that the proper role of the courts is to interpret laws as they are written, and only if policy arguments are helpful in that context should they be referenced. However, when the language of the statute is clear on its face, then the courts are duty-bound to interpret the statute as written, and the legislature is the proper place for those disappointed with the statute’s application to voice their policy arguments. As Alexander Hamilton appropriately stated in the Federalist Paper No. 78, “The courts must declare the sense of the law; and if they should be disposed to exercise WILL instead of JUDGMENT, the consequence would equally be the substitution of their pleasure to that of the legislative body.”¹¹⁰ Those who advocate that policy justifications dictate that the courts expand the implied cause of action under section 10(b) and rule 10b-5 through use of the “substantial participation” test essentially argue that

explaining the reasons for the “clarity” or distinguishing between “substantial participation” and mere “aiding and abetting”).

¹⁰⁷ See, e.g., Prentice, *supra* note 10, at 727-32.

¹⁰⁸ *Cent. Bank of Denver*, 511 U.S. at 188. In addressing the policy arguments forwarded by the Commission, the Court stated:

The SEC points to various policy arguments in support of the 10b-5 aiding and abetting cause of action. It argues, for example, that the aiding and abetting cause of action deters secondary actors from contributing to fraudulent activities and ensures that defrauded plaintiffs are made whole.

Policy considerations cannot override our interpretation of the text and structure of the Act, except to the extent that they may help to show that adherence to the text and structure would lead to a result “so bizarre” that Congress could not have intended it. That is not the case here.

Extending the 10b-5 cause of action to aiders and abettors no doubt makes the civil remedy more far reaching, but it does not follow that the objectives of the statute are better served. Secondary liability for aiders and abettors exacts costs that may disserve the goals of fair dealing and efficiency in the securities markets.

Id. (citations omitted).

¹⁰⁹ *Id.* at 177.

¹¹⁰ THE FEDERALIST NO. 78, at 230 (Alexander Hamilton) (Roy P. Fairfield ed., 2d ed. 1966).

the courts should “substitut[e] . . . their pleasure to that of the legislative body.”¹¹¹

This result cannot be tolerated in a government that relies on the separation of powers, which envisions different governmental bodies with distinct roles. Unlike the legislature, the courts have neither the resources nor the time to thoroughly examine these policy arguments and thereby arrive at an informed decision. The current security statutes represent the legislature’s position on these issues, and, while it is desirable that security fraud be punished, the Supreme Court has rightly concluded, based on the text of the statute, that “not every instance of financial unfairness constitutes fraudulent activity under § 10(b).”¹¹²

III. IN THE WAKE OF *CENTRAL BANK OF DENVER*, WHO IS A PRIMARY VIOLATOR?

Because the Supreme Court’s decision in *Central Bank of Denver* requires that a secondary actor be a primary violator to be held liable under a section 10(b) and rule 10b-5 cause of action,¹¹³ it is necessary to evaluate what constitutes a primary violation in the typical sense. While there are varying formulations of what constitutes a primary violation of section 10(b) and rule 10b-5, generally there are two broad categories under which a primary violation can occur: misstatements and omissions.¹¹⁴ Although the elements vary slightly depending on the category of the violation,¹¹⁵ the

¹¹¹ *Id.*

¹¹² *Chiarella v. United States*, 445 U.S. 222, 232 (1980).

¹¹³ *See supra* Parts I and II.

¹¹⁴ Rule 10b-5 also forbids the use of “device[s], scheme[s], or artifice[s] to defraud,” and prohibits “engag[ing] in any act, practice, or course of business” that defrauds. 17 C.F.R. § 240.10b-5 (2000). The Supreme Court has seemingly categorized anything that is not a misstatement or an omission as a manipulation, which has been defined as a term of art that covers wash sales, matched orders, and the like. *Prentice*, *supra* note 10, at 699 n.30 (citing *Santa Fe Indus. v. Green*, 430 U.S. 462, 472-74 (1977); and *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 199 (1976)). Consequently, courts and commentators focus on misstatements and omissions as the two main categories of primary violations by secondary actors. *See, e.g.*, *Wright v. Ernst & Young*, 152 F.3d 169 (2d Cir. 1998), *cert. denied*, 525 U.S. 1104 (1999); *In re Kendall Square Research Corp. Sec. Litig.*, 868 F. Supp. 26 (D. Mass. 1994); *Prentice*, *supra* note 10, at 699. Likewise, this Note focuses only on misstatements and omissions in determining who is a primary violator.

¹¹⁵ *See generally* Rutheford B Campbell, Jr., *Elements of Recovery Under Rule 10b-5: Scienter, Reliance, and Plaintiff’s Reasonable Conduct Requirement*, 26

following elements are common to both categories: (1) a misstatement or omission made by the defendant,¹¹⁶ (2) that is material,¹¹⁷ (3) made in connection with the purchase or sale of securities¹¹⁸ (4) with a degree of scienter,¹¹⁹ (5) that is *actually* relied upon,¹²⁰ (6) and *justifiably* relied upon,¹²¹ (7) and that causes¹²² (8) damages.¹²³ Further, in the case of an omission, the defendant must also have had a duty to disclose the non-public information and must have in some way made a fraudulent use of the information, such as through trading or tipping.¹²⁴ For the purposes of determining when a secondary actor's conduct rises to the level of a primary violation, it is not necessary to discuss every element of a primary

S.C. L. REV. 653 (1975).

¹¹⁶ *Stransky v. Cummins Engine Co.*, 51 F.3d 1329, 1331 (7th Cir. 1995); 17 C.F.R. § 240.10b-5(b) (2000); see 2 HAZEN, *supra* note 14, § 13.2.2.1, at 468.

¹¹⁷ *Basic, Inc. v. Levinson*, 485 U.S. 224, 231-32 (1988); *Stransky*, 51 F.3d at 1331; 2 HAZEN, *supra* note 14, § 13.2.1, at 466-67; see, e.g., *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 848-49 (2d Cir. 1968); *List v. Fashion Park, Inc.*, 340 F.2d 457, 460-61 (2d Cir. 1965).

¹¹⁸ 15 U.S.C. § 78j(b) (1994); *Stransky*, 51 F.3d at 1331; 17 C.F.R. § 240.10b-5(c) (2000); 2 HAZEN, *supra* note 14, § 13.2.1, at 465-66; see *Blue Chips Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975).

¹¹⁹ *Aaron v. SEC*, 446 U.S. 680, 695 (1980); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976); *Stransky*, 51 F.3d at 1331; 2 HAZEN, *supra* note 14, § 13.2, at 460, § 13.2.1, at 467, § 13.4; see *Campbell*, *supra* note 115, at 655-64, 685-89. See generally James D. Cox, *Ernst & Ernst v. Hochfelder: A Critique and Evaluation of Its Impact upon the Scheme of the Federal Securities Laws*, 28 HASTINGS L.J. 569 (1977).

¹²⁰ *Basic*, 485 U.S. at 243; *Stransky*, 51 F.3d at 1331; 2 HAZEN, *supra* note 14, § 13.2.1, at 468; see 2 *id.* § 13.5B; *Campbell*, *supra* note 115, at 674-83, 692-93, 701; see, e.g., *List*, 340 F.2d at 457.

¹²¹ *Kennedy v. Josephthal & Co.*, 814 F.2d 798, 804 (1st Cir. 1987); see 2 HAZEN, *supra* note 14, § 13.2.1, at 468, § 13.5B, at 531-34, § 13.12; *Campbell*, *supra* note 115, at 664-69, 689-91, 700; see, e.g., *Teamsters Local 282 Pension Fund v. Angelos*, 762 F.2d 522, 529-30 (7th Cir. 1985) (citing *Zobrist v. Coal-X, Inc.*, 708 F.2d 1511 (10th Cir. 1983)).

¹²² *Stransky*, 51 F.3d at 1331; 2 HAZEN, *supra* note 14, § 13.2.1, at 468; see 2 *id.* § 13.6; see, e.g., *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 154 (1972); *Bastian v. Petren Res. Co.*, 892 F.2d 680, 685-86 (7th Cir. 1990).

¹²³ *Stransky*, 51 F.3d at 1331; 2 HAZEN, *supra* note 14, § 13.2.1, at 466, 468; see 2 *id.* § 13.7.

¹²⁴ See *United States v. O'Hagan*, 521 U.S. 642, 651-53 (1997); *Dirks v. SEC*, 463 U.S. 646, 653-55, 661-64 (1983); *Chiarella v. United States*, 445 U.S. 222, 230 (1980); 2 HAZEN, *supra* note 14, § 13.9-.10.

violation in detail because many of the elements will apply identically to primary and secondary actors alike. Accordingly, this Note discusses only those elements relevant to determining whether a secondary actor's conduct rises to the level of a primary violation: (1) misstatement or omission; (2) scienter; and (3) reliance.

A. *Defining Misstatement or Omission*

The *Central Bank of Denver* decision mandates that the secondary actor actually make the misstatement or omission to be liable as a primary violator under section 10(b) and rule 10b-5.¹²⁵ Because the secondary actor must actually make the misstatement or omission, it is most likely that the Court in *Central Bank of Denver* intended the use of the "bright line" test over the use of the "substantial participation" test.¹²⁶ Thus, the question left to be answered is how one determines when a secondary actor has actually made the misstatement or omission. This Note proposes that the test to determine whether a secondary actor actually made the misstatement or omission should be whether a reasonable investor would conclude that the secondary actor made the misstatement or omission in question.

For many reasons, this standard provides a workable and logical guide for judges, juries, and secondary actors in determining whether a misstatement or omission has been "made" for the purposes of classifying the secondary actor as a primary violator under section 10(b) and rule 10b-5. First, this standard should not cause judges, juries, or secondary actors trouble or confusion in its application because they are already accustomed to applying this type of reasonable investor standard with respect to other elements of recovery in an action under section 10(b) and rule 10b-5. For example, the Supreme Court has announced a reasonable investor standard in the context of judging materiality, holding that a misstatement or omission is material if there is "a substantial likelihood that a reasonable shareholder [or investor] would consider it important."¹²⁷ Accordingly, there is no reason to conclude that the reasonable investor standard proposed herein would be unacceptably confusing when a similar standard has been successfully applied to gauge the materiality of a statement or omission.

¹²⁵ *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 177 (1994).

¹²⁶ See *supra* notes 95-103 and accompanying text.

¹²⁷ *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976) (assessing the standard in the rule 14a-9 context); *accord Basic, Inc. v. Levinson*, 485 U.S. 224, 231-32 (1988) (assessing the standard in the rule 10b-5 context).

Further, the standard proposed herein is consistent with the Supreme Court's decision in *Central Bank of Denver* and the language of section 10(b), because the secondary actor must actually make the misstatement or omission in order to be a primary violator. Unlike the "substantial participation" test, the proposed "reasonable investor" standard does not revive aiding and abetting liability under a different name. Instead, it addresses some of the fairness concerns underlying the "substantial participation" test, albeit within the textual limitations of the statute. Specifically, holding a secondary actor liable only when both (1) all of the elements of a rule 10b-5 action have been satisfied, and (2) a reasonable investor would conclude that such misstatement or omission was made by the secondary actor is fair to plaintiffs and within the bounds of section 10(b). If a reasonable investor would not conclude that the secondary actor actually made the misstatement or omission, one might still argue that in fairness the secondary actor should be held liable. The statute, however, dictates that the secondary actor *not* be held liable. As such, the standard proposed herein maintains the proper role of the judiciary as interpreters of legislative enactments.

Though a standard similar to the proposed "reasonable investor" standard is already implicit under the "bright line" test, to eliminate any doubt it is necessary that the Supreme Court take up another case on this issue and directly and unequivocally state the proper standard. Until then, a secondary actor's liability under section 10(b) and rule 10b-5 will be a function of the circuit in which the secondary actor commits the alleged violation.

B. *Central Bank of Denver's Implication for the Scienter Requirement*

Scienter is discussed here not because it is helpful in determining whether a secondary actor's conduct rises to the level of a primary violation, but because *Central Bank of Denver* has important implications for secondary actors regarding the scienter requirement. The Supreme Court's elimination of aider and abettor liability in *Central Bank of Denver* demonstrates its desire to limit liability under section 10(b) and rule 10b-5. The statutory language does not include recklessness, nor does fraud typically include recklessness. Yet the Court has twice specifically reserved the question whether recklessness can constitute scienter.¹²⁸ If the Court follows its recent pattern of strict construction of section 10(b) and rule

¹²⁸ See *Aaron v. SEC*, 446 U.S. 680, 686 n.5 (1980); *Ernst & Ernst v. Hockfelder*, 425 U.S. 185, 194 n.12 (1976).

10b-5 as in *Central Bank of Denver*, it will likely rule that recklessness does not constitute scienter.

If the Court were to so hold, this ruling would have a profound impact on secondary actor liability, because secondary actors almost never act with the intent to defraud. Truly, "it is highly unlikely that an accounting firm's certification of inaccurate financial statements resulting from an inadequate audit is attributable to a desire to defraud investors."¹²⁹ Accordingly, the ambit of section 10(b) and rule 10b-5 liability for secondary actors may be receptive to another shock wave like the one resulting from *Central Bank of Denver*.

C. *Why the Reliance Requirement Should be Left Alone*

In *Central Bank of Denver*, the Supreme Court stated that "[w]ere we to allow the aiding and abetting action proposed in this case, the defendant could be liable without any showing [of reliance]."¹³⁰ This statement illustrates that the Supreme Court believes that reliance is vital to causes of action for primary violations of section 10(b) and rule 10b-5. Accordingly, commentators and courts have looked to reliance as the crucial element for determining when a secondary actor's conduct could violate section 10(b) and rule 10b-5.¹³¹

Reliance is a very complicated element of recovery in actions under rule 10b-5.¹³² This has led to many complicated analyses based on various ideas of reliance, such as fraud-on-the-market, efficient versus non-efficient markets, and the inference of reliance from other elements such as materiality.¹³³ However, these analyses ignore the question that must be central to any section 10(b) and rule 10b-5 claim against a secondary actor—namely, did the secondary actor actually make the misstatement or omission in question? Consequently, the already overburdened reliance

¹²⁹ Fischel, *supra* note 2, at 108 n.152.

¹³⁰ *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 180 (1994). The Court's statement makes perfect sense. If the defendant has not made a misstatement or omission, there is nothing upon which a plaintiff can rely.

¹³¹ *See, e.g.*, Prentice, *supra* note 10, at 737 (citing *Anixter v. Home-Stake Prod. Co.*, 77 F.3d 1215, 1225 (10th Cir. 1996)); Lisa Klein Wager & John E. Failla, *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.—The Beginning of an End, or Will Less Lead to More?*, 49 BUS. LAW. 1451, 1461 (1994).

¹³² *See* 2 HAZEN, *supra* note 14, § 13.5B.

¹³³ *See id.*

element¹³⁴ should not be given the additional task (which is one that it cannot complete satisfactorily) of determining when a secondary actor's conduct rises to the level of a primary violation of section 10(b) and rule 10b-5.

Further, altering the analysis under reliance is unnecessary if it is determined that the secondary actor made the statement under the test herein proposed. If the secondary actor made the statement, then the reliance analysis can be conducted as it would in any other section 10(b) and rule 10b-5 case. If not, a reliance analysis is unnecessary for the section 10(b) and rule 10b-5 claims against the secondary actor because, as the Supreme Court stated in *Central Bank of Denver*, section 10(b) and rule 10b-5 "prohibit[] only the making of a material misstatement (or omission)."¹³⁵

Finally, a statement made in *ZZZZ Best* illustrates the type of flawed analysis that can result if the courts look to "reliance" as the test to determine when a secondary actor's conduct rises to the level of a primary violation. The court stated that "[w]hile the investing public may not be able to reasonably attribute the additional misstatements and omissions to [the secondary actor], the securities market still relied on those public statements and anyone intricately involved in their creation and the resulting deception should be liable under Section 10(b)/Rule 10b-5."¹³⁶ This statement highlights how the Supreme Court's mandate that the secondary actor actually make the misstatement or omission can easily get lost in the shuffle of an analysis based on reliance.

CONCLUSION

The Supreme Court's decision in *Central Bank of Denver* unequivocally abolished aider and abettor liability under section 10(b) and rule 10b-5, but lower courts and commentators have been unable to agree upon the point at which a secondary actor's conduct rises to the level of a primary violation. Courts and commentators have proposed and advanced two rival tests: the "bright line" test and the "substantial participation" test. The "bright line" test is more faithful to the language of section 10(b) and *Central Bank of Denver*, and thus must be preferred to the "substantial

¹³⁴ The complexity of the reliance element and its inconsistent application make this element ill-suited to answer the additional question whether the secondary actor actually made the misstatement or omission in question.

¹³⁵ *Cent. Bank of Denver*, 511 U.S. at 177.

¹³⁶ *In re ZZZZ Best Sec. Litig.*, 864 F. Supp. 960, 970 (C.D. Cal. 1994).

participation” test, which is little more than aiding and abetting liability under a different name. However, for ease of application and to provide a proper analytical framework, the “bright line” test should be modified to definitively state that a secondary actor’s conduct rises to the level of a primary violation if a reasonable investor would construe the misstatement or omission to be made by the secondary actor, and if all the other elements for recovery are met. Such a test would adhere to the statutory language of section 10(b) and provide a logical test by which secondary actors could guide their conduct, while also promoting fairness to investors.