This fact pattern has arisen in many of the recent accounting scandals such as Enron, Parmalat and Homestore, and the courts have taken divergent approaches to defining what constitutes a primary violation. Two recent district court decisions—in the Homestore and Lernout & Hauspie cases—are now pending before the Ninth and First Circuit Courts of Appeals, respectively, and their ultimate disposition may have far-reaching implications for secondary actor liability.

A Watershed Decision

In 1994, in Central Bank of Denver v. First Interstate Bank of Denver the Supreme Court ruled that there is no private cause of action for aiding and abetting securities fraud under Section 10(b) of the Exchange Act and Rule 10b-5. The decision is of great significance to “secondary actor” defendants that, prior to Central Bank, often were sued as aiders and abettors. Significantly, however, the Supreme Court in Central Bank left open the possibility that secondary actors could be held liable under §10(b) as primary violators where “all of the requirements for primary liability under Rule 10b-5 are met.”

In the wake of Central Bank, securities fraud plaintiffs began alleging that secondary actors themselves were primary violators, rather than aiders and abettors. The courts’ treatment of such allegations has resulted in a split among federal circuits, at least in cases

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AFTER THE U.S. Supreme Court ruled in 1994 that the securities laws do not permit civil claims for aiding and abetting, litigants have vigorously debated the question of when a secondary actor—such as a banker, lawyer or accountant—may be considered a primary violator of the securities laws. This article focuses on the recent evolution of that debate in cases where secondary actors did not themselves make misstatements upon which investors relied but, instead, participated in transactions that impacted an issuer’s financial statements.

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where plaintiffs rely on Rule 10b-5(b), which creates liability for untrue statements or omissions of material fact.\(^4\)

A majority of the circuit courts that have addressed the question, including the Second Circuit, have applied a bright line test, holding that the secondary actor must itself directly or indirectly make the false statement or omission.\(^5\) Thus, for example, reviewing, editing, or approving a statement attributed to others is insufficient to create primary liability in those circuits.\(^5\)

In contrast, the Ninth Circuit has held that a secondary actor whose conduct amounts to substantial participation in making the false statement (such as playing a significant role in its drafting) can be liable as a primary violator.\(^7\)

**‘Scheme’ Theory Evolves**

Apparently due to the difficulty of pleading and proving a primary violation by a secondary actor under Rule 10b-5(b), plaintiffs increasingly have turned to allegations of so-called “scheme” liability under subsections (a) and (c) of Rule 10b-5 as an alternative to claims under subsection (b).

Until recently, subsections (a) and (c) rarely were invoked in cases involving false statements in or omissions from a company’s financial statements and disclosures. Subsection (a) makes it unlawful to “employ any device, scheme, or artifice to defraud,” and subsection (c) makes it unlawful 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,”\(^6\)

Recently, plaintiffs have aggressively pursued scheme theories of liability against secondary actors under subsection (a) and/or (c) in cases involving major accounting scandals such as Homestore, Lernout & Hauspie, Parmalat, and Enron. In those cases, plaintiffs allege that secondary actor defendants—who did not make the misleading financial statements and disclosures—are liable under subsections (a) and/or (c) for knowingly or recklessly participating in “schemes” with insiders that allowed the companies to misstate their financial condition.

A threshold question presented in these cases is whether a secondary actor who participates in a scheme intended to generate false financial results, but does not itself participate in generating the company’s financial statements, can be held liable under Rule 10b-5.

In In re Homestore.com Inc. Securities Litigation,\(^9\) the U.S. District Court for the Central District of California held, among other things, that where a plaintiff had suffered injury through its reliance on false and misleading financial statements, it was the statements—and not the underlying scheme to generate false revenues—that were actionable.\(^10\)

The court’s decision is now on appeal to the Ninth Circuit. Notably, the Securities and Exchange Commission has submitted an amicus brief on the appeal, arguing for a more expansive view of secondary actor liability under subsections (a) and (c) of Rule 10b-5.

In direct contrast to the district court’s decision in Homestore, the U.S. District Court for the District of Massachusetts ruled, in In re Lernout & Hauspie Securities Litigation\(^11\) that, even where a defendant is not alleged to have made or participated in the false and misleading statement, that defendant can still be liable as a scheme participant where it has knowingly or recklessly engaged in a sham transaction that allowed an issuer to record false revenue in its financial statements.\(^12\)

The court found sufficient allegations of reliance on the secondary actors’ conduct by viewing the alleged scheme “as a whole” rather than by viewing the alleged sham transactions and subsequent financial statement disclosures separately from each other.\(^13\)

Recognizing the importance of the issue, the district court has certified the matter for interlocutory appeal to the First Circuit.\(^14\)

The U.S. District Court for the Southern District of Texas reached a similar result (albeit through somewhat different reasoning) in the Enron securities litigation in denying motions to dismiss by secondary actor defendants who were alleged to have participated in transactions designed to manipulate Enron’s financial results, but who were not alleged to have helped prepare the financial statements themselves.\(^15\)

More recently, Judge Lewis Kaplan of the U.S. District Court for the Southern District of New York, ruling in the Parmalat litigation, essentially followed the court’s decision in the Lernout & Hauspie case in denying motions to dismiss claims under subsections (a) and (c) of Rule 10b-5.\(^16\) In so doing, Judge Kaplan noted that his scheme “analysis is not a back door into liability for those who help others make a false statement or omission in violation of subsection (b) of the Rule 10b-5,” which, in Judge Kaplan’s view, is different from “whether a defendant’s challenged conduct in relation to a fraudulent scheme constitutes the use of a deceptive device or contrivance.”\(^17\)

The use of scheme liability under subsections (a) and (c) of Rule 10b-5 against secondary actors in such cases where (i) plaintiffs allegedly relied on false and misleading financial statements, and (ii) the secondary actors did not prepare or substantially participate in preparing the financial statements has broad implications for the continuing application of Central Bank, pleading the
elements of reliance and loss causation, and the scope of joint and several liability for knowing violations of Rule 10b-5.

Reliance and Loss Causation

The rise of scheme allegations raises a fundamental question: How direct a relationship must there be between a “primary” violator’s conduct and a plaintiff’s losses?

As discussed above, the Supreme Court in Central Bank held that secondary actors could be primary violators under §10(b) only if plaintiff were able to plead and prove “all of the requirements for primary liability under Rule 10b-5.” The Court emphasized that this requirement is essential because to hold otherwise would subject defendants to liability “without any showing that the plaintiff relied upon the aider and abettor’s statements or actions.”

Since Central Bank, however, a number of courts that have found secondary actors potentially liable as primary participants in a scheme (including in the Lernout, Enron and Parmalat cases discussed above) have done so by requiring only a loose connection between the secondary actor defendants’ conduct and plaintiffs.

In these cases, the element of reliance often is satisfied by showing that plaintiffs relied on other defendants’ conduct; the element of loss causation occasionally is not addressed at all. In short, it is not clear that all courts are adhering rigorously to the Supreme Court’s requirement that plaintiffs prove “all of the requirements for primary liability.”

For example, the divergent results in the Homestore and Lernout cases may be attributed, at least in part, to the courts’ treatment of the element of reliance.

The district court’s opinion in Homestore—finding that plaintiffs directly relied only on the financial statement misrepresentations, rather than the underlying alleged scheme—embodied a rigorous and defendant-specific requirement of reliance. In contrast, the Lernout decision found a less direct connection to be sufficient, holding that primary liability could apply to “any person who substantially participates in a manipulative or deceptive scheme…even if a material misstatement by another person creates the nexus between the scheme and the securities market.”

Courts’ views also diverge on the loss causation requirement in the context of a scheme case. In a broadly defined scheme case, the question will arise as to whether plaintiffs must show that each defendant committed a securities law violation that directly caused a portion of plaintiffs’ losses or whether, instead, plaintiffs merely need to show that the scheme, considered in the aggregate, caused those losses.

Although few courts have addressed the issue squarely, plaintiffs contend that some decisions have focused on the loss causation impact of the overall scheme, rather than on the impact of each defendant’s individual conduct, thereby tacitly adopting plaintiffs’ view that a showing of “scheme-wide” loss causation is sufficient.

Defendants interpret such cases differently and contend that such an approach would effectively eliminate the element of loss causation and undermine the Central Bank decision. Defendants’ argument begins with the language of the Private Securities Litigation Reform Act, which places upon plaintiffs the burden of proving that the “act or omission of the defendant alleged to violate this chapter caused the loss for which plaintiff seeks to recover damages.”

Defendants also cite to both pre- and post-PSLRA cases holding that loss causation must be traced to each defendant’s conduct, even in the context of a multiple-defendant, broad-based scheme.

Joint and Several Liability

Many expect that the Ninth Circuit in Homestore, and the First Circuit in Lernout, will provide guidance concerning the degree to which a primary violator and a plaintiff must be connected for purposes of reliance and loss causation. Until then, however, it seems likely that plaintiffs will continue to push for broadly defined schemes under Rule 10b-5(a) and (c), raising a final and perhaps most controversial issue: the application of the joint and several liability provisions of the PSLRA in the context of a scheme case.

Courts have only recently begun to grapple with this issue. The PSLRA provides that “[a]ny covered person against whom a final judgment is entered in a private action shall be liable for damages jointly and severally only if the trier of fact specifically determines that such covered person knowingly committed a violation of the securities laws.” In the context of a scheme in which many defendants were aware of and participated in only limited aspects of the overall scheme, the question becomes “joint and several liability for what?”

Clearly, the PSLRA is intended to provide for joint and several liability against a knowing violator for losses caused by the transaction in which it was a primary participant. But is such a defendant also responsible for losses caused by other transactions that, although part of the alleged overall
scheme, it did not even know about, much less participate in?

Plaintiffs argue in a number of cases that any defendant who knowingly commits a primary violation in furtherance of a larger scheme should be jointly and severally liable for the entire scheme. The rather straightforward argument is that under the PSLRA, defendants who are found to be primary participants in a scheme under Rule 10b-5(a) are jointly and severally liable if participants in a scheme under Rule 10b-5(a) are jointly and severally liable if

In ruling on defendants' motions to dismiss, however, Judge Kaplan declined to treat the defendants as participants in a single overarching scheme, for which joint and several liability could apply. Instead, Judge Kaplan analyzed each defendant's individual role in each relevant transaction to determine whether that defendant was a primary violator with respect to each transaction or act only. 20

Confronted with similar allegations in Enron, Judge Melinda Harmon did not necessarily reject the notion of an overarching scheme, but she did not accept plaintiffs' argument that one who commits a knowing violation in furtherance of that overarching scheme can be jointly and severally liable for all losses caused. Rather, she observed that the PSLRA's "knowing" requirement for joint and several liability "seems incompatible with Lead Plaintiff's argument that a participant is liable for damages caused by all participants, known or unknown in the scheme." 20

Ultimately, courts' willingness to predicate §10(b) liability on broad-based, multi-year schemes, and to impose joint and several liability for such schemes, will have a significant impact on the continued meaningfulness of the Supreme Court's Central Bank decision and the balance of power among the parties in settlement negotiations.

Should the guidance provided by the Ninth and First Circuits differ materially, it is conceivable that the Supreme Court would accept an opportunity to further clarify the distinction between actionable primary violations and nonactionable aiding and abetting.

2. Id. at 177.
3. Id. at 191.
4. 17 C.F.R. §240.10b-5.
5. See Zerbe v. Cascade Int’l, Inc., 256 F.3d 1194, 1205 (11th Cir. 2001); Shapiro v. Cannor, 123 F.3d 711, 720 (2d Cir. 1997); Anzotti v. Home-State Prod. Co., 17 F.3d 1215, 1219 (10th Cir. 1996).
6. See, e.g., Wright v. Ernst & Young LLP, 152 F.3d 169, 175 (2d Cir. 1998).
7. See In re Bear Stearns Sec. Litig., 961 F. Supp. 569, 576 (S.D.N.Y. 1997) (“Where with respect to loss causation, the principal question is whether the loss is a reasonably foreseeable consequence of the fraudulent actions. Here, the economic harm to the Plaintiffs from the ultimate collapse of the price of the Bear Stearns securities that were inflated by the actions of Bear Stearns (and Blech and his confederates) was a foreseeable consequence of Bear Stearns’ alleged conduct. Accordingly, loss causation is also adequately pleaded.”).