

**Life After Central Bank —  
Should Securities Professionals  
Really Sleep Better at Night?**



Joel W. Sternman  
Garrett L. Gray

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# Life After Central Bank — Should Securities Professionals Really Sleep Better at Night?

*by Joel W. Sternman and Garrett L. Gray*

## **I. Introduction**

In Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164 (1994), the United States Supreme Court held that there is no private cause of action for aiding and abetting under Section 10(b)/Rule 10b-5 of the Securities Exchange Act of 1934. Prior to this decision, professionals such as accountants, underwriters and attorneys frequently were named as defendants in federal securities law class actions as aiders and abettors.<sup>1</sup>

The Central Bank decision appeared, at first, drastically to alter the exposure to liability of secondary actors in private securities fraud claims. "In ruling that there is no aiding and abetting liability under Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934, the Court overturned thirty years of precedent and seemingly freed securities professionals from a kind of statutory sword of Damocles." 75 N.C. L. Rev. at 691. However, lower courts interpreting Central Bank have had to address numerous theories, claimed to be consistent with the language of that decision, under which plaintiffs now seek to hold secondary actors primarily liable for securities fraud.

These theories usually proceed from the following portion of the Central Bank majority opinion:

The absence of § 10(b) aiding and abetting liability does not mean that secondary actors in the securities market 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. 511 U.S. at 191.

In other words, secondary actors do not enjoy absolute immunity after Central Bank: accountants, underwriters and attorneys still may be subject to liability on claims of primary liability under section 10(b).

This article surveys post-Central Bank decisions addressing (1) the recasting of secondary liability claims as primary liability claims so as to circumvent the impact of Central Bank, as well as the ongoing debate regarding the "significant role" theory,<sup>2</sup> and (2) efforts, usually unsuccessful, to expose secondary actors to section 10(b) liability under conspiracy and respondeat superior theories.

## II. Attempts to Circumvent the Effects of Central Bank on Secondary Liability

### A. Amended Complaints

While the Central Bank decision appeared on its face to strike a devastating blow to private securities class actions, some courts allowed plaintiffs to replead aiding and abetting claims as claims for primary liability, effectively defeating the purpose of Central Bank. In so doing, they diluted what at first appeared to be the clear holding of Central Bank, prompting one court to inquire: "where is the line between secondary and primary liability?" In re MTC Elec. Technologies Shareholders Litig., 898 F. Supp. 974, 985 (E.D.N.Y. 1995).

Some courts have held that the line is clearly drawn and that primary liability must include an allegation that a material misstatement or omission was made by or is directly attributable to the defendant. These courts have been alert to plaintiffs' attempts to survive the Central Bank holding merely by repleading their secondary liability claims, substituting the phrase "primary liability" for the phrase "aiding and abetting."

For example, in Wells v. Monarch Capital Corp., 1996 WL 728125 (D. Mass. Oct. 22, 1996), the court denied plaintiffs' motion to amend a complaint to allege that Ernst & Young was primarily liable for securities fraud, and granted Ernst & Young's motion for summary judgment on the remaining secondary liability claims. Plaintiffs originally alleged that "Ernst & Young violated § 10(b) of the 1934 Act and SEC Rule 10b-5 by auditing, preparing or assisting the preparation of public financial documents that materially misrepresented the financial condition of Monarch Capital." *Id.* at \*3. Because virtually all of the plaintiffs' claims could be characterized as aiding and abetting claims, the court granted Ernst & Young's motion for summary judgment. *Id.* at \*10.

Plaintiffs moved to amend their complaint on the same day Ernst & Young's motion for summary judgment was due. *Id.* at \*9. Plaintiffs claimed that the second amended complaint would clarify Ernst & Young's primary liability and would withdraw any claims for secondary liability. *Id.* at \*7. Ernst & Young opposed this motion on the grounds that it was untimely and that it would "alter substantially Plaintiffs' claims." *Id.*

The court determined that, instead of providing proof that the proposed amendments had substantial merit, "the proposed complaint attempts to alter the focus and bases of Plaintiffs' claims in order to defeat Ernst & Young's motion for summary judgment." *Id.* at \*9. For example, the focus of plaintiffs' pre-Central Bank claims had related to documents that Ernst & Young assisted in preparing. However, in the proposed amended complaint, plaintiffs alleged that Ernst & Young violated § 10(b) by actually issuing audit opinions containing certain material misrepresentations and omissions. *Id.* However, plaintiffs offered no evidence to support their allegations. By rejecting plaintiffs' amended complaint, the court implicitly recognized that plaintiffs were simply trying to re-characterize their aiding and abetting claim as a claim for primary liability, without setting forth sufficient factual support.

Although much of the court's reasoning was based on the untimeliness of plaintiffs' motion, it also stated that, "even if Plaintiffs had moved in a timely fashion and the tendered complaint did not prejudice Ernst & Young, I find that the proposed amendments are not supported by substantial and convincing evidence." *Id.* at \*10.

In sharp contrast to Wells, however, the court in In re ICN/Viratek Sec. Litig., 1996 WL 164732 (S.D.N.Y. Apr. 9, 1996), allowed plaintiffs to amend their complaint. The three earlier complaints, all filed prior to Central Bank, had alleged that defendants, related corporations and their officers, all were liable as aiders and abettors. After Central Bank, plaintiffs sought to "allege defendants' primary liability for research reports on Virazole issued by Paine Webber in its capacity as a securities analyst, and allegedly reviewed by several officers of the defendant corporations." *Id.* at \*2 (emphasis added).

Plaintiffs' pre-Central Bank complaints contained allegations that the corporation and its officers aided and abetted Paine Webber in making fraudulent statements. Those complaints were devoid of any allegations that defendants themselves made any fraudulent statements. *Id.* However, because Central Bank forced plaintiffs to concede the legal insufficiency of their aiding and abetting claims, they sought to allege that defendants were primarily liable under a theory rendering their alleged "entanglement" with a third party's analyst's statements sufficient to make those statements attributable to them. See Elkind v. Liggett & Myers, Inc., 635 F.2d 156 (2d Cir. 1980).

In granting plaintiffs' motion to amend, the court stated that, "[d]efendants have not alleged any specific prejudice from this amendment to the complaint, which adds only new legal claims, rather than new factual allegations." *Id.* In rejecting defendants' motion for summary judgment, the court disagreed with defendants' argument that Central Bank would be undermined if plaintiffs were allowed to "recast claims more accurately viewed as 'aiding and abetting' claims as claims of primary liability." *Id.* at \*6. It stated that "plaintiffs' claim may be characterized as an aiding and abetting claim, but it may just as easily be characterized as a claim of primary liability, pled on the theory that defendants used Paine Webber as their agent to make false or misleading statements to the market." *Id.* Despite the fact that plaintiffs never alleged that defendants themselves had made a material misstatement or omission, the court held that primary liability was sufficiently alleged because "a reasonable factfinder could conclude from the evidence submitted that defendants so entangled themselves with the initial Paine Webber, report, by their review and amendment of the final draft of the report just before its issuance, that the report's statements could properly be attributed to them." *Id.* at \*7.

Similarly, the original complaint in Adam v. Silicon Valley Bancshares, 884 F. Supp. 1398, 1401 (N.D. Cal. 1995), was filed prior to Central Bank. *Id.* at 1399. The court dismissed plaintiffs' first § 10(b) claim "after finding that plaintiffs had failed to allege an actionable misrepresentation by [Deloitte & Touche], had failed to allege facts supporting an inference of scienter, and had failed to state a claim for secondary liability." *Id.* In an amended complaint, filed three months after Central Bank, plaintiffs made allegations that defendants had participated in a scheme to defraud. Despite the fact that the term "participated" is practically synonymous with aiding and abetting, the court refused to dismiss, viewing the complaint as now alleging defendants' primary liability for their own participation.<sup>3</sup> *Id.* at 1400-01.

## **B. The "Significant Role" Theory**

Class plaintiffs, in their continuing effort to assert claims against secondary actors in order to name as many "deep pocket" defendants as possible, have set their sights on, and have had some success with, the "significant role" theory. Under this theory, they assert that, as a result of a secondary actor's "significant role" or "substantial involvement" in the underlying fraud, those secondary actors should be held primarily liable. Quite often, however, these claims are nothing more than secondary liability claims recast or renamed as primary liability claims. As shown below, a sharp split of authority exists as to the viability of this theory.

### **1. Courts Holding That § 10(b) Claims Based On A Secondary Actor's Significant Role Survive Central Bank**

#### *a. Court of Appeals Decisions*

In re Software Toolworks, Inc., 50 F.3d 615 (9th Cir. 1994), is the leading case holding that § 10(b) claims based on a secondary actor's "significant role" or "substantial involvement" in a fraud are legally sufficient. Plaintiffs alleged that Deloitte & Touche violated § 10(b) "by participating in drafting the two letters that Toolworks sent to the SEC. . . . [P]laintiffs allege, that the letters falsely stated that Toolworks did not have preliminary financial data available for the June quarter and misleadingly described the nature of Toolworks' OEM contracts." *Id.* at 628. In reversing, in part, the award of summary judgment to defendants, the Ninth Circuit stated that "[d]espite Central Bank, we nevertheless consider this issue because plaintiffs' complaint clearly alleges that Deloitte is primarily liable under section 10(b) for the SEC letters. . . . [T]he plaintiffs presented evidence that Deloitte played a significant role in drafting and editing the July 4 SEC letter. This evidence is sufficient to sustain a primary cause of action under section 10(b)" *Id.* n. 3.

In McGann v. Ernst & Young, 102 F.3d 390 (9th Cir. 1996), cert. denied, 117 S. Ct. 1460 (1997), Ernst & Young was alleged to be both a primary violator of § 10(b) and a secondary violator as a conspirator and aider and abettor, arising from its alleged preparation of a fraudulent audit report. 102 F.3d at 391. Plaintiffs alleged that Ernst & Young knew its client would include the audit report in its 10-K, thereby disseminating the fraudulent information to the market, and that omission of material information from that report caused an artificial inflation of the price of the company's stock. *Id.* In dismissing the plaintiffs' primary liability claim, the District Court held that "an independent accounting firm does not act 'in connection with' securities trading when it produces a fraudulent audit report that it knows its client will include in a Form 10-K." *Id.*

In reversing, the Ninth Circuit held that if plaintiffs' allegations were true, "E&Y made false assertions 'in a manner reasonably calculated to influence the investing public,' and thus 'in connection with' securities trading in violation of Section 10(b) and Rule 10b-5." It further noted that "[t]he fact that E&Y is an outside accounting firm does not foreclose

liability under §10(b). As Central Bank explained, "[a]ny person or entity, including a lawyer, accountant, or bank . . . may be liable as a primary violator under 10b-5. *Id.* at 397.

*b. District Court Decisions*

In Flecker v. Hollywood Entertainment Corp., 1997 WL 269488 at \*7 (D. Or. Feb. 12, 1997), the court denied underwriters' motions for summary judgment, rejecting their assertion "that plaintiffs' claims against them constitute no more than an attempt to reinvoke 10(b) aiding and abetting liability." Relying on Software Toolworks and McGann, the court held that "defendants' role 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)." *Id.* at \*9. Nowhere in the opinion, however, is it suggested that any of the allegedly fraudulent statements was attributable directly to the underwriters.

In In re ZZZZ Best Securities Litigation, 864 F. Supp. 960 (C.D. Cal. 1994), the court denied Ernst & Young's motion for summary judgment, holding that it could be primarily liable for the creation of a deceptive device released by someone else to the investing public. According to plaintiffs, ZZZZ Best had perpetuated a massive fraud in connection with the offering and trading of its securities. Ernst & Young had issued a review report of financial information containing material misrepresentations and/or omissions, which ZZZZ Best included in an offering prospectus. Plaintiffs further alleged that Ernst & Young was responsible for thirteen other publicly released statements related to ZZZZ Best's fraudulent scheme. *Id.* at 964.

Ernst & Young argued that, other than the review report directly attributable to it, it had no duty to disclose any of the other acts or omissions at issue and, therefore, it could not be primarily liable. *Id.* at 968. However, the court accepted plaintiffs' argument that "anyone who directly helps to prepare a misstatement, (i.e., a quarterly financial report, press release, prospectus, etc.), which is released to the investing public, may be held *primarily* liable for creation of a deceptive device, even though the device is technically released to the outside world by someone else, is attributable to someone else, and does not inform the reader that the aider and abettor had anything to do with the document." *Id.* It reasoned that, "[w]hile the investing public may not be able to reasonably attribute the additional misstatements and omissions to E & Y, 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." *Id.* at 970.

In Employers Ins. of Wausau v. Musick, Peeler & Garrett, 871 F. Supp. 381, 388 (S.D. Cal. 1994), the court refused to dismiss claims against attorneys and accountants charged with drafting a materially misleading prospectus. As to the attorneys, the court, relying on Software Toolworks, held 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. As to the accountants, it characterized as "flexible" the test to determine the significance of their involvement in the preparation of offering documents. *Id.* Thus, it rejected the accountants' argument that Software Toolworks did not apply because, in that case, the accountants were named in the offering documents. The court did "not read that case to create the rigid rule that an accountant must actually be named in a document to be liable as a primary actor." *Id.* at 389-90; see also Adam v. Silicon Valley Bancshares, *supra*, 884 F. Supp. at 1401 (denying motion to dismiss, holding that "plaintiffs in this case may maintain a cause of action alleging primary liability against [Deloitte & Touche] based on the various financial statements, press statements and reports issued by SVB", which plaintiffs had alleged that Deloitte & Touche "caused or permitted" SVB to issue); Cashman v. Coopers & Lybrand, 877 F. Supp. 425, 432 (N.D. Ill. 1995) (denying motion to dismiss, holding that "[p]laintiffs have alleged with sufficient particularity that Coopers played a central role in the drafting and formation of the alleged misstatements which the Stotler Partnership incorporated into its Prospectus").

In Phillips v. Kidder, Peabody & Co., 933 F. Supp. 303 (S.D.N.Y. 1996), the court, adopting the "significant role" theory, denied underwriter Kidder's motion for summary judgment, holding that plaintiffs had sufficiently raised issues of fact that Kidder had "actively participated in formulating the language of the prospectus. It would be reasonable to conclude, therefore, that this conduct amounts to 'making' the statement, even though the Prospectus was published in the name of the issuer." *Id.* at 316.

In addressing Kidder's argument that Central Bank precludes liability based on the underwriter's significant role in drafting documents, the court stated that "defendant urges an interpretation of Central Bank that would impose primary liability on the underwriters only for the statements that are directly attributable to them, or put more simply, signed by them. Although some cases would support this interpretation, such a test would virtually always absolve the underwriters from liability under 10b-5. This is clearly not a result anticipated by the Court in Central Bank." *Id.* at 316-17.

## 2. Courts Holding That § 10(b) Claims Based On A Secondary Actor's Significant Role Are Precluded By Central Bank

### a. Court of Appeals Decisions

In Anixter v. Home-Stake Prod. Co., 77 F.3d 1215, 1218 (10th Cir. 1996), the court reversed a judgment on a jury verdict against the estate of an independent auditor because of improper instructions on aiding and abetting liability. Plaintiffs had charged the independent auditor with participating in the preparation and filing of the registration statements, program books, prospectuses, certifications and opinion letters verifying Home-Stake's overall health "with knowledge of the false statements contained therein, or with reckless disregard as to the truth or falsity of the statements." *Id.* at 1219.

The Tenth Circuit stated that "[t]here is no requirement that the alleged violator directly communicate misrepresentations to plaintiffs for primary liability to attach." *Id.* at 1226, citing SEC v. Holschuh, 694 F.2d 130, 142 (7th Cir. 1982) ("actual or first-hand contact with offerees or buyers [is not] a condition precedent to primary liability for antifraud violations").<sup>4</sup> However, "for an accountant's misrepresentations to be actionable as a primary violation, there must be a showing that he knew or should have known that his representation would be communicated to investors because § 10(b) and Rule 10b-5 focus on fraud made 'in connection with the sale or purchase' of a security." *Id.* "Reading the language of § 10(b) and 10b-5 through the lens of Central Bank of Denver, we conclude that in order for accountants to 'use or employ' a 'deception' actionable under the antifraud law, they must themselves make a false or misleading statement (or omission) that they know or should know will reach potential investors." *Id.*

### b. District Court Decisions

In In re Kendall Square Research Corp. Sec. Lit., 868 F. Supp. 26, 27 (D. Mass. 1994), the court denied Price Waterhouse's motion to dismiss claims alleging that it knew, in issuing an unqualified audit opinion, that Kendall Square had improperly recognized revenues. However, the court dismissed so much of the complaint as alleged that Price Waterhouse was primarily liable for its "review and approval of the 1992 and 1993 quarterly financial statements and the 1992 and 1993 Prospectuses", *id.* at 28, reasoning that "these activities do not rise to the level of actionable conduct as set forth by the Supreme Court in Central Bank." *Id.*

The court addressed plaintiffs' argument that the "significant role" approach advanced in In re ZZZZ Best should apply. It held that "[o]nly 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). . . 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." *Id.* The court stated that "[t]o the extent ZZZZ Best provides such support [for plaintiffs' claims], the Court declines to follow that decision, relying instead on the Supreme Court's emphatic conclusion in Central Bank that 'Section 10(b) prohibits only the making of a material misstatement (or omission) or the commission of a manipulative act.'" *Id.* at 28-29 n.2, quoting, 511 U.S. at 177. See also Vosgerichian v. Commodore Int'l, 862 F. Supp. 1371, 1378 (E.D. Pa. 1994) (granting Arthur Andersen's motion to dismiss where plaintiff's allegations "do not go beyond allegations that AA assisted Commodore in perpetrating securities fraud and are thus not cognizable").

In In re MTC Electronic Technologies Shareholders Litigations, 898 F. Supp. 974, 978 (E.D.N.Y. 1995), plaintiffs alleged that MTC made a number of false statements intended to artificially inflate the value of MTC stock in anticipation of a large stock and debt offering. Against an underwriter, H.J. Myers, and an accountant, BDO Dunwoody, plaintiffs alleged primary violations of § 10(b) based on two theories: (1) the preparation or drafting of one of MTC's prospectuses; and (2) the actual making of materially false or misleading statements in a research report issued by H. J. Myers. *Id.* The court granted the portion of H.J. Myers' motion to dismiss the claim that H.J. Myers prepared or drafted the prospectus. However, it denied the motions to dismiss claims that H.J. Meyers and BDO Dunwoody actually had made materially false or misleading statements. *Id.* at 989.

Flatly rejecting the "significant role" theory, the court concluded that "if Central Bank is to have any real 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)." *Id.* at 987. With respect to allegations that H.J. Myers participated in drafting MTC's prospectus, the court stated that "[t]here is no allegation that H.J. Myers made any of the allegedly fraudulent representations in that prospectus. Indeed, there is no allegation that it did anything that is not done by lead underwriters with respect to all such public offerings." *Id.* However, the Court did conclude that "[t]he allegedly fraudulent statements in the [research] report . . . are statements by H.J. Myers itself, and thus may support an allegation of primary liability." *Id.*

Finally, in Picard Chemical Inc. Profit Sharing Plan v. Perrigo Co., 940 F.Supp. 1101 (W.D. Mich. 1996), the court denied underwriters' motion to dismiss on the grounds that the claims against them raised issues of primary liability. The court discussed cases following the "significant role" theory and held that "those post-Central Bank decisions which have held that a third-party defendant may be held liable for materially misleading statements made by others where the defendant 'substantially participated' in preparing the statements do not comport with Central Bank insofar as these cases reformulate the 'substantial assistance' element of aiding and abetting liability into primary liability and allow liability to attach without requiring a representation to be made by defendant." *Id.* at 1120.

### III. Other Theories of Liability

In addition to the "significant role" theory as a means of pursuing claims against secondary actors, the other theories most often advanced against such actors involve conspiracy and respondeat superior. As shown below, however, with rare exception, most courts view these theories as effectively abolished by Central Bank.

#### A. The Conspiracy Theory

##### 1. Courts Holding That § 10(b) Conspiracy Claims Survive Central Bank

In Trafton v. Deacon Barclays De Zoete Wedd, Ltd., 1994 WL 746199 (N.D. Cal. Oct. 21, 1994), plaintiffs alleged that three defendants, acting as "controlling persons", provided false and misleading information regarding PowerBurst, which was merging with another company. *Id.* at \*24. In denying a motion to dismiss following Central Bank, the court held that plaintiffs' conspiracy claims were legally sufficient in alleging that defendants had agreed to, and acted in concert for, the common goals of "effectuating DeBartolo's 'exit strategy', providing the other individual defendants an opportunity to liquidate otherwise worthless stock on the open market and to obtain Western Canada Beverage Corporation's assets at fire-sale prices . . ." 1994 WL 746149 at \*25.

Dinsmore v. Squadron, Ellenoff, Plesent, Sheinfeld & Sorkin, 945 F. Supp. 84, 86 (S.D.N.Y. 1996), also refused to dismiss conspiracy claims following Central Bank. The court, referring to the transcript of the oral argument before the Supreme Court in Central Bank, concluded that "at least two of the Justices considered that a well pleaded complaint could successfully allege a claim for conspiracy to violate section 10(b)." *Id.* at 85.

In Dinsmore, investors in bonds alleged to have been issued in connection with a "Ponzi" scheme sued the law firm representing the issuer. The court concluded that "[i]f the case goes to trial the jury will be instructed that it can find liability against the defendant only if it finds by *clear and convincing evidence* that" a conspiracy existed. *Id.* at 86. It noted that even though a civil conspiracy ordinarily may be established by a preponderance of the evidence, it would hold plaintiffs to this higher evidentiary standard to accomplish Central Bank's goals of protecting lawyers and accountants from the "special risks arising from [their] professional duties . . . and the importance as a matter of public policy that they be not inhibited from performing those duties." *Id.* at 87 n. 6.

Dinsmore, the most recent case in the Southern District of New York to address the conspiracy issue, would, if followed, render conspiracy claims under § 10(b) viable, even though, as discussed below, decisions issued before Dinsmore had held conspiracy claims precluded by Central Bank. Because it did not dispute or distinguish any of those cases, however, Dinsmore may be an aberration and given little weight by other courts.

## 2. Courts Holding § 10(b) Conspiracy Claims Precluded By Central Bank

The majority view holds conspiracy claims precluded by Central Bank.

### a. Court of Appeals Decisions

In In re GlenFed, Inc. Securities Litigation, 60 F.3d 591, 592 (9th Cir. 1995), the Ninth Circuit stated that the Central Bank "rationale precludes a private right of action for 'conspiracy' liability." In Glenfed, defendants had moved to dismiss allegations that GlenFed's officers and directors "made misrepresentations and omissions designed to conceal GlenFed's deteriorating financial condition, lack of adequate internal controls and declining market." In re GlenFed Securities Litigation, 42 F.3d 1541, 1543 (9th Cir. 1994) (en banc). Although plaintiffs made no claims against accountants, attorneys or underwriters, they did allege that officers and directors of GlenFed were secondary actors involved in a conspiracy. The court's holding that conspiracy liability is precluded by Central Bank's aiding and abetting rationale appears applicable to conspiracy claims against other secondary actors.

### b. District Court Decisions

In In re Faleck & Margolies, Ltd., 1995 WL 33631 at \*12 (S.D.N.Y. Jan. 30, 1995), the complaint included a conspiracy claim alleging that accountants had issued opinions on financial statements recklessly disregarding the omission of material adverse information. *Id.* at \*2. Noting that Central Bank had inferred that "'Congress likely would not have attached aiding and abetting liability to § 10(b) had it provided a private § 10(b) cause of action'" (511 U.S. at 179), Faleck held that "'to permit a private plaintiff to maintain an action for conspiracy to violate Rule 10b-5 would make Central Bank of Denver meaningless, since virtually every aiding and abetting claim can be alleged as a conspiracy claim.'" 1995 WL 33631 at \*12.

The conspiracy issue also was addressed in In re College Bound Consolidated Litigation, 1995 WL 450486 (S.D.N.Y. July 31, 1995), where the court dismissed claims that, in connection with the issuance of securities by College Bound, defendants had overstated the company's income and assets, and manipulated the price of its stock. In particular, plaintiffs claimed that "several European individuals and entities" had raised more than \$24 million through the sale of convertible notes in order to create cash infusions to make College Bound's overstated profits more believable. In re College Bound Consolidated Litigation, 1994 WL 172408 at \*1 (S.D.N.Y. May 4, 1994).

Pointing to the statement in Central Bank that the "statutory text controls the definition of conduct covered by § 10(b)" (511 U.S. at 175), and holding that the statute neither directly nor indirectly covered aiding and abetting (*id.* at 177), College Bound recognized that "[n]either 'conspiracy' nor 'conspirators' can be found in the text of either § 10(b) or 10(b)-5. That other statutes impose liability for conspiracy (criminal conspiracy statute) . . . reinforces the conclusion that if Congress had wished to add the concept of conspiracy to the securities laws, it would have done so." 1995 WL 450486 at \*8.

Other decisions have followed the reasoning of College Bound. See Phillips v. Kidder Peabody & Co., 933 F. Supp. 303, 316 (S.D.N.Y. 1996) (granting underwriters' summary judgment motion on the grounds that "liability based on allegations of conspiracy has been eliminated" by Central Bank); Primavera Familienstiftung v. Askin, 1996 WL 494904 at \*7 (S.D.N.Y. Aug. 30, 1996) (holding that "to the extent that the Complaint sets forth allegations of conspiracy, it does not state a cause of action"); In re MTC Electronic Technologies Shareholders Litigation, 898 F. Supp. 974 (E.D.N.Y. 1995) (granting defendants' motion to strike allegations of conspiracy from complaint, holding that "conspiratorial liability for 10(b) does not survive Central Bank.")

In Otto v. Variable Annuity Life Ins. Co., 1995 WL 121519 at \*1 (N.D. Ill. March 17, 1995), the court entered judgment on the pleadings dismissing allegations that individual and corporate defendants conspired to violate § 10(b). Even though the Seventh Circuit previously had held (pre-Central Bank) that the complaint adequately stated a claim for conspiracy, Otto v. Variable Annuity Life Ins. Co., 814 F.2d 1127, 1137 (7th Cir. 1986), the District Court agreed with defendants that Central Bank "casts doubt on that opinion":

While it is true that the Central Bank Court was addressing the question of aider and abettor liability, its analysis is equally applicable to conspiracy claims. As with aiding and abetting, conspiracy is mentioned nowhere in the text of § 10(b). And because 'the text of the statute control[led]' the Court's decision, [511 U.S. at 173], it naturally follows that that decision implicates other forms of secondary liability, including conspiracy. 1995 WL 121519 at \*1.

Although Otto did not address a conspiracy claim against accountants, lawyers or underwriters, its reasoning would appear applicable to claims against such professionals. See Vennittilli v. Primerica, Inc., 943 F. Supp. 793, 796-97 (E.D. Mich. 1996) (granting insurance company and broker-dealer defendants' motion to dismiss allegations that defendants conspired to violate securities laws); Kidder Peabody & Co. v. Unigestion Int'l Ltd., 903 F. Supp. 479, 496-98 (S.D.N.Y. 1995) (adopting the textual approach of Central Bank and rejecting a conspiracy claim against a broker-dealer as the same as alleging aiding and abetting liability); In re Syntex Corp. Sec. Litig., 855 F. Supp. 1086, 1098 (N.D. Cal. 1994) (same).

In Van De Velde v. Coopers & Lybrand, 899 F. Supp. 731, 732 (D. Mass. 1995), the court dismissed allegations that Coopers & Lybrand had participated in a conspiracy by issuing materially false and misleading financial statements. 889 F. Supp. at 738. "Coopers & Lybrand wrote an unqualified audit opinion . . . filed with the SEC . . . certifying that, after conducting an audit in compliance with [GAAS], it had a reasonable basis for the opinion that Ferrofluidics' financial statements for FY 1992 complied with [GAAP]." *Id.* at 733-34. It withdrew this opinion the following year, after an SEC investigation, issuance by Ferrofluidics of revised financial statements, a severe market correction, and the departure of two top executives. *Id.*

In dismissing, the court noted that the complaint specifically alleged that "Coopers also conspired with Ferrofluidics to defraud plaintiffs and the Class through the issuance of materially false and misleading financial statements." *Id.* at 738. It held that "[t]o the extent that this constitutes a distinct claim for conspiracy to violate the securities laws, defendant is correct that this claim is barred by Central Bank." *Id.* The court left open the possibility that, had plaintiffs' allegations contained well-pleaded claims that Coopers & Lybrand's actions constituted primary liability, dismissal might have been denied. *Id.* However, because there was no primary liability claim, only a claim of conspiracy, dismissal was required.

In Sunrise Financial, Inc. v. Paine Webber, Inc., 948 F. Supp. 1002, 1008 (D. Utah 1996), the court held as sufficient primary liability claims against Paine Webber, acting as a broker, for delivering two million shares of securities "[i]n direct violation of the instructions issued by Green as agent for the owners of the securities, and with knowledge that its customers had paid no consideration whatsoever for the 2 million shares." However, it also held that, "[t]o the extent the plaintiffs' first cause of action asserts liability for aiding and abetting or conspiracy to commit securities fraud, the claim is hereby dismissed." 948 F. Supp. at 1008 n. 5.

Finally, in Diana Paolucci Corp. v. Carbonell & Astor, 949 F. Supp. 65, 68 n. 2 (D. Puerto Rico 1996), the court, citing Faleck, dismissed a conspiracy claim, stating "[v]arious courts have concluded that the decision in Central Bank precludes the possibility of all forms of secondary liability for violations of the securities laws." In its view, the language "all forms of secondary liability" included conspiracy liability.

## ***B. Respondeat Superior***

Before Central Bank, it was well settled that aiding and abetting a § 10(b) violation gave rise to a private cause of action. A majority of pre-Central Bank courts had also held that respondeat superior was a viable theory under § 10(b). See, e.g., Hollinger v. Titan Capital Corp., 914 F.2d 1564 (9th Cir. 1990). These courts proceeded under the theory that § 20(a) "controlling person" liability did not provide the sole source of secondary liability for § 10(b) violations. Central Bank provides little, if any, guidance as to whether the elimination of aiding and abetting liability effectively eliminated respondeat superior and other agency liability. The majority did not address whether respondeat superior survived, or was even affected by its decision. The only words on the issue came from Justice Stevens who, in dissent and with little supporting analysis, indicated that respondeat superior would probably not survive Central Bank. 511 U.S. at 201 n. 12. The majority of courts faced with this issue have overwhelmingly interpreted Central Bank as eliminating respondeat superior liability.

### **1. Courts Holding That Respondeat Superior Claims Survive Central Bank**

In Seolas v. Bilzerian, 951 F. Supp. 978 (D. Utah 1997), the court denied defendants' motion for summary judgment on the respondeat superior issue. Plaintiff claimed that Bilzerian, acting as agent for Cimetrix, "wrongfully induced Plaintiff and his family to return approximately 215,000 shares of Cimetrix stock back to Cimetrix without monetary consideration" in order to inflate Bilzerian's own stock options and to fund an employee stock option plan without diluting Bilzerian's own interests in Cimetrix. *Id.* at 980. Relying on respondeat superior, plaintiff claimed Cimetrix was liable for Bilzerian's alleged

violation. *Id.* at 981. Cimetrix argued that Central Bank eliminated all forms of respondeat superior, reasoning that its rejection of aiding and abetting as a viable claim because it is not specifically mentioned in § 10(b) should apply as well to respondeat superior, which also is not specifically mentioned in the statute. *Id.* at 983.

The court rejected Cimetrix's argument, stating that "unlike the issues in Central Bank, . . . the issue in this case --whether respondeat superior is a legitimate basis of liability under § 10(b) -- is not a question of defining the scope of affirmative conduct proscribed by the statute. Instead, the issue is 'deciding on whose shoulders to place responsibility for conduct indisputably proscribed' by the statute." *Id.* Cimetrix could be liable, not because it acted within the scope of § 10(b), but because its status as Bilzerian's agent warrants responsibility for his acts.

The court also stated that "the respondeat superior theory of liability is consistent with the language of § 10(b) and the intent of the securities laws to promote full disclosure and discourage fraud in the securities markets." *Id.* Because Congress included corporations in the definition of "persons" under the securities laws (15 U.S.C. § 77b(a)(2)), it foresaw that corporations would be liable under agency theories. 951 F. Supp. at 983-84.

## **2. Courts Holding That Respondeat Superior Claims Are Precluded By Central Bank**

In In re Fidelity/Micron Securities Litigation, 964 F. Supp. 539 (D. Mass. 1997), the court granted a motion to dismiss a respondeat superior claim against Magellan, a mutual fund, alleging its responsibility for the actions of Vinik, a portfolio manager of Magellan funds directly employed by FMR, a registered investment advisor for Magellan. *Id.* at 541. Plaintiffs claimed that, in an interview with Vinik included in Magellan's November 1995 report, Vinik falsely represented that Magellan's success was due to its heavy investments in technology stocks and that Magellan would continue to invest in technology stocks. *Id.* In fact, Magellan sold virtually all of its technology stocks immediately prior to the issuance of the November 1995 report. *Id.* Plaintiffs alleged that Vinik's statements were intended to deceive investors into believing that Magellan would continue investing in technology stocks. *Id.*

Plaintiffs claimed that "at least some of the allegedly misleading statements appeared in Magellan's Semiannual Report to its shareholders, and that Magellan directly benefitted from the scheme to manipulate the price of Micron stock. Consequently, plaintiffs argue that Magellan shares primary liability for these statements under section 10(b)." *Id.* at 543. Magellan argued that, as an entity, it made no statements regarding the fund and that all statements were attributable to Vinik. *Id.*

The court rejected plaintiffs' argument that Central Bank did not preclude liability of a principal for the acts of its agent. It held that a critical element of § 10(b) primary liability, reliance on misstatements or omissions, could not be established by respondeat superior. "To hold Magellan liable under Rule 10b-5 on a theory of respondeat superior would impose liability without any showing that the market relied on statements or actions directly or indirectly attributable to Magellan in evaluating Micron shares." *Id.* at 544. Therefore, respondeat superior claims could not survive Central Bank.

In In re Prudential Ins. Co. Litigation, 1996 WL 392145 (D. N.J. May 10, 1996), the court dismissed a fraud claim based on respondeat superior. Plaintiffs alleged that Prudential provided its agents with various materials used to sell insurance products mischaracterized as other types of investment plans, and the taking of unauthorized loans against cash values amassed in insurance policies. *Id.* at \*1-\*2.

The court dismissed plaintiffs' claims based on respondeat superior, relying solely on Justice Stevens' comment in dissenting in Central Bank -- that the majority opinion would likely preclude respondeat superior liability. *Id.* at \*26, *citing*, 511 U.S. at 201 n. 12. It noted that "controlling person" liability under § 20(a) of the appeared to be the only form of secondary liability available to private plaintiffs after Central Bank. *Id.* at \*26.

Finally, in ESI Montgomery County, Inc. v. Montenay International Corp., 1996 WL 22979 (S.D.N.Y. Jan. 23, 1996), the court dismissed plaintiffs' respondeat superior claim against MERMCI. The action arose in the context of the purchase by ESI of a 72% interest in a limited partnership in which defendant MIC had retained as 28% interest. MERMCI, a wholly owned subsidiary of MIC, was the general partner of the limited partnership. During negotiations, MIC transmitted various financial documents to ESI which ESI claimed contained material misstatements and omissions about the limited partnership. *Id.* at \*1. MERMCI claimed it could not be liable under § 10(b) because it was not a party to the purchase

agreement and because it did not prepare or assist in the preparation of any of the financial documents in question. *Id.* at \*2. In rejecting plaintiffs' claims against MERMCI, based on actions of its directors and officers in negotiations for the sale of the limited partnership, the court succinctly concluded that, because Central Bank eliminated all forms of secondary liability, respondeat superior claims were no longer valid. *Id.* at \*3.

#### **IV. Conclusion**

Central Bank seemed at first to protect accountants, attorneys and underwriters from claims for securities fraud perpetrated by their clients. But if "Supreme Court decisions mean only what the lower courts say they mean" (75 N.C. L. Rev. at 691), then the collective sigh of relief breathed by these professionals following that decision may have been premature.<sup>5</sup> Many lower courts have interpreted Central Bank to render professionals answerable for the wrongs of others, effectively turning Central Bank into a "nonevent." *Id.*

It is clear that, following Central Bank, conspiracy and respondeat superior liability theories are no longer viable. Because there has been little, if any, serious debate on this issue, claims based on such theories are likely to be dismissed.

The real dispute has arisen with respect to the "significant role" or "substantial involvement" theory. The courts that have adopted what has been deemed the "bright line" approach -- that, in order for secondary actors to be primarily liable, plaintiffs must allege material misstatements or omissions directly attributable to them -- have ruled in a manner consistent with the spirit and letter of Central Bank. By eliminating all forms of secondary liability, these courts have done the most to further Central Bank's purpose.

However, other courts have expressed concern that such a bright line approach may accomplish the unintended result of allowing wrongdoers to escape liability. These courts have permitted plaintiffs to substitute primary liability labels for claims previously labelled aiding and abetting, often without requiring the specification of new facts to support such claims. Courts that allow plaintiffs to replead or recast aiding and abetting claims in this manner seriously undermine Central Bank's holding.

It is unclear, and indeed it may be unclear for years to come, which philosophy will prevail. Perhaps the only thing that is clear is that if Central Bank attempted to eliminate all forms of secondary liability, it did not accomplish its goal.

Joel W. Sternman

Garrett L. Gray

## Endnotes

Joel W. Sternman is a member of Rosenman & Colin LLP. Garrett L. Gray is an associate at Rosenman & Colin LLP. This article represents the views of the authors only, and not necessarily those of their firm. The authors thank and acknowledge the significant contribution of Robert S. Hoff, a second-year law student at the Brooklyn School of Law and a 1997 Summer Associate at Rosenman & Colin LLP.

1. For example, in 1992, the Big Six accounting firms paid approximately \$373.8 million to satisfy Section 10(b)/Rule 10b-5 claims, an amount equal to one third of the total amount recovered on all such claims. 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, 693 (1997).
2. Several courts, mostly in California, have held that secondary actors may be primarily liable if alleged to have played a significant role, or to have been substantially involved, in the dissemination of materially false or misleading information. Others have rejected this theory.
3. The court, noting that the complaint did not allege that Deloitte & Touche made any material misrepresentation or omission, stated that "the Ninth Circuit has indicated that an accounting firm can be primarily liable for representations made by others." 884 F. Supp. at 1401.
4. This statement, which suggests that the court followed the "significant role" approach, has led to some disagreement in interpreting its holding. Compare, Picard Chemical Inc. Profit Sharing Plan v. Perrigo Co., 940 F. Supp. 1101, 1120 (W.D. Mich. 1996), with Phillips v. Kidder, Peabody & Co., 933 F. Supp. 303, 315 (S.D.N.Y. 1996).
5. For another excellent analysis of this subject, see G. Evans and D. Floyd, Secondary Liability Under Rule 10b-5: Still Alive and Well After Central Bank?, 52 Business Lawyer 13 (November 1996).

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### KattenMuchinRosenman LLP Locations

[www.kattenlaw.com](http://www.kattenlaw.com)

401 S. Tryon Street  
Suite 2600  
Charlotte, NC 28202-1935  
704.444.2000 tel  
704.444.2050 fax

525 W. Monroe Street  
Chicago, IL 60661-3693  
312.902.5200 tel  
312.902.1061 fax

5215 N. O'Connor Boulevard  
Suite 200  
Irving, TX 75039-3732  
972.868.9058 tel  
972.868.9068 fax

1-3 Frederick's Place  
Old Jewry  
London EC2R 8AE  
+44.20.7776.7620 tel  
+44.20.7776.7621 fax

2029 Century Park East  
Suite 2600  
Los Angeles, CA 90067-3012  
310.788.4400 tel  
310.788.4471 fax

575 Madison Avenue  
New York, NY 10022-2585  
212.940.8800 tel  
212.940.8776 fax

260 Sheridan Avenue  
Suite 450  
Palo Alto, CA 94306-2047  
650.330.3652 tel  
650.321.4746 fax

1025 Thomas Jefferson Street, NW  
East Lobby, Suite 700  
Washington, DC 20007-5201  
202.625.3500 tel  
202.298.7570 fax

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