COMMENT

Primary Securities Fraud Liability for Secondary Actors: Revisiting *Central Bank of Denver* in the Wake of Enron, WorldCom, and Arthur Andersen

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INTRODUCTION

Prior to declaring bankruptcy on December 2, 2001, Enron Corporation ("Enron") was the seventh largest corporation in the United States.[1] At the time, Enron's billion-dollar bankruptcy proceeding was the largest in United States history.[2] Sadly, Enron held this dubious distinction for only seven months. On July 21, 2002, WorldCom Inc. ("WorldCom"), one of America's largest telecommunications companies, initiated a

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[1] *See* William W. Bratton, *Does Corporate Law Protect the Interests of Shareholders and Other Stakeholders?: Enron and the Dark Side of Shareholder Value*, 76 TUL. L. REV. 1275, 1276 (2002) (stating that Enron was seventh largest American firm by market capitalization until declaring bankruptcy on December 2, 2001); Jeffrey N. Gordon, *What Enron Means for the Management and Control of the Modern Business Corporation: Some Initial Reflections*, 69 U. CHI. L. REV. 1233, 1234 (2002) (stating that when Enron declared bankruptcy, it was seventh largest company in United States); William S. Lerach, *"The Chickens Have Come Home to Roost," How Wall Street, the Big Accounting Firms and Corporate Interests Chloroformed Congress and Cost American Investors Trillions*, 1324 PLI/CORP. 759, 778 (2002) (stating that Enron was seventh largest company in United States with hundred billion dollars in yearly revenue, billion dollars in annual profits, and extremely prestigious Board of Directors).

[2] William F. Dietrich, *Legal and Ethical Issues for Attorneys Dealing With Financial Data: Heightened Scrutiny After the Enron and Andersen Debacle*, 1325 PLI/CORP. 925, 936 (2002); Lerach, *supra* note 1, at 778.

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bankruptcy proceeding nearly twice as large as Enron's.[3]

The similarity in the circumstances leading to the downfall of these two companies is striking and disturbing. Both Enron and WorldCom allegedly employed fraudulent accounting methods to overstate reported assets and disguise liabilities, thereby artificially inflating the price of their stock.[4] Before these fraudulent activities came to light, executives at both companies encouraged employees to acquire company stock at the same time that the executives were selling their own shares.[5] Moreover, both companies paid the accounting firm of Arthur Andersen LLP ("Andersen") tens to hundreds of millions of dollars a year for services that allegedly facilitated this fraud.[6]

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[3] Shawn Young et al., *Debt, Scandal Overwhelm; Operations Set to Continue During a Reorganization*, WALL ST. J., July, 22, 2002, at A3 (stating that WorldCom's assets were listed at $107 billion, making bankruptcy filing largest in U.S. history, succeeding Enron's $63.4 billion bankruptcy).

[4] *See, e.g.*, Deborah Solomon, *The Economy: WorldCom Reaches Partial Settlement With SEC*, WALL ST. J., Nov. 27, 2002, at A2 (stating that WorldCom has admitted to inflating profits by at least nine billion); *Enron's Many Strands: Excerpts from Testimony Before House Subcommittee on Enron Collapse*, N.Y. TIMES, Feb. 5, 2002, at C4 (explaining one method Enron used to inflate stock); *see also* Dietrich, *supra* note 2, at 937 (stating that Enron purported to enter into illusionary hedging transactions to avoid recognizing losses from investments); Lerach, *supra* note 1, at 779 (stating that Enron created extraordinarily fragile corporate structure with billions of dollars dependent on stock price so that first bad news that caused stock to fall triggered massive stock issuance obligations, resulting in Enron's vaporization in matter of weeks); Gordon, *supra* note 1, at 1234 (stating that Enron filed false and misleading disclosure documents).

[5] *See* Bratton, *supra* note 1, at 1293 (stating that Enron management froze employee 401K plan accounts in October, 2001, same month Enron revealed third quarter loss of $638 million, while top executives were not similarly restricted); Gordon, *supra* note 1, at 1234 (stating that Enron insiders sold stock and exercised options while publicly restating their faith in company, locking employee 401K plans, and disallowing rank and file employees from selling their own shares); Joann S. Lublin, *As Their Companies Crumbled, Some CEOs Got Big-Money Payouts*, WALL ST. J., Feb. 26, 2002, at B1 (stating that Enron leader Kenneth Lay urged employees to keep buying its shares even though he was selling most of his); *see also* C. Evan Stewart, *Liability For Securities Lawyers in the Post-Enron Era*, 126 PLI/NY 123, 129 (2002) (stating that Enron executives profited by their fraudulent partnerships, and that collapse of Enron's stock price wiped out literally thousands of Enron employees' retirement accounts which were concentrated in Enron stock); Symposium, *Enron: What Went Wrong?*, 8 FORDHAM J. CORP. & FIN. L. 1, 3 (2002) (stating that Chairman of Enron was personally selling significant number of shares of Enron stock while continuing to advise Enron employees that stock was undervalued).

[6] Daniel Kadlec, *Who's Accountable?; Inside the Growing Enron Scandal: How Evidence Was Shredded and Top Executives Fished for a Bailout As the Company Imploded*, TIME, Jan. 21, 2002, at 28, 34; *see also* Bratton, *supra* note 1, at 1349 (stating that Enron's 2001 proxy statement reported that company paid Andersen $25 million in auditor fees and $27 million in consulting fees); Edward J. Cleary, *Lessons for Lawyers from the Enron Debacle*, BENCH & B. OF MINN., Apr., 2002, at 16, 16 (stating that Enron paid Andersen $25 million for its 2001 audit and $27 million for consulting work and other services).

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Andersen played the dual role of auditor and consultant for Enron.[7] At the same time that Andersen's accounting department was auditing Enron's financial statements, Andersen's consulting department was advising Enron management regarding the techniques used to inflate Enron's reported earnings.[8] Thus, Andersen auditors arguably had an economic incentive to ignore the questionable suggestions of their colleagues in the lucrative consulting business.[9]

Andersen was also WorldCom's auditor during the period in which WorldCom engaged in apparently fraudulent practices.[10] In the wake of the Enron scandal, WorldCom switched auditors from Andersen to KPMG, another of the then "big five" accounting firms.[11] KPMG's initial audit of WorldCom uncovered the magnitude of WorldCom's accounting irregularities.[12]

Andersen's involvement in both the Enron and WorldCom debacles revives an almost decade old legal issue: the extent to which federal securities laws should hold a secondary actor primarily liable for securities fraud. Surprisingly, in most federal circuits, secondary participants like lawyers or accountants are largely able to avoid liability for their roles in corporate securities fraud.[13] There are two main reasons

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[7] *See, e.g.*, Cleary, *supra* note 6, at 16; Michael C. Dorf, *Conflicts of Interest Aren't All Bad: Lessons From the Corporate Accounting Scandals and Beyond*, *available at* http://writ.corporate.findlaw.com/dorf/20020724.html (last visited Oct. 7, 2003); Gordon, *supra* note 1, at 1236-37 (stating that Andersen's failure was foreseeable because it lost its independence as auditor when it also became consultant, and that there are problems in letting accounting firms cross-sell consulting services to audit clients).

[8] *See* Cleary, *supra* note 6, at 16 (stating that there is inherent conflict of interest in doing both consulting and auditing work for same company); Lerach, *supra* note 1, at 781 (stating that Andersen, as business consultants, helped structure very transactions that they were to later audit).

[9] *See* Bratton, *supra* note 1, at 1349 (stating that in order to protect flow of consulting fees and value of long-term relationship with Enron, Andersen's auditors permitted actors at Enron to bully them into signing off on dubious financials); Cleary, *supra* note 6, at 16 (stating that accounting firms offering non-audit services along with auditing service often results in auditor integrity being compromised); John C. Coffee, Jr., *Understanding Enron: "It's About the Gatekeepers, Stupid,"* 57 BUS. LAW. 1403, 1411 (2002) (acknowledging argument that auditing is used as loss leader to market more lucrative services which has eroded auditor independence); *Though Enron Case Isn't Over, Lessons Already Emerge*, WALL ST. J., Jan. 15, 2002, at A4 (stating that auditors find it difficult to resist incentive to go easy on companies to avoid jeopardizing lucrative consulting contracts).

[10] William S. Lerach, *Plundering America: How American Investors Got Taken for Trillions by Corporate Insiders*, 8 STAN. J. L. BUS. & FIN. 69, 108 (2002) (stating that Andersen somehow managed to overlook $7 billion of WorldCom's falsifications in three years time).

[11] Peter Elstrom, *Special Report: Scandals in Corporate America; How to Hide $3.8 Billion in Expenses*, BUSINESSWEEK, July 8, 2002, at 41.

[12] *Id.*

[13] *See infra* Part I.C.1 (explaining that majority of circuits have adopted Bright Line Test

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for this. First, in 1994, the United States Supreme Court in *Central Bank of Denver v. First Interstate Bank of Denver* ("*Central Bank*") eliminated aider and abettor liability under federal securities law.[14] Second, the confusion *Central Bank* created led many federal circuits to interpret it in a way that exonerates most secondary actors from primary securities fraud liability.

Central Bank and its interpretation by most circuits need to be reexamined, and a stricter stance must be taken. Secondary actors should not be able to avoid liability by remaining behind the scenes, as a majority of the circuits currently permit. Instead, it is exactly this behind the scenes fraud that courts need the leeway to catch and deter. In the absence of Supreme Court guidance or congressional clarification as to what warrants primary securities fraud liability for secondary actors, lower courts should reevaluate *Central Bank*'s legacy to better serve the interests of both business and investors.

Part I of this Comment provides a summary of the federal law governing securities fraud liability for secondary actors. It then offers an overview of the *Central Bank* decision. Finally, Part I discusses the circuit courts' two principle interpretive approaches to *Central Bank*: the "Bright Line" standard ("Bright Line Test") and the "Substantial Participation" standard ("Substantial Participation Test"). Part II then argues that until Congress provides further legislative guidance regarding what constitutes primary versus secondary securities fraud liability, the Substantial Participation Test is superior to the Bright Line Test. Part III discusses two recent events that may have an important impact on secondary liability under federal securities law. The first is the July 30, 2002 passage of the Sarbanes-Oxley Act and the second is a December 2002 decision from the federal district court in Texas currently adjudicating the Enron securities fraud cases. Part III then discusses how these two events may signal a shift away from the Bright Line Test. Finally, Part III argues that federal courts should reconsider the Bright Line Test in future decisions and expand the scope of liability under federal securities law to conform to the Substantial Participation Test.

in determining securities fraud liability of secondary actors, which limits liability only to misstatements that are publicly attributable to actor).

[14] Cent. Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164 (1994).

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I. LEGAL BACKGROUND

A. *Aiding and Abetting Liability Under Federal Securities Laws Before* Central Bank

The stock market crash of 1929 and the accompanying reports of abuses in the securities industry led Congress to enact the Securities Act of 1933 (the "33 Act") and the Securities Exchange Act of 1934 (the "34 Act") (alternatively the "Acts").[15] Two fundamental goals prompted passage of the Acts.[16] First, Congress sought to ensure public disclosure of material company information to enable investors to make knowledgeable decisions in connection with the purchase or sale of securities.[17] Second, Congress wanted to rid securities markets of fraudulent practices.[18] The Acts create an extensive scheme of civil liability centered on the implied antifraud provision of section 10(b) of the 34 Act ("section 10(b)") and its progeny, the Securities and Exchange Commission ("SEC")-created Rule 10b-5 ("Rule 10b-5").[19]

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[15] Securities Act of 1933, 48 Stat. 74 (codified as amended at 15 U.S.C. § 77a *et seq.* (1994 & Supp. 1995)); Securities Exchange Act of 1934, 48 Stat. 881 (codified as amended at 15 U.S.C. § 78a *et seq.* (1994 & Supp. 1995)); *see Cent. Bank*, 511 U.S. at 170-71 (recounting history of Acts).

[16] *See* Brennan v. Midwestern United Life Ins. Co., 259 F. Supp. 673, 680 (N.D. Ind. 1966), *aff'd*, 417 F.2d 147 (7th Cir. 1969) (stating that basic philosophy of Securities Exchange Act of 1934 is disclosure and is directed toward creation and maintenance of post-issuance securities market that is free from fraudulent practices); Kyle M. Globerman, *The Elusive and Changing Definition of a Security: One Test Fits All*, 51 FLA. L. REV. 271, 279 (1999) (explaining goals and history of securities acts); *see also Cent. Bank*, 511 U.S. at 171 (citing *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 151 (1972) ("Together, the Acts 'embrace a fundamental purpose . . . to substitute a philosophy of full disclosure for the philosophy of caveat emptor.'").

[17] *See Brennan*, 259 F. Supp. at 680 (stating that one of basic philosophies of Securities Exchange Act of 1934 is disclosure).

[18] *See id.* (stating that one of basic philosophies of Securities Exchange Act of 1934 is creation and maintenance of post-issuance securities market that is free from fraudulent practices).

[19] *Cent. Bank*, 511 U.S. at 171. Section 10(b) contains both express and implied causes of action. It states:

> "It shall be unlawful for any person, directly or indirectly . . . (b) To use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest to the protection of investors."

15 U.S.C. § 78j (1994 & Supp. 1995).

Section 10(b) grants the Securities Exchange Commission (the "SEC") the power to make further rules and regulations for the public good or interest of investors. *Id.*. In 1942,

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Section 10(b) does not explicitly mention aiding and abetting liability for securities fraud.[20] Following initial recognition in *Brennan v. Midwestern United Life Insurance Co.*,[21] however, aiding and abetting liability became one of the larger branches of the section 10(b) and Rule 10b-5 body of law.[22] Every federal circuit soon acknowledged section 10(b) claims based on aiding and abetting of securities fraud.[23]

Prior to 1994, both primary violators and secondary aiders and abettors could face section 10(b) liability.[24] Accordingly, most courts felt

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the SEC used this authority to create Rule 10b-5 which states:

> "It shall be unlawful for any person, directly or indirectly . . . (a) To employ any device, scheme, or artifice to defraud, (b) To make any untrue statement of material fact . . . or (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the sale of any security."

17 C.F.R. § 240.10b-5 (1996).

[20] *See* 15 U.S.C. § 78j(b).

[21] *Brennan*, 259 F. Supp. at 673, *aff'd*, 417 F.2d 147, 154 (7th Cir. 1969) (stating that in absence of clear legislative expression to contrary, section 10(b) liability can be imposed upon persons who do no more than aid and abet violation of section 10(b) and Rule 10b-5).

[22] *See* 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, 700 (1997) (stating that aiding and abetting is one of larger branches of section 10(b)/Rule 10b-5 judicial oak).

[23] *See, e.g.*, Farlow v. Peat, Marwick, Mitchell & Co., 956 F.2d 982, 986 (10th Cir. 1992); Akin v. Q-L Invs., 959 F.2d 521, 525-27 (5th Cir. 1992); Schatz v. Rosenberg, 943 F.2d 485, 495 (4th Cir. 1991); Robin v. Arthur Young & Co., 915 F.2d 1120, 1123-24 (7th Cir. 1990); Moore v. Fenex, Inc., 809 F.2d 297, 303 (6th Cir. 1987); Zoelsch v. Arthur Andersen & Co., 824 F.2d 27, 35-36 (D.C. Cir. 1987); Rudolph v. Arthur Andersen & Co., 800 F.2d 1040, 1045-46 (11th Cir. 1986); Cleary v. Perfectune, Inc., 700 F.2d 774, 778-79 (1st Cir. 1983); SEC v. Seaboard Corp., 677 F.2d 1301, 1311 (9th Cir. 1982); IIT v. Cornfeld, 619 F.2d 909, 922-25 (2d Cir. 1980); Monsen v. Consol. Dressed Beef Co., 579 F.2d 793, 799-801 (3d Cir. 1978); *see also Cent. Bank*, 511 U.S. at 192 (Stevens, J., dissenting) (stating that in hundreds of judicial and administrative proceedings in every circuit, courts and SEC have concluded that aiders and abettors are subject to liability under section 10(b) and Rule 10b-5).

[24] According to one popular formulation, in order to state a claim for primary liability under section 10(b)/Rule 10b-5, a plaintiff must show that the defendant (a) made a misstatement or omission, (b) of material fact, (c) with scienter, (d) in connection with the sale or purchase of securities, (e) upon which the plaintiff relied, and (f) that reliance proximately caused (g) damages to the plaintiff. *See* Stransky v. Cummins Engine Co., 51 F.3d 1329, 1331 (7th Cir. 1995); Prentice, *supra* note 22, at 699. In contrast, the most prevalent test for aiding and abetting liability under section 10(b)/Rule 10b-5 stated that plaintiff had to prove: (a) a primary violation by another party; (b) that the defendant had "knowledge" of the wrong and of his role in furthering it; and (c) that the defendant substantially assisted the violation. Prentice, *supra* note 22 at 701. Despite different tests, however, the fraudulent conduct covered by the two theories are nearly coextensive and during the thirty-year existence of the aiding and abetting theory, no court ever clearly established exactly what is covered by aiding and abetting liability that is not covered by primary liability. *Id.* at 709.

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that it was unnecessary to draw a precise distinction between the two types of liability.[25] In 1994, however, the Supreme Court decided *Central Bank* and the distinction became paramount.[26] With its decision, the Supreme Court overturned thirty years of precedent and held that section 10(b) and Rule 10b-5 do not provide for the liability of secondary parties as aiders and abettors.[27]

B. The Central Bank *Decision*

Central Bank of Denver v. First Interstate Bank of Denver involved a failed residential and commercial development in Colorado Springs, Colorado.[28] The Central Bank of Denver ("CBD") served as trustee for a bond issue that backed the development.[29] When land prices fell, CBD ignored the advice of its in-house appraiser and bond underwriter and did not review the value of the bonds until it was too late.[30] The development defaulted and the bonds became worthless.[31]

Plaintiffs brought suit against CBD alleging violations of section 10(b).[32] They argued that CBD's delay constituted aiding and abetting of

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[25] *See* Patricia Blanchini, Note, *The Statement Someone Else Makes May Be Your Own: Primary Liability Under Section 10(b) After Central Bank*, 71 ST. JOHN'S L. REV. 767, 777 (1997) (stating that, prior to *Central Bank*, culpability distinction between primary and secondary liability was insignificant); Broady R. Hodder, Note, Central Bank v. First Interstate Bank *and Its Aftermath: Securities Professionals' Ever-Changing Liabilities*, 39 ARIZ. L. REV. 343, 343 (1997) (stating that aiding and abetting liability was secondary to liability of defendants who committed primary securities violation under code, but that under doctrine of "joint and several" liability, these aiders and abettors were subject to same liability imposed upon primary violators); Prentice, *supra* note 22 at 704 (stating that because both primary liability and aiding and abetting liability punished virtually same conduct, courts seldom troubled themselves to draw any distinction between them).

[26] *Cent. Bank*, 511 U.S. at 167; *see In re* MTC Elec. Techs. S'holder Litig., 898 F. Supp. 974, 986 (E.D.N.Y. 1995) (stating that *Central Bank* made distinction between primary and secondary liability extremely important).

[27] *See Cent. Bank*, 511 U.S. at 192-94 (Stevens, J., dissenting) ("In *hundreds* of judicial and administrative proceedings in every Circuit in the federal system, the courts and the SEC have concluded that aiders and abettors are subject to liability under Section 10(b) and Rule 10b-5."); *In re MTC*, 898 F. Supp. at 985 (stating that *Central Bank* held, contrary to established law in every federal circuit, that Congress had never imposed aiding and abetting liability); Prentice, *supra* note 22, at 694 (stating that *Central Bank* overturned thirty years of settled precedent confirmed by literally hundreds of lower court cases).

[28] *Cent. Bank*, 511 U.S. at 167.

[29] *Id.* The bonds were secured by landowner assessment liens requiring that at all times the land subject to the liens be worth at least 160% of the bonds' outstanding principal and interest. *Id.*

[30] *Id.* at 168.

[31] *Id.*

[32] *Id.*

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securities fraud and they sought to hold CBD secondarily liable for the loss.[33] The United States District Court for the District of Colorado disagreed with the plaintiffs and granted summary judgment to CBD.[34] The Tenth Circuit Court of Appeals reversed.[35]

In a 5-4 decision, the Supreme Court reversed the Tenth Circuit.[36] In doing so, the Supreme Court focused on an issue that the defendants had not raised in the lower courts.[37] This issue was whether section 10(b) affords an implied private right of action against aiders and abettors.[38] The Supreme Court applied strict construction to section 10(b). According to the Court, section 10(b)'s lack of express reference to "aiding and abetting" indicated that Congress had not intended to establish secondary liability for a section 10(b) violation.[39]

Despite this apparent victory for secondary actors, the Supreme Court's decision contained an important caveat.[40] The Court explained that the absence of aiding and abetting liability under section 10(b) did not necessarily mean that secondary actors, like lawyers and accountants, are immune from liability under the Acts.[41] The Court stated that any person or entity who employs a manipulative device or makes a material misstatement on which a purchaser or seller of

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[33] *Id.* Plaintiffs alleged that the Stetson Hills Housing Authority, bond underwriters, and project developer were all primarily liable under section 10(b). *Id.* CBD was the only party alleged to be secondarily liable under section 10(b). *Id.*

[34] *Id.*

[35] First Interstate Bank of Denver v. Pring, 969 F.2d 891, 891 (10th Cir. 1992).

[36] *Cent. Bank*, 511 U.S. at 192.

[37] *Id.* at 166-67, 194-95 (Stevens, J., dissenting) (criticizing majority for reaching out to overturn settled law). The issue that was initially presented to the court was whether recklessness was sufficient to satisfy the scienter requirement under Rule 10b-5. The petitioner in *Central Bank* did not even raise the aiding and abetting issue until the Court issued a *sua sponte* order requiring the parties to address it. Jill E. Fisch, *The Scope of Private Securities Litigation: In Search of Liability Standards for Secondary Defendants*, 99 COLUM. L. REV. 1293, 1297 (1999); *see also* Richard J. Pierce, Jr., *The Supreme Court's New Hypertextualism: An Invitation to Cacophony and Incoherence in the Administrative State*, 95 COLUM. L. REV. 749, 760 (1995) (stating that petitioner briefed issue only after Court issued *sua sponte* order directing parties to do so).

[38] *See* Cent. Bank of Denver v. First Interstate Bank of Denver, 508 U.S. 959, 959 (1993) (granting certiorari) ("parties are directed first to brief and argue the following question: 'Whether there is an implied private right of action for aiding and abetting violations of Section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5.'").

[39] *Cent. Bank*, 511 U.S. at 177 ("If . . . Congress intended to impose aiding and abetting liability, we presume it would have used the words 'aid' and 'abet' in the statutory text. But it did not.").

[40] *Id.* at 191.

[41] *Id.*

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securities relies may be liable as a primary violator under Rule 10b-5.[42]

C. *Post*-Central Bank *Circuit Split*

The *Central Bank* holding provided the lower courts with little guidance on the important issue of what constitutes primary liability, actionable under section 10(b) and Rule 10b-5, and what constitutes secondary aiding and abetting liability, non-actionable after *Central Bank*.[43] Not surprisingly, after *Central Bank*, plaintiffs began alleging primary liability for conduct that the judicial system previously considered a secondary violation.[44] Lower court decisions continue to reflect the absence of Supreme Court guidance for determining the limits of primary liability under section 10(b) and Rule 10b-5.[45]

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[42] *Id.*

[43] *See In re* MTC Elec. Techs. S'holders Litig., 898 F. Supp. 974, 985 (E.D.N.Y. 1995) (stating that *Central Bank* has generated confusion in lower courts in identifying line between primary and secondary liability); *see also* Ziemba v. Cascade Int'l Inc., 256 F.3d 1194, 1205 (11th Cir. 2001) (detailing federal courts' split over threshold requirement to show that secondary actor is primarily liable under section 10(b)); Blanchini, *supra* note 25, at 779 (stating that *Central Bank* did little to resolve confusion surrounding primary liability); Scott A. Crist, *Walking On Thin Ice: The Changing Liability of Attorneys in the Securities Arena*, 27 J. MARSHALL L. REV. 909, 937 (1994) (stating that *Central Bank* is both suspect and disappointing and casts more uncertainty upon future of securities law enforcement than existed prior to its decision); Russell P. Marsella, *Who's Primarily to Blame? The Quest for the Better Test of Section 10(b) Liability*, 6 ROGER WILLIAMS U. L. REV. 421, 433 (2000) (stating that deciding when conduct constituting aiding and abetting rises to level of prohibited primary conduct is not well settled); Ben D. Orlanski, *Whose Representations Are These Anyway? Attorney Prospectus Liability After Central Bank*, 42 UCLA L. REV. 885, 888 (1995) (stating that *Central Bank* raised question of what is meant by "primary" liability and "secondary" liability); Prentice, *supra* note 22, at 712 (stating that *Central Bank* itself does not in any way directly address proper scope of primary liability under section 10(b) and Rule 10b-5).

[44] *See* Blanchini, *supra* note 25, at 778 (stating that since *Central Bank*, plaintiffs have alleged primary liability in many contexts where secondary liability previously applied); Amanda J. Aymond, *You'd Better Watch What They Say: An Examination of Primary Liability for Secondary Actors Under Section 10(b)*, 68 U. CIN. L. REV. 835, 845 (2000) (stating that in wake of *Central Bank*, plaintiffs have claimed primary liability against lawyers, accountants, and other professionals where secondary liability was previously alleged); Marsella, *supra* note 43, at 422 (stating that after *Central Bank*, many situations formerly thought of as secondary liability actually met threshold test for primary liability); *see also, e.g.*, John W. Cotton, *Tied to the Stake*, 24 L.A. LAW. 33, 35 (Feb. 2002) (stating that *Central Bank* forced investors and their lawyers to dig deeper into their pleading bag and bring their claims under somewhat more onerous framework for primary liability); Stewart, *supra* note 5, at 141 (stating that after *Central Bank*, plaintiffs lawyers in securities field began to litigate one of issues left open by Court: that secondary actors should be held to same standard of accountability for fraud as their clients).

[45] *See also* Blanchini, *supra* note 25, at 768 (stating that with little guidance provided by *Central Bank* decision, lower courts have struggled to define boundaries of primary

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Two tests have emerged out of this confusion: the Bright Line Test and the Substantial Participation Test.[46] The majority of circuits that have addressed the issue have adopted the Bright Line Test.[47] Only the Ninth Circuit has adopted the Substantial Participation Test.[48]

1. The Bright Line Test

The Eastern District of New York provided a good description of the Bright Line Test in its decision *In re MTC Electronics Technologies Shareholders Litigation*.[49] The court in *MTC Electronics* stated that if *Central*

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liability); Mary M. Wynne, Comment: *Primary Liability Amongst Secondary Actors: Why the Second Circuit's "Bright Line" Standard Should Prevail*, 44 ST. LOUIS U. L.J. 1607, 1607 (2000) (stating that courts have disagreed about appropriate standard of liability to be imposed upon secondary actors such that they will be found primarily liable). *Compare, e.g., In re* Software Toolworks, Inc. v. Dannenberg, 50 F.3d 615, 628 n.3 (9th Cir. 1994) (holding that accountants may be primarily liable for statements made by others where accountants reviewed statements and played significant role in drafting and editing of statements), *and* Carley Capital Group v. Deloitte & Touche, L.L.P., 27 F. Supp. 2d 1324, 1334 (N.D. Ga. 1998) (holding that "a secondary actor can be primarily liable when it, acting alone or with others, creates a misrepresentation even if the misrepresentation is not publicly attributed to it."), *and In re* ZZZZ Best Sec. Litig., 864 F. Supp. 960, 970 (C.D. Cal. 1994) (concluding that primary liability attaches to accounting firm that was "intimately involved" in creation of false documents), *with* Ziemba v. Cascade Int'l Inc., 256 F.3d 1194 (11th Cir. 2001) (holding that mere fact that law firm played significant role in drafting, creating, reviewing, or editing corporation's allegedly fraudulent letters and press releases was insufficient basis for holding it primarily liable under Rule 10b-5), *and* Anixter v. Home-Stake Prod. Co., 77 F.3d 1215, 1226, 1227 (10th Cir. 1996) (rejecting "a rule allowing liability to attach to an accountant or other outside professional who provided 'significant' or 'substantial assistance' to representations of others" and holding that, to be liable, secondary actors "must themselves make a false or misleading statement (or omission) that they know or should know will reach potential investors"), *and* Wright v. Ernst & Young, L.L.P., 152 F.3d 169, 175 (2d Cir. 1998) (holding that "a secondary actor cannot incur primary liability under the [Securities] Act for a statement not attributed to that actor at the time of its dissemination").

[46] *See Wright*, 152 F.3d at 175 (characterizing two approaches as "bright line" or "substantial participation"); *see also* Shapiro v. Cantor, 123 F.3d 717, 720 (2d Cir. 1997); *Anixter*, 77 F.3d at 1226-27 ("[T]his rule, though far from a bright line, provides more guidance to litigants than a rule allowing liability to attach to an accountant or other outside professional who provided 'significant' or 'substantial' assistance to representations of others.").

[47] *See Ziemba*, 256 F.3d at 1205-06 (holding that mere fact that law firm played significant role in drafting, creating, reviewing, or editing corporation's allegedly fraudulent letters and press releases was insufficient basis for holding it primarily liable under Rule 10b-5); *Wright*, 152 F.3d at 169 (holding that secondary actor cannot incur primary liability under Acts for statement not attributed to that actor at time of statement's dissemination); *Anixter*, 77 F.3d at 1215 (rejecting rule allowing liability to attach to secondary actor for participation in representations of others).

[48] *See infra* Part I.C.2 (detailing Ninth Circuit's use of substantial participation test).

[49] *In re* MTC Elec. Techs. S'holder Litig., 898 F. Supp. 974 (E.D.N.Y. 1995).

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Bank is to have any real meaning, a secondary defendant must actually make a false or misleading statement to the public in order to be liable under section 10(b).[50] This requirement is the essence of the Bright Line Test.[51] The Bright Line Test narrowly interprets *Central Bank* and limits primary liability for secondary actors to those who make actual misstatements to the public.[52]

This approach employs a "bright line" because it premises liability *solely* on whether or not the secondary actor made a misstatement directly to the public.[53] If the actor makes a misleading statement to the public, primary liability can attach.[54] If, however, the public cannot attribute the misstatement specifically to the secondary party, the secondary party's actions merely constitute aiding and abetting.[55] *Central Bank* precludes liability for this level of involvement.[56]

2. The Substantial Participation Test

To date, only the Ninth Circuit has adopted the Substantial Participation Test.[57] Under the Substantial Participation Test, secondary

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[50] *Id.* at 987.

[51] *See id.* at 986 (defining Bright Line Test as requiring that defendant actually made alleged misstatement and denying primary liability if misstatement not directly made by defendant no matter how much assistance was rendered).

[52] *See id.* at 987 (stating that if *Central Bank* is to have any real meaning, defendant must actually make false or misleading statement in order to be held liable under section 10(b)); Fisch, *supra* note 37, at 1295, 1317 (describing Second Circuit's Bright Line Test as "narrower" than substantial participation approach and "unnecessarily restrictive"); Prentice, *supra* note 22, at 723 (stating that requiring direct misstatement for primary liability to attach is "narrow view" of what activity can constitute primary liability after *Central Bank*).

[53] *See In re MTC*, 898 F. Supp. at 987 (describing Bright Line Test as only extending liability when misstatement was made to public and not for anything short of such conduct).

[54] *Id.*

[55] *Id.; see, e.g.*, Fisch, *supra* note 37, at 1300 (stating that under Bright Line Test, secondary actors are not responsible for their clients' disclosures).

[56] Cent. Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164 (1994).

[57] The Third Circuit came close to adopting a Substantial Participation type test but ultimately did not. In Klein v. Boyd, Fed. Sec. L. Rep. P 90,136, 90,317 (3d Cir. Feb. 12, 1998), a panel of the Third Circuit held that a secondary defendant could incur liability for participation in the creation of fraudulent statements issued by someone else. Fisch, *supra* note 37, at 1295. The Third Circuit, however, vacated the panel decision and ordered reargument en banc. *See* Klein v. Boyd, 1998 U.S. App. LEXIS 4121 (Mar. 9, 1998). Before the case could be reargued, the parties settled, depriving the Third Circuit of the opportunity to resolve the scope of liability for secondary defendants and adopt or reject the Substantial Participation Test. Fisch, *supra* note 37, at n.11 (recounting judicial history of *Klein v. Boyd*).

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actors may be primarily liable under section 10(b) for statements attributable to others in which the actor significantly participated.[58] The Ninth Circuit first applied this test in *In re Software Toolworks Inc. Securities Litigation*.[59]

In re Toolworks involved investors in a computer software company who brought a securities fraud class action against the company's securities issuer, underwriters, and accountants for alleged misdeeds in connection with a public stock offering.[60] The plaintiffs alleged that the accountants and underwriters had knowingly assisted in defrauding investors in violation of section 10(b) and Rule 10b-5 by issuing a misleading securities prospectus and statement.[61] The district court dismissed the aiding and abetting claim against these second-party defendants on *Central Bank* grounds.[62]

The Ninth Circuit reversed and found that the defendants could be liable as primary violators even though they made no misstatements directly to the public.[63] Thus, *In re Toolworks* supports the proposition that a secondary actor may be liable under section 10(b) for the mere participation in fraud.[64] A publicly attributable misstatement is not required.[65]

II. Discussion

Although the Ninth Circuit stands alone in applying the Substantial Participation Test, this Comment argues that the Substantial Participation Test is superior to the majority Bright Line Test.[66]

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[58] Wright v. Ernst & Young, L.L.P., 152 F.3d 169, 175 (2d Cir. 1998); *In re MTC*, 898 F. Supp. at 986; *In re* Software Toolworks, Inc. Sec. Litig., 50 F.3d 615, 628, n.3 (9th Cir. 1994).

[59] 50 F.3d 615 (9th Cir. 1994). Although *In re Toolworks* was the first time the Ninth Circuit Court of Appeals addressed the issue, the Ninth Circuit district courts had already used the Substantial Participation Test. *See In re* ZZZZ Best Sec. Litig., 864 F. Supp. 960, 970 (C.D. Cal. 1994) (holding that liability can be based upon accounting firm's intricate involvement in creating false documents); Employers Ins. of Wausau v. Musick, Peeler, & Garrett, 871 F. Supp. 381, 389-90 (S.D. Cal. 1994) (holding that attorneys and accountants may be primarily liable for assisting in preparation of false statements of issuer).

[60] *In re Toolworks*, 50 F.3d at 620.

[61] *Id.*

[62] *Id.* at 629.

[63] *Id.*

[64] *See Employers Insurance*, 871 F. Supp. at 389 (discussing *In re Toolworks'* holding).

[65] *See In re Toolworks*, 50 F.3d at 628 n.3 (stating that significant role in drafting and editing misrepresentation was sufficient to sustain primary cause of action under section 10(b)).

[66] *See* Blanchini, *supra* note 25, at 786-87 (criticizing Bright Line Test as inconsistent with *Central Bank* and intent of Congress); Fisch, *supra* note 37, at 1317 (stating that Bright

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Significant "participation" in a fraud could be the basis for primary fraud liability before *Central Bank*, and should be sufficient to constitute primary liability after *Central Bank*.[67] There are several grounds for this approach. First, imposing primary liability on secondary actors is truer to the language of section 10(b) than the Bright Line Test.[68] Furthermore, imposing such liability is entirely consistent with the *Central Bank* decision.[69] Finally, more compelling legal policy supports the Substantial Participation Test.[70] Secondary actors should not avoid liability by remaining behind the scenes. Indeed, it is exactly this type of conduct that the law must have the flexibility to catch and deter. Although the Bright Line Test has the advantage of predictability, this advantage does not justify allowing willful deception to go unpunished.[71]

A. Imposing Primary Section 10(b) Liability on Secondary Actors Is Consistent With Central Bank's *"Textual" Argument*

The *Central Bank* majority applied a strict textual analysis to support its finding that section 10(b) does not provide for an implied private right of action based on aiding and abetting liability.[72] The *Central Bank* holding, however, does not restrict liability for secondary actors to the extent that the cases applying the Bright Line Test suggest.[73] A strict textual

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Line Test is unnecessarily restrictive and effectively allows unscrupulous professionals to insulate themselves from liability at expense of investor protection); Melissa Harrison, *The Assault on the Liability of Outside Professionals: Are Lawyers and Accountants Off the Hook?*, 65 U. CIN. L. REV. 473, 533 (1997) (agreeing that primary liability should extend to those who play "significant role" in misstatement because such rule recognizes how outside professionals may conduct their work and commit fraud); Prentice, *supra* note 22, at 727, 777-79 (stating that advantages of Bright Line Test are outweighed by its weaknesses, and that "participation" standard would reduce fraud, increase fairness, and improve accuracy of financial reporting); *infra* Part II.B. (arguing that substantial participation approach is supported by better legal policy than is Bright Line Test); *see also* Newby v. Enron Corp. (*In re* Enron Corp. Sec. Derivative & ERISA Litig.), 235 F. Supp. 2d 549, 586-87 (S.D. Tex. 2002)) (agreeing with SEC that Bright Line Test is improper reading of *Central Bank*); Marsella, *supra* note 43, at 443 (stating that Bright Line Test, while easier to administer, could be harmful to markets over time).

[67] Prentice, *supra* note 22, at 697.

[68] *See infra* Part II.A.1.

[69] *See infra* Part II.A.2.

[70] *See* sources cited *supra* note 66; *see also infra* Part II.B (arguing that Substantial Participation Test is supported by superior legal policy).

[71] *See infra* Part II.B.1 (arguing that strengths of Bright Line Test are outweighed by weaknesses).

[72] Cent. Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164, 177, 190 (1994).

[73] *See infra* Part II.A. (arguing that *Central Bank* does not limit primary liability for secondary actors in way Bright Line Test contends); *see also* Fisch, *supra* note 37, at 1295, 1317 (describing Second Circuit's Bright Line Test as "narrower" than Substantial

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interpretation of section 10(b) supports holding more than the speaking party primarily liable for securities fraud.[74] Furthermore, such an interpretation of section 10(b) would not run afoul of the *Central Bank* holding.[75]

1. The Text of Section 10(b)

Section 10(b) supports holding more than the speaking party primarily liable for securities fraud. The Substantial Participation Test recognizes this and in doing so stays truer to the text of that statute. Simply put, the section 10(b) text imposes liability on those who both directly and indirectly make misrepresentations.[76] The Bright Line Test, however, completely ignores the term "indirectly," imposing liability only for direct misstatements.[77] In doing so, the Bright Line Test imposes an overly simplistic binary approach, which allows for egregious behind-the-scenes misconduct to go unpunished.[78] In contrast, by recognizing Congress' explicit imposition of liability for both direct and indirect misconduct, the Substantial Participation Test stays truer to the text and intent of the Acts.[79] This argument is detailed below.

a. Indirect Misstatements Are Not the Same Thing as Aiding and Abetting a Primary Section 10(b) Violation

In *Central Bank*, both the plaintiffs and the SEC argued that Congress intended aiding and abetting liability to be included within the scope of section 10(b) by virtue of the term "indirectly" in the text of the statute.[80] The Supreme Court disagreed, and applied a strict textual interpretation to section 10(b).[81] The Court stated that the language of section 10(b) does not include the term "aiding and abetting," and if Congress had in fact intended to impose aiding and abetting liability then it would have

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Participation Test and "unnecessarily restrictive"); Prentice, *supra* note 22, at 723 (stating that requiring direct misstatement for primary liability to attach is "narrow view" of what activity can constitute primary liability after *Central Bank*).

[74] *See infra* Part II.A.1.

[75] *See infra* Part II.A.2.

[76] 15 U.S.C § 78j (1994 & Supp. 1995); 17 C.F.R § 240.10b-5 (1996).

[77] *See infra* Part I.C.1.

[78] *See infra* Part II.B

[79] *See infra* Part II.A.1.iii.

[80] Cent. Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164, 175-76 (1994).

[81] *See Cent. Bank*, 511 U.S. at 172, 176 (stating that scope of conduct prohibited by section 10(b) is controlled by text of section 10(b) statute).

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used the words "aid" and "abet."[82] Congress' imposition of liability for indirect misstatements was insufficient to extend liability to aiding and abetting.[83]

The Court further noted that section 10(b) only prohibits making a misstatement or committing a manipulative act in connection with the purchase or sale of a security.[84] The Court then reasoned that, because aiding and abetting another's manipulative act is not itself manipulative or deceptive, aiding and abetting is not included under section 10(b).[85] The Court stated that including such conduct would expand section 10(b) beyond the statute's intended scope.[86] In short, the Court held that an indirect misstatement, as that term is used in section 10(b), is not the same thing as aiding and abetting.

b. The Text of Section 10(b) Imposes Liability on Those Who Make Direct Misstatements as Well as Those Who Make Indirect Misstatements

While section 10(b) does not contain the phrase "aiding and abetting," it also does not exclude primary liability for secondary actors.[87] To limit the liability of secondary actors only to those who make misstatements directly to the public ignores the text of both section 10(b) and Rule 10b-5.[88] The Acts expressly condemn those who both "directly and indirectly" employ devices or make misstatements in connection with the purchase or sale of any security.[89] Ignoring indirect misstatements, as the Bright Line Test seeks to do, is inconsistent with the section 10(b) text.

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[82] *Id.* at 175-77.

[83] *Id.* at 176 ("In short, respondents' interpretation of the 'directly or indirectly' language fails to support their suggestion that the text of § 10(b) itself prohibits aiding and abetting.").

[84] *Id.* at 177.

[85] *Id.* at 177-78.

[86] *Id.* at 174.

[87] 15 U.S.C. § 78j(b) (1994).

[88] *See supra* Part I.C.1. (discussing Bright Line Test).

[89] 15 U.S.C. § 78j (1994) ("It shall be unlawful for any person, directly or indirectly . . . to use or employ . . . manipulative or deceptive device."); 17 CFR § 240.10b-5 (1993) ("It shall be unlawful for any person, directly or indirectly. . . to employ any device . . . to make any untrue statement of a material fact . . . in connection with the purchase or sale of any security.").

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c. The Term "Indirectly" Should Not Go Without Meaning and the Substantial Participation Test Stays Truer to the Text of Section 10(b) by Recognizing This Fact

Central Bank's holding that Congress did not intend to include aiding and abetting liability within the term "indirectly" does not mean that the term "indirectly" should go without meaning.[90] Indirect fraud was expressly recognized and condemned by Congress in the Acts and both types of liability should be recognized.[91] The Bright Line Test excludes too much in its interpretation of *Central Bank* by only imposing section 10(b) liability for directly attributable misstatements.[92]

Under the Bright Line Test, the wrongful action of a secondary party falls into one of two categories: 1) a material misstatement directly made to the victim of the fraud, or 2) aiding and abetting a primary violator.[93] This analysis is overly simplistic and ignores the text of section 10(b). That section expressly states that an actor's fraud can occur both directly and indirectly.[94] Yet in *Central Bank* the Court ruled that section 10(b)'s "indirect" misstatement is separate from aiding and abetting.[95] Making an indirect misstatement, therefore, cannot be the same thing as aiding and abetting, as the Bright Line Test contends. It must be the case that an actor can make a fraudulent misstatement that falls short of being direct, yet goes beyond aiding and abetting.[96]

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[90] *See* Robert A. Prentice, *Conceiving the Inconceivable and Judicially Implementing the Preposterous: The Premature Demise of Respondeat Superior Liability Under Section 10(b)*, 58 OHIO ST. L.J. 1325, 1353 (1997) (stating that *Central Bank* announced what "or indirectly" does not mean, but did not hint at what it does mean and ignoring term is not proper statutory construction); Prentice, *supra* note 22, at 731 (stating that view that one can be liable only for one's own statements arguably ignores the "indirectly" term).

[91] 15 U.S.C § 78j (1994 & Supp. 1995); 17 C.F.R § 240.10b-5 (1996).

[92] *See supra* text accompanying notes 89-91; *infra* text accompanying notes 92-105; *see also* Fisch, *supra* note 37, at 1295, 1317 (describing Second Circuit's Bright Line Test as "narrower" than Substantial Participation Test and "unnecessarily restrictive"); Prentice, *supra* note 22, at 723 (stating that requiring direct misstatement for primary liability to attach is "narrow view" of what activity can constitute primary liability after *Central Bank*).

[93] *See In re* MTC Elec. Techs. S'holder Litig, 898 F. Supp. 974, 987 (E.D.N.Y. 1995) ("[I]f *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."); *see also* Shapiro v. Cantor, 123 F.3d 717, 720 (2d Cir. 1997) (citing *In re MTC*); *In re* JWP Inc. Sec. Litig., 928 F. Supp. 1239, 1255-56 (S.D.N.Y. 1996) (stating that allowing liability to attach without requiring representation to be made by defendant would not comport with *Central Bank*).

[94] *See* Prentice, *supra* note 22, at 732 (stating that language of section 10(b) must mean that persons can primarily violate section 10(b)/Rule 10b-5 without speaking themselves).

[95] Cent. Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164, 191 (1994).

[96] *Id.*; *see also* Prentice, *supra* note 90, at 1353 (stating that leaving words "or indirectly"

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The middle ground between aiding and abetting and making a publicly attributable misleading statement is what Congress sought to cover with the term "indirectly."[97] Thus, while Congress may not have meant for aiding and abetting liability to be included in section 10(b), it also did not mean for indirect fraud to go unpunished.[98] Primary liability under section 10(b) should incorporate more than the Bright Line Test permits.[99] The Substantial Participation Test recognizes this distinction.[100] By doing so, the Substantial Participation Test stays truer to the text of section 10(b) than the Bright Line Test.[101]

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completely devoid of meaning is hardly proper statutory construction).

[97] *See, e.g., In re* Software Toolworks, Inc. Sec. Litig. , 50 F.3d 615, 628 n.3 (9th Cir. 1994) (holding that secondary actor may be primarily liable for conduct that went beyond aiding and abetting, although not publicly attributable misrepresentation); Newby v. Enron Corp. (*In re* Enron Corp. Sec. Derivative & ERISA Litig.), 235 F. Supp. 2d 549, 587, 590-91 (S.D. Tex. 2002) (agreeing with SEC that liability can be extended to actor whose conduct of creating misrepresentation went beyond aiding and abetting although not direct, publicly attributable statement); Carley Capital Group v. Deloitte & Touche, L.L.P., 27 F. Supp. 2d 1324, 1334 (N.D. Ga. 1998) (holding that secondary actor can be liable for creating misrepresentation even though not publicly attributable to it); *see also* Donald C. Langevoort, *Words on High About Rule 10b-5: Chiarella's History, Central Bank's Future*, 20 DEL. J. CORP. L. 865, 889-91 (1995) (stating that term "indirectly" in both section 10(b) and underlying statutory authorization lends much elasticity to concept of primary violation, and that Ninth Circuit's Substantial Participation Test "makes a good deal of sense"); Marsella, *supra* note 43, at 444 (stating that concept of indirect action was clearly intended to create liability in some instances, as the term was used in both section 10(b) and Rule 10b-5); Prentice, *supra*, note 22, at 732 (stating that very nature of fraud tends to be sneaky, behind-the-scenes, and indirect, and it is more logical to conclude that Congress used term "indirectly" to try to prevent and punish this type of activity).

[98] 15 U.S.C. § 78j (1994) ("It shall be unlawful for any person, directly or indirectly . . . to use or employ . . . manipulative or deceptive device."); 17 C.F.R. § 240.10b-5 (1993) ("It shall be unlawful for any person, directly or indirectly . . . to employ any device . . . to make untrue statement of a material fact . . . in connection with the purchase or sale of any security.").

[99] The Supreme Court's argument that if Congress had intended for aiding and abetting liability to be in section 10(b) then it would have used the term "aiding and abetting" is a sound argument. It does not follow, however, that by not putting "aiding and abetting" in section 10(b) that Congress meant to prohibit more than aiding and abetting liability. *See* Prentice, *supra* note 22, at 712 (stating that holding that there is no secondary liability does not necessarily carry any implications for proper scope of primary liability).

[100] *See supra* Part I.C.2. (explaining that Substantial Participation Test seeks to impose liability on secondary actors who have made no direct misstatements but have nonetheless participated in fraudulent activities).

[101] *See* sources cited *supra* note 89; *see also* Aymond, *supra* note 44, at 858 (stating that Bright Line Test contains major flaw that is inconsistent with goals of *Central Bank* because it allows deceitful actors to escape liability as primary violator if they are sly enough to use semantics to get around liability by arguing that they did not "make" misstatements).

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2. The Substantial Participation Test Satisfies *Central Bank*'s Requirements

Central Bank does not explicitly limit primary liability to those secondary actors who make publicly attributable misstatements.[102] On the contrary, *Central Bank* makes it clear that those who employ manipulative devices can be liable for fraud.[103] There is no requirement that the misstatement be publicly attributable to the entity that made it.[104] *Central Bank* only requires that a misstatement be both "made" and "relied upon."[105] A secondary actor can meet these two requirements without necessarily making the misstatement directly to investors.[106]

A secondary actor can "make" a statement without an investor seeing or hearing it.[107] Moreover, under section 10(b) an investor can rely on a misstatement without directly seeing or hearing it under the "fraud on the market" theory of reliance.[108] Thus, a misstatement that is not

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[102] *See* Cent. Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164, 164 (1994).

[103] *Id.* at 191.

[104] *Id.*

[105] *Id.*

[106] *See* Newby v. Enron Corp. (*In re* Enron Corp. Sec., Derivative & ERISA Litig.), 235 F. Supp. 2d 549, 586-87, 590-91 (S.D. Tex. 2002) (agreeing with SEC that there is no requirement that alleged violator directly communicate misrepresentations to plaintiffs for primary liability to attach); Carley Capital Group v. Deloitte & Touche, L.L.P., 27 F. Supp. 2d 1324, 1334 (N.D. Ga. 1998) (stating that nothing in *Central Bank* with regards to terms "makes" or "making a material misstatement" limits liability to those who sign documents or are otherwise identified to investors); *see also* Langevoort, *supra* note 97, at 885 (stating that people can have significant influence on how fraudulent disclosure is packaged, and hence how effective it is, without being identifiable to victim).

[107] *See Carley Capital*, 27 F. Supp. 2d at 1334 (stating that nothing in *Central Bank* with regards to terms "makes" or "making a material misstatement" limits liability to those who sign documents or are otherwise identified to investors); *In re Enron*, 235 F. Supp. 2d at 586-87 (recounting argument of SEC that "makes" in *Central Bank* does not mandate that allegedly material misstatement be signed by or attributed to secondary party so that secondary party is identified to investors); Prentice, *supra* note 22, at 736 (stating that if attorney revises or drafts client information that is known to be false, and then allows information to be issued knowing it will be relied upon by investors, "speaking" has occurred and any reasonable investor would conclude that attorney is "saying" that documents are believed to be fraud-free); *see also* Orlanski, *supra* note 43, at 895 (stating that courts have not undertaken rigorous analysis of what counts as representation, often assuming existence of representation and focusing on other elements of section 10(b) claim).

[108] *See* Basic, Inc. v. Levinson, 485 U.S. 224, 245-47 (1988) (affirming lower court's application of rebuttable presumption of reliance, partially supported by fraud-on-the-market theory since presumption is consistent with, and supports, congressional policy of 1934 Securities Exchange Act); *In re Enron*, 235 F. Supp. 2d at 574 ("To satisfy reliance element in section 10(b) and Rule 10b-5 securities violation action, where a plaintiff investor may not have read or heard the purported misrepresentations, a plaintiff may employ the 'fraud-on-the-market' doctrine.").

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publicly attributable to a secondary actor can nonetheless satisfy *Central Bank*'s requirements for imposing primary liability on that actor. The Bright Line Test is therefore overly and unnecessarily restrictive in the requirements it sets for the imposition of primary section 10(b) liability on secondary actors.

3. The Difference Between Aiding and Abetting and Substantial Participation is More Than Semantic

Critics of the Substantial Participation Test argue that there is no real difference between aiding and abetting liability and the conduct for which the Substantial Participation Test seeks to impose liability.[109] Thus, critics contend, the Substantial Participation Test runs afoul of the *Central Bank* decision.[110] *Central Bank* identified the term "substantial assistance" as an element of aiding and abetting liability.[111] This term, critics argue, is indistinguishable from the term "substantial participation."[112] Further, critics say that distinguishing the two is "more semantics than substance."[113]

Such an oversimplified comparison ignores the fundamental difference between the terms "assistance" and "participation." One dictionary defines assistance as "help given or made available to

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The elements of the fraud on the market theory as noted by the Court in *Basic* are: (1) that the defendant made public misrepresentations; (2) that the misrepresentations were material; (3) that the shares were traded on an efficient market; (4) that the misrepresentations would induce a reasonable, relying investor to misjudge the value of the shares; and (5) that the plaintiff traded shares between the time the misrepresentations were made and the time the truth was revealed. *Basic*, 485 U.S. at 219. In short, the foundation of the fraud-on-the-market theory is the hypothesis that, in an open and developed market, all the available material information regarding the company and its business determine the price of a company's stock. *Id.* at 241-42. Misleading statements will therefore defraud purchasers of stock as soon as they enter the market, even if the purchasers do not directly rely on the misstatements. *Id.*

[109] *See* Shapiro v. Cantor, 123 F.3d 717, 720 (2d Cir. 1997) (noting that words such as "assisting," "participating in," and "complicity in," as well as similar synonyms, all fall within what *Central Bank* bars); Rodney D. Chrisman, *"Bright Line," "Substantial Participation," or Something Else: Who is a Primary Violator Under Rule 10b-5?*, 89 KY. L.J. 201, 216-17 (2000) (arguing that Substantial Participation Test is little more than aiding and abetting liability under different name and that difference between it and "substantial assistance" is more semantics than substance).

[110] *See* sources cited *supra* note 107.

[111] *See* Cent. Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164, 168 (1994) (citing First Interstate Bank of Denver v. Pring, 969 F.2d 891 (10th Cir. 1992)).

[112] *See* sources cited *supra* note 107.

[113] Chrisman, *supra* note 109, at 216-17.

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another" and participation as "to take part in an event or activity." [114] Though subtle, there is a difference in meaning between the two terms. A person may, perhaps unknowingly, assist another who commits a fraud without actually participating in that fraud.[115] It is therefore reasonable that liability not reach a secondary actor who simply assists a primary violator who commits fraud.[116] "Participation," however, is different and infers knowing involvement in a fraudulent activity.[117] Such a distinction should be the standard for the imposition of liability on a secondary actor.[118]

The *Central Bank* court recognized this distinction.[119] The Court barred aiding and abetting liability under section 10(b) out of fear that a secondary actor might be liable for securities fraud for merely assisting a company in some aspect of its business operations.[120] Liability for actual participation in fraudulent activities, however, is something else altogether.[121] This distinction is the reason why *Central Bank* left open

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[114] MICROSOFT ENCARTA COLLEGE DICTIONARY 80, 1059 (2001).

[115] *C.f. Cent. Bank*, 511 U.S. at 176 (stating that "aiding and abetting" — defined as "substantial assistance" — extends beyond persons who engage, even indirectly, in proscribed activity but who give degree of aid to those who do); Prentice, *supra* note 22, at 756 (stating that one who intentionally takes part in fraud should be punished and should have to compensate innocent victim).

[116] *See Cent. Bank*, 511 U.S. at 177 (stating that section 10(b) does not prohibit giving aid to another, who then commits primary section 10(b) violation); *see also* Prentice, *supra* note 22, at 733 (stating that collateral participants should not be potential section 10(b)/Rule 10b-5 defendants when involvement is limited to simply "standing around" or serving as professionals for client who hired them to lend respectability to what turns out to be fraudulent operation).

[117] *See* sources cited *supra* note 116. The dictionary definition of participation — "to take part in an event or activity" — necessarily implies that some "event" or "activity" is participated in. Assistance requires no specific activity, only another party. *See* MICROSOFT ENCARTA COLLEGE DICTIONARY 80 (2001) (defining assistance as "help given or made available to another," which necessarily requires another party but not specific activity).

[118] *See In re* Software Toolworks, Inc. Sec. Litig., 50 F.3d 615, 628 n.3 (9th Cir. 1994) (creating distinction based on participation in fraud); Prentice, *supra* note 22, at 733, 750 (stating that collateral defendants should be liable for misrepresentations of their clients when they participate in their client's fraud but not for merely "standing around").

[119] *See Cent. Bank*, 511 U.S. at 176 (stating that problem with aiding and abetting liability is that it can extend beyond persons who engage, even indirectly, in proscribed activity).

[120] *See id.* ("[A]iding and abetting liability extends beyond persons who engage, even indirectly, in a proscribed activity; aiding and abetting liability reaches persons who do not engage in proscribed activities at all, but who give a degree of aid to those who do.").

[121] *See id.* at 191 (stating that primary liability can attach to secondary actor who employs manipulative device or makes material misstatement); *see also* Prentice, *supra* note 22, at 754 (stating that term "take part in" as used in language of Rule 10b-5 is synonymous with "participate").

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primary liability for secondary actors.[122] It is also the reason why Congress expressly included the term "indirectly" in the text of section 10(b).[123] The distinction between aiding and abetting and substantial participation is more than semantic.

B. *The Substantial Participation Test Better Serves Public Policy*

The legal system must hold secondary actors responsible for their own misrepresentations if it is to adequately deter misconduct.[124] The Bright Line Test does not do this.[125] Under the Bright Line Test, an accounting firm may avoid section 10(b) liability even if it enables a client to report earnings in a misleading manner or makes false statements to potential investors on the client's behalf.[126] Similarly, under the Bright Line Test, an attorney who drafts a fraudulent press release, induces a company to issue that release in the company's name, and receives a fee for those services is not a primary violator under section 10(b).[127]

A system that absolves secondary actors of liability because their misrepresentations occur out of the public's view does not promote

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[122] *Cent. Bank*, 511 U.S. at 191.

[123] *See* 15 U.S.C. § 78j (1994).

[124] *See* Fisch, *supra* note 37, at 1315 (stating that lax liability standards interfere with incentive of professionals to perform gatekeeping function by allowing professionals to sacrifice investor protection in favor of maintaining relationship with unscrupulous clients); Joel Seligman, *The Implications of Central Bank*, 49 BUS. LAW. 1429, 1445 (1994) (stating that imposing liability on outside professionals will increase care with which they perform their work); *see also* Harrison, *supra* note 66, at 521 (arguing that *Central Bank* decision lets secondary actors off hook for securities fraud liability and that increased liability encourages outside professionals to meet higher professional standards); Prentice, *supra* note 90, at 1382 (noting that courts have traditionally believed that most effective means for insuring adequate supervision is to impose liability for injury resulting from its absence).

[125] *See* sources cited *infra* note 128.

[126] Prentice, *supra* note 22, at 728; *see, e.g.*, Lycan v. Walters, 904 F. Supp. 884, 901 n.12 (S.D. Ind. 1995) (stating that, after *Central Bank*, plaintiffs' claims "cannot survive Defendants' motions for summary judgment by asserting that Defendants assisted in the perpetration of a fraud"); *In re* Kendall Square Research Corp. Sec. Litig., 868 F. Supp. 26, 28, 28 n.1 (D. Mass. 1994) (denying liability for accounting firm that reviewed and approved fraudulent financial statements because by not actually engaging in reporting of statements, statements were not attributable to firm, and further stating that "[w]hile participation in the 'structuring' of transactions may be evidence of Price Waterhouse's knowledge at the time it provided its audit opinion, the participation in the 'structuring' does not constitute the making of a material misstatement . . . . Once again, it is clear that after Central Bank, only the making of material misstatements (or omissions) will be actionable under Section 10(b).").

[127] Prentice, *supra* note 22, at 728-29 (outlining such hypothetical).

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investor confidence.[128] Imposing liability only on those who make public misrepresentations, as the Bright Line Test does, encourages concealment and subterfuge rather than conformity to the intent of the Acts.[129] Financial statements that conceal billions of dollars in losses and lead to the bankruptcy of large companies are not ordinary, acceptable mistakes, and America should not tolerate them as such.[130] Courts need the leeway to punish fraud wherever it occurs.[131] The Substantial Participation Test provides this leeway.[132]

1. Predictability Is Not Necessarily an Advantage

Critics have attacked the judicial leeway that the Substantial Participation Test provides.[133] They argue that the Bright Line Test is preferable because it is certain and predictable.[134] Predictability, the

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[128] *See also* Newby v. Enron Corp. (*In re* Enron Corp. Sec. Derivative & ERISA Litig.), 235 F. Supp. 2d 549, 587 (S.D. Tex. 2002) (stating that rule that imposes liability only when person is identified with misrepresentation would place premium on concealment and subterfuge rather than on compliance with federal securities laws); Marsella, *supra* note 43, at 445 (stating that Bright Line Test allows one to shirk all liability by simply marking exhibits as "unaudited").

[129] *In re Enron*, 235 F. Supp. 2d at 587.

[130] *Cf.* Marsella, *supra* note 43, at 446 (stating that in order to prevent fraud and uphold goals of section 10(b) and Rule 10b-5, perhaps hard line needs to be taken that says that despite secondary actor being duped by elaborate hoax, such outrageous scheme should not have gone undetected).

[131] *See* Langevoort, *supra* note 97, at 889, 891 (stating that behind-the-scenes involvement in fraudulent disclosure by no means absolves participant from culpability and that imposing primary liability for participation in fraud "makes a good deal of sense"); Prentice, *supra* note 22, at 729, 732 (stating that very nature of fraud tends to be sneaky, behind-the-scenes, and indirect, and that under Bright Line Test, puppeteers who manipulate from behind-the-scenes will go unpunished); *see also In re Enron*, 235 F. Supp. 2d at 587, 587 (agreeing with SEC and rejecting Bright Line Test because it has unfortunate and unwarranted consequence of providing safe harbor from liability for everyone except those identified with misrepresentation by name); Aymond, *supra* note 44, at 858 (stating that Bright Line Test absolves from liability actors who use semantics to get around term "make").

[132] *See infra* Part II.B.1.

[133] *See* Cent. Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164, 188 (1994) (stating that decisions made on ad hoc basis offer little predictive value which is undesirable in area that demands certainty and predictability); *see also* Chrisman, *supra* note 109, at 217 (stating that uncertainty caused by Substantial Participation Test is something law should strive to avoid because it imposes added costs to society with no reciprocal benefit); Wynne, *supra* note 45, at 1627 (stating that Bright Line Test is superior to Substantial Participation Test because subjectivity does not enter into imposition of liability).

[134] *See* Prentice, *supra* note 22, at 727 (stating that advantage of Bright Line Test is that it is clear rule that people can count on in planning their activities); *see also* Chrisman, *supra* note 107, at 217 (stating that uncertainty caused by Substantial Participation Test is

critics contend, assures that secondary actors do not unwittingly open themselves up to potential liability, or prematurely settle fraud actions due to the cost of mounting an uncertain defense.[135]

The bright line that many circuits have adopted may increase legal predictability, but it does not demarcate right and wrong. Instead, the bright line allows a culpable party to use another person or entity as its public mouthpiece to escape liability for even willful wrongdoing.[136] In other words, the Bright Line Test permits misconduct in the manner in which it most often occurs.[137] Thus, although the Bright Line Test possesses a predictability that the Substantial Participation Test does not, the advantage of certainty is outweighed by the Bright Line Test's inherent weaknesses.[138]

In today's marketplace, behind the scenes actors often perpetrate securities fraud.[139] The Substantial Participation Test provides an avenue to hold these actors responsible for their misdeeds.[140] In so doing, the Substantial Participation Test better upholds the basic policy behind the Acts: consumer protection rather than *caveat emptor*.[141]

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something law should strive to avoid and causes costs to society with no reciprocal benefit); Wynne, *supra* note 45, at 1627 (stating that Bright Line Test is superior to Substantial Participation Test because subjectivity does not enter into imposition of liability).

[135] *See Cent. Bank*, 511 U.S. at 189 (1994) (stating that if governing rules were uncertain, entities subject to secondary liability may find it prudent and necessary to abandon substantial defenses and pay settlements in order to avoid expense and risk of going to trial).

[136] *See* Prentice, *supra* note 22, at 729 (stating that under Bright Line Test, puppeteers who manipulate from behind-the-scenes will go unpunished); *see also* Aymond, *supra* note 44, at 858 (stating that Bright Line Test absolves from liability actors who use semantics to get around term "make").

[137] *See* Langevoort, *supra* note 97, at 889 (stating that very nature of securities fraud often involves obscuring source and interests of its authors); Prentice, *supra* note 22, at 732 (stating that very nature of fraud tends to be sneaky, behind-the-scenes, and indirect).

[138] Prentice, *supra* note 22, at 727.

[139] *See* Harrison, *supra* note 66, at 512-13 (agreeing with test for primary liability which recognizes significant role that outside professionals may play that allows them to conduct their work and commit fraud); Langevoort, *supra* note 97, at 889 (stating that very nature of securities fraud often involves obscuring source and interests of its authors); Prentice, *supra* note 22, at 732 (stating that very nature of fraud tends to be sneaky, behind-the-scenes, and indirect).

[140] *See supra* Part II.B.

[141] *See* Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128, 151 (1972) (citing SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186 (1963)) (stating that fundamental purpose of securities laws is to substitute philosophy of full disclosure for philosophy of caveat emptor and thus to achieve high standard of business ethics in securities industry).

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III. A LOOK TO THE FUTURE

Central Bank ushered in a new era of reduced liability for secondary actors.[142] There is hope, however, that the recent spate of corporate disasters such as Enron and WorldCom may signal the end of that era.[143] Both the judiciary and the public may finally be growing weary of the weakness of the Bright Line Test.[144]

The recent dramatic displays of corporate fraud should serve as a catalyst for the expansion of potential securities fraud liability and judicial leeway to punish wrongdoers. Two recent events may signal the beginning of a new era of accountability. The first event was the July 30, 2002, passage of the Sarbanes-Oxley Act,[145] and second, the December 20, 2002, federal district court decision *Newby v. Enron Corp.* (*In re Enron Corp. Securities, Derivative & ERISA Litigation*) ("*In re Enron*").[146] While federal securities laws still have a long way to go, these two events suggest that both the legislature and judiciary may be refocusing on investor protection and fraud-free information disclosure, the original goals of the Acts.[147]

A. The Sarbanes-Oxley Act

In the aftermath of the Enron and WorldCom scandals, Congress hurriedly passed the Sarbanes-Oxley Act ("Sarbanes-Oxley"), which President Bush immediately signed into law.[148] President Bush called Sarbanes-Oxley the most far-reaching reform of American business practices since the presidency of Franklin Delano Roosevelt.[149] Sarbanes-Oxley, however, did nothing to expand or define the potential liability of

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[142] *See supra* Part I.C.1 (detailing prevalence of Bright Line Test in most circuits since *Central Bank*).

[143] *See* Lerach, *supra* note 10, at 121 (stating that with recent corporate frauds, change might be "in the wind").

[144] *See* Newby v. Enron Corp. (*In re* Enron Corp. Sec. Derivative & ERISA Litig.), 235 F. Supp. 2d 549, at 585, 590-91 (S.D. Tex. 2002) (agreeing with SEC, which stated that Bright Line Test has unfortunate and unwarranted consequences and "misses the mark"); Prentice, *supra* note 22, at 727 (stating that advantage of Bright Line Test is outweighed by weaknesses that potentially allow egregious wrongdoing to go unpunished).

[145] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002) (codified as amended in scattered sections of 11, 15, 18, 28, and 29 U.S.C.).

[146] *See In re Enron*, 235 F. Supp. 2d at 549.

[147] *See supra* text accompanying notes 16-18 (recounting goals behind creation of 1933 and 1934 Securities Acts).

[148] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204.

[149] President George W. Bush, Remarks at Signing of Sarbanes-Oxley Act, *in* U.S. NEWSWIRE, July 30, 2002.

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secondary actors under the federal securities laws.[150] Accounting firms can no longer shred documents, but they can still facilitate securities fraud as long as nothing conveyed to the public is attributable to them.[151]

Nevertheless, Sarbanes-Oxley is important.[152] Sarbanes-Oxley represents an important step towards increased liability for secondary actors for two reasons. The publicity Sarbanes-Oxley garnered has helped to bring the current need for reform to the forefront of public consciousness.[153] Sarbanes-Oxley also illustrates Congress' recognition that problems existed in the pre-Enron era and that these problems must be remedied.[154]

Moreover, Sarbanes-Oxley illustrates Congress' willingness to do something to change the legal climate that allowed such blatant fraud to be committed against the American public.[155] Perhaps the courts will see the same problems inherent in the old system and will be tempted to act in a similar manner. Hopefully, the courts will act by increasing the

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[150] *See* Neil H. Aronson, *Preventing Future Enrons: Implementing the Sarbanes-Oxley Act of 2002*, 8 STAN. J. L. BUS. & FIN. 127, 153 (2002) (stating that Sarbanes-Oxley is insufficient on its own); Kurt Eichenwald, *A Higher Standard for Corporate Advice*, N.Y. TIMES, Dec. 23, 2002, at A1 (stating that Sarbanes-Oxley does little to overcome legal hurdles that have caused prosecutors to not bring accounting fraud charges involving issues approved by Andersen); *see also* Christina R. Salem, *The New Mandate of the Corporate Lawyer After the Fall of Enron and the Enactment of the Sarbanes-Oxley Act*, 8 FORDHAM J. CORP. & FIN. L. 765, 777 (2003) (stating that provisions in Sarbanes-Oxley are not new or novel to legal profession but are merely restatements of conduct previously characterized as illegal, but seldom enforced).

[151] Section 802 of the Act amends the federal obstruction of justice statute by adding two new offenses. The first makes it unlawful to knowingly alter, destroy or falsify documents with the intent to impede, obstruct, or influence any federal investigation or bankruptcy proceeding. Sarbanes-Oxley Act § 802, 18 U.S.C. § 1519 (2003). The second is directed at accountants, and creates an obligation to maintain corporate records or review work papers for a period of five years. *Id.* §§ 1520(a)-(b).

[152] *See* Lawrence A. Cunningham, *The Sarbanes-Oxley Yawn: Heavy Rhetoric, Light Reform (And It Just Might Work)*, 35 CONN. L. REV. 915, 919, 987-88 (2003) (stating that, despite its weaknesses, Sarbanes-Oxley is not trivial and that "the rhetoric accompanying [Sarbanes-Oxley], echoed dutifully throughout American power centers, will on its own stiffen spines throughout corporate America" and will promote ability to deter and educate those lacking integrity, thus providing fairness on which investors may place their trust and confidence).

[153] *See* Aronson, *supra* note 150, at 153 (stating that Sarbanes-Oxley is insufficient but step in right direction). *But see* Lerach, *supra* note 10, at 122 (calling Sarbanes-Oxley "waterdown" and stating that it does precious little to empower investors).

[154] *See* Cunningham, *supra* note 152, at 917, 979 (stating that Congress passed Sarbanes-Oxley to address deep causes and systematic dysfunction and because Congress knew that constituents wanted action).

[155] *Id.* at 918, 942 (stating that changes in Sarbanes-Oxley implements are more likely to have psychological rather than substantive effects but these psychological impacts may be significant and Sarbanes-Oxley's main provisions are mere stunts to promote investor confidence).

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standard of liability for those who perpetrate the type of fraud that led to the need for the Sarbanes-Oxley Act in the first place. Fortunately, a federal district court in Texas has already taken the first step.[156]

B. Newby v. Enron *(In re* Enron Corp. Securities, Derivative & ERISA Litigation*)*

Perhaps the biggest indication of an impending shift towards expanding the scope of liability for secondary actors is a recent federal district court decision. *In re Enron* addressed the standard of secondary actor liability in connection with the Enron debacle.[157] In its ruling, the district court held that corporate advisors can be primary participants in a fraud if they created transactions with the knowledge that those transactions might mislead investors.[158]

The district court's ruling gave considerable weight to the liability standard urged by the SEC.[159] The SEC's standard is an intermediate one, requiring more than participation in fraud but less than a direct misstatement.[160] Under the SEC's standard, primary section 10(b) liability can attach to secondary actors if they *created* fraudulent documents, regardless of whether misrepresentations to the public were publicly attributable to them.[161] The district court stated that this test was well reasoned and balanced in its concern both for victimized investors and potential defendants.[162] The district court applied the SEC's standard and denied motions to dismiss brought by Andersen and several other secondary actors involved in the Enron lawsuit.[163]

In re Enron is a significant step towards the expansion of liability for secondary actors.[164] It resurrects the SEC's standard only a year and a half after the Eleventh Circuit expressly rejected the test and adopted the

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[156] *See infra* Part III.B (discussing *Newby v. Enron Corp.*).

[157] Newby v. Enron Corp. (*In re* Enron Corp. Sec., Derivative & ERISA Litig.), 235 F. Supp. 2d 549 (S.D. Tex. 2002); *see also* Eichenwald, *supra* note 150, at A1 (quoting Stanford Law Professor Stephen L. Meagher as stating that *In re Enron* "transforms the landscape of securities law enforcement").

[158] *In re Enron*, 235 F. Supp. 2d at 588, 590-91; Eichenwald, *supra* note 150, at A1.

[159] *In re Enron*, 235 F. Supp. 2d at 588.

[160] *Id.* ("[W]hen a person, acting alone or with others, creates a misrepresentation . . . the person can be liable as primary violator.").

[161] *Id.*

[162] *Id.* a' 590.

[163] *Id.* at 708.

[164] *See* Eichenwald, *supra* note 150, at A1 (quoting Stanford Law Professor Stephen L. Meagher as stating that *In re Enron* "transforms the landscape of securities law enforcement").

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Bright Line Test.[165] Moreover, *In re Enron* is currently good law and looks as though it will stay that way, at least for now. The *In re Enron* court refused to certify its decision for immediate appeal to the Fifth Circuit, and the Fifth Circuit denied an application for a writ of mandamus.[166] Whether or not other courts have the courage to follow the *In re Enron* decision, however, will largely determine the extent of the decision's legacy.

C. The Next Step

In re Enron is not fundamentally different from other district court decisions that have adopted the SEC's approach or the Substantial Participation Test.[167] Nevertheless, its potential impact is particularly significant.[168] The *In re Enron* decision comes at a time when securities fraud liability for secondary actors is an issue of great public concern. It also comes in a case involving Enron, today's brand name for corporate fraud.

The *In re Enron* court's decision to adopt the SEC's standard is commendable given the burden of established precedent that the court faced.[169] The next appellate court to consider the issue, however, should

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[165] *See* Ziemba v. Cascade Int'l Inc., 256 F.3d 1194, 1205 (2001) (adopting Bright Line Test and rejecting holding of *Carley Capital Group v. Deloitte & Touche, L.L.P.*, 27 F. Supp. 2d 1324, 1334 (N.D. Ga. 1998) that secondary actor can be primarily liable when it creates misrepresentation even if representation not publicly attributed to it).

[166] Marcy Ressler & Charlotte A. Kelley, *Setting Up Framework on Secondary Liability for Securities Fraud*, N.Y. L.J., June 23, 2003, *available at* http://www.srz.com/PDF-files/HarrisKelley.pdf (last visited Dec. 5, 2003).

[167] *See, e.g., In re* Software Toolworks, Inc. Sec. Litig., 50 F.3d 615, 628 n.3 (9th Cir. 1994) (holding that accountants may be primarily liable for statements made by others where accountants reviewed statements and played significant role in drafting and editing of statements); Carley Capital Group v. Deloitte & Touche, L.L.P., 27 F. Supp. 2d 1324, 1334 (N.D. Ga. 1998) (holding that "a secondary actor can be primarily liable when it, acting alone or with others, creates a misrepresentation even if misrepresentation is not publicly attributed to it."); *In re* ZZZZ Best Sec. Litig., 864 F. Supp. 960, 970 (C.D. Cal. 1994) (concluding that primary liability attaches to accounting firm that was "intimately involved" in creation of false documents).

[168] *See* Eichenwald, *supra* note 150, at A1 (quoting Stanford Law Professor Stephen L. Meagher as stating that *In re Enron* "transforms the landscape of securities law enforcement").

[169] *See* Newby v. Enron Corp. (*In re* Enron Corp. Sec., Derivative & ERISA Litig.), 235 F. Supp. 2d 549, 591 (S.D. Tex. 2002) (holding that "since the SEC's proposed test is a reasonable interpretation of the text of the [section 10(b)] statute and serves its underlying policies, the Court adopts it in this litigation"); Eichenwald, *supra* note 150, at A1 (stating that *In re Enron* has established precedent increasing potential liability for corporate advisors that aid companies like Enron in disguising their financial condition — something no reform measure this year has accomplished).

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go a step further. The SEC's approach, adopted by *In re Enron*, is far better than the Bright Line Test at assuring that those who commit fraud face securities fraud liability.[170] This test, however, does not provide a potential remedy against all willful wrongdoers.[171] For example, under the SEC's approach, a secondary actor who does not create a fraudulent document but actively and knowingly conceals the fraud will not face section 10(b) liability.[172] The Substantial Participation Test allows courts to close such loopholes by allowing liability to reach an actor who participated in fraud rather than limiting liability only to those who created the fraud.[173]

The Ninth Circuit currently continues to stand alone as the only circuit willing to impose primary liability on secondary actors for conduct less than an actual misstatement made to the public.[174] Other circuits should recognize the importance of permitting judicial leeway to address fraudulent conduct. The inadequacies inherent in the Bright Line Test are glaring and the courts should not allow secondary actors to exploit them any longer.[175] Adopting the SEC's standard, as *In re Enron* did, would be a positive step towards protecting investors and deterring fraud. Those circuits adopting the Substantial Participation Test, however, will best ensure that the actors who commit securities fraud are held responsible for their actions.[176]

CONCLUSION

Central Bank changed everything about securities fraud liability for secondary actors by eliminating aider and abettor liability under the

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[170] *See In re Enron*, 235 F. Supp. 2d at 587 (agreeing with SEC's argument that Bright Line Test would have unfortunate and unwarranted consequence of providing safe harbor from liability for everyone except those identified with misrepresentation by name).

[171] *See supra* note 168 and accompanying text.

[172] *See* Langevoort, *supra* note 97, at 891 (arguing that there is no reason to absolve actor from liability when actor makes already misleading statement less likely to draw regulatory attention because actor has played important causal role in deception).

[173] *See supra* Parts I.C.2, II.B.2 (explaining that Substantial Participation Test is not constrained by bright line requirement that misstatement be publicly attributable to defendant for primary liability to attach, but gives court ability to impose liability for participation in fraud, whether or not actor's name is attached).

[174] *See supra* Part I.C (outlining post-*Central Bank* circuit court split).

[175] *See supra* Part II.B.2 (arguing that Bright Line Test is flawed because it allows secondary actors to act fraudulently and avoid liability by remaining behind-the-scenes).

[176] *See supra* Part II.B (arguing that Substantial Participation Test better ensures that those who commit fraud are held liable because it does not allow secondary actors to hide behind scenes).

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Acts.[177] *Central Bank,* however, did not deny injured investors all recourse against the secondary actors who participated in the fraud that caused them harm.[178] In fact, the Supreme Court expressly left open the possibility of primary securities fraud liability for secondary actors.[179]

Unfortunately, the majority of circuits, incorrectly reading *Central Bank,* have adopted the overly narrow Bright Line Test.[180] This test is inadequate. The Substantial Participation Test is entirely consistent with *Central Bank* and truer to the text of section 10(b). Moreover, more compelling legal policy supports the Substantial Participation Test. When even supposedly independent auditors begin to defraud, the individual investor becomes a sitting duck. To bar section 10(b) liability because the fraud took place behind the scenes, is to permit fraud in the very manner in which it most often occurs. Any benefits flowing from the Bright Line Test's certainty do not outweigh the cost of letting egregious wrongdoing go unpunished.

The *In re Enron* decision and the Sarbanes-Oxley Act may indicate that a new era of investor protection may be on the horizon. This change is badly needed. The Bright Line Test sends the wrong message to both the secondary actor and the public. Unless and until Congress reinstates aiding and abetting liability under section 10(b) or defines the line between primary and secondary liability, courts should adopt the Substantial Participation Test. This test is in the best interests of both business and investors.

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[177] *See* Cent. Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164, 191 (1994) (concluding that there is no private aiding and abetting liability under section 10(b)).

[178] *Id.*

[179] *Id.*

[180] *See supra* Parts I.C.1, II.B (discussing use and shortcomings of Bright Line Test).

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