PRESENTED AT

38th Annual Conference on
Securities and Business Law

February 11-12, 2016

Dallas, Texas

Where Were the Lawyers and Accountants? Primary liability under Section 10(b) of the Exchange Act

Andrew Ostapko
Mark Johnson

Author contact information:

Andrew Ostapko
Winstead PC
500 Winstead Building
2728 N. Harwood Street
Dallas, Texas 75201
214.745.5617
aostapko@winstead.com
www.winstead.com

Mark Johnson
Winstead PC
500 Winstead Building
2728 N. Harwood Street
Dallas, Texas 75201
214.745.5600
mgjohnson@winstead.com
www.winstead.com

TABLE OF CONTENTS

Page

I. Introduction 1
II. Section 10(b) of the Exchange Act and Rule 10b-5 1
  a. Central Bank 2
  b. Misstatements and Omissions after Central Bank 3
  c. Clarifying the Reliance Element to Scheme Liability 4
III. Primary Violations in the Post-*Janus* World 5
  a. Misstatement Liability 5
    1. Lawyers, Accountants, Investment Bankers and other Professionals 5
    2. Shareholders and Other Corporate Insiders 6
    3. Corporate Officers 7
  b. Scheme Liability 8
  c. Practice Points 10
IV. Conclusion 11

WHERE WERE THE LAWYERS AND ACCOUNTANTS?

PRIMARY LIABILITY UNDER SECTION 10(b) OF THE EXCHANGE ACT

I. INTRODUCTION

Section 10(b) ("§ 10(b)") of the Securities Exchange Act of 1934 (the "Exchange Act") provides the best-known and most often invoked basis for liability in connection with the purchase or sale of securities. Congress adopted § 10(b) to serve as a deterrent for, and a remedy against, the fraudulent securities practices that largely contributed to the Great Depression. The broad antifraud provisions of § 10(b), and Rule 10b-5 promulgated thereunder, have long presented the courts with the challenge of striking an appropriate balance between curbing vexatious litigation and providing an adequate remedy against manipulative and deceptive conduct in the sale of securities. In 1994, the Supreme Court attempted to strike that balance in broad strokes by significantly narrowing the scope of conduct prohibited by § 10(b). In *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994), the Court ruled that secondary actors, such as accountants, investment bankers, and lawyers, are not subject to aiding and abetting liability in private lawsuits brought under § 10(b). Rather, a plaintiff must prove a primary violation of § 10(b) for each defendant. In the two decades that followed *Central Bank,* the Court continued to narrow the scope of conduct prohibited by § 10(b). In 2008, on the eve of the Great Recession, the Court adopted a formidable standard for proving reliance. *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta*, 552 U.S. 148 161-2, 128 S. Ct. 761, 169 L. Ed. 2d 627 (2008). Three years later, the Court adopted a bright line test for distinguishing primary and secondary violations of § 10(b). *Janus Capital Group, Inc. v. First Derivative Traders*, 564 U.S. 135, 131 S. Crt. 2296, 180 L. Ed. 2d 166 (2011). This paper discusses the evolution of primary liability for secondary actors after the *Central Bank* decision, with a focus on legal developments in the post-*Janus* world.

II. SECTION 10(b) OF THE EXCHANGE ACT AND RULE 10b-5

Since its passage during the new deal era, § 10(b) has provided that "[i]t shall be unlawful for any person, directly or indirectly …"

> 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 [U.S. Securities and Exchange] Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. 78j. On its face, § 10(b) enables the U.S. Securities and Exchange Commission (the "SEC") to bring civil enforcement actions for material misstatements and deceptive schemes. In the event the SEC refers a case to the Department of Justice, § 10(b) can also form the basis for criminal liability. More significantly, however, the U.S. Supreme Court has long recognized § 10(b) as the source of an implied private right of action, thereby enabling private plaintiffs to bring suit directly against violators of § 10(b). Under the authority of § 10(b), the SEC promulgated Rule 10b-5 which provides that:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5. Rule 10b-5 conceptually prohibits two categories of conduct. Subsection (b) of Rule 10b-5 specifically addresses material misstatements and omissions ("Misstatement Liability"), whereas subsections (a) and (c) of Rule 10b-5 more generally address the use of manipulative or deceptive devices ("Scheme Liability").

In their infancy, § 10(b) and Rule 10b-5 provided the basis for both public and private remedies against a broad scope of conduct, including direct liability of primary actors and aiding and abetting liability for secondary actors. Over the past two decades, however, the Supreme Court has incrementally narrowed the scope of conduct that creates liability in a private cause of action brought under § 10(b) and Rule 10b-5.

a. Central Bank

In *Central Bank*, the Supreme Court significantly curtailed the private cause of action under § 10(b) by holding that aiding and abetting liability under § 10(b) is only available in public causes of action. Central Bank of Denver ("Central Bank") was the indenture trustee of two bond issues of a public building authority. 511 U.S. at 167. The bond covenants specified a minimum collateralization threshold and, when questions arose regarding the value of the collateral, Central Bank allegedly delayed its independent appraisal until after the second offering closed. Before the independent appraisal was complete, the public building authority defaulted on the second bond issue. In response, the purchaser of the bonds sued Central Bank, asserting secondary liability under § 10(b) for aiding and abetting fraud by the public building authority and other defendants. On appeal from an order on a motion for summary judgment, the Supreme Court overruled "*hundreds* of judicial and administrative proceedings in every Circuit in the federal system" by holding that private civil liability under § 10(b) is only available for primary violations of § 10(b). *Id*. at 192 (Stevens, J., dissenting) (emphasis in original). In other words, accountants, lawyers and investment advisors would no longer be liable in private suits for merely aiding and abetting a violation of § 10(b).

The Court predominately based its conclusion on the lack of aiding and abetting language in § 10(b), despite arguments that § 10(b)'s inclusion of the phrase "directly or indirectly" encompassed aiding and abetting. *Id*. at 175. The Court also reasoned that aiding and abetting liability could allow plaintiffs to circumvent the element of reliance required under Rule 10b-5. *Id*. at 180. In conclusion, the Court held that "[a]ny person or entity, including a lawyer,

UT LAW CLE THE UNIVERSITY OF TEXAS TEXASLAW

Find the full text of this and thousands of other resources from leading experts in dozens of legal practice areas in the UT Law CLE eLibrary (utcle.org/elibrary)

Title search: Where Were the Lawyers and Accountants? Primary Liability under Section 10(b) of the Exchange Act

Also available as part of the eCourse
Gatekeeper Duties and Liabilities

First appeared as part of the conference materials for the
38th Annual Conference on Securities and Business Law session
"Where Were the Lawyers and Accountants?"