UIC Law Review

Volume 27 | Issue 4 Article 2

Summer 1994

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Recommended Citation

Marvin Motsenbocker, Walking on Thin Ice: The Changing Liability of Attorneys in the Securities Arena, 27 J. Marshall L. Rev. 909 (1994)

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WALKING ON THIN ICE: THE CHANGING LIABILITY OF ATTORNEYS IN THE SECURITIES ARENA

SCOTT A. CRIST*

INTRODUCTION

The position that securities lawyers hold within the legal community differs, both in form and in substance, from that of most other practitioners. Securities lawyers play a "unique and pivotal role in the effective implementation of the securities laws,"[1] and since the Securities and Exchange Commission (SEC) does not have sufficient resources to detect or investigate all securities law violations, it is often up to the securities lawyer to ensure that the public does not fall victim to fraudulent conduct. This unique position has been the subject of discussion by courts and commentators concerning the adequacy of current standards of professional responsibility with respect to securities lawyers.

This Article discusses the changing liability of securities lawyers. Part I discusses the liability of securities lawyers under the Securities Act of 1933 and the Securities Exchange Act of 1934. Part II discusses the Securities Enforcement Remedies and Penny Stock Reform Act of 1990 (SERPSRA). Finally, Part III analyzes the recent Supreme Court decision in *Central Bank of Denver v. First Interstate Bank of Denver.*[2] This discussion will hopefully serve to underscore the recent uncertainty in potential liability that securities lawyers face, both through insufficient and volatile Supreme Court decisions, and through newly acquired SEC administrative remedies.

I. LIABILITY OF SECURITIES LAWYERS UNDER THE 1933 AND 1934 ACTS

In the aftermath of the Stock Market Crash of 1929, Congress enacted the Securities Act of 1933 and the Securities Exchange Act of 1934.[3] In doing so, Congress attempted to provide protection for

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1. SEC v. Spectrum, Ltd., [1972 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,631 (S.D.N.Y. Oct. 10, 1972).

2. 114 S. Ct. 1439 (1994).

3. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 194 (1976).

the investing public that had previously been lacking by imposing broad disclosure requirements upon those offering securities to the public, and thereafter, through regular reporting requirements to the Securities and Exchange Commission by those listed on the national securities exchanges.[4] In an effort to provide some means of ensuring that the requirements imposed by the Acts were faithfully carried out, and to prevent inadequate or inaccurate disclosure during the issuance of securities, Congress included several flexible enforcement powers which, after 1934, the SEC could invoke, along with broad rulemaking authority in the Commission to promulgate rules consistent with the provisions of the Acts.[5]

A. *Rule 2(e)(1)*

Rule 2(e)(1)[6] provides:

> [t]he Commission may deny, temporarily or permanently, the privilege of appearing or practicing before it in any way to any person who is found by the Commission after notice of and opportunity for hearing in the matter (i) not to possess the requisite qualifications to represent others, or (ii) to be lacking in character or integrity or to have engaged in unethical or improper professional conduct, or (iii) to have willfully violated, or willfully aided and abetted the violation of any provision of the federal securities laws . . . or the rules and regulations thereunder.[7]

The most relevant portions of this Rule for securities lawyers have historically been sections (ii) and (iii). In 1981, the Commission had the opportunity in *In re Carter*[8] to set forth the standard of conduct required of securities lawyers under both of these sections. The Commission stated that Rule 2(e) was not promulgated to create a new administrative remedy, but rather to address the problem of professional misconduct.[9] Rule 2(e)'s sanction, therefore, is limited to that necessary to protect the investing public and the

4. *Id.* at 195.
5. *Id.*
6. 17 C.F.R. § 201.2(e)(1) (1992).
7. *Id.*
8. [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,847 (S.E.C. Feb. 28, 1981). In *Carter*, the attorneys, Carter and Johnson, acting as outside counsel for National Telephone Company, were found to have "willfully aided and abetted violations of Section 10(b) and Rule 10b-5," and to have "engaged in unethical and improper professional conduct" by the Administrative Law Judge when National failed to make requisite disclosures concerning its financial condition contrary to their directions. *Id.* at 84, 146. In its decision, the SEC reversed the findings of the Administrative Law Judge. *Id.* at 84, 173. However, the SEC stated prospectively that, when a lawyer with significant responsibilities in the effectuation of a company's compliance with the disclosure requirements of the federal securities laws becomes aware that his client is engaged in a substantial and continuing failure to satisfy those disclosure requirements, his continued participation violates professional standards unless he takes prompt steps to end the client's noncompliance. *Id.*
9. *Id.* at 84,149.

Commission from the potential impact of misconduct by the attorneys, accountants, and other professionals that practice before it.[10]

In applying section (ii) of Rule 2(e)(1), which prohibits unethical or improper professional conduct, the Commission stated that some prompt action is necessary when the lawyer "becomes aware that his client . . . engage[s] in a substantial and continuing failure to satisfy disclosure requirements."[11] However, "[s]o long as a lawyer is acting in good faith and exerting reasonable efforts to prevent violations of the law by his client, his professional obligations have been met."[12] Although the Commission in *Carter* indicated that section (ii) may create additional duties of disclosure beyond those of the Model Rules of Professional Conduct, it declined to expand existing ethical and professional standards, referring instead to a release to be issued in the future by the Commission further defining the obligations of securities lawyers.[13] The Commission, however, has never issued the future release promised in *Carter*.[14]

With regard to section (iii) of Rule 2(e)(1), although it did not decide what level of intent was required for an attorney to be held liable as an aider and abettor, the Commission in *In re Carter* held that liability under section (iii) required a showing of awareness or knowledge on the part of the attorney that their role was part of an activity that was improper or illegal.[15] The Commission stated that "the traditional role of the lawyer as counselor is to advise his client, not the public, about the law, [and] Rule 2(e) does not change the nature of that obligation."[16]

As a practical matter, despite its broad language and promise of future releases increasing the obligations of securities lawyers, Rule 2(e)(1) has not been a significant factor in defining attorney liability under the 1933 and 1934 Acts. In fact, "cases upholding sanctions imposed under Rule 2(e) do so primarily by way of dicta."[17]

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10. *Id.* at 84,150.

11. *Id.* at 84,172.

12. *Id.* at 84,172-73.

13. *In re* Carter, [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,847, at 84,170 (S.E.C. Feb. 28, 1991).

14. *See* LARRY D. SODERQUIST, SECURITIES REGULATION 610 (2d ed. 1988).

15. *In re* Carter, [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,847, at 84,176. "If a securities lawyer is to bring his best judgment to bear on a disclosure problem, he must have the freedom to make innocent — or even, in certain cases, careless — mistakes without fear of legal liability or loss of the ability to practice before the Commission." *Id.* at 84,167.

16. *Id.* at 84,150.

17. Robert G. Day, Note, *Administrative Watchdogs or Zealous Advocates? Implications for Legal Ethics in the Face of Expanded Attorney Liability*, 45 STAN. L. REV. 645, 673 (1993).

B. Section 15(c)(4) of the Securities Exchange Act

Section 15(c)(4) of the Exchange Act[18] provides that, upon a finding of a failure to comply with certain provisions of the Exchange Act, the Commission

> may publish its findings and issue an order requiring [the person failing to comply], and any person who was a cause of the failure to comply . . . to comply, or to take steps to effect compliance with such provisions . . . upon such terms and conditions and within such time as the Commission may specify in such order.[19]

Administrative enforcement actions may be instituted under Section 15(c)(4) where the Commission finds a failure to comply with Sections 12, 13, 14 or 15(d) of the Exchange Act.[20] It also "applies whenever the SEC finds that 'any person' knowingly caused another person's failure to comply with disclosure requirements under the Act."[21] "In general, lawyers are not liable under [this section] for the legal advice they give, but they may be liable for the decisions actually made if they accept a role in the decision-making process."[22] This embraces the traditional view of ethics, "which perceives a lawyer as an adviser and not as a principal actor or 'cause' of violations."[23]

After providing the respondent with notice and an opportunity for a hearing, the Commission may also issue an order requiring the respondent "to comply, or to take steps to effect compliance with such provisions . . . upon such terms and conditions and within such time as the Commission may specify."[24] However, because SERPSRA provides even broader authority to order compliance, or steps to effect compliance, through a permanent cease-and-desist order,[25] Section 15(c)(4) is virtually superfluous.[26] Furthermore, the recent decision in *In re Kern*[27] substantially curbed the SEC's authority

18. Securities Exchange Act of 1934 § 15(c)(4), 15 U.S.C. § 15(c)(4) (1993).
19. *In re* Kern, [1991 Transfer Binder] Fed. Sec. L. Rep.(CCH) ¶ 84,815, at 82,006 (S.E.C. Jun. 21, 1991).
20. Harvey L. Pitt, *Report of the Task Force on SEC Settlements of the Subcommittee on Civil Litigation and SEC Enforcement Matters of the Federal Securities Law Committee of the American Bar Association Section of Business Law*, in BUS. LAW 1992, at 101 (PLI Litig. & Admin. Practice Course Handbook Series No. H4-5138, 1992).
21. Day, *supra* note 17, at 675.
22. Arthur F. Mathews et al., *Liability Exposure of Attorneys in the Corporate Arena and the Limits of Advocacy* C859 A.L.I.-A.B.A. 841, 857 (1993).
23. Day, *supra* note 17, at 675.
24. *In re* Kern, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,815, at 82,006 (June 21, 1991).
25. See Part II for a discussion of SERPSRA.
26. Pitt, *supra* note 20, at 115.
27. *In re* Kern, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,815 (S.E.C. June 21, 1991). "In *Kern*, the SEC brought an administrative action under Section 15(c)(4) against George Kern, a prominent mergers and acquisitions attorney, alleging that he caused a failure to comply with Section 14(d)(4) of the 1934 Act, which requires the reporting of negotiations in response to a

under Section 15(c)(4).[28]

In upholding the Administrative Law Judge's ruling in *Kern*, the SEC held that section 15(c)(4) was not intended to impose orders of general future compliance with the securities laws.[29] Congress intended the SEC to address only the conduct of the particular issuer who already had failed to comply with the disclosure rules, not other issuers with whom the securities lawyer might come in contact in the future.[30] Although the decision of the SEC in *Kern* referred to the legislative history of Section 15(c)(4) as a basis for limiting the remedies available under that section, the more plausible explanation for the Commission's decision seems to be its developing predisposition for seeking expansion of the agency's authority under SERPSRA rather than under the less certain authority provided by Section 15(c)(4).[31]

C. *Section 11 of the 1933 Act*

Section 11[32] provides a civil remedy when a registration statement contains "an untrue statement of a material fact or [omits] to state a material fact [required to be stated therein or] necessary . . . to make the statements [therein] not misleading."[33] Joint and several liability is incurred under this section by the issuer, all members of its board, and all who sign the prospectus or are named as preparing it.[34] "Each defendant other than the issuer, [however], has a defense, called a due diligence defense, that provides an escape from liability."[35]

Under Section 11(b)(3)(A) and (C), a person, other than the issuer, will not be liable if, after reasonable investigation, he had reasonable grounds to believe that the statement was true and that no

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tender offer." Richard M. Phillips & Christian E. Plaza, *Insider Trading, Fraud, and Fiduciary Duty Under the Federal Securities Laws: Implementation of the Remedies Act*, C873 A.L.I.-A.B.A. 205, 216 (1993). However, as Kern no longer represented Allied in the matter, the Administrative Law Judge declined to issue an order of future compliance under Section 15(c)(4) with respect to Kern "because Kern was no longer in a position either to require Allied to make corrective filings or to control its future compliance." *Kern*, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,815, at 82,005. The Administrative Law Judge concluded that issuance of an order was beyond his authority under these circumstances, and accordingly, discontinued the proceedings. *Id.*

28. *Id.*

29. *Id.* at 82,008.

30. *Id.* at 82,005.

31. *See SEC Discontinues Kern Proceedings Based on Lack of Statutory Authority*, 23 Sec. Reg. & L. Rep. (BNA) 997 (June 28, 1991).

32. Securities Act of 1933 § 11, 15 U.S.C. § 11 (1988).

33. SODERQUIST, *supra* note 14, at 237.

34. Barker v. Henderson, Franklin, Starnes & Holt, 797 F.2d 490, 494 (7th Cir. 1986).

35. SODERQUIST, *supra* note 14, at 238.

material fact was omitted.[36] Section 11(c) defines reasonable investigation and reasonable ground for belief as "that required of a prudent man in the management of his own property."[37] *Escott v. Barchris Construction Corporation*[38] helped to clarify what constituted a "reasonable investigation" and a "reasonable belief." An attorney is generally not considered an expert within the meaning of Section 11.[39] However, "an attorney can be sued . . . as an expert responsible for preparation of specific portions of a registration statement, such as tax or patent opinions, to which his name is attached."[40] In such cases, the attorney would only incur liability with regard to the portion of the statement that he "expertised."[41]

In discussing the standard of inquiry required of an attorney under Section 11 concerning the unexpertised portions of the registration statement, the court in *Escott* stated, "To require an audit would obviously be unreasonable. On the other hand, to require a check of matters easily verifiable is not unreasonable."[42] Therefore, in order to satisfy the requirements of due diligence, an attorney must, at the very least, "test oral information by examining the original written documents," and he must make inquiries of information which he does not know that "would put him on his guard."[43]

D. *Section 17(a) of the 1933 Act*

Section 17(a) of the 1933 Act,[44] which applies only to sellers, provides:

> It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly: (1) to employ any device, scheme, or artifice to defraud, or (2) to obtain money or property by means of any untrue statement of a material fact or any omission 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 (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.[45]

This section contains no requirement that the alleged violator

36. Escott v. Barchris Constr. Corp., 283 F. Supp. 643, 682-83 (S.D.N.Y. 1968).
37. 283 F. Supp. 643, 683 (S.D.N.Y. 1968).
38. 283 F. Supp. 643 (S.D.N.Y. 1968).
39. *Id.* at 683.
40. Mathews et al., *supra* note 22, at 852.
41. *Id.*
42. Escott v. Barchris Constr. Corp., 283 F. Supp. 643, 690 (S.D.N.Y. 1968).
43. *Id.* at 690, 692.
44. Securities Act of 1933 § 17(a), 15 U.S.C. 77q(a) (1988).
45. *Id.*

act with scienter.[46] Accordingly, the Second Circuit in *SEC v. Spectrum, Ltd.*[47] held that an attorney, who had only negligently issued an opinion letter, had nevertheless violated Section 17(a).[48] The court specifically relied on the fact that "the legal profession plays a unique and pivotal role in the effective implementation of the securities laws," asserting that "the public trust demands more of its legal advisers than 'customary' activities which prove to be careless."[49] The Supreme Court later held, however, in *Aaron v. SEC*,[50] that the SEC must prove scienter in actions under Section 17(a)(1), but held that scienter is not required under Sections 17(a)(2) or 17(a)(3), permitting negligence to form the basis of liability.[51]

The first case to adequately provide some guidelines as to what is expected of securities lawyers under Section 17(a), and one which sent the securities industry into a tailspin upon its release, was *SEC v. National Student Marketing Corp.*[52] In *National Student Marketing*, attorneys to a merger transaction allowed approval of the merger by the shareholders on the basis of materially misleading information.[53] The Court held that the attorneys had aided and abetted the violations under Sections 17(a), 10(b), and Rule 10b-5 through their participation in the closing of the merger since they were generally aware of the fraudulent activity, and they knowingly provided substantial assistance to the violation.[54] The court concluded that, "at the very least, they were required to speak out at the closing concerning the obvious materiality of the information," and not allow the merger to be closed "until the adjustments were disclosed and approval of the merger was again obtained from the shareholders."[55] "Their silence was not only a breach of this duty to speak, but in addition lent the appearance of legitimacy to the closing."[56] The Court declined, however, to grant the injunctive relief requested by the SEC, since there did not exist a reasonable likelihood of future illegal conduct by the attorney defendants.[57]

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46. Day, *supra* note 17, at 672.
47. [1972 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,631 (S.D.N.Y. Oct. 10, 1972).
48. *Id.*
49. *Id.*
50. 446 U.S. 680 (1980).
51. *Id.* at 701-02.
52. 457 F. Supp. 682 (D.D.C. 1978).
53. *Id.* at 713.
54. *Id.* at 715.
55. *Id.* at 713.
56. *Id.*
57. SEC v. National Student Mktg. Corp., 457 F. Supp. 682, 716 (D.D.C. 1978). Although sanctions were not imposed, the decision in *National Student Marketing* was ground-breaking in its recognition of attorney liability for the failure to disclose material information in a securities transaction. The court attempted to ease the impact of its decision, however, by stating that, "Courts will not lightly overrule an attorney's determination of materiality and the need

E. Section 10(b) of the 1934 Act

Section 10(b)[58] provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange,
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.[59]

In 1942, acting pursuant to its rulemaking power conferred by section 10(b), the Commission promulgated Securities and Exchange Commission Rule 10b-5, which provides:

> 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.[60]

"Although section 10(b) does not by its terms create an express civil remedy for its violation, and there is no indication that Congress, or the Commission when adopting Rule 10b-5, contemplated such a remedy, the existence of a private cause of action for violations of the statute and the Rule is now well established."[61] Primary liability under Section 10(b) and Rule 10b-5 requires direct participation in the deceit at issue.[62] "The elements of a claim of primary liability are (1) a misstatement or an omission (2) of material fact (3) made with scienter (4) on which plaintiff relied (5) that

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for disclosure . . . [but] where . . . the significance of the information clearly removes any doubt concerning the materiality of the information, attorneys cannot rest on asserted 'business judgments' as justification for their failure to make a legal decision pursuant to their fiduciary responsibilities to client shareholders." *Id.* at 713-14.

58. 15 U.S.C. § 78j(b) (1988).

59. *Id.*

60. 17 C.F.R. § 240.10b-5 (1993).

61. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 196 (1976).

62. Mercer v. Jaffe, Snider, Raitt & Heuer, 713 F. Supp. 1019, 1025 (W.D.Mich. 1989), *aff'd,* 933 F.2d 1008 (6th Cir. 1991). "A person undertaking to furnish information which contains a material misstatement or omission is a primary participant, so long as he or she is not so far removed from the transmission of the misleading information that liability would necessarily become vicarious." *Id.* (citing SEC v. Washington Co. Util. Dist., 676 F.2d 218, 223-24 (6th Cir. 1982).

proximately caused his injury."[63] "Thus, to prosecute charges brought under Rule 10b-5, the SEC must show that the alleged violator acted with scienter, or a state of mind embracing an intent to deceive."[64]

The Supreme Court in *Ernst & Ernst v. Hochfelder*[65] defined "scienter" as a mental state embracing intent to deceive, manipulate, or defraud.[66] The legal definition of scienter, however, also includes recklessness.[67] Whether recklessness is sufficient to satisfy the level of scienter required by Section 10(b) and Rule 10b-5 remains the subject of much debate. In *Ernst & Ernst*, the Court noted in footnote 12 of its opinion that "in certain areas of the law recklessness is considered to be a form of intentional conduct for purposes of imposing liability" but declined to address the question of whether reckless behavior would be sufficient to create civil liability under Section 10(b) and Rule 10b-5.[68] Therefore, until the Supreme Court has occasion to revisit the issue of scienter, it appears that legal scholars on both sides of the issue will continue to espouse policy arguments, statutory interpretations, and a self-proclaimed superior understanding of Congressional intent, while the appellate courts remain split in their opinions and continue to provide little guidance for the securities practitioner.

Another source of conflict under Section 10(b) and Rule 10b-5 of the securities laws involves the issue of whether attorneys can be held liable absent an existing duty to disclose information to the third party. The Fifth Circuit Court of Appeals, in *Abell v. Potomac Insurance Co.*,[69] attempted to resolve this issue by stating that primary liability cannot be brought against attorneys under Section 10(b) and Rule 10b-5 absent a duty to disclose.[70] "Such a duty arises only when an attorney either owes a fiduciary duty to the third party investor, or makes materially false statements, with scienter, that are authorized and intended for the use of third party

63. Gilmore v. Berg, 761 F. Supp. 358, 368 (D.N.J. 1991).

64. Day, *supra* note 17, at 672.

65. 425 U.S. 185 (1976).

66. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 n.12 (1976).

67. The Third Circuit has defined recklessness as "highly unreasonable conduct, involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it." *Gilmore*, 761 F. Supp. at 370.

68. *Ernst & Ernst*, 425 U.S. at 193 n.12.

69. Abell v. Potomac Ins. Co., 858 F.2d 1104 (5th Cir., 1988), *vacated on other grounds*, 492 U.S. 914 (1989).

70. *Id.* at 1126. Although recognizing that securities lawyers often play a pivotal role in securities transactions, the court in *Abell* supported its decision that liability depends on an existing duty to disclose by stating that "an award of damages under the securities laws is not the way to blaze the trail toward improved ethical standards in the legal . . . profession." *Id.*

investors, such as where an attorney issues a formal opinion regarding tax or patent issues."[71] The court supported its decision by stating that "an award of damages under the securities laws is not the way to blaze the trail toward improved ethical standards in the legal profession."[72]

II. THE SECURITIES ENFORCEMENT REMEDIES AND PENNY STOCK REFORM ACT OF 1990

A. *Analysis of the Specific Provisions of the Act*

In 1990, Congress enacted the Securities Enforcement Remedies and Penny Stock Reform Act (SERPSRA).[73] As a reaction to perceived deficiencies in existing remedies, "[t]his landmark legislation changed dramatically the law enforcement profile of the Securities and Exchange Commission."[74] SERPSRA was not enacted as a separate provision under the securities law, but rather consists of several provisions that were inserted by amendment into various provisions of the Securities Act of 1933 and the Exchange Act of 1934. The following is a brief summary of the relevant provisions.

1. *Cease and Desist Orders*

The SEC first requested cease and desist authority in a proposal introduced by Chairman Breeden at the February 1, 1990, Senate Subcommittee hearings, which had been scheduled to focus upon the then-existing Securities Law Enforcement Remedies Act of 1989.[75] "Because no draft of the Breeden Testimony or the February 1990 Proposal was circulated beforehand, those testifying were required to respond without preparation to the proposal as described by Chairman Breeden that day."[76]

According to the Senate Report, Congress had three purposes behind its creation of the SEC's cease and desist authority. "First, Congress sought to provide the SEC with greater flexibility to address securities violations."[77] "Second, Congress believed that this authority would provide a 'more effective remedy' than was cur-

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71. Mathews et al., *supra* note 22, at 849.
72. *Abell*, 858 F.2d at 1126.
73. Securities Enforcement Remedies and Penny Stock Reform Act of 1990 Pub. L. No. 101-429, § 102, 104 Stat. 931, 933-34 (1990).
74. Harvey L. Pitt & Dixie L. Johnson, *The Securities Enforcement Remedies and Penny Stock Reform Act of 1990: Provisions and Implications of the New Remedies Available to the SEC*, PLI Corp. Law & Practice Handbook Series No. 718, 1990.
75. *Id.*
76. *Id.*
77. Phillips & Plaza, *supra* note 27, at 214. "The Committee believe[d] the power to impose a cease and desist order would enhance the SEC's ability to flexibly tailor remedies to the facts and circumstances of a particular case." *Id.* at 214-15.

rently available under Section 15(c)(4) of the Exchange Act."[78] Finally, Congress sought to address what it saw as a disparity in the SEC's enforcement powers when compared with those of other federal agencies.[79]

The SEC's cease and desist authority under SERPSRA includes both permanent and temporary cease and desist authority. "In administrative proceedings, the SEC . . . may enter a permanent cease and desist order against any person who violates or is about to violate any provision of the federal securities laws, or against any person who causes such a violation".[80] Since the Act's cease and desist provisions are patterned after Section 15(c)(4) of the 1934 Act, it seems clear, based upon the language "knew or should have known," that the SEC will take the position that negligence is sufficient for a "cause" finding in connection with a cease and desist order. . . .[81] "This would be consistent with the SEC staff arguments and the decision of the Administrative Law Judge in *In re George C. Kern*."[82]

The SEC may enter temporary cease and desist orders against regulated entities and their associated persons with or without prior notice and opportunity for hearing.[83] This provision "clearly has been the most controversial measure in SERPSRA, since it allows the SEC to unilaterally issue an emergency order temporarily restricting activities pending completion of a permanent cease and

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78. *Id.* at 215.

79. *Id.* "[O]f all the federal financial regulatory agencies, only the SEC [did] not have authority to issue a cease and desist order." *Id.*

80. *Id.* at 209. The Act specifically provides that:

> If the Commission finds, after notice and opportunity for hearing, that any person is violating, has violated, or is about to violate any provision . . . the Commission may publish its findings and enter an order requiring such person, and any other person that is, was, or would be a cause of the violation, due to an act or omission the person knew or should have known would contribute to such violation, to cease and desist from committing or causing such violation and any future violation of the same provision . . . Such order may, in addition, require such person to comply . . . with such provision . . . upon such terms and conditions and within such time as the Commission may specify in such order.

Securities Enforcement Remedies and Penny Stock Reform Act of 1990, Pub. L. No. 101-429, § 102, 104 Stat. 931, 933-34 (1990).

81. Phillips & Plaza, *supra* note 27, at 215-16.

82. *Id.* at 216.

83. *Id.* at 209. The Act provides that:

> Whenever the Commission determines that the alleged violation or threatened violation . . . is likely to result in significant dissipation or conversion of assets, significant harm to investors, or substantial harm to the public interest . . . the Commission may enter a temporary order requiring the respondent to cease and desist from the violation or threatened violation . . . as the Commission deems appropriate pending completion of such proceeding. Such an order shall be entered only after notice and opportunity for a hearing, unless the Commission determines that notice and hearing prior to entry would be impracticable or contrary to the public interest.

§ 102, 104 Stat. at 934.

desist proceeding, rather than bothering to go to court."[84] Since the Commission's determination that notice is unnecessary, it is possible that the SEC will be the party that determines an order should be issued, the party will issue the order, and will also hears the initial appeal from the order.[85]

The temporary cease and desist order, however, may only be entered against regulated entities and their associated persons, which include brokers, dealers, investment advisers, investment companies, municipal securities dealers, government securities brokers, government securities dealers or transfer agents, or persons acting in those capacities, or persons associated with such persons, or persons seeking to become associated with such persons.[86] Although intended to limit the number of persons subject to a temporary cease and desist order, "regulated entity" is defined so broadly as to bring most persons within its purview.

In support of the SEC's newly acquired cease and desist authority, Commissioner Edward Fleischman pointed out at the annual gathering of the ABA's Business Law Section that banking regulators were given cease and desist and other powers in the Financial Institutions Reform, Recovery, and Enforcement Act.[87] "Moreover, because court calendars are crowded, the SEC needs cease and desist authority so that some cases - which would be too old when they finally get before a judge - can be heard on an accelerated basis."[88] In addition, SEC Associate Enforcement Director Harry Weiss stated that pursuing a cease and desist order has some advantages over seeking injunctive relief.[89] "For example, the Commission does not have to show the likelihood of future violation with a cease and desist order."[90] Consequently, "temporary cease and desist orders would be useful for emergency situations."[91]

2. *Administrative Orders for Accounting and Disgorgement in Cease and Desist Proceedings*

"Prior to the passage of SERPSRA, the SEC did not have the

84. Pitt & Johnson, *supra* note 74.

85. *Id.*

86. Securities Enforcement Remedies and Penny Stock Reform Act of 1990, Pub. L. No. 101-429, § 102, 104 Stat. 931, 934 (1990).

87. *ABA Group Opposes SEC Remedies Bill; C&D Section Especially Controversial*, 22 Sec. Reg. & L. Rep. (BNA) 548 (1990) [hereinafter *ABA Group*] ("The Commission should get a similar boost," he said, "so that people don't do something on the securities side rather than the banking side just because the SEC lacks cease and desist authority.")

88. *Id.*

89. *Cease-And-Desist Authority May Have Limited Use, SEC Staff Officials Say*, 23 Sec. Reg. & L. Rep. (BNA) 369 (1991).

90. *Id.*

91. *Id.*

express authority to order an accounting and disgorgement . . . ."[92] The SEC was limited to injunction actions in order to obtain such relief."[93] SERPSRA provides that "[i]n any cease-and-desist proceeding . . . the Commission may enter an order requiring accounting and disgorgement, including reasonable interest."[94] Further the Commission can adopt rules and regulations "concerning payments to investors, rates of interest, periods of accrual, and such other matters as it deems appropriate to implement [orders for accounting and disgorgement]."[95] As such rules have yet to be adopted, the exact scope of this newfound authority is unclear.[96] However, "[b]ecause the remedy is available expressly in cease and desist proceedings, as well as SEC administrative proceedings in which monetary penalties could be imposed, the remedy is available against virtually everyone."[97]

3. *Money Penalties*

a. Court Ordered Monetary Penalties (Civil Actions)

The Act provides that, "Whenever it shall appear to the Commission that any person has violated any provision . . . the Commission may bring an action . . . to seek, and the court shall have jurisdiction to impose, upon a proper showing, a civil penalty to be paid by the person who committed such violation."[98] The broad language of this provision allows the SEC to seek money penalties in the federal district courts against any person that appears to have violated any provision of the federal securities laws, including cease and desist orders pursuant to this Act.[99]

"Although the penalty to be imposed is determined in light of the facts and circumstances of each case, SERPSRA establishes a three-tier structure for determining the penalty in a given case, with penalties increasing with each tier."[100] "The selection of the proper tier is based upon the level of culpability of the wrongdoer and the actual or potential amount of harm caused."[101] In each case, however, the court may disregard the tier limit and impose a penalty equal to "the gross amount of pecuniary gain to such de-

92. Phillips & Plaza, *supra* note 27, at 221.
93. *Id.*
94. Securities Enforcement Remedies and Penny Stock Reform Act of 1990, Pub. L. No. 101-429, § 102, 104 Stat. 931, 935 (1990).
95. *Id.*
96. Phillips & Plaza, *supra* note 27, at 222.
97. Pitt & Johnson, *supra* note 74.
98. Securites Enforcement Remedies and Penny Stock Reform Act of 1990, Pub. L. No. 101-429, § 102, 104 Stat. 931, 932 (1990).
99. *See* Phillips & Plaza, *supra* note 27, at 208.
100. *Id.*
101. *Id.*

fendant as a result of the violation" if that amount is greater.[102] "SERPSRA provides that these monetary penalties are not to be considered an exclusive remedy, and that an action to seek monetary penalties 'may be brought in addition to any other action that the Commission or the Attorney General is entitled to bring'."[103]

b. Monetary Penalties in SEC Administrative Proceedings

SERPSRA provides that:

> In any proceeding instituted pursuant to sections 15(b)(4), 15(b)(6), 15B, 15C, or 17A of this title against any person, the Commission . . . may impose a civil penalty if it finds, on the record after notice and opportunity for hearing, that such person:
> (1) has willfully violated any provision . . . ;
> (2) has willfully aided, abetted, counseled, commanded, induced, or procured such a violation by another person;
> (3) has willfully made or caused to be made in any application for registration or report to be filed with the Commission . . . any statement which was, at the time and in the light of the circumstances under which it was made, false or misleading with respect to any material fact, or has omitted to state in any such application or report any material fact which is required to be stated therein; or
> (4) has failed reasonably to supervise . . . another person who commits such a violation, if such other person is subject to his supervision; and that such penalty is in the public interest.[104]

"Administrative monetary penalties are imposed under the same three-tier system employed for the determination of penalties in civil cases, with one notable exception: For reasons not explained in the legislative history, in administrative proceedings the SEC is limited to the maximum amounts established for each tier."[105] "[U]nlike federal district courts in SEC injunctive actions, the SEC in administrative actions cannot impose a penalty equal to the amount of the net pecuniary gain if that amount is more than the maximum for that tier."[106]

The SEC also must determine that a monetary penalty is in the public interest.[107] The Commission may, but is not required to, consider the following factors:

> 1. whether the act or omission involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement;
> 2. the harm to others resulting either directly or indirectly from the act or omission;
> 3. the extent to which any person was unjustly enriched, taking into account any restitution made to persons injured by such behavior;

102. § 101, 104 Stat. at 932-33.
103. Pitt & Johnson, *supra* note 74.
104. Securities Enforcement Remedies and Penny Stock Reform Act of 1990, § 202, 104 Stat. 931, 937 (1990).
105. Phillips & Plaza, *supra* note 27, at 212.
106. *Id.*
107. § 202, 104 Stat. at 937.

4. whether such person previously has been found by the SEC, another appropriate regulatory agency, or a self-regulatory organization to have violated federal or state securities laws, or the rules of a SRO, has been enjoined by a court of competent jurisdiction for violations of such laws or rules, or has been convicted by a court of competent jurisdiction of violations of such laws or any felony or misdemeanor described in section 15(b)(4)(B);
5. the need to deter such person and others from committing such acts or omissions;
6. the ability of the violator to pay the penalty; and
7. such other matters as justice may require.[108]

4. *Restrictions on Corporate Service*

SERPSRA provides the SEC "with the authority to seek orders from the federal courts that prohibit persons found to have violated certain anti-fraud provisions of the 1933 Act or the 1934 Act from acting as a director or an officer of a public company."[109] In order to impose this remedy, the court is required to determine that the person's conduct demonstrates "substantial unfitness" to serve as an officer or director.[110] "Although Congress did not provide a definition of what constitutes substantial unfitness, Congress did indicate that 'the remedy of a bar or suspension from service as a corporate officer or director is especially appropriate in cases in which a defendant has engaged in fraudulent conduct while serving in a corporate or other fiduciary capacity'."[111] However, as restrictions on corporate service may only be imposed for violations of Sections 17(a) and 10(b), or the rules and regulations thereunder, the problem again arises as to what level of scienter will be required to impose liability under those sections. If a lesser standard of scienter is deemed to be sufficient, additional concerns may develop relating to the impact on securities lawyers and law firms, as many securities lawyers hold positions on corporate boards of directors, and occasionally as corporate officers.

B. *Implications for the Securities Lawyer*

The enactment of SERPSRA has caused great concern among the legal community due to the broad language used in its enforce-

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108. *Id.* at 938.
109. Phillips & Plaza, *supra* note 27, at 209. SERPSRA provides that:
[T]he court may prohibit, conditionally or unconditionally, and permanently or for such period as time as it shall determine, any person who violated [Section 17(a)(1) of the Securities Act or] Section 10(b) of [the Exchange Act] or the rules or regulations thereunder from acting as an officer or director . . . if the person's conduct demonstrates substantial unfitness to serve as an officer or director.
Securities Enforcement Remedies and Penny Stock Reform Act of 1990, § 201, 104 Stat. 931, 935-36 (1990).
110. *Id.*
111. Phillips & Plaza, *supra* note 27, at 220.

ment provisions. Among the new enforcement powers granted in SERPSRA, "the SEC can seek civil money penalties for any securities law violation and can issue cease and desist orders against violators, as well as anyone who is a cause of the violation."[112] "This prohibited conduct could be broader than aiding and abetting and could apply to lawyers."[113]

In addition, "these new remedies allow the SEC to choose whether to bypass the Federal courts and bring any case in its own administrative forum."[114] "[O]ne Washington attorney warned that if the SEC is not subject to the judicial checks imposed by the injunctive process, the integrity of its enforcement program will suffer."[115]

But perhaps most troubling is the fact that the extent of these broad remedies has yet to be defined by the SEC. The potential liability under SERPSRA is devastating, and as yet there are no clear guidelines as to how broadly it will be interpreted. From the language employed in its provisions, SERPSRA includes virtually everyone involved in securities transactions within the cross-hairs of its arsenal of remedies, but fails to provide any guidance as to when these remedies may be implemented. Although the Act was designed, in part, to allow the SEC flexibility in tailoring remedies for securities law violations, the SEC needs to define with substantial clarity the extent of liability under the Act in order to establish some level of certainty in securities transactions.

In an attempt to quell the concerns of the legal community regarding potential liability under SERPSRA, Bruce Hiler, Associate Director of the SEC Enforcement Division, told a group gathered for the American Bar Association's annual convention on August 9, 1993 that, "[t]he Securities and Exchange Commission Enforcement Division is not targeting attorneys or brokerage industry compliance officials, but it does respond to trends that it sees in the media and to congressional interest."[116] "The division may give the impression that it is targeting a particular industry, but that is not really true."[117]

Hiler continued by saying that "the division takes a facts and circumstances approach, considering various factors, such as the need for deterrence and damage to the public."[118] "[I]n deciding on

112. Peter C. Kostant, *When Zeal Boils Over: Disclosure Obligations and the Duty of Candor of Legal Counsel in Regulatory Proceedings after the Kaye, Scholer Settlement*, 25 ARIZ. ST. L.J. 487, 544-45 (1993).

113. *Id.* at 545.

114. Pitt & Johnson, *supra* note 74.

115. *ABA Group, supra* note 87.

116. *SEC Isn't Targeting Attorneys, Others, Enforcement Official Says*, 25 Sec. Reg. & L. Rep. (BNA) 1113 (1993) [hereinafter *Targeting Attorneys*].

117. *Id.*

118. *Id.*

the appropriate target penalty, the staff does look at previous cases."[119] However, it also looks at "how much time has passed since those cases, and whether things 'are getting out of hand,' the perception of the conduct involved, and what the market will bear as a penalty."[120] " 'As we gain experience,' Hiler noted, 'we'll look at the deterrent effect we're having.' "[121] "However, practitioners are not going to be able to look at a case and say that X and Y are the reasons why the violator got such and such a penalty."[122]

III. The Supreme Court's Recent Decision in *Central Bank of Denver v. First Interstate Bank of Denver*

On April 19, 1994 the Supreme Court issued its decision in *Central Bank of Denver v. First Interstate Bank of Denver*,[123] a decision which may prove to be one of the most surprising and disappointing decisions in the history of securities law. Perhaps the most alarming aspect of the Court's opinion is that the reasoning which underlies the decision jeopardizes other existing remedies which the SEC currently implements to police fraud in the market, and to enforce the securities laws.

A. *Background*

The facts leading up to this case, as set forth in the brief for the Securities and Exchange Commission as Amicus Curiae,[124] are as follows. Central Bank of Denver (petitioner) served as indenture trustee for two separate bond issues sold in 1986 and 1988 by the Colorado Springs-Stetson Hills Public Building Authority to finance public improvements to a planned community. The indenture required the bonds to be secured at all times by land having an appraised value of at least 160% of the outstanding principal and interest.

In early 1988, before the second offering, petitioner received an updated appraisal covering both the land securing the 1986 bonds and the separate parcels that were to secure the 1988 bonds. The new appraisal, prepared by the same individual who had supplied the original appraisal in 1986, showed land values essentially unchanged from 1986, even though local real estate values had declined in the interim. The lead underwriter for the 1986 bonds notified petitioner that the 160% test was not being met for those

119. *Id.*
120. *Id.*
121. *Targeting Attorneys*, *supra* note 116.
122. *Id.*
123. 114 S. Ct. 1439 (1994).
124. Brief for the SEC as Amicus Curiae in Support of Respondents, Central Bank of Denver v. First Interstate Bank of Denver, 114 S. Ct. 1439 (1991) (No. 92-854) [hereinafter *SEC Brief for Respondents*].

bonds, and expressed concern that the 1988 appraisal was unreliable. Petitioner's own investigation raised similar questions.

Petitioner, as trustee for the 1986 bonds, at first directed that an independent review of the appraisal be conducted by a different appraiser. After meetings with the issuer, the developer, and others, however, petitioner agreed to defer the independent review until late 1988, at least six months after the 1988 bonds were to be sold. As one condition for petitioner's forbearance, the developer agreed to pledge an additional $2 million in property as security for the 1986 bonds. No additional property was pledged as security for the 1988 bonds, which were sold as scheduled in June 1988. Thereafter the issuer refused to complete the promised independent appraisal, and ultimately defaulted on the 1988 bonds.

Respondents were purchasers of 1988 bonds who brought a securities fraud action against petitioner and others, alleging that the 1988 sale violated Section 10(b) of the Securities Exchange Act of 1934, and the Commission's Rule 10b-5. In particular, respondents alleged that petitioner knowingly or recklessly aided and abetted the fraud by withdrawing its demand for an immediate independent review of the appraisal despite serious concerns about its accuracy, and by agreeing to delay the review until after the 1988 bonds had been sold.

The district court granted summary judgment for Central Bank, holding that the scienter requirement for aiding and abetting liability may not be satisfied by showing recklessness absent an additional duty to disclose, or a finding of a genuine issue of material fact as to the bank's knowledge or a duty to disclose. The court of appeals agreed that petitioner had no duty to disclose, but reversed and remanded, holding that aiding and abetting liability based upon recklessness could be established absent a duty to disclose when the defendant assists the primary violation by "affirmative action."

The issues to be resolved by the Court were: (1) 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, and (2) what degree of scienter is required in order to establish liability for aiding and abetting if an implied private right of action does exist. The Supreme Court held, however, in a 5-4 decision, that because the text of Section 10(b) does not prohibit the aiding and abetting of proscribed fraudulent conduct, a private plaintiff is precluded from maintaining an action for aiding and abetting under Section 10(b) and Rule 10b-5.[125] In so holding, the Court not only sidestepped the issues before it, but also contravened nearly 30 years of judicial precedent that had been estab-

125. *Central Bank of Denver*, 114 S. Ct. at 1455.

lished for aider and abettor liability.[126]

The Court based its decision, that a cause of action for aiding and abetting may not be brought under Section 10(b), upon two principle methods of analysis. First, the text of Section 10(b) does not expressly, or in terms, mention aiding and abetting liability. Second, even if the text of the Section 10(b) does not resolve the issue, the Court will attempt to infer how the 1934 Congress would have addressed the issue. In the Court's opinion, the 1934 Congress likely would not have attached aiding and abetting liability to Section 10(b) had it provided a private cause of action. Each of these decisions will be explored further in turn.

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126. "Instead of simply addressing the questions presented by the parties, on which the law really was unsettled, the Court sua sponte directed the parties to address a question on which even the petitioner justifiably thought the law was settled, and reached out to overturn a most considerable body of precedent." *Central Bank of Denver*, 114 S. Ct. at 1457 (Stevens, J., dissenting). Since 1966, with the decision in Brennan v. Midwestern United Life Ins. Co., 259 F. Supp. 673, 680-81 (N.D. Ind. 1966), *aff'd*, 417 F.2d 147 (7th Cir. 1969), that "in the absence of a clear legislative expression to the contrary, [Section 10(b)] must be flexibly applied so as to implement its policies and purpose," recognition of aider and abettor liability under Section 10(b) and Rule 10b-5 has become commonplace, and indeed, "has become an important part of the Commission's enforcement arsenal." *Central Bank of Denver*, 114 S. Ct. at 1460 (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." *Id.* at 1457. This has created a foundation of precedent which has provided a sufficient level of certainty and predictability through a clear delineation of the necessary elements required in order to impose liability as an aider and abettor under Section 10(b) and Rule 10b-5.

The elements that have developed to establish an aiding and abetting claim under Section 10(b) are (1) that there be a primary fraud, (2) that the aider and abettor have "knowledge" of the fraud, and (3) that the aider and abettor provide "substantial assistance" to the achievement of the primary fraud. IIT v. Cornfeld, 619 F.2d 909, 922 (2d Cir. 1980). Other courts have used variations of this test to achieve slightly different results. For example, the Seventh Circuit's test is more restrictive, requiring that the aider and abettor (1) commit one of the manipulative or deceptive acts prohibited under section 10(b) and Rule 10b-5 (2) with the same degree of scienter that primary liability requires. Robin v. Arthur Young & Co., 915 F.2d 1120, 1123 (7th Cir. 1990). In addition, the Ninth Circuit has recently restated the elements as follows: (1) the existence of an independent primary wrong; (2) actual knowledge by the alleged aider and abettor of the wrong and of his or her role in furthering it; and (3) substantial assistance in the wrong. Harmsen v. Smith, 693 F.2d 932, 943 (9th Cir. 1982). However, as Judge Friendly, writing for the Second Circuit, explained: "Although this list of prerequisites has become commonplace, the exact content of its rather vague phrases, especially "knowledge" . . . is still being delineated by the courts." *IIT*, 619 F.2d at 922.

The two primary issues that have developed, and which have caused genuine disagreement among the lower courts, are whether there is an implied private right of action for aiding and abetting violations of Section 10(b) and Rule 10b-5, and the degree of scienter that is required in order to establish liability. Not coincidentally, these were the same two issues before the Court in *Central Bank of Denver*. It was because of this fact that the legal community, bench and bar alike, awaited with heightened anticipation for the issuance of the Court's opinion.

The Court began by stating that, "[w]ith respect . . . to the scope of conduct prohibited by Section 10(b), the text of the statute controls our decision."[127] The statutory language is the starting point in every case involving construction of a statute, and a private plaintiff may not bring a 10b-5 suit against a defendant for acts not prohibited by the text of Section 10(b).[128] The language of Section 10(b) does not in terms mention aiding and abetting. Since Congress knew how to impose aiding and abetting liability when it wanted to do so, it presumably would have used the words "aid" and "abet" in the statutory context of Section 10(b) if that was its intention.[129] The Court held, therefore, that the statute prohibited only the making of a material misstatement (or omission) or the commission of a manipulative act, not the giving of aid to a person who commits a manipulative or deceptive act.[130]

Since the case concerned the conduct prohibited by Section 10(b), in the Court's opinion, the statute itself resolved the case.[131] However, the Court went on to state that even if the statute did not resolve the case, it would have reached the same conclusion because "[w]hen the text of Section 10(b) does not resolve a particular issue, [the Court] attempts to infer how the 1934 Congress would have addressed the issue had the 10b-5 action been included as an express provision in the 1934 Act."[132] Since Congress did not include private aiding and abetting liability in any of the express causes of action in the Securities Acts, the Court inferred that Congress likely would not have included aiding and abetting liability in Section 10(b) had it provided a private cause of action.[133]

Furthermore, the Court stated that "[i]t is impossible to assert with any degree of assurance that Congressional failure to act represents affirmative Congressional approval of the [court's] statutory interpretation."[134] "Congressional inaction lacks persuasive significance because several equally tenable inferences may be drawn from such inaction . . . ."[135] Although conceding that the Court's prior cases have not been consistent in rejecting such arguments, the Court concluded that Congress would not have included aiding and abetting liability in Section 10(b), and that "it is not plausible to interpret the statutory silence as tantamount to an im-

127. *Id.* at 1446.
128. Central Bank of Denver v. First Interstate Bank of Denver, 114 S. Ct. 1439, 1446 (1994).
129. *Id.* at 1448.
130. *Id.*
131. *Id.*
132. *Id.*
133. Central Bank of Denver v. First Interstate Bank of Denver, 114 S. Ct. 1439, 1449 (1994).
134. *Id.* at 1453 (quoting Pension Benefit Guaranty Corp. v. LTV Corp., 496 U.S. 633, 650 (1990)).
135. *Id.*

plicit Congressional intent [to do so]."[136]

Finally, the Court stated that policy considerations cannot override its interpretation of the text and structure of the Act, "except to the extent that they may help to show that adherence to the text and structure would lead to a result so bizarre that Congress could not have intended it."[137] The policy arguments espoused by the SEC in its brief as *Amicus Curiae* evidently did not meet this standard set by the Court.

In attempting to address the potential alternatives that were available to the Court in making this decision, the progression of cases decided by the Court regarding the determination of whether a private remedy is implicit in a statute not expressly providing one must be considered. In 1975, the Supreme Court in *Cort v. Ash*[138] set forth four factors that it considered "relevant" in determining whether a private remedy is implicit in a statute not expressly providing one.[139] The four factors it considered relevant are: (1) whether the plaintiff is one of the class for whose benefit the statute was enacted, (2) whether there is any indication of legislative intent, explicit or implicit, either to create such a remedy or to deny one, (3) whether it is consistent with the underlying purposes of the legislative scheme to imply such a remedy for the plaintiff, and (4) whether the cause of action is one traditionally relegated to state law so that it would be inappropriate to infer a cause of action based solely on federal law.[140] The Court failed to state, however, whether each factor would be given equal weight, or whether one factor would be given more weight than the others.

Four years later, in *Touche Ross & Co. v. Redington*,[141] the Supreme Court refined its analysis set forth in *Cort* by making it clear that each of the four factors stated there do not carry equal weight.[142] "The ultimate question is one of Congressional intent, not one of whether this Court thinks that it can improve upon the statutory scheme that Congress enacted into law."[143] Therefore, under the analysis set forth in *Touche*, in order for the Court to find that a cause of action for aiding and abetting liability does exist under Section 10(b), it must find that Congress implicitly intended to create such a cause of action when it enacted Section 10(b) in 1934.

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136. *Id.* at 1452.
137. *Id.* at 1454.
138. 422 U.S. 66 (1975).
139. *Id.* at 78.
140. *Id.*
141. 442 U.S. 560 (1979).
142. SODERQUIST, *supra* note 14, at 274.
143. Touche Ross & Co. v. Redington, 442 U.S. 560, 578 (1979).

Additional language in *Touche*, referring to Section 17(a) of the 1934 Act, stated that since two other provisions of the 1934 Act explicitly provided for private causes of action, the fact that Section 17(a) did not is strong evidence that Congress did not intend to do so.[144] The reasoning for such analysis seems to be that, since Congress knew how to impose a private cause of action when it wanted to do so, the fact that a provision does not provide for such a remedy is strong evidence that Congress did not intend for one to be available under that provision. Therefore, the explicit language in certain provisions of the 1934 Act providing for aiding and abetting liability provides strong evidence that Congress specifically chose not to provide this remedy under other provisions of the Act not expressly including such language. Since Section 10(b) does not expressly provide for aider and abettor liability, the analysis of *Touche* would indicate that an action for aider and abettor liability under that provision is without basis.

In *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Curran*,[145] however, the Supreme Court took a more expansive approach to implied remedies by holding that leaving "intact the statutory provisions under which the federal courts had implied a cause of action is itself evidence that Congress affirmatively intended to preserve that remedy."[146] This approach departs from the older analysis of *Cort* and *Touche*, which based Congressional intent on the actions and inactions of Congress at the time of the enactment of the 1934 Act, not taking into account current market developments which were not present at the time of the Act's enactment. The approach in *Merrill Lynch* allows the judiciary to take a more responsive approach to changing conditions in the market without the time consuming process of legislative action, and without having to justify its actions under the Congressional mindset of 1934, by permitting the Court to infer Congressional intent from the acquiescence of Congress to current judicial activity. As the lower courts have consistently permitted an implied private cause of action for aider and abettor liability under Section 10(b) without Congressional interference, the analysis in *Merrill Lynch* provided the most logical basis for decision in *Central Bank of Denver*.

As stated in Justice Stevens' dissent in *Central Bank of Denver*, a "settled construction of an important federal statute should not be disturbed unless and until Congress so decides."[147] "A policy of respect for consistent judicial and administrative interpretations leaves it to elected representatives to assess settled law and to eval-

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144. *Id.* at 571.
145. 456 U.S. 353 (1982).
146. SODERQUIST, *supra* note 14, at 275.
147. Central Bank of Denver v. First Interstate Bank of Denver, 114 S. Ct. 1439, 1457 (1994) (Stevens, J. dissenting).

uate the merits and demerits of changing it."[148] "Even when there is no affirmative evidence of ratification, the Legislature's failure to reject a consistent judicial or administrative construction counsels hesitation from a court asked to invalidate it."[149]

Perhaps the greatest proponent of permitting aider and abettor liability, together with private enforcement, under Section 10(b) is the SEC. In its brief as *Amicus Curiae* in *Central Bank of Denver*, the SEC set forth several policy reasons for permitting such a cause of action. First, the Commission has only limited resources to detect or investigate federal securities law violations, and private actions accordingly serve as "a necessary supplement to Commission action."[150] The existing private right of action's "effectiveness as a supplement to Commission enforcement would be severely undercut if it did not also reach aiders and abettors."[151] Second, "private actions also serve the compensatory purposes of the securities laws."[152] "Although the Commission may seek certain monetary relief, its remedies are designed primarily to deter violations by making them unprofitable, rather than to make investors whole."[153] "Accordingly, the primary means of compensating injured investors remains the private action, and all participants in a fraud should be liable in order to ensure full recovery."[154] Finally, it has long been settled in the lower courts that private plaintiffs may sue aiders and abettors under Rule 10b-5."[155] In fact, no court has held to the contrary.[156] "[A]ny decision to reverse direction and reject aider and abettor liability under Rule 10b-5 would, at this late date, be better left to Congress."[157]

The analysis of the Court in *Merrill Lynch,* by permitting a broader interpretation of Congressional intent, would have allowed the Court the flexibility to consider the special needs of the SEC, to uphold the progression of decisions in the lower courts, and to more readily respond to issues causing concern in the market that were not contemplated at the time of the Act's enactment. Concerns that such judicial activism may encroach upon the jurisdiction of the Legislature are unfounded, as the Legislature is still able to express its intent, or correct a misinterpretation by the judiciary, by amending those provisions of the Act which it feels need clarification. The bottom line is that the Legislature cannot anticipate all issues that

148. *Id.*
149. *Id.*
150. *SEC Brief for Respondents, supra* note 124.
151. *Id.*
152. *Id.*
153. *Id.*
154. *Id.*
155. *SEC Brief for Respondents, supra* note 124.
156. *Id.*
157. *Id.*

may arise in the securities markets, nor can it draft statutory language that will cover all possible occurrences. Therefore, the Court must be given some latitude in its ability to interpret the provisions of the Act in light of changing market needs. The analysis set forth in *Merrill Lynch* permits this latitude.

The Court, however, reverted back to its prior analysis of *Touche* in its decision to reject aider and abettor liability under Section 10(b) and did not consider the policy arguments proffered by the SEC. Issues such as the vast amount of investors that are affected by transactions in the securities markets; the inability of the SEC to adequately monitor all transactions and detect fraudulent conduct due to its limited resources; and the entitlement of plaintiffs to full recovery from all persons responsible under Section 10(b) should have been taken into account as the Court made its decision whether to allow aiding and abetting liability under Section 10(b). The more reasoned approach for the Court would have been to continue its analysis set forth in *Merrill Lynch*, and to uphold not only aiding and abetting liability under Section 10(b), but also an implied private right of action for aiding and abetting liability.

B. The Issue of Scienter

By sidestepping the issues presented by the parties, the Court failed to address the question of what level of scienter is required to establish liability under Section 10(b) and Rule 10b-5, either as a primary violator or as an aider and abettor. In *Ernst & Ernst v. Hochfelder*,[158] the Court noted in footnote 12 of its opinion that in certain areas of the law recklessness is considered to be a form of intentional conduct for purposes of imposing liability but declined to address the question of whether reckless behavior would be sufficient to create civil liability under Section 10(b) and Rule 10b-5.[159] Since that decision in 1976, the Court has failed to clarify the scienter requirement of Section 10(b) and has left the Courts of Appeal divided. In *Central Bank of Denver*,[160] the Court once again had the opportunity to address the issue but failed to do so.

The issue of scienter is of such importance under Section 10(b) and Rule 10b-5 that it warrants a discussion of the current approaches taken by the lower courts. Since the decision of the Court in *Central Bank of Denver* was merely a 5-4 majority, and because Congress has not had an opportunity to act in response to the Court's decision, the following discussion will also include the level

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158. Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976).
159. *Id.* at 193 n.12.
160. Central Bank of Denver v. First Interstate Bank of Denver, 114 S. Ct 1439 (1994).

of scienter required for aider and abettor liability, even though the Court has held that such a remedy does not exist under Section 10(b).

The reason for requiring some level of knowledge of the fraud before imposing liability as an aider and abettor is to exclude those persons from liability that innocently and inadvertently contribute to the fraud absent any awareness of its existence. Without the requirement of some level of knowledge, a wide range of persons would face liability for facilitating roles in transactions which seemed ordinary and honest to them, and "the securities laws would become an amorphous snare for guilty and innocent alike."[161] The question that arises is what level of scienter is required under Section 10(b) and Rule 10b-5 to satisfy the knowledge requirement, and to establish liability as an aider and abettor. As the Court in *Ernst & Ernst* failed to decide the issue, it has been up to the lower courts to establish if, and when, recklessness will be sufficient to impose liability.

There are several reasons why a recklessness standard may be preferable, in certain circumstances, to one requiring conscious intent on the part of the defendant. One reason would be to discourage deliberate ignorance of facts indicating fraud and to prevent a defendant from escaping liability simply by denying any conscious intent to defraud.[162] Furthermore, proof of a defendant's knowledge or intent will often be inferential, and to require that a fact finder must find a specific intent to deceive or defraud in all types of 10b-5 cases would for all intents and purposes disembowel the private cause of action under Section 10(b).[163] Another reason for applying a recklessness standard for aiding and abetting is that it comports with the purposes of Section 10(b).[164] "Section 10(b) serves broad remedial purposes, and [the Court] has stated that the securities laws should be liberally construed to effectuate those purposes."[165] "By facilitating enforcement of Rule 10b-5, the recklessness standard promotes the Congressional policy embodied in the 1934 Act."[166] The lower courts have developed three approaches in analyzing the scienter requirement: the "duty" approach (majority view),[167] the "assistance by action" approach,[168] and the "sliding

161. Alan R. Bromberg & Lewis D. Lowenfels, *Aiding and Abetting Securities Fraud: A Critical Examination*, 52 ALB. L. REV. 637, 671-72 (1988) (quoting Woodward v. Metro Bank, 522 F.2d 84, 97 (5th Cir. 1975)).

162. *SEC Brief for Respondents, supra* note 124.

163. Bromberg & Lowenfels, *supra* note 161, at 680 (quoting Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 38, 44-47 (2nd. Cir. 1978)).

164. *SEC Brief for Respondents*, supra note 124.

165. *Id.*

166. *Id.*

167. *Id.*

168. Brief for Petitioner, Central Bank of Denver v. First Interstate Bank of Denver, 114 S. Ct. 1439 (1994) (No. 92-854) [hereinafter *Brief for Petitioner*].

scale" approach.[169]

1. The "Duty" Approach

In applying the "duty" approach, the majority of courts have held that recklessness does not suffice for Rule 10b-5 aiding and abetting liability absent a breach of some duty to disclose or act.[170] "[Without] such a breach, a plaintiff must always prove conscious intent to defraud, even if the defendant's substantial assistance consisted of affirmative action."[171] Silence on the part of the defendant can be misleading or deceptive where there is some relationship which reasonably creates in another person the expectation that the defendant would take steps to protect that person's interests.[172] Such an expectation is reasonable, however, only where there was a preexisting duty to disclose or act.[173] "[T]his duty does not come from section 10(b) or Rule 10b-5; if it did the inquiry would be circular."[174] "[Instead, t]he duty must come from a fiduciary relation outside securities law."[175]

There are generally three situations in which an attorney will have a pre-existing duty to disclose, thereby permitting the use of a recklessness standard: (1) when acting on behalf of a client who has a duty to disclose information to third parties;[176] (2) when preparing legal documents intended for the benefit of third parties, and upon which they rely;[177] and (3) towards his own client.[178] Ab-

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169. *SEC Brief for Respondents*, *supra* note 124.

170. *Id.*; *see also* Schatz v. Rosenberg, 943 F.2d 485, 496 (4th Cir. 1991).

171. *SEC Brief for Respondents*, *supra* note 124.

172. *Brief for Petitioner*, *supra* note 168.

173. *Id.*

174. Barker v. Henderson, Franklin, Starnes & Holt, 797 F.2d 490, 496 (7th Cir. 1986).

175. *Id.*

176. In SEC v. National Student Mktg Corp., 457 F. Supp. 682 (D.D.C. 1978), the lawyers' duties to their corporate client made them aiders and abettors by silence and inaction when they failed to reveal material information to the shareholders prior to the closing of the transaction.

177. In Abell v. Potomac Insurance Co., 858 F.2d 1104, 1124 (D.D.C. 1978), the court explained that the law, as a general rule, only recognizes causes of action by third parties against attorneys for the insufficiency of their legal opinions if they can prove that the attorney prepared specific legal documents for the benefit of the plaintiff that represent explicitly the legal opinion of the attorney preparing them. *Accord* Schatz v. Rosenberg, 943 F.2d 485, 492 (4th Cir. 1991). A lawyer cannot be held liable for misrepresentation under Section 10(b) for failing to disclose information about a client to a third party absent some fiduciary or other confidential relationship with the third party. *Id.* at 490.

178. In Morgan v. Prudential Groups, Inc., 527 F. Supp. 957, 961 (S.D.N.Y. 1981), *aff'd*, 729 F.2d 1443 (2nd Cir. 1983), the court held that attorneys can be held liable as aiders and abettors if, in reckless disregard of the truth, they omit material information, or include erroneous information, from documents they draft where it is reasonably foreseeable that potential investors will rely on such documents. *See also* Andreo v. Friedlander, Gaines, Cohen, Rosenthal & Rosenberg, 660 F. Supp. 1362, 1367 (D.Conn. 1987). The court explained that this does not mean that attorneys have an affirmative duty to verify all infor-

sent any pre-existing duty to disclose by the defendant, a plaintiff must prove conscious intent to defraud in order to invoke a recklessness standard.

The reasoning behind application of the "duty" approach is that where the defendant owes some duty to the plaintiff, reckless acts which otherwise would not be actionable under the securities laws may fairly be regarded as deceptive in nature.[179] Where the defendant knows he is subject to a duty to disclose, liability may properly be imposed when he subsequently acts in reckless disregard of that duty. It is this pre-existing duty that should put the defendant on notice that his conduct will be subject to greater scrutiny, and, therefore, permits the just application of a recklessness standard of scienter.

2. *The "Assistance by Action" Approach*

Under the "assistance by action" approach, recklessness will suffice for aiding and abetting liability under Section 10(b) and Rule 10b-5 whenever the defendant has taken affirmative action to assist a fraudulent scheme. In the Seventh Circuit, for example, "a defendant may be held liable for aiding and abetting a securities fraud if he substantially aids the fraud and either knew of the fraud or was reckless in failing to discover it."[180]

Although this approach would alleviate the burden of proving intent to defraud by permitting recklessness to satisfy the scienter requirement when a defendant has taken some affirmative action to assist the fraud, it appears that many innocent contributors, ignorant of any fraudulent scheme, may be caught up in its overreaching presumptions and subject to liability for conduct only later deemed to be reckless. The practical effect of this approach on persons assisting in securities transactions is to "bootstrap a duty where none exists," and to "create an unwarranted presumption that the alleged aider and abettor intended to defraud the plaintiff simply because his conduct was later judged as reckless."[181]

3. *The "Sliding Scale" Approach*

Under the 'sliding scale' approach, scienter depends "both on the nature of the conduct and on whether the defendant had a duty

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mation provided by their clients, or to discover if any pertinent information might have been omitted, but rather imposes a responsibility not to act in reckless disregard of the truth when using the information provided by their clients. *Id.*

179. *See Brief for Petitioner, supra* note 168.

180. Bromberg & Lowenfels, *supra* note 161, at 677 (quoting Tucker v. Janota, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,701 (N.D.Ill. Nov. 1, 1978)).

181. *Brief for Petitioner, supra* note 168.

to disclose."[182] . The level of evidence required to prove actual knowledge may increase where the defendant's participation in the alleged wrongdoing is less substantial.[183] A defendant who affirmatively acts to assist a fraudulent scheme, but who has no duty to disclose, is liable for aiding and abetting only if the plaintiff can prove "conscious intent," unless the character and degree of his assistance in the fraud is particularly unusual, in which case recklessness will suffice.[184] Where some special duty of disclosure exists, then liability can be imposed if the plaintiff can show reckless conduct on the part of defendant.[185]

This approach permits recklessness to satisfy the scienter requirement of aiding and abetting liability when the defendant has a duty to disclose or, in the absence of such a duty, if his affirmative actions constitute unusual conduct. Accordingly, this approach appears to be an attempt to achieve a compromise between the other two methods of analyzing the scienter requirement: If a duty to disclose exists, recklessness will suffice ("duty" approach), and if defendant undertakes some affirmative action, regardless of a duty to disclose, recklessness will suffice if the conduct is unusual (quasi-"assistance by action" approach).

Although all three approaches have each found favor in opinions of the lower courts, the "duty" approach has been used in a majority of jurisdictions and seems to provide the most logical basis for permitting recklessness to satisfy the scienter requirement for aider and abettor liability under Section 10(b) and Rule 10b-5. Not only does this approach comport with the traditional view of the attorney-client relationship, ensuring that client information will not be forcibly disclosed absent some duty on the part of the defendant to do so, but it also promotes fairness by providing notice to a potential defendant that his conduct may later be subject to judicial scrutiny under a recklessness standard. Absent such a duty to disclose, the plaintiff must show a conscious intent to defraud on the part of the defendant.

182. *SEC Brief for Respondents*, *supra* note 124.

183. *Brief for Petitioner*, *supra* note 168.

184. *SEC Brief for Respondents*, *supra* note 124. *See* Akin v. Q-L Investments, Inc., 959 F.2d 521, 531 (5th Cir. 1992) (quoting Woodward v. Metro Bank of Dallas, 522 F.2d 84, 97 (5th Cir. 1975)). In *Akin*, the court stated that an accountant may be held liable for recklessly aiding and abetting a primary violation, regardless of whether he has made misrepresentations of his own, when his assistance in the fraud is particularly substantial and unusual or when he owes some special duty of disclosure. *Id.*

185. IIT v. Cornfeld, 619 F.2d 909, 925 (2nd Cir. 1980) (quoting *Woodward*, 522 F.2d at 97).

C. Central Bank of Denver *and its Implications for the Securities Lawyer*

As stated previously, the failure of the Court once again to address the question of what level of scienter is required under Section 10(b) and Rule 10b-5 to establish liability, as either a primary violator or an aider and abettor, is a tragic disservice to the securities industry. The Supreme Court must determine whether recklessness may be sufficient to satisfy the scienter requirement, and, if so, the appropriate circumstances which would fairly permit its application. Such a decision is necessary, not only to provide uniformity among the lower courts, but to provide some level of assurance for securities lawyers that they will not be subject to liability for conduct only later deemed to be reckless.

Perhaps the most alarming aspect of the Court's opinion, however, is the analysis the Court used in reaching its conclusion. The reasoning which underlies the Court's decision, that aider and abettor liability is not available under Section 10(b) since such conduct is not expressly prohibited by the text of the statute, jeopardizes other existing remedies which the SEC currently implements to police fraud in the market and to enforce the securities laws.[186] One example may be the private right of action for primary liability which is implied under Section 10(b) and Rule 10b-5.

One saving grace is the knowledge that, "when a decision of the Supreme Court upsets settled law, Congress may step in to reinstate the old law."[187] Perhaps this was what the majority had in mind when issuing this opinion, to force the Legislature to expressly state its intent concerning the extent of liability under Section 10(b) and Rule 10b-5, rather than rely upon implied causes of action that have developed in the courts, despite long-standing acceptance by the courts. Whatever the reason for their decision, the Court has now cast more uncertainty upon the future of securities law enforcement than existed prior to its decision. It is for this reason that the Court's analysis must be considered suspect, and its result disappointing.

CONCLUSION

"The Securities and Exchange Commission, with its small staff and limited resources, [cannot] implement the objectives of its dis-

186. "[T]he majority's approach to aiding and abetting at the very least casts serious doubt, both for private and SEC actions, on other forms of secondary liability that, like the aiding and abetting theory, have long been recognized by the SEC and the courts but are not expressly spelled out in the securities statutes." Central Bank of Denver v. First Interstate Bank of Denver, 114 S. Ct. 1439, 1460 (1994) (Stevens, J., dissenting).

187. *Id.* at 1459 n.7.

closure policy without the cooperation of the legal profession, [and they] must rely heavily on them to perform their tasks diligently and responsibly."[188] Consequently, "safeguards to protect the investing public depend 'in large measure on the attorneys who serve in an advisory capacity to those engaged in securities transactions.' "[189]

It is because of this "unique and pivotal role that securities lawyers play in the effective implementation of securities laws"[190] that the level of disclosure required of them under traditional ethical standards has recently been questioned. The answer, however, to preventing potential abuse by those that would gain by this role does not lie in an increase in disclosure obligations of securities lawyers, but rather in the more effective use of the current regulatory framework.

As is evident from the previous discussion, securities lawyers currently face an increase in potential liability through the newly acquired administrative remedies available to the SEC with the enactment of SERPSRA. In addition, the decision of the Supreme Court in *Central Bank of Denver* leaves open the question of whether recklessness may be a sufficient level of scienter to impose liability under Section 10(b) and Rule 10b-5. Even though the Court has eliminated aider and abettor liability under Section 10(b) and Rule 10b-5, thereby reducing a major source of concern for securities lawyers, there is no guarantee that Congress will not legislate in response to the Court's decision. As a result, the potential liability of securities lawyers appears to be as uncertain as ever before, and any further increase in potential liability through heightened disclosure requirements would, in effect, render the securities lawyer incapable of maintaining a traditional attorney-client relationship.

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188. Kostant, *supra* note 112, at 537.

189. *Id.* (quoting SEC v. Spectrum, Ltd., [1972 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,631 (S.D.N.Y. Oct. 10, 1972)).

190. SEC v. Spectrum, Ltd., [1972 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,631 (S.D.N.Y. Oct. 10, 1972).