1993

Does SEC Rule 10b-5 Provide an Implied Private Right of Action for Aiding and Abetting Securities Fraud?

Matthew J. Barrett
Notre Dame Law School, matthew.j.barrett.1@nd.edu

Does SEC Rule 10-b5 Provide an Implied Private Right of Action for Aiding and Abetting Securities Fraud?

by Matthew J. Barrett

Central Bank of Denver, N.A.
v.
First Interstate Bank of Denver, N.A.
and Jack K. Naber
(Docket No. 92-854)

Argument Date: November 30, 1993
From: The Tenth Circuit

Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b) ("Section 10(b)"), and Securities and Exchange Commission Rule 10b-5, 17 C.F.R. 240.10b-5 ("Rule 10b-5"), prohibit securities fraud. Section 10(b) 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 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.

Rule 10b-5 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.

Case at a Glance

This case concerns the civil liability of persons who aid and abet securities fraud in violation of federal law. First, the Supreme Court will decide if federal securities law recognizes an implied private right of action against those who aid and abet securities fraud. Second, if the Court concludes that there is a private right of action, it is asked to decide if recklessness satisfies the mental-state requirement which lower courts have held is a prerequisite for imposing civil liability.

ISSUES

1. Do Section 10(b) and Rule 10b-5 provide an implied private right of action for aiding and abetting violations of those provisions?
2. If so, does recklessness satisfy the mental-state requirement for aiding and abetting Section 10(b) and Rule 10b-5 violations when the alleged aider and abettor has not breached a duty to disclose or to act?

FACTS

In 1988, Central Bank of Denver, N.A. ("Central") served as bond trustee when the Colorado Springs-Stetson Hills Public Building Authority (the "Authority") sold $11 million in tax-exempt municipal bonds to finance public improvements in a planned residential and commercial community in Colorado Springs called Stetson Hills. The Authority pledged land in the development to secure the bonds and agreed that the collateral would at all times have an appraised value at least equal to 160 percent of the bonds' outstanding principal and interest. First Interstate Bank of Denver, N.A. ("First Interstate") purchased $2.1 million of the bonds, later selling some of the bonds to various customers, including Jack K. Naber.

Central previously served as trustee for a 1986 issuance of similar bonds. Before the 1988 bonds were issued, Central received an updated appraisal covering both the land securing the 1986 bonds and the separate parcels which the Authority proposed as security for the 1988 bonds.

The updated appraisal showed land values essentially unchanged from a 1986 appraisal, even though local real estate values had declined in the interim. Subsequently, the lead underwriter for the 1986 bonds notified Central that the collat-

Matthew J. Barrett is associate professor of law at Notre Dame Law School, Notre Dame, IN 46556; telephone (219) 631-8121.

eral's value did not satisfy the 160 percent test and expressed concern that the 1988 appraisal was unreliable. Central's own investigation raised similar concerns.

As trustee for the 1986 bonds, Central requested that a different appraiser conduct an independent review of the updated appraisal. After meetings with the Authority, the developer, and others, Central agreed to defer the independent review until late 1988, at least six months after the Authority planned to sell the 1988 bonds. As a condition for Central's agreement, the developer agreed to pledge an additional $2 million in property to secure the 1986 bonds. However, neither the Authority nor the developer actually pledged any additional property as security for the 1988 bonds, which the Authority sold as scheduled in June 1988 without a new appraisal of the collateral. The Authority later refused to complete the promised independent review and, ultimately, defaulted on the 1988 bonds.

In response to the default, Naber and First Interstate sued Central Bank and others, alleging that the sale of the 1988 bonds violated Section 10(b) and Rule 10b-5. Naber and First Interstate alleged that Central knowingly or recklessly aided and abetted the fraud by withdrawing its demand for an immediate independent review of the updated appraisal in the face of its concerns about the appraisal's accuracy and by agreeing to delay the review until after the Authority had sold the 1988 bonds.

In an unpublished order, the United States District Court for the District of Colorado held that recklessness could not satisfy the mental-state requirement for aiding and abetting liability unless the alleged aider and abettor also had a duty to disclose information. Because the district court could not find any genuine issue of material fact as to Central's knowledge or duty to disclose, the court granted Central's motion for summary judgment. The United States Court of Appeals for the Tenth Circuit reversed, holding that a plaintiff could establish aiding and abetting liability based on recklessness even though the alleged aider and abettor had no duty to disclose, so long as the defendant's "affirmative action" assisted the primary violation. 969 F.2d 891 (10th Cir. 1992).

The Supreme Court granted Central's petition for a writ of certiorari on the question of whether recklessness satisfies the mental-state requirement to impose civil liability for aiding and abetting, even though the alleged aider and abettor has not breached a duty to disclose or act. In addition, the Court directed the parties to brief and argue whether there is an implied private right of action for aiding and abetting violations of Section 10(b) and Rule 10b-5.

BACKGROUND AND SIGNIFICANCE

Implied Cause of Action

Section 10(b) and Rule 10b-5 prohibit manipulative or deceptive devices or contrivances that operate to mislead investors in connection with the purchase or sale of any security through the use of any means or instrumentality of interstate commerce, the mails, or any national securities exchange. Neither Section 10(b) nor Rule 10b-5, however, create an express private right of action for violations. In this context, a private right of action means that a private, nongovernmental party can file a lawsuit alleging violations of Section 10(b) or Rule 10b-5.

Beginning with *Kardon v. National Gypsum Co.*, 69 F. Supp. 512 (E.D. Pa. 1946), the lower federal courts have concluded that Section 10(b) allows a private right of action by implication, reasoning, in part, that such private remedies reinforce federal statutory duties. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 730 (1975); *Musick, Peeler & Garrett v. Employers Ins.*, 113 S. Ct. 2085, 2088 (1993).

In 1971, the Supreme Court seemed to acquiesce in the private right of action for primary violations of Section 10(b). *Superintendent of Ins. v. Bankers Life & Casualty Co.*, 404 U.S. 6, 13 n.9 (1971); *Touche Ross & Co. v. Redington*, 442 U.S. 560, 577-79 n.19 (1979). Twelve years later, the Supreme Court left no doubt, observing that "[t]he existence of this implied remedy is simply beyond peradventure." *Herman & MacLean v. Huddleston*, 459 U.S. 375, 380 & n.10 (1983).

In this case, the Supreme Court will decide whether a private cause of action exists for aiding and abetting violations of Section 10(b) and Rule 10b-5. In two previous cases, *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 191 n.7 (1976), and *Herman & MacLean*, 459 U.S. at 379 n.5, the Court reserved the question of whether the statute and rule impose civil liability for aiding and abetting and also reserved the question of the elements necessary to establish such liability.

At least since *Brennan v. Midwestern United Life Ins. Co.*, 259 F. Supp. 673 (N.D. Ind. 1966), and 286 F. Supp. 702 (1968), *aff'd*, 417 F.2d 147 (7th Cir. 1969), *cert. denied*, 397 U.S. 989 (1970), the lower federal courts have unanimously concluded that there is a private right of action for aiding and abetting securities fraud in violation of Section 10(b) and Rule 10b-5.

Interestingly, Central did not raise this issue in the lower courts or in its petition for a writ of certiorari because the Tenth Circuit, like the other courts of appeals that have considered the question, had previously recognized a private right of action for aiding and abetting under Section 10(b) and Rule 10b-5. However, several lower courts have questioned and criticized the creation of an implied private right of action in the aiding and abetting context. *Akin v. Q-L Investments, Inc.*, 959 F.2d 521, 525 (5th Cir. 1992); *Renovitch v. Kaufman*, 905 F.2d 1040, 1045 n.7 (7th Cir. 1990). In granting Central's petition for a writ of certiorari on the question of recklessness, the Supreme Court directed the parties to brief and argue whether there is an implied private right of action for aiding and abetting violations of Section 10(b) and Rule 10b-5.

As a practical matter, the private right of action for aiding and abetting recognized by the lower federal courts has enabled investors to recover from various professionals and business entities that have rendered services in connection with transactions involving securities fraud. These professionals and business entities — accountants, lawyers, appraisers, geologists, engineers, actuaries, banks and rating agencies — often are instrumental to securities transactions. But, while important,

they do not actually buy and sell securities and usually do not have a fiduciary relationship with those people who do. Without aiding and abetting liability, investors might not be able to recover losses in securities fraud cases from these ancillary, but necessary, actors in securities transactions. In essence, the issue in this case becomes whether the implied private right of action applies only to defendants that engage in manipulative, deceptive, or fraudulent acts or goes farther to reach defendants that assist others, whether through action or inaction, in such conduct.

Central argues that the implied private right of action for aiding and abetting conflicts with the language in Section 10(b) which proscribes only manipulative or deceptive conduct. Central also argues that the courts that have recognized a private right of action for aiding and abetting violations of Section 10(b) and Rule 10b-5 have improperly applied tort law concepts to securities law. Central asserts that in recent years the Supreme Court has rejected application of general tort law principles to create implied private rights of action under the federal securities laws.

In contrast, First Interstate and Naber argue that neither Section 10(b) nor Rule 10b-5 make any distinction between primary violations and secondary, i.e., aiding and abetting, violations of the statute or the rule. In their opinion, the comprehensive language in Section 10(b) that "[i]t shall be unlawful for *any* person, directly or *indirectly*," to engage in the prohibited conduct underscores that the statute applies to a broad class of defendants. They also argue that since the prohibitions in Section 10(b) and Rule 10b-5 have given rise to criminal aiding and abetting liability, the Supreme Court should not interpret the provisions to immunize aiders and abettors from civil liability.

Recklessness

If the Supreme Court concludes that Section 10(b) and Rule 10b-5 provide an implied private right of action for aiding and abetting violations, the Court must determine whether recklessness satisfies the mental-state requirement which the lower courts have adopted as a prerequisite for imposing aiding and abetting liability.

Lower courts agree that a plaintiff must prove that the defendant possessed scienter, i.e., "a mental state embracing intent to deceive, manipulate, or defraud." *Ernst & Ernst*, 425 U.S. at 194 n.12. On this element, a majority of lower courts have concluded that recklessness satisfies the scienter requirement for aiding and abetting violations of Section 10(b) and Rule 10b-5.

Relying in large part upon *Levine v. Diamanthuset, Inc.*, 950 F.2d 1478, 1483-85 (9th Cir. 1991), the Tenth Circuit in this case held that recklessness satisfies the scienter requirement even though the alleged aider and abettor has not breached a duty to disclose or act, if that person has taken "affirmative action" that assists the primary violation of these provisions. 969 F.2d at 902-03. However, the Tenth Circuit's holding conflicts with decisions in the Second, Fourth, and Eighth Circuits which have held that recklessness does not establish scienter unless the alleged aider and abettor also breached a duty. *Ross v. Bolton*, 904 F.2d 819, 824 (2d Cir. 1990); *Schatz v. Rosenberg*, 943 F.2d 485, 496 (4th Cir. 1991), *cert. denied*, 112 S. Ct. 1475 (1992); *Camp v. Dema*, 948 F.2d 455, 462 (8th Cir. 1991).

Other courts of appeals use different tests. The Fifth and Eleventh Circuits have adopted a "sliding scale" approach under which the requisite degree of scienter varies depending upon whether the alleged aider and abettor breached a duty to disclose and upon the nature of the defendant's conduct. *Woodward v. Metro Bank*, 522 F.2d 84, 95-97 (5th Cir. 1975); *Woods v. Barnett Bank*, 765 F.2d 1004, 1009-11 (11th Cir. 1985).

The Seventh Circuit imposes the most restrictive test, requiring, at a minimum, that the alleged aider and abettor (1) commit a "manipulative or deceptive" act which Section 10(b) and Rule 10b-5 prohibit and (2) satisfy the same scienter requirement necessary for primary liability. *Robin v. Arthur Young & Co.*, 915 F.2d 1120, 1123 (7th Cir. 1990), *cert. denied*, 499 U.S. 923 (1991). On the issue of scienter, this case enables the Court to reconcile these conflicting views.

The standard used to establish scienter can be critical in determining civil liability for aiding and abetting. As a general rule, a recklessness standard is easier for a plaintiff to prove than a conscious-intent standard.

Central contends that the operative language in Section 10(b) and Rule 10b-5 indicates that the provisions prohibit only conduct committed with actual knowledge of the securities fraud. Central also asserts that the recklessness standard creates uncertainty because it borders on negligence which, the Supreme Court has held, cannot establish scienter for a primary violation of Section 10(b) and Rule 10b-5. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976).

First Interstate and Naber argue that a recklessness standard operates to discourage deliberate ignorance, especially in cases in which the defendant has affirmatively acted to assist the primary violation. Moreover, because the victims of fraud could recover tort damages for reckless conduct when Congress enacted the Securities Exchange Act of 1934 and Congress designed the federal securities laws to offer more protection to investors, they argue that a recklessness standard for aiding and abetting liability advances Congressional intent.

If the Supreme Court determines that recklessness does not establish scienter for aiding and abetting liability, the Court need not reach the issue of whether recklessness would suffice to establish the requisite scienter for a primary violation under Section 10(b) or Rule 10b-5. On two previous occasions, the Court has reserved that question. *Aaron v. Securities & Exchange Comm'n*, 446 U.S. 680, 686 n.5 (1980); *Ernst & Ernst*, 425 U.S. at 194 n.12. If the Court holds that recklessness satisfies the scienter requirement for aiding and abetting liability, its holding may imply that recklessness would suffice to establish a primary violation.

PREVIEW OF UNITED STATES SUPREME COURT CASES
American Bar Association, 541 N. Fairbanks Court, Chicago, Illinois 60611-3314

1993–94 TERM

New Decisions — Page 115

ISSUE NO. 4
January 3, 1994

OF UNITED STATES SUPREME COURT CASES

Covering the Court's January calendar of cases, including...

Elder v. Holloway

Unlawful Arrest, Damages, and Technical Defenses

Since the Supreme Court's 1980 decision in *Payton v. New York*, a person cannot be arrested at home without a warrant unless police enter with consent or in hot pursuit. A person arrested in violation of this rule can sue for damages. In this case, police arrested Charles Elder after ordering him out of his home. Courts in some cases have held that this type of arrest also violates the *Payton* rule. Elder sued but lost because he did not raise these cases in the trial court. Now the Court is asked to decide if Elder's lapse bars recovery.

Farmer v. Brennan

Prisoner Assault and Prison Responsibility

Dee Farmer, a federal prisoner and also a pre-operative transsexual with a feminine appearance, was transferred for disciplinary reasons to a maximum security prison and placed in the prison's general male population. Within two weeks, Farmer was raped. Farmer then sued prison officials, claiming that they were deliberately indifferent to the obvious risk of sexual assault. Farmer lost because the lower courts found that the officials did not have actual knowledge of any danger to Farmer. Now the Court is asked to determine if deliberate indifference means disregarding an obvious risk or only a risk actually known.

United States v. Granderson

Punishing Probation Violations: 2 Months in Prison or 20?

A person whose probation is revoked for a drug offense must be given a sentence equal to one third of his of her original sentence. In this case, the Court will decide whether the term original sentence refers to the length of the initial probationary sentence or to the length of the prison sentence which could have been imposed in lieu of probation. For Ralph Stuart Granderson the answer means the difference between a two-month or a 20-month prison sentence.

A PUBLICATION OF THE AMERICAN BAR ASSOCIATION'S PUBLIC EDUCATION DIVISION

PREVIEW OF UNITED STATES SUPREME COURT CASES

PREVIEW OF UNITED STATES SUPREME COURT CASES for the 1993-94 term (ISSN: 0363-0048) is published September through May. It is a publication of the Public Education Division of the American Bar Association, with the cooperation of the Association of American Law Schools and the Newspaper Association of America Foundation. The views expressed herein have not been approved by the House of Delegates or the Board of Governors of the American Bar Association and, accordingly, should not be construed as representing the policy of the American Bar Association. Subscription price: $130 per term.

For subscription information, call (312) 988-5522 or 5729; editorial offices are located at 541 North Fairbanks Court, Chicago, IL 60611-3314; telephone (312) 988-5728.