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## NOTES

### Aiding and Abetting Securities Fraud

#### INTRODUCTION

Section 10(b) of the Securities Exchange Act of 1934 (1934 Act)<sup>1</sup> and Securities and Exchange Commission (SEC) Rule 10b-5<sup>2</sup> prohibit fraud in connection with the purchase or sale of securities.<sup>3</sup> The fraud

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

15 U.S.C. § 78j(b) (1988).

2. Rule 10b-5, promulgated by the SEC in accordance with its authority under § 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 of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5 (1991).

3. Section 10(b) is a catchall provision of the Securities Exchange Act of 1934, “but what it catches must be fraud.” *Chiarella v. United States*, 445 U.S. 222, 234-35 (1980).

which is actionable under Section 10(b) of the 1934 Act and SEC Rule 10b-5 is limited to: (a) manipulative practices which artificially affect securities markets in a way misleading to investors and (b) misrepresentations or omissions of material facts made in connection with the purchase or sale of securities.<sup>4</sup>

The securities laws do not provide a private civil remedy for violation of section 10(b). An implied private right of action for damages under Section 10(b) and Rule 10b-5 was first recognized in 1946 by a federal district court,<sup>5</sup> and its existence has been described by the United States Supreme Court as "well established"<sup>6</sup> and "simply beyond peradventure."<sup>7</sup> The Court found that a private remedy under Section 10(b) and Rule 10b-5 had received overwhelming support in the lower federal courts, was a needed supplement to SEC enforcement of the anti-fraud rules, and was consistent with ensuring that Congress' broad remedial purposes in enacting the 1934 Act were fulfilled.<sup>8</sup>

Although the Court's policy in shaping the private action under Section 10(b) and Rule 10b-5 has been to construe these provisions "not technically and restrictively, but flexibly to effectuate [their] remedial purposes,"<sup>9</sup> the Court has, in the Section 10(b) private action context, begun to prune<sup>10</sup> this "judicial oak grown from a legislative acorn."<sup>11</sup>

4. *Sante Fe Indus., Inc. v. Green*, 430 U.S. 462, 474-77 (1977).

5. *Kardon v. National Gypsum Co.*, 69 F. Supp. 512 (E.D. Pa. 1946). The court predicated its finding of an implied private right of action on the tort law maxim, *ubi jus ibi remedium*, i.e., where there is a right, there is a remedy. *Id.* at 513.

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

7. *Herman & MacLean v. Huddleston*, 459 U.S. 375, 380 (1983).

8. See, e.g., *Basic Inc. v. Levinson*, 485 U.S. 224, 231 (1988) (private action under § 10(b) and Rule 10b-5 "constitutes an essential tool for enforcement of the 1934 Act's requirements"); *Herman & MacLean*, 459 U.S. at 380 & n.10 (private remedy has been consistently recognized for over 35 years); *Sante Fe Indus.*, 430 U.S. at 477-78 (recognizing private action fulfills the fundamental purpose of the 1934 Act which is a philosophy of full and fair disclosure in securities transactions); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 730 (1975) (private enforcement provides a necessary supplement to SEC action).

9. *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 151 (1972).

10. See Alan R. Bromberg & Lewis D. Lowenfels, *Aiding and Abetting Securities Fraud: A Critical Examination*, 52 ALB. L. REV. 637 (1988). The authors divide the Supreme Court's decisions construing the federal securities laws (the Securities Act of 1933, 15 U.S.C. § 77a (1988), and the Securities Exchange Act of 1934, 15 U.S.C. § 78a (1988)) into an "Expansion Era," lasting until about 1974 and a "Contraction Era," which began about 1975. Bromberg & Lowenfels, *supra*, at 648 nn.63-64. In the Contraction Era, the Court refused to recognize new implied rights of action, restricted old implied rights of action, criticized all implied rights of action, and cut back on the SEC's enforcement powers. *Id.* at 648 n.64.

11. *Blue Chip Stamps*, 421 U.S. at 737 ("When we deal with private actions under Rule 10b-5, we deal with a judicial oak which has grown from little more than a legislative

This Note focuses on another judicially-created branch of Section 10(b) — aiding and abetting liability under Section 10(b) and Rule 10b-5. A cause of action for aiding and abetting Section 10(b) securities fraud (both private actions and SEC enforcement actions) has been implied by all of the federal circuit courts of appeals that considered the issue.<sup>12</sup> The Supreme Court has yet to decide whether aiding and abetting is a valid basis for liability under Section 10(b) and Rule 10b-5 and has twice reserved decision on this issue.<sup>13</sup> This Note focuses on

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acorn.”). The basic elements of a private action under § 10(b) and Rule 10b-5 are: (1) plaintiff is an actual seller or purchaser of the securities; and (2) defendant made a misstatement or omission; (3) of a material fact; (4) with scienter, i.e., an intent to deceive, manipulate, or defraud; (5) on which the plaintiff relied; and (6) that proximately caused his injury. *See, e.g.,* Schlifke v. Seafirst Corp., 866 F.2d 935, 943 (7th Cir. 1989); Shivangi v. Dean Witter Reynolds, Inc., 825 F.2d 885, 888 n.6 (5th Cir. 1987); Bloor v. Carro, Spanbock, Londin, Rodman & Fass, 754 F.2d 57, 61 (2nd Cir. 1985); Hartman v. Blinder, 687 F. Supp. 938, 941 (D.N.J. 1987). *See also Basic Inc.*, 485 U.S. at 231-32 (materiality requires “substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information made available,” and proof of reliance is essential to a § 10(b) action); Chiarella v. United States, 445 U.S. 222 (1980) (omissions without a duty to disclose are not actionable); Sante Fe Indus., Inc. v. Green, 430 U.S. 462 (1977) (holding that § 10(b) fraud is limited to misstatements and omissions of material facts and manipulations of securities markets); Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976) (requisite scienter is intent to deceive, manipulate or defraud; rejecting negligence as basis for liability); *Blue Chip Stamps*, 421 U.S. at 723 (persons who would have purchased or sold securities had the defendant not misrepresented the attractiveness of the investment do not have standing under § 10(b)); *Affiliated Ute Citizens*, 406 U.S. at 153 (positive proof of reliance not required where case involves primarily a failure to disclose); Superintendent of Ins. v. Bankers Life & Casualty Co., 404 U.S. 6, 12-13 (1971) (defendant’s misstatement or omission must touch the plaintiff’s decision as an investor to purchase or sell the securities in order to meet the “in connection with” requirement).

12. *See* Robin v. Arthur Young & Co., 915 F.2d 1120 (7th Cir. 1990), *cert. denied*, 111 S. Ct. 1317 (1991); Zoelsch v. Arthur Andersen & Co., 824 F.2d 27 (D.C. Cir. 1987); Moore v. Fenex, Inc., 809 F.2d 297 (6th Cir. 1987), *cert. denied*, 483 U.S. 1006 (1987); Woods v. Barnett Bank, 765 F.2d 1004 (11th Cir. 1985); Cleary v. Perfectune, Inc., 700 F.2d 774 (1st Cir. 1983); Harmsen v. Smith, 693 F.2d 932 (9th Cir. 1982), *cert. denied*, 464 U.S. 822 (1983); Stokes v. Lokken, 644 F.2d 779 (8th Cir. 1981); IIT v. Cornfeld, 619 F.2d 909 (2d Cir. 1980); Monsen v. Consolidated Dressed Beef Co., 579 F.2d 793 (3d Cir. 1978), *cert. denied*, 439 U.S. 930 (1978); Woodward v. Metro Bank, 522 F.2d 84 (5th Cir. 1975); SEC v. Coffey, 493 F.2d 1304 (6th Cir. 1974), *cert. denied*, 420 U.S. 908 (1975); Zabriskie v. Lewis, 507 F.2d 546 (10th Cir. 1974); Brennan v. Midwestern United Life Ins. Co., 417 F.2d 147 (7th Cir. 1969), *cert. denied*, 397 U.S. 989 (1970). This Note focuses on the implied private right of action for aiding and abetting liability, rather than the SEC’s use of an aiding and abetting liability theory in enforcement actions. For separate treatment of the SEC enforcement action, see Bromberg & Lowenfels, *supra* note 10, at 752-70.

13. Herman & MacLean v. Huddleston, 459 U.S. 375, 379 n.5 (1983); *Ernst & Ernst*, 425 U.S. at 191 n.7.



a comparison of the approach used in the Seventh Circuit Court of Appeals and in the other circuits regarding aiding and abetting liability. The Note suggests that the Seventh Circuit's framework for analyzing liability better reflects the Supreme Court's "Contraction Era philosophy"<sup>14</sup> for Section 10(b) and Rule 10b-5 securities fraud.

Part I of this Note examines the theory of aiding and abetting Section 10(b) and Rule 10b-5 securities fraud, including the borrowed concepts from tort and criminal law which support a recognition of this theory. Next, this Note focuses on the Seventh Circuit's different approach to this theory of liability, and includes a discussion of the courts' conceptual distinctions between primary liability and aiding and abetting liability and the substantive tests for aiding and abetting liability. Finally, this Note compares the Seventh Circuit's position with the other circuits' positions regarding the required mental state and the duty of disclosure in the aiding and abetting context.

## I. THE THEORY OF AIDING AND ABETTING LIABILITY

Aiding and abetting is a form of secondary liability under federal securities law.<sup>15</sup> Secondary liability is broadly described as "the judicially implied civil liability which has been imposed on defendants who have not themselves been held to have violated the express prohibition of the securities statute at issue, but who have some relationship with the primary wrongdoer."<sup>16</sup> Secondary liability is a hybrid theory based upon tort and criminal law concepts.

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14. The term, "Contraction Era," is used in Bromberg & Lowenfels, *supra* note 10, at 648 n.64.

15. The federal securities laws include the Securities Act of 1933, 15 U.S.C. § 77a (1988) and the Securities Exchange Act of 1934, 15 U.S.C. § 78a (1988). This Note focuses on aiding and abetting liability under § 10(b) of the 1934 Act. Courts have implied an action for aiding and abetting liability under other sections of the securities laws, for example, § 12(2) of the 1933 Act, 15 U.S.C. § 77i(2) (1988), and § 17(a) of the 1934 Act, 15 U.S.C. § 78q(a) (1988). See Daniel R. Fischel, *Secondary Liability Under Section 10(b) of the Securities Act of 1934*, 69 CALIF. L. REV. 80, 109-11 (1981).

16. Fischel, *supra* note 15, at 80 n.4. Other forms of secondary liability imposed by courts are conspiracy liability and respondeat superior liability. *Id.* at 85-87. See also Bromberg & Lowenfels, *supra* note 10, at 639-40 nn.8 & 10. A form of secondary liability expressly provided for in the 1933 and 1934 Acts is control person liability. Section 15 of the 1933 Act states:

Every person who . . . controls any person liable under [the express liability provisions of §§ 11 and 12] shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person had no knowledge of or reasonable ground to believe in the existence of the facts by reason of which

### A. *Genesis in Tort Law and Criminal Law*

1. *Tort Law Antecedent*.—Like the 1946 decision in *Kardon v. National Gypsum Co.*,<sup>17</sup> where the court turned to tort law principles in implying a private remedy under § 10(b) and Rule 10b-5, early court decisions recognizing liability for aiding and abetting a Section 10(b) violation relied on tort law principles, primarily the *Restatement of Torts* section 876(b).<sup>18</sup> Section 876(b) provides:

For harm resulting to a third person from the tortious conduct of another, one is subject to liability if he (a) does a tortious act in concert with the other or pursuant to a common design with him, or (b) knows that the other's conduct constitutes a breach of duty and gives substantial assistance or encouragement to the other so to conduct himself, or (c) gives substantial assistance or encouragement to the other in accomplishing a tortious result and his own conduct, separately considered, constitutes a breach of duty to the third person.<sup>19</sup>

The first major decision to explicitly turn to the tort law principles set forth in Section 876(b) for imposing Section 10(b) aiding and abetting liability was *Brennan v. Midwestern United Life Insurance Co.*<sup>20</sup> The *Brennan* case, an influential decision,<sup>21</sup> helps demonstrate the tort basis for aiding and abetting liability. The *Brennan* court found the defendant life insurance company, Midwestern, civilly liable as an aider and abettor of a violation of Section 10(b) by a brokerage firm, Dobich Securities Corporation.<sup>22</sup>

the liability of the controlled person is alleged to exist.

15 U.S.C. § 77o (1988). Section 20(a) of the 1934 Act states:

Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.

*Id.* § 78t(a).

17. 69 F. Supp. 512 (E.D. Pa. 1946). *See supra* note 5.

18. *See, e.g.*, *Landy v. FDIC*, 486 F.2d 139 (3rd Cir. 1973), *cert. denied*, 416 U.S. 960 (1974); *Brennan v. Midwestern United Life Ins. Co.*, 259 F. Supp 673 (N.D. Ind. 1966).

19. RESTATEMENT (SECOND) OF TORTS § 876 (1977).

20. 286 F. Supp. 702 (N.D. Ind. 1968), *aff'd*, 417 F.2d 147 (7th Cir. 1969), *cert. denied*, 397 U.S. 989 (1970).

21. *See* David S. Ruder, *Multiple Defendants in Securities Law Fraud Cases: Aiding and Abetting, Conspiracy, In Pari Delicto, Indemnification and Contribution*, 120 U. PA. L. REV. 597 (1972) (calling *Brennan* "to date the most important securities law case dealing with secondary liability").

22. *Brennan*, 286 F. Supp. at 702.

Dobich created an artificially-high market price for Midwestern stock through a short-selling scheme<sup>23</sup> involving a significant percentage of the total shares sold of Midwestern stock.<sup>24</sup> Instead of covering all of his short sales, Dobich used his customers' purchase funds for his own capital needs, concealing his scheme by abnormally delaying deliveries to his customers of their Midwestern stock and lying to them about the reasons for the late deliveries. Dobich's scheme finally collapsed, leaving \$2,900,000 worth of purchased Midwestern stock undelivered. The trial court found Midwestern liable as an aider and abettor to a class of plaintiffs who purchased, but never received, Midwestern stock from Dobich.<sup>25</sup>

The Seventh Circuit affirmed, holding that Midwestern aided and abetted securities fraud through knowing and purposeful encouragement and assistance to Dobich's continued market manipulation of Midwestern's stock.<sup>26</sup> Midwestern knew that Dobich improperly used customer funds, failed to report Dobich to the Indiana Securities Commission, and affirmatively signaled Dobich that it would not report Dobich's unusual activity to the Commission if Dobich would deliver purchased stock to the customers who complained to Midwestern about late delivery.<sup>27</sup> Further, Midwestern benefited from Dobich's manipulative active trading because the increased stock price put Midwestern in a favorable position for a pending stock-exchange merger.<sup>28</sup> The court concluded

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23. A short-sale is "[a] contract for sale of shares of stock which the seller does not own, or certificates for which are not within his control, so as to be available for delivery at the time when, under rules of the exchange, delivery must be made." BLACK'S LAW DICTIONARY 1237 (5th ed. 1979). Short sales are not illegal but, in *Brennan*, they were part of a manipulative scheme because Dobich was not covering (buying and delivering) his short sales.

24. In a 14-month period, from May 1964 to July 1965, Dobich brokered about 21% of the total shares presented by all brokers to Midwestern for transfer on its books. *Brennan*, 417 F.2d at 151.

25. *Brennan v. Midwestern United Life Ins. Co.*, 286 F. Supp. 702, 728 (N.D. Ind. 1968), *aff'd*, 417 F.2d 147 (7th Cir. 1969), *cert. denied*, 397 U.S. 989 (1970).

26. *Brennan*, 417 F.2d at 154.

27. After Midwestern received several complaints of late deliveries of Midwestern stock from Dobich customers, Midwestern informed Dobich that it suspected Dobich of misusing customer funds and threatened to refer the matter to the Indiana Securities Commission should further complaints be made. Midwestern did not follow-up on its threat, but instead began advising complaining Dobich customers by letter to contact Dobich and to then contact the Indiana Securities Commission if Dobich did not deliver their stock or give a satisfactory explanation for late delivery. Midwestern sent Dobich copies of these letters. The court interpreted these letters as a signal to Dobich that if deliveries were made to the customers who made complaints, Midwestern would not involve regulatory authorities, who would have uncovered Dobich's scheme, putting an end to the propped-up Midwestern stock price. *Id.* at 150-54.

28. *Id.* at 151-54. The exchange ratio, one share of Midwestern stock for ten shares of the merger company's stock, was based primarily on market price. *Id.* at 151-52.



that Midwestern's actions "amounted to a tacit agreement with Dobich to prevent complaints from reaching the Commission, thus facilitating the fraud and allowing Dobich's scheme to continue to Midwestern's benefit."<sup>29</sup>

A tort law approach, which considers an actor's knowledge of another's wrongful acts and the actor's assistance or encouragement of those acts, is manifested in the majority approach among the circuits for Section 10(b) and Rule 10b-5 aiding and abetting liability.<sup>30</sup>

2. *Criminal Law Antecedent.*—Courts also borrow a criminal law theory of aiding and abetting for imposing Section 10(b) and Rule 10b-5 aiding and abetting liability.<sup>31</sup> In the criminal law context, a defendant aids and abets another's criminal act if the defendant "in some sort associate[s] himself with the venture, . . . participate[s] in it as something he wishes to bring about, [and] seek[s] by his action to make it succeed."<sup>32</sup> Criminal aiding and abetting focuses on an actor's *intent* to participate in and further another's wrongful acts.

Although it might appear that the criminal law analog of aiding and abetting is more severe than the tort law analog, courts have not suggested such a distinction in securities fraud cases. For example, in *IIT v. Cornfeld*,<sup>33</sup> the Second Circuit described aiding and abetting securities fraud liability using criminal law concepts, but analyzed the defendants' liability using the conventional tort law knowledge/assistance model.<sup>34</sup>

3. *Significance of Distinction Between Tort Law and Criminal Law Antecedent.*—In general, there is not an overriding significant difference in Section 10(b) and Rule 10b-5 aiding and abetting liability decisions depending on whether a tort law or criminal law antecedent is espoused. In fact, courts sometimes acknowledge both tort and criminal law bases of aiding and abetting.<sup>35</sup> It is, however, interesting that the Seventh Circuit, which no longer analyzes Section 10(b) and Rule 10b-5 aiding and abetting liability based on the *Brennan* tort law knowledge and substantial assistance model, describes the aiding and abetting securities

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29. *Id.* at 155.

30. *See infra* notes 66, 67.

31. *See* *Zoelsch v. Arthur Andersen & Co.*, 824 F.2d 27 (D.C. Cir. 1987); *SEC v. Timetrust, Inc.*, 28 F. Supp. 34 (N.D. Cal. 1939).

32. *Zoelsch*, 824 F.2d at 36 (quoting *Nye & Nissen v. United States*, 366 U.S. 613, 619 (1949)).

33. 619 F.2d 909 (2d Cir. 1980).

34. *Id.* at 922.

35. *See, e.g.*, *Admiralty Fund v. Hugh Johnson & Co.*, 677 F.2d 1301, 1311 (9th Cir. 1982); *SEC v. Coffey*, 493 F.2d 1304, 1315-16 (6th Cir. 1974), *cert. denied*, 420 U.S. 908 (1975).

fraud rubric as an example of judicially-creative borrowing of criminal law concepts.<sup>36</sup>

Further, the Supreme Court has cautioned that reliance on tort law principles for implying private rights of action under the securities laws is misplaced.<sup>37</sup> Whether a private right of action exists must be based on statutory construction and an analysis of congressional intent.<sup>38</sup> Reliance on criminal law concepts to imply private rights of action is therefore similarly misplaced.<sup>39</sup>

The misplaced reliance on tort and criminal law antecedents in fashioning Section 10(b) and Rule 10b-5 aiding and abetting liability prompted commentators to question the continued viability of this theory, particularly given the Supreme Court's narrowing of the scope of the federal securities laws.<sup>40</sup> The Seventh and Ninth Circuits, as well as some federal district courts, have also questioned the status of this theory.<sup>41</sup> To date, no circuit court has decided to do away with aiding and abetting securities fraud liability. Moreover, it is likely that courts will continue to recognize this theory until the Supreme Court says differently. In fact, the Seventh Circuit, although questioning the continued propriety of implying this cause of action, stated that "[o]ur recognition of aider

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36. *Latigo Ventures v. Laventhol & Horwath*, 876 F.2d 1322, 1327 (7th Cir. 1989).

37. *Touche Ross & Co. v. Redington*, 442 U.S. 560 (1979). The Court rejected an argument implying a private right of action under § 17(a) of the 1934 Act, 15 U.S.C. § 78q(a) (1988), which was based upon tort law principles, as "entirely misplaced." *Touche Ross*, 442 U.S. at 568.

38. *Touche Ross*, 442 U.S. at 568.

39. Criminal law may, however, support continued use in SEC enforcement actions of aiding and abetting liability if the SEC is permitted to rely on the general federal criminal aiding and abetting statute. 18 U.S.C. § 2(a) (1988). This statute provides that aiders and abettors of an offense against the United States are punishable as principals. *Id.* The early case of *SEC v. Timetrust, Inc.*, 28 F. Supp. 34, 43 (N.D. Calif. 1939), relied on such a criminal statute in upholding an SEC injunction complaint against alleged aiders and abettors of § 17(a), a provision which is similar to § 10(b) and Rule 10b-5.

40. See *Bromberg & Lowenfels*, *supra* note 10, at 639-61; *Fischel*, *supra* note 15, at 89-94.

41. See *Congregation of the Passion, Holy Cross Province v. Kidder Peabody & Co.*, 800 F.2d 177, 183 (7th Cir. 1986) ("[T]here is some ambiguity about the existence of a civil cause of action for aiding and abetting a section 10(b) and Rule 10b-5 violation."); *Little v. Valley Nat'l Bank*, 650 F.2d 218, 220 n.3 (9th Cir. 1981) ("The status of aiding and abetting as a basis for liability under the securities laws is in some doubt."); *Seattle-First Nat'l Bank v. Carlstedt*, 101 F.R.D. 715, 722-23 (W.D. Okla. 1984) ("The notion that aiding and abetting securities fraud constitutes a justiciable violation of law is itself a questionable assertion."), *rev'd*, 800 F.2d 1008 (10th Cir. 1986); *Benoay v. Decker*, 517 F. Supp. 490, 495 (E.D. Mich. 1981), *aff'd mem.*, 735 F.2d 1363 (6th Cir. 1984) ("It is . . . doubtful that a claim for 'aiding and abetting' . . . will continue to exist under 10(b).").



and abettor liability is rooted in 20+ years' precedent . . . and we stand by this decision until the Supreme Court tells us otherwise."<sup>42</sup>

The implicit demand for guidance from the Supreme Court may serve to prompt the Court to address directly the propriety of Section 10(b) and Rule 10b-5 aiding and abetting liability.<sup>43</sup> Other factors also indicate that this theory of liability is "ripe" for adjudication by the Supreme Court. The theory has had time to develop in the lower federal courts,<sup>44</sup> has received critical examination by commentators,<sup>45</sup> and a split has emerged between the Seventh Circuit and the other circuits regarding the proper analytical framework for aiding and abetting securities fraud liability. The Seventh Circuit's split from the other circuits emerges in the courts' conceptual distinctions between primary liability and aiding and abetting liability.

### *B. Conceptual Distinction Between Primary Liability and Aiding and Abetting (Secondary) Liability*

Aiding and abetting is the most widely used theory for holding persons not in privity with the deceived buyer or seller of securities liable for Section 10(b) and Rule 10b-5 securities fraud.<sup>46</sup> A closer look at the conceptual distinctions between primary liability and aiding and abetting liability under these antifraud provisions reveals distinguishing features of the Seventh Circuit's approach. The following discussion first examines the conceptual distinctions advanced by courts other than the Seventh Circuit, and second, examines those advanced by the Seventh Circuit.

1. *Courts Other Than the Seventh Circuit.*—Several courts use a direct participant/indirect participant duality to explain the difference between primary and aiding and abetting (secondary) liability. *Smith v. Ayres*<sup>47</sup> illustrates this distinction. In *Smith*, a shareholder in a family-owned, close corporation brought a derivative action alleging that the corporation had been fraudulently induced to issue shares to an individual, Clayton. In issuing the shares, the board of directors relied on

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42. *Robin v. Arthur Young & Co.*, 915 F.2d 1120, 1123 (7th Cir. 1990).

43. The Court twice reserved decision on this issue. *Herman & MacLean v. Huddleston*, 459 U.S. 375, 379 n.5 (1983); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 191 n.7 (1976).

44. In 1969, the Seventh Circuit decided *Brennan v. Midwestern United Life Ins. Co.*, 417 F.2d 147 (7th Cir. 1969), the first circuit court decision recognizing § 10(b) and Rule 10b-5 aiding and abetting liability.

45. See Bromberg & Lowenfels, *supra* note 10; Fischel, *supra* note 15; Ruder, *supra* note 21.

46. Bromberg & Lowenfels, *supra* note 10, at 639.

47. 845 F.2d 1360 (5th Cir. 1988).

a letter that was presented to the board, but contained misrepresentations.<sup>48</sup> The court decided that Clayton could not be a primary violator of Section 10(b) and Rule 10b-5 because the complaint did not show that Clayton had been a direct participant in the alleged fraud against the corporation.<sup>49</sup> Direct participation was lacking because the complaint did not sufficiently allege that Clayton assisted in the preparation of the letter or its presentation to the board.<sup>50</sup> The court also ruled the complaint insufficient as to indirect participation, i.e., aiding and abetting.<sup>51</sup> Similarly, the Ninth Circuit used a direct participation label to distinguish primary liability from aiding and abetting liability.<sup>52</sup>

The Sixth Circuit used a direct contacts characterization to differentiate between a primary violation and an aiding and abetting violation of Section 10(b) and Rule 10b-5 in *SEC v. Coffey*.<sup>53</sup> In *Coffey*, a company sold \$5,000,000 worth of its notes to the State of Ohio. The SEC alleged that misrepresentations had been made to the state and a rating agency in connection with the state's purchase of the company's notes.<sup>54</sup> In deciding if the company treasurer could be primarily liable under Section 10(b) and Rule 10b-5, the court looked to whether the treasurer had direct contacts with the parties who were misled.<sup>55</sup> The Sixth Circuit explained in a later case that a person meets the direct contacts criteria, which gives rise to primary liability, when that person "undertak[es] to furnish information which is misleading because of a failure to disclose a material fact."<sup>56</sup>

A slightly different conceptual distinction between primary and aiding and abetting liability was suggested in *DMI Furniture, Inc. v. Brown*,

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48. Upon the issuance of the shares, effective control of the corporation shifted away from the complainant shareholder who alleged that the fraudulent plan to issue the shares allowed corporate assets to be diverted for improper purposes.

49. *Smith*, 845 F.2d at 1365.

50. *Id.*

51. *Id.*

52. *See Admiralty Fund v. Hugh Johnson & Co.*, 677 F.2d 1301, 1312 (9th Cir. 1982) ("An accountant may be liable for direct violation of [Rule 10b-5] if its participation in the misrepresentation is direct.").

53. 493 F.2d 1304 (6th Cir. 1974), *cert. denied*, 420 U.S. 908 (1975).

54. In order to qualify to sell its notes to the state, the company obtained a "prime" rating for its commercial paper from the rating agency. *Id.* at 1308.

55. *Id.* at 1315.

56. *SEC v. Washington County Util. Dist.*, 676 F.2d 218, 223 (6th Cir. 1982). *See also Mercer v. Jaffee, Snider, Raitt & Heuer*, 713 F. Supp. 1019, 1025 (W.D. Mich. 1989) ("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.").

*Kraft & Co.*<sup>57</sup> According to the *DMI* court, the imposition of primary liability is limited to the actual buyer and seller of securities, and

defendants who had acted in capacities in which their liability was expressly prescribed by specific statutory provisions, or in which their allegedly violative acts were done in the performance of a role which is understood and contemplated to be an integral part of the statutory scheme adopted by Congress for the protection of investors.<sup>58</sup>

The direct participation and direct contacts distinctions used by the circuit courts seem to be based on the nearness of the relationship between the defendant's acts and the plaintiff's injury, a kind of proximity analysis. In contrast, the Seventh Circuit's conceptual distinction is more like the *DMI* formulation.

2. *The Seventh Circuit.*—The Seventh Circuit's conceptual distinction between primary liability and aiding and abetting liability is like the *DMI* formulation to the extent that primary liability is limited to persons who acted in capacities in which their liability is expressly prescribed by provisions of the 1933 and 1934 Acts. The Seventh Circuit determined that a natural reading of Section 10(b) and Rule 10b-5 is that these provisions apply only to the same people otherwise covered by the 1933 and 1934 Acts.<sup>59</sup> Thus, the antifraud provisions are directed at: (a) an issuer of securities, members of the issuer's board of directors, and those who sign a prospectus or are named as preparing the prospectus;<sup>60</sup> (b) persons who offer or sell the securities;<sup>61</sup> and (c) persons who control the persons described in (a) and (b).<sup>62</sup> Aiding and abetting liability is

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57. 644 F. Supp. 1517 (C.D. Cal. 1986).

58. *Id.* at 1519 (footnotes omitted). The difficulty in expressing a wholly workable conceptual distinction contributes to dissatisfaction with the aiding and abetting cause of action. See Cheryl L. Pollak, *Rule 10b-5 Liability After Hochfelder: Abandoning the Concept of Aiding and Abetting*, 45 U. CHI. L. REV. 218, 219-20 (1977).

59. *Barker v. Henderson*, Franklin, Starnes & Holt, 797 F.2d 490, 494-95 (7th Cir. 1986).

60. Section 11 of the 1933 Act imposes liability when securities are sold using false or misleading documents on the issuer, members of the issuer's board of directors, persons who sign the prospectus or who are named as preparers of the prospectus, and underwriters. 15 U.S.C. § 77k (1988).

61. Section 12 of the 1933 Act imposes liability on persons who offer or sell securities which have not been properly registered or persons who offer or sell securities using false or misleading documents. *Id.* § 77l.

62. Section 15 of the 1933 Act imposes liability on persons who control other persons liable under §§ 11 and 12. *Id.* § 77o There is a parallel provision in § 20(a) of the Securities Exchange Act of 1934. *Id.* § 78t(a). "Control" under these statutes means "the practical ability to *direct* the actions of the people who issue or sell the securities." *Barker*, 797 F.2d at 494.



a proper theory for persons whose Section 10(b) liability is not predicated on acts expressly prescribed by specific statutory provisions, and who are not otherwise control persons of those primarily liable.<sup>63</sup>

Thus, the Seventh Circuit distinguishes primary and aiding and abetting liability based on the role played by the defendant within the securities laws statutory scheme. This contrasts with the other circuits which distinguish primary from secondary liability based chiefly on the role the defendant played in the primary violator's fraudulent scheme.

## II. ELEMENTS OF AIDING AND ABETTING LIABILITY

In light of its distinctive view on the difference between primary and secondary liability, the Seventh Circuit devised a different test for imposing Section 10(b) and Rule 10b-5 aiding and abetting liability.

### A. *The Seventh Circuit Test*

In the Seventh Circuit, a person is liable as an aider and abettor of a Section 10(b) and Rule 10b-5 violation, if the plaintiff shows:

- (1) someone committed a primary violation;
- (2) in aiding this violation, the alleged aider and abettor *committed* one of the manipulative or deceptive acts proscribed by Section 10(b) and Rule 10b-5; and
- (3) did so with the same degree of scienter that is required for primary liability.<sup>64</sup>

Before discussing the Seventh Circuit's development of its test, it is useful to first display the different test used by the other circuits.

### B. *The Other Circuits*

There are two basic formulations of the test for aider and abettor liability used in the other circuits.<sup>65</sup> One version of the test, articulated

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63. *Barker*, 797 F.2d at 495.

64. See *Robin v. Arthur Young & Co.*, 915 F.2d 1120, 1123 (7th Cir. 1990), *cert. denied*, 111 S. Ct. 1317 (1991); *DiLeo v. Ernst & Young*, 901 F.2d 624, 628 (7th Cir.), *cert. denied*, 111 S. Ct. 347 (1990); *Schlifke v. Seafirst Corp.*, 866 F.2d 935, 947 (7th Cir. 1989); *LHLC Corp. v. Cluett, Peabody & Co.*, 842 F.2d 928, 932 (7th Cir.), *cert. denied*, 488 U.S. 926 (1988); *Barker v. Henderson, Frankin, Starnes & Holt*, 797 F.2d 490, 495 (7th Cir. 1986). The Seventh Circuit also requires that the plaintiff show more than but-for causation between the act (or failure to act) of the alleged aider and abettor and the damages suffered by the plaintiff. See, e.g., *First Interstate Bank v. Chapman & Cutler*, 837 F.2d 775, 778-80 (7th Cir. 1988).

65. For a detailed analysis of the various tests for aiding and abetting liability, see Bromberg & Lowenfels, *supra* note 10, at 651-751.

by the First, Fifth, Sixth and Eleventh circuits, requires the plaintiff to show:

- (1) someone committed a securities law violation;
- (2) the alleged aider and abettor had general awareness that his role was part of an overall improper activity; and
- (3) the alleged aider and abettor knowingly and substantially assisted the primary violation.<sup>66</sup>

The second basic version of the test, as articulated by the Second, Third, Eighth and Tenth circuits, requires:

- (1) commission of an underlying securities law violation;
- (2) knowledge of this violation on the part of the alleged aider and abettor; and
- (3) substantial assistance in the achievement of the primary violation.<sup>67</sup>

The first version seems to be a little more strict because of the greater knowledge requirement. The second version has been referred to as the majority rule.<sup>68</sup> This may be attributed to the great influence of the Seventh Circuit's *Brennan* decision, embodying the knowledge and substantial assistance model. The Seventh Circuit, because of the early *Brennan* decision, considers itself to be the home of aider and abettor liability.<sup>69</sup> With its new formulation of the test for Section 10(b) and Rule 10b-5 aiding and abetting liability, it has again distinguished itself among the circuits in this area of law.

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66. See *Bane v. Sigmundr Exploration Corp.*, 848 F.2d 579, 581 (5th Cir. 1988); *Moore v. Fenex, Inc.*, 809 F.2d 297, 303 (6th Cir.), *cert. denied*, 483 U.S. 1006 (1987); *Woods v. Barnett Bank*, 765 F.2d 1004, 1009 (11th Cir. 1985); *Cleary v. Perfectune, Inc.*, 700 F.2d 774, 777 (1st Cir. 1983); *Woodward v. Metro Bank*, 522 F.2d 84, 94-95 (5th Cir. 1975); *SEC v. Coffey*, 493 F.2d 1304, 1316 (6th Cir. 1974), *cert. denied*, 420 U.S. 908 (1975).

67. See *National Union Fire Ins. Co. v. Turtur*, 892 F.2d 199, 206-07 (2d Cir. 1989); *Walck v. American Stock Exchange, Inc.*, 687 F.2d 778, 791 (3rd Cir. 1982), *cert. denied*, 461 U.S. 942 (1983); *Stokes v. Lokken*, 644 F.2d 779, 782-83 (8th Cir. 1981); *Edward J. Mawod & Co. v. SEC*, 591 F.2d 588, 595-96 (10th Cir. 1979); *Rolf v. Blyth, Eastman Dillon & Co.*, 570 F.2d 38, 47-48 (2d Cir. 1978), *cert. denied*, 439 U.S. 1039 (1978); *Landy v. FDIC*, 486 F.2d 139, 162-63 (3rd Cir. 1973), *cert. denied*, 416 U.S. 960 (1974). Additionally, the Ninth Circuit's test for aiding and abetting liability is similar. See *Harmsen v. Smith*, 693 F.2d 932, 943 (9th Cir. 1982) (requiring the existence of an independent primary wrong, actual knowledge by the alleged aider and abettor of the wrong and of his or her role in furthering it, and substantial assistance in the wrong), *cert. denied*, 464 U.S. 822 (1983).

68. See *Bromberg & Lowenfels*, *supra* note 10, at 662.

69. See *DiLeo v. Ernst & Young*, 901 F.2d 624, 628 (7th Cir.), *cert. denied*, 111 S. Ct. 347 (1990).

## III. DEVELOPMENT OF THE SEVENTH CIRCUIT TEST

The basic outline of the Seventh Circuit's test, requiring that the alleged aider and abettor committed a manipulative or deceptive act with scienter, was first announced in *Barker v. Henderson, Franklin, Starnes & Holt*.<sup>70</sup> The court adopted these requirements out of a concern that the court should not undo, with implied causes of action, the defenses and presumptions crafted by Congress under the express civil remedies provisions of the securities laws.<sup>71</sup> The Seventh Circuit was guided by the Supreme Court's opinions in *Ernst & Ernst v. Hochfelder*<sup>72</sup> and *Herman & MacLean v. Huddleston*.<sup>73</sup>

*Ernst & Ernst* came to the Supreme Court on appeal from the Seventh Circuit.<sup>74</sup> The Seventh Circuit ruled that an accounting firm could be liable as an aider and abettor of a company's securities fraud because of its failure to carry out its statutory duty of inquiry and duty of care owed to investors in that company by *negligently* performing its audit of the company's books.<sup>75</sup> The Supreme Court reversed, holding that Congress intended liability under Section 10(b) to attach only when persons act with an intent to deceive, manipulate or defraud (scienter).<sup>76</sup> Based on the *Ernst & Ernst* holding, the Seventh Circuit required proof of scienter, i.e., an intent to deceive, manipulate or defraud,<sup>77</sup> as an

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70. 797 F.2d 490 (7th Cir. 1986). The Seventh Circuit acknowledged the three-part test used by the other circuits and referred to the elements of their test as *additional* requirements other courts have established for secondary liability. *Id.* at 496. The Seventh Circuit neither adopted the additional requirements nor, since *Barker*, analyzed an allegation of aiding and abetting under these "additional" requirements. *See Schlifke v. Seafirst Corp.*, 866 F.2d 935, 947 n.13 (7th Cir. 1989). Some district courts within the Seventh Circuit proceeded under the knowledge and substantial assistance model prior to *Barker*. *See, e.g., Delany v. Blunt, Ellis & Loewi*, 631 F. Supp. 175, 179 (N.D. Ill. 1986).

71. *Barker*, 797 F.2d at 495.

72. 425 U.S. 185 (1976).

73. 459 U.S. 375 (1983).

74. *Hochfelder v. Ernst & Ernst*, 503 F.2d 1100 (7th Cir. 1974), *rev'd*, 425 U.S. 185 (1976).

75. *Id.* at 1107.

76. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 214 (1976). The scienter requirement extends to Rule 10b-5 because the scope of the rule adopted by the SEC cannot exceed the power granted by Congress under § 10(b). *Id.*

77. The Seventh Circuit also permits a showing of severe recklessness to satisfy the scienter requirement, an issue which was left open in *Ernst & Ernst*. *Id.* at 193 n.12. *See Barker v. Henderson, Franklin, Starnes & Holt*, 797 F.2d 490, 495 (7th Cir. 1986). The degree of reckless conduct necessary to meet the scienter standard is that "involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and 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." *Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033, 1045 (7th Cir. 1977) (quoting *Franke v. Midwestern Oklahoma Dev. Auth.*, 428 F. Supp. 719, 725 (W.D. Okla. 1976), *cert. denied*, 434 U.S. 875 (1977)).



element of aiding and abetting liability.<sup>78</sup>

In *Herman & MacLean*, the Court held that a plaintiff having an express civil remedy under Section 11 of the 1933 Act was not prohibited from also alleging a violation of Section 10(b) against the same person for the same misrepresentations or omissions of material fact which gave rise to Section 11 liability.<sup>79</sup> Permitting the Section 10(b) claim in conjunction with the Section 11 claim would not nullify the "effectiveness of the carefully drawn procedural restrictions" for the express Section 11 action.<sup>80</sup> Because the plaintiff has a greater burden in proving a Section 10(b) violation since that claim requires proof of scienter, there is no danger that plaintiffs will use the implied private right of action under Section 10(b) to circumvent the carefully drawn presumptions of liability and defenses contained in the express remedy provisions of Section 11.<sup>81</sup>

The Seventh Circuit, by requiring proof that the defendant committed a manipulative or deceptive act, may be ensuring that plaintiffs will not use an aiding and abetting claim to circumvent the restrictions carefully drawn by the judiciary for primary violations of Section 10(b) and Rule 10b-5.<sup>82</sup>

#### IV. APPLYING THE TESTS OF AIDING AND ABETTING LIABILITY

The Seventh Circuit's different approach goes beyond the facts that it stands alone in its conceptual distinction between primary and aiding and abetting liability and in its test for aiding and abetting liability. The type of proof required to support aiding and abetting liability is different from, and in fact more onerous on the plaintiff, than that required in the other circuits. One reason for the difference is that the other circuits view the *Ernst & Ernst* scienter requirement as susceptible to a sliding scale of required culpability depending upon the alleged aider and abettor's level and type of participation in the primary violator's fraudulent activities.<sup>83</sup> Perhaps the greatest difference between the approach of the Seventh Circuit and the other circuits is the Seventh Circuit's requirement that the alleged aider and abettor have committed one of the manipulative or deceptive acts proscribed by Section 10(b)

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78. *Barker*, 797 F.2d at 495.

79. *Herman & MacLean v. Huddleston*, 459 U.S. 375, 387 (1983).

80. *Id.* at 384.

81. *Id.*

82. See *Barker v. Henderson, Franklin, Starnes & Holt*, 797 F.2d 490, 495 (7th Cir. 1986).

83. See *infra* notes 102-16 and accompanying text.

and Rule 10b-5.<sup>84</sup> The existence of this element in the Seventh Circuit's test suggests that its theory of aiding and abetting liability is not truly a secondary liability theory at all.<sup>85</sup>

A review of Section 10(b) and Rule 10b-5 aiding and abetting liability case law illustrates the Seventh Circuit's different approach. The following discussion presents a comparison of the Seventh Circuit's analysis of scienter to the sliding-scale scienter approach and a review of the duty of disclosure. The existence of a duty of disclosure is an extremely important factor in Section 10(b) and Rule 10b-5 aiding and abetting liability cases because quite often the sole or most prominent source of the alleged aider and abettor's liability is a failure to disclose the primary violator's fraudulent acts to the injured plaintiff.

### A. *The Scienter Requirement*

The Supreme Court has held that no one is liable under Section 10(b) or Rule 10b-5 unless he acts with the requisite scienter, *i.e.*, an intent to deceive, manipulate, or defraud.<sup>86</sup> The Court left open whether reckless conduct could be the equivalent of intentional conduct for purposes of civil liability under Section 10(b) and Rule 10b-5.<sup>87</sup> The lower federal courts have determined that a severe form of reckless conduct satisfies the scienter requirement.<sup>88</sup>

1. *Scienter in the Seventh Circuit.*—The Seventh Circuit has made it clear that the same level of scienter required for primary liability is required for aiding and abetting liability.<sup>89</sup> An alleged aider and abettor must have acted (or failed to act) in a reckless manner (the kind of reckless conduct that is equivalent to willful fraud) or with a specific intent to deceive, manipulate, or defraud.<sup>90</sup>

In several recent cases, plaintiffs have brought aiding and abetting claims against attorneys and accountants based on a failure to reveal

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84. See *supra* text accompanying note 64.

85. Fischel argues that aiding and abetting should no longer be recognized as a valid theory of liability because "peripheral defendants in securities cases can be liable only if they engage in a 'manipulative or deceptive' practice within the meaning of section 10(b)." Fischel, *supra* note 15, at 83.

86. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976). The scienter requirement also applies to SEC enforcement actions brought under § 10(b) and Rule 10b-5. *Dirks v. SEC*, 463 U.S. 646 (1983).

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

88. See, e.g., *Sundstrand Corp. v. Sun Chemical Corp.*, 553 F.2d 1033, 1045 (7th Cir. 1977).

89. See, e.g., *DiLeo v. Ernst & Young*, 901 F.2d 624, 628 (7th Cir.), *cert. denied*, 111 S. Ct. 347 (1990).

90. *Sundstrand Corp.*, 553 F.2d at 1044 n.16, 1045.

false and misleading statements made by issuers of securities.<sup>91</sup> Apart from the question of whether attorneys or accountants have a duty to disclose knowledge of the issuers' false statements,<sup>92</sup> the claims failed because the plaintiffs did not sufficiently allege scienter. In securities fraud cases, the Seventh Circuit strictly enforces Federal Rule of Civil Procedure 9(b), which requires that circumstances constituting fraud be pleaded with particularity.<sup>93</sup> Strict application of the scienter requirement and strict enforcement of Rule 9(b) has proved too much recently for plaintiffs alleging aiding and abetting liability.

The Seventh Circuit requires that, in the absence of direct evidence that the defendant knew that the issuer was making false and misleading statements, plaintiffs demonstrate some basis for believing that the defendant intended to participate in the fraudulent acts of the issuer.<sup>94</sup> The question is whether there are facts from which the court could conclude that the plaintiff can show that the defendant "[threw] in his lot with the primary violators,"<sup>95</sup> had something to gain by bilking the plaintiffs,<sup>96</sup> or tried to "feather [his] nest by defrauding investors."<sup>97</sup> The gain must exceed the usual fees a lawyer or accountant receives for performing services for the issuer.<sup>98</sup>

Moreover, the Seventh Circuit suggests that it is inconceivable or unreasonable that lawyers or accountants, whose greatest assets are reputations for honesty and careful work, would cover up their clients' fraud when they have nothing to gain and everything to lose by such

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91. *Robin v. Arthur Young & Co.*, 915 F.2d 1120 (7th Cir. 1990), *cert. denied*, 111 S. Ct. 1317 (1991); *Renovitch v. Kaufman*, 905 F.2d 1040 (7th Cir. 1990); *DiLeo v. Ernst & Young*, 901 F.2d 624 (7th Cir.), *cert. denied*, 111 S. Ct. (1990); *Barker v. Henderson, Franklin, Starnes & Holt*, 797 F.2d 490 (7th Cir. 1986).

92. See *infra* notes 123-40 and accompanying text.

93. To fulfill the pleading requirements under Rule 9(b), the plaintiff must allege "the who, what, when, where, and how: the first paragraph of any newspaper story." *DiLeo*, 901 F.2d at 627. Cf. *Mercer v. Jaffe, Snider, Raitt & Heuer, P.C.*, 713 F. Supp. 1019, 1026 (W.D. Mich. 1989) ("[T]he complaints do not contain a significant portion of the who, what, when, and where of each individual plaintiff's alleged defrauding. . . . [T]his court does not favor the strict application of Rule 9(b) in complex securities fraud cases."), *aff'd*, 933 F.2d 1008 (6th Cir. 1991).

94. See, e.g., *DiLeo*, 901 F.2d at 629; *Barker*, 797 F.2d at 497.

95. *DiLeo*, 901 F.2d at 629.

96. *Renovitch v. Kaufman*, 905 F.2d 1040, 1046 (7th Cir. 1990).

97. *Barker v. Henderson, Franklin, Starnes & Holt*, 797 F.2d 490, 497 (7th Cir. 1986).

98. *DiLeo v. Ernst & Young*, 901 F.2d 624, 629 (7th Cir.), *cert. denied*, 111 S. Ct. 347 (1990). The same is true in alleging indirect evidence of scienter when a bank participates in financing the issuer's investment scheme. The bank's receipt of interest payments on its loan does not "provide a sound basis for inferring an intent to deceive." *Schlifke v. Seafirst Corp.*, 866 F.2d 935, 948 n.14 (7th Cir. 1989).



conduct.<sup>99</sup> The defendant's conduct must be outside of the realm of reasonable business conduct. In *DiLeo*, the court stated, "People sometimes act irrationally, but indulging ready inferences of irrationality would too easily allow the inference that ordinary business reverses are fraud. One who believes that another has behaved irrationally *has to make a strong case.*"<sup>100</sup> So far, no plaintiff has been able to meet this burden.<sup>101</sup>

2. *Scienter in the Other Circuits.*—*IIT v. Cornfeld*<sup>102</sup> represents a typical analysis of the scienter requirement for aiding and abetting liability in the other circuits.<sup>103</sup> IIT was an investment trust in which fundholders participated in a portfolio of securities chosen and managed by related companies. The securities transactions giving rise to the fundholders' complaint ultimately bankrupted IIT. The transactions were acquisitions of common stock and debentures from companies referred to as the King complex. The principals of the King complex and IIT's management companies allegedly entered into the securities transactions as part of a scheme to defraud IIT. One of the parties alleged to have aided and abetted this scheme was the accounting firm of Arthur Andersen & Co., which had served at various times as the independent accountants for the King complex, IIT, and IIT's management companies. Arthur Andersen allegedly failed to inform regulatory authorities or fundholders of irregularities in the relationship between IIT and the King complex. An underwriting firm, who participated in the offerings of King complex common stock and debentures, allegedly aided and abetted the scheme to defraud IIT because the firm knew or should have known that the prospectus which it circulated in connection with the offerings contained certain material misrepresentations.

The court applied the knowledge and substantial assistance model in analyzing whether the accountants or underwriters possessed the necessary degree of scienter. The court viewed knowledge of the primary violation as a scienter equivalent.<sup>104</sup> Scienter is also a function of the

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99. See *DiLeo*, 901 F.2d at 629; *Barker*, 797 F.2d at 497.

100. *DiLeo*, 901 F.2d at 629 (emphasis added).

101. *Robin v. Arthur Young & Co.*, 915 F.2d 1120 (7th Cir. 1990) (affirming dismissal of complaint against accounting firm), *cert. denied*, 111 S. Ct. 1317 (1991); *Renovitch v. Kaufman*, 905 F.2d 1040 (7th Cir. 1990) (affirming summary judgment in favor of lawyers); *DiLeo*, 901 F.2d at 626 (affirming dismissal of complaint against accounting firm); *Barker*, 797 F.2d at 497 (affirming summary judgment in favor of law firm and accounting firm).

102. 619 F.2d 909 (2d Cir. 1980).

103. *Id.* See also *Woods v. Barnett Bank*, 765 F.2d 1004, 1010 (11th Cir. 1985); *Metge v. Baehler*, 762 F.2d 621, 624 (8th Cir. 1985), *cert. denied*, 474 U.S. 1057 (1986); *Monsen v. Consolidated Dressed Beef Co.*, 579 F.2d 793, 799 (3rd Cir.), *cert. denied*, 439 U.S. 930 (1978); *Woodward v. Metro Bank*, 522 F.2d 84, 93 (5th Cir. 1975).

104. *Cornfeld*, 619 F.2d at 922.

interplay between knowledge of the primary violation and substantial assistance in the achievement of the primary violation.<sup>105</sup> The existence or nonexistence of a fiduciary duty between the alleged aider and abettor and the defrauded party is also critical to the analysis.<sup>106</sup>

Several degrees of required scienter result. The degree of scienter depends on whether the alleged aider and abettor owes a fiduciary duty, whether his activities seem remote, and whether his liability is based primarily on inaction, i.e., his failure to disclose known wrongs. Thus: (1) reckless conduct will satisfy the scienter requirement when the alleged aider and abettor owes a fiduciary duty to the defrauded party;<sup>107</sup> (2) when there is no fiduciary duty, and the activities of the alleged aider and abettor are remote to the primary violator's fraudulent activities, the "scienter requirement scales upward so that the assistance rendered should be both substantial and knowing";<sup>108</sup> (3) when there is no duty of disclosure, the alleged aider and abettor "should be found liable only if scienter of the high 'conscious intent' variety can be proved";<sup>109</sup> and (4) inaction or a failure to disclose can constitute substantial assistance (a) when there is no fiduciary relationship between the aider and abettor and the defrauded party only if something close to an actual intent to aid in the fraud is proven,<sup>110</sup> or (b) when there is a "conscious or reckless violation of an independent duty to act."<sup>111</sup>

Applying these rules, the court held the complaint insufficient as to Arthur Andersen because its failure to disclose was a remote activity and the complaint did not indicate that Arthur Andersen acted with scienter of the high conscious intent variety.<sup>112</sup> Further, since Arthur Andersen did not have an independent duty to act, its inaction did not support a claim of aiding and abetting because there was no showing of an actual intent to aid in the fraud.<sup>113</sup> The complaint against the underwriters was upheld because the plaintiff alleged that the underwriters knew of the misrepresentations contained in the prospectus. The underwriter's actual knowledge satisfied the scienter requirement.<sup>114</sup>

By using knowledge and, sometimes, an interplay of knowledge and substantial assistance, as substitutes for scienter, parties can be held

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105. *Id.*

106. *Id.*

107. *Id.* at 923.

108. *Id.*

109. *Id.* at 925 (quoting *Woodward v. Metro Bank*, 522 F.2d 84, 97 (5th Cir. 1975)).

110. *Id.* at 926.

111. *Id.* at 927.

112. *Id.* at 925.

113. *Id.* at 927.

114. *Id.* at 924.

liable as aiders and abettors to securities fraud even though there is no showing of an *Ernst & Ernst* intent to deceive, manipulate, or defraud.<sup>115</sup> The Ninth Circuit acknowledged that the knowledge and substantial assistance test is less stringent than a test requiring proof of an alleged aider and abettor's intent to deceive or defraud.<sup>116</sup>

### B. *The Duty to Disclose*

In *Chiarella v. United States*,<sup>117</sup> the Supreme Court held that a failure to disclose material facts in connection with the purchase or sale of a security is not actionable fraud under Section 10(b) and Rule 10b-5 unless the defendant had a duty to disclose those facts.<sup>118</sup>

The duty to disclose does not arise from merely possessing material information, nor does it arise merely because one party has superior information or superior access to information.<sup>119</sup> The duty of disclosure arises from a relationship between two persons, such as an agent-principal relationship, a fiduciary relationship, or a relationship of trust and confidence that arose between the parties because of their prior dealings.<sup>120</sup>

As provided in Rule 10b-5, a duty of disclosure also arises when it is necessary to disclose a material fact in order to make statements already made, in light of the circumstances in which they were made, not misleading.<sup>121</sup> This duty of disclosure prohibits incomplete disclosures or half-truths.<sup>122</sup>

Thus, under Section 10(b) and Rule 10b-5, apart from the necessity to correct half-truths and absent a fiduciary-type relationship, the failure to disclose material facts in connection with a securities transaction is not a manipulative or deceptive act. The remaining discussion concerning the duty of disclosure assumes that the alleged aider and abettor has not made an incomplete disclosure which is necessary for him to correct.

1. *The Duty of Disclosure For Aiding and Abetting Liability in the Seventh Circuit.*—Because a failure to disclose material facts absent a

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115. *Edward J. Mawod & Co. v. SEC*, 591 F.2d 588 (10th Cir. 1979); *Rolf v. Blyth, Eastman Dillon & Co.*, 570 F.2d 38 (2d Cir.), *cert. denied*, 439 U.S. 1039 (1978); *Morgan v. Prudential Group, Inc.*, 527 F. Supp. 957, 959 (S.D.N.Y. 1981), (“[T]he question here is not truly one of ‘state of mind’ — *i.e.*, not one of intent, attitude, motive, point of view — but rather whether defendants actually had knowledge. . . .”), *aff’d mem.*, 729 F.2d 1443 (2d Cir. 1983).

116. *Orloff v. Allman*, 819 F.2d 904, 907 (9th Cir. 1987).

117. 445 U.S. 222 (1980).

118. *Id.* at 232.

119. *Id.* at 228 & nn.9-10.

120. *Id.* at 232.

121. 17 C.F.R. § 240.10b-5(b) (1991).

122. *Schlifke v. Seafirst Corp.*, 866 F.2d 935, 944 (7th Cir. 1989).



duty to do so is not a manipulative or deceptive act, plaintiffs who allege that a defendant is liable as an aider and abettor because of a failure to disclose known misrepresentations made by the primary violator must show that the defendant owed the plaintiff a duty of disclosure.<sup>123</sup> Further, the duty of disclosure does not come from Section 10(b) or Rule 10b-5, but must come from some type of fiduciary relationship outside of the securities laws.<sup>124</sup>

Plaintiffs' claims of aiding and abetting liability against attorneys and accountants who had some relationship with the primary violator have failed not only because the plaintiffs have been unable to establish scienter. A duty of disclosure has also been lacking. Even if the plaintiffs could have shown the defendants' knowledge of the primary violator's fraud and intent to further that fraud by remaining silent, the plaintiffs have been unable to establish that the defendants owed them a duty to disclose misrepresentations made by the primary violator.<sup>125</sup> The Seventh Circuit has termed these types of cases as attempts to invoke a "theory of whistle blower liability."<sup>126</sup>

For accountant-defendants, the Seventh Circuit has declined to impose "financial good Samaritanism."<sup>127</sup> In *DiLeo v. Ernst & Young*,<sup>128</sup> investors in Continental Illinois Bank alleged that Continental's auditors aided and abetted Continental's employees' securities fraud by "lending its name to [Continental's] financial statements and keeping its mouth shut about what was really going on."<sup>129</sup>

In analyzing whether the auditors had a duty of disclosure, the court decided that under the applicable Illinois law, the accountants had no duty "to search and sing"<sup>130</sup> beyond the duty to exercise care in rendering their opinion on the accuracy and adequacy of Continental's financial statements. The court expressed concern that imposing a greater duty on auditors would hinder the relationship of trust between auditors and

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123. *Id.* at 948.

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

125. *See Robin v. Arthur Young & Co.*, 915 F.2d 1120 (7th Cir. 1990), *cert. denied*, 111 S. Ct. 1317 (1991); *Renovitch v. Kaufman*, 905 F.2d 1040 (7th Cir. 1990); *DiLeo v. Ernst & Young*, 901 F.2d 624, 628 (7th Cir.), *cert. denied*, 111 S. Ct. 347 (1990); *Latigo Ventures v. Laventhol & Horwath*, 876 F.2d 1322, 1326 (7th Cir. 1989); *LHLC Corp. v. Cluett, Peabody & Co.*, 842 F.2d 928, 932 (7th Cir.), *cert. denied*, 488 U.S. 926 (1988); *Barker*, 797 F.2d at 497.

126. *Latigo Ventures*, 876 F.2d at 1326.

127. *Id.*

128. 901 F.2d 624 (7th Cir.), *cert. denied*, 111 S. Ct. 347 (1990).

129. *Id.* at 628.

130. *Id.* at 629.

their clients, and would adversely affect the reliability of audited financial statements in general.<sup>131</sup>

Further, making auditors choose between disclosing or paying damages would raise the costs of all audits.<sup>132</sup> Investors would eventually be the losers as companies purchased fewer auditing services.<sup>133</sup> These same practical concerns of destroying the relationship of trust between an accountant and his client and increasing auditing costs as accountants passed on to their clients their risk of securities fraud liability prompted the Seventh Circuit in *Latigo Ventures v. Laventhol & Horwath*,<sup>134</sup> to decline to impose a general duty of disclosure on accountants.<sup>135</sup>

The Seventh Circuit has also declined to recognize any duty upon lawyers to "tattle on their clients."<sup>136</sup> Thus, lawyers do not participate in a client's fraudulent scheme by remaining silent and failing to disclose to potential investors that the client is issuing securities using false and misleading material statements.<sup>137</sup> Lawyers have privileges and duties not to disclose.<sup>138</sup>

The Seventh Circuit's refusal to impose a duty on lawyers to disclose known fraudulent activities to persons with whom they are not in a fiduciary relationship or even to the SEC may seem to unduly forgo an effective deterrent to securities fraud. Lawyers, because of their access to information and knowledge of securities laws requirements, may be in unique positions to aid the integrity of securities markets. However, the Seventh Circuit has concluded that "an award of damages under the securities laws is not the way to blaze the trail toward improved ethical standards in the legal and accounting professions. Liability depends on an *existing* duty to disclose. The securities law therefore must lag behind changes in ethical and fiduciary standards."<sup>139</sup> The Supreme Court recognized the same dilemma: "In a statutory area of law such as securities regulation . . . there may be 'significant distinctions between

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131. *Id.*

132. *Id.*

133. *Id.*

134. 876 F.2d 1322 (7th Cir. 1989).

135. *Id.* at 1327.

136. *Barker v. Henderson, Franklin, Starnes & Holt*, 797 F.2d 490, 497 (7th Cir. 1986).

137. *Id.* at 497; *Renovitch v. Kaufman*, 905 F.2d 1040, 1048 (7th Cir. 1990). See also *Ackerman v. Schwartz*, 733 F. Supp. 1231 (N.D. Ind. 1989) (discussing lawyer's duties under Indiana law to persons with whom he is not in privity), *appeal dismissed mem.*, 922 F.2d 843 (7th Cir. 1991).

138. *Barker*, 797 F.2d at 497 (citing *Upjohn Corp. v. United States*, 449 U.S. 383 (1981)).

139. *Id.*

actual legal obligations and ethical ideals.”<sup>140</sup> In contrast, the other circuits attempt to close the gap between ethical ideals and legal obligations by creating additional legal obligations to disclose.

2. *The Duty of Disclosure For Aiding and Abetting Liability in Other Circuits.*—The other circuits have rejected arguments that the duty of disclosure must be analyzed under *Chiarella*.<sup>141</sup> The knowledge and substantial assistance model provides its own duty of disclosure. The duty arises in the aiding and abetting context from the alleged aider and abettor’s knowing assistance or participation in the underlying securities fraud violation without regard to the aider and abettor’s relationship with the deceived investor.<sup>142</sup>

In *Roberts v. Peat, Marwick, Mitchell & Co.*,<sup>143</sup> an accounting firm prepared audited financial statements of the issuer of securities. The financial statements were included in an offering memorandum distributed to investors. The complaint alleged that the accounting firm knew that portions of the offering memorandum, excluding the financials, were false, and participated in the fraud by permitting its name to be included in the offering memorandum. The court ruled that these allegations of knowledge and participation in the offering created a duty to disclose by the accounting firm, stating that “investors can reasonably be expected to assume that an accounting firm would not consent to the use of its name on reports and offering memoranda it knew were fraudulent.”<sup>144</sup>

The Eleventh Circuit similarly held that an accountant cannot stand idly by “knowing one’s good name is being used to perpetrate a fraud.”<sup>145</sup> An accountant has a special relationship of trust with the public and this duty extends to safeguard the public interest. An accountant who knows that a prospectus contains false statements, with which its audited financial statements are a part, owes a duty to disclose the client’s fraud.<sup>146</sup>

By rejecting the *Chiarella* fiduciary relationship test for finding a duty of disclosure, the other circuits have maintained their division

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140. *Dirks v. SEC*, 463 U.S. 646, 661 n.21 (1983) (quoting SEC REPORT OF SPECIAL STUDY OF SECURITIES MARKETS, H.R. DOC. NO. 95, 88th CONG., 1st SESS. 237-38 (1963)).

141. See, e.g., *Harmsen v. Smith*, 693 F.2d 932, 944 (9th Cir. 1982), *cert. denied*, 464 U.S. 822 (1983); *Andreo v. Friedlander, Gaines, Cohen, Rosenthal & Rosenberg*, 660 F. Supp. 1362, 1368 (D. Conn. 1987).

142. *Harmsen*, 693 F.2d at 944; *In re National Smelting of N.J., Inc. Bondholders’ Litigation*, 722 F. Supp. 152, 174 (D.N.J. 1989); *SEC v. Electronics Warehouse, Inc.*, 689 F. Supp. 53, 68 (D. Conn. 1988), *aff’d*, 891 F.2d 457 (2d Cir. 1989), *cert. denied*, 110 S. Ct. 3228 (1990).

143. 857 F.2d 646 (9th Cir. 1988), *cert. denied*, 493 U.S. 1002 (1989).

144. *Id.* at 653.

145. *Rudolph v. Arthur Andersen & Co.*, 800 F.2d 1040, 1044 (11th Cir. 1986), *cert. denied*, 480 U.S. 946 (1987).

146. *Id.*



between primary liability and aiding and abetting liability under Section 10(b) and Rule 10b-5. Thus, defendants in Section 10(b) and Rule 10b-5 securities fraud cases can be found not liable as a primary violator because they did not owe a duty of disclosure under the *Chiarella* test but liable for aiding and abetting for failure to disclose.<sup>147</sup>

## V. CONCLUSION

The judge-made cause of action of aiding and abetting Section 10(b) and Rule 10b-5 securities fraud has undergone such fundamental change in the Seventh Circuit that it has all but been eliminated. Under the Seventh Circuit's modern test, aiding and abetting securities fraud is arguably not a secondary liability theory at all, but merely bears the label. The Seventh Circuit discarded the knowledge and substantial assistance model of aiding and abetting liability which it adopted over twenty years ago, and which spurred wide recognition in the federal circuit courts of such a cause of action. It remains to be seen whether the Seventh Circuit will again spur change in this area of the law.

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147. See *Harmsen v. Smith*, 693 F.2d 932, 944 (9th Cir. 1982) (A contention that the alleged aider and abettor owes no duty of disclosure under *Chiarella* "blurs the distinction between primary and secondary violations of section 10(b)."). See also *Martin v. Pepsi-Cola Bottling Co.*, 639 F. Supp 931, 935-36 (D. Md. 1986).