Rule 10b-5 Liability of Secondary Actors: Second Circuit Rejects Creator Theory and Adopts Attribution Requirement in *Pacific Investment Management Co. v. Mayer Brown*

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Since the U.S. Supreme Court's decision in *Central Bank of Denver v. First Interstate Bank of Denver*,[1] which ended aider and abettor liability in Rule 10b-5[2] cases, the U.S. Circuit Courts of Appeal have been split on the standard for liability of secondary actors. This article will examine the state of the law in several circuits and will address in particular the recent decision from the Second Circuit in *Pacific Investment Management Co. v. Mayer Brown* (*PIMCO*).[3]

Bright Line Rule

The Tenth and Eleventh Circuits have adopted a "bright line" rule, which holds a secondary actor liable for private actions under Rule 10b-5 only if he or she actually *made* a material misstatement or omission.[4] "Reliance only on representations made by others cannot itself form the basis of liability."[5] This standard establishes a clear rule that is easy for actors to predict and for courts to apply. It also potentially "limits meritless or vexatious litigation against deep-pocket defendants," as plaintiff's burden of proving reliance is significant.[6] Finally, it may encourage open and frank discussion among companies and their attorneys or accountants without risking secondary liability. However, the bright-line rule has its detractors. The Securities and Exchange Commission (SEC) maintains that "the bright line test's requirement of identification of the misrepresenter to investors at the time of dissemination [could] have the unfortunate and unwarranted consequence of providing a safe harbor from liability for everyone except those identified with the misrepresentation by name."[7] This "safe harbor," the SEC notes, potentially could extend beyond outside counsel, accountants, and representatives and could provide protection even for in-house counsel or corporate officers who made certain not to reveal their identities to investors.[8]

Substantial Participation Test

The Ninth Circuit, by contrast, has adopted a more liberal "substantial participation" test to determine when a secondary actor has made a material misstatement or omission sufficient for a plaintiff to plead reliance.[9] Under the Ninth Circuit test, "substantial participation or intricate involvement in the preparation of fraudulent statements is grounds for primary liability even though that participation might not lead to the actor's actual making of the statements."[10] Plaintiffs under this test must demonstrate that they relied on the misstatement as a whole, not that they knew exactly which specific actor made each misstatement. Proponents of the substantial participation standard of secondary liability argue that it incentivizes secondary actors such as attorneys or auditors to confirm their clients' statements and disclosures before drafting or filing public statements.[11] Opponents of the test, however, claim that the meaning of substantial participation is too ambiguous and ill-defined, and that it therefore leaves secondary actors uncertain and hesitant to transact business for fear that it may result in securities fraud liability.[12] They further argue that the vague standard may actually result in fewer or more-restricted attorney-client communications, which could compromise the utility of outside counsel.[13] Finally, opponents challenge the test as substantively identical to the aider and abettor theory of liability that was rejected by the Supreme Court in *Central Bank*.

Creator Standard Proposed by the SEC

The SEC has proposed a third test to determine when a secondary actor may be liable for making a material misstatement on which a third-party investor relied. Under the SEC's "creator standard," a defendant may be held liable for "creating" a false statement that investors then relied on, even if that statement cannot be directly attributed to him at the time of dissemination. The SEC maintains that a defendant creates a statement if he or she (1) writes or speaks the statement, (2) supplies the false information that another person then puts into the statement, or (3) allows the statement to be attributed to him or her.[14] Like the Ninth Circuit's test, the creator standard may impose liability on defendants who intentionally refrain from being publicly identified. The SEC distinguishes this standard, however, by only imposing liability on those whose "involvement in the creation of a material misrepresentation is sufficiently significant that he or she can properly be deemed the author or co-author of the misrepresentation."[15] Proponents claim that this standard is "balanced in its concern for protection for victimized investors as well as for meritlessly harassed defendants (including businesses, law firms, accountants and underwriters), in addition to the policies underlying the statutory private right of action for defrauded investors."[16] Those opposed to the creator standard argue that, like the substantial participation test, it is too ambiguous and difficult to apply.

Against this backdrop, the Second Circuit recently was faced with secondary liability claims against an attorney and his law firm under Rule 10b-5. In *PIMCO*, on April 27, 2010, the Second Circuit upheld the dismissal of claims by Pacific Investment Management Company, LLC and RH Capital Associates, LLC against the law firm Mayer Brown LLP and its former partner Joseph Collins.[17]

Second Circuit Rejects Creator Standard and Adopts Attribution Requirement

Sham Transactions

In *PIMCO*, plaintiffs alleged that defendants violated Rule 10b-5 while representing Refco Inc. (Refco), a brokerage firm, by facilitating fraudulent transactions between Refco and third parties and by drafting portions of Refco's offering documents that contained false information. The case arose from the bankruptcy and collapse of

Refco in 2005. Mayer Brown had long served as Refco's chief outside counsel, and Collins as its primary contact at the law firm. In the late 1990s, Refco allegedly transferred a massive amount of uncollectible debt to an entity controlled by Refco's CEO, and then allegedly engaged in a series of "sham" loan transactions to conceal the losses. Plaintiffs claimed that Mayer Brown took part in engineering several of these sham transactions by negotiating, drafting, revising, transmitting, and distributing documents related to the loans. Plaintiffs further claimed that the law firm participated in creating false statements contained in certain Refco offering materials. The offering materials noted that Mayer Brown represented Refco, but none of the documents named Collins or specifically attributed any of the information contained therein to Mayer Brown or Collins. Plaintiffs, who had purchased securities from Refco during the time when Mayer Brown and Collins were allegedly engaging in fraud, brought claims against them for violations of Section 10(b) of the Securities Exchange Act of 1934 (Exchange Act) and for control person liability under Section 20(a) of the Exchange Act.

The U.S. District Court for the Southern District of New York dismissed plaintiffs' claims and found that none of the statements in Refco's offering documents could be attributed to Mayer Brown and Collins, and that, at most, their conduct amounted to aiding and abetting, for which there is no private cause of action under *Central Bank*. Plaintiffs appealed to the Second Circuit.

Secondary Actor Liability

On appeal, plaintiffs argued that attribution is not the sole means by which outside attorneys and other secondary actors can be held liable for securities fraud. They also argued that the Court should "adopt a 'creator standard' and hold that a defendant can be liable for *creating* false statements that investors rely on, regardless of whether that statement is attributed to the defendant at the time of dissemination."[18] Plaintiffs further argued that Mayer Brown and Collins were liable for "scheme liability" in that their facilitation of false transactions enabled Refco to make false statements upon which plaintiffs relied.

Writing for the Court, Circuit Judge Cabranes rejected plaintiffs' argument and held that "a secondary actor can be held liable in a private damages action brought pursuant to Rule 10b-5(b) *only for* false statements attributed to the secondary-actor defendant at the time of dissemination."[19] The Second Circuit analyzed controlling precedent on secondary liability for securities fraud, beginning with *Central Bank*. The Second Circuit noted that it had applied *Central Bank* in *Wright v. Ernst & Young, LLP*, adopting a bright-line rule that "a secondary actor cannot incur primary liability under [Rule 10b-5] for a statement not attributed to that actor at the time of its dissemination."[20] The *Wright* court reasoned that attribution is necessary to satisfy the reliance element of a Rule 10b-5 claim, and that reliance on statements made by others cannot alone form the basis of liability.[21] However, the *PIMCO* Court also noted that a 2001 case, *In re Scholastic Corp. Securities Litigation*, held that a corporate officer—the individual responsible for corporate communications with investors and analysts—"could be held liable for misrepresentations made by the corporation, despite the fact that none of the statements had been specifically attributed to him," and that trial courts had struggled to reconcile *Scholastic* with *Wright*.[22]

The Court also discussed the 2008 Supreme Court ruling in *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, which rejected Rule 10b-5 liability in circumstances where plaintiffs failed to allege that they had relied on the deceptive conduct of an issuer's customers and suppliers.[23] This decision, the *PIMCO* Court noted, stood "for the proposition that reliance is a critical element in private actions under Rule 10b-5."[24] Upon reviewing these cases, the *PIMCO* Court found that "attribution is necessary to show reliance."[25] Accordingly, the *PIMCO* Court rejected plaintiffs' creator standard for secondary liability and held that a bright-line attribution requirement is more consistent with prior Second Circuit and Supreme Court case law, as well as simpler for district courts to apply and for secondary actors to follow.

Applying the attribution rule, the *PIMCO* Court upheld the district court's dismissal and found that plaintiffs failed to state a Rule 10b-5(b) claim. The Court noted that no statements in the offering documents could be attributed to Collins, and that he was "not even mentioned by name in any of [the] documents,"[26] thus, plaintiffs failed to show that they relied on any of his statements. Although certain of the offering materials noted that Mayer Brown represented Refco, they did not attribute any specific statements to the law firm.

The Second Circuit also rejected plaintiffs' Rule 10b-5(a) and (c) claims based on a theory of scheme liability. Although Mayer Brown and Collins were alleged to have enabled Refco's false and misleading statements by assisting in sham loan transactions, plaintiffs were unaware of the transactions when they purchased Refco stock and therefore did not rely on the law firm's dealings. Under *Stoneridge*, "the mere fact that the ultimate result of a secondary actor's deceptive course of conduct is communicated to the public through a company's financial statements is insufficient to show reliance on the secondary actor's *own* deceptive conduct."[27] The indirect reliance upon which plaintiffs based their claim was "too remote for liability."[28]

While concurring in the judgment, Circuit Judge Parker observed that Second Circuit case law on the issue of attribution was still "far from a model of clarity."[29] Judge Parker spoke to the split among circuits on the issue of attribution, and noted that the SEC supported plaintiffs' argument and believed the attribution requirement could "prevent the securities laws from deterring individuals who make false statements anonymously or through proxies."[30] Judge Parker concluded: "In light of the importance of the existence, *vel non*, of an attribution requirement to the securities law, the bar, and the securities industry, this case could provide our full Court, as well as, perhaps, the Supreme Court, with an opportunity to clarify the law in this area."[31]

Significance of PIMCO

PIMCO is noteworthy in that it purports to settle questionable Second Circuit precedent on the issue of secondary liability for securities fraud under Rule 10b-5. As the Court noted, this is likely to affect the conduct of secondary actors because "those who sign or otherwise allow a statement to be attributed to them expose themselves to liability. Those who do not are beyond the reach of Rule 10b-5's private right of action."[32] *PIMCO* may therefore serve as a deterrent for secondary actors to allow corporate documents to be attributed to them in any way.

It is important to note, however, that the decision in this case has two crucial limitations: (1) it relates only to civil actions under Rule 10b-5 brought by *private* individuals and does not speak to liability with respect to any government enforcement actions;[33] and (2) it explicitly refrains from addressing whether attribution is required for claims against corporate insiders, as in *Scholastic*.[34] The Court noted that "[t]here may be a justifiable basis for holding that investors rely on the role corporate executives play in issuing public statements even in the absence of explicit attribution."[35] Thus, corporate officials should not assume that they may only be held liable for statements directly attributable to them; their role and responsibilities in the corporate structure may still be sufficient for a finding of liability.

Perhaps most significant, however, is Judge Parker's concurrence. Judge Parker essentially calls for *en banc* review of the case, and even invites the Supreme Court to weigh-in on the matter. Given the split among the circuits, a Supreme Court pronouncement on the scope of secondary liability seems appropriate and inevitable.

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1 511 U.S. 164 (1994).

2 Rule 10b-5, promulgated under Section 10(b) of the Securities Exchange Act of 1934, makes it unlawful, in connection with the purchase or sale of any security, "[t]o 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." The Rule also makes it unlawful to "employ any device, scheme, or artifice to defraud" or 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, which constitutes so-called "scheme liability."

3 603 F.3d 144 (2d Cir. 2010).

4 *See, e.g.*, *Ziemba v. Cascade Int'l, Inc.*, 256 F.3d 1194, 1205 (11th Cir. 2001); *Anixter v. Home-Stake Prod. Co.*, 77 F.3d 1215, 1226–27 (10th Cir. 1996).

5 Ronald J. Colombo, *Cooperation With Securities Fraud*, 61 Ala. L. Rev. 61, 81 (2009).

6 Elizabeth Cosenza, *Rethinking Attorney Liability Under Rule 10b-5 in Light of the Supreme Court's Decisions in Tellabs and Stoneridge*, 16 Geo. Mason L. Rev. 1, 26 (2008).

7 *In re Enron Corp. Sec., Deriv. & ERISA Litig.*, 235 F. Supp. 2d 549, 587 (S.D. Tex. 2002). In *Enron*, the court considered the SEC's *amicus* brief in a Third Circuit case, *Klein v. Boyd*, Fed. Sec. L. Rep. (CCH) P90,136 (3d Cir. 1998), which was written for the *en banc* review of the case. However, the case settled before the entire court could examine the issue.

8 *Id.*

9 *See, e.g.*, *Howard v. Everex Sys. Inc.*, 228 F.3d 1057, 1061 (9th Cir. 2000).

[10] Id. at 1061 n.5 (citing *In re Software Tools Inc. Sec. Litig.*, 50 F.3d 615, 628 (9th Cir. 1994)).
[11] Cosenza at 32.
[12] *Id.*
[13] *Id.* at 33.
[14] *PIMCO*, 603 F.3d at 151 (citing Brief for SEC as *Amicus Curiae* Supporting Plaintiffs-Appellants, at 7).
[15] Cosenza at 27 (citing Brief for the SEC as *Amicus Curiae*, *Klein v. Boyd*, Fed. Sec. L. Rep. (CCH) P90,136 (3d Cir. 1998)).
[16] *Enron*, 235 F. Supp. 2d at 590.
[17] *PIMCO*, 603 F.3d at 148.
[18] Id. at 151 (emphasis in original).
[19] *Id.* at 148 (emphasis supplied).
[20] *Wright v. Ernst & Young LLP*, 152 F.3d 169, 174–75 (2d Cir. 1998).
[21] *Id.*
[22] *PIMCO*, 603 F.3d at 154 (citing *In re Scholastic Corp. Sec. Litig.*, 252 F.3d 63, 75–76 (2d Cir. 2001)).
[23] *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148, 160–61 (2008).
[24] *PIMCO*, 603 F.3d at 156.
[25] *Id.*
[26] *Id.* at 158.
[27] *Id.* at 159 (emphasis in original).
[28] *Id.* at 156 (quoting Stoneridge, 552 U.S. at 159).
[29] *Id.* at 161.
[30] *Id.* at 162.
[31] *Id.*
[32] *Id.* at 157.
[33] In fact, defendant Collins in this case was convicted in a criminal case and sentenced to seven years in prison. *Id.* at 162 (citing Amended Judgment, *United States v. Collins*, No. 07-CR-01170 (S.D.N.Y. Mar. 24, 2010)).
[34] *Id.* at n.6.
[35] *Id.*