

Clarifying Accountants' Secondary Liability

Law360, New York (August 08, 2011, 1:26 PM ET) -- The June 13, 2011, United States Supreme Court decision in *Janus Capital Group v. First Derivative Traders*, 2011 (June 13, 2011) provides long-awaited clarity on the question of whether outside accountants can be held liable in a private action under Section 10(b) of the Securities Exchange Act of 1934 or Rule 10b-5 promulgated thereunder when they perform quarterly reviews or provide comments on draft press releases and U.S. Securities and Exchange Commission filings.

In a 5-4 ruling, the court held that because Janus Capital Management ("JCM"), an investment adviser, did not "make" any statements in the prospectus of an affiliated mutual fund (Janus Investment Fund, "JIF"), JCM could not be liable under Rule 10b-5, even if JCM played a key role in writing those prospectuses. This draws a clear line between primary and secondary actors in the securities law context, to the benefit of accountants and other outside professionals.

Persons who "make any untrue statement of a material fact" in connection with the purchase or sale of securities may be primarily liable in private actions brought under Rule 10b-5. Until the Supreme Court's decision *Central Bank of Denver NA v. First Interstate Bank of Denver NA*, 511 U.S. 164 (1994), private liability under Rule 10b-5 could extend also to aiders and abettors of a primary violation, and the potential primary liability of accountants was largely ignored.

However, after *Central Bank* rejected the concept of aiding and abetting liability in private securities litigation, the debate turned to the scope of primary liability, with widely divergent results. The *Janus* decision is important because it provides much needed clarity as to precisely what conduct may give rise to primary liability in a private action under Rule 10b-5.

The History of Secondary Liability

Until 1994, federal courts held that accountants and others who were not liable as a primary violators of Section 10(b) and Rule 10b-5 could be held liable as aiders and abettors. In the absence of Supreme Court precedent, lower courts were left to formulate the elements of 10b-5 aiding and abetting liability on their own, leading to divergent formulations of the elements and wide disagreement on the scope of liability that should be imposed.

The courts agreed that plaintiffs were required to establish at least the following elements for aiding and abetting under Rule 10b-5: (1) a primary violation of Section 10(b) by an independent party; (2) the aider and abettor's knowledge of the violation (i.e., "scienter"); and (3) the aider and abettor's "substantial assistance" in achieving the primary violation. Some courts also required that the aider and abettor knowingly and substantially assisted in the primary violation, or possessed the same level of scienter as the primary violator and committed one of the manipulative and deceptive acts in Rule 10b-5.

Before *Central Bank*, the first element — violation of the securities laws by a primary party — was largely ignored. Plaintiffs frequently prepared ambiguous complaints that made it impossible to determine whether they were alleging primary or aiding and abetting liability.

Accountants were often sued, and found liable, under both theories. Although an audit opinion might arguably have served as an independent misrepresentation sufficient to support a claim for primary liability, many courts in the pre-*Central Bank* era nevertheless analyzed cases involving audit opinions, as well as cases where no audit opinion was issued, mainly on the theory of aiding and abetting liability.

In 1994, in *Central Bank of Denver NA v. First Interstate Bank of Denver NA*, the Supreme Court held that there is no private right of action for aiding and abetting violations of Rule 10b-5. This led to a dramatic shift. Where conduct had previously been analyzed within an ever expanding aiding and abetting framework, securities plaintiffs and the SEC (as amicus

curiae in private actions) now began a persistent campaign to expand the definition of primary violations to encompass the same conduct that was, at most, aiding and abetting.

Courts agreed that Central Bank eliminated secondary liability, and all agreed that the plaintiff had to allege that each defendant “made” a misrepresentation to allege primary liability, but the consensus ended there.

The “bright line” test followed by the Second and Eleventh Circuits required that a statement be publicly attributed to the defendant before that defendant could be said to have “made” a misstatement or omission within the meaning of Rule 10b-5. However, under the “substantial participation” test adopted by the Ninth Circuit, liability attached even to those who “substantially participated” in the “preparation” of a false statement knowing that it would be publicly disseminated.

Under this test, simply reviewing a document might suffice to qualify one as a “maker” of a misstatement, particularly where the defendant engaged in “extensive review and discussions.” The SEC similarly advocated that in private securities actions there should be a broad test equating the word “make” with “create.”

While there was increasing pressure for Congress to reinstate aiding and abetting liability, this never happened, and in 2008 the Supreme Court again confirmed that there is no aiding and abetting liability in private securities actions. *Stoneridge Investment Partners LLC v. ScientificAtlanta Inc.*, 552 U.S. 148 (2008).

The Janus Decision

Against this history, the Fourth Circuit, in *In re Mutual Funds Investment Litigation*, 566 F.3d 111 (4th Cir. 2009), applied a hybrid standard that the court characterized as neither the “bright line” nor the “substantial participation” standard, finding that “a plaintiff seeking to rely on the fraud-on-the-market presumption must ultimately prove that interested investors (and therefore the market at large) would attribute the allegedly misleading statement to the defendant.” *Id.*

Coming very close to the “substantial participation” standard adopted by the Ninth Circuit, the court found that “the attribution determination is properly made on a case-by-case basis by considering whether interested investors would attribute to the defendant a substantial role in preparing or approving the allegedly misleading statement.” *Id.* at 124.

The Supreme Court granted certiorari and reversed. In so doing, it ended the previous split in authority and decided what it means to “make” a statement for purposes of Rule 10b-5. The court essentially adopting at a minimum the “bright line” test followed by the Second and Eleventh circuits; as it explained:

“[f]or purposes of Rule 10b-5, the maker of a statement is the person or entity with ultimate authority over the statement, including its content and whether and how to communicate it. Without control, a person or entity can merely suggest what to say, not ‘make’ a statement in its own right ... in the ordinary case, attribution within a statement or implicit from surrounding circumstances is strong evidence that a statement was made by — and only by — the party to whom it is attributed. This rule might best be exemplified by the relationship between a speechwriter and a speaker. Even when a speechwriter drafts a speech, the content is entirely within the control of the person who delivers it. And it is the speaker who takes credit — or blame — for what is ultimately said.” *Janus*, 2011, at *5.

The court found that this rule follows from *Central Bank*: “a broader reading of ‘make,’ including persons or entities without ultimate control over the content of a statement, would substantially undermine *Central Bank*, and would make aiders and abettors almost nonexistent.” *Id.* at *5.

The court specifically rejected the “substantial participation” test, even where secondary actors are “significantly involved in preparing the prospectus,” explaining that “although JCM,

like a speechwriter, may have assisted [JIF] with crafting what [JIF] said in the prospectuses, JCM itself did not 'make' those statements for purposes of Rule 10 b-5." Id. at *7.

The court also rejected the SEC's argument that the word "make" should be defined as "create," because this definition, "... fails to capture its meaning when directed at an object expressing the action of a verb," and to adopt the SEC's definition would lead to results inconsistent with Supreme Court precedent.

The court similarly rejected the contention that the word "indirectly" in Rule 10b-5 may broaden the meaning of "make," believing that it merely clarifies that as long as a statement is made, it does not matter whether it was communicated directly or indirectly to the recipient. It reasoned that a different understanding of "indirectly" would, like a broad definition of "make," threaten to erase the line between primary and aiders and abettors that the court established in *Central Bank*.

Implications for Accounting Firms

This ruling is of enormous importance to auditors of public companies since it clarifies when and for what an outside accountant may have liability in a private action under Rule 10b-5. It is implicated where plaintiffs attempt to hold outside accountants responsible for erroneous unaudited financial statements, or other financial information released by a company.

Post-*Central Bank*, accountants were often held liable if they "substantially participated" in the preparation of unaudited financial statements or other statements of the company, but the *Janus* opinion makes clear that this is no longer the law. Now, an outside accountant may be liable under Rule 10b-5 only for statements actually made by, and attributed to, the outside accountant. *Janus*, 2011 at *7.

In other words, while an outside accountant may be liable for misstatements in its publicly filed audit reports or reports on internal controls, its liability is confined to such reports and may not be extended to other documents filed by a public company and not attributed to the outside accountant.

The *Janus* opinion also does not allow liability for work that outside accountants perform for companies that does not result in the issuance of a public statement by the outside accountant, and that is specifically attributed to the outside accountant, even if it ultimately results in a public statement by the company. Examples include quarterly reviews where no review report is issued or reading and commenting on a company's publicly disseminated document such as a prospectus or press release.

--By Gwyn Quillen (pictured) and Amy June, Bingham McCutchen LLP

Gwyn Quillen is a partner in the Santa Monica, Calif., office of Bingham McCutchen. Amy June is counsel in the firm's Silicon Valley, Calif., office.

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