New York Law Journal
SERVING THE BENCH AND BAR SINCE 1888
WWW.NYLJ.COM

An ALM Publication
VOLUME 243—NO. 63
MONDAY, APRIL 5, 2010

Outside Counsel

Expert Analysis

Theory of 'Implied' Misrepresentation In Security Fraud Cases

In a much anticipated decision on an issue of first impression, the U.S. Court of Appeals for the First Circuit, sitting en banc, ruled on March 10, 2010, that one may not be held liable as a primary violator for "implied" statements, closing an avenue of liability the Securities and Exchange Commission (SEC) sought to open based on its broad construction of the term "make" in Rule 10b-5(b), promulgated by the SEC pursuant to §10(b) of the Securities Exchange Act of 1934.

In an opinion drafted by Judge Bruce M. Selya, the court held in *SEC v. Tambone* that the SEC's "expansive interpretation" of Rule 10b-5(b) is inconsistent with the text and structure of the rule and relevant statutes, and in tension with Supreme Court precedent. No. 07-1384, 2010 WL 796996 (1st Cir. March 10, 2010).

The defendants, employees at an underwriter, were not alleged to have uttered or written direct misstatements, but the SEC brought suit based on an "implied misrepresentation" theory. Under this theory, Rule 10b-5 liability could attach to one who was not the actual speaker of an alleged misstatement but used the alleged misstatement to sell securities. Rule 10b-5 makes it unlawful "to make any untrue statement of a material fact…in connection with the purchase or sale of any security." 17 CFR §240.10b-5(b).

In *Tambone*, the SEC argued that the individuals "made" misrepresentations in two ways: (1) by using prospectuses drafted by others to sell mutual funds that allegedly contained misrepresentations; and (2) by impliedly making false representations to investors to the effect that they had a reasonable basis to believe that the representations in the prospectuses were truthful and complete.

The SEC based its implied statement theory on the premise that underwriters have a "special duty" to undertake an investigation that would provide them with a reasonable basis for believing that the representations in the prospectus are truthful and complete. The court sat en banc to determine whether primary liability under Rule 10b-5 could extend to these defendants on the basis of these theories and determined that it could not. As described more fully below, this decision maintains the current boundaries of the SEC's enforcement tools, and it does not create a new avenue for private civil suits under Rule 10b-5.

SUSAN F. DICICCO *is a financial institutions litigation partner at Bingham, and* CYNTHIA HANAWALT *is an associate at the firm, both resident in the firm's New York City office.*


By **Susan F. DiCicco**

And **Cynthia Hanawalt**

The SEC's Theory

In filing suit against James Tambone and Robert Hussey, the SEC challenged the legacy of *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164 (1994), which clarified that defendants must actually make a false or misleading statement in order to be primary violators under §10(b) of the 1934 Act and Rule 10b-5 promulgated thereunder.

> The 'Tambone' decision closes an avenue of liability the SEC sought to open based on its broad construction of the term 'make' in Rule 10b-5(b).

Mssrs. Tambone and Hussey were senior executives of broker-dealer Columbia Funds Distributor, Inc., which served as the principal underwriter and distributor of more than 140 mutual funds. The SEC accused the defendants of engaging in federal securities fraud based on allegations that the defendants knew several funds allowed certain preferred customers to engage in excessive trading while the defendants offered those mutual funds to other investors using prospectuses representing that "market timing" was discouraged or prohibited.

The SEC's arguments that the defendants should be held liable as "primary" violators for misstatements or omissions in fund offering documents that the defendants did not draft were rejected at the district court level. The district court in Massachusetts granted the defendants' motion to dismiss the SEC's complaint, without prejudice. The SEC ultimately filed a new complaint in May 2006, but the district court again granted the defendants' motion to dismiss the complaint because neither Mr. Tambone nor Mr. Hussey personally made any statement.

However, on Dec. 3, 2008, a panel opinion of the First Circuit reversed the decision, adopting the SEC's theory of implied liability under Rule 10b-5, and reinstating previously dismissed claims for violations of §17(a)(2) of the Securities Act of 1933 and for aiding and abetting §10(b) violations.

Noting the broad scope of Rule 10b-5, the panel held that the defendants had a duty to confirm the accuracy of the prospectuses they used to sell the funds, and therefore impliedly had "made" untrue statements by distributing the allegedly inaccurate materials.

In what became a preview of the en banc decision, Judge Selya wrote a vigorous dissent to the panel opinion. Upon petition by the defendants, the First Circuit granted an en banc review, limiting it to Rule 10b-5(b) issues, and oral argument was heard on Oct. 6, 2009.

On rehearing, the SEC argued Mssrs. Tambone and Hussey made implied statements to investors: as senior executives, the defendants allegedly implied that they had a reasonable basis to believe the statements in the prospectuses regarding market timing were accurate and complete. The SEC further asserted that Mssrs. Tambone and Hussey made false statements within the purview of Rule 10b-5(b) by impliedly adopting the statements of the drafters of the prospectuses when they distributed the prospectuses containing false statements on market timing practices.

The SEC also emphasized the distinction between its enforcement actions under §10(b) and private civil litigation, asserting that policy concerns about the latter should not narrow the scope of primary liability in an SEC enforcement action.[1]

The defendants disputed the SEC's theory of liability, arguing it did not fit within the statutory language of Rule 10b-5 and blurred the distinction between primary and secondary liability. The defendants asserted that the "bright line" test, routinely applied in Rule 10b-5 cases to determine the bounds of primary liability, is applicable to their conduct, which would require the SEC to allege that the defendants personally made statements in order to establish their primary liability claims.

The defendants also noted that a theory of implied representation could extend liability to auditors, underwriters, investment bankers, and others who "impliedly bless" others' alleged misstatements by virtue of their role in the securities markets.[2]

Among the many amici briefs, the Securities Industry and Financial Markets Association (SIFMA) filed a brief in support of the defendants, arguing that the SEC sought an atextual expansion of Rule 10b-5 that violates the Supreme Court's guidance not to stray from the text of securities laws when imposing liability. SIFMA argued that the question was straightforward: Rule 10b-5(b) requires that defendants "make" a statement, and, as the SEC conceded, the defendants here did not "literally" make any false or misleading statements. The National Association of Shareholder and Consumer Attorneys disagreed, filing an amicus brief advocating in favor of allowing liability to attach, arguing that the defendants should be found to have impliedly adopted or endorsed the statements of others.

Secondary vs. Primary

In rejecting both dimensions of implied liability asserted by the SEC, the court rested its fundamental analysis on a detailed examination of the language and construction of §10(b) and Rule 10b-5. Based on the ordinary meaning of the word "make," and the absence of any suggestion by the drafters that they intended to imbue the word with "exotic meaning," the court concluded that the SEC's proposed reading was inconsistent with the text of both the statute and the rule. *Tambone*, 2010 WL 796996, at 5.

The court buttressed this conclusion with a contextual analysis of other statutory provisions. Observing the "obvious distinction" between the verbs used in §10(b) ("use or employ") and the verb used in Rule 10b-5(b) ("make"), the court noted that the different and narrower verb in Rule 10b-5(b) "virtually leaps off the page," and must be rendered meaningful.

The opinion also recognizes the intentions of the regulations' drafters, noting (1) the SEC knew how to wield the broad authority conferred by §10(b), as evidenced by its selection of a more inclusive verb in Rule 10b-5(a) ("employ"), and (2) the text of Rule 10b-5(b) is saliently different from the text of §17(a)(2) of the Securities Act of 1933, after which Rule 10b-5 was modeled.[3] "The drafters—who faithfully tracked Section 17(a) in other respects—deliberately eschewed the expansive language of Section 17(a)(2)."

The *Tambone* decision also addresses the relevance of *Central Bank* and its progeny. "Under modern Supreme Court precedent dealing with Rule 10b-5, much turns on the distinction between primary and secondary violators." According to the court, this distinction must be vigilantly maintained in order to remain faithful to *Central Bank* and its "carefully drawn circumscription of the private right of action." "Allowing courts to imply that 'X' has made a false statement with only a factual allegation that he passed along what someone else wrote would flout a core principle that underpins the *Central Bank* decision."

Rejecting the SEC's assertion that the "implied representation" avenue of enforcement is unremarkable, the court analyzed the case law and regulatory decisions presented by the SEC and found that none of them embraced the "implied statement" theory of liability, and that most of the SEC's purported authorities antedated *Central Bank*. Indeed, the court acknowledged that this was an issue of first impression before the court.

Describing the SEC's position as "alarmingly ambitious," Judges Michael Boudin and Sandra Lynch amplify in their concurring opinion some of the themes addressed in the majority opinion. The concurrence underscores that Mr. Tambone and Mr. Hussey were employed by an entity entirely separate from the entity responsible for drafting the prospectuses, and notes that the defendants simply disseminated the documents to broker-dealers and investors, as required by their role as underwriters.

The concurring judges expressed great concern that adopting the SEC's "making a statement" theory would result in broad liability for "virtually anyone involved in the underwriting process," and would expand the universe of private civil actions as well. They also observed that increasing the potential liability under §10(b) of underwriters, auditors or others who provide services in connection with securities offerings would inevitably increase costs that would be borne by the public.

Noting that the SEC already has enforcement tools necessary to address the conduct at issue in *Tambone*—a claim for aiding and abetting violations of §10(b)—the concurring opinion concludes: "More than enough is too much."

The dissent of Judges Kermit Lipez (author of the original First Circuit panel decision) and Juan R. Torruella argues that the majority's emphasis on *Central Bank* is overstated, though they do agree with the majority that neither the "bright-line" test nor the "substantial participation" test developed in the wake of *Central Bank* are relevant to the resolution of this case.

> The 'Tambone' decision is most important for what it does not do: it does not extend primary liability under Rule 10b-5(b) to securities professionals whenever they use a prospectus drafted by others that fails to disclose material information.

Another core point of departure involves statutory interpretation: the dissenters argue that the broad "use or employ" language in §10(b) should inform the meaning of Rule 10b-5(b), and thus allow it to encompass less literal forms of "making" a statement. They also argue that concerns about a flood of private civil litigation are inappropriate, positing that those inevitable costs should not prompt courts to circumscribe the SEC's authority to address alleged fraud in the securities industry.

Implications of the Decision

The *Tambone* decision is most important for what it does not do: it does not extend primary liability under Rule 10b-5(b) to securities professionals whenever they use a prospectus drafted by others that fails to disclose material information. Most significantly, it rejects the concept that use of an offering document means the underwriter impliedly vouches for the accuracy and completeness of such document.

Recently, courts have been reluctant to embrace versions of this theory in other circumstances. As the concurring opinion notes, four circuits have rejected the implied representation concept when asserted with regard to accountants or lawyers,[4] and the U.S. Court of Appeals for the Ninth Circuit has only embraced the implied representation theory in limited contexts.[5] No other courts have confronted the precise issue before the First Circuit.

By resisting the SEC's invitation to depart from what most practitioners believed was the status quo, the court recognizes that the SEC's theories would have been "tantamount to imposing a free-standing and unconditional duty to disclose," because securities professionals could have become liable whenever a prospectus failed to disclose material information, regardless of who prepared the prospectus.

Further, had the *Tambone* court adopted the SEC's interpretation of primary liability under Rule 10b-5, private litigants would have had a basis for asserting claims against underwriters and other market participants based on the argument that such service providers allegedly breached representations they impliedly made in securities offering documents. *Tambone* squarely rejects that expansion of liability under federal securities law.

The court also declines to define "make" for the purposes of Rule 10b-5 liability, explaining that resolution of the *Tambone* matter did not require the explication of a comprehensive test for determining when a speaker may be said to have made a statement. However, the court's thorough analysis of the relevant statutory framework provides some guidance on this issue that will likely inform future matters.

Conclusion

As the concurring opinion emphasizes, the SEC still maintains its traditional arsenal of enforcement methods. Thus, the *Tambone* decision is again more noteworthy for its restraint because it did not introduce new opportunities for the SEC or impose new obligations for underwriters and other market participants.

Indeed, the SEC's claims against Mssrs. Tambone and Hussey pursuant to §17(a)(2) and for aiding and abetting §10(b) violations already survived the defendants' motions to dismiss, having been reinstated by the panel opinion, and were not addressed in the en banc proceeding. The court remanded these claims to the district court for further proceedings, so litigation of those claims will likely continue.

1. *SEC v. Tambone*, No. 07-1384, Brief of Plaintiff-Appellant (filed Sept. 8, 2009).
2. *SEC v. Tambone*, No. 07-1384, Briefs of Defendants-Appellees (filed Sept. 4, 2009).
3. Section 17(a)(2) makes it unlawful "to obtain money or property *by means of* any untrue statement of a material fact," 15 USC §77q(a)(2) (emphasis added), while Rule 10b-5(b) makes it unlawful "to *make* any untrue statement of a material fact," 17 CFR §240.10b-5(b) (emphasis added).
4. *Tambone*, slip op. at 37 n.14, citing: *Lattanzio v. Deloitte & Touche LLP*, 476 F.3d 147, 155 (2d Cir. 2007); *Fidel v. Farley*, 392 F.3d 220, 235 (6th Cir. 2004); *Ziemba v. Cascade Int'l, Inc.*, 256 F.3d 1194, 1205-06 (11th Cir. 2001); *Anixter v. Home-Stake Prod. Co.*, 77 F.3d 1215, 1226-27 (10th Cir. 1996).
5. *Tambone*, slip op. at 37 n.14, citing *Howard v. Everex Systems, Inc.*, 228 F.3d 1057, 1061 (9th Cir. 2000) (endorsing liability of a corporate officer who signed a SEC filing allegedly containing misrepresentations); see also *In re Software Toolworks*, Inc., 50 F.3d 615, 628 (9th Cir. 1994) (allowing primary liability to attach to accountants who allegedly played a significant role in drafting the statements at issue).