The Limits of Central Bank's Textualist Approach—Attempts to Overdraw the Bank Prove Unsuccessful

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INTRODUCTION

On April 19, 1994, the United States Supreme Court decided the landmark case of Central Bank v. First Interstate Bank,¹ in which it held by a 5-4 vote that a private plaintiff may not maintain an aiding and abetting action under section 10(b) of the Securities Exchange Act of 1934² ("Exchange Act"). Section 10(b) is the principal weapon used by

2. 15 U.S.C. § 78j(b) (1994). 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 . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

   Id.
the Securities and Exchange Commission ("SEC" or "Commission") to combat fraud in the securities markets. Central Bank joined a well-developed body of Supreme Court cases decided over the last twenty-two years narrowing the broad scope of section 10(b). Even in light of these earlier decisions, the holding of Central Bank still "struck the securities bar like a thunderbolt because it was so unexpected." Prior to Central Bank, aiding and abetting had long been recognized by all the numbered circuit courts of appeals. Indeed, the doctrine was so well-established that Central Bank did not even raise the issue of whether there was a private right of action for aiding and abetting in the lower courts.

Perhaps as noteworthy as Central Bank's holding was the Court's methodology in reaching its decision. Specifically, the Court utilized a strict "textualist" approach which it took to new heights in defining what conduct is prohibited by section 10(b). The textualist approach mandates


5. See Farlow v. Peat, Marwick, Mitchell & Co., 956 F.2d 982, 986 (10th Cir. 1992); Levine v. Diamanbuset, Inc., 950 F.2d 1478, 1483 (9th Cir. 1991); K & S Partnership v. Continental Bank, 952 F.2d 971, 977 (8th Cir. 1991); Schatz v. Rosenberg, 943 F.2d 485, 496 (4th Cir. 1991); Fine v. American Solar King Corp., 919 F.2d 290, 300 (5th Cir. 1990); Schlifke v. SeaFirst Corp., 866 F.2d 935, 947 (7th Cir. 1989); Schneberger v. Wheeler, 859 F.2d 1477, 1480 (11th Cir. 1988); Moore v. Fenex, Inc., 809 F.2d 297, 303 (6th Cir. 1987); Cleary v. Perfectune, Inc., 700 F.2d 774, 777 (1st Cir. 1981); ITT v. Comfeld, 619 F.2d 909, 922 (2d Cir. 1980); Monds v. Consolidated Dressed Beef Co., 579 F.2d 793, 799-800 (3d Cir. 1978).

6. See United States Supreme Court Official Transcript at 8, Central Bank v. First Interstate Bank, 511 U.S. 164 (1994) (No. 92-854) (Nov. 30, 1993) ("We did not raise the issue of whether there was a private right of action [for aiding and abetting] because it would have been fruitless . . . ." (statement of Central Bank's counsel)).

7. The opinion, written by Justice Kennedy, is consistent with the approach to statutory interpretation of Justice Scalia, the leader in the Court's recent textualist movement. See William N. Eskridge, Jr., The New Textualism, 37 UCLA L. REV. 621, 624 (1990) (discussing the new textualist approach).
that legislative history be ignored if the meaning of the statute is plain. 8
Resort to policy may be undertaken only to demonstrate that a textualist
approach “would lead to a result ‘so bizarre’ that Congress could not
have intended it.” 9

Employing the textualist approach in Central Bank, the Court stated that “the statutory text controls the definition of conduct
covered by § 10(b).” 10 Because “the language of Section 10(b) does not
in terms mention aiding and abetting,” the Court ruled in favor of
Central Bank. 11

The Court’s decision in Central Bank was influenced significantly
by two overlapping concerns. First, the Court does not favor implied
private rights of action and is likely to apply a textualist approach in
limiting such rights where they have previously been recognized. 12
Second, the Court was prompted by its belief that “litigation under Rule
10b-5 presents a danger of vexatiousness different in degree and in kind
from that which accompanies litigation in general.” 13

Although the express holding of Central Bank was narrow, it has
widely been cited in support of a multitude of broad propositions. A
creative defense bar has attempted to expand Central Bank’s holding by
frequently asking courts to apply its textualist approach in cases
involving a variety of federal securities law provisions. 14

 movement led by Justice Scalia and noting that this approach is a “bold rethink-
ing” of the Court’s traditional approach; the traditional approach aimed to implement the intent of the enacting Congress and permitted the Court to seek guidance from legislative history and other sources).
the language of those laws is clear, we are not free to replace it with an unenacted legislative
intent.”).
9. Central Bank, 511 U.S. at 188 (quoting Demarest v. Manspeaker, 498 U.S. 184, 191
(1991)).
10. Id. at 175.
11. Id. (quoting Amicus Curiae Brief for the SEC at 8, Central Bank v. First Interstate Bank,
511 U.S. 164 (1994) (No. 92-854)).
Scalia, J., & Thomas, J., concurring) (“[W]hen rights of action are judicially ‘implied,’
categorical limitations upon their remedial scope may be judicially implied as well.”); Thompson v. Thompson,
484 U.S. 174, 190, 192 (1988) (Scalia, J., concurring) (“[T]his Court has long since abandoned its
hospitality attitude towards implied rights of action. . . . [and] [i]f a change is to be made, we should
get out of the business of implied private rights of action altogether.”).

Indeed, the Court recently limited its own holding in Central Bank and distinguished that
case from SEC enforcement actions and criminal prosecutions charging aiding and abetting
violations, where the right of action is express, stating “Central Bank’s discussion concerned only
private civil litigation under § 10(b) and Rule 10b-5.” United States v. O’Hagan, 117 S. Ct. 2199,
723, 739 (1975)).
14. See discussion infra Parts II.B.1-6.
textualist approach, however, is not well-suited to interpreting the federal securities laws, which were intentionally drafted broadly to capture new and unforeseen frauds in connection with the purchase or sale of securities. Defendants' efforts to use textualism to strike down or narrow important enforcement rights and remedies have been, for the most part, unsuccessful. Courts adjudicating securities law issues have refused to adopt the narrow textual approach of Central Bank, except with respect to section 10(b) conspiracy liability. Defendants' Central Bank challenges to the misappropriation theory of insider trading, the validity of SEC Rule 14e-3(a) (which prohibits trading on material nonpublic information in the tender offer context), certain core elements of section 10(b) actions, and remedies available in Commission enforcement actions have all soundly been rejected. More recently, in United States v. O'Hagan, even the Supreme Court appears to have retreated from the approach used in Central Bank by tempering its textual analysis of section 10(b) with an analysis of the "animating purpose" of the federal securities laws.

15. See Stock Exchange Regulation: Hearing on H.R. 7852 and 8720 Before the Comm. on Interstate and Foreign Commerce, 73d Cong. 115 (1934) ("Subsection (c) says, 'Thou shalt not devise any other cunning devices.' . . . Of course subsection (c) is a catch-all clause to prevent manipulative devices I do not think there is any objection to that kind of a clause. The Commission should have the authority to deal with new manipulative devices." (statement of Thomas Gardiner Corcoran, a drafter of the bill that became the Exchange Act)); see also Affiliated Ute Citizens v. United States, 406 U.S. 128, 151 (1972) ("The proscriptions [of section 10(b) and Rule 10b-5 thereunder] are broad and, by repeated use of the word 'any,' are obviously meant to be inclusive.").

16. See Joel Seligman, The Implications of Central Bank, 49 Bus. LAW. 1429, 1432 (1994) (describing the Court's textualist approach in Central Bank as "legal fiction" as "[i]t is clear that there is no language in the text of the statute that clearly specifies [the scope of conduct prohibited by Section 10(b)]."

[The textualist approach] dictates that Congress must include every eventuality when enacting a particular statute, or risk that the judiciary will hold that the statute fails to encompass the relief requested, even if such relief is favorably viewed by that and subsequent Congresses. Such a wooden construction ignores the realities of the political process, demands a "crystal ball" approach from the Congress enacting the legislation, ill serves a body as eminent as the Supreme Court, and frustrates the effectuation of legitimate, if not sometimes noble, public policy objectives.


17. See infra note 86 and accompanying text.


19. See infra Part II.B.3.


21. See infra Part II.B.5.


23. Id. at 2203.
This Article attempts to chart the limits of *Central Bank* by surveying the failed efforts to expand its textualist approach to other areas of the federal securities laws. In Part I, we discuss the Court's methodology in *Central Bank* and the opinion's scope. Part II focuses on the reactions to *Central Bank* by Congress, the SEC, and litigants. This section principally reviews those cases involving efforts to import the textualist approach of *Central Bank* to other areas of the securities laws. Based on the opinions in these cases, we analyze the express limits of *Central Bank*. In Part III, we conclude that *Central Bank* has proven not to be a device suited to pruning the federal securities laws, and we recommend that courts continue to confine *Central Bank* to its holding. This reading of *Central Bank* is consistent with *O'Hagan*, the Supreme Court's most recent pronouncement on the statutory interpretation of the federal securities laws, and best serves the public interest by keeping the broad remedial purposes of the securities laws paramount.

I. *CENTRAL BANK*: THE DECISION

Over the years, the Supreme Court has rendered a number of decisions establishing the elements of, and limitations on, civil actions brought under the federal securities laws. Many of these decisions have had broad applicability. Others have had a narrower focus. The issue addressed by the lower courts in *Central Bank*—the level of scienter needed to establish aiding and abetting liability—was an issue charged with potentially broad consequences, not just for aiding and abetting actions, but for all other securities actions requiring proof of scienter. The issue addressed by the Supreme Court in *Central Bank*, on the other hand, was of far narrower scope than the scienter issue addressed in the lower courts. Even though *Central Bank* resulted in the elimination of an entire cause of action, its holding produced greater finality, leaving few loose ends. Notwithstanding the holding's relatively

24. See also Simon M. Lome, Central Bank of Denver v. SEC, 49 Bus. LAW. 1467, 1467 (1994) ("[A] decision reached by the Supreme Court by a decision of 5 justices against 4 justices cannot 'clearly' or 'obviously' or 'unquestionably' stand for any proposition that is not explicitly covered in the 5-vote majority opinion . . . .")).
25. See cases cited supra note 3; see also Central Bank v. First Interstate Bank, 511 U.S. 164, 170-78 (1994) (tracing the history of the Supreme Court's jurisprudence in securities regulation). See generally Steinberg, supra note 16 (discussing the implications of the Supreme Court's recent decisions in the field of securities regulation).
26. See *Central Bank*, 511 U.S. at 169-70; see also Steinberg, supra note 16, at 491.
28. See *Central Bank*, 511 U.S. at 168.
limited scope and apparent finality, the Court’s methodology served as a platform for assaults on fundamental elements of the securities law.

A. The Facts

The Central Bank of Denver served as indenture trustee for two separate bond issues sold in 1986 and 1988 by the Colorado Springs Stetson Hills Public Building Authority ("Authority") to finance public improvements at Stetson Hills, a planned community. The offerings raised a total of $26 million. The bond covenants required the bonds to be secured at all times by land having an appraised value of at least 160 percent of their outstanding principal and interest.

In January 1988, prior to the second offering, Central Bank received an updated appraisal covering both the land securing the 1986 bonds and the land proposed to secure the 1988 bonds. The updated appraisal reported essentially unchanged land values. The senior underwriter for the 1986 offering notified Central Bank and expressed concern that the 160 percent requirement was not being met, as property values had been declining and the appraisal was over sixteen months old. The underwriter further stated that "[i]t appears that . . . the [Authority has] failed to conform to the Bond Covenants to which they agreed."

Central Bank's in-house appraiser proceeded to conduct a review of the updated appraisal and concluded that it indeed appeared optimistic. The appraiser suggested that Central Bank retain an outside appraiser to conduct a new independent appraisal. After communicating with the developer, the issuer, and others, Central Bank agreed to defer the independent review until the end of 1988, approximately six months after the 1988 bonds were to be sold. Before completion of the independent appraisal, the Authority defaulted on the 1988 bonds.

The respondents, First Interstate Bank and Jack Naber, purchased

29. See id. at 167.
30. See id.
31. See id.
32. See id.
33. See id.
34. See id.
36. See Central Bank, 511 U.S. at 167.
37. See id. at 167-68.
38. See id. at 168.
39. See id.
over two million dollars of the 1988 bonds.40 After default, the respondents brought suit in the United States District Court for the District of Colorado against the Authority and the underwriters, alleging violations of Exchange Act section 10(b) and Rule 10b-5 thereunder. The complaint also charged Central Bank with section 10(b) violations for “aiding and abetting the fraud.”41

B. The Path to the Supreme Court

The district court entered summary judgment for Central Bank on the ground that the plaintiffs failed to raise a genuine issue as to the element of scienter. Specifically, the court determined that the plaintiffs had not established a duty to disclose by Central Bank and held that in the absence of such a duty, recklessness does not satisfy the scienter requirement for aider and abettor liability.42 The plaintiffs could not prove that Central Bank acted knowingly.43

On appeal, the Tenth Circuit reversed.44 The court agreed that Central Bank owed plaintiffs no duty to disclose.45 The court, however, viewed the case not as one of nondisclosure but rather as one involving affirmative action by Central Bank by agreeing to delay the independent appraisal until after completion of the offering. The court framed the issue as follows: “[W]hen an alleged aider-and-abettor owes no duty to plaintiffs, but takes affirmative action that assists the primary violation, does recklessness satisfy the scienter requirement for aiding-and-abetting liability?”46 The court held that it did, and concluded that a trier of fact could reasonably find Central Bank was reckless.47 Accordingly, the court remanded the case.48

The Supreme Court granted Central Bank’s petition for a writ of certiorari, limited to the question of whether recklessness satisfied the scienter element of aiding and abetting liability under section 10(b) where defendant’s alleged wrongdoing consisted of affirmative action.

40. See id.
41. Id.
43. See id. at 899-900.
44. See id. at 904-05.
45. See id. at 900.
46. Id. at 902.
47. See id. at 903-04.
48. See id. at 904-05.
rather than silence.\textsuperscript{49} The Court, however, \textit{sua sponte}, directed the parties to brief the following question: "Whether there is an implied private right of action for aiding and abetting violations of § 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5?"\textsuperscript{50}

This latter question came as a surprise even though the Supreme Court had twice previously reserved decision on the issue.\textsuperscript{51} The existence of a private right of action for aiding and abetting had been recognized by all numbered circuit courts of appeals,\textsuperscript{52} with the first such decision predating \textit{Central Bank} by over a quarter-century.\textsuperscript{53}

\textbf{C. The Majority's Ruling}

The Supreme Court never reached the scienter question on which it granted certiorari. Rather, the Court reversed the Tenth Circuit, in an opinion written by Justice Kennedy, concluding "[b]ecause the text of § 10(b) does not prohibit aiding and abetting, we hold that a private plaintiff may not maintain an aiding and abetting suit under § 10(b)."\textsuperscript{54}

The Court divided its prior cases interpreting section 10(b) and Rule 10b-5 into two categories. The first category was comprised of those cases where the Court determined the scope of conduct prohibited by section 10(b), such as whether certain conduct constituted illegal insider trading. Here, the textualist approach applied.\textsuperscript{55} The second category included those cases where the defendant's conduct was prohibited by section 10(b), but the Court had to decide collateral questions about the elements of the 10b-5 private liability scheme, such as whether there was a right to contribution. Here, the Court attempted to infer what Congress would have intended had it enacted an express private right of action under section 10(b).\textsuperscript{56}

The Court classified the existence of a private right of action for aiding and abetting violations of section 10(b) in the first category.\textsuperscript{57}


\textsuperscript{50} \textit{Central Bank}, 508 U.S. at 959.


\textsuperscript{52} See cases cited \textit{supra} note 5.


\textsuperscript{55} See \textit{id.} at 173.

\textsuperscript{56} See \textit{id.} at 178.

\textsuperscript{57} See \textit{id.} at 175.
Seemingly turning its back on other interpretive tools, including analysis of congressional intent and the policies underlying the securities laws, the Court stated: "With respect [to] ... the scope of conduct prohibited by § 10(b), the text of the statute controls our decision"\(^{58}\) and "[t]hat bodes ill for respondents, for 'the language of Section 10(b) does not in terms mention aiding and abetting.'"\(^{59}\)

Notwithstanding this vow of textual fidelity, policy concerns did play a limited role in the Court's decision.\(^{60}\) The Court stated "that it is far from clear ... that the statutory purposes [of the Exchange Act] would be furthered by the imposition of private aider and abettor liability",\(^{61}\) "[s]econdary liability for aiders and abettors exacts costs that may disserv[e] the goals of fair dealing and efficiency in the securities markets",\(^{62}\) and "the rules for determining aiding and abetting liability are unclear, in 'an area that demands certainty and predictability.'"\(^{63}\) In addition, the Court reiterated its concerns about vexatious litigation under section 10(b) and the high cost of defense.\(^{64}\)

Perhaps concerned that its opinion would not be read so broadly as to exempt some categories of potential wrongdoers from liability, the Court emphasized, in a statement which has since been seized upon by a number of plaintiffs:

The absence of § 10(b) aiding and abetting liability does not mean that

\(^{58}\) Id. at 173.

\(^{59}\) Id. at 175.

\(^{60}\) See id. at 183-90. Senator Christopher J. Dodd, during Congressional hearings following the Central Bank decision, expressed his belief that a policy concern motivated the Supreme Court's holding:

I also believe that we cannot pretend that th[e] issue [of aiding and abetting liability] exists in a vacuum. It is clear that the Supreme Court's analysis in Central Bank and other securities cases has been strongly swayed by a concern about the potential for abuses of the private securities litigation system.

Abandonment of the Private Right of Action for Aiding and Abetting Securities Fraud/Staff Report on Private Securities Litigation: Hearing Before the Subcomm. on Sec. of the Senate Comm. on Banking, Hous. & Urban Affairs, 103d Cong. 3 (1994) [hereinafter Central BankHearing] (opening statement of Sen. Christopher J. Dodd); see also Donald C. Langevoort, Words from on High About Rule 10b-5: Chiarella's History, Central Bank's Future, 20 Del. J. Corp. L. 865, 888 (1995) ("Central Bank rode a wave of anti-private litigation attitudes that has not yet broken and is now being legitimized in legislation."); David S. Ruder, The Future of Aiding and Abetting and Rule 10b-5 After Central Bank of Denver, 49 Bus. Law. 1479, 1485 (1994) (noting that the majority's opinion "reflect[s] policy viewpoints and indicat[e]s that the Court is concerned with problems related to large claim securities class actions").

\(^{61}\) Central Bank, 511 U.S. at 183-90.

\(^{62}\) Id. at 188.

\(^{63}\) Id. (quoting Pinter v. Dahl, 486 U.S. 622, 652 (1988)).

\(^{64}\) See id. at 189.
secondary actors in the securities markets are always free from liability under the securities Acts. Any person or entity, including a lawyer, accountant, or bank, who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator under 10b-5, assuming all of the requirements for primary liability under Rule 10b-5 are met.65

D. The Dissent

Justices Blackmun, Souter, and Ginsburg joined Justice Stevens's dissent. Justice Stevens dissented "for the simple reason that a 'settled construction of an important federal statute should not be disturbed unless and until Congress so decides.'"66 Justice Stevens also objected to the majority's textualist approach and described the language of section 10(b) as "encompassing" and "broad," and reminded that the Supreme Court traditionally read section 10(b) "'flexibly to effectuate its remedial purposes.'"67

Justice Stevens feared the potential breadth of the majority's opinion:

The majority leaves little doubt that the Exchange Act does not even permit the SEC to pursue aiders and abettors in civil enforcement actions under § 10(b) and Rule 10b-5. . . . Moreover, the majority's approach to aiding and abetting at the very least casts serious doubt, both for private and SEC actions, on other forms of secondary liability that, like the aiding and abetting theory, have long been recognized by the SEC and the courts but are not expressly spelled out in the securities statutes.68

As Justice Stevens correctly anticipated, the battle lines were soon drawn on the applicability of Central Bank to SEC enforcement actions and other forms of secondary liability. Even Justice Stevens did not anticipate, however, the extent to which defendants would try to expand the majority's approach to other areas of the federal securities laws unrelated to secondary liability.

65. Id. at 191.
66. Id. at 196 (quoting Reves v. Ernst & Young, 494 U.S. 56, 74 (1990) (Stevens, J., concurring)).
67. Id. at 198 (quoting Affiliated Ute Citizens v. United States, 406 U.S. 128, 151 (1972)).
68. Id. at 200 (citations omitted).
II. THE AFTERMATH

Central Bank had an immediate ripple effect, within both Congress and the courts, that changed the existing landscape of federal securities litigation. As perceived by one court, "with the decision in Central Bank, the securities laws have undergone a significant transformation the results of which will not be settled for many years." The decision captured attention not only because of its textualism, but also because it highlighted the importance of the dividing line between aiding and abetting and primary liability. Three years later, however, sufficient returns are in from lower courts to conclude that Central Bank had an effect more limited than predicted by commentators.

A. Reaction by the Congress

The Central Bank opinion immediately captured Congress’s attention and revived interest in a previously stalled securities litigation reform movement. Twenty-three days after the Supreme Court issued its opinion, the Subcommittee on Securities of the Senate Committee on Banking, Housing, and Urban Affairs held a hearing to examine the opinion and its implications. SEC Chairman Arthur Levitt and several members of the bar and academia testified.

At the hearing, Central Bank was described as “catastrophic,”

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70. The movement began in 1991 after the Supreme Court decided Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson, 501 U.S. 350 (1991), which held that private section 10(b) actions must be brought within one year after discovery of the alleged violation, and no more than three years after the violation occurred. See id. at 361-62. Hearings held by the 102d Congress to consider the extension of the limitations period decreed by Lampf provided the initial forum at which concerns were raised about alleged abuses in the system of private litigation under the federal securities laws. See Securities Investor Protection Act of 1991: Hearing Before the Subcomm. on Sec. of the Senate Comm. on Banking, Hous., and Urban Affairs, 102d Cong. (1991); Securities Investors Legal Rights: Hearing Before the Subcomm. on Telecomms. and Fin. of the House Comm. on Energy and Commerce, 102d Cong. (1991).
71. See Central Bank Hearing, supra note 60.
72. Among those who testified at the Congressional hearings were Donald C. Langevoort, Lee S. and Charles A. Speir Professor of Law, Vanderbilt Law School, see id. at 21-22, 52-56; Mark J. Griffin, Director, Securities Division, Utah Department of Commerce, see id. at 22-24, 56-62; Stuart J. Kaswell, Senior Vice President and General Counsel, Securities Industry Association, see id. at 24-25, 64-69; Harvey J. Goldschmid, Dwight Professor of Law, Columbia University School of Law, see id. at 25-28, 69-72; Eugene I. Goldman, Partner, McDermott, Will & Emery, see id. at 28-30, 73-75; and David S. Ruder, Professor of Law, Northwestern University School of Law and former Chairman of the SEC, see id. at 30-45, 75-79.
73. Id. at 7 (statement of Sen. Howard M. Metzenbaum).
"regrettable,"74 and "a devastating blow."75 SEC Chairman Levitt expressed Commission support for legislation to clarify the availability of aiding and abetting in Commission actions and for its restoration in private actions.76 He further testified that "at this time, we [the SEC] will generally refrain from asserting aiding and abetting theories of liability, where the statute does not expressly provide for such claims."77 Of the twelve persons present, only two believed that Central Bank should not be overturned by the legislature.78

Senators Dodd and Domenici questioned whether Congress should consider merely inserting the words "aiding and abetting" into section 10(b) or rather, whether it should address Central Bank as part of a

74. Id. at 11 (statement of Sen. Donald W. Riegle, Jr.) (quoting Joel Seligman, Professor of Law, University of Michigan School of Law).
75. Id. at 22 (statement of Mark J. Griffin, Director, Securities Division, Utah Department of Commerce).
76. Arthur Levitt, Chairman of the SEC, stated:
Four years ago, this Subcommittee took a leading role in advancing the Remedies Act, which greatly increased the strength and the flexibility of [the SEC's] enforcement program. Congressional action is needed now to preserve the benefits of that legislation.
Legislation is also needed to restore aiding and abetting liability in private actions which are a necessary supplement to [the SEC's] overall enforcement program.
Id. at 14.
77. Id. at 13.
78. The two were Senator Phil Gramm and Stuart J. Kaswell, Senior Vice President and General Counsel, Securities Industry Association.

Senator Gramm stated:
I believe [the Central Bank] decision is a decision moving us in the right direction.

... 
So I think the Court has made an important decision. I think they have done it for exactly the right reasons.

... 
When we hamper the ability of the capital markets to work, we stick a knife in the heart of the American economy. I'm very leery about knowingly allowing that to happen.
Id. at 4-5. Later in the hearings, Stuart J. Kaswell presented the Security Industry Association's point of view:

The Subcommittee is considering whether to enact legislation providing a private right of action for aiding and abetting a violation of Rule 10b-5. Our answer is an unequivocal no.

After Central Bank of Denver, investors who are defrauded still have many weapons against the bad apples. There is no gap that Congress must fill.

... The Supreme Court's decision in Central Bank of Denver is both good law and good policy. The securities laws fully protect those who are injured.
Id. at 24-25.
comprehensive examination of the federal securities laws. These two senators had previously introduced S. 1976, the “Private Securities Litigation Reform Act of 1994,” but the bill had not advanced in Congress.

Senator Domenici used the hearings to rekindle interest in S. 1976 and the litigation reform movement. He stated:

I think waiting and delay on Dodd-Domenici is no longer a wise option. . . . [I]f we’re going to take a real look at [the Central Bank decision, it is] not going to be done without a comprehensive examination of and strong movement on the Dodd-Domenici bill to clarify significant aspects of securities class action litigation above and beyond the Denver Bank case.

The Dodd-Domenici bill was not acted upon in committee and expired with the 103d Congress. At the start of the next Congress, Senators Dodd and Domenici reintroduced the bill as S. 240, the “Private Securities Litigation Reform Act of 1995.” By the end of the session, and after a Congressional override of a presidential veto, a revised version of the bill, revamping the conduct of private securities litigation, became law. Notably, the new law failed to restore aiding and abetting

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79. Specifically, Senator Domenici stated:
   I submit [that writing language into the statute is] not very easy at all, because as you now look at [section 10(b)], in order to define secondary liability, clearly we have to have a clear definition of the primary violation. And that too is rather fuzzy. The case law is inconsistent. Predictive statement cases are but one example of this inconsistency. To reverse the Central Bank of Denver decision we need to resolve what the appropriate standard of care should be.

   Id. at 5 (opening statement of Sen. Pete V. Domenici). To further amplify Senator Domenici’s statement, Senator Dodd stated that “[t]he mere insertion of [aiding and abetting] language in [section 10(b)], in my view, is not enough. We’ve got to do a more comprehensive job if we’re going to do our job thoughtfully and responsibly as we look at this particular question.” Id. at 6.

80. See id. at 6 (“[T]his is a very fortuitous hearing . . . because we were ready to proceed with a broader based bill, and perhaps some, who thought we could wait, in fact, some might have thought we could wait forever on the Dodd-Domenici bill. I’ve heard that said before.” (statement of Sen. Pete V. Domenici)).

81. Id.


84. Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (codified as amended in scattered sections of 15 U.S.C.). The Reform Act made a number of sweeping changes to the conduct of private securities litigation aimed at eliminating vexatious litigation. Among these are: (1) a safe harbor for forward-looking statements such as forecasts or projections, see id. § 102, 109 Stat. at 749-56; (2) a discovery stay pending decision on motions to
in private securities actions. The law does make explicit, however, that
the Commission may bring enforcement actions against aiders and
abettors who act knowingly.85

B. Reaction by the Defense Bar

While Congress was debating how to best respond to Central Bank,
the defense bar began testing its limits. The decision, however, has not
proved to be particularly elastic. While defendants were initially
successful in persuading two circuit courts to strike down the misappro-
priation theory of insider trading, relying on Central Bank to varying
degrees,66 a recent Supreme Court decision reversed the latter of these
cases (and rejected the reasoning of the earlier one) and upheld the
validity of the misappropriation theory.87 The only remaining area in
the federal securities laws where defendants have successfully extended
Central Bank's textualism is conspiracy liability.88

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85. See 15 U.S.C. § 78t(f) (1994). Central Bank has not had a significant negative impact on
the Commission's enforcement program. The Commission already possessed express statutory
authority to bring aiding and abetting actions against registered entities and their associated persons.
See id. §§ 78o(b)(4)(E), 80a-9(b)(3), 80b-3(e)(5). The Commission also had the power to bring
cease-and-desist proceedings against any person who is a "cause" of another's primary violation,
although civil penalties are not available in such proceedings against those not regulated by the
Commission. See id. §§ 78u-3, 80a-9(d)(1), 80b-3(c)(1). Moreover, in SEC v. Fehn, 97 F.3d 1276,
1284-87 (9th Cir. 1996), cert. denied, 66 U.S.L.W. 3249 (U.S. Oct. 7, 1997) (No. 96-1883), the
Ninth Circuit held that the Reform Act's aiding and abetting provision applied retroactively to Fehn's
conduct. The court believed that since Feh acted prior to Central Bank, application of the Reform
Act provision to his conduct did not upset any settled expectations Feh might have had about his
potential liability. See id. The Supreme Court declined to grant certiorari to the Ninth Circuit. See

86. See United States v. O'Hagan, 92 F.3d 612 (8th Cir. 1996), rev'd, 117 S. Ct. 2199 (1997);
United States v. Bryan, 58 F.3d 933 (4th Cir. 1995).


88. Defendants have also achieved some success applying the reasoning of Central Bank
to preclude aiding and abetting charges under state blue sky provisions parallel to section 10(b).
See Teague v. Balk, 35 F.3d 978, 991-92 (4th Cir. 1994) (North Carolina blue sky law); Broadview
1. Challenge to the Misappropriation Theory of Insider Trading

Probably the most significant, albeit temporary, judicial extension of Central Bank's textualist approach came on August 2, 1996 when the Eighth Circuit rejected the misappropriation theory of insider trading.89


89. See O'Hagan, 92 F.3d at 617. The theory had been previously accepted by three circuits. See SEC v. Cherif, 933 F.2d 403, 410 (7th Cir. 1991); SEC v. Clark, 915 F.2d 439, 449 (9th Cir. 1990); United States v. Newman, 664 F.2d 12, 18-19 (2d Cir. 1981). Arguably, the Third Circuit had also adopted the misappropriation theory. See Rothberg v. Rosenbloom, 771 F.2d 818, 822-23 (3d Cir. 1985).

The misappropriation theory had been rejected in 1995 by the Fourth Circuit in United States v. Bryan, 58 F.3d 933, 944 (4th Cir. 1995). Central Bank was not pivotal to the decision in that case, however. Nowhere in his briefs did Bryan cite to Central Bank. In fact, of the more than 80 pages of text constituting Bryan's opening and reply briefs, only four buried sentences challenged the validity of the misappropriation theory. See Appellant's Opening Brief at 43, United States v. Bryan, 58 F.3d 933 (4th Cir. 1995) (No. 94-5124) (on file with the Hofstra Law Review). Bryan mainly made evidentiary challenges in attempting to overturn his conviction. See id. at 1 ("The trial court should have entered judgment of acquittal . . . as there was no evidence that . . . Bryan, violated any
The damage was quickly undone, however, when the United States Supreme Court reversed the Eighth Circuit decision in O'Hagan and upheld the validity of the theory.\textsuperscript{90}

The misappropriation theory allows the SEC to proceed against persons who are not insiders of the company whose stock they are trading.\textsuperscript{91} Under this theory, an insider trading violation occurs when a person trades on confidential information obtained in breach of a duty of trust and confidence.\textsuperscript{92} In such cases, the trader does not owe a duty to the shareholders of the traded stock.\textsuperscript{93} Instead, the trader has another relationship that has provided access to the confidential information.\textsuperscript{94} The validity of the misappropriation theory is a question concerning the scope of section 10(b) that, according to Central Bank, must be judged

\begin{quote}
law, statute or binding regulation . . . with respect to [the contracts at issue] . . . "). To the extent he asserted that the misappropriation theory was invalid, he argued that the theory was void for vagueness, not that it could not be squared with the text of section 10(b). See id. at 43 ("[W]ith respect to the misappropriation theory of insider trading, there is the serious question of whether the theory itself . . . is so ill-defined and incomplete as to be subject to the void for vagueness doctrine . . ." (citations omitted)).

The Fourth Circuit, in reversing the conviction, struck down the misappropriation theory. See Bryan, 58 F.3d at 944. As a foundation for its decision, the court looked to Central Bank for the "admonition" that "the Supreme Court has repeatedly warned against expanding the concept of fraud in the securities context beyond what the words of the Act reasonably will bear." Id. at 945. The court, however, did not employ a textualist analysis in the manner of Central Bank. Rather, the court surveyed Supreme Court case law, focusing on two cases in particular, Santa Fe Industries, Inc. v. Green, 430 U.S. 462 (1977) (holding that section 10(b) does not prevent breaches of fiduciary duty without an accompanying misrepresentation or omission), and Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975) (holding that only purchasers and sellers may bring a section 10(b) action), to conclude:

In light of the [Supreme] Court's consistent interpretation of section 10(b) as proscribing only the deception, by material misrepresentation or omission, of a purchaser or seller of securities, or of a person in some way connected with or having a stake in an actual or proposed purchase or sale of securities, we believe that the misappropriation theory cannot be defended. Bryan, 58 F.3d at 949. The Bryan court further stated that, because the misappropriation theory could apply to situations involving a "mere breach of a fiduciary relationship or similar relationship of trust and confidence," (with no element of deception), the theory could not be reconciled with Santa Fe. Id.

\textsuperscript{90} See O'Hagan, 117 S. Ct. at 2213-14.

\textsuperscript{91} See RALPH C. FERRARA ET AL., FERRARA ON INSIDER TRADING AND THE WALL § 2.02[6], at 2-16 to -17 (1997); Gregory S. Crespi, The Availability After Carpenter of Private Rights of Action Under Rule 10b-5 Based upon the Misappropriation of Information Concerning Acquisitions, 26 AM. BUS. L.J. 709, 709-10 (1989).

\textsuperscript{92} See FERRARA ET AL., supra note 91, § 2.02(6), at 2-16 to -17; Crespi, supra note 91, at 710.

\textsuperscript{93} See FERRARA ET AL., supra note 91, § 2.02(6), at 2-17.

\textsuperscript{94} See id.
against the language of the statute.95

2. O'Hagan

James Herman O'Hagan was a partner at Dorsey & Whitney, counsel for Grand Metropolitan PLC in connection with the planning of a tender offer for the common stock of Pillsbury Company.96 O'Hagan was not one of the Dorsey attorneys assigned to the General Metropolitan transaction.97 Through his position at Dorsey, however, he learned of the tender offer and made large purchases of Pillsbury securities.98 Grand Metropolitan’s announcement of the tender offer caused Pillsbury’s stock price to soar.99 O'Hagan sold his securities, reaping a profit of more than four million dollars, which he used to replenish funds he had previously stolen from a number of his Dorsey clients.100 O'Hagan was criminally convicted on fifty-seven counts arising from his Pillsbury transactions.101 Seventeen of these counts were based on the misappropriation theory of insider trading.102

In his brief to the Eighth Circuit challenging the validity of the misappropriation theory, O'Hagan relied extensively on the textualist approach of Central Bank:

Central Bank, N.A. v. First Interstate Bank, N.A. . . . totally undercuts the Government’s legal theory.

. . . .

Just as the text of Section 10(b) does not mention aiding and abetting, the text does not mention inside traders or outside traders, much less the misappropriation theory upon which the Government relies in this case. And as the Supreme Court explained in Central Bank, with regard to the scope of conduct, “the text of the statute controls our decision.” To paraphrase Central Bank, if Congress intended Section 10(b) to cover insider trading “we presume it would have used the words [insider] . . . and [trading] . . . in the statutory text.”103

97. See id.
98. See id.
99. See id.
100. See id.
101. See id.
102. See id.
O'Hagan’s literalist reading of section 10(b) proved too much a stretch. A strict textual reading of section 10(b) would not only invalidate the misappropriation theory, but would eviscerate insider trading liability altogether. The Supreme Court, however, expressly recognized that at least some forms of insider trading violate section 10(b). 104 O'Hagan also separately argued that the text of section 10(b) requires a breach of a duty to shareholders of the company whose securities were traded (as opposed to a duty to the source of the misappropriated information) for a violation to occur. 105

With one judge dissenting, the Eighth Circuit reversed O'Hagan’s conviction. 106 The court began its opinion with citations to Central Bank for the following propositions: “In construing the scope of conduct that may be regulated under § 10(b), the Supreme Court has definitively ruled that the text of the statute is dispositive,” 107 and “Rule 10b-5 fraud cannot prohibit conduct that does not amount to § 10(b) deception.” 108 The court stated that it would judge the validity of the misappropriation theory “against this backdrop.” 109

In doing so, the court held that the theory was not valid because, in its view, the theory imposes liability upon a breach of a fiduciary duty without a showing of a misrepresentation or omission, and in any event, the fraud in a misappropriation case is not “in connection with” the purchase or sale of a security. 110 Since the trader’s duty is not owed to parties to the securities transaction or other market participants, the court held that the connection between the breach of duty and the resultant securities transaction was too tenuous. 111 The court cited Central Bank extensively throughout its opinion. In particular, the court noted that adopting the government’s view that the “in connection with” prong was satisfied, even though no market participant was defrauded, “simply cannot be reconciled with the Central Bank holding that the text of

104. See, e.g., Dirks v. SEC, 463 U.S. 646 (1983) (confirming the Chiarella formation of “tippee-tippee” liability for insider trading, yet rejecting it where the tipper’s fiduciary duty cannot be traced to the target corporation); Chiarella v. United States, 445 U.S. 222 (1980) (noting that an insider trading violation occurs under section 10(b) where a tipper breaches his or her fiduciary duty by passing on inside information to a tippee who subsequently trades on the information).
105. See O'Hagan 8th Cir. Brief, supra note 103, at 51-52.
106. See O'Hagan, 92 F.3d at 613-14.
107. Id. at 616 (citing Central Bank v. First Interstate Bank, 511 U.S. 164, 173 (1994)).
108. Id. at 615 (citing Central Bank, 511 U.S. at 173).
109. Id. at 616.
110. See id. at 618.
111. See id.
§ 10(b) governs the scope of conduct which may be regulated under that provision.¹¹⁻¹²

The Supreme Court reversed the Eighth Circuit and upheld the misappropriation theory in a 6-3 decision.¹¹⁻¹³ Notably, the majority discussed the relevance of Central Bank only once in reference to a peripheral point in the Eighth Circuit's decision. Specifically, the Eighth Circuit had relied on dictum from Central Bank to hold that "[section] 10(b) covers only deceptive statements or omissions on which purchasers and sellers, and perhaps other market participants, rely."¹¹⁻¹⁴ The Court concluded that the Eighth Circuit had misconstrued this dictum.¹¹⁻¹⁵ The Court appeared to go out of its way to emphasize the narrow scope to which Central Bank might be confined, taking the opportunity to note that "Central Bank's discussion concerned only private civil litigation under § 10(b) and Rule 10b-5, not criminal liability."¹¹⁻¹⁶ Even more striking is the fact that the dissents by Justice Thomas¹¹⁻¹⁷ and Justice Scalia¹¹⁻¹⁸ did not mention Central Bank at all.

Contrary to the Eighth Circuit, the Court found that the misappropriation theory does require proof of a deceptive device or contrivance.¹¹⁻¹⁹ When a person feigns loyalty to the principal, while actually converting information belonging to the principal for personal use, this element is satisfied.¹¹⁻²⁰ The Court next concluded that the "in connection with" element is also satisfied because the trader's fraud is consummated not when he misappropriates the information, but rather, when he trades on such information.¹¹⁻²¹ Finding that the misappropriation theory was faithful to the text of the statute, the Court therefore held that "the misappropriation at issue here was properly made the subject of a § 10(b)
charge because it meets the statutory requirement that there be 'deceptive' conduct 'in connection with' the securities transaction."

Justice Ginsburg, writing for the Court, employed policy analysis, presumably as a check against a bizarre result. Justice Ginsburg concluded that it would make "scant sense" to hold O'Hagan liable if his law firm represented the target (where he would be liable under the classical theory of insider trading as a temporary insider), but not if it represented the bidder. Notably, the majority opinion went on to consider additional broad policy considerations that seemed to go beyond testing whether the textualist approach would lead to an overly bizarre result. The Court stated that "[t]he theory is also well-tuned to an animating purpose of the Exchange Act: to insure honest securities markets and thereby promote investor confidence." The Court detailed how investors would be hesitant to invest in a rigged market. Because of the Court's consideration of policy factors in addition to the text of the statute, the bar characterized O'Hagan as "reminiscent of the Supreme Court's expansive interpretations of the federal securities laws in the 1960s and early 1970s."

O'Hagan confirms that Central Bank has not ushered in the revolution in the interpretation of the securities laws that some have proclaimed. The mere fact that a specific fraudulent practice, such as insider trading, is not literally prohibited by the text of section 10(b) does not mean, under Central Bank, that the practice does not violate section 10(b)'s broad prohibition against manipulative or deceptive devices or contrivances. O'Hagan thus establishes the first broad limit on Central Bank. Simply put, textualism does not require literalism. As long as defendant's conduct reasonably comes within the flexible language of section 10(b), Central Bank will not shield that defendant from liability simply because the conduct has historically been described in specific

122. Id. at 2211.
123. See id. at 2210-11.
125. See id. at 2210.
127. See, e.g., Seligman, supra note 16, at 1434-37 (arguing that Central Bank would preclude SEC claims of aiding and abetting, respondent superior, and conspiracy under section 10(b)).
language not found in the statute.

3. Challenge to SEC Rule 14e-3(a)

O'Hagan also relied on Central Bank to challenge the validity of his convictions under Rule 14e-3(a). Even though Central Bank was extensively relied upon by O'Hagan, the Supreme Court did not cite the opinion in the course of its Rule 14e-3 discussion. Arguably, this suggests a possible second limit of Central Bank—it has no application outside the section 10(b) context.

Rule 14e-3(a) states that it is illegal for a person to trade in the securities of a company that is the target of a tender offer if the person has received knowledge of the tender offer from a person associated with either the target or bidding company. A breach of a duty by the trader is not an element of the violation. The rule has been a linchpin in the SEC's fight against insider trading in connection with tender offers.

The SEC's authority to promulgate the Rule is found in section 14(e) of the Exchange Act. This section directs the SEC to “define, and prescribe means reasonably designed to prevent . . . acts and practices [that] are fraudulent, deceptive, or manipulative,” in connection with a tender offer. Three circuits have held that the Commission did not exceed its rulemaking authority when promulgating the rule.

O'Hagan argued to the Eighth Circuit:

Central Bank makes clear that the substantive text of the statute determines the scope of prohibited conduct. The substantive text of Section 14(e) is the prohibition of “fraudulent, manipulative, and deceptive acts.” “Fraudulent practices” in this context involve a breach

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130. See id.


133. See SEC v. Maio, 51 F.3d 623, 635 (7th Cir. 1995); SEC v. Peters, 978 F.2d 1162, 1165 (10th Cir. 1992); United States v. Chestman, 947 F.2d 551, 558 (2d Cir. 1991).
of a duty to disclose. If one were to accept Chestman's conclusion that the rulemaking provision in Section 14(e) permits the SEC to redefine "fraudulent practices" to exclude the requirement of a breach of duty to disclose, then the prohibited conduct would no longer be determined by the substantive text of the statute. This is impermissible under Central Bank. 134

O'Hagan maintained that it was logical to resort to Central Bank's section 10(b) textualist approach when examining section 14(e) because the latter "is modeled upon the antifraud provision of section 10(b)." 135 The government countered that Rule 14e-3(a) qualifies as a means "reasonably designed to prevent" instances of fraudulent conduct and, therefore, can reach conduct that itself does not meet the elements of common law fraud. 136 The Eighth Circuit, believing that the statute only allows the SEC to regulate acts and practices that the law already deems fraudulent, agreed with O'Hagan and struck down Rule 14e-3(a). 137

O'Hagan invoked Central Bank again in opposition to the government's petition for certiorari, going so far as to use the case to argue that no conflict exists among the circuits: "Because the court below is the only court of appeals to analyze Rule 14e-3 in light of Central Bank, the issue of whether the Rule survives Central Bank is not yet suitable for review by this Court." 138 After certiorari was granted, O'Hagan reiterated the Central Bank arguments he presented in the Eighth Circuit. 139

The Supreme Court reversed the Eighth Circuit. 140 The Court held that Rule 14e-3(a) is a means reasonably designed to prevent trading on the basis of material, nonpublic information in the tender offer setting and, as a prophylactic measure, can encompass conduct that is nonfraudulent. 141 Significantly, the Court did not even address O'Hagan's Central Bank arguments, much less cite to Central Bank,

134. O'Hagan 8th Cir. Brief, supra note 103, at 54 (citation omitted).
135. Id. at 52 (citing Schreiber v. Burlington N., Inc., 472 U.S. 1, 10 (1985) ("Section 14(e) adds a 'broad antifraud prohibition,' modeled on the antifraud provisions of § 10(b) of the Act and Rule 10b-5 . . . " (citation omitted) (quoting Piper v. Chris-Craft Indus., Inc., 430 U.S. 1, 24 (1977)))).
137. See O'Hagan, 92 F.3d at 627.
140. See O'Hagan, 117 S. Ct. at 2220.
141. See id. at 2219.
even though the validity of Rule 14e-3(a) depended upon the Court's interpretation of the scope of its authorizing statute, section 14(e). The Court's disregard of Central Bank in analyzing the scope of section 14(e), a parallel antifraud provision to section 10(b), provides a strong basis for concluding that the Court does not believe Central Bank extends beyond section 10(b) and its narrow holding thereunder.

4. Challenges to Core Elements of Section 10(b)

Aside from using Central Bank unsuccessfully to challenge the misappropriation theory and Rule 14e-3(a), defendants have attempted to use the case to narrow both the “in connection with” and scienter requirements of section 10(b).142 These arguments, however, have been uniformly rejected.143 The decisions in these cases mark Central Bank's third limit. The case holds only that, in a section 10(b) action, where the text is wholly unambiguous in determining the scope of conduct prohibited, the text both begins and ends the inquiry. Where the text alone is not determinative, however, Central Bank has no bearing.

a. The “In Connection With” Requirement

For primary liability to attach under section 10(b) and Rule 10b-5, the plaintiff must prove, inter alia, that the defendant’s fraudulent actions took place “in connection with” the purchase or sale of any security.144 The precise contours of the “in connection with” requirement, however, are not apparent from the text of the statute itself.

In the seminal case of SEC v. Texas Gulf Sulphur Co., the Second Circuit interpreted the “in connection with” requirement broadly and held that false and misleading statements are made “in connection with” securities trading “whenever [such] assertions are made...in a manner reasonably calculated to influence the investing public.”145 The Texas Gulf court further stated that this standard can be met whether or not the maker of the statement is a buyer or seller in the underlying securities transactions.146 The standard is necessary to safeguard the integrity of statements by nonparties to a securities transaction, such as statements by

142. See infra Part II.B.4.
143. See infra notes 151, 192 and accompanying text.
145. 401 F.2d 833, 862 (2d Cir. 1968).
146. See id. at 860.
the corporation itself or its auditors.\textsuperscript{147} Such statements are regularly taken into account by market participants and reflected in the prices of securities.\textsuperscript{148} Accordingly, every other circuit to have addressed the issue has adopted the \textit{Texas Gulf} interpretation of the "in connection with" requirement.\textsuperscript{149} The Supreme Court similarly provided an expansive interpretation of this element.\textsuperscript{150}

In four reported cases, the defense argued that \textit{Central Bank}'s textualist approach effectively overruled \textit{Texas Gulf} and its progeny.\textsuperscript{151} In each case, the defendants attempted to constrict the class of persons subject to section 10(b) liability by narrowing the interpretation of the "in connection with" element.\textsuperscript{152} Finding that the \textit{Texas Gulf} interpretation is compatible with the language of section 10(b), all four courts have rejected this argument.\textsuperscript{153}

In \textit{McGann v. Ernst & Young},\textsuperscript{154} the plaintiffs alleged that Ernst & Young, as outside auditor for Community Psychiatric Centers, issued a false and misleading audit opinion attesting to the accuracy of Community's financial statements, with knowledge that it would be included in Community's Form 10-K.\textsuperscript{155} The plaintiffs alleged that although Ernst's opinion was not distributed to potential investors, it

\begin{footnotesize}
\begin{enumerate}
\item[147.] See id. at 860-61.
\item[148.] See id. at 858-59.
\item[149.] See SEC v. Rana Research, 8 F.3d 1358, 1362-63 (9th Cir. 1993); Akin v. Q-L Invs., Inc., 959 F.2d 521, 528-29 (5th Cir. 1992); SEC v. Savoy Indus., 587 F.2d 1149, 1171 (D.C. Cir. 1978); Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90, 101-02 (10th Cir. 1971); Gottlieb v. Sandia Am. Corp., 452 F.2d 510, 516 (3d Cir. 1971); Wessel v. Buhler, 437 F.2d 279, 282 (9th Cir. 1971).
\item[150.] See Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 12-13 (1971) ("The crux of the present case is that Manhattan Casualty Company suffered an injury as a result of deceptive practices \textit{touching} its sale of securities as an \textit{investor}.") (emphasis added)).
\item[152.] See McGann, 102 F.3d at 393; Silicon Valley, 884 F. Supp. at 1402; Leslie Fay, 871 F. Supp. at 695; Spear, 1994 WL 585815, at *5.
\item[153.] See McGann, 102 F.3d at 396; Silicon Valley, 884 F. Supp. at 1402; Leslie Fay, 871 F. Supp. at 697; Spear, 1994 WL 585815, at *7.
\item[155.] See id. at *1.
\end{enumerate}
\end{footnotesize}
contributed to Community's stock price trading at artificially inflated prices during the class period. The United States District Court for the Central District of California granted Ernst's summary judgment motion, holding that on these facts, the "in connection with" requirement of section 10(b) had not been met. The court accepted Ernst's argument that Texas Gulf and its progeny were no longer good law after Central Bank as these cases improperly rested on the "policies and purposes regarding the 1934 Act," rather than the text of section 10(b). The court concluded, without further analysis, that Ernst's actions did not satisfy the "in connection with" requirement. While not clearly expressed, it appears that the court found determinative the fact that the auditor's opinion, which was filed with the SEC, was not included in any offering document.

On appeal to the Ninth Circuit, Ernst reiterated that Central Bank ended "[t]he heyday of Texas Gulf Sulphur and like policy-driven decisions." Ernst attempted to redefine "in connection with" as follows:

The statutory text couples the phrase "in connection with the purchase or sale of any security" with the phrase "to use or employ any manipulative or deceptive device or contrivance." The dictionary definitions of the verbs "to use" and "to employ" denote positive action.

Moreover, section 10(b) refers in the singular to "the purchase or sale" of securities (rather than "a" or "any" purchase or sale). The most natural meaning is that the defendant must act in connection with a particular securities transaction. Read plainly, the text thus indicates

156. See id. at *2-3.

157. See id. at *8-9.

158. Id. at *7. This same argument was made in Adam v. Silicon Valley Bancshares, 884 F. Supp. 1398 (N.D. Cal. 1995). Silicon shareholders alleged that Deloitte & Touche, Silicon's auditor, caused or permitted Silicon to issue false and misleading financial reports in violation of section 10(b). See id. at 1399. In moving to dismiss, Deloitte similarly argued that Central Bank rejected the policy-based approach underlying the broad view of the "in connection with" requirement. See id. at 1402. Deloitte contended that after Central Bank, the only statements that may satisfy the "in connection with" requirement are those found in "selling documents," i.e. documents used by either sellers or purchasers of securities to effect a particular sales transaction." Id.

The Northern District of California was not, however, persuaded. It held that Central Bank could not be used to alter the expansive view of the "in connection with" requirement as Central Bank decided a "limited issue" and "did not even discuss the 'in connection with' requirement, much less interpret that clause to exclude from 10(b) liability the conduct of non-traders." Id.


160. Answering Brief of Appellee Ernst & Young LLP at 16, McGann v. Ernst & Young, 102 F.3d 390 (9th Cir. 1996) (No. 95-55925) (on file with the Hofstra Law Review).
that liability under section 10(b) is limited to defendants who take action with respect to particular securities transactions. Plaintiffs allege no such action by Ernst & Young, who merely submitted an audit opinion to a client, who then filed it in a routine regulatory Form 10-K.\[161\]

The Commission filed an amicus curiae brief arguing that the Texas Gulf construction of the "in connection with" requirement remains good law after Central Bank.\[162\] The Commission pointed out that the Texas Gulf court based its decision on the broad catchall language found in section 10(b), the absence of any limiting language in section 10(b) often found in other antifraud provisions, and legislative history demonstrating that the provision was meant to be sweeping in scope.\[163\] The Commission stressed that this mode of statutory analysis fully complied with Central Bank.\[164\]

McGann was reversed by the Ninth Circuit.\[165\] The Ninth Circuit concluded that "reports of Texas Gulf's demise are greatly exaggerated. There is no tension between the holding of Central Bank and the holding of Texas Gulf . . . .\[166\]" The court ruled that the textualist approach of Central Bank does not undermine Texas Gulf because "[o]n its face, [the] language [of section 10(b)] does not limit liability to those who actually trade securities."\[167\]

In Spear v. Ernst & Young,\[168\] Ernst tried to take the argument one step further to attain a blanket exemption for auditors in section 10(b)

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161. Id. at 17.
162. See Brief of the Securities and Exchange Commission, Amicus Curiae at 8-11, McGann v. Ernst & Young, 102 F.3d 390 (9th Cir. 1996) (No. 95-55925) (on file with the Hofstra Law Review).
163. See id. at 9-10.
164. See id. at 9.
165. See McGann, 102 F.3d at 397.
166. Id. at 393.
167. Id. The court also applied structural and policy analyses. In undertaking the structural analysis, the court took note of section 12(2) of the Securities Act of 1933 and Exchange Act sections 17(a) and 15, which contain explicit language requiring the defendant to be a participant in the securities transaction. See id. at 394-95. The court thus agreed with the statement in Texas Gulf that "'when Congress intended that there be a participation in a securities transaction as a prerequisite of a violation, it knew how to make that intention clear.'" Id. at 394 (quoting SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 860 (2d Cir. 1968) (en banc)). Lastly, from a policy standpoint, the court concluded that the position advocated by Ernst & Young was inconsistent with the "broad remedial goals" of the securities laws as "[i]t would exempt from the remedial breadth of § 10(b) a broad range of misinformation and market manipulation, so long as the perpetrators did not buy or sell securities in connection therewith." Id. at 396.
actions.169 Plaintiffs, shareholders of Policy Management Systems Corp., alleged that Ernst was primarily liable under section 10(b) for preparing faulty audit reports.170 The defendants argued that Central Bank "represents a watershed decision which implicitly overturns established precedents allowing Section 10(b) liability to attach to auditors" because "a natural reading of ['in connection with'] is that liability extends only to persons who engage in fraud and purchase or sell securities."171

The District Court of South Carolina rejected this argument. First, the court noted that even the Central Bank decision recognized that accountants may be liable as primary violators in section 10(b) actions assuming all the elements of a cause of action are met.172 The court also noted that the Supreme Court broadly interpreted the "in connection with" requirement to extend to transactions "touching" the purchase or sale of securities.173 Lastly, the Spear court found convincing that section 10 broadly applies to "any person" whereas other sections, such as section 12, expressly limit the class of potential defendants.174

Finally, in In re Leslie Fay Cos., Inc. Securities Litigation,175 the Southern District of New York rejected a similarly expansive argument posed by BDO Seidman, Leslie Fay's independent auditor. BDO argued that because the alleged false statements were only made in documents filed with the SEC and not readily available to investors, Central Bank mandated that the false statements were not actionable because they were not made "in connection with" the purchase or sale of a security.176 The argument failed to recognize that the central purpose of filing offering

169. See id. at *5.
170. See id. at *2.
171. Id. at *5. Ernst suggested that plaintiffs' only remedies after Central Bank against nonsellers and nonpurchasers are those provided by state law and Exchange Act section 18, which provides relief for misrepresentations in documents filed with the SEC. See Memorandum of Ernst & Young in Support of Motion to Dismiss the Complaint at 21 n.14, Spear v. Ernst & Young, 1994 WL 585815 (D.S.C. Aug. 15, 1994) (No. 3-94-1150-17) [hereinafter Ernst & Young Motion to Dismiss] (on file with the Hofstra Law Review).
174. See id.
176. See id. at 694.
documents with the SEC is to provide information to investors, either
directly or by dissemination via analysts.\(^\text{177}\)

The court stated that a textualist approach does not foreclose BDO's
liability given the ambiguous nature of the phrase "in connection
with."\(^\text{178}\) Instead, the court chose to continue to interpret the require-
ment broadly. The court rejected as unfounded BDO's attempt to expand
Central Bank into the "in connection with" province:

Acknowledging [the] broad remedial purpose [of section 10(b)], and
hence the endless variety of factual situations that § 10(b) was meant
to address, the Supreme Court has admonished that courts should read
§ 10(b) and Rule 10b-5 "flexibly, not technically and restrictively." Central Bank did not alter this fundamental tenet.

Central Bank merely held that courts should not expand a § 10(b)
implied cause of action to reach conduct completely outside its textual
authority . . . . That does not mean that courts should not flexibly read
the text itself to cover conduct within § 10(b)'s textually supported
purposes, however. Absent such flexibility, § 10(b) could not address
the realities of today's complicated securities markets. That cannot be
what Congress intended.\(^\text{179}\)

In sum, these cases make clear that Central Bank does not alter the
traditional methods of analyzing the reach of the "in connection with"
element of section 10(b). The phrase is inherently fuzzy at its outer edges
and is best interpreted in a manner that will achieve the statute's broad
remedial goals.

b. The Scienter Requirement and Recklessness

A second area in which the text of section 10(b) does not spell out
the precise parameters for maintaining an action is the state of mind
required to establish scienter. In Ernst & Ernst v. Hochfelder,\(^\text{180}\) the
Supreme Court defined scienter to include "knowing or intentional

\(^{177}\) Recognizing this, the Second Circuit stated:
The dominant congressional purposes underlying the Securities Exchange Act of
1934 were to promote free and open public securities markets and to protect the investing
public from suffering inequities in trading, including, specifically, inequities that follow
from trading that has been stimulated by the publication of false or misleading corporate
information releases.
SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 858 (2d Cir. 1968) (en banc).

\(^{178}\) See Leslie Fay, 871 F. Supp. at 695.

\(^{179}\) Id. at 696 (emphasis added) (citation omitted).

\(^{180}\) 425 U.S. 185 (1976).
misconduct," but expressly reserved the question of "whether, in some circumstances, reckless behavior is sufficient for civil liability under § 10(b) and Rule 10b-5."\textsuperscript{181} Since the \textit{Ernst} decision, every circuit court to consider the question has held that recklessness satisfies the scienter requirement.\textsuperscript{182}

Defendants were quick to invoke \textit{Central Bank} to argue that reckless conduct does not satisfy the scienter standard in actions brought under the antifraud provisions.\textsuperscript{183} To date, five attempts to press this claim have failed.\textsuperscript{184}

The SEC opposed efforts to raise the bar for establishing scienter.\textsuperscript{185} The thrust of the arguments raised in each of the cases challeng-

\textsuperscript{181} Id. at 194 n.12.
\textsuperscript{182} See Hollinger v. Titan Capital Corp., 914 F.2d 1564, 1569-70 (9th Cir. 1990); \textit{In re Phillips Petroleum Sec. Litig.}, 881 F.2d 1236, 1244 (3d Cir. 1989); Van Dyke v. Coburn Enters., Inc., 873 F.2d 1094, 1100 (8th Cir. 1989); McDonald v. Alan Bush Brokerage Co., 863 F.2d 809, 814 (11th Cir. 1989); Dirks v. SEC, 681 F.2d 824, 844-45 & n.27 (D.C. Cir. 1982), rev'd on other grounds, 463 U.S. 646 (1983); Hackbart v. Holmes, 675 F.2d 1114, 1117-18 (10th Cir. 1982); Broad v. Rockwell Int'l Corp., 642 F.2d 929, 961-62 (5th Cir. 1981); Mansbach v. Prescott, Ball & Turben, 598 F.2d 1017, 1023-24 (6th Cir. 1979); Cook v. Avien, Inc., 573 F.2d 685, 692 (1st Cir. 1978); Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 38, 44 (2d Cir. 1978); Sundstrand Corp. v. Sun Chem. Corp., 553 F.2d 1033, 1044 (7th Cir. 1977).

Some commentators, however, have suggested that the apparent harmony among the circuits may be misleading:

Notwithstanding the apparent consensus among the circuits, some tension seems to exist between courts that suggest a showing of reckless conduct in and of itself is sufficient to constitute scienter and those courts that appear to require a showing of recklessness that is of such a nature that it can serve as evidence of actual knowledge or intent.


Recently, a few district court cases held that the heightened pleading standards imposed by the Private Securities Litigation Reform Act of 1995 require plaintiffs to create a strong inference of knowing or intentional misconduct. See Norwood Venture Corp. v. Converse Inc., 959 F. Supp. 205, 208 (S.D.N.Y. 1997); \textit{In re Silicon Graphics}, Inc. Sec. Litig., 970 F. Supp. 746, 757 (N.D. Cal. 1997); Powers v. Eichen, No. 96-1431-B, 1997 WL 587034, at *6 (S.D. Cal. Mar. 14, 1997); Friedman v. Discreet Logic Inc., 959 F. Supp. 42, 50 (D. Mass. 1997). The \textit{Silicon Graphics} court, however, held that a showing of "deliberate recklessness" (a previously unknown term) would suffice. \textit{Silicon Graphics}, 970 F. Supp. at 757 ("Knowing or intentional misconduct includes deliberate recklessness . . . "). The \textit{Silicon Graphics} court defined "deliberate recklessness" to mean conduct which presents such a danger of misleading buyers or sellers that the defendant either knew or must have been aware of it. See \textit{id.} at 755. This strict definition of recklessness was first spelled out by the Seventh Circuit in \textit{Sundstrand Corp.}, 553 F.2d at 1045.

\textsuperscript{183} See infra notes 186-92 and accompanying text.
\textsuperscript{184} See cases cited infra note 192.
\textsuperscript{185} In advocating a lower scienter standard, the SEC stated:

The Commission has consistently supported a recklessness standard for Section 10(b) liability in both Commission and private actions under the federal securities laws.
ing recklessness, with some variation, has been that the terms "manipulative" and "deceptive," found in section 10(b), have been held to connote knowing behavior,\textsuperscript{186} and that the word "reckless" is absent from the text of the statute.\textsuperscript{187}

For example, in \textit{Spear v. Ernst & Young},\textsuperscript{188} the defendants argued that "although most courts (but not the Fourth Circuit) have held that recklessness is sufficient to satisfy the state-of-mind requirement for section 10(b), the Supreme Court's recent decision in \textit{Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.}, undercuts this expansive approach to liability."\textsuperscript{189} Analyzing the text of section 10(b), Ernst argued that it is "difficult to imagine a person 'recklessly' 'devising' or 'contriving' to violate the law."\textsuperscript{190}

In squarely rejecting this argument, the court stated:

> There is nothing in the text of Section 10(b) nor in the Supreme Court's decision in \textit{Central Bank} that says that recklessness is insufficient to fulfill the scienter requirement imposed by the courts on the statute. The text of Section 10(b) actually contains no scienter requirement. Rather, this component of the cause of action has been added over the years by courts interpreting the statute. Since the Section contains no scienter requirement, a strict and literal reading of the \textit{Central Bank} case would result in scienter being actually immaterial to the cause of action.\textsuperscript{191}

Since \textit{Spear}, \textit{Central Bank} has repeatedly proved to be a dull knife because such a standard is needed to protect investors and the securities markets from fraudulent conduct and to protect the integrity of the disclosure process. A higher scienter standard would lessen the incentives for corporations to conduct a full inquiry into potentially troublesome or embarrassing areas, and thus would threaten the process that has made our markets a model for nations around the world.

\textsuperscript{186} \textit{See Ernst & Ernst v. Hochfelder}, 425 U.S. 185, 197 (1976) ("The words 'manipulative or deceptive' used in conjunction with 'device or contrivance' strongly suggest that § 10(b) was intended to proscribe knowing or intentional misconduct." (citing SEC \textit{v. Texas Gulf Sulphur Co.}, 401 F.2d 833, 868 (2d Cir. 1968) (en banc)). The Court reserved decision on whether recklessness is sufficient for section 10(b) liability. \textit{See id.} at 194 n.12.

\textsuperscript{187} \textit{See infra} note 189 and accompanying text.

\textsuperscript{188} No. CIV.A.3:94-1150-17, 1994 WL 585815 (D.S.C. Aug. 15, 1994).

\textsuperscript{189} \textit{Ernst & Young Motion to Dismiss, supra} note 171, at 1 (citation omitted).

\textsuperscript{190} \textit{Id.} at 13.

\textsuperscript{191} \textit{Spear}, 1994 WL 585815, at *7 (citation omitted).
in attempts to carve recklessness out of section 10(b).\textsuperscript{192}

\textsuperscript{192.} The same argument was unsuccessfully made in four other cases:

1. Anixter v. Home-Stake Prod. Co., 77 F.3d 1215 (10th Cir. 1996). In holding that recklessness remains sufficient, the court addressed the auditor's \textit{Central Bank} argument, in a footnote which pointedly began, "\textit{Central Bank of Denver} does not address the scienter requirement for primary violations." \textit{Id.} at 1233 n.22. The footnote concluded by noting that although \textit{Central Bank} quoted the portion of \textit{Ernst} which recites that "§ 10(b) was intended to proscribe knowing or intentional misconduct," \textit{Ernst} & \textit{Ernst} v. Hochfelder, 425 U.S. 185, 197 (1976) this was of no benefit to the auditor because \textit{Ernst} explicitly did not answer whether "knowing or intentional" conduct could include recklessness. See \textit{Anixter}, 77 F.3d at 1233 n.22. Indeed, \textit{Ernst} expressly reserved the question. See \textit{Ernst}, 425 U.S. at 194 n.12 ("We need not address here the question whether, in some circumstances, reckless behavior is sufficient for civil liability under § 10(b) and Rule 10b-5.").

2. \textit{In re MTC Elec. Techs. Shareholders Litig.}, 898 F. Supp. 974 (E.D.N.Y. 1995). A defendant accounting firm, charged with recklessly conducting a series of audits, asserted that "\textit{Central Bank}'s strict textual reading of Section 10(b) compels the conclusion that the scienter element can no longer be established by a showing of mere recklessness." \textit{Id.} at 988. In disposing of this argument, the court stated that "\textit{Central Bank} did not address the scienter requirement, and the Second Circuit—in a decision post-dating \textit{Central Bank}—has reaffirmed recklessness as a means of establishing scienter." \textit{Id.} at 989 (referring to \textit{Shields v. Citytrust Bancorp, Inc.}, 25 F.3d 1124, 1128-29 (2d Cir. 1994), which did not cite to \textit{Central Bank}).

3. \textit{In re Phar-Mor, Inc. Sec. Litig.}, 892 F. Supp. 676 (W.D. Pa. 1995). This action was one of many stemming from a financial fraud committed by Phar-Mor, a discount pharmaceutical chain. See \textit{id.} at 680. Plaintiffs alleged, among other things, that had Coopers & Lybrand, Phar-Mor's outside auditor, not recklessly and improperly performed certain audits of Phar-Mor, Coopers would have uncovered the financial fraud and the plaintiffs would not have purchased their Phar-Mor shares. See \textit{id.} at 682. Coopers was charged as a primary violator of section 10(b). See \textit{id.} at 683.

Coopers argued, without regard to the prior Third Circuit standard, that \textit{Central Bank}'s textualist approach now barred section 10(b) from reaching reckless conduct. See \textit{id.} at 685. The court summarized Cooper's argument as follows: "In short, defendant contends that had Congress intended to make reckless conduct unlawful under section 10(b), it would have used the term 'reckless' in the statute." \textit{Id.} (footnote omitted). The court rejected this argument for two reasons. First, it noted that the Southern District of New York had rejected this argument when presented in \textit{Leslie Fay}. See \textit{id.} Second, the court cited to a post-\textit{Central Bank} Third Circuit case, \textit{Kline v. First Western Government Securities, Inc.}, 24 F.3d 480 (3d Cir. 1994), which, in passing reference, reaffirmed that the scienter requirement of section 10(b) may be satisfied by reckless conduct. \textit{Phar-Mor}, 892 F. Supp. at 685. Moreover, the \textit{Kline} court was cognizant of \textit{Central Bank} as it cited to it, albeit on a different issue. Accordingly, the \textit{Phar-Mor} court held that reckless conduct satisfies the scienter requirement of section 10(b). See \textit{id}.

4. \textit{In re Leslie Fay Cos., Inc. Sec. Litig.}, 871 F. Supp. 686 (S.D.N.Y. 1995). In its opinion, the court sidestepped the issue of what is the necessary level of scienter to establish a section 10(b) violation. Instead, the court referred to an earlier decision in this same case, in which the court had held that the appropriate scienter standard is "behavior which is either deliberate or so reckless that an inference of fraudulent intent might be drawn by a reasonable finder of fact." \textit{Id.} at 692 (quoting \textit{In re Leslie Fay Cos., Inc. Sec. Litig.}, 835 F. Supp. 167, 173 (S.D.N.Y. 1993)). The court concluded that "plaintiffs' allegations of reckless conduct, which we previously held provide sufficient circumstantial evidence of intent, satisfy even BDO's contention that \textit{Central Bank} requires pleading actual intent," \textit{Id.} at 693-94 (referring to a separate line of cases, beginning with \textit{Wechsler v. Steinberg}, 733 F.2d 1054 (2d Cir. 1984), and that "\textit{Central Bank} does not affect the scienter standard we adopted in \textit{Leslie Fay I}."). The court thus declined BDO's invitation to use \textit{Central Bank} to
5. Remedies

Attempts have also been made to expand \textit{Central Bank}'s textualist approach to limit remedies available to the SEC in enforcement actions.\footnote{See, e.g., SEC v. Fehm, 97 F.3d 1276, 1283-88 (9th Cir. 1996), \textit{cert. denied}, 66 U.S.L.W. 3249 (U.S. Oct. 7, 1997) (No. 96-1883) (challenging the SEC's injunctive authority); SEC v. O'Hagan, 901 F. Supp. 1461, 1471-73 (D. Minn. 1995) (arguing that because disgorgement is not an express remedy for a securities violation in section 21(d) of the Exchange Act, \textit{Central Bank} mandates that the SEC cannot order disgorgement of profits).} Simple logic dictates, however, that \textit{Central Bank} has no application here. \textit{Central Bank} involved the question of whether there was an implied right of action for aiding and abetting.\footnote{See \textit{Central Bank} v. First Interstate Bank, 511 U.S. 164 (1993).} But the federal securities laws provide an express right of action for the SEC.\footnote{See \textit{Lane} v. Pena, 116 S. Ct. 2092, 2099 (1996) ("\[T\]he federal courts have the power to award any appropriate relief in a cognizable cause of action brought pursuant to a federal statute."\)” (quoting Franklin v. Gwinnett County Pub. Sch., 503 U.S. 60, 71 (1992))).} Moreover, the question of what remedies are available to redress a proven violation is separate and distinct from the question of what conduct is prohibited by the statute.

The Supreme Court indicated that federal courts have the power to grant appropriate relief in an action explicitly authorized by statute.\footnote{See Franklin, 503 U.S. at 66.} It is settled that once a district court possesses subject matter jurisdiction, "[u]nless otherwise provided by statute, all the inherent equitable powers of the District Court are available for the proper and complete exercise of that jurisdiction."\footnote{Porter v. Warner Holding Co., 328 U.S. 395, 398 (1946); accord Franklin, 503 U.S. at 66.} A growing body of case law adhered to this rule, making clear that \textit{Central Bank} does not limit the SEC's remedies.\footnote{See infra notes 204-05 and accompanying text.} These decisions illuminate the next limit of \textit{Central Bank}: the case does not in any way restrict a court's inherent equitable powers, even though those powers are not codified.

The SEC's statutory authority to bring injunctive actions alleging violations of the Exchange Act is set forth in Exchange Act section 21, which expressly provides that whenever "any person is engaged or about to engage" in a violation of the Exchange Act, the SEC may enjoin such person and obtain money penalties and an officer and director bar.\footnote{15 U.S.C. § 78u(d)(1)-(3) (1994).} The statute does not expressly authorize the SEC to obtain disgorgement and appointment of a receiver. Both of these remedies, however, are
firmly grounded in equity jurisprudence and have been mainstays in the SEC's enforcement program. Nevertheless, in the wake of Central Bank, new challenges have been asserted as to the availability of these remedies, as well as to the authority to obtain injunctions based upon past misconduct. These challenges have failed.

Courts have continued to invoke their equitable powers to allow the SEC to seek disgorgement. For example, in SEC v. Sands, the district court held that Central Bank does not "renounce[] the once predominant view that courts may invoke whatever rights and remedies they deem appropriate to effectuate the purposes of the securities laws." Central Bank "did not address the issue of remedies or overrule its prior decisions that provide federal courts with the power to award appropriate relief, including disgorgement, when the defendant violates a federal statute.

200. See, e.g., SEC v. Lorin, 76 F.3d 458, 462 (2d Cir. 1996) (per curiam) ("The decision to order disgorgement of ill-gotten gains, and the calculation of those gains, lie within the discretion of the trial court . . ."). SEC v. Patel, 61 F.3d 137, 139 (2d Cir. 1995) ("In the exercise of its equity powers, a district court may order the disgorgement of profits acquired through securities fraud."); SEC v. Weneke, 622 F.2d 1363, 1369 (9th Cir. 1980) (concluding that the district court had the power to issue a stay of all proceedings against the receivership); SEC v. Manor Nursing Ctrs., Inc., 458 F.2d 1082, 1104 (2d Cir. 1972) ("Clearly the provision requiring the disgorging of proceeds received in connection with the . . . offering was a proper exercise of the district court's equity powers.").

201. See, e.g., SEC v. O'Hagan, 901 F. Supp. 1461, 1472 (D. Minn. 1995) ("O'Hagan asserts that Central Bank overruled the numerous decisions upholding disgorgement under the Exchange Act. The Court, however, is unwilling to construe the rather narrow holding of Central Bank so broadly as to drastically restrict the district court's long established equitable powers.").

202. See infra notes 203-09 and accompanying text.


204. Id. The issue was similarly disposed of in SEC v. First Jersey Securities, Inc., 101 F.3d 1450 (2d Cir. 1996), cert. denied, 66 U.S.L.W. 3249 (U.S. Oct. 7, 1997) (No. 96-1862). The Southern District of New York found that defendant Robert E. Brennan ran First Jersey as a boiler room, charging customers excessive markups and engaging in widespread market manipulation. See id. at 1459. The judgment required First Jersey and Brennan to disgorge approximately $75 million. See id. at 1456. In his appeal to the Second Circuit, Brennan erroneously stated: "The decision in Central Bank of Denver v. First Interstate Bank of Denver is the most recent and graphic example of the [Supreme Court's] restrictive approach toward implying remedies." Brief for Defendant-Appellant Robert E. Brennan at 59, SEC v. First Jersey Sec., Inc., 101 F.3d 1450 (2d Cir. 1996) (No. 95-6192) (citation omitted) (on file with the Hofstra Law Review). To the contrary, Central Bank did not address remedies. Brennan argued to no avail that Exchange Act section 21(d) expressly provides only for injunctive relief and not disgorgement and that, according to Central Bank, the latter may therefore not be awarded. See id. at 60. In its opinion, the Second Circuit easily disposed of this argument, without even referencing Central Bank, by simply reiterating that "[o]nce the district court has found federal securities law violations, it has broad equitable power to fashion appropriate remedies, including ordering that culpable defendants disgorge their profits." First Jersey, 101 F.3d at 1474. Brennan filed a Petition for a Writ of Certiorari with the United States Supreme
In the only reported decision challenging the appointment of a receiver, the court similarly held that *Central Bank* does not displace the court's inherent equitable authority. The court then proceeded to appoint a receiver.

Efforts to apply *Central Bank* to limit the availability of injunctive relief under Exchange Act section 21 based upon past misconduct have likewise been unsuccessful. Those who have argued that they may not be enjoined because their misconduct took place in the past fail to recognize that a past violation is not used as a substantive basis for an injunction, but simply to gauge whether the defendant is likely to engage in future violations. Accordingly, at least one court has agreed that

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Court, wherein he repeated his *Central Bank* arguments. The Court, however, declined the opportunity to address his argument when they denied his Petition. See SEC v. First Jersey Sec., Inc., 66 U.S.L.W. 3249 (U.S. Oct. 7, 1997) (No. 96-1862).

The argument was also raised in SEC v. O'Hagan, 901 F. Supp. 1461, 1471 (D. Minn. 1995). Echoing the sentiments of the other courts ruling on the issue, Senior Judge Renner of the District of Minnesota, stated: "The Court . . . is unwilling to construe the rather narrow holding of *Central Bank* so broadly as to drastically restrict the district court's long established equitable powers." Id. at 1472 (emphasis added). The appeal to the U.S. Court of Appeals for the Eighth Circuit of the SEC's civil case was stayed pending O'Hagan's appeal from his insider trading criminal conviction.

205. See SEC v. KS Resources, CV 95-8608-WDK (C.D. Cal. July 23, 1996). While no written opinion was issued by the district court, the transcript of oral argument indicated that defense counsel argued: "The *Central Bank of Denver* case says that in interpreting the securities laws, we must look first of all to the statute itself. And if we look first of all to the statute itself, there is clearly no right to a remedy of a receivership." Reporter's Transcript of Proceedings at 25-26, SEC v. KS Resources, CV 95-8608-WDK (C.D. Cal. Apr. 4, 1996). The Central District of California trial judge did not find this argument convincing, stating during oral argument:

> I believe that the *Central Bank* case stands for the proposition that there cannot be aiding and abetting civil liability . . . . However, in my view, a receivership is not a form of liability, but instead an equitable remedy that this circuit and others have repeatedly confirmed that the respective district courts possess.

*Id.* at 22-23. Judge Keller proceeded to order the appointment of a permanent receiver. The Ninth Circuit affirmed the district court's interlocutory order appointing a permanent receiver. See SEC v. KS Resources, 110 F.3d 69 (9th Cir. 1997) (unpublished disposition).

206. See *KS Resources*, 110 F.3d at 69.

207. See, e.g., SEC v. Fehn, 97 F.3d 1276, 1282 (9th Cir. 1996), cert. denied, 66 U.S.L.W. 3249 (U.S. Oct. 7, 1997) (denying appellant's use of *Central Bank* to challenge the SEC's right to injunctive relief and relying on the legislative history of the Private Securities Litigation Reform Act of 1995 to justify upholding the SEC's right to injunctive relief); O'Hagan, 901 F. Supp. at 1472-73 (refusing to extend *Central Bank* to restrict remedies available under the Exchange Act).

it is of no consequence that section 21 only authorizes the Commission to obtain injunctive relief where the defendant "is engaged or about to engage" in a violation, but not where the defendant "has engaged" in such a violation.209

6. Agency Principles of Liability

Section 10(b) liability has on occasion been imposed based on the agency principles of apparent authority and respondeat superior.210 Apparent authority holds an employer liable when he puts an employee or other agent in a position which enables the agent, while apparently acting within his authority, to commit a fraud upon third persons.211 Respondeat superior subjects an employer to liability for the violations that his employee committed while acting in the scope of employment.212

In the wake of Central Bank, these theories have been challenged, yielding mixed results.213 In the seven cases addressing the issue to
date, plaintiffs have prevailed three times and defendants have prevailed on four occasions. In three of the four cases in which defendants prevailed, however, the courts conducted virtually no analysis of the issue and simply assumed their holdings were required by Central Bank. In the fourth case, the court's reasoning does not appear persuasive. Considering the mixed record on this issue, a final limitation of Central Bank is apparent—the case does not stand, as dissenting Justice Stevens feared, for the broader proposition that all forms of secondary liability, other than controlling person liability under section 20(a) of the Exchange Act, are without basis.

The conclusion that all secondary liability has not been eliminated by Central Bank is underscored by the decision in AT&T v. Winback & Conserve Program, Inc. In Winback, AT&T sued a competitor and its president, alleging acts of unfair competition in violation of, inter alia, section 43(a) of the Lanham Act, based upon the actions of the competitor's sales representatives. AT&T relied on common law theories of agency, including the doctrine of apparent authority. The district court denied AT&T's application for a preliminary injunction, holding that the sales representatives resembled independent contractors more than agents.

On appeal, the defendants for the first time raised the argument that, in light of Central Bank, common law doctrines of secondary liability

Subcommittee of the Senate Committee on Banking, Housing and Urban Affairs)); id. at 152 (letter from Professor Joel Seligman, University of Michigan Law School to Sen. Donald Riegle, Jr., Chairman, Senate Committee on Banking, Housing, and Urban Affairs (noting that respondeat superior is unlikely to survive after the Central Bank decision)).


216. See infra notes 227-36 and accompanying text.

217. 42 F.3d 1421 (3d Cir. 1994).

218. See id. at 1423-24.

219. See id. at 1428-29.

220. See id. at 1426.
may not be imported into the Lanham Act.\textsuperscript{221} The court held that "Central Bank's discussion of aiding and abetting should not be transplanted into the more settled realm of agency law."\textsuperscript{222} The court reasoned as follows:

[A]iding and abetting liability, with its focus on the defendant's substantial and knowing assistance to the commission of a tort, rests by definition upon acts that encourage a tort rather than acts constituting the tort. By definition then, the act rendered unlawful under an aiding and abetting theory is different than the act rendered unlawful by the underlying tort.

By contrast, courts imposing liability on agency theories are not expanding the category of affirmative conduct proscribed by the relevant statute; rather, they are deciding on whose shoulders to place responsibility for conduct indubitably proscribed by the relevant statute. The principal is held liable not because it committed some wrongdoing outside the purview of the statute which assisted the wrongdoing prohibited by the statute, but because its status merits responsibility for the tortious actions of its agent.\textsuperscript{223}

While \textit{Winback} involved alleged violations of the Lanham Act, the court's reasoning seems equally applicable in the federal securities law context. Indeed, when faced with the issue in a securities context, the District of Utah, in \textit{Seolas v. Bilzerian},\textsuperscript{224} relied on \textit{Winback} and rejected defendants' argument that "because the text of § 10(b) does not specifically mention agency or respondeat superior, the reasoning of \textit{Central Bank} makes these theories of liability unavailable."\textsuperscript{225}

\begin{itemize}
\item \textsuperscript{221} See \textit{id.} at 1429. The Third Circuit addressed the argument after finding that plaintiffs had failed to assert that defendants waived it by not raising it in the lower court. See \textit{id.} at 1429 n.10.
\item \textsuperscript{222} \textit{id.} at 1432.
\item \textsuperscript{223} \textit{id.} at 1430-31 (citation omitted).
\item \textsuperscript{224} 951 F. Supp. 978 (D. Utah 1997).
\item \textsuperscript{225} \textit{id.} at 983. Similarly, in \textit{Pollack v. Laidlaw Holdings, Inc.}, Civ. No. 90-5788, 1995 WL 261518 (S.D.N.Y. May 3, 1995), the Southern District of New York refused to preempt agency liability claims on the basis of \textit{Central Bank}. Judge Cote, while noting that \textit{Central Bank} has "called into question all common law claims that are adjunct to a direct securities claim," \textit{id.} at *17, allowed the claims to proceed because "[u]nlike aiding and abetting ..., liability of a principal based upon apparent authority has long been recognized by federal courts," \textit{id.} at *17; see also Tranchina v. Howard, Weil, Labouisse, Friedrichs, Inc., No. CIV.A.95-2886, 1997 U.S. Dist. LEXIS 12361, at *5 (E.D. La. Aug. 18, 1997) (rejecting \textit{Central Bank} challenge to respondeat superior).
\item At least two other courts have allowed section 10(b) agency theories of liability to go forward post-\textit{Central Bank}. See \textit{Denten v. Merrill Lynch, Pierce, Fenner & Smith, Inc.}, 887 F. Supp. 176 (N.D. Ill. 1995); \textit{In re Stat-Tech Sec. Litig.}, 905 F. Supp. 1416 (D. Colo. 1995). While it appears that in these cases no challenge was made to the validity of these theories, the courts were still very much aware of \textit{Central Bank} as they cited to it on other issues.
\end{itemize}
Three of the courts that have rejected agency claims engaged in little or no analysis of whether such claims are barred by *Central Bank*; they have simply assumed that *Central Bank* forecloses the inquiry. For example, in *ESI Montgomery County, Inc. v. Montenay International Corp.*, Judge Carter of the Southern District of New York stated:

"In view of *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, where the Supreme Court recently found that one form of secondary liability—aiding and abetting—was no longer applicable to claims brought under the securities laws . . . . the court finds that MERMCI is not liable for violations of § 10(b) and Rule 10b-5 arising from the alleged misrepresentations made by the officers of MERMCI based on the principle of respondeat superior."

The court offered no additional explanation for its holding.

The court in the remaining case, *In re Fidelity/Micron Securities Litigation*, analyzed the issue in greater detail. Plaintiffs sought to invoke the doctrine of respondeat superior to hold a mutual fund liable for alleged misrepresentations by its portfolio manager that he favored a certain stock, when he was actually divesting the fund of the stock. Rejecting this argument, the court stated that to hold otherwise would allow liability without any showing of reliance on a misstatement or omission by the defendant. The court elaborated that it was not conferring immunity on corporate entities which by nature can only speak through their agents:

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226. No. 94-0119, 1996 U.S. Dist. LEXIS 592, at *6 (S.D.N.Y. Jan. 23, 1996) (footnote omitted). Prudential Insurance also prevailed on this issue in *In re Prudential Insurance Co. Sales Practices Litigation*, No. 1061, CIV.A.95-4704, 1996 WL 392145 (D.N.J. May 10, 1996). With only a single cite to *ESI Montgomery*, the court dismissed plaintiffs' securities law claims against Prudential based upon respondeat superior. See id. at *26. It appears that the court found little need to expend energy analyzing the issue because, even prior to *Central Bank*, respondeat superior was unavailable in the Third Circuit in securities cases. See *Rochez Bros., Inc. v. Rhoades*, 527 F.2d 880, 884-85 (3d Cir. 1975) (holding that respondeat superior is inconsistent with the Third Circuit's "culpable participant" approach to section 20(a) controlling person liability).

Rounding out this string of cases is *Seidel v. Lee*, 954 F. Supp. 810 (D. Del. 1996). Here, the District of Delaware refused to hold two defendants vicariously liable for their employees' violations of the Investment Company Act. See id. at 819-20. The court found persuasive that the plain language of the section charged contains a "willful" requirement which the secondary defendants did not satisfy. See id. at 820. The court's analysis overlooks that the defendants were not being charged as primary violators, but rather were being charged based on their vicarious responsibility for the acts of their agents. Under the court's analysis, a corporate employer would not be liable for damage caused in an automobile accident by its employee because the employer itself was not negligent. This conclusion is certainly erroneous.


228. See id. at 544.
The difference between primary corporate liability, which survives *Central Bank*, and secondary liability, which does not, lies in the fact that in primary liability the corporate delegate has spoken as the corporation. By contrast, in the realm of vicarious liability, a corporate delegate has simply spoken in the scope of his employment or agency and the corporation is strictly liable by reason of that relationship to the delegate.229

This approach is flawed for several reasons. First, it conflicts with the Supreme Court’s pronouncements in this area. In *American Society of Mechanical Engineers, Inc. v. Hydrolevel Corp.*,230 the Court stated that “the apparent authority theory has long been the settled rule in the federal system... [and] ‘few doctrines of the law are more firmly established or more in harmony with accepted notions of social policy than that of the liability of the principal without fault of his own.”231 The Court expressly cited with approval *Holloway v. Howerdd*,232 which invoked agency principles in a case involving violations of the federal securities laws.233

Second, the Court’s central inquiry in *Hydrolevel*, an antitrust case, focused on whether liability under an apparent authority theory was consistent with the intent behind the Sherman Act.234 Agency principles of liability are clearly consistent with the intent behind the federal securities laws. “[I]mposing such liability will encourage corporate officials to prevent unauthorized... misrepresentations, thereby helping to achieve an important Securities Act purpose.”235 Finally, the dividing line drawn by the court in *Fidelity* seems artificial. Exchange Act section 3(9) defines person to include any “company.” Clearly, the drafters contemplated some form of vicarious liability would apply as companies can only act through their agents. Nothing found in the text of the securities laws supports limiting a company’s liability along the lines of the test set out in *Fidelity*.

229. Id. at 544 n.10.
231. Id. at 567-68 (quoting Gleason v. Seaboard Air Line R. Co., 278 U.S. 349, 356 (1929)).
232. 536 F.2d 690 (6th Cir. 1976).
233. See *Hydrolevel*, 456 U.S. at 568.
234. See id. at 570.
C. Reaction by the Plaintiff Bar

*Central Bank* has caused plaintiffs to reexamine section 10(b) and Rule 10b-5 in an effort to identify alternative theories of liability for those traditionally charged as aiders and abettors. With the loss of aiding and abetting, private plaintiffs have most often alleged that secondary actors should be held liable as primary violators on one or more of the following grounds: (1) participation in a conspiracy to violate section 10(b), (2) issuance of a material misstatement or omission, and (3) participation in a "scheme to defraud" under Rule 10b-5.

1. Conspiracy Liability

In his *Central Bank* dissent, Justice Stevens predicted: "The Court’s rationale would sweep away the decisions recognizing that a defendant may be found liable in a private action for conspiring to violate § 10(b) and Rule 10b-5." To date, Justice Stevens’s prediction has proven accurate, but the issue is very much alive.

Since *Central Bank*, at least twenty-eight decisions have held that conspiracy to violate section 10(b) is no longer a viable theory.\(^236\)

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These courts based their decisions on a variety of rationales. Some have held that because the text of section 10(b) does not mention "conspiracy," there is no conspiracy liability. At least four opinions have cited to Justice Stevens's *Central Bank* dissent as support for their dismissal of these claims. Other courts, pointing to the provisions of the securities laws which impose liability on those who "control" the primary violator, have concluded that Congress knew how to impose secondary liability expressly when it desired to do so. Still others have expressed the concern that every aiding and abetting claim can be recast as a conspiracy, thus rendering *Central Bank* meaningless.

The SEC asserted claims for conspiracy liability in an enforcement action brought after *Central Bank*. In *SEC v. U.S. Environmental*, the SEC sued multiple defendants charging, inter alia, that six of the defendants conspired to violate several provisions of the securities laws, including section 10(b) of the Exchange Act and Rule 10b-5. In so doing, the SEC relied on two Supreme Court precedents, *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Curran* and *Herman & MacLean v. Huddleston*. In *Curran*, the Supreme Court endorsed a civil conspiracy claim under a Commodity Exchange Act rule analogous to Rule


238. See, e.g., *GlenFed*, 60 F.3d at 592 ("The Court's rationale [in *Central Bank*] precludes a private right of action for 'conspiracy' liability."); *Gupta Corp.*, 900 F. Supp. at 1244 ("The text of Section 10(b) does not refer to any form of conspiracy liability. Under *Central Bank*, therefore, plaintiffs may not maintain a private action for conspiracy to violate Section 10(b).")); *Syntex Corp.*, 855 F. Supp. at 1098 ("The Court's rationale in *Central Bank* of Denver...forecloses Plaintiffs' conspiracy liability theory. Section 10(b) is silent as to conspiracy liability... ").

239. See, e.g., *U.S. Envtl.*, 897 F. Supp. at 119 ("The Court's rationale would sweep away the decisions recognizing that a defendant may be found liable in a private action for conspiring to violate § 10(b) and Rule 10b-5.") (quoting *Central Bank* v. First Interstate Bank, 511 U.S. 164, 201 n.12 (1994) (Stevens, J., dissenting)); *Upton*, 887 F. Supp. at 1580 (same); *Pitten*, 903 F. Supp. at 950 ("Thus, *Central Bank* 'forecloses... conspiracy liability theory.' Indeed, the dissenting opinion...recognized this implication of the Court's opinion." (citations omitted) (citing *Central Bank*, 511 U.S. at n.12) (Stevens, J., dissenting)); *Ross Sys.*, 1994 WL 583114, at *3 ("[T]he assessment of the majority holding [in *Central Bank*] by dissenting Justice Stevens that the Supreme Court has 'swe(pt) away' a cause of action for conspiracy under § 10(b)...[O]n the merits Justice Stevens has it right." (alteration in original) (citation omitted)).

240. See *Central Bank*, 511 U.S. at 184 ("[W]hen Congress wished to create such [secondary] liability, it had little trouble doing so." (quoting *Pinter v. Dahl*, 486 U.S. 622, 650 (1988))).

241. See, e.g., *Pitten*, 903 F. Supp. at 950 (giving an example of an attempt to recast an aiding and abetting claim as a conspiracy).


10b-5. In Huddleston, the Court cited Curran in a footnote in a manner supporting the belief that while it never passed on 10b-5 aiding and abetting liability, it approved of conspiracy liability.

The SEC based the conspiracy charge on allegations that the defendants agreed to manipulate the price of U.S. Environmental shares by dominating and controlling its trading in the aftermarket. The district court, granting a motion to dismiss, held:

The Commission is authorized to bring an enforcement action, only in the event of an imminent or actual "violation" of the Securities Acts, and the Commission has failed to identify any statutory text that makes it a... violation of the Securities Acts... to conspire to violate any one or all of the [federal securities laws]. Under the reasoning of Central Bank, the Commission's failure in this regard is dispositive.

Because Curran was decided prior to Central Bank, the court was not persuaded that it required a different result.

Notwithstanding the weight of contrary precedent, at least one court has been unwilling to scrap conspiracy liability. In In re Towers Financial Corp. Noteholders Litigation, Judge Whitman Knapp of the Southern District of New York held that Central Bank does not preclude the possibility of Rule 10b-5 conspiracy liability. Judge Knapp began by stating that he was not persuaded by the decisions from other courts on this issue. He then noted that it was clear that the aiding and abetting allegations in Central Bank were based on reckless conduct. Judge Knapp observed that "[t]his does not seem to us the action of a Court that considered itself to be eliminating the possibility of Rule 10b-5 conspiracy liability for intentional wrongdoers." Judge Knapp rejected the argument that recognizing conspiracy liability would render...
Central Bank meaningfully since aiding and abetting claims can easily be repleaded as conspiracy claims.254 Rather, he noted that not all aiding and abetting claims are so easily transformed because aiding and abetting liability can be based on reckless conduct, whereas conspiracy liability requires knowing and willful participation.255

2. Recasting Actions by Secondary Defendants as Primary Violations

Prior to Central Bank, the distinction between primary and secondary violations was largely academic. Secondary actors, such as accountants, lawyers, and underwriters, were routinely charged as aiders and abettors and, if found liable, were subject to liability joint and several with primary violators. With the elimination of private actions for aiding and abetting, plaintiffs have begun to explore various theories of primary liability in efforts to reach these secondary actors.256 In particular, plaintiffs have brought claims against these persons under two subsections of Rule 10b-5 that have not traditionally been used to charge secondary actors.257

255. See id. After the plaintiffs in Towers amended their complaint to include the conspiracy charges, the defendant, the law firm of Squadron, Ellenoff, Plesent, Sheinfeld & Sokin, moved to dismiss. See Dinsmore v. Squadron, Ellenoff, Plesent, Sheinfeld & Sokin, 945 F. Supp. 84, 85 (S.D.N.Y. 1996). Judge Knapp denied the motion but did certify the question for interlocutory appeal to the Second Circuit Court of Appeals. See id. at 87. In denying the motion, Judge Knapp referred to the transcript of oral argument before the Supreme Court in Central Bank and was influenced by questions apparently asked by Justices Kennedy and Scalia, both in the Central Bank majority, suggesting that conspiracy to violate section 10(b) remains a viable claim. See id. at 85-86. Specifically, both justices asked counsel for defendant-petitioner why the case against Central Bank could not simply be reframed as conspiracy, to which counsel essentially responded that the theory had not been presented in the case. See id. While not noted by Judge Knapp, a review of the Central Bank oral argument transcript discloses that a third Justice stated:

The question, as Justice Scalia raised, is whether it really falls within sort of the rounding-out jurisprudence, and I mean, Justice Kennedy's point is that they could have been pursued on a conspiracy theory, and at least on traditional tort principles that would not have been regarded as a departure.

United States Supreme Court Official Transcript at 6, Central Bank v. First Interstate Bank, 511 U.S. 164 (1994) (No. 92-854). As of this writing, the appeal is pending before the Second Circuit.

256. See, e.g., In re Blech Sec. Litig., 961 F. Supp. 569, 583 (S.D.N.Y. 1997) (alleging that a clearing agent had actual knowledge of broker's fraudulent conduct as well as motive to engage in deception with broker).
257. See cases cited infra note 261.
a. Material Misrepresentations or Omissions

In a number of cases post-Central Bank, plaintiffs have charged that secondary actors have made misstatements or omissions in violation of Rule 10b-5(b) under circumstances in which the statements or omissions are in fact the joint product of multiple persons. An example of such a case is the preparation of a corporation’s prospectus with either drafting assistance from, or review by, accountants, lawyers, underwriters, and other professionals. In other cases, plaintiffs have alleged that secondary actors are liable for misstatements or omissions in documents they have not prepared, but which contain alleged misstatements they have made. An example of this type of case is where an attorney or accountant’s opinion is included in a corporation’s offering documents which are alleged to be fraudulent. Significant questions have arisen as to what it means to “make” a misstatement or omission.

In such cases, secondary defendants—most often accountants and underwriters—routinely make motions either to dismiss for failure to state a claim or for summary judgment on these charges, arguing that at most they aided and abetted and such charges cannot be sustained post-Central Bank. Defendants, however, have had only limited success with these arguments. In an examination of twenty-five rulings on motions in which the defendant argued that secondary violations were being improperly couched as primary violations, we found only four

258. See 17 C.F.R. § 240.10b-5(b) (1997) (making it unlawful to “make any untrue statement of a material fact... in connection with the purchase or sale of any security”).


260. See id. at 316.

In which defendants succeeded in getting the charges dismissed. In an additional four, defendants were successful in getting some of the allegations dismissed, with the case proceeding on the remaining allegations. In the other seventeen cases, the motions were denied.

Three circuit courts have ruled on the dividing line between primary and secondary liability, each drawing the line quite differently. The broadest formulation came from the Second Circuit in SEC v. First Jersey Securities, Inc. The court held that "[p]rimary liability may be imposed ‘not only on persons who made fraudulent misrepresentations but also on those who had knowledge of the fraud and assisted in its preparation." A later Second Circuit case, however, appears to be at odds with First Jersey. In Shapiro v. Cantor, the Second Circuit panel stated: "Allegations of ‘assisting,’ ‘participating in,’ ‘complicity in’ and similar synonyms used throughout the complaint all fall within the prohibitive bar of Central Bank." The court held that section 10(b) requires the defendant to have personally made a material misrepresentation or omission.

In Software Toolworks, the Ninth Circuit ruled that primary liability could attach to an accounting firm that played a "significant role" in

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264. See SEC v. First Jersey Sec., Inc., 101 F.3d 1450, 1471 (2d Cir. 1996), cert. denied, 66 U.S.L.W. 3249 (U.S. Oct. 6, 1997) (No. 96-1862) (holding that knowledge of the fraud and assistance in the preparation of the fraudulent documents constitutes primary liability); Anixter, 77 F.3d at 1226 (holding that defendants must actually make an alleged misleading statement or omission to be primarily liable); Software Toolworks, 50 F.3d at 628 (holding that primary liability may be imposed only on those who had a "significant role" in the preparation of the misleading materials, even though they were not the author of the statement).

265. 101 F.3d 1450 (2d Cir. 1996).

266. Id. at 1471 (quoting Azrielli v. Cohen Law Offices, 21 F.3d 512, 517 (2d Cir. 1994)).

267. No. 96-9529, 1997 WL 547939, at *3 (2d Cir. Sept. 8, 1997).

268. See id.
drafting and editing misleading offering materials, even though the firm itself was not the maker of the statement. The court did not, however, specify which prong of Rule 10b-5 the accounting firm may have violated.

By contrast, the Tenth Circuit, in *Anixter*, created a bright-line test and ruled, similar to the Second Circuit in *Shapiro*, that regardless of which prong of Rule 10b-5 is alleged to have been violated, the terms of section 10(b) still require the defendant to have made an alleged misleading statement or omission. The court specified that the amount of assistance rendered is irrelevant if no misstatement or omission is made by the secondary actor himself. The district courts appear equally split.

269. See *Software Toolworks*, 50 F.3d at 628 n.3.
270. See *Anixter*, 77 F.3d at 1226.
271. See *id.* at 1226 n.10.


Case following *First Jersey Securities: In re Health Management, Inc. Sec. Litig.*, No. 96-889, 1997 U.S. Dist. LEXIS 10665, at *48 (E.D.N.Y. July 21, 1997) ("[P]laintiffs need not allege that [certain corporate officers] made any fraudulent statements during the Class period," as long as the officers had knowledge of the fraud and assisted in its perpetration.).
A clearer picture of whether participation in drafting offering documents, without more, suffices for primarily liability will emerge as more circuit courts rule on the issue. The firmest conclusion in this area to date is that an accountant or attorney opinion letter issued in conjunction with an offering will be considered the making of a statement in connection with the purchase or sale of a security, sufficient to attach primary liability.273

b. Scheme to Defraud

When it is clear that no misstatement or omission has been made, plaintiffs fall back on the “scheme to defraud” language of Rule 10b-5(1).274 Section 10(b) authorizes the Commission to adopt rules to forbid the direct or indirect use or employment of any “deceptive device or contrivance,” language that appears broad enough to justify the scheme prong of Rule 10b-5.275 There have been nine reported opinions ruling on whether Central Bank precludes allegations that a defendant engaged in a “scheme to defraud.”276

Opining that these are essentially artfully pleaded conspiracy claims, four of the eight courts have held that such claims are now precluded.277 In a fifth case, In re Gupta Securities Litigation,278 the plaintiffs argued that the text “scheme . . . to defraud” creates an implied private


274. See 17 C.F.R. § 240.10b-5(a) (1997) (making it unlawful “to employ any device, scheme, or artifice to defraud . . . in connection with the purchase or sale of any security”).


right of action for conspiracy. The court dismissed the claim because “[a] scheme need not refer to a conspiracy . . . . One person can scheme alone to break all manner of laws, including federal securities laws.” This decision is somewhat puzzling because it does not explain how a single person can be liable for a “scheme to defraud,” but multiple persons engaged together in a scheme cannot. The remaining four cases, however, have held that Central Bank does not sound the death knell for “scheme to defraud” charges.

CONCLUSION

Over the years, court decisions interpreting the federal securities laws have covered a wide spectrum, with broad and expansive interpretations at one end and narrow and restrictive holdings at the other. The pendulum has frequently shifted, often in response to pronouncements by the Supreme Court. Central Bank was viewed by many as the beginning of another pendulum swing toward a narrow, literal interpretation of the securities laws. A creative defense bar was quick to urge courts to follow the strict textualist methodology employed by the Supreme Court in Central Bank in efforts to whittle away other well-established securities law principles. For the most part, the defense bar’s arguments have been rejected. If anything, Central Bank has proven to mark both the

279. Id. at 1244.
280. Id.
281. See Cooper v. Pickett, No. 95-55657, 1997 U.S. App. LEXIS 21034, at *10 (9th Cir. Aug. 8, 1997) (“Central Bank does not preclude liability based on allegations that a group of defendants acted together to violate the securities laws, as long as each defendant committed a manipulative or deceptive act in furtherance of a scheme.”); Silicon Graphics, 970 F. Supp. at 762. "Plaintiff's scheme allegations appear to be 'no more than a thinly disguised attempt to avoid the impact of the Central Bank decision.'" Id. The court, however, refused to dismiss the charges. Rather, the court set the ground rules for what plaintiffs will be required to prove, stating that “[a]lthough plaintiffs need not allege that every defendant participated in every aspect of a fraudulent scheme to state a claim, section 10 liability requires a finding that each individual took some action in furtherance of the scheme.” Id.; see U.S.A. Classic, 1995 WL 363841, at *5 (“[P]laintiffs correctly note that Central Bank does not limit the liability of those who participate in a scheme to defraud, for Central Bank had not committed a manipulative or deceptive act.”); Hometown Buffet, 1995 U.S. Dist. LEXIS 17870, at *18 (“[T]he court recognizes that in some situations a plaintiff might successfully allege a scheme to defraud under section 10(b) when there are specific allegations that several plaintiffs participated in producing misrepresentations . . . .”).

In O'Hagan, the Supreme Court provided some indication that it would allow “scheme to defraud” charges. The Court clarified that its statement in Central Bank that secondary actors may be chargeable as primary violators for making a material misstatement or omission was merely meant as one example of conduct which would suffice, with the implication that scheme charges would also be sufficient. See United States v. O'Hagan, 117 S. Ct. 2199, 2213 (1997).
beginning and the end of any pendulum swing toward a more restrictive interpretation of the securities laws. This conclusion is underscored by the Court’s recent opinion in *O’Hagan*, which tempers its textual analysis by paying homage to the animating purposes of the securities laws, namely, safeguarding the integrity of the securities markets and protecting investors.

In addition to *O’Hagan*, other decisions by lower courts after *Central Bank* establish important limits on the scope of the case. In sum, the limits are as follows: First, *Central Bank*’s textualist approach does not equate to literalism. Section 10(b)’s broad terms continue to capture conduct not literally proscribed by the statute. Second, *Central Bank* arguably does not extend beyond section 10(b). Third, textualism does not control when there is any degree of ambiguity in the statute. Fourth, textualism does not abrogate the court’s inherent equitable powers. Finally, *Central Bank* does not stand for the broader proposition that all forms of secondary liability, other than those provided for by statute, are eradicated.

So what has been the fallout from *Central Bank*? In short, with the exception of the virtual elimination of conspiracy liability, *Central Bank* has been limited to its holding. Its strict textualist approach is not being widely and blindly followed by lower courts. The proscriptions of the federal securities laws have remained flexible, and courts have retained broad powers to fashion remedies.

We believe that this approach is the proper one. The Supreme Court made it clear in *Central Bank* that it has not uniformly applied a strict textualist approach to interpreting the federal securities laws. Rather, it stated that it has resorted to such an approach in determining the *scope of conduct prohibited by section 10(b)*, when the text is unambiguous in the context presented. The Court’s decision provides no mandate that this approach applies when interpreting any other aspect of the federal securities laws.

In addition, the Court’s decision was likely influenced by its fear of the potential for vexatious litigation under section 10(b)’s implied private right of action. More than three years after the opinion, however, the securities laws have undergone a major revamping by Congress meant to

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283. *See discussion supra* Part II.B.3.
284. *See discussion supra* Parts II.B.1,4.
alleviate this concern. In December 1995, Congress passed the Private Securities Litigation Reform Act of 1995. The Act, which revised both substantive and procedural law governing private actions under the federal securities laws, was designed to address Congressional concerns about the filing of meritless securities lawsuits solely for their settlement value.

In April 1997, the Commission submitted a report to President Clinton and the Congress on the first year of practice under the Act. While generally concluding that it is too soon to make definitive assessments about the Act’s impact, the report did make some observations tending to show that the Act is having some force. Traditional “aiders and abettors,” such as accountants and lawyers, were being named much less frequently. Moreover, the report found that certain of the Act’s provisions—namely, the discovery stay and heightened pleading standards—have made it more difficult for plaintiffs to bring and prosecute class action lawsuits. The report also found that the complaints appeared to be specific to the action, and not cookie cutter.

Coupled with the loss of aiding and abetting in Central Bank, these reforms suggest that the concerns expressed by the Supreme Court and the Congress about vexatious litigation under section 10(b) hold less true today than when first enunciated by the Court more than two decades ago. It is for these reasons that we believe that courts should contin-
ue to construe the securities laws “not technically and restrictively, but flexibly to effectuate [their] remedial purposes.”