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Tarnished Reputations: Gatekeeper Liability After Janus

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Cover Page Footnote

J.D. Candidate, Fordham University School of Law, 2015; Member of the Chartered Alternative Investment Analyst (CAIA) Association. This Note would not have been possible without the invaluable advice and guidance from my note advisor, Prof. Caroline Gentile. I would also like to thank my family and friends for their support and the editorial staff and members of the Fordham Journal of Corporate and Financial Law for their efforts.

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TARNISHED REPUTATIONS: GATEKEEPER LIABILITY
AFTER *JANUS*

Daniel R. Tibbets

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*Daniel R. Tibbets, CAIA**

ABSTRACT

Courts have long recognized the role of the securities industry's accountants, lawyers, securities analysts, and credit-rating agencies as "gatekeepers"—reputational intermediaries who, for a fee, effectively rent their reputations for honesty, accuracy, and integrity to their corporate clients in order to provide confidence to the clients' investors. Under this reputational model, a gatekeeper's reputation is its chief capital asset. While it seems that gatekeepers would need very little incentive to avoid risking this asset by helping their clients commit securities fraud, debacles such as Enron, WorldCom, Refco, and the 2008 Financial Crisis demonstrate that this is not true. Notable commentators suggest that if gatekeepers face a low risk of litigation, then the expected value derived from risking their reputations by committing fraud increases. Yet ever since the Supreme Court's 1994 decision in *Central Bank of Denver v. First Interstate Bank of Denver*, even when gatekeepers knowingly assist their clients to commit securities fraud, the clients' investors cannot bring aiding and abetting claims against these gatekeepers in Rule 10b-5 actions. Unsurprisingly, the period after *Central Bank* is marked by an increase in risky accounting practices and less conservative reporting strategies. Furthermore, in both *Stoneridge Investment Partners, LLC v. Scientific-Atlanta* (2008) and *Janus Capital Group, Inc. v. First Derivative Traders* (2011), the Supreme Court further limited theories by which gatekeepers could be held liable as primary violators under Rule 10b-5. Congress had several chances after *Central Bank* to restore the aiding and abetting private right of action under 10b-5 but declined to do so. As a result, gatekeepers who aid and abet fraud face a substantially reduced risk

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of litigation and therefore a substantially reduced risk to their reputational capital.

To effectively curtail securities fraud committed by gatekeepers, private aiding and abetting liability must be reinstated. This Note will examine the history of gatekeeper liability under the securities laws, particularly the rise and fall of the private right of action for aiding and abetting liability under Rule 10b-5. It will then explore theories from several notable commentators of why gatekeepers would rationally risk their reputational capital by knowingly acquiescing to their clients' securities frauds. In concluding that the current state of securities law does not provide the market with enough incentive to demand that gatekeepers invest in and maintain their reputations, this Note argues that Congress must restore the right of private plaintiffs to bring aiding and abetting claims under 10b-5.

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INTRODUCTION

It is perhaps dismaying that participants in a fraudulent scheme who may even have committed criminal acts are not answerable in damages to the victims of [their] fraud However, . . . the fact that the plaintiff-investors have no claim is the result of a policy choice by Congress This choice may be ripe for legislative re examination.¹

This quotation from Judge Gerald Lynch of the Southern District of New York neatly sums up the state of securities law today and its treatment of aiding and abetting liability for the securities industry’s gatekeepers—accountants, lawyers, securities analysts, and credit-rating agencies.² Judge Lynch made these remarks in *In re Refco, Inc. Securities Litigation* in which a lawyer, Joseph Collins, a partner at the law firm of Mayer Brown LLP, was alleged to have knowingly helped his client, Refco, fraudulently conceal its massive debts from its shareholders through an elaborate financial scheme.³ While Mr. Collins was later found to be criminally liable for his actions,⁴ the law does not

1. *In re Refco, Inc. Sec. Litig.*, 609 F. Supp. 2d 304, 319 n.15 (S.D.N.Y. 2009), *aff’d sub nom.* Pac. Inv. Mgmt. Co. LLC v. Mayer Brown LLP, 603 F.3d 144 (2d Cir. 2010).

2. JOHN C. COFFEE, *GATEKEEPERS: THE ROLE OF THE PROFESSIONS AND CORPORATE GOVERNANCE* 103 (2006).

3. *In re Refco*, 609 F. Supp. 2d at 306-09.

4. Bob Van Voris, *Ex-Refco Lawyer Guilty of Aiding \$2.4 Billion Fraud*, BLOOMBERG (Nov. 17, 2012), available at <http://www.bloomberg.com/news/print/2012-11-16/ex-refco-lawyer-guilty-of-aiding-2-4-billion-fraud.html>.

currently allow any private plaintiff to collect damages from him, Mayer Brown, or any other gatekeeper who aids and abets fraud.⁵

When financial market participants learn about gatekeeper-aided fraud, the effect on stock prices can be devastating.⁶ Investors, who rely on the work product of gatekeepers to evaluate the market, lose faith in the market and shift stock prices downward because they no longer trust that work product.⁷ This penalty is usually very severe.⁸ One study shows that public companies that announce financial statement restatements due to revenue recognition issues (an indicator of fraud) lose on average over 25% of their market value.⁹ Many such companies become insolvent, a fact which many commentators claim justifies private liability for gatekeepers.¹⁰

Courts have long recognized the important role of gatekeepers in the financial markets as “reputational intermediaries.”¹¹ In essence, gatekeepers use their reputations for accurate reporting, thorough due diligence, and trustworthiness to assure investors that their capital will be used wisely by the companies in which they invest and that it will

5. See *In re Refco*, 609 F. Supp. 2d at 318-19.

6. COFFEE, *supra* note 2, at 55.

7. See *id.*

8. See *id.* at 83 (“When a restatement calls management’s credibility into question . . . the market reaction is . . . severe.”).

9. See Richardson et al., *Predicting Earnings Management: The Case of Earnings Restatements*, at 16 (Oct. 2002), available at <http://ssrn.com/abstract=338681> (measured over a time period of 120 days before the announcement of the restatement to 120 days after the announcement).

10. See Andrew F. Tuch, *Multiple Gatekeepers*, 96 VA. L. REV. 1583, 1608-09 (2010).

11. See, e.g., *Pac. Inv. Mgmt. Co. LLC v. Mayer Brown LLP*, 603 F.3d 144, 156 (2d Cir. 2010) (“Where statements are publicly attributed to a well-known national law or accounting firm, buyers and sellers of securities (and the market generally) are more likely to credit the accuracy of those statements.”); see also, e.g., *United States v. Arthur Young & Co.*, 465 U.S. 805, 817-18 (1984) (“By certifying the public reports that collectively depict a corporation’s financial status, the independent auditor assumes a public responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporation’s creditors and stockholders, as well as to investing public.”); *DiLeo v. Ernst & Young*, 901 F.2d 624, 629 (7th Cir. 1990) (“An accountant’s greatest asset is its reputation for honesty, followed closely by its reputation for careful work.”).

have the true potential to produce a good return on investment.¹² In effect, gatekeepers “rent” their reputations to issuers.¹³ This enables an issuer to raise more capital at a lower expense than it otherwise would have incurred had it been necessary to build a reputation on its own (this is especially true if the issuer is smaller or more unknown). At the same time, gatekeepers serve investors by reducing informational asymmetries between issuers and the investors.¹⁴ If the reputation of a gatekeeper is good, the investor trusts the information being provided and will use it in deciding whether and how much to invest in an issuer or in the market as a whole.¹⁵

It would seem then that gatekeepers would have very little reason to risk their valuable reputations by knowingly aiding their clients to commit fraud.¹⁶ However, as high profile gatekeeper failures in debacles such as Refco, Enron, and WorldCom prove, this is not always the case.¹⁷

These debacles took place during an era in which the threat of litigation against gatekeepers was substantially reduced, an era that continues to this day.¹⁸ In 1994, the Supreme Court held that plaintiffs could no longer bring civil actions for aiding and abetting securities

12. Jonathan Macey, *The Value of Reputation in Corporate Finance and Investment Banking (and the Related Roles of Regulation and Market Efficiency)*, 22 J. APPLIED CORP. FIN. 18, 18 (Fall 2010), available at <http://ssrn.com/abstract=1733798>.

13. Jonathan Macey, *The Demise of the Reputational Model in Capital Markets: The Problem of the “Last Period Parasites”*, 60 SYRACUSE L. REV. 427, 436 (2010) [hereinafter *Demise of the Reputational Model*].

14. COFFEE, *supra* note 2, at 9.

15. See Macey, *supra* note 12, at 19.

16. See COFFEE, *supra* note 2, at 4 (noting that “reputational intermediaries face losses that exceed the likely one-time gain from acquiescence in fraud . . .”).

17. See generally *In re Refco, Inc. Sec. Litig.*, 609 F. Supp. 2d 304 (S.D.N.Y. 2009), *aff’d sub nom. Pac. Inv. Mgmt. Co. LLC v. Mayer Brown LLP*, 603 F.3d 144 (2d Cir. 2010) (lawyers helped to fraudulently conceal massive company debt); *In re Enron Corp. Sec., Derivative & “ERISA” Litig.*, 439 F. Supp. 2d 692 (S.D. Tex. 2006) (accountants helped to fraudulently conceal debt and create the appearance that Enron was healthy); *In re WorldCom, Inc. Sec. Litig.*, 352 F. Supp. 2d 472, 480 (S.D.N.Y. 2005) (auditors aided fraud by certifying company’s fraudulent financial statements).

18. See Mark Klock, *Improving the Culture of Ethical Behavior in the Financial Sector: Time to Expressly Provide for Private Enforcement Against Aiders and Abettors of Securities Fraud*, 116 PENN ST. L. REV. 437, 467 (2011) (lamenting that without a private right of action, only the SEC can enforce aiding and abetting liability, but the SEC cannot pursue all such cases).

fraud.¹⁹ A year later, Congress enacted the Private Securities Litigation Reform Act of 1995 (“PSLRA”),²⁰ which restored the SEC’s ability to bring aiding and abetting claims, but not those of private plaintiffs.²¹ In the years that followed, evidence suggests that accounting firms lowered risk management standards and adopted less conservative reporting policies.²² Few gatekeepers took precautions to protect their reputational capital and many relaxed risk management standards that had previously been in place.²³

In seeking to answer the question of why gatekeepers help their clients commit fraud, notable commentators such as Professor John C. Coffee, Jr. of Columbia University School of Law, Professor Jonathan Macey of Yale University School of Law, and Professor Frank Partnoy of the University of San Diego School of Law have looked to the theory of reputational capital.²⁴ The theory puts forth that a firm’s reputation is a valuable capital asset that is “pledged or placed at risk by the gatekeeper’s vouching for its client’s assertions or projections.”²⁵ And just like any other form of capital, the value of reputational capital can rise or fall depending on several factors, including (significantly) the risk of litigation.²⁶ When the risk of litigation is low, the expected cost to a gatekeeper of acquiescing to a client’s fraud is decreased.²⁷ For this

19. Cent. Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164, 191 (1994).

20. Pub. L. No. 104-67, 109 Stat. 737 (codified as amended in scattered sections of 15 U.S.C.).

21. See *id.* § 104 (codified as amended at 15 U.S.C. § 78t(e) (2012)).

22. See, e.g., UNITED STATES GENERAL ACCOUNTING OFFICE, GAO-03-138, REPORT TO THE CHAIRMAN, COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS, U.S. SENATE, FINANCIAL STATEMENT RESTATEMENTS: TRENDS, MARKET IMPACTS, REGULATORY RESPONSES AND REMAINING CHALLENGES, 6 (October 2002), available at <http://www.gao.gov/new.items/d03138.pdf> (last accessed Nov. 28, 2014) [hereinafter GAO STUDY].

23. COFFEE, *supra* note 2, at 317.

24. See generally COFFEE, *supra* note 2; Macey, *supra* note 12; *Demise of the Reputational Model*, *supra* note 13; Frank Partnoy, *Barbarians at the Gatekeepers?: A Proposal for A Modified Strict Liability Regime*, 79 WASH. U. L.Q. 491 (2001) (elaborating on the theory of reputational capital and how the theory helps to explain why gatekeepers would aid and abet fraud).

25. COFFEE, *supra* note 2, at 3.

26. See *infra* Part II.

27. See John C. Coffee, *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 B.U. L. REV. 301, 337 (2004) [hereinafter *Gatekeeper Failure*].

reason primarily, the private right to bring a Rule 10b-5 action for aiding and abetting liability should be restored by Congress.²⁸

Part I of this Note will examine gatekeeper liability under the federal securities laws and its development since the enactments of the '33 Act and '34 Act. Part II will examine current theories about reputational capital and why gatekeepers choose to acquiesce to their clients' securities frauds. In Part III, I argue that if one accepts the theory that gatekeepers serve as reputational intermediaries, as the courts seem to do, then the case for reinstating private liability gains new urgency.

I. THE RISE AND FALL OF GATEKEEPER LIABILITY UNDER THE FEDERAL SECURITIES LAWS

In response to the stock market crash of 1929 and the subsequent Great Depression, Congress enacted The Securities Act of 1933 ("the '33 Act") and the Securities Exchange Act of 1934 ("the '34 Act").²⁹ The '33 Act established registration requirements for securities issued on the primary market.³⁰ The '34 Act provided for the regulation of securities trading, exchanges, and broker-dealers, and it established the Securities and Exchange Commission ("SEC").³¹ The four most important provisions for the imposition of liability upon gatekeepers for securities violations are Sections 11, 12(a)(1), and 12(a)(2) of the '33 Act, and Section 10(b) under the '34 Act.³²

28. See Klock, *supra* note 18, at 493 (calling for the same action by Congress).

29. Erin L. Massey, *Control Person Liability Under Section 20(a): Striking A Balance of Interests for Plaintiffs and Defendants*, 6 Hous. Bus. & Tax L.J. 109, 111-12 (2005).

30. THOMAS L. HAZEN, *THE LAW OF SECURITIES REGULATION* § 1.2[3][A] (6th ed. 2009).

31. *Id.* § 1.2[3][B].

32. Carsten Gerner-Beuerle, *The Market for Securities and Its Regulation Through Gatekeepers*, 23 TEMP. INT'L & COMP. L.J. 317, 333 (2009).

A. THE SECURITIES ACT OF 1933

1. Section 11

Section 11 of the '33 Act imposes strict liability on issuers for any material misstatement or omission in a registration statement.³³ It also provides an express private right of action against “every accountant, engineer, or appraiser, or any person whose profession gives authority to a statement made by him, who has with his consent been named as having prepared or certified any part of [such] registration statement”³⁴ Through this provision, Congress arguably recognized a deterrence role for the gatekeeping professions in preventing the filing of materially false or misleading registration statements.³⁵ However, Section 11 also provides a due diligence defense for gatekeepers which can relieve them of liability if the defense is properly established.³⁶ So while Section 11 is a strict liability regime for issuers, it is only a fault-based liability regime for gatekeepers.³⁷

Furthermore, the courts will find gatekeepers liable under Section 11 only in very specific circumstances.³⁸ In *McFarland v. Memorex Corp.*, the district court held that “there is no accountant liability unless . . . misleading data [certified by the accountant in the registration statement] can be expressly attributed to the accountant.”³⁹ Therefore,

33. 15 U.S.C. § 77k(a)(1) (2012).

34. *Id.* § 77k(a)(4).

35. See Shuenn (Patrick) Ho, *A Missed Opportunity for “Wall Street Reform”:* *Secondary Liability for Securities Fraud After the Dodd-Frank Act*, 49 HARV. J. ON LEGIS. 175, 184 (2012) (“In the past, Congress has recognized that gatekeepers are uniquely placed to detect and block fraudulent transactions and explicitly adopted a strategy of imposing civil liability on gatekeepers such as accountants and appraisers to deter the filing of false securities registration statements.”) (citing 15 U.S.C. § 77k(a)(1)(4)).

36. 15 U.S.C. § 77k(b)(3).

37. Tuch, *supra* note 10, at 1636.

38. See, e.g., *Herman & MacLean v. Huddleston*, 459 U.S. 375, 386 n.22 (1983); *McFarland v. Memorex Corp.*, 493 F. Supp. 631, 643 (N.D. Cal. 1980) (holding that “there is no accountant liability unless . . . misleading data can be expressly attributed to the accountant”); *Escott v. BarChris Const. Corp.*, 283 F. Supp. 643, 683 (S.D.N.Y. 1968) (attorneys who help prepare a registration statement generally cannot be held liable under Section 11 unless they act as “experts”).

39. *McFarland*, 493 F. Supp. at 643.

Section 11 liability will not apply to an accountant unless she is an auditor or has otherwise lent her name to a registration statement.⁴⁰

Similarly, attorneys who help prepare a registration statement generally cannot be held liable under Section 11 unless they act as “experts”⁴¹ or if they also serve as directors or officers of the company.⁴² A non-director, non-officer attorney is an “expert” within Section 11’s statutory meaning only if she “expertises” a portion of the registration statement, usually by providing a legal opinion that is included within the statement.⁴³

2. Section 12(a)(1)

Section 12(a)(1) of the ‘33 Act provides that “[a]ny person who . . . offers or sells a security in violation of [Section 5⁴⁴] . . . shall be liable . . . to the person purchasing such security from him”⁴⁵ This provision makes available an express private right of action for a purchaser against a seller of securities found to be in violation of Section 5.⁴⁶ In effect, Section 12(a)(1) was designed to enforce the registration requirements of Section 5.⁴⁷

In *Pinter v. Dahl*, the Supreme Court held that “‘seller’ is not limited to an owner who passes title . . . but extends to a broker or other person who successfully solicits a purchase of securities, so long as he is motivated at least in part by a desire to serve his own financial interests or those of the securities owner.”⁴⁸ So, theoretically, a gatekeeper as agent for the securities owner could be held liable under Section 12(a)(1) so long as she solicits the purchase of a security that is in

40. HAZEN, *supra* note 30, § 7.3[10].

41. *Huddleston*, 459 U.S. at 386 n.22.

42. HAZEN, *supra* note 30, § 7.3[10].

43. Ben D. Orlanski, *Whose Representations Are These Anyway? Attorney Prospectus Liability After Central Bank*, 42 UCLA L. REV. 885, 904 (1995); *see also BarChris*, 283 F. Supp. at 683 (“To say that the entire registration statement is expertised because some lawyer prepared it would be an unreasonable construction of the statute.”).

44. Section 5 of the ‘33 Act provides that all securities not exempted from doing so by other provisions in the Act must be registered. 15 U.S.C. § 77e(c) (2012).

45. 15 U.S.C. § 77l(a)(1).

46. *Id.*; *see also* HAZEN, *supra* note 30, § 7.2[1].

47. HAZEN, *supra* note 30, § 7.2[1].

48. *Pinter v. Dahl*, 486 U.S. 622, 623 (1988).

violation of Section 5.⁴⁹ However, on its face, Section 12(a)(1) imposes a privity requirement, and the *Pinter* Court recognized such in its opinion.⁵⁰ Thus, the mere participation by a gatekeeper in the preparation of a registration statement is not enough to trigger liability under Section 12(a)(1).⁵¹ Indeed, even the substantial involvement in such preparation will not create liability unless the gatekeeper is also actively involved in the negotiations leading to the sale in question.⁵² Damages under Section 12(a) are limited to “the consideration paid for [the] security with interest thereon, less the amount of any income received thereon.”⁵³

3. Section 12(a)(2)

Section 12(a)(2) of the ‘33 Act imposes the same level of liability as 12(a)(1) for those who offer or sell securities and, in doing so, make omissions or untrue statements of material fact in prospectuses or oral communications.⁵⁴ Just as in actions under 12(a)(1), gatekeepers must also be “sellers” under § 12(a)(2) in order to be found liable.⁵⁵ Section 12(a)(2) is viewed as a strict liability provision,⁵⁶ and unlike fraud

49. *See id.*

50. *See id.* at 642 (“At the very least . . . the language of § 12[(a)](1) contemplates a buyer-seller relationship not unlike traditional contractual privity.”).

51. HAZEN, *supra* note 30, § 7.2[2].

52. *See In re DDi Corp. Sec. Litig.*, No. CV 03-7063, 2005 WL 3090882, at *18 (C.D. Cal. July 21, 2005); *see also* *Junker v. Crory*, 650 F.2d 1349, 1360 (5th Cir. 1981) (holding an attorney to be “an active negotiator in the transaction” and liable under Section 12(a)(1)).

53. 15 U.S.C. § 771(a) (2012).

54. *See id.* § 771(a)(2); *Wright v. Nat’l Warranty Co.*, 953 F.2d 256, 262 n.3 (6th Cir. 1992) (“In order to establish a section 12(2) violation, a plaintiff must show that (1) defendants offered or sold a security, (2) by the use of any means of communication in interstate commerce; (3) through a prospectus or oral communication; (4) by making a false or misleading statement of a material fact or by omitting to state a material fact; (5) plaintiff did not know of the untruth or omission; and (6) defendants knew, or in the exercise of reasonable care could have known of the untruth or omission.”).

55. *See In re Morgan Stanley Info. Fund Sec. Litig.*, 592 F.3d 347, 359 (2d Cir. 2010) (“ . . . the list of potential defendants in a section 12(a)(2) case is governed by a judicial interpretation of section 12 known as the ‘statutory seller’ requirement.”) (citing *Pinter*, 486 U.S. at 643-47).

56. *See* Jack E. Karns et. al., *Accountant and Attorney Liability As “Sellers” of Securities Under Section 12(2) of the Securities Act of 1933: Judicial Rejection of the Statutory, Collateral Participant Status Cause of Action*, 74 NEB. L. REV. 1, 3 (1995)

claims under Rule 10b-5,⁵⁷ it is not necessary for the plaintiff to show either his or her own reliance or scienter on the part of the defendant.⁵⁸ However, Section 12(a)(2) also offers defendants an affirmative defense if they can “sustain the burden of proof that [they] did not know, and in the exercise of reasonable care could not have known, of [the] untruth or omission.”⁵⁹ “Reasonable care” connotes negligence liability for gatekeeper sellers facing an action under §12(a)(2).⁶⁰ Such gatekeepers will be held liable unless they can show that their actions were reasonable, not just without recklessness or intent.⁶¹

B. THE SECURITIES EXCHANGE ACT OF 1934 – SECTION 10(B) AND RULE 10B-5

As can be seen, the ‘33 Act provides liability for gatekeepers only under specific limited circumstances.⁶² Gatekeepers have liability under the ‘33 Act (1) where the gatekeeper has made false statements in a registration statement that can be attributed to her, and (2) where the gatekeeper is an active seller of a security and the security is either unregistered and nonexempt, or the gatekeeper has made material misstatements or omissions in oral communications or in the security’s prospectus.⁶³ Gatekeepers who commit securities fraud outside of these circumstances are most often subject to liability under Section 10(b) of the ‘34 Act.⁶⁴

(“The reason that investors have persistently sought to establish liability against attorneys and accountants under section 12, is that the provision is viewed as imposing strict liability on anyone violating it.”).

57. See *infra* Part II.B.

58. HAZEN, *supra* note 30, § 7.6[1]; see also *Wright*, 953 F.2d at 262 (“... reliance on alleged misrepresentations or omissions is not an element of a section 12[(a)](2) cause of action.”).

59. 15 U.S.C. § 77l(a)(2). In 2005, the SEC promulgated a rule clarifying that the “know, and . . . could not have known” language of § 12(a)(2) means “knowing at the time of sale.” 17 C.F.R. § 230.159(c).

60. 15 U.S.C. § 77l(a)(2); see also Partnoy, *supra* note 24, at 515 (“... § 12(a)(2) imposes negligence liability on issuers and gatekeepers selling a security using a prospectus (or oral statement) that is false or misleading . . .”).

61. Partnoy, *supra* note 24, at 515.

62. See *supra* Part I.A.

63. See *infra* Part II.A.

64. Cf. John C. Coffee, Jr., *Partnoy’s Complaint: A Response*, 84 B.U. L. REV. 377, 378 (2004) (“... most securities class actions are brought . . . with respect to the

Section 10(b) makes it “unlawful for any person, directly or indirectly, . . . [t]o 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”⁶⁵ In 1942, the SEC promulgated Rule 10b-5 pursuant to its statutory authority under 10(b).⁶⁶ Rule 10b-5 makes it unlawful through the use of an instrumentality or interstate commerce:

(a) [t]o employ any device, scheme, or artifice to defraud, (b) [t]o make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (c) [t]o engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.⁶⁷

The language of Rule 10b-5 has been described as open-ended and adaptable, allowing it to reach a wide variety of fraudulent schemes.⁶⁸

I. Primary vs. Secondary Liability

Generally, most securities violations have multiple participants, ranging from directors, officers, and employees of a corporation to

secondary market (where scienter must be proven before the issuer can be held liable under Rule 10b-5.”); Assaf Hamdani, *Gatekeeper Liability*, 77 S. CAL. L. REV. 53, 62 (2003) (“The general prohibition on fraud under Rule 10b-5 covers an unlimited number of transactions and an undefined range of capital-market participants.”); *Evaluating S. 1551: The Liability for Aiding and Abetting Securities Violations Act of 2009: Hearing Before the Subcomm. on Crime and Drugs of the S. Comm. on the Judiciary*, 111th Cong. 2-4 (2009) (testimony of Professor John C. Coffee, Jr., Adolf A. Berle Professor of Law, Columbia University Law School) (commenting that most fraud by gatekeepers will go undetected if the private right of action for aiding and abetting liability under § 10(b) is not restored) [hereinafter *Hearing on S. 1551*].

65. 15 U.S.C. § 78j(2)(b). Section 10(b) is often described as a “catchall” provision. *See, e.g.,* Chiarella v. United States, 445 U.S. 222, 234-35 (1980) (“Section 10(b) is aptly described as a catchall provision, but what it catches must be fraud.”).

66. JAMES D. COX ET AL., *SECURITIES REGULATION CASES AND MATERIALS* 695 (7th ed. 2013).

67. 17 C.F.R. § 240.10b-5 (2015).

68. *See* Donald C. Langevoort, *Rule 10b-5 As an Adaptive Organism*, 61 FORDHAM L. REV. S7, S19-S21 (1993) (describing the benefits of the ambiguity of Rule 10b-5’s language).

members of the gatekeeping professions whose services are employed by such a corporation.⁶⁹ In a securities fraud action, the participants are classified as either primary violators or secondary violators.⁷⁰ “A *primary violator* commits the act proscribed by the statute or rule; a *secondary violator* either assists or supports the primary violator”⁷¹

A primary violation of Rule 10b-5 consists of six elements that a plaintiff has the burden of showing: “(1) a material misrepresentation or omission by the defendant; (2) scienter; (3) a connection between the misrepresentation or omission and the purchase or sale of a security; (4) reliance upon the misrepresentation or omission; (5) economic loss; and (6) loss causation.”⁷² In *Central Bank of Denver v. First Interstate Bank of Denver*, the Supreme Court noted in dicta that gatekeepers such as lawyers, accountants, and bankers could be held liable as primary violators provided that “all of the requirements for primary liability under Rule 10b-5 are met.”⁷³ However, most gatekeeper defendants are alleged to be secondary violators.⁷⁴

2. Aiding and Abetting Liability

Gatekeeper defendants in Rule 10b-5 actions are generally alleged to be liable under aiding and abetting theories of secondary liability.⁷⁵ Prior to the enactment of the Private Securities Litigation Act PSLRA of 1995 (“the PSLRA”),⁷⁶ the SEC brought aiding and abetting claims mostly under concepts that were well-established in criminal law⁷⁷ and

69. COX ET AL., *supra* note 66, at 795.

70. *Id.*

71. *Id.* (italics in the original).

72. *See Janus Capital Grp., Inc. v. First Derivative Traders*, 131 S. Ct. 2296, 2301 n.3 (2011).

73. *Cent. Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164, 191 (1994).

74. *See* COX ET AL., *supra* note 66, at 795 (listing secondary violators as “lawyers, accountants, and banks, to mention just a few”); *see also* Ho, *supra* note 35, at 183-84 (discussing the rationale for extending secondary liability to gatekeepers such as “auditors, credit rating agencies, investment bankers, and lawyers”).

75. COX ET AL., *supra* note 66, at 796.

76. *See infra* Part II.B.2.c.

77. *See, e.g., SEC v. Timetrust, Inc.*, 28 F. Supp. 34, 43 (N.D. Cal. 1939) (permitting aiding and abetting due to the precedent set in criminal cases).

under joint tortfeasor liability theories developed in tort law.⁷⁸ Later, in *Brennan v. Midwestern United Life Insurance Co.*, the court concluded that the failure of Congress to enact specific language pertaining to aiding and abetting liability did not establish that such liability could not be imposed under Rule 10b-5.⁷⁹ Therefore, the court held that aiding and abetting claims could proceed in actions under the Rule.⁸⁰

A gatekeeper is found to be liable for aiding and abetting when she has knowingly or recklessly⁸¹ provided “substantial assistance” to a primary violator.⁸² The courts have generally required the satisfaction of three elements in order to successfully bring an aiding and abetting claim: “1) a violation by a primary violator; 2) knowledge by the secondary violator of the violation; and 3) the rendering of substantial assistance by the secondary violator.”⁸³

a. The Private Right of Action for Aiding and Abetting Liability

The ‘34 Act does not expressly provide a private right of action under section 10(b).⁸⁴ However, shortly after the SEC promulgated Rule 10b-5, the federal courts beginning with *Kardon v. National Gypsum Co.* started recognizing an implied private right of action for violations

78. William H. Kuehnle, *Secondary Liability Under the Federal Securities Laws-Aiding and Abetting Conspiracy, Controlling Person, and Agency: Common-Law Principles and the Statutory Scheme*, 14 J. CORP. L. 313, 321-22 (1989) (“Although aiding and abetting liability generally is not provided expressly for under the federal securities laws, courts almost universally have been willing to infer joint tortfeasor liability for aiding and abetting, utilizing the statement of liability in section 876(b) of the Restatement.”) (internal citations omitted). Restatement (Second) of Torts § 876 (1979) provides that “[f]or harm resulting to a third person from the tortious conduct of another, one is subject to liability if he . . . knows that the other’s conduct constitutes a breach of duty and gives substantial assistance or encouragement to the other so to conduct himself”

79. *Brennan v. Midwestern United Life Ins. Co.*, 259 F. Supp. 673, 680-81 (N.D. Ind. 1966).

80. *Id.*

81. The Dodd-Frank Act added the words “or recklessly” after the word “knowingly” in § 20(e) of the ‘34 Act. *See infra* note 181.

82. *See* 15 U.S.C. § 78t(e) (2012).

83. Kuehnle, *supra* note 78, at 322 (citing cases articulating various formulations of the three elements).

84. Ronald J. Colombo, *Cooperation with Securities Fraud*, 61 ALA. L. REV. 61, 67 (2009).

of the rule.⁸⁵ The *Kardon* court applied the tort law principle that the performance of an act prohibited by a statute that is meant to protect a third party's interest makes the actor liable for the invasion of that interest.⁸⁶ The court reasoned that since the entire '34 Act disclosed a broad purpose to eliminate manipulative or deceptive practices from securities transactions of all kinds, then the intention of the '34 Act therefore could not be to deny a remedy for such practices to private plaintiffs.⁸⁷

In 1971, the Supreme Court gave formal recognition to this private right of action in *Superintendent of Insurance of the State of New York v. Bankers Life and Casualty Company*.⁸⁸ With this recognition came the ability for private plaintiffs to bring Rule 10b-5 actions against gatekeepers under aiding and abetting theories of liability, and plaintiffs routinely did so.⁸⁹

However, shortly after recognizing the implied right of action, the Supreme Court began to pare it back.⁹⁰ The Court's recognition in *Superintendent* came at a time when its willingness to recognize implied private rights of action had started to wane.⁹¹ Four years after *Superintendent*, in *Blue Chip Stamps v. Manor Drug Stores*, the Court ruled that in order to maintain a private action under Rule 10b-5, the plaintiff must be either a purchaser or seller of the security or securities at issue.⁹² In a seeming rebuke to the reasoning of the *Kardon* court,

85. *Kardon v. Nat'l Gypsum Co.*, 69 F. Supp. 512, 513-14 (E.D. Pa. 1946).

86. *Id.* at 513.

87. *Id.* at 514.

88. 404 U.S. 6, 13 n.9 (1971) ("It is now established that a private right of action is implied under § 10(b).").

89. See COX ET AL., *supra* note 66, at 796 ("For three decades [before *Central Bank* in 1994], accountants, lawyers, underwriters, banks, and others were routinely held liable under Section 10(b) and Rule 10b-5 of the ['34 Act] on the ground [that] they had aided and abetted their client's violation.").

90. See, e.g., *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 754-55 (1975) (discussed herein); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 187-88 (1976) (discussed herein).

91. See *Corr. Servs. Corp. v. Malesko*, 534 U.S. 61, 67 (2001) ("... we have retreated from our previous willingness to imply a cause of action where Congress has not provided one Just last Term it was noted that we 'abandoned' the view of *Borak* decades ago, and have repeatedly declined to 'revert' to 'the understanding of private causes of action that held sway 40 years ago.'" (quoting *Alexander v. Sandoval*, 532 U.S. 275, 287 (2001))).

92. *Blue Chip Stamps*, 421 U.S. at 754-55.

Justice Rehnquist in his majority opinion expressed reservations about implying any Congressional intent to provide a private remedy under Section 10(b).⁹³

A year later, in *Ernst & Ernst v. Hochfelder*, the Court held that plaintiffs must show that the defendant acted with scienter; mere negligence would not be enough.⁹⁴ In that case, the plaintiffs brought an action against the defendant accounting firm for aiding and abetting a brokerage in conducting a fraudulent securities scheme.⁹⁵ In light of its holding that a showing of scienter is required for such claims, the Court reserved the question of whether civil liability for aiding and abetting was appropriate under Rule 10b-5.⁹⁶ However, eighteen years later, the Court finally addressed that issue.⁹⁷

b. *Central Bank*

By 1994, every circuit court that considered the question recognized the existence of aiding and abetting liability under Rule 10b-5.⁹⁸ But to the surprise of the litigation bar⁹⁹ and other observers,¹⁰⁰ the Supreme Court reversed the course of such jurisprudence in *Central Bank of Denver v. First Interstate Bank of Denver*.¹⁰¹ In that case, the Court held that “a private plaintiff may not maintain an aiding and abetting suit under section 10(b)” because “the text of § 10(b) does not

93. See *id.* at 737 (“... it would be disingenuous to suggest that either Congress in 1934 or the Securities and Exchange Commission in 1942 foreordained the present state of the law with respect to Rule 10b-5. It is therefore proper that we consider . . . what may be described as policy considerations when we come to flesh out the portions of the law with respect to which neither the congressional enactment nor the administrative regulations offer conclusive guidance.”). Rehnquist also stated that “[w]hen we deal with private actions under Rule 10b-5, we deal with a judicial oak which has grown from little more than a legislative acorn.” *Id.*

94. *Ernst & Ernst*, 425 U.S. at 187-88.

95. *Id.* at 188-90.

96. *Id.* at 191 n.7. Six years later, the Court had another chance to reach the question but again declined to do so. See *Herman & MacLean v. Huddleston*, 459 U.S. 375, 379 n.5 (1983).

97. See *Cent. Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164, 191 (1994) (discussed herein).

98. HAZEN, *supra* note 30, § 7.13[1][A].

99. COX ET AL., *supra* note 66, at 796.

100. HAZEN, *supra* note 30, § 7.13[1][A].

101. *Cent. Bank of Denver*, 511 U.S. at 191.

prohibit aiding and abetting.”¹⁰² In doing so, the Court explicitly rejected the holding and reasoning of *Brennan v. Midwestern United Life Insurance*.¹⁰³ The Court noted its more recent decisions in *Ernst & Ernst* and another case,¹⁰⁴ where it paid “close attention to the statutory text in defining the scope of conduct prohibited by § 10(b)”¹⁰⁵ The Court ruled that the text of the statute controls its decision regarding such scope and that a “private plaintiff may not bring a 10b-5 suit against a defendant for acts not prohibited by the text of § 10(b).”¹⁰⁶ Thus, private plaintiffs could no longer bring aiding and abetting claims against gatekeepers in Rule 10b-5 actions.¹⁰⁷

c. The Private Securities Litigation Reform Act (“PSLRA”)

While the Court’s decision in *Central Bank* only expressly prohibited private plaintiffs from bringing aiding and abetting claims under section 10(b), the Court’s reasoning that such claims were not within the scope of section 10(b)’s statutory text also on its face applied to SEC enforcement actions under 10(b).¹⁰⁸ Fearing that this was now the case,¹⁰⁹ Congress enacted the Private Securities Litigation Reform Act of 1995 (“the PSLRA”).¹¹⁰ The act amended section 20(e) of the ‘34 Act to give the SEC the express authority to bring aiding and abetting claims against those who provided “substantial assistance” to primary violators.¹¹¹ However, the PSLRA failed to reinstate the private right of action to bring such claims.¹¹² At the time of publication of this Note, private plaintiffs still cannot bring aiding and abetting claims under Rule 10b-5 against gatekeepers; only the SEC can do so.¹¹³

102. *Id.* at 191.

103. *See supra* Part I.B.2.

104. *Santa Fe Indus, Inc. v. Green*, 430 U.S. 462, 477 (1977).

105. *Cent. Bank of Denver*, 511 U.S. at 169.

106. *Id.* at 173.

107. *Id.*

108. *See id.* at 192 (reasoning that the text of section 10(b) itself does not prohibit aiding and abetting).

109. Matthew P. Wynne, *Rule 10b-5(b) Enforcement Actions in Light of Janus: Making the Case for Agency Deference*, 81 *FORDHAM L. REV.* 2111, 2120 (2013).

110. Pub. L. No. 104-67, 109 Stat. 737 (codified as amended in scattered sections of 15 U.S.C.).

111. *Id.* § 104 (codified as amended at 15 U.S.C. § 78t(f) (2012)).

112. Wynne, *supra* note 109, at 2120.

113. Klock, *supra* note 18, at 467.

Not only did the PSLRA fail to restore a private right of action for Rule 10b-5 aiding and abetting claims, it also heightened pleading standards for scienter by requiring that plaintiffs “state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.”¹¹⁴ Congress was concerned that securities litigation had become too “lawyer-driven,” leading to excessive legal fees and plaintiffs who were unrepresentative of the class in which they served as the named plaintiff.¹¹⁵ Under this standard, a plaintiff must plead with particularity each statement alleged to be misleading and the basis of the plaintiff’s belief as to why the alleged statements were misleading.¹¹⁶ Additionally, the PSLRA replaced joint and several liability with proportionate liability.¹¹⁷

d. The Aftermath of *Central Bank* and the PSLRA

After the enactment of the PSLRA, there was a significant drop-off in the number of securities class action suits filed against at least one type of gatekeeper: accountants.¹¹⁸ A 1997 SEC study of the PSLRA’s impact on securities litigation found a substantial decrease in the number of securities class actions following passage of the PSLRA.¹¹⁹ From 1990 through 1992, the study found that the total number of audit-related suits filed against the then Big Six accounting¹²⁰ firms each year

114. 15 U.S.C. § 78u-4(b)(2)(A); see also Elizabeth Cosenza, *Is the Third Time the Charm? Janus and the Proper Balance Between Primary and Secondary Actor Liability Under Section 10(b)*, 33 CARDOZO L. REV. 1019, 1029-30 (2012) (PSLRA was enacted in 1995 and included “a heightened pleading standard for allegations of scienter in section 10(b) cases.”). The accounting industry lobbied aggressively for the passage of the PSLRA. See COFFEE, *supra* note 2, at 363.

115. See COFFEE, *supra* note 2, at 337.

116. Cosenza, *supra* note 114, at 1030.

117. Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67 § 201, 109 Stat. at 758-62.

118. OFFICE OF THE GEN. COUNSEL, U.S. SEC. & EXCH. COMM’N, REPORT TO THE PRESIDENT AND THE CONGRESS ON THE FIRST YEAR OF PRACTICE UNDER THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995, at 2, 73 (1997), available at <http://www.sec.gov/news/studies/lreform.txt> [hereinafter SEC STUDY].

119. *Id.* at 1.

120. “The Big Six firms were Arthur Andersen LLP, Deloitte & Touche LLP, Ernst & Young LLP, KPMG LLP, Price Waterhouse, and Coopers Lybrand.” COFFEE, *supra* note 2, at 73 n.33.

were “192, 171, and 141, respectively.”¹²¹ However, the study found that in 1996, the year after the PSLRA was enacted, out of 105 total class-action securities suits that year, accounting firms were named in just six of them.¹²²

In his book, *Gatekeepers: The Professions and Corporate Governance*,¹²³ Professor John C. Coffee Jr. of Columbia University discusses other accounting studies that show an increase in risky practices in the accounting industry.¹²⁴ In the early 1990s, major accounting firms were trying to reduce their exposure to litigation by adopting more cautious risk management policies.¹²⁵ This included eliminating riskier companies from client rosters.¹²⁶ However, after the passage of the PSLRA, the industry relaxed its risk management policies, took on riskier client portfolios, and its reporting strategies became less conservative.¹²⁷ Professor Coffee summarizes these findings by remarking that “litigation exposure and accounting conservatism seem to be positively correlated.”¹²⁸

Indeed, there was also a marked increase in the number of financial restatements (i.e. companies issuing corrections to previously reported financial statements) in the years immediately following passage of the PSLRA.¹²⁹ One study shows that financial restatements increased from an average of forty-nine per year from 1990 to 1997, to a total of ninety-one in 1998, 150 in 1999, and 156 in 2000.¹³⁰ Another study from the General Accounting Office (GAO) found that from January 1997 to June 2002, approximately “ten percent of all listed companies announced at least one restatement.”¹³¹ Companies that issued a restatement during this time period suffered on average an immediate

121. SEC STUDY, *supra* note 118, at 21.

122. *Id.*

123. COFFEE, *supra* note 2, at 61.

124. *Id.*

125. *Id.*

126. *Id.*

127. *Id.*

128. *Id.*

129. *Id.* at 57.

130. See George B. Moriarty & Phillip B. Livingston, *Quantitative Measures of the Quality of Financial Reporting*, 17 FIN. EXEC. 53, 54 (July/August 2001), available at EBSCOhost, Accession No. 11873640.

131. See GAO STUDY, *supra* note 22, at 4.

ten percent decline in their stock prices,¹³² suggesting that investors were surprised and reacted by selling shares and sharply lowering the market value of restating companies.¹³³ In 2002, eighty-five percent of all identified restatements came from companies listed on the NYSE or NASDAQ,¹³⁴ suggesting that such restatements were not confined to small inexperienced companies but instead reflected increased risk-taking at larger more mature firms.¹³⁵ The GAO found that the dominant reason for financial restatements from 1997 to 2002 was revenue recognition (i.e. misreported or non-reported revenue) issues, which accounted for thirty-nine percent of restatements.¹³⁶ Restatements involving revenue recognition led to greater market losses than other types of restatements, accounting for over half of immediate market losses.¹³⁷ Attempts by management to prematurely recognize revenue became the dominant cause of financial restatements.¹³⁸

This period of lower risk management and riskier business practices by accounting firms culminated with the back-to-back accounting scandals of Enron and WorldCom, respectively.¹³⁹

e. *Stoneridge*

After *Central Bank* and the passage of the PSLRA, plaintiff-investors sought new theories to hold secondary actors liable for securities violations.¹⁴⁰ One such theory was “scheme liability.”¹⁴¹ Under

132. *Id.* at 5 (measuring stock prices on the basis of a company’s three-day price movement starting from the trading day before the announcement and ending at the trading day following the announcement).

133. COFFEE, *supra* note 2, at 59.

134. GAO STUDY, *supra* note 22, at 4.

135. COFFEE, *supra* note 2, at 58.

136. GAO STUDY, *supra* note 22, at 5. The other reason categories were “Cost/Expense” (15.7%), “Other” (14.1%), “Restructuring/assets/inventory” (8.9%), “Acquisition/merger” (5.9%), “Securities-related” (5.4%), “Reclassification” (5.1%), “In-process research and development” (3.6%), and “Related-party transactions” (3.0%). *See id.* at 21-22 (figures and full definitions of these reason categories).

137. *Id.* at 5.

138. COFFEE, *supra* note 2, at 59.

139. *See id.* at 16 (discussing how Congress increased regulations on auditors with the Sarbanes-Oxley Act after the Enron and Worldcom scandals).

140. Cosenza, *supra* note 114, at 1050.

this theory, plaintiffs sought to use Rule 10b-5(a) and 10b-5(c)¹⁴² to hold secondary actors primarily liable if they commit a deceptive act in the process of aiding a primary violation.¹⁴³

However, in *Stoneridge Investment Partners, LLC v. Scientific-Atlanta*, the court held that such a theory of scheme liability was not valid under section 10(b).¹⁴⁴ The plaintiffs alleged that defendants Motorola and Scientific-Atlanta knowingly falsified contracts with defendant Charter Communications, Inc. in a scheme to artificially inflate earnings figures on Charter's financial statements.¹⁴⁵ The court found that the plaintiffs did not establish the reliance element of primary liability because they did not rely on the statements of Motorola and Scientific-Atlanta.¹⁴⁶ Therefore, the two defendants were not liable under Rule 10b-5.¹⁴⁷ The Court reasoned that if it adopted scheme liability, it would in substance revive the private right of action for aiding and abetting that *Central Bank* had struck down and Congress had declined to revive in the PSLRA.¹⁴⁸ The Court stated that the decision to expand the private right of action is for Congress, not the Court.¹⁴⁹ Thus, a potential theory for holding gatekeepers liable under Rule 10b-5 as primary violators was quashed.¹⁵⁰

f. *Janus*

In *Janus Capital Group, Inc. v. First Derivative Traders*, the plaintiff shareholders contended that Janus Capital Group, Inc. (JCM)

141. *Id.* at 1051-52; *see also In re Enron Corp. Sec., Derivative & "ERISA" Litig.*, 439 F. Supp. 2d 692, 723 (S.D. Tex. 2006) (court considers "the issue of loss causation in scheme liability").

142. *See infra* Part II.B.

143. *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta*, 552 U.S. 148, 162 (2008).

144. *Id.* at 162-63.

145. *Id.* at 153-55.

146. *Id.* at 159.

147. *Id.*

148. *See id.* at 162-63 ("Petitioner's view of primary liability makes any aider and abettor liable under § 10(b) if he or she committed a deceptive act in the process of providing assistance. Were we to adopt this construction of § 10(b), it would revive in substance the implied cause of action against all aiders and abettors except those who committed no deceptive act in the process of facilitating the fraud") (citation omitted).

149. *Id.* at 165.

150. Klock, *supra* note 18, at 453.

and its subsidiary, Janus Capital Management LLC (JCM) “materially mislead the investing public” with statements that they made in prospectuses for a family of mutual funds organized in a trust under the name Janus Investment Funds.¹⁵¹ After the Fourth Circuit reversed the lower court’s dismissal of the plaintiffs’ claims, the Supreme Court granted certiorari “to address whether JCM can be held liable in a private action under Rule 10b–5 for false statements included in Janus Investment Fund’s prospectuses.”¹⁵² The Court stated that “[u]nder Rule 10b–5, it is unlawful for ‘any person, directly or indirectly, ... [t]o make any untrue statement of a material fact’ in connection with the purchase or sale of securities. [citation omitted].”¹⁵³ To be liable, therefore, the Court said that JCM must have “made” the material misstatements in the prospectuses.”¹⁵⁴

The Court held that JCM, even though it administered the fund and prepared the prospectuses, did not “make” the statements within them that the plaintiffs alleged were false.¹⁵⁵ The Court ruled that for claims under Rule 10b-5 alleging that a person made false statements, the “maker” of a statement “is the person or entity with ultimate authority over the statement, including its content and whether and how to communicate it.”¹⁵⁶ The Court further stated that “[o]ne who prepares or publishes a statement on behalf of another is not its maker.”¹⁵⁷ The Court analogized its rule to the relationship between a speaker and a speechwriter: “[e]ven when a speechwriter drafts a speech, the content is entirely within the control of the person who delivers it[, a]nd it is the speaker who takes credit—or blame—for what is ultimately said.”¹⁵⁸ In a footnote, the Court explained that it was drawing

a clean line between [those who are primarily liable (and thus may be pursued in private suits) and those who are secondarily liable (and thus may not be pursued in private suits)]—the maker is the person

151. 131 S. Ct. 2297, 2301 (2011).

152. *Id.*

153. *Id.*

154. *Id.*

155. *Id.*

156. *Id.* at 2302.

157. *Id.*

158. *Id.*

or entity with ultimate authority over a statement and others are not.¹⁵⁹

Thus, to be held primarily liable under Rule 10b-5 for a materially false or misleading statement, a gatekeeper must have “ultimate authority” over that statement.¹⁶⁰

C. SARBANES-OXLEY AND DODD-FRANK

Two recent major pieces of legislation have attempted to increase liability for and regulation of gatekeepers. This subsection examines them.

1. Sarbanes-Oxley

Congress passed the Sarbanes-Oxley Act of 2002 in response to the waves of massive corporate accounting scandals from that time period such as Enron and WorldCom.¹⁶¹ The purpose of the legislation was to redesign the network of institutions and intermediaries that served investors in the capital markets in order to reduce deception and fraud.¹⁶²

Sarbanes-Oxley created the Public Company Accounting Oversight Board (PCAOB).¹⁶³ The PCAOB is charged with establishing quality control, auditing, and independence standards for accountants that perform auditing services for public companies.¹⁶⁴ It is also charged with inspecting registered public accounting firms and establishing disciplinary procedures for auditors and their firms.¹⁶⁵ Section 102 of

159. *Id.* at 2302 n.6.

160. *See, e.g.*, SEC v. Garber, 959 F. Supp. 2d 374, 381 (S.D.N.Y. 2013); SEC v. Merkin, No. 11-23585-CIV, 2012 WL 5245561, at *6 (S.D. Fla. Oct. 3, 2012); SEC v. Boyd, No. 95-CV-03174-MSK-MJW, 2012 WL 1060034, at *7 (D. Colo. Mar. 29, 2012), *reconsideration denied*, No. 95-CV-03174-MSK-MJW, 2012 WL 4955244 (D. Colo. Oct. 17, 2012) (“Under *Janus*, an attorney who prepares a false statement to be disseminated to investors can be liable for the contents of that statement if *the attorney* has the ultimate authority over the contents and dissemination of the statement, but not where the attorney is simply preparing the statement at the direction of a client who is controlling the contents of that statement.”).

161. COFFEE, *supra* note 2, at 16.

162. *Id.*

163. Sarbanes-Oxley Act of 2002, Pub. Law 107-204 § 101, 116 Stat. 745, 750 (2002) (codified at 15 U.S.C. § 7211(a) (2012)).

164. *Id.* § 103, 116 Stat. at 755 (codified as 15 U.S.C. § 7213).

165. *Id.* §§ 104-105, 116 Stat. at 757-759 (codified as 15 U.S.C. §§ 7214-7215).

Sarbanes-Oxley requires all accounting firms that conduct audits of public companies to be registered with the PCAOB.¹⁶⁶ This section essentially gives the PCAOB jurisdiction over every accounting firm in the industry.¹⁶⁷ Commenters have suggested that the key to the PCAOB's success is its resistance to agency capture.¹⁶⁸

Sarbanes-Oxley also took several steps to curtail conflicts of interest for auditors.¹⁶⁹ Section 201 prohibits accounting firms from providing specific services to its audit clients, including management functions, human resources, appraisal services, fairness opinions, and legal services.¹⁷⁰ The same section also prohibits accounting firms from performing audits on companies whose officers used to work for the accounting firm and participated in their current companies' audits.¹⁷¹ Finally, Section 301 called for issuers' independent audit committees to handle control and supervision of their outside auditors.¹⁷²

Sarbanes-Oxley also gave the SEC greater authority to regulate securities lawyers.¹⁷³ Section 307 of the law authorizes the SEC to establish "minimum standards of professional conduct for attorneys appearing and practicing before the Commission."¹⁷⁴ Sarbanes-Oxley also established a "reporting up" requirement for securities lawyers.¹⁷⁵ Attorneys are required to report evidence of "material" securities law violations by a company to its chief legal counsel or the CEO.¹⁷⁶ If the latter two parties do not "appropriately respond," then the attorney is

166. *Id.* § 102(a), 116 Stat. at 753 (codified at 15 U.S.C. § 7212(a)).

167. Celia R. Taylor, *Breaking the Bank: Reconsidering Central Bank of Denver After Enron and Sarbanes-Oxley*, 71 MO. L. REV. 367, 381 (2006).

168. *See, e.g.*, William W. Bratton, *Enron, Sarbanes-Oxley and Accounting: Rules Versus Principles Versus Rents*, 48 VILL. L. REV. 1023, 1032 (2003) (discussing the PCAOB, "[t]he agency delegation model works well only so long as the agency successfully resists capture by the interests of the actors it regulates").

169. COFFEE, *supra* note 2, at 333.

170. Sarbanes-Oxley Act § 201(g), 116 Stat. 771 (codified at 15 U.S.C. § 78j-1(g)).

171. *Id.* § 206(l) (codified at 15 U.S.C. § 78j-1(l)).

172. *Id.* § 301(m)(3)(A) 116 Stat. 771 (codified as amended at 15 U.S.C. § 78j-1(m)(3)(A)); *see also Gatekeeper Failure*, *supra* note 27, at 336 (explaining how Sarbanes-Oxley transferred control and supervision of auditors to the audit committee to address concerns about management compromising auditors).

173. Sarbanes-Oxley Act § 307, 116 Stat. 784 (codified at 15 U.S.C. § 7245) (discussed herein).

174. *Id.*

175. Taylor, *supra* note 167, at 383.

176. Sarbanes-Oxley Act § 307, 116 Stat. 784 (codified at 15 U.S.C. § 7245).

required to report the evidence to the independent auditing committee of the company's board of directors.¹⁷⁷

As a result of Sarbanes-Oxley, the SEC promulgated Rule 102(e) enabling the Commission to sanction gatekeepers for negligent behavior.¹⁷⁸ However, Sarbanes-Oxley did nothing to enhance litigation remedies for private plaintiffs under Rule 10b-5.¹⁷⁹

2. Dodd-Frank

In response to the 2008 Financial Crisis, Congress enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") in 2010.¹⁸⁰ Its primary impact on gatekeeper liability was to expand the scienter requirement of aiding and abetting liability from "knowingly" to "knowingly or recklessly."¹⁸¹ This was done to counter "plausible deniability" defenses by gatekeepers who would argue that they merely served as functionaries to primary violators and did not meet the "knowledge" requirement of scienter.¹⁸²

Dodd-Frank also affects credit ratings agencies in two ways.¹⁸³ First, it lowers pleading standards for plaintiffs in actions against credit rating agencies.¹⁸⁴ Second, it expressly establishes that "the enforcement and penalty provisions of the '34 Act shall apply to statements made by a credit rating agency in the same manner and to the same extent as such provisions apply to statements made by a registered public accounting

177. *Id.* Section 10A of the '34 Act imposes similar duties on auditors. The auditor is required to report evidence of a material illegal action to the issuer's management. If the auditor later discovers that the illegal act is material, the auditor must report this fact to management, who then has one business day to inform the SEC and to provide notice to the auditor of doing so. If the auditor does not receive such notice, then she must either resign or provide the SEC with a report of her findings. *See* 15 U.S.C. § 78j-1(b).

178. 17 C.F.R. § 201.102(e)(iv).

179. *Gatekeeper Failure*, *supra* note 27, at 336 (noting that Sarbanes-Oxley does nothing to increase the deterrent threat for gatekeepers).

180. Helene Cooper, *Obama Signs Overhaul of Financial System*, N.Y. TIMES, July 22, 2010, at B3, available at http://www.nytimes.com/2010/07/22/business/22regulate.html?_r=0&pagewanted=print.

181. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. Law 111-203, § 929O, 124 Stat. 1376, 1861 (codified at 15 U.S.C. § 78t(e)) [hereinafter Dodd-Frank].

182. Tuch, *supra* note 10, at 1655.

183. *See infra* notes 186-87.

184. Dodd-Frank § 933(b), 124 Stat. 1883 (codified at 15 U.S.C. § 78u-4(b)(2)(B)).

firm or a securities analyst under the securities laws.”¹⁸⁵ Once again though, Congress deferred reinstating the private right of action for aiding and abetting liability.¹⁸⁶

II. GATEKEEPERS AND REPUTATIONAL CAPITAL

This Part explains the theory developed by several noteworthy commentators that gatekeepers serve as reputational intermediaries. It examines the theory that a gatekeeper’s reputation is a capital asset and explains why it is sometimes rational for a gatekeeper to deplete its reputational capital by acquiescing to a client’s fraud.

A. THE REPUTATION MODEL

Under reputation theory, in industries where trust is essential, a gatekeeper’s reputation is considered a valuable capital asset.¹⁸⁷ It can be “pledged or placed at risk by the gatekeeper’s vouching for its client’s assertions or projections.”¹⁸⁸ Gatekeepers are trusted to the extent that they are repeat players who possess significant reputational capital that may be lost or destroyed if they are found to have condoned or aided wrongdoing.¹⁸⁹ The model assumes that new companies begin without any reputation and must build it over time.¹⁹⁰ If they wish to stay in business for the long-run, then they must invest in, develop, and maintain a good reputation.¹⁹¹ As long as the value of that reputational capital exceeds the expected profit from the client, the gatekeeper should remain faithful to shareholders and refrain from supplying false or misleading certifications.¹⁹²

185. *Id.* § 933(a), 124 Stat. 1872 (codified at 15 U.S.C. § 78o-7).

186. *See id.* § 929Z (instructing the GAO to “conduct a study on the impact of authorizing a private right of action against any person who aids or abets another person in violation of the securities laws”).

187. *See Macey, supra* note 12, at 18.

188. COFFEE, *supra* note 2, at 3.

189. *See id.* at 4.

190. *See Macey, supra* note 12, at 21.

191. *See id.* Professor Macey postulates that the existence of gatekeepers such as credit rating agencies and accounting firms can only be explained by reputation theory. *See id.*

192. *See COFFEE, supra* note 2, at 3.

Significantly, the reputation of gatekeepers is essential to the functioning of the capital markets.¹⁹³ Investors rely on the information provided by gatekeepers to reduce information asymmetries between investors and issuers, thereby increasing transparency and reducing the cost of capital.¹⁹⁴ Likewise, issuers make use of gatekeepers as “reputational intermediaries” in order to efficiently bolster their reputations for trustworthiness at a cost lower than if they attempted to build their reputations on their own.¹⁹⁵ The reputation of the intermediary assures the investor that a company will use the investor’s capital wisely and produce a good rate of return.¹⁹⁶ Courts have recognized the role of gatekeepers in the capital markets as reputational intermediaries¹⁹⁷ as well as the value of reputational capital.¹⁹⁸ But in order for this model to work, investors need to trust that they are receiving objective and accurate information from gatekeepers.¹⁹⁹ Information from an untrustworthy gatekeeper is worth little or nothing.²⁰⁰ In an economy with a dispersed ownership structure (i.e. companies with many diffuse shareholders like those in the U.S.), the role of reputational intermediaries becomes even more important.²⁰¹

193. See Macey, *supra* note 12.

194. See COFFEE, *supra* note 2, at 371.

195. See Macey, *supra* note 12, at 19 (defining “reputational intermediary” as “a firm whose business it is to ‘rent’ its own reputation to client companies that are not large or established enough to have their own, or that obtain added value from burnishing their reputations by associating with a reputational intermediary”). “Investment banks, credit rating agencies, accounting firms, law firms, and organized stock exchanges like the NYSE have all served as reputational intermediaries at one time or another.” *Id.*

196. See *id.* at 23.

197. See, e.g., *Pac. Inv. Mgmt. Co. LLC v. Mayer Brown LLP*, 603 F.3d 144, 156 (2d Cir. 2010) (“Where statements are publicly attributed to a well-known national law or accounting firm, buyers and sellers of securities (and the market generally) are more likely to credit the accuracy of those statements.”).

198. See, e.g., *DiLeo v. Ernst & Young*, 901 F.2d 624, 629 (7th Cir. 1990) (“An accountant’s greatest asset is its reputation for honesty, followed closely by its reputation for careful work.”).

199. See COFFEE, *supra* note 2, at 371.

200. See Macey, *supra* note 12, at 19.

201. COFFEE, *supra* note 2, at 8.

B. DISINCENTIVES FOR DEVELOPING A GOOD REPUTATION

Conventional wisdom suggests that rational gatekeepers should not be willing to risk losing their reputational capital on behalf of just one client.²⁰² However, in theory, a rational gatekeeper will risk depleting at least some reputational capital so long as it seems that the gains from inaccurate or misleading statements exceed the costs.²⁰³

1. Conflicts of Interest

Gatekeepers can face conflicts of interest that can cause them to rationally engage in reputation-depleting activities.²⁰⁴ This is largely due to what is arguably the source of gatekeeper conflicts of interest: the manner in which gatekeepers are compensated.²⁰⁵ Although they are hired to assure shareholders, gatekeepers are compensated by and take instructions from corporate management.²⁰⁶

One major conflict of interest that arose in the 1990s stemmed from accounting firms expanding their offerings by cross-marketing consulting services to their audit clients.²⁰⁷ This provided an additional incentive for these firms to acquiesce to their clients' demands.²⁰⁸ If they did not, the corporate client could not only cease its auditing business with that firm but also its consulting business.²⁰⁹ Professor Coffee points to the sharp rise in financial statement restatements in the late 1990s as strong evidence that auditors changed their behavior in the face of these new incentives that conflicted with the duties of a neutral auditor.²¹⁰ He

202. *Id.* at 8.

203. Partnoy, *supra* note 24, at 497-98.

204. *See* COFFEE, *supra* note 2, at 317 (mentioning conflicts of interest as a reason that gatekeepers may risk or willingly sacrifice their reputational capital).

205. *See id.* at 371.

206. *Id.* at 3-4.

207. *Id.* at 322-23.

208. *Id.* at 323. Coffee acknowledges that empirical studies show no correlation between a high ratio of non-audit services to audit services and a higher probability of a financial statement restatement. However, he also makes the point that in a highly concentrated industry such as auditing, an auditor might still be deferential to her client as long as there was the *potential* of receiving consulting income sometime in the future. Auditors still had a motivation to acquiesce.

209. John C. Coffee, *Understanding Enron: "It's About the Gatekeepers, Stupid"*, 57 BUS. LAW. 1403, 1411-12 (2002).

210. *See* COFFEE, *supra* note 2, at 323.

also notes that in spite of the market's clear aversion to financial restatements based on revenue recognition issues, they became the most common form of earnings restatement in the late 1990s.²¹¹

Another possible source for conflicts of interest is the segmentation by gatekeeping firms of their clients into "regular" client groups and "special" (i.e., more profitable) client groups.²¹² Even though clients in both groups generally have similar contractual relationships with a given gatekeeping firm, the gatekeeper will invest more heavily in building relationships with the special, more profitable clients.²¹³ While there is nothing illegal or unethical about this practice, if gatekeeping firms do not have proper internal controls in place, then this client segmentation can result in favoring clients in the special group at the expense of clients in the regular group.²¹⁴ For instance, Professor Jonathan Macey points to persuasive evidence from the 2008 Financial Crisis that the credit rating agencies were less effective at rating structured assets for lucrative clients than they were for the bond issues of their traditional corporate and municipal customers.²¹⁵ It is suspected that since the credit rating agencies received substantially higher fees from the former group, they exercised a lower standard of care in evaluating the risks of their structured products.²¹⁶

2. The Last Period Problem

Evidence also suggests that if a gatekeeper's large favored client is facing a "last period" scenario, the gatekeeping firm is more likely to participate in the client's fraudulent scheme to artificially avoid or delay bankruptcy.²¹⁷ Derived from game theory, the "last period problem"

211. *Id.* at 60.

212. Macey, *supra* note 12, at 19.

213. *Id.*

214. *Id.*

215. *Id.*

216. *Id.* Macey cites an article by Martin Fridson which stated that "89% of the investment grade mortgage-backed securities ratings that Moody awarded in 2007 were subsequently reduced to speculative grade." See Martin Fridson, *Bond Rating Agencies: Conflicts and Competence*, 22 J. OF APPLIED CORP. FIN. 56, 56 (Summer 2010), available at <http://ssrn.com/abstract=1684896>.

217. Enron accounted for 27% of audit fees collected by Arthur Andersen's Houston office. Andersen earned \$27 million in consulting fees and \$25 million in audit fees from Enron. Professor Coffee cites these figures as evidence of the loss of Andersen's professional independence with Enron, leading the accounting firm's Houston office to

postulates that when a player knows that he is in the final period of a given timeframe, then any cooperative undertaking in which the player had engaged during the previous time periods deteriorates.²¹⁸ The system of rewards and punishments that governed his behavior during the previous time periods no longer applies, and the player considers himself free to pursue more selfish objectives.²¹⁹ For instance, in the classic prisoners' dilemma game, in which two prisoners in separate interrogation rooms must decide whether or not to inculcate the other, a cooperative strategy is appealing at first.²²⁰ However, if the prisoners are told that they only have one more chance to make a move, then the rational choice becomes to abandon the cooperative strategy and inculcate the other prisoner.²²¹

In the business world, when an ordinarily risk-averse rational officer realizes that her firm is under potentially catastrophic stress due to business declines, she will suddenly become risk-prone and take aggressive and clandestine measures in order to avoid bankruptcy.²²² Committing fraud to shore up her firm's stock price, preventing creditors from calling in debts, or simply buying more time becomes more appealing.²²³ Enron and Refco seem to fit this pattern, as managers, accountants, and lawyers at both companies were attempting to conceal massive liabilities that would have most likely triggered bankruptcy.²²⁴

Theoretically, the dynamics of the end period problem apply to gatekeepers just as they do to issuers.²²⁵ If a gatekeeper finds itself in a

ignore or overrule internal recommendations designed to prevent the 'capture' of a local office or audit partner by a powerful client. See COFFEE, *supra* note 2, at 28.

218. Sean J. Griffith, *Afterward and Comment: Towards an Ethical Duty to Market Investors*, 35 CONN. L. REV. 1223, 1239 (2003).

219. *Id.*

220. *Id.*

221. *Id.*

222. William W. Bratton, *Enron and the Dark Side of Shareholder Value*, 76 TUL. L. REV. 1275, 1328 (2002).

223. See Jennifer H. Arlen & William J. Carney, *Vicarious Liability for Fraud on Securities Markets: Theory and Evidence*, 1992 U. ILL. L. REV. 691, 702-03 (1992).

224. See *In re Refco, Inc. Sec. Litig.*, 609 F. Supp. 2d 304, 306 (S.D.N.Y. 2009) (hundreds of million in "uncollected receivables"); *In re Enron Corp. Sec., Derivative & ERISA Litig.*, 235 F. Supp. 2d 549, 613 (S.D. Tex. 2002).

225. Partnoy, *supra* note 24, at 501; see also Ken Brown & Ianthe J. Dugan, *Arthur Andersen's Fall From Grace Is a Sad Tale of Greed and Miscues*, WALL ST. J. (June 7,

last-period scenario, its reputational capital becomes virtually worthless.²²⁶

3. Competition

Competition among gatekeepers can also significantly affect the quality of gatekeeper performance.²²⁷ Too much competition can pressure gatekeepers to acquiesce more to their clients' preferences out of fear of being replaced, while too little competition can cause gatekeepers to underperform.²²⁸ In the world of gatekeepers, the legal and securities research industries are characterized by active competition, while the accounting and credit rating industries are not.²²⁹

In a noncompetitive market, gatekeepers have reduced incentives to enhance existing controls, invest in new technology, or make overall improvements to their practices.²³⁰ Credit-ratings agencies (of which there are only two major ones²³¹), for example, are slow to provide updated monitoring of financial instruments after their initial rating.²³² Alternatively, in a highly competitive market, a gatekeeper may feel compelled to acquiesce to her corporate client's demands out of a fear of being easily replaced.²³³ However, a gatekeeper's willingness to resist client demands in a competitive industry, or the temptation of complacency in a noncompetitive industry, depends on whether the gatekeeper faces either the loss of its reputational capital or litigation from investors.²³⁴

Competition can also induce desired behavior from gatekeepers but only to the extent that gatekeepers want to compete on the basis of reputation.²³⁵ However, up until the Enron debacle, it became clear that auditing firms at least were not competing on the basis of integrity or

2002), <http://online.wsj.com/articles/SB1023409436545200> (detailing accounting firm Arthur Andersen's collapse from participating in Enron's Fraud).

226. See Partnoy, *supra* note 24, at 501.

227. COFFEE, *supra* note 2, at 104.

228. *Id.*

229. *Id.* at 318.

230. *Id.*

231. Moody's and S&P. See COFFEE, *supra* note 2, at 35.

232. COFFEE, *supra* note 2, at 324-25.

233. *Id.* at 104.

234. *Id.* at 318.

235. *Id.* at 321.

reporting accuracy but rather on flexibility and cooperation with clients.²³⁶ Issuers demanded that their accounting firms assist them with maximizing the firm's stock price by using any accounting methods that were not prohibited.²³⁷ Such incidents show that in a competitive market, a gatekeeper's maintenance of its reputational capital may lose out to other interests.²³⁸

C. THE MARKET FOR REPUTATIONAL CAPITAL

Professor Jonathan Macey theorizes that for market participants, laws and regulations are substitutes for reputational capital.²³⁹ As the amount of seemingly effective regulation for issuers and gatekeepers increases, the demand for reputational capital decreases.²⁴⁰ Consequently, gatekeepers in markets that are perceived to be effectively regulated, such as the United States, will be less willing to invest in their reputations.²⁴¹ As proof of this theory, Professor Macey cites surveys showing that corporations in emerging economies (where regulations are less developed) rank very high in terms of their reputations, and that corporate trust is higher in emerging economies and lower in developed economies (where regulation is more robust and effective).²⁴² He argues that demand for reputation in the United States has collapsed since investors have become so heavily reliant on regulation, rather than the reputations of issuers or their gatekeepers, when making investment decisions.²⁴³ According to Professor Coffee, firms left with "excess" reputational capital cannot profit from it.²⁴⁴

236. *Id.* at 327.

237. *Id.*

238. *See id.*

239. *See Demise of the Reputational Model*, *supra* note 13, at 429.

240. *Id.*

241. *Id.* at 445.

242. *Id.* at 446, 446 n.39-40 (citing multiple surveys conducted by the Reputation Institute).

243. *Id.* at 429.

244. COFFEE, *supra* note 2, at 329-30.

D. PRIVATE LITIGATION AS A DETERRENT TO REPUTATION-DEPLETING
ACTIVITIES

Just as reputation theory explains why gatekeepers would choose to deplete their reputational capital, deterrence theory focuses on the expected liability of gatekeepers who do so.²⁴⁵ Prior to *Central Bank* and the PSLRA, auditors faced a very real risk of liability enforced by class action litigation.²⁴⁶ The plaintiff's bar was entrepreneurially motivated by contingency fees and stood ready to act as private attorneys general for victims of securities fraud.²⁴⁷ However, once private plaintiffs could no longer bring aiding and abetting lawsuits against gatekeepers, the risk of liability became substantially less.²⁴⁸ Enforcement of such liability now fell to one overburdened agency, the SEC, who in the late 1990s was scaling back enforcement against the major accounting firms and who was also facing budgetary shortfalls.²⁴⁹

1. The Expected Value of Fraud

In describing how Sarbanes-Oxley failed to reinstate a private right of action for aiding and abetting liability,²⁵⁰ Professor Coffee concludes that:

while the potential benefits from acquiescing in accounting irregularities appear to have been reduced for auditors, the expected costs to them from such acquiescence also remain low because the level of deterrence that they once faced has not been restored.²⁵¹

Implicitly, Professor Coffee is invoking the finance principle of "expected value" or "expected return."²⁵² Expected value is calculated by multiplying each possible outcome of a given scenario with the

245. *Id.* at 60.

246. *Id.*

247. *Id.* at 78.

248. *Id.* at 62.

249. *See id.*

250. *See supra* Part I.B.2.a.

251. *Gatekeeper Failure, supra* note 27, at 337.

252. *See* ROSS ET AL., *ESSENTIALS OF CORPORATE FINANCE* 325-27 (5th ed. 2007).

likelihood that the given outcome will occur and then summing the totals.²⁵³

Inferentially, in the world of gatekeeping liability, the expected value of acquiescing to an issuer's accounting fraud is a scenario with two possible outcomes: (1) the gatekeeper has a successful civil action filed against it, or (2) the gatekeeper does not have a successful civil action filed against it.²⁵⁴ The following hypotheticals will illustrate two possible expected values for these outcomes.²⁵⁵

Hypothetical #1

An accounting firm is contemplating whether to acquiesce to its biggest client's demand to help it commit fraud.²⁵⁶ If the firm acquiesces and is not caught, then the client will contribute a fifteen percent increase in the firm's net worth over the next year.²⁵⁷ However, if the firm is caught and a successful civil action is filed against the company, the firm will face a huge loss of seventy percent of its net worth, with fifty percent of that loss constituting payments of damages, fines, and penalties, and the other twenty percent consisting of lost business due to the firm's tarnished reputation.²⁵⁸ With a private right of action for aiding and abetting liability in place, the risk of litigation (i.e. the probability of being caught) is thirty-five percent, which means the chance that no litigation will occur is sixty-five percent.²⁵⁹ Therefore, the expected value of acquiescing to the client's demand is $(0.35 \times -0.7) + (0.65 \times 0.15) = -0.15$. (See Table 1 below).²⁶⁰ With a negative

253. *Id.* For example, in a scenario with only two possible outcomes, Expected Value (EV) = (value of possible outcome 1) x (probability of outcome 1) + (value of possible outcome 2) x (probability of outcome 2).

254. For simplicity's sake, criminal liability is not considered here.

255. These hypotheticals are derived from Professor Coffee's comments regarding the level of deterrence that accountants now face from acquiescing in accounting irregularities as well as the calculation for expected value. *See generally Gatekeeper Failure, supra* note 27; ROSS, *supra* note 252.

256. *See generally Gatekeeper Failure, supra* note 27 (explaining that accountants face a lower level of deterrence due to the decreased threat of litigation).

257. *Id.*

258. *Id.*

259. *Id.*

260. ROSS, *supra* note 252.

expected value of acquiescing, the accounting firm would rationally choose not to do so.²⁶¹

Table 1

PRIVATE RIGHT OF ACTION			
State of Enforcement	Probability of Litigation	Rate of Return if State Occurs	Product
Caught	0.35	-0.7	-0.25
Not Caught	<u>0.65</u>	0.15	<u>0.10</u>
	1.0		EV = -0.15

Hypothetical #2

This hypothetical has the same conditions as Hypothetical #1 except there is no private right of action for aiding and abetting liability.²⁶² This has the effect of reducing the risk of litigation (i.e. the risk of being caught) to ten percent, which means that the chance of no litigation occurring is ninety percent.²⁶³ Therefore, the expected value of acquiescing to the client's demand here is $(0.10 \times -0.7) + (0.90 \times 0.15) = 0.07$ (see Table 2 below).²⁶⁴ With a positive expected value of seven percent, the accounting firm would rationally choose to acquiesce to its client's demand to help it commit fraud.²⁶⁵

261. *See id.*

262. *See generally Gatekeeper Failure, supra note 27* (explaining that accountants face a lower level of deterrence due to the decreased threat of litigation).

263. *Id.*

264. ROSS, *supra* note 252.

265. *See id.*

Table 2

NO PRIVATE RIGHT OF ACTION			
State of Enforcement	Probability of Litigation	Rate of Return if State Occurs	Product
Caught	0.10	-0.7	-0.07
Not Caught	<u>0.90</u>	0.15	<u>0.14</u>
	1.0		EV = 0.07

These scenarios suggest that under the right circumstances, even with the possibility of massive losses resulting from being caught, gatekeepers can be rationally motivated to aid and abet their client's fraudulent endeavors if the risk of being caught is low enough.²⁶⁶

III. CONGRESS SHOULD RESTORE THE PRIVATE RIGHT OF ACTION FOR AIDING AND ABETTING LIABILITY

If courts and law enforcement officials truly expect gatekeepers to serve as reputational intermediaries,²⁶⁷ then the need to reinstate private aiding and abetting liability gains additional urgency.²⁶⁸ The current legal framework does not provide the market with a strong enough incentive to demand that gatekeepers invest in their reputations.²⁶⁹ In fact, assuming that Professor Macey's theories are correct, it is quite the opposite.²⁷⁰ The increase in regulation on gatekeepers from recent reforms such as Dodd-Frank and Sarbanes-Oxley is having the effect of further driving down the value of gatekeepers' reputational capital.²⁷¹ Perversely, this can provide an even larger incentive for gatekeepers to aid and abet a client's fraud, especially if that client is, for instance, a large favored client facing a "last period" scenario.²⁷² The problem is also compounded for gatekeepers either in highly competitive

266. See generally *Gatekeeper Failure*, *supra* note 27 (suggesting that deterrence and the threat of litigation are positively correlated); ROSS, *supra* note 252.

267. See *supra* note 11.

268. See Klock, *supra* note 18, at 492-93.

269. See *supra* Part II.C.

270. *Id.*

271. *Id.*

272. See *supra* Part II.B.2.

industries²⁷³ or who have conflicts of interest that encourage reputation-depleting activities.²⁷⁴ Under a decreased threat of litigation, the expected costs of participating in fraud decrease, making its expected value more positive.²⁷⁵ To prevent such temptations and increase the incentive for gatekeepers to act as reputational intermediaries, Congress must restore the private remedy.²⁷⁶ It would be perfectly reasonable for Congress to cap damages under such a regime.²⁷⁷ After all, the goal ultimately is deterrence for gatekeepers, not insolvency.²⁷⁸ But regardless of damages, by providing investors the ability to hold gatekeepers accountable for the market information they generate, one improves the functioning of the securities markets by creating more trust in an industry where trust is essential.²⁷⁹

It was surely no coincidence that a period of major accounting scandals followed shortly after *Central Bank* and the PSLRA significantly reduced the threat of litigation for gatekeepers.²⁸⁰ Basic principles of finance and economics show that when the probability of a negative outcome to an action decreases, its costs relative to its benefits also decrease.²⁸¹ While Sarbanes-Oxley was enacted in part to mitigate this more “permissive” environment for gatekeepers,²⁸² the Refco debacle and the Financial Crisis provide strong evidence that its reforms were not enough.²⁸³ A plaintiffs’ bar acting as private attorneys general and supplementing the efforts of the SEC and the PCAOB may have averted or at least somewhat alleviated these crises.²⁸⁴ As it stands now

273. See *supra* Part II.B.3.

274. See *supra* Part II.B.1.

275. See *supra* Part II.D.

276. See generally *Hearing on S. 1551, supra* note 64, 103-13 (laying out the argument that restoring the private right of action will decrease gatekeepers’ incentives to acquiesce to fraud).

277. *Id.* at 111.

278. *Id.* at 112.

279. Macey, *supra* note 12, at 18.

280. See *supra* Part II.B.2.d.

281. See *supra* Part II.D.

282. See COFFEE, *supra* note 2, at 16.

283. See generally *In re Refco, Inc. Sec. Litig.*, 609 F. Supp. 2d 304 (S.D.N.Y. 2009) (fraud occurred after Sarbanes-Oxley was enacted), *aff’d sub nom.* Pac. Inv. Mgmt. Co. LLC v. Mayer Brown LLP, 603 F.3d 144 (2d Cir. 2010); see also Macey, *supra* note 12, at 19 (credit ratings agencies gave overly favorable ratings to the securities of high fee-paying clients in the period after Sarbanes-Oxley was enacted).

284. See COFFEE, *supra* note 2, at 78.

though, these two government agencies are the only entities with the power to civilly enforce the relevant securities laws.²⁸⁵ Therefore, the likelihood and frequency of litigation that holds gatekeepers accountable for aiding and abetting fraud is substantially decreased.²⁸⁶

As Judge Lynch's comments in *In re Refco* seem to suggest, it is incongruous that while most criminal defendants convicted under accomplice liability theories can also be held civilly liable by their victims, the victims of criminal securities frauds cannot similarly sue the gatekeeper "accomplices" who helped perpetrate them.²⁸⁷ Since the defendant corporation is most likely insolvent in such cases, aiding and abetting liability could potentially provide private plaintiffs with their sole means of restitution.²⁸⁸ But victims of securities frauds with judgment proof bankrupt defendants are currently stymied by the lack of a private aiding and abetting remedy.²⁸⁹ Unless they can successfully develop theories of liability under sections 11 or 12 of the '33 Act or of primary liability under section 10(b) of the '34 Act, then the courthouse door is effectively shut for them.²⁹⁰ The holdings of *Stoneridge* and especially *Janus* ensure that holding a gatekeeper liable for a primary violation will be very difficult.²⁹¹

CONCLUSION

Gatekeepers in the United States currently have little incentive to build or preserve the reputational capital necessary to effectively serve in their expected roles of reputational intermediaries. In a highly regulated securities market like the United States, regulation must be combined with the credible deterrent threat of litigation in order to provide that incentive. History and mathematics show that when the risk of litigation decreases, the incidence of fraud and accounting irregularities increases. The private remedies under the '33 Act are too limited in scope to provide effective deterrence for gatekeepers who are

285. See 15 U.S.C. §§ 7214-7215; HAZEN, *supra* note 30, § 1.4[6].

286. See *supra* Part II.D.

287. Cf. *In re Refco*, 609 F. Supp. 2d at 319 n.15 ("It is perhaps dismaying that participants in a fraudulent scheme who may even have committed criminal acts are not answerable in damages to the victims of [their] fraud . . .").

288. Tuch, *supra* note 10, at 1608-09.

289. See Klock, *supra* note 18, at 467.

290. See *supra* Part I.B.

291. See *supra* Parts I.B.2.e-f.

tempted to acquiesce to their clients' fraudulent schemes. Also, the SEC and PCAOB are vulnerable to agency capture, budget cuts, and other limitations. The scope, scale, and the profusion of securities and accounting frauds are too much for only one or two agencies to handle, regardless of how competent and diligent they are. Plaintiffs as private attorneys general can provide much needed reinforcements. Therefore, Congress should restore the private right of action under Rule 10b-5 for aiding and abetting liability.