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A Wider Scope Of Primary Liability?

Law360, New York (January 07, 2009) -- In a recent novel decision, SEC v. Tambone, ___ F.3d ___ (1st Cir. 2008), available at 2008 U.S. App. LEXIS 24457, the First Circuit held that the SEC had adequately alleged a primary violation of Section 10(b) and Rule 10b-5(b) for material misstatements "impliedly" made by the defendants.

A sharply worded dissent criticized the Court's holding for enlarging the scope of primary liability and blurring the line between primary and secondary liability that the Supreme Court recently drew in Stoneridge.

Even though its impact remains to be seen, the First Circuit opinion has potentially significant implications for the scope of liability of defendants in both SEC enforcement actions and private civil securities litigation.

Background

Tambone is one of the mutual fund market timing cases brought by the SEC. Defendants James Tambone and Robert Hussey were executives of Columbia Funds Distributor Inc. ("Columbia Distributor"), the principal underwriter and distributor for the Columbia family of mutual funds.

As underwriter, Columbia Distributor was responsible for selling Columbia funds and disseminating informational materials on the funds, including prospectuses, to investors and potential investors and for answering inquiries from the investing public and other entities seeking information about Columbia funds.

As co-president of Columbia Distributor, Tambone's duties included the sales and marketing of Columbia funds and dissemination of fund prospectuses and other materials to investors.

As Managing Director for National Accounts, Hussey's responsibilities included selling funds to investment advisers and others for the benefit of their clients. Hussey reported directly to Tambone.

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Columbia Advisors, the investment adviser to the Columbia funds, was primarily responsible for creating the content of the prospectuses for the funds.

Between 1999 and 2003, various Columbia funds adopted disclosures in their prospectuses limiting or prohibiting market timing by fund investors. Hussey co-led a working group that recommended that all of the Columbia funds adopt a consistent position against market timing in their prospectuses. Tambone and Hussey reviewed the revised prospectus language prohibiting market timing and provided comments on the disclosure to Columbia Advisors' in-house counsel.

On behalf of Columbia Distributor, Tambone also signed hundreds of selling agreements with dealers that contained express representations and warranties concerning the content of the prospectuses, including a representation that each prospectus “will not by statement or omission be misleading.”

The SEC alleged that, despite these limitations on market timing in the funds' prospectuses, Tambone and Hussey affirmatively approved or knowingly allowed certain investors to trade frequently in certain Columbia Funds in violation of the prospectus language.

The SEC charged the defendants with primary violations of Section 17(a)(2) of the Securities Act of 1933 and Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder, as well as with aiding and abetting violations of Section 206 of the Investment Advisers Act of 1940 and Section 15(c)(1) of the Exchange Act by Columbia Advisors and Columbia Distributor.

After the district court dismissed the initial complaint, the SEC filed a second complaint adding a charge of aiding and abetting Columbia Distributors’ violation of Section 10(b).

The District Court Dismissed The Complaint

The district court dismissed the SEC's complaint for failure to state a claim upon which relief could be granted and for failure to plead fraud with particularity.

Addressing the defendants’ primary liability, the district court applied an “attribution test,” which requires an allegation that the defendant personally made the materially misleading statement (or put another way, that the misleading statement can be attributed to the defendant).

The district court found that neither the defendants' role in disseminating the allegedly misleading prospectuses nor their participation in the process of revising the prospectus disclosures was sufficient to attribute the allegedly untrue statements in the prospectuses to the defendants.

According to the district court, “[t]he major flaw with the SEC's complaint was ... a failure to attribute misleading statements to either Tambone or Hussey.” Accordingly the

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district court found that the defendants had not “made” any false or misleading statements and therefore could not be held liable as primary violators under Section 17(a)(2) or Section 10(b) and Rule 10b-5.

The district court also rejected the SEC's assertion that Tambone and Hussey owed a duty to the investors to whom they sold funds because “an individual owes a duty to clarify a misleading statement only if that statement is attributable to them.” Since the court had already decided there were no statements attributable to the defendants, there could be no commensurate duty to clarify.

The First Circuit Reversed

The Majority’s “Implied Statement” Theory

The First Circuit reversed and held that the SEC had adequately stated a claim under Section 17(a)(2) of the Securities Act and Section 10(b) and Rule 10b-5(b) of the Exchange Act.[1]

With respect to Section 17(a)(2), the Court concluded that, by distributing the misleading prospectuses to investors who then invested in the Columbia funds, the defendants “obtained money or property” by means of an untrue statement of material fact in violation of the statute.

For purposes of primary liability under Section 17(a)(2), the Court held “it is irrelevant whether the seller uses his own false statement or one made by another individual. Liability attaches so long as the statement is used ‘to obtain money or property,’ regardless of its source.” (Emphasis in original.)

With respect to Section 10(b) and Rule 10b-5(b), the Court took a more novel approach. Rule 10b-5(b), in relevant part, makes it unlawful for any person “[t]o make any untrue statement of material fact” in connection with the purchase or sale of securities. Thus, the critical issue was whether the SEC's complaint adequately alleged that the defendants made a materially misleading statement.

The Court began by analyzing the language of Section 10(b) and Rule 10b-5. In the absence of any specific definition in the Rule of “make,” the Court reasoned that the word must be read in conjunction with the language of Section 10(b), which makes it unlawful “[t]o use or employ ... any manipulative or deceptive device or contrivance” in connection with the purchase or sale of a security.

The SEC's complaint alleged that the defendants knowingly or recklessly “used” and “employed” misleading prospectuses to sell securities. The Court reasoned that the defendants “made implied statements of their own regarding the accuracy and completeness of those prospectuses.”

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According to the Court, the defendants' implied statements about the truth and accuracy of the prospectuses “derive[d] from their statutory duties and their central role in the securities market.”

As the Court explained, “by virtue of his role in the market and his statutory duties, [a defendant may] make an implied statement without actually uttering the words in question.”

In defining the defendants' implied statements, the Court looked to the defendants' duties as executives of the principal underwriter of the funds.

The Court cited case law and other statutory provisions (namely Sections 11 and 12 of the Securities Act) which emphasize the “unique position” underwriters have in securities offerings and the responsibility they undertake to ensure the accuracy of registration statements and prospectuses.

The Court concluded that “[i]n light of this duty to review and confirm the accuracy of the material in the documentation it distributes, an underwriter impliedly makes a statement of its own to potential investors that it has a reasonable basis to believe that the information contained in the prospectus it uses to offer or sell securities is truthful and complete.”

According to the Court, the SEC alleged that the defendants made such implied statements to investors about market timing practices in the Columbia funds when they knew, or were reckless in not knowing, that those representations were false. In sum, the Court held that “[t]his falsity [in the prospectuses] made their implied statements false.”

Ever since Central Bank, in which the Supreme Court held there is no private right of action for aiding and abetting a violation of the antifraud provisions of the securities laws, the circuit courts have grappled with the distinction between primary and secondary liability in this context.

In Tambone, the First Circuit reviewed the leading tests — the “bright-line” test and the “substantial participation” test — but ultimately rejected both as inapplicable in this case.

Under the bright-line test, used by the Second Circuit and others, primary liability requires a showing that a defendant made a false or misleading statement and that the statement (or omission) was attributed to the defendant at the time of public dissemination.

Under the substantial participation test, used solely by the Ninth Circuit, primary liability requires a showing that a defendant “substantially participated” or played “a significant role” in the making of a fraudulent statement.

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The First Circuit concluded that neither test applied to in this case. The bright-line test did not apply because it does not address what it means to “make” a statement and requires attribution in order to show reliance, an element not required in SEC actions.

The substantial participation test did not apply because it evaluates whether a defendant can be deemed to have “made” a statement made by another because of the defendant’s substantial participation in creating the statement.

In Tambone, the Court found that the defendants had made their own implied statements, rendering unnecessary any inquiry into whether they substantially participated in the statements of another.

The Spirited Dissent

In a strident response, Judge Selya dissented. Referring to the majority opinion as “judicial adventurism,” Judge Selya criticized the majority for “rewriting” Rule 10b-5(b) in a way that “stretches the concept” of primary liability and “blurs the line” between primary and secondary liability — a line the Supreme Court recently took pains to draw in Stoneridge.

Judge Selya began with the dictionary definition of “make” as to “‘act’ or ‘cause to exist, occur, or appear,’ or ‘create [or] cause.’” Judge Selya then contended that the majority “casually conflates this carefully chosen verb (‘make’) with a very different verb (‘use’) in order to impose primary liability on defendants who have not 'made' any misstatements, but rather, are alleged to have used prospectuses that contain misstatements crafted by others.”

According to Judge Selya, the majority's interpretation of the word “make” was not only inaccurate but “flies in the teeth of the Supreme Court's circumspect vision of primary liability” under the securities laws articulated in Central Bank.

While acknowledging that underwriter executives owe a duty to those who purchase securities, Judge Selya cautioned that a breach of that duty, without more, does not give rise to liability under Rule 10b-5.

According to Judge Selya, “[t]he SEC's attempt in this case to employ Rue 10b-5(b) to punish such a breach impermissibly equates a passive omission — failing to correct a false statement made by another — with affirmative misconduct that the language of the rule targets.”

Implications Of The First Circuit Decision

Although the impact of the Court's holding remains to be seen, the decision has potential consequences for both SEC enforcement actions and private securities litigation.

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For enforcement actions, the decision may help the SEC pursue cases against individuals who act as part of a larger organization. Amid the financial scandals of the last decade, the SEC has focused substantial enforcement resources on holding individuals accountable.

Indeed, the vast majority of the SEC's litigation docket is devoted to cases against individuals. One of the challenges the SEC faces in complex cases is proving a violation of Rule 10b-5 by an individual in circumstances in which the elements of liability are arguably disaggregated among multiple individuals.

For example, the person responsible for making the statement was not aware of the conduct by others that rendered the representation misleading. Conversely, the individual involved in the misconduct did not personally make the misleading statements.

In a jurisdiction applying a strict attribution test to Rule 10b-5(b), as the district court did in Tambone, the SEC can find itself in a difficult litigation position.

In this sense, the First Circuit's “implied statement” test gives the SEC another theory for holding individuals in organizations liable for violations of Rule 10b-5, despite the involvement of multiple individuals in the totality of the conduct giving rise to the violation.

In private civil litigation, the implications of the decision are less clear. On one hand, the implications of the decision may be quite narrow if limited to the facts of this case, i.e., underwriters in securities offerings.

Moreover, arguably the Court's “implied statement” holding should be limited to SEC enforcement actions. Unlike the SEC, plaintiffs in private securities actions must show that they relied on the defendant's misrepresentation.

Establishing a direct link between a defendant's implied misrepresentation, where there has been no actual statement, and plaintiff's injury could present substantial evidentiary issues.

In this case, one of the reasons the Court rejected the attribution test was the absence of a reliance element in an SEC enforcement action. This suggests that in a private action in the First Circuit, a plaintiff will still need to meet the attribution test.

On the other hand, the decision potentially opens a window through which private plaintiffs will seek to expand the liability of third parties under Rule 10b-5 in the wake of Stoneridge.

In Tambone, the Court derived the defendants' implied statements about the truth and accuracy of the prospectuses from their statutory duties as senior executives of the

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principal underwriter and their central role in the securities market. At a minimum, the decision expands the potential liability of individual senior executives of underwriters.

The remaining question is the extent to which plaintiffs will be able to allege other contexts in which defendants made an implied statement by virtue of their central role in the securities markets, such as auditors, lawyers, investment bankers, financial advisers or significant counterparties.

If Judge Selya is correct in his dissent, the majority's “implied statement” theory “captures a much broader range of conduct” than either the attribution test or the substantial participation test and has the potential to cause “a great deal of mischief.”

Coming at a time of unprecedented market turmoil, and a concomitant surge in securities class action litigation, the First Circuit’s decision may provide plaintiffs with a welcome weapon as they seek from an expanding list of defendants remedies for the largest alleged shareholder losses in history.

--By Mark K. Schonfeld and Akita St. Clair, Gibson Dunn & Crutcher LLP

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[1] The SEC did not appeal the district court’s dismissal of its claims under Section 17(a)(1) and (3) or Rule 10b-5(a) and (c) and thus, the First Circuit did not address those claims.

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