Defending Lawyers and Accountants in Securities Cases

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by

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Introduction

I. PRIMARY SOURCES OF LAWYER AND ACCOUNTANT LIABILITY IN SECURITIES CASES

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II. ACCOUNTING FRAUD: A RECENT FOCUS OF SEC ENFORCEMENT PRACTICES

In a recent press release, SEC Enforcement Director Richard H. Walker stated that,

> Accurate and reliable financial reporting is the bedrock of our capital markets. This case is the latest in our ongoing fight against fraudulent earnings management practices that have caused investors billions of dollars in losses and threaten to undermine the integrity of our markets. As the case makes clear, we will attack such conduct aggressively in whatever guise it may appear (in this case, practices ranging from "cookie jar" reserves to channel stuffing) and against whomever may be involved (here, senior company management and the outside auditor).

"SEC Sues Former CEO, CFO, and Other Top Former Officers of Sunbeam Corporation in Massive Financial Fraud; Complaint Also Charges Former Arthur Andersen Engagement Partner With Fraud," *SEC Press Release* 2001-49, May 15, 2001.

According to SEC data for the year 2000, 100 of the SEC's enforcement cases involved accounting fraud. During that year, charges were filed against 26 companies, 19 CEOs and 19 CFOs. Neil Roland, "SEC to Stay Focused on Accounting Practices," *Los Angeles Times*, February 28, 2001.

The most common type of fraud investigated is the improper recording of revenue. Neil Roland, "SEC to Stay Focused on Accounting Practices," *Los Angeles Times*, February 28, 2001.

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A. The Gap in GAAP

Another possibly contentious issue between accountants and the SEC has been and will be the valuation of intangible assets. The dot.com craze generated criticism for the profession's failure to properly recognize values which investors perceived in many companies. *See* Floyd Norris, "Seeking Ways to Value Intangible Assets," *The New York Times*, May 22, 2001.

B. Current Investigations

According to Thomas Newkirk, associate enforcement director of the SEC, as of May 16, the SEC was investigating 260 cases of financial or accounting fraud. David Andelman, "Fraud Cutter Feels Fraud Rap Blade," *The New York Daily News*, May 16, 2001.

III. THE SUNBEAM CASE: EXPECTATIONS FULFILLED (ALMOST)

A. The Importance of the Case

According to one commentator, reporting fraudulent information is material for investors regardless of the amounts involved. Floyd Norris, "They Noticed the Fraud but Figured It Was Not Important," *The New York Times*, May 18, 2001.

B. The Alleged Reason for the Fraud

Sunbeam hired corporate "turnaround" specialist Al Dunlap as Chairman and CEO in July 1996. Dunlap promised positive results quickly. Along with several Sunbeam executives, the organization allegedly employed improper accounting techniques and other undisclosed non-recurring transactions in order to fulfill Dunlap et al's promises. Sunbeam's financial statements, press releases, 1996 year-end results, 1997 quarterly and year-end results, and 1998 first quarter results were deemed by the SEC to be materially false and misleading. *SEC v. Dunlap; In the Matter of Sunbeam Corporation*, Accounting and Auditing Enforcement Release No. 1395, 2001 *SEC Lexis* 928 (May 15, 2001).

C. The Alleged Fraud

Sunbeam owned a large number of spare parts for its products. A company named EPI Printers stored the parts, and estimated their value at approximately $2 million. Sunbeam persuaded EPI to enter into an agreement to buy the parts for $11 million. The agreement also contained an escape clause whereby EPI could decline to buy the parts several months later. Sunbeam booked the profits at $8 million but the parts were never sold pursuant to the escape clause. Floyd Norris, "They Noticed the Fraud but Figured It Was Not Important," *The New York Times*, May 18, 2001.

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D. Auditor Participation

The Arthur Andersen partner in charge of the audit, Phillip Harlow apparently concluded that booking the profit at $8 million, but allowed Sunbeam to record a profit on the sale of $5 million on the grounds that the remaining profit was not material. Arthur Andersen has since paid $110 million to settle a Sunbeam shareholders' suit against the firm. *Id.*

E. SEC Response

The SEC responded, among other things, that the improperly reported profits amounted to 16 percent of Sunbeam's reported annual profits. The Commission contends that Sunbeam reported "sham profits." *Id.*

F. Examples of Accounting Fraud

Examples of accounting fraud such as the one offered above resulted in record-setting profits for Sunbeam in FY 1997. According to the SEC, of the company's $189 million in booked earnings for that year, $60 million came from accounting fraud. "SEC Sues Former CEO, CFO, and Other Top Former Officers of Sunbeam Corporation in Massive Financial Fraud; Complaint Also Charges Former Arthur Andersen Engagement Partner With Fraud," *SEC Press Release* 2001-49, May 15, 2001.

IV. THE XEROX CASE: TECHNICALITIES TURN "PROFITS"

Xerox Corp. recently restated its financial results for the past three years. The restatement was issued amidst increasing investigation of Xerox by the SEC. Mark Maremont and James Bandler, "Concession by Xerox May Not Satisfy SEC," *The Wall Street Journal* (June 1, 2001).

In a May 30, 2001 filing, Xerox disclosed that it had "misapplied" a number of accounting rules regarding, e.g., the way it books revenues for copier leasing. The misapplication resulted in an addition of $253 million in pre-tax income for the company over the past three years. Xerox's auditor, KPMG, LLP, approved the practices. Mark Maremont and James Bandler, "Concession by Xerox May Not Satisfy SEC," *The Wall Street Journal* (June 1, 2001).

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<u>**The Private Securities Litigation Reform Act of 1995**</u>

I. HISTORY AND ENACTMENT

A. Lodestar Incentive

For over twenty years, the securities laws provided incentives for attorneys to represent shareholders in class action lawsuits against corporate officers, directors, auditors, and attorneys. The attraction was a court-approved attorney's fee, often a percentage of the recovery or a multiple of the lawyer's time spent on the case (the lodestar).

B. Republican Party's "Contract with America"

The Reform Act was a part of the Republican Party's "Contract With America" goal of litigation reform. The enacting coalition was the result of lobbying by the accounting industry, the securities industry, high-technology companies, and public retirement funds.

C. Veto Override

The bill passed in December of 1995 but was vetoed by President Clinton. Clinton stated that the bill would "have the effect of closing the courthouse door on investors who have legitimate claims." Congress overrode the veto shortly thereafter. *See* "Investor Risk is Major Concern In Veto of Litigation Overhaul," *Congressional Quarterly*, December 23, 1995.

II. THE NAME SAYS WHAT IT IS:

The Reform Act attempted to change securities litigation in, among others, the following ways:

- Discourage professional plaintiffs through a variety of procedural and economic disincentives;
- Encourage institutional investors to act as class representatives;
- Encourage the settlement process by limiting attorney's fees and increasing the availability and quality of information contained in settlement notices to the class;
- Limit joint and several liability in favor of proportionate liability in cases where violations are not knowing;
- Provided for greater specificity in the pleading requirements;
- Damages in some cases are calculated according to a statutory formula;
- Liability for projections is eliminated if accompanied by "sufficient and meaningful cautionary statements" (the "Bespeaks-Caution Doctrine")

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III. REFORM ACT RESULTS:

Since the adoption of the Reform Act, certain patterns have emerged:

- The number of issuers sued has not changed dramatically since the passage of the Reform Act. Although litigation declined sharply in 1996, any decline was likely a transition effect;
- Under the Reform Act, a larger percentage of litigation focuses on accounting fraud, with revenue recognition being a significant cause of litigation;
- Under the Reform Act, a larger percentage of litigation focuses on insider trading during periods when frauds are allegedly "alive" in the market;
- Settlement amounts have increased dramatically, particularly for "mega cases." Under the Reform Act, three cases have settled for more than $200 Million. The Cendant litigation settled for $3.25 Billion; the 3-Com litigation settled for $259 Million; the Waste Management litigation settled for $220 Million. *See* Securities Class Action Clearinghouse at Stanford Law School (http://securities.stanford.edu), May 31, 2001.

IV. PRIMARY LIABILITY

A. Joint and Several Liability.

"Any covered person against whom a final judgment is entered in a private action shall be liable for damages jointly and severally only if the trier of fact specifically determines that such covered person knowingly committed a violation of the securities laws." 15 U.S.C.A. § 78u-4(f)(2)(A).

a. Under a joint and several liability system, joint tort feasors were responsible for the investor's entire loss regardless of fault or culpability.

b. Under the Act, joint tortfeasors are jointly and severally liable only in cases of a "knowing" violation (actual knowledge by defendant; persons are likely to reasonably rely on misrepresentation) or when the plaintiff's loss was more than 10% of the plaintiff's net worth (provided that net worth does not exceed $200,000).

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B. Proportionate Liability.

"A covered person against whom a final judgment is entered in a private action shall be liable solely for the portion of the judgment that corresponds to the percentage of responsibility of that covered person." 15 U.S.C.A. § 78u-4(f)(2)(B)(I).

a. Under a proportionate liability system, the jury first determines the percentage of fault for the plaintiffs' loss among individual defendants.

b. Defendants then only pay for that percentage of the damages.

V. ONLY THE SEC MAY PROSECUTE FOR SECONDARY LIABILITY

In *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.,* 511 U.S. 164 (1994), the Supreme Court stated that there is no private right of action for aiding and abetting liability under the Exchange Act. Consequently, some question existed as to whether the SEC could prosecute for such violations. Under the Reform Act, only the SEC has a right of action for aiding and abetting violations.

Section 104 of the Reform Act explicitly authorized the SEC to prosecute aiding and abetting despite the Supreme Court's decision in Central Bank. Section 20 of the Exchange Act (15 U.S.C. § 78t) was amended to read as follows:

> "(f) Prosecutions of Persons Who Aid and Abet Violations. For the purposes of any action brought by the Commission *** any person that knowingly provides substantial assistance to another person in violation of a provision of this title, or of any rule or regulation issued under this title, shall be deemed to be in violation to the same extent as the person to whom such assistance is provided."

VI. THE DISTINCTION BETWEEN PRIMARY AND SECONDARY LIABILITY UNDER 10(B) AND 10B-5

The Central Bank court was careful to point out that the absence of § 10(b) aiding and abetting liability does not necessarily mean that secondary actors will always be free from liability under the Securities Acts. In complex securities fraud cases, there are often numerous violators. Despite their place behind the scenes, professionals remain primarily liable so long as the elements for primary liability are met. See *Central Bank* 511 U.S. at 1455.

The line between primary and secondary liability may be difficult to discern, especially where accountants are involved. In *DiLeo v. Ernst & Young*, 901 F.2d 624, 628 (1990), the court stated that "when an accountant certifies that a firm's financial statements "present fairly" its financial position, it is certifying the absence of materially misleading omissions, a source of primary liability."

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In *Anixter v. Home-Stake Production Co.*, 77 F.3d 1215 (10th Cir. 1996), court stated that "the critical element separating primary from aiding and abetting violations is *the existence of a representation*, either by statement or omission, made by the defendant, that is relied on by the plaintiff. Reliance only on representations made by others cannot itself form the basis of liability." *Anixter*, 77 F.3d at 1225. (Emphasis added)

The rule of *Anixter* is thus "in order for accountants to 'use or employ' a 'deception' actionable under the anti-fraud law, they must themselves make a false or misleading statement (or omission) that they know or should no will reach potential investors.

The Third Circuit has held that a lawyer who participates in the preparation of client documents thereby becomes the author of those documents even though the lawyer did not sign a disclosure package, nor did the investors even know the defendant lawyers had prepared it. *Klien v. Boyd*, Fed. Sec. L. Rep. (CCH) & 90,136 (3d Cir. 1998) (later vacated and settled before rehearing). There the court found that the requirements for liability were that:

- The lawyer knows that the statement will be relied upon by investors;
- The lawyer is aware of the material misrepresentation or omission;
- The lawyer played such a substantial role in the creation of the statement that the lawyer could fairly be said to be the "author" or "co-author" of the statement;
- The other requirements of primary liability are satisfied. *Klien* at 90,318 n.1.

A. If you must Speak, Speak Wisely

Succinctly, although lawyers may not always have an independent duty to provide information about a client, "The lawyer assumes a duty to provide complete and non-misleading information with respect to subjects on which he or she undertakes to speak." Lewis D. Lowenfels and Alan R. Bromberg, "Liabilities of Lawyers and Accountants Under Rule 10b-5," *The Business Lawyer*, Vol. 53 No. 4 (August 1998).

VII. AUDITOR DISCLOSURE

The Reform Act also required procedures for auditors to detect and disclose illegal acts to a company's board of directors. The company is in turn required to report such acts to the SEC. If the company fails to report the acts to the SEC, the auditor must resign and report the acts himself. The Act as amended requires the following:

1. Procedures designed to provide reasonable assurance of detecting illegal acts that would have a direct and material effect on the determination of financial statement amounts;
2. Procedures designed to identify related party transactions that are material to the financial statements or otherwise require disclosure therein; and

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3. An evaluation of whether there is substantial doubt about the ability of the issuer to continue as a going concern during the ensuing fiscal year. 15 U.S.C.A. § 78j-1 (2001).

On April 24, 2001, KPMG, auditor of Avant! Corp., notified the SEC that it had brought several "reportable events" involving ineffective internal controls to the attention of Avant!'s board of directors. KPMG's notice disclosed ineffective internal controls concerning revenue recording, incomplete and missing contract documentation, and lack of timely and accurate account reconciliations for 1999 and 2000. KPMG notified the SEC 10 days after Avant! replaced KPMG as auditors with PricewaterhouseCoopers and 20 days after Avant! filed its annual report with the SEC. "Auditor is Dismissed After Filing Warning," *The New York Times* (May 10, 2001).

Rule 102(e) Proceedings Against Accountants and Lawyers

I. THE COMMISSION HAS BROAD AUTHORITY

The Commission has broad authority to promote and enforce compliance with professional standards under the securities laws. 1998 *SEC LEXIS* 2256 at *7.

Under Rule 102(e), the SEC may censure, suspend or bar lawyers or accountants who appear or practice before it. 1998 *SEC LEXIS* 2256 at *1; 17 C.F.R. § 201.102(e).

A. "Practicing Before the SEC"

"Practicing before the SEC" is defined as:

- Transacting any business with the Commission; and
- The preparation of any statement, opinion, or other paper by an attorney [or] accountant *** that was filed with the Commission in any registration statement, notification, application, report or other document with the consent of the attorney or accountant. 17 C.F.R. § 201.102(f).

B. When the Commission will Take Action

The Commission may take such action upon a finding that the professional:

- Lacks the requisite qualifications to represent others; or
- Lacks the requisite character or integrity or has engaged in improper or unethical conduct; or
- Willfully violated, or willfully aided and abetted a violation of any provision of the federal securities laws. 17 C.F.R. § 201.102(e) (2001); *See also* Marc I Steinberg, *Corporate and Securities Malpractice*, Practicing Law Institute (1992).

Despite a lack of express statutory authority, the Second Circuit upheld the Rule in *Touche Ross & Co v. SEC*, 609 F.2d 570 (2nd Cir. 1979).

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- In Touche Ross, the court stated that Rule 102(e) is a "means to ensure that those professionals, on whom the Commission relies heavily in the performance of its statutory duties, perform their tasks diligently and with a reasonable degree of competence." *Touche Ross* 609 F.2d at 582.
- The rule was sustained as a necessary element of the Commission's power to protect the integrity of its administrative procedures and the public in general. *Touche Ross* at 582.

II. AS APPLIED TO ACCOUNTANTS

The rule was amended in 1998 and was intended to clarify the circumstances under which accountants engage in "improper professional conduct" under the rule. 1998 *SEC Lexis* 2256 at *2.

- Several commentators, including the AIPCA, Ernst & Young, KPMG Peat Marwick, and Arthur Andersen, opined that when compared to the standard as applied to attorneys, the 1998 amendment discriminated against accountants. 1998 *SEC Lexis* 2256 at *37. The SEC responded by noting the importance of the financial reporting process to investors. 1998 *SEC Lexis* 2256 at *37.
    - The accountant's role before the SEC is in the auditing of financial statements. 1998 *SEC Lexis* 2256 at *10. Investors must possess accurate information in order to make investment decisions. 1998 *SEC Lexis* 2256 at *13.
    - As the Supreme Court pointed out, "Corporate financial statements are one of the primary sources of information available to guide the decisions of the investing public." *U.S. v. Arthur Young & Co.*, 465 U.S. 805, 810 (1984).
    - Accountants issue reports in conjunction with an audit that states that the audit was conducted in accordance with Generally Accepted Accounting Standards (GAAS) while applying Generally Accepted Accounting Principles (GAAP) and that the financial statement fairly described the financial position of the company in all material respects. 1998 *SEC Lexis* 2256 at *12.

A. The Standard for Liability Prior to the 1998 Amendments

The standard for liability was interpreted in *Checkosky v. SEC*, 23 F.3d 452 and again in *Checkosky v. SEC*, 139 F.3d 221 (D.C. Cir. 1998) (*Checkosky II*).

- The *Checkosky II* court blamed the SEC for its failure to give sufficient guidance for the interpretation of "improper professional conduct." *Checkosky II*, 139 F.3d at 224.
- In turn the SEC stated that the 1998 amendments were designed to clarify what the SEC thought was an improper articulation of the standard for "improper professional conduct" set forth in *Checkosky II.* 1998 *SEC Lexis* 2256 at *3.

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B. The Standard Under the Amendments

The rule reads, in pertinent part, "improper professional conduct" under § 201.102(e)(1)(ii) means:

i. Intentional or Knowing Conduct

Intentional or knowing conduct, including reckless conduct, that results in a violation of applicable professional standards; or

ii. Negligent Conduct

Either of the following two types of negligent conduct:

- A single instance of highly unreasonable conduct that results in a violation of applicable professional standards in circumstances in which an accountant knows, or should know, that heightened scrutiny is warranted;
- Repeated instances of unreasonable conduct, each resulting in violation of applicable professional standards, that indicate a lack of competence to practice before the Commission. 17 C.F.R. § 201.102(e).

iii. "Competence"

Competence means technical skills and the professional's willingness and ability to adhere to professional standards, including standards of honesty and fair dealing. 1998 *SEC Lexis* 2256 at *15. The Rule is not designed to cover every misstep, nor does it seek to establish new standards of professional conduct. Rule 102 proceedings simply determine whether an alleged violation of those standards indicates a lack of the requisite competence to practice before the Commission. 1998 *SEC Lexis* 2256 at *18.

iv. "Applicable Professional Standards"

Applicable professional standards means GAAP, GAAS, the AICPA Code of Professional Conduct, other Commission regulations, and standards "routinely used by accountants in the preparation of statements, opinions, or other papers filed with the Commission." 1998 *SEC Lexis* 2256 at *19.

v. Intentional, Knowing, or Reckless Conduct

Intentional, knowing, or reckless conduct addresses blatant violations of the professional standards articulated above and conclusively demonstrates a lack of competence to practice before the commission. 1998 *SEC Lexis* 2256 at *22. The standards for recklessness are the same as under the anti-fraud provisions of Securities Exchange Act: The professional's departure from the standard of ordinary care "presents a danger of misleading buyers or sellers that is either known to the actor or is so obvious that the actor must have been aware of it." 1998 *SEC Lexis* 2256 at *23, *citing SEC v. Steadman*, 967 F.2d 636, 641 (D.C. Cir. 1992).

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vi. Highly Unreasonable Conduct

Highly unreasonable conduct is an objective standard of care higher than ordinary negligence but lower than recklessness as defined by the Rule and the Exchange Act. 1998 *SEC Lexis* 2256 at *26. The analysis turns on the "degree of departure" from professional standards. 1998 *SEC Lexis* 2256 at *26. Heightened scrutiny is warranted when, for example, questions arise about the accountant's independence or when other warning signals would alert a reasonable accountant of increased risk.

vii. Repeated Instances of Unreasonable Conduct

Repeated instances of unreasonable conduct means more than one negligent act, whether it be several negligent acts during the course of one audit or one negligent act over several audits. 1998 *SEC Lexis* 2256 at *39.

III. AS APPLIED TO ATTORNEYS

A. Contrasted to Accountants

The traditional role of the lawyer is to advise the client, not the public, about the law. However, if a lawyer violates ethical or professional standards, consciously participates in violations of the securities laws, or ignores the consequences of his work, "it will not do to say that because the lawyer's duty is to his client alone, this Commission must stand helplessly by while the lawyer carries his privilege of practicing before the Commission to the next client." Louis Loss and Joel Seligman, *Fundamentals of Securities Regulation* 1386 (4th ed. rev. 2001), *citing* William R. Carter, 47 *SEC* 471, 478 (1981).

The violation must be of a character that threatens the integrity of the Commission's processes in the way that the activities of unqualified or unethical professionals do. Loss and Seligman at 1386, *citing* Carter, 47 *SEC* at 478.

The Commission does not distinguish between advice given orally or in writing, regardless of whether the documents will be filed with the Commission. Loss and Seligman at 1386, *citing* Carter, 47 *SEC* at 478.

B. Guidelines for Written Opinions

Guidelines for Written Opinions as prepared by the Association of the Bar of the City of New York. Cited in Loss and Seligman at 1376 (paraphrased).

- Ascertain the purpose for the opinion. The lawyer should know whether the information will be addressed to, used, or otherwise relied upon by the client, some other person, or some specific group of persons.
- The lawyer should not give an opinion she knows or suspects will be used to further an illegal securities transaction.

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- Identify, consider, and reach a conclusion about the legal issues after performing the necessary legal and factual research on which proper analysis depends.
- The lawyer should not render an opinion based on information that she knows or suspects is materially misleading in any respect. Although the attorney has no obligation to independently verify such information, she should also express:
  1. That she has not done so; and
  2. Which pieces of information have not been independently verified. Information need not be verified unless the lawyer knows of inconsistent information or the circumstances reasonably alert the lawyer of inaccuracies in any material respect.
- If reasonable lawyers might differ as to a legal conclusion, the opinion should so state. If the lawyer's opinion departs from an administrative or other authority, the lawyer should likewise state.
- Opinions may be given based on a set of hypothetical facts but should state that the opinion might change with the facts. Lest there be any misunderstanding or misuse of the lawyer's legal advice, such opinions should only be given under circumstances where the use of and reliance on the information is clearly limited to the client or other specified group.

Liability of Accountants for Negligent Misrepresentation

I. THE RESTATEMENT VIEW

Restatement, Second (Torts) § 552 states:

a. One who, in the course of his business, profession, or employment, or in any other transaction in which he has a pecuniary interest, supplies false information for the guidance of others in their business transactions, is subject to liability for pecuniary loss caused to them by their justifiable reliance upon the information, if he fails to exercise reasonable care or competence in obtaining or communicating the information.

b. Liability under subsection (1) is limited:
   - by the person or one of a limited group of persons for whose benefit and guidance he intends to supply the information or knows that the recipient intends to supply it; and
   - through reliance upon it in a transaction that he intends the information to influence or knows that the recipient so intends or in a substantially similar transaction.

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c. The liability of one who is under a public duty to give the information extends to loss suffered by any of the class of persons for whose benefit the duty is created, in any of the transactions in which it is intended to protect them.

- Minnesota has adopted the Restatement approach. *Bonhiver v. Graff*, 248 N.W.2d 291 (1976) (test adopted while § 552 was in tentative draft stages).
- Under Minnesota law, liability is extended to "a limited number of third parties who are expected to gain access to the financial statement information in an expected transaction." *TCF Banking & Sav. F.A. v. Arthur Young & Co.*, 706 F.Supp. 1408, 1481 (D. Minn. 1988).
- It is not enough that the maker merely knows of the ever-present possibility of repetition to anyone, and the possibility of action in reliance upon it, on the part of anyone to whom it may be repeated. *NorAm Investment Services, Inc. v. Stirtz, Bernards, Boyden, Surdel & Larder, P.A.*, 611 N.W.2d 372 (Minn. App. 2000), *citing Restatement* § *552, Comment h.*

II. THE PRIVITY RULE

In *Ultramares Corp. v. Touche,* 174 N.E. 441 (N.Y. 1931), Justice Cardozo first articulated the "privity" rule while sitting as Chief Judge of the New York Court of Appeals.

1. Under the privity rule, accountants are generally not liable to non-clients: auditors may be liable for negligence only where a third party's reliance on the auditor's work was "not merely one possibility among many, but the end and aim of the transaction." *Ultramares*, 174 N.E. at 445.
2. Subsequent decisions have set forth three factors for a finding of liability under *Ultramares*:
   - The accountants must have been aware that the financial reports were to be used for a particular purpose;
   - In the furtherance of which a known party or parties was intended to rely;
   - There must have been some linking conduct which evinced the accountant's understanding of that party's reliance. *Securities Investor Protection Corp. v. BDO Seidman, LLP*, 746 N.E.2d 1042 (N.Y. 2001), *citing Credit Alliance Corp. v. Arthur Andersen & Co.*, 483 N.E.2d 110 (N.Y. 1985).
3. The rule is quite restrictive and has been criticized because such financial reports are often obtained precisely for the purpose of certifying that the financial information is indeed reliable.

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III. THE FORESEEABILITY APPROACH

Some state courts have also adopted the foreseeability approach that holds auditors responsible to all foreseeable users of audits who rely on the audits to their detriment. *See, e.g., H. Rosenblum, Inc. v. Adler*, 461 A.2d 138 (N.J. 1983) (superseded by statute resembling the Restatement view); *Citizens State Bank v. Timm Schmidt & Co.*, 335 N.W.2d 361 (Wis. 1983).

- One commentator suggested that Minnesota has adopted a "liberal interpretation of the Restatement" and that Minnesota law falls somewhere between § 552 and the reasonably foreseeable plaintiff approach. *See* Carl Pacini and David Sinason, *Gaining a New Balance in Accountants' Liability to Nonclients for Negligence: Recent Developments and Emerging Trends*, 103 Com. L. J. 15 at 27, 53 (Spring 1998).
- This view is supported by the Minnesota Supreme Court's suggestion in *Bonhiver* that the defining line for liability should be drawn in favor of recovery for the injured plaintiff: "personal reliance, indirect though it may be through the commissioner, was reasonable on the part of [plaintiff] and sufficient to accord him protection against defendants' negligence." *Bonhiver*, 248 N.W.2d at 303.

Direct vs. Derivative Claims Against Accountants

I. GENERALLY

Generally under Minnesota law, individual shareholders may not assert a cause of action that belongs to the corporation. *See Wessin v. Archives Corp.*, 592 N.W.2d 460 (Minn. 1999); *Northwest Racquet Swim and Health Clubs v. Deloitte & Touche*, 535 N.W.2d 612, 617 (Minn. 1995).

II. THE RULE FROM WESSIN

The rule from *Wessin*: "In analyzing whether a claim is direct or derivative, we look not to the theory in which the claim is couched, but instead to the injury itself." *Wessin*, 592 N.W.2d at 464.

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III. THE NORTHWEST RACQUET CASE

In *Northwest Racquet*, the health club purchased $15 million worth of subordinated debentures from Midwest Federal Savings and Loan Association. Northwest claimed to have purchased the debentures based upon the year-end audited financial statements of defendant accounting firm Deloitte & Touche, Midwest Federal's auditor. *Northwest,* 535 N.W.2d at 612.

In contemplation of the debenture agreement, Midwest Federal provided Northwest with financial statements prepared in accordance with Regulatory Accounting Principles (RAP) rather than GAAP. Under RAP, certain gains and losses were deferred rather than immediately recognized as under GAAP; in addition, certain debentures were classified as regulatory capital rather than liabilities. The end result was a difference of nearly $160 million in retained earnings. *Northwest*, 535 N.W.2d at 616.

The question on appeal was whether Northwest's injuries, as debenture holder in Midwest Federal, belonged to Northwest or Midwest Federal.

The Minnesota Supreme Court found that Northwest alleged and directly relied upon very specific incidences of misrepresentation in Touche's audit report. Such representations directly affected Northwest's decision to purchase the debentures. As a result, Northwest was able to show injury separate and distinct from other holders of Midwest Federal debentures. *Northwest*, 535 N.W.2d at 619.

As the original trial court order stated, "In order to appreciate the distinction between the two claims, it is helpful to think in the following terms: The misrepresentations upon which Northwest relied were made in Midwest Federal's financial statements. Midwest Federal's position with regard to these fraud claims, if any, would be that of joint tortfeasor. Midwest Federal could have no claim for fraud against Touche based upon its own fraudulent financial statements which Midwest used to induce investment. Conversely, Northwest may assert a direct claim for fraud against both Touche and Midwest Federal due to the misrepresentations in the financial statements, and could recover its lost investment from either on a joint and several basis. Thus there exists [a] direct claim of fraud against Touche which is separate and distinct from any claim that can be asserted by Midwest Federal, or its successor." *Northwest Racquet, Swim, & Health Clubs, Inc. v. Deloitte & Touche*, No. 923467 (Hennepin County Dist. Ct.).

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Securities Transactions: Potential Sources of Exposure

I. 10B-5: THE WIDEST NET

A. History of 10-b--5

Investors' ability to bring claims derives from an implied right of action under rule 10b-5, a rule loosely drafted in an attempt to close a loophole in the '34 Act. As one commissioner remembers,

I do not remember whether we got there that morning or after lunch. We passed a piece of paper around to all the commissioners. All the commissioners read the rule and they tossed it on the table, indicating approval. Nobody said anything except Summer Pike who said, "Well," he said, "we are against fraud aren't we?" That is how it happened.

cited in A. Jacobs, *Litigation and Practice Under Rule 10b-5,* § 5.02 (1995); *SEC v. Clark*, 915 F.2d 439, 451 (9th Cir. 1990).

B. Elements of a 10b-5 Violation

In order to prove a 10b-5 violation, the plaintiff must show:

- Misrepresentation or omission of fact;
- That is material,
- Made with fraudulent intent (scienter),
- In connection with the purchase or sale of securities,
- Upon which the plaintiff relied, and
- The statement or omission was the proximate cause of the loss.

See, e.g. *Davidson v. Wilson*, 973 F.2d 1391, 1400 (8th Cir. 1992).

II. REGISTRATION STATEMENTS (§ 11 OF THE 1933 ACT) 15 U.S.C. § 77K.

A. Generally

Generally, § 11 imposes liability for any material misrepresentation or omission in registration statements, including a prospectus, upon certain enumerated parties such as the issuer, its directors or partners, underwriters, and accountants who are named as having prepared or certified the registration statement.

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B. Elements of a Cause of Action Under § 11

- The Plaintiff purchased a registered security that was the subject of the defective registration statement;
- The registration statement or prospectus contained a material misrepresentation or omission;
- The securities were registered securities;
- Defendant falls within the statutory class of defendants;
- The statute of limitations has not run.

C. Experts

"Experts" are defined as any person whose profession gives authority to a statement made by him. 15 U.S.C. § 77(k)(5).

D. Liability of Experts

Attorneys who render tax opinions for use in the offering and who use their own name in the prospectus are considered "experts" under § 11. Accountants are liable for misstatements they prepare or certify, but only if the information is directly attributable to them. Liability is limited to statements made in the registration statement.

E. Liability of Non-Experts

Attorneys who simply prepare the registration statement are generally not liable under § 11.

- In *Herman & MacLean v. Huddleston*, 459 U.S. 375, 386 n. 2, the Supreme Court stated that lawyers acting as non-experts and accountants who worked on parts of registration which they are not named as having prepared or certified.
- If the attorney is also an officer or director of the issuer, that attorney may also incur liability as such but may be held to the higher standards of the legal profession. *See Feit v. Leasco Data Processing Eqt. Corp.*, 332 F.Supp. 544 (E.D.N.Y. 1971).

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III. SELLER FRAUD: PRIVATE PLACEMENT AND OFFERING MEMORANDA (§ 12 OF THE 1933 ACT) 15 U.S.C. § 77L

A. Strict Liability Under § 12(1)

Section 12(1) provides that "any person who offers or sells a security in violation of Section 5 (dealing with unregistered securities) *** shall be liable to the person purchasing the security from him."

B. Fault-Based Liability Under § 12(2)

Under Section 12(2), a person who offers or sells a security through a prospectus or oral communication which includes an untrue statement of a material fact or fails to state a material fact necessary to make the statements made not misleading is liable where:

- The person is a seller from whom the buyer purchased the security;
- The purchaser did not know of the untrue statement or omission;
- The transaction was a public offering by an issuer or controlling person;
- The purchaser need not have relied on the untrue statement or omission.

C. "Seller" Defined

Under Section 12, a seller is a person who successfully solicits the purchase, motivated at least in part by financial gain. *See Pinter v. Dahl*, 486 U.S. 622 (1988).

- Attorneys without direct purchaser contact are not liable under § 12. *See, e.g. Wilson v. Saintine Exploration & Drilling Corp.*, 872 F.2d 1124 (2d Cir. 1989) (law firm prepared and mailed offering statement with cover letter stating that the offering statement was prepared at the request of an issuer was not a seller); *Ackerman v. Schwartz*, 733 F.Supp. 1231 (N.D. Ind. 1989) (issuing opinion letter does not make attorney a seller under § 12).
- Where attorneys do have direct contact with purchasers, liability turns on whether the contact constitutes a solicitation. *See Morin v. Trupin*, 747 F.Supp. 1051 (S.D.N.Y. 1990) (lawyers who earn a commission from the seller for persuading investors may be a seller under § 12).

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IV. STATE LAW CLAIMS UNDER SECTION 80A

A. General Provisions of § 80A.01

Section 80A.01 is similar to Rule 10b-5. Under Section 80A.01, It is unlawful for any person, in connection with the offer, sale or purchase of any security, directly or indirectly:

- to employ any device, scheme, or artifice to defraud;
- to make any untrue statement of a material fact or omit to state material facts necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading; or
- to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person. *See* Minn. Stat. Ann § 80A.01 (2001).

1. Primary Liability

In *In re Flight Transport Securities Litigation,* 593 F.Supp. 612 (D. Minn. 1984), plaintiff's allegations against law firm that counseled underwriter in preparing prospectus containing materially misleading statements had stated a sufficient claim for primary liability.

2. Scienter not Required

Section 80A.01 supports recovery not solely on scienter, but also for mere negligence. *Sprangers v. Interactive Tech, Inc.*, 394 N.W.2d 498 (Minn. App. 1986).

B. § 80A.03

Under Section 80A.03, "It is unlawful for any person to effect any transaction in, or to induce the purchase or sale of any security by means of any manipulative, deceptive, or other fraudulent device or contrivance." In *In re Flight Transport*, the court held that section 80A.03 was limited to acts that artificially effected market activity and that the law firm was thus not liable. *In re Flight Transport Securities*, 593 F.Supp. 612 (D. Minn. 1984).

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V. COMMON LAW AIDING AND ABETTING UNDER MINNESOTA LAW

A. Extension of Common Law Aiding and Abetting to Securities Cases?

Although no reported Minnesota cases have directly addressed the issue, professionals may be subject to common law liability for securities transactions under Restatement (Second) Torts § 876(b).

B. Elements of the Cause of Action

In order for a professional to be held liable for aiding and abetting the tortious conduct of another it must be shown:

- The primary tortfeasor committed a tort that causes injury to the plaintiff;
- The Defendant knew that the primary tortfeasor's conduct constituted a breach of duty;
- The Defendant substantially assisted or encouraged the primary tortfeasor in the achievement of the breach. *See Restatement (Second) Torts* § 876(b), *cited in Witzman v. Lehrman, Lehrman, & Flom*, 601 N.W.2d 179, 187 (Minn. 1999).

C. The Witzman Case

In *Witzman,* a trust beneficiary sued her trustee's accountants, alleging that the accountants were jointly and severally liable under an aiding and abetting theory. Although Minnesota courts have applied Restatement § 876 in other contexts, *Witzman* was the first such instance against professionals. *Witzman*, 601 N.W.2d at 186.

i. Policy

The Supreme Court avoided granting a "wholesale exclusion" to professionals for aiding and abetting their clients' torts: "To grant professionals such immunity would conceivably give them free reign to provide any assistance short of fraud in helping clients engage in conduct the professionals know to be tortious." *Witzman*, 601 N.W.2d at 187.

ii. Factors

The latter two elements, knowing and substantial assistance, are evaluated in tandem, and the factors the court will use to determine are the relationship between the defendant and the primary tortfeasor, the nature of the primary tortfeasor's activity, the nature of the assistance provided by the defendant, and the defendant's state of mind.

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iii. Substantial Assistance

In addition, the Court pointed out that "substantial assistance" was something more than rendering routine professional services and that "the mere presence of the particular defendant at the commission of the wrong, or his failure to object to it, is not enough to charge him with responsibility." *Witzman*, 601 N.W.2d at 189.

The Oregon Supreme Court recently held a corporate attorney liable for his participation in a squeeze-out of a minority shareholder in a closely-held corporation under § 876. The attorney's work in re-drafting the corporate by-laws and subsequent issuance of new shares to the majority shareholders was knowing assistance in the officers' breach of fiduciary duty. *Granewich v. Harding*, 985 P.2d 788 (Or. 1999).

Protecting Against Loss: Attorney and Accountant Professional Liability Insurance

I. "ACTS AND OMISSIONS" POLICIES"

"Acts and Omissions" Policies generally exclude claims arising under securities laws.

A. General Exclusion for Fraud

"This insurance does not apply to any claim *** arising out of any dishonest, fraudulent, criminal, or malicious act or omission of any insured or employee of any insured." Since the essence of a 10b-5 violation is misrepresentation or fraud, this general exclusion can, in some cases, operate to exclude coverage.

1. In St. Paul Fire and Marine Insurance Co. v. Weiner, 606 F.2d 864 (9th Cir. 1979)

The district court had ruled that the defendant accountant's professional liability policy excluded coverage for violations of federal and state securities laws. The policy contained provisions which stated, in pertinent part, "the insuring agreement includes *** liability arising from any claim or claims which may be brought about or contributed to by reason of dishonesty, misrepresentation or fraud." The policy's exclusions also contained a conflicting provision which stated that "coverage does not apply: to the liability of any *** insured for his dishonesty, misrepresentation, or fraud." On appeal the Ninth Circuit reversed, holding that coverage should apply because the included terms "dishonesty, misrepresentation, or fraud" were equally specific. Had the policy not contained conflicting provisions or had the exclusion contained more specific terms, coverage could have applied.

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2. *Sterling & Esther Jensen v. Snellings*, 841 F.2d 600 (5th Cir. 1988)

In *Sterling & Esther Jensen v. Snellings*, 841 F.2d 600 (5th Cir. 1988), the Fifth Circuit held that an exclusion for fraudulent or dishonest conduct did not release an attorney's professional liability insurer from its duty to defend because the face of the complaint also alleged improper, albeit possibly non-fraudulent, conduct by the insured.

B. Exclusions Specific to Securities Transactions

Acts and omissions insurance generally does not apply to any claim arising out of acts or omissions, without regard to the legal theory on which any claim or suit might be based, "involving any security or any activities or transactions subject or claimed to be subject in whole or in part to" any of the following:

- The Securities Act of 1933,
- The Securities Exchange Act of 1934,
- The Public Utility Holding Company Act of 1935,
- The Trust Indenture Act of 1939,
- The Investment Company Act of 1940,
- The Investment Advisors Act of 1940,
- any State Blue Sky or Securities Law,
- any rules or regulations made pursuant thereto.

C. Knowing Participation

In Giles v. St. Paul Fire and Marine Insurance Co., 405 F.Supp. 719 (N.D. Ala. 1975), the plaintiff lawyer's professional liability policy excluded coverage for all acts of "knowing participation *** in any activity rendered unlawful under rule 10b-5." The court rejected the insurer's claim that the language "knowing participation" created an exclusion from coverage for all acts in which an insured knowingly engaged or participated. Rather, the court held that in order for the exclusion to be applicable, the attorney must have participated in acts which he knew to be in violation of 10b-5. *Giles*, 405 F.Supp. at 727.

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II. SECURITIES ENDORSEMENTS

Professional liability insurers that exclude coverage may offer additional securities endorsements at an additional premium. Insurers discern the risks involved in securities transactions in much the same manner as for general liability policies.

Professional liability securities endorsements may read as follows:

> Insurer will indemnify *** against such loss, liability or expense as the insured may incur by reason of any claim or claims which may be made against the Insured in respect of any transaction *** under any provision or provision of the Securities Act of 1933, the Securities Exchange Act of 1934, any state Blue Sky or securities law, or any rules or regulations pursuant thereto, with respect to the purchase or sale of securities but only to the extent that such loss, liability, cost or expense is incurred or sustained by reason of any claim or claims that the Registration Statement, any Preliminary Prospectus, or Prospectus in the form filed with the Securities Exchange Commission *** contained an untrue statement of a material fact or omitted to state a material fact to be stated therein or necessary to make the statements therein not misleading. *See, e.g., Shapiro v. American Home Assurance Co.*, 616 F.Supp. 906, 910 (D. Mass. 1985).

In *Shapiro*, coverage under the policy applied because plaintiffs were sued for allegedly filing false financial statements contained in a registration statement filed with the SEC. *Shapiro*, 616 F.Supp. at 912.

The typical securities endorsement application contains questions concerning:

- The type of securities practice engaged in by the insured, including the frequency of various services provided (e.g. issuing of securities, tender offers, proxy contests, etc.).
- The controls exercised by the insured’s firm concerning internal policies for, e.g., lawyer-directors, trading client securities, management committee reviews, procedures of a due diligence investigation, etc.

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Vincent Louwagie is a shareholder of the Minneapolis law firm of Anthony Ostlund & Baer, P.A. A 1988 graduate of the University of Minnesota law school, Mr. Louwagie has practiced in the area of business litigation his entire legal career. Among other things, Mr. Louwagie has represented investors and defendants in securities fraud claims, shareholders and management in corporate governance disputes, brokers and customers in investment disputes, leasing companies, and various parties embroiled in a variety of business disputes. Mr. Louwagie is a Certified Public Accountant, and a member of the Minnesota Society of Certified Public Accountants. Mr. Louwagie is a frequent lecturer at professional seminars and a published author on business litigation topics.

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