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The Legal Blitz Against Accountants: An Analysis of Section 12

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Introduction

In the past, when accountants thought of trials, they thought of balances, and adjusting entries. Suits to them were a sartorial matter, in the realm of sobriety, conservatism, and quiet dress. But in recent years associations have changed,[1] changed dramatically—along with the very character of business in this country Today, business is beset by legal considerations, threats of litigation, and rising insurance rates. More law suits have been filed against accountants in the past fifteen years than in the entire previous history of the profession.[2] And the figures seem to be rising uncontrollably[3] From 1980 to 1987, the Big Eight accounting firms paid more than $300 million in settlements of audit-related law suits,[4] and major lawsuits pending against these firms world-wide exceed $2 billion in requested damages.[5] This situation has prompted threats from Lloyds of London to drop insurance coverage of the Big Eight; but the insurance problem

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[1] Accountants are becoming increasingly familiar with lawsuits. *See generally* O'Brien, *The Legal Environment of the Accounting Profession*, 25 Duq. L. Rev 283 (1987); Jurinski, *The Common Law Liability of Auditors: Judicial Allocation of Business Risk*, 23 Willamette L. Rev. 367 (1987).

[2] Berton, *Investors Call CPAs to Account*, Wall St. J., Jan. 28, 1985, at 28, col. 3 (quoting Newton Minow).

[3] Morrison, *CPA Suits Are Adding Up*, Nat'l L.J., May 16, 1983, at 1, col. 1.

[4] Berton, *Touche Ross, Setting Precedent, Names a Lawyer to Top International Position*, Wall St. J., Sept. 1, 1987, at 36, col. 1.

[5] Berton, *Price Waterhouse Is Urging Formation of Group to Regulate Accounting Firms*, Wall St. J., Nov. 20, 1985, at 8, col. 1.

has been felt even more keenly by small to medium-sized firms,[6] who cannot afford sky-rocketing insurance rates. Some insurers have dropped the policies of these smaller firms altogether.[7]

A proliferation of legal theories used against auditors accounts for much of the explosion in litigation. The common law negligence theory has been used in many recent court decisions to expand accountants' liability to third parties with whom the accountants had no contractual relationship.[8] In securities-related litigation, plaintiffs have looked to the "fraud on the market theory"[9] to support recoveries against accountants[10] under sec-

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[6] Galen, *Litigation Blitz Hits Accountants*, Nat'l L.J., June 16, 1986, at 1, col. 6.

[7] In 1985 alone, malpractice insurance rates for firms of all sizes increased by 200% to 400%, and further increases are expected for the remainder of the decade. Berton, *Small CPA Firms' Liability Rates Soar*, Wall St. J., Nov. 19, 1985, at 6, col. 1. Indeed, most insurers of small to medium-sized firms have stopped writing policies in recent years. Galen, *supra* note 6, at 1, col. 1.

[8] *E.g.*, International Mortgage Co. v. John P. Butler Accountancy Corp., 223 Cal. Rptr. 218 (Cal. Ct. App. 1986); H. Rosenblum, Inc. v. Adler, 461 A.2d 138 (N.J. 1983); Blue Bell, Inc. v. Peat, Marwick, Mitchell & Co., 715 S.W.2d 408 (Tex. Ct. App. 1986); Citizens State Bank v. Timm, Schmidt & Co., 335 N.W.2d 361 (Wis. 1983). *But see, e.g.*, Credit Alliance Corp. v. Arthur Andersen & Co., 493 N.Y.S.2d 435 (N.Y. 1985) (largely standing by the ruling of Ultramares Corp. v. Touche & Co., 174 N.E. 441 (N.Y. 1931), holding accountants liable to third parties for fraud but not for negligence in the absence of a privity relationship).

[9] Under this theory, a corporation's faulty financial reports can provide the basis for lawsuits by investors who never saw the reports but who relied on the "integrity of the market" itself. The market is assumed to reflect all available information and is undermined by those faulty reports. *E.g.*, Peil v. Speiser, 806 F.2d 1154, 1161 (3d Cir. 1986); Lipton v. Documation, Inc., 734 F.2d 740 (11th Cir. 1984), *cert. denied*, 469 U.S. 1132 (1985); Panzirer v. Wolf, 663 F.2d 365 (2d Cir. 1981), *vacated as moot*, 459 U.S. 1027 (1982); Shores v. Sklar, 647 F.2d 462 (5th Cir. 1981), *cert. denied*, 459 U.S. 1102 (1983); Blackie v. Barrack, 524 F.2d 891 (9th Cir. 1975), *cert. denied*, 429 U.S. 816 (1976).

[10] *E.g.*, Manufacturers Hanover Trust Co. v. Drysdale Sec. Corp., 801 F.2d 13 (2d Cir. 1986), *cert. denied*, 107 S. Ct. 952 (1987) ($17 million judgment against Arthur Andersen & Co. upheld). *But see, e.g.*, Windon Third Oil & Gas Drilling Partnership v. F.D.I.C., 805 F.2d 342, 347 (10th Cir. 1986), *cert. denied*, 107 S. Ct. 1605 (1987) (absent a preexisting fiduciary relationship, an accountant had no Rule 10b-5 liability for failing to disclose material information about issuer's financial condition); Gutfreund v. Christoph, 658 F. Supp. 1378, 1385 (N.D. Ill. 1987) (accountant has limited duty to "blow the whistle" on client); *In re* Gas Reclamation, Inc. Sec. Litig., 659 F. Supp. 493 (S.D.N.Y. 1987) (accounting firm which did not do an audit or take part in preparation of prospectus had no Rule 10b-5 duty to investors); DMI Furniture, Inc. v. Brown, Kraft & Co., 644 F. Supp. 1517, 1518 (C.D. Cal. 1986) (refusing to hold accounting firm liable under Rule 10b-5 for breach of audit contract).

tion 10(b)[11] and Rule 10b-5[12] of the Securities Exchange Act of 1934. And, of course, the omnipresent RICO[13] claim, sustained by the Supreme Court's *Sedima* decision,[14] plagues both large and small accounting firms.[15]

This Article focuses upon another provision that frequently provides a cause of action in plaintiffs' securities suits against accountants: section 12 of the Securities Act of 1933.[16]

Our attention in this Article will center on four areas of discussion. First, we will explain the workings of section 12. Second, we will describe the history and the development of the various approaches to defining "seller" under section 12.[17] Third, we will consider cases involving accounting defendants under section 12;[18] in particular, we will examine how the courts have treated these defendants. Finally, we will present arguments that accountants and their attorneys can lodge in favor of the strict-privity approach to section 12 liability (the approach which obviously is most favorable for collateral participant defendants such as accountants).[19]

In promoting strict privity as an approach to section 12 liability, we will present arguments against the broader views of liability: proximate cause/substantial factor[20] and aiding and abetting/conspiracy.[21] Our argumentation is not merely for the

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[11] 15 U.S.C. § 78j(b) (1982).

[12] 17 C.F.R. § 240.10b-5 (1986).

[13] The Racketeering Influenced Corrupt Organizations Act of 1970, 18 U.S.C. §§ 1962, 1964 (1983).

[14] Sedima, S.P.R.L. v. Imrex Co., 473 U.S. 479 (1985).

[15] Every major accounting firm has been sued under RICO, and such suits are now being brought against relatively small firms. *E.g.,* Beck v. Cantor, Fitzgerald & Co., 621 F. Supp. 1547, 1562-64 (N.D. Ill. 1985); Ahern v. Gaussoin, 611 F. Supp. 1465, 1491 (D. Or. 1985). *See generally* Berton, *supra* note 7, at 6, col. 1.

[16] 15 U.S.C. § 77l (1982).

[17] *See infra* notes 52-87 (early developments), 89-100 (strict-privity approach), 143-92 (proximate cause/substantial factor approach), 229-55 (aiding and abetting and conspiracy) and accompanying text. *See generally* Bershad & Grasberger, *Prosecuting Public Offering Litigation,* in RECENT DEVELOPMENTS IN SECURITIES LITIGATION 20-32 (1984); Annotation, *Necessity of Privity Between a Purchaser and Issuer of Security in Action Against Issuer Under § 12 of the Securities Act of 1933,* 56 A.L.R. FED. 659 (1982).

[18] *See infra* notes 101-10 (strict-privity cases), 195-210 (proximate cause/substantial factor cases), 256-66 (aiding and abetting and conspiracy cases) and accompanying text.

[19] *See infra* notes 111-42 and accompanying text.

[20] *See infra* notes 212-28 and accompanying text.

[21] *See infra* notes 267-80 and accompanying text.

sake of academic dialectic. The law of section 12 is in flux. Some federal circuits have not had occasion to decide which view of section 12 to adopt.[22] Other circuits have decided several cases without clearly settling upon an approach.[23] Part of the conflict arises from mixed signals sent by the Supreme Court;[24] in some cases the Court uses a conservative interpretation of securities statutes,[25] and in others it stresses the remedial nature of the laws.[26] Cogent arguments, well presented, could yet move

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[22] The Tenth Circuit provides one example. *See In re* Wicat Sec. Litig., 600 F. Supp. 1236, 1240 (D. Utah 1984); Woods v. Homes & Structures, 489 F. Supp. 1270, 1294 (D. Kan. 1980). In Busch v. Carpenter, 827 F.2d 653, 659-60 (10th Cir. 1987), the court declined to choose between what we denominate the strict privity and "proximate cause/substantial factor" approaches.

[23] Lerach, *Securities Class Actions and Derivative Litigation Involving Public Companies: A Plaintiff's Perspective*, in NEW DIMENSIONS IN SECURITIES LITIGATION PLANNING AND STRATEGIES 582 (1987) (court discussion of the subject deemed "murky"). The Ninth Circuit's decisions have not been particularly lucid. *See* Anderson v. Aurotek, 774 F.2d 927, 930 (9th Cir. 1985) (using proximate cause/substantial factor test, but unclear on aiding and abetting); Feldman v. Simkins Indus., 679 F.2d 1299, 1306 (9th Cir. 1982) (appearing to adopt a strict-privity approach); Admiralty Fund v. Jones, 677 F.2d 1289, 1294 (9th Cir. 1982) (proximate cause/substantial factor approach applied, but issues of aiding and abetting and conspiracy avoided). The district courts in the Ninth Circuit are unclear on which approach they are to follow. *E.g., In re* Victor Technologies Sec. Litig., [Current Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,158 (N.D. Cal. Jan. 8, 1987) (surveying inconsistent Ninth Circuit decisions); *In re* Eagle Computer Sec. Litig., [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,297 (N.D. Cal. Aug. 28, 1985) (approving aiding and abetting theory); Lazar v. Sadlier, 622 F. Supp. 1248, 1251-52 (C.D. Cal. 1985) (approving "proximate cause/substantial factor" theory).

[24] The Supreme Court has not directly addressed the definition of "seller" under § 12 but will do so this term in Dahl v. Pinter, 787 F.2d 985 (5th Cir. 1986), *cert. granted,* 107 S. Ct. 1885 (1987). *See infra* notes 186-92 and accompanying text.

[25] *E.g.,* Schreiber v. Burlington N., Inc., 472 U.S. 1 (1985) (narrowly defining "manipulative" under § 14(e) of the 1934 Act); Aaron v. SEC, 446 U.S. 680 (1980) (requiring proof of scienter in SEC 10b-5 enforcement action); Santa Fe Indus. v. Green, 430 U.S. 462 (1977) (ruling that Rule 10b-5 does not remedy mere breaches of fiduciary duty); Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976) (holding that scienter must be proved in Rule 10b-5 suit for civil damages); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975) (holding that only purchasers and sellers have standing to sue for damages under Rule 10b-5).

[26] *E.g.,* Landreth Timber Co. v. Landreth, 471 U.S. 681 (1985) (adopting relatively liberal approach to definition of "security"); Herman & MacLean v. Huddleston, 459 U.S. 375, 382-87, 390 (1983) (allowing cumulative remedies in securities cases and adopting a relatively low burden of proof in Rule 10b-5 cases); Affiliated Ute Citizens v. United States, 406 U.S. 128, 151 (1972) (eliminating reliance requirement in "omission" cases under § 10(b), stating that federal securities laws should be construed flexibly, not technically); Superintendent of Ins. v. Bankers Life & Casualty Co., 404 U.S. 6, 12 (1971) (holding that § 10(b) prohibits the use of any manipulative or deceptive device or contrivance "in connection with" the sale of any security).

the law in a direction favorable to the accountant defendant.

I. ELEMENTS OF SECTION 12

Section 12 has two important subsections. The lesser used of the two, section 12(1),[27] provides an express civil cause of action to remedy violations of section 5[28] of the 1933 Act. Section 12(1) is a strict liability statute[29] as to "[a]ny person who offers or sells a security."[30] Most of these suits involve the unregistered offering of shares for which the issuer claims an exemption.[31] A plaintiff can win a section 12(1) suit by proving the following elements: (a) use of mails or interstate commerce, (b) lack of required registration, and (c) sale of securities by defendant.[32] If these elements are established, a proper defendant's only defense is the statute of limitations.

The other significant provision, section 12(2),[33] is an anti-misrepresentation clause that has been described as "so potent that both plaintiffs and defendants tend to approach it with a sense of disbelief."[34] We quote it here in full, following Professor Loss's advice that "section 12(2) is not too happily drafted, so it is best not to attempt a paraphrase."[35]

> Any person who . . . (2) offers to sell a security (whether or not exempted by the provisions of section 77c of this title, other than paragraph (2) of subsection (a) of said section), by

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[27] 15 U.S.C. § 77*l* (1982).

[28] *Id.* at § 77e (1982). Section 5 forbids the offer or sale of unregistered securities, the sale of securities unaccompanied by a prospectus, and the use of a defective prospectus.

[29] Pharo v. Smith, 621 F.2d 656, 665, *reh'g granted, cause remanded,* 625 F.2d 1226 (5th Cir. 1980).

[30] 15 U.S.C. § 77l(1) (1982). *See generally,* Augenbraun, *Private Offerings and Accountants' Liability Under Section 12(1): A Problem and a Recommended Solution,* 7 SEC. REG. L.J. 158 (1979).

[31] R. PRENTICE, LAW OF BUSINESS ORGANIZATIONS AND SECURITIES REGULATION 518 (1987).

[32] *See generally* Hill York Corp. v. American Int'l Franchises, Inc., 448 F.2d 680, 686 (5th Cir. 1971); Anders v. Dakota Land & Dev. Co., 380 N.W.2d 862, 867-68 (Minn. Ct. App. 1986) (enumerating elements a plaintiff must prove to win a § 12 suit).

[33] 15 U.S.C. § 77*l*(2) (1982).

[34] Kaminsky, *An Analysis of Securities Litigation Under Section 12(2) and How It Compares with Rule 10b-5,* 13 HOUS. L. REV. 231, 231 (1976).

[35] 3 L. LOSS, SECURITIES REGULATION 1699 (2d ed. 1964).

> the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements in light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known of such untruth or omission, shall be liable to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon tender of such security, or for damages if he no longer owns the security.[36]

To establish a prima facie case under section 12(2), a plaintiff must establish: "(a) an offer or sale of a security, (b) by the use of any means of interstate commerce, (c) through a prospectus or oral communication, and (d) which includes an untrue statement of material fact or omits to state a material fact."[37] If the defendant cannot establish a statute of limitations defense, his only recourse is a "due diligence" defense.[38] Thus, section 12(2) is a negligence statute, and the burden of proof is on the defendant. Similar to section 12(1), a defendant under section 12(2) is defined as "[a]ny person who . . . offers or sells."[39]

Although accountants are rarely "sellers" in the sense that they part with title to securities in exchange for consideration,[40] they frequently find themselves as defendants in section 12 civil suits for damages.[41] How can this be, in light of the fact that

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[36] 15 U.S.C. § 77*l*(2) (1982).

[37] Gridley v. Sayre & Fisher Co., 409 F. Supp. 1266, 1272-73 (D.S.D. 1976); *see also In re* Itel Sec. Litig., 89 F.R.D. 104, 115 (N.D. Cal. 1981).

[38] L. Loss, *supra* note 35, at 1028-29.

[39] 15 U.S.C. § 77*l*(2) (1982).

[40] *See* Junker v. Crory, 650 F.2d 1349, 1361 (5th Cir. 1981); Swenson v. Englestad, 626 F.2d 421, 427 (5th cir. 1980) (It is "clear that one who parts with title to securities in exchange for consideration is a seller for purposes of § 12(1).").

[41] *E.g.*, Beck v. Cantor, Fitzgerald & Co., 621 F. Supp. 1547, 1560-62 (N.D. Ill. 1985); Seidel v. Public Serv. Co., 616 F. Supp. 1342 (D.N.H. 1985); Ahern v. Gaussoin, 611 F. Supp. 1465 (D. Or. 1985); En Yun Hsu v. Leaseway Transp. Corp., [1984-1985

section 12 appears to impose a strict privity-requirement?[42]

Early section 12 cases involving both subsections (1) and (2); which most courts agree should be construed comparably,[43] did impose a strict-privity requirement.[44] Soon thereafter, a line of cases developed which held brokers liable under section 12 on an agency theory.[45] This broader "participation" approach labeled as "seller" any person who participated in the sale.[46] Because the participation approach was somewhat ill-defined, it was replaced with a "proximate cause/substantial factor" test.[47] While this "proximate cause/substantial factor" approach has become established as the majority view, two other theories complete the modern scene. First, on the conservative side, the strict-privity approach has enjoyed a substantial revival among both the courts[48] and the commentators.[49] Second, on the liberal

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Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,043 (N.D. Cal. March 29, 1985). *See generally*, Gormley, *Civil Liability of Professionals Under the Federal Securities Laws*, in ACCOUNTANTS' LIABILITY 43-57 (1983).

[42] *See generally* T. HAZEN, THE LAW OF SECURITIES REGULATION 182 (1985).

[43] *Hill York Corp.*, 448 F.2d at 692; Cady v. Murphy, 113 F.2d 988, 991 (1st Cir.), *cert. denied*, 311 U.S. 705 (1940); *Ahern*, 611 F. Supp. at 1484.

[44] *E.g.*, Nicewarner v. Bleavins, 244 F. Supp. 261 (D. Colo. 1965); Barlas v. Bear, Stearns & Co., [1964-1966 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,674 (N.D. Ill. Mar. 31, 1966).

[45] *E.g.*, *Cady*, 113 F.2d at 988.

[46] *E.g.*, Freed v. Szabo Food Serv., 23 F.R.D. 281 (N.D. Ill. 1964); Wonneman v. Stratford Sec. Co., Inc., [1957-1961 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 90,923 (S.D.N.Y. June 26, 1959).

[47] *E.g.*, Davis v. Avco Fin. Serv., Inc., 739 F.2d 1057 (6th Cir. 1984), *cert. denied*, 105 S. Ct. 1359 (1985); *Junker*, 650 F.2d at 1349; Lennerth v. Mendenhall, 234 F. Supp. 59 (N.D. Ohio 1964).

[48] *E.g.*, Sanders v. John Nuveen & Co., 619 F.2d 1222 (7th Cir. 1980), *cert. denied*, 450 U.S. 1005 (1981) (dicta); Collins v. Signetics Corp., 605 F.2d 110 (3d Cir. 1979).

[49] *E.g.*, O'Hara, *Erosion of the Privity Requirement in Section 12(2) of the Securities Act of 1933: The Expanded Meaning of Seller*, 31 U.C.L.A. L. REV. 921 (1984); Schneider, *Section 12 of the Securities Act of 1933: The Privity Requirement in the Contemporary Securities Law Perspective*, 51 TENN. L. REV. 235 (1984); Comment, *Secondary Liability Under Section 12(2) of the Securities Act of 1933*, 78 NW. U.L. REV. 832 (1983) [hereinafter Comment, *Secondary Liability*]. But for articles applauding the extension of liability see Branson, *Collateral Participant Liability Under the Securities Laws—Charting the Proper Course*, 65 OR. L. REV. 327 (1986) (criticizing the strict-privity approach as unduly stingy but suggesting many improvements for the more liberal approaches); Rapp, *Expanded Liability Under Section 12 of the Securities Act: When Is a Seller Not a Seller*, 27 CASE W. RES. 445 (1977); Note, Davis v. Avco Financial Services, Inc.: *Secondary Seller Liability Under Section 12(2) of the Securities Act of*

side, some courts extend section 12 liability to aiders and abettors[50] and to conspirators.[51]

II. EARLY DEVELOPMENTS

A. *Strict-Privity Cases*

Only a few early cases applied a strict-privity approach to the definition of "seller" under section 12. *Nicewarner v. Bleavins*[52] provides an example of the early strict privity approach. *Nicewarner* involved an attorney defendant who performed the necessary legal services for consummation of a sale of unregistered securities in violation of section 12(1). Using a narrow definition of the term "seller," the court refused to hold the attorney liable even though he

> had reason to anticipate a public offering; he knew that no registration statement was in effect; he should have known that the assignments were securities; he knew that the [buyers] were from Illinois and could have foreseen the use of the mails or of interstate facilities; and he could see that the [buyers] needed the protection of the Act.[53]

Nicewarner is one of the few early cases[54] that can be characterized as following the strict-privity approach.[55] Almost from

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1933, 16 TOL. L. REV. 775 (1985) [hereinafter Note, Davis v. Avco]; Comment, *Redefining "Seller" Under Section 12(2) of the Securities Act of 1933: Building a Securities Tortfolio*, 54 U. CIN. L. REV. 157 (1985) [hereinafter Comment, *Redefining "Seller"*]; Comment, *Seller Liability Under Section 12(2) of the Securities Act of 1933: A Proximate Cause-Substantial Factor Approach Limited by a Duty of Inquiry*, 36 VAND. L. REV. 361 (1983) [hereinafter Comment, *Seller Liability*].

[50] *E.g.*, Stokes v. Lokken, 644 F.2d 779, 782 (8th Cir. 1981); Woods v. Homes & Structures, 489 F. Supp. 1270, 1295 (D. Kan. 1980); Stern v. American Bankshares Corp., 429 F. Supp. 818, 824 (E.D. Wis. 1977).

[51] *E.g.*, *In re* Seagate Technology Sec. Litig., [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,435 (N.D. Cal. Dec. 23, 1985); deBruin v. Andromeda Broadcasting Sys., Inc., 465 F. Supp. 1276, 1280 (D. Nev. 1979); *In re* Caesars Palace Sec. Litig., 360 F. Supp. 366, 383 (S.D.N.Y. 1973).

[52] 244 F. Supp. 261 (D. Colo. 1965).

[53] *Id.* at 266.

[54] Others include Russell v. Travel Concepts Corp., [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,230 (M.D. Tenn. June 19, 1975) and Jackson Tool & Die, Inc. v. Smith, 339 F.2d 88, 90 (5th Cir. 1964).

[55] Even this characterization is questionable. O'Hara, *supra* note 49, at 960, views *Nicewarner* as a causation case rather than a strict-privity case.

the first use of the Act, courts have expanded the notion of "seller."

B. Broker/Agency Cases

As early as 1940 the courts extended the section 12 definition of "seller" beyond the actual seller to include the seller's broker. In *Cady v. Murphy*,[56] the plaintiff, Murphy, a small securities dealer, had purchased shares of South American Utilities Corp. through the defendant Rhoades & Co. The shares turned out to have little value, and Murphy sued under section 12(2). The evidence clearly established that the defendant's principal trader had effected the sale by misrepresenting material facts, and that the defendant should have been aware of the trader's misstatements.[57] The evidence did not clearly establish whether the defendant acted as an owner or as a broker in the transaction. The court concluded that the defendant should be liable in either case:

> § 12(2) imposes a liability for misrepresentations not only upon principals, but also upon brokers when selling securities owned by other persons. This is not a strained interpretation of the statute, for a selling agent in common parlance would describe himself as a "person who sells," though title passes from his principal, not from him.[58]

The defendant argued that Congress intended only the true seller, not its agent, to be a section 12(2) defendant because section 12(2) primarily provides a rescission remedy. The court rejected this argument on two grounds. First, section 12 neither uses the word "rescission" nor does it indicate that "the remedy provided is limited to rescission in the narrower sense as between the principals to the transaction."[59] Second, the court cited common law precedent for allowing rescission against a seller's agent.[60]

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[56] 113 F.2d 988 (1st Cir.), *cert. denied*, 311 U.S. 705 (1940); *see* Unicorn Field, Inc. v. Cannon Group, Inc., 60 F.R.D. 217, 222 (S.D.N.Y. 1973).

[57] *Cady*, 113 F.2d at 989.

[58] *Id.* at 990.

[59] *Id.* at 991.

[60] *Id.* (citing Peterson v. McManus, 172 N.W. 460, 471 (Iowa 1919)).

The agency theory[61] operates harshly because it deprives a defendant, such as a brokerage firm, of the "good faith" defense provided in section 15 of the Securities Act of 1933.[62] Section 15 extends 1933 Act liability to those who "control" persons liable for section 12 violations.[63] Section 15 also requires that a plaintiff prove the actual seller violated the section and prove the existence of a control relationship[64] between the seller and the section 15 defendant.[65] A section 15 defendant has the advantage of an express defense if he can prove that he "had no knowledge of or reasonable grounds to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist."[66] A principal is denied such a defense in a cause of action based on the common law agency theory.[67]

In *Johns Hopkins University v. Hutton*,[68] the plaintiff sued the partners of a stock brokerage firm under section 12(2) be-

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[61] The agency theory in *Cady* operated on two levels. Naturally, the brokerage firm (principal) was held liable for the actions of its principal trader (agent). In addition, the brokerage firm became liable as a "seller" because it was the agent of the real seller, its customer.

[62] 15 U.S.C. § 77o (1983).

[63] If applicable, § 15 imposes joint and several liability on a person who controlled a wrongdoer. Wright v. Schock, 571 F. Supp. 642, 664 (N.D. Cal. 1983).

[64] Exactly what it means to "control" another person for § 15 purposes is somewhat unclear because Congress found it undesirable to define "control," reasoning that "[i]t would be difficult if not impossible to enumerate or to anticipate the many ways in which control may be exerted." H.R. REP. No. 1383, 73d Cong., 2d Sess. 26 (1934). According to at least one court, a plaintiff must establish two things to recover under § 15: (1) that the defendant "actually . . . exercised control over the operations of the [wrongdoing issuer]," and (2) "that the defendant possessed the power to control the specific transaction or activity upon which the primary violation is predicated." Metge v. Baehler, 762 F.2d 621, 631 (8th Cir. 1985), *cert. denied*, 106 S. Ct. 798 (1986). Substantial authority exists for a more stringent standard which requires the plaintiff to show that the defendant actually participated in the alleged violation. *E.g.*, Orloff v. Allman, 819 F.2d 904, 906 (9th Cir. 1987); Rochez Bros. v. Rhoades, 527 F.2d 880, 889-90 (3d Cir. 1975); Gordon v. Burr, 506 F.2d 1080, 1085-86 (2d Cir. 1974).

[65] Section 15 is to be construed liberally. Myzel v. Fields, 386 F.2d 718, 738 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968).

[66] *E.g.*, McDaniel v. Compania Minera Mar de Cortes, Sociedad Anonimo, Inc., 528 F. Supp. 152 (N.D. Ariz. 1981). *See generally* Ferrara & Sanger, *Derivative Liability in Securities Law: Controlling Person Liability, Respondeat Superior, and Aiding and Abetting*, 40 WASH. & LEE L. REV. 1007, 1009-15 (1983).

[67] Johns Hopkins Univ. v. Hutton, 422 F.2d 1124, 1130 (4th Cir. 1970), *cert. denied*, 416 U.S. 916 (1974).

[68] 422 F.2d 1124 (4th Cir. 1970), *cert. denied*, 416 U.S. 916 (1974).

cause of the misrepresentations of a firm employee. Although the partners were personally blameless and therefore would likely have had an adequate defense to a claim under section 15,[69] the Fourth Circuit rejected the notion that Congress meant section 15 to provide the only alternative theory for liability. Instead, the court held that section 15 supplemented, rather than replaced, common law agency theory.[70] The firm was held potentially "liable, under familiar principles, for the tortious representations of its agent."[71]

"Controlling person" liability under section 15 is not of particular concern to accountant defendants[72] who usually do not control issuers or other true sellers.[73] Whether agency theory or section 15 is applied, brokers seem natural defendants under section 12.[74] Even commentators who call for a narrow reading

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[69] San Francisco-Oklahoma Petroleum Exploration Corp. v. Carstan Oil Co., 765 F.2d 962, 965 (10th Cir. 1985).

[70] *Hutton*, 422 F.2d at 1130.

[71] *Id.* (citing RESTATEMENT (SECOND) OF AGENCY §§ 257, 258 (1958)).

[72] Courts have not held accountants liable in cases litigated under § 15. *E.g.*, Barker v. Henderson, Franklin, Starnes & Holt, 797 F.2d 490 (7th Cir. 1986); Grimm v. Whitney-Fidalgo Seafoods, [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,029 (S.D.N.Y. Dec. 4, 1973). However, cases that find attorneys liable under § 15 cannot provide accountants much comfort. *E.g.*, Seidel v. Public Serv. Co. of New Hampshire, 616 F. Supp. 1342, 1362 (D.N.H. 1985) ("It is difficult to perceive that a corporation and its board of directors would not follow the advice of counsel in situations concerning documents to be issued for examination by prospective investors, particularly where such documents bear the imprimatur of expertise on the part of such counsel."); Westlake v. Abrams, 565 F. Supp. 1330, 1350 (N.D. Ga. 1983) (legal counsel may be held liable when acting as a culpable participant in the controlled person's acts but not when engaged only in rendering advice and handling litigation not related to securities law or a broker's day-to-day activities); Felts v. National Account Sys. Ass'n, 469 F. Supp. 54, 68 (N.D. Miss. 1978).

[73] Plaintiffs seeking to hold accountants liable as "controllers" under § 15 of the 1933 Act might cite cases decided under the 1934 Act's comparable provision, § 20(a). However, § 20(a) cases are not truly relevant in the § 12(2) context because under § 10(b), for example, a primary violator can include a wide range of persons other than just a seller. For example, in Sharp v. Coopers & Lybrand, 457 F. Supp. 879, 891-93 (E.D. Pa. 1978), *aff'd*, 649 F.2d 175 (3d Cir. 1981), *cert. denied*, 455 U.S. 938 (1982), an accounting firm was held liable for having controlled a primary violator of § 10(b)—its own employee who was the issuer's tax supervisor. Yet under § 20(a), accounting firms do not control the companies they work for. *E.g.*, Decker v. Massey-Ferguson, Ltd., 534 F. Supp. 873, 882 (S.D.N.Y. 1981), *aff'd in part, rev'd in part on other grounds*, 681 F.2d 111 (2d Cir. 1982); *In re* Commonwealth Oil/Tesoro Petroleum Sec. Litig., 484 F. Supp. 253, 268-69 (W.D. Tex. 1979).

[74] *E.g.*, Swank Fed. Credit Union v. C.H. Wagner & Co., 405 F. Supp. 385, 387

of section 12 concede that broker-dealers may be held liable.[75] Others decry courts that incorrectly ignore the qualitative distinction between what brokers do and what accountants do in facilitating the sale of securities.[76]

C. Participation Cases

In expanding section 12 "seller" liability beyond brokers, courts had to implement a broader theory than that of agency. The "participation" theory came to the forefront in cases like *Wonneman v. Stratford Securities Co.*[77] *Wonneman* involved officers of a brokerage firm whose employee had allegedly made misleading and untrue statements about securities the plaintiff purchased. In denying the defendant officers' motion for summary judgment, the court stated that the defendants must prove "that they did not *participate* in the sale and not merely that they did not actually sell the securities to plaintiff."[78] The court indicated that one of the defendants could establish her lack of participation only by showing that she was not a director, that she did not attend board meetings, that she did not vote for the sale of these securities, and that she did not supervise the firm's activities.[79]

Zachman v. Erwin[80] provides an application of the participation approach that goes beyond the brokerage firm setting. The case involved a section 12(2) suit which arose from the sale of the securities of two insurance companies. Combining the

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(D. Mass. 1975) (controlling persons of brokerage firm acting as agent for issuer held liable under § 12(1)); *In re* Caesars Palace Sec. Litig., 360 F. Supp. 366, 379 (S.D.N.Y. 1973) ("Brokers have repeatedly been included within the coverage of both parts of § 12, whether the broker represents both parties to the transaction or only the seller."). Of course, if the broker represents only the buyer in an agency relationship, the broker will not be considered a "seller." *E.g.*, Rindner v. Stockcross, Inc., [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,885 (D. Mass. Jan. 23, 1981).

[75] O'Hara, *supra* note 49, at 988.

[76] Comment, *Secondary Liability, supra* note 49, at 852-53.

[77] [1957-1961 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 90,923 (S.D.N.Y. June 26, 1959).

[78] *Id.* (emphasis added).

[79] *Id.* In a latter opinion in the same case, a second judge criticized the participation approach. Wonneman v. Stratford Securities Co., Inc., 23 F.R.D. 281, 285 (S.D.N.Y. 1959).

[80] 186 F. Supp. 681 (S.D. Tex. 1959).

concepts of "participation" and "controller" liability under section 15, the court found that the complaint stated a cause of action against a broad range of defendants including: (a) officers and directors of the issuer, (b) other corporations that had a role in falsifying financial statements, (c) the securities dealer, (d) an insurance reporting firm that had issued false reports on the issuer, and (e) the issuer's "board of advisors."[81] Few of these defendants actually sold the securities; most of these defendants were simply involved in the broad transaction.

Similarly, in *Freed v. Szabo Food Services, Inc.*,[82] the court stressed the liberal policies of the securities laws[83] in holding that any defendant—no matter how far removed from the actual seller—could be liable under section 12(2) if he had made a misrepresentation which the plaintiff had relied upon in purchasing.[84] *Gould v. Tricon, Inc.*[85] broadens the participation test further in stating that simply having the status of a director whose name appears in a prospectus renders one a "seller."

The participation test obviously spelled trouble for collateral defendants in section 12 cases. If the theory had gained a substantial following,[86] accountant defendants would have suffered considerable section 12 exposure. Fortunately, the very breadth of the test led to its virtual disappearance.[87]

III. MODERN APPROACHES TO DEFINING "SELLER"

As other approaches have replaced the broker/agency test[88] and the participation approach has become largely defunct, the

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[81] *Id.* at 684-86.

[82] [1961-1964 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,317 (N.D. Ill. 1964).

[83] *Id.* at 94,363-65 (citing SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963)).

[84] *Id.*

[85] 272 F. Supp. 385, 392 (S.D.N.Y. 1967).

[86] Katz v. Amos Treat & Co., 411 F.2d 1046 (2d Cir. 1969) also used the participation approach. Indeed, Branson, *supra* note 49, at 357, suggests that *Katz* is the only true participation case. *Grimm*, [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) at ¶ 96,029 quotes Barlas v. Bear, Stearns & Co., [1964-1966 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,674 (N.D. Ill. Mar. 31, 1966) as characterizing *Freed v. Szabo Foods Serv., Inc.* and *Zachman v. Erwin* as being aimed only at preventing sellers from working through straw men or underwriters. However, this interpretation of those two cases seems unduly narrow.

[87] O'Hara, *supra* note 49, at 956, criticizes the participation test as vague, unprincipled, and inconsistent with the rescissionary remedy provided in § 12.

[88] The reasoning of the broker/agency cases, such as Cady v. Murphy, 113 F.2d

courts have established three avenues to section 12 liability. The first two—strict privity and "proximate cause/substantial factor"—are methods of establishing primary liability by defining given defendants as "sellers." The third approach—use of aiding and abetting and conspiracy theories—is a method of establishing collateral section 12 liability for non-sellers.

A. *Strict Privity*

1. *Key Cases*

The strict-privity approach to defining "seller," which had some modest early acceptance,[89] has been revived lately. The leading case is *Collins v. Signetics Corp.*[90] In *Collins* a purchaser of Signetics stock sued Signetics Corporation and its parent, Corning Glass Works, under section 12, alleging that the registration statement and prospectus did not disclose Corning's intention to sell its substantial interest (ninety-two percent before the offering; seventy percent after) in Signetics soon after the offering was completed. Because the offering occurred pursuant to a "firm commitment" underwriting[91] and because the plaintiff did not allege that he had purchased the shares directly from

988 (1st Cir.), *cert. denied,* 311 U.S. 705 (1940) is still cited often. Indeed, *Cady* seemed to be instrumental in the recent district court decision of Quincy Coop. Bank v. A.G. Edwards & Sons, Inc., 655 F. Supp. 78 (D. Mass. 1986). However, both *Quincy* and Seidel v. Public Serv. Co., 616 F. Supp. 1342 (D.N.H. 1985) treat the § 12 "seller" definition issue as unresolved in the First Circuit. Yet, in Kilmartin v. H.C. Wainwright & Co., 637 F. Supp. 938, 944 (D. Mass. 1986), the court adopted a broad aiding and abetting approach in extending § 12(2) potential liability to an engineering firm which prepared an engineering report included in a confidential offering circular.

[89] *See supra* notes 52-55 and accompanying text (discussing Nicewarner v. Bleavins, 244 F. Supp. 261 (D. Colo. 1965)).

[90] 605 F.2d 110 (3d Cir. 1979); *see In re* Catanella, 583 F. Supp. 1388, 1418 (E.D. Pa. 1984); B&B Investment Club v. Kleinert's, Inc., 391 F. Supp. 720, 725 (E.D. Pa. 1975) (accountant defendant not discussed).

[91] In a "firm commitment" underwriting, upon signing the underwriting agreement, the underwriters are contractually bound to purchase all the offering company's shares. They then resell the shares to the public at a mark-up (the "spread"). In a "best efforts" underwriting, the underwriters do not purchase the shares; rather, they agree to act as the issuer's agents and exert their best efforts to find purchasers. D'Alimonte, *The Letter of Intent and Basic Structure of an Offering*, in SECURITIES UNDERWRITING: A PRACTITIONER'S GUIDE 94 (K. Bialkin & W. Grant eds. 1985).

either Corning or Signetics, the Third Circuit affirmed a summary judgment on behalf of those two defendants:

> We have no difficulty in concluding that Congress intended the unambiguous language of § 12(2) to mean exactly what it says: "Any person who—. . . (2) offers or sells a security . . . shall be liable to the person purchasing from him . . . ." This section is designed as a vehicle for a purchaser to claim against his immediate seller. Any broader interpretation would not only torture the plain meaning of the statutory language but would also frustrate the statutory scheme because Congress has also provided a specific remedy for a purchaser to utilize against the issuer as distinguished from the seller of a security [in § 11].[92]

Thus, the Third Circuit used the strict privity approach because it closely followed the literal wording of section 12,[93] and because the court saw no reason to provide a purchaser with a second avenue of recovery against the issuer when Congress had expressly provided one such remedy in section 11.[94] The court refused to address the aiding and abetting theory.[95]

Although *Collins*' narrow approach has found favor with several commentators,[96] it has become the leading approach in only one other federal circuit[97]—the Seventh, based on dicta in

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[92] *Collins*, 605 F.2d at 113.

[93] *Id.* (quoting Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976), for the proposition that "[a]scertainment of congressional intent with respect to the standard of liability created by a particular section of the securities acts must 'rest primarily on the language of that section.' ").

[94] While this conclusion pre-dated the Supreme Court's decision in Herman & MacLean v. Huddleston, 459 U.S. 375 (1983) that cumulative remedies are sometimes appropriate, that decision does not undermine the conclusion in the text. The contrasts that the Supreme Court drew between § 11 of the 1933 Act and § 10(b) of the 1934 Act do not exist between §§ 11 and 12.

[95] *Collins*, 605 F.2d at 113-14.

[96] *See supra* note 49.

[97] Arguably, the strict-privity approach has gained some acceptance in the Ninth Circuit. *See, e.g.*, Feldman v. Simkins Indus., 679 F.2d 1299, 1306 (9th Cir. 1982); McFarland v. Memorex Corp., 493 F. Supp. 631, 647 (N.D. Cal. 1980). However, the proximate cause/substantial factor test appears to have become the predominant Ninth Circuit view. *E.g.*, Anderson v. Aurotek, 774 F.2d 927, 930 (9th Cir. 1985); Admiralty Fund v. Jones, 677 F.2d 1289, 1294 (9th Cir. 1982). The appropriateness of aiding and abetting liability is still unclear in that circuit. *See infra* note 242.

The Second Circuit also appears to require either strict privity *or* scienter (probably

Sanders v. John Nuveen & Co.[98] Some district courts in the Seventh Circuit do not consider the matter settled;[99] others have used the strict-privity approach to deny section 12(2) standing to plaintiffs who did not purchase the issued shares under fraudulent circumstances.[100]

2. *Accountants' Cases*

Most accountant defendants would prefer the strict-privity approach to defining "seller" under section 12(2). That definition virtually guarantees that accountants will not have section 12 exposure unless they have stepped well beyond the boundaries of what accountants and auditors normally do.

For example, in *Dorfman v. First Boston Corp.*,[101] the plaintiff investors sued, among others, Peat, Marwick, Mitchell & Co. (PMM), the firm that had acted as auditor and as accountant for a failing company and its parent. The court dismissed the section 12(2) claim against PMM because that section creates liability only for the "person purchasing such security from

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through an aiding and abetting theory). *E.g.*, Mayer v. Oil Field Sys. Corp., 803 F.2d 749, 756 (2d Cir. 1986); Bozsi Ltd. Partnership v. Lynott, [Current Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,572, at 97,552 (S.D.N.Y. 1987); Akerman v. Oryx Communications, Inc., 609 F. Supp. 363, 373 (S.D.N.Y. 1984), *aff'd*, 810 F.2d 336, 344 (2d Cir. 1987); Lanza v. Drexel & Co., 479 F.2d 1277, 1299 (2d Cir. 1973); Hitchcock v. deBruyne, 377 F. Supp. 1403, 1406 (D. Conn. 1974). *But see* Jubran v. Musikahn Corp., 673 F. Supp. 108, 113 (E.D.N.Y. 1987) (allowing recovery against non-seller who "substantially participated" in the offering).

[98] 619 F.2d 1222 (7th Cir. 1980), *cert. denied*, 450 U.S. 1005 (1981); *see* Barker v. Henderson, Franklin, Starnes & Holt, 797 F.2d 490, 494 (7th Cir. 1986); Frymire v. Peat, Marwick, Mitchell & Co., 657 F. Supp. 889, 892 (N.D. Ill. 1987); Steinberg v. Illinois Co., 659 F. Supp. 58, 60 (N.D. Ill. 1987).

[99] Schueter v. Cozad, 674 F. Supp. 1351, 1356 (C.D. Ill. 1987); Ambling v. Blackstone Cattle Co., 658 F. Supp. 1459, 1466 (N.D. Ill. 1987); Excalibur Oil, Inc. v. Sullivan, 616 F. Supp. 458 (N.D. Ill. 1985); Hackett v. Village Court Assoc., 602 F. Supp. 856, 859 (E.D. Wis. 1985); Stern v. American Bankshares, 429 F. Supp. 818, 824 (E.D. Wis. 1977).

[100] *See, e.g.*, Soderberg v. Gens, 652 F. Supp. 560, 564 (N.D. Ill. 1987). In a § 10(b) situation plaintiff must be a "purchaser" or a "seller." Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 731, 734 (1975). However, *Soderberg* is apparently the first case to extend this analogy to § 12; *see also* Prudential-Bache Securities, Inc. v. Cullather, [1987 Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,421, at 97,191 (E.D. Va. 1987) (options writer is not a "purchaser" under § 12(2)).

[101] 336 F. Supp. 1089 (E.D. Pa. 1972).

him."[102] PMM had acted as accountant and as auditor but had not sold the securities.

The plaintiffs in *Dorfman* argued in favor of a more liberal approach, citing two precedents. But the *Dorfman* court distinguished *Buchholtz v. Renard*,[103] a simple broker/agent case in the mold of *Cady v. Murphy*,[104] and rejected *Bailey v. Huntington Securities Co.*,[105] a conspiracy case, because the plaintiffs had not alleged that PMM was part of a conspiracy. The plaintiffs also raised section 15, but the accounting firm clearly had not "controlled" the issuer or underwriters.[106]

Deloitte, Haskins & Sells (DH&S), a CPA firm, was one of the defendants facing a section 12(2) claim in the wake of allegations that Memorex had attempted to misrepresent its financial condition and to conceal numerous financial problems. In *McFarland v. Memorex Corp.*,[107] the court quickly dismissed the section 12(2) claims against DH&S, noting that "[u]nder a literal reading of section 12, only the underwriters bear potential liability: they are the only defendants who sold securities to the plaintiff. Surely the accountants cannot be considered sellers under any interpretation."[108]

The plaintiffs sought a more liberal interpretation of the term "seller," including invocation of the aiding and abetting theory and the conspiracy theory. The court, however, held that such an expansion of liability would be appropriate only if congressional intent were unclear.[109] The court concluded that such intent is not unclear because section 12(2) unambiguously allows a buyer to sue his seller for rescission. To define the accountants as sellers would produce a curious result, the court observed, for "it would indeed be strange . . . if a victorious plaintiff could present to the accountants for repurchase securities that they never owned."[110]

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[102] *Id.* at 1092.
[103] 188 F. Supp. 888 (S.D.N.Y. 1960) (no accountant defendants).
[104] 113 F.2d 988 (1st Cir.), *cert. denied,* 311 U.S. 705 (1940).
[105] 35 F.R.D. 169 (S.D.N.Y. 1963) (no accountant defendants).
[106] *Dorfman*, 336 F. Supp. at 1093.
[107] 493 F. Supp. 631 (N.D. Cal. 1980).
[108] *Id.* at 647.
[109] *Id.* at 648.
[110] *Id.; see Bozsi Ltd. Partnership,* [Current Binder] Fed. Sec. L. Rep. (CCH), at

3. *Arguments in Favor of the Strict-Privity Approach*

Other cases applying a strict-privity approach to section 12 cases have reached the same result: no "seller" status for accountants and therefore no liability.[111] Thus, accountant defendants will always favor the application of this test, and many strong arguments exist in favor of its application.[112]

First, the remedy provided in section 12 is rescissionary in nature,[113] indicating that the proper defendant is the actual or "true" seller.[114] Although there are cases to the contrary,[115] the common law, from which this remedy was derived, usually allowed rescission only from the true seller.[116] Many courts take this limitation to signify that Congress intended only the true seller to be a defendant.[117]

Second, section 12 is unambiguous on its face. Nothing in the statute gives any indication that the term "seller" has any meaning other than its ordinary one.[118] For example, when a tire store sells a tire, the store's accountant is not considered a "seller" in the transaction. In the ordinary sense of the word, the "seller" is the person who transfers the title after negotiating the sale.

Two different clauses in section 12 identify the proper defendant as "seller," stating that "[a]ny person who—offers or sells" can become liable, and such a person "shall be liable to the person *purchasing such security from him.*"[119] The language

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97,553 (accountants cannot be viewed as "immediate and direct sellers" even under the most expansive view).

[111] *E.g.*, Beck v. Cantor, Fitzgerald & Co., 621 F. Supp. 1547, 1560-62 (N.D. Ill. 1985).

[112] As the succeeding footnotes will illustrate, the commentators, not the courts, have made the most of these arguments. The courts that have adopted the strict-privity approach have not written persuasive opinions in support of that view.

[113] If the plaintiff no longer holds the securities, so that rescission becomes impossible, damages may be recovered. Junker v. Crory, 650 F.2d 1349, 1362 (5th Cir. 1981); *In re* Itel Sec. Litig., 89 F.R.D. 104, 115 (N.D. Cal. 1981).

[114] O'Hara, *supra* note 49, at 943, 1002.

[115] *E.g.*, Peterson v. McManus, 172 N.W. 460, 471 (Iowa 1919).

[116] *E.g.*, Hafner v. A.J. Stuart Land Co., 224 N.W. 630, 632 (Mich. 1928).

[117] *E.g.*, *Collins*, 605 F.2d at 113; *Akerman*, 609 F. Supp. at 374; *McFarland*, 493 F. Supp. at 648.

[118] *O'Hara*, *supra* note 49, at 992-93 n.387.

[119] 15 U.S.C. § 77l (1982) (emphasis added).

does not lend itself to interpretation; it has a literal and direct meaning, devoid of ambiguity.

The Supreme Court has clearly indicated that "a determination of the standard of liability under the various provisions of the federal securities laws must begin with and rest primarily on the language of the statutes."[120] In its reading of securities laws, the Court has gravitated toward a conservative, narrow interpretation of statutory language.

The language of the Securities Act of 1933 shows that Congress did create liability for persons other than the issuer or the seller when it so desired.[121] For example, section 11[122] provides an entire list of potential defendants. In section 15,[123] Congress provided for "controller" liability. That Congress did not make any such provision in section 12 indicates an intent not to create liability for collateral participants such as accountants.[124]

Indeed, in section 11, Congress spoke of "participants" in contrast to its use of the singular "seller" in section 12.[125] Furthermore, because Congress provided a list of multiple defendants in section 11, that provision contains a method of adjusting the liabilities among the parties.[126] The absence of such

[120] Hagert v. Glickman, Lurie, Eiger & Co., 520 F. Supp. 1028, 1034 (D. Minn. 1981) (citing *Hochfelder*, 425 U.S. at 200-01; Transamerica Mortgage Advisors, Inc. v. Lewis, 444 U.S. 11 (1979)). The Court could have, but did not, cite *Blue Chip Stamps*, 421 U.S. at 723.

[121] Since congressional intent is the overriding issue, the argument that the strict-privity approach may mean no recovery for innocent investors, because the true seller may be insolvent, is not convincing. *See* Branson, *supra* note 49, at 345. This is analogous to arguing that a specific intent statute should be construed to cover negligence because plaintiffs suffer the same injury whether defendants intend to do wrong or are simply careless. Justice Blackmun made this argument in his dissent in *Hochfelder*, 425 U.S. at 216 (Blackmun, J., dissenting). Obviously, the majority in *Hochfelder* did not accept the argument.

[122] 15 U.S.C. § 77k (1982).

[123] *Id.* at § 77o.

[124] Accountants *are* expressly listed as potential defendants in § 11. Their liability extends only to errors contained in the portion of the registration statement that they prepare. *Id.* at § 77k(a)(4).

[125] *See* Comment, *Secondary Liability, supra* note 49, at 858.

[126] 15 U.S.C. § 77k(f) (1982):

> All or any one or more of the persons specified in subsection (a) shall be jointly and severally liable, and every person who becomes liable to make any payment under this section may recover contribution as in cases of contract from any person who, if sued separately, would have been

a provision in section 12 also indicates that Congress did not intend to extend liability to multiple defendants.[127]

Unfortunately, the legislative history of section 12 is brief.[128] However, the report of the House Committee on Interstate and Foreign Commerce,[129] submitted in 1933, discussed section 12 liability only in terms of the "seller" (singular)[130] and emphasized that liability should not extend to persons such as preparers of financial statements, because their responsibility merely involved paper activity.[131]

Arguably, whenever Congress provides a relatively low burden of proof for plaintiffs, as in section 12,[132] it limits the number of potential defendants. But when Congress imposes a relatively high burden of proof, as in section 10(b) of the 1934 Act, it increases the number of potential defendants.[133] In section 12 no scienter is required for liability.[134] Instead, the section places the burden on the defendant to prove "that he did not know, and in the exercise of reasonable care could not have

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> liable to make the same payment, unless the person who has become liable was, and the other was not, guilty of fraudulent misrepresentation.

[127] *See* O'Hara, *supra* note 49, at 990-91.

[128] Landis, *The Legislative History of the Securities Act of 1933*, 28 GEO. WASH. L. REV. 29 (1959).

[129] H.R. REP. No. 85, 73d Cong., 1st Sess. (1933).

[130] *See supra* note 125 and accompanying text.

[131] *Id.*

[132] Commentators have formulated numerous suggestions for bolstering the defenses of unfortunate defendants against § 12(1) liability. *E.g.*, Schneider & Zall, *Section 12(1) and the Imperfect Exempt Transaction: The Proposed I & I Defense*, 28 BUS. LAW. 1011 (1973) (issuer should have defense against § 12(1) liability arising out of an innocent and immaterial defect in offer or sale).

[133] Branson, *supra* note 38, at 350 (noting a natural "sliding scale"); *see* Rapp, *supra* note 38, at 491; Comment, *Attorneys and Participant Liability Under § 12(2) of the Securities Act of 1933*, 1982 ARIZ. ST. L.J. 529, 573 (1982).

In Lanza, 479 F.2d at 1299 (1973), the court said:

> It is apparent that in passing the 1933 Act Congress could not have intended that purchasers of securities who could not sue directors under Section 11 could sue such directors (unless privity or scienter were found) under Section 12(2). Since the public interest in private offerings is less clear than that in public offerings, the duties imposed upon directors in private offerings were intended to be correspondingly less stringent.

[134] University Hill Found. v. Goldman, Sachs & Co., 422 F. Supp. 879, 893 (S.D.N.Y. 1976).

known" of the misrepresentation.[135] In the Committee report accompanying what became the 1933 Act, Congress justified this shift of the usual burden of proof

> as both just and necessary, inasmuch as the knowledge of the *seller* as to any flaw in his selling statements or the failure of the *seller* to exercise reasonable care are matters in regard to which the *seller* may readily testify, but in regard to which the buyer is seldom in a position to give convincing proof.[136]

To allow section 12 plaintiffs to reach a large number of collateral defendants without proving scienter[137] or reliance[138] circumvents the procedural requirements that Congress imposed. The Supreme Court's decision in *Ernst & Ernst v. Hochfelder*[139] counsels against such an action.[140] Section 10(b) is a "catch-all" antifraud provision;[141] section 12 is not.[142]

B. Proximate Cause/Substantial Factor

1. *Key Cases*

The seminal case *Lennerth v. Mendenhall*[143] is widely recognized for spelling out what has become the majority approach

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[135] 15 U.S.C. § 771 (1982). Regarding the burden of proof on the defendant, see Justice Powell's dissent to a denial of *certiorari* in John Nuveen & Co. v. Sanders, 450 U.S. 1005 (1981). *See Junker,* 650 F.2d at 1361; *Quincy Coop. Bank,* 655 F. Supp. at 84.

[136] H.R. REP. No. 85, 73d Cong., 1st Sess. 23-24 (1933) (emphasis added).

[137] Section 10(b) of the 1934 Act does, after all, require a showing of scienter. *Hochfelder,* 425 U.S. at 185. To meet this requirement, most circuits hold that "recklessness" will suffice. *E.g.,* Warren v. Reserve Fund, Inc., 728 F.2d 741, 745 (5th Cir. 1984); Hackbart v. Holmes, 675 F.2d 1114, 1118 (10th Cir. 1982); Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 38, 44 (2d Cir.), *cert. denied,* 439 U.S. 1039 (1978).

[138] Reliance is not an element of § 12(2) recovery. *Junker,* 650 F.2d at 1362; Klein v. Computer Devices, Inc., 591 F. Supp. 270, 277 (S.D.N.Y. 1984). Reliance is generally considered an element in § 10(b) cases. *E.g.,* Rifkin v. Crow, 574 F.2d 256, 261-62 (5th Cir. 1978). However, even in § 10(b) cases, the reliance requirement has been eliminated in "mere omission" cases such as in Affiliated Ute Citizens v. United States, 406 U.S. 128, 153-54 (1972), and loosened for active misrepresentation cases in which the "fraud on the market" theory applies. *See supra* note 9.

[139] 425 U.S. 185 (1976).

[140] *Id.* at 210.

[141] Comment, *Seller Liability, supra* note 49, at 400.

[142] *See id.*

[143] 234 F. Supp. 59 (N.D. Ohio 1964).

to the section 12(2) "seller" definition. The court addressed the "seller" status of Roger, who had initiated contact with the plaintiff investors by phone, had outlined the details of the issuer's venture at an initial meeting and had described it as successful and well-financed. These representations and estimated profits were reiterated at a second meeting, and the plaintiffs were introduced to the issuer's vice-president at a third meeting.

The court briefly discussed the broker/agent view of *Cady* and the participation approach of *Wonneman*. The decision's key language is as follows:

> [L]iability must lie somewhere between the narrow view, which holds only the parties to the sale, and the too-liberal view which would hold all who remotely participated in the events leading up to the transaction. We think that the line of demarcation must be drawn in terms of *cause and effect*: To borrow a phrase from the law of negligence, *did the injury to the plaintiff flow directly and proximately from the actions of this particular defendant?* If the answer is in the affirmative, we would hold him liable. *But for* the presence of the defendant Roger in the negotiations preceding the sale, could the sale have been consummated? If the answer is in the negative and we find that the transaction could never have materialized without the efforts of that defendant, we must find him guilty.[144]

After characterizing Roger's activities as tantamount to doing "everything but draw and sign the contract," the court concluded that "[t]he hunter who seduces the prey and leads it to the trap he has set is no less guilty than the hunter whose hand springs the snare."[145] Roger was deemed a "seller" in keeping with "the liberal remedial spirit of the securities laws."[146]

The inclusion of negligence principles in section 12(2) cases has become extremely popular; however, the "but for" approach of *Lennerth* has been deemed too broad.[147] "But for" the assistance of secretaries who type letters and contracts, many trans-

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[144] *Id.* at 65 (emphasis added).

[145] *Id.*

[146] *Id.*

[147] *See infra* notes 148-210 and accompanying text.

actions would not occur. Therefore, refinements to the approach were inevitable. The anticipated refinements came from the Fifth Circuit.

In *Hill York Corp. v. American International Franchises, Inc.*,[148] the Fifth Circuit, quoting extensively from the *Lennerth* opinion, held the defendants liable, under sections 12(1) and 12(2), as "sellers" who were the motivating force behind a pyramid scheme disguised as a franchise operation.[149] The defendants had sought out the original incorporators, had trained them to solicit additional capital, had provided sales brochures, and had rendered advice on every aspect of the corporate formation and subsequent development. The *Hill York* opinion quoted the "proximate cause" language from *Lennerth* but omitted any reference to the "but for" test.[150]

In *Lewis v. Walston & Co.*,[151] the Fifth Circuit addressed the "seller" status of a securities broker who had touted the issuer's stock, showed the plaintiffs pictures of the issuer's machine, voiced repeated optimistic predictions for the issuer's stock, arranged a meeting between the plaintiffs and principals of the issuer, and falsely stated that the securities firm would take a position in the issuer's securities. The court cited *Hill York* for establishing the "proximate cause" test as the proper approach in defining a "seller."[152] In concluding that the defendant was properly termed a "seller," the court added, significantly, that "[t]he jury could permissibly infer from these facts that [defendant's] actions were a '*substantial factor*' in bringing about the plaintiffs' purchases, and thus the 'proximate cause' of those purchases."[153] Casually used above, the term "substantial factor"[154] became an element in the "proximate cause/sub-

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[148] 448 F.2d 680 (5th Cir. 1971).

[149] *Id.* at 692-93.

[150] *Id.* at 693.

[151] 487 F.2d 617 (5th Cir. 1973).

[152] *Id.* at 621-22.

[153] *Id.* at 622 (emphasis added).

[154] Although the *Lewis* opinion seemed to pluck the "substantial factor" test out of mid-air, a Fifth Circuit opinion rummaged around and found some precedent for it. Pharo v. Smith, 621 F.2d 656, 667 n.8 (5th Cir. 1980) (citing Sprayregen v. Livingston Oil Co., 295 F. Supp. 1376, 1378 (S.D.N.Y. 1968)).

stantial factor" test, currently the majority approach in section 12 cases.[155]

Over the years the proximate cause/substantial factor test, with some minor alterations,[156] has become the favored approach for a majority of the circuit courts—the Second,[157] the Fourth,[158] the Fifth,[159] the Sixth,[160] the Eighth,[161] the Ninth,[162] the Eleventh,[163] and perhaps the Tenth[164] (although some of these courts supplement it with the aiding and abetting and the conspiracy theories).[165]

Davis v. Avco Financial Services, Inc.[166] is one case worthy of discussion because it is recent, thoughtful, and addresses collateral participant liability. The plaintiffs invested in Glenn

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[155] *See infra* notes 156-65 and accompanying text.

[156] Some courts emphasize the "proximate cause" language of the test while others emphasize the "substantial factor" term. This fact has led some observers to treat them as separate approaches. *E.g., Quincy Coop. Bank*, 655 F. Supp. at 83. *See generally* Bershad & Grasberger, *supra* note 17.

[157] *E.g., In re* Gas Reclamation, Inc. Sec. Litig., 659 F. Supp. 493, 504 (S.D.N.Y. 1987) (also accepting aiding and abetting and conspiracy theories); *Klein*, 591 F. Supp. at 280 (also accepting aiding and abetting). *But see* Benzoni v. Greve, 54 F.R.D. 450, 454 (S.D.N.Y. 1972) (strict privity required).

[158] *E.g.,* Adalman v. Baker, Watts & Co., 807 F.2d 359, 364 (4th Cir. 1986); Lawler v. Gilliam, 569 F.2d 1283, 1287 (4th Cir. 1978) (stressing "substantial factor" language).

[159] In addition to the cases discussed in the text, see Croy v. Campbell, 624 F.2d 709, 713-14 (5th Cir. 1980); *Pharo*, 621 F.2d at 667.

[160] *See, e.g.,* Davis v. Avco Fin. Serv., Inc., 739 F.2d 1057, 1065-66 (6th Cir. 1984), *cert. denied,* 472 U.S. 1012 (1985).

[161] Stokes v. Lokken, 644 F.2d 779, 785 (8th Cir. 1981); Wasson v. SEC, 558 F.2d 879, 886 (8th Cir. 1977) (adding as a consideration "whether the defendant was uniquely positioned to ask relevant questions, acquire material information, or disclose his findings" with regard to the sale).

[162] *Anderson*, 774 F.2d at 930; *Admiralty Fund*, 677 F.2d at 1294. *But see Feldman*, 679 F.2d at 1305 (apparently applying the strict privity test); *In re* Rexplore, Inc. Sec. Litig., 671 F. Supp. 679, 685-86 (N.D. Cal. 1987) (noting different approaches to defining "substantial factor"); Sec. Investor Protection Corp. v. Poirier, 653 F. Supp. 63, 67 (D. Or. 1986) (using "participant" language).

[163] *See, e.g.,* Foster v. Jesup & Lamont Sec. Co., 759 F.2d 838, 846 (11th Cir. 1985).

[164] *E.g.,* Farlow v. Peat Marwick Mitchell & Co., 666 F. Supp. 1500, 1504 (W.D. Okla. 1987); *In re* Wicat Sec. Litig., 600 F. Supp. 1236, 1240 (D. Utah 1984); Woods v. Homes & Structures, 489 F. Supp. 1270, 1294 (D. Kan. 1980); *see* Busch v. Carpenter, 827 F.2d 653, 659-60 (10th Cir. 1987) (applying this test but refusing to rule out strict privity approach).

[165] *See infra* notes 229-55 and accompanying text.

[166] 739 F.2d 1057 (6th Cir. 1984), *cert. denied,* 472 U.S. 1012 (1985).

W. Turner's famous "Dare to be Great" (DTBG) pyramid scheme.[167] Salespeople, following Turner's "fake it until you make it" philosophy, based the scheme on hard-sell tactics and promises of quick wealth. One defendant, Avco, provided loans secured by promissory notes to potential investors. An Avco manager attended three meetings of DTBG and provided potential investors with blank Avco loan application forms. At one of the meetings he made a speech to offer investment financing through Avco. Forty-eight people eventually borrowed $2,000 or more each from Avco to invest in DTBG.[168]

The Sixth Circuit deemed the proximate cause/substantial factor test "an appropriate synthesis of the sometimes antithetical policies that the securities laws are to be construed as statutes while, at the same time, giving effect to their far-reaching remedial purpose."[169] Avco and its manager became liable to each plaintiff who testified that the manager's actions were a substantial factor in their decision to buy DTBG securities.

A review of the proximate cause/substantial factor cases reveals that the test is generally not applied consistently, although a number of trends can be identified. Several cases have stated that under this test a "seller" must have a) actively solicited an order, b) negotiated the sale, or c) made arrangements for the sale.[170] In the realm of selling activities, the following constitute "substantial factors" that proximately cause a sale of securities: a broker's seeking out the plaintiff investor, recommending the issuer's bonds, and supplying all the information that the investor received;[171] a dealer-manager's putting

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[167] *See e.g., In re* Glenn W. Turner Enter. Litig., 521 F.2d 775 (3d Cir. 1975); SEC v. Koskot Interplanetary, Inc., 497 F.2d 473 (5th Cir. 1974); SEC v. Glenn W. Turner Enter. Inc., 474 F.2d 476 (9th Cir.), *cert. denied,* 414 U.S. 821 (1973).

[168] *Davis,* 739 F.2d at 1061.

[169] *Id.* at 1067.

[170] *In re* Activision Sec. Litig., 621 F. Supp. 415, 421 (N.D. Cal. 1985); *In re* Diasonics Sec. Litig., 599 F. Supp. 447, 457 (N.D. Cal. 1984). Branson studied 14 cases involving corporate officials as defendants in cases in which courts applied the "substantial factor/proximate cause" test. In 10 of the 14 cases, the defendants had no communications with the plaintiff investors leading up to or at the time of sale. In all 10 cases, defendants were not liable. Branson, *supra* note 49, at 347.

[171] *Quincy Coop. Bank,* 655 F. Supp. at 82-84; *see* Plunkett v. Francisco, 430 F. Supp. 235, 241 (N.D. Ga. 1971) (defendant's signing of a "warrant letter" that induced plaintiffs to invest money in a cattle leasing agreement was a proximate cause of the sale).

an offering together, ensuring that the dealer alone controls the flow of information by requiring the exclusive use of its offering circular, determining the terms and the conditions of the sale, and acting as the administrator and holder of letters of credit;[172] and a management consultant's creating limited partnerships to channel an investor's funds to an entrepreneur, rather than simply introducing the investor to the issuer as the investor had requested.[173]

On the other hand, courts have not considered the following as "substantial factors" proximately causing a sale: being the issuer in a firm commitment underwriting,[174] acting as a lead underwriter,[175] or even acting as an underwriter and making a single favorable comment to an investor's accountant.[176]

Another case in this area involved a real estate agent who flew the plaintiffs over the issuer's property, introduced them to the sellers, and received a commission on the sale. Because the agent was not "uniquely positioned" to ask questions about the transaction and was not in a position to lower the sale price as the true seller could have, his activity was not considered a "substantial factor."[177]

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[172] *Adalman*, 807 F.2d at 364. Defendant was also an affiliate of the issuer. *Id.*

[173] *Lawler*, 569 F.2d at 1288; *see* Lukovich v. E.F. Hutton & Co., [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,701, at 93,413 (D. Or. Apr. 21, 1986) (both broker and brokerage firm held to be "sellers"); *In re* Eagle Computer Sec. Litig., [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,297, at 92,017 (N.D. Cal. Aug. 28, 1985) (doing acts commonly necessary to marketing securities *can* constitute a substantial factor); Frogner v. Merrill Lynch, Pierce, Fenner & Smith, Inc., [1983-1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,504, at 96,927-28 (N.D. Cal. Sept. 26, 1983) (broker and brokerage firm held to be "sellers" but not broker's supervisors).

[174] *Akerman*, 609 F. Supp. at 374; *Wicat Sec. Litig.*, 600 F. Supp. at 1240.

[175] Klein v. Computer Devices, Inc., 602 F. Supp. 837, 840 (S.D.N.Y. 1985).

[176] *Foster*, 759 F.2d at 839. In these other cases the defendants' actions were held insufficient to constitute "substantial factors." *Activision*, 621 F. Supp. at 421 (defendant officers drafted prospectus, participated in "road show" information presentations to securities brokers and investment analysts, analyzed the market and set the price of the shares, and negotiated an agreement with the underwriters); *Diasonics*, 599 F. Supp. at 457; Deneau v. Walker, No. C82-3132 MPH, slip op. (N.D. Cal. Sept. 30, 1983) (issuer's principals created securities and a plan for their issuance, arranged for listing on the NYSE, arranged for SEC filings, supplied the public with data about the issuer through SEC materials, and arranged mechanisms for the transfer of deposit slips); Canizaro v. Kohlmeyer & Co., 370 F. Supp. 282, 287-88 (E.D. La. 1974), *aff'd,* 512 F.2d 484 (5th Cir. 1975) (broker-dealer acted as plaintiff buyer's agent, but its name appeared on the confirmation slip as the principal).

[177] Anders v. Dakota Land & Dev. Co., 380 N.W.2d 862, 867-68 (Minn. Ct. App.

The general notion that merely assisting in the preparation of a registration statement and prospectus does not constitute a "substantial factor" in the sale of the securities being registered should provide comfort to lawyers and accountants.[178] In one case, an attorney wrote an opinion letter concluding that the issuer's margin transactions were exempt from the securities laws.[179] The letter became part of an auditor's report that was referred to in an advertising brochure the issuer compiled. The court held the attorney's actions did not constitute a "substantial factor" in the transaction.[180] Nor did an attorney's actions become a "substantial factor" in the sale of securities out of a "boiler room"[181] operation even though the attorney knew the nature of the operation, represented the broker-dealer in a suit to force the phone company to install phones, arranged for additional space for the broker-dealer and negotiated the lease, arranged for state registration, and worked nearly nine hours a day for the broker-dealer.[182] Similarly, an attorney's actions were not a "substantial factor" in an issuer's sale when the attorney untangled the legal debris created by the issuer's fraudulent acts, prepared corporate minutes, attempted to trace missing funds, responded to investor complaints, and served as a channel of

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1986). This ruling may not give a true reading of the proximate cause/substantial factor test because the court gave substantial weight to the unique Eighth Circuit approach which considers whether a defendant was "uniquely positioned" to ask questions about the accuracy of representations. *Id.*

[178] *Gas Reclamation, Inc.*, 659 F. Supp. at 505; *In re* Victor Technologies Sec. Litig., [Current Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,158, at 95,716 (N.D. Cal. Jan. 8, 1987); Fine v. Rubin, 623 F. Supp. 171, 173 (N.D. Cal. 1985); Ahern v. Gaussoin, 611 F. Supp. 1465, 1482 (D. Or. 1985); *In re* Fortune Sys. Sec. Litig., 604 F. Supp. 150, 160-64 (N.D. Cal. 1984); Hudson v. Capital Management Int'l, Inc., [1982-1983 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,222, at 95,904 (N.D. Cal. Aug. 24, 1982).

However, not all courts appear to agree. *E.g.*, *Eagle Computer*, [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 92,017-18 (refusing to hold that such activities could never constitute a substantial factor in a sale).

[179] *Stokes*, 644 F.2d at 782.

[180] *Id.* at 785.

[181] A boiler room operation typically involves "cold" calling of names derived from a "sucker" list. The calls aggressively recommend large blocks of speculative securities using misleadingly optimistic predictions of earnings. *E.g.*, *In re* Harold Grill, 41 S.E.C. 321 (1963).

[182] Westlake v. Abrams, 504 F. Supp. 337, 347 (N.D. Ga. 1980).

communication between the issuer and an attorney hired to represent the issuer in state investigations.[183]

Alternatively, the following attorneys' actions constituted "substantial factors," making the attorneys liable as "sellers" under section 12: a) proposing a merger, advocating it as a solution for the issuer's problems, preparing the necessary documents, and attempting to persuade investors to support the merger;[184] and b) acting as the principal architect of a loan brokerage agreement designed to avoid detection as an integratable offering and to minimize section 12(1) exposure.[185]

Before we proceed to cases involving accountants' liability under the proximate cause-substantial factor test, one more recent case deserves attention. *Dahl v. Pinter*[186] involved an optimistic investor, Dahl, who was quite taken with an oil and gas venture that Pinter had put together. Dahl was so enthusiastic that he not only invested his own funds in the project, but he also solicited friends and family to invest. Dahl received no compensation from Pinter for these efforts; his motivation simply consisted of a desire to enrich family and friends. Dahl helped the other investors complete investment letter-contracts, knowing the interests were being sold without registration. He was apparently unaware of the legal violation involved.[187]

When interests in Pinter's enterprise proved worthless, Dahl and the other investors sued, claiming a section 12 violation. In defense, Pinter claimed that because of Dahl's promotional activities, he, too, was liable as a "seller" and should pay contribution to Pinter.[188] Although the Fifth Circuit had no difficulty in concluding that Dahl's efforts were a "substantial factor" which "proximately caused" the other plaintiffs' investments,[189] it declined to hold Dahl liable as a seller. The court based its

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[183] Van Boeckel v. Weiss, [1983-1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,648, 97,589 (N.D. Cal. Sept. 12, 1983).

[184] *Junker*, 650 F.2d at 1360.

[185] Koehler v. Pulvers, 614 F. Supp. 829, 843 (S.D. Cal. 1985); *see* Parquitex Partners v. Registered Fin. Planning Serv., Inc., [1987 Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,255, at 96,226 (D. Or. 1987).

[186] 787 F.2d 985 (5th Cir. 1986), *cert. granted,* 107 S. Ct. 1885 (1987).

[187] *Id.* at 986-87.

[188] *Id.* at 987.

[189] *Id.* at 990-91.

conclusion on a decision to add the additional element of self-interest to the definition of "seller":

> The substantial factor test was formulated and has been applied under facts which differ substantially from the facts of this case. In every case we have found employing this test (or its substantial equivalent), the person sought to be held liable as a "seller" received or hoped to receive some financial benefit from his efforts. We believe that had this circuit previously been confronted with a promoter of unregistered securities whose efforts were intended to benefit neither the seller nor himself, we would have created a different test. That test would have incorporated a threshold requirement that the promoter be motivated by a desire to confer a direct or indirect benefit on someone other than the person he has advised to purchase. We believe that a rule imposing liability (without fault or knowledge) on friends and family members who give one another gratuitous advice on investment matters unreasonably interferes with well-established patterns of social discourse. Absent express direction by Congress, we decline to impose liability for mere gregariousness.[190]

Dahl v. Pinter becomes more important because the Supreme Court has granted *certiorari*[191] and it may address this important section 12 issue for the first time.[192]

2. *Accountants' Cases*

The "proximate cause/substantial factor" approach is not as favorable to section 12 accountant defendants as is the "strict privity" approach. Nonetheless, this approach is not as harsh as the participation approach[193] or, in at least some instances, as harsh as the aiding and abetting and the conspiracy approaches.[194] One of its biggest failings, as shall be seen, is its inconsistency in application.

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[190] *Id.* (citations omitted). Judge Brown lodged a strong dissent against this additional requirement. *Id.* at 992-95.

[191] *Dahl*, 107 S. Ct. 1885 (1987).

[192] The Supreme Court's decision may also address the *in pari delicto* doctrine recently applied in Eichler, Inc. v. Berner, 105 S. Ct. 2622, 2623 (1985).

[193] *See supra* notes 77-87 and accompanying text.

[194] *See infra* notes 229-80 and accompanying text.

A leading case out of California is *Mendelsohn v. Capital Underwriters, Inc.*,[195] in which the defendant accounting firm, Harris, Kerr, Forster & Co. (HKF), was retained to set up bookkeeping records and to prepare corporate tax returns for the issuer. HKF's goal was to "clean up" the issuer's bookkeeping practices. HKF did this and also prepared various tax returns. HKF did no work in connection with the preparation of any prospectuses or offering circulars; however, without HKF's authorization, the issuer incorporated into a prospectus two tax letters that HKF wrote. HKF had no direct contact with potential investors and had never expressed any opinion on the financial condition of the issuer or any of its related entities.[196]

The court concluded that setting up books to record faithfully the issuer's dubious transactions did not constitute a "substantial factor" in the plaintiffs' decision to invest.[197] Therefore, HKF was not deemed a "seller" under section 12.[198]

In *Ahern v. Gaussoin*,[199] the accounting firm of Touche Ross & Co. prepared financial statements which were included in the issuer's registration statement and prospectus.[200] Additionally, Touche Ross's manager for the account spoke at a shareholders' meeting:

> Our firm gave your Management and its accounting practices a clean bill of health for 1981 . . . I am very encouraged by your growth plans and in the way your Board and Management have handled the Company's business in these recessionary times. Many companies have not done as well: keep up the good work. . . .
> I am looking forward to reporting to you a "clean bill of health" at your Annual Meeting for many years to come.[201]

This alleged "sales pitch," coupled with the assistance given in preparing the prospectus and registration statement, was deemed

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[195] 490 F. Supp. 1069 (N.D. Cal. 1979).
[196] *Id.* at 1076-77.
[197] *Id.* at 1085.
[198] *Id.* at 1087.
[199] 611 F. Supp. 1465 (D. Or. 1985).
[200] *Id.* at 1472.
[201] *Id.* at 1486.

not sufficient to constitute a "substantial factor" in the sale; Touche Ross was not a section 12 "seller."[202]

Yet in *In re Wickes Co.*,[203] the plaintiffs alleged that Peat, Marwick, Mitchell & Co. (PMM) prepared a report, financial statements, and "comfort letters" that contained material misrepresentations and omissions and that did not fairly represent the issuer's financial condition. The plaintiffs also claimed the financial statements failed to disclose that PMM would not continue to audit the issuer's books and that the proposed new company would suffer substantial losses because of changes in accounting policies.[204] These allegations were held sufficient to state a section 12(2) claim against PMM as a "seller."[205]

PMM met with a similarly unfavorable result in *Gold v. LTV Corp.*,[206] in which the court held simply that "[a]n accountant's evaluation of a corporation's financial condition surely can constitute a 'substantial factor' in inducing sales of that

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[202] *Id.*

[203] [1982-1983 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,055 (S.D. Cal. Jan. 6, 1983).

[204] *Id.* at 95,006.

[205] *Id.* at 95,009. PMM fared better in *Gas Reclamation, Inc.*, [Current Binder] Fed. Sec. L. Rep. (CCH) at ¶ 96,020, in which its relationship with the issuer began several months *after* the allegedly misleading private placement memorandum was prepared and in which the plaintiffs did not allege the existence of any misleading documents attributable to PMM. Naturally, PMM's actions were held not to be "substantial factors" proximately causing the sale.

PMM similarly escaped liability in *Farlow*, 666 F. Supp. at 1500, in which it allegedly certified false financial statements used in a promoter's "ponzi" scheme. Plaintiffs had difficulty finding any specific errors in financial statements that were actually included in offering circulars, although they did allege that some PMM financial statements were hand-delivered to them by the promoter. The allegation that PMM was a "substantial factor" in the sale of securities because plaintiffs would not have purchased them "[i]f PMM had properly disclaimed, qualified, or footnoted the financial statements" was rejected as inadequate, being

> indicative of the most remote connection with the sale of the limited partnerships. . . . Plaintiffs must do more than allege Peat Marwick was a substantial factor in causing the sale; plaintiffs must also allege facts which tend to show Peat Marwick's *participation in the buy-sell transaction* in order to satisfy the substantial factor test . . .

Id. at 1504 (emphasis omitted and in original).

[206] [1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,654 (N.D. Tex. Aug. 24, 1984). This brief conclusion is at odds with the more widely held view that assisting with preparation of a registration statement and prospectus does not constitute a "substantial factor" under this test. *See supra* note 178 and accompanying text.

corporation's stock."[207] This is a broad interpretation of the "substantial factor" element that harkens back to the participation approach.[208]

Finally, in *En Yun Hsu v. Leaseway Transportation Corp.*,[209] the defendant accounting firm, which had been the plaintiffs' financial advisor for seven years, convinced the plaintiffs to invest in a truck leasing scheme that the defendant arranged and managed through a corporation the defendant's individual accountants owned. The defendant's principals altered some investment documents, signed documents on the plaintiffs' behalf without a power of attorney, and made several misrepresentations to the plaintiffs about the progress of the venture. The court decided the accounting firm acted as a seller under section 12(1); its involvement clearly became a "significant factor" in leading the plaintiffs to invest in the venture.[210]

At least two conclusions may be drawn from this survey of accountants' cases under the proximate cause/substantial factor test. First, the decisions applying the test are not consistent.[211] Second, accountants who stray from their ledgers, like shoemakers who stray from their lasts, risk facing legal trouble by being characterized as section 12 "sellers."

3. *Arguments Against the Proximate Cause/Substantial Factor Test*

Accountant defendants in section 12 cases will want to convince courts to reject the proximate cause/substantial factor

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[207] *Id.* at 99,307.

[208] *See supra* notes 77-87 and accompanying text.

[209] [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,043 (N.D. Cal. Mar. 29, 1985).

[210] *Id.* at 91,199. *Contra Croy*, 624 F.2d at 709, in which the defendant was an attorney *and a CPA* who gave tax and investment advice to the plaintiffs. The defendant told the plaintiffs that the issuer's tax shelter was one of the best he had seen. He reviewed one of the issuer's brochures with the plaintiffs and made projections of the plaintiffs' tax liability based on the issuer's numbers. The defendant never made an independent investigation of the project and considered himself the plaintiffs' attorney although the issuer paid his fee for giving this advice. *Id.* at 711. The defendant was held not to be a § 12 "seller" under the proximate cause/substantial factor test. *Id.* at 714.

[211] *See supra* notes 192-210 and accompanying text.

approach and to use instead the strict privity test which is the more advantageous and reasonable choice.[212] The courts that adopt the tort-based proximate cause/substantial factor approach frequently justify their choice by reference to the remedial purposes of the securities laws.[213] However, such remedial purpose is not an automatic justification for departing from the statutory language of section 12.[214] As indicated earlier, the language of section 12, properly read, seems to require a strict privity relationship as a prerequisite to recovery.[215] If the statutory language is clear, the "remedial purpose" of the Securities Act of 1933 should not enter the analysis.[216]

Certainly many commentators are concerned about injured plaintiffs remaining uncompensated and wrongdoing defendants going unpunished.[217] These policy factors ordinarily would deserve consideration; however, the language of section 12 expresses a clear meaning. Furthermore, if courts want to extend liability beyond the true seller to promote these policies, sections 11, 15, and 17(a)[218] of the 1933 Act and section 10(b) of the 1934 Act can serve this function.[219]

When the Supreme Court addresses policy factors in securities litigation, it uses a rather conservative approach. In *Blue Chip Stamps v. Manor Drug Stores*,[220] for example, now Chief Justice Rehnquist's majority opinion limited the right to bring a

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[212] *See supra* notes 111-42 and accompanying text.

[213] *E.g.*, *In re* Caesars Palace Sec. Litig., 360 F. Supp. 366, 382 (S.D.N.Y. 1973) (citing SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 181-82 (1963)).

[214] *See* Touche Ross & Co. v. Redington, 442 U.S. 560, 579-80 (1979) (Brennan, J., concurring).

[215] *See supra* notes 48, 52-76 and accompanying text.

[216] *See Davis*, 739 F.2d at 1069-70 (Lively, C.J., concurring and dissenting).

[217] *E.g.*, Branson, *supra* note 49, at 345; Note, Davis v. Avco, *supra* note 49, at 818; Comment, *Seller Liability, supra* note 49, at 390.

[218] 15 U.S.C. § 77q(a) (1982). A private cause of action under § 17(a) is not recognized in all circuits but appears to be available in the Fourth Circuit (Newman v. Prior, 518 F.2d 97, 99 (4th Cir. 1975)), the Seventh Circuit (Daniel v. Int'l Bhd. of Teamsters, 561 F.2d 1223, 1230 (7th Cir. 1977), *rev'd on other grounds,* 439 U.S. 551 (1979)), and the Ninth Circuit (Mosher v. Kane, 784 F.2d 1385, 1390-91 (9th Cir. 1986)). Only the Fifth Circuit (Landry v. All Am. Assurance Co., 688 F.2d 381, 389 (5th Cir. 1982)) and the Eighth Circuit (Brannan v. Eisenstein, 804 F.2d 1041, 1043 n.1 (8th Cir. 1986)) have clearly rejected such a cause of action.

[219] O'Hara, *supra* note 49, at 998.

[220] 421 U.S. 723 (1975).

civil damages action under section 10(b) to actual buyers and sellers of securities.[221] His opinion voiced concern about vexatious litigation and about potentially undermining judicial economy,[222] problems that can result from reading the securities laws too liberally. Extending section 12 "seller" status beyond the strict privity relationship requirement runs against each of these policies. Professor Schneider has observed:

> The fundamentally factual inquiry of causation would offend each of the *Blue Chip* considerations. Enlarging the potential defendant class would increase the opportunities for vexatious litigation against numerous parties and would disrupt numerous businesses. Finally, because the inquiry about causation is fundamentally a factual inquiry, a court's rendering disposition without trial would be most unlikely.[223]

While some commentators support the proximate cause/substantial factor test for injecting some standards into the definition of "seller,"[224] such standards only became necessary because some courts needlessly extended the "seller" definition beyond strict privity by using the unprincipled participation approach.[225] This extension violates the Supreme Court's directive that principles of statutory construction should determine the scope and availability of remedies under the securities laws.[226]

Furthermore, resorting to the tort principle of "proximate causation," as complicated by the "substantial factor" language, creates a large degree of uncertainty for potential section 12 defendants,[227] especially collateral participants such as accountants and attorneys. The cases discussed in this section clearly illustrate how inconsistent court decisions can be. How then, are defendants to predict the way a jury will judge their conduct? In multimillion dollar transactions, the inability to out-guess a future jury is particularly frightening. Professor Leon Green has noted that "in financial transactions certainty, ease in determin-

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[221] *Id.* at 742, 749, 755.
[222] *Id.* at 739-49.
[223] Schneider, *supra* note 49, at 263.
[224] Comment, *Redefining "Seller," supra* note 49, at 170-71.
[225] *See supra* notes 77-87 and accompanying text.
[226] *See Touche Ross & Co.*, 442 U.S. at 578.
[227] Schneider, *supra* note 49, at 262.

ing liability and uniformity in result are at a premium. The rule of law must have a high degree of predictability and decisiveness."[228]

C. *Aiding and Abetting and Conspiracy*

The most controversial approach to section 12 liability concerns extending exposure to aiders and abettors and to co-conspirators of the primary violators.[229] These two extensions are not mentioned in the 1933 Act or the 1934 Act, but virtually every circuit court addressing the issue has accepted them as a proper basis for broadening liability under at least some sections of the Acts.[230] Our concern is specifically with section 12.[231]

The conditions necessary for aiding and abetting liability are well-established: (a) an independent wrong must have existed, (b) the aider and abettor must have known of its existence, and (c) the aider and abettor must have provided substantial assistance in effecting the wrong.[232]

To hold a defendant liable under a conspiracy theory, a court must find: (a) the existence of a plan to accomplish a securities violation, (b) the defendant's participation in the venture, and (c) the defendant's intention to make the plan succeed.[233]

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[228] Green, *The Duty to Give Accurate Information*, 12 UCLA L. REV. 464, 472 (1964-65), *quoted in* Schneider, *supra* note 49, at 262 n.147. Professor Branson shares Green's concern but believes that the tort approach is proper and can be improved by more fully utilizing traditional tort factors such as foreseeability, cost-benefit evaluation, and the remedial nature of the securities laws. Branson, *supra* note 49, at 357-59.

[229] An important distinction exists between extending primary liability by broadening the definition of "seller" and by resorting to secondary liability through the aiding and abetting or the conspiracy theories. *See id.* at 332; Ruder, *Multiple Defendants in Securities Law Fraud Cases: Aiding and Abetting, Conspiracy,* In Pari Delicto, *Indemnification, and Contribution*, 120 U. PA. L. REV. 597, 600 (1972).

[230] T. HAZEN, *supra* note 42, at 208-09. In Ernst & Ernst, 425 U.S. at 191-92 n.7, the Supreme Court expressly refused to decide the applicability of aiding and abetting under the securities laws.

[231] *See generally* Comment, *supra* note 133, at 531 (arguing in favor of an aiding and abetting approach to § 12(2)).

[232] Armstrong v. McAlpin, 699 F.2d 79, 91 (2d Cir. 1983); Monsen v. Consol. Dressed Beef Co., 579 F.2d 793, 799 (3d Cir. 1978); Tkaczuk v. Weill, [Current Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,199, at 95,933 (N.D. Ill. Jan. 28, 1987).

[233] *See generally* Lorber v. Beebe, 407 F. Supp. 279, 288 (S.D.N.Y. 1975).

The following circuits appear to accept the aiding and abetting theory, the conspiracy theory, or both in section 12 actions: First,[234] Second,[235] Fourth,[236] Sixth,[237] Eighth,[238] and Tenth.[239] Only the Third[240] and the Seventh[241] Circuits appear to reject both theories. The Ninth Circuit's position is hopelessly muddled.[242] However, almost all of these conclusions are based on district court cases. The only circuit courts to address the issue directly are the Second in *Akerman v. Oryx Communications,*

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[234] Kilmartin v. H.C. Wainwright & Co., 637 F. Supp. 938, 944 (D. Mass. 1986) (aiding and abetting only).

[235] *Gas Reclamation, Inc.*, 659 F. Supp. at 503 (aiding and abetting and conspiracy); Ackerman v. Clinical Data, Inc., [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,207, at 91,569 (S.D.N.Y. July 8, 1985) (aiding and abetting only); Klein, 602 F. Supp. at 843 (both); *Lorber*, 407 F. Supp. at 288 (both); *Caesars Palace*, 360 F. Supp. at 383 (both); *see Akerman*, 810 F.2d at 344 (holding that to be liable under § 12(2), a mere "participant" must at least act with scienter).

[236] Frankel v. Wyllie & Thornhill, Inc., 537 F. Supp. 730, 744 (W.D. Va. 1982) (aiding and abetting only).

[237] Sandusky Land, Ltd. v. Uniplan Groups, Inc., 400 F. Supp. 440, 444 (N.D. Ohio 1975) (aiding and abetting only). *But see* Benoay v. Decker, 517 F. Supp. 490, 494 (E.D. Mich. 1981). In the face of conflicting lower court decisions, the Sixth Circuit expressly ducked the issue in *Davis*, 739 F.2d at 1065.

[238] *Stokes*, 644 F.2d at 785.

[239] Stone v. Fossil Oil & Gas, 657 F. Supp. 1449, 1458 (D.N.M. 1987) (aiding and abetting only); *Woods*, 489 F. Supp. at 1294 (aiding and abetting only). *But see Farlow*, 666 F. Supp. at 1504 (rejecting aiding and abetting).

[240] *Collins*, 605 F.2d at 113. Actually, the court seemed to have accepted aiding and abetting liability in *Monsen*, 579 F.2d at 799; however, this holding probably did not survive *Collins*. Earlier district court opinions had rejected the conspiracy theory. Kramer v. Scientific Control Corp., 452 F. Supp. 812, 814 (E.D. Pa. 1978); *Dorfman*, 336 F. Supp. at 1092.

[241] *Barker*, 797 F.2d at 495; *see Sanders*, 619 F.2d at 1226; *Frymire*, 657 F. Supp. at 892; *Ambling*, 658 F. Supp. at 1467.

[242] Accepting aiding and abetting and conspiracy theories: *In re* Seagate Technology Sec. Litig., [1985-1986 Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,435 (N.D. Cal. Dec. 23, 1985); *Eagle Computer*, [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 92,019; *Itel*, 89 F.R.D. at 117; deBruin v. Andromeda Broadcasting Sys., Inc., 465 F. Supp. 1276, 1280 (D. Nev. 1979). Rejecting aiding and abetting: Ius v. Butcher, [Current Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,501, at 97,211 (D. Or. 1987); Parquitex Partners v. Registered Fin. Planning Serv., Inc., [1987 Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,255, at 96,226 (D. Or. 1987); Lazar v. Sadlier, 622 F. Supp. 1248, 1252 (C.D. Cal. 1985); *Ahern*, 611 F. Supp. at 1486; *Diasonics*, 599 F. Supp. at 458; Hokama v. E.F. Hutton & Co., 566 F. Supp. 636, 642 (C.D. Cal. 1983); *In re* Equity Funding Corp. of Am. Sec. Litig., 416 F. Supp. 161, 181 (C.D. Cal. 1976). Rejecting both aiding and abetting and conspiracy: *McFarland*, 493 F. Supp. at 647.

Inc.,[243] and the Eighth in *Stokes v. Lokken*.[244]

1. *Key Cases*

The most influential aiding and abetting/conspiracy case under section 12 is *In re Caesars Palace Securities Litigation*,[245] in which a broad range of defendants were sued under section 12(2). In a lengthy discussion, the court traced the "gradual but progressive expansion of [the 'seller'] concept,"[246] citing such cases as *Cady v. Murphy*[247] (broker/agent), *Wonneman v. Stratford Securities Co.*,[248] (participation), and *Hill York Corp. v. American International Franchises, Inc.*[249] (proximate cause/substantial factor). In light of the remedial purposes of the 1933 Act,[250] the court favorably examined criminal precedents for aiding and abetting and for conspiracy liability.[251] It concluded:

> Our interpretation of § 12(2) is, we believe, wholly consistent with these [remedial] ends. Persons participating directly in a violation of the statute will not escape liability under the express language of the Act; similarly those persons who are aware of and, to some lesser degree, participate in a violation of the securities laws and either enter into an agreement with or give assistance to the primary wrongdoers should not be permitted to escape the imposition of liability.[252]

Examples of collateral participants caught inside the aiding and abetting net include a bank that encouraged an issuer to continue to finance itself through a note program although it

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[243] 810 F.2d 336, 344 (2d Cir. 1987).

[244] 644 F.2d 779, 785 (8th Cir. 1981). *Stokes* is sufficiently muddled that two later district court cases in the circuit have rejected aiding and abetting. Antinore v. Alexander & Alexander Serv., Inc., 597 F. Supp. 1353 (D. Minn. 1984); Briggs v. Sterner, 529 F. Supp. 1155, 1173 (S.D. Iowa 1981).

[245] 360 F. Supp. 366 (S.D.N.Y. 1973).

[246] *Id.* at 379.

[247] 113 F.2d at 988.

[248] [1957-1961 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 90,923 (S.D.N.Y. 1959).

[249] 448 F.2d at 692-93.

[250] *Caesars Palace*, 360 F. Supp. at 382 (citing SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963)).

[251] *Id.* at 381.

[252] *Id.* at 383.

knew the issuer was in a precarious financial position;[253] officers and directors of an issuer, some of whom personally sold shares during the class period;[254] and a bank and its appraisers who allegedly inflated the value of the property securing the issuer's bonds.[255]

2. *Accountants' Cases*

A review of accountants' cases under section 12 reveals that application of the aiding and abetting and the conspiracy theories provides a mixed bag for the defendants. These theories widen the scope of potential defendants, bringing in accountants and other collateral participants who might not be defined as "sellers" under other theories. Unlike the other theories, however, *scienter* is a requirement for liability under both aiding and abetting and conspiracy.[256]

In *Ackerman v. Clinical Data, Inc.*,[257] the defendant accounting firm Arthur Andersen allegedly over-valued an issuer's assets with knowledge and intent to assist in the issuer's initial public offering. Such an allegation was held sufficient to withstand a motion to dismiss the plaintiffs' aiding and abetting claim.[258] A similar claim and a similar result met Price Waterhouse (PW) in *Lorber v. Beebe*[259] although the court stressed that to succeed

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[253] *Monsen*, 579 F.2d at 801. While banks that engage in only routine commercial loans will not be deemed sellers, Wright v. Schock, 571 F. Supp. 642, 657-58 (N.D. Cal. 1983), banks which cross over the line to develop a special stake in the plaintiff's investment may be held liable either as sellers or as aiders and abettors. *E.g.*, White v. ITC Corp., [Current Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,105, at 95,436 (D. Or. Aug. 5, 1986); *see Gas Reclamation, Inc.*, 659 F. Supp. at 499 (bank which allegedly reviewed and approved a private placement document containing numerous misrepresentations and continued to finance the issuer after learning of claims of fraud was held potentially liable under § 12).

[254] *In re* Seagate Technology Sec. Litig., [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,435 at 92,655-3, 92,658 (N.D. Cal. Dec. 23, 1985).

[255] *Frankel*, 537 F. Supp. at 744-45.

[256] *Klein*, 602 F. Supp. at 842; *Itel*, 89 F.R.D. at 117; *Stern*, 429 F. Supp. at 824.

[257] [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,207 (S.D.N.Y. July 8, 1985).

[258] *Id.* at 91,569

[259] 407 F. Supp. 279, 288 (S.D.N.Y. 1975). Proof of scienter is always important, as shown in *deBruin*, 465 F. Supp. at 1280. In *deBruin*, the defendant accountant did much accounting work for the issuer and even rustled up a couple of investors, including the plaintiff. However, the court did not have to decide whether defendant's actions

at trial the plaintiff would have to establish that PW acted with scienter.[260]

In *Sandusky Land, Ltd. v. Uniplan Groups, Inc.*,[261] the plaintiffs alleged that the firm of Haskins & Sells (H&S) knowingly issued a misleading written opinion regarding the flow-through tax benefits supposedly stemming from the issuer's plan.[262] H&S moved to dismiss the section 12(2) claim, but the court denied the motion, stating:

> The defendant contends it did no more than serve as a general accountant and thus is not liable. The Court finds nothing incorrect in this statement of law, provided the facts as developed established this position. The plaintiffs contend that the facts as presented will show that Haskins and Sells served as more than a general accountant, that it facilitated the sale by issuing opinions which it knew or should have known were false or misleading and that in so doing it aided and abetted the defendant [issuer].
>
> To some extent *any* accounting firm issuing an opinion as to a particular partnership, corporation or company facilitates securities transactions. . . . Yet not all accountants will be found to be sellers under § 12(2). It is only when the evidence establishes that there was an *aiding* or *abetting* of the seller of the security or offeror of an investment that liability will be found to exist.[263]

The *Sandusky* court refused to state exactly what facts might be required to demonstrate aiding and abetting,[264] but in *Vogel v. Trahan*[265] allegations that Price Waterhouse rendered advice re-

constituted the type of "substantial participation" necessary to aiding and abetting theory application because the plaintiff could not prove the accountant acted with scienter. *Id.* at 1281.

[260] *Lorber*, 407 F. Supp at 288.

[261] 400 F. Supp. 440 (N.D. Ohio 1975).

[262] *Id.* at 442.

[263] *Id.* at 444 (emphasis in original).

[264] *Id.*

[265] [1979-1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,303 (E.D. Pa. Jan. 11, 1980). The court in *In re* Home-Stake Prod. Co. Sec. Litig., 76 F.R.D. 351, 374-75 (N.D. Okla. 1977), appears to have approved aiding and abetting and conspiracy counts against accountants and attorneys under § 12(2). However, the opinion gives little indication that these professional defendants had done anything more than what such professionals normally do.

garding the availability and the legality of intangible drilling cost tax deductions adequately stated an aiding and abetting claim.[266]

3. *Arguments Against Aiding and Abetting and Conspiracy Liability*

Because of the broad reach of aiding and abetting and of conspiracy theories, accountant defendants under section 12 will wish to argue against their application, and several strong arguments exist. The law should be fairly fluid in this area because circuit courts have offered little authority on the matter.

Starting with matters of statutory construction, all arguments made in favor of the strict privity approach[267] are relevant here. Although the arguments in favor of strict privity do not absolutely rule out the application of aiding and abetting and conspiracy as supplemental theories, they strongly weigh against their adoption.

Aiding and abetting[268] and conspiracy theories are not mentioned in the Securities Act of 1933. To introduce these theories as a method of expanding section 12 liability acts as the "ultimate bootstrap."[269] Arguably, the original expansion of the "seller" concept under section 12 occurred precisely because the courts believed they had no basis for invoking aiding and abetting and conspiracy theories. However, after expansionary theories such as participant and proximate cause/substantial factor became accepted, the *Caesars Palace* court accepted aiding and abetting and conspiracy because:

> it would be nothing more than an exercise in semantic hair-splitting for this Court to attempt to delineate a legally cognizable distinction between those categories of persons who have previously been exposed to liability under § 12(2) and those persons charged with aiding and abetting and conspiring in the violation of § 12(2).[270]

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[266] *Vogel*, [1979-1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 97,083.

[267] *See supra* notes 111-42 and accompanying text.

[268] *See supra* note 230 and accompanying text.

[269] O'Hara, *supra* note 49, at 985. It has also been called "backdoor" aiding and abetting in the § 12(2) context. Phillips & Hanback, *Remedies for Defrauded Purchasers*, 12 SEC. REG. REV. 943, 957 (1979).

[270] *Caesars Palace*, 360 F. Supp. at 380.

In considering congressional intent, a strong argument can be made for rejection of the aiding and abetting and the conspiracy theories in the section 12 context. In 1959, Congress considered but did not pass a proposed amendment which would have expressly prohibited the aiding and abetting of a securities law violation.[271] The SEC Staff Memorandum that accompanied the Senate Bill clearly stated that the proposed amendment was intended only to prohibit aiding and abetting for purposes of SEC civil and administrative proceedings, and was not intended to extend civil liability.[272]

Some courts have rejected the aiding and abetting theory on grounds that its scienter requirement merely duplicates the elements necessary for recovery under section 10(b).[273] To the extent that these theories become duplicative, our discussion may be merely academic. However, to the extent that the two modes of recovery differ, use of the aiding and abetting theory appears to violate the notion that collateral theories should not be used to evade the procedural restrictions of other sections.[274] To allow aiding and abetting recovery under section 12 would circumvent the reliance requirement of section 10(b) of the 1934 Act because the former has no such requirement and the latter does (at least under some circumstances).[275] The point becomes even clearer when section 11 enters the analysis. Allowing aiding and abetting recovery under section 12 will create liability for section 11 defendants, even when the allegedly false statements have been made outside the registration statement.[276] Also, it will allow recovery against entities not listed as potential defendants in

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[271] *See Securities Acts Amendments, 1959: Hearings on H.R. 5001 Before a Subcommittee of the House Committee on Interstate and Foreign Commerce*, 86th Cong., 1st Sess. 89, 103 (1959).

[272] *SEC Legislation: Hearings on S. 1178-1182 Before a Subcommittee of the Senate Committee on Banking and Currency*, 86th Cong., 1st Sess. 288 (1959), *cited in* Schneider, *supra* note 49, at 253 n.110.

[273] *E.g.*, Beck, 621 F. Supp. at 1562; Hackett v. Village Court Assocs., 602 F. Supp. 856, 859 (E.D. Wis. 1985).

[274] *See Ernst & Ernst*, 425 U.S. at 210.

[275] *Compare* Currie v. Cayman Resources Corp., 835 F.2d 780, 782 (11th Cir. 1988) (reliance is not a § 12 element) *with Rifkin*, 574 F.2d at 261-63 (reliance is a § 10(b) element under some circumstances).

[276] Schneider, *supra* note 49, at 256.

section 11, such as the banks in *Monsen v. Consolidated Dressed Beef Co.*[277] and *Frankel v. Wyllie & Thornhill, Inc.*[278]

The end result is that an express primary liability section (such as section 12) is extended to include a secondary level of liability which, unlike the primary level, contains a scienter requirement. Such a result is unusual, to say the least.[279] Supplementary theories, such as aiding and abetting and conspiracy, complement a "violation" section such as section 10(b) much better than they do express liability provisions such as sections 11 or 12.[280]

CONCLUSION

No good reason exists to justify section 12 becoming a substantial part of the avalanche of legal theories inundating accountants in recent years. Bringing collateral participants in a securities offering, such as accountants, within the definition of section 12 "seller" by using the "proximate cause/substantial factor" approach seems difficult to justify theoretically and creates inconsistent and unpredictable results, as the case law illustrates. Using the aiding and abetting and the conspiracy approaches to loop the lasso of section 12 liability around non-"sellers" is similarly unjustified but at least has the virtue of requiring that a plaintiff demonstrate a defendant's scienter before liability is imposed.

Section 12 is aimed at "sellers" of securities, making the strict privity approach to defining "seller" the most logical and defensible. Under this strict privity approach, accountants and other collateral participants have little to fear from section 12.

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[277] 579 F.2d 793 (3d Cir. 1978).

[278] 537 F. Supp. 730 (W.D. Va. 1982).

[279] Comment, *Seller Liability, supra* note 49, at 400.

[280] *Hagert*, 520 F. Supp. at 1034; *Briggs*, 529 F. Supp. at 1173 (quoting 3 A. BROMBERG, SECURITIES FRAUD AND COMMODITIES FRAUD, § 8.5(315) (1986)).