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Will The 1st Circ. Reverse Its Tambone Decision?

Law360, New York (May 22, 2009) -- In December 2008, the First Circuit sent shockwaves through the securities industry and defense bar with its decision in SEC v. Tambone, 550 F.3d 106 (1st Cir. 2008).

In a 2-1 decision the court held that two executives at a mutual fund's underwriters could be primarily liable under Section 10(b) and Rule 10b-5(b) for false statements involving the funds' market timing practices made in the funds' prospectus based only on the executives' implicit statement to investors that they believed that the statements made in the prospectus were complete and accurate.

Relying on its view of the unique role played by underwriters in marketing mutual funds, the court held that it was not necessary for a defendant to personally make a false statement for liability to attach under Rule 10b-5(b).

At a minimum, the decision reverses a strong trend, beginning with the Supreme Court's 1994 decision in Central Bank, of judicial limitations on (or elimination of) 10b-5 liability for those not personally making the representations that form the basis for a 10b-5 claim.

In a pointed dissent, Judge Selya labeled the panel's majority decision a "radical departure" from settled law and a "path-breaking step" "involving nothing less than a rewriting of [Rule 10b-5(b)]" that "stretches the concept of primary liability beyond which I believe the Supreme Court would countenance and allows the SEC to cast a wider net than any court has ever thought possible."

The decision's initial impact was dampened somewhat by the court's subsequent order concerning the defendants' motion for rehearing en banc.

Citing the complexity of the case and the seriousness of the issues presented, the court solicited the views of the parties and of amici on the issue of whether primary liability under Rule 10b-5 extends, on the basis of an implied statement theory, to underwriters

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of a mutual fund who are responsible for and direct the firm's efforts to sell shares of the fund and who, in connection with these sales efforts, disseminate prospectuses containing material statements that they knew, or were reckless in not knowing, were false.

The court also directed the parties and amici to address three "related considerations:"

1) Would the panel holding also apply to private party suits and, if so, what principles, if any, would limit the reach of that holding in private party actions under Rule 10b-5?

2) Assuming the SEC has stated a claim for aiding and abetting liability, what purpose is served by expanding the scope of primary liability under Rule 10b-5?

3) What factual information about the role of underwriters in the securities industry is pertinent to the issue?

The court's order suggests that a rehearing en banc will be granted, and the questions on which it invited comment may signal a desire to cabin the decision' s reach by limiting it to underwriters and the particular facts and circumstances of the case.

At the very least the court's order indicates that the concerns raised by Judge Selya in his dissent (and strongly echoed elsewhere) are being given careful consideration.

In their rehearing briefs, defendant-appellees James Tambone and Robert Hussey frontally attack the panel's attempt to distinguish its decision from the Supreme Court's seminal decision Central Bank of Denver NA v. First Interstate Bank of Denver NA, 511 U.S. 164 (1994).

Central Bank rejected secondary "aiding and abetting" liability in private actions under Rule 10b-5. The defendant-appellees noted that the overwhelming majority of Circuit courts of Appeals have applied Central Bank to limit Rule 10b-5(b)'s prohibition on making a misstatement to defendants who actually spoke, wrote or created the alleged misrepresentation at issue.

Picking up on the majority panel's theme, the SEC emphasized the basis for imposing "special obligations" on underwriters, relying heavily on a series of pre-Central Bank cases holding that by participating in an offering, underwriters make implied representations about the securities.

In response to one of the court's specific questions, the SEC acknowledged that the court's holding would apply not only in suits brought by the SEC, but also in private party suits as well.

The commission downplayed the significance of this broader application by arguing that it seemed unlikely that a private party would seek relief against an underwriter in a

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public offering under Rule 10b-5, given the availability of causes of action and remedies under Sections 11 and 12(a)(2) of the Securities Act.

Also, while steadfastly denying that Tambone expanded the scope of primary liability under Rule 10b-5, the SEC noted the importance of having available primary liability for implied statements because proving aiding and abetting liability can be more onerous than proving a primary violation.

While recklessness will suffice for finding primary liability under Rule 10b-5, aiding and abetting liability requires the plaintiff to establish "knowing" and "substantial" assistance.

The SEC further argued that it is important for deterrence purposes that it be able to seek a finding of primary liability (as opposed to secondary liability) and that courts, in exercising their discretion in awarding remedies, would tend to view aiding and abetting as less serious than a primary violation and consequently award the commission less relief.

Perhaps more interesting than anything that either the SEC or the defendant-appellees had to say in their rehearing papers were the arguments advanced by the eight amici who submitted briefs.

Weighing in on the panel's decision and the three specific questions posited were: the American Institute of Certified Public Accountants (AICPA), the Center for Audit Quality, the Securities Industry and Financial Markets Association (SIFMA), the Chamber of Commerce of the United States of America, the New England Legal Foundation and Associated Industries of Massachusetts, all of which supported the rehearing petition, and the National Association of Shareholder and Consumer Attorneys (NASCAT), who opposed rehearing.

All of the amici agreed that the court's holding would apply equally to 10b-5 claims brought by private plaintiffs. The Association of Shareholder and Consumer Attorneys largely echoed the SEC's arguments in favor of letting the decision stand. The seven amici supporting rehearing, however, all raised new arguments.

The AICPA warned that "despite the panel's emphasis on underwriters' 'unique' role in the process of issuing securities, its reasoning threatens to embroil auditors and other secondary actors — a prospect that the SEC welcomes, but that Congress precluded."

Fearing that auditors will be targeted by plaintiffs for their "deep pockets," the group predicted that the decision will be used by private plaintiffs to attack auditors based on errors made in a company's quarterly financial statements, which typically are unaudited but reviewed by auditors, or render auditors liable to shareholders for advice given to clients on the potential accounting ramifications of business decisions.

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This expanded potential liability would have “a chilling effect on the performance by auditors of services that are beneficial to companies and their shareholders,” according to the AICPA.

The Center for Audit Quality expressed similar concerns, arguing that the panel’s decision “would increase uncertainty about the application of the securities laws, thereby raising costs for public companies and reducing shareholder returns.”

Added uncertainty was also at the forefront of SIFMA’s reasons why the decision should be reversed. The industry group cited questions left unanswered by the panel’s decision concerning how the standards for pleading and proof of the elements of a claim — for example, materiality, scienter, reliance, and loss causation — would apply in practice to an implied misstatement.

The group also noted that the decision created uncertainty as to when the duties of an institutional underwriter devolve upon an underwriter’s employees, and which market participants other than underwriters should be deemed to have made implied statements in light of their roles in the securities industry.

The Chamber of Commerce sounded this theme as well in its amicus brief, arguing that the panel’s “implied statement” theory of liability “might reach lawyers or investor relations personnel who pass on materials, auditors (with respect to the unaudited sections of an issuer’s financial statements), proxy solicitors and others who (like underwriters) lack a fiduciary duty to make disclosures to an issuer’s shareholders, but who have various statutory duties or assertedly ‘central roles’ in the securities markets.”

Such a regime would, in the chamber’s view, “contradict Central Bank’s admonition that § 10(b) is ‘an area that demands certainty and predictability.’”

The amici’s concerns that Tambone will precipitate a flood of new Rule 10b-5 claims against an expanded universe of potential defendants is more than just speculation; it is already happening.

Since the First Circuit handed down its decision last December, the SEC has seized upon the decision to argue in different cases across the country that market participants other than underwriters should be held primarily liable under Rule 10b-5 in circumstances where before Tambone it would not have occurred to anyone that primary liability was even a possibility.

For example, in SEC v. Uberuaga, No. 08-CV-0625, 2009 WL 569842 (S.D. Cal. Feb. 20, 2009) the SEC cited Tambone in support of its claim against auditor who reviewed materials incorporated into offering materials.

Similarly, the SEC relied on Tambone in SEC v. Sabhlok, No. 3:08-CV-04238 (N.D. Cal. Jan. 16, 2009) in arguing that a controller should be liable for options backdating. The

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SEC has already demonstrated that it will aggressively use Tambone’s expanded concept of Rule 10b-5 liability in a variety of contexts against a variety of actors.

Briefing on the rehearing en banc issue currently is slated to be completed June 1. A decision by the First Circuit should follow soon after. A number of factors favor rehearing, not the least among them the considerable uncertainty and confusion raised by the panel’s majority decision as to its reach and significance.

The First Circuit has a track record of being careful and conservative in its approach to securities claims, and Tambone’s unexpected expansion of liability under Rule 10b-5 appears to be an aberration. The court is likely at a minimum to reign in the panel’s sweeping decision, if not reverse it outright.

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