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Aiding and Abetting Liability under Securities Exchange Act Section 10(b) and Sec Rule 10b-5: The Infusion of a Sliding-Scale, Flexible-Factor Analysis

Jeffrey Farley Keller

AIDING AND ABETTING LIABILITY UNDER SECURITIES EXCHANGE ACT SECTION 10(b) AND SEC RULE 10b-5: THE INFUSION OF A SLIDING-SCALE, FLEXIBLE-FACTOR ANALYSIS

I. INTRODUCTION

In the area of securities law, the antifraud provisions of Securities Exchange Act of 1934 section 10(b)[1] and Securities and Exchange Commission Rule 10b-5[2] have constituted about one-third of all securities actions brought.[3] Plaintiffs have concentrated, not merely on the primary

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1. Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j(b) (1982) [hereinafter "section 10(b)"]. Section 10(b) states that it is unlawful for any person:

> To use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [Securities and Exchange] Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Id.

2. 17 C.F.R. § 240.10b-5 (1988) [hereinafter "Rule 10b-5"]. Rule 10b-5 states:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange:
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with purchase or sale of any security.

Id.

Section 10(b) and Rule 10b-5 do not explicitly provide for a private right of action; however, the courts have inferred a civil cause of action. *See, e.g.*, Kardon v. National Gypsum Co., 73 F. Supp. 798, 800, 802-03 (E.D. Pa.), *supplemented by*, 83 F. Supp. 613 (E.D. Pa. 1947). The Supreme Court first acknowledged a civil right of action for section 10(b) and Rule 10b-5 in Superintendent of Ins. v. Bankers Life & Casualty Co., 404 U.S. 6, 13 n.9 (1971). Recently, in Herman & MacLean v. Huddleston, 459 U.S. 375 (1983), the Supreme Court acknowledged that "a private right of action under § 10(b) of the 1934 Act and Rule 10b-5 has been consistently recognized for more than 35 years. The existence of this implied remedy is simply beyond peradventure." *Id.* at 380. See also Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976), where the Supreme Court stated that "the existence of a private cause of action for violations of the statute and the Rule is now well established." *Id.* at 196. *See* Note, *Liability for Aiding and Abetting Violations of Rule 10b-5: The Recklessness Standard in Civil Damage Actions*, TEX. L. REV. 1087, 1088 (1984).

3. *See generally* Fischel, *Secondary Liability Under Section 10(b) of the Securities Act of*

violator, but increasingly on those who aid and abet[4] in the illegal conduct.[5] Aiding and abetting has been found to be a violation of section 10(b) and Rule 10b-5[6] giving rise to liability equal to that of the primary perpetrators.[7]

The theory of aiding and abetting liability has its roots in both criminal[8] and tort common-law[9] doctrines. However, the *Restatement of*

1934, 69 CALIF. L. REV. 80, 83-88 (1981); Note, *The Recognition of Aiding and Abetting in the Federal Securities Laws*, 23 HOUS. L. REV. 821, 823 (1986).

4. *See, e.g.*, 5 A. JACOBS, LITIGATION AND PRACTICE UNDER RULE 10b-5 § 40.02, at 2-391 (1987) ("A person aids or abets another person . . . when he knows or is reckless in not knowing that a violation is occurring and he renders substantial assistance either by remaining silent or inactive when he has a duty to speak or act, or by taking affirmative action."). Stated in general terms, "aider and abettor liability is a theory of secondary liability intended to apply to 'fringe' parties who knowingly assist in a primary violation." Hokama v. E.F. Hutton & Co., 566 F. Supp. 636, 642 (C.D. Cal. 1983).

5. It is important to differentiate between primary and secondary liability. Professor Fischel has defined secondary liability under the securities laws as a term:

> used to describe the judicially implied civil liability which has been imposed on defendants who have not themselves been held to have violated the express prohibition of the securities statute at issue, but who have some relationship with the primary wrongdoer. Courts have imposed this type of liability on defendants who aid and abet, conspire with, or employ a defendant who does violate the express prohibition of a statute.

Fischel, *supra* note 3, at 80 n.4.

6. *Id.* at 82-83. *See* A. JACOBS, *supra* note 4, § 40.02, at 2-391.

7. *See, e.g.*, Brennan v. Midwestern United Life Ins. Co., 417 F.2d 147, 151-55 (7th Cir. 1969) (aiders and abettors are jointly and severally liable with the primary violator), *cert. denied*, 397 U.S. 989 (1970); Kalinski v. Hunt Int'l Resources Corp., 609 F. Supp. 649, 652-53 (N.D. Ill. 1985) (aider-abettor not liable for damages prior to assistance); Morgan v. Prudential Funds, Inc., 446 F. Supp. 628, 633 (S.D.N.Y. 1978) (aider-abettor cannot be liable for damages if joined after all damages incurred); *In re* Home-Stake Prod. Co. Sec. Litig., 76 F.R.D. 351, 374-75 (N.D. Okla. 1977) (aiders and abettors who join part way into a scheme are jointly and severally liable for damages accruing prior to enlistment); *see also* Kerbs v. Fall River Indus., Inc., 502 F.2d 731, 740 (10th Cir. 1974); Felts v. National Account Sys. Ass'n, Inc., 469 F. Supp. 54, 68 (N.D. Miss. 1978); Sprayregen v. Livingston Oil Co., 295 F. Supp. 1376, 1378 (S.D.N.Y. 1968); Pettit v. American Stock Exch., 217 F. Supp. 21, 28 (S.D.N.Y. 1963).

The *Restatement (Second) of Torts* provides that "[i]f the encouragement or assistance is a substantial factor in causing the resulting tort, the one giving it is himself a tortfeasor and is responsible for the consequences of the other's acts." RESTATEMENT (SECOND) OF TORTS § 836 (1977).

8. Aiding and abetting is a concept of criminal law where " '[i]n order to aid and abet another to commit a crime it is necessary that a defendant "in some sort associate himself with the venture, that he participate in it as in something that he wishes to bring about, that he seek by his action to make it succeed." ' " Franke v. Midwestern Okla. Dev. Auth., 428 F. Supp. 719, 725 (W.D. Okla. 1976) (quoting Nye & Nissen v. United States, 336 U.S. 613, 619 (1949), quoting United States v. Peoni, 100 F.2d 401, 402 (2nd Cir. 1949)); *see also* 18 U.S.C. § 2(a) (1986) (anyone who "aids, abets, counsels, commands, induces or procures [the perpetration of a crime], is punishable as a principal"); CAL. PENAL CODE § 31 (West 1989) ("All persons concerned in the commission of a crime . . . whether they directly commit the act constituting

Torts provides the most notable articulation of the concept by stating that:

> For harm resulting to a third person from tortious conduct of another, a person is liable if he (a) orders or induces such conduct, knowing of the conditions under which the act is done or intending the consequences which ensue, or (b) knows that the other's conduct constitutes a breach of duty and gives substantial assistance or encouragement to the other so to conduct himself, or (c) gives substantial assistance to the other in accomplishing a tortious result and his own conduct, separately considered, constitutes a breach of duty to the third person.[10]

Recently, the concept of aiding and abetting has become increasingly important in federal securities violations, since in many cases, the primary violator is either insolvent or bankrupt and plaintiff's counsel may bring actions against anyone who might have the ability to pay the judgment, no matter how remotely connected with the transaction.[11] Generally, Rule 10b-5 actions for aiding and abetting liability are brought against banks, for they tend to have "deep pockets,"[12] and attorneys and brokers because they generally carry liability insurance.[13] As

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the offense, or aid and abet in its commission, or, not being present, have advised and encouraged its commission . . . are principals . . . .").

9. *See infra* note 10.

10. RESTATEMENT (SECOND) OF TORTS § 876(b) (1977). The first case to rely upon the *Restatement* was Brennan v. Midwestern United Life Ins. Co., 259 F. Supp. 673, 680 (N.D. Ind. 1966), *aff'd*, 417 F.2d 147 (7th Cir. 1969), *cert. denied*, 397 U. S. 989 (1970). Section 876 of the *Restatement of Torts*, cited in *Brennan*, is substantially the same as the *Restatement (Second) of Torts* § 876. *See infra* notes 35-46 and accompanying text for a discussion of *Brennan*.

11. *See, e.g.*, Landy v. Federal Deposit Ins. Corp., 486 F.2d 139 (3d Cir. 1973), *cert. denied*, 416 U.S. 960 (1974). In *Landy*, the plaintiff sued the primary violator, who stole money from the bank (causing plaintiff injury as a shareholder), as well as the following: (1) twelve brokerage firms and sixteen individuals associated with those firms, (2) the New York Stock Exchange, (3) the National State Bank of Elizabeth, New Jersey, (4) a firm of certified public accountants, (5) the Federal Reserve Bank of New York, and (6) the Federal Deposit Insurance Corporation. *Id.* at 143-44. "This is a relatively modest example of people being sued in federal securities law cases." R. JENNINGS & H. MARSH, SECURITIES REGULATIONS CASES & MATERIALS, 1139 n.3 (5th ed. 1982).

Aiders and abettors are also jointly and severally liable with the primary violator; thus, they may make good "deep pocket" defendants. *See infra* note 12; *see also Kerbs*, 502 F.2d at 740.

12. A "deep pocket" defendant is a party commonly referred to in many areas of the law as a defendant who has a vast reserve of readily available cash which could be used to satisfy a judgment.

13. Due to the vast number of Rule 10b-5 actions filed against banks, lawyers, and accountants, liability insurance coverage has become prohibitively expensive and generally unavailable. *See* Wall St. J., Aug. 15, 1986, § 7, col. 1 (pac. coast ed.).

plaintiffs continue to endeavor to expand the pool of potential defendants, courts too have been receptive to the acceptance of aiding and abetting common-law principles in securities laws.[14]

The Supreme Court of the United States has never validated the use of aiding and abetting as a proper theory of liability under Rule 10b-5; thus, there may be doubt as to its continued viability.[15] However, the lower courts appear to have established the legitimacy of aiding and abetting liability.[16] They have recognized that Rule 10b-5's basic principles would be circumvented if defendants who knowingly assist in securities violations were free to do so with impunity.[17]

Generally, the United States Courts of Appeals concur that the plaintiff must prove three basic elements to establish liability based on an aiding and abetting theory under Rule 10b-5.[18] The general test requires:

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14. *See, e.g.*, Admiralty Fund v. Hugh Johnson & Co., 677 F.2d 1301, 1311-13 (9th Cir. 1982); *Brennan*, 259 F. Supp. at 680 (aiding and abetting recognized as a supplement to secondary liability).

15. *See generally* Fischel, *supra* note 3. In *Hochfelder*, 424 U.S. at 185-86, an aiding and abetting case, the Supreme Court neither invalidated nor addressed the validity of such a cause of action. However, the continued vitality of aiding and abetting liability has been questioned by a string of Ninth Circuit cases, known collectively as the *Seaboard* case. *See* (1) Admiralty Fund v. Hugh Johnson & Co., 677 F.2d 1301, 1311 n.12 (9th Cir. 1982); (2) Admiralty Fund v. Tabor, 677 F.2d 1297, 1299 n.2 (9th Cir. 1982); and (3) Admiralty Fund v. Jones, 677 F.2d 1289, 1294 nn.3-4 (9th Cir. 1982). Notwithstanding, the Ninth Circuit in Harmsen v. Smith, 693 F.2d 932 (9th Cir. 1982), *cert. denied*, 464 U.S. 822 (1983), in response to the *Seaboard* cases, pronounced that "[i]n the absence of any authority or compelling reason for holding that aider and abettor liability no longer exists, we hold that it remains a viable part of securities regulation." *Id.* at 944; *see also* Congregation of the Passion v. Kidder Peabody & Co., Inc., 800 F.2d 177, 183 (7th Cir. 1986) ("This court has nevertheless held that such a cause of action [aiding and abetting liability under section 10(b) and Rule 10b-5] may be maintained under certain circumstances." (citing Baker v. Henderson, Franklin, Starnes & Holt, 797 F.2d 490 (7th Cir. 1986)); SEC v. Holschuh, 694 F.2d 130, 140 n.15 (7th Cir. 1982).

16. The notion that liability exists for aiding and abetting violations under Rule 10b-5 has been accepted by every court of appeals that has faced the issue. *See, e.g.*, Schneberger v. Wheeler, 859 F.2d 1477 (11th Cir. 1988); Cleary v. Perfectune, Inc., 700 F.2d 774 (1st Cir. 1983); Harmsen v. Smith, 693 F.2d 932 (9th Cir. 1982), *cert. denied*, 464 U.S. 822 (1983); Stokes v. Lokken, 644 F.2d 779 (8th Cir. 1981); Investors Research Corp. v. SEC, 628 F.2d 168 (D.C. Cir.), *cert. denied*, 449 U.S. 919 (1980); Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 38 (2d Cir.), *cert. denied*, 439 U.S. 1039 (1978); Monsen v. Consolidated Dressed Beef Co., 579 F.2d 793 (3d Cir.), *cert. denied*, 439 U.S. 930 (1978); Sundstrand Corp. v. Sun Chem. Corp., 553 F.2d 1033 (7th Cir. 1977), *cert. denied*, 434 U.S. 875 (1977); Woodward v. Metro Bank, 522 F.2d 84 (5th Cir. 1975); SEC v. Coffey, 493 F.2d 1304 (6th Cir. 1974), *cert. denied*, 420 U.S. 908 (1975); Pargas, Inc. v. Empire Gas Corp., 423 F. Supp. 199 (D. Md.), *aff'd*, 546 F.2d 25 (4th Cir. 1976).

17. *See, e.g.*, Aldrich v. New York Stock Exch., 446 F. Supp. 348, 355 n.5 (S.D.N.Y. 1977).

18. *See, e.g.*, *Investors Research Corp.*, 628 F.2d at 178; IIT, An Int'l. Inv. Trust v. Cornfeld, 619 F.2d 909, 922 (2d Cir. 1980); *Monsen*, 579 F.2d at 799; Rochez Brothers, Inc. v. Rhoades, 527 F.2d 880, 886 (3d Cir. 1975); *Woodward*, 522 F.2d at 93, 97; *see also* Ruder,

(1) a violation of Rule 10b-5 by a primary party; (2) that the aider and abettor had knowledge of the violation; and (3) that the aider and abettor substantially assisted in the fulfillment of the primary violation.[19] While the courts now generally agree on all aspects of the primary violation required, there is a lack of accord as to how the second and third prongs of the test are to be applied.[20] Since the Supreme Court has failed to give the courts direction and the courts of appeals have not agreed on how the elements are to be applied, the lower courts have been without the necessary guidance to decide Rule 10b-5 cases.

This Comment undertakes to study the courts of appeals' inconclusive statements and analyses by examining the historical development of aiding and abetting liability, the respective formulations of each element of the existing test and policy considerations behind the securities laws.[21] The remaining sections advance a model for a "sliding-scale, flexible-factor" analysis.[22] In proposing this model, the Comment endeavors to balance Rule 10b-5's goal of protecting the investor with the need to have vigorous securities markets[23] and to formulate a consistent but fair approach to liability under Rule 10b-5 cases. In the process, this Comment sets out several relevant factors courts should apply to reconcile the respective relationships between the knowledge and assistance prongs, and suggests some possible results of certain combinations of factors.

Multiple Defendants in Securities Law Fraud Cases: Aiding and Abetting, Conspiracy, In Pari Delicto, *Indemnification, and Contribution,* 120 U. PA. L. REV. 597, 627-38 (1972).

19. See *infra* note 53 for a slightly different articulation of the elements required to find aiding and abetting liability.

20. See *infra* notes 67-82 and accompanying text for a discussion of the knowledge prong and see *infra* notes 78-111 and accompanying text for a discussion of the substantial assistance prong.

21. *See supra* notes 24-111 and accompanying text.

22. *See infra* notes 112-205 and accompanying text.

23. In Herpich v. Wallace, 430 F.2d 792 (5th Cir. 1970), the Fifth Circuit set out the proper concerns in determining standards of relief. The court stated:

> In the formulation of relief, however, concepts of fairness to those who are expected to govern their conduct under Rule 10b-5 should be considered. Protection for investors is of primary importance, but it must be kept in mind that the nation's welfare depends upon the maintenance of a viable, vigorous business community. Considered alone, the sweeping language of Rule 10b-5 creates an almost completely undefined liability. All that the rule requires for its violation is that someone 'do something bad,' in connection with a purchase or sale of securities. Without further delineation, civil liability is formless, and the area of proscribed activity could become so great that the beneficial aspects of the rule would not warrant the proscription. In recognition of this problem, courts have sought to construct workable limits to liability under section 10(b) and Rule 10b-5 which will accommodate the interests of investors, the business community, and the public generally.

Id. at 804-05 (citations omitted); *accord Woodward,* 522 F.2d at 91.

II. PURPOSE AND EVOLUTION OF AIDING AND ABETTING LIABILITY IN THE RULE 10b-5 CONTEXT

A. Design of the Securities Laws

It is well recognized that Congress had broad remedial goals in passing the securities laws and providing civil remedies.[24] These laws were enacted in response to the inequitable distribution of relevant information in the free-wheeling 1920s and the depression years of the early 1930s.[25] To alleviate the problem, the securities laws were designed to encourage the dissemination of complete and accurate information helpful to the investing public and to combat fraudulent interstate transactions.[26]

At the heart of the securities laws is the goal of protecting the investing public.[27] Consistent with this goal, the Supreme Court of the United States has maintained that courts interpret federal securities laws, such as Rule 10b-5, "not technically and restrictively, but flexibly to effectuate [their] remedial purposes."[28]

In achieving investor protection, the Supreme Court has repeatedly identified that one of the major objectives of federal securities regulation is "to achieve a high standard of business ethics . . . in every facet of the

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24. *See* Pinter v. Dahl, 108 S. Ct. 2063, 2081-82 (1988) ("the Court has recognized that Congress had 'broad remedial goals' in enacting the securities laws and providing civil remedies"); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 200 (1976) (realizing Congress' broad remedial goals in enacting express civil remedies).

25. *See generally* Silver v. New York State Stock Exch., 373 U.S. 341, 366 (1963), *overruled on other grounds*, Northwest Wholesale Stationers, Inc., v. Pacific Stationary & Printing Co., 472 U.S. 84 (1985).

26. *See* R. JENNINGS & H. MARSH, *supra* note 11, at 78; *see also* Radzanower v. Touche Ross & Co., 426 U.S. 148, 155 (1976) ("primary purpose of the Securities Exchange Act was to . . . 'provide fair and honest mechanisms for the pricing of securities to assure that dealing in securities is fair and without undue preferences or advantages among investors.' ") (quoting H.R. REP. No. 94-229, 94th Cong., 1st Sess., at 91 (1975)).

The condition of the securities markets affects the stream of new capital into private enterprise, thus affecting the nation's overall economic growth. Further, original distributions of securities are promoted by investors' confidence in the securities markets. Thus, the actual state of the markets and public opinion toward the conditions of the markets are believed to have an important bearing on the state of the overall economy. *See* REPORT OF SPECIAL STUDY OF SECURITIES MARKETS, H.R. Doc. No. 95, 88th Cong., 1st Sess. 10 (1963); A. JACOBS, *supra* note 4, § 6.01-05, at 1-185-96.

27. "The 1934 Act was intended principally to protect investors against manipulation of stock prices through regulation of transactions . . . and to impose regular reporting requirements." *Hochfelder*, 425 U.S. at 194-95; *see* S. REP. No. 792, 73d Cong., 2d Sess. 1-5 (1934); H.R. REP. No. 85, 73d Cong., 1st Sess. 1-5 (1933); A. JACOBS, *supra* note 4, § 6.06 at 1-196-202.

28. Affiliated Ute Citizens v. United States, 406 U.S. 128, 151 (1972) (citing SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 195 (1963); *see also* Superintendent of Ins. v. Bankers Life & Casualty Co., 404 U.S. 6, 12 (1971).

securities industry."[29] Accordingly, it is essential to an honest and efficient market that there be a "justifiable expectation of the securities marketplace that all investors trading on impersonal exchanges have relatively equal access to material information,"[30] and "be subject to identical market risks."[31] At the same time, however, there must be a balancing of the investor's need for equal knowledge against preserving an environment conducive to the pursuit of business and professional ventures necessary for a robust securities industry.[32] In close cases, the balance should "be resolved in favor of those the statute is designed to protect," the public investor.[33]

In sum, the securities laws were designed to set a minimum standard of behavior for those who participate in the securities industry.[34] Thus, courts should apply the securities laws flexibly to effectuate the goals and objectives of Rule 10b-5 to create a market free of manipulation and one of high investor confidence. This next section examines how courts have

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29. United States v. Nafalin, 441 U.S. 768, 775 (1979) (quoting SEC v. Capital Gains Research Bureau Inc., 375 U.S. 180, 186-87 (1963)). "One of the principal policies behind the Act is to protect investors against fraud and, through the imposition of specified civil liabilities, to promote ethical standards of honesty and fair dealing." Zobrist v. Coal-X, Inc., 708 F.2d 1511, 1522 (10th Cir. 1983) (Halloway, J., concurring and dissenting); *cf. Hochfelder*, 425 U.S. at 195.

In passing the first major piece of legislation on securities regulation, the Securities Act of 1933, Congress explicitly proclaimed the essential purpose of the regulation of the markets:

> The purpose of this bill is to protect the investing public and honest business . . . . The aim is to prevent further exploitation of the public by the sale of unsound, fraudulent, and worthless securities through misrepresentation; to place adequate and true information before the investor; to protect honest enterprise, seeking capital by honest presentation, against the competition afforded by dishonest securities offered to the public through crooked promotion; to restore the confidence of the prospective investor in his ability to select sound securities; to bring in to productive channels of industry and development capital which has grown timid to the point of hoarding; and to aid in providing employment and restoring buying and consumer power.

S. REP. No. 47, 73d Cong., 1st Sess. 1 (1933).

30. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir.), *cert. denied*, 394 U.S. 976 (1968). It is generally assumed that the price of a security reflects all relevant information available to the market at that time. Thus when the market is manipulated through misrepresentations or omissions, the information accessible on the market is not indicative of the securities' value. Those who have the honest and complete information can use it to their advantage at the expense of the investing public. R. POSNER & K. SCOTT, ECONOMICS OF CORPORATION LAW AND SECURITIES REGULATION 156, 157-58 (1980).

31. *Texas Gulf Sulphur*, 401 F.2d at 852.

32. *See* TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 448-49 (1976).

33. *Id.*

34. In *Hochfelder*, 425 U.S. at 200, the Supreme Court acknowledged that "Congress did create [in some circumstances] express liability predicated upon a failure to exercise reasonable care." Furthermore, in SEC v. Kasser, 548 F.2d 109 (3d Cir.), *cert. denied*, 431 U.S. 938 (1977), the Third Circuit stated that "the antifraud provisions of the 1933 and 1934 Acts were designed to insure high standards of conduct in securities transactions within this country in addition to protecting domestic markets and investors from the effects of fraud." *Id.* at 116.

applied these policies to develop a cause of action against those who aid others in securities violations.

B. Historical Development of Aiding and Abetting Liability

Building on the Supreme Court's appreciation for the need to be flexible in developing civil remedies, lower courts have developed a cause of action for aiding and abetting liability.[35] Aiding and abetting liability for civil damages is not explicitly mentioned in section 10(b) or Rule 10b-5.[36] In the leading early case of *Brennan v. Midwestern United Life Insurance Co.*,[37] decided in 1966, the district court implied such a cause of action.[38] In *Brennan*, the plaintiff claimed that the defendant aided and abetted a broker who allegedly violated section 10(b) and Rule 10b-5.[39] The complaint contended that in order to receive an economic benefit from the artificial mark-up on its stock caused by the fraud, the alleged aider-abettor allowed and encouraged the fraudulent scheme to con-

35. *See infra* notes 16, 52 and 71.

36. *See supra* notes 6-7 and 15-16 and accompanying text. Although aiding and abetting liability is not mentioned in Rule 10b-5, it is considered elsewhere in the federal securities statutes. The term is in the Investment Advisers Act of 1940 (Investment Act), 15 U.S.C. § 80b (1982); *see, e.g., id.* at § 80b-9(e) (SEC given power to enjoin violations of Securities Exchange Act by aiders and abettors); *id.* at § 80b-3(e)(5) (SEC given power to hold liable any investment advisor who "has willfully aided, abetted, counseled, commanded, induced, or procured" violation of securities laws). Both the Securities Act and the Securities Exchange Act deal with concepts that impose liability on those who do not participate directly in a violation of the federal securities law. *See, e.g.*, Securities Act of 1933, 15 U.S.C. § 77o (1976); Securities Exchange Act of 1934, 15 U.S.C. § 78j (1976). In 1959 Congress contemplated but rejected an amendment to the securities acts which included aiding and abetting as a direct violation of the acts. *See Hearing Before a Subcommittee of the Senate Committee on Banking and Currency*, 86th Cong., 1st Sess. 275-76 (1959) (due to industry fears, SEC agreed to clarify the bill to provide that no civil liability was intended); *Hearings Before the House Committee on Interstate and Foreign Commerce*, 86th Cong., 1st Sess. 93, 103 (1959). For a further discussion of this amendment, see *supra* note 41; *see also* S. REP. No. 1757, 86th Cong., 2d Sess. 9 (1960) (purpose of bill was to strengthen and clarify the injunctive power of SEC). However, the House Committee Report on Insider Trading Sanctions Act of 1984 approved the judicial application of the aider and abettor concept. Insider Trading Sanctions Act of 1983, H.R. REP. No. 355, 98th Cong., 1st Sess. 10 (1983). *See* Ruder, *Civil Liability Under Rule 10b-5: Judicial Revision or Legislative Intent?*, NW. U.L. REV. 627, 642-60 (1963); Ferrara & Sanger, *Derivative Liability in Securities Law: Controlling Persons Liability, Respondeat Superior, and Aiding and Abetting*, 16 SEC. L. REV. 97, 112 (1984); Note, *supra* note 3, at 1091.

37. 259 F. Supp. 673 (N.D. Ind. 1966), *aff'd*, 417 F.2d 147 (7th Cir. 1969), *cert. denied*, 397 U.S. 989 (1970).

38. *Id.* at 680-81. The doctrine of aiding and abetting was first introduced into the federal securities laws in SEC disciplinary proceedings and injunction actions. *See, e.g.*, SEC v. Scott Taylor & Co., 183 F. Supp. 904, 909 n.12 (S.D.N.Y. 1959); Southeastern Sec. Corp., 29 S.E.C. 609, 615 (1949); Burley & Co., 23 S.E.C. 461, 464 (1946); Bruns, Nordeman & Co., 40 S.E.C. 652, 659, 662 (1961). *See generally* A. JACOBS, *supra* note 4, at 2-391-92.

39. *Brennan*, 259 F. Supp. at 675.

tinue.[40] Implying the cause of action, the district court acknowledged that both the statute and legislative history were devoid of any express indication that Congress intended to hold aiders and abettors liable for the violations of others.[41] Nevertheless, the court reasoned that by not expressly excluding liability for activity that aids and abets a violation of the securities laws, Congress implied that a private remedy could be formulated by the court:[42]

> [A] statute with a broad and remedial purpose such as the Securities Exchange Act of 1934 should not easily be rendered impotent to deal with new and unique situations within the scope of the evils intended to be eliminated. In the absence of a clear legislative expression to the contrary, the statute must be flexibly applied so as to implement its policies and purposes. In this regard, it cannot be said that civil liability for damages, so well established under the Securities Exchange Act of 1934, may never under any circumstances be imposed upon persons who do no more than aid and abet a violation of Section 10(b) and Rule 10b-5.[43]

In establishing the breadth of liability for aiding and abetting, the court relied upon section 876 of the *Restatement of Torts*.[44] The court asserted that "general principles of law should continue to guide the development of federal common law remedies under Section 10(b) and Rule 10b-5."[45] Thus, the court viewed aiding and abetting liability as a "logical and natural complement" to implying a private right under section 10(b) and Rule 10b-5, which have their roots in tort principles.[46]

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40. *Id.* The defendant attacked the complaint's sufficiency on the ground that there was no congressional intent to impose liability for those who aid and abet in violation of section 10(b) and Rule 10b-5. *Id.* at 679-80.

41. *Id.* at 677-78. The defendant argued that Congress' failure to amend section 10(b) and Rule 10b-5 to allow for explicit liability for aiders and abettors represented a congressional intent not to incorporate these remote parties. *Id.* at 678. *See, e.g.*, H.R. 5001, 86th. Cong., 1st Sess. (1959) and S. 1178 (1959), which would have made it unlawful "for any person to aid, abet, counsel, command, induce or procure the violation of any provisions of [the Securities Act of 1933]." *Securities Acts Amendments, 1959, Hearings on H.R. 5001 Before a Subcomm. of the House Comm. on Interstate and Foreign Commerce*, 86th Cong., 1st Sess. 103 (1959). In *SEC Legislation: Hearings on S. 1178-1182 Before a Subcomm. of the Senate Comm. on Banking and Currency*, 86th Cong., 1st Sess. 288 (1959), the SEC agreed that clarification of the bill to read "no civil liability is intended," was necessary due to the industry fears that "private litigants . . . may find this section a vehicle by which to sue aiders and abettors." *Id.*

42. *Brennan*, 259 F. Supp. at 680.

43. *Id.* at 680-81.

44. *Id.* at 680 (citing RESTATEMENT OF TORTS § 876 (1939)). *See supra* note 10 and accompanying text.

45. *Brennan*, 259 F. Supp. at 680.

46. *Id.* The judicial implication of a private right of action under Section 10(b) and Rule

Building upon *Brennan*, the Third Circuit in *Landy v. Federal Deposit Insurance Corp.*,[47] articulated a three-part test that must be satisfied for a finding of aiding and abetting liability. The court must conclude "(1) that an independent wrong exist[s]; (2) that the aider or abettor kn[e]w of that wrong's existence; and (3) that substantial assistance [was] given in effecting that wrong."[48] Although, the plaintiff in *Landy* was unable to prove all the elements,[49] courts have used *Landy*'s formulation as the foundation in developing the modern tests. The next two sections of this Comment address the prevailing requirements for aiding and abetting liability and the lower courts' interpretations of these standards.

III. PREVAILING STANDARDS FOR AIDING AND ABETTING LIABILITY UNDER SECTION 10(b) AND RULE 10b-5

Traditionally, most courts have agreed that three requirements must be satisfied in order to impose aider-abettor liability under Rule 10b-5.[50] In *SEC v. Coffey*,[51] the Seventh Circuit pronounced the most frequently cited articulation of the three-part test: "[I]f [1] some other person has committed a securities law violation, if [2] the accused party had general awareness that his role was part of an overall activity that is improper, and if [3] the accused aider-abettor knowingly and substantially assisted in the violation,"[52] then that accused party shall be liable for aiding and

10b-5 was founded upon tort principles. *See supra* note 10 and Kardon v. National Gypsum Co., 69 F. Supp. 512 (E.D. Pa. 1946).

47. 468 F.2d 139 (3d Cir. 1973), *cert. denied*, 416 U.S. 960 (1974). See *infra* text notes 48-49, 54-61 and 80-82 and accompanying text for an analysis of *Landy*.

48. *Landy*, 468 F.2d at 162-63. In *Landy*, the shareholders of an insolvent bank brought an action against numerous defendants for damages from losses caused by the bank president's misuse of bank funds in speculative securities transactions. *Id.* at 143-44. See *supra* note 11 for a list of the defendants.

49. *Landy*, 468 F.2d at 163. The plaintiff in *Landy* was unable to prove the requisite assistance to justify aiding and abetting liability. *Id.* "In this case, it would appear that the amount of assistance given by the brokers was minor." *Id.* See *infra* notes 80-82 and accompanying text for the standards of assistance required by *Landy*.

50. *See, e.g.*, Cleary v. Perfectune, Inc., 700 F.2d 774, 777 (1st Cir. 1983); Woodward v. Metro Bank, 522 F.2d 84, 94-95 (5th Cir. 1975). *See also supra* note 19 and accompanying text.

51. 439 F.2d 1304 (6th Cir. 1974), *cert. denied*, 420 U.S. 908 (1975).

52. *Id.* at 1316. The *Coffey* court, in setting forth the three-part test, qualified its statement by saying it was not "set[ting] forth an inflexible definition of aiding and abetting [liability]." *Id.* at 1316. However, most courts have followed *Coffey*'s lead. For other courts following the *Coffey* formulation, see *Woodward*, 522 F.2d at 94-96; Metge v. Baehler, 762 F.2d 621, 624 (8th Cir. 1985), *cert. denied*, 974 U.S. 1057 (1986); Bloor v. Carro, Spanbock, Londin, Rodman & Fass, 754 F.2d 57, 62 (2d Cir. 1985); SEC v. Washington County Util. Dist., 676 F.2d 218, 224 (6th Cir. 1982); Decker v. Massey-Ferguson, Ltd., 681 F.2d 111, 119 (2d Cir. 1982); Walck v. American Stock Exch., Inc., 687 F.2d 778, 790-91 (3d Cir. 1982), *cert. denied*, 461 U.S. 942 (1983); Admiralty Fund v. Hugh Johnson & Co., 677 F.2d 1301,

abetting. However, some courts relying upon the same general elements have pronounced a slightly different formulation.[53] Thus, it is necessary to examine each element of the tripartite test to determine how different courts have viewed each element.

A. Violation By Primary Party or Independent Wrong

In the pioneering case of *Landy v. Federal Deposit Insurance Corp.*,[54] the Third Circuit required that the primary party need only commit "an independent wrong," rather than actually violate the securities laws.[55] The majority of courts, however, have required that a party other than the aider-abettor have violated a securities law.[56] For example, in *Woodward v. Metro Bank of Dallas*,[57] the Fifth Circuit criticized the *Landy* standard as failing to make the necessary connection to the securities laws.[58] The court theorized that a standard not requiring a connection to the securities laws such as *Landy*'s would result in liability for one who knew of the existence of a wrong, although he was unaware of his role in the scheme.[59] Capitulating to the criticism, the Third Cir-

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1311 (9th Cir. 1982); Admiralty Fund v. Jones, 677 F.2d 1289, 1295-96 (9th Cir. 1982); Admiralty Fund v. Tabor, 677 F.2d 1297, 1299 (9th Cir. 1982); Harmsen v. Smith, 693 F.2d 932, 943 (9th Cir. 1982), *cert. denied*, 464 U.S. 822 (1983); Stokes v. Lokken, 644 F.2d 779, 782-83 (8th Cir. 1981); IIT, An Int'l. Inv. Trust v. Cornfeld, 619 F.2d 909, 922, 925, 927 (2d Cir. 1980); Monsen v. Consolidated Dressed Beef Co., 579 F.2d 793, 799 (3d Cir.), *cert. denied*, 439 U.S. 930 (1978); Rolf v. Blyth, Eastman Dillion & Co., 570 F.2d 38, 47 (2d Cir.), *cert. denied*, 439 U.S. 1039 (1978); Rochez Bros. v. Rhoades, 527 F.2d 880, 886 (3d Cir. 1975); Landy v. Federal Deposit Ins. Corp., 486 F.2d 139, 162-63 (3d Cir. 1973), *cert. denied*, 416 U.S. 960 (1974).

53. Although there is a general consensus as to the elements required to find liability, courts have disagreed about the specific requirements. The three-part test has sometimes been articulated slightly differently requiring:

> (1) the existence of a securities law violation by the primary (as opposed to the aiding and abetting) party; (2) 'knowledge' of this violation on the part of the aider and abettor; and (3) 'substantial assistance' by the aider and abettor in the achievement of the primary violation.

IIT, 619 F.2d at 922.

54. 486 F.2d 139 (3d Cir. 1973), *cert. denied*, 416 U.S. 960 (1974).

55. *Id.* at 162.

56. *See supra* note 50.

57. 522 F.2d 84 (5th Cir. 1975).

58. *Id.* at 95.

59. *Id.* In *Woodward*, the court recognized that it was essential that "[a] remote party not only be aware of his role, but he should also know when and to what degree he is furthering the fraud." *Woodward*, 522 F.2d at 95.

Landy also omitted the knowing requirement for the substantial assistance prong. This formulation risks the danger of over-inclusiveness and seems to lose sight of the required connection to the securities laws. See *infra* notes 80-82 criticizing *Landy*'s formulation of the substantial assistance prong.

cuit in *Monsen v. Consolidated Dressed Beef Co.*,[60] retreated from the standard set forth in *Landy* and identified the first requirement as "a commission of a wrongful act—an underlying securities violation."[61] A consensus among the circuits is now established that there must be a primary violation of the securities laws for the first prong of the test to be satisfied.[62]

Courts find a primary violation when a plaintiff proves that the primary actor violated all the elements of a private civil action under section 10(b) and Rule 10b-5.[63] In addition, determining who is the primary violator is usually not very difficult.[64] However, some courts require that the plaintiff specifically identify the primary violator so that the court can determine if those who allegedly assisted in the wrongful conduct may even be exposed to possible aiding and abetting liability.[65] In sum, an aider-abettor cannot be held liable without first establishing a primary violation.[66] Once a primary violation is established the remaining two elements of aiding and abetting liability also must be fulfilled.

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60. 579 F.2d 793 (3d Cir.), *cert. denied*, 439 U.S. 930 (1978).

61. *Id.* at 799.

62. *See supra* note 50 and accompanying text.

63. *See* Ruder, *supra* note 18, at 600. The elements of a modern section 10(b) and Rule 10b-5 claim are: (1) a material misrepresentation or omission; (2) made in connection with the purchase or sale of a security; (3) upon which the purchaser or seller reasonably relied; (4) which causes a loss; and (5) scienter on the part of the person who made the misrepresentation or omission. *See, e.g.*, Santa Fe Indus., Inc. v. Green, 430 U.S. 462 (1977) (manipulative or deceptive requirement); TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976) (materiality); Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1975) (scienter); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975) (in connection with the purchase or sale); Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972) (reliance). See Reliance Ins. Co. v. Eisner & Lubin, 685 F. Supp. 449, 453 (D.N.J. 1988) (citing Peil v. Speiser, 806 F.2d 1154 (3d Cir. 1986)); Sachs, *The Relevance of Tort Law Doctrines to Rule 10b-5: Should Careless Plaintiffs Be Denied Recovery*, 71 CORNELL L. REV. 96, 99-100 (1985), for a similar list of the requisite elements of a Rule 10b-5 securities fraud cause of action.

64. *See, e.g.*, Chemical Bank v. Arthur Anderson & Co., 552 F. Supp. 439, 454-55 (S.D.N.Y. 1982), *rev'd on other grounds*, 726 F.2d 930 (2d Cir.), *cert. denied*, 469 U.S. 884 (1984). *Cf.* Klein v. Computer Devices, Inc., 591 F. Supp. 270, 278 (S.D.N.Y. 1984); *see also* Kaliski v. Hunt Int'l Resources Corp., 609 F. Supp. 649 (N.D. Ill. 1985) (acts constituting aiding and abetting must have occurred before completion of allegedly fraudulent transaction, although one *can* be held *primarily* liable for damages incurred as direct result of "lulling activities"); Sheftelman v. N. L. Industries, Inc., Fed. Sec. L. Rep. (CCH) ¶ 92,040, at 91,190 (D.N.J. Feb. 1, 1985) (necessity "to prove a securities *violation* . . . in no way indicates that the primary *violator* need be named as a defendant" (emphasis in original)).

65. *See* Ruder, *supra* note 18, at 600. *See also* Employers Ins. v. Paine, Webber, Jackson & Curtis, Inc., Fed. Sec. L. Rep. (CCH) ¶ 98,792, at 94,065 (S.D.N.Y. Aug. 23, 1982) (it is not necessary to sue the principal violator).

66. It should be noted that some courts will dismiss an aiding and abetting complaint where the plaintiff fails to adequately allege the existence of a primary securities law violation. *See, e.g.*, Morgan v. Prudential Funds, Inc., Fed. Sec. L. Rep. (CCH) ¶96,345, at 93,172 (S.D.N.Y. Feb. 28, 1978).

B. General Awareness or Knowledge

The courts now agree that the primary violation must be of the securities laws; however, there is discord over what level of knowledge[67] the aider-abettor must possess to be held liable.[68] At a minimum, the aider-abettor must have scienter, "a mental state embracing intent to deceive, manipulate or defraud."[69] The courts of appeals conflict over the level of knowledge that comprises scienter.

The most notable and followed articulation of the knowledge requirement provides that the aider and abettor have a "general awareness that his role was part of an overall activity that is improper."[70] How-

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67. Knowledge is a critical element in proving aiding and abetting liability: "[W]ithout this requirement financial institutions, brokerage houses, and other such organizations would be virtual insurers of their customers against security law violations. Culpability of some sort is necessary to justify punishment of a secondary actor and mere unknowing participation in another's violation is an improper predicate to liability." Monsen v. Consolidated Dressed Beef Co., 579 F.2d 793, 799 (3d Cir.), *cert. denied*, 439 U.S. 930 (1978). In Investors Research Corp. v. SEC, 628 F.2d 168, 178 (D.C. Cir.), *cert. denied*, 449 U.S. 919 (1980), the court stated that "[t]he awareness of wrong-doing requirement for aiding and abetting liability is designed to insure that innocent, incidental participants in transactions later found to be illegal are not subjected to harsh, civil, criminal, or administrative penalties." *See also* Sennott v. Rodman & Renshaw, 474 F.2d 32, 39 (7th Cir.), *cert. denied*, 414 U.S. 926 (1973); Lowenschuss v. Kane, 367 F. Supp. 911, 914 (S.D.N.Y. 1973), *rev'd*, 520 F.2d 255 (2d Cir. 1975); A. JACOBS, *supra* note 4, at 2-398-99; Ruder, *supra* note 18, at 638.

68. *Compare* SEC v. Coffey, 493 F.2d 1304, 1316 (6th Cir. 1974), *cert. denied*, 420 U.S. 908 (1975) (general awareness that the aider-abettor's role was part of an overall activity that was improper) *and* Woodward v. Metro Bank, 522 F.2d 84, 95 (5th Cir. 1975) *with* Rochez Bros. v. Rhoades, 527 F.2d 880, 886 (3d Cir. 1975) ("It has been held that liability for aiding and abetting may be found on less than actual knowledge of the illegal activity.... How much or how little knowledge would seem to vary with the facts of each case. Courts that have considered the knowledge requirement have differed somewhat on its scope.").

69. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 194 n.12 (1976). In *Hochfelder*, the Supreme Court declined to resolve whether recklessness satisfies the scienter requirement; however, it did note that "[i]n certain areas of the law recklessness is considered to be a form of intentional conduct for purposes of imposing liability for some act." *Id.*

In Baker v. Henderson, Franklin, Starnes & Holt, 797 F.2d 490 (7th Cir. 1986), the court stated:

> We take *Ernst & Ernst*, together with *Herman & MacLean*, as establishing that aiders, abettors, conspirators, and the like may be liable only if they have the same mental state required for primary liability. No one may be held liable without proof that he acted with scienter otherwise the premise of *Herman & MacLean* will not be satisfied.

Id. at 495 (citations omitted) (emphasis in original).

70. *Coffey*, 493 F.2d at 1316. In Woods v. Barnett Bank, 765 F.2d 1004 (11th Cir. 1985), the court in discussing the "general awareness" element noted that:

> [T]he surrounding circumstances and expectations of the parties were critical, because knowledge of the existence of a violation must usually be inferred. . . . For instance, stronger evidence of complicity would be required for the alleged aider and abettor who conducts what appears to be a transaction in the ordinary course of his business.... [K]nowledge could be shown by circumstantial evidence, or by reckless

ever, other courts have turned to a "sliding-scale" of knowledge to determine aiding and abetting liability.[71] For example, in *Woodward v. Metro Bank of Dallas*,[72] the Fifth Circuit noted that factors such as whether the transaction was of an ordinary nature or atypical,[73] the type of security[74] and whether there was any special duty present,[75] determined the degree

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conduct, but . . . 'the proof must demonstrate actual awareness of the party's role in the fraudulent scheme.'

Id. at 1009-10 (citations omitted).

In *Woodward*, 522 F.2d at 95, following the reasoning of *Coffey*, the court attacked the *Landy* court's decision that required that the accused merely have knowledge of the primary violation. The *Woodward* court recognized that "[o]ne could know of the existence of a 'wrong' without being aware of his role in the scheme, and it is the participation that is at issue." *Id.* However, the Third Circuit still allows liability for aider-abettors who do not have knowledge of their role in the violation, but have consciously involved themselves in the impropriety or constructive notice of intended impropriety, which may be demonstrated by the aider-abettor's general awareness of his role as part of an overall activity that is improper. *Monsen*, 579 F.2d at 79; *see also* Gould v. American-Hawaiian S.S. Co., 535 F.2d 761 (3d Cir. 1976).

71. For example, the Fifth Circuit in *Woodward* stated that the knowledge requirement is not a static standard but a flexible, sliding-scale requirement, in that "[k]nowledge may be shown by circumstantial evidence, or by reckless conduct, but the proof must demonstrate actual awareness of the party's role in the fraudulent scheme . . . [where] the surrounding circumstances and expectations of the parties are critical." *Woodward*, 522 F.2d at 95-96; *see also* Barker v. Henderson, Franklin, Starnes & Holt, 797 F.2d 490, 497 (7th Cir. 1986) ("[T]he plaintiff must support the inference [of scienter or knowledge] with some reason to conclude that the defendant has thrown in his lot with the primary violators. . . . If the plaintiff does not have direct evidence of scienter, the court should ask whether the fraud (or cover-up) was in the interest of the [aiding and abetting] defendants. Did they gain by bilking the buyers of the securities?"); Monsen v. Consolidated Dressed Beef Co., Inc., 579 F.2d at 799 (" 'the requirement of knowledge may be less strict where the alleged aider and abettor derives benefits from the wrongdoing' ") (quoting Gould v. American-Hawaiian S.S. Co., 535 F.2d 761, 780 (3d Cir. 1975)); SEC v. Washington County Util. Dist., 676 F.2d 218, 226 (6th Cir. 1982) ("if the alleged aider and abettor conducts a transaction of an extraordinary nature, less evidence of his complicity is necessary"); Rochez Bros. v. Rhoades, 527 F.2d 880, 886 (3d Cir. 1975) ("It has been held that liability for aiding and abetting may be found on less than actual knowledge of the illegal activity. . . . How much or little knowledge would seem to vary with the facts of each case.").

72. 522 F.2d 84 (5th Cir. 1975). Although *Woodward* was decided prior to *Hochfelder*, the analysis is still relevant since the court in *Woodward* stressed the requirement that scienter was a component of knowledge, *id.* at 95-96, and thus is consistent with *Hochfelder*, 425 U.S. at 194.

73. *Woodward*, 522 F.2d at 95 ("If the alleged aider and abettor conducts what appears to be a transaction in the ordinary course of his business, more evidence of his complicity is essential."). *See also* Bane v. Sigmundr Exploration Corp., 848 F.2d 579, 582 (5th Cir. 1988). See *infra* notes 146-55 and accompanying text for a discussion on the importance of a duty in determining aiding and abetting liability.

74. *Woodward*, 522 F.2d at 95. *See infra* note 154 and accompanying text.

75. *Woodward*, 522 F.2d at 95-96 ("Still, even for facially ordinary commercial transactions, a court may be influenced by a special duty imposed by the securities acts on the particular type of party, such as an insider, a controlling person, an accountant, or a broker."). *See infra* notes 156-65 and accompanying text. A duty to disclose may arise upon "knowing assist-

of scienter or knowledge required to hold an aider and abettor liable.[76] Still other courts have held that where a person makes representations that are foreseeably relied upon, a standard lower than that of actual knowledge will fulfill the scienter or knowledge requirement.[77]

C. *Substantial Assistance: Affirmative Acts, Inaction, Nondisclosure and Causation*

Under the third prong of the aiding and abetting test, courts have generally agreed that the plaintiff must prove that the aider-abettor has "substantially assisted" in the primary violator's securities violation.[78] In applying this element, most courts have held that ingrained in this requirement is the concept of knowledge.[79] Although in *Landy v. Fed-*

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ance of or . . . upon consent and approval[ ] of fraudulent practices by a director," Strong v. France, 478 F.2d 747, 752 (9th Cir. 1973) or upon some special obligations imposed by law. *Woodward*, 522 F.2d at 97 n.28.

In many circuits, the issue of whether the aider-abettor owed the plaintiff a duty is important. Many circuits will not apply a recklessness standard without first establishing the existence of a duty. *See, e.g.*, Armstrong v. McAlpin, 699 F.2d 79, 91 (2d Cir. 1983); Rolf v. Blyth, Eastman Dillion & Co., 570 F.2d 38, 44 (2d Cir.), *cert. denied*, 439 U.S. 1039 (1978). Generally, as a matter of proof, recklessness is easier to prove than actual knowledge. Thus, plaintiffs have stretched the dimensions of traditional duties in order to decrease the degree of culpability necessary to hold an aider-abettor liable. *See also*, *Woodward*, 522 F.2d at 97; Mishkin v. Peat, Marwick, Mitchell & Co., 658 F. Supp. 271, 273 (S.D.N.Y. 1987) ("[T]he existence and nature of the regulatory system under which brokerage firms operate warrants the application of a recklessness standard in this case.").

76. In *Woodward*, the court stated that:

> Generally speaking, though, the securities acts do not impose strict liability upon all who come in contact with a security. The postman who mails a fraudulent letter is not covered by the [Securities Exchange] Act, nor is the company that manufactured the paper on which the violating documents are printed.

Woodward, 522 F.2d at 96.

" '[T]he clue to liability is some sort of knowledge.' " *Id.* (quoting A. BROMBERG, SECURITIES LAW: FRAUD § 8.5, at 582 (1974)).

77. *See, e.g.*, *Woods*, 765 F.2d at 1011 ("Several courts have applied a recklessness standard to alleged aiders and abettors who have issued statements or certifications foreseeably relied upon by investors, reasoning that a duty to disclose arises under such circumstances."). *See infra* notes 164-65 and accompanying text.

78. *See* Cleary v. Perfectune, Inc., 700 F.2d 774, 777 (1st Cir. 1983); Harmsen v. Smith, 693 F.2d 932, 943 (9th Cir. 1982), *cert. denied*, 464 U.S. 822 (1983); Stokes v. Lokken, 644 F.2d 779, 784 (8th Cir. 1981); IIT, An Int'l Investment Trust v. Cornfeld, 619 F.2d 909, 922 (2d Cir. 1980); Edward J. Mawood & Co. v. SEC, 591 F.2d 588, 596 (10th Cir. 1979); Rochez Bros. v. Rhoades, 527 F.2d 880, 888-89 (3d Cir. 1975); Woodward v. Metro Bank, 522 F.2d 84, 94-97 (5th Cir. 1975); SEC v. Coffey, 493 F.2d 1304, 1316 (6th Cir. 1974), *cert. denied*, 420 U.S. 908 (1975); Landy v. Federal Deposit Ins. Corp., 486 F.2d 139, 162-63 (3d Cir. 1973), *cert. denied*, 416 U.S. 960 (1974); SEC v. International Chem. Dev., 469 F.2d 20, 27 (10th Cir. 1972); Lewis v. Midland Trust Co., 63 F.R.D. 39, 45 (S.D.N.Y. 1973).

79. It is important to note that while there are two clear articulations of the three-part test, both tests, although phrased differently, are comprised of the same elements. For example, where the court requires only a general awareness of the aider-abettor's role in the fraud, the

eral Deposit Insurance Corp.,[80] the Third Circuit for a short time took a more relaxed approach to the substantial assistance prong by not requiring "knowing assistance,"[81] the requirement of "knowingly and substantially assisted" has now been accepted by every court that has addressed the issue.[82]

Although there seems to be unanimity about the requisite formulation of the standard, there is considerable dissension among the circuits as to how to apply the substantial assistance standard. Some courts have turned to more specific devises such as section 876 of the *Restatement (Second) of Torts*[83] to determine if the aider-abettor's assistance is substantial.[84] In *Monsen v. Consolidated Dressed Beef Co.*,[85] the Third Circuit acknowledged the difficulty in determining whether conduct is substantial, and turned to the *Restatement* for guidance:

> The Restatement instructs the trier of fact to consider the following factors in determining whether a defendant's conduct constitutes substantial assistance: (1) the amount of assistance given by the defendant, (2) his presence or absence at the time of the tort, (3) his relation to the other person, and (4) his state of mind.[86]

Other circuits have formulated their own definitions of "substantial assistance."[87] However, most courts have tried to avoid such precise ar-

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court will insist on knowing and substantial assistance in the violation. *See, e.g., Coffey*, 493 F.2d at 1316. On the other hand, where the court requires knowledge of the violation on the part of the aider-abettor, the court will require only substantial assistance. *See, e.g.*, Rolf v. Blyth, Eastman Dillion & Co., 570 F.2d 38 (2d Cir.), *cert. denied*, 439 U.S. 1039 (1978). What both tests require is that the aider-abettor have some degree of knowledge of the securities violation and his or her role in rendering substantial assistance in the violation. *See* SEC v. Washington County Util. Dist., 676 F.2d 218, 227 n.18 (6th Cir. 1982).

80. 486 F.2d 139 (3d Cir. 1973), *cert. denied*, 416 U.S. 960 (1974).

81. *Id.* at 162-63. *Landy*'s omission of the "knowing" requirement for the substantial assistance aspect was criticized in *Woodward*, where the Fifth Circuit argued that the aider-abettor "must not only be aware of his role, but he should also know when and to what degree he is furthering the fraud." *Woodward*, 522 F.2d at 95. Consequently, in Monsen v. Consolidated Dressed Beef Co., 579 F.2d 793, 799-800 (3d Cir.), *cert. denied*, 439 U.S. 930 (1978), the Third Circuit adopted the "knowing and substantial assistance" formulation.

82. *See, e.g., Harmsen*, 693 F.2d at 943-44; *IIT*, 619 F.2d at 922; *Woodward*, 522 F.2d at 95; *Coffey*, 493 F.2d at 1316.

83. *See* RESTATEMENT, *supra* note 10, § 876(b).

84. *See, e.g.*, Metge v. Baehler, 762 F.2d 621, 624 (8th Cir. 1985); *Monsen*, 579 F.2d at 800; *Landy*, 486 F.2d at 163; Mendelsohn v. Capital Underwriters, Inc., 490 F. Supp. 1069, 1083-84 (N.D. Cal. 1979), *cert. denied*, 474 U.S. 1257 (1986).

85. 579 F.2d 793 (3d Cir.), *cert. denied*, 439 U.S. 930 (1978).

86. *Id.* at 800 (citing Landy v. Federal Deposit Ins. Corp., 486 F.2d 139, 162 (3d Cir. 1973), *cert. denied*, 416 U.S. 960 (1974)).

87. In Foltz v. U.S. News & World Report, Inc., 627 F. Supp. 1143 (D.D.C. 1986), the district court set out its own definition stating that " '[k]nowing assistance' means just that:

ticulations and have looked to the actual conduct itself to make ad hoc determinations of substantial assistance.[88] To these courts, substantial assistance might include "repeating . . . misrepresentations (or aiding in their preparation), by acting as [a] conduit[] to accumulate or to distribute securities, by executing transactions or investing proceeds, or perhaps by financing transactions."[89] Notwithstanding the difficulty the courts of appeals have had in defining "substantial assistance," the type of assistance and the doctrine of causation have also been a cause for disagreement among the courts.

1. Types of substantial assistance

Along with defining substantial assistance, the courts of appeals have differed on the specific types of assistance that qualify for aiding and abetting liability. Assistance may take the form of either affirmative action or silence or inaction.

a. substantial assistance through inaction and nondisclosure

At one time there was considerable argument whether an aider-abettor could be held liable for mere inaction or silence.[90] It is now well

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that the party charged (1) has knowingly undertaken certain actions, (2) which it knows will provide (3) assistance to the party committing the primary violation." *Id.* at 1163.

88. *See* A. BROMBERG, SECURITIES LAWS, § 8.5, at 515 (1974). Generally, these courts require substantial assistance to mean something beyond mere "ministerial tasks," Wright v. Schock, 571 F. Supp. 642, 663 (N.D. Cal. 1983), and to mean "more than just a little aid," Barker v. Henderson, Franklin, Starnes & Holt, 797 F.2d 490, 496 (7th Cir. 1986).

89. A. BROMBERG, *supra* note 88, § 8.5, at 515. *See also Rolf*, 570 F.2d at 48 (assistance was both active and passive).

90. In Brennan v. Midwestern United Life Ins. Co., 259 F. Supp. 673 (N.D. Ind. 1966), *aff'd*, 417 F.2d 147 (7th Cir. 1969), *cert. denied*, 397 U.S. 989 (1970), the court held that aiding and abetting liability could rest on the aider-abettor's acts or omissions. *Id.* at 677-79. In Kerbs v. Fall River Indus., 502 F.2d 731, 739-40 (10th Cir. 1974), the Tenth Circuit held that inaction alone was adequate to hold the aider-abettor liable. *See also* Edwards & Hanly v. Wells Fargo Sec. Clearance Corp., 602 F.2d 478, 484 (2d Cir. 1979), *cert. denied*, 444 U.S. 1045 (1980); Green v. Jonhop, 358 F. Supp. 413, 419 (D. Ore. 1973); Anderson v. Francis I. duPont & Co., 291 F. Supp. 705, 709 (D. Minn. 1968). However, *Landy*, 486 F.2d at 163-64 and Wessel v. Buhler, 437 F.2d 279, 283 (9th Cir. 1971) absolutely rejected the notion that aiding-abetting liability could stand on inaction alone without a duty to act. *See also* Ruder, *supra* note 18, at 644 (arguing that even with a duty to disclose, silence as a basis for liability applies only to primary liability, not to secondary liability); *Barker*, 797 F.2d at 495-97. It was not until the Fifth Circuit in *Woodward* combined the teachings of Strong v. France, 474 F.2d 747, 752 (9th Cir. 1973) (liability for inaction or silence arises "only when a duty to disclose has arisen"), and *Coffey*, 493 F.2d at 1317 (liability is to be imposed "only where it is shown that the silence of the accused aider and abettor was consciously intended to aid the securities law violation"), that the uncertainty was resolved. *Woodward*, 522 F.2d at 96-97.

established that where an aider-abettor has a duty to disclose or act,[91] silence or inaction may be sufficient to constitute substantial assistance.[92] Even in cases where implying such a duty is impossible, silence or inaction may justify a Rule 10b-5 claim when it is either joined by an affirmative act or is "consciously intended" to aid in the violation.[93] Recently, however, in *Basic, Inc. v. Levinson*,[94] the Supreme Court found that in the context of a primary violation, the failure to disclose is actionable under Rule 10b-5 only if there is a duty to disclose.[95] Thus, there is a question whether an aider-abettor may be liable for silence absent a duty to disclose.[96]

b. substantial assistance through affirmative acts

When an aider-abettor affirmatively aids the primary violator, courts have an easier time deciding aiding and abetting cases. Courts have recognized the following affirmative acts as satisfying the substan-

91. See *supra* note 75 for a discussion on what relationships will result in the implication of a duty.

92. *See, e.g., Metge*, 762 F.2d at 624-25; Armstrong v. McAlpin, 699 F.2d 79, 91 (2d Cir. 1983); *Washington County*, 676 F.2d at 226; *IIT*, 619 F.2d at 926-27; *Woodward*, 522 F.2d at 97; *Kerbs*, 502 F.2d at 739-40.

93. *See, e.g., Woodward*, 522 F.2d at 94-95, 97.

94. 108 S. Ct. 978 (1988).

95. *Id.* at 987 n.17; *see also* Dirks v. SEC, 463 U.S. 646 (1983) (if no breach of a duty by insider, then no breach by tippee); Chiarella v. United States, 445 U.S. 222 (1980) (no liability absent duty to disclose—insider has fiduciary duty to either disclose or abstain from trading).

96. There are courts that argue that the duty for a primary violator is different from that of an aider-abettor. *See, e.g., Wright*, 571 F. Supp. at 663 ("The primary violator's duty to disclose arises from his involvement with the entity whose securities are at issue and his relationship to the plaintiffs. The secondary violator's duty arises from 'knowing assistance of or participation in a fraudulent scheme.' "); H. L. Federman & Co. v. Greenberg, 405 F. Supp. 1332, 1335-36 (S.D.N.Y. 1975) (Aiding-abetting liability "is not dependent upon any affirmative duty to disclose. Rather, aiding and abetting liability may be present as a result of defendant's substantial assistance and participation in the wrong doing."); *see also* Sirota v. Solitron Devices, Inc., 673 F.2d 566, 575 (2d Cir.) (whether there is a duty, not only has an effect on the degree of scienter required to prove a violation, but decreases the level of scienter required), *cert. denied*, 459 U.S. 838 (1982).

The above reliance on a difference between a primary and secondary violator's source of a duty is illusory, for it avoids answering the question of whether there is a valid justification for allowing silence to be considered assistance or participation in a fraudulent scheme without an independent duty to disclose. *See* SECURITIES ENFORCEMENT INSTITUTE, *Liability for Insider Trading Under the Federal Securities Laws*, 235, 301 (1988). *Contra Barker*, 797 F.2d at 495-96 (which noted that in context of sections 11 and 12 of the Exchange Act, if there is no independent duty to speak, silence is not actionable under 10b-5). In *Baker*, the court noted that "knowledge of a material omission is not enough to violate the act or rule." *Id.* at 495. *See also* LHLC Corp. v. Cluett, Peabody & Co., Inc., 842 F.2d 928, 932 (7th Cir.) (in 10b-5 aiding and abetting context, absent legal duty to disclose, silence alone not enough to hold aider-abettor liable, moral culpability does not have legal consequences), *cert. denied*, 109 S. Ct. 311 (1988); First Interstate Bank v. Chapman & Cutler, 837 F.2d 775, 778 (7th Cir. 1988).

tial assistance[97] requirement: the rendering of opinion letters;[98] verification of misleading financial statements in a prospectus;[99] audits;[100] letters of recommendation;[101] functioning as conduits for circulation and collection of securities;[102] disclosing false information to securities firms and concealing debt through falsification of bank records;[103] and affirmative concealment of fraud.[104]

2. Causation: proximate or but-for requirement?

In interpreting "substantial assistance," courts have debated whether principles of causation are incorporated into the "substantial assistance" requirement.[105] Moreover, courts that have required a showing of causation have not agreed on the appropriate standard. Some courts require the assistance to be a "substantial causal factor in the perpetration of . . . [the] fraud."[106] For example, in *Woods v. Barnett*

97. The element of substantial assistance does not necessitate the act required to have been necessary to the scheme; it must merely contribute to the accomplishment of the scheme. *See* Gross v. SEC, 418 F.2d 103, 106-07 (2d Cir. 1969); *see also* A. JACOBS, *supra* note 4, § 40.02, at 2-400.

98. *See, e.g.*, SEC v. Spectrum, Ltd., 489 F.2d 535 (2d Cir. 1973).

99. Admiralty Fund v. Hugh Johnson & Co., 677 F.2d 1301 (9th Cir. 1982).

100. *See, e.g.*, *Sirota*, 673 F.2d at 569; Panzirer v. Wolf, 663 F.2d 365 (2d Cir. 1981), *cert. denied*, 458 U.S. 1107 (1982); Mishkin v. Peat, Marwick, Mitchell & Co., 658 F. Supp. 271 (S.D.N.Y. 1987).

101. *See, e.g.*, Woods v. Barnett Bank, 765 F.2d 1004, 1007 (11th Cir. 1985); Hudson v. Capital Management Int'l, Inc., 565 F. Supp. 615, 623 (N.D. Cal. 1983) (citing Anderson v. Francis I. duPont & Co., 291 F. Supp. 705, 709 (D. Minn. 1968) ("Defendants 'knowing assistance' in *Anderson* went beyond mere silence to include providing the principal defrauder with office space, endorsing his skill as a commodities trader and holding him out as a valued customer.").

102. *See, e.g.*, *Rolf*, 570 F.2d at 48.

103. Odette v. Shearson, Hammill & Co., 394 F. Supp. 946 (S.D.N.Y. 1975).

104. *See, e.g.*, *Armstrong*, 699 F.2d at 91.

105. *See, e.g.*, *Woods*, 765 F.2d at 1013 (11th Cir. 1985) (acknowledging a causal factor in substantial assistance); Mendelsohn v. Capital Underwriters, Inc., 490 F. Supp. 1069, 1088 (N.D. Cal. 1979) ("A plaintiff must show some causal connection between the culpable conduct of the aider and abettor and the plaintiff's harm."). *See generally* Bloor v. Carro, Spanbock, Londin, Rodman & Fass, 754 F.2d 57, 61-62 (2d Cir. 1985); *Metge*, 762 F.2d at 624; Edwards & Hanly v. Wells Fargo Sec. Clearance Corp., 602 F.2d 478, 484 (2d Cir. 1979), *cert. denied*, 444 U.S. 1045 (1980); *Armstrong*, 699 F.2d at 92; *Landy*, 486 F.2d at 163; *Mishkin*, 658 F. Supp. at 274; *In re* Gas Reclamation, Inc., Sec. Litig., 659 F. Supp. 493, 504 (S.D.N.Y. 1987); Connors v. Lexington Ins. Co., 666 F. Supp. 434, 445 (E.D.N.Y. 1987). *Cf.* Manufacturers Hanover Trust Co. v. Drysdale Sec. Corp., 801 F.2d 13, 20-21 (2d Cir. 1986).

106. *Rolf*, 570 F.2d at 48. In *Rolf*, the Second Circuit set out a general requirement that the aider-abettor's conduct must be "a substantial causal factor in the perpetration of . . . [the] fraud and in the culmination of . . . [plaintiff's] losses." *Id.*; *see also* Stokes v. Lokken, 644 F.2d 779 (8th Cir. 1981) (causation required in terms of participation in preparation of fraudulent brochure).

Bank,[107] the Eleventh Circuit asserted a much more relaxed standard of the causation requirement where "substantiality [in terms of assistance] is based upon all the circumstances surrounding the transaction in question."[108] On the other hand, circuits have expressed the view that the substantial assistance requirement necessitates the plaintiff proving that the aider-abettor's conduct proximately caused the plaintiff's harm.[109] For example, in *Bloor v. Carro, Spanbock, Londin, Rodman & Fass*,[110] the Second Circuit supported a strict causation requirement by stating that "aid[ing] and abet[ting] liability [will] not attach where the injury was not a direct or reasonably foreseeable result of the conduct."[111]

In sum, courts have had a difficult time determining the precise parameters of the three-part aiding and abetting test. Thus, courts have sought a flexible approach to a complicated analysis. The next section examines how courts have utilized such an approach.

V. THE SLIDING-SCALE ANALYSIS IN THE CONTEXT OF AIDING AND ABETTING LIABILITY

In the area of aiding and abetting liability there has been an evolution of an ad hoc flexible analysis, based on a sliding scale of factors. A majority of the courts of appeals and district courts have tried to add substance to the existing three-part test[112] by harmonizing the balance between knowledge and substantial assistance and the requisite proof for each.[113] These courts have employed a flexible analysis which allocates

107. 765 F.2d 1004 (11th Cir. 1985).

108. *Id.* at 1013. In *Woods*, the defendant had convinced the bank trustee to allow the transaction to progress piecemeal without a full commitment by the underwriter to purchase the entire issue. *Id.* The court stated that "[t]his act sealed the fate of the investor's money." *Id.* The court upheld the aiding and abetting liability where the aider-abettor's conduct "was a causal factor in the perpetration of the fraud and in the culmination of the investor's losses." *Id.*

109. *See, e.g., Bloor*, 754 F.2d at 61-62; *Edwards & Hanly*, 602 F.2d at 484; *Metge*, 762 F.2d at 624; *cf. First Interstate Bank*, 837 F.2d at 779 ("something more than but-for causation required").

110. 754 F.2d 57 (2d Cir. 1985).

111. *Id.* at 63.

112. *See supra* notes 120-68 and accompanying text.

113. *See, e.g.*, Zoelsch v. Arthur Andersen & Co., 824 F.2d 27, 36 (D.C. Cir. 1987) (court spoke favorably of proposition that where there is "passive failure to disclose . . . inaction cannot create liability as an aider and abettor unless the defendant recklessly violates an independent duty to act or manifests a conscious intention to further the principal violation"); Metge v. Baehler, 762 F.2d 621, 625 n.1 (8th Cir.) (leaving open question whether absent a duty, recklessness may be applied), *cert. denied*, 474 U.S. 1057 (1985); Woods v. Barnett Bank, 765 F.2d 1004, 1009-10 (11th Cir. 1985) (follows principles of *Woodward*); Monsen v. Consolidated Dressed Beef Co., 579 F.2d 793, 799 (3d Cir.) (the knowledge requirement is less where aider-abettor derives benefit from wrongdoing), *cert. denied*, 439 U.S. 930 (1978); Mishkin v.

the proper levels of knowledge and assistance necessary for liability depending upon certain factors. Some of these factors allow the courts to infer knowledge or assistance, or both.[114] In addition, the type of relationship among the parties is one factor that may justify requiring a lower level of both knowledge and assistance.[115]

A. Flexible Analysis: Sliding Scale of Knowledge and Assistance

In determining whether aiding and abetting liability exists, courts have looked to factors that ensure that strict liability is not imposed on all who merely come into contact with a security involved in a violation of the securities laws.[116] Consequently, the courts following a flexible analysis have relied upon such factors as the existence of a duty to disclose or act,[117] the type of transaction[118] and type of benefit the aider-abettor received from his or her role in the fraudulent scheme,[119] to determine the proper levels of knowledge and assistance justifying aiding and abetting liability.

In the leading case formulating a flexible analysis, *Woodward v. Metro Bank*,[120] the Fifth Circuit consolidated the disjointed pronouncement of prior case law into a comprehensive analysis. In *Woodward*, the plaintiff cosigned a promissory note to a bank pledging some of its stock as collateral against a debtor's present debts and all debts to the bank that may accrue in the future.[121] The plaintiff thought that the debtor

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Peat, Marwick, Mitchell & Co., 658 F. Supp. 271, 273 (S.D.N.Y. 1987) (cases compiled); *see also* Bane v. Sigmundr Exploration Corp., 848 F.2d 579, 581 (5th Cir. 1988); Moore v. Fenex, Inc., 809 F.2d 297, 303-04 (6th Cir.), *cert. denied*, 107 S. Ct. 3231 (1987); Cleary v. Perfectune, Inc., 700 F.2d 774, 777-79 (1st Cir. 1983); SEC v. Washington County Util. Dist., 676 F.2d 218, 226 (6th Cir. 1982); Harmsen v. Smith, 693 F.2d 932, 944 (9th Cir. 1982), *cert. denied*, 464 U.S. 822 (1983); IIT, An Int'l Inv. Trust v. Cornfeld, 619 F.2d 909, 925 (2d Cir. 1980); Investors Research Corp. v. SEC, 628 F.2d 168, 178 n.61 (D.C. Cir.), *cert. denied*, 449 U.S. 919 (1980); Woodward v. Metro Bank, 522 F.2d 84, 96-97 (5th Cir. 1975); Foltz v. U.S. News & World Report, Inc., 627 F. Supp. 1143, 1162-63 (D.D.C. 1986).

114. *See supra* notes 120-68 and accompanying text.

115. *See supra* notes 156-65 and accompanying text.

116. Secondary liability should "not sweep up all people who can be characterized as participants in or contributors to the success of the firm that issues the securities." Barker v. Henderson, Franklin, Starnes & Holt, 797 F.2d 490, 495 (7th Cir. 1986); *see also Woodward*, 522 F.2d 84, 96 (5th Cir. 1975); Hochfelder v. Midwest Stock Exch., 503 F.2d 364 (7th Cir.), *cert. denied*, 419 U.S. 875 (1974).

117. *See supra* notes 90-96 and accompanying text. The source of a duty may also come from the existence and nature of the regulatory scheme. *See infra* notes 164-65 and accompanying text.

118. *See infra* notes 146-55 and accompanying text.

119. *See infra* notes 132-45 and accompanying text.

120. 522 F.2d 84 (5th Cir. 1975).

121. *Id.* at 88.

was a corporation, but in fact the debtor was an officer of the corporation who deposited the loan proceeds into the corporate account.[122] The bank demanded payment from the plaintiff when the officer defaulted on succeeding indebtedness.[123] The plaintiff then sued the officer for securities fraud and the bank for aiding and abetting the officer.[124]

The *Woodward* court constructed a method of analysis that has proven influential:

> When it is impossible to find any duty of disclosure, an alleged aider-abettor should be found liable only if scienter of the high "conscious intent" variety can be proved. Where some special duty of disclosure exists, then liability should be possible with a lesser degree of scienter or knowledge. In a case combining silence/inaction with affirmative assistance, the degree of knowledge required should depend on how ordinary the assisting activity is in the business involved.[125]

Applying these standards to the facts, the *Woodward* court found that the defendant bank's actions neither constituted substantial assistance nor demonstrated the requisite intent to participate in the primary actor's section 10(b) and Rule 10b-5 violations.[126] The court recognized as key to its decision the fact that the bank owed no special duties to the plaintiff and that the lower court had concluded that the transaction was ordinary in nature.[127] Thus, the court held that the plaintiff did not prove her claim for Rule 10b-5 relief under an aiding and abetting theory.[128]

The flexible analysis, as introduced by *Woodward*, recognizes the relationship between standards of proof and the types of proof necessary to fulfill those standards. The subsections below demonstrate how the courts have relied on certain factors to infer the knowledge and assistance elements of aiding and abetting liability.

1. Inference of culpable conduct from the surrounding circumstances

In *Woodward*, the court's affirmation that knowledge may be inferred depending on the type of transaction, has been followed and expanded by other courts.[129] Generally, two methods have become

122. *Id.*
123. *Id.* at 88-89.
124. *Id.* at 89.
125. *Id.* at 97 (citations omitted).
126. *Id.* at 100.
127. *Id.* at 98, 100.
128. *Id.* at 98.
129. *See infra* notes 146-55 and accompanying text.

significant in circumstantially proving the scienter or knowledge requirement on the part of the aider-abettor. Courts have been willing to infer a culpable state of mind when the defendant has both substantially assisted in the fraudulent scheme and either (1) stood to gain personally from the fraudulent method or transaction;[130] or (2) engaged in a transaction that was "atypical" or lacked business justification that should have made the defendant suspicious of possible wrongdoing.[131]

a. inference of scienter or knowledge through the aider-abettor's securing of a benefit from the fraudulent transaction

In *Gould v. American-Hawaiian Steamship Co.*,[132] the Third Circuit stated that the "requirement of knowledge may be less strict where the alleged aider and abettor derives benefits from the wrongdoing."[133] If the plaintiff is unable to present direct evidence of scienter or knowledge, the court may infer the requisite culpable standard through the defendant's economic motivation to benefit himself or herself by assisting in the fraud or cover-up. To ascertain this, the court should ask whether the aider-abettor gained by participating in the bilking of the buyers of the securities.[134]

For example, the Eighth Circuit in *Metge v. Baehler*,[135] found aiding and abetting liability against a bank that had financed a corporation originally involved in the business of buying, selling and servicing real estate contracts on low-cost homes.[136] When the corporation experienced financial difficulty, the defendant bank had engaged in strategies to keep the corporation afloat.[137] The bank, although taking a substantial loss, was able to prolong the corporation's financial viability and cut its losses by receiving significant payments of principal, interest, and service charges at the expense of those who held the corporation's thrift securi-

130. *See, e.g., Barker*, 797 F.2d at 497; IIT, An Int'l Inv. Trust v. Cornfeld, 619 F.2d 909, 927 (2d Cir. 1980); Brennan v. Midwestern United Life Ins. Co., 417 F.2d 147 (7th Cir. 1969), *cert. denied*, 397 U.S. 989 (1970); Martin v. Pepsi-Cola Bottling Co., 639 F. Supp. 931 (D. Md. 1986).

131. *See, e.g., Woods*, 765 F.2d at 1012; *Brennan*, 417 F.2d 147; *In re* Gas Reclamation, Inc. Sec. Litig., 659 F. Supp. 493 (S.D.N.Y. 1987); Goldman v. McMahan, Brafman, Morgan & Co., Fed. Sec. L. Rep. (CCH) ¶ 93,354, at 96,810-11 (S.D.N.Y. 1987); Ruder, *The Private Action Against Securities Fraud Aider and Abettor: Silent and Inactive Conduct*, 29 VAND. L. REV. 1233 (1976).

132. 535 F.2d 761 (3d Cir. 1976).

133. *Id.* at 780; *see also Monsen*, 579 F.2d at 799.

134. *Barker*, 797 F.2d at 497.

135. 762 F.2d 621 (8th Cir. 1985), *cert. denied*, 474 U.S. 1057 (1986).

136. *Id.* at 623.

137. *Id.*

ties.[138] In determining whether the aider-abettor bank had knowledge of the fraudulent scheme, the court found significant the fact that the aider-abettor had benefitted from the scheme.[139] The court held that:

> [There is an] inference arising from the evidence which suggests that, although [the aider-abettor] made no profits on its loans to [the corporation] nor even recovered its outstanding funds by postponing [the corporation's] demise, it may have been able to lever itself into a more favorable position than the holders of thrift certificates.[140]

In *IIT v. Cornfeld*,[141] the Second Circuit in an opinion by Judge Friendly, considered an appeal from a dismissal of a complaint against an alleged aider-abettor.[142] Like the Third Circuit, Judge Friendly thought it critical that the "plaintiffs [did] not allege that [the alleged aider-abettor] intended by its silence to forward completion of the fraudulent transactions in the expectation of benefitting from the success of the fraud."[143] The court upheld the dismissal.[144]

The above cases demonstrate that the existence of an economic motive is an accepted way to show that the aider-abettor has thrown in his or her lot with the primary violator,[145] and usable as proof to substantiate the inference that the aider-abettor had the requisite scienter or knowledge to justify liability.

b. inference of scienter or knowledge when transaction is atypical and without business justification

In *Woods v. Barnett Bank*,[146] the Eleventh Circuit held a bank liable

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138. *Id.* at 629-30.

139. *Id.*

140. *Id.* at 630.

141. 619 F.2d 909 (2d Cir. 1980).

142. *Id.* at 927.

143. *Id.* In *Brennan*, 417 F.2d at 154-55, the court imposed liability on an issuer for not exposing a securities dealer's fraudulent activity that had increased the value of the issuer's shares. The aider-abettor had an incentive to conceal the information of the fraud, for it would benefit the aider-abettor's negotiations with a potential merger partner. *Id.* at 153. The court recognized that a motivation toward non-disclosure will establish the requisite culpability, with the required level of affirmative assistance reduced. *Id.*; *see also*, SEC v. Washington County Util. Dist., 676 F.2d 218, 227 (6th Cir. 1982) (Sixth Circuit inferred culpable state of mind where the alleged aider-abettor sought to benefit from continued cover-up of kickback scheme. The court emphasized that the aider-abettor "knew that the payments he received would continue only as long as he assisted in the passage of the authorizing resolutions.").

144. *IIT*, 619 F.2d at 927.

145. *Id.* (aiders and abettors should "associate themselves with the venture or participate in it as something they wish to bring about").

146. 765 F.2d 1004 (11th Cir. 1985).

for aiding and abetting a securities fraud.[147] One of the bank's loan officers sent a reassuring letter of recommendation to a second bank for one of the aider-abettor's clients, the primary violator, facilitating the fraudulent underwriting of a bond issue.[148] The *Woods* court supported its finding of scienter by recognizing that the issuance of a letter "containing statements of which the writer has no knowledge, without even minimal investigation to determine whether its contents are accurate, solely for the purpose of 'currying favor' with a good client, can hardly be regarded as 'the daily grist of the mill.' "[149] The court found that the behavior was both "suspicious" and "atypical" in the banking business.[150]

Additionally, district courts have been denying motions to dismiss, identifying allegations of atypical transactions and business conduct as sufficient to support inferences of scienter or knowledge.[151] For example, in *In re Gas Reclamation, Inc., Securities Litigation*,[152] the district court, in upholding the sufficiency of a complaint, recognized that "one might reasonably infer knowledge and intent from the allegations of substantial assistance . . . . Such allegations include, among others, participation in atypical financing transactions."[153]

Courts also look to the nature of the security to determine whether the transaction was atypical. The type of security reveals much about the circumstances in which the transaction is consummated. One court has succinctly set forth this concept:

> If the securities involved are shares of common stock and someone aids and abets a fraud perpetrated in their sale, the culprit would be hard pressed to argue innocence once his awareness of the general sales activity was shown. On the other hand, if the document is barely a security at all, like a loan, then other independent commercial assumptions come into play, and the al-

147. *Id.* at 1011-12.

148. *Id.*

149. *Id.* at 1012; *see* Frankel v. Wyllie & Thornhill, Inc., 537 F. Supp. 730, 744 (W.D. Va. 1982) (court held scienter may be inferred when the aider-abettor holds himself out as an expert in the field, receives compensation for services and where the transaction is not in "daily grist of the mill"); *see also Washington County Util. Dist.*, 676 F.2d at 226 ("if the alleged aider and abettor conducts a transaction of an extraordinary nature, less evidence of his complicity is necessary"); Wright v. Schock, 571 F. Supp. 642, 663 (N.D. Cal. 1983), *aff'd*, 742 F.2d 541 (9th Cir. 1984).

150. *Woods*, 765 F.2d at 1012.

151. *See, e.g., Goldman*, Fed. Sec. L. Rep., (CCH) ¶ 93,354, at 96,811. *See generally In re* Gas Reclamation, Inc. Sec. Litig., 659 F. Supp. 493 (S.D.N.Y. 1987).

152. 659 F. Supp. 493 (S.D.N.Y. 1987).

153. *Id.* at 503-04.

leged aider-abettor may be unaware of any improper activity.[154]

Using a sliding-scale analysis to determine the necessary level of scienter or knowledge exemplifies how the courts have recognized the need for flexibility in determining aiding and abetting liability.[155] Factors such as the type of transactions—atypical or in the ordinary course of business—allow courts the flexibility to balance the expectations of the parties based on the surrounding circumstances, while taking into consideration the need for vigorous securities markets. However, other factors also play a role in affecting the expectations of the parties.

2. Duty and the level of scienter or knowledge required

Of the factors considered in determining aiding and abetting liability, courts most often ground the flexible analysis in the presence of a duty owed by the alleged aider-abettor to the investor.[156] However, most courts have limited the scope of a sliding-scale approach to situations where the aider-abettor assisted only through inaction or silence, varying the required level of scienter or knowledge depending upon the existence of a duty.[157] These courts have generally held that absent a duty to disclose, the plaintiff must show that the aider-abettor had a higher degree of knowledge, than if a duty were present.[158]

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154. *Woodward*, 522 F.2d at 95.

155. *See supra* notes 113-68 and accompanying text.

156. *See, e.g.*, Armstrong v. McAlpin, 699 F.2d 79, 91 (2d Cir. 1983); *IIT*, 619 F.2d at 927; *Woodward*, 522 F.2d at 97.

157. *See supra* note 90 and accompanying text. *Contra IIT*, 619 F.2d at 923; Rolf v. Blyth, Eastman Dillion & Co., 570 F.2d 38, 47 (2d Cir.), *cert. denied*, 439 U.S. 1039 (1978).

The true significance of this limitation has to be questioned. For an aider-abettor to be liable, he or she must have either committed some affirmative act of assistance or deliberately failed to disclose his knowledge of the fraud. *See supra* notes 90-96 and accompanying text. In Metge v. Baehler, 762 F.2d 621 (8th Cir. 1985), *cert. denied*, 474 U.S. 1057 (1986), the Eighth Circuit recognized that the "distinction between positive action and deliberate inaction is elusive." *Id.* at 624. In the case of affirmative participation, it is much easier to prove knowledge and assistance. However, as for inaction, the aider-abettor's intent, knowledge and assistance generally must be inferred from the surrounding circumstances. Thus, the reasoning of Harmsen v. Smith, 693 F.2d 932 (9th Cir. 1982), that a duty arises from "knowing assistance of or participation in a fraudulent scheme," *id.* at 944, is followed—both those who have acted affirmatively and passively would have breached a duty to the investor, and thus are equally culpable. However, when there is just inaction and nothing more, the special treatment is justified. Some type of proof showing that the alleged aider-abettor is culpable is required, so as not to find innocent participants liable. Where silence is coupled with affirmative assistance, the degree of knowledge required will depend upon how ordinary the transaction is in the business involved. *See Woodward*, 522 F.2d at 96-97. See *supra* notes 116-68 and accompanying text for arguments why other factors should affect the level of scienter or knowledge and assistance required for aiding and abetting liability.

158. *See, e.g., Armstrong*, 699 F.2d at 91 (where no duty is present, "the 'scienter' requirement scales upward"); Sirota v. Solitron Devices, Inc., 673 F.2d 566, 575 (2d Cir.), *cert. de-*

Some courts have followed a strict view when a duty is lacking. These courts require that the scienter requirement "must, in fact, approximate an actual intent to aid in the fraud being perpetrated."[159] Other courts have been more flexible, requiring that where there is no fiduciary relationship, "an alleged aider-abettor should be found liable only if scienter of the high 'conscious intent' variety can be proved."[160] Other courts allow that even in the absence of a fiduciary duty, a lower standard of scienter or knowledge may be applied depending on the circumstances of the particular case.[161]

Courts that permit a lesser degree of scienter or knowledge to establish liability reason that the presence of a duty reflects the expectations of the parties; when a duty is present the investor expects a higher degree of good faith in the relationship.[162] Conversely, without substantial knowl-

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nied, 459 U.S. 838 (1982); Edwards & Hanly v. Wells Fargo Sec. Clearance Corp., 602 F.2d 478, 485 (2d Cir.) (to find aider-abettor liable under 10b-5 absent fiduciary duty, something closer to actual intent to aid in fraud required), *cert. denied*, 444 U.S. 1045 (1979); *Woodward*, 522 F.2d at 97 ("When it is impossible to find a duty to disclose, an alleged aider-abettor should be found liable only if scienter of the high 'conscious intent' variety can be proved."); *see also* SEC v. Coffey, 493 F.2d 1304, 1317 (6th Cir. 1974); *Washington County Util. Dist.*, 676 F.2d at 226; *Monsen*, 579 F.2d at 800; *cf. Cleary*, 700 F.2d at 777 ("Where the defendant has a duty to disclose the primary violations, however, courts have been willing to impose liability on the basis of a recklessness standard, or on a lesser showing of actual awareness than is otherwise required." (citations omitted)). *Contra Barker*, 797 F.2d at 496-97 (absent duty to speak concerning knowledge of ongoing fraud, silence even if morally culpable, does not have legal consequences under securities laws); LHLC Corp. v. Cluett, Peabody & Co., 842 F.2d 928, 932-33 (7th Cir.) ("When the problem consists in keeping silent while the primary violator carries out the fraud, the plaintiff must show that the silent person had a legal duty to speak."), *cert. denied*, 109 S.Ct. 311 (1988).

159. Decker v. Massey-Ferguson, Ltd., 681 F.2d 111, 121 (2d Cir. 1982).

160. *IIT*, 619 F.2d at 925 (quoting Woodward v. Metro Bank, 522 F.2d 84, 97 (5th Cir. 1975)). *See Edwards & Hanly*, 602 F.2d at 485 ("Finding a person liable for aiding and abetting . . . requires something closer to an actual intent to aid in a fraud, at least in the absence of some special relationship with the plaintiff that is fiduciary in nature."). Similarly, other courts have required that where there is no duty to disclose, the plaintiff must prove the silence of the accused aider-abettor "was consciously intended to aid the securities law violation," and "must prove either a culpable state of mind or conduct from which a culpable state of mind may be inferred." *Washington County Util. Dist.*, 676 F.2d at 226; *see also* Moore v. Fenex, Inc., 809 F.2d 297, 304 (6th Cir.), *cert. denied*, 107 S. Ct. 3231 (1987); *Metge*, 762 F.2d at 625.

161. In *Frankel*, 537 F. Supp. at 744, the district court acknowledged prior case law requiring a "high conscious intent" standard of scienter for liability in cases where inaction is plead in the absence of a duty. However, the court took a flexible approach to its analysis and looked to several factors in deciding to require a lower level of scienter. *Id.* The court relied upon factors such as the aider-abettors holding themselves out as experts and receiving compensation for services that were not in the "daily grist of the mill." *Id.* Further, the existence or nonexistence of a duty on behalf of the aider-abettor relates only to the degree of scienter or knowledge required to find liability. *See, e.g., Sirota*, 673 F.2d 566, 575; *IIT*, 619 F.2d at 923, 927; *Monsen*, 579 F.2d at 800.

162. *See Rolf*, 570 F.2d at 44-45; *Woodward*, 522 F.2d at 95.

edge and assistance, aiding and abetting liability is unsuitable when the relationship between the plaintiff and defendant is "remote."[163]

Further recognizing the importance of the parties' expectations springing from their relationship, district courts are increasingly applying a lower threshold of scienter or knowledge where it was foreseeable that the plaintiff would have relied upon the defendant's representations or lack thereof.[164] These courts have applied a lower standard of culpability to "alleged aiders and abettors who have issued statements or certifications foreseeably relied upon by investors, reasoning that a duty to disclose arises under such circumstances."[165]

Courts have relied on the existence of a benefit to the aider-abetter, the character of the transaction and the presence of a duty as factors that imply culpable conduct. However, the interrelationship between the knowledge and assistance elements has also been considered a factor in a flexible analysis.

3. Relation between knowledge and assistance

Finally, some courts have taken the view that each of the elements are not to be viewed in isolation.[166] The Fifth Circuit has stated: "The *scienter* requirement scales upward when the activity is more remote; therefore, the assistance rendered should be both substantial and knowing."[167] Conversely, when there is a limited demonstration of substantial

163. *See, e.g., Monsen*, 579 F.2d at 800; *Rolf*, 570 F.2d at 44-45; *cf. Woodward*, 522 F.2d at 95 (where there is lack of fiduciary duty "the scienter requirement scales upward when the activity is more remote, therefore, the assistance rendered should be both substantial and knowing").

164. *See, e.g., In re* Investors Funding Corp., 523 F. Supp. 533 (S.D.N.Y. 1980); Oleck v. Fischer, Fed. Sec. L. Rep. (CCH) ¶ 96,898, at 95,680 (S.D.N.Y. June 8, 1979), *aff'd on other grounds*, 623 F.2d 791 (2d Cir. 1980).

165. *Woods*, 765 F.2d at 1011-12 (citing Fund of Funds, Ltd. v. Arthur Andersen & Co., 545 F. Supp. 1314, 1356-57 (S.D.N.Y. 1982); Morgan v. Prudential Group, Inc., 527 F. Supp. 957, 960-61 (S.D.N.Y. 1981), *aff'd without opinion*, 729 F.2d 1443 (2d Cir. 1983); *see also IIT*, 619 F.2d at 927 ("Accountants do have a duty to take reasonable steps to correct misstatements they have discovered in previous financial statements on which they know the public is relying."); *cf.* United States v. Benjamin, 328 F.2d 854 (2d Cir.) (recognizing that one may not shut one's eyes to what is plainly to be seen, when one is charged with the specific responsibility of a competent professional audit), *cert. denied*, 377 U.S. 953 (1964).

166. *See, e.g., IIT*, 619 F.2d at 922 ("Moreover, the three requirements cannot be considered in isolation from one another."); *Metge*, 762 F.2d at 624 ("The factors—particularly the second and third—are not to be considered in isolation, but should be considered relative to one another. . . . [t]he two factors vary inversely relative to one another . . . ."); Johnson v. Chilcott, 658 F. Supp. 1213, 1222 (D. Colo. 1987) ("The last two elements of aiding and abetting liability cannot be viewed in a vacuum but must be considered together.").

167. *Woodward*, 522 F.2d at 95 (emphasis added).

assistance, a greater showing of scienter or knowledge is required.[168]

The courts' assertion of such a flexible analysis adds substance to the bare elements of the three-part test. By providing factors by which the court may determine liability, participants in the securities industry can tailor their transactions to avoid aiding and abetting liability. At the same time, judges have the flexibility to weigh all the circumstances in the case to fairly determine liability. However, to be effective the guidance must be realistic and consistent. The remaining sections of this Comment propose an analytical model to determine aiding and abetting liability that seeks to be practical and useful.

VI. MODEL FOR A SLIDING-SCALE, FLEXIBLE-FACTOR ANALYSIS

The inability of the courts of appeals to render clear guidance as to the level of knowledge and assistance required and to the type of proof necessary to find aiding and abetting liability has left this area of the law unpredictable. Participants in the securities industry lack a clear standard from which to conform their behavior in transactions. In addition, the courts have not demonstrated sufficient flexibility in their analyses to halt the ever-increasing ingenuity of the securities violator in an area of the law where a myriad of complex fact situations arise. The remaining sections of this Comment advocate the infusion of a sliding-scale, flexible-factor analysis into the courts' existing three-part test. This proposed analysis incorporates the circuits' several flexible analyses into a single sliding-scale, flexible-factor model. The result is a consistent and coherent way to address aiding and abetting cases.

A. Source of the Sliding-Scale, Flexible-Factor Analysis

The source of the sliding-scale, flexible-factor analysis is *White v. Abrams*,[169] a case involving a securities violation by a primary party. While the actual content of the *White* analysis arguably has little significance in the aiding and abetting context,[170] the Ninth Circuit's analytical

168. *Id.*; *see Metge*, 762 F.2d at 624.

169. 495 F.2d 724 (9th Cir. 1974).

170. In *White*, all the factors focused "upon the relationship between the plaintiff and the defendant, leading to the conjecture that the court did not intend to deal with situations where there is no relationship between the plaintiff and the defendant, but where the defendant, nonetheless materially and substantially contributes to the wrong done." *In re* Gap Stores Sec. Litig., 457 F. Supp. 1135, 1144 (N.D. Cal. 1978). Another district court has stated:

> [a] distinction [exists] between a duty to disclose under the *White v. Abrams* test and the duty to disclose that pertains to aider and abettor liability. The primary violator's duty to disclose arises from his involvement with the entity whose securities are at issue and his relationship to the plaintiffs. The secondary violator's duty arises from 'knowing assistance of or participation in a fraudulent scheme.'

model assists in formulating a flexible-factor analysis that determines the required level of knowledge and assistance based on certain factors relevant to the aiding and abetting context.[171]

In *White*, the Ninth Circuit sought to eliminate reliance on the scienter element in Rule 10b-5 securities fraud cases and advanced a new mode of securities analysis.[172] In the court's analysis, a sliding-scale of factors, inchoate in earlier decisions, determined whether a high or low standard would be required of the primary violator to find liability.[173] The standard of culpability shifted depending on the factual circumstances and helped determine the extent to which certain distinct duties may arise.[174] These duties included an affirmative duty to disclose, a duty not to misrepresent, and a duty to investigate and to disclose based on that investigation.[175] The court attempted to avoid a set standard of culpability. It set out its factors without a formula for weighing those factors and, without establishing precise limits, gave examples of how the duty to disclose or investigate might fluctuate depending upon the circumstances.[176] The *White* court stated:

> Where the defendant derives great benefit from a relationship of extreme trust . . . [and] the defendant know[s] that [the] plaintiff completely relies upon him for information to which he has ready access, but to which the plaintiff has no access, the law imposes a duty upon the defendant to use extreme care in assuring that all material information is accurate and disclosed. . . . On the other hand, where the defendant's relation-

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Wright v. Schock, 571 F. Supp. 642, 663 (N.D. Cal. 1983), *aff'd*, 742 F.2d 541 (9th Cir. 1984) (citing Harmsen v. Smith, 693 F.2d 932, 944 (9th Cir. 1982), *cert. denied*, 464 U.S. 822 (1983)). "This distinction may be more semantic than real, however, where the involvement of the defendant in the securities transactions at issue is minimal." Mirotznick v. Sensney, Davis & McCormick, 658 F. Supp. 932, 941 (W.D. Wash. 1986).

171. According to courts that have interpreted *White's* flexible duty analysis, "the closer the relationship of the person charged to the corporation and the greater his participation in the transaction attacked, the easier it will be to prove the requisite scienter." Robinson v. Heilman, 563 F.2d 1304, 1308 (9th Cir. 1977) (per curiam).

172. *Id.* at 734-36. The continued reliance on *White* has been questioned since Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976). However, the mode of analysis is a valuable way to balance the need for predictability and flexibility. *See* Branson, *Statutory Securities Fraud in the Post-*Hochfelder *Era: The Continued Viability of Modes of Flexible Analysis*, 52 TUL. L. REV. 50, 53-64 (1977).

173. *White*, 495 F.2d at 734-36.

174. *Id.*

175. *Id.*

176. *Id.* at 736. The sliding-scale factors included the nature of the parties relationship, the degree of trust plaintiff had placed in defendant's guidance or expertise, the benefit defendant received from the relationship and defendant's access to relevant investment information in comparison to plaintiff's access. *Id.* at 735-36.

> ship with the plaintiff is so casual that a reasonably prudent person would not rely upon it in making investment decisions, the defendant's only duty is not to misrepresent intentionally material facts.[177]

The *White* analysis provides the basic model which can be altered to apply to the aiding and abetting context. This mode of analysis has the advantage of weighing the facts and circumstances of each case in determining the level of scienter or knowledge and assistance required for liability. Moreover, it allows courts to balance the conflicting concerns for the protection of the investor and the need for robust securities markets.

B. The Sliding-Scale, Flexible-Factor Analysis

The difficulty the courts have had in drawing clear conclusions in the aider-abettor area demonstrates that a straightforward and consistent analysis should be developed to give direction to the courts in determining liability. The proposed model is not to dispose of the existing three-part test, but merely to be incorporated within it. It permits the principle variables,[178] of knowledge and assistance to fluctuate in various gradations.[179] This proposal only recommends certain factors for courts to

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177. *Id.* at 736.

178. *See* Branson, *supra* note 172, at 90.

179. There are several legally identifiable degrees to which the knowledge variable may be viable. Professors Ruder and Cross suggest the following categories:

> 1. Deliberate conduct exists when the defendant has an intent to injure others.
> 2. Knowing conduct exists when the defendant acts with the knowledge that his acts may injure others. Knowing conduct would include knowing misrepresentation or nondisclosure.
> 3. Reckless conduct exists when the defendant acts in conscious disregard of, or indifference to, the risk that others will be misled. This conduct includes what is sometimes referred to as "gross negligence."
> 4. Negligent conduct exists when the defendant acts unreasonably but does not act with conscious disregard of consequences.
> 5. Innocent conduct exists when the defendant cannot reasonably be expected to know the true facts.

Ruder & Cross, *Limitations on Civil Liability Under Rule 10b-5*, DUKE L.J. 1125, 1140 (1972) (footnote omitted).

Notwithstanding the above delineations of degrees of culpability, the term reckless or gross negligence may still be broken down to even smaller increments of degrees.

> [T]he secondary wrongdoer may have been only grossly negligent [or reckless] but in the egregious sense of having been consciously indifferent to the suspected nature of the primary wrongdoer's acts; or the aider and abettor may, through lack of even the slightest care, have failed to become aware of the primary wrongdoer's illegal course of conduct. An act of the last kind might be called gross negligence in the lesser sense.

Branson, *supra* note 172, at 90 (footnote omitted).

While it is clear that since Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976), negligence will not suffice to establish liability, the plaintiff must prove scienter. Scienter has been characterized by the United States Supreme Court as a mental state embracing intent to deceive,

consider and demonstrates how these factors may affect the required level of culpability and assistance. It does not endeavor to set precise parameters since the courts require flexibility as to which levels of knowledge and assistance the circumstances of each particular case shall compel. However, the use of factors which the courts and participants in the industry may rely upon will provide the guidance necessary to ensure predictability in establishing aiding and abetting liability under the three-part test.

1. Proposed model for the sliding-scale, flexible-factor analysis

A court analyzing an aiding and abetting case should look to the following factors once a primary violation has been established: (1) the existence of the aider-abettor's knowledge of the violation and role in the fraudulent scheme; (2) the type and degree of participation or assistance; (3) the type of relationship among the parties and whether the relationship resulted in the plaintiff reasonably relying upon the representations or omissions of the aider-abettor; (4) the existence and type of economic benefit derived from the relationship by the aider-abettor; and (5) the nature of the security that is the object of the transaction.[180] The key to this analysis is to give substance to the well-established existing three-part test. This analysis does not set out a fixed level of scienter or knowledge to be applied;[181] it attempts to give guidance in how varying standards of scienter or knowledge and participation interrelate with varying factors to exhibit proof of knowledge and assistance.

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manipulate, or defraud. *Id.* at 193-99. However, the Supreme Court in *Hochfelder* reserved decision on the issue of whether recklessness or gross negligence will satisfy the scienter requirement. *See supra* note 69. Thus, the above recital of various levels of culpability, except for negligent and innocent conduct, are all within the minimum level of scienter the Court may allow and, therefore, the lower courts are free to apply these standards.

180. *See supra* notes 20 and 23 and accompanying text.

181. The meaning of scienter is the subject of several very comprehensive comments, and is beyond the scope of this Comment. *See, e.g.*, Bucklo, *The Supreme Court Attempts to Define Scienter Under Rule 10b-5*: Ernst & Ernst v. Hochfelder, 29 STAN. L. REV. 213 (1977); Fischel, *Secondary Liability Under Section 10(b) of the Securities Act of 1934*, 69 CALIF. L. REV. 80 (1981); Gilmore & McBride, *Liability of Financial Institutions for Aiding and Abetting Violations of Securities Laws*, 42 WASH. & LEE L. REV. 811 (1985); Sachs, *The Relevance of Tort Law Doctrines To Rule 10b-5: Should Careless Plaintiffs be Denied Recovery?*, 71 CORNELL L. REV. 96 (1985); Steinberg & Gruenbaum, *Variations of "Recklessness" after* Hochfelder *and* Aaron, 8 SEC. REG. L.J. 179 (1980); Note, *Liability for Aiding and Abetting Violations of Rule 10b-5: The Recklessness Standard in Civil Damage Actions*, 62 TEX. L. REV. 1087 (1984); Note, *Recklessness and the Rule 10b-5 Scienter Standard after* Hochfelder, 48 FORDHAM L. REV. 817 (1980); Note, *Reckless Conduct: The Securities Fraud Aider and Abettor as a Concurrent Tortfeasor*, 45 BROOKLYN L. REV. 1391 (1979); Comment, *The Recognition of Aiding and Abetting in the Federal Securities Laws*, 23 HOUS. L. REV. 821 (1986).

2. Applications of the sliding-scale, flexible-factor analysis

In determining aiding and abetting liability, courts should concurrently weigh the evidence of knowledge and the evidence of assistance.[182] Where the court finds a high level of knowledge, then a lesser degree of assistance should be required. For instance, if the proof shows that the aider-abettor deliberately participated in the furtherance of a fraudulent scheme, then the assistance prong should be satisfied by less than actual participation. However, if there is proof only that the alleged aider-abettor was merely reckless in not detecting his or her participation in the fraudulent scheme, a higher degree of actual assistance would be necessary.

It is important to keep in mind that knowledge is the key to aiding and abetting liability.[183] Proof of some degree of knowledge of the wrongdoing is necessary to differentiate between innocent, ordinary-course-of-business transactions and transactions that are tainted with indicia of fraud.[184] Without a minimum degree of knowledge, "banks, brokers, clearing agents, transfer agents and other such participants in the process could become virtual insurers of their customers against securities law violations."[185] Thus, courts should be cautious when reducing the degree of knowledge necessary for liability when a high level of assistance is present. If there is a high degree of assistance, a substantial reduction in the amount of knowledge required may have grave effects. However, the level and type of assistance may be a strong indication of the aider-abettor's knowledge; therefore, the courts should not overlook assistance itself as a factor in determining the proper requisite level of knowledge.[186]

Courts should also recognize that a greater degree of knowledge is required to satisfy the scienter requirement when the alleged aider-abettor's activity is more remote. Remoteness is mainly a function of the relationship between the plaintiff and the aider-abettor.[187] The expectations for good faith and fair dealing of the parties decrease the more remote the aider-abettor's participation is from the primary violation. Thus, when the transaction creates a relationship in which the law im-

182. Depending upon the degree and type of knowledge and assistance, the court should vary the standard of culpability and the level of assistance necessary to impose aiding and abetting liability.

183. *See supra* note 67 and accompanying text.

184. Ferrara & Sanger, *supra* note 36, at 115.

185. *Id.*

186. *See supra* notes 97-104 and accompanying text.

187. *See* Woodward v. Metro Bank, 522 F.2d 84, 95 (5th Cir. 1975). *See supra* notes 162-63 and accompanying text.

poses a duty on the aider-abettor to the investor, the degree of scienter or knowledge required should decrease.[188]

Inherent in a fiduciary relationship is the understanding that a person having the duty is to act primarily on behalf of the one to whom the duty is owed in matters connected with the relationship.[189] Thus, the existence of a duty symbolizes an expectation of good faith and fair dealing.[190] Accordingly, the standard of culpability should vary depending upon the relationship and the expectation of the parties. For example, if an independent fiduciary relationship is created, such as that existing between a broker and client,[191] then the court would demand a lower level of scienter or knowledge. However, if the relationship does not create a duty, a higher level of scienter or knowledge would be required to establish liability on the part of the aider-abettor.

Further, if a relationship of trust results in the plaintiff reasonably relying upon the defendant's representations or lack thereof, a lower degree of scienter or knowledge should also be sufficient to find liability. Foreseeable reliance on those who play important roles in the securities markets is another factor that justifies a lower standard of scienter or knowledge in order to ensure a minimum standard of due care in their representations.[192] In this situation, the court may either impose an independent duty to disclose or act or allow a lower standard of scienter or knowledge as sufficient for liability.[193]

If the transaction does not create a duty to disclose or act, then the court should look to other factors that may affect the expectations of the parties, such as the type of transaction.[194] If the transaction is in the ordinary course of business, more evidence of complicity would be required. However, if the transaction was extraordinary or atypical in nature, a lower standard of culpability would be necessary.

The type of defendant participation is a factor that should also be

188. *See supra* note 96 and accompanying text. Some courts have imposed a duty of disclosure for knowingly participating in a fraudulent scheme, without the requirement of a relationship of trust and confidence. *See, e.g.*, Strong v. France, 474 F.2d 747, 752 (9th Cir. 1973). *See supra* note 161 and accompanying text.

189. BLACK'S LAW DICTIONARY 320 (5th ed. 1979). A fiduciary relationship arises out of a relationship of trust and confidences between the parties to the transactions. *See* Chiarella v. United States, 445 U.S. 222, 230 (1980).

190. *See supra* note 170 and accompanying text.

191. *See supra* note 75.

192. *See* Mishkin v. Peat, Marwick, Mitchell & Co., 658 F. Supp. 271, 273 (S.D.N.Y. 1987) (accounting firm may be held liable as an aider and abettor in a securities fraud case for "recklessly" performing an audit). *See also supra* notes 164-65 and accompanying text.

193. *See supra* notes 23-34 and 156-59 and accompanying text.

194. *See supra* notes 23-34 and 146-55 and accompanying text.

evaluated in conjunction with other factors of the analysis. If the defendant's participation includes affirmative acts, then a lesser degree of knowledge would be required, depending upon the amount of assistance and other factors that show proof of such knowledge.[195] A lower level of knowledge is appropriate in these situations, because even at low levels the culpable conduct must show that the aider-abettor consciously disregarded the interests of others or lacked the slightest care, which in itself shows a form of knowledge.[196] These secondary defendants tend to be the brokers, bankers, accountants, lawyers and other participants in the securities markets who perform an important role in maintaining investor confidence and protection.[197] Thus, allowing a lesser degree of knowledge, such as gross negligence or recklessness, would establish a minimum level of diligence by these important participants, consistent with the goal of protecting the investor.[198]

If the defendant's participation is less direct, say, inaction or silence, then a higher degree of knowledge should be required. This guarantees that innocent and remote participants are not left insuring the wrongful actions of others. The lack of action on the part of the alleged aider-abettor creates problems for courts, for they generally have to infer the knowledge and assistance elements. Thus, the courts have required something more than mere silence, inaction or both.[199]

While it may be desirable to hold every participant to a transaction who has knowledge that some form of fraudulent scheme is underway liable for failure to act or disclose,[200] "Rule 10b-5 was not designed to be

195. *See supra* notes 76-104, 132-55 and 166-68 and accompanying text. The thrust of this proposal is that except in cases where the alleged aider-abettor owes no duty to the investor and was silent or failed to act, a degree of culpability less than "conscious intent" should apply. The use of this analysis is to determine in what situations and at what level certain lower levels of culpability should be required.

196. *See supra* notes 67-69 and accompanying text and *supra* note 182.

197. *See supra* notes 23-34 and accompanying text. *See also* Felts v. National Account Sys. Ass'n, 469 F. Supp. 54, 67 (N.D. Miss. 1978) (recognizing that attorney of issuer plays a "unique and pivotal role in the effective implementation of the securities laws").

198. *See* Note, *Establishment of Liability for Aiding and Abetting Fraud Under Rule 10b-5 and the Common Law*, 25 UCLA L. REV. 862, 883-84 (1978). It is very difficult for a plaintiff to prove that an aider-abettor had actual knowledge of a fraudulent scheme. *See, e.g.*, G. A. Thompson & Co. v. Partridge, 636 F.2d 945, 961 n.32 (5th Cir. 1981) ("It is usually difficult for the plaintiff to prove more than that the defendant must have known about the misrepresentation or omission and its potential harm. Such [a] showing would prove recklessness, but is usually insufficient to prove specific intent."). This problem of proof creates difficulty of accountability for those upon whom the investors essentially rely.

199. *See supra* note 161 and accompanying text.

200. The Supreme Court has established that absent a duty in the primary violation context, there is no liability for the failure to disclose the existence of a fraudulent scheme. *See supra* notes 94-96 and accompanying text.

the ethical Ten Commandments for all securities transactions."[201] There needs to be a balance between the absolute protection of the investor and unconditional *laissez faire*.[202] There should be some showing that the defendant sought the outcome of the fraudulent scheme. Thus, if there is proof that the defendant's silence is influenced by an economic motive beyond ordinary fees or commissions,[203] then a lesser degree of knowledge and assistance would be required.[204] The existence of an independent duty owed to the investor by the aider-abettor, however, creates a different situation in which a higher expectation of good faith and fair dealing exists.[205] Therefore, an independent duty should create liability based on a lower degree of knowledge and assistance than that which would be required absent such a duty.

VI. CONCLUSION

In recent years the importance of aiding and abetting liability for fraudulent securities transactions has grown. Unfortunately, the Supreme Court of the United States has not provided guidance in the development of a clear cause of action. The lower federal courts, though, have agreed on a three-part test to determine aiding and abetting liability; however, they differ sharply on the interrelationship among the parts.

As a result of the disagreement over the operation of the test, this area of the securities laws lacks the predictability, flexibility and safeguards necessary to combat the wide variety of securities fraud. This

201. *Woodward*, 522 F.2d at 91.

202. *Laissez faire* is alternatively defined as "the theory or system of government that upholds the autonomous character of the economic order, believing that government should intervene as little as possible in the direction of economic affairs. . . . [or as t]he practice or doctrine of noninterference in the affairs of others, esp[ecially] with reference to individual conduct or freedom of action." RANDOM HOUSE DICTIONARY OF THE ENGLISH LANGUAGE 1076 (2d ed. 1987).

203. For an example of how an economic motive may effect a court's reasoning in finding liability for inaction and silence see Monsen v. Consolidated Dressed Beef Co., 579 F.2d 793, 802-03 (3d Cir.), *cert. denied*, 439 U.S. 930 (1978) (Third Circuit held bank substantially assisted in Rule 10b-5 violation through inaction and silence, where court focused on fact that bank's motive was based upon self interest in encouraging clients to borrow from client's employees on subordinated basis while bank's loans were secured).

204. *See supra* note 132-45 and accompanying text. If a defendant were to be liable merely for pursuing his livelihood, then such a standard would be a trap for guilty and innocent alike. The business reality of such a standard would essentially force all parties involved in the transaction to implement expensive mechanisms to protect against such a result. Thus, the benefits of protecting the investor would be overshadowed by the costs of complying with the standard. Such a result cannot be what Rule 10b-5 was intended to produce.

205. *See supra* note 189-93 and accompanying text.

Comment proposes to remedy these problems by infusing a balance of predictability and flexibility into the existing analytical framework.

The courts should incorporate a sliding-scale, flexible-factor analysis into the existing test. Factors such as whether the defendant's conduct was affirmative or passive, whether the defendant owed the plaintiff a fiduciary duty, the nature of the security and other considerations should all be evaluated in determining the appropriate levels of knowledge and assistance—the second and third elements of the test—necessary for liability.

The result of applying the sliding-scale, flexible-factor model may be in fringe cases less predictable than when applying a rigid test. Yet, this loss of predictability will only affect the person whose acts border on illegality, a region where predictions are usually futile. Most importantly, the sliding-scale, flexible-factor model serves the two equally important but somewhat conflicting policy considerations of protecting the investor and insuring a robust securities market. The model advances the goal of investor protection without taking the savvy out of the securities markets at a time when investor confidence is waning and securities frauds are becoming more complex.

*Jeffrey Farley Keller**

* I wish to dedicate this article to my father, Jerry Keller. I know he would be proud. I further wish to thank Kathryn W. Tate for her valuable guidance and feedback throughout the preparation of this Comment.