Liability of Third Party Professionals: Federal v. State Securities Laws

During the last 30 months allegations of securities fraud have been lodged against the monarchs and matriarchs[i] of the banking, brokerage, and accounting professions. Enron's complex scheme to manufacture income and create off-balance sheet expenses included Merrill, Lynch & Co., Inc., J.P. Morgan Chase & Co., Citigroup, Inc., Credit Suisse First Boston, National Westminister Bank, CIBC, and Barclays Bank PLC, along with several senior officers at Enron, the venerable law firm, Vinson & Elkins, and the hapless accounting firm[ii], Arthur Anderson & Co.. WorldCom, on the other hand, involved a simple accounting entry that changed an expense item (line costs paid to other carriers) to an asset. The entry converted a $662,000,000 loss to a $2,393,000,000 ** that's billion ** profit for 2001.[iii] Apparently, only WorldCom's mid-level and senior financial officers and its outside auditor were participants. That auditor was, of course, Arthur Anderson & Co. Recently, ten major brokerage houses agreed to pay penalties of $487,500,000 and disgorge $387,500,000 in ill-gotten gains.[iv] The charges range from outright fraudulent research reports by Merrill, Lynch to the unethical spinning of hot IPO's to favored customers by Credit Suisse and Citigroup (f/k/a Salomon Smith Barney). The independent auditor associated with Just for Feet was Deloitte & Touche LLP. At Feet, false accounting entries were made to create income of $10,000,000. One of those entries related to Feet's account with its advertising agent and the use of phony rebates.[v] The other was its accounts with Converse, Adidas, Fila, and Nike[vi] that were altered to overstate Feet's accounts receivables. Other examples of professional misconduct are the plea of guilty by an Ernst & Young partner to charges of obstruction of justice resulting from his having altered and destroyed documents in the NextCard debacle,[vii] and the accounting fraud accusations against Xerox and four KPMG partners.[viii] Why, we ask ourselves, would a respected worldwide accounting firm like Anderson get involved in what was clearly a fraudulent scheme on the part of both Enron and WorldCom? Might it have been the money? Perhaps. In 2001 Anderson received fees from Enron amounting to more than $52,000,000.[ix] It is more likely, however, that Anderson arrogantly believed (hoped) it was immune to any civil repercussions for having <u>only</u> aided and abetted a fraud. The same is probably true for Deloitte & Touche, and the other third party professionals as well. But how could these sophisticated professionals entertain such an expectation? Some history is helpful. As will be seen, the evolution of federal securities law in the 1980's and 90's did in some respects justify that surreal expectancy.

From a historical perspective, hucksters, con men and thieves have been the backbone of the securities fraud industry. In the 80's, however, CEO's, bankers, brokers, accountants and lawyers were added to this list. State and federal regulators manned the trenches to protect the public against its willingness to believe in and invest with these pitchmen, and successful administrative and criminal prosecutions under state ***Blue Sky Laws***[x] and the federally adopted ***Securities Act of 1933 (33 Act)*** [xi] and ***Securities Exchange Act of 1934*** (***34 Act***),[xii] combined with the substantial damages available through private litigation, virtually assured that violators would be dealt with harshly. Even the Supreme Court's 1976 decision in ***Ernst & Ernst v Hochfelder***,[xiii] requiring proof of scienter[xiv] (intent to deceive, manipulate or defraud) to support a federal cause of action under the ***34 Act*** for misrepresentations or omissions in the purchase or sale of a security, did little to allay the perpetrators' fear of civil lawsuits and administrative enforcement actions. Of course, the single greatest threat to corporate America and its operatives, bankers, brokers, lawyers and accountants was the *strike suit*. That was the name given the massive class action lawsuits that asserted securities law violations filed by professional plaintiffs[xv] through lawyers specializing in this form of coercion.

Such a suit was usually generated when a company revealed in reports it was required to file with the SEC that it had been negligent or inattentive or had violated some rule of the SEC, resulting in a drop in its stock price. The unparalleled success of the tactic eventually led Congress to impose tort reform on this cottage industry. The legislative history of this reform legislation shows that Congress treated the professional plaintiffs and their lawyers as opportunistic gluttons.[xvi]

Federal causes of action for securities violations began their fall from grace in 1994, although some would argue that the fall actually began in 1988 with ***Pinter v Dahl***.[xvii] In that case the Supreme Court rejected the *substantial factor* and *proximate cause* tests to identify the persons who could be held liable as sellers of securities under the ***33 Act***.[xviii] In their stead the Court announced that to be a seller the person had to successfully solicit a sale of a security motivated at least in part by a desire to serve his own financial interest.[xix] ***Pinter,*** therefore, virtually eliminated third-party professionals (bankers, accountants and lawyers) as putative sellers under the ***33 Act***,[xx] although they remained potentially liable as aiders and abettors.[xxi] Then in 1994, the Court in ***Central Bank of Denver, N.A. v First Interstate Bank of Denver, N.A.***,[xxii] decided that Section 10b of the ***34 Act***, 15 USCA '78j(b), that imposed liability on those who used misrepresentations or omissions *in connection with*[xxiii] the sale or purchase of a security, did not permit the imposition of aider and abettor liability.[xxiv] The following term the Court in ***Gustafson v Alloyd Co.***[xxv] determined that Section 12(a)(2) of the ***33 Act***, 15 USCA '77l(a)(2), that imposed strict liability for misrepresentations in prospectus materials, applied only to the public sale of a security by an issuer or controlling shareholder. ***Central Bank of Denver*** and ***Gustafson*** were decided by a 5 to 4 vote of the Justices. Federal securities law was thus set on its new course by the slimmest of margins at the highest of levels.

Congress joined the steerage in 1995 with enactment of the ***Private Securities Litigation Reform Act of 1995 (PSLRA)***, [xxvi] that had as its purpose the elimination of the Astrike suit,@ and it placed significant compliance requirements on class actions that were based on federal law and filed in federal court. See 15 USCA '78u-4(a) and '77z-1(a). ***PSLRA*** was not limited, however, to federal securities cases filed as class actions. It also dealt with such cases generally, imposing an automatic stay of discovery if a Motion to Dismiss[xxvii] was pending (15 USCA '78u-4(b)(3)(B)); limiting joint and several liability (15 USCA '78u-4(f)); capping damage (15 USCA '78u-4(e)(1)); creating a safe harbor for forward looking projections (15 USCA '78u-5 and '77z-2); and enhancing the standards for pleading and proving fraud (15 USCA '78u-4(b)(1) and (2)). But ***PSLRA*** did not cure the problem. *Strike suits* could still be filed in state courts as long as the securities claims were not founded on the ***34 Act's*** prohibitions against misrepresentations and omissions.[xxviii] Congress cured most of this oversight in 1998 by enacting the ***Securities Litigation Uniform Standards Act of 1998 (SLUSA)***.[xxix] That legislation nullified state laws that authorized class actions in state law securities cases based upon misrepresentations and omissions and vested the federal courts with original and removal jurisdiction over a *covered class action* as well as individual state court suits if there were more than 50 potential class members or 50 individual plaintiffs, respectively, asserting misrepresentations or omissions in connection with the purchase or sale of a *covered security*. See 15 USCA '77p(f)(2) and '78bb(f).[xxx] In the mean time Congress enacted the ***National Securities Market Improvement Act of 1996 (NSMIA)***,[xxxi] that further insulated most securities transactions from state registration or regulatory requirements. These securities made immune by ***NSMIA*** were called *covered securities*. See 15 USCA '77r(b). So, when ***SLUSA*** was adopted two years later, this immunity for *covered securities* was extended to include state law class actions and multi-plaintiff

litigation. Thus a *strike suit* alleging ***34 Act*** or state law violations disappeared into the fog of securities lore. Whether a strike suit founded on the ***33 Act*** will meet a similar fate, remains to be seen.[xxxii]

It is not clear that this wave of court decisions and legislation was responsible for the egregious conduct of Enron, WorldCom, Just for Feet, and the others. But all of the major business failures in the passed few years appear to involve misrepresentations or omissions made or joined in by brokers, accountants, lawyers, bankers and senior company operatives. Congress' reaction to this state of affairs was the adoption of the ***Sarbanes-Oxley Act (SOA)***.[xxxiii] That legislation is examined in the last section of this article.

As pointed out above, federal law after 1976 required proof of scienter (intent to deceive, manipulate or defraud) to recover under the ***34 Act*** for securities misrepresentations and omissions, and by 1994 it was becoming increasingly more difficult to comply with the pleading requirements of FRCP Rule 9(b).[xxxiv] The second part of ***PSLRA,*** the part not limited in application to just class actions, put two more graves in that procedural burial ground by directing that the plaintiff must plead with particularity the false statements complained of and also explain in detail what was misleading about those statements.[xxxv] See 15 USCA '78u-4(b)(1). In addition, if the legal claim required proof of intent or the like, the plaintiff had to plead all facts that *give rise to a strong inference* of that state of mind. See 15 USCA '78u-4(b)(2). Congress also directed **in** ***PSLRA*** that the federal courts must stay discovery in a securities case if a Motion to Dismiss was filed and permitted the trial court little latitude to authorize further discovery.[xxxvi] See 15 USCA '78u-4(b)(3). This pleading problem was heightened by the fact that a Motion to Dismiss pursuant to FRCP, Rule 12(6) (failure to state a claim), would normally be filed and evaluated before discovery was completed or even started in some cases. If a defendant were on its toes, a plaintiff would have to discover, if he could, the facts of the wrongful conduct without any assistance from judicial processes. One court went so far as to say: *The purpose of these provisions (was) to **** (provide) protection of the corporate defendants from plaintiffs' counsel discovering their way into facts which could allow them to amend an initially frivolous complaint so as to state a claim.* See ***In re Transcrypt Intn'l. Sec. Litig.,*** 57 F.Supp2d 836, 841(D. Neb. 1999). As a consequence, a plaintiff's knowledge, real or imputed, might well be sufficient to initiate the statute of limitations under inquiry notice because of, for example, information available in a newspaper article but insufficient to survive a Rule 12(6), Motion to Dismiss.

For all of these reasons third party professionals like Arthur Anderson & Co. no doubt believed, or at least hoped, that they were reasonably immune to civil prosecutions by damaged investors proceeding under federal law.

There should be no surprise that by 1995 non-class action relief available under ***Blue Sky Laws*** had become more popular with plaintiffs.

The Texas version of the ***Blue Sky Laws*** is investor oriented.[xxxvii] Frequently it is said that federal laws require disclosure and state laws protect investors. The Texas Securities Act (***TSA***) attempts, or at least attempted, to do just that. The misrepresentation portions of the Act provide: *A person who offers or sells a security (whether or not the security is exempt under Section 5 or 6 of this Act) by means of an untrue statement of a material fact or an omission to state a material fact necessary in*

order to make the statement made, in light of the circumstances under which they are made, not misleading, is liable to the person buying the security from him, who may sue either at law or in equity for rescission, or for damages if the buyer no longer owns the security. However, a person is not liable if he sustains the burden of proof that either (a) the buyer knew of the untruth or omission or (b) he (the offeror or seller) did not know and in the exercise of reasonable care could not have known, of the untruth or omission. ***TSA*** ' 33A(2), Tex.R.Civ.Stat., Art. 581-33A(2). The statute provides protection for investors by exempting from state registration requirements securities listed on a National Securities Exchange **only** if they *are of ascertained, sound asset or income value.* See ***TSA*** ' 6(F)(2)(3rd). Texas further requires that a company seeking to register its securities by notification (when there is no federal registration of the security) have more than *sufficient net income to pay specified interest or dividends or have net income equal to 5% of the market capitalization of the company computed by using the offering price of the security being issued to value all issued and outstanding shares*. See ***TSA*** ' 7B(1). If a security is to be registered by coordination (when it piggybacks a federal registration) the company must prove that its business plan is *fair, just and equitable.* See ***TSA*** ' 7C(2). ***NSMIA*** rendered **impotent** these **merit** safeguards when Acovered securities@ were involved. See 15 USCA ' 77r(a)(3).

While recovery under ***TSA*** is restricted to out of pocket (rescission) damages[xxxviii] a plaintiff need only show a material misrepresentation, or an omission to state material facts necessary to make the facts stated not misleading. ***TSA*** remedies are available to a purchaser as well as a seller if misled by a purchaser.[xxxix] In addition the ***Act*** permits recovery of costs, interest, and attorney's fees. See ***TSA*** ' 33(D)(3). The latter is discretionary with the court, however. A defense of *knowledge* of the true facts is available to the defendant. That is, if the plaintiff knows the true facts, he cannot recover damages based upon the untrue representation. Similarly, a *lack of knowledge* defense is available if the defendant can show that he did not know the untruth of the statement and could not have learned of the untruth by the exercise of ordinary care.[xl] Scienter need not be shown; nor is it necessary for the plaintiff to prove that he relied on the misrepresentation in making the purchase or that he might have acted differently had he known the true facts.[xli]

Plaintiff is required to plead and prove that he qualifies as a *purchaser* under the ***TSA.*** The term is not defined, but the broad definition of a *sale* [xlii] has convinced most courts to liberally construe the term *purchaser* in identifying appropriate plaintiffs. See ***Summers v WellTech, Inc.,*** 935 SW2d 228, 233 (Tex.App.CHouston[1st District] 1996, no writ).

The plaintiff must also show that the defendant was a seller. Once again the term is not defined in ***TSA***, but the same liberalism that identified a purchaser has not been universally used to identify a seller. Indeed there are conflicting decisions in the Courts of Appeals and the Supreme Court. Under vintage case law, a *seller* could be anyone who participated as *a link in the selling process*. See ***Brown v Cole,*** 291 SW2d 704, 708 (Tex. 1956). A recent decision calls into question the continued vitality of that expansive concept of seller. See ***Frank v Bear, Stearns & Co., Inc.,*** 11 SW3d 380, 383 (Tex.App. Houston[14th District] 2000, review denied). The ***Frank*** court relied on certain interpretative *Comments* to the 1977 amendments of ***TSA***, prepared by a State Bar subcommittee that was a co-sponsor of the legislation, to reach its conclusion that only the person making the sale to the purchaser could be held liable as a seller. A more recent decision, however, restates the holding in ***Brown v Cole.*** See ***Tex. Capital Securities, Inc. v Sandefer,*** 58 SW3d 760, 765-766

(Tex.App.CHouston[14th] 2001, pet. denied)(***Sandefer 1)***. The ***Sandefer 1*** court does not cite ***Brown v Cole*** to support its conclusion. Nor does the court cite ***Frank.*** The court relies on one of its own decisions from 1976, ***Rio Grande Oil Co. v State,*** 539 SW2d 917, 922 (Tex.App.CHouston[14th District] 1976, writ ref'd, n.r.e.). According to the ***Frank*** court the expansive concept of seller was amended out of the statute in 1977 when aider, abettor and control liability were added. The particular *Comment* relied on by the ***Frank*** court does, indeed, support a narrow interpretation of the term *seller*. It states that privity is now required between seller and purchaser. But this conclusion is clearly not supported by the statutory language. The Court in ***Brown v Cole,*** supra, 291 SW2d 704, 708, relied on the expansiveness of the definition of Asale@ to conclude that the term Aseller@ must have a very broad meaning as well, and the definition of Asale@ was not altered by the 1977 amendments and has not been changed as of today. Frankly, under the usual rules of statutory construction, adding another group of potentially liable persons doesn't diminish the liability of those already included and doesn't mean that a Aseller@ should now be restricted to those in privity with the purchaser. It is true that AComments@ were provided to the legislature with the final draft bill (Draft 12-November 21, 1976, as enacted) submitted by the State Bar subcommittee, and thus might be considered as Alegislative history,@ but the AComment@ in question was **not** included with the draft bill and does not qualify as such history. See Bromberg, ***Civil Liability Under Texas Securities Act ' 33 (1977) and Related Claims***, 32 SW. L.J. 867, 891 (1978). I would give the AComment@ in question the same weight I would give to a legal article published without being peer reviewed B not much. When adopted by the Texas legislature the AComments@ stated that a Aseller@ was to be identified by reference to federal law, and the predominate federal view at that time was that a person who Aproximately caused@ a sale was considered a Aseller.@ Bromberg, *supra*, at 884-85. So, the ***Sandefer 1*** court got it right, just not for the reasons expressed.

Under***TSA***, third party professionals who aid and abet a violation can be held liable to the same extent as the seller, and those who control a violator are subject to liability as well. Just as in the case of a direct violation by a seller, a control person can escape liability by showing that he did not know of the activity that gave rise to the violation and could not have known of it by exercising ordinary care. ***TSA*** ' 33F(1). The courts have not accorded the same subjective/objective (knew or should have known) defense to an aider and abettor. The reason for this seemingly inconsistent result is the language in ***TSA*** that defines Aaiding@ liability. That language requires that the aider and abettor act with *intent to deceive or defraud or with reckless disregard for the truth or the law (that) materially aids a seller, buyer, or issuer of a security is liable *** jointly and severally with the seller, buyer, or issuer.* ***TSA*** ' 33F(2). The Texas Supreme Court recently held that Aaiding liability@ requires subjective (actual) awareness of unlawful conduct on the part of the primary violator, although the aider need not know the details of that conduct. See ***Sterling Trust Co. v Adderley***, ___ SW3d ___ (Tex. 2005)(No. 03-1001, decided June 17, 2005). The Court found the aider's subjective knowledge of the *Ponzi* scheme being utilized by the primary violator would be sufficient to support a finding of aider liability, if the jury were properly instructed on the aider issue. Whether that *unlawful conduct* must constitute a securities law violation is apparently an issue for another day.[xliii]

Little Texas case law exists on the issue of control, and no definition of *control* is contained in ***TSA***. State regulations have been adopted by the Commission that define *control* in the same language used

in the federal regulations: *Control is the power to direct or influence the direction of the management or policies of a person, directly or indirectly, through the ownership of voting securities, contract or otherwise.* TAC Title 7, Part 7, Chapter 113, Rule '113.14(b)(7). The similar federal definition is at 17 CFR 230.405. A Texas case considering the control issue purported to rely on federal law in holding that Acontrol@ exists only if the person has the power to determine the activities and direction of the corporation, in general, and the power to influence the specific activities in question. See ***Frank v Bear, Stearns & Co.,*** *supra*, 11 S.W.3d at 384. That interpretation or adaptation of federal law is incorrect. See Ravkind, ***We New Wizards of Wall Street,*** 66 Tex. B. J. 120 (2003). Under federal law control can exist with considerably less power or influence. For example, control is generally thought to arise if a person owns 20% of the stock of a major corporation. See ***Order Approving Proposed Rule Change Relating to Shareholder Approval***, Exchange Act Release No. 27035 (July 18, 1989). Logically a somewhat greater percentage of stock ownership would be needed to control a smaller entity. The SEC has proposed a rule providing that a person must own 10% of the shares of a company before an issue of affiliate (control) status would arise under Rule 144. See Proposed Rules, 62 FR 9246 (Feb. 27, 1997). That proposal has languished for eight years without action. Recently the SEC did adopt regulations that use 10% ownership as a threshold for determining affiliate (control) status for persons serving on the newly prescribed audit committees. See ***Final Rule: Standards Relating to Listed Company Audit Committee***, SEC Release Nos. 33-8220, 34-47654, and IC-26001.[xliv] A number of commentators state that 10% stock ownership raises a presumption of control. But there is no support for that assertion except prior statements by other commentators. See Ravkind***,*** *supra*, 66 Tex.B.J. at 128 note 32. A few Texas cases have struggled with the control issue. In ***Barnes v SWS Financial Services, Inc.,*** 97 SW3d 759 (Tex.App.-- Dallas 2003, no pet.) a registered representative working at a brokerage firm (SWS) engaged in fraudulent practices in the sale of certain church bonds. The sales were not made through SWS, the firm had no knowledge of the transactions, and, indeed, SWS did not sell this type of security nor did it receive any share of the monies earned by its representative. The court first concluded that the firm did not need to participate in the culpable conduct in order to establish control liability and rejected this requirement that had been recently imposed by the Texarkana court in ***Tex. Cap. Sec. Mgmt., Inc. v Sandefer***.[xlv] ***(Sandefer 2).*** The court then looked to the criteria set forth by the Houston court in ***Frank,*** *supra,* 11 SW3d at 382-84, and found that SWS did not control the specific activity in question. Thus the court concluded that SWS was not liable as a control person. ***Sandefer 2*** at 765. The problem with the analysis is that the court's conclusion is based upon factual matters relevant to whether SWS knew or should have known of the activity. Those facts establish a <u>defense</u>**,** and they should not be considered part of plaintiff's burden to show a violation. In effect the court required the plaintiff to prove the absence of the defense, and that is virtually the same requirement imposed by the ***Sandefer 2*** court that was rejected by the ***Barnes*** court earlier in its opinion. The ***Barnes*** court should have resolved the control issue using master-servant and agency considerations.[xlvi] Particularly relevant is Judge Hudspeth's piercing analysis in ***Gonzalez v Morgan Stanley Dean Witter, Inc.,*** 2004 U.S. Dist. Lexis 26709 (W.D. Tex. 2004). He directs attention to ***G.A. Thompson & Co. v Partridge***, 636 F.2d 945 (5th Cir. 1981), where a 24% shareholder who served as a director and participated in the day to day activities of the company was found to be a Acontrol@ person. Importantly, the court cites with approval ***Dyer v Eastern Trust and Banking Co.***, 336 F.Supp. 890 (N.D. Me. 1971). There the court found *prima facia* control status to exist where the individual was one of the twelve directors that controlled the corporate violator. Be that as it may, this concept of control has enormous possibilities as a tool in a security-plaintiff's arsenal useable against third party professionals if the issue of

control is determined by reference to federal law. This is so because federal law recognizes Acontrol groups@ as meeting the definition of control even though most of the individual members of the control group would not have sufficient power to influence conduct if they were not a member of the group.[xlvii] The ***Dyer*** decision referred to above is an excellent example of the concept. Stock ownership and employment by the company are not prerequisites to establish control under federal law. Liability of third parties based upon control is the subject of a recent ALR annotation. The annotation provides great detail about the divergent views of the various federal courts relating to the proof necessary to impose control liability. See ***Liability of Officer, Director, Employee, or other Individual Associated with Seller or Issuer of Securities as >Control Person' under ' 15 of the Securities Act and ' 20(A) of the Securities Exchange Act,*** 183 A.L.R. Fed. 141 (2003). Control liability under the ***33 Act*** (Securities Act), 15 USCA ' 77o, is different than such liability under the ***34 Act*** (Securities Exchange Act), 15 USCA ' 78t(a); although the definition of control is the same, the defenses are different. The Texas Acontrol@ concept is virtually the same as the one provided by the ***33 Act***, and the defenses are the same. The ***34 Act*** defense requires the controlling party to exercise Agood faith.@ This defense also requires proof that the controlling party did not induce, directly or indirectly, the acts that constitute the violation. The defenses under the ***33 Act*** require proof that the controlling party did not know of the facts constituting the violation and had no reasonable cause to believe the existence of those facts. The statutory defense for control liability under Texas law is proof that the defendant did not know of the violation and could not have discovered it by exercising ordinary care. ***TSA*** ' 33F(1).

Corporate activities subject to control can be specifically defined, and different persons may well control different aspects of corporate life. One set of corporate officers may have responsibility for acquisitions. Clearly such officers would have considerable influence in evaluating merger possibilities. Another set of officers may have responsibility for financial reporting. Just as clearly these officers would have the ability to influence how various financial matters are presented. This financial group within the corporation would need cooperation from third-party accountants and lawyers in order to effectively control the improper reporting of financial matters, particularly if adverse financial information is being concealed from the Board of Directors. To date at least no securities case has been found that imposes liability on the third-party bankers, lawyers or accountants because of their membership and participation in the Acontrol group,@ although there are cases imposing non-group control liability on these professionals.[xlviii] Judge Harmon's opinion in the ***Enron***,[xlix] contains an exhaustive analysis of the factual allegations in the case and the applicable law. While I might quarrel with one or two of her conclusions about Texas securities law, her opinion is a superb, almost text book, exposition into this complex area of law. In ***Enron*** she finds that lawyers, accountants, and bankers may be subject to liability to investors as direct violators of Section 10(b) and Rule 10(b)-5, under the allegations in the consolidate complaint. Her rationale appears to incorporate Acontrol group@ concepts. Intentional or not, her discussion of the issues demonstrates that a group of persons acting together can achieve results not possible if their actions had been separate. None of the professionals did any actual selling of Enron stock, but the court found that their alleged activities Ain connection with@ such sales were sufficiently egregious to impose direct liability on them. At all events, it seems inevitable that an enterprising plaintiff will assert that bankers, accountants and lawyers are, indeed, part of a control group and liable along with the involved corporate officers.

From a federal standpoint, the question of the moment is whether the ***Sarbanes-Oxley Act (SOA)*** together with ***PSLRA*** will re-establish the fear of non-compliance that once upon a time was generated by the potential of a Astrike suit.@ At this time the answer has to be Ano.@ The reason is obvious. ***SOA*** creates the possibility of administrative prosecutions and even some criminal liability, but it does not create a private civil cause of action for damages against the perpetrators,[l] and one is not likely to be implied. See Bloomenthal, ***Sarbanes-Oxley Act in Perspective,*** pp. 134-136 (1st ed. 2002).[li] ***SOA*** does refer to disgorgement and does create new and enhanced civil penalties in actions initiated by the SEC. But disgorgement and, to a large extent, civil penalties relate to the profit made by the perpetrator not to the damages caused by the illegal acts. See ***SEC v Blavin***, 760 F.2d 706, 713 (6th Cir. 1985). Nevertheless the statute directs the SEC to use the collected funds to benefit the victims of the violations. See ***SOA*** Section 308(a), 15 USCA '7246(a). The term *victims* is not defined, nor are there any procedures in place to set up the fund or disperse the money. Further ***SOA*** provides no clue about the priority of any particular victim. If this sounds to us like an illusory remedy, just think how it sounds to a Avictim.@

In ***SOA*** Section 308(c), 15 USCA '7246(c), the SEC was directed by Congress to study disgorgement and penalty cases concluded in the passed five years and report on the success and impact of these remedies. That report was filed on January 24, 2003.[lii] Congress also directed in ***SOA*** Section 703, 15 USCA '7201 Note, that the Commission study and report which group of securities professionals had committed the most violations in the passed five years. That report was also filed on January 24, 2003.[liii] The two reports show that securities brokers committed the highest percentage of violations (60%). Accountants committed 3.5% of the violations, lawyers 2.8%, and transfer agents 1.6%. The total dollar amount of disgorgement orders was $800,000,000, and $167,000,000 had been collected. Civil penalties amounted to $226,000,000 with $77,000,000 collected. Apparently the only monies that had been transferred to benefit a victim at that time were a payment to a bankruptcy trustee and a payment into two different class action funds ($11.6MM). The Report that is responsive to ***SOA*** Section 803c states that A*most of the money returned to investors comes from the successful conclusion of actions filed in federal district court. Eighty-seven district court actions involving 358 defendants were reviewed *** (and) in 34 of these cases, payments totaling a little over one billion dollars were made directly to approximately 125,000 investors.*@ [liv] These numbers obviously do not jibe with the specific numbers reported[lv] and most likely include the results from private litigation.

It is noteworthy that ***PSLRA*** does not permit any of the funds collected by the SEC to be used to pay attorneys' fees of private litigants seeking participation in the disgorged monies.[lvi] The purpose of this provision may simply be a final slap at lawyers or it may be intended to discourage private litigants who seek recovery of some of the money generated in the SEC's litigation. Either way it clearly marks Congress's current distaste for lawyers and private litigants. We lawyers are regular whipping boys when it comes time for legislative reform. The public seems to accept without question the proposition that Aif it's bad for lawyers it's good for the country.@ Our profession has historically withstood these tactics with a winsome shrug, knowing: AWhat goes around comes around.@ In time it seems likely that the right to recover damages will be reinvested in those who have actually been damaged by the illegal acts, and lawyers will be called upon to render services to remedy the harm. Remember, the call for reform came from those committing fraud not those

damaged by it, and those committing fraud are never disappointed that the imposed remedy is only modestly effective. The complaints about strike suits, professional plaintiffs, and their lawyers came from the companies that had committed violations and were being terrorized by that litigation. These bleeding hearts convinced Congress that strike suit allegations were without merit, but they had to cough up big money or else spend millions in defense. The premise that these companies would rather pay a large ransom than respond to discovery is, in a word, poppycock. Not one example of an innocent company being damaged by a strike suit can be found in the public record. Truth is that the companies paid the money to settle a case because their internal documents were so damning. Had unaltered Texas law applied to the DotCom IPO's marketed in the late 90's, that generated such enormous profits for the issuers, affiliates, brokers, and investment bankers, not to mention the enormous losses suffered by the investing public, those frauds would have never left the starting gate.

ENDNOTES

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i. The only successful SEC action that involves allegations against lawyers for their legal work is the 2DoTrade, Inc., scam. SEC-SAR Release 51218. However, Vinson & Elkins has been seriously implicated in the Enron civil lawsuits.

ii. See ***In re Enron Corporation Securities, Derivative & ERISA Litigation,*** 235 F.Supp.2d 549, 694-703 (S.D. Tex. 2002).

iii. See WorldCom's Sworn Statement Pursuant to Section 21(a)(1). (www.sec.gov/news/wcresponse.html).

iv. SEC News Release 03-54. (www.sec.gov/news/press/2003-54.html)

v. D0J Release #283

vi. _News.morningstar.com/news/DJ/M02/D25/200402251608DOWJONESDJONLINE001075.html

vii. SEC News Release 03-123. (www.sec.gov/news/press/2003-123.html).

viii. SEC News Release 03-16 (www.sec.gov/news/press/2003-16.html).

ix. See ***In re Enron Litigation,*** *supra,* 235 F.Supp.2d at 673 and at 676 Note 108.

x. Texas' Blue Sky Law is Tex.Rev.Civ.Stat. Article 581-1, et seq.

xi. 15 USCA '77a, et seq.

xii. 15 USCA '78a, et seq.

xiii. 425 U.S. 185 (1976)

xiv. Section 10b of the ***34 Act***, 15 USCA '78j(b), and SEC Rule 10b-5, 17 CFR '240.10b(5), make no mention of scienter.

xv. See S. Rep. 104-98, 1995 USCCAN 679 at 683. The term is now defined by the limitations placed on a person who is a plaintiff in multiple class action cases. A person can act as lead plaintiff in no more than five federal class action cases in any three year time span. See 15 USCA '78u-4(a)(3)(B)(vi)

xvi. See S. Rep. 104-98, 1995 USCCA 679 at 687-689.

xvii. 486 U.S. 622 (1988)

xviii. These were clearly the tests used by of a great majority of the lower federal courts to identify a seller. See ***Hines v Data Line Sys., Inc.,*** 766 P.2d 1109 (Wash.App. 1989).

xix. 486 U.S. at 647.

xx. See ***Ackerman v Schwartz,*** 947 F.2d 841, 845-846 (7th Cir. 1991).

xxi. E.g***. W.O. Akin v Q-L Investments, Inc.,*** 959 F.2d 521 (5th Cir. 1992); ***Hines v Data Line Sys., Inc.,*** 766 P2d 1109 (Wash.App. 1989).

xxii. 511 U.S. 164 (1994).

xxiii. The phrase Ain connection with a sale@ distinguishes and broadens liability under the ***34 Act***. The operative phrase in the ***33 Act*** is Aa sale.@ See ***McGann v Ernst & Young***, 102 F.3d 390 (9th Cir. 1996).

xxiv. The same rationale excludes aider and abettor liability under the strict liability provisions of the 33 Act. Aiding and abetting liability was revived in 1995 in ***PSLRA,*** but only in actions brought by the SEC or DOJ. No private remedy is authorized. See 15 USCA '78t(f)

xxv. 513 U.S. 561 (1995).

xxvi. PL 104-67, 1995 HR 1058.

xxvii. The statute even provides its own Motion to Dismiss. See 15 USCA '78u-4(b)(3)(A). In addition the federal courts were authorized to enjoin discovery in any state court case if necessary to aid or protect its jurisdiction. See 15 USCA '78u-4(b)(3)(D).

xxviii. Claims under Section 10(b) of the 34 Act or Rule 10b-5 can only be pursued in federal court. See 15 USCA '78aa. Anomalously, claims under the 33 Act are not even removable to federal court. 15 USCA ' 77v(a).

xxix. PL 105-353, 1998 S. 1260.

xxx. ***SLUSA*** does not apply to class actions filed in the state of incorporation of the target company. See 15 USCA '78bb(f)(3)(A)(i).

xxxi. PL 104-290, 1996 HR 3005.

xxxii. See ***Zia v Network, Inc.,*** 336 F.Supp.2d 1306 (S.D. Fla. 2004); ***In re Tyco International Sec. Litig.,*** 322 F.Supp.2d 116 (D. N.H. 2004); ***In re Waste Mgmt., Inc., Sec. Litig.,*** 194 F.Supp.2d 590 (S.D. Tex. 2002). These cases hold that a ***33 Act*** Astrike suit@ is not removable. But see ***In re King Pharmaceuticals, Inc.,*** 2004 U.S. Dist. Lexis 20222 (E.D. Tenn. 2004); ***Alkow v TXU Corp.,*** 2003 U.S. Dist. Lexis 7900 (N.D. Tex. 2003). These hold just the opposite.

xxxiii. PL 107-204 (2002).

xxxiv. This rule requires that fraud be pleaded with particularity. The pleading must state specifically the what, when, where, and by whom concerning the misrepresentation, and must explain why it is fraudulent. A failure to satisfy this pleading requirement makes the pleading subject to a FRCP, Rule 12(6), Motion to Dismiss. See e.g. ***Shields v CityTrust Bancorp, Inc.,*** 25 F3d 1124, 1127-1128 (2nd Cir. 1994).

xxxv. These requirements did not actually make the plaintiff's burden more onerous than it already was.

xxxvi. The court can permit discovery only when A*particularized discovery is necessary to preserve evidence or to prevent undue prejudice.*@ 15 USCA '78u-4(b)(3)(B). In ***Faulkner v Verizon Comm., Inc.,*** 156 F.Supp.2d 384 (S.D.N.Y. 2001), the court observed: A*The sole example proffered by Congress as to what justifies lifting the stay is the terminal illness of an important witness which might necessitate the deposition of the witness prior to ruling on the motion to dismiss.*@ Id at 402.

xxxvii. See ***Flowers v Dempsey-Tegeler & Co., Inc.,*** 472 SW2d 112, 115 (Tex. 1971).

xxxviii. See ***TSA*** ' 33D.

xxxix. Texas is one of the few states that allows a recovery to a seller if he is duped by a purchaser. See ***TSA*** '33B.

xl. Only a buyers knowledge of the *truth* is a defense available to an issuer if the misrepresentation appears in prospectus materials filed with the state commissioner or the SEC. See ***TSA*** '33C.

xli. See ***Duperier v Texas State Bank,*** 28 SW3d 740, 754 (Tex.App-C.C. 2000, pet. dism'd by agreement); ***Anheuser-Busch Companies, Inc. v Summit Coffee Co.,*** 858 SW2d 928, 936 (Tex.App.-Dallas 1993, writ denied).

xlii. Sale is defined by ***TSA*** '4E: *The terms "sale" or "offer for sale" or "sell" shall include every disposition, or attempt to dispose of a security for value. The term "sale"means and includes contracts and agreements whereby securities are sold, traded or exchanged for money, property or other thing of value, or any transfer or agreement to transfer in trust or otherwise. ****.*

xliii. The inference one may draw from the opinion is that the Aunlawful conduct@ need not itself constitute a securities law violation since a *Ponzi* scheme may not always involve the sale of a security. It might be better practice to make no such assumption at this point in time.

xliv. See www.sec.gov/rules/final/33-8220.html.

xlv. ***Tex. Cap. Sec. Mgmt., Inc. v Sandefer,*** 80 SW3d 260, 267 (Tex.App. Texarkana 2002, no pet.)(***Sandefer 2)***.

xlvi. See ***Paul F. Newton & Co. v Tex. Comm. Bank,*** 620 F.2d 1111, 1120 (5th Cir. 1980).

xlvii. There is little federal case law defining Acontrol groups. The SEC has discussed the control group concept primarily in its *no action* letters. These are letters stating that the staff will not recommend adverse action by the Commission under particular circumstances. Sometimes, of course, the staff would advise in its letter that it can not agree to take no action under the particular circumstances. The staff has uniformly declined to agree to take no action where the facts show family or business relationships that suggested a control group. See Carnation Company, 1980 WL 17775 (SEC No-Action Letter)(Publicly Available Feb. 3, 1980); Commodore Corporation, 1978 WL 13693 (SEC No-Action Letter)(Publicly Available Oct. 6, 1978); Perini Corporation, 1972 WL 11257 (SEC No-Action Letter)(Publicly Available Oct. 23, 1972); Power Dyne Vehicles, Incorporated, 1972 WL 11204 (SEC No-Action Letter)(Publicly Available Aug. 21, 1972); Bishop Graphics, Incorporated, 1972 WL 8980 (SEC No-Action Letter)(Publicly Available June 7, 1972); Glosser Brothers Incorporated, 1972 WL 8810 (SEC No-Action Letter)(Publicly Available May 8, 1972).

xlviii. But see, ***Kalnit v Eichler,*** 85 F.Supp. 2d 232 (S.D. N.Y. 1999). There the court confuses an already confusing issue in holding that control allegations against directors are inappropriate because the directors are alleged to have directly violated the ***34 Act.*** In my view the court misses the point. The corporation may certainly be considered the direct violator and the directors control the corporation. The importance of the issue in a federal setting cannot be overstated. Unlike allegations of direct violations control liability does not raise the specter of Rule 9(b). This decision highlights another perplexing issue. The court appropriately states the definition of materiality applicable to ***34 Act*** cases that *there be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the total mix of information available* and Aassumed actual significance@ in the deliberations of the reasonable investor to invest. Because the ***34 Act*** requires scienter, proximate cause and reliance this definition makes sense. It doesn't make sense in a ***33 Act*** case or a case under ***TSA.*** All that is required by the statute is a demonstration of control.

xlix. ***In re Enron Corporation Securities, Derivative & ERISA Litigation,*** *supra*, 235 F.Supp.2d 549.

l. ***SOA*** Section 804(c), 28 USCA '1658 Note.

li. Mr. Bloomenthal has authored a great many articles and books dealing with securities issues. This one is essential reading for any serious student of securities law.

lii. Report Pursuant to Section 308c. (www.sec.gov/news/stories.shtml).

liii. Report Pursuant to Section 703. (www.sec.gov/news/stories.shtml).

liv. Report p. 10.

lv. The SEC recently announced that it would be setting up a fund to compensate investors harmed by the broker misconduct referred to in News Release cited in Note 3. The amount for distribution is said to be $399,000,000. One would have to speculate that the penalties collected by the SEC ($487,500,000) will not find their way to investors.

lvi. See 15 USCA ' 78t(f)