AIDING AND ABETTING: 
THE EXPANDING ZONE OF LIABILITY 
UNDER TEXAS AND FEDERAL SECURITIES LAWS 

DAVID D. STERLING, Houston 
Baker Botts 

State Bar of Texas 
4TH ANNUAL ADVANCED BUSINESS LAW COURSE 
October 26 – 27, 2006 
Houston 

CHAPTER 2
DAVID D. STERLING  
Partner, Litigation  
Baker Botts LLP

David Sterling is a partner at Baker Botts L.L.P. He principally represents issuers and underwriters in class action securities fraud actions; corporate officers and directors in derivative lawsuits; broker-dealers in securities lawsuits and arbitrations; and companies in takeover and proxy litigation.

Mr. Sterling also represents brokerage firms and individuals in investigations and proceedings before a variety of agencies, including the SEC, NYSE, NASD, Department of Justice, and the Texas State Securities Board. He represents accounting firms in securities fraud and malpractice actions, as well as special litigation committees and audit committees in connection with investigations and derivative litigation. In October 2002, Texas Lawyer named Mr. Sterling one of six “Go To” securities lawyers in Texas. Chambers ranked Mr. Sterling in the first tier of securities trial lawyers in 2006; Lawdragon magazine recently named him one of the top 3000 lawyers in America; and Texas Monthly designated him as a Super Lawyer on three occasions.

Mr. Sterling was lead counsel in several of the leading securities fraud cases in the Fifth Circuit, including Abrams v. Baker Hughes Inc., 292 F.3d 424 (5th Cir. 2002), Nathenson v. Zonagen, Inc., 267 F.3rd 400 (5th Cir. 2001), and Kapps v. Torch Offshore, Inc., 379 F.3d 207 (5th Cir. 2004).

He is a graduate of Williams College and the University of Texas Law School where he was a member of the Texas Law Review and the Order of the Coif.
TABLE OF CONTENTS

I. FEDERAL SECONDARY LIABILITY - CENTRAL BANK OF DENVER .......................................................... 2
   A. “Scheme” Liability Under Rule 10b-5(a) & (c) - The Central Bank Caveat ........................................... 2
   B. Simpson v. AOL Time Warner Inc. (In re Homestore.com) ........................................................................ 2
   C. In re Charter Communications .............................................................................................................. 4
   D. Other Decisions ........................................................................................................................................ 5

II. TEXAS SECONDARY LIABILITY ............................................................................................................... 5
AIDING AND ABETTING: THE EXPANDING ZONE OF LIABILITY UNDER TEXAS AND FEDERAL SECURITIES LAWS
by David Sterling¹ and Brad Thompson²

In these times of high profile corporate scandals, heightened corporate governance and increasing governmental investigations, questions frequently arise as to who besides the corporate issuer of securities (and its officers and directors) may be targets of suits under federal or state securities laws. Traditionally, the “zone of liability” under the securities laws was more restricted to the issuer and those who were excessively entangled in the issuer’s misleading statements or omissions. As the stakes in some corporate scandals have escalated, and as other issuers have had limited assets and insurance to satisfy securities claims, accounting firms, law firms, banking institutions, insurance companies and various other business partners and individuals are also finding themselves subject to additional scrutiny as secondary participants.

Modern times indicate that any affiliation with an issuer could potentially serve as the basis for naming a secondary actor (e.g., lawyers, bankers, and accountants) to a securities lawsuit. Recent developments under both federal and Texas law indicate that secondary actors are having increasing difficulty getting out of litigation at the summary judgment or motion to dismiss stage. Moreover, under both federal and Texas securities law there appear to be more questions than answers as to the dividing line between primary and secondary (aiding and abetting) liability.

Strictly speaking, the U.S. Supreme Court’s landmark ruling in 1994, Central Bank of Denver v. First Interstate Bank of Denver, established that there is no private right of action for secondary aiding and abetting liability under the federal securities laws. However, in an effort to circumvent the limitation set forth in Central Bank, many plaintiffs have creatively characterized the behavior of secondary actors as participating in a “scheme to defraud” with the issuer such that they are primarily liable, rather than secondarily liable as an aider and abettor. The increased recognition of “scheme liability” in the federal circuits threatens to erode the limitations imposed by Central Bank against secondary aiding and abetting liability.

Unlike the federal limitation on aider and abettor liability set forth in Central Bank, the Texas Securities Act expressly provides plaintiffs with a private right of action for aiding and abetting liability. The specific degree of awareness of the secondary actor was unsettled until the 2005 Texas Supreme Court decision of Sterling Trust Co. v. Adderley.⁴ In Adderley, the Court found that plaintiffs must establish that a secondary participant was “generally aware” of the primary violator’s improper activities in order to be liable as an aider. The Adderley decision also explored the somewhat anomalous scenario in which a secondary actor might prove an affirmative defense to a primary violation (by showing it did not know, or in the exercise of reasonable care could not have known, of the material misrepresentation or omission) and yet still be secondarily liable as an aider.

In an environment of ever-increasing scrutiny in the securities arena, the question arises: just how far can the zone of secondary liability extend? This paper explores some cases analyzing the degree to which a non-issuer secondary participant could find itself subject to liability. First, a brief survey of some recent federal decisions exploring the concept of “scheme” liability under Rule 10b-5 is provided. Second, an analysis of secondary liability under the Texas Securities Act aider provision is provided in the context of the recent Texas Supreme Court’s decision in Adderley.

Unfortunately, this area is fraught with uncertainty and no bright line tests exist that could help a secondary actor better assess its potential exposure under a given set of facts. This lack of certainty will likely make settlement negotiations even more problematic as respective parties may have difficulty accurately predicting their respective risk in going forward. Moreover, even where a secondary participant can escape civil liability under the securities laws, the secondary actor may still find itself subject to

¹ David Sterling is a partner in the Houston office of Baker Botts LLP. David’s practice specializes in securities litigation and arbitration. David’s clients include a broad range of issuers and underwriters, as well as secondary actors such as accounting and brokerage firms. David also represents individuals and audit committees before various governmental agencies including the SEC, NYSE, NASD, Department of Justice, and the Texas State Securities Board. This paper was prepared in connection with The State Bar of Texas CLE course on Advanced Business Law, and as such, the information herein is general and should not be considered or relied upon as legal advice.

² Brad Thompson is a litigation associate in the Houston office of Baker Botts LLP. Brad’s practice generally includes representation of various entities in commercial and securities-related disputes in state and federal court, as well as in arbitration.


⁴ Sterling Trust Co. v. Adderley, 168 S.W.3d 835 (Tex. 2005).
an investigation or enforcement action by various governmental agencies.

I. FEDERAL SECONDARY LIABILITY - CENTRAL BANK OF DENVER

Prior to the U.S. Supreme Court’s decision in Central Bank of Denver v. First Interstate Bank of Denver, various federal circuits struggled to determine whether there was an implied “aider and abettor” private right of action under Section 10(b) of the Securities Exchange Act of 1934. Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164, 170-71 (1994). The confusion among circuits regarding aiding and abetting liability under Section 10(b) eventually led the Supreme Court to grant certiorari to resolve the uncertainty. Id. at 170. Central Bank carefully analyzed the statutory language of Section 10(b) and determined that no private cause of action exists for aiding and abetting a primary violation of Section 10(b) (or under the related SEC Rule 10b-5). Id. at 191.

Significantly, however, the Supreme Court did not completely foreclose the potential for secondary actor liability. The Central Bank opinion specifically carved out a caveat whereby secondary actors could still be held liable as a primary violators under §10(b):

The absence of § 10(b) aiding and abetting liability does not mean that secondary actors in the securities markets are always free from liability under the securities Acts. Any person or entity, including a lawyer, accountant, or bank, who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator under 10b-5, assuming all of the requirements for primary liability under Rule 10b-5 are met.

Id. From this language plaintiffs began eating away at the proscription against aider and abettor liability by arguing that secondary actors were part of larger “scheme” in violation of Rule 10b-5, and as such, could be held liable as primary violators. Scheme liability involves cases where secondary actors themselves have not make any misstatements (or omissions, where under a duty to disclose) upon which an investor (or the market, in the typical fraud on the market 10b-5 case) relied but, instead, participated in a larger scheme or transaction that somehow impacted the issuer’s financial statements.

A. “Scheme” Liability Under Rule 10b-5(a) & (c) - The Central Bank Caveat

In light of the prohibitions on aiding and abetting liability in Central Bank, plaintiffs struggled to plead and prove that secondary actors should be held liable as primary violators under Rule 10b-5(b). Rule 10b-5(b) prohibits the making an untrue statement of material fact or failing to disclose necessary information in order to make statements not misleading. 17 C.F.R. §240.10b-5(b) (2006). Secondary actors generally do not directly or indirectly make any untrue statements (or omissions) to the public. Instead, secondary actors generally work behind or along with the issuer, and as such, 10b-5(b) primary liability can be difficult to plead and prove against secondary actors.

Accordingly, plaintiffs have more recently turned to the language of Rule 10b-5(a) and (c) to try and creatively characterize the behavior of secondary actors as primary violators. Subsection (a) makes it unlawful to “employ any device, scheme, or artifice to defraud,” while subsection (c) makes it unlawful 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 the purchase or sale of any security.” 17 C.F.R. §240.10b-5(a) & (c) (2006). The extent to which secondary actors can be found liable under Rule 10b-5(a) & (c) is far from settled, and differing tests across circuits may eventually lead the U.S. Supreme Court to grant certiorari to resolve the confusion.

A survey of relatively recent decisions indicates that the federal circuits are increasingly entertaining secondary actor “scheme” liability under Rule 10b-5(a) & (c) — notwithstanding the arguments of secondary actors that such liability is prohibited by the proscription against aiding and abetting liability set forth in Central Bank. A brief overview of some relatively recent cases provides some insight into the increasingly blurry line between activity characterized as mere “aiding and abetting,” for which there is no civil liability, and activity characterized as part of a “scheme to defraud,” for which primary liability may exist under certain circumstances.

B. Simpson v. AOL Time Warner Inc. (In re Homestore.com)

The Ninth Circuit recently announced the most detailed test to date for determining when a secondary actor can be held primarily liable for its participation in a “scheme to defraud.” Simpson v. AOL Time Warner Inc., 452 F.3d 1040 (9th Cir. 2006). In Simpson, the plaintiffs’ claims stemmed from a downward restatement of Homestore.com’s revenues because of certain fraudulent “triangular transactions” used to meet its revenue expectations. Id. at 1043.

Plaintiffs alleged Homestore.com (“Homestore”) engaged in triangular sham transactions with various vendors for services and products that Homestore did not actually need. Id. The vendors would then contract with AOL Time Warner (“AOL”), the exclusive website provider for Homestore, for advertising on Homestore’s website. Id. Accordingly,
the money Homestore paid to the vendors went to AOL for advertising space, and ultimately flowed back to Homestore as advertising revenue (less a commission to AOL). Id. Although the third party vendors did not make any statements, plaintiffs alleged they were nevertheless liable because the triangular transactions were part of a larger scheme to defraud, thereby enabling Homestore to improperly recognize false revenue on its financial statements. Id. The district court dismissed the claims against the vendors, finding that the vendors “only facilitated and participated in Homestore’s fraud.” Id. at 1045. Stated alternatively, the district court found that the vendors merely aided and abetted Homestore’s fraud, and as such, could not be liable under the prohibition against aider and abettor liability set forth in Central Bank. Id.

On appeal, the Ninth Circuit announced the following new standard for establishing scheme liability under Rule 10b-5:

We hold that to be liable as a primary violator of § 10(b) for participation in a “scheme to defraud,” the defendant must have engaged in conduct that had the principal purpose and effect of creating a false appearance of fact in furtherance of the scheme. It is not enough that a transaction in which a defendant was involved had a deceptive purpose and effect; the defendant’s own conduct contributing to the transaction or overall scheme must have had a deceptive purpose and effect.

Id. at 1048. The court attempted to clarify the “principal purpose” prong as being “related to but different from the element of scienter,” stating further that:

the “principal purpose” prong examines instead whether the challenged conduct of the defendant had a principal purpose, and not just an accidental effect, of creating a false appearance as part of a deceptive transaction or fraudulent scheme. Unlike the scienter requirement, the “purpose and effect” test is focused on differentiating conduct that may form the basis of a primary violation under § 10(b) from mere aiding and abetting activity that the Supreme Court has held does not constitute a primary violation. A defendant may intend to deceive the public by substantially assisting another's misconduct as part of a scheme to defraud, but fail to perform personally any action that created a false appearance as part of this scheme. The scienter requirement, therefore, will not in all cases distinguish aiding and abetting from primary liability. In applying the “scienter” element, we look at whether a defendant's state of mind was sufficiently culpable for § 10(b) liability. By contrast, we may examine the “principal purpose and effect” of the defendant's challenged conduct in a fraudulent scheme as an aid to assessing whether the defendant's conduct was sufficiently deceptive for § 10(b) liability.

Id. at n.5 (emphasis added). The “principal purpose and effect” prong of the Ninth Circuit’s standard attempts to provide a dividing line between mere aiding and abetting for which there is no private cause of action, and “scheme to defraud” for which secondary actors may be held liable as primary violators for their own actions.

The Ninth Circuit’s analysis emphasized the need to carefully evaluate each defendant’s own individual conduct for evidence of culpability — not just the overall fraudulent scheme. Id. at 1050. Merely pleading scienter is not sufficient to establish scheme liability as a plaintiff must also adequately plead “primary purpose” allegations to maintain a claim under Rule 10b-5(a) or (c). Id. at 1051. A secondary actor will have no Rule 10b-5 scheme liability if it “intend[ed] to deceive the public by substantially assisting another’s misconduct as part of a scheme to defraud, but it fail[ed] to perform personally any action that created a false appearance as a part of th[e] scheme.” Id. at 1048 n.5 (emphasis added). The court further explained:

Conduct by the defendant that does not have a principal legitimate business purpose, such as the invention of sham corporate entities to misrepresent the flow of income, may have a principal purpose of creating a false appearance. Conduct that is consistent with the defendants' normal course of business would not typically be considered to have the purpose and effect of creating a misrepresentation. Participation in a legitimate transaction, which does not have a deceptive purpose or effect, would not allow for a primary violation even if the defendant knew or intended that another party would manipulate the transaction to effectuate a fraud. If a defendant's conduct or role in an illegitimate transaction has the principal purpose and effect of creating a false appearance of fact in the furtherance of a scheme to defraud, then the defendant is using or employing a deceptive device within the meaning of § 10(b). A test that examines
the purpose and effect of a defendant's conduct in an alleged scheme to defraud, as a means to assess whether the defendant used or employed a deceptive device, ensures that the defendant's conduct is sufficiently deceptive to justify imposing primary liability. Thus, when determining whether a defendant is a “primary violator,” the conduct of each defendant, while evaluated in its context, must be viewed alone for whether it had the purpose and effect of creating a false appearance of fact in the furtherance of an overall scheme to defraud.

Id. at 1050 (citations omitted). After clarifying the appropriate standard for Rule 10b-5(a) & (c) liability, the Ninth Circuit remanded the case to allow the plaintiffs an opportunity to amend their pleading in light of the court's new analysis. Id. at 1055 (“Plaintiff should have the opportunity to seek leave to file an amended complaint that may take advantage of the reasoning in this opinion.”).

It remains to be seen how workable the Ninth Circuit's scheme standard will be in practice. Although the opinion lends further credence to the notion that secondary actors can still be liable as primary violators for participation in a “scheme to defraud,” the decision also arguably narrows the scope of such liability to situations where the secondary actor’s conduct truly had no economic substance or legitimate business purpose.

C. In re Charter Communications

In contrast to the Ninth Circuit's decision in Simpson v. AOL Time Warner, the Eighth Circuit gave a very broad reading to Central Bank's prohibition against aider and abettor liability. In In re Charter Communications, Inc. Sec. Litig., 443 F.3d 987 (8th Cir. 2006), the Eighth Circuit interpreted the Central Bank holding as a “categorical declaration that a private plaintiff 'may not bring a 10b-5 suit against a defendant for acts not prohibited by the text of § 10(b),' includ[ing] claims under Rule 10b-5(a) and (c), as well as Rule 10b-5(b).” Id. at 992 (citation omitted).

In this case, plaintiffs alleged that Charter Communications Inc. (“Charter”) engaged in a “pervasive and continuous fraudulent scheme intended to artificially boost [Charter’s] reported financial results.” Id. at 989. With respect to secondary actors, the plaintiffs alleged Charter entered into sham transactions with various equipment vendors to improperly overstate Charter’s cash flow and operating revenues. Id. Specifically, Charter allegedly agreed to pay vendors an “extra” $20.00 per cable box in exchange for the vendors immediately returning the $20.00 payments to Charter in the form of advertising fees. Id. Charter then treated the advertising fees as immediately recognizable revenue, thereby inflating its operating cash flow by approximately $17 million. Id. at 989-90.

The district court dismissed the plaintiffs’ claims against the vendors, finding that the vendors merely aided and abetted Charter’s violations and thus could not be liable under the limitation in Central Bank. Id. at 989. Plaintiffs appealed, arguing that the vendors were primarily liable under 10b-5(a) and (c) by participating in a “scheme or artifice to defraud” as well as engaging in a course of business operating as a fraud or deceit. Id. at 991.

On appeal, the plaintiffs advanced a narrow interpretation of Central Bank that would have limited the holding to Rule 10b-5(b) (fraudulent misrepresentations or failure to disclose, when under a duty to do so). Id. The Eighth Circuit disagreed, and affirmed the lower court’s dismissal of their claims, finding “the district court properly dismissed the claims against the Vendors as nothing more than claims, barred by Central Bank, that the vendors knowingly aided and abetted the Charter defendants in deceiving the investor plaintiffs.” Id. at 992. The court concluded:

Thus, any defendant who does not make or affirmatively cause to be made a fraudulent misstatement or omission, or who does not directly engage in manipulative securities trading practices, is at most guilty of aiding and abetting and cannot be held liable under § 10(b) or any subpart of Rule 10b-5. Id. (emphasis added). The court was keen to note that the transactions between the vendors and Charter appeared to be arm’s length transactions in and of themselves. Id. Charter then took the transactions and reported them in a misleading way on their financial statements. Id. The Court feared that:

To impose liability for securities fraud on one party to an arm's length business transaction in goods or services other than securities because that party knew or should have known that the other party would use the transaction to mislead investors in its stock would introduce potentially far-reaching duties and uncertainties for those engaged in day-to-day business dealings. Decisions of this magnitude should be made by Congress.

Id. at 992-93. However, unlike the Ninth Circuit’s decision in Simpson, the Eighth Circuit did not remand the case and give plaintiffs another chance to amend their complaint in light of their opinion. Id. Instead the Eighth Circuit affirmed the dismissal, with prejudice, of the plaintiffs’ complaint against the vendors. Id. Moreover, under the Eighth Circuit’s analysis, a secondary participant could only be primarily liable under Rule 10b-5 if it made a material
misstatement or failed to disclose when under a duty to do so.

**D. Other Decisions**

A brief overview of some other decisions provides some additional insight into the increasing confusion as to *Central Bank*’s purported prohibition against aider and abettor liability. In *In re Parmalat*, Parmalat was sued along with several banks and other professionals under Rule 10b-5 for participating in a complex series of structured transactions allegedly designed to overstate Parmalat’s financial position. *In re Parmalat Sec. Litig.*, 376 F. Supp. 2d 472, 480-90 (S.D.N.Y. 2005). The U.S. District Court for the Southern District of New York articulated its own test for liability under Rule 10b-5(a) & (c) as “whether the banks directly or indirectly used or employed any device or contrivance with the capacity or tendency to deceive.” Id. at 504. The court found sufficient allegations that the banks were participating in sham transactions in furtherance of a fraudulent scheme, and as such, their behavior constituted the impermissible use of a deceptive device in violation of Rule 10b-5(a) and (c). Id. at 509. Accordingly, the court denied the banks’ motions to dismiss. Id. at 512.

Judge Harmon also refused to dismiss the claims against several secondary actors for their participation in the affairs of Enron. *In re Enron Corp. Sec., Derivative & ERISA Litig.*, 235 F. Supp. 2d 549, 577-83 (S.D. Tex. 2002). For example, the court refused to dismiss claims against Enron’s outside law firm which was allegedly intimately involved in creating Enron’s disclosures for public filings, shareholder reports, and press releases. The court determined that the law firm’s participation made it sufficiently involved with Enron’s fraudulent transactions that it could be deemed a co-author (rather than a mere drafter) of the public disclosures on which investors could have relied. Id. at 704-05.

However, in *In re Dynegy Inc.*, the Judge Lake found that claims against Citigroup were not actionable in connection with its loans to Dynegy that Dynegy allegedly disguised as cash flow from operations. *In re Dynegy Inc. Sec. Litig.*, 339 F. Supp. 2d 804, 819 (S.D. Tex. 2004). The court held that “[u]nder *Central Bank* the aid that Citigroup provided Dynegy is not actionable under § 10(b), and plaintiffs cannot invoke subsections (a) and (c) of Rule 10b-5 to circumvent *Central Bank*’s limitations on liability for a secondary actor’s involvement in the preparation of false and misleading statements.” Id. at 916.

As the foregoing cases illustrate, it is difficult to predict with certainty whether under a given set of facts the extent to which a secondary actor might be held liable as a primary violator under Rule 10b-5. Although some courts seem more conservative in their application of *Central Bank*’s limitation on aider and abettor liability, other courts are more willing to entreat “scheme” liability as a manner in which secondary actors might still be held liable under Rule 10b-5(a) & (c). As a general matter, it appears that courts are more willing to entertain claims under Rule 10b-5(a) and (c) where the underlying transactions at issue are clearly sham transactions with no economic substance. If the underlying transaction is arms length, especially from the perspective of the secondary actor, the court may be more disposed towards characterizing the secondary actor’s behavior as being, at most, “aiding and abetting” for which no private cause of action exists under *Central Bank*.

In any event, it is important to note that although a secondary actor may successfully avoid civil liability for merely aiding and abetting a primary violation, the *Central Bank* limitation in no way hinders the SEC’s ability to bring an enforcement action against a secondary actor for aiding and abetting. In recent years, there has been a proliferation of SEC investigations and enforcement actions against numerous secondary actors. Accordingly, just because a party may get a court to dismiss a private civil lawsuit against it for mere aiding and abetting, the dismissal will in no way preclude the SEC from lodging its own enforcement action against the secondary participant.

**II. TEXAS SECONDARY LIABILITY**

Unlike federal law, under the Texas Securities Act (the “TSA”) a person can be both primarily liable as a seller or secondarily liable as a control person or an aider. Primary liability arises if a person “offers or sells a security ... by means of an untrue statement of a material fact or an omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading.” TEX. REV. CIV. STAT. ANN. art. 581-33A(2) (Vernon 2006). Unlike under 10b-5, a TSA plaintiff does not have to prove scienter — i.e., that the primary defendant knew or, in the exercise of reasonable care, should have known of the untrue statement or omission. Id. A primary violator can only escape liability if it proves as an affirmative defense that the purchaser knew of the untruth or omission, or that the primary defendant “did not know, and in the exercise of reasonable care could not have known, of an untruth or omission.” Id.

Secondary liability is derivative for another’s primary securities violation and can attach to either a “control person” or to an “aider.”5 Id. art. 581-33F. A

5 The Texas Securities Act only uses the word “aider” rather than the phrase “aider and abettor.” Substantively, there is
Sterling Trust Co. v. Adderley

“control person” is defined as “[a] person who directly or indirectly controls a seller, buyer, or issuer of a security.”6 Id. art. 581-33F(1). An aider is defined as a person “who directly or indirectly with intent to deceive or defraud or with reckless disregard for the truth or the law materially aids a seller, buyer, or issuer of a security.” Id. art. 581-33F(2). Control persons and aiders are jointly and severally liable with the primary violator “to the same extent as if [they] were” the primary violator. Id. However, unlike as to sellers and control persons, an aider is not liable unless a plaintiff establishes that the aider acted “with intent to deceive or defraud or with reckless disregard for the truth or the law.” Id. In other words, the plaintiff must show that the alleged aider acted with the requisite scienter.

Under the TSA there has been some confusion as to the appropriate standard for secondary aider liability under 581-33(F). Specifically, Texas courts have struggled as to whether an aider must be “generally aware” of the primary violation in order to be secondarily liable. The Texas Supreme Court has now held that the TSA does contain a subjective “general awareness” requirement in order for an aider to be held secondary liable.

Sterling Trust Co. v. Adderley

The Sterling Trust Co. v. Adderley decision was significant given that the Texas Supreme Court established, for the first time, that an alleged aider must be subjectively aware of the underlying primary securities violation in order to be secondarily liable under the TSA. 168 S.W.3d 835 (Tex. 2005). To fully understand the Court’s holding, a brief overview of the underlying facts is necessary.

In Adderley, a group of elderly individuals sought recovery for millions of dollars of losses in connection with their investment in Avalon Custom Homes (“Avalon”). Id. at 837-38. Avalon and its related corporate entities were created by Norman Cornelius (“Cornelius”) for the stated purpose of designing and developing luxury custom homes. Id. at 837. At the time, Cornelius worked for Sunpoint Securities (“Sunpoint”) as an investment advisor and broker. Id. Cornelius encouraged his Sunpoint brokerage clients, as well as members from his church and other retirees, to invest their money in Avalon promissory notes and stock. Id. at 837-38.

In order to accept certain tax-advantaged retirement accounts, such as IRAs and lump-sum pension distributions, Cornelius needed a third-party trustee to accept such funds on behalf of Avalon. Id. at 838. Cornelius began directing Avalon investors to Sterling Trust Company (“Sterling”), a self-directed account custodian, as custodian for their IRAs. Id.

Eventually, Cornelius and Avalon became the target of a SEC investigation that exposed the Avalon investments as a “Ponzi” scheme.7 Id. Avalon was then forced into receivership rendering the value of its securities worthless and prompting the defrauded investors to file suit against Cornelius, Sunpoint, and Sterling. The investors presented the jury with several alternative theories of liability against Cornelius, Sunpoint, and Sterling:

1) whether each of the defendants offered or sold securities “by means of an untrue statement of material fact or the omission to state a material fact necessary in order to make the statements made, if any, in light of the circumstances under which they were made not misleading”;
2) whether Sterling aided Cornelius in committing securities fraud by “directly or indirectly with intent to deceive or defraud or with reckless disregard for the truth or the law materially aid[ing] a seller of a security”;
3) whether Sterling was “part of a conspiracy that damaged [the investors]”;
4) whether Sterling “fail[ed] to comply with its fiduciary duty” to its account holders; and
5) whether the defendants committed fraud against the investors.

Id. With respect to Sterling specifically, the investors sought to impose both primary and secondary liability under the TSA. In support of their claim that Sterling was secondarily liable as an aider under the Texas Securities Act, the investors presented evidence of the following:

- Sterling failed to follow its own internal procedures and facilitated the pyramid scheme by allowing Cornelius to hide the scheme from investors.
- Sterling held promissory notes that were in default, in violation of its policy against doing so.

---

6 This paper explores the extent to which liability can extend to an aider or abettor, and as such, “control person” liability under the TSA is beyond the scope of the issues discussed herein.

7 A “Ponzi” scheme is commonly known as a kind of pyramid scheme where money from newer investors is used to pay off money owed to earlier investors. The scheme collapses as soon as there are insufficient new investors pouring new money into the enterprise.
Aiding and Abetting: The Expanding Zone of Liability Under Texas and Federal Securities Laws

Chapter 2

Sterling failed to obtain several Avalon stock certificates and original promissory notes (Sterling’s policy precluded employees from entering into such transactions without the appropriate documentation).

Lower-level employees notified Sterling’s management about the lack of Avalon documentation, but were told Sterling had entered into an agreement with Avalon that allowed Avalon to retain such documents.

An internal Sterling memorandum questioned Cornelius’s commingling of investors’ funds (whereby one Avalon company made payments on a note for which another Avalon company was indebted).

Cornelius failed to pay back investors the principal balance on a number of promissory notes as they became due, but instead directed the money into other Avalon companies - - and Sterling passively allowed Cornelius to make such transfers unilaterally without any documentation of investor approval.

Id. at 838-39.

The jury returned somewhat confusing findings regarding Sterling’s liability under the TSA.8 As to primary liability under the TSA, the jury found that Sterling did not know and could not have known of the untruth or omission on which the securities fraud claim against Cornelius was based. Notwithstanding that finding, the jury found Sterling secondarily liable as an aider of Cornelius’s primary violation. Sterling sought appeal to the Ft. Worth Court of Appeals.

1. Ft. Worth Court of Appeals - No “General Awareness” Requirement

With respect to the jury’s imposition of aider liability, Sterling raised three points on appeal to the Fort Worth Court of Appeals.9 See Sterling Trust Co. v. Adderley, 119 S.W.3d 312 (Tex. App.—Ft. Worth 2003, pet. granted). First, Sterling argued that it could not be secondarily liable because the jury found Sterling lacked knowledge of Cornelius’s untrue statement or omission — an affirmative defense to Sterling’s primary violation. Id. at 316-17. Second, Sterling argued the trial court erred in failing to give a “general awareness” instruction regarding its alleged secondary violation. Id. at 319. Third, Sterling argued the trial court should not have awarded damages to certain investors with whom it had no direct contact. Id. at 322-25.

The Fort Worth Court of Appeals affirmed the judgment with respect to Sterling’s aider liability under the TSA, finding: (1) the language of the TSA’s aider statute does not provide an affirmative defense, and as such, the legislature did not intend for the affirmative defense available for a primary violation to also apply to a secondary violation; (2) the TSA does not require proof that an aider be “generally aware” of its role in the securities violation to be liable as an aider; and (3) the TSA does not require an aider to have any direct contact with the defrauded party. Id. at 318-19, 325.

The Fort Worth Court of Appeals’ decision holding that the TSA contained no “general awareness” requirement signaled a potentially huge shift in aider liability under the TSA. Previously, other Texas Courts of Appeals had looked to the federal securities law for guidance and determined that there was a subjective, general awareness requirement for aider liability to exist under the TSA. See, e.g., Goldstein v. Mortenson, 113 S.W.3d 769, 776 (Tex. App.—Austin 2003, no pet.) (“In order to establish [aider] liability, a plaintiff must demonstrate: (1) that a primary violation of the securities laws occurred; (2) that the alleged aider had ‘general awareness’ of its role in this violation; (3) that the actor rendered ‘substantial assistance’ in this violation; and (4) that the alleged aider either a) intended to deceive plaintiff or b) acted with reckless disregard for the truth of the representations made by the primary violator.”); Crescendo Invs., Inc., v. Brice, 61 S.W.3d 465, 472 (Tex. App.—San Antonio 2001, pet denied) (same); Frank v. Bear, Stearns & Co., 11 S.W.3d 380, 384 (Tex. App.—Houston [14th Dist.] 2000, pet. denied) (same).

After losing in the Fort Worth Court of Appeals, Sterling sought review by the Texas Supreme Court.

2. Texas Supreme Court - “General Awareness” is Required

The Texas Supreme Court agreed with the Fort Worth Court of Appeals in most respects (discussed further infra), but found reversible error with respect to the trial court’s failure to give a “general awareness” instruction:

8 By the time of trial, Cornelius had passed away leaving behind a meager estate from which no viable recovery was available to the defrauded investors. Id. at 838. Moreover, the SEC had forced Sunpoint into receivership and the claims against Sunpoint were severed out, leaving Sterling as the only remaining viable defendant at trial. Id.

9 Sterling also appealed other points of error that are beyond the scope of this paper. Specifically, Sterling challenged the trial court’s award of punitive damages for the jury’s finding of a willful violation of its fiduciary duty, and also the sufficiency of evidence as to various other portions of the jury’s verdict.
We disagree with the court of appeals' conclusion that the TSA contains no awareness requirement. The statute's history demonstrates that the Legislature intended the TSA to be interpreted in harmony with federal securities law, and the TSA itself instructs that “[t]his Act may be construed and implemented to effectuate its general purpose to maximize coordination with federal and other states’ law and administration.” When the Legislature added the aider-liability provision to the TSA in 1977, most federal courts considering the issue had held that aider liability could be imposed under the federal securities law only when the aider was generally aware of its role in an improper scheme.

Instead, we conclude that the statute's use of the phrase “reckless disregard for the truth or the law” accords with the requirement that an aider must be aware of the primary violator's improper activities before it may be held liable for assisting in the securities violation. The Legislature's use of the phrase “reckless disregard” is consistent with a requirement of subjective awareness ...

Adderley, 168 S.W.3d at 840-41 (citations and footnotes omitted) (emphasis added). Accordingly, aider liability can only exist if a plaintiff establishes that the alleged aider provided “assistance in the face of a perceived risk that its assistance would facilitate untruthful or illegal activity by the primary violator.” Id. at 842. The Texas Supreme Court emphasized the need to show the aider’s subjective awareness and refused to interpret the TSA’s “reckless disregard” standard as allowing liability for a mere failure to investigate. Id. at 841.

The Adderley opinion analyzed the TSA’s knowledge standard for aiders against the knowledge standard for control persons and sellers. Id. at 843-45. Unlike primary liability, where the burden of proof is on the defendant to establish his or her own affirmative defense, aider liability requires that the plaintiff prove that the defendant aider acted with “intent to deceive or defraud or with reckless disregard for the truth or law.” Id. at 844. Moreover, “while the TSA allows a broader class of persons to qualify as aiders, it imposes a stricter scienter restriction on them.” Id.

The Court attempted to reconcile how a party could prove an affirmative defense to a primary violation under the TSA by showing it “did not know, and in the exercise of reasonable care could not have known, of the untruth or omission” and yet still be secondarily liable as an aider. Id. at 845. Specifically, the Court noted:

We acknowledge that there is some tension between the jury's finding that Sterling acted with “reckless disregard for the truth or the law” and its finding that Sterling did not know and could not have reasonably known of “the untruth or omission” made by Cornelius.

In this case, the jury may have agreed that Sterling could not have known what Cornelius was telling the investors but nevertheless believed that Sterling knew that Cornelius was operating an illegal pyramid scheme. Because the jury in this case was asked only whether Sterling knew of “the untruth or omission,” the jury's “no” answer does not shed light on whether the jury believed that Cornelius was engaged in illegal activity. Sterling’s argument to the jury also focused on whether Sterling had knowledge of Cornelius’s statements, not whether it had knowledge of the underlying scheme. Specifically, Sterling argued that the jury must find that Sterling “did not know, and in the exercise of reasonable care, could not have known of the untruth or omission” because Sterling “had no way of knowing what Norman Cornelius was telling or not telling these people.” Consequently, we hold that the jury’s finding that Sterling “did not know, and in the exercise of reasonable care could not have known of the untruth or omission” is not dispositive of the question of whether Sterling had knowledge of the underlying wrongdoing.

Id. at 845-46. (emphasis added). In other words, the jury’s finding that Sterling did not know of Cornelius’s specific untruths or omissions (Sterling’s affirmative defense to its primary violation) in no way precluded the possibility that Sterling still had some general awareness of its participation in the Avalon scheme. The Court clarified this distinction stating:

Aider may know that the primary violator is engaging in improper activity, but, if the aider is not involved in the actual sale or offer of the securities, it may not know what particular misrepresentations or misleading omissions were made to the investors. Consequently, it makes sense to predicate liability on the aider's “reckless
disregard for the truth or the law” rather than
the aider's knowledge of specific
misrepresentations or omissions. The
investors acknowledge that Sterling may not
have known the exact misrepresentations that
Cornelius was making to the investors, but
they argue that Sterling did know that
Cornelius was operating an illegal pyramid
scheme. We agree that knowledge of such
an illegal scheme, if proven, could support a
finding that Sterling acted “with reckless
disregard for the truth or the law” even if
Sterling could not have known of the
particular misrepresentations made by
Cornelius

Id. at 845. (citations omitted).

The Texas Supreme Court also noted that it was
irrelevant whether Sterling had any direct contact with
the investors. Id. at 843. The Court noted “the TSA
does not require the aider to have had direct dealing
with the defrauded party; indeed, a person who
‘materially aids a seller’ may have no contact at all
with the investors.” Id. Accordingly, under the TSA, a
secondary actor can still be liable as an aider even
where it had no dealings whatsoever with the investors.

Accordingly, plaintiffs under the TSA must
establish that a secondary actor was at least generally
aware of the primary securities violation in order to
establish aider liability. Although the subjective
general awareness requirement offers some protection
to bankers, lawyers, accountants, and other business
partners of an issuer, the increasing willingness of
courts to stretch the zone of liability for secondary
actions should cause secondary participants to
carefully evaluate their participation with the issuer.
Secondary participants cannot simply “look the other
way” and continue to assist the issuer if they become
generally aware of something that seems improper with
respect to the issuer’s underlying activities.