St. John's Law Review

Volume 84, Summer 2010, Number 3 Article 8

Not My Brother's Keeper: Accounting Firms Face Increased Securities Claims for Audits Performed by Affiliates in Other Countries

Bryan J. Hall

NOT MY BROTHER'S KEEPER

ACCOUNTING FIRMS FACE INCREASED SECURITIES CLAIMS FOR AUDITS PERFORMED BY AFFILIATES IN OTHER COUNTRIES

BRYAN J. HALL[†]

INTRODUCTION

Call it "Enron" with an Italian accent. On Christmas Eve 2003, Parmalat, the world's largest dairy producer and Italy's eighth largest public company, declared bankruptcy in the wake of a massive corporate fraud.[1] Parmalat's Chief Executive and Chief Financial Officer admitted to cooking the books, and investigators discovered that as much as $12 billion in assets, including a $4.9 billion bank account, simply did not exist.[2] Parmalat's bankruptcy, coming just two years after the spectacular collapse of Enron[3] and the bankruptcy of WorldCom,[4]

† Notes & Comments Editor, *St. John's Law Review*; J.D. Candidate, 2011, St. John's University School of Law; B.A., 2008, Baruch College. I would like to thank Cheryl L. Wade, the Dean Harold F. McNiece Professor of Law at St. John's University School of Law, for her suggestions and input to this Note. Additionally, I would like to acknowledge and thank my family for their unending love and support.

1 *See* STEWART HAMILTON & ALICIA MICKLETHWAIT, GREED AND CORPORATE FAILURE: THE LESSONS from RECENT DISASTERS 153 (2006); Peter Gumbel, *How It Went Sour*, TIME, Dec. 13, 2004, at A2, *available at* http://www.time.com/time/magazine/article/0,9171,1009674,00.html; Gail Edmonson, David Fairlamb & Nanette Byrnes, *The Milk Just Keeps on Spilling at Parmalat*, BUS. WK., Jan. 26, 2004, at 54, *available at* http://www.businessweek.com/magazine/content/04_04/b3867074_mz054.htm.

2 *See* HAMILTON & MICKLETHWAIT, *supra* note 1, at 163–65; Gail Edmondson & Laura Cohn, *How* Parmalat *Went Sour*, BUS. WK., Jan. 12, 2004, *available at* http://www.businessweek.com/magazine/content/04_02/b3865053_mz054.htm; Edmonson, Fairlamb & Byrnes, *supra* note 1.

3 On December 2, 2001, Enron declared what was then the largest corporate bankruptcy in history, bringing an end to what had been a $60 billion company just one year earlier. *See* HAMILTON & MICKLETHWAIT, *supra* note 1, at 33–34, 46.

shattered the view that Europe might escape America's accounting scandals.[5] As had happened in the wake of Enron and WorldCom, the focus in the Parmalat investigation turned immediately to its outside auditors, two of the biggest names in accounting, Deloitte & Touche and Grant Thornton.[6] Local partners of Grant Thornton were arrested, and Deloitte-Italy was placed under investigation.[7] Grant Thornton International expelled its Italian member firm.[8] And investors filed a civil suit against the auditors, claiming billions of dollars in losses.[9]

The investors' lawsuit took a novel approach. They alleged that Parmalat's Italian auditors, Deloitte & Touche S.p.A. and Grant Thornton S.p.A., committed primary violations of section 10(b) of the Securities Exchange Act of 1934[10] by either participating in or acquiescing in Parmalat's fraud.[11] Section 10(b), the antifraud provision of the Securities Exchange Act of

---

[4] On July 21, 2002, WorldCom succeeded Enron as the largest corporate bankruptcy in history, having reported nearly $11 billion in nonexistent income. *See* HAMILTON & MICKLETHWAIT, *supra* note 1, at 59, 72.

[5] *See Corporate Scandals: Déjà Vu All Over Again?*, ECONOMIST, Dec. 20, 2003, at 73. U.S. corporate governance was once viewed as the "gold standard," Roger Leeds, *Breach of Trust: Leadership in a Market Economy*, 25 HARV. INT'L REV. 76, 79 (2003), *available at* http://hir.harvard.edu/index.php?page=article&id=1164, but its luster had, in fact, faded years before the Enron scandal. *See Corporate Scandals: Déjà Vu All Over Again?*, *supra*. By contrast, in Europe there were "claims that corporate governance [had] been improving" until Parmalat unfolded. *Id.*

[6] *See* Joseph Weber & Gail Edmondson, *Auditors Asleep at the Wheel. Sound Familiar?*, BUS. WK., Jan. 12, 2004, at 47, *available at* http://www.businessweek.com/magazine/content/04_02/b3865055_mz054.htm.

[7] *See* Edmonson, Fairlamb & Byrnes, *supra* note 1.

[8] *See In re* Parmalat Sec. Litig., 640 F. Supp. 2d 243, 252 (S.D.N.Y. 2009).

[9] *See* Third Amended Consol. Class Action Complaint for Violation of the Fed. Sec. Laws at ¶ 62, *In re* Parmalat Sec. Litig., 594 F. Supp. 2d 444 (S.D.N.Y. 2009) (No. 04 MD 1653(LAK)). The investors sued Parmalat's current Italian auditors, Deloitte & Touche S.p.A., as well as the global accounting network that it belongs to, Deloitte Touche Tohmatsu ("DTT" or "the global firm"). *See In re* Parmalat Sec. Litig., 594 F. Supp. 2d 444, 447 (S.D.N.Y. 2009). Along with DTT, the investors sued Deloitte & Touche LLP, DTT's U.S. member firm. *See id.* at 446–47. These entities are collectively referred to as "the Deloitte Defendants" in this Note. Along with Deloitte, investors sued Parmalat's former Italian auditors, Grant Thornton S.p.A., and the global accounting firm it belonged to, Grant Thornton International ("GTI"). *See Parmalat*, 640 F. Supp. 2d at 245–46. Grant Thornton S.p.A. was subsequently expelled from GTI for its role in the Parmalat audit. *See id.* at 252. Together with GTI, the investors sued the U.S. member firm, Grant Thornton LLP. *See id.* at 245–46. These entities are collectively referred to as "the Grant Thornton Defendants."

[10] 15 U.S.C. § 78j(b) (2006).

[11] *See Parmalat*, 640 F. Supp. 2d at 245–48; *Parmalat*, 594 F. Supp. 2d at 446–48.

1934, prohibits the knowing use of a manipulative or deceptive document or other device in connection with the purchase or sale of securities.[12] The investors sued not only Parmalat's Italian auditors but also the global accounting firms they belonged to and the U.S. member firms of each of these global accounting firms.[13] In this way, the investors were able to reach the deep-pocketed U.S. accounting firm by means of a "stepping stone" approach.[14] The investors first alleged that the global accounting firms controlled the Italian auditors and were, therefore, vicariously liable for the Italians' bad acts.[15] Next, the investors claimed that the U.S. accounting firms, by virtue of their size and financial resources, controlled the global firms and should be secondarily liable for the misdeeds of the Italian auditors.[16]

In early 2009, the U.S. district court in *Parmalat* ruled that the global accounting firms can be held vicariously liable for the Italian auditors' primary violations of section 10(b) under the common law theory of agency, which requires only a right to control, not actual control, of the alleged wrongdoer.[17] The court also found that the investors could sue the global accounting firms under section 20(a) of the Securities Exchange Act of 1934,[18] which imposes liability on a party that controls anyone who commits a primary violation of the Act.[19] Section 20(a) is distinguishable from section 10(b) in that 20(a) provides an affirmative defense if the control defendant acted in good faith

[12] 15 U.S.C. § 78j(b) ("It shall be unlawful for any person . . . [t]o use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance.").

[13] *See Parmalat*, 640 F. Supp. 2d at 245 (discussing the claims against the Grant Thornton Defendants); *Parmalat*, 594 F. Supp. 2d at 446 (discussing various claims against the Deloitte Defendants); *see also infra* Part II.B.

[14] *See* James Roberts & Andrew Forsyth, *The Risks of Globalisation*, LEGAL WK., Sept. 17, 2009, at 26, *available at* http://www.legalweek.com/legal-week/analysis/1533842/professional-negligence-the-risks-globalisation.

[15] *See Parmalat*, 640 F. Supp. 2d at 245–52; *Parmalat*, 594 F. Supp. 2d at 447, 451–59.

[16] *See Parmalat*, 640 F. Supp. 2d at 252–54; *Parmalat*, 594 F. Supp. 2d at 458–60.

[17] *See Parmalat*, 640 F. Supp. 2d at 246–52; *Parmalat*, 594 F. Supp. 2d at 451–55.

[18] *See Parmalat*, 640 F. Supp. 2d at 255; *Parmalat*, 594 F. Supp. 2d at 455–56.

[19] *See* 15 U.S.C. § 78t(a) (2006). The statute provides that "[e]very person who, directly or indirectly, controls any person liable under any provision of this chapter . . . is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action." *Id.*

and did not directly or indirectly induce the violation.[20] Turning to the U.S. accounting firms, the court found that they could be subject to secondary liability for controlling the global firms, which, in turn, controlled the Italian auditors.[21]

This Note argues that plaintiffs who sue a global accounting firm or a U.S. accounting firm for an audit performed by an affiliated accounting firm should be required to prove that the global or U.S. firm actually controlled the audit at issue in the litigation.[22] Plaintiffs should not be permitted to bypass the express statutory limitations that Congress has placed on secondary liability in the Securities Exchange Act by applying broader common law principles of vicarious liability. The use of common law vicarious liability in section 10(b) litigation conflicts with Supreme Court precedent, which has taken a narrow view of liability under 10(b), particularly given that Congress has limited secondary liability by including a good faith defense in section 20(a). Furthermore, this Note argues that public policy considerations and organizational factors caution against

[20] *See id.*; *see also infra* Part III.B.1.

[21] *See Parmalat*, 640 F. Supp. 2d at 252–55; *Parmalat*, 594 F. Supp. 2d at 458–60. While the *Parmalat* Court accepted plaintiffs' securities fraud claims premised on agency liability, it rejected claims that the U.S. auditors should be held liable as the *alter ego* of their Italian counterparts because plaintiffs failed to allege a lack of corporate formalities, intermingling of funds, common leadership, or domination by the U.S. firms of their counterparts. *See In re* Parmalat Sec. Litig., 375 F. Supp. 2d 278, 296–97 (S.D.N.Y. 2005). To establish a claim of alter ego, plaintiffs must show "complete domination of the corporation in respect to the transaction attacked, and . . . that such domination was used to commit a fraud or wrong against the plaintiff which resulted in plaintiff's injury." *In re* Alstom SA Sec. Litig., 454 F. Supp. 2d 187, 215 (S.D.N.Y. 2006) (internal citation and quotation marks omitted). The *Parmalat* plaintiffs appear not to have pursued a claim of enterprise liability, which "provides a horizontal form of liability" to hold the various subsidiaries of a business enterprise jointly liable. Stephen M. Bainbridge, *Abolishing Veil Piercing*, 26 J. CORP. L. 479, 526 (2001); *see* Las Palmas Assocs. v. Las Palmas Ctr. Assocs., 1 Cal. Rptr. 2d 301, 318 (Cal. Ct. App. 1991) (finding that "under the single-enterprise rule, liability can be found between sister companies"). This may have been due to "[t]he recurrent rejection of traditional enterprise liability by some [courts]." Alfred F. Conard, *Enterprise Liability and Insider Trading*, 49 WASH. & LEE L. REV. 913, 928 (1992).

[22] This Note addresses claims against accounting firms based on vicarious or secondary liability when the accounting firms did not conduct or actually control the audit at issue in the litigation. Accounting firms can be held liable for their own primary violations of the Securities Exchange Act of 1934, provided that all the elements of the cause of action are met. *See* Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164, 191 (1994); *infra* note 63.

imposing secondary liability on independent, but affiliated, accounting firms, absent a showing of actual control of the audit at issue in the litigation.

This Note proceeds in three parts. Part I discusses the development of the modern global structure of accounting firms and analyzes recent district court decisions in which accounting firms have not been held liable for audits performed by affiliated accounting firms. Part I also considers the implications of three Supreme Court decisions that rejected secondary liability under section 10(b) of the Securities Exchange Act. Part II explores the facts leading up to Parmalat's bankruptcy and the district court's decision to apply agency and control liability to global and U.S. accounting firms. Part III argues that the court in *Parmalat* erred in applying common law agency liability to accounting firms under section 10(b) for the actions of legally separate affiliated firms. Rather, the court should have applied the secondary liability provision that Congress expressly provided in section 20(a) of the Securities Exchange Act. Turning to section 20(a), Part III argues that the more rigorous actual control of the audit standard should apply to secondary liability claims against accounting firms, rather than the less rigorous power to control standard. Finally, Part III applies the actual control of the audit standard to the facts of *Parmalat* and demonstrates how, under this standard, public policy and organizational considerations are adequately addressed, while providing for meaningful recovery against accounting firms that actually control the audit at issue in the litigation.

I. MEGA FIRMS AND MASSIVE LIABILITY

A. *A Nontraditional Global Structure*

From the outside, accounting firms look like any modern international corporation, with global headquarters and branches in different countries. But despite their efforts to present a uniform global brand, accounting firms are actually associations of distinct national partnerships, and the individual national firms have limited involvement in and, presumably, liability for the actions of their affiliates in other countries.[23] This unique

[23] *See* ADVISORY COMMITTEE ON THE AUDITING PROFESSION, FINAL REPORT OF THE ADVISORY COMMITTEE ON THE AUDITING PROFESSION TO THE U.S. DEPARTMENT

structure has developed out of a need to meet the demands of large global clients, while adhering to national laws on ownership and practice, which vary greatly by state and country.[24]

From fairly modest beginnings as small partnerships of practitioners, accounting firms grew rapidly in the second half of the twentieth century to match the size and scale of their multinational corporate clients.[25] As they expanded globally, accounting firms retained their traditional partnership structure because this structure is often mandated by law[26] in part to ensure that junior accountants develop their practical experience and professional judgment by working alongside more seasoned professionals.[27] In the United States, many states continue to require that licensed public accountants own a majority stake in any accounting practice licensed to do business in the state.[28] Similarly, many foreign countries impose partnership structures on accounting firms or prohibit foreign-owned firms from

---

OF THE TREASURY V:10–11 (2008) [hereinafter ADVISORY COMMITTEE REPORT], *available at* http://www.treas.gov/offices/domestic-finance/acap/docs/final-report.pdf. Then-Treasury Secretary Henry M. Paulson, Jr., commissioned the report to examine the current state of the auditing profession and to develop recommendations for making the profession more sustainable. *See id.* at I:1. The Advisory Committee could not agree on changes to private securities litigation involving accounting firms, but it did recommend that the firms provide greater information to the public. *See id.* at II:8–9.

[24] *See id.* at V:10.

[25] *See id.* at V:4–5, V:10; GARY JOHN PREVITS & BARBARA DUBIS MERINO, A HISTORY OF ACCOUNTANCY IN THE UNITED STATES: THE CULTURAL SIGNIFICANCE OF ACCOUNTING 298–301, 348–49 (1998).

[26] *See* UNITED STATES GOVERNMENT ACCOUNTABILITY OFFICE, AUDITS OF PUBLIC COMPANIES 7–9 (2008) [hereinafter GAO REPORT], *available at* http://www.gao.gov/new.items/d08163.pdf. The Government Accountability Office ("GAO") prepared this report as part of an ongoing initiative to assist Congress in examining the highly concentrated market for public company audits. *See id.* at 2. Although audit market concentration may limit a company's choice in selecting an auditor, the GAO found "no compelling need" for Congress to act. *See id.* at 4–6.

[27] *See* DAVID GRAYSON ALLEN & KATHLEEN MCDERMOTT, ACCOUNTING FOR SUCCESS: A HISTORY OF PRICE WATERHOUSE IN AMERICA 1890–1990, at 7–8 (1993); PREVITS & MERINO, *supra* note 25, at 201–02.

[28] *See* ADVISORY COMMITTEE REPORT, *supra* note 23, at V:10; CENTER FOR AUDIT QUALITY, REPORT OF THE MAJOR PUBLIC COMPANY AUDIT FIRMS TO THE DEPARTMENT OF THE TREASURY ADVISORY COMMITTEE ON THE AUDITING PROFESSION 23 n.5 (2008) [hereinafter CENTER FOR AUDIT QUALITY], *available at* http://www.thecaq.org/publicpolicy/data/TRData2008-01-23-FullReport.pdf ("state laws require audit firms to be owned to a substantial degree by CPAs").

operating within their borders.[29] These ownership laws have prevented the development of global accounting corporations, and, as a result, today all global accounting firms operate as networks of nationally owned partnerships.[30]

Within this network structure, accounting firms remain legally separate and distinct entities.[31] The primary relationship between the various national partnerships is their membership in the global accounting network, or global firm.[32] Under the umbrella of the global firm, the national accounting firms share a common brand name and apply common standards and procedures established by the global firm.[33] The global firm does not perform audits but sets the standards and procedures that its member firms apply, monitors compliance with those standards and procedures, and coordinates activities at a global level.[34] Because their role is primarily that of a standard setter and caretaker of the brand name, these global firms are typically organized as limited liability, nonprofit entities.[35]

---

[29] *See* Cromer Fin. Ltd. v. Berger, Nos. 00 Civ. 2284(DLC), 00 Civ. 2498(DLC), 2002 WL 826847, at *4 (S.D.N.Y. May 2, 2002) (acknowledging accounting firm's argument that "the laws of many nations in which its member firms operate prohibit the operation of foreign accounting firms"); ADVISORY COMMITTEE REPORT, *supra* note 23, at V:10.

[30] *See* ADVISORY COMMITTEE REPORT, *supra* note 23, at V:10 ("[T]he development of [accounting] networks grew out of a need to comply with country-specific regulations, which . . . mandate that auditing firms be controlled and owned by locally licensed professionals.").

[31] *See id.* at V:13–14.

[32] *See id.* at V:14.

[33] *See id.* at V:10.

[34] *See id.* at V:14–15. While setting standards, monitoring compliance, and coordinating global activities are strong evidence of control, courts have generally found them to be insufficient to establish liability against global accounting firms. *See infra* notes 69–73 and accompanying text.

[35] *See* CENTER FOR AUDIT QUALITY, *supra* note 28, at 5–21 (discussing the organizational structures of the six largest global accounting networks). BDO International is incorporated in the Netherlands as BDO Global Coordination B.V. *Id.* at 5. Deloitte Touche Tohmatsu has been established as a *verein* under Swiss law. *Id.* at 8. In German, " 'Verein' means association, society, club or union." *In re* Parmalat Sec. Litig., 594 F. Supp. 2d 444, 447 n.5 (S.D.N.Y. 2009) (quoting CASSEL'S GERMAN DICTIONARY 662 (1978)). Ernst & Young Global Limited is a private company limited by guarantee under United Kingdom law. CENTER FOR AUDIT QUALITY, *supra* note 28, at 12. Grant Thornton International Ltd. is a private company limited by guarantee in England and Wales. *Id.* at 15. KPMG International operates as a Swiss cooperative. *Id.* at 19. Lastly, PricewaterhouseCoopers International Limited is an English private company limited by guarantee. *Id.* at 21.

This global network structure enables modern accounting firms to achieve several important organizational and business objectives. First, the network structure has, until recently, insulated the national member firms from liability for one another's alleged wrongdoing.[36] Second, nationally oriented accounting firms are better able to understand and comply with national standards on accounting, auditing, independence, and education.[37] Third, a coordinated approach enables national firms to operate on a global scale by sharing resources to service multinational clients under a common, recognized brand name.[38] Fourth, by applying international standards and procedures, the firms ensure a consistent quality of work globally.[39]

Although this global network structure has many advantages, it has one significant disadvantage: Accounting firms have had to become very large to match the size of their corporate clients, and this has resulted in the industry being dominated by a handful of large global accounting firms. To address the size and scale of many of their clients, accounting firms consolidated during the 1980s and 1990s through a series of "mega mergers."[40] By the end of the 1990s, the eight largest accounting firms had consolidated through mergers into five firms.[41] With the collapse of Arthur Andersen in 2002 in the wake of the Enron scandal,[42] this number was reduced to just four large global accounting firms.[43] The four remaining mega

---

[36] *See infra* Part I.C.

[37] *See* ADVISORY COMMITTEE REPORT, *supra* note 23, at II:8, V:10 ("[T]o effectively operate in foreign jurisdictions, auditing firms . . . need to employ individuals familiar with the accounting, legal, cultural, linguistic, and business practices of each relevant jurisdiction.").

[38] *See id.* at V:10.

[39] *See id.*; *see also* International Federation of Accountants, Forum of Firms, http://www.ifac.org/Forum_of_Firms/ (last visited Dec. 22, 2010) (discussing global accounting firms' role in promoting compliance with international standards by their member firms).

[40] *See generally* SAMUEL A. CYPERT, FOLLOWING THE MONEY: THE INSIDE STORY OF ACCOUNTING'S FIRST MEGA-MERGER 189–222 (1991) (discussing the first mega merger that created the global accounting firm now known as KPMG).

[41] *See* ADVISORY COMMITTEE REPORT, *supra* note 23, at V:4–5; GAO REPORT, *supra* note 26, at 8–9.

[42] *See infra* Part I.D.

[43] *See* ADVISORY COMMITTEE REPORT, *supra* note 23, at V:4–5; GAO REPORT, *supra* note 26, at 75 ("[T]he overall market for public company audits continues to be highly concentrated among the largest accounting firms.").

firms[44] audit ninety-eight percent of the 1,500 largest public companies in the United States,[45] and ninety-four percent of all audit fees paid by publicly listed U.S. companies are remitted to these four accounting firms.[46] While smaller and midsized accounting firms continue to grow and pursue ever larger clients, their share of the overall market for large public company audits remains small.[47] The highly concentrated nature of the audit industry has already had a negative impact on auditor independence, conflicts of interest, and the ability of public companies to switch auditors.[48] The loss of one of the four remaining large global accounting firms to a massive civil judgment from a suit like *Parmalat* would likely result in inadequate choice and increased cost for companies, as well as impaired auditor independence, all of which would greatly harm both public companies and the investing public.[49] Public policy, therefore, strongly cautions against expanding accounting firm liability at a time when the industry is highly concentrated and extremely vulnerable to large tort judgments.

B. "Public Watchdog" Accounting

Along with the rapid growth brought about by globalization, one of the most important elements in the development of the modern accounting industry was the requirement that all publicly listed corporations undergo annual audits of their financial statements.[50] In the United States, this requirement was introduced in the Securities Exchange Act of 1934.[51]

---

[44] The four largest global accounting networks are PricewaterhouseCoopers International Ltd., Deloitte Touche Tohmatsu, Ernst & Young Global Ltd., and KPMG International. *See* ADVISORY COMMITTEE REPORT, *supra* note 23, at V:10–12.

[45] *See* GAO REPORT, *supra* note 26, at 4.

[46] *See id.* at 75.

[47] *See* ADVISORY COMMITTEE REPORT, *supra* note 23, at V:7; GAO REPORT, *supra* note 26, at 15–18.

[48] *See* GAO REPORT, *supra* note 26, at 21–24. Public companies today have fewer choices in selecting an outside auditor because frequently only one or two of the largest firms provides the breadth of services and has the industry expertise that the client needs. *See id.* at 15–18.

[49] *See* GAO REPORT, *supra* note 26, at 32–36.

[50] *See* PREVITS & MERINO, *supra* note 25, at 274 ("Passage [of the Securities Exchange Act] increased demand for accounting services . . . . The legislation [also] conferred upon CPAs a legally defined social obligation: to assist in creating and sustaining investor confidence in the public capital markets.").

[51] *See* Gideon Mark, *Accounting Fraud: Pleading Scienter of Auditors Under the PSLRA*, 39 CONN. L. REV. 1097, 1145–46 (2007).

Publicly traded companies listed on U.S. exchanges must file annual reports with the Securities and Exchange Commission ("SEC") that have been certified by "independent public accountants."[52] Corporations pay for their outside auditors to conduct these audits, but the investing public is the ultimate beneficiary of audited financial reports.[53]

By mandating regular audits of all public companies, the Securities Exchange Act imposed a dual responsibility on auditors: to advise and serve their clients and to protect the public trust.[54] This dual role has led to an "expectation gap," where shareholders expect auditors to "root out management fraud,"[55] whereas auditors view their role as "provid[ing] *reasonable assurance* that the financial statements are free of material misstatement."[56] However, when fraud is uncovered at a public company, investors and the public, somewhat naturally, ask why the auditors failed to detect it sooner.[57] Beginning in the 1970s, the public's expectation that auditors would root out fraud led to a dramatic increase in litigation as plaintiffs and courts came to view accounting firms as a "deep pocket" source for recompensing aggrieved shareholders.[58]

---

[52] *See* 15 U.S.C. § 78m(a) (2006); 17 C.F.R. §§ 210.1-01–.2-07 (2010).

[53] *See* PREVITS & MERINO, *supra* note 25, at 273–74. Following passage of the Securities Exchange Act of 1934, "[r]egulators promoted audited financial statements as the means by which stockholders could exercise their ownership rights." *Id.* at 274.

[54] The U.S. Supreme Court has stated that:

> By certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a *public* responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public. This "public watchdog" function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust.

United States v. Arthur Young & Co., 465 U.S. 805, 817–18 (1984).

[55] *See* ADVISORY COMMITTEE REPORT, *supra* note 23, at VII:14–15; THOMAS A. KING, MORE THAN A NUMBERS GAME: A BRIEF HISTORY OF ACCOUNTING 67 (2006). *See generally* Marianne Ojo, *Eliminating the Audit Expectations Gap: Myth or Reality?*, MUNICH PERSONAL REPEC ARCHIVE, Feb. 2006, http://mpra.ub.uni-muenchen.de/232/1/MPRA_paper_232.pdf.

[56] ADVISORY COMMITTEE REPORT, *supra* note 23, at VII:15.

[57] *See id.* at VII:14–15.

[58] *See* PREVITS & MERINO, *supra* note 25, at 375–78 ("Accountants are popular targets of the plaintiff's bar, sometimes because of the notion that firms have the resources (deep pockets) to reward the litigants.").

C. Accounting Scandals and the Search for Deep Pockets

In recent years, accounting firms have faced increased liability for not detecting fraud or preventing financial misstatements by their clients, resulting in billions of dollars in settlements and judgments.[59] Investors frequently react by suing the corporation's accounting firms for violations of the Securities Exchange Act.[60] While litigation has become a cost of doing business for accounting firms,[61] the primary risk to their long-term sustainability comes from the potential "big ticket" suit for billions of dollars that could bankrupt a firm.[62] This risk is particularly acute in cases where the accounting firm does not participate in or control the audit but is only affiliated with the accounting firm that actually performed the audit.

1. Section 10(b) and Secondary Liability

Plaintiffs frequently bring claims against auditors under section 10(b) of the Securities Exchange Act of 1934, which prohibits the use of manipulative or deceptive devices in connection with the purchase or sale of securities.[63] In a suit against an accounting firm, plaintiffs typically claim that the auditors knowingly or recklessly ignored fraud that was perpetrated by company insiders, while issuing clean audit

[59] *See* CENTER FOR AUDIT QUALITY, *supra* note 28, at 49 (stating that the six largest U.S. accounting firms paid out $3.68 billion to settle lawsuits related to public company audits between 1996 and 2007).

[60] See *infra* Part I.C.1 for a discussion of claims under section 10(b) of the Securities Exchange act. See *infra* Part I.C.2 for a discussion of claims under section 20(a).

[61] *See* CENTER FOR AUDIT QUALITY, *supra* note 28, at 27–28. Total litigation costs for the six largest U.S. accounting firms represented 15.1% of audit-related revenues, the firms' largest expense after employee and partner compensation and client-related expenses. *See id.*

[62] *See* Eric L. Talley, *Cataclysmic Liability Risk Among Big Four Auditors*, 106 COLUM. L. REV. 1641, 1642–44 (2006).

[63] *See* 15 U.S.C. § 78j (2006). Pursuant to 10(b), the Securities and Exchange Commission has promulgated Rule 10b-5. 17 C.F.R. § 240.10b-5 (2010). To establish a violation of section 10(b) or Rule 10b-5, the plaintiff must show a material misrepresentation or omission; scienter; a connection between the misrepresentation and the purchase or sale of securities; reliance on the misrepresentation; economic loss; and loss causation. *See* Stoneridge Inv. Partners v. Scientific-Atlanta, Inc., 552 U.S. 148, 157 (2008). In 2010, after the *Parmalat* decision was rendered, the Second Circuit limited private suits under section 10(b)/Rule 10b-5 against accountants and other secondary actors to instances in which "false statements [are] attributed to the secondary-actor defendant at the time of dissemination." Pac. Inv. Mgmt. Co. v. Mayer Brown LLP, 603 F.3d 144, 148 (2d Cir. 2010).

opinions of the company's financial statements on which the plaintiffs or the market relied.[64] Section 10(b) did not establish an express private cause of action; the cause of action was judicially created.[65] As a result, courts have struggled with the precise contours of the private cause of action, particularly when plaintiffs sue both primary violators and secondary parties who have some relationship with the primary violator of 10(b).[66] Adding to the complexity, in cases involving accounting firms, plaintiffs and courts often conflate legally distinct entities by using the common brand name to refer to all the defendants.[67]

Although federal district and appellate courts have generally treated the 10(b) private cause of action as a broad remedy,[68] most courts have rejected attempts to hold U.S. accounting firms and global firms secondarily liable for the work of an affiliated accounting firm in another country.[69] This has frequently been

[64] *See, e.g.*, *In re* Parmalat Sec. Litig., 375 F. Supp. 2d 278, 283–84 (S.D.N.Y. 2005).

[65] The private cause of action under 10(b) was first recognized in Kardon v. Nat'l Gypsum Co., 69 F. Supp. 512, 513–14 (E.D. Pa. 1946). The Supreme Court acknowledged its existence in a footnote in *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 13 n.9 (1971).

[66] *See In re* Lernout & Hauspie Sec. Litig., 230 F. Supp. 2d 152, 172–73 (D. Mass. 2002).

[67] *See Parmalat*, 375 F. Supp. 2d at 288–89 (stating that plaintiffs' use of the terms "Deloitte" and "Grant Thornton" to refer to multiple defendants was "ill-advised"); Cromer Fin. Ltd. v. Berger, Nos. 00 Civ. 2284(DLC), 00 Civ. 2498(DLC), 2002 WL 826847, at *3 (S.D.N.Y. May 2, 2002). The *Cromer* Court denied summary judgment for the global firm, Deloitte Touche Tohmatsu, in part because the audit report was "signed 'Deloitte & Touche,' in a cursive signature." *Id.* However, "Deloitte & Touche" is not the global firm's name; Deloitte Touche Tohmatsu is. *See id.* at *1. Deloitte's member firm in Bermuda operated under the name "Deloitte & Touche (Bermuda)." *Id.*

[68] *See* Laperriere v. Vesta Ins. Group, Inc. 526 F.3d 715, 725 & n.21 (11th Cir. 2008) (finding a seven-to-one split among the other federal courts of appeals in favor of applying common law vicarious liability to section 10(b)). The Third Circuit has generally limited secondary liability to section 20(a). *See* Sharp v. Coopers & Lybrand, 649 F.2d 175, 182–83 (3d Cir. 1981); Rochez Bros. v. Rhoades, 527 F.2d 880, 884–85 (3d Cir. 1975). Along with the Third Circuit, a number of district courts have rejected vicarious liability claims brought under 10(b). *See, e.g.*, *In re* Fidelity/Micron Sec. Litig., 964 F. Supp. 539, 544 (D. Mass. 1997); Converse, Inc. v. Norwood Venture Corp., No. 96 CIV. 3745(HB), 1997 WL 742534, at *3 (S.D.N.Y. Dec. 1, 1997); *In re* Prudential Ins. Co. of Am. Sales Practices Litig., 975 F. Supp. 584, 612–13 (D.N.J. 1996).

[69] *See, e.g.*, Anwar v. Fairfield Greenwich Ltd., No. 09 Civ. 0118(VM), 2010 WL 3341636, at *71–73 (S.D.N.Y. Aug. 18, 2010) ("[A]llegations of generalized control are insufficient to state a plausible claim of coordinating-entity control over its member firms in the auditing context."); Nuevo Mundo Holdings v. Pricewaterhouse Coopers LLP, No. 03 Civ. 0613 GBD, 2004 WL 112948, at *3 (S.D.N.Y. Jan. 22,

84 St. John's L. Rev. 1133 (2010)

due to the plaintiffs' relatively weak factual arguments regarding the relationship between the foreign audit firm that actually performed the audit and the global or U.S. firm.[70] Plaintiffs have had some success with facts showing that the accounting firm was actually involved in the particular audit[71] or employed the individual alleged to have committed the wrongdoing.[72] Plaintiffs, however, have generally been unsuccessful in suing global accounting firms based on a theory of vicarious liability under section 10(b).[73]

In contrast with some lower courts, the Supreme Court has consistently read section 10(b) quite narrowly, limiting the private cause of action to the express language of the statute.[74] On three occasions, the Court has refused to recognize secondary liability under section 10(b).[75] In *Ernst & Ernst v. Hochfelder*, the Supreme Court rejected secondary liability premised on the auditor's alleged negligence in failing to properly audit a brokerage fund, finding that the statute required, at a minimum, recklessness by the defendant.[76] The plaintiffs in *Ernst & Ernst* claimed that the auditors had failed to conduct proper audits of the company, which would have uncovered the wrongdoing at the

---

2004) ("[C]ourts have declined to treat different [accounting] firms as a single entity, holding them liable for one another's acts, simply because they shared an associational name and/or collaborated on certain aspects of a transaction."); *In re* Asia Pulp & Paper Sec. Litig., 293 F. Supp. 2d 391, 396 (S.D.N.Y. 2003); *In re* WorldCom, Inc., Sec. Litig., No. 02 Civ. 3288(DLC), 2003 WL 21488087, at *10 (S.D.N.Y. June 25, 2003); *Lernout & Hauspie*, 230 F. Supp. 2d at 173; Howard v. Klynveld Peat Marwick Goerdeler, 977 F. Supp. 654, 661–62 (S.D.N.Y. 1997). *But see In re* Parmalat Sec. Litig., 594 F. Supp. 2d 444, 451–59 (S.D.N.Y. 2009).

[70] *See Nuevo Mundo Holdings*, 2004 WL 112948, at *3; *Asia Pulp*, 293 F. Supp. 2d at 396; *WorldCom*, 2003 WL 21488087, at *10; *Lernout & Hauspie*, 230 F. Supp. 2d at 173.

[71] *See Cromer*, 2002 WL 826847, at *2–3 (refusing to dismiss the complaint because the global accounting firm's name and logo were included on the audit opinion, and the lead partner on the audit was a member of the global firm's leadership).

[72] *See Sharp*, 649 F.2d at 182–83.

[73] *See supra* note 69; *In re* Parmalat Sec. Litig., 375 F. Supp. 2d 278, 296–97 (S.D.N.Y. 2005) (rejecting a claim of alter ego liability against the Deloitte Defendants); *Lernout & Hauspie*, 230 F. Supp. 2d at 173 (rejecting a claim of agency liability against a global accounting firm).

[74] *See, e.g.*, Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164, 173 (1994) ("[T]he text of the statute controls our decision.").

[75] *Stoneridge Inv. Partners*, 552 U.S. at 158, 166–67; *Cent. Bank*, 511 U.S. at 176–78; Ernst & Ernst v. Hochfelder, 425 U.S. 185, 206, 215 (1976).

[76] *See* 425 U.S. at 190, 215.

heart of the fraud.[77] Plaintiffs conceded, however, that there was no evidence that the auditors had intentionally participated in or aided the fraud, claiming only that the failure to conduct a proper audit was "inexcusable negligence."[78] Relying on the text of section 10(b) and congressional intent, the Court concluded that the private cause of action under 10(b) does not reach "negligent wrongdoing,"[79] limiting claims to defendants who exhibit scienter.[80] The Court, thus, refused to "broaden the class of plaintiffs who may seek to impose liability upon accountants . . . under the Acts."[81]

The Court continued to apply its narrow construction of section 10(b) in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, in which the Court rejected a claim of secondary liability under 10(b) against a trustee for allegedly aiding a fraud by bond issuers who had defaulted.[82] Plaintiffs sought to hold Central Bank liable for aiding and abetting[83] the fraud. Because Central Bank had been aware that the value of the land used to secure the bonds had not appreciated in value as predicted, it delayed conducting an independent appraisal and the bond issuer defaulted.[84] Rejecting the plaintiffs' argument and overturning the decisions of nearly every circuit court to consider the issue,[85] the Supreme Court found that the language of section 10(b) did not prohibit—or even address—aiding and abetting a fraud,[86] and the plaintiffs had failed to establish that these defendants made a material misstatement or omission.[87]

---

[77] *See id.* at 190.

[78] *Id.* at 190 n.5.

[79] *Id.* at 210.

[80] *See id.* at 202 ("There is no indication . . . that § 10(b) was intended to proscribe conduct not involving scienter.").

[81] *Id.* at 214 n.33.

[82] 511 U.S. 164, 176–78, 191 (1994).

[83] As defined by the Tenth Circuit in the *Central Bank* litigation, aiding and abetting liability required a primary violation of section 10(b), recklessness by the aider and abettor as to the existence of the violation, and substantial assistance given by the aider and abettor to the party that committed the 10(b) violation. *See id.* at 168.

[84] *See id.* at 167–68.

[85] *See id.* at 194 n.1 (Stevens, J., dissenting) (stating that nearly every circuit had approved of some form of secondary liability for aiding and abetting under section 10(b)).

[86] *See id.* at 173 (majority opinion). The Court found that aiding and abetting "reaches persons who do not engage in the proscribed activities at all." *Id.* at 176.

[87] *See id.* at 177.

The Court thus refused to read the judicially created private cause of action more broadly than the statutory language.[88]

More recently, in 2008, the Court again rejected secondary liability that had been packaged as "scheme liability"[89] in *Stoneridge Investment Partners v. Scientific Atlanta, Inc*.[90] The *Stoneridge* plaintiffs claimed that the defendants, which were customers and vendors of the company that had committed the fraud, should be held liable for engaging in arrangements with the company that made its financial position appear healthier than it was.[91] While acknowledging that the defendants' actions were "deceptive,"[92] the Court concluded that plaintiffs had failed to establish that they relied on the defendants' deceptive acts.[93] In doing so, the Court reaffirmed that "Section 10(b) does not incorporate common-law fraud into federal law" and cautioned against reading 10(b) broadly in the absence of direction from Congress.[94] The Court also noted that its decision in *Central Bank* had resulted in calls for Congress to expand secondary liability under 10(b) but that Congress had actually narrowed the private cause of action when it enacted the Private Securities Litigation Reform Act of 1995 ("PSLRA").[95] While *Stoneridge* did not expressly disclaim all forms of secondary or vicarious liability

---

[88] *See id.* at 180.

[89] The Ninth Circuit, which until *Stoneridge* applied scheme liability, described it as follows:

> [T]he 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.

Simpson v. AOL Time Warner Inc., 452 F.3d 1040, 1048 (9th Cir. 2006), *vacated sub nom.*, Avis Budget Group, Inc. v. Cal. State Teachers' Ret. Sys., 552 U.S. 1162 (2008).

[90] *See* 552 U.S. 148, 159 (2008).

[91] *See id.* at 152–55.

[92] *Id.* at 160.

[93] *See id.*

[94] *Id.* at 162–63.

[95] *See id.* at 158 (citing 15 U.S.C. § 78t(e) (2006)). In enacting the PSLRA, Congress directed the SEC to prosecute aiders and abettors, rather than permit private suits. *See id.* Congress also imposed "heightened pleading requirements" on suits under 10(b). *See id.* at 165.

under 10(b), it reiterated that, to establish liability under 10(b), "[t]he conduct of *a secondary actor* must satisfy each of the elements or preconditions for liability."[96]

2. Section 20(a): Expressly Providing for Secondary Liability

Given the Supreme Court's narrow reading of the 10(b) private cause of action very narrowly, some plaintiffs have sought to impose liability against global accounting firms under section 20(a) of the Securities Exchange Act of 1934.[97] Section 20(a) imposes joint and several liability on any party that directly or indirectly controls a party that commits a primary violation of the Act.[98] To establish liability under 20(a), plaintiffs must show both a primary violation of the Act and control of the violator by the defendant.[99] Section 20(a) enables plaintiffs to sue corporate officers, boards of directors, and majority shareholders when they control an entity or an individual who commits a securities violation.[100] Unlike primary liability under the Act, however, section 20(a) includes an affirmative defense for control persons that can prove that they acted in good faith and did not induce the underlying violation.[101] Therefore, where a primary violation and a control relationship are established, the control person is presumed liable by virtue of its control, unless it can establish good faith and an absence of inducement.

As with suits seeking to impose vicarious liability on accounting firms, claims brought under section 20(a) seeking to impose control person liability on affiliated accounting firms have, until recently, been largely unsuccessful. In particular, courts have rejected imposing control person liability on

[96] *Id.* at 158 (emphasis added); *see* SEC v. Lucent Techs., Inc., 610 F. Supp. 2d 342, 355 (D.N.J. 2009) ("From *Central Bank* to *Stoneridge*, the Supreme Court has consistently narrowed the class of defendants reachable by the implied cause of action under Section 10(b).").

[97] 15 U.S.C. § 78t(a) (2006).

[98] *See id.*

[99] *See In re* Parmalat Sec. Litig., 375 F. Supp. 2d 278, 307 (S.D.N.Y. 2005) (discussing 15 U.S.C. § 78t(a)).

[100] *See* Loftus C. Carson, II, *The Liability of Controlling Persons Under the Federal Securities Acts*, 72 NOTRE DAME L. REV. 263, 278–81 (1997).

[101] *See* 15 U.S.C. § 78t(a). There is currently a split among the circuits and within the Second Circuit as to whether the elements of good faith and inducement are part of a plaintiff's prima facie case or an affirmative defense. *See infra* Part III.B.1.

accounting firms based on membership in a global firm,[102] a common brand name,[103] use of marketing materials that promote a single firm identity,[104] or the member firm's representations that it was acting as an agent of the global firm.[105] Similarly, courts have rejected claims that accounting firms should be secondarily liable for the actions of their affiliates in nonsecurities litigation.[106]

D. Arthur Andersen: A Cautionary Tale

No discussion of auditor liability would be complete without mention of Arthur Andersen, the accounting firm that collapsed following allegations of involvement in the fraudulent conduct by the management of Enron and Andersen's efforts to cover it up. Founded by its namesake in 1913 and regarded as "a great and venerable American brand,"[107] Andersen ceased doing business barely nine months after its largest client, Enron, filed for what was then the largest corporate bankruptcy in history.[108] Andersen would later be sued for its audit work for a number of clients, including Enron,[109] WorldCom,[110] and Global Crossing.[111] In many of these suits, plaintiffs alleged that the various national accounting firms that operated under the Andersen

[102] *See In re* WorldCom, Inc., Sec. Litig., No. 02 Civ. 3288(DLC), 2003 WL 21488087, at *10 (S.D.N.Y. June 25, 2003).

[103] *See* Nuevo Mundo Holdings v. Pricewaterhouse Coopers LLP, No. 03 Civ. 0613 GBD, 2004 WL 112948, at *3 (S.D.N.Y. Jan. 22, 2004).

[104] *See In re* Asia Pulp & Paper Sec. Litig., 293 F. Supp. 2d 391, 396 (S.D.N.Y. 2003).

[105] *See* Star Energy Corp. v. RSM Top-Audit, No. 08 Civ. 00329(DC), 2008 WL 5110919, at *5 (S.D.N.Y. Nov. 26, 2008).

[106] *See, e.g.*, *Nuevo Mundo Holdings*, 2004 WL 112948, at *3 (rejecting agency claim in a suit for fraud and negligence); Howard v. Klynveld Peat Marwick Goerdeler, 977 F. Supp. 654, 661–62 (S.D.N.Y. 1997) (rejecting agency claim in employment discrimination suit).

[107] BARBARA LEY TOFFLER, FINAL ACCOUNTING: AMBITION, GREED, AND THE FALL OF ARTHUR ANDERSEN 7 (Doubleday 2004) (2003).

[108] *See id.* at 213. Andersen's collapse was the result of a criminal indictment for obstruction of justice, *id.* at 219, which arose from its shredding of "as many as 26 trunks and 24 boxes" of documents relating to its audits of Enron. *Id.* at 214.

[109] *See In re* Enron Corp. Sec., Derivative & "Erisa" Litig., Nos. MDL-1446, Civ.A. H-01-3624, Civ.A. H-01-3913, 2003 WL 22962792, at *1 (S.D. Tex. Nov. 5, 2003).

[110] *See In re* WorldCom, Inc. Sec. Litig., No. 02 Civ. 3288(DLC), 2003 WL 21488087, at *1 (S.D.N.Y. June 25, 2003).

[111] *See In re* Global Crossing, Ltd. Sec. Litig., 322 F. Supp. 2d 319, 324 (S.D.N.Y. 2004).

name and the global firm they belonged to, Andersen Worldwide Société Coopérative, should be held vicariously liable for the actions of Arthur Andersen LLP, the U.S. accounting firm that actually performed the audits.[112] The courts, however, rejected these secondary liability claims, focusing instead on the culpable actions of Arthur Andersen LLP.[113]

Andersen's demise resulted not only from its criminal obstruction of justice conviction, which a unanimous Supreme Court overturned three years later,[114] but also from the loss of confidence of its clients, partners, and employees.[115] Andersen's partnership structure aided in its demise by inhibiting fast decisionmaking in response to the Department of Justice's criminal investigation and indictment.[116] In addition, Andersen's network structure enabled its member firms to break from the U.S. firm in search of "new homes."[117]

In the wake of Enron and Arthur Andersen, Congress acted swiftly to pass the Sarbanes-Oxley Act of 2002.[118] This legislation brought sweeping changes to the regulation of accounting and financial reporting, including requiring CEOs and CFOs of public companies to certify their financial statements under civil and criminal penalty, imposing internal control reviews of public companies, and establishing the Public

---

[112] *See Enron*, 2003 WL 22962792, at *9; *WorldCom*, 2003 WL 21488087, at *9–10.

[113] *See Enron*, 2003 WL 22962792, at *9 (finding plaintiffs' claims that the global firm and its member firms were a single entity were "vague" and accepting a settlement to resolve the litigation); *WorldCom*, 2003 WL 21488087, at *10 (rejecting a claim of vicarious liability under 10(b) against the global firm because the complaint lacked "specific allegations of a conveyance of actual authority" from the global firm to Andersen-U.S.). In *Global Crossing*, the global firm did not move for dismissal, for reasons not entirely clear, and the court did not address the issue. *See* 322 F. Supp. 2d 324–25 & n.2.

[114] *See* Arthur Andersen LLP v. United States, 544 U.S. 696, 698 (2005). The Supreme Court unanimously overturned Andersen's conviction on the grounds that the trial court's jury instructions "failed to convey properly the elements of a 'corrup[t] persua[sion]' conviction" under 18 U.S.C. § 1512(b). *Id.* The Court found that the trial judge had omitted the element of "dishonesty" from the jury charge on corrupt persuasion, and that the judge had failed to explain that the jury must find a nexus between the destruction of the documents and the government proceeding that was being obstructed. *See id.* at 706–07.

[115] *See* PETER C. FUSARO & ROSS M. MILLER, WHAT WENT WRONG AT ENRON 179 (2002); TOFFLER, *supra* note 107, at 218–19, 223.

[116] *See* TOFFLER, *supra* note 107, at 218–19, 247–48.

[117] *See Enron*, 2003 WL 22962792, at *9.

[118] Sarbanes-Oxley Act of 2002, Pub. L. 107-204, 116 Stat. 745 (2002).

Company Accounting Oversight Board to oversee the accounting industry.[119] Sarbanes-Oxley also sought to reduce or remove conflicts of interest between corporations and their auditors.[120] Congress, however, failed to take any steps to address the issues of accounting firm liability and sustainability arising from private securities litigation premised on vicarious or secondary liability. The cautionary tale of Arthur Andersen highlights the risks faced by global accounting firms, notably the "mass exodus" of partners, staff, and clients.[121] The tale of Andersen also demonstrates the potential impact on the market, because the loss of Andersen resulted in the remaining four global accounting firms raising audit fees and forgoing clients due to inadequate resources.[122]

II. PARMALAT: EUROPE'S ENRON

Not long after the Enron bankruptcy brought down Arthur Andersen, the accounting industry in Europe was rocked by a homegrown accounting scandal: Parmalat. Investigations, recriminations, and finger-pointing followed swiftly, as did a raft of private securities litigation.[123] U.S. investors who had lost billions investing in Parmalat sued the company's bankers, advisors, and its current and former auditors.[124] The plaintiffs sought to impose liability on both the accounting firms that had actually audited Parmalat—who were accused of complicity in its fraud—and the global firms and U.S. accounting firms with

[119] *See* John C. Coates IV, *The Goals and Promise of the Sarbanes-Oxley Act*, 21 J. ECON. PERSP. 91, 96–100 (2007), *available at* http://www.aeaweb.org/articles.php?doi=10.1257/jep.21.1.91.

[120] *See* HENRY N. BUTLER & LARRY E. RIBSTEIN, THE SARBANES-OXLEY DEBACLE 21 (2006). For a detailed discussion of the changes brought about by the passage of Sarbanes-Oxley, see ROBERT R. MOELLER, SARBANES-OXLEY AND THE NEW INTERNAL AUDITING RULES 9–58 (2004); GAO REPORT, *supra* note 26, at 10–13. For an in-depth critique of Sarbanes-Oxley, in particular, the incentives it created for greater securities litigation, see BUTLER & RIBSTEIN, *supra*, at 38–81.

[121] *See* GAO REPORT, *supra* note 26, at 9.

[122] *See id.* at 18.

[123] *See In re* Parmalat Sec. Litig., 640 F. Supp. 2d 243, 245 (S.D.N.Y. 2009); *In re* Parmalat Sec. Litig., 594 F. Supp. 2d 444, 446–47 (S.D.N.Y. 2009).

[124] *See Parmalat*, 640 F. Supp. 2d at 245; *Parmalat*, 594 F. Supp. 2d at 446.

which the Italian auditors were affiliated, claiming vicarious liability under sections 10(b) and 20(a) of the Securities Exchange Act of 1934.[125]

A. From Rural Dairy to Global Scandal

Parmalat, a name now synonymous with corporate fraud, began as a humble dairy in a small Italian town.[126] Started in 1961 by Stefano Tanzi, Parmalat grew rapidly, expanding internationally through massive borrowing.[127] By 2003, Tanzi had transformed Parmalat into the world's largest dairy business and Italy's eighth largest company.[128] But as Parmalat expanded globally, a ticking time bomb lay at the center of the corporation: false accounting and special purpose entities designed to conceal Parmalat's debt.[129]

Reminiscent of Enron, Parmalat's star shone brightly until the moment before it burned out.[130] In the year before its bankruptcy, Parmalat continued to receive favorable ratings from stock analysts and credit rating agencies.[131] As Parmalat accumulated billions in off balance sheet debt, it reported record sales and profits.[132] But while its auditors signed off on the financial statements, red flags began to appear.[133] In January 2003, Parmalat's stock fell forty percent below its market high, and in May 2003, Parmalat withdrew a $360–600 million bond offer due to a lack of interest.[134] But business continued as usual at Parmalat until November 10, 2003, when it announced that the Italian securities regulator had asked the company to clarify some of the accounting treatment used in its financial

[125] *See Parmalat*, 640 F. Supp. 2d at 247, 255–56; *Parmalat*, 594 F. Supp. 2d at 449–50.

[126] *See* HAMILTON & MICKLETHWAIT, *supra* note 1, at 153–55.

[127] *See id.* at 154–59.

[128] *See* Gumbel, *supra* note 1.

[129] *See* HAMILTON & MICKLETHWAIT, *supra* note 1, at 156–61.

[130] For example, less than a year before it would be declared insolvent, Parmalat was chosen to join the Italian stock exchange's prestigious blue chip index, the Mib30. *See id.* at 159.

[131] *See id.* at 159–60.

[132] *See id.* at 160.

[133] *See id.* at 168.

[134] *See id.* at 159.

statements.[135] With investors growing nervous and the media asking questions, the house of cards collapsed as Parmalat failed to make a bond repayment in early December.[136] Trading in Parmalat's shares was suspended, and the Chairman and CFO resigned.[137] Parmalat declared bankruptcy on December 24, 2003, and three days later, the company was declared insolvent when it was discovered that Parmalat's purported $4.9 billion bank account simply did not exist.[138] The bankruptcy court appointed a corporate turnaround specialist to be Parmalat's bankruptcy commissioner,[139] and one of his first acts was to fire Parmalat's auditors.[140]

"Europe's Enron" had the classic hallmarks of an accounting scandal.[141] Parmalat's executives were accused of pulling off a multi-billion dollar accounting scam and looting the company,[142] while Parmalat's Italian auditors, Deloitte & Touche S.p.A. and Grant Thornton S.p.A., were accused of helping to create and sustain the fraud.[143] Not only had Parmalat's auditors signed off on its financial statements and its labyrinth of shell companies, but Parmalat's former group auditor, Grant Thornton S.p.A., stood accused of orchestrating the numerous offshore subsidiaries that had helped Parmalat hide its debt.[144] Deloitte & Touche, Parmalat's auditors at the time of its bankruptcy, fared no better when it was revealed that a Deloitte affiliate in Brazil, which had audited Parmalat's Brazilian subsidiary, had warned the global firm about Parmalat's accounting in 2001 and 2002, but Deloitte-Brazil's warnings went unheeded.[145]

[135] *See id.* at 161. The Italian securities regulator is the Commissione Nazionale per le Società e la Borsa. *See* Consob, http://www.consob.it/mainen/index.html?mode=gfx (last visited Dec. 22, 2010).

[136] *See* HAMILTON & MICKLETHWAIT, *supra* note 1, at 162.

[137] *See id.* at 162–64.

[138] *See id.* at 164. The fictitious bank account was held by Parmalat's Cayman Islands subsidiary, Bonlat. *See id.*

[139] Dr. Enrico Bondi was appointed Parmalat's Extraordinary Bankruptcy Commissioner. *See id.* at 162–64.

[140] *See id.* at 168.

[141] *See id.* at 153; *Parma Splat—Europe's Corporate Governance*, ECONOMIST, Jan. 17, 2004, at Special Report (2); Peter Gumbel & Jeff Israely, *Enron, Italian Style*, TIME, Jan. 12, 2004, at 53; Weber & Edmondson, *supra* note 6.

[142] *See* HAMILTON & MICKLETHWAIT, *supra* note 1, at 165–66.

[143] *See id.* at 167–69.

[144] *See id.* at 168–69.

[145] *See id.* at 168; Alessandra Galloni & David Reilly, *Auditor Raised Parmalat Red Flag*, WALL ST. J., Mar. 29, 2004, at A3.

B. Agency and Control: Two Theories of Liability

Following news of Parmalat's fraudulent reporting, lawsuits quickly followed.[146] In August 2004, Parmalat's administrator sued the company's former Italian auditors, as well as the global accounting firms to which they belonged and their U.S. affiliates.[147] This suit, which was joined by U.S. investors who had lost billions in Parmalat,[148] alleged that the global firms to which Parmalat's Italian auditors belonged should be held secondarily liable for their Italian member firms' violations of section 10(b).[149] Plaintiffs also sued the global firms and their U.S. member firms under section 20(a), claiming that they controlled the Italian firms that had committed the primary violations of the Securities Exchange Act.[150] The global accounting firms and their U.S. member firms moved to dismiss the complaint[151] and subsequently moved for summary judgment, but the court rejected these motions, finding triable issues of fact as to each defendant.[152]

The *Parmalat* plaintiffs advanced two theories of liability against the Deloitte Defendants.[153] First, the plaintiffs argued that the global firm, Deloitte Touche Tohmatsu ("DTT"), should be vicariously liable for Deloitte-Italy's primary violation of section 10(b) based on a common law theory of agency.[154] Second, the plaintiffs contended that both DTT and Deloitte-U.S. should be secondarily liable as control persons under a theory that the DTT controlled Deloitte-Italy and Deloitte-U.S. controlled DTT.[155]

First addressing the common law agency theory, the court held that the law required an "agreement between the principal

---

[146] *See In re* Parmalat Sec. Litig., 594 F. Supp. 2d 444, 447–49 (S.D.N.Y. 2009).

[147] *See* Luisa Beltran, *Parmalat Goes After Former Auditors*, CBS MARKETWATCH.COM (Aug. 18, 2004, 12:25 PM), http://www.marketwatch.com/story/lazards-restructuring-team-readies-for-new-blow-ups.

[148] *See In re* Parmalat Sec. Litig., 375 F. Supp. 2d 278, 283 (S.D.N.Y. 2005).

[149] *See Parmalat*, 594 F. Supp. 2d at 449–55.

[150] *See id.* at 455–60.

[151] *See Parmalat*, 375 F. Supp. 2d at 282.

[152] *See In re* Parmalat Sec. Litig., 640 F. Supp. 2d 243, 256 (S.D.N.Y. 2009) (rejecting Grant Thornton's motion); *Parmalat*, 594 F. Supp. 2d at 460 (rejecting Deloitte's motion).

[153] The legal claims and key facts are generally the same for the Deloitte Defendants and the Grant Thornton Defendants. For the sake of clarity, the following analysis only discusses the claims against the Deloitte Defendants.

[154] *See Parmalat*, 594 F. Supp. 2d at 451–55.

[155] *See id.* at 455–60.

and the agent that the agent will act for the principal, and the principal retains a degree of control over the agent," with the control element typically being the central issue.[156] To establish liability on the part of a secondary party, the agent must have actual,[157] apparent,[158] or implied[159] authority to act on the principal's behalf.[160] Once the agency relationship has been established, the court concluded, the common law principle of respondeat superior operates to hold the principal liable for the section 10(b) violation by its agent.[161]

The court found that the plaintiffs had pled sufficient evidence of an agency relationship between DTT and Deloitte-Italy to expose DTT to vicarious liability for Deloitte-Italy's alleged violation of 10(b).[162] The court cited the following facts as evidence that DTT controlled Deloitte-Italy: (1) DTT required that its member firms use a common audit software; (2) DTT set documentation policies and quality control standards; (3) DTT conducted compliance and quality control reviews of its member firms; (4) DTT retained the right to require that its member firms accept or reject audit engagements; and (5) DTT provided

---

[156] *Id.* at 451.

[157] Actual authority " 'is created by direct manifestations from the principal to the agent.' " Cromer Fin. Ltd. v. Berger, Nos. 00 Civ. 2284(DLC), 00 Civ. 2498(DLC), 2002 WL 826847, at *4 (S.D.N.Y. May 2, 2002) (quoting Reiss v. Société Centrale du Groupe des Assurances Nationales, 235 F.3d 738, 748 (2d Cir. 2000)).

[158] Apparent authority may be "implied from 'the parties' words and conduct as construed in light of the surrounding circumstances.' " *Id.* (quoting Riverside Research Inst. v. KMGA, Inc., 108 A.D.2d 365, 370, 489 N.Y.S.2d 220, 223 (1st Dep't 1985)).

[159] Implied authority " 'is dependent on verbal or other acts by a principal which reasonably give an appearance of authority' in a manner that is 'brought home to the agent.' " *Id.* (quoting Greene v. Hellman, 51 N.Y.2d 197, 204, 412 N.E.2d 1301, 1306, 433 N.Y.S.2d 75, 80 (1980)).

[160] *See Parmalat*, 594 F. Supp. 2d at 451–52.

[161] *See id.* at 451.

[162] *See id.* at 452–55. In finding that an agency relationship existed, the *Parmalat* Court relied on a Florida state court case, Banco Espirito Santo Int'l, Ltd. v. BDO Int'l, 979 So. 2d 1030 (Fla. Dist. Ct. App. 2008). The Florida District Court of Appeals found a triable issue of fact as to whether an agency relationship existed between the global accounting firm, BDO International, and its U.S. member, BDO Seidman. *See id.* at 1032–33. Following remand, the jury deliberated for one hour before reaching its verdict that the U.S. accounting firm, BDO Seidman, was not an agent of its global firm and that the global firm did not control its member firm. *See* Erik Larson & Sophia Pearson, *BDO Cleared of Responsibility for Seidman Verdict*, BLOOMBERG.COM, June 18, 2009, http://www.bloomberg.com/apps/news?pid=21070001&sid=acqwPbkZqoWI.

some legal and risk management services its member firms.[163] While the court acknowledged that other courts in the Second Circuit had rejected claims of agency liability against global accounting firms because their structure did "not demonstrate control,"[164] it buttressed its decision with a single instance in which DTT resolved a disagreement between Deloitte-Italy and the Deloitte affiliate in Brazil regarding the proper accounting treatment for a transaction in the Parmalat audit.[165]

Turning to the plaintiffs' second cause of action, "control person" liability under section 20(a), the *Parmalat* Court found that the ability to control the violating party's actions generally was sufficient to satisfy the statute.[166] The court rejected defendants' argument that the plaintiffs must prove that the global accounting firm actually controlled the transaction at issue, because the court found this imposed too high a burden on plaintiffs.[167] The court further reduced the plaintiffs' burden, finding that the statutory provision that exculpated a defendant that "acted in good faith" created an affirmative defense and was not an element of the plaintiff's prima facie case.[168]

As with vicarious liability under 10(b), the court found sufficient evidence to sustain the section 20(a) claims against DTT and Deloitte-U.S.[169] For DTT, the court relied on the same analysis it used for vicarious liability under 10(b) to find that plaintiffs had stated a claim of control over Deloitte-Italy under 20(a).[170] For Deloitte-U.S., the court drew a line of connection from Deloitte-U.S. to DTT to Deloitte-Italy.[171] To support this chain of inferences, the court relied on the fact that DTT shared some executive staff with Deloitte-U.S., most notably the CEO and Deloitte-U.S.'s provision of funding and guaranteeing of financing for DTT.[172] In concluding that Deloitte-U.S. controlled

[163] *See Parmalat*, 594 F. Supp. 2d at 452–53.
[164] *Id.* at 453 & n.63.
[165] *See id.* at 453–54.
[166] *See id.* at 454 n.72, 455–56.
[167] *See id.* at 456.
[168] *See id.* at 456–57 (discussing 15 U.S.C. § 78t(a) (2006)).
[169] *See id.* at 458.
[170] *See id.* at 456–58; *supra* notes 162–65 and accompanying text.
[171] *See id.* at 458–60.
[172] *See id.* at 458–59

DTT, the court also relied on the allegation that Deloitte-U.S. influenced DTT's decision to sell its consulting business.[173]

The *Parmalat* Court's decision to permit the plaintiffs to proceed under both vicarious liability and section 20(a) provided impetus for the accounting firms to resolve the case. In March 2010, the court approved a settlement with the Deloitte and Grant Thornton defendants.[174] Under the agreement, plaintiffs will receive a total of $15 million from Parmalat's auditors, with the Deloitte Defendants providing $8.5 million.[175] Grant Thornton International agreed to settle the claims against it for $6.5 million, while Grant Thornton U.S. was dismissed with prejudice from the case and will not face any liability for the losses allegedly caused by its former Italian affiliate's audits of Parmalat.[176] The relatively small settlement is due in part to settlements that plaintiffs had reached with Parmalat's Italian auditors and other defendants, but it also reflects the difficult task that plaintiffs faced in proving that the global and U.S. firms controlled the Italian auditors.[177]

Although a settlement has been reached, the *Parmalat* Court's decision highlights the current conflict in securities law regarding secondary liability: whether section 20(a) provides the sole basis for private causes of action against secondary actors, such as affiliated accounting firms, that did not actually commit a securities violation. The *Parmalat* Court permitted plaintiffs to proceed against the accounting firms both under common law vicarious liability and control person liability under 20(a),[178] rejecting the argument that vicarious liability under section 10(b) is no longer viable in light of the Supreme Court's holding in

---

[173] *See id.* at 460.

[174] *See* Grant McCool, *US Judge Approves Parmalat Ex-Auditors Settlement*, REUTERS, Mar. 11, 2010, *available at* http://www.reuters.com/article/idUSN1125315520100311?type=marketsNews; *see also* Stipulation and Agreement on Settlement at 11, *In re* Parmalat Sec. Litig., 594 F. Supp. 2d 444 (S.D.N.Y. 2009) (No. 04 MD 1653(LAK)); Andrew Longstreth, *Parmalat Shareholders Milk Small Settlements from Auditors*, LAW.COM (Nov. 23, 2009), http://www.law.com/jsp/PubArticle.jsp?id=1202435772952 (discussing the details of the settlement).

[175] *See* Longstreth, *supra* note 174.

[176] *See id.*

[177] *See id.* (citing statements by the plaintiffs' co-lead counsel that there was no guarantee of proving the global and U.S. accounting firms controlled their Italian counterparts); *see also* Chad Bray, *Auditors Reach $15M Settlement in Parmalat Holder Case*, DOW JONES NEWSWIRES, Nov. 19, 2009.

[178] *See Parmalat*, 594 F. Supp. 2d at 451–52, 455–56.

Stoneridge Investment Partners v. Scientific Atlanta, Inc.[179] The court, however, failed to consider that *Stoneridge*'s holding that " 'the conduct of a secondary actor must satisfy each of the elements or preconditions for liability' " precludes common law theories of liability under section 10(b).[180]

III. REJECTING VICARIOUS LIABILITY IN FAVOR OF ACTUAL CONTROL

On three occasions, the Supreme Court has rejected attempts to impose liability under section 10(b) of the Securities Exchange Act in the absence of a primary violation by the defendant.[181] Nevertheless, lower courts have generally taken an expansive view of secondary liability under 10(b), particularly in the area of vicarious liability for violations committed by an employee or agent.[182] These courts have rejected arguments that control person liability under section 20(a) provides an effective—and exclusive—means to impose liability on those who control primary violators of section 10(b), even though the result is that liability under 20(b) becomes redundant.[183] Many courts are driven to apply vicarious liability under 10(b) because some federal courts of appeals have imposed too high a burden on control person liability claims brought under section 20(a) by requiring culpable participation.[184] Rather than applying a culpable participation standard, which is at odds with the language of the statute and congressional intent, courts should

---

[179] *See id.* at 449–51 (discussing Stoneridge Inv. Partners v. Scientific-Atlanta, Inc., 552 U.S. 148 (2008)). Subsequent decisions have called into question the viability of vicarious liability suits under section 10(b). *See In re* Tronox, Inc. Sec. Litig., No. 09 Civ. 6220(SAS), 2010 WL 2835545, at *8 n.120 (S.D.N.Y. June 28, 2010) (questioning whether claims for vicarious liability can be brought under § 10(b) following the Second Circuit's decision in Pacific Investment Management Co., LLC v. Mayer Brown LLP, 603 F.3d 144 (2d Cir. 2010)).

[180] *Parmalat*, 594 F. Supp. 2d at 450 (quoting *Stoneridge*, 522 U.S. at 158).

[181] *See Stoneridge*, 552 U.S. at 152–53; Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164, 191 (1994); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 214 (1976).

[182] *See* Laperriere v. Vesta Ins. Group, Inc., 526 F.3d 715, 725 & n.21 (11th Cir. 2008) (finding a seven-to-one split among the other courts of appeals in favor of applying vicarious liability to 10(b)).

[183] *See, e.g.*, *Parmalat,* 594 F. Supp. 2d at 450–55 (applying common law agency liability to section 10(b)).

[184] *See id.* at 456 & n.83 (discussing the split among the district courts in the Second Circuit caused by an unclear standard on culpability); *see also supra* notes 252–60 and accompanying text).

apply an actual control of the audit standard to claims of secondary liability brought against accounting firms for the alleged wrongdoing of affiliated accounting firms.[185]

A. *Section 10(b) Does Not Encompass Vicarious Liability Claims*

The majority of federal courts of appeals to consider the issue have concluded that plaintiffs can bring a private cause of action under section 10(b) premised on common law theories of vicarious liability.[186] These decisions are in tension with Supreme Court precedent, which rejects a broad view of the private 10(b) cause of action and focuses on the express provisions of the Securities Exchange Act.[187] Furthermore, these decisions conflict with congressional intent as shown through the express provision for secondary liability under section 20(a) with its good faith defense.[188] While corporations should not be permitted to profit from the wrongdoing of their employees without facing liability, this does not justify imposing secondary liability on accounting firms for alleged violations by independent accounting firms in other countries. Rather, the organizational structure of accounting firms, as well as public policy concerns about the sustainability of the industry, support a narrow view of accounting firm liability focused on whether the firm actually controlled the audit at issue in the litigation.

1. Supreme Court Precedent and Legislative Intent Do Not Support Vicarious Liability Under Section 10(b)

In 1933 and 1934, Congress passed major securities reform litigation to combat the root causes of the stock market crash of

---

[185] *See infra* Part III.B.2–3.

[186] *See Laperriere*, 526 F.3d at 725 & n.21. *But see In re* Tronox, Inc. Sec. Litig., No. 09 Civ. 6220(SAS), 2010 WL 2835545, at *8 n.120 (S.D.N.Y. June 28, 2010).

[187] *See* Stoneridge Inv. Partners v. Scientific-Atlanta, Inc., 552 U.S. 148, 158–59 (2008); Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164, 191 (1994); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 214 (1976). For a discussion of pre-*Central Bank* Supreme Court cases rejecting secondary liability claims under 10(b), see Daniel R. Fischel, *Secondary Liability Under Section 10(b) of the Securities Act of 1934*, 69 CAL. L. REV. 80, 90–92, 94–98 (1981) (quoted and cited with approval by the U.S. Supreme Court in *Central Bank*, 511 U.S. at 169, 184, 191); William J. Fitzpatrick & Ronald T. Carman, *Respondeat Superior and the Federal Securities Law: A Round Peg in a Square Hole*, 12 HOFSTRA L. REV. 1, 14–22 (1983).

[188] *See infra* Part III.A.2.

1929.[189] To address perceived widespread fraud in securities transactions, Congress enacted section 10(b) of the Securities Exchange Act of 1934, which prohibits the use of "any manipulative or deceptive device" in connection with the purchase or sale of securities.[190] Section 20(a), a companion provision of the Act, imposes liability on any party that directly or indirectly controls a party that is liable under the Act, unless the controlling party acted in good faith and did not induce the violation.[191] While the legislative history does not indicate whether Congress intended section 10(b) to be supplemented by common law vicarious liability, the existence of a control liability provision in section 20(a), along with the good faith defense that is unavailable under the strict liability theories of agency or respondeat superior, demonstrates Congress's intent to hold secondary actors accountable when they have acted in bad faith.[192] This express statement of Congress's intent is wholly at odds with the application of common law strict liability principles to private causes of action under 10(b).[193]

Each time the Supreme Court has considered a claim of vicarious or secondary liability under 10(b), it has roundly rejected it.[194] Relying instead on the express terms of the statute, the Court has consistently limited 10(b) claims to defendants who

---

[189] *See Ernst & Ernst*, 425 U.S. at 194–96; KING, *supra* note 55, at 59–61; Carson, *supra* note 100, at 265–73. The Securities Act of 1933 applies to direct or indirect sales of securities by the issuer. *See* 15 U.S.C.A. § 77e (West 2011). The Securities Exchange Act of 1934 covers securities transactions in exchanges and over-the-counter markets. *See* 15 U.S.C. § 78b (2006).

[190] 15 U.S.C. § 78j(b).

[191] *See* 15 U.S.C. § 78t(a).

[192] *See* Carson, *supra* note 100, at 270–72; Fitzpatrick & Carman, *supra* note 187, at 22–27.

[193] *See* Lewis D. Lowenfels & Alan R. Bromberg, *Controlling Person Liability Under Section 20(a) of the Securities Exchange Act and Section 15 of the Securities Act*, 53 BUS. LAW. 1, 8 (1997).

[194] *See supra* Part I.C.1. At least one commentator has argued that the Supreme Court has recognized vicarious liability under the Securities Exchange Act in *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972). *See* William H. Kuehnle, *Secondary Liability Under the Federal Securities Laws—Aiding and Abetting, Conspiracy, Controlling Person, and Agency: Common Law Principles and the Statutory Scheme*, 14 J. CORP. L. 313, 317 (1988). While the Court in *Affiliated Ute* recognized that the bank's liability was "coextensive" with that of its employees, 406 U.S. at 154, no precedent was cited to support this holding, and the Supreme Court has never cited *Affiliated Ute* for the proposition that an employer may be held vicariously liable under the Securities Exchange Act.

84 St. John's L. Rev. 1133 (2010)

actually commit a primary violation of the statute.[195] For example, in *Ernst & Ernst*, the Court correctly found that Congress's use of the words "manipulative" and "deceptive" strongly suggest that 10(b) proscribes only "knowing or intentional misconduct," not a negligent failure to act.[196] The Court reiterated this holding in *Central Bank*, when it properly rejected attempts to impose secondary liability on those who aid and abet manipulative or deceptive conduct because 10(b) does not proscribe aiding and abetting conduct.[197] Most recently, in *Stoneridge*, the Supreme Court rejected secondary liability under 10(b) packaged as "scheme liability."[198] First, the Court reiterated its position that the scope of the judicially created private cause of action under 10(b) is delineated by the text of the statute alone.[199] Second, the Court found that the PSLRA, which Congress passed in response to *Central Bank*, modified section 10(b) to further restrict, rather than expand, the 10(b) private cause of action.[200]

The primary reason that the Supreme Court has consistently refused to broaden the private cause of action under 10(b) is that it was created by judicial decision, not by the statute.[201] The Court has stated that the "decision to extend the cause of action is for Congress, not for us."[202] As a result, the Court has refused to expand the scope of 10(b) because of its remedial effect,[203] relying instead on provisions of the statute that expanded governmental enforcement rather than private actions.[204]

---

[195] *See* Fitzpatrick & Carman, *supra* note 187, at 14–22 (contending that "the Supreme Court has specifically rejected several of the rationales . . . advanced by appellate courts in upholding a plaintiff's right to hold the defendants liable under respondeat superior").

[196] Ernst & Ernst v. Hochfelder, 425 U.S. 185, 197 (1976).

[197] Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164, 176–77 (1994).

[198] Stoneridge Inv. Partners v. Scientific-Atlanta, Inc., 552 U.S. 148, 159–64 (2008).

[199] *See id.* at 157.

[200] *See id.* at 162–63.

[201] *See id.*; *Cent. Bank*, 511 U.S. at 179–80; *Ernst & Ernst*, 425 U.S. at 210.

[202] *Stoneridge*, 552 U.S. at 165.

[203] *See Ernst & Ernst*, 425 U.S. at 199–200; *see also* Aaron v. SEC, 446 U.S. 680, 695 (1980) ("[G]eneralized references to the remedial purposes of the securities laws will not justify reading a provision more broadly than its language and the statutory scheme reasonably permit." (internal citations and quotation marks omitted)); Touche Ross & Co. v. Redington, 442 U.S. 560, 578 (1979) ("The invocation of the 'remedial purposes' of the 1934 Act is similarly unavailing.").

[204] *Stoneridge*, 552 U.S. at 165–66.

Despite the Supreme Court's consistent position, some courts have held that plaintiffs can pursue vicarious liability claims under 10(b), reasoning that liability is based on the relationship between the defendant and the primary violator, not the defendant's conduct.[205] In sustaining vicarious liability under 10(b), some district courts[206] have relied on appellate court decisions upholding a corporation's liability for its employee's violation of 10(b) on the grounds that a "corporation can only act through its employees and agents."[207] This remains the majority position[208] because its supporters believe that without vicarious liability under 10(b), investment banks, brokerage firms, and other corporations will escape liability for the misdeeds of their employees.[209] These lower court decisions, however, ignore the repeated holdings of the Supreme Court that liability under 10(b) is defined by the defendant's conduct, not by its relationship with

[205] *See, e.g.*, *In re* Parmalat Sec. Litig., 375 F. Supp. 2d 278, 291 n.73 (S.D.N.Y. 2005).

[206] *See, e.g.*, *id.*; *In re* WorldCom, Inc., Sec. Litig., No. 02 Civ. 3288(DLC), 2003 WL 21488087, at *9 (S.D.N.Y. June 25, 2003).

[207] *See* Suez Equity Investors, L.P. v. Toronto-Dominion Bank, 250 F.3d 87, 100–01 (2d Cir. 2001) (involving allegations that an employee of an investment bank corporation violated 10(b)). In addition to *Suez Equity*, some courts that have applied vicarious liability to 10(b) claims have relied on the Third Circuit's reasoning in *AT&T, Co. v. Winback & Conserve Program, Inc.*, 42 F.3d 1421, 1431 (3d Cir. 1994). However, *AT&T* did not address a Securities Act violation, but a violation of the Lanham (Trademark) Act. *Id.* at 1430. In that context, the Third Circuit simply refused to import *Central Bank*'s holding into federal trademark law, an area never addressed in *Central Bank*. *See id.* ("[W]e do not believe that the [Supreme] Court's restrictive reading of the [Securities] Exchange Act impacts on the determination of the scope of liability *under the Lanham Act*." (emphasis added)). Therefore, *AT&T* is irrelevant to determining whether vicarious liability claims may be brought under 10(b).

[208] *See supra* note 68. This is not, however, a universal position. *Compare* Regents of Univ. of Cal. v. Credit Suisse First Boston (USA), Inc., 482 F.3d 372, 386 (5th Cir. 2007) (finding that the Supreme Court "conclusively foreclosed the application of secondary liability under 10(b)"), *with Parmalat*, 375 F. Supp. 2d at 291 n.73 (finding that *Central Bank* "does not eliminate corporate defendants' liability for the misrepresentations or manipulations of their agents").

[209] *See generally* Robert A. Prentice, *Conceiving the Inconceivable and Judicially Implementing the Preposterous: The Premature Demise of Respondeat Superior Liability Under Section 10(b)*, 58 OHIO ST. L.J. 1325, 1343–96 (1997) (discussing a number of arguments in favor of retaining vicarious liability under section 10(b), including the statute's defining "person" to include a corporation, Congress's failure to exclude vicarious liability, and policy considerations, such as promoting greater control of agents).

another party.[210] Rather than supplementing 10(b) with common law vicarious liability, lower courts should follow the instruction of the Supreme Court, which has recognized that section 20(a), the control person provision, provides the means to impose liability on secondary actors.[211] The Court has relied on the existence of secondary liability under 20(a) in rejecting secondary liability under section 10(b).[212] In *Central Bank*, the Supreme Court admonished lower courts not to take it upon themselves to graft common law liability principles onto 10(b) when the text of the statute governs the outer limits of liability.[213] As the Court instructed, the "fact that Congress chose to impose some forms of secondary liability, *but not others*, indicates a deliberate congressional choice with which the courts should not interfere."[214]

2. Vicarious Liability Under 10(b) Renders 20(a) Redundant

Permitting vicarious liability under section 10(b) violates a "cardinal principle" of statutory construction because it renders section 20(a) redundant. One reason courts have been willing to impose secondary liability under both sections 10(b) and 20(a) appears to be a lack of distinction between primary and secondary liability.[215] Under a vicarious liability analysis, the

[210] *See* Stoneridge Inv. Partners v. Scientific-Atlanta, Inc., 552 U.S. 148, 158 (2008) ("The *conduct* of a secondary actor must satisfy each of the elements or preconditions for liability . . . ." (emphasis added)); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 214 (1976) ("When a statute speaks so specifically in terms of manipulation and deception, . . . we are quite unwilling to extend the scope of the statute to negligent *conduct*." (emphasis added)).

[211] *See* Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164, 184 (1994).

[212] *See id.* ("Congress did not overlook secondary liability when it created the private rights of action in the 1934 Act. Section 20 of the 1934 Act imposes liability on controlling persons . . . ." (internal citations and quotation marks omitted)).

[213] *See id.* at 183–84.

[214] *Id.* at 184 (emphasis added). The *Central Bank* dissent recognized that the Court's holding "at the very least casts serious doubt . . . on *other* forms of secondary liability" other than aiding and abetting. *Id.* at 200 (Stevens, J., dissenting); *see* Fischel, *supra* note 187, at 96–98 (cited with approval by the Court in *Central Bank*, 511 U.S. at 184).

[215] *See In re* Global Crossing, Ltd. Sec. Litig., 322 F. Supp. 2d 319, 330 (S.D.N.Y. 2004). "At the outset, the Supreme Court's ruling in *Central Bank* does not amount to a categorical prohibition on claims against secondary actors such as accountants." *Id.* However, the Supreme Court emphasized in *Central Bank* that accountants and others could only be held liable for primary violations of section 10(b) if "*all* of the requirements for primary liability . . . are met." *Cent. Bank*, 511 U.S. at 191.

only relevant consideration is whether the primary violation occurred within the scope of an agency or employment relationship.[216] No consideration of the conduct or good faith of the control defendant is appropriate, and no fault on the part of the control defendant is necessary to impose liability.[217] The imposition of common law strict liability, therefore, contradicts the express language of section 20(a), which provides an affirmative, good faith defense.[218] The application of vicarious liability also conflicts with the legislative history, which indicates that Congress did not intend to hold control persons strictly liable but chose to afford them a good faith defense.[219]

Nevertheless, lower courts generally have treated vicarious liability under 10(b) as an alternative to section 20(a) liability, giving plaintiffs the option of pleading either, or both. Whether a plaintiff pleads vicarious liability under 10(b) or control liability under 20(a), the end result is the same: The control defendant is subject to secondary liability for another party's primary violation of the Securities Exchange Act. The only noteworthy distinction is that a defendant sued under 20(a) enjoys the protection of the good faith affirmative defense, while a defendant sued vicariously under common law agency principles receives no such protection. Given that both approaches provide the same outcome, no rational plaintiff would ever sue a secondary actor only under 20(a) because of the risk of losing the case if the defendant prevails on the good faith defense.

---

[216] *See* Fitzpatrick & Carman, *supra* note 187, at 11, 27–28; Kuehnle, *supra* note 194, at 320 ("One is primarily liable, then, if he or she directly does, alone or with others, an act prohibited by the statute. Secondary violators are those who, though they do not perform the act, have responsibility for it through assistance or a relationship with the primary violator.").

[217] *See In re* Parmalat Sec. Litig., 375 F. Supp. 2d 278, 291 n.73 (S.D.N.Y. 2005) (finding that "the principal is held liable on a theory of agency 'not because it committed some wrongdoing . . . but because its *status* merits responsibility for the tortious actions of its agent' " (quoting Am. Tel. & Tel. Co. v. Winback & Conserve Program, Inc., 42 F.3d 1421, 1431 (3d Cir. 1994) (a case involving the Lanham Act))); Fitzpatrick & Carman, *supra* note 187, at 13 ("Once a court determines that liability may be found under respondeat superior, any discussion of a firm's duty to supervise or its negligent actions becomes irrelevant."); Prentice, *supra* note 209, at 1332, 1350.

[218] *See* 15 U.S.C. § 78t(a) (2006); *see also infra* Part III.B.

[219] *See* Lowenfels & Bromberg, *supra* note 193, at 8–9 ("Legislative history clearly supports congressional intent . . . to reject a standard of conduct which imposes strict liability" on secondary actors.).

When plaintiffs have no rational basis to employ section 20(a), because vicarious liability under 10(b) provides all the same benefits and more, 20(a) has been made redundant.[220] Such a result is impermissible under the cannons of statutory construction employed by the Supreme Court, which has frequently "cautioned against reading a text in a way that makes part of it redundant."[221] Section 20(a) expresses a strong congressional intent to impose liability on secondary control actors, but it also demonstrates an equally strong desire to not impose liability on controlling parties that have acted in good faith.[222] By incorporating strict liability common law principles into claims brought under section 10(b), courts have subverted the will of Congress as evidenced by the affirmative defense in 20(a) and have rejected the Supreme Court's teachings not to read section 10(b) in a way that makes 20(a) redundant.

3. Policy Considerations Support Limiting Section 10(b) to Primary Violators

Accounting firms occupy a precarious position in the realm of securities law liability. The work of auditors necessarily involves the exercise of a significant amount of judgment,[223] which leaves accounting firms open to massive liability based on hindsight. Shareholders frequently sue a corporation's auditors after fraud or other financial misfeasance is disclosed because of the potential for large recovery and the likelihood that accounting firms will settle rather than fight the suit.[224] As a result, "[l]itigation-related expenses are a significant component of auditing firms' cost structures,"[225] with the primary risk coming

---

[220] *See* Fischel, *supra* note 187, at 94 n.83. Properly read, the two statutes have complementary roles: section 10(b) applies to primary violators while section 20(a) applies to secondary control persons, subject to the limits of the good faith defense.

[221] Nat'l Ass'n of Home Builders v. Defenders of Wildlife, 551 U.S. 644, 669 (2007); *see* TRW Inc. v. Andrews, 534 U.S. 19, 31 (2001) ("It is 'a cardinal principle of statutory construction' that 'a statute ought, upon the whole, to be so construed that, if it can be prevented, no clause, sentence, or word shall be superfluous, void, or insignificant.' " (quoting Duncan v. Walker, 533 U.S. 167, 174 (2001))).

[222] *See infra* Part III.B.1.

[223] *See* GAO REPORT, *supra* note 26, at 89 (indicating that "[a]udit quality is often thought to include the experience and technical capability of the auditing firm partners and staff").

[224] *See* Mark, *supra* note 51, at 1106–07.

[225] ADVISORY COMMITTEE REPORT, *supra* note 23, at II:7.

from large "big ticket liability" suits.[226] When a large corporation like Enron or Parmalat collapses, accounting firms are subject to liability for the full market value of investors' losses, which is typically many billions of dollars.[227] Over the past ten years, the four largest global accounting firms have collectively paid out more than $5.86 billion to settle such claims.[228] Accounting firms also face regulatory causes of action and, possibly, criminal actions when fraud is uncovered.[229] For the most part, accounting firms have no way to insure against the risk posed by billion-dollar judgments because of the uncertainty regarding the extent of their potential liability.[230]

Together with the sheer size of the potential liability they face, accounting firms' unique structure cautions against imposing secondary liability under section 10(b). First, because global accounting firms are organized as independent national partnerships, their control over affiliated firms largely consists of setting common standards and procedures and enforcing compliance with these procedures.[231] A global firm's disciplinary power is limited to terminating its relationship with its member firm, which can continue to practice under a new name.[232] Second, state and foreign laws limit an accounting firm's ability to control its affiliates by restricting ownership and mandating a partnership structure.[233] Third, the accounting industry is

[226] Talley, *supra* note 62, at 1644.

[227] *See id.* at 1642 ("Auditors now face enhanced vulnerabilities to liability risks that—at least according to some—threaten the very viability of the industry as we know it."); ADVISORY COMMITTEE REPORT*, supra* note 23, at II:7 ("The largest U.S. public companies have enormous market capitalization and, if a large cap company becomes insolvent or suffers a significant diminution in market value, such market loss often greatly exceeds the total capital of the auditing firm which audited that company.").

[228] *See* Tammy Whitehouse, *Audit Firms Sure To Face New Litigation, Experts Say*, COMPLIANCE WK., July 22, 2009, *available at* http://www.complianceweek.com/blog/whitehouse/2009/07/22/audit-firms-sure-to-face-new-litigation-experts-say/.

[229] *See* GAO REPORT, *supra* note 26, at 34; Talley, *supra* note 62, at 1649.

[230] *See* Talley, *supra* note 62, at 1642 n.5.

[231] *See* ADVISORY COMMITTEE REPORT*, supra* note 23, at V:10; GAO REPORT, *supra* note 26, at 8–9.

[232] *See In re* Parmalat Sec. Litig., 640 F. Supp. 2d 243, 249 (S.D.N.Y. 2009) (describing the powers of the global firm Grant Thornton International as extending only to "demotion of a member firm to correspondent status, hiring of new partners for the member firm, termination of existing personnel, and expulsion of the member firm").

[233] *See* ADVISORY COMMITTEE REPORT*, supra* note 23, at V:10; CENTER FOR AUDIT QUALITY, *supra* note 28, at 23 n.5.

currently highly concentrated, with just four global accounting networks auditing nearly all major auditing publicly held corporations.[234] As a result, the loss of even one global accounting network to a large civil judgment would likely cause a significant reduction in corporations' choice of outside auditors,[235] negatively impacting auditor independence and increasing audit costs.[236] Fourth, because U.S. accounting firms are often much larger than their foreign counterparts, plaintiffs are more likely to sue the deep-pocketed U.S. firm rather than the less well-funded local accounting firm that committed the alleged wrongdoing.[237]

Some commentators have argued in favor of greater liability for accounting firms based on a number of factors.[238] First, accounting firms collectively earn billions of dollars each year.[239] Second, accounting firms are not seen as being completely transparent in their operations.[240] Third, accountants and auditors owe a fiduciary duty to investors and the public, which the Supreme Court has recognized.[241] Fourth, global accounting firms do exercise a significant degree of control over their member firms in setting standards, monitoring compliance, and regulating use of the brand name.[242] In addition, some have asked whether the market really would suffer from the loss of another global accounting firm, since other large accounting firms and smaller firms could absorb much of its audit work and its employees.[243]

---

[234] *See supra* Part I.A.

[235] *See* ADVISORY COMMITTEE REPORT, *supra* note 23, at VIII:3; GAO REPORT, *supra* note 26, at 34–35.

[236] *See* GAO REPORT, *supra* note 26, at 35–36.

[237] *Called To Account—The Future of Auditing*, ECONOMIST, Nov. 20, 2004.

[238] *See generally* Mark, *supra* note 51, at 1174–210.

[239] *See* ADVISORY COMMITTEE REPORT, *supra* note 23, at II:1 ("In 2007, the four largest global network firms reported, in the aggregate, approximately $90 billion in total revenues.").

[240] *See id.* at II:8 ("The largest [accounting] firms provide only limited information to the investing public about the sources of their revenue, their governance practices, the amount of their earnings, and their financial condition.").

[241] *See* United States v. Arthur Young & Co., 465 U.S. 805, 817–18 (1984).

[242] *See supra* notes 231–32 and accompanying text. Although strong evidence of control, these factors have generally been found to be insufficient to establish control person liability. *See supra* notes 69–73 and accompanying text.

[243] *See* Mark, *supra* note 51, at 1195–96; Talley *supra* note 62, at 1691–92 (noting that after the collapse of Arthur Andersen, "displaced employees appeared to be absorbed by other firms in a relatively orderly way, not only by other large firms, but also by second-tier accounting firms").

Nevertheless, secondary liability under section 10(b) is unnecessary to achieve the policy aims its supporters claim it protects, and in the context of accounting firm liability, it creates much harm. Secondary liability under section 10(b) is unnecessary to hold an accounting firm liable as an employer or as a control person because a control defendant sued under section 20(a) must establish that it took "some precautionary measures . . . to prevent an injury caused by an employee" to avoid liability.[244] To establish good faith, an accounting firm sued as a control defendant may be required to show that it "maintain[ed] an adequate system of internal control, and that [it] maintain[ed] the system in a diligent manner."[245] While supervisory liability may not be absolute, plaintiffs can establish liability on the part of a control defendant by showing a negligent failure to supervise or control.[246] This is hardly an insurmountable hurdle. In addition, the Supreme Court has recognized that secondary actors remain subject to primary liability for their own violations of 10(b).[247] In sum, the structure of global accounting firms, the highly concentrated nature of the industry, and the implications for auditor independence if a global firm were to collapse under a large civil judgment all caution against imposing secondary liability outside the statutory limits created by Congress.[248]

B. Section 20(a) Liability Should Be Limited to Firms That Actually Controlled the Audit

Having established that section 20(a) is the proper vehicle for imposing secondary liability, the next issue is determining

[244] Carpenter v. Harris, Upham & Co., 594 F.2d 388, 394 (4th Cir. 1979).

[245] *Id.*

[246] *See id.*

[247] *See* Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164, 191 (1994) ("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.").

[248] The adverse impacts caused by the collapse of a large global accounting firm, such as decreased competition, reduced auditor independence, and increased audit costs, are widely recognized. *See, e.g.*, GAO REPORT, *supra* note 26, at 32–36; Lawrence A. Cunningham, *Too Big To Fail: Moral Hazard in Auditing and the Need To Restructure the Industry Before It Unravels*, 106 COLUM. L. REV. 1698, 1700–02 (2006). *See generally* Talley, *supra* note 62.

what standard of control should be applied. In 20(a), Congress sought to impose liability on "[e]very person who, directly or indirectly, controls any person liable under any provision of this chapter" of the Act, unless the control defendant acted in good faith and did not induce the violation.[249] Properly understood within the context of the legislative history, the good faith exception should be read as an affirmative defense, not as an element of the plaintiff's prima facie case.[250] Additionally, the standard of control for secondary liability of accounting firms for audits performed by affiliated accounting firms should be an actual control of the audit standard, not a general right to control standard.[251]

1. Culpable Participation Is an Affirmative Defense

The phrase "culpable participation" does not appear in the text of section 20(a).[252] The federal courts of appeals, nevertheless, cannot agree on whether the plaintiff must establish culpability as an element of the cause of action, or whether the defendant must raise a lack of culpability as an affirmative defense.[253] The Second Circuit was the first to require that plaintiffs establish that a control defendant was a culpable participant in the underlying violation of the Securities Exchange Act.[254] The Second Circuit reasoned that the text and the legislative history offered "no evidence" that Congress intended that anyone should be "an insurer against false or misleading statements made non-negligently or in good faith."[255]

Rather than stick with this simple, yet implausible standard, the Second Circuit's decisions applying culpable participation have hopelessly confused the issue. In *Marbury Management, Inc. v. Kohn*, the court backed away from requiring plaintiff to prove the control person's culpability, reasoning that "[d]ifferent

---

[249] 15 U.S.C. § 78t(a) (2006).

[250] *See infra* Part III.B.1.

[251] *See infra* Part III.B.2.

[252] *See* 15 U.S.C. 78t(a).

[253] *See* Newby v. Enron Corp. (*In re* Enron Corp. Sec., Derivative & "Erisa" Litig.), Nos. MDL-1446, Civ.A. H-01-3624, 2003 WL 230688, at *9–10 (S.D. Tex. Jan. 28, 2003) (discussing the circuit split); Rieger v. Drabinsky (*In re* Livent, Inc., Noteholders Sec. Litig.), 151 F. Supp. 2d 371, 413–18 (S.D.N.Y. 2001) (discussing the split both among the federal courts of appeals and within the Second Circuit).

[254] *See* Lanza v. Drexel & Co., 479 F.2d 1277, 1299 (2d Cir. 1973).

[255] *Id.* (quoting Kohn v. Am. Metal Climax, Inc., 458 F.2d 255, 280 (3d Cir. 1972)).

considerations control the application of *respondeat superior* principles."[256] Despite this statement, the Second Circuit reversed course again in *Securities & Exchange Commission v. First Jersey Securities, Inc.*, reiterating its earlier holding that plaintiffs must show that the control defendant was "in some meaningful sense [a] culpable participant[ ] in the fraud."[257] Determined not to leave well-enough alone, in the very next paragraph of *First Jersey*, the court seemed to shift the burden back to the defendant, stating that "[o]nce the plaintiff makes out a prima facie case of section 20(a) liability, the burden shifts to the defendant to show that he acted in good faith and that he did not directly or indirectly induce the act or acts constituting the violation."[258] The Second Circuit has repeatedly readopted its *First Jersey* test without shedding any light as to which party bears the burden of culpability.[259]

Not surprisingly, this schizophrenic approach has resulted in differing standards being applied by the district courts within the Second Circuit.[260] The court in *Parmalat* sided with the majority of circuits outside the Second Circuit, holding that lack of culpability is a good faith defense that the accounting firm defendants can raise, not an element of the plaintiff's prima facie case.[261] Other district courts applying 20(a) have required plaintiffs to prove a control defendant's culpable participation.[262] Still other courts have avoided the issue entirely, deciding claims

[256] 629 F.2d 705, 716 (2d Cir. 1980) (emphasis added).

[257] 101 F.3d 1450, 1472 (2d Cir. 1996) (alteration in original) (quoting Gordon v. Burr, 506 F.2d 1080, 1085 (2d Cir. 1974)).

[258] *Id.* at 1473 (internal citations and quotation marks omitted).

[259] *See, e.g.*, Suez Equity Investors, L.P. v. Toronto-Dominion Bank, 250 F.3d 87, 101–02 (2d Cir. 2001); Boguslavsky v. Kaplan, 159 F.3d 715, 720 (2d Cir. 1998); *First Jersey*, 101 F.3d at 1472–73.

[260] *See In re* Parmalat Sec. Litig., 594 F. Supp. 2d 444, 456 n.83 (S.D.N.Y. 2009) (discussing the split); Jeff G. Hammel & Robert J. Malionek, *Elusive Standard To Plead § 20(a) Control Person Liability*, N.Y.L.J., Mar. 5, 2007, at 4.

[261] *See Parmalat*, 594 F. Supp. 2d at 456.

[262] *See* Lapin v. Goldman Sachs Group, Inc., 506 F. Supp. 2d 221, 245–46 (S.D.N.Y. 2006); *In re* Alstom SA Sec. Litig., 406 F. Supp. 2d 433, 489–90 (S.D.N.Y. 2005); *see also* Anwar v. Fairfield Greenwich Ltd., No. 09 Civ. 0118(VM), 2010 WL 3341636, at *39 (S.D.N.Y. Aug. 18, 2010) (treating control as analogous to culpable participation). As discussed *infra* Part III.B.2, a control defendant may have actual control of the primary violator without being a culpable participant in the violation. The distinction between control and culpability—or scienter—is critical because, as discussed in this Section, culpable participation is an affirmative defense that the control defendant may raise, whereas control is an element of a prima facie section 20(a) claim, which the plaintiff must establish. *See* 15 U.S.C. § 78t(a) (2006).

under 20(a) on the more narrow issue of whether the 20(a) defendant had "control" of the party that committed the actual violation.[263]

The language of the statute indicates that lack of culpability is an affirmative defense to be raised by the alleged controlling party. Structurally, the elements of lack of culpability, good faith, and an absence of inducement appear after the main part of the statute and are separated by a comma and the word "unless."[264] A nearly identical exculpatory clause was added to section 15, an analogous control person provision of the Securities Act of 1933, to soften the imposition of strict liability by allowing for a defense of good faith.[265] In addition, the wording that Congress chose, "unless the controlling person acted in good faith and did not directly or indirectly induce the act," more naturally reads as an affirmative defense than as an element of the plaintiff's cause of action.[266] Had Congress wanted to include culpability as part of the prima facie case under 20(a), it could have required plaintiffs to show "bad faith and inducement in the violative acts" by the controlling person.[267] Despite the continuing confusion wrought by the Second Circuit's bifurcated test, the good faith and absence of inducement elements of section 20(a) are best treated as an affirmative defense that accounting firms and other control defendants may raise on a motion to dismiss.[268]

[263] *See In re* Asia Pulp & Paper Sec. Litig., 293 F. Supp. 2d 391, 395–96 (S.D.N.Y. 2003).

[264] 15 U.S.C. § 78t(a); *see* Kuehnle, *supra* note 194, at 364; Lowenfels & Bromberg, *supra* note 193, at 3–7.

[265] *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 211 n.27 (1976) (indicating that Congress amended section 15 of the Securities Act of 1933, a corollary provision to section 20(a), to include a good faith defense as it had done with 20(a)); Fischel, *supra* note 187, at 98–99 (stating that section 15, as originally passed in 1933, imposed strict liability on control persons but that Congress amended the law in 1934 to include the same good faith defense as in section 20(a) to address concerns that strict liability would impose liability on nonculpable parties); Prentice, *supra* note 209, at 1404–05.

[266] *See* Lowenfels & Bromberg, *supra* note 193, at 6–7.

[267] *See id.*

[268] *See* FED. R. CIV. P. 8(c)(1).

2. The Proper Standard of Control Is Actual Control of the Audit

Like the split over culpable participation, the meaning of "control" under section 20(a) is a source of much debate. Congress did not define "control" in the Act. Some courts, including the Second Circuit, have applied the definition of "control" in the SEC's regulations, which permits liability based on the power or right to control generally the party that committed the primary violation, rather than the application of actual control.[269] The *Parmalat* Court similarly applied this power to control standard.[270] While the SEC's regulations may be considered in defining "control" under 20(a), they are not dispositive. Rather, the Supreme Court has rejected the agency's interpretation in other contexts where that interpretation was broader than the statutory language.[271] Use of a broad agency interpretation of "control" also fails to take account of the Supreme Court's consistently narrow reading of the private causes of action under the Securities Exchange Act in conformance with the express language of the statute.[272]

Other courts have followed the Eighth Circuit's standard, which requires actual control over the primary violator's general activities and the power to control the specific transaction at issue in the litigation.[273] This standard more closely addresses the central issue in secondary liability claims brought under 20(a): whether the control person defendant could or did control the specific act that allegedly violated the Securities Exchange Act. The Eighth Circuit's standard, however, is undermined by the fact that it was developed within case law that treated section 10(b) as a broad remedial statute,[274] a view that the

[269] *See* SEC v. First Jersey Sec., Inc., 101 F.3d 1450, 1472–73 (2d Cir. 1996) ("Control over a primary violator may be established by showing that the defendant possessed 'the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise.' " (quoting 17 C.F.R. § 240.12b-2 (2010))).

[270] *See In re* Parmalat Sec. Litig., 594 F. Supp. 2d 444, 455–56 (S.D.N.Y. 2009).

[271] *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 212–14 (1976) (rejecting the SEC's interpretation of the term "manipulative" in 10(b) as it included negligent conduct, and noting that the agency's power extends only to giving effect to Congress's intent, not making law).

[272] *See supra* Part III.A.1.

[273] *See* Metge v. Baehler, 762 F.2d 621, 631 (8th Cir. 1985).

[274] *See id.* at 630 (citing Myzel v. Fields, 386 F.2d 718 (8th Cir. 1967)).

Supreme Court has expressly rejected.[275] As a result, the Eighth Circuit's standard is in doubt and subject to challenge.

The better reasoned decisions on "control" chart a middle course. Applying a pragmatic approach, these courts have applied a standard of "actual control of the transactions in question."[276] In light of the limits imposed by the statute, which the Supreme Court has repeatedly emphasized, this standard considers the relationship between the control person and the primary violator with respect to the alleged violation, rather than considering their relationship generally. As such, the standard affirms the often-stated principle that the "mere existence of a parent/subsidiary relationship may be an insufficient basis from which to infer control."[277] Similarly, this standard does not require a showing of the control person's scienter, as is required by the decisions of courts that require that the plaintiff establish culpable participation by the control person.[278] This standard, therefore, balances the need to hold those who control—or should control—primary violators accountable, while not reading section 20(a) in such an overly broad manner that it conflicts with Congress's intent to limit liability for control persons.

While the actual control of the transaction standard is more narrowly focused, by no means does it provide blanket immunity for control person defendants. Rather, control persons still face liability for failing to act in good faith when they actually control the primary violator.[279] A control defendant, therefore, may be held liable under 20(a) for negligently failing to supervise or control an employee or agent. The control defendant is, thus, not

[275] *See* Aaron v. SEC, 446 U.S. 680, 695 (1980); Touche Ross & Co. v. Redington, 442 U.S. 560, 578 (1979); *Ernst & Ernst*, 425 U.S. at 199–200.

[276] Ross v. Bolton, No. 83 CIV. 8244 (WK), 1989 WL 80428, at *3 (S.D.N.Y. Apr. 4, 1989), *vacated on other grounds by* No. 83 CIV. 8244 (WK), 1989 WL 80425 (S.D.N.Y. Apr. 10, 1989) (reversing an erroneous dismissal of common law fraud claims for jurisdictional reasons); *see In re* Tronox, Inc. Sec. Litig., No. 09 Civ. 6220(SAS), 2010 WL 2835545, at *14 n.198 (S.D.N.Y. June 28, 2010); *In re* Global Crossing, Ltd. Sec. Litig., No. 02 Civ. 910(GEL), 2005 WL 1875445, at *3–4 (S.D.N.Y. Aug. 5, 2005) (applying the standard to section 15 of the Securities Act (15 U.S.C. § 77o) an analogous control person statute to section 20(a)).

[277] *Global Crossing*, 2005 WL 1875445, at *4.

[278] *See Tronox*, 2010 WL 2835545, at *15 (rejecting argument that plaintiff must establish culpable participation).

[279] *See supra* Part III.B.1.

vicariously liable for another's primary violation but is held secondarily liable for its failure to control the transaction at issue in good faith.

This actual control of the transaction standard has been successfully applied by courts in considering section 20(a) claims. For example, in *Global Crossing*, the court refused to dismiss a secondary liability claim brought against an investment bank under 20(a) where the entity that had committed the primary violation of 10(b) was a "wholly owned subsidiary" of the parent company.[280] The *Global Crossing* Court concluded that the parent company actually controlled the party that had committed the securities violation because "the directors of both corporations were interchangeable" and the parent company had "direct involvement in the day-to-day operations" of its subsidiary and, presumably, could have prevented the violation had the parent acted in good faith.[281]

The actual control of the transaction standard has also been applied to claims of secondary liability against accounting firms. For example, in *In re Lernout & Hauspie Securities Litigation*, the district court applied this standard by examining what role each accounting firm played with regard to the alleged securities violations.[282] Investors in a Belgian speech technology corporation alleged 10(b) and 20(a) violations by KPMG Belgium, the corporation's auditors, as well as KPMG International—the global firm—and the KPMG member firms in the United States, the United Kingdom, and Singapore.[283] First addressing primary liability, the court refused to dismiss the 10(b) claims against KPMG Belgium because it had actually performed the audits and had signed off on the speech company's financial reports.[284] The court also rejected KPMG U.S.'s motion to dismiss because the U.S. firm's partners had played "a significant role in drafting the financial statements and in conducting the audit."[285] By contrast, the court dismissed the claims against KPMG UK and KPMG Singapore on the grounds that their having reviewed audits and commented on documents was insufficient to trigger primary

[280] *Global Crossing*, 2005 WL 1875445, at *4.
[281] *Id.* (internal citations and quotation marks omitted).
[282] 230 F. Supp. 2d 152, 175–76 (D. Mass. 2002).
[283] *See id.* at 156–57.
[284] *See id.* at 163–64.
[285] *Id.* at 166.

84 St. John's L. Rev. 1133 (2010)

liability under *Central Bank*.[286] Turning to secondary liability, the court rejected section 20(a) claims against KPMG International, KPMG U.S., and KPMG UK on the grounds that there was "no evidence that KPMG U.S. or KPMG UK ever *actually exercised control* over KPMG Belgium in the issuance of audit reports."[287]

The *Lernout & Hauspie* Court conducted a proper analysis of whether each accounting firm was actually involved in the audit at issue in the litigation. Where the Belgian and U.S. firms were substantially involved in preparing the audit reports alleged to be deceptive, the court refused to dismiss the claims based on 10(b) primary liability.[288] With regard to secondary liability under 20(a), however, the court rejected the control liability claims because the plaintiffs had failed to establish that any KPMG entity had actually controlled KPMG Belgium for the purpose of the particular audit at issue.[289]

3. The Actual Control of the Audit Standard Provides an Effective Means of Reaching Control Defendants

The actual control of the audit standard is particularly useful for analyzing the *Parmalat* plaintiffs' secondary liability claims against the Deloitte Defendants. In *Parmalat*, Deloitte-Italy was alleged to have committed the primary violation of 10(b) by either discovering and failing to report, or recklessly ignoring, the fraud committed by Parmalat's officers.[290] DTT, the global firm, was alleged to have controlled the Parmalat audit by arbitrating the dispute between Deloitte-Italy and Deloitte-Brazil at the center of the audit.[291] Under the analysis undertaken in *Lernout & Hauspie* and *Global Crossing*, this intervention by DTT into the particular Parmalat audit at issue in the litigation likely raises an issue of fact as to whether the global firm actually controlled Deloitte-Italy for the purposes of that particular audit. Application of the actual control of the audit

[286] *See id.* at 168, 171.
[287] *Id.* at 176 (internal citation and quotation marks omitted) (emphasis added).
[288] *See id.* at 163–64, 166.
[289] *See id.* at 176.
[290] *See In re* Parmalat Sec. Litig., 594 F. Supp. 2d 444, 447–48 (S.D.N.Y. 2009).
[291] *See id.* at 453–54.

standard would, thus, result in the same outcome with regard to secondary liability claims against DTT as the *Parmalat* Court's analysis.[292]

With regard to Deloitte-U.S., however, no facts indicate that it actually controlled any audit of Parmalat. Plaintiffs alleged, and the court relied on, the fact that Deloitte-U.S. and DTT shared some executives, Deloitte-U.S. guaranteed loans for its global firm, and Deloitte-U.S. persuaded the global firm to sell its consulting business.[293] None of these allegations demonstrates any actual control by Deloitte-U.S. of DTT or Deloitte-Italy for the purposes of the audit at issue in the litigation. Under the actual control of the audit standard, Deloitte-U.S. could not be held secondarily liable because there was no evidence that it actually controlled another party involved in the auditing of Parmalat.

Imposing liability only on those firms that actually controlled a primary violator has numerous advantages. First, by limiting liability to those entities that actually controlled the audit, the actual control of the audit standard meaningfully addresses the systemic risk posed by the loss of a major global accounting network when a rogue member acts outside of the legitimate control that the global firm had over the member. On the other hand, accounting firms that actually controlled an audit cannot escape liability if they failed to control or supervise in good faith. Second, the standard recognizes and respects the unique organizational structure of accounting firms by not conflating independent national partnerships and their global network entity into a single persona. Respecting the independent partnership structure of national accounting firms is important because a third party's perception is not a basis for measuring liability.[294] While this standard may limit an investor's recovery to the entities that were actually involved in or controlled the audit, courts routinely limit investors' recovery against other defendants, such as boards of directors, by applying

[292] *See id.* at 455–56.

[293] *See id.* at 458–59.

[294] *See* Cromer Fin. Ltd. v. Berger, Nos. 00 Civ. 2284(DLC), 00 Civ. 2498(DLC), 2002 WL 826847, at *4 (S.D.N.Y. May 2, 2002) ("Whether actual authority exists 'depends on the actual interaction between the putative principal and agent, not on any perception a third party may have of the relationship.' " (quoting Itel Containers Int'l Corp. v. Atlanttrafik Express Serv. Ltd., 909 F.2d 698, 702 (2d Cir. 1990))).

84 St. John's L. Rev. 1133 (2010)

a similar "active control" standard.[295] Third, by focusing the secondary liability analysis on the entity that actually controlled the audit, this standard properly correlates liability with actual control of the actions that gave rise to the primary violation. Such a result is important to promote and protect honest capital markets without subjecting accounting firms to the threat of massive civil liability.

In *Central Bank*, the Supreme Court expressed its concern that excessive secondary liability "exacts costs that may disserve the goals of fair dealing and efficiency in the securities markets,"[296] resulting in more harm than good to the securities marketplace as a whole. The investing public will ultimately be disserved by the imposition of excessive secondary liability on accounting firms. As the example of Arthur Andersen vividly shows, the loss of a large global accounting firm will likely result in fewer choices for corporations, fewer safeguards on auditor independence, and fewer sources of vital financial information for the investing public.

CONCLUSION

The Supreme Court has frequently stated that the private cause of action under section 10(b) of the Securities Exchange Act of 1934 must be limited to the express conduct proscribed by Congress in the Act. Congress has rejected imposing secondary liability through 10(b), choosing instead to rely on section 20(a) of the Securities Exchange Act, which imposes liability on those who control a primary violator, subject to a good faith defense. The court in *In re Parmalat Securities Litigation* rejected the holding of the Supreme Court and congressional intent when it permitted plaintiffs to sue two global accounting firms and two U.S. accounting firms under a vicarious liability theory of 10(b). Such an approach is inconsistent with Supreme Court precedent and congressional intent as evidenced by the inclusion of the good faith defense in section 20(a), and it is antithetical to the notion of holding wrongdoers accountable.

Because of their size, their role in auditing public companies' financial reports, and their global network structure, large

[295] *See* Kuehnle, *supra* note 194, at 358 & n.225.

[296] Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164, 188 (1994).

84 St. John's L. Rev. 1133 (2010)

accounting firms are uniquely susceptible to the harm wrought by imposing strict secondary liability under 10(b). The loss of a large global accounting firm to a private securities claim would have major implications for auditor independence and would likely reduce public companies' options regarding their outside auditors, while simultaneously increasing public company audit fees. The solution proposed in this Note, that global accounting firms should only face secondary liability under section 20(a) when they have actually controlled the audit, balances the need to hold accounting firms accountable for their own actions, while enabling them to limit liability within the realistic boundaries of control that they have over affiliated accounting firms.