# Securities Litigation

Volume 15, Number 1
Fall 2004

American Bar Association, Section of Litigation, Securities Litigation Committee



## State Law Securities "Holding" Claims and SLUSA Preemption

-John R. Bielema, Jr. and Michael P. Carey[1]

The "holding claim" is a subset of securities fraud litigation that has long been disfavored under federal law and has until recently been largely ignored under state law. A holding claim is one brought by a plaintiff who claims that the alleged fraud actually caused him to hold stock he already owned, rather than purchase or sell any shares. Such a plaintiff is barred from bringing a federal securities fraud claim under Section 10(b) of the Securities Exchange Act of 1934[2] and Securities and Exchange Commission Rule 10b-5[3] because of the firmly established *Birnbaum* rule, which limits standing in 10b-5 cases to those who purchase or sell a security "in connection with" the alleged fraud.[4] For decades, little attention was paid to the possibility of maintaining holding claims under state law fraud theories, including common law fraud.

That, however, may be changing. In the past year, appellate courts in the nation's two most populous states have endorsed the holding claim theory, ruling that such claims can be brought as common law fraud claims.[5] In a related development, a number of federal courts have held that holding claim class actions brought in state court are not subject to removal to federal court—and ultimately dismissal—under the Securities Litigation Uniform

*continued on page 2*

## A Trap for the Unwary Attorney SEC Rule 13b2-2: Improper Influence on Conduct of Audits

-Paul B. Uhlenhop

The Securities and Exchange Commission (SEC) adopted Rule 13b2-2 (the Rule)[1] as part of the Sarbanes-Oxley Act of 2002 (the Act).[2] The Rule was designed to preclude issuers, their officers, directors and others, including attorneys, from misleading independent public accountants.

The Rule affects attorneys representing issuers, private or public, including broker-dealers and investment advisers that file with the SEC financial statements audited or reviewed by independent public accountants. Attorneys will need to pay careful attention in responding to any auditor inquiries, oral or written, because any response to an independent public accountant regarding an issuer, publicly or privately, will necessarily be within the scope of the Rule if the issuer's financial statements are filed with the SEC. Further, the Rule may be violated in certain cases even though there is no scienter. The Rule also has as an underlying assumption as discussed below that attorneys responding to an auditor's request understand generally accepted accounting principles (GAAP) and generally accepted auditing standards (GAAS). Further, hindsight judgment may subject attorneys to significant regulatory liability under the

*continued on page 7*

## In This Issue

A Trap for the Unwary Attorney
continued from cover

Rule, particularly in the absence of a scienter requirement. The only good news is that the Rule does not create a private right of action.[3] These and other issues are discussed below.

## Sarbanes-Oxley Act

The Sarbanes-Oxley Act in Section 303(a) provided that:

> It shall be unlawful, in contravention of such rules or regulations as the Commission shall prescribe as necessary or appropriate in the public interest and for the protection of investors, for any officer or director of an issuer, or any other person acting under the direction thereof, to take any action to fraudulently influence, coerce, manipulate, or mislead any independent public or certified accountant engaged in the performance of an audit of the financial statements of that issuer for the purpose of rendering such financial statements materially misleading.[4]

Under this mandate the SEC promulgated Rule 13b2-2.

## Rule 13b2-2

Although Rule 13b2-2 is relatively short, the proposing release (Proposing Release)[5] and adopting release (the Release)[6] provide substantial explanatory information about how the Rule will be interpreted. Set forth below is the Rule with certain key phrases and words underlined for emphasis:

> Issuer's representations and conduct in connection with the preparation of required reports and documents.
> (a) No director or officer of an *issuer* shall, directly or indirectly:
> (1) Make or cause to be made a materially false or misleading statement to an accountant in connection with; or
> (2) Omit to state, or cause another person to omit to state, any material fact necessary in order to make statements made, in light of the circumstances under which such statements were made, not misleading, to an accountant in connection with:
> (i) Any audit, review or examination of the financial statements of the issuer required to be made pursuant to this subpart; or
> (ii) The preparation or filing of any document or report required to be filed with the Commission pursuant to this subpart or otherwise.
> (b)(1) No officer or director of an issuer, or any other person acting under the direction thereof, shall directly or indirectly take any action to coerce, manipulate, mislead, or fraudulently influence any independent public or certified public accountant engaged in the performance of an audit or review of the *financial statements* of that issuer *that are required to* be filed with the Commission pursuant to this subpart or otherwise if that *person knew or should have known that such action*, if successful, could result in rendering the issuer's financial statements materially misleading.
> (2) For purposes of paragraphs (b)(1) and (c)(2) of this section, actions that, "if successful, could result in rendering the issuer's financial statements materially misleading" include, but are not limited to, actions taken at any time with respect to the professional engagement period to coerce, manipulate, mislead, or fraudulently influence an auditor:
> (i) To issue or reissue a report on an issuer's financial statements that is not warranted (due to material violations of generally accepted accounting principles, generally accepted auditing standards, or other professional or regulatory standards);
> (ii) Not to perform audit, review or other procedures required by *generally accepted auditing standards or other professional standards*;
> (iii) Not to withdraw an issued report; or
> (iv) Not to communicate matters to an issuer's audit committee.
> (c) In addition, in the case of an investment company registered under section 8 of the Investment Company Act of 1940 (15 U.S.C. 80a-8), or a business development company as defined in section 2(a)(48) of the Investment Company Act of 1940 (15 U.S.C. 80a-2(a)(48)), no officer or director of the company's investment adviser, sponsor, depositor, trustee, or administrator (or, in the case of paragraph (c)(2) of this section, any other person acting under the direction thereof) shall, directly or indirectly:
> (1)(i) Make or cause to be made a materially false or misleading statement to an accountant in connection with; or
> (ii) Omit to state, or cause another person to omit to state, any material fact necessary in order to make statements made, in light of the circumstances under which such statements were made, not misleading to an accountant in connection with:
> (A) Any audit, review, or examination of the financial statements of the investment company required to be made pursuant to this subpart; or
> (B) The preparation or filing of any document or report required to be filed with the Commission pursuant to this subpart or otherwise; or
> (2) Take any action to coerce, manipulate, mislead, or fraudulently influence any independent public or certified public accountant engaged in the performance of an audit or review of the financial statements of that investment company that are required to be filed with the Commission pursuant to this subpart or otherwise if that person knew or should have known that such action, if successful, could result in rendering the investment company's financial statements materially misleading.[7]

## Analysis

***The Term "ISSUER" is Broadly Defined to Include Any Issuer, Private or Public, Filing Financial Statements with the SEC***

The proposing Release[8] makes it clear that the SEC is

applying the term "issuer" in Rule 13b2-2 to mean "issuer" as defined in Section 3(a)(8) of the Securities Exchange Act (34 Act), which reads as follows:

> The term "issuer" means any person who issues or proposes to issue any security; except that with respect to certificates of deposit for securities, voting trust certificates, or collateral-trust certificates, or with respect to certificates of interest or shares in an unincorporated investment trust not having a board of directors or of the fixed, restricted management, or unit type, the term "issuer" means the person or persons performing the acts and assuming the duties of depositor or manager pursuant to the provisions of the trust or other agreement or instrument under which such securities are issued; and except with respect to equipment-trust certificates or like securities or like securities, the term "issuer" means the person by whom the equipment or property is, or is to be, used.[9]

The broad scope of the term "issuer" in Section 3(a)(8) goes well beyond the definition of issuer as defined in the Sarbanes-Oxley Act in Section 2(a)(7),[10] which generally means an issuer that has publicly held securities or is in the process of registering securities for distribution under the Securities Act of 1933.[11] The broader definition means that the rule applies to any issuer, public or private, filing financial statements and in some cases as explained below other documents with the SEC. It would not apply to a sole proprietor and probably would not apply to a partnership, but any other type of entity that has issued an interest that is a security would qualify. This means that it will apply to publicly held companies and to certain privately held firms that file audited financial statements or other documents with the SEC such as broker-dealers.

***Subparagraph (a) of Rule 13b2-2***

Subparagraph (a) provides that no officer or director of an issuer shall "directly or indirectly" make any materially false or misleading statements or omit to state or cause another person to omit to state any material fact necessary in order to make statements made, in light of the circumstances in which such statements were made, not misleading "to an accountant in connection" with:

1. an audit or examination of financial statements of the issuer required to be made pursuant to this subpart; or

2. the preparation of any document or report required to be filed with the Commission pursuant to this subpart or *otherwise* (emphasis added).

The "or otherwise" appears to apply to any document or report involving an accountant. However, this broad provision of subparagraph (a) applying subparagraph (a) to any report or document "or otherwise" is not found in subparagraph (b) involving attorneys, but is found in subparagraph (c) involving attorneys acting at the direction of an investment company, its officers or directors.

***Subparagraph (b) of Rule 13b2-2***

*1. The Scope*

Subparagraph (b) broadens the applicability of the rule to include attorneys by prohibiting an officer or director of an issuer or "*any person acting under direction thereof*" to

> "directly or indirectly take *any* action to coerce, manipulate, mislead, or fraudulently influence any independent public or certified public accountant engaged in the performance of an audit or review of the financial statements of the issuer that are required to be filed with the Commission. ..." (emphasis added).

There is a further qualification that if the person "knew or *should have known* that such action could, if successful, result in rendering such financial statements materially misleading" (emphasis added).

More important, the language "for any other person acting under the direction" thereof sweeps in any attorney responding to an audit letter request, any attorney issuing an opinion at the request of a client, any attorney that discusses any matter with an accountant while employed, engaged or acting for an issuer. The SEC's proposing and adopting Releases confirm the rule's broad scope. In the Release, on page 3, the Commission states as follows:

> As noted in the proposing release, we interpret Congress' use of the term "direction" to encompass a broader category of behavior than "supervision." In other words, someone may be "acting under the direction" of an officer or director even if they are not under the supervision or control of that officer or director. Such persons might include not only the issuer's employees but also, for example, customers, vendors or creditors who, under the direction of an officer or director, provide false or misleading confirmations or other false or misleading information to auditors, or who enter into "side agreements" that enable the issuer to mislead the auditor. In appropriate circumstances, persons acting under the direction of officers and directors also may include not only lower level employees of the issuer but also other partners or employees of the accounting firm (such as consultants or forensic accounting specialists retained by counsel for the issuer) and attorneys, securities professionals, or other advisers who, for example, pressure an auditor to limit the scope of the audit, to issue an unqualified report on the financial statements when such a report would be unwarranted, to not object to an inappropriate accounting treatment, or not to withdraw an issued audit report

> on the issuer's financial statements. In the case of a registered investment company, persons acting under the direction of officers and directors of the investment company may include, among others, officers, directors, and employees of the investment company's investment adviser, sponsor, depositor, administrator, principal underwriter, custodian, transfer agent, or other service providers (emphasis added).[12]

Equally troublesome is the SEC's definition of "direction" in footnote 22 where the Release states:

> "*See, e.g., Webster's Dictionary* (9th edition), which defines 'direction' to include not only guidance or supervision of action or conduct but also explicit instruction."[13]

*2. Scienter*

The SEC's Release indicates that within the words "coerce, manipulate, mislead, or fraudulently influence," only the word "influence" is limited by the word "fraudulently." Manipulation and fraud have been held by the Supreme Court to require scienter.[14] Whether or not scienter is required for coercion or for misleading statements could be argued either way. The better way would be to require scienter rather than negligence. The lack of clarity by the SEC in the Release is troublesome.[15] However, in the Release, the SEC articulates examples of prohibited conduct as follows:

- Offering or paying bribes or other financial incentives, including offering future employment or contracts for non-audit services,
- Providing an auditor with an inaccurate or misleading legal analysis,
- Threatening to cancel or canceling existing non-audit or audit engagements if the auditor objects to the issuer's accounting,
- Seeking to have a partner removed from the audit engagement because the partner objects to the issuer's accounting,
- Blackmailing, and
- Making physical threats.[16]

These all involve scienter.

*3. Subparagraph (b)(2)*

The provisions of subparagraph (b)(2) are equally troubling. Subparagraph (b)(2) provides that "actions that 'could, if successful, result in rendering such financial statements materially misleading' include, but are not limited to, actions taken at any time with respect to the professional engagement period to coerce, manipulate, mislead, or fraudulently influence an auditor" followed by a listing of specific conduct. The listed specific conduct in the Rule includes:

(i) To issue a report on an issuer's financial statements that is not warranted in the circumstances (due to *material violations of generally accepted accounting principles, generally accepted* auditing standards, or other standards);

(ii) Not to perform audit, review or other procedures required by generally accepted auditing standards or other professional standards;

(iii)Not to withdraw an issued report; or

(iv) Not to communicate matters to an issuer's audit committee (emphasis added).[17]

Underlying both (i) and (ii) above, is the assumption that an attorney responding to an auditor's request understands GAAP, GAAS and "other professional or regulatory standards." This assumption is compounded by the wording in (b)(1) that provides liability "if that person ... knew or should have known that such actions could if successful result in rendering such financial statements materially misleading." This may impose an obligation to understand GAAP, GAAS and the "other professional or regulatory standards". Presumably "regulatory standards" means Regulation S-X. But what does other professional standards mean? As discussed below, it is highly unlikely that most attorneys will understand GAAP and Regulation S-X. It is less likely that most attorneys will understand GAAS. The other phrase, "other professional ... standards" is undefined. It seems difficult for an attorney to know what undefined "other professional ... standards" might be.

***Subparagraph (c) of Rule 13b2-2***

Subparagraphs (c)(1) and (c)(2) largely track the substance of subparagraphs (b)(1) and (b)(2) but with some important differences in that subparagraph (c) is an amalgamation of subparagraphs (a) and (b) with respect to investment companies and business development companies. Where subparagraph (b) is limited to financial statements, subparagraph (c) applies to any document or report filed with the SEC as does subparagraph (a). Importantly from the perspective of an attorney, subparagraph (c)(1), which includes activities of an attorney acting under the direction of an officer or director of the investment adviser of an investment company, would include not only financial statements, but also "any document or report" filed with the SEC.

## Issues Confronting Attorneys

***General***

As noted above, Rule 13b2-2 will apply to any issuer, public or private, that files any financial statements, audited or not, required pursuant to the 34 Act, the rules thereunder or otherwise required to be filed with the SEC under any other rule or provision. Part of the Rule will apply to any report or document filed with the SEC, not just financial statements. Contrary to the mandate of the Sarbanes-Oxley Act which was intended to apply to public issuers, the SEC's rule extends far beyond the scope of the Sarbanes-Oxley Act and will apply to attorneys and others acting at the direction of an issuer, whether public or privately held if they file financial statements or in some cases other "documents" required by the SEC.

***Assumption that Attorneys Know GAAP and GAAS***

As discussed above, underlying Rule 13b2-2 is the basic assumption that persons including attorneys acting at

the direction of an issuer understand GAAP and GAAS. This assumption is a simplistic and incorrect view. For example, in responding to an annual audit letter request regarding litigation, most attorneys are going to be unfamiliar with the GAAP and the GAAS rules that may be applicable, particularly the rules as to whether a contingent liability should be accrued or disclosed in the footnotes to financial statements. As demonstrated above, the wording in subparagraph (b)(1) imposes without an apparent scienter a requirement that a person "know or should have known" that the person's actions could if successful result in rendering such financial statements materially misleading. These words could also be interpreted by the SEC to mean that an attorney should know GAAP or GAAS. However, such an interpretation is unreasonable in and of itself because even attorneys that represent issuers in many cases will not be familiar with GAAP or GAAS, except for certain particular rules and statements. The rule should be clarified because it would be unreasonable to assume that most attorneys responding to audit letters would be familiar with GAAP or GAAS or other professional or regulatory standards.

***Familiarity with Disclosures of the Issuer***

In most cases, litigation counsel responding to an auditor's request has never seen and probably never will see the financial statements that are proposed to be filed with the SEC or the issuer's disclosures to the SEC. Nevertheless, the proposed rule seems to impose an obligation on any attorney responding to an auditor's request to be familiar with the issuer's prior disclosures to the SEC and the issuer's financial statements. Hopefully the SEC will issue some interpretation or change the Rule so that it is clear that attorneys that would not normally review the issuer's financial statements or disclosures would not be required to do so in responding to audit letter requests, particularly when attorneys is handling a limited piece of litigation.

***Hindsight Application***

The single biggest problem in the Rule is that it would obviously be applied with hindsight. This is compounded, as noted above, because the Rule assumes that attorneys are familiar with GAAP, GAAS and the issuer's disclosures. In most cases, any deficiency will be a material nondisclosure, not an affirmative misstatement. This puts attorneys in an impossible position and exposes attorneys to significant regulatory liability.

***Audit Letter Responses***

In responding to an issuer's request for a response to its auditors, attorneys will certainly be within the scope as contemplated by 13b2-2(b) and (c). Consequently, a host of issues arise. Attorney audit letter responses must be carefully drafted in accordance with the Auditors Letter Handbook containing the accord between the American Bar Association and the American Institute of Certified Public Accountants (AICPA). Because of Rule 13b2-2, attorneys' audit letter responses should be even more critically examined by committees of issuing law firms. Although it is unclear whether an audit letter response is a waiver of attorney-client privilege, it is expected that this will become an even bigger issue and will probably be tested.

Attorneys that are handling litigation and other matters on a one time or even on a regular basis but are not involved with financial statements or disclosures of the issuer will need to necessarily qualify their audit responses that they do not have available and have not seen any financial statements of the issuer. These opinions will probably disclaim advice, opinion or statement with respect to the impact of their response on the financial statements or disclosures of an issuer's SEC filing. Whether these disclaimers would be effective or not remains to be seen.

Often, attorneys are asked by independent public accountants orally for additional information regarding their audit letter or for clarification. Because of the regulatory penalties that might be applied to an attorney, attorneys should be very careful in responding outside of the written audit request response. In any case, any response should be in writing and reviewed by the law firm's opinion committee. Some law firms may elect to refuse to discuss their audit letter responses at all.

***Opinions***

Opinions for an issuer provided to an issuer's underwriter in connection with corporate transactions may be shared with independent public accountants. Attorneys may wish to specifically provide in their opinions that they will not be shared with independent public accountants without the consent in writing of the law firm. This should be done to avoid issuers using stale opinions with public accountants and to prevent the attorney from being charged with "misleading" an auditor.

***Client Review of Audit Letter Responses***

Attorneys may be reluctant to submit their audit letter responses to their clients for review as is usually done before the attorney releases an audit letter response. If the client asks for a change, it makes a record that can be used in the future to argue that the change was to mislead the accountant. Alternatively, if the attorney doesn't have the letters reviewed by the issuer and doesn't know of a material development, the letter itself may result in material omission because it was not submitted to review by the issuer and its inside counsel.

***Discussions with Accountants Regarding Corporate Transactions***

It is not infrequent that accountants will discuss with attorneys that have been involved in structuring or documenting a corporate transaction the relevant documents and what they may mean. It appears that such discussions at the direction of a client would fall within the scope of the rule. The proper response is probably to inform the independent public account-

ants that they should consult with their own attorneys regarding any conclusions to be drawn from the documents. However, this approach has the downside that the failure to disclose something that is material could be actionable in and of itself.

Rule 13b2-2 is a significant trap for both the wary and the unwary attorney. Every attorney might be, but shouldn't be, held to a standard of knowledge with respect to GAAP and GAAS and familiarity with an issuer's financial statements and disclosures. This is compounded because the rule will operate by hindsight. The Rule raises the question whether attorneys, in order to protect themselves, will limit their audit letter responses and opinions to disclaim knowledge of GAAP or GAAS and the issuer's financial statements? Will such disclaimers be accepted by the SEC? In addition, should the American Bar Association significantly revise the Accord between the American Bar Association and the AICPA with respect to audit letter responses? It seems that the time has come to do so. It also appears that informal communication with independent public accountants will be limited, if not eliminated, as a result of the rule. One seriously wonders whether this rule is in the public interest and defeats the mandated goal of Congress in the Sarbanes-Oxley Act.

*Mr. Uhlenhop is a member of the bars of the states of Illinois and of New York and is a senior member of Lawrence, Kamin, Saunders & Uhlenhop, L.L.C., in Chicago.*

---

1. Rule 13b2-2; 17 C.F.R. 240.13b2-2.
2. Sarbanes-Oxley Act of 2002 (hereafter the "Act"); Pub.L. 107-204, 116 Stat. 745 (2002).
3. Release, p. 11, FN 117.
4. Act §303(a).
5. Release No. 34-46685, October 18, 2002 (herein called the "Proposing Release").
6. Release No. 34-47890, May 20, 2003 (herein called the "Release").
7. 17 C.F.R. 240.13b2-2.
8. Release, p. 2.
9. 15 U.S.C. 78c(a)(8).
10. The Act §2(a)7(7).
11. 15 U.S.C. 77a, *et seq.*
12. Release, p. 3.
13. Release, FN 22.
14. Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976).
15. See discussion of Release, pp. 4 and 5.
16. Release, p. 5.
17. Rule 13b2-2(b)(2); 17 C.F.R. 240.13b2-2.