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Chelsea Ortega*

Malack v. BDO Seidman, LLP: Gatekeepers Not So Conflicted in the Fraud-Created-the-Market Theory

In *Malack v. BDO Seidman, LLP*,[1] the United States Court of Appeals for the Third Circuit held that the fraud-created-the-market theory of reliance is not a valid presumption of reliance in securities fraud class action cases.[2] In so holding, the court deepened the split in the circuit courts over whether to recognize the fraud-created-the-market theory;[3] a presumption of reliance that allows investors to rely on the "integrity of the market" when purchasing securities.[4] The court should have adopted the theory, but mistakenly focused on the argument that the theory is invalid because of the lack of an entity, or gatekeeper, to prevent fraudulent securities from reaching the market.[5] The court should have recognized that gatekeepers of securities transactions commonly face conflicts, but that the conflict in issuing securities is not a debilitating one.[6] Gatekeepers will choose to ensure that securities are genuine to avoid being liable.[7] Furthermore, the court ignored Congress's main purpose in adopting the securities laws, which is to protect investors from fraud.[8]

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1. 617 F.3d 743 (3d Cir. 2010).
2. *Id.* at 745.
3. *See id.* (noting that the circuits are split over the recognition of the theory).
4. *Id.* at 747.
5. *See infra* Part IV.
6. *See infra* Part IV.A.
7. *See infra* Part IV.B.
8. *See infra* Part IV.C.

I. The Case

From October 3, 2002, to January 20, 2005, a group of investors[9] purchased notes[10] from American Business Financial Services, Inc. ("American Business"), a diversified financial services organization.[11] American Business bought and sold home mortgage loans and business loans of those with impaired credit.[12] In the beginning of the June 2003 quarter, American Business was no longer able to securitize[13] its mortgages.[14] As a result, American Business began borrowing money from banks and other institutions, and selling notes to investors in order to finance loans to its customers.[15] BDO Seidman, LLP ("BDO Seidman"), an accounting and auditing firm retained by American Business, provided "clean" audit opinions[16] for American Business in order to file the notes with the Securities and Exchange Commission ("SEC").[17] These opinions were included in American Business's 2002 and 2003 Registration Statements.[18] On January 21, 2005, American Business filed for bankruptcy.[19]

As a result, John A. Malack and the other investors who had purchased notes during this time period filed a securities fraud class action suit under Section 10(b) of the Securities Exchange Act of 1934[20] and Rule 10b-5[21] against BDO Seidman. [22] Malack alleged that BDO Seidman should not have issued clean audit opinions for American Business and that these opinions did not accurately represent American

9. The investors were John A. Malack, Michael R. Rosati, Virgil Magnon, S.S. Rajaram, M.D., Hayward Pediatrics, Inc. and Henry Munster. Malack v. BDO Seidman, LLP, No. 08-0784, 2009 WL 2393933, at *1 (E.D. Pa. Aug. 3, 2009).

10. These notes included "subordinated debt securities, subordinated money-market notes and subordinated debentures." *Id.*

11. *Id.*

12. *Id.* Additionally, American Business's customers were generally not able to obtain loans from other organizations, such as banks, or savings and loan associations. *Id.*

13. In this process, American Business would "transfer[] a pool of mortgage loans to a trust in exchange for certificates, notes or other securities issued by the trust that were then sold to investors for cash." American Business made a profit by "retain[ing] the rights to service the loan for a fee." *Id.*

14. *Id.*

15. *Id.*

16. A clean audit opinion signifies that the client's financial statements are free of discrepancies and is "the highest level of assurance that an auditor can give on an organization's financial statements." *In re* IKON Office Solutions, Inc., 277 F.3d 658, 663 n.4 (3d Cir. 2002).

17. *Malack*, 2009 WL 2393933, at *2. American Business's financial information, files, and employees were available to BDO Seidman in issuing its opinion. As a result, the court noted that BDO Seidman "had the opportunity to observe and review [American Business's] business and accounting practices and internal control structure." *Id.* As an independent certified public accountant, an auditor is responsible for reviewing a company's financial statements which are submitted to the SEC. *All About Auditors: What Investors Need to Know*, U.S. Securities and Exchange Commission, http://www.sec.gov/investor/pubs/aboutauditors.htm (last modified June 24, 2002). As to the process required by the SEC when issuing securities, s*ee infra* note 90 and accompanying text.

18. *Malack*, 2009 WL 2393933, at *2.

19. *Id.* at *1 n.1.

20. 15 U.S.C. § 78j(b) (2006).

21. 17 C.F.R. § 240.10b-5 (2011).

22. *Malack*, 2009 WL 2393933, at *1.

Business's financial status at the time they were issued.[23] Furthermore, Malack claimed that if BDO Seidman had not issued clean audit opinions, American Business would not have been able to file the notes with the SEC, and Malack and the other investors would not have purchased the notes.[24]

The district court denied Malack's request for class certification, finding that the proposed class did not meet the predominance requirement of Federal Rule of Civil Procedure 23(b)(3).[25] Malack alleged that the fraud-created-the-market theory established a presumption of reliance necessary to satisfy the requirement that common issues predominated over issues affecting individual class members.[26] The district court held that there was not enough evidence to establish a presumption of reliance under the fraud-created-the-market theory or "that the SEC would not have registered the notes at issue 'but for' defendant's audit opinions omitting the alleged fraud."[27]

Malack petitioned for permission to appeal under Rule 23(f).[28] The Court of Appeals for the Third Circuit granted the petition to determine whether the district court erred in denying class certification.[29]

II. Legal Background

The main issue examined in *Malack* was whether there was sufficient reliance by the plaintiffs in order to assert a securities fraud class action suit.[30] One of the major hurdles plaintiffs face in obtaining class certification in securities fraud cases is establishing that all of the members in the class relied on the defendant's misrepresentation or omission.[31] As a result, the Supreme Court has recognized two types of presumptions of reliance in securities fraud actions; the *Ute* presumption and the fraud-on-the-market theory.[32] Some circuits have created another presumption of reliance, known as the fraud-created-the-market theory, while other circuits have rejected this theory.[33] The role of gatekeepers in bringing a security to market plays a part in why some of the courts have refused to recognize the fraud-created-the-market theory.[34]

23. *Id.* at *2.

24. *Id.*

25. *Id.* at *12. The relevant portion of Rule 23(b)(3) provides that "[a] class action may be maintained . . . if: the court finds that the questions of law or fact common to class members predominate over any questions affecting only individual members." Fed. R. Civ. P. 23(b)(3) (2009).

26. *Malack*, 2009 WL 2393933, at *6.

27. *Id.* at *12.

28. Malack v. BDO Seidman, LLP, 617 F.3d 743, 746 (3d Cir. 2010).

29. *Id.*

30. *Id.* at 745.

31. *See infra* Part II.A.

32. *See infra* Part II.B.

33. *See infra* Part II.C.

34. *See infra* Part II.D.

A. Reliance in Rule 10b-5 Cases

After the crash of the stock market in 1929, Congress passed a series of securities laws in order to protect investors.[35] Section 10(b) of the 1934 Securities Exchange Act provides that it is unlawful "[t]o use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [Securities and Exchange] Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."[36] Pursuant to the authority granted to it by Section 10(b),[37] the SEC implemented Section 10(b) by issuing Rule 10b-5,[38] which prohibits the use of fraud or the omission or misstatement of material facts in securities transactions.[39] The Supreme Court recognized that an implied private right of action exists under Rule 10b-5,[40] thirty years after the first lower court found this right.[41] The elements of a Rule 10b-5 action include: "(1) a material misrepresentation (or omission); (2) scienter . . . ; (3) a connection with the purchase or sale of a security; (4) reliance . . . ; (5) economic loss; and (6) 'loss causation,' i.e., a causal connection between the material misrepresentation and the loss."[42] The Supreme Court established the majority of these elements, but in piecemeal fashion over a period of many years.[43]

Reliance was the only element of Rule 10b-5 at issue in *Malack*.[44] To establish reliance, the plaintiff must establish that but for the claimed misrepresentations or omissions, the investor would not have entered into the transaction.[45] Traditionally,

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35. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 194–95 (1976).

36. 15 U.S.C. § 78j(b) (2010).

37. Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 729 (1975).

38. 17 C.F.R. § 240.10b-5 (2010).

39. Rule 10b-5 states:

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

Id.

40. Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 13 (1971).

41. Kardon v. Nat'l Gypsum Co., 69 F. Supp. 512, 514 (E.D. Pa. 1946).

42. Dura Pharms, Inc. v. Broudo, 544 U.S. 336, 341–42 (2005) (citations omitted).

43. *Id. See* Basic Inc. v. Levinson, 485 U.S. 224, 231–32 (1988) (establishing elements of materiality and reliance); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 197 (1976) (establishing scienter element); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 730–31 (1975) (requiring connection element). Congress created the elements of economic loss and loss causation in Rule 10b-5 actions. 15 U.S.C. § 78u-4(b)(4).

44. Malack v. BDO Seidman, LLP, 617 F.3d 743, 746–47 (3d Cir. 2010).

45. Lentell v. Merrill Lynch & Co., Inc., 396 F.3d 161, 172 (2d Cir. 2005). *See also* Newton v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 259 F.3d 154, 172 (3d Cir. 2001) (noting that a plaintiff meets the reliance

plaintiffs had to establish that they relied directly on defendant's misrepresentations.[46] Rule 10b-5 actions are typically brought as civil or criminal enforcement actions by the SEC or as civil enforcement actions by investors.[47] When it comes to class action suits brought by investors, plaintiffs can struggle with obtaining class certification because the plaintiffs must prove that the issue of reliance for each plaintiff does not predominate over common issues.[48]

B. Presumptions of Reliance Currently Recognized by the Supreme Court

Because reliance is so difficult to prove, especially in class action cases, the Supreme Court has created two circumstances where reliance can be presumed in securities fraud cases.[49] In *Affiliated Ute Citizens of Utah v. United States*,[50] the Court held that when the issuer fails to disclose material facts to investors, the plaintiff does not have to prove reliance in order to recover.[51] This presumption of reliance is commonly referred to as the *Ute* presumption.[52] In order to establish this presumption, the plaintiff only needs to show that there was an obligation on the part of the issuer to disclose and that "the facts withheld [are] material in the sense that a reasonable investor might have considered them important" when purchasing a security.[53]

For example, in *Rochez Bros., Inc. v. Rhoades*,[54] the defendant, the owner of 50% of the stock of a business, was in talks to buy the plaintiff's stock, co-owner of the same business.[55] The defendant was also in negotiations with potential purchasers for the sale of the business.[56] The court held that the defendant was liable under Rule 10b-5 for failing to disclose to the plaintiff that he had been negotiating with

requirement by proving that "but for the fraudulent misrepresentation, the investor would not have purchased or sold the security").

46. Joseph De Simone, *Should Fraud on the Market Theory Extend to the Context of Newly Issued Securities?*, 61 Fordham L. Rev. S151, S152 (1993). *See* List v. Fashion Park, Inc., 340 F.2d 457, 463 (2d Cir. 1965) (noting that a class action was only permitted by the court in a prior Rule 10b-5 case because all of the class members relied on defendant's misrepresentation).

47. Joan MacLeod Heminway, *Hell Hath No Fury Like an Investor Scorned: Retribution, Deterrence, Restoration, and the Criminalization of Securities Fraud under Rule 10b-5*, 2 J. Bus. & Tech. L. 3, 6 (2007). The SEC does not have to establish reliance in its enforcement actions. *Id.*

48. *See* Richard A. Nagareda, *Class Certification in the Age of Aggregate Proof*, 84 N.Y.U. L. Rev. 97, 116 (2009).

49. Julie A. Herzog, *Fraud Created the Market: An Unwise and Unwarranted Extension of Section 10(b) and Rule 10b-5*, 63 Geo. Wash. L. Rev. 359, 363 (1995).

50. 406 U.S. 128 (1972).

51. *Id.* at 153. Because reliance is presumed, the defendant is then responsible for showing that disclosure would not have changed the plaintiff's actions. Rochez Bros., Inc. v. Rhoades, 491 F.2d 402, 410 (3d Cir. 1973) ("If defendant is able to demonstrate that . . . even if the material facts had been disclosed, plaintiff's decision as to the transaction would not have been different from what it was, then the non-disclosure cannot be said to have caused the subsequent loss and . . . recovery should be denied.").

52. Herzog, *supra* note 49, at 363.

53. *Affliated Ute,* 406 U.S. at 153–54.

54. 491 F.2d 402 (3d Cir. 1973).

55. *Id.* at 405.

56. *Id.* at 406.

potential purchasers for the sale of the business while the plaintiff was considering selling his interest to the defendant because this information would have changed the sale price to the defendant.[57]

The second presumption, known as the fraud-on-the-market theory, was adopted by the Court in *Basic Inc. v. Levinson*.[58] There, the Court held that plaintiffs do not have to prove they relied on defendants' misrepresentations, but instead only need to show that they relied on the integrity of the market in purchasing securities.[59] The fraud-on-the-market theory posits that available information on the market is directly related to the price of securities and misleading statements can distort the actual value of a security – thereby causing the purchaser to rely on the misstatements *indirectly*.[60]

For instance, in *Blackie v. Barrack*,[61] the defendant corporation issued an annual report which in 1970 showed a profit of $12 million, and which two years later reported a loss of $90 million.[62] The purchasers of the defendant corporation's securities during this time period brought suit.[63] The court held that the plaintiffs could rely on the fraud-on-the-market theory as a presumption of reliance instead of proving actual reliance when the defendant corporation issued multiple misrepresentations about its finances, which may have artificially inflated the value of the corporation's stock.[64]

C. Circuits are Split on Whether to Recognize the Fraud-Created-The-Market Theory

A third presumption of reliance has been articulated by some of the circuits,[65] although the Supreme Court has not addressed the issue yet.[66] Fraud-created-the-market theory posits that plaintiffs can rely on the presence of the security on the market when purchasing securities.[67] Thus, plaintiffs assert the theory to "show that absent the defendant's fraud, the securities would have been unmarketable."[68]

The Fifth Circuit in *Shores v. Sklar*[69] first articulated the fraud-created-the-market theory.[70] In *Shores*, the plaintiff sued those involved in the issuance of revenue bonds that he purchased after the value of the bonds decreased.[71] The

57. *Id.* at 408–09.
58. 485 U.S. 224 (1988).
59. *Id.* at 241.
60. *Id.* at 242.
61. 524 F.2d 891 (9th Cir. 1975).
62. *Id.* at 894.
63. *Id.*
64. *Id.* at 907.
65. Malack v. BDO Seidman, LLP, 617 F.3d 743, 745 (3d Cir. 2010).
66. *See id.* at 754 (noting that the Supreme Court has cautioned against expanding the §10(b) cause of action when it held that §10(b) liability does not extend to aiders and abettors).
67. Herzog, *supra* note 49, at 359.
68. *Id.*
69. 647 F.2d 462 (5th Cir. 1981) (en banc).
70. Herzog, *supra* note 49, at 374.
71. *Shores*, 647 F.2d at 464.

plaintiff claimed that the defendants had misrepresented and omitted material facts in the Offering Circular disseminated by the defendant, even though the plaintiff was neither aware of the Circular nor relied on it at the time of his purchase.[72] The court held that the plaintiff did not have to prove that he relied on the Circular since the "theory is not that he bought inferior bonds, but that the Bonds he bought were fraudulently marketed."[73] In addition, the court noted that "[t]he securities laws allow an investor to rely on the integrity of the market to the extent that the securities it offers to him for purchase are entitled to be in the marketplace."[74]

The Tenth Circuit has also adopted the fraud-created-the-market theory. In *T.J. Raney & Sons, Inc. v. Fort Cobb, Oklahoma Irrigation Fuel Auth.,*[75] the court stated that in adopting the theory, the court was merely "extend[ing] the protection of Rule 10b-5 to those cases in which the securities were not qualified legally to be issued, and . . . there was a scheme to defraud or act to defraud."[76] Similarly, in *Joseph v. Wiles*,[77] the court recognized that the theory allows investors "to rely on the integrity of the market to contain only genuine securities."[78] The court noted that the securities must be unmarketable in order for the investor to invoke the fraud-created-the-market theory.[79]

In contrast, the Seventh Circuit has refused to recognize the theory. In *Eckstein v. Balcor Film Investors*,[80] the court found that "[t]he existence of a security does not depend on, or warrant, the adequacy of disclosure."[81] The court refuted the holding in *Shores* and noted that even if issuers disclose all the negative information about a security, the security will still be included in the market, although the disclosure may affect the price.[82] Additionally, the court noted that the securities laws do not regulate the purported value of securities.[83]

While not expressing the same outright rejection of the theory as the Seventh Circuit, the Ninth Circuit has also declined to adopt the theory when presented with the opportunity.[84] In *Desai v. Deutsche Bank Sec. Ltd.*,[85] the court affirmed the district court's refusal to adopt the fraud-created-the-market theory.[86] The court

72. *Id.*
73. *Id.* at 471.
74. *Id.*
75. 717 F.2d 1330 (10th Cir. 1983).
76. *Id.* at 1333.
77. 223 F.3d 1155 (10th Cir. 2000).
78. *Id.* at 1163.
79. *Id.* at 1164.
80. 8 F.3d 1121 (7th Cir. 1993).
81. *Id.* at 1130 (italics omitted).
82. *Id.* at 1131.
83. *Id.* at 1130–31.
84. *See* Desai v. Deutsche Bank Sec. Ltd., 573 F.3d 931 (9th Cir. 2009); *see also In re* NationsMart Corp. Sec. Litig., 130 F.3d 309 (8th Cir. 1997).
85. 573 F.3d 931 (9th Cir. 2009).
86. *Id.* at 942.

noted that it was cautious to adopt the theory when the Supreme Court has not done so.[87]

D. The Role of Gatekeepers in Taking a Security to Market

There are several entities involved in the process of issuing securities, including accountants, lawyers, and investment bankers, who are often referred to as gatekeepers or promoters.[88] These professionals assist the issuer, the company that is issuing the stock or security for profit.[89] Auditors perform the function of reviewing corporate financial statements and opine as to the accurateness of the statements,[90] while lawyers provide legal advice to the company.[91] Securities lawyers, specifically, are responsible for preparing the disclosure document, which prospective investors use to determine whether to purchase a security.[92] Investment bankers participate in the underwriting process by providing financing for the security to the issuer.[93] In order to take a security to market, the issuer must register the security by filing a registration statement and prospectus with the SEC.[94] Finally, the security can enter the market to be purchased by investors.[95]

The Supreme Court of the United States in *United States v. Arthur Young & Co.*[96] recognized the importance of gatekeepers, stating that accountants owe a duty to the public, and therefore, must remain independent from their employers.[97] The Sixth Circuit in *Ockerman v. May Zima & Co.*[98] noted that promoters determine the

87. *Id.* The court noted that "the Supreme Court has adopted a rather restrictive view of private suits under §10(b)." *Id.*

88. Hillary A. Sale, *Banks: The Forgotten(?) Partners in Fraud*, 73 U. Cin. L. Rev. 139, 140 (Fall, 2004). The term "gatekeeper" has also been defined broadly as "some form of outside or independent watchdog or monitor—someone who screens out flaws or defects or who verifies compliance standards or procedures." John C. Coffee, Jr., Gatekeepers: The Professions and Corporate Governance 2 (2006) [hereinafter Coffee, Jr., Gatekeepers].

89. Frank Partnoy, *Barbarians at the Gatekeepers?: A Proposal For a Modified Strict Liability Regime*, 79 Wash. U. L. Rev. 491, 494–95 (Summer 2001).

90. *All About Auditors: What Investors Need to Know*, U.S. Securities and Exchange Commission, http://www.sec.gov/investor/pubs/aboutauditors.htm (last modified June 24, 2002).

91. Poonam Puri, *Taking Stock of Taking Stock*, 87 Cornell L. Rev. 99, 148 (2001). *See* Lawrence A. Cunningam, *Beyond Liability: Rewarding Effective Gatekeepers*, 92 Minn. L. Rev. 323, 338 (2007) ("Securities professionals are responsible for approving transactions, designing or opining on them or related disclosure, and providing assurance and attestation of financial statement assertions.").

92. Manning Gilbert Warren III, *The Primary Liability of Securities Lawyers*, 50 SMU L. Rev. 383, 387–88 (1996).

93. *See* 1 Thomas Lee Hazen, Treatise on the Law of Securities Regulation §2.1 (6th ed. 2009). The Securities Act of 1933 defines an underwriter as "any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security, or participates . . . in any such undertaking, or participates . . . in the direct or indirect underwriting of any such undertaking." Securities Act of 1933, § 2(a)(11), 15 U.S.C. § 77b(a)(11) (2006).

94. 15 U.S.C. § 77f(a) (2010); Julie B. Rubenstein, *Fraud on the Global Market: U.S. Courts Don't Buy It; Subject-Matter Jurisdiction in F-Cubed Securities Class Actions*, 95 Cornell L. Rev. 627, 632 (2010).

95. *See generally* 15 U.S.C. § 77f(a) (2010).

96. 465 U.S. 805 (1984).

97. *Id.* at 817–18.

98. 27 F.3d 1151 (6th Cir. 1994).

price of securities and since these individuals are self-interested, the price they set may not reflect that security's actual value in the market.[99] As a result, the *Ockerman* court rejected the fraud-created-the-market theory.[100]

III. The Court's Reasoning

In *Malack v. BDO Seidman*, the United States Court of Appeals for the Third Circuit affirmed the district court's denial of class certification, holding that the fraud-created-the-market theory is not a valid theory of reliance because there is no entity to prevent fraudulent securities from entering the market,[101] the theory is not supported by probability,[102] and public policy dictates that the court reject the theory.[103] The court noted that even if it recognized the fraud-created-the-market theory, Malack would still not be able to meet his burden of proof in establishing that the notes he relied on were legally unmarketable.[104]

A. The Court Rejected the Fraud-Created-the-Market Theory Because of the Lack of Entities to Prevent Fraudulent Securities from Entering the Market

Writing for the majority, Judge Smith reviewed the standard for deciding a motion for class certification.[105] The court recognized that the Third Circuit had not yet visited the issue of whether the fraud-created-the-market theory was valid and that there was a split in the circuits on whether to recognize the theory.[106] The court explained that the fraud-created-the-market theory does not comport with common sense because there is no agency that protects against fraud in the process of taking the security to the market.[107] The court discussed the fact that the professionals involved in promoting securities, like the underwriter, auditor, and attorneys, are self-interested and are mainly concerned with increasing the price of securities.[108] Further support for this proposition in the court's view was that legal counsel and underwriters are compensated via contingency fees.[109] In a footnote, the court rejected the viewpoint that entities involved in taking a security to market will not act fraudulently to maintain their reputation, instead stating that "[m]any

99. *Id.* at 1159.

100. *Id.*

101. *See infra* Part III.A.

102. *See infra* Part III.B.

103. *See infra* Part III.C.

104. *See infra* Part III.D.

105. Malack v. BDO Seidman, LLP, 617 F.3d 743, 745 (3d Cir. 2010). The court reviews a decision on class certification for an abuse of discretion, which occurs if the district court relies on a "clearly erroneous finding of fact, an errant conclusion of law, or an improper application of law to fact." *Id.* (quoting *In re* Hydrogen Peroxide Antitrust Litig., 552 F.3d 305, 312 (3d Cir. 2008)).

106. *Id.*

107. *Id.* at 749.

108. *Id.*

109. *Id.* at 749–50 (quoting Ross v. Bank South, N.A., 885 F.2d 723, 740 (11th Cir. 1989)).

entities now forgo the long term benefits of accurate disclosures for the prospect of short term gain."[110]

In addition, the court explained that the SEC cannot be relied upon to prevent fraudulent securities from reaching the market because the SEC only regulates the adequacy of issuer's disclosure statements.[111] The court further discussed the fact that the SEC does not verify the price of securities or the representations by issuers.[112] The court noted that Malack conceded at oral argument that even if BDO Seidman had fully disclosed the problems with the notes, the SEC still would have allowed the notes to go to the market, illustrating the problem with holding the SEC responsible for fraudulent securities.[113]

B. The Court Found That the Theory is Not Supported by Probability

The court rejected Malack's argument that the fraud-created-the-market theory is supported by probability.[114] The court reasoned that the fraud-created-the-market theory eliminates the reliance requirement in Section 10(b) claims since, based on the theory, all securities on the market are legally marketable.[115] As a result, the court explained that adopting the theory would create an investor insurance, which was not the intent of Congress in passing the securities laws.[116]

The court discussed the securities laws' purpose of full disclosure and the fact that in adopting this theory, the court would be encouraging investors to ignore disclosure statements since investors only need to rely on the security's presence on the market.[117] The court rejected Malack's argument that the theory would advance honesty and fair dealings in the securities market on the basis that federal courts have limited Section 10(b) to its current scope and accepting Malack's argument would expand this cause of action to all actions that seek to prevent fraud.[118]

C. The Court Rejected the Theory Because of Public Policy Concerns

The court also discussed the policy reasons for rejecting the theory.[119] The court focused on the high cost of litigating Rule 10b-5 claims.[120] These costs, the court reasoned, are imputed to the entire securities market.[121] When discussing frivolous

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110. *Id.* at 750 n.7.

111. *Id.* at 750.

112. *Id.* at 750–51.

113. *Id.* at 751.

114. *Id.* at 752.

115. *Id.*

116. *Id.*

117. *See id.* at 753 ("The less an investor knows about the security, aside from the fact that it is on the market, the less likely it is that she will learn of information that would sever the link between the alleged fraud and her decision to purchase the security.").

118. *Id.* at 753–54.

119. *Id.* at 754–55.

120. *Id.* at 755.

121. *Id.*

class actions claims, the court explained that adopting the theory would make obtaining class certification easier.[122] The court noted that obtaining class certification enhances the probability that defendants will settle, even when the plaintiffs' claims are not valid.[123]

D. Malack Would Be Unable to Establish Presumption of Reliance Even if the Court Adopted the Theory

The court explained that even if it adopted the fraud-created-the-market theory, Malack would still not be able to create a presumption of reliance.[124] Malack argued that the court should adopt the Tenth Circuit's legal unmarketability test, which posits that "the issuer never had the legal right to issue the bonds."[125] The court found, however, that even if BDO Seidman had fully disclosed the problems with American Business's notes, the securities would still have made it to the market.[126] As a result, the notes were not legally unmarketable and the court upheld the district court's denial of class certification.[127]

IV. Analysis

In *Malack v. BDO Seidman*, the Third Circuit held that the fraud-created-the-market theory is not a valid presumption of reliance in securities cases.[128] In reaching this holding, the court incorrectly determined that the promoters of securities are too self-interested to ensure that fraudulent securities do not reach the market, even though these actors face similar conflicts in other areas of the law.[129] In addition, it would be fair to hold issuers liable because they must intend to defraud investors.[130] The court also ignored the securities laws' goal of preventing fraud, one of the main purposes of the securities laws.[131]

A. The Court Incorrectly Determined that Promoters of Securities Cannot Be Relied Upon to Prevent Fraud

One of the court's main arguments for rejecting the fraud-created-the-market theory was that there is no one to ensure that securities are free from fraud before the securities enter the market.[132] The court concluded that promoters of securities,

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122. *Id.*

123. *Id.* The court stated that "[r]ewarding frivolous actions with settlements is clearly undesirable." *Id.*

124. *Id.*

125. *Id.* at 756. This test was first adopted in T.J. Raney & Sons, Inc. v. Fort Cobb, Okla. Irrigation Fuel Auth., 717 F.2d 1330, 1333 (10th Cir. 1983). *Id.* at 755–56.

126. *Id.* at 756.

127. *Id.*

128. *Id.*

129. *See infra* Part IV.A.

130. *See infra* Part IV.B.

131. *See infra* Part IV.C.

132. *Malack*, 617 F.3d at 749.

such as underwriters, auditors, and attorneys, cannot fulfill this role because they are self-interested.[133] Yet even the SEC has stated that "the task of enforcing the securities laws rests in overwhelming measure on the bar's shoulders."[134] The Third Circuit has also noted that "[a] securities professional has an obligation to investigate the securities he or she offers to customers."[135] Likewise, "prominent securities attorneys have long endorsed the idea that they owe a duty to the investor who relies on their work – one that requires them to be skeptical of, and independent from, their client."[136]

Furthermore, unlike the issuer, the gatekeepers of the security receive a small payoff and thus, there is less incentive to engage in fraudulent activity.[137] In addition, the gatekeeper risks his reputational capital by participating in fraudulent activity.[138] Promoters develop reputational capital by serving many of the same clients over several years.[139] Lawyers also risk their wealth and social status in committing fraud.[140] The Model Rules of Professional Conduct prohibits lawyers from assisting clients in conduct that the lawyer knows is criminal or fraudulent.[141] The SEC has also adopted Rules of Professional Conduct for securities attorneys and sanctions those that violate these rules.[142]

Because the costs outweigh the benefits of participating in fraudulent activity, lawyers are unlikely to engage in this activity under the rational-actor model. The rational-actor model posits that "lawyers are rational, self-interested actors" who "act to further their own interests."[143] The rational-actor model is not limited to "costs and benefits to goods or losses to which monetary value can be assigned,"[144]

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133. *Id. See also* Coffee, Jr., Gatekeepers, *supra* note 88, at 3 (noting that gatekeepers are paid by the corporations which they are supposed to "monitor"). A recent survey by the American Bar Association (ABA) takes issue with the conclusory nature of the court's statement, noting that "a study of a large and relevant sample" is necessary before making this assertion. American Bar Association, *Caselaw Developments 2010*, 66 Bus. Law. 785, 854 (2011).

134. Puri, *supra* note 91, at 144 (citation omitted).

135. *In re* Suprema Specialties, Inc. Securities Litig., 438 F.3d 256, 282 (3d Cir. 2006) (quoting SEC v. Dain Rauscher, Inc., 254 F.3d 852, 857 (9th Cir. 2001)).

136. John C. Coffee, Jr., *The Attorney as Gatekeeper: An Agenda for the SEC*, 103 Colum. L. Rev. 1293, 1298–99 (2003) [hereinafter Coffee, Jr., *The Attorney as Gatekeeper*].

137. *See* John C. Coffee, Jr., *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 B.U. L. Rev. 301, 308–09 (noting that a gatekeeper, "a reputational intermediary who provides verification or certification services to investors," receives "only a limited payoff from any involvement in misconduct").

138. *Id.* at 308. *But see* Partnoy, *supra* note 89, at 498 (arguing that "a strong theoretical argument exists supporting the conclusion that gatekeepers might rationally decide to deplete their reputational capital (just as they would deplete any other capital asset) in an attempt to maximize expected profits").

139. Coffee, Jr., Gatekeepers, *supra* note 88, at 2.

140. Stephen G. Bené, Note, *Why Not Fine Attorneys?: An Economic Approach to Lawyer Disciplinary Sanctions*, 43 Stan. L. Rev. 907, 925 (1991).

141. *See* Model Rules of Prof'l Conduct R. 1.2(d) (stating that "[a] lawyer shall not counsel a client to engage, or assist a client, in conduct that the lawyer knows is criminal or fraudulent").

142. *See* 17 C.F.R. § 205.3(a) (2005) (requiring that attorneys report fraudulent activity to officers inside the corporation).

143. Tanina Rostain, *Ethics Lost: Limitations of Current Approaches to Lawyer Regulation*, 71 S. Cal. L. Rev. 1273, 1276 (1998).

144. *Id.* at 1301.

and therefore a rational-actor will consider his reputational capital and social status when thinking about participating in fraudulent activity.[145] As a result, "[w]hen the other costs are sufficiently high, a rational actor may forebear from violating a law or rule even if he is likely to get away with the violation or the tangible benefits associated with the violation far exceed the probable sanction."[146]

The *Malack* court also relied on the fact that underwriters and legal counsel are self-interested because they are retained on a contingency fee basis.[147] However, the Supreme Court has noted that contingency fees "are common in the United States in many settings."[148] In addition, the American Bar Association has issued an opinion that other than criminal and divorce cases, "contingency fees do not violate professional conduct standards as long as they are appropriate in the circumstances and reasonable in amount, and the client has been fully advised of the availability of alternative fee arrangements."[149] Some of the concerns that are usually associated with contingency fees are not present in the issuance of securities, such as concern for the unsophisticated client[150] and the incentive to settle.[151] As a result, contingency fees have been widely accepted in the legal setting and are not indicative of selfish or fraudulent behavior by underwriters and attorneys involved in the issuance of securities.

B. Promoters are Only Held Liable if They Know Securities are Fraudulent

Because intent is a required element of the fraud-created-the-market theory, it is fair to hold promoters liable for fraudulently issuing securities.[152] The court in *Ross v. Bank South, N.A.*[153] recognized that "*Shore* imposes a scienter requirement: the defendant must have *known* the securities could not be marketed and must have

145. *See supra*, notes 137 and 138 and accompanying text.

146. Fred C. Zacharias, *Steroids and Legal Ethics Codes: Are Lawyers Rational Actors?*, 85 Notre Dame L. Rev. 671, 677 (2010). *See* Bené, *supra* note 140, at 924 (finding that lawyers are more likely to weigh the costs and benefits of breaking the law than other criminals because of their education and sophistication).

147. Malack v. BDO Seidman, LLP, 617 F.3d 743, 749–50 (3d Cir. 2010). While some state legislatures have imposed limitations on contingency fees, this has only been done in the area of tort law. Rostain, *supra* note 143, at 1300 n.110.

148. Gisbrecht v. Barnhart, 535 U.S. 789, 803 (2002).

149. ABA Comm. on Ethics and Professional Responsibility, Formal Op. 389 (1994). Rule 1.5 of the Model Rules of Professional Conduct provides that "[a] fee may be contingent on the outcome of the matter for which the service is rendered except in a matter in which a contingent fee is prohibited by paragraph (d) or other law." Model Rules of Prof'l Conduct R. 1.5.

150. Lester Brickman, *Contingent Fees Without Contingencies: Hamlet Without the Prince of Denmark?*, 37 UCLA L.Rev. 29, 65 (1989).

151. Murray L. Schwartz & Daniel J.B. Mitchell, *An Economic Analysis of the Contingent Fee in Personal-Injury Litigation*, 22 Stan. L. Rev. 1125, 1125–26 (1970).

152. *See* Shores v. Sklar, 647 F.2d 462, 471 (5th Cir. 1981) (en banc) (rejecting the argument that its holding "imposes new burdens on defendants or enhances their liability. Lawyers, underwriters, and accountants who participate in bond issues in good faith are unaffected by [their] decision"). Under some state securities laws, such as Texas, one who aids in the selling of a security meets the intent requirement of liability if he/she is simply subjectively aware of the primary issuer's fraudulent activity. Marc I. Steinberg & Chris Claassen, *Attorney Liability Under the State Securities Laws: Landscapes and Minefields*, 3 Berkeley Bus. L.J. 1, 35 (2005).

153. 885 F.2d 723 (11th Cir. 1989).

brought the securities to market with the intent to defraud."[154] The Third Circuit has noted in the past that in order to hold auditors liable for securities violations, plaintiffs "must show that [the auditor]'s judgment – at the moment exercised – was sufficiently egregious such that a reasonable accountant reviewing the facts and figures should have concluded that [the company]'s financial statements were misstated and that as a result the public was likely to be misled."[155] Holding promoters of securities liable is not only fair, but it is also in keeping with the purpose of the Securities Exchange Act of 1934.[156] The court in *Malack* does not discuss this requirement, instead finding that promoters would not have an interest in ensuring the genuineness of the security because they are self-interested.[157] However, if the theory only holds those liable that are involved in intentionally issuing fraudulent securities, then promoters could be gatekeepers to the market since they would be interested in not being liable.

While critics may argue that attorneys should not be held responsible for their client's fraudulent activities because attorneys owe a duty of loyalty to clients, limitations on the attorney-client relationship already exist, such as the crime/fraud exception.[158] In addition, concerns that "disclosure of a client's confidences incurs risk of waiving both the attorney-client and work product privileges,"[159] are addressed in the SEC's Rules, which require attorneys to notify upper level management in the company about any fraudulent activity the attorney knows is taking place.[160]

C. Fraud-Created-The-Market Theory Would Fulfill the Securities Act's Goal of Preventing Fraud

One of the main Congressional goals in passing the federal securities laws was to prevent fraud and protect investors.[161] Recognizing the fraud-created-the-market

154. *Id.* at 729–30.

155. *In re* IKON Office Solutions, Inc., 277 F.3d 658, 673 (3d Cir. 2002). *See also In re* Suprema Specialties, Inc. Sec. Litig., 438 F.3d 256, 282 (3d Cir. 2006) ("Whereas a reckless failure to investigate an issuer of securities can give rise to liability under Section 10(b), simple negligence, even inexcusable negligence, is not enough.").

156. *See In re* IKON, 277 F.3d at 666–67 (noting that holding secondary actors liable for misrepresentations likely to reach the public "is consistent with the primary purpose of the Securities Exchange Act of 1934 which is to protect against manipulated stock prices by imposing strict and extensive disclosure requirements, irrespective of the type of actor that disseminates information to the investing public"); *see also* Eichenholtz v. Brennan, 52 F.3d 478, 484 (3d Cir. 1995) ("The underlying goal of securities legislation is encouraging diligence and discouraging negligence in securities transactions. These goals are accomplished 'by exposing issuers and underwriters to the substantial hazard of liability for compensatory damages.'") (internal citations omitted).

157. Malack v. BDO Seidman, LLP, 617 F.3d 743, 749–50 (3d Cir. 2010). *See also supra* Part IV.A.

158. Coffee, Jr., *The Attorney as Gatekeeper*, *supra* note 123, at 1307.

159. Marc I. Steinberg, *The Corporate/Securities Attorney as a "Moving Target" – Client Fraud Dilemmas*, 46 Washburn L.J. 1, 21 (Fall 2006).

160. 17 C.F.R. § 205.3(a) (2005).

161. Blackie v. Barrack, 524 F.2d 891, 907 (9th Cir. 1975). *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 195 (1976) (noting that the securities acts were designed "to protect investors against fraud and . . . promote ethical standards of honesty and fair dealing").

theory would fulfill this goal.[162] The *Malack* court and other critics argue that the fraud-created-the-market theory rejects the goal of securities' laws to promote disclosure to investors.[163] However, when a promoter, such as an attorney or underwriter, intentionally makes misrepresentations or omissions in disclosure statements, then an investor is not going to be able to accurately rely on these statements whether or not he reads them.[164] As a result, if courts recognize that there are individuals responsible for ensuring that only those securities which are free from fraud are able to go to the market, then an investor will be able to rely on the security's presence on the market as an assurance that the security is marketable.[165] Therefore, the Third Circuit should have recognized that the fraud-created-the-market theory is a valid presumption of reliance in order to protect investors.

Not only would adopting the fraud-created-the-market theory fulfill Congress's goal of protecting investors, it would also encourage participation in the market.[166] If an investor can rely on the fact that a security is free from fraud, this will encourage more individuals to invest in the market.[167] Therefore, the market would benefit from recognition of the fraud-created-the-market theory.[168]

V. Conclusion

In *Malack v. BDO Seidman, LLP*,[169] the United States Court of Appeals for the Third Circuit rejected the fraud-created-the-market theory of reliance as a valid theory of reliance in securities fraud cases.[170] The court improperly relied on the argument that those involved in the process of taking the security to market cannot be relied upon to ensure that the security is not fraudulent.[171] In doing so, the court failed to recognize that attorneys face numerous conflicts in other areas of law and are still held to ethical regulations.[172] Additionally, because promoters are only liable when they intentionally violated the law, it would be fair to hold them liable as gatekeepers.[173] Finally, adopting the fraud-created-the-market theory as a

162. *See* Shores v. Sklar, 647 F.2d 462, 470 (5th Cir. 1981) (en banc) (rejecting the argument that the fraud-created-the-market theory is limited to the goal of disclosure and finding instead that the "central purpose of the acts is the protection of investors").

163. Malack v. BDO Seidman, LLP, 617 F.3d 743, 753 (3d Cir. 2010). *See* Herzog, *supra* note 49, at 397 (arguing that "the fraud-created-the-market theory does not provide any incentive to investors to utilize the disclosure materials").

164. *See Shores*, 647 F.2d at 470–71 (stating that under the fraud-created-the-market theory, "it would have availed [the plaintiff] nothing to have read the Offering Circular").

165. *See supra* Part IV.B.

166. De Simone, *supra* note 46, at S181.

167. *Id.*

168. *See generally id.*

169. 617 F.3d 743 (3d Cir. 2010).

170. *Id.* at 745.

171. *See supra* Part IV.

172. *See supra* Part IV.A.

173. *See supra* Part IV.B.

presumption of reliance would be in accordance with Congress's goal of preventing fraud in the market and protecting investors.[174]

174. *See supra* Part IV.C.