November 17, 2010 | Posted By

Fifth Circuit Rejects Section 10(b) Scheme Liability in Absence of Explicit Attribution of Conduct or Statements to Defendant

In *Affco Investments 2001 LLC v. Proskauer Rose L.L.P.*, No. 09-20734, 2010 WL 4226685 (5th Cir. Oct. 27, 2010), the United States Court of Appeals for the Fifth Circuit held that a law firm which allegedly assisted in developing a fraudulent tax shelter scheme could not be held liable under Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and Rule 10b-5, 17 C.F.R. § 240.10b-5, for conduct and statements not explicitly attributed to it. In the absence of such express attribution, the Court held, the investor plaintiffs could not demonstrate reliance upon the law firm in deciding whether to invest. This decision echoes a recent, similar ruling by the Second Circuit establishing a "bright line" rule limiting liability of secondary actors only to instances where conduct or statements are expressly attributed to them.

According to plaintiffs' amended complaint, the accounting firm of KPMG, LLP ("KPMG") targeted and solicited plaintiffs for participation in a tax shelter involving investment in LLCs specially created for that purpose. In its soliciting materials, KPMG represented the scheme as "a legitimate investment vehicle as well as a legitimate tax shelter," and promised to provide investors with independent opinions from "several major national law firms" that had analyzed and approved the tax strategy. Based on these assurances, plaintiffs agreed to invest. After plaintiffs' invested, they received an opinion letter from the law firm of Sidley Austin Brown & Wood, LLP that the IRS would likely condone the tax scheme. Later, in response to an IRS notice regarding so-called "prohibited transactions," plaintiffs sought — and received — tax opinions from Proskauer Rose LLP ("Proskauer") concluding that the KPMG transactions were not substantially similar to the "prohibited transactions" noticed by the IRS, and that plaintiffs did not need to disclose their involvement in the tax scheme on their tax returns. The IRS eventually audited plaintiffs, fining them several millions of dollars for their participation in an abusive tax shelter.

Plaintiffs sued KPMG and other alleged participants in the tax scheme, including the law firms, alleging violations of, *inter alia*, Section 10(b) and Rule 10b-5. Proskauer, the only defendant that did not settle, moved to dismiss, arguing (among other things) that plaintiffs could not demonstrate reliance upon the Proskauer opinions since they received the opinions only after they invested. The district court granted the motion, holding that plaintiffs failed to plead the elements of reliance and scienter against Proskauer in connection with the scheme.

On appeal, plaintiffs argued that Proskauer could be held liable "for participating in the creation of a false statement or misrepresentation that investors rel[ied] upon, regardless of whether that statement [was] attributed to [Proskauer] at the time of dissemination." Specifically, plaintiffs alleged that "law firms (such as Proskauer . . .) . . . [worked with KPMG] to promote, sell, and support the tax strategies on a broad scale"; that KPMG's "associations with Proskauer, . . . and others allowed [it] to offer skeptical taxpayers the assurance that the strategies had been reviewed and approved in 'independent' tax opinions from several major national law firms"; that a partner at Proskauer worked with KPMG "to refine the tax strategies, review the marketing materials, and create model template opinions addressing the tax consequences and reporting requirements of the tax transactions"; that "the strategy contemplated that the taxpayer would receive one or more of these opinions from his choice of four firms, including Proskauer"; that KPMG assured plaintiffs that "several major national law firms had also vetted the [tax scheme] and could provide [p]laintiffs [with] an ‘independent’ opinion corroborating KPMG’s representations”; and that plaintiffs agreed to the deal based in part on “the assurance that national law firms such as Proskauer . . . were prepared to provide opinions supporting the [tax scheme].”

Citing the United States Supreme Court decisions in *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148 (2008) [*see* blog article here], and *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*., 511 U.S. 164 (1994), the Fifth Circuit held that because Proskauer was never specifically identified as participating in the alleged scheme, plaintiffs could not demonstrate that they relied upon Proskauer in advance of their investment. The Court followed the recent, factually analogous decision by the Second Circuit in *Pacific Investment Management Co. LLC v. Mayer Brown LLP*, 603 F.3d 144 (2d Cir. 2010) [*see* blog article here]. In *Pacific Investment*, a corporation’s outside counsel was accused of creating and disseminating material misrepresentations on behalf of the corporation. There, the Second Circuit held that the law firm could be held liable in a private Section 10(b) action only for false statements expressly attributed to that secondary actor at the time of dissemination, and that “[a]bsent attribution, plaintiffs cannot show that they relied on defendants’ own false statements, and participation in the creation of those statements amounts, at most, to aiding and abetting securities fraud.”

The Fifth Circuit, finding *Pacific Investment* persuasive, ruled that “explicit attribution [was] required to show reliance under section 10(b).” While the *Affco* plaintiffs’ allegations painted “a clear picture of Proskauer’s intimate involvement in the tax scheme,” the plaintiffs’ scrupulous avoidance of “any explicit assertion that they had knowledge of Proskauer’s role prior to their actual investment in the tax scheme,” and failure to allege either that “they ever saw or heard any Proskauer work product before making their decision,” or that KPMG “specifically identified Proskauer as one of the ‘major national law firms’ that had vetted and cleared the tax scheme or that had agreed to provide opinions supporting the same,” fell short of the “explicit attribution” required to implicate secondary actors making material misrepresentations.

According to the Fifth Circuit, “[k]nowing the identity of the speaker is essential to show reliance because a word of assurance is only as good as its giver.” Thus, even though KPMG advertised support from “major national law firms,” this representation was not a sufficient showing that the *Affco* plaintiffs relied on Proskauer itself. *Affco* and *Pacific Investments* thus establish a “bright line” rule that reinforces the Supreme Court’s limitation of liability of secondary actors under Section 10(b).

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