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WHEN MINDING YOUR OWN BUSINESS MEANS SPEAKING UP: CRIMINALLY PUNISHING A CORPORATE EXECUTIVE FOR FAILING TO BLOW THE WHISTLE ON THE ILLEGAL MISCONDUCT OF A COLLEAGUE

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*Craig Ehrlich**

Imagine that during a quarterly conference call with stock analysts, a corporation's Chief Financial Officer ("CFO") remains silent although he knows that another senior officer on the call has just made a material misrepresentation concerning the corporation's financial statements. When asked by an analyst whether there were any "inventory issues," the senior officer responded "no." However, both the senior officer and the CFO know that the corporation has engaged in a "channel stuffing" scheme, temporarily increasing the corporation's apparent revenues by selling excess inventory to distributors who neither needed nor wanted it, and paying them to accept it. The corporation uses channel stuffing near the end of each quarter in order to give the appearance that it is meeting its revenue targets. Both the scheme itself and the senior officer's failure to reveal it are misleading.¹ Our hypothetical CFO remains silent to avoid contradicting his colleague in public, to shield the fraud from public view, and, because his compensation is tied to the company's stock price, for his personal gain.

Although the fraud could have been nipped in the bud had the CFO spoken out, his silence allows it to grow and the resulting damage to multiply. Upon disclosure of the scheme a few months later, the corporation's stock price quickly falls twenty-five percent, providing

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¹ Lynn E. Turner, Chief Accountant, U.S. Sec. & Exch. Comm'n, Revenue Recognition Remarks (May 31, 2001), *available at* <http://www.sec.gov/news/speech/spch495.htm> (The SEC has signaled its concerns about channel stuffing. "The Sunbeam case (AAER No. 1393) highlights many of these issues, including bill and hold and channel stuffing abuses, among others, and sends a message to registrants and their auditors—the SEC will aggressively attack fraudulent revenue recognition practices.").

evidence (in the absence of other obvious reasons for the drop) of the materiality of the information misrepresented by the senior officer.

Assuming that the senior officer's misrepresentation is a violation of § 10(b) of the Securities Exchange Act of 1934 ("Exchange Act")² and the Securities and Exchange Commission Rule 10b-5,³ has our hypothetical CFO also violated these rules by remaining silent and failing to correct the misrepresentation? If so, and if his decision to remain silent was wilful, he can be held criminally liable.⁴ Will his liability be primary or secondary?⁵

The answer more or less boils down to this: The CFO will be liable under § 10(b) if his silence was in breach of a duty to speak. If such a duty exists, it might be found in state corporation law (which imposes a duty of candor upon officers), Rule 10b-5 jurisprudence (which sometimes recognizes a relationship of trust and confidence between the shareholders of a corporation and its insiders), or possibly a general theory of criminal law.

No court, to the knowledge of this writer, has held that there exists a duty to speak in the circumstances of our hypothetical case. Similar facts were presented in *United States v. Schiff*, and the United States Court of Appeals for the Third Circuit held that there was no duty to speak and no violation of § 10(b).⁶ However, neither the government nor the court of appeals emphasized the defendant's special status as the CFO of a publicly traded corporation. He and the speaker of the falsehood were grouped together and called "high corporate officers" by the government, a phrase rightly criticized by the court for its vagueness.⁷ There are, as well, other aspects to *Schiff* that may limit its effect. The court analyzed Schiff's liability under Rule 10b-5(b), but, as discussed below, a better case might

² 15 U.S.C. § 78j(b) (2012).

³ 17 C.F.R. § 240.10b-5 (2014).

⁴ 15 U.S.C. § 78ff(a) (2012) ("Any person who willfully violates any provision of this chapter . . . or any rule or regulation thereunder . . . shall upon conviction be fined not more than \$5,000,000, or imprisoned not more than 20 years, or both" Willfully, in this context, means intentionally undertaking an act that one knows to be wrongful.); see also *United States v. Tarallo*, 380 F.3d 1174 (9th Cir. 2004).

⁵ Secondary liability imposes responsibility on those who aided the primary actor to commit the crime. In an armed robbery, the primary wrongdoer is the robber. Secondary wrongdoers include those who supplied the gun and the getaway car, knowing their purpose.

⁶ *United States v. Schiff*, 602 F.3d 152 (3d Cir. 2010).

⁷ *Id.* at 164-65.

be made under the other two subparts of the Rule, (a) and (c). The Third Circuit also holds a more restrictive view of omission liability than the Second, Ninth and Tenth Circuits. As this article will demonstrate, *Schiff* is flawed and the liability of our hypothetical CFO merits further exploration.

Moreover, existing case law may be broad enough to permit the courts to recognize the existence of a CFO's duty to speak in these circumstances. As well, it has been a decade since one writer called the officer's duty of candor "an empty space" in the law.⁸ The CFO of a publicly traded corporation is entrusted with control of the firm's financial reporting and public disclosure and is required by federal law to disclose to the firm's auditors and audit committee any fraud that involves management or other employees who have a significant role in the issuer's internal controls.⁹ Under Delaware law, "Like directors, officers also have other contextual obligations as fiduciaries. These include the responsibility to disclose to their superior officer or principal 'material information relevant to the affairs of the agency entrusted to them.'"¹⁰ Since the breach of a fiduciary duty to disclose can be a deceptive act in violation of § 10(b), it is possible that a CFO's failure to disclose financial fraud to the corporation's board of directors may in some circumstances violate the statute and Rule 10b-5.

If a court can find a basis in existing law to impose a duty to speak upon a CFO who has merely witnessed another officer make a material misrepresentation, then the question whether to do so becomes one of policy. Maybe the Third Circuit was wise in its rejection of the government's theory. There is already one person, the speaker of the falsehood, who is easily subject to prosecution. "More than enough is too much."¹¹ It is one thing for a prosecutor¹² or a sentencing court¹³ to reward

⁸ Donald C. Langevoort, *Agency Law Inside the Corporation: Problems of Candor and Knowledge*, 71 U. CIN. L. REV. 1187, 1189 (2003).

⁹ Investopedia, *What does a Chief Financial Officer (CFO) do?*, <http://www.investopedia.com/ask/answers/04/042204.asp> (last visited Feb. 20, 2014).

¹⁰ *Hampshire Group, Ltd. v. Kuttner*, CIV.A. 3607-VCS, 2010 WL 2739995 at 13 (Del. Ch. July 12, 2010).

¹¹ *SEC v. Tambone*, 597 F.3d 436, 452 (1st Cir. 2010) (Boudin, J., concurring). It has been estimated that "there are 4,500 criminal statutes and tens of thousands of regulations that carry criminal penalties, including prison."; Gary Fields & Neil King, Jr., *Task Force Aims to Lighten Criminal Code: Bipartisan Congressional Initiative Targets Bloated Federal Provisions Cited by Critics for Driving Up Incarceration Rates*, WALL ST. J., May 5, 2013; Paul J. Larkin, Jr., *Public Choice Theory and Overcriminalization*, 36 HARV. J.L. & PUB. POL'Y 715, 720 (2013) (Overcriminalization has been called

a corporation for voluntarily reporting its own wrongdoing to authorities, or to protect or pay a bounty to a whistleblower,¹⁴ but we do not in America criminally punish people who choose to look the other way when they witness a violation of law. To do so evokes thoughts of a surveillance state whose citizens must denounce each other to the authorities.

While there are persuasive arguments against punishing silence, this writer believes that the unique role played by a corporate CFO justifies judicial recognition of an affirmative duty to respond to misrepresentations by other corporate officers concerning the corporation's financial statement. Our silent man is not simply some accidental passerby; he is the chief financial officer of a publicly traded corporation, the high priest of the integrity of the firm's finances. Surely all who rely upon him, including the board and the stockholders, would expect him to be intolerant of deception. That he may be deliberately indifferent to a financial statement fraud committed at his side, yet bear no legal responsibility, goes too far. The law should deter such silence, just as the law requires many categories of persons to report witnessed wrongdoing, and to act for the protection of others.

In our hypothetical, the senior officer's misrepresentation concerned not some obscure infraction among the multitude of crimes to be found in manifold statutes and regulations, but securities fraud, *malum in se*, something that a CFO ought to recognize when he encounters it. Is it unreasonable, then, to expect that the CFO of publicly traded corporation would also know that he ought to say *something* because it is his job to do so and because others—including the audience on that analyst call—would expect him to do so? A corporation may be criminally liable if its

“an increasingly important issue in modern-day criminal law.” It involves not only the sheer number of crimes but also the elimination of *mens rea* in public welfare offenses and administrative regulatory crimes. “If the penal code regulates too much conduct that is beyond the common law definitions of crimes or that is not inherently blameworthy, several problems arise. It becomes a formidable task for the average person to know what the law forbids . . .”).

¹² *E.g.*, U.S. DEP'T OF JUSTICE, UNITED STATES ATTORNEYS' MANUAL 9-28.700 (2008) (assessing the value of a corporation's cooperation).

¹³ FEDERAL SENTENCING GUIDELINES MANUAL § 8C4.1 (2013) (reduction of fine based on an organization's substantial assistance to authorities).

¹⁴ Section 806 of the Sarbanes-Oxley Act of 2002 established protection for employees of publicly traded companies who provide evidence of fraud. Section 922 of the Dodd-Frank Act of 2010 established a whistleblower bounty program.

employees violate the law; it must be within the CFO's brief to assure the integrity the corporation's financial statements, at least to the extent of repudiating a material falsehood concerning the financial statements spoken at his side by a colleague. In other cases, a contractual relationship has been the source of a legal duty to act; the failure to act has been a criminal omission. A CFO's employment responsibilities distinguish him from all others who could have prevented or corrected the fraud, but who have too attenuated a connection to it to be held criminally responsible.

The courts in Rule 10b-5 cases recognize a duty to correct one's own misstatement. There is no duty to correct another's misstatement, but the courts do recognize a duty to speak arising from a fiduciary relationship, such as a CFO owes to the corporation and its board of directors. In short, this writer argues that, under existing law, a court would be justified in holding a CFO criminally liable for failing to report to the board of directors a statement, made by another officer of the corporation, which is materially misleading concerning the corporation's financial statements. Further, given the special position of the CFO, doing so would be consistent with well-established public policies.

Part I of this article explores the special status of the CFO, as it relates to whether the CFO should have a duty to speak. Part II, examines laws that require one to act for the protection of another and to report offenses committed by another, and then examines the general theory of criminal omissions. Holding our CFO criminally responsible for his silence would be wholly consistent with the general theory. Part III examines the duty of candor owed by a corporate officer. It concludes that such a duty exists, but is owed to the board of directors rather than to the stockholders of the corporation. Part IV discusses the circumstances in which silence constitutes a breach of § 10(b) and Rule 10b-5. It concludes that § 10(b) and Rule 10b-5 do not impose a federal duty upon our CFO to speak to the stockholders, but that our CFO's breach of his duty of candor to the board is a violation of Rule 10b-5 if his silence was "in connection with" the purchase and sale of the corporation's securities. Part V explores the "in connection with" requirement in greater detail. Since our hypothetical CFO remained silent in order to affect the market price of the corporation's stock, his failure to inform the board is in connection with the purchase and sales of the corporation's securities and constitutes a violation of Rule 10b-5.

Having provisionally established that our CFO committed a primary violation of § 10(b), we consider in Part VI the possibility of secondary liability. We consider and reject the possibility of liability for aiding and abetting his colleague's fraud. In the course of examining aiding and abetting under § 10(b) and Rule 10b-5, we encounter an interesting wrinkle concerning primary liability, and turn our attention to Supreme Court's opinion in *Janus Capital Group v. First Deriv. Traders*, decided one year after *Schiff*.¹⁵ We then resume consideration of secondary liability, look at the possibility of control person liability for our CFO, and conclude that there is a strong case to be made for an SEC civil enforcement action. In Part VII, we come to terms with *Schiff*, and critically analyze the Third Circuit's opinion. We conclude that the opinion is flawed, and so cannot be the last word on the subject. Part VIII summarizes and restates our main conclusions. While the focus of this article is on criminal liability, we also consider SEC enforcement actions to the extent that they illuminate the requirements for criminal liability.

PART I: THE CFO'S SPECIAL STATUS

Sections 302 and 906 of the Sarbanes-Oxley Act of 2002 are evidence of the public's understanding and expectation regarding the duties of the CFO of a publicly traded corporation. § 302,¹⁶ a civil provision, required the SEC to adopt final rules under which the principal executive and principal financial officers of a company filing periodic reports under §§ 13(a) or 15(d) of the Exchange Act must provide a certification in each quarterly and annual report filed with the Commission. The SEC adopted Exchange Act Rules 13a-14¹⁷ and 15d-14,¹⁸ which require the certifications to be filed as an exhibit to the report. As part of their certifications, 15 U.S.C. 7241(a)(5) requires that the CFO must certify that he has disclosed to the audit committee of the corporation's board of directors any fraud that he knows about which involves management.

¹⁵ *Janus Capital Group, Inc. v. First Derivative Traders*, 131 S. Ct. 2296 (2011).

¹⁶ 15 U.S.C. § 7241.

¹⁷ 17 C.F.R. § 240.13a-14 (2014).

¹⁸ 17 C.F.R. § 240.5d-14 (2014).

(5) *the signing officers have disclosed to the issuer's auditors and the audit committee of the board of directors (or persons fulfilling the equivalent function)—*

(A) all significant deficiencies in the design or operation of internal controls which could adversely affect the issuer's ability to record, process, summarize, and report financial data and have identified for the issuer's auditors any material weaknesses in internal controls; and

(B) *any fraud, whether or not material, that involves management or other employees who have a significant role in the issuer's internal controls;* (emphasis added)

Section 906,¹⁹ a criminal provision, contains a certification requirement that is separate and distinct from the § 302 certification. It establishes the duty of chief executive officers and chief financial officers of publicly traded companies to certify the accuracy of the company's periodic financial reports required under §§ 13(a) or 15(d) of the Exchange Act. The statute further defines the content of the certifications in 18 U.S.C. §§ 1350(b) and (c) and establishes the criminal penalties for violations in 18 U.S.C. § 1350(c).

(a) Certification of periodic financial reports. Each periodic report containing financial statements filed by an issuer with the Securities Exchange Commission pursuant to §§ 13(a) or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m(a) or 78o(d)) shall be accompanied by a written statement by the chief executive officer and chief financial officer (or equivalent thereof) of the issuer.

(b) Content. The statement required under subsection (a) shall certify that the periodic report containing the financial statements fully complies with the requirements of §§ 13(a) or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m or 78o(d)) and that information contained in the periodic report fairly presents, in all material respects, the financial condition and results of operations of the issuer.

(c) Criminal penalties. Whoever—

(1) certifies any statement as set forth in subsections (a) and (b) of this section knowing that the periodic report accompanying the statement does not comport with all the requirements set forth in this section shall be fined not more than \$1,000,000 or imprisoned not more than 10 years, or both; or

¹⁹ 18 U.S.C. § 1350.

(2) willfully certifies any statement as set forth in subsections (a) and (b) of this section knowing that the periodic report accompanying the statement does not comport with all the requirements set forth in this section shall be fined not more than \$5,000,000, or imprisoned not more than 20 years, or both.

The duty to report created by § 302 is not subject to the criminal provision of § 906. However, “[a]n officer providing a false certification potentially could be subject to Commission action for violating §§ 13(a) or 15(d) of the Exchange Act and to both Commission and private actions for violating § 10(b) of the Exchange Act and Exchange Act Rule 10b-5.”²⁰ Moreover, an officer who “willfully” makes a false § 302 certification may be liable for criminal violation of the Exchange Act.

There is no false certification in our hypothetical and no direct violation of these rules. More broadly, however, the statutes and regulations signal that the public expects the CFO of a publicly traded corporation not to countenance any instance of material financial statement fraud. This is corroborated by an October 2004 survey conducted by *CFO Magazine* and the National Association of Corporate Directors (“NACD”). Of 434 NACD members, forty-two percent of respondents who sit on public company boards said the CFO’s primary role in corporate governance should be to “lead in ensuring that the letter of the law is met.”²¹ Another twenty percent believe the CFO should go further, pushing “for change above and beyond the letter of the law.”²²

The CFO of a publicly traded corporation has a special status. His job is to ensure the integrity of the corporation’s financial statements, thereby protecting the stockholders. Both the publicly traded corporation that hired our hypothetical CFO and the investing public have a serious and sustained expectations that, the CFO will take positive action to “rescue” the corporation from the adverse impact of another employee’s financial statement fraud.

²⁰ Certification of Disclosure in Companies’ Quarterly and Annual Reports, Exchange Act Release Nos. 33-8124, 34-46427, IC-25722 (Aug. 29, 2002), available at http://www.sec.gov/rules/final/33-8124.htm#P161_38746.

²¹ Roy Harris, *Across the Board*, CFO MAG., Jan. 17, 2005, at 40, available at <http://ww2.cfo.com/risk-compliance/2005/01/across-the-board/>.

²² *Id.*

PART II

We turn now to an examination of duties imposed by law on certain persons to act for the protection of others. The examples discussed below will enable us to construct an external frame of reference by which to test the conclusions drawn later about the culpability of our CFO under current law. Our conclusions about precedent and policy differ sharply from that of the Third Circuit in *Schiff*. We seek, and find, corroboration. A CFO's duty to speak would be fully consistent with those laws that impose a duty to report witnessed wrongdoing and with the general theory of criminal liability for omissions.

A. Acting for the Protection of Others

Although “[t]he common law traditionally took a hard line, rejecting any legal duty to be a good Samaritan[],”²³ there are manifold exceptions to the general rule. For example, it is a crime for any person to be indifferent to the distress of a child in California. One type of the offense of child endangerment punishes indifference even to non-life threatening circumstances. Under California Penal Code: Any person who, under circumstances or conditions other than those likely to produce great bodily harm or death, willfully . . . permits any child to suffer . . . unjustifiable physical pain or mental suffering . . . is guilty of a misdemeanor.²⁴

Mere indifference to the distress of another is also punishable under Minnesota, Rhode Island, and Vermont statutes that require someone at the scene of an emergency, or who knows that another is exposed to grave physical harm, to give “reasonable assistance.”²⁵ More than a dozen civil law jurisdictions have enacted “bad Samaritan” laws.²⁶

²³ *Stockberger v. United States*, 332 F.3d 479, 480 (7th Cir. 2003).

²⁴ CAL. PENAL CODE § 273a (2014); see generally Michael T. Cahill, *Attempt by Omission*, 94 IOWA L. REV. 1207, 1237–39 (2009) (discussing endangerment prosecutions).

²⁵ See MINN. STAT. ANN. § 604A.01 (2013) (Violation is a petty misdemeanor.); R.I. GEN. LAWS ANN. § 11-56-1 (2013) (Violation is punishable by a term in prison of not more than six months, a fine of up to \$500, or both.); VT. STAT. ANN., tit. 12, § 519(c) (2013) (The penalty for violation is a fine of not more than \$100.).

²⁶ Ken Levy, *Killing, Letting Die and the Case for Mildly Punishing Bad Samaritanism*, 44 GA. L. REV. 607, 616–17 (2010).

In addition to statutes that require persons to render aid to strangers, established common law imposes a duty on certain high corporate officers to take action to protect the public from dangers that they know have been created by other corporate employees. Consider a simple criminal case involving a duty to warn of a harm one has created. A trucker who negligently dumped more than a ton of gravel on the highway saw what he had done, and drove away. The trucker failed to warn anyone of the danger, in violation of a duty imposed upon him by state statute, and an approaching motorist was killed when she hit the gravel and lost control of her car. If a person acts culpably to imperil another, he or she has a legal duty to rescue the victim. Courts have imposed criminal liability for a failure to act in such circumstances. A Maryland Appeals Court stated in dictum that these facts would have been enough to convict the trucker of involuntary manslaughter, had the indictment charged it.²⁷

Let's add a fact. What if the trucking firm's chief operating officer had been riding along as a passenger? As chief of operations (COO), he is supposed to see that firm's operator's act in accordance with law. However, although he saw and understood everything, he said and did nothing. Should he bear some measure of criminal responsibility for the death of the motorist, which he could have avoided had he done his job? One might argue the trucker's prosecution is enough. Criminal law is potent stuff and should not be administered too liberally. The rule of lenity might be cited broadly as an example of this guiding principle.²⁸ On the other hand, the COO was no mere bystander. It was his job to act, and he failed to do his

²⁷ *State v. DiGennaro*, 3 A.3d 1201, 1208–09 (2010); *Tarasoff v. Regents of the University of California*, 551 P.2d 334 (Cal. 1976) (The failure to warn others of the danger of physical harm can also give rise to tort liability in certain circumstances, such as the duty of possessor of land to warn a licensee of dangerous conditions, *Restatement (Second) of Torts* § 342, the duty of a therapist to use reasonable care (often, to warn) if a patient presents a serious danger of violence to another, and the duty of a product manufacturer to warn about non-obvious dangers that cause physical injury or pose safety concerns.); *Daugherty v. American Honda Motor Co.*, 144 Cal. App. 4th 824, 836 (2006); *cf.* *Woods v. Maytag*, 807 F. Supp. 2d 112, 125 (E.D.N.Y. 2011) (“Although normally this duty to disclose arises in the context of direct business transactions, courts have also imposed this duty on a manufacturer who has exclusive knowledge of a product defect or danger.”).

²⁸ Courts should interpret ambiguity in a criminal statute in the light most favorable to the defendant. *United States v. O'Hagan*, 521 U.S. 642, 679 (1997) (Scalia, J., concurring in part and dissenting in part).

duty. Criminal liability is appropriate when the officer has knowledge of the wrong and the power to control it but fails to do so.²⁹

Imagine now, that at a press conference, a high ranking official at an imperiled nuclear power plant falsely denies rumors that the company is planning to release highly toxic steam into the atmosphere that evening. The steam is released, leading to tragedy. Had the official told the truth, or had the other executives who were also present corrected him, the public could have taken simple precautionary measures to avoid the harm.

If the COO in the spilled gravel example should bear liability, then so should the nuclear plant executives. And, if this is true in those two cases, then why should the CFO in our hypothetical case of securities fraud escape

²⁹ *Sea Horse Ranch v. Super. Ct. of San Mateo County*, 30 Cal. Rptr. 2d 681, 688–89 (Ct. App. 1994) (corporate president who knew of a potential risk and had the authority to prevent it but failed to do so could be charged with involuntary manslaughter); *People v. Conway*, 117 Cal. Rptr. 251, 258 (Ct. App. 1974) (President of a car dealership held criminally liable for false advertising because he had control over the activities of the dealership and permitted the unlawful practices to continue after being informed of them.). Tort law also imposes a duty in certain circumstances to control a third party's conduct to prevent harm to another individual. The general rule is stated in *Restatement (Second) of Torts* § 314 (1965): "The fact that the actor realizes or should realize that action on his part is necessary for another's aid or protection does not of itself impose upon him a duty to take such action." The rule has been carried over to the *Restatement (Third) of Torts: Liability for Physical and Emotional Harm* § 37 (2012). As stated in the *Second Restatement*, a duty to take some affirmative action to aid or protect may arise where a special relationship exists between parties. RESTATEMENT (SECOND) OF TORTS § 315 (1965). Some of these special relationships include the relation between a parent and a child, an employer and an employee, and someone who takes charge of a person whom he knows or should know to be likely to cause bodily harm to others if not controlled. §§ 316, 317, 319. The rules too are carried over into the *Third Restatement*. Section 41 of the *Third Restatement* describes the duty of a parent to prevent dependent children child from harming others, the affirmative duty of a custodian to control the conduct of those in its custody from harming third parties, an employers' duty to control the conduct of its employees from harming others, and a mental health professional's duty to prevent harm to others caused by his or her patients. RESTATEMENT (THIRD) OF TORTS: LIABILITY FOR PHYSICAL AND EMOTIONAL HARM § 41 (2012). For example, in *Volpe v. Gallagher*, a woman allowed her mentally-ill son to live with her in her home, where he kept several firearms. *Volpe*, 821 A.2d at 702–03 (R.I. 2003). The son killed the defendant's neighbor with a shotgun that he kept in the house. *Id.* at 703. She owed a duty to exercise reasonable care in controlling her son. "[U]nder these circumstances, defendant knew or had reason to know that she had the ability to control her son's conduct on her property merely by—as she herself admitted—telling him to remove the guns and ammunition from her house, and, if he failed to do so, by removing them herself." *Id.* at 709. The *Restatement* rule concerns the prevention of physical harm, not economic harm, but the analogy is apt. Much as one who has charge of a dangerous person must exercise care to control the person and prevent harm to others, so too the CFO has charge of the firm's finances and should be required to exercise care to prevent harm to others caused by the dissemination of false information—at least to the extent of correcting a financial statement misstatement made at the CFO's side during a public analyst call.

liability? The only difference is the nature of the harm suffered: physical injury as opposed to monetary loss.

But why should that be a meaningful distinction? An alien who has committed a crime of “moral turpitude” is ineligible for admission to the country,³⁰ and fraud is “universally recognized” as falling into the category of moral turpitude.³¹ Debts for money obtained by fraud have long been ineligible for discharge in bankruptcy, and Congress, in 2002, added § 523(a)(19) to the Bankruptcy Code, which specifically denies discharge for a securities fraud debt.³² Tort law exceptionally provides remedy for purely economic harm, if caused by fraud,³³ and even common law fraud is sufficiently reprehensible to warrant an award of punitive damages.³⁴ Congress made fraud a crime when perpetrated in connection with the purchase or sale of a security as well as in many other contexts. The penalties for securities fraud can be heavy. The crime is punishable by a fine of not more than \$5 million (\$25 million if the defendant is a corporation) and a term of imprisonment of not more than 20 years.³⁵

B. The Failure to Report Offenses Committed by Another

More common are laws that punish indifference to a witnessed crime. Some European legal systems, for example, require people to report known crime.³⁶ United States common law originally required people to report

³⁰ 8 U.S.C. § 1182(a)(2)(A)(i)(I) (2012).

³¹ *Jordan v. De George*, 341 U.S. 223, 232 (1951).

³² 11 U.S.C. §§ 523(a)(2)(A), (a)(4), (a)(11) (2012).

³³ The economic-loss doctrine bars most negligence suits for purely financial loss. It is based on the view commercial disputes ought to be resolved according to the principles of commercial law, rather than according to tort principles designed for accidents that cause personal injury or property damage. An exception allows a suit for fraud against one's contract counterpart. *Schreiber Foods v. Lei Wang*, 651 F.3d 678 (7th Cir. 2011); *Rardin v. T&D Machine Handling*, 890 F.2d 24 (7th Cir. 1989).

³⁴ *Newton v. Standard Fire Ins.*, 229 S.E.2d 297, 302 (N.C. 1976).

³⁵ 15 U.S.C. § 78ff(a) (2012).

³⁶ In Ireland, Section 9 of the Offences Against the State (Amendment) Act, 1998, provides that a person shall be guilty of an offense if they fail to disclose to the police information to prevent or punish the commission of a “serious offence” by another. Offences Against the State (Amendment) Act 1998 (Act No. 39/1998) (Ir.), available at <http://www.irishstatutebook.ie/1998/en/act/pub/0039/sec0009.html>. As well, section 19 of the Criminal Justice Act 2011 makes it an offense for a person not to report to police information which he knows or believes might be of material assistance in preventing the commission of certain offenses or obtaining the conviction of any persons for those relevant offenses. Criminal Justice Act 2011 (Act No. 22/2011) (Ir.), available at <http://www.irishstatutebook.ie/>

crime to the authorities, but does not today. Moreover, statutes, which once were interpreted as requiring members of the public to report crime, are now applied only when a person has taken some affirmative act to further the crime. Instead of a general duty to report, many jurisdictions in the United States have enacted statutes requiring certain specific persons to report certain specific offenses committed by another, punishing the failure to do so.

We examine laws that require members of the general public to report crime, the general duty to report violations of law imposed upon those who have assumed a greater responsibility, and then survey a variety of specific offense reporting statutes.

Laws That Require Members of the General Public to Report Crime

A citizen's duty to "raise the 'hue and cry' and report felonies to the authorities," was an established tenet of Anglo-Saxon law at least as early as the 13th century.³⁷ As recently as 1923, it seems to have been a common law crime in Delaware for someone present at the scene of a felony to "willfully" fail and neglect to make any effort to bring the felon to justice.³⁸

By 1940, though, the Supreme Court of Michigan declared the common law crime of misprision of felony to be "wholly unsuited to American criminal law,"³⁹ and a 1945 law review note concluded that the common law crime was "obsolete."⁴⁰ The final nail in the coffin for the common law crime may have been from a state appeals court in Florida in 1972, which stated,

2011/en/act/pub/0022/sec0019.html. "The duty to notify, or to take other steps, at the planning stage of the crime is also found in several European legal systems." Miriam Gur-Arye, *A Failure to Prevent Crime—Should it be Criminal?*, 20 CRIMINAL JUSTICE ETHICS 3, 6 (2001). A more passive approach is (or was) to be found in the Belgian Code of Criminal Instruction (1978). Article 30 provided that any person having knowledge of a criminal offense must report the case to the authorities. The obligation was strictly a moral one which was not enforced by any kind of sanction. CODE D'INSTRUCTION CRIMINELLE [C.I.CR.] 30 (Belg.), available at <https://www.ncjrs.gov/App/publications/abstract.aspx?ID=60328>.

³⁷ *Roberts v. United States*, 445 U.S. 552, 557 (1980) (internal citations omitted).

³⁸ *State v. Biddle*, 124 A. 804 (Del. Gen. Sess. 1923).

³⁹ *People v. Lefkowitz*, 293 N.W. 642, 643 (Mich. 1940).

⁴⁰ Raymond Huevler, *Criminal Law—Misprision of Felony. Failure to Report Knowledge of the Commission of a Felony Insufficient for Conviction*, 32 VA. L. REV. 170, 171 (1945).

While it may be desirable, even essential, that we encourage citizens to “get involved” to help reduce crime, they ought not be adjudicated criminals themselves if they don’t. The fear of such a consequence is a fear from which our traditional concepts of peace and quietude guarantee freedom. We cherish the right to mind our own business when our own best interests dictate.⁴¹

The common law crime probably no longer exists in any jurisdiction in the United States.⁴²

On their face, eight state statutes require a member of the general public who has witnessed a defined crime (usually a crime of violence) to report to law enforcement.⁴³ However, these statutes are rarely enforced.

The federal misprision of felony statute punishes one’s failure to report known or likely criminal activity, although recent case law strongly suggests that mere inaction is not enough to warrant conviction.⁴⁴ In 1790, Congress enacted a federal misprision statute that is essentially the same as 18 U.S.C. § 4 today. The statute derives from the English common law offense.⁴⁵ It states,

Whoever, having knowledge of the actual commission of a felony cognizable by a court of the United States, conceals and does not as soon as possible make known the same to some judge or other person in civil or military authority under the United States, shall be fined under this title or imprisoned not more than three years, or both.

The meaning of the word “conceals” has changed over time. “The early cases started with the assumption that an ordinary citizen had a duty to control crime, to raise the hue and cry, and they questioned whether the

⁴¹ *Holland v. State*, 302 So. 2d 806, 810 (Fla. App. 1974).

⁴² Gabriel D.M. Ciociola, *Misprision of Felony and Its Progeny*, 41 BRANDEIS L.J. 697, 721 (2003). As of 2003, only two states had misprision of felony statutes, South Dakota and Ohio. *Id.* at 726; Levy, *supra* note 26, at 620 n.27.

⁴³ CAL. PENAL CODE § 152.3 (West Supp. 2013); FLA. STAT. § 794.027 (West 2014); MASS. GEN. LAWS ANN. ch. 268 § 40 (West 2013); MASS. GEN. LAWS ANN. ch. 269 § 18 (West 2013); OHIO REV. CODE ANN. § 2921.22 (2013); R.I. GEN. LAWS § 11-1-5.1 (West 2013); WASH. REV. CODE ANN. § 9.69.100 (West 2013). HAW. REV. STAT. § 663-1.6 (West 2013) requires an attempt to obtain aid. The failure to transport a suffocated child to the hospital, in violation of this duty, resulted in conviction for involuntary manslaughter. *State v. Martinez*, 68 P.3d 606 (Haw. 2002); WIS. STAT. § 940.34 (2013); *State v. La Plante*, 521 N.W.2d 448 (Wis. Ct. App. 1994) (The host of a party witnessed the brutal beating of one of her guests by a group of other guests, but waited to summon assistance, convicted for violating the statute.); Eugene Volokh, *Duty to Rescue/Report Statutes*, VOLOKH CONSPIRACY (Nov. 3, 2009), available at <http://www.volokh.com/2009/11/03/duty-to-rescuereport-statutes/>.

⁴⁴ 18 U.S.C. § 4 (2012).

⁴⁵ *United States v. Caraballo-Rodriguez*, 480 F.3d 62, 71 (1st Cir. 2007) (*en banc*).

citizen failed in that duty. The modern cases assume the duty rests with law enforcement, and they question whether the citizen interfered with that duty.⁴⁶ Thus, the elements of the modern crime are that: “(1) the principal committed and completed the felony alleged; (2) the defendant had knowledge of the fact; (3) the defendant failed to notify the authorities; and (4) the defendant took affirmative steps to conceal the crime of the principal.”⁴⁷ Many courts have held that “the statute requires some positive act of concealment; mere failure to reveal one’s knowledge of a federal felony is not made criminal by the statute.”⁴⁸ With regard to what constitutes a positive act of concealment, a 2003 law review article concluded that mere silence is insufficient to support a conviction for misprision, that lying to authorities about a crime is an act sufficient to constitute concealment, and, citing *United States v. Ciambrone*,⁴⁹ that making truthful but incomplete statements may not amount to concealment.⁵⁰

The point remains unsettled. In *United States v. Caraballo-Rodriguez*, the court, *en banc*, wrote, “[W]hile this court and the Supreme Court may someday adopt the majority rule in the circuits that an affirmative act is required for a misprision offense, there is now no binding precedent to that effect.”⁵¹

Caraballo was a police officer who was involved with others in a drug crime. He nonetheless reported the crime, imperfectly, by leaving an anonymous and incomplete tip with the Drug Enforcement Agency. He pleaded guilty to misprision in exchange for the narcotics charges being dropped. He then sought to withdraw his guilty plea, arguing that he could not be guilty of misprision since he did not act to conceal the drug crime. He could not show “plain error,” however, and his plea stood. The court expressly left open the possibility that mere failure to report may be all that the statute requires.

⁴⁶ Christopher M. Curenton, *The Past, Present, and Future of 18 U.S.C. § 4: An Exploration of the Federal Misprision of Felony Statute*, 55 ALA. L. REV. 183, 186 (2003).

⁴⁷ *Id.* at 185 (2003).

⁴⁸ Ciociola, *supra* note 42, at 722.

⁴⁹ *United States v. Ciambrone*, 750 F.2d 1416, 1418 (9th Cir. 1984).

⁵⁰ Curenton, *supra* note 46, at 186.

⁵¹ *United States v. Caraballo-Rodriguez*, 480 F.3d 62 at 70.

If the statute requires more, then one may wonder what remains of the crime. An act of physical concealment resembles an obstruction of justice crime,⁵² lying to the authorities resembles the false statement crime,⁵³ and either might make one an accessory after the fact.⁵⁴

The apparent demise of the crime of misprision of felony is probably a good thing. Given the vast numbers of federal felonies, it would be an immense task for anyone to be able to know when they have witnessed one.⁵⁵

General Duty upon Those Who Have Assumed a Greater Responsibility

Attendant to their special status, certain members of the armed services and law enforcement are required to report known offenses. United States Navy Regulations, § 1137, provides that,

[p]ersons in the naval service shall report as soon as possible to superior authority all offenses under the Uniform Code of Military Justice which come under their observation, except when such persons are themselves already criminally involved in such offenses at the time such offenses first come under their observation.⁵⁶

A law enforcement officer is also under a duty to report crime, or at least to report crimes with which he is involved. Obviously, an officer

⁵² See 18 U.S.C. § 1505 (2012).

⁵³ See 18 U.S.C. § 1001 (2012).

⁵⁴ See 18 U.S.C. § 3 (2012). Thus, when the United States, in 1996, charged a corporation with misprision for the first time, the indictment alleged that Daiwa Bank officials “engaged in a complex scheme” to prevent the Federal Reserve from discovering the underlying crime: massive long term concealed trading losses. Daiwa settled the charges by paying a \$340 million fine. Cynthia E. Carrasco & Michael K. Dupee, *Corporate Criminal Liability*, 36 AM. CRIM. L. REV. 445, 456–57 (1999).

⁵⁵ “At present, there are an estimated 4,500 federal crimes in the U.S. Code[.]” Press Release, House Judiciary Committee Creates Bipartisan Task Force on Over-Criminalization (May 5, 2013), available at <http://judiciary.house.gov/index.cfm/2013/5/housejudiciarycommitteecreatesbipartisantaskforceonovercriminalization>.

⁵⁶ United States Navy General Regulations, ch. 11 § 1137 (Defense Logistics Agency 2011), available at <http://doni.daps.dla.mil/US%20Navy%20Regulations/Chapter%2011%20-%20General%20Regulations.pdf>.

enjoys some measure of discretion not to pull over every motorist who speeds.⁵⁷

The CFO of a publicly traded corporation can be likened to management's top financial cop. He or she often presides over the corporation's accounting and financial compliance and internal audit functions.⁵⁸

Specific Offense Reporting Statutes

Many statutes impose a duty to report on members of a particular profession, who, in the course of their work, can be expected to encounter and recognize signs that certain crimes are being committed. These statutes often concern the abuse or neglect of the old and the young or violent assault upon another. A specific duty to report may cover various offenses, including money laundering or other financial misconduct, environmental violations, treason, sexual assault, domestic violence, child pornography, child abuse, elder abuse, animal neglect, crimes involving gunshot wounds, and other violent crimes.⁵⁹ Although none directly supports the duty of a CFO to report or correct material financial misstatements of a colleague, such a duty would fit comfortably in this pattern. For example:

- Under New York State Penal Law § 265.25, any injury caused by the discharge of a firearm, and any injury which is likely to cause death inflicted by a sharp or pointed instrument, must be reported at once to the police authorities by the attending physician.⁶⁰

⁵⁷ *Devoney v. Retirement Board of the Policemen's Annuity and Benefit Fund of the City of Chicago*, 746 N.E.2d 836, 843 (Ill. App. 2001) ("By participating in a scheme to defraud with others and concealing the scheme, petitioner breached his duty to report crime, which is a duty arising out of or in connection with his service as a policeman. The public demands faithfulness from police officers to their duty to report and arrest others involved in criminal activity.").

⁵⁸ The majority of public companies' top internal auditors split their reporting duties between the audit committee and the CFO. Sarah Johnson, *Should Internal Audit Report to the CFO?*, CFO.COM (Oct. 13, 2006), available at <http://ww2.cfo.com/accounting-tax/2006/10/should-internal-audit-report-to-the-cfo/>.

⁵⁹ Cahill, *supra* note 24, at 1236–37; Sandra GuerraThompson, *The White-Collar Police Force: "Duty to Report" Statutes in Criminal Law Theory*, 11 WM. & MARY BILL RTS. J. 3, 3–4 (2002).

⁶⁰ N.Y. PENAL LAW § 265.25 (McKinney 2014) The failure to do so is punishable as a Class A misdemeanor. See N.Y. PENAL LAW § 70.15 (McKinney 2013). Ohio requires certain health care practitioners to report gunshot, stab wounds, burn injuries and domestic violence injuries. Violation is a misdemeanor. OHIO REV. CODE ANN. § 2921.22 (West 2013). See also MO. ANN. STAT. § .350 (West

- Nearly all states and territories designate professions whose members are mandated by law to report child maltreatment, including: social workers, school personnel, health-care workers, mental health professionals, child care providers, medical examiners and law enforcement officers.⁶¹ In a notable case, the director of athletics and a senior vice president of Penn State University were charged with failing to report child abuse committed by the convicted sexual predator and former Penn State football coach Jerry Sandusky, in violation of Pa. C.S. §§ 6301–6365 (2014). The crime is “punishable by up to 90 days in prison and a \$200 fine.”⁶²
- Under § 4 of the Illinois Elder Abuse and Neglect Act, when an older adult is unable to seek assistance, certain licensed professionals and state employees must report, within 24 hours, any suspected abuse, neglect or financial exploitation to the Department on Aging’s Elder Abuse and Neglect Program.⁶³
- Twenty-nine states impose a mandatory duty on mental health professionals to report information about patients who may become violent.⁶⁴ In most cases, failure is not punishable by the

2014) (failure is punishable as an Infraction under § 560.016), TEX. HEALTH & SAFETY CODE ANN. § 161.041 (West 2013) (failure is punishable as a misdemeanor under § 161.043).

⁶¹ U.S. Department of Health and Human Services, Mandatory Reporters of Child Abuse and Neglect 2 (Aug. 2012), available at https://www.childwelfare.gov/systemwide/laws_policies/statutes/manda.pdf.

⁶² Press Release, Pennsylvania Attorney General, Child sex charges filed against Jerry Sandusky; two top Penn State University officials charged with perjury & failure to report suspected child abuse (Nov. 5, 2011), available at <http://www.attorneygeneral.gov/press.aspx?id=6270>. The field continues to be the focus of legislative attention. “Approximately 119 bills in 37 states have been introduced in the 2013 legislative session on the reporting of suspected child abuse and neglect. Twenty three bills have been enacted.” National Conference of State Legislatures, Mandatory Reporting of Child Abuse and Neglect (June 27, 2013), <http://www.ncsl.org/issues-research/human-services/mandatory-rprtng-of-child-abuse-and-neglect-2013.aspx>.

⁶³ Failure is punishable by the relevant licensing board as an administrative offense or as a Class A misdemeanor. 320 ILL. COMP. STAT. 20/4 (2013); see section 4(e) of the Act. For a 50-state survey of elder abuse reporting laws, current as of December 31, 2006, see Lori Steigel & Ellen Klem, *Reporting Requirements: Provisions and Citations in Adult Protective Services Laws, By State*, A.B.A. COMM’N ON L. & AGING (2007), available at <http://www.americanbar.org/content/dam/aba/migrated/aging/docs/MandatoryReportingProvisionsChart.authcheckdam.pdf>.

⁶⁴ *Mental Health Professionals’ Duty to Warn*, 50 State Table, NAT’L CONF. OF STATE LEGISLATURES (Jan. 2013), available at <http://www.ncsl.org/issues-research/health/mental-health-professionals-duty-to-warn.aspx>.

state. Rather, the discharge of the duty entitles the practitioner to immunity from civil suit.⁶⁵

- A few states require auto repair garages to notify police of cars showing evidence of having been in an accident or struck by a bullet. In one state only, Indiana, is there a penalty for noncompliance.⁶⁶

In contrast to the foregoing examples, which seek to protect persons from physical injury, the following concern financial wrongdoing:

- Under 12 C.F.R. § 21.11 (2014), issued by the Office of the Comptroller of the Currency, national banks are required to report certain known or suspected criminal offenses, and transactions over \$5,000 that they suspect involve money laundering or violate the Bank Secrecy Act. The bank must prepare a Suspicious Activity Report, which it files with the Financial Crimes Enforcement Network of the Department of the Treasury.⁶⁷ Similar regulations apply to other financial institutions.⁶⁸
- § 10A(b) of the Exchange Act requires the auditor of a publicly traded company to notify the SEC,

if an illegal act was been detected in the course of the audit that has a material effect on the financial statements on the issuer; and the auditor communicated this to the audit committee of the board of directors of the issuer; but senior management has not taken, and the board of directors has not caused senior management to take, timely and appropriate

⁶⁵ *But see* OHIO REV. CODE ANN. § 2305.51(B) (1999) (providing that the license professional “may be made subject to disciplinary action by an entity with licensing or other regulatory authority over the professional”).

⁶⁶ Ciociola, *supra* note 42, at 730–31.

⁶⁷ *See Suspicious Activity Report (SAR) Program*, OFFICE OF THE COMPTROLLER OF THE CURRENCY, <http://www.occ.gov/tools-forms/forms/bank-operations/suspicious-activity-report-program.html>. The failure to maintain an effective anti-money laundering program in violation of 31 U.S.C. § 5318(h)(l) is criminally punishable under § 5322(a). *See* Press Release, United States Department of Justice, North Carolina Bank Agrees to Pay \$400,000 in Restitution to Victims of Investment Fraud Scheme It Failed to Detect and Report (Apr. 27, 2011), available at <http://www.justice.gov/opa/pr/2011/April/11-crm-533.html> (a recent enforcement that was resolved by deferred prosecution agreement).

⁶⁸ *E.g.*, 31 C.F.R. §§ 103.15–103.19 (2014) (requiring other banks, mutual funds, insurance companies, and securities brokers and dealers, among others, to file SARs in defined circumstances). *See also* 12 C.F.R. §§ 208.62, 211.5(k), 225.4(f) (2014) (Board of Governors of the Federal Reserve System); 61 FR 6095 (1996) (Federal Deposit Insurance Corporation); 12 C.F.R. § 748 (2014) (National Credit Union Administration); 12 C.F.R. § 563.180 (2014) (Office of Thrift Supervision).

remedial action.⁶⁹ A willful violation of the Exchange Act is criminally punishable.⁷⁰

- Rule 8.3 of the ABA Model Rules of Professional Conduct (2005) states that a “lawyer having knowledge that another lawyer has committed a violation of the Rules of Professional Conduct that raises a substantial question as to that lawyer’s honesty, trustworthiness or fitness as a lawyer in other respects, shall inform the appropriate professional authority.” The rule is enforced administratively and there is no criminal punishment for its violation.⁷¹
- Federal “[e]mployees shall disclose waste, fraud, abuse, and corruption to appropriate authorities.”⁷² Although phrased in mandatory language, the rule seems to be a general principle of ethical conduct, without sanction for its violation.

These examples teach a few things about a duty to report witnessed wrongdoing. The duty, when it exists, applies to specific groups of people, who, by the nature of their professional knowledge, may become aware of or suspect that certain crimes are being committed, and who might be expected to come across them during the course of their work. The scope of the duty is accordingly limited to crimes which are likely to be seen on the job, much as a physician must report gunshot wounds and child abuse seen in the ER, or as a publicly traded company’s external auditor must report certain errors in the client’s financial statements to the SEC. The witnessed wrongdoing encompasses financial crimes as well as physical harms. Requiring a CFO to speak, in the circumstances described in our hypothetical example, would be entirely consistent with these common aspects of the reporting statutes.

⁶⁹ 15 U.S.C. § 78j-1(b)(2) (2012).

⁷⁰ 15 U.S.C. § 78ff(a) (2012).

⁷¹ See *In re Himmel*, 533 N.E.2d 790 (Ill. 1988) (lawyer suspended one year for failure to report his unprivileged knowledge of conversion of settlement funds by client’s prior lawyer).

⁷² 5 C.F.R. § 2635.101(b)(11) (2014).

C. Criminal Omissions

In each of the examples discussed so far, a failure to act was wrongful because it was in violation of a duty to act. May one derive from these examples a general rule about the circumstances in which the law should impose a duty to act?

Consider again the person in grave distress who perishes because no one else would help. It is this scenario which has driven the development of a general theory to explain where to draw the line between mere bystanders and those who should bear criminal responsibility for failing to act.⁷³

In a comprehensive study of criminal omissions, Professor Leavens summarizes several categories of cases in which the law imposes a duty to act, so that inaction is criminally punishable:⁷⁴

- Duty based on relationship, *e.g.*, a parent's duty to care for and protect their child.⁷⁵
- Duty based on contract, *e.g.*, operator of boarding home is under a duty to feed and care for elderly patients.⁷⁶

⁷³ Leavens, *A Causation Approach to Criminal Omissions*, 76 CALIF. L. REV. 547, 553 (1988).

⁷⁴ *Id.* at 557–59. There are obvious similarities to the tort rules discussed above. The overlap is not surprising. Both tort and criminal law are concerned with the moral fault of the defendant (though both systems recognize strict liability in some cases). Darryl K. Brown, *Criminal Law Theory and Criminal Justice Practice*, 49 AM. CRIM. L. REV. 73, 75 (2012) (“[M]oral-based accounts have long informed our conceptualization of criminal law and punishment. A strictly deontological approach justifies punishment on grounds of the actor’s fault and culpability”). Culpability alone does not make conduct criminal, however; while there is much overlap between the two, not every tort, not even every intentional tort, is a crime. Just because a defendant should compensate a plaintiff does not mean that the defendant should also go to prison. “Other considerations must tip the balance between civil and criminal sanctions when the same culpable conduct is covered by both, and those factors are commonly prudential rather deontological.” *Id.* at 80. As well, criminal prosecution and punishment should accomplish something useful. “[F]or criminal punishment, the hoped-for result is typically crime reduction.” *Id.* at 74. The benefit of criminally punishing our hypothetical CFO is the same benefit sought by the whistleblower protection and bounty statutes; the encouragement of early disclosure in cases of financial statement fraud, thereby avoiding widespread loss.

⁷⁵ *See, e.g.*, *State v. Williquette*, 385 N.W.2d 145 (Wis. 1986) (wife who knowingly permitted her husband to abuse their children guilty of the crime of child abuse because of the duty of a parent to protect their child).

⁷⁶ *See, e.g.*, *State v. Brown*, 631 P.2d 129 (Ariz. Ct. App. 1981), cited by Professor Leavens, the owner of a boarding home was under a criminally enforceable legal duty to ensure that her boarding home premises were safely operated and to see that her employees were able to and actually did provide necessary care.

- Duty based on ownership of premises to maintain premises in safe condition for lawful visitors.
- Duty based on master-servant relationship to ensure that his or her servants do not injure others can, in appropriate circumstances, lead to criminal liability.
- Duty arising from creation of peril.⁷⁷
- Duty arising from (other) voluntary assumption of care.⁷⁸

One of the categories involves the existence of a contractual duty to provide services. For example, “Where those services are closely related to protecting or caring for dependent persons, courts have imposed criminal liability when a failure to provide the services leads to a prohibited harm such as death.”⁷⁹ One writer would generalize the rule and apply it where the prohibited harm is purely economic, such as in breach of a contract to provide CFO services.⁸⁰ Other categories also seem analogous, such as the master’s duty to see that employees do not injure another, as well as the duty arising from the creation of a peril. Our hypothetical case might easily fit within more than one category.

But not every breach of contract is or should be a crime, and categorization as a method has its limits. Professor Leavens suggests an alternative “proximate causation” approach. A person’s failure to act should give rise to criminal liability if there is a “valid expectation” that persons in similar circumstances would act to prevent a harm, and a “deeply ingrained common understanding that society relies on that individual to prevent the harm.”⁸¹ “Thus parents have a ‘duty’ to prevent harm to their children because empirically, almost all parents act this way, and normatively, our

⁷⁷ See *State v. Digennaro*, 3 A.3d 1201 (Md. 2009).

⁷⁸ Other writers have identified other categories. For example the author of *Criminal Omissions* finds a duty to act in the following circumstances:

1. Duty to aid anyone in peril, found in some European systems.
2. Duty in a status relationship, e.g., parent child, spouse.
3. Defendant’s exercise of a privilege to practice a calling or engage in a business or trade.
4. Duty by participation in some permitted sphere of activity.
5. Duty undertaken by contract

Graham Hughes, *Criminal Omissions*, 67 YALE L.J. 590, 599–600 (1958).

⁷⁹ Leavens, *supra* note 73, at 558.

⁸⁰ Todd S. Aagaard, *A Fresh Look at the Responsible Relation Doctrine*, 96 J. CRIM. L. & CRIMINOLOGY 1245, 1281 (2006).

⁸¹ Leavens, *supra* note 73, at 575.

society would consider it reprehensible if they did not.”⁸² Only those individuals whose failure to act is inconsistent with society’s expectation that they will prevent a particular harm can be said to cause that harm and should be criminally liable. Others who fail to act, however culpable from a moral standpoint, are merely observers, not causers, of the harm.

Conclusion

Holding our hypothetical CFO criminally responsible would be consistent with fundamental ideas about criminal culpability for one’s failure to act, and with what the law could and perhaps should be. As discussed in subsection A, above, a corporate officer may appropriately be held liable when the officer has knowledge of a wrong committed by another employee of and also, due to his position in the corporation, has the power to control it but fails to do so. In subsection B, above, we concluded that although members of the general public usually have no statutory or common law duty to report crime, many state impose a duty to report on members of a particular profession, who, in the course of their work, can be expected to encounter and recognize signs that certain crimes are being committed. We also found, in subsection C, above, that holding our hypothetical CFO criminally liable for his omission (his failure to correct the senior officer’s misrepresentation) would be consistent with accepted theories of criminal omission liability, of both the categorical and proximate cause varieties.

Accordingly, we can make a strong case that our CFO should be held criminally liable for his failure to speak. The question, then, is whether a basis for criminal liability exists in current law. We turn now to the actual letter of the law applicable to our silent CFO.

PART III: A CORPORATE OFFICER’S DUTY OF CANDOR

A corporate officer, including our hypothetical CFO, owes a duty of candor to the corporation’s board of directors.⁸³ The duty is related to the

⁸² *Id.*

⁸³ As well,

agency law principle that an agent must disclose to his principal material information relevant to the affairs of the agency entrusted to him. Notably, as set forth below, the officer owes no such duty to the shareholders.

The explicit recognition of the duty is a fairly recent development. In discussing the financial scandals at the dawn of the new century, such as Enron, Professor Langevoort, in 2003, argued in favor recognizing an officer's duty of candor to the board of directors, particularly a duty of the CEO to honestly tell the board what it needs to know to do its job. "I would venture a guess that in these scandals' aftermath, courts will soon be tempted to address the duty of candor inside the corporation,"⁸⁴ He noted the absence of case law and called the point an "empty space."⁸⁵

He was joined by other commentators. One argued that "[s]enior corporate officers of public companies, CEOs and CFOs, owe directors and the corporation a duty to inform. . . ."⁸⁶ She noted that the CEO and CFO are the two most senior officers, are required to sign Sarbanes Oxley certifications, and are subject to Delaware's personal jurisdiction statute.⁸⁷

In 2007, Professor Johnson analyzed state corporation law concerning the duty owed by an officer to the corporation.⁸⁸ In 16 states, there was common law only, the chief source being agency law. In 34 states, he found statutory and case law concerning an officer's fiduciary duty and in 32 of those, the source of the statute was § 8.42 of the Model Business Corporation Act ("MBCA"). A 2005 amendment to § 8.42 added subsection (b), which imposes a disclosure obligation on officers. The 2005

a number of whistleblower statutes, both state and federal, include a "first report" requirement, wherein a whistleblower is required to "first report" the violation of law to the employer so as to provide an opportunity for the employer to cure the defect. Should the whistleblower fail to make this "first report," he cannot invoke the protection of the whistleblower statute.

See John B. Chiara & Michael D. Orenstein, *Whistler's Nocturne in Black and Gold—The Falling Rocket: Why the Sarbanes-Oxley Whistleblower Provision Falls Short of the Mark*, 23 HOFSTRA LAB. & EMP. L.J. 235, 252 n.128 (2005).

⁸⁴ Langevoort, *supra* note 8, at 1195.

⁸⁵ *Id.* at 1189.

⁸⁶ Z. Jill Barclift, *Senior Corporate Officers and the Duty of Candor*, 41 VAL. U. L. REV. 269, 270 (2006).

⁸⁷ *Id.* at 270 n.7. Nonresident senior officers of Delaware corporations consent to service of process in all civil actions brought in Delaware for violation of duty. DEL. CODE tit. 10, § 3114 (2009).

⁸⁸ Lyman Johnson, *Having the Fiduciary Duty Talk: Model Advice for Corporate Officers (and Other Senior Agents)*, 63 BUS. LAW. 147 (2007).

amendment was intended to make explicit a duty that “implicit in, and embraced under, the broader” preexisting standard of good faith and due care.⁸⁹ It has not yet been adopted by any state. Professor Johnson then gave “model fiduciary advice for officers,” including the following passage based on § 8.42 (b) of the MBCA:

It is important for you to know that *you must report certain matters to others in the company*. This includes any business information within your sphere of responsibility that you know, or have reason to believe, to be either significant to the person to whom you report or that that person would wish to have, so that he or she can effectively perform his or her job. *It also includes any information you have concerning actual or probable material violations of law*, or breach of duty by any employee or agent of the company, that you believe has already occurred or is about to occur. Any such past or imminent violation of law or duty should be immediately reported to [specify]. Information, or a violation of law or duty, can be significant or material either because of the dollar amount involved or because of its serious nature.⁹⁰

Another commentator has also argued in favor recognizing an officer’s duty of candor to the board of directors.⁹¹

The Delaware courts have also begun to address the point. We review Delaware case law, and then consider the *Second* and *Third Restatements of Agency Law*, and § 8.42(b) of the MBCA.

Delaware

In *Mills Acquisition v. Macmillan*, the Delaware Supreme Court stated the common sense principle that the CEO and COO of a public company may not deceive the board of directors in connection with a sale of the company.⁹² Maxwell and its rival KKR both sought control of Macmillan. The Macmillan board of directors delegated nearly all responsibility for dealings with Maxwell and KKR to its CEO and COO who, unbeknownst to the board, wished to acquire Macmillan in conjunction with KKR. Maxwell sought to enjoin an asset option agreement, a “lockup,” between

⁸⁹ MBCA § 8.42 Official Comment, p. 8-85.

⁹⁰ Johnson, *supra* note 88, at 155 (emphasis added).

⁹¹ Shannon German, *What They Don’t Know Can’t Hurt Them: Corporate Officers’ Duty of Candor to Directors*, 34 DEL. J. CORP. L. 221 (2009).

⁹² 559 A.2d 1261 (Del. 1989).

Macmillan and KKR, which the Macmillan board had approved after KKR was the high bidder in an auction which the CEO and COO had rigged in favor of KKR.

The CEO and COO manipulated the Macmillan board to favor KKR's bid by giving the board a selective and skewed presentation of the facts. They also improperly favored KKR in the auction, wrongfully providing KKR a "tip" as to Maxwell's bid. Macmillan's board was uninformed as to such clandestine advantages. "Their silence was misleading and deceptive. In short, it was a fraud upon the board."⁹³ An officer may not withhold material information in order to deceive the board and gain personal advantage.

The Delaware Supreme Court again addressed the duties of an officer in *Gantler v. Stephens Shareholders of First Niles Financial, Inc.* sued officers and directors of First Niles for violating their fiduciary duties by rejecting a valuable opportunity to sell the company, by deciding instead to reclassify the company's shares in order to benefit themselves, and by disseminating a materially misleading proxy statement to induce shareholder approval.⁹⁴ The Delaware Supreme Court concluded that the complaint pleaded sufficient facts to overcome the business judgment rule, and to state substantive fiduciary duty and disclosure claims.

The key language for our purposes is this passage:

The Court of Chancery has held, and the parties do not dispute, that *corporate officers owe fiduciary duties that are identical to those owed by corporate directors*. That issue—whether or not officers owe fiduciary duties identical to those of directors—has been characterized as a matter of first impression for this Court. In the past, we have implied that officers of Delaware corporations, like directors, owe fiduciary duties of care and loyalty, and that the fiduciary duties of officers are the same as those of directors. We now explicitly so hold.⁹⁵

The duties may be in a general sense identical, but officers and the board of directors perform different functions and communicate to different audiences. "In the absence of a request for stockholder action, the Delaware General Corporation Law does not require directors to provide shareholders

⁹³ *Id.* at 1283.

⁹⁴ 965 A.2d 695 (Del. 2009).

⁹⁵ *Id.* at 708–09 (emphasis added).

with information concerning the finances or affairs of the corporation.”⁹⁶ In contrast, the corporation’s executive officers should be reporting regularly to the board in order for the board to be able to do its job.⁹⁷ Though it is an imperfect analogy, it may serve well enough.

Because the duties of officers are arguably analogous to those of directors, we consider the duties of the board of directors when it communicates with shareholders in hope of illuminating the disclosure obligations of corporate officers like our hypothetical CFO.

Malone, Pfeffer, and Omissions

The complaint in *Malone v. Brincat*, alleged that the directors intentionally overstated the financial condition of Mercury, a publicly traded company, on repeated occasions throughout a four-year period in disclosures to Mercury’s shareholders.⁹⁸ Did Mercury’s directors breach their fiduciary duty of loyalty and good faith by knowingly disseminating to the stockholders false information about the financial condition of the company?

“When directors communicate publicly or directly with shareholders about corporate matters the *sine qua non* of directors’ fiduciary duty to shareholders is honesty,” wrote the court.⁹⁹ Directors who knowingly disseminate false information “violate their fiduciary duty, and may be held accountable in a manner appropriate to the circumstances.”¹⁰⁰ The point would seem to apply with equal ease to an officer.

The *Malone* court organized director communications into three categories:¹⁰¹

- Public statements made to the market, including shareholders. The court noted that it has not recognized a state common law

⁹⁶ *Malone v. Brincat*, 722 A.2d 5, 11 (Del. 1998).

⁹⁷ See generally *Smith v. Van Gorkum*, 488 A.2d 858 (Del. 1985) (directors must exercise an informed business judgment). See also MBCA § 8.42 Official Comment: “Subsection (b)(1) addresses the flow of information to the board of directors and to superior officers necessary to enable them to perform their decision-making and oversight functions. See the Official Comment to section 8.31.”

⁹⁸ 722 A.2d 5 (Del. 1998).

⁹⁹ *Id.* at 10.

¹⁰⁰ *Id.* at 9.

¹⁰¹ *Id.* at 11.

cause of action against the directors of Delaware corporations for “fraud on the market.”

- Statements informing shareholders about the affairs of the corporation without a request for shareholder action. When the directors disseminate information to stockholders when no stockholder action is sought, the fiduciary duties of care, loyalty and good faith apply. Dissemination of false information could violate one or more of those duties.
- Statements to shareholders in conjunction with a request for shareholder action. There is a duty to disclose all material facts when seeking stockholder action. This duty of disclosure is a specific application of the general fiduciary duty owed by directors; it obligates directors to provide the stockholders with accurate and complete information material to a transaction or other corporate event that is being presented to them for action.

The dissemination of inaccurate information may be the result of carelessness or calculation.¹⁰² It is the latter which can lead to meaningful personal liability for the members of the breaching board.¹⁰³

The board’s duty of disclosure was also discussed in *Pfeffer v. Redstone*.¹⁰⁴ Pfeffer brought a class action against the directors of Viacom and Blockbuster. Viacom spun-off its controlling interest in Blockbuster. Two transactions were challenged: (1) a special \$5 dividend paid to Blockbuster stockholders (the “Special Dividend”); and, (2) a later offer to Viacom stockholders to exchange their Viacom stock for Blockbuster stock (the “Exchange Offer”).

Pfeffer claimed that the Viacom board of directors violated their duty of disclosure—the third of *Malone’s* categories—in relation to the Exchange Offer. Specifically, Pfeffer alleged that the Viacom directors

¹⁰² *Malone v. Brincat*, 722 A.2d at 11.

¹⁰³ See *In re Tyson Foods, Inc. Consol S’holder Litig.*, 919 A.2d 563, 597–98 (Del. Ch. 2007) (“Disclosure violations may, but do not always, involve violations of the duty of loyalty. A decision violates only the duty of care when the misstatement or omission was made as a result of a director’s erroneous judgment with regard to the proper scope and content of disclosure, but was nevertheless made in good faith. Conversely, where there is reason to believe that the board lacked good faith in approving a disclosure, the violation implicates the duty of loyalty.”). Since care violations are waived in the corporate charter, are indemnified by the corporation, and subject to review under the lenient business judgment rule, only a breach of loyalty or good faith has teeth.

¹⁰⁴ 965 A.2d 676 (Del. 2009).

failed to disclose the true state of Blockbusters' operational cash flow. A Blockbuster treasury department manager had compiled a cash flow analysis seven months before the Exchange Offer which showed that Blockbuster's operational cash flow could not support the Special Dividend or Exchange Offer. The court recognized that corporate fiduciaries can breach their duty of disclosure under Delaware law by omitting to state a material fact, but dismissed Pfeffer's claim because there was no showing that the Viacom directors knew or should have known of the omitted facts. *Pfeffer* stands for the proposition that a calculated, knowing omission is a breach of the duty of disclosure.

Having considered the pronouncements of the Delaware Supreme Court, we turn to two recent cases decided by the Court of Chancery concerning an officer's duty to disclose. An officer's duty to disclose information to the board was at issue in *Hampshire Group v. Kuttner*.¹⁰⁵ The former Hampshire Group CFO and Chief Accounting Officer, Clayton and Clark, were sued by Hampshire Group, which claimed, *inter alia*, that they had violated their fiduciary duties in carrying out an assignment to process and bring up to date former CEO Kuttner's lavish expense reports, which had not been filed for many years.

The court gave an overview of the basic fiduciary standard that governed Hampshire's claims. As officers, both Clayton and Clark owed certain fiduciary duties to Hampshire:

Like directors, officers also have other contextual obligations as fiduciaries. These include the responsibility to disclose to their superior officer or principal "material information relevant to the affairs of the agency entrusted to them." Liability for a failure in this regard, however, must be examined under the standards just outlined, to determine whether any failure in information sharing was the product of gross negligence or disloyalty.¹⁰⁶

¹⁰⁵ *Hampshire Group, Ltd. v. Kuttner*, 2010 Del. Ch. LEXIS 144 (July 12, 2010).

¹⁰⁶ *Id.* at 13 n.85. With respect to the duty to disclose material information, the *Hampshire Group* court provided the following additional citations: see *Science Accessories Corp. v. Summagraphics Corp.*, 425 A.2d 957, 962 (Del. 1980) ("Encompassed within such general duties of an agent is a duty to disclose information that is relevant to the affairs of the agency entrusted to him."); 2 MODEL BUS. CORP. ACT ANN. § 8.42(b)(1) (4th ed. 2009) ("The duty of an officer includes the obligation to inform the superior officer to whom, or the board of directors or the committee thereof to which, the officer reports of information about the affairs of the corporation known to the officer, within the scope of the officer's functions, and known to the officer to be material to such superior officer, board, or committee . . ."); see also RESTATEMENT (SECOND) OF AGENCY § 381 (1958) ("Unless otherwise agreed, an agent

The court found Clayton and Clark not liable for any excessive reimbursements to Kuttner. There was no evidence of a lack of good faith on their part in carrying out the expense project, and thus no violation of the duty of loyalty. They were required to process expenses for many years under a tight deadline, and, applying a gross negligence standard, the court found that the executives had not been grossly negligent and therefore had not violated their duty of care.

Notably, Hampshire contended that it was a breach of fiduciary duty for Clayton and Clark not to inform the Audit Committee of the difficulties in the review process. But, the Audit Committee knew that Kuttner's expense reports would be imperfect, and there was no breach in failing to tell the board what its members already knew.¹⁰⁷

Reading *Mills Acquisition, Gantler, Pfeffer, Malone and Hampshire Group* together, it is clear that an officer of a Delaware corporation may not mislead the board by failing to reveal facts known to the officer but not known to the board, and which are material to the board.

The most recent Delaware case is also the only case that directly addresses the duty of a corporate officer to disclose material facts to a stockholder. *In re Wayport* involved insider trading in a face-to-face transaction.¹⁰⁸ The plaintiffs sued for damages arising out of their sales of stock in Wayport, Inc. to corporate insiders. They asserted both breach of fiduciary duty and fraud causes of action, alleging that the insider purchasers had failed to disclose certain facts to the sellers. The court relied on the Delaware's "special facts doctrine," which applies when a corporate

is subject to a duty to use reasonable efforts to give his principal information which is relevant to affairs entrusted to him and which, as the agent has notice, the principal would desire to have and which can be communicated without violating a superior duty to a third person."); A. Gilchrist Sparks, III & Lawrence A. Hamermesh, *Common Law Duties of Non-Director Corporate Officers*, 48 BUS. LAW. 226-29 (describing the corporate officers' duty to keep the board of directors informed)."

¹⁰⁷ The *Hampshire Group* court cited *Science Accessories Corp. v. Summagraphics Corp.*, 425 A.2d 957 (Del. 1980). In that case, SAC, a corporate employer sought equitable relief against former employees for alleged breach of fiduciary and contractual duties with respect to an alleged corporate opportunity. The chancery court held against the employer. Affirming, the Delaware Supreme Court noted that "under elemental principles of agency law, an agent owes his principal a duty of good faith, loyalty, and fair dealing. 3 CJS Agency § 271; RESTATEMENT (SECOND) OF AGENCY § 387 (1957). Encompassed within such general duties of an agent is a duty to disclose information that is relevant to the affairs of the agency entrusted to him." *Id.* at 962, citing RESTATEMENT (SECOND) OF AGENCY § 381.

¹⁰⁸ *In re Wayport, Inc. Litig.*, 76 A.3d 296 (Del. Ch. 2013).

fiduciary buys shares directly from or sells shares directly to an existing stockholder. Under that doctrine, the fiduciary has a duty of disclosure only when he has an insider's knowledge of important transactions such as prospective mergers, probable sales of the entire assets or business, agreements with third parties to buy large blocks of stock at a high price, and impending declarations of unusual dividends.¹⁰⁹ The *Wayport* court dismissed the claims, finding that the defendants knew no special facts.

Wayport and the special facts doctrine have no direct application to the conduct of our hypothetical CFO who is neither a buyer nor a seller of his corporation's stock. The duties imposed by the special facts doctrine do not exist in connection with purchases or sales made in the public markets.

In summary, Delaware case law provides a general foundation for finding that an officer is duty bound to report to the board or to the audit committee violations of law or other wrongs known to the officer but not to the board, if material to the board's ability to perform its functions. However, it provides no basis for concluding that an officer owes a duty of disclosure to the stockholders, except when the officer is involved in a face-to-face purchase or sale of the corporation's stock which implicates the special facts doctrine.

Beyond Delaware

Nearly all the commentators, as well as the Delaware Court of Chancery in *Hampshire Group*, cite the *Restatement (Second) of Agency*. Johnson's article cited the *Restatement (Third) of Agency*. There is little difference between the two formulations, and while both certainly support the duty of a corporate officer to disclose material information to his "principal," both are general in terms and neither specifically addresses the duty. In both, the duty of the agent is to use reasonable efforts to give or provide the principal with facts or information relevant to the agent's duties (or to the affairs entrusted to him) and which the agent has notice (or knows

¹⁰⁹ See *Jordan v. Duff & Phelps, Inc.*, 815 F.2d 429, 435 (7th Cir. 1987) ("The 'special facts' doctrine developed by several courts at the turn of the century is based on the principle that insiders in closely held firms may not buy stock from outsiders in person-to-person transactions without informing them of new events that substantially affect the value of the stock. See, e.g., *Strong v. Repide*, 213 U.S. 419, 433-34 (1909).").

or should know) that the principal would wish (or desire) to have.¹¹⁰ Given their generality, neither specifies whether a corporate officer's principal would be the board, the corporation, or the stockholders.

Beyond the Common Law

In contrast to the generality of the *Restatements*, which after all concern the broader topic of agency, the Model Business Corporation Act specifically addresses the duties of a corporate officer, and, as predicted by Professor Langevoort, was amended in 2005 in response to Enron.¹¹¹

Section 8.42(b)(1) concerns the duty of an officer to provide information about corporate affairs, much as the Restatements require of an agent. But unlike the *Restatements*, § 8.42(b)(2) of the MBCA specifically requires an officer to report "up the chain" violations of law and breaches of duty.

8.42 Standards of Conduct for Officers

(b) The duty of an officer includes the obligation:

(1) to inform the superior officer to whom, or the board of directors or the committee thereof to which, the officer reports of information about the affairs of the corporation known to the officer, within the scope of the officer's

¹¹⁰ RESTATEMENT (SECOND) OF AGENCY § 381 (1958)

Duty to Give Information

Unless otherwise agreed, an agent is subject to a duty to use reasonable efforts to give his principal information which is relevant to affairs entrusted to him and which, as the agent has notice, the principal would desire to have and which can be communicated without violating a superior duty to a third person.

RESTATEMENT (THIRD) OF AGENCY § 8.11 (2006)

Duty to Provide Information

An agent has a duty to use reasonable effort to provide the principal with facts that the agent knows, has reason to know, or should know when

- (1) subject to any manifestation by the principal, the agent knows or has reason to know that the principal would wish to have the facts or the facts are material to the agent's duties to the principal; and
- (2) the facts can be provided to the principal without violating a superior duty owed by the agent to another person.

¹¹¹ R. Franklin Balotti & Megan W. Shaner, *Safe Harbor for Officer Reliance: Comparing the Approaches of the Model Business Corporation Act and Delaware's General Corporation Law*, 74 LAW & CONTEMP. PROBS. 161, 163 (Winter 2011).

functions, and known to the officer to be material to such superior officer, board or committee; and

(2) to inform his or her superior officer, or another appropriate person within the corporation, or the board of directors, or a committee thereof, of any actual or probable material violation of law involving the corporation or material breach of duty to the corporation by an officer, employee, or agent of the corporation, that the officer believes has occurred or is likely to occur.

The Official Comment to § 8.42 explains that “the common law, including the law of agency, has recognized a duty on the part of officers and key employees to disclose to their superiors material information relevant to the affairs of the agency entrusted to them.”¹¹² Subsection (b)(2) states this disclosure obligation by confirming that the officer must:

inform the relevant superior authority, or other appropriate person within the corporation of violations of law or breaches of duty that the officer believes have occurred or are about to occur (i.e., more likely than not to occur) and are or would be material to the corporation.

As with Delaware law, the officer is supposed to tell the board, or, since many codes of conduct establish a system for reporting violations of law, officers may make report to the ethics officer, internal auditor, general counsel or the like.¹¹³ However, subsection (b)(2) imposes no duty to inform the stockholders of the corporation.

Conclusion

The corporate officer’s duty of candor is owed to the board. Nothing in Delaware law, the *Restatement* or the MBCA, suggests that a corporate officer—even a CFO—is under a duty to circumvent internal reporting procedures and speak directly to the stockholders. The only cases which found that an officer has a fiduciary duty to disclose to a stockholder involved stock transactions directly with the stockholder. Yet, our CFO may still be liable under Rule 10b-5 based on his failure to disclose to the board. As developed below, even if the fraud is against the board, it can still be “in connection with” stock market purchases and sales of the corporation’s stock for purposes of Rule 10b-5.

¹¹² MBCA § 8.42 Official Comment, p. 8-351.

¹¹³ *Id.*

It seems likely that our hypothetical CFO should have reported the misstatement immediately to the audit committee of the board, given his seniority, the magnitude of the matter, and the requirement of § 302 of the Sarbanes Oxley Act, discussed above, that CFO certify that he has disclosed to the audit committee any fraud he knows about which involves management.¹¹⁴ Had he done so, he would have discharged his duty under state law, and, as we shall see, would face no prospect of liability under Rule 10b-5.¹¹⁵ Had he contradicted his colleague during the call, that act alone, while commendable, would not have discharged his duty to the board. The incident would require a report to the board.

PART IV

In Part III, we determined that our CFO owes a duty of disclosure to the board but not to the stockholders. To determine whether the CFO may be held criminally liable for violation of § 10(b) and Rule 10b-5, we must consider whether an officer's silence, in breach of a fiduciary duty to disclose, can constitute a violation of § 10(b) and Rule 10b-5? In this part, we address that issue.

Silence, in Breach of Fiduciary Duty, as a Violation of § 10(b) and Rule 10b-5

When is silence a fraud in breach of section 10(b) and Rule 10b-5? § 10(b) of the Exchange Act states,

It shall be unlawful for any person . . .

(b) To 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 Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Rule 10b-5 states,

It shall be unlawful for any person . . .

¹¹⁴ See also *Hampshire Group v. Kuttner*, 2010 Del. Ch. LEXIS 144 (July 12, 2010) (discussing disclosure to the board).

¹¹⁵ See *United States v. O'Hagan*, 521 U.S. 642 (1997).

- (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.

The subsections of Rule 10b-5 are in the disjunctive and violation of any one of them is sufficient to violate the Rule.

In an SEC enforcement action under § 10(b) and Rule 10b-5, the SEC must prove that in connection with the purchase or sale of a security the defendant, acting with scienter, made a material misrepresentation (or a material omission if the defendant had a duty to speak) or used a fraudulent device. In order to impose criminal liability, the government must also prove that the defendant willfully violated the law. Neither the SEC nor the prosecutor need prove reliance. The government, as opposed to a private plaintiff, need prove only materiality, meaning that there is a substantial likelihood that a reasonable investor would find the omission or misrepresentation important in making an investment decision, and not that a victim did, in fact, rely on it.¹¹⁶

We consider three Supreme Court decisions, *Affiliated Ute Citizens of Utah v. United States*,¹¹⁷ *Chiarella v. United States*,¹¹⁸ and *United States v. O'Hagan*,¹¹⁹ and recent appeals court opinions involving enforcement actions brought by the SEC and the Department of Justice, which applied Rule 10b-5 to punish fiduciary silence in cases that did not involve insider trading.¹²⁰ We also consider a district court opinion that recognized a silent CFO's duty to speak.

¹¹⁶ *United States v. Vilar*, 729 F.3d 62, 75 (2d Cir. 2013).

¹¹⁷ *Affiliated UTE Citizens of UT v. United States*, 406 U.S. 89 (1972).

¹¹⁸ *Chiarella v. United States*, 445 U.S. 219 (1980).

¹¹⁹ *United States v. O'Hagan*, 521 U.S. 642 (1997).

¹²⁰ There are other duties to disclose, for which breach is also a violation of section 10(b), such as a duty to correct one's own prior statement believed to be true when made, if it is revealed that those statements were in fact inaccurate when made and those statements would be materially misleading absent correction. See *In re Burlington Coat Factory Sec. Litig.*, 114 F.3d 1410, 1430–31 (3d Cir. 1997); *Backman v. Polaroid Corp.*, 910 F.2d 10, 16–17 (1st Cir. 1990) (*en banc*). There may also be a duty to update statements that were accurate when made, if those statements no longer reflect the true facts and would be materially misleading absent updating. *Id.* But see *Stransky v. Cummings Engine Co.*, 51 F.3d

The key rule for our purposes was stated by the court in *Chiarella*:

silence in connection with the purchase or sale of securities may operate as a fraud actionable under § 10(b) despite the absence of statutory language or legislative history specifically addressing the legality of nondisclosure. But such liability is premised upon a duty to disclose arising from a relationship of trust and confidence between parties to a transaction.¹²¹

The Court based this understanding of the statute upon the common law rule that,

one who fails to disclose material information prior to the consummation of a transaction commits fraud only when he is under a duty to do so. And the duty to disclose arises when one party has information that the other party is entitled to know because of a fiduciary or other similar relation of trust and confidence between them.¹²²

The Court's reference to a fiduciary or other similar relation of trust and confidence as the basis of a duty to disclose suggests two questions: First, might there be a relationship of trust and confidence between the CFO and the stockholders that derives from federal law and which imposes a duty to speak in the circumstances of our hypothetical? In the alternative, if our hypothetical CFO's silence were in breach of a duty to disclose arising from the relationship of trust and confidence between the CFO and the board of directors of a publicly traded corporation, might that silence also constitute a breach of § 10(b) and Rule 10b-5 if it is in connection with the purchase and sale of the corporation's stock?

The first question may be simpler to answer. The federal relationship of trust and confidence between an officer and shareholders has been found only in insider trading cases. A "corporate insider," while in possession of material non-public information, must either disclose that information or abstain from trading in the corporation's securities.¹²³ The *Chiarella* Court explained the basis for the duty to disclose. "In its *Cady, Roberts* decision,

1329 (7th Cir. 1995); *Gallagher v. Abbott Laboratories*, 269 F.3d 806, 810 (7th Cir. 2001) (no duty to update). Moreover, the express language of Rule 10b-5(b) incorporates the half-truth rule (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). See Donald C. Langevoort & G. Mitu Gulati, *The Muddled Duty to Disclose Under Rule 10b-5*, 57 VAND. L. REV. 1639, 1664-71 (2004).

¹²¹ *Chiarella*, 445 U.S. at 230.

¹²² *Id.* at 228.

¹²³ *Id.* at 227.

the [Securities and Exchange] Commission recognized a relationship of trust and confidence between the shareholders of a corporation and those insiders who have obtained confidential information by reason of their position with that corporation.”¹²⁴ If the trades are made in a face-to-face transaction, then presumably the disclosure must be made to the counterpart, much as with the common law special facts doctrine. If the trades are made via a market transaction, then disclosure must be made to the public.¹²⁵

One way of understanding the rule is to imagine the insider standing face to face with every stockholder and every prospective buyer in the market. If the insider buys from or sells to any of them (even if this is their first purchase of the stock and they are not currently stockholders to whom he owes a common law fiduciary duty), he must disclose the material non-public information to his counterpart. Unlike the common law “special facts” rule, which benefits only current stockholders who enter into face to face transactions with insiders, this duty extends to prospective stockholders purchasing in the market when the insider is selling. In this context at least, when the insider is buying or selling, there is a federal relationship of trust and confidence between the insider and his counterparts.¹²⁶ The Court reiterated the point in *O’Hagan*:

Under the “traditional” or “classical theory” of insider trading liability, § 10(b) and Rule 10b-5 are violated when a corporate insider trades in the securities of his corporation on the basis of material, nonpublic information. Trading on such information qualifies as a “deceptive device” under § 10(b), we have affirmed, because “a relationship of trust and confidence [exists] between the shareholders of a corporation and those insiders who have obtained confidential information by reason of their position with that corporation.” *Chiarella v. United States* . . . That relationship, we recognized, “gives rise to a duty to disclose [or to abstain from trading]”¹²⁷

Such a duty was urged by the government in *Schiff*, a case not involving insider trading. Such a duty, had it existed, would have been

¹²⁴ *Id.* at 228.

¹²⁵ SEC v. Texas Gulf Sulfur Co., 401 F.2d 833, 848 (2d Cir. 1968) (*en banc*). Of course, the disclosure cannot be made in most cases; the trader has no authority to do so, and must abstain.

¹²⁶ If our hypothetical CFO were himself trading at the time of the analyst call, then he is an insider trader and the case against him becomes simple.

¹²⁷ *O’Hagan*, 521 U.S. at 651–52.

consistent with the special responsibility of the CFO of a publicly traded corporation, as discussed above. Unfortunately, and contrary to the government's contention in *Schiff* that high corporate officers "have a fiduciary duty to shareholders under both federal and Delaware law that can give rise to a duty of disclosure,"¹²⁸ corporate officers have been found to owe a duty of candor to public stockholders and to the stock market as a whole, only in insider trading cases. This is consistent with the usual corporate model of up-the-chain reporting of wrongdoing, as expressed in § 8.42(b) of the MBCA. The officer speaks to the board, and the board to the stockholders.

We must turn then to the second question, which is more difficult to answer. If our hypothetical CFO's silence were in breach of his fiduciary duty to disclose owed to the board, might that silence also constitute a breach of § 10(b) and Rule 10b-5 if it is "in connection with" the purchase and sale of the corporation's stock? That argument was not made, and the Third Circuit did not address it, in *Schiff*. Probably that court would have rejected the argument, given the court's narrow view of the duty to disclose in Rule 10b-5 cases. The *Schiff* court held that that a duty to disclose under Rule 10b-5 may arise in three circumstances, the first being "when there is . . . insider trading. . . ."¹²⁹ (The other two circumstances involve a statute requiring disclosure and the duty to correct one's own misstatement, and have no bearing on our hypothetical case or the facts in *Schiff*.) The Third Circuit was not willing to consider other instances of wrongful fiduciary silence as violations.

Other courts have and have found that silence can violate § 10(b) and Rule 10b-5 even where insider trading is not alleged. The wrongful silence rule traces back to a case that did not involve insider trading. The defendant stock buyers in *Affiliated Ute Citizens of Utah v. United States* had no special knowledge about the affairs of the issuer, yet their silence violated § 10(b) and Rule 10b-5.¹³⁰

¹²⁸ Reply Brief for Appellant, the United States of America, *United States v. Schiff*, 602 F.3d 152 (3d Cir. 2010). Nos. 08-1909, 08-1903, at 14 (Mar. 31, 2009).

¹²⁹ *Schiff*, 602 F.3d at 162.

¹³⁰ *Affiliated Ute Citizens of Utah* is one of its foundations of insider trading law, cited by the Court in *Chiarella* in support of the proposition that "silence in connection with the purchase or sale of securities may operate as a fraud actionable under § 10(b)." *Chiarella*, 445 U.S. at 230.

Pursuant to federal statute, the Ute Distribution Corp. (“UDC”) held the natural resources belonging to the mixed blood members of an Indian tribe. UDC appointed First Security Bank of Utah to be UDC’s stock transfer agent, the bank to hold the stock certificates and issue receipts to the mixed blood shareholders. UDC’s board advised the bank “to discourage the sale of stock of the Ute Distribution Corporation by any of its stockholders and to emphasize and stress to the said stockholders the importance of retaining said stock.”

In fact, there was a small shares market, effectively controlled by the bank. Gale and Haslem were assistant managers at the bank’s branch office in Roosevelt, Utah, where many mixed bloods lived. They actively promoted a market for the UDC stock among whites.

Some members sold their UDC shares to nonmembers, including Gale and Haslem. The mixed-blood sellers considered the two to be familiar with the market for the shares, and relied upon them when they desired to sell their shares. The complaint alleged that the two devised a scheme to acquire shares in UDC for themselves and others for less than fair value.

The Court concluded that, in the circumstances, the two should have disclosed to the sellers material facts that reasonably could have been expected to influence their decision to sell, including that UDC shares were selling for a higher price in the non-Indian market. Notably, the Court indicated that the defendants might be liable under Rule 10b-5(a) or 10b-5(c) even if they had not made any untrue statements as required by Rule 10b-5(b):

[T]he Court of Appeals erred when it held that there was no violation of the Rule unless the record disclosed evidence of reliance on material fact misrepresentations by Gale and Haslem. We do not read Rule 10b-5 so restrictively. To be sure, the second subparagraph of the rule specifies the making of an untrue statement of a material fact and the omission to state a material fact. The first and third subparagraphs are not so restricted. These defendants’ activities, outlined above, disclose, within the very language of one or the other of those sub-paragraphs, a “course of business” or a “device, scheme, or artifice” that operated as a fraud upon the Indian sellers.¹³¹

¹³¹ *Affiliated Ute*, 406 U.S. at 152–53 (internal citation omitted).

The Court explained, as well, that the materiality of the omitted fact establishes the causal connection between the defendant's silence and the harm suffered.

Under the circumstances of this case, involving primarily a failure to disclose, positive proof of reliance is not a prerequisite to recovery. All that is necessary is that the facts withheld be material in the sense that a reasonable investor might have considered them important in the making of this decision. This obligation to disclose, and this withholding of a material fact, establish the requisite element of causation in fact.¹³²

Applying the teaching of *Affiliated Ute*, The Second, Ninth and Tenth Circuits have applied Rule 10b-5 to fiduciary silence cases that did not involve insider trading.

SEC v. Cochran¹³³

Cochran was Executive Vice President of a municipal bond underwriting firm called Stifel. He advised governmental agencies regarding their issuance of bonds and the interim reinvestment of the proceeds. Cochran acted not merely as an underwriter but also as the agencies' advisor and agent during the reinvestment phase. In one transaction, he solicited bids for a certain forward transaction and selected Sakura Global Capital, Inc. as the winning bidder. There was evidence that Sakura's success was a foregone conclusion because Cochran rigged the bidding. Undisclosed to the client, the Oklahoma Turnpike Authority, Sakura paid Stifel \$6.593 million in relation to the transaction.

Citing *Chiarella*, the *Cochran* court wrote that "[a] failure to disclose is actionable as fraud under § 10(b) of the Securities Exchange Act of 1934 only if one party has information 'that the other party is entitled to know because of a fiduciary or other similar relation of trust and confidence between them.'"¹³⁴ As there was some evidence that Cochran had a fiduciary relationship with the OTA, the district court's grant of summary judgment was reversed.

¹³² *Id.* at 153–54 (internal citations omitted).

¹³³ SEC v. Cochran, 214 F.3d 1261 (10th Cir. 2000).

¹³⁴ *Id.* at 1264.

SEC v. DiBella¹³⁵

The Connecticut State Treasurer, who managed the Connecticut Retirement and Trust Funds, failed to disclose to his overseer, the Investment Advisory Council, that in connection with his investment of \$75 million in Fund money with a firm called Thayer, a bogus “finder fee” of \$374,500 was paid by Thayer to an associate of the State Treasurer. The State Treasurer was a fiduciary of the Fund; he should have disclosed “material omissions at least to the IAC.”¹³⁶ The court held that the failure of a fiduciary to disclose such material information constituted a violation of Rule 10b-5.¹³⁷ The court did not specify which subsection of the Rule applied.

United States v. Laurienti¹³⁸

Senior brokers of a securities broker-dealer firm engaged in a “pump and dump” scheme and, to that end, were paid massive commissions by the firm if a client purchased a targeted house stock. The bonus commissions were not disclosed to the clients. The court discussed *Chiarella*, concluding that “a party has a duty to disclose material ‘inside information’ to another party only if there is a fiduciary or other similar relationship of trust and confidence between the parties. . . .”¹³⁹ “Although *Chiarella* concerned the use of ‘inside information,’ the foundation for the Supreme Court’s rule was . . . the rule that persons in trust relationships have greater duties to each other than do persons involved in arms-length transactions.” The court could think of no reason “why the general *Chiarella* rule should not apply here.”¹⁴⁰

The court also suggested that subsections (a) and (c) of Rule 10b-5 apply when the defendant makes no statements; subsection (b) applies when the defendant makes a material misstatement or a material half-truth.¹⁴¹

¹³⁵ SEC v. DiBella, 587 F.3d 553 (2d Cir. 2009).

¹³⁶ *Id.* at 565.

¹³⁷ *Id.* at 566.

¹³⁸ 611 F.3d 530 (9th Cir. 2010).

¹³⁹ *Id.* at 539.

¹⁴⁰ *Id.* at 540.

¹⁴¹ *Id.* at 541.

This observation is consistent with the Supreme Court's opinion in *Affiliated Ute*, and its relevance will become clear when we consider the Supreme Court's decision in *Janus Capital Group v. First Deriv. Traders*,¹⁴² below. A fourth case, *United States v. Wolfson*,¹⁴³ is on all fours with *Laurienti*.

As the foregoing cases indicate, true to *Affiliated Ute*, the courts of appeal for the Second, Ninth and Tenth Circuits have held in cases not involving insider trading that a fiduciary's wrongful silence violates Rule 10b-5.

A fifth case, from the First Circuit, involved facts similar to those in our hypothetical. In *SEC v. Papa*,¹⁴⁴ the SEC argued that senior executives of a fiduciary trust company owed a duty to tell the client that the fiduciary trust company had mismanaged the client's assets and then engaged in a cover-up. Their wrongful silence allegedly violated Rule 10b-5. Putnam Fiduciary Trust Co. ("PFTC"), an administrator of employee defined contribution plans, was responsible for investing the client's assets. It waited a day longer to do so than it should have. PFTC did not make the investments until January 3, 2001, causing the client's plan to miss a sharp upswing in the markets. Had the same funds been invested on January 2, the value of the holdings of the plan would have been almost \$4 million greater.

Six officers of PFTC met on January 5, 2001. They agreed to conceal the error by using "as-of" transactions—backdated purchases that used the price from an earlier day rather than the price current on the date the transaction occurred. Such as-of trades can dilute the value of other shares in a mutual fund. The as-of transactions generated about \$3 million for the client's plan at the expense of the other mutual fund shareholders. The remaining one million in losses went uncompensated.

The court of appeals was concerned with only three of the six officers. It was not concerned with the most senior officer of the six, described as "the highest ranking executive of PFTC," who gave the order to execute the scheme, nor with two others who carried out the pertinent transactions. However, the district court had dismissed the SEC's complaint against the

¹⁴² 131 S. Ct. 2296 (2011).

¹⁴³ 642 F.3d 293 (2d Cir. 2011).

¹⁴⁴ 555 F.3d 31 (1st Cir. 2009).

three others: one a senior officer who reported to the highest ranking executive; the other two, unit heads (“the three”).

The three were present when the scheme was proposed and agreed to on January 5, 2001. One and two years later, in January 2002, and February 2003, they had signed letters stating that they were unaware of any frauds or illegal acts, despite knowing that the as-of transactions and accounting adjustments had occurred and not been disclosed.¹⁴⁵

The SEC made no claim based directly on the three officers’ agreement at the January 5, 2001, meeting. The court of appeals remarked “Where a wrongful act is proposed, there is some precedent for treating as aiding and abetting a bystander’s assurance that no repercussions will follow.”¹⁴⁶ Nonetheless, the SEC did not make this argument, and the court of appeals expressly did not consider it. Nor was PFTC named as a defendant in the SEC’s Complaint.

Instead, the SEC’s complaint alleged that PFTC and the six individual defendants failed to disclose to the client: (a) the one-day delay in investing its assets; (b) that the client was only partially compensated for the missed opportunity arising from the delay; and (c) that the client was partially compensated at the expense of Putnam mutual funds in violation of PFTC policy.¹⁴⁷

In the district court, the SEC contended that PFTC had fiduciary duties to the client arising out of its status as agent for the client and as trustee of a trust consisting of the assets that the client transferred to it.¹⁴⁸ These duties required PFTC to disclose the truth to the client. The SEC also contended that all six individuals breached a duty to disclose the truth to the client, and that their silence violated Rule 10b-5. In its trial brief, the SEC argued:

[B]ecause each defendant was an employee—and most, senior executives—of PFTC, each defendant shared in PFTC’s duties with respect to the [client], including duties of disclosure of material facts. . . . A failure to disclose is actionable under the antifraud provisions if “one party has information that the

¹⁴⁵ As part of an audit of internal controls for the years 2001 and 2002, certain senior managers were required to sign statements that they were “unaware of any uncorrected errors, frauds or illegal acts attributable to” PFTC that had affected its clients. *Id.* at 34.

¹⁴⁶ *Id.* at 38.

¹⁴⁷ Complaint at 1–2, 12, 14, 17, *SEC v. Papa*, 2005 WL 3776465 (D. Mass. 2005) (No. 05 CA 12618 NMG).

¹⁴⁸ *Id.* at 7–8.

other [party] is entitled to know because of a fiduciary or other similar relationship of trust and confidence between them.” . . . “Because the Complaint alleges that none of the defendants disclosed the truth to the [client] . . . the Complaint states a claim for an actionable omission in light of the defendants’ duties under state law.”¹⁴⁹

Although the First Circuit does recognize that “[a] breach of fiduciary duty can sometimes be central to a § 10(b) violation”¹⁵⁰ the district court dismissed the claims against the three violators since they had not ordered or executed any of the wrongful transactions.¹⁵¹

On appeal, however, the SEC abandoned this theory of primary liability, and instead argued that the three “aided and abetted PFTC’s uncharged primary violations of § 10(b) as implemented by Rule 10b-5, by signing the 2002 and 2003 audit letters.”¹⁵² This was probably a sensible concession in the circumstances. Why should a unit head be expected to circumvent whatever internal up the chain reporting mechanisms may be in place, and speak directly to the client? Clearly, the surer duty was the fiduciary trust company’s duty to be honest with its client.

The SEC’s argument in the district court is intriguing because it would support the duty of our hypothetical CFO to disclose the truth to the stockholders. The theory was rejected by the district court and was not argued on appeal to the First Circuit. *Papa* is of interest not because of what it holds but because, like *Schiff*, the government sought to hold accountable silent witnesses to fraud. In both cases the silence was claimed to be wrongful because it was in breach of a duty to disclose the truth to the victim of the fraud—the client in *Papa*, the stockholders in *Schiff*. The basis of the duty urged by the government in *Schiff* was unclear; possibly it was

¹⁴⁹ Securities and Exchange Commission’s Memorandum of Law in Opposition to All Defendants’ Motions to Dismiss at 12, *SEC v. Durgarian*, No. 105 CV 12618 (D. Mass. 2005) (citing *Rayden Engineering Corp. v. Church*, 337 Mass. 652, 660–61 (1958)) (regular employees of an agent are sub-agents and have a similar duty to the principal); see also *Spritz v. Brockton Sav. Bank*, 305 Mass. 170, 172 (1940) (in light of this duty, “[t]he principal has a right to be informed of all material facts known to the agent in reference to the transaction in which he is acting for his principal, and good faith requires a disclosure of such facts by the agent”); *SEC v. Cochran*, 214 F.3d 1261, 1265 (10th Cir. 2000) (quoting *Chiarella v. United States*, 445 U.S. 222, 228 (1980)) (a duty to disclose may be present if some authority, such as a federal statute, state statute, or common law recognizes a fiduciary or similar relationship of trust and confidence giving rise to such).

¹⁵⁰ *Papa*, 555 F.3d at 37.

¹⁵¹ *Id.* at 34.

¹⁵² *Id.* at 35. This aspect of the case is discussed *infra*, at Part VI.

the same duty articulated by the SEC in *Cady Roberts* and the Supreme Court in *Chiarella*. The claimed duty in *Papa* was also problematic, being derivative of PFTC's fiduciary duty to its client, and abandoned on appeal.¹⁵³ In neither case was the theory suggested herein argued.

A Nevada district court recognized a CFO's duty to speak in *In re Agribiotech*,¹⁵⁴ our sixth case. A company's CEO made misrepresentations about the company's finances during a meeting with creditors. Also present at the meeting were the company's CFO and its general counsel. They were alleged to have known that the CEO's statements were false, but remained silent. The district court held that creditors' complaint stated a cause of action under Nevada law against the general counsel and CFO for their negligent failure to disclose.

The court cited *Restatement (Second) of Torts* § 551(2) (1977), which imposes a duty of reasonable care to disclose facts to one's counterpart in a "business transaction" if, among other things, there is a "fiduciary or other similar relation of trust and confidence between them" § 551(2)(a) (the court found in an unpublished order that the creditors had "placed confidence" in the two¹⁵⁵), or if he knows the other party is about to enter into the transaction under a mistake as to the basic facts, and, "because of the relationship between them, the customs of the trade or other objective circumstances," the other party reasonably would expect the alleged tortfeasor to disclose those facts § 551(2)(e).¹⁵⁶ The latter rule is the so called "termite house" rule. "A sells to B a dwelling house, without disclosing to B the fact that the house is riddled with termites. This is a fact basic to the transaction."¹⁵⁷ As explained in *FDIC v. WR Grace*, "when the seller has without substantial investment on his part come upon material information which the buyer would find either impossible or very costly to

¹⁵³ Note that a Delaware corporation owes no fiduciary duty to its stockholders. *Arnold v. Soc'y for Sav. Bancorp, Inc.*, 678 A.2d 533, 539 (Del. 1996).

¹⁵⁴ 291 F. Supp. 2d 1186 (D. Nev. 2003) (denying defendants' motion to dismiss complaint).

¹⁵⁵ *Id.* at 1192. The factual basis for this finding is not stated in the published opinion. It seems unusual that experienced businessmen would not understand that their counterpart's employees stand at arm's length.

¹⁵⁶ *Id.* at 1193.

¹⁵⁷ RESTATEMENT (SECOND) OF TORTS § 551 illus. 3.

discover himself, then the seller must disclose it—for example, must disclose that the house he is trying to sell is infested with termites.¹⁵⁸

Might this duty provide an alternative to a fiduciary's duty to speak, for Rule 10b-5 purposes? The termite house rule does not apply with equal force to our hypothetical CFO. It applies only to parties to a "business transaction." There is virtually no authority applying it to a Rule 10b-5 claim.¹⁵⁹ It is a fuzzy rule without clear limits, as the drafters of the *Restatement* acknowledged: "It is extremely difficult to be specific as to the factors that give rise to this known, and reasonable, expectation of disclosure."¹⁶⁰ This would be especially true if there were no face-to-face transaction involving our CFO, who might have only a general idea what the multitude of public stockholders expect in the aggregate and no idea what any particular stockholder might expect at any moment. Given its potential breadth of application, such a rule, if used as the basis for a Rule 10b-5 duty to disclose, might in effect require an issuer to continually disclose all material information, converting the Exchange Act system of periodic disclosure to a real time system of continual disclosure.

It may seem odd to suggest that a breach of duty owed to the board is enough to invoke section 10(b), which is meant to protect the stockholders. We conclude this section by coming full circle, back to *United States v. O'Hagan*, which solves the apparent conundrum. The Court explained that wrongful silence is also the foundation of the "misappropriation" type of insider trading.¹⁶¹

The "misappropriation theory" holds that a person commits fraud "in connection with" a securities transaction, and thereby violates § 10(b) and Rule 10b-5, when he misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information. Under this theory, a fiduciary's undisclosed, self-serving use of a principal's information to purchase or sell securities, in breach of a duty of loyalty and confidentiality, defrauds the

¹⁵⁸ 877 F.2d 614, 619 (7th Cir. 1989).

¹⁵⁹ *In re J.P. Jeanneret Associates, Inc.*, 769 F. Supp. 2d 340, 372 n.12 (S.D.N.Y. 2011) (rejecting the application of the common law rule in a Rule 10b-5 suit). A pair of older cases allowed such claims. See *Ram Investment Assoc. v. Citizens Fidelity Bank*, 1992 U.S. Dist. Lexis 13695; *OnBank & Trust Co. v. F.D.I.C.*, 967 F. Supp. 81 (W.D.N.Y. 1997).

¹⁶⁰ RESTATEMENT (SECOND) OF TORTS § 551 cmt. l.

¹⁶¹ Since insider trading law is not the focus of this article, we do not discuss other aspects of insider trading, such as tipper-tippee liability, Rules 10b-5-1,-2,-3, Regulation FD, or section 16(b) short swing trading.

principal of the exclusive use of that information. In lieu of premising liability on a fiduciary relationship between company insider and purchaser or seller of the company's stock, the misappropriation theory premises liability on a fiduciary-turned-trader's deception of those who entrusted him with access to confidential information.¹⁶²

Section 10(b) proscribes the use of any deceptive device in connection with the purchase or sale of any security, and the misappropriation theory fits the statute. The deception is in keeping the scheme secret from the entruster of the information.¹⁶³ "Because the deception essential to the misappropriation theory involves feigning fidelity to the source of information, if the fiduciary discloses to the source that he plans to trade on the nonpublic information, there is no 'deceptive device' and thus no § 10(b) violation—although the fiduciary-turned-trader may remain liable under state law for breach of a duty of loyalty."¹⁶⁴

The breach in a misappropriation case is of a duty owed to the source of the information. The other party to the trade, in contrast, has not been defrauded. Fraud against party *A* may nonetheless be in connection with the purchase and sale of securities carried out with party *B*

because the fiduciary's fraud is consummated, not when the fiduciary gains the confidential information, but when, without disclosure to his principal, he uses the information to purchase or sell securities. The securities transaction and the breach of duty thus coincide. This is so even though the person or entity defrauded is not the other party to the trade, but is, instead, the source of the nonpublic information.¹⁶⁵

Conclusion

Our examination of relevant case law leads to the conclusion that an officer's breach of his fiduciary duty to disclose material facts to the board may constitute a violation of § 10(b) and Rule 10b-5. We found that

¹⁶² *O'Hagan*, 521 U.S. at 652 (internal citation and quotation marks omitted).

¹⁶³ Section 10(b) requires that a defendant act deceptively. Deceptive acts include omissions by those with a duty to disclose. *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148, 158 (2008).

¹⁶⁴ *O'Hagan*, 521 U.S. at 655. While notification to the source of the information will not automatically protect innocent investors, how many schemers will be this bold, and how many sources will fail to react coolly to an invitation to join a conspiracy?

¹⁶⁵ *Id.* at 656.

silence, in breach of fiduciary duty can violate § 10(b) and Rule 10b-5, even where insider trading is not alleged. Where an officer has breached his fiduciary duty to the board by remaining silent, he may violate subsections (a) and (c) of Rule 10b-5 even if silence does not violate Rule 10b-5(b). However, for any such violation to exist, the officer's silence must still be "in connection with" the purchase and sale of securities.

Our hypothetical CFO's fraud is consummated . . . when? His silence is meant to affect the market price of the corporation's stock, just as a material misstatement about the corporation's finances, and it is as much in connection with market sales and purchases of the corporation's stock as a misstatement. This point is developed below.

Our CFO violated a fiduciary duty of candor to the board. As more fully developed in the next part, although he did not engage in trading activity himself, the CFO's fraud upon the board is nonetheless "in connection with" the purchase and sale by others of the corporation's stock in the stock market and thus violated § 10(b) and Rule 10b-5.

PART V: IN CONNECTION WITH

The language of § 10(b) requires that the deception be in connection with the purchase or sale of any security.¹⁶⁶ The courts have broadly interpreted this requirement.

In *Superintendent of Ins. v. Bankers Life & Cas. Co.*,¹⁶⁷ the defendants had persuaded the board of directors of the victim corporation, Manhattan, to sell its United States Treasury bonds, based on the misrepresentation that the sale proceeds would be exchanged for a certificate of deposit of equal value.¹⁶⁸ In fact, the defendants misappropriated the proceeds. The defendants argued that, because the victim of the fraud was Manhattan's board, not the purchasers of the bonds, and because the trading process remained "unsullied," the misrepresentation was not "in connection with" a sale of securities as required by § 10(b) and Rule 10b-5.¹⁶⁹ The Court

¹⁶⁶ See generally Thomas J. Molony, *Making a Solid Connection: A New Look at Rule 10b-5's Transactional Nexus Requirement*, 53 SANTA CLARA L. REV. 767 (2013).

¹⁶⁷ *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6 (1971).

¹⁶⁸ *Id.* at 8 n.1.

¹⁶⁹ *Id.* at 10.

disagreed, noting that, “[t]he crux of the present case is that Manhattan suffered an injury as a result of deceptive practices *touching* its sale of securities as an investor.”¹⁷⁰

In *United States v. O’Hagan*, the Court held that a defendant committed fraud in connection with a securities transaction when he used misappropriated confidential information for trading purposes.¹⁷¹ The Court reasoned that “the fiduciary’s fraud is *consummated*, not when the fiduciary gains the confidential information, but when, without disclosure to his principal, he uses the information to purchase or sell securities.”¹⁷² Accordingly, “[t]he securities transaction and the breach of duty thus coincide,” and “[t]his is so even though the person or entity defrauded is not the other party to the trade, but is, instead, the source of the nonpublic information.”¹⁷³

In *SEC v. Zandford*, the Woods granted Zandford, a broker, discretion to manage their account and a power of attorney to engage in securities transactions for their benefit without prior approval.¹⁷⁴ Relying upon Zandford’s promise to conservatively invest their money, the Woods entrusted him with more than \$400,000, all of which Zandford misappropriated. Zandford had sold securities in the Woods’ account and then made personal use of the proceeds. Each sale was deceptive because it was neither authorized by, nor disclosed to, the Woods. The fraud was upon them, not upon the purchasers of the securities. The Supreme Court held that Zandford’s deceptive conduct was nonetheless, “in connection with the purchase or sale of any security” within the meaning of § 10(b) and Rule 10b-5, because the securities sales and Zandford’s fraudulent practices “were not independent events.”¹⁷⁵ The securities transactions and the breaches of fiduciary duty *coincided*.¹⁷⁶

It might be objected that these three cases are inapplicable since, unlike those defendants; our hypothetical CFO did not buy or sell stock.

¹⁷⁰ *Id.* at 12–13 (emphasis added).

¹⁷¹ *United States v. O’Hagan*, 521 U.S. 642 (1997).

¹⁷² *Id.* at 656 (emphasis added).

¹⁷³ *Id.*

¹⁷⁴ *SEC v. Zandford*, 535 U.S. 813 (2002).

¹⁷⁵ *Id.* at 819–20.

¹⁷⁶ *Id.* at 820.

The objection would be incorrect. In *SEC v. Texas Gulf Sulphur*,¹⁷⁷ the court held that Congress, in using the phrase “in connection with,” “intended only that the device employed, whatever it might be, be of a sort that would cause reasonable investors to rely thereon, and, in connection therewith, so relying, cause them to purchase or sell a corporation’s securities.”¹⁷⁸ The court went on to say that “[t]here is no indication that Congress intended that the corporations or persons responsible for the issuance of a misleading statement would not violate the section unless they engaged in related securities transactions. . . .”¹⁷⁹

To touch, to coincide, consummation, the courts’ metaphors are imprecise. In a 2009 opinion, the Fourth Circuit articulated “several factors” to be considered, which

include, but are not limited to: (1) whether a securities sale was necessary to the completion of the fraudulent scheme, (2) whether the parties’ relationship was such that it would necessarily involve trading in securities, (3) whether the defendant intended to induce a securities transaction, and (4) whether material misrepresentations were disseminated to the public in a medium upon which a reasonable investor would rely.¹⁸⁰

A court will presume investor reliance on omitted information if the information is material, *i.e.*, there is a substantial likelihood that a reasonable shareholder would consider it important to know.¹⁸¹ The materiality of the omission also satisfies the “in connection with” requirement. In *SEC v. Texas Gulf Sulphur Co.*,¹⁸² the Second Circuit held that “Rule 10b-5 is violated whenever assertions are made . . . in a manner reasonably calculated to influence the investing public” Subsequent decisions have refined *Texas Gulf Sulphur Co.*, and several circuits now agree that:

¹⁷⁷ *SEC v. Tex. Gulf Sulphur*, 401 F.2d 833 (2d Cir. 1968) (*en banc*).

¹⁷⁸ *Id.* at 860.

¹⁷⁹ *Id.*, quoted with approval in *Steiner v. Ames Dep’t Stores, Inc.*, 991 F.2d 953, 965 (2d Cir. 1993).

¹⁸⁰ *United States SEC v. Pirate Investor LLC*, 580 F.3d 233, 244 (4th Cir. 2009) (internal quotations and citations omitted).

¹⁸¹ *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 153–54 (1971); *TSC Indus. v. Northway*, 426 U.S. 438, 499 (1976).

¹⁸² 401 F.2d at 862.

Where the fraud alleged involves public dissemination in a document such as a press release, annual report, investment prospectus or other such document on which an investor would presumably rely, the “in connection with” requirement is generally met by proof of the means of dissemination and the materiality of the misrepresentation or omission.¹⁸³

Conclusion

Our CFO intended by his silence to allow a colleague to disseminate materially false information in a public forum, to securities analysts and thence to the market as a whole. The channel stuffing scheme could succeed only if the market overvalued the corporation and its stock. A share of its stock, however, has only such price as a buyer actually promises to pay in an actual securities transaction. Market trading of the corporation’s securities was thus necessary to the completion of the channel stuffing scheme. The CFO’s silence directly and immediately affected the price of the corporation’s publicly traded stock.

Since our hypothetical CFO remained silent in order to affect the market price of the corporation’s stock, his failure to inform the board is “in connection with” the purchase and sales of the corporation’s securities and constitutes a violation of Rule 10b-5. He is, therefore, a primary violator of § 10(b) and Rule 10b-5.

PART VI: SECONDARY LIABILITY

Unlike an injured private investor, both the Department of Justice and the SEC may enforce Rule 10b-5 violations against aiders and abettors, as well as primary violators.¹⁸⁴ Having determined that our hypothetical CFO is subject to criminal liability as a primary violator of § 10(b) and Rule 10b-5, we now ask whether our CFO’s silence might make him secondarily liable for having aided and abetted the false statement fraud of his colleague (*see* subsection A, below), or perhaps as a control person (*see* subsection C,

¹⁸³ *Pirate Investor LLC*, 580 F.3d at 249 (internal citations omitted).

¹⁸⁴ Private party claims may not be brought against aiders and abettors. *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994); *Stoneridge Inv. Partners LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148 (2008).

below). Subsection B deals with a question about primary liability, raised by a case discussed in subsection A.

A. Secondary Liability for Aiding and Abetting

It is very unlikely that our CFO will be criminally liable for aiding and abetting. As developed in this subpart, mere silence is insufficient to satisfy the “assistance” element of aiding and abetting.

Aiding and abetting liability in criminal cases is governed by 18 U.S.C. § 2(a), “Whoever commits an offense against the United States or aids, abets, counsels, commands, induces or procures its commission, is punishable as a principal.”¹⁸⁵ Criminal aiding and abetting under 18 U.S.C. § 2, requires the defendant to have known of the crime, wanted it to succeed, and acted affirmatively to assist it. The mere presence of a defendant where a crime is being committed even coupled with knowledge by the defendant that a crime is being committed, or the mere acquiescence by a defendant in the criminal conduct of others even with guilty knowledge is not sufficient to establish aiding and abetting.¹⁸⁶

While the focus of this article is on criminal liability, we consider SEC civil enforcement to the extent that it shines additional light on the question whether silence can constitute assistance. SEC civil enforcement is governed by § 20(e) of the Exchange Act.¹⁸⁷

For purposes of any action brought by the Commission . . . any person that knowingly or recklessly provides substantial assistance to another person in violation of a provision of this chapter, or of any rule or regulation issued under this chapter, shall be deemed to be in violation of such provision to the same extent as the person to whom such assistance is provided.¹⁸⁸

In a civil enforcement action against an aider and abettor, the SEC must prove: “(1) the existence of a securities law violation by the primary (as opposed to the aiding and abetting) party; (2) knowledge of this violation

¹⁸⁵ See Baruch Weiss, *What Were They Thinking?: The Mental States of the Aider and Abettor and the Causer Under Federal Law*, 70 *FORDHAM L. REV.* 1341 (2002) (emphasizing the minimal *actus reus* requirement under the statute, and the different understandings of the *mens rea* element).

¹⁸⁶ *United States v. Sabhnani*, 599 F.3d 215, 239 (2d Cir. 2010).

¹⁸⁷ 15 U.S.C. § 78t(e) (2010).

¹⁸⁸ *Id.*

on the part of the aider and abettor; and (3) ‘substantial assistance’ by the aider and abettor in the achievement of the primary violation.”¹⁸⁹

It is unclear whether mere silence and inaction can constitute substantial assistance. “The question how far mere inaction . . . can fulfill the requirement of substantial assistance is unsettled.”¹⁹⁰ Some courts impose aiding and abetting liability for inaction if there existed an independent duty to disclose.¹⁹¹ If the defendant were under a duty to disclose, as our hypothetical CFO arguably is, then his silence might also make him liable as an aider and abettor, but such liability would be duplicative.

Other courts have taken the view that mere inaction can constitute substantial assistance even in the absence of an independent duty to disclose if but only if there was a “conscious intention” to forward the violation of Rule 10b-5.¹⁹²

This language can be traced back to *SEC v. Coffey*: “Inaction may be a form of assistance in certain cases, but only where it is shown that the silence of the accused aider and abettor was consciously intended to aid the securities law violation.”¹⁹³ Yet there appears to be no published case in which the court actually held someone liable on that basis.¹⁹⁴

Consider again *SEC v. Papa*.¹⁹⁵ Unlike our hypothetical case, in which the fraud is ongoing and fresh and might be nipped in the bud if disclosed, the wrong in *Papa* was stale—over and done with. The fraud had ended one

¹⁸⁹ *SEC v. Apuzzo*, 689 F.3d 204, 206 (2d Cir. 2012) (internal citations and quotation marks omitted).

¹⁹⁰ *ITT v. Cornfeld*, 619 F.2d 909, 925 (2d Cir. 1980) (finding no aiding and abetting liability).

¹⁹¹ *ITT v. Cornfeld*, 619 F.2d at 925; *Edwards & Hanly v. Wells Fargo Securities*, 602 F.2d 478, 484 (2d Cir. 1979) (dictum).

¹⁹² *ITT v. Cornfeld*, 619 F.2d at 926.

¹⁹³ 493 F.2d 1304, 1317 (6th Cir. 1974).

¹⁹⁴ Cases often cited for this proposition include *Brennan v. Midwestern United Life Insurance Co.*, 417 F.2d 147, 155 (7th Cir. 1969) (court expressly did not decide whether silence alone would give rise to aiding and abetting liability); *Woodward v. Metro Bank of Dallas*, 522 F.2d 84, 97 (5th Cir. 1975) (no aiding and abetting liability found); *SEC v. Coffey* (one aiding and abetting claim dismissed, another remanded for a new hearing); *Schneberger v. Wheeler*, 859 F.2d 1477, 1480 (11th Cir. 1988) (no aiding and abetting liability); *Moore v. Fenex, Inc.*, 809 F.2d 297, 303-04 (6th Cir. 1987) (no aiding and abetting liability); *Woods v. Barnett Bank*, 765 F.2d 1004, 1010 (11th Cir. 1985) (real assistance rendered); *Monsen v. Consolidated Dressed Beef Co.*, 579 F.2d 793, 800 (3d Cir. 1978) (defendant’s conduct aided the fraud); *Rochez Bros. v. Rhoades*, 527 F.2d 880, 889 (3d Cir. 1975) (no aiding and abetting liability found).

¹⁹⁵ *SEC v. Papa*, 555 F.3d 31 (1st Cir. 2009).

and two years before the three signed the letters. One cannot substantially assist, and therefore cannot aid and abet, a completed wrong. To that, the SEC argued that PFTC had an *ongoing* fiduciary duty to disclose the truth to its clients, and that the audit letters signed by the defendants had assisted the breach of *that* duty. Still, the court of appeals didn't bite. The false audit letters may constitute an obstruction of justice or some other wrong, but one who later denies knowledge of a fraudulent transaction and is otherwise not liable for it, does not become so unless the fraud is ongoing and assisted by the lie.¹⁹⁶

Moreover, since the greater includes the lesser, if signing a false certificate after the fact does not substantially assist a completed fraud, then mere silence cannot be substantial assistance either, and failing to disclose a completed fraud cannot make one an accomplice. The false "no" spoken by the other officer is the primary violation in our hypothetical case. Although the channel stuffing scheme was ongoing, the primary violation was complete when the analyst call ended and our silent CFO could not thereafter assist it.

In its brief in *Papa*, SEC argued that silence would be sufficient to meet the "substantial assistance" requirement: As noted by the First Circuit in *Tambone*, "[a] defendant's silence or inaction may satisfy the 'knowing and substantial assistance' standard if such silence or inaction was consciously intended to further the principle [sic] violation."¹⁹⁷

However, the SEC's quotation from *Tambone* is taken out of context.¹⁹⁸ As we discuss below, *Tambone* further supports the conclusion that mere silence cannot constitute aiding and abetting. The defendants in *Tambone* actually used false documents, written by others, in their sales activity.¹⁹⁹ Thus the *Tambone* court continued, "[h]aving reached this conclusion, we need not address, as the district court did, whether the defendants' *inaction* was accompanied by a 'conscious intent[] to further the principal violation.'²⁰⁰

¹⁹⁶ *Id.* at 37–38.

¹⁹⁷ *Tambone*, 550 F.3d at 144 (citing *Clery v. Perfectune*, 700 F.2d 774, 777 (1st Cir. 1983)).

¹⁹⁸ *Tambone*, 550 F.3d 106 (1st Cir. 2008), *vacated on other grounds*, SEC v. *Tambone*, 597 F.3d 436 (1st Cir. 2010).

¹⁹⁹ 550 F.3d at 145.

²⁰⁰ *Id.* at 146 n.48.

In *Tambone*, two senior executives of a broker-dealer that underwrote and marketed mutual funds gave their customers prospectuses—written by an affiliated company—that contained representations about the funds’ prohibition of a practice known as “market timing.” According to the pleadings, the two defendants approved arrangements allowing certain preferred customers to engage in market timing. Hence, the prospectuses contained a material misrepresentation.

The SEC seems also to have alleged an actionable omission, though it is not clearly described in the appellate opinions. The omission may have been the failure of the two executives to clarify or correct the misleading statement made by another person in the prospectuses.²⁰¹ The key language is in the opinion of the court *en banc*, reversing in part the judgment of the panel: there would be such a duty to speak only if the two stood in a fiduciary or other relationship to their clients.

The SEC brought a civil enforcement action, charging the two executives with, *inter alia*, primary violations of § 10(b) of the Exchange Act and § 17(a)(2) of the Securities Act, and aiding and abetting violations of both statutes by the involved corporate entities in violation of § 20(e) of the Exchange Act. Specifically, the SEC alleged that the defendants substantially assisted Columbia Advisors and Columbia Distributor in committing acts of primary liability under the securities laws. By overseeing the distribution of fund prospectuses which they knew (or were reckless in not knowing) were false, the defendants allegedly assisted these entities in making false statements.²⁰²

The district court dismissed the § 17(a)(2) claim and the § 10(b) claim (specifically, a Rule 10b-5(b) claim), because the defendants were not the “makers” of misleading statement. The aiding and abetting claim was also dismissed.

²⁰¹ The majority wrote, “. . . the district court rejected the Commission’s allegation that Tambone and Hussey owed a duty to the investors to whom they sold the funds. It wrote: ‘[A]n individual owes a duty to clarify a misleading statement only if that statement is attributable to the individual.’” *Id.* at 117–18. However, the dissent did not believe that the case presented an omission. “The SEC’s attempt in this case to employ Rule 10b-5(b) to punish such a breach impermissibly equates a passive omission—failing to correct a false statement made by another—with the affirmative misconduct that the language of the rule targets.” *Id.* at 153. And, “In this civil enforcement action, the SEC accuses the defendants of sins of commission, not sins of omission; that is, of making untrue statements of material fact.” *Id.* at 150.

²⁰² 550 F.3d at 116–17.

There were two appellate reviews, first by a panel of the First Circuit and later by the court *en banc*. According to the panel:²⁰³

- The § 17(a)(2) claims should not have been dismissed by the district Court. This survived *en banc* review. We pass over it, as inessential to our discussion.
- So too, the Rule 10b-5(b) claim should not have been dismissed. The panel adopted an “implied statement” theory to find that the defendants had made the misleading statements. This holding was reversed by the full court, and we will consider it shortly.
- The aiding and abetting claim was sufficiently pleaded and should not have been dismissed by the district court. This survived *en banc* review, and bears closer examination. The panel said three things:

The defendants’ *failure to correct* the misleading disclosures in the prospectuses, given their duties as underwriters, *as well as their use of those prospectuses to sell the funds* to investors, *substantially assisted Columbia Advisors* in its own violation.²⁰⁴

Defendants’ conduct in overseeing the distribution of the false prospectuses to potential investors *amounted to affirmative acts* in substantial assistance of the primary violations.²⁰⁵

Having reached this conclusion, we need not address, as the district court did, whether the defendants’ *inaction* was accompanied by a “conscious intent[] to further the principal violation.”²⁰⁶

May we conclude that if the two hadn’t used the prospectuses to sell the funds, there could be no aiding and abetting liability? The language isn’t entirely clear.

Anticipating the Supreme Court’s opinion in *Janus Capital Group v. First Deriv. Traders*,²⁰⁷ the First Circuit, *en banc*²⁰⁸ reversed one holding of

²⁰³ SEC v. Tambone, 550 F.3d 106 (1st Cir. 2008).

²⁰⁴ *Id.* at 145.

²⁰⁵ *Id.*

²⁰⁶ *Id.* at 146 (emphasis added).

²⁰⁷ *Janus Capital Grp., Inc. v. First Derivative Traders*, 131 S. Ct. 2296 (2011).

the panel, affirming the district court's dismissal of the Rule 10b-5(b) claim. Using is not making, and since the defendants did not "make" the statements at issue, they cannot be primary violators of Rule 10b-5(b). The *en banc* opinion was critical of the "implied representation" theory of liability adopted by the panel, equating it with a duty to disclose material information not included in a prospectus prepared by another. *Chiarella* and its progeny impose such a duty only where there is a fiduciary or other similar relationship between the parties. No such allegation seems to have been made.²⁰⁹ And here is the key point: If there were such a relationship, the breach would be a primary violation under 10b-5(b).²¹⁰ This statement is problematic for two reasons. It is at variance with *Affiliated Ute* and *Laurienti*, which suggest that fiduciary silence claims are covered by subsections (a) and (c), not (b), and because the *Janus* case, which we will shortly consider, suggests that pure silence cases may not be brought under subsection (b).

Nor does *Cleary*, also cited by in the SEC's brief in *Papa*, support the theory that mere silence or inaction can amount to aiding and abetting, even if consciously intended to help the primary wrongdoer.

Courts are not in agreement as to the standard to be applied to determine whether inaction, such as the failure of the defendants in this case to inform anyone that they were not directors at the time the Offering Memorandum was issued, can constitute knowing and substantial assistance of the primary violation. Several courts have suggested that absent an independent duty to act, inaction cannot constitute the assistance necessary to support the imposition of liability for aiding and abetting . . . ([I]naction can create aider and abettor liability only when there is a conscious or reckless violation of an independent duty to act.). Other courts have held that in the absence of an independent duty to act mere inaction will constitute substantial assistance only where there was a conscious intention to further the principal violation.

We need not determine which standard should be applied in this case because it is clear that the plaintiffs' affidavits fail to present sufficient evidence to raise as a genuine question whether the defendants consciously intended to

²⁰⁸ *Tambone*, 597 F.3d 436 (1st Cir. 2010).

²⁰⁹ Only those broker-dealers that exercise discretion or control over customer assets, or have a relationship of trust and confidence with their customers, are found to owe customers a fiduciary duty. *See, e.g.*, *United States v. Skelly*, 442 F.3d 94, 98 (2d Cir. 2006); *United States v. Szur*, 289 F.3d 200, 211 (2d Cir. 2002).

²¹⁰ *Tambone*, 597 F.3d at 448.

further McHugh's allegedly fraudulent scheme. *Brennan v. Midwestern United Life Insurance Co.* . . . does not dictate a contrary result. In *Brennan* the Seventh Circuit, upon finding that the defendant knew of the fraudulent activity and did not expose it in order to benefit itself, affirmed the imposition of liability as an aider and abettor for inaction combined with [defendant's] affirmative acts. . . . In this case, not only did plaintiffs fail to identify any affirmative acts for which defendants might be liable, they failed to produce any evidence from which it might be inferred that defendants' inaction was consciously intended to further McHugh's allegedly fraudulent activity. For these reasons, the district court's grant of summary judgment for defendants on the ground that they did not knowingly and substantially assist any primary violation was proper.²¹¹

Apply this to our hypothetical CFO. Plainly his colleague lied. The liar (and via *respondeat superior*, the corporation) will be liable as primary violators. It seems unlikely that the mere silence or inaction of the CFO will make him an aider and abettor. If our hypothetical CFO is to be criminally liable, it must be in conjunction with an independent duty to act, which would give rise to primary liability.²¹²

The foregoing establishes that mere silence about another's Rule 10b-5 violation does not make one an aider and abettor. Our CFO will be liable, if at all, as a primary violator.

*B. Primary Liability Reexamined—Janus Capital Group v. First Deriv. Traders*²¹³

Tambone's suggestion about the application of Rule 10b-5(b) makes *Janus* relevant to our inquiry. *Janus Capital Management* (“JCM”) served

²¹¹ *Cleary v. Perfecture*, 700 F.2d 774, 778–79 (1st Cir. 1983) (citing *Wessel v. Buhler*, 437 F.2d 279, 283 (9th Cir.1971)); *Landy v. Federal Deposit Insurance Corp.*, 486 F.2d at 161-62. *Cf.* *IIT v. Cornfeld*, 619 F.2d at 927; *Woodward v. Metro Bank of Dallas*, 522 F.2d at 96-97; *SEC v. Coffey*, 493 F.2d at 1317; *Brennan v. Midwestern United Life Insurance Co.*, 417 F.2d 147 (7th Cir. 1969) (internal quotation marks omitted).

²¹² *Aagaard*, *supra* note 80, at 1245, 1272–73 (In *Criminal Law: The General Part*, Glanville Williams noted the general rule that mere acquiescence cannot constitute aiding and abetting, and asserted that a corporate officer's acquiescence in the misconduct of the company's employees does not make him responsible for their illegal actions. However, he also argued that, “where a person has the right to control another, his inactivity may be taken as evidence of encouraging the conduct, making him guilty as abettor.” The cases on which Williams relied, primarily British, included owners of cars who knowingly allowed their drivers to drive dangerously and were found guilty of aiding and abetting dangerous driving, and masters who knowingly allowed servants to act illegally.).

²¹³ *Janus*, 131 S. Ct. at 2296.

as investment adviser and administrator to the Janus Investment Fund (“Fund”), a separate but affiliated legal entity. The Fund issued prospectuses. JCM participated in their writing and dissemination, but without attribution. The prospectuses allegedly misrepresented the market timing practices and policies of the Funds. Investors in JCM’s parent sued for damages. Rule 10b-5(b) states that it “is unlawful for any person, directly or indirectly, to make any untrue statement of a material fact.” The case turned on the meaning of the verb “to make.”

The Court held that JCM could not be held liable because it did not “make” the alleged misstatements in the prospectuses. Only the maker of the statement can be held liable in a private action under Rule 10b-5(b) for material misstatements, and even one who prepares a statement on behalf of another is not its maker.²¹⁴

... in the ordinary case, attribution within a statement or implicit from surrounding circumstances is strong evidence that a statement was made by—and only by—the party to whom it is attributed. This rule might best be exemplified by the relationship between a speechwriter and a speaker. Even when a speechwriter drafts a speech, the content is entirely within the control of the person who delivers it. And it is the speaker who takes credit—or blame—for what is ultimately said.²¹⁵

In our hypothetical case, it was the CFO’s colleague who spoke. *Janus* would limit liability to him alone if Rule 10b-5(b) applies. It should not, and *Tambone*’s suggestion that it does seems mistaken.

Subsections (a) and (c) address scheme liability. Subsection (a) proscribes schemes to defraud, while subsection (c) prohibits a course of business which operates as a fraud. There is authority for the view that pure fiduciary silence is governed by subsections (a) and (c), in contrast to misstatements and half-truths which are governed by subsection (b). The Supreme Court in *Affiliated Ute* held the promoters’ silence to violate subsections (a) and (c), and the Ninth Circuit in *United States v. Laurienti*, citing *Chiarella*, suggested that a fiduciary who had made no statements to anyone should be charged under subsections (a) and (c).²¹⁶ The Ninth Circuit’s reading of the Rule in *United States v. Laurienti* is faithful to the

²¹⁴ *Id.* at 2302.

²¹⁵ *Id.*

²¹⁶ *United States v. Laurienti*, 611 F.3d 530, 539–41 (9th Cir. 2010).

text of the Rule. Rule 10b-5(b) refers to misstatements and half-truths. It does not purport to cover pure silence cases. “Subsection (b) of Rule 10b-5 prohibits the telling of material lies and prohibits the telling of material half-truths, where the speaker ‘omit[s] 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.’”²¹⁷ Other court of appeals opinions which discuss the differences among the subsections of the rule are consistent with this understanding: the Eighth and Ninth Circuits rejected the application of subsections (a) and (c) in cases that involved half-truths, which were governed instead by subsection (b).²¹⁸

The point is not clear, however. Other authority suggests that the case against our silent CFO arises under subsection (b): Our CFO’s silence is deceptive only because of the corporation’s public misrepresentations about its finances, and therefore, the case really is one for misstatement under subsection (b).²¹⁹ If so, perhaps our silent CFO might be regarded as the maker of the misleading statement. By what strange magic might he be deemed the maker of the statement uttered by his colleague? “The maker of a statement” held the Court in *Janus*, “is the entity with authority over the content of the statement and whether and how to communicate it. Without such authority, it is not ‘necessary or inevitable’ that any falsehood will be contained in the statement.”²²⁰ It was the Janus Funds which had this authority, which is why the writer, JCM, was not the maker. Since the CFO is entrusted with control of the firm’s financial reporting and public disclosure, a plausible case can be made that our hypothetical CFO had ultimate authority regarding the statement made by his colleague. And yet the Court’s opinion in *Janus* turned on the plain meaning of the verb to make. “One ‘makes’ a statement by stating it.”²²¹ Though the appeal to the CFO’s authority is consistent with the language of the opinion, the

²¹⁷ *Id.* at 539.

²¹⁸ *Pub. Pension Fund Grp. v. KV Pharm. Co.*, 679 F.3d 972, 986–87 (8th Cir. 2012); *WPP Luxembourg Gamma Three Sarl v. Spot Runner, Inc.*, 655 F.3d 1039, 1057–58 (9th Cir. 2011) (There was no allegation of fiduciary silence in either case.).

²¹⁹ *SEC v. Kelly*, 817 F. Supp. 2d 340, 344 (S.D.N.Y. 2011); *SEC v. Sells*, 2012 U.S. Dist. LEXIS 112450, at *8 (N.D. Cal. 2012); *In re Smith Barney Transfer Agent Litig.*, 884 F. Supp. 2d 152, 161 (S.D.N.Y. 2012).

²²⁰ *Janus*, 131 S.Ct. at 2303.

²²¹ *Id.* at 2302.

argument it is wholly inconsistent with the plain meaning of the word “makes.” While it may make sense to find that one person has ultimate authority over written statements issued in the name of the corporation, such as pres releases,²²² it makes little sense to say that person has authority over the spontaneous verbal utterances of another.

In sum, *Janus* held that subsection (b) applies only to the maker of a statement and would preclude a case against our silent CFO. Yet *Tambone* correctly anticipated the logic and holding of *Janus*, and First Circuit *en banc* suggested that our silent CFO violated Rule 10b-5(b). On the other hand, *Affiliated Ute* and *Laurienti* suggest that the case against our CFO is governed by subsection (a) or (c). If that is correct, *Janus* presents no obstacle to the primary liability of our CFO.

C. Control Person Liability

The reference in *Janus* to the authority and control of a defendant to make a statement suggests two other possible bases for secondary liability. The federal criminal aiding and abetting statute provides for the liability of a mastermind who uses an innocent dupe to carry out the crime.²²³ If our CFO had instructed his colleague to lie, the CFO would be liable just as though he had made the false statement. This additional element connotes action. It takes the case beyond the realm of pure silence, the subject of this exploration, and we do not pursue the line of thought.

The authority and control of the CFO over the corporation’s financial disclosure also suggests the possibility of “control person” liability. § 20(a) of the Exchange Act provides,

Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable (including to the Commission . . .), unless the controlling person acted in good faith and did not

²²² *In re Pfizer Inc. Securities Litigation*, 936 F. Supp. 2d 252 (S.D.N.Y. 2013).

²²³ 18 U.S.C. § 2(b) (2013) (stating, “Whoever willfully causes an act to be done which if directly performed by him or another would be an offense against the United States, is punishable as a principal”).

directly or indirectly induce the act or acts constituting the violation or cause of action.²²⁴

A *prima facie* case requires proof of at least two elements: (1) that a primary securities law violation was committed by another, and (2) that the executive charged with control person liability had control over the primary violator.²²⁵

As against our hypothetical CFO, the primary violation would be his colleague's material misstatement. The CFO's control can be established by any "indirect means of discipline or influence short of actual direction,"²²⁶ or an "ability to exert influence, directly or indirectly, over the decision making process of another,"²²⁷ or "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."²²⁸ This would not seem difficult to establish, given the dominant role played by the CFO with respect to the corporation's finances.²²⁹

While intriguing, the likelihood of criminal control person liability seems remote. One writer concludes that "[a] criminal charge under § 20(a), while a theoretical possibility, is extremely unlikely and has not been previously brought."²³⁰ The statute has no mens rea requirement.

In contrast, a civil enforcement action by the SEC is a realistic possibility.²³¹ The elements of a *prima facie* case vary from circuit to

²²⁴ 15 U.S.C. § 78t(a) (2013).

²²⁵ Brianna L. Gates, *The SEC on a Forum Shopping Spree: SEC Enforcement Power and Control Person Liability After Dodd-Frank*, 99 IOWA L. REV. 393, 396 (2013); *In re Nat'l Century Fin. Enter., Inc.*, Inv. Litig., 504 F. Supp. 2d 287, 301 (S.D. Ohio 2007) (The law is "unsettled" as to whether a control person must have actually exercised his capacity to control.).

²²⁶ *Sennott v. Rodman & Renshaw*, 414 U.S. 926, 929 (1973).

²²⁷ KEVIN F. O'MALLEY ET AL., FEDERAL JURY PRACTICE AND INSTRUCTIONS: CIVIL § 162.222 (6th ed. 2012).

²²⁸ *SEC v. First Jersey, Inc.*, 101 F.3d 1450, 1473 (2d Cir. 1996).

²²⁹ See *In re Digi Int'l, Inc. Sec. Litig.*, 6 F. Supp. 2d 1089, 1101 (D. Minn. 1998) (complaint adequately alleged that defendant Wall, the Chief Financial Officer and Vice President of Digi, had the requisite authority and knowledge to be liable under section 20(a)).

²³⁰ Adam Felsenthal, *The Blindsided Insider: Insider Trading Liability for Supervising a Rogue Trader*, 61 CLEV. ST. L. REV. 167, 193 (2013).

²³¹ The SEC may seek monetary penalties against violators, among other remedies. Section 21(d)(3) of the Securities Exchange Act of 1934 provides,

Whenever it shall appear to the Commission that any person has violated any provision of this chapter, the rules or regulations thereunder, . . . the Commission may bring an action in a United States District Court to seek, and the court shall have jurisdiction to impose,

circuit.²³² The most stringent are applied by the Second and Third Circuits, where a plaintiff must prove three things: (1) a primary violation, (2) control of the primary violator by the defendant, and (3) that the defendant was in some meaningful sense a culpable participant in the primary violation. The first two elements are the same as those required by the majority of circuits.²³³ The third element—culpable participation—connotes activity, and takes the case out of the realm of pure silence. Pure silence does not make one an aider and abettor or a control person under this formulation.

The First, Fifth, Sixth, Seventh, Eighth, Ninth, and Tenth Circuits do not require the third element to make out a *prima facie* case.²³⁴ A plaintiff need only show (1) that a primary securities law violation was committed by another, and (2) that the control person had the power to control the activity giving rise to the primary violation. Both can be shown in our hypothetical case. The CFO's colleague committed the primary violation and our CFO had by virtue of his position the power to control his colleague. An officer's involvement in the preparation of the corporation's financial statements is an indicator of control.²³⁵

The SEC has brought control person enforcement actions against CFOs. In 2009, the SEC charged former American International Group ("AIG") Chairman and CEO Maurice "Hank" Greenberg and former Vice Chairman and CFO Howard Smith for their involvement in numerous improper accounting transactions that allegedly inflated AIG's reported financial results between 2000 and 2005. The complaint alleged that Greenberg and Smith were liable as control persons for AIG's violations of the antifraud and other provisions of the securities laws. The defendants

upon a proper showing, a civil penalty to be paid by the person who committed such violation.

15 U.S.C. § 78u(d)(3) (2012). Similarly, § 21B(a)(2) permits the imposition of civil penalties in administrative proceedings against any person who "is violating or has violated any provision of [the Exchange Act], or any rule or regulation issued under [the Exchange Act]" or who is or was "a cause of the violation." 15 U.S.C. § 78u-2(a)(2) (2012).

²³² Gates, *supra* note 225, at 405.

²³³ *Id.* at 407–08.

²³⁴ *Id.* at 405.

²³⁵ SEC v. Todd, 642 F.3d 1207, 1223 (9th Cir. 2011); Adams v. Kinder-Morgan, 340 F.3d 1083, 1109 (10th Cir. 2003).

settled the charges.²³⁶ At about the same time, the SEC brought another control person case against a CFO, alleging liability for the corporation's Foreign Corrupt Practices Act violations. Those charges were also settled.²³⁷

Section 20(a) expressly provides an affirmative defense if the controlling person acted in "good faith." A control person acts in good faith where he takes precautionary measures to prevent the controlled party from causing injury to someone else.²³⁸ It would be surprising if our silent CFO, deliberately indifferent to his colleague's fraud, could persuade anyone of his good faith in the matter. We have assumed his culpable mental state throughout this exploration.

Conclusion

We saw in subpart A that our CFO's silence would not make him an aider and abettor of his colleague's fraud. Following the discussion of *Tambone* in subpart A, we returned to the question of primary liability in subpart B and saw that the cases are not in accord as to whether a fiduciary's silence is actionable under subparts (a) and (c), or (b), of Rule 10b-5. If subpart (b) applies to the case against our hypothetical CFO, it is unclear whether *Janus* allows a claim against one who is not the maker of a false statement. We resumed our consideration of secondary liability in subpart C, and saw that our CFO might be liable as a control person in a civil SEC enforcement action.

We are now prepared to grapple with reasoning of the Third Circuit in *Schiff*.

²³⁶ SEC Charges Hank Greenberg and Howard Smith, SEC Litigation Release No. 21170 (Aug. 6, 2009), available at <http://www.sec.gov/litigation/litreleases/2009/lr21170.htm>.

²³⁷ SEC Charges Nature's Sunshine Products, Inc. with Making Illegal Foreign Payments, SEC Litigation Release No. 21162 (July 31, 2009), available at <http://www.sec.gov/litigation/litreleases/2009/lr21162.htm>.

²³⁸ *Carpenter v. Harris, Upham & Co., Inc.*, 594 F.2d 388, 394 (4th Cir. 1979) ("In order to satisfy the requirement of good faith it is necessary for the controlling person to show that some precautionary measures were taken to prevent an injury caused by an employee."). See also John H. Walsh, *Right the First Time: Regulation, Quality, and Preventive Compliance in the Securities Industry*, 1997 COLUM. BUS. L. REV. 165, 227 (1997) ("[G]ood faith and noninducement is shown by maintaining an adequate preventive system.").

PART VII: COMING TO TERMS WITH *SCHIFF*

Our hypothetical is based on the facts of *United States v. Schiff*. The defendant was the CFO of Bristol Myers Squibb. The Third Circuit and the district court dismissed the government's claim that Schiff's silence violated Rule 10b-5, but allowed other charges based on Schiff's misstatements to stand.²³⁹ The Third Circuit recognized that precedent did not allow for the existence of a duty to correct another's misstatement and that, as a matter of policy, such a duty was vague and open ended and therefore unsuitable for criminal enforcement. However, the court's understanding of the fiduciary silence rule seems mistaken, and there are straightforward answers to the court's concerns about the scope of the duty. The court's conclusion is, nonetheless, defensible. There is the law's antipathy for punishing mere silence—the demise of misprision of felony, the absence of secondary liability—which, coupled with the rule of lenity, supports the holding. *Janus* was not discussed in *Schiff* because it was decided a year later, but it suggests that the *Schiff* court correctly read Rule 10b-5(b). Against *Schiff* are: the possibility that the case against our CFO is based on subsection (a) or (c), so that *Janus* does not apply, or that subsection (b) supports the claim, as suggested by *Tambone*; the misreading of precedent by the *Schiff* court; and the arguments made thus far in this

²³⁹ Schiff and his colleague Lane entered into deferred prosecution agreements with the Department of Justice in June 2010. Schiff, the focus of our attention, paid \$225,000, and was barred from serving as an officer of a public company for two years. David Voreacos, *Ex-Bristol-Myers's Executives Prosecution in Fraud Case Deferred in Deal*, BLOOMBERG NEWS (June 29, 2010, 6:17 PM), available at <http://www.bloomberg.com/news/2010-06-29/ex-bristol-myers-s-executives-prosecution-in-fraud-case-deferred-in-deal.html>.

The SEC filed a civil enforcement action against both of them, which was settled in March 2012. Schiff was enjoined from violating §§ 17(a)(2) and (3) of the Securities Act of 1933, disgorged \$130,922, and was barred for one year from serving as an officer or director of a public company. *Securities and Exchange Commission v. Frederick S. Schiff and Richard J. Lane*, SEC Litigation Release No. 22313 (Mar. 20, 2012), available at <http://www.sec.gov/litigation/litreleases/2012/lr22313.htm>.

Bristol paid \$150 million in 2004 to settle a related SEC civil enforcement action. Press Release 2004-105, U.S. SEC, Bristol-Myers Squibb Company Agrees to Pay \$150 Million to Settle Fraud Charges (Aug. 4, 2004), available at <http://www.sec.gov/news/press/2004-105.htm>. And in 2005, it entered into a deferred prosecution agreement with the Department of Justice, which effectively put the company on probation for two years, *Deferred Prosecution Agreement*, available at <http://www.law.virginia.edu/pdf/faculty/garrett/bristol-meyers.pdf> (last visited Feb. 20, 2014).

article. *Schiff*'s holding is one possible answer, within reason, but because of the flaws in the opinion, it cannot be the final answer.

Precedent

The cases cited by the Third Circuit in support of its narrow reading of a duty to disclose do not support the court's conclusion. The court explained what it believed to be the governing principles:

Absent a duty to disclose, silence is not fraudulent or misleading under Rule 10b-5. . . . We explained in *Oran v. Stafford* that a duty to disclose under Rule 10b-5 may arise in three circumstances: "when there is [1] insider trading, [2] a statute requiring disclosure, or [3] an inaccurate, incomplete or misleading prior disclosure." To support this proposition, the *Oran* Court cited to (i) a First Circuit Court of Appeals *en banc* opinion, *Backman v. Polaroid Corp.*, 910 F.2d 10, 12 (1st Cir. 1990) (*en banc*), explaining that a duty to disclose arises in the same three circumstances listed in *Oran*, (ii) a Second Circuit Court of Appeals opinion, *Glazer v. Formica Corp.*, 964 F.2d 149, 157 (2d Cir. 1992), noting that, absent the same three circumstances, there is no duty to speak, and (iii) a District of Delaware Court opinion, *In re General Motors Class E Stock Buyout Sec. Litig.*, 694 F. Supp. 1119, 1129 (D. Del. 1988).²⁴⁰

The first ground, insider trading, is a narrowly stated version of the fiduciary silence rule. As we have seen, however, *Affiliated Ute* does not require the rule to be read so narrowly, a view confirmed by the Second, Ninth and Tenth Circuits (and suggested by the First).²⁴¹ Silence can be a violation of § 10(b) and Rule 10b-5 even in cases not involving insider trading.²⁴² The cases cited by the *Oran* court do not support such a narrow reading, either.

Backman concerned the existence and scope of a duty to update a statement made in a third quarter report which was true at the time it was made. Ours is not a duty to update case. The senior officer's statement in

²⁴⁰ *United States v. Schiff*, 602 F.3d 152, 162 (3d Cir. 2010).

²⁴¹ The Third Circuit used Rule 10b-5(b) as the "relevant legal grounding" to the appeal. *Schiff*, 602 F.3d at 161. This may have been because of an odd procedural aspect to the case. The government's specific argument was that Schiff should have rectified Lane's misstatements in a subsequent SEC 10-Q filing, apparently trying to avoid the effect of an earlier stipulation it made that eliminated all allegations concerning misstatements in Bristol's SEC filings. *Id.* at 161–62. Whatever the reason, a better legal grounding may have been Rules 10b-5(a) and 10b-5(c), as per *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128 (1972).

²⁴² See *supra* text accompanying notes 128–63.

our hypothetical case was false when it was made. In *Tambone*, the First Circuit, which decided *Backman*, recognizes a broader fiduciary silence rule than the Third Circuit.²⁴³

Glazer involved undisclosed preliminary buyout negotiations. The defendant had made no public statement. The Second Circuit concluded that “[t]here was no suggestion that defendants . . . made any public statements other than the September Releases. Those releases were not false or misleading. . . .”²⁴⁴ Our case involved a false and misleading public statement. Further, the Second Circuit in *DiBella* recognized a broader fiduciary silence rule than did the Third in *Schiff*.²⁴⁵ General Motors likewise involved the non-disclosure of negotiations.²⁴⁶

The Third Circuit in *Schiff* also found fault with the government’s fiduciary duty theory. “The Government argues that *Schiff*’s duty to disclose in the SEC filings derives from a general fiduciary obligation of ‘high corporate executives’ to the company’s shareholders, which it concedes is not one of the three circumstances described in *Oran*.”²⁴⁷ The court doubted such a duty existed:

The Government cites to a Supreme Court case, *Chiarella v. United States* . . . to demonstrate that fiduciary obligations can be federalized in the securities law context. *Chiarella* involved insider trading charges against a printing company hired by a corporation to print corporate takeover bids. While the Court discussed fiduciary obligations, it did so in the context of insider trading, an entirely different situation than the one before us.²⁴⁸

While the *federal* duty to disclose to stockholders probably *is* limited to insider trading cases, as discussed above, Rule 10b-5 encompasses more. Other wrongful instances of fiduciary silence can violate the Rule, as illustrated by *Affiliated Ute* and the cases decided by the Second, Ninth and Tenth Circuit courts discussed above.

Moreover, the theory suggested herein is different from that urged by the government in *Schiff*. The CFO here owes a fiduciary duty of candor to the corporation’s board. The existence of this duty is beyond doubt. That

²⁴³ *Tambone*, 550 F.3d at 144–45.

²⁴⁴ *Glazer v. Formica Corp.*, 964 F.2d 149, 157 (2d Cir. 1992).

²⁴⁵ *SEC v. DiBella*, 587 F.3d 553 (2d Cir. 2009).

²⁴⁶ *In re General Motors Class E Stock Buyout Sec. Litig.*, 694 F. Supp. 1119 (D. Del. 1988).

²⁴⁷ *Schiff*, 602 F.3d at 163.

²⁴⁸ *Id.* at 165–66.

the breach of this duty might also constitute a violation of Rule 10b-5 does not, as the Third Circuit feared, “encroach into conduct traditionally left to state corporation law,”²⁴⁹ so long as there is deception which is “in connection with” the purchase or sales of securities as required by the language of section 10(b).

Policy

The *Schiff* court wondered about the vagueness of the government’s proposed duty. To whom does it apply? The government said “high corporate officers.” But, “what company employees qualify as high corporate officers?”²⁵⁰

There are two possible answers.

1. As suggested by criminal omission theory, the CFO of a publicly traded corporation would have a duty to speak, since it is especially his job among management to police financial statement fraud. Since the duty is not based on corporate law principles, it could be owed directly to the stockholders, and in that way resembles the government’s theory in *Schiff* of the duty of a high corporate officer to stockholders. While consistent with basic ideas of criminal culpability, the theory finds no support in 10b-5 jurisprudence as a basis for primary liability, beyond the insider trading cases. The CFO’s status may provide a basis for civil control person liability, though, as discussed above.

2. A better answer, then, is any officer subject to a duty of candor to the board of directors. While this is a broad category, only if the breach of that duty is “in connection with” the purchase or sale of any security would the breach also constitute a primary violation of section 10(b).

The court of appeals also wondered what exactly the performance of the duty might require. It referred to a colloquy between the district court and the prosecutor. The district court asked, “Are they required in front of investors to have an argument back and forth?” The government answered,

²⁴⁹ *Id.* at 165 (citing *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 472, 478–80 (1977)).

²⁵⁰ The phrase “high corporate officers” is undefined. *Schiff*, 602 F.3d at 164. Exchange Act Rule 3b-7 defines the phrase “executive officer.” 17 C.F.R. § 240.3b-7 (2013); and the Principles of Corp. Governance § 1.33 (1994) defines a “senior executive.”

“They’re required to correct it in some way when they have the time.”²⁵¹ Our response refers to the language of MBCA § 8.42(b)(2). The performance of the duty requires a report to superior authority within the corporation of violations of law that have occurred.

Other concerns voiced by the *Schiff* court are also answered by reference to § 8.42(b)(2). The district court asked, “What if he about [the misstatements] the next day?”²⁵² It commented that “[b]efore people can be charged with a crime, they have to know what they’re supposed to do.”²⁵³ The court of appeals elaborated these concerns by quoting Schiff’s brief, which argued that

a fiduciary presumably would owe shareholders a duty “to rectify” public misstatements of others whenever they are made (on a conference call or, say, in a written report or on the internet), whoever makes them (a fellow employee or, say, a securities analyst), and however the fiduciary learns about them (by hearing them on a joint call or, say, by reading them in a newspaper).²⁵⁴

It hardly seems a stretch, though, to assume that the CFO of a publicly traded corporation would know that he should report “up the chain” a false statement made at his side in a public forum. Such a duty is fully consistent with the special role of the CFO.

The court of appeals asked, for how long would this duty attach?²⁵⁵ One might look for guidance to the duty to correct one’s own misstatement.²⁵⁶ The duty lasts as long as the misinformation is “alive” in the minds of investors, affecting the market as a continuing representation. The duty expires when the uncorrected misrepresentation ceases to be material and investor reliance may no longer be presumed.²⁵⁷

²⁵¹ *Schiff*, 602 F.3d at 164 n.4.

²⁵² *Id.*

²⁵³ *Id.*

²⁵⁴ *Id.* at 165.

²⁵⁵ *Id.*

²⁵⁶ *See supra* note 118.

²⁵⁷ *Ross v. A.H. Robins Co.*, 465 F. Supp. 904, 908 (S.D.N.Y. 1979).

PART VIII: CONCLUSION

There are flaws in the Third Circuit's opinion in *Schiff* which, when considered in combination with the special status of the CFO, suggest that the Third Circuit's opinion should not be the final word.

The theory of liability suggested herein is consistent with the general theory of criminal omissions, is based upon a clear breach of the CFO's duty of candor owed to the corporation's board of directors, and is therefore also consistent with finding a violation of section 10(b) and Rule 10b-5, since the CFO's silence was in connection with the purchase and sale of the corporation's securities.

Janus, decided a year after *Schiff*, may present an obstacle to the prosecution of our CFO. *Janus* limits primary liability under Rule 10b-5(b)—concerning misstatements and half-truths—to the maker of the statement. Our CFO made no statement at all. Yet there is authority for the view that pure silence cases against a fiduciary are governed by the two other subparts of the Rule. If that is correct, then the prosecution will be able to avoid *Janus*. In either case, there remains the possibility of an SEC civil enforcement action against our CFO as a control person.