THE FUTURE OF SECONDARY ACTOR LIABILITY UNDER RULE 10(B)-5 AFTER *STONERIDGE INVESTMENT PARTNERS, LLC V. SCIENTIFIC-ATLANTA, INC.*

JAMES C. DUGAN AND TODD G. COSENZA*

INTRODUCTION

In *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A* (1994),[1] the U.S. Supreme Court ruled that there is no private cause of action for aiding and abetting securities fraud under Section 10(b) of the Securities Exchange Act and Rule 10b-5. At the time, it was widely believed that this decision limited the ability of securities class action plaintiffs to bring claims against secondary actors, such as lawyers, accountants, and investment bankers, who did not themselves make any false or misleading statements. However, in the years after *Central Bank* was decided, it became common for plaintiffs to bring claims against secondary actors under a theory of direct Rule 10b-5 liability, known as "scheme" liability. Scheme liability rested not on the making of any false or misleading statement but on participation in a scheme to defraud. Even so, courts lacked consensus as to whether "scheme" liability was a viable legal theory when applied to traditional secondary actors under the *Central Bank* precedent.

In *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.* (2008),[2] the Supreme Court, in addressing the viability of scheme liability as a cause of action, held that secondary actors are not liable to the issuer's investors in the absence of a public statement or other conduct on which the investors could have relied. The Court's holding in *Stoneridge* seemed to put to

* James C. Dugan is a partner and Todd G. Cosenza is an associate in the New York office of Willkie Farr & Gallagher LLP. Contact: jdugan@willkie.com and tcosenza@willkie.com. Both authors would like to thank Norman P. Ostrove, an associate at the firm, for his assistance in the preparation of this Article.

1. Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A, 511 U.S. 164 (1994).

2. Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., 128 S. Ct. 761 (2008).

Reprinted with the Permission of the New York University Law School

rest the scheme liability cause of action. Since then, lower courts have construed *Stoneridge* to stand for the proposition that liability under Rule 10b-5 requires either (i) the making of a false or misleading statement or (ii) the existence of a duty to disclose on the part of the defendant. Some courts have gone even further, refusing to find even the potential for liability unless the defendant is alleged to have made a false or misleading statement to investors.

Part I of this Article will discuss the scope of liability under Section 10(b) and Rule 10b-5 and the Supreme Court's decision in *Central Bank.* Part II examines the rise of "scheme liability" as means to establish securities fraud liability against secondary actors in the wake of *Central Bank.* Part III discusses the Supreme Court's decision in *Stoneridge.* Finally, Part IV reviews lower court decisions construing *Stoneridge* and identifies some common themes.

I.
BACKGROUND

A. *Parameters of Section 10(b) and Rule 10b-5 Liability*

The starting point for any discussion of Section 10(b) liability under the Securities Exchange Act is the text of the statute itself.[3] Section 10(b) states:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange . . .
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, or any securities-based swap agreement (as defined in [S]ection 206B of the Gramm-Leach-Bliley Act), 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.[4]

3. *See* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 756 (1975) (Powell, J., concurring).

4. 15 U.S.C. § 78j (2006).

Reprinted with the Permission of the New York University Law School

Pursuant to the statute, the Securities and Exchange Commission ("SEC") promulgated Rule 10b-5, which states:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.[5]

A private cause of action pursuant to Rule 10b-5 requires plaintiffs to establish five elements: (i) a false or misleading statement or deceptive conduct, (ii) scienter, (iii) reliance, (iv) loss causation, and (v) damages;[6] this Article focuses on two of these elements: (a) false and misleading statement or deceptive conduct and (b) reliance.

When the SEC announced the adoption of Rule 10b-5 over sixty years ago, it failed to clarify the rule's intended scope. The Commission's short public statement made only the modest claim that Rule 10b-5 "closes a loophole in the protections against fraud administered by the Commission by prohibiting individuals or companies from buying securities if they engage in fraud in their purchase."[7] However, some insight into Rule 10b-5's scope may be gained from the language of Section 10(b) itself.[8] In this respect, Section 10(b), by its terms, addresses two unlawful forms of conduct: that which is

5. 17 C.F.R. § 240.10b-5 (2008).

6. *See* Dura Pharm., Inc. v. Broudo, 544 U.S. 336, 341-42 (2005).

7. Employment of Manipulative and Deceptive Devises, Exchange Act Release No. 3230, Fed. Reg. 3804 (May 21, 1942).

8. *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 214 (1976) (noting that the scope of Rule 10b-5 "cannot exceed the power granted the Commission by Congress under [Section] 10(b)").

Reprinted with the Permission of the New York University Law School

"manipulative" and that which is "deceptive." Although the statute itself does not define "manipulative" or "deceptive" conduct, the legislative history of the Exchange Act suggests that Congress sought to address two related but distinct forms of wrongdoing. The first was manipulative trading schemes such as wash sales or matched orders that were "designed to create a misleading appearance of activity with a view to enticing the unwary into the market."[9] The second was "[f]alse and misleading statements designed to induce investors to buy when they should sell and to sell when they should buy."[10]

The Supreme Court has generally declined to expand the scope of Rule 10b-5 beyond Section 10(b)'s requirement that conduct prohibited by the statute involve a manipulative or deceptive act. In *Hochfelder*, for instance, the Supreme Court held that Rule 10b-5 did not permit claims based on a defendant's negligent conduct and that scienter or "a mental state embracing an intent to deceive, manipulate, or defraud" was required to establish a violation of Rule 10b-5.[11] The Supreme Court based its decision on the text of Section 10(b), noting that "when a statute speaks so specifically in terms of manipulation and deception, and of implementing devises and contrivances—the commonly understood terminology of intentional wrongdoing—and when its history reflects no more expansive intent, we are quite unwilling to extend the scope of the statute to negligent conduct."[12] Likewise, in *Santa Fe v. Green*,[13] the Supreme Court declined to extend Rule 10b-5 liability to breaches of fiduciary duties not involving a false statement or omission.[14] In its ruling, the Court again focused on the text of Section 10(b), noting that the provision provides no indication that Congress "meant to prohibit any conduct not involving manipulation or deception."[15]

---

9. H.R. Rep. No. 1383, 73-1383, at 15 (1934); *see also* Santa Fe Indust., Inc. v. Green, 430 U.S. 462, 476 (1977) ("manipulative . . . refers generally to practices such as wash sales, matched orders, or rigged prices, that are intended to mislead investors by artificially affecting market activity").

10. H.R. Rep. No. 73-1383, at 10 (1934).

11. Hochfelder, 425 U.S. at 185.

12. *Id.* at 214.

13. Santa Fe v. Green, 430 U.S. 462.

14. *Id.* at 473.

15. *Id.*

Reprinted with the Permission of the New York University Law School

In addition to manipulative or deceptive conduct, liability under a private 10b-5 cause of action requires a showing of reliance—that plaintiffs relied on something the defendants said or did (or did not say) in making an investment decision.[16] Although neither Section 10(b) nor Rule 10b-5 make any express mention of reliance, courts have long deemed the judicially-created private right of action under Rule 10b-5 to require such a showing.[17] As the Supreme Court observed in *Basic v. Levinson*, "reliance provides the requisite causal connection between a defendant's misrepresentation and a plaintiff's injury."[18] In addition to positive proof of the plaintiff's reliance on a defendant's false statement, reliance may be presumed where a defendant violates a duty to disclose owed to the plaintiff or where the fraud-on-the-market presumption applies.[19]

When a plaintiff seeks to hold accountable secondary actors—those who do not themselves make false or misleading statements—under Rule 10b-5, the element of reliance is particularly difficult to satisfy. This is because, in the absence of a false statement or deceptive act attributable to the secondary actors, reliance cannot be established absent special circumstances in which either the secondary actors owe plaintiffs a duty to disclose or the fraud-on-the-market presumption of reliance somehow applies.

B. *Central Bank of Denver*

In *Central Bank of Denver*, the Supreme Court had occasion to consider the scope of Rule 10b-5 as applied to secondary actors. The issue in *Central Bank* was whether liability under Section 10(b) and Rule 10b-5 extended to secondary actors

16. *See* Ernst & Ernst, 425 U.S. at 206 (quoting S. Rep. No. 792, at 12-13 (1934)).

17. *E.g.*, Basic, Inc. v. Levinson, 485 U.S. 224, 243 (1988).

18. *Id.*

19. *Id.* at 247 ("where materially misleading statements have been disseminated into an impersonal, well-developed market for securities, the reliance of individual plaintiffs on the integrity of the market price may be presumed . . . an investor who buys or sells stock at the price set by the market does so in reliance on the integrity of that price. Because most publicly available information is reflected in the market price, an investor's reliance on any public material misrepresentations . . . may be presumed for purposes of a Rule 10b-5 action.")

Reprinted with the Permission of the New York University Law School

who merely aided and abetted a primary violation.[20] In ruling that it did not, the Court viewed as determinative the language of Section 10(b), which makes no mention of aiding and abetting.[21] Construing the scope of conduct prohibited by Section 10(b), the Court concluded that "the statute prohibits only the making of a material misstatement (or omission) or the commission of a manipulative act."[22] Consequently, aiding another's fraud was simply not within the scope of conduct prohibited by Section 10(b).[23] Further supporting its decision, the Court noted, was the lack of any reliance placed by the plaintiff on an "aider and abettor," whose identity or role in the fraud typically is not publicly known.[24] In the Court's view, permitting an aiding and abetting action would allow plaintiffs to circumvent Rule 10b-5's reliance requirement and "disregard the careful limits on 10b-5 recovery mandated by our earlier cases."[25] The Court also reasoned that the SEC has the power to bring administrative actions and injunctive proceedings against aiders and abettors of federal securities law violations. Thus, the abolition of a private right of action did not completely eviscerate the enforceability of aiding and abetting liability.[26] The Court envisioned that the SEC—rather than private plaintiffs—would enforce the statutory prohibition against aiding and abetting.[27]

In reaching its decision, the *Central Bank* Court also considered the practical consequences of imposing liability for aiding and abetting another's Rule 10b-5 violation. The Court expressly noted that, as a matter of public policy, the lack of clarity surrounding the parameters of aiding and abetting liability, coupled with a "vexatiousness [in being forced to defend a 10b-5 claim] different in degree and in kind from that which accompanies litigation in general," supported its decision that aiding and abetting was not a viable cause of action

20. Cent. Bank of Denver, 511 U.S. at 1674.

21. *See id.* at 175.

22. *Id. at* 177.

23. *Id.*

24. *Id. at* 180.

25. *Id.*

26. *See id.* at 183 (noting that "various provisions of the securities laws prohibit aiding and abetting, although violations are remediable only in actions brought by the SEC").

27. *See id.*

Reprinted with the Permission of the New York University Law School

under Rule 10b-5.[28] In particular, the Court expressed concern that due to the uncertainty of the rules governing aiding and abetting liability "entities subject to secondary liability as aiders and abettors may find it prudent and necessary, as a business judgment, to abandon substantial defenses and to pay settlements in order to avoid the expense and risk of going to trial."[29] Following its seemingly definitive pronouncement of the absence of a private right of action for aiding and abetting, the Court then cautioned that its decision did not immunize secondary actors from liability under the securities laws.[30] To the contrary:

> Any person or entity, including a *lawyer, accountant, or bank*, who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator under 10b-5, assuming all of the requirements for primary liability under Rule 10b-5 are met. In any complex securities fraud, moreover, there are likely to be multiple violators . . . . (emphasis added)[31]

These cautionary words prompted more than a decade's worth of ambiguity regarding the exact contours of secondary actor liability under Section 10(b) and Rule 10b-5.[32]

II.
SECONDARY LIABILITY IN THE WAKE OF *CENTRAL BANK OF DENVER*

A. *Rule 10b-5 Liability Post-Central Bank*

In the wake of the Supreme Court's decision in *Central Bank of Denver*, federal courts grappled with the question of

28. *Id.* at 189.
29. *Id.*
30. *Id.* at 191.
31. *Id.*
32. *See* Cecil C. Kuhne, III, *Expanding the Scope of Securities Fraud? The Shifting Sands of Central Bank*, 52 DRAKE L. REV. 25, 27-28 (2003) ("This small linguistic concession has emboldened some courts and commentators to promote a more liberal interpretation of the act—one that allows a secondary actor to be held liable as a primary violator for 'participation' in the making of a material misstatement—even though that individual was never identified in any way to the public.").

Reprinted with the Permission of the New York University Law School

when a secondary actor's conduct gives rise to liability under Rule 10b-5. In answer to this question, three competing modes of analysis emerged: the "bright line," "substantial participation," and "creator" tests.

Under the "substantial participation" test, which has been adopted principally by the Ninth Circuit and by a number of district courts, a secondary actor may be liable under Section 10(b) if he or she "substantially participates" in the creation of a false statement or omission by others.[33] In *Software Toolworks*, the court held that an accounting firm could be found liable as a primary violator based on false statements contained in two letters submitted by its client to the SEC. Although the accounting firm did not sign or issue the letters, primary liability was appropriate, the court held, because the firm had "played a significant role in drafting and editing" the letters.[34] Similarly, the district court in *In re ZZZZ Best Securities Litigation*,[35] held that an accounting firm could be liable as a primary violator under Rule 10b-5 for another's false statement based upon "extensive" participation in the creation of the statement.[36] Rejecting the argument that reliance could not be established in the absence of a deceptive statement or act attributable to the defendant, the *ZZZZ Best* court reasoned that, if a secondary actor substantially participated in preparing the false statements and "the securities markets . . . relied on those public statements", then "anyone intricately involved in their creation and the resulting deception should be liable under Section 10(b) / Rule 10b-5."[37]

Under the "bright line" test, which was adopted by the Second, Tenth, and Eleventh Circuits, a secondary actor can be liable under Section 10(b) only if he or she actually made a false statement or omission on which the plaintiff relied.[38] In *Shapiro v. Cantor*, the Second Circuit held that an accounting

33. *See* In re Software Toolworks, Inc. Secs. Litig., 50 F.3d 615 (9th Cir. 1994).

34. *Id.* at 628.

35. In re ZZZZ Best Securities Litigation, 864 F. Supp. 960 (C.D. Cal. 1994).

36. *See id.* at 970.

37. *Id.*

38. *See* Shapiro v. Cantor, 123 F.3d 717 (2d Cir. 1997); *see also* Anixter v. Home-Stake Prod. Co., 77 F.3d 1215, 1225 (10th Cir. 1996); *see also* Ziemba v. Cascade Int'l., Inc., 256 F.3d 1194 (11th Cir. 2001).

Reprinted with the Permission of the New York University Law School

firm that had participated in creating allegedly false statements issued by its client could not be liable under Rule 10b-5 because it had not actually made a false statement or omission. The Second Circuit expressly declined to follow the "substantial participation" test, noting that:

> [I]f Central Bank is to have any real meaning, a defendant must actually make a false or misleading statement in order to be held liable under Section 10(b). Anything short of such conduct is merely aiding and abetting, and no matter how substantial that aid may be, it is not enough to trigger liability under Section 10(b).[39]

The Second Circuit found that, in the wake of *Central Bank*, "a claim under [Section]10(b) must allege a defendant has made a material misstatement or omission indicating an intent to deceive or defraud in connection with the purchase or sale of a security."[40]

Under the "creator" test—which in some respects is indistinguishable from the "substantial participation" test—a secondary actor is primarily liable when it creates a false and misleading statement, even if the statement is not attributable to him.[41] This test, which was proposed by the SEC in an amicus brief, requires plaintiff to prove that: (i) the secondary actor knew that the statement would be relied on by investors, (ii) the secondary actor was aware of the misrepresentation, (iii) the secondary actor could fairly be characterized as the author or co-author of the misrepresentation, and (iv) the other requirements for liability were met.[42] The Third Circuit adopted this standard of liability in *Klein v. Boyd*,[43] where it held that the law firm of Drinker Biddle & Reath could be primarily liable for allegedly misleading statements contained in a client's

39. Shapiro, 123 F.3d at 720.

40. *Id. at* 721. *See also* Wright v. Ernst & Young LLP, 152 F.3d 169 (2d Cir. 1998) (holding a secondary actor liable under Rule 10b-5 for another's false statement "would circumvent the reliance requirements of the Act" because "reliance only on representations made by others cannot itself form the basis of liability.").

41. *See* In re Enron Corp. Sec., Derivative & ERISA Litig., 235 F.Supp.2d 549 (S.D.Tex. 2002).

42. *Id.* at 588.

43. *Klien v. Boyd*, No. 97-1143 (3d Cir. Feb. 12, 1998), *rehearing en banc granted, judgment vacated*, 1998 WL 55245 (Mar. 9, 1998).

Reprinted with the Permission of the New York University Law School

offering documents even though the law firm was not publicly identified as the author of the statements.[44] The Third Circuit thought it significant that the law firm knew the false statements in the offering circular would be disseminated to investors; in such circumstances, the law firm "has elected to speak to the investors, even though the document may not be facially attributed to the lawyer."[45]

The creator standard regained momentum with the decision issued by the Southern District of Texas in *In re Enron Securities and ERISA Litigation.*[46] There, the district court found that the allegations made against Enron's primary outside counsel, Vinson & Elkins ("V&E"), were sufficient to state a Rule 10b-5(b) claim against it.[47] In that case, plaintiffs alleged that V&E knew that, in a number of transactions, there were side deals between Enron and related third parties and subsequently drafted false and misleading language of proposed disclosures concerning those transactions that were included in Enron's 10-Ks, 10-Qs, and proxy statements.[48] Relying on these claims, the court found that "when a person, acting alone or with others, creates a misrepresentation [on which the investor-plaintiffs relied], the person can be liable as a primary violator . . . if . . . he acts with the requisite scienter."[49] The court's invocation of the creator test in the high-profile Enron

44. *See id.*

45. Fed. Sec. L. Rep. (CCH) ¶ 90, 136 (3d Cir. 1998); *see also* In re Enron Corp. Sec., Derivative & ERISA Litig., 235 F. Supp. 2d at 588 (S.D.Tex. 2002) (finding a Rule 10b-5 claim successfully alleged against the law firm Vinson & Elkins based on the law firm's preparation of 10-Ks and 10-Qs that it knew to be false, citing SEC's proposed rule: "when a person, acting alone or with others, creates a misrepresentation . . . the person can be liable as a primary violator . . if . . . he acts with the requisite scienter." (second and third ellipses in original)).

46. *See* 235 F. Supp. 2d at 587-88 (S.D. Tex. 2002).

47. *Id.* at 588 ("Because [Section] 10(b) expressly delegated rule-making authority to the agency, which it exercised inter alia in promulgating Rule 10b-5(b), this Court accords considerable weight to the SEC's construction of the statute since the Court finds that construction is not arbitrary, capricious or manifestly contrary to the statute."); *id.* at 590-91 ("This Court finds that the SEC's approach to liability under § 10(b) and Rule 10b-5 is well reasoned and reasonable, balanced in its concern for protection for victimized investors as well as for meritlessly harassed defendants. . . .").

48. *See id.* at 664.

49. *See id.* at 588 (citation omitted).

Reprinted with the Permission of the New York University Law School

securities class action thus highlighted the viability of the creator test as a standard of secondary actor liability.

B. *The Rise of Scheme Liability—A Circuit Split is Born*

Notwithstanding the availability in some jurisdictions of the "substantial participation" and "creator" tests, *Central Bank*'s bar of aiding and abetting liability, coupled with the difficulty of meeting the prevailing "bright line" test, led to creative thinking among plaintiffs' lawyers seeking to pursue secondary actors with big pockets. In response, plaintiffs began to make more use of Rule 10b-5(a) and (c)—formerly little-used provisions of Rule 10b-5—to argue that liability under those sections could be established without the making of a false statement or omission if a secondary actor employed a "device, scheme, or artifice" to defraud or engaged in an "act, practice, or course of business conduct" that operated as a fraud or deceit. Using the broad language of 10b-5(a) and (c) as a starting point, plaintiffs in securities class actions increasingly turned their attention to secondary actors beyond the traditional outside professionals who assist or participate in crafting an issuer's allegedly false statements, such as business entities that had nothing to do with preparing an allegedly false statement, but had engaged in transactions with an issuer that plaintiffs alleged were falsely represented on the issuer's financial statements. Some of the more prominent decisions addressing scheme liability prior to *Stoneridge* are discussed below.

In *In re Parmalat Securities Litigation* ("*Parmalat I*"),[50] the district court considered allegations of scheme liability against Citigroup Inc., Citibank, N.A., Bank of America, and Banca Nazionale del Lavoro. Plaintiffs alleged that these defendants violated Rule 10b-5(a) and (c) by virtue of their participation in two deceptive schemes: one involved loans disguised as equity transactions and the other involved the securitization of phony receivables for the purpose of improperly enhancing Parmalat's reported earnings.[51] Notably, none of the defendants, except Bank of America, were alleged to have participated in the creation of a false statement or omission by

50. In re Parmalat Securities Litigation ("Parmalat I"), 376 F. Supp. 2d 472 (S.D.N.Y. 2005).

51. *See id.* at 481-88.

Reprinted with the Permission of the New York University Law School

Parmalat.[52] Rather, the allegations focused on transactions that were subsequently misrepresented by Parmalat on its financial statements.[53]

The court construed a claim under 10b-5(a) and (c) as requiring: (i) the commission of a "deceptive or manipulative act," (ii) "with scienter," that (iii) "affected the market for securities or was otherwise in connection with their purchase or sale," and that (iv) "caused the plaintiff's injuries."[54] Addressing the scope of Rule 10b-5(a) and (c), the court held that these provisions covered, not merely manipulative securities trading practices, but other forms of deceptive conduct as well. In particular, the court determined that 10b-5(a) and (c) covered defendants' knowing participation in transactions that were "by nature deceptive."[55] In the district court's view, liability under 10b-5(a) or (c) for the bank defendants would not be appropriate if the deceptiveness of the alleged scheme "resulted from the manner in which Parmalat or its auditors described the transactions on Parmalat's balance sheets and elsewhere," rather than from the deceptive nature of the transaction itself.[56] Thus, scheme liability applied if it was "impossible to separate the deceptive nature of the transactions [between the bank defendants and Parmalat] from the deception actually practiced upon Parmalat's investors."[57] With this distinction in mind, the district court reviewed plaintiffs' allegations against each defendant to determine whether plaintiffs had sufficiently alleged participation in a sham transaction.[58]

In analyzing the issue of reliance, *Parmalat I* acknowledged that, in the absence of a false statement by the bank defendants, plaintiffs "cannot be said to have relied on the banks."[59] However, the court side-stepped the reliance issue by positing that it was essentially inapplicable to a cause of action under Rule 10b-5(a) and (c).[60] As the court explained, the reliance requirement was a proxy for causation—a way "to

52. *See id.*
53. *Id.* at 503.
54. *Id.* at 492.
55. *Id.* at 504.
56. *Id.* at 505.
57. *Id.* at 504.
58. *Id.* at 504-506.
59. *Id.* at 509.
60. *Id.*

Reprinted with the Permission of the New York University Law School

certify that the conduct of the defendant actually caused the plaintiff's injury."[61] In the absence of a false statement or omission on which a plaintiff could rely, the court held that this requirement could be met by evidence that the defendant's conduct was a "substantial, i.e., a significant contributing cause" of the plaintiff's injury.[62] In *Parmalat I*, this evidence was supplied by the fact that the defendant banks' actions "actually and foreseeably" caused losses in the securities markets:

> The banks made no relevant misrepresentations to those markets, but they knew that the very purpose of certain of their transactions was to allow Parmalat to make such misrepresentations. In these circumstances, both the banks and Parmalat are alleged causes of the losses in question. So long as both committed acts in violation of statute and rule, both may be liable.[63]

The Ninth Circuit's decision in *Simpson v. AOL Time Warner Inc.* was another example of how courts viewed the viability of scheme liability pre-*Stoneridge*.[64] There, plaintiffs alleged that a number of Homestore.com's vendors had violated 10b-5(a) and (c) by engaging in "round-trip" or barter transactions whereby Homestore recorded revenue from the receipt of monies that ultimately came from Homestore's own cash reserves.[65] The district court dismissed the claims asserted against the vendors, finding that *Central Bank* effectively precluded the plaintiffs' 10b-5(a) and (c) claims because the vendors had only participated in or facilitated Homestore's fraudulent scheme and were thus mere aiders and abettors.[66] The district court also found that plaintiffs could not establish reliance as to the vendor defendants.[67]

Although the Ninth Circuit affirmed the district court's dismissal of the complaint, it disagreed with its rationale. In particular, the Ninth Circuit noted that a scheme liability cause of action was viable if it could be shown that "the defen-

61. *Id.* (internal citations omitted).
62. *Id.* (internal citations omitted).
63. *Id.*
64. Simpson v. AOL Time Warner, Inc., 452 F.3d 1040 (9th Cir. 2006).
65. *See id.* at 1042.
66. *See id.* at 1045.
67. *See id.*

Reprinted with the Permission of the New York University Law School

dant . . . engaged in conduct that had the principal purpose and effect of creating a false appearance of fact in furtherance of the scheme."[68] In other words, "the defendant's own conduct contributing to the transaction or overall scheme must have had a deceptive purpose and effect."[69] As to reliance, the Ninth Circuit—as it had articulated in establishing the "substantial participation" test—found that "absent persuasive conflicting evidence" it could be presumed that "purchasers relied on misstatements produced by a defendant as part of a scheme to defraud, even if the defendant did not publish or release the misrepresentations directly to the securities market."[70]

Having concluded that scheme liability could be a valid cause of action under Rule 10b-5, the court preceded to review the allegations against each secondary actor. As with the *Parmalat* decision, the Ninth Circuit focused on whether defendants had created or employed "sham business entities," had engaged in a transaction that had no "legitimate economic value," or otherwise had created a "false appearance" in their dealings with Homestore.[71]

In contrast to *Parmalat I* and the Ninth Circuit's approach in *Simpson*, the Eighth Circuit reached a different conclusion in *In re Charter Communications, Inc. Securities Litigation v. Scientific-Atlantic, Inc.*[72] In that case, Scientific-Atlanta, Inc. and Motorola, Inc., sellers of telecommunications equipment to Charter Communications, were sued under a Rule 10b-5(a) and (c) scheme liability cause of action. According to the plaintiffs, Scientific-Atlanta and Motorola both participated in sham transactions in which Charter agreed to purchase equipment from them at a premium price with the understanding that the vendors would remit part of this premium back to Charter in the form of advertising fees, thereby enabling Charter to report falsely enhanced revenues.[73] Plaintiffs further alleged that the vendors knew that Charter intended to account for these transactions improperly.[74]

68. *Id.* at 1048.
69. *Id.*
70. *Id.* at 1052.
71. *See id.* at 1052-1053.
72. In re Charter Commc'ns, Inc. Sec. Litig. v. Scientific-Atlantic, Inc., 443 F.3d 987 (8th Cir. 2006).
73. *See id.* at 989.
74. *See id.*

Reprinted with the Permission of the New York University Law School

The district court rejected plaintiff's Rule 10b-5 claim against the vendors based on *Central Bank of Denver*. In essence, the district court found that the allegations against the vendors amounted to little more than the assertion that they had engaged in business transactions that Charter had recorded improperly and that such claims were tantamount, at best, to aiding and abetting.[75]

The Eighth Circuit affirmed. In doing so, the appellate court found that *Central Bank*, and the earlier Supreme Court decisions on which it had relied, stood for three "governing principles:" (i) claims under 10b-5 may not be brought "against a defendant for acts not prohibited by the text of Section 10(b)"; (ii) a "device or contrivance is not 'deceptive' within the meaning of Section 10(b), absent some misstatement or a failure to disclose by one who has a duty to disclose"; and (iii) the term "manipulative" as used in Section 10(b) "has the limited contractual meaning ascribed in [the Supreme Court's decision in *Santa Fe Industries, Inc. v. Green*]."[76] Distilling these three principles, the appellate court held that "any defendant who does not make or affirmatively cause to be made a fraudulent misstatement or omission, or who does not directly engage in manipulative securities trading practices, is at most guilty of aiding and abetting and cannot be held liable under Section 10(b) or any subpart of Rule 10b-5."[77]

Applying this test, the Eighth Circuit found neither Motorola nor Scientific-Atlanta could be liable because neither was alleged to have engaged in a deceptive act.[78] They had issued no misstatements that were relied on by the investing public nor were they under a duty to disclose information about Charter's true financial condition.[79] The appellate court found that, in such circumstances:

> [T]o impose liability for securities fraud on one party to an arm's length business transaction in goods or services other than securities because that party knew or should have known that the other party would use the transaction to mislead investors . . . would intro-

75. *See id.* at 991.
76. *Id.* at 992.
77. *Id.*
78. *Id.*
79. *Id.*

Reprinted with the Permission of the New York University Law School

duce potentially far-reaching duties and uncertainties for those engaged in day-to-day business dealings.[80]

With the Eighth Circuit's decision in *In re Charter Communications* rejecting scheme liability as a viable cause of action against non-speaking secondary actors and the Ninth Circuit's contrary decision in *Simpson v. AOL Time Warner*, the stage was set for the U.S. Supreme Court to consider the viability of scheme liability. And, by granting *certiorari* and agreeing to review the Eighth Circuit's decision in *In re Charter Communications*, the Supreme Court demonstrated its willingness to weigh in on the issue with uncharacteristic speed.

III.
THE SUPREME COURT'S DECISION IN *STONERIDGE INVESTMENT PARTNERS LLC V. SCIENTIFIC-ATLANTA, INC.*

In *Stoneridge Investment Partners LLC v. Scientific-Atlanta, Inc.*, the issue before the Court was whether third parties could be liable to Charter's investors in a pending securities class action solely because they participated in a "scheme" to commit securities law violations.

The Supreme Court affirmed the Eighth Circuit's decision,[81] holding that Scientific-Atlanta and Motorola ("the vendors") were not liable to Charter's investors. In its analysis, the Court expressly refused to apply either the *Affiliated Ute*[82] or the *Basic* fraud-on-the-market[83] presumptions of reliance to

80. *Id.* at 992-93.

81. Although, as noted *infra*, the Supreme Court specifically disagreed with the Eighth Circuit's reasoning that deceptive conduct, as opposed to deceptive statements or omissions, could not be subject to Section 10(b) liability. 128 S. Ct. at 770.

82. Under the Supreme Court's decision in *Affiliated Ute*, plaintiffs are afforded a presumption of reliance where their claims are *primarily* ones of fraudulent "omissions" of information that a defendant had a duty to disclose. *See* Affiliated Ute Citizens v. United States, 406 U.S. 128, 153-54 (1972).

83. Under the fraud-on-the-market doctrine (adopted by the Supreme Court in *Basic v. Levinson*), reliance is presumed when the alleged false statement becomes public. The "fraud-on-the market" doctrine is based on the theory that "in an open and developed securities market, the price of a company's stock is determined by the available material information regarding the company and its business [and that] [m]isleading statements will therefore defraud purchasers of stock even if the purchasers do not directly rely on the misstatements." *Basic*, 485 U.S. at 241-42.

Reprinted with the Permission of the New York University Law School

the case. First, the Court held that the *Affiliated Ute* presumption was inapplicable to the claims brought against the vendors because the vendors "had no duty to disclose" the transactions to investors. The Court next considered the investors' argument—premised, in part, on the district court's decision in *Parmalat I*—that they were entitled to the fraud-on-the-market presumption because the vendors had intentionally engaged in conduct that resulted in the falsification of Charter's financial statements—as part of a larger scheme to misrepresent Charter's revenue. The Court rejected the notion that the reliance element could be satisfied as to the vendors' conduct according to the theory that in an efficient market investors rely on the veracity of the transactions underlying the statements contained in a company's public disclosures: "[w]ere this concept of reliance to be adopted, the implied cause of action would reach the whole marketplace in which the issuing company does business; and there is no authority for this rule." The Court also noted that the vendors' deceptive acts were not communicated to the public: "[n]o member of the investing public had knowledge, either actual or presumed, of [the vendors'] deceptive acts during the relevant times." As a result, investors could not show any reliance on the vendors' actions "except in an indirect chain" that the Court found "too remote for liability."

Although the broad language of its decision could be read as eliminating, or at least severely restricting, secondary actor liability under Section 10(b), the Court noted that "[c]onduct itself can be deceptive" and can provide the basis for liability.[84] According to the Court, the key inquiry is whether the secondary actors' actions or conduct "were immediate or remote to the injury."[85] The Court added that it would be "erroneous" to conclude that the Eighth Circuit's decision be "read to suggest there must be a specific oral or written statement before there could be liability under Section 10(b) or Rule 10b-5."[86]

In the wake of this ruling, commentators questioned whether the Court's holding was limited to claims against com-

84. *Id.*
85. *Id.* at 770.
86. *Id.*

Reprinted with the Permission of the New York University Law School

mercial parties like the vendors in *Stoneridge*.[87] Some support for this interpretation is found in the *Stoneridge* decision, specifically the Court's observation that:

> Unconventional as the arrangement [between the vendors and Charter Communications] was, *it took place in the marketplace for goods and services, not in the investment sphere.* Charter was free to do as it chose in preparing its books, conferring with its auditor, and preparing and then issuing its financial statements. *In these circumstances* the investors cannot be said to have relied upon any of respondents' deceptive acts in the decision to purchase or sell securities.[88]

The Court's comment suggests an effort to differentiate between the third-party vendors in *Stoneridge*—those who act in the "marketplace for goods and services"—and those who act in the "investment sphere," such as lawyers, accountants, and investment bankers. This, in turn, led some to wonder whether "scheme liability" could still be a valid claim against financial and legal professionals. Almost as soon as the question was posed, it was answered by the Supreme Court when, one week after issuance of the *Stoneridge* decision, the Court denied the *certiorari* petition of plaintiffs in the *Enron*[89] class action securities litigation, who argued that *Stoneridge* did not extend to financial professionals accused of facilitating securities fraud.

With the Supreme Court's ruling in *Stoneridge* and its denial of *certiorari* in the *Enron* class action, the stage has been set for a sweeping rejection of scheme liability in the lower courts. And, as illustrated below, with a few exceptions, lower courts have so far taken a broad view of *Stoneridge*.

---

87. *See* Douglas McCollam, *Stoneridge Ruling Shields Third-Party Advisers*, BUSINESSWEEK, Jan. 15, 2008, at http://www.businessweek.com/investor/content/jan2008/pi20080115_844276.htm?chan=top+news_top+news+index_investing; *Is Stoneridge the Death Knell for Scheme Liability?*, SECURITIES LAW 360, Jan. 17, 2008, at http://securities.law360.com/secure/ViewArticle.aspx?Id=44442; *Stoneridge: What Does it Mean?* SECURITIES LAW 360, Jan. 16, 2008, at http://securities.law360.com/Secure/ViewArticle.aspx?id=44416.

88. 128 S. Ct. at 774 (emphasis added).

89. *See* Regents of the Univ. of Cal. v. Credit Suisse First Boston (USA), Inc., 482 F.3d 372 (5th Cir. 2007), *cert. denied*, 128 S. Ct. 1120 (2008).

Reprinted with the Permission of the New York University Law School

IV.
POST-*STONERIDGE* LITIGATION: AN EXAMINATION

Thus far, there have been several significant cases applying *Stoneridge* with seemingly varying results. This section will discuss several of those cases, examine the courts' holdings, and attempt to reconcile the results.

A. *In re DVI Inc. Securities Litigation*

In *In Re DVI Inc. Securities Litigation*,[90] the question was whether outside counsel's participation in drafting an allegedly false public statement was sufficient to trigger securities fraud liability. The court answered no.

DVI was a medical equipment finance company that supplied credit secured by healthcare receivables.[91] DVI's business deteriorated and it was ultimately liquidated in bankruptcy proceedings.[92] Plaintiff investors brought securities fraud claims against the company's officers, directors, and others—including the law firm Clifford Chance, which had acted as DVI's lead corporate counsel.[93] Plaintiffs alleged that the price of DVI's securities had been artificially inflated through a variety of schemes, including concealed cash shortages, double pledged collateral, pledged ineligible collateral, and a refusal to report impaired assets and loans.[94] As to Clifford Chance, plaintiffs principally alleged that the law firm, with full knowledge of the truth of DVI's dire condition, had "directed" and "coordinated" the publication of false financial reports.[95]

Although plaintiffs recognized that *Stoneridge* limited "scheme liability" under Section 10(b), they contended that Clifford Chance's "unique role" in drafting public disclosures and creating and masterminding certain aspects of the fraudulent scheme was intimately related to the injury suffered by DVI's investors.[96] Thus, investors argued that they were entitled to a class-wide presumption of reliance under the fraud-

90. In Re DVI Inc. Securities Litigation, 249 F.R.D. 196 (E.D. Pa. Apr. 29, 2008).
91. *Id.* at 198.
92. *Id.*
93. *Id.* at 199.
94. *Id.*
95. *Id.* at 217.
96. *Id.* at *21.

Reprinted with the Permission of the New York University Law School

on-the-market doctrine for their Section 10(b) and Rule 10b-5 claims against Clifford Chance.[97] In support of their argument, plaintiffs noted *Stoneridge*'s express language that conduct itself could be "deceptive," even if a secondary actor—like Clifford Chance—was not specifically identified in the allegedly fraudulent public disclosures.[98] Attempting to follow the reasoning in *Stoneridge*, plaintiffs contended that because "reliance is tied to causation," the district court had to determine whether Clifford Chance's acts were so immediate to the injury suffered by DVI's investors that its acts established the requisite reliance.[99] Clifford Chance opposed the class certification motion, arguing that plaintiffs could not rely on either the fraud-on-the-market presumption or the existence of a duty to disclose to establish reliance on the law firm's allegedly deceptive conduct.[100]

Relying on the *Stoneridge* decision, the district court considered Clifford Chance to be analogous to the third-party vendors at issue in *Stoneridge* who made no public statements on which investors relied. Consequently, the *DVI* court held that that there could be no fraud-on-the-market presumption of reliance.[101] The court further held that Clifford Chance had no duty to disclose to DVI's investors, thus the *Affiliate Ute* presumption of reliance did not apply.[102]

In reaching its decision, the court analyzed neither the extensive role that Clifford Chance had played in drafting and facilitating DVI's allegedly false disclosures nor whether such conduct fell within the "investment sphere" as defined by *Stoneridge*. Further, the court failed to differentiate between "scheme liability" under Rule 10b-5(a) and (c) and liability under Rule 10b-5(b) for the making of false statements. Instead, the court appeared to conclude that *Stoneridge* applies beyond the "scheme" context and to all claims under Rule 10b-5—including situations in which a non-publicly identified secondary actor is alleged to have "created" or "substantially

97. *Id.*
98. *Id.*
99. *Id.* at 217.
100. *Id.* at 216.
101. *Id.* at 218.
102. *Id.*

Reprinted with the Permission of the New York University Law School

participated" in a public misstatement.[103] Lastly, the court did not address whether, regardless of the fact that none of the alleged misleading statements had been publicly attributed to Clifford Chance, a law firm could be under an independent duty to disclose the truth to DVI's investors based on its role in the drafting of the public statements.

B. *Lopes v. Vieira*

The district court in *Lopes v. Vieira*[104] reached a conclusion that differs from the one reached by the district court in *DVI*, albeit on somewhat atypical facts. Plaintiffs were investors in Valley Gold, LLC, whose main asset was promoted as a future cheese manufacturing company. However, Valley Gold was allegedly created for the sole purpose of assisting its promoter, George Vieira, in a massive fraud. After the scheme unraveled and his scam came to light, the plaintiffs (in a non-class action) sued, among others, the law firm of Downey Brand LLP, which had drafted the offering memorandum for Valley Gold. Essentially, plaintiffs alleged that the firm knew Vieira was under criminal investigation for a similar scheme while drafting the offering memorandum for Valley Gold but failed to disclose this fact to the investors.

Downey Brand moved to dismiss the securities fraud claims on the basis that none of the alleged false statements in the offering memorandum were publicly attributed to the firm and it had no duty to disclose to the investors.[105] Plaintiffs argued that Downey Brand was primarily liable for its "substantial participation" in the drafting and preparation of the misleading offering.[106]

Although the court acknowledged the *Stoneridge* decision, it seemingly attempted to distinguish it, noting that *Stoneridge* involved a corporation's "vendors and suppliers, who are secondary actors or aiders and abettors," whereas Downey Brand's role as the drafter of the offering memorandum implied the existence of a duty to disclose.[107] The court noted

103. Plaintiffs have requested that the Court reconsider its class certification ruling as to Clifford Chance. That motion is now pending.

104. Lopes v. Viera, 543 F. Supp. 2d 1149 (E.D. Cal. 2008).

105. *See id.* at 1175-78.

106. *Id.* at 1176.

107. *Id.* at 1177-78 (citing *Stoneridge*, 128 S. Ct. 761).

Reprinted with the Permission of the New York University Law School

that Downey was not being sued as an aider and abettor "but as a direct participant in the preparation and drafting of the misleading offering memorandum."[108] Citing the Ninth Circuit's decision in *In re Software Toolworks, Inc. Securities Litigation*,[109] the court invoked the substantial participation test and found that a law firm (like other secondary actors) could face liability under Rule 10b-5(b), even if not publicly identified, as long as it had "played a significant role in drafting and editing" the allegedly fraudulent disclosure.[110]

Without conducting a stringent analysis as to whether Downey's conduct was "immediate or remote to the injury" and within the "investment sphere" so as to satisfy the element of reliance, the court then reviewed Downey's role in the scheme. In distinguishing its ruling from *Stoneridge*, the court suggested that an attorney or law firm, unlike a counterparty in a business transaction, could—depending on the circumstances—have an implied duty to investors.[111] However, at the pleading stage, the court concluded that it could not make such a determination as to Downey's conduct.[112] The court thus denied Downey's motion to dismiss plaintiffs' Rule 10b-5 and held that the existence of the implied duty to disclose for a law firm "will depend upon the facts."[113]

C. *In Re Parmalat Securities Litigation (Parmalat II)*

Following the Supreme Court's decision in *Stoneridge*, several of the defendants in *Parmalat* attempted to have their cases dismissed once again. Bank of America, Citigroup, and Pavia e Ansaldo ("Pavia") moved for summary judgment, seeking to dismiss the scheme liability claims that had previously been upheld.[114] The moving defendants argued that it was the issuer, Parmalat, that had made the misleading public state-

108. *Id.* at 1176.

109. In re Software Toolworks, 50 F.3d 615 (9th Cir. 1994).

110. *See* Lopes, 543 F. Supp. 2d at 1176 (citing Software Toolworks, 50 F.3d at 628, n.3).

111. *Id.* at 1177-78.

112. *Id.*

113. *Id.*

114. *See In re* Parmalat Sec. Litig. (*Parmalat II*), 570 F. Supp. 2d 521, 521 (S.D.N.Y. 2008).

Reprinted with the Permission of the New York University Law School

ments and that, post-*Stoneridge*, absent actionable misrepresentations, plaintiffs could not establish the requisite reliance.[115]

With respect to Bank of America and Pavia, plaintiffs maintained that reliance should be presumed, because each had breached a duty to disclose.[116] Plaintiffs alleged that Bank of America had breached its duty to disclose "the true facts about the BoA Brazilian transaction" to investors who purchased securities from Bank of America in private placements.[117] The district court found this argument unavailing, because none of the named plaintiffs purchased those securities and "only investors to whom the duty was owed may avail themselves of that presumption."[118] With respect to Pavia, the Italian law firm that had represented Parmalat, plaintiffs argued that Pavia had breached a duty to disclose by violating Rule 4.1 of the Model Rules of Professional Conduct.[119] The district court summarily rejected that contention because the Model Rules state that they are "not designed to be a basis for civil liability."[120]

Plaintiffs' next effort was to show that the public was made aware of the deceptive transactions in which the defendants were involved. They claimed that various press releases, bond prospectuses, offering memoranda, private placement memoranda and financial statements issued by Parmalat mentioned Bank of America, Citigroup, and Pavia, which, in turn, "led investors to rely on the deceptive transactions themselves, not merely on financial statements that were impacted by those transactions."[121] As the court put it, "[t]his argument too is unconvincing."[122]

According to the district court, *Stoneridge* had "made plain that investors must show reliance upon a defendant's *own deceptive conduct* before that defendant . . . may be found prima-

115. *Id.* at 524.

116. *Id.*

117. *Id.*

118. *Id.* at 525 (citing *Stoneridge*, 128 S.Ct. at 769 ("[I]f there is an omission of a material fact by one with a duty to disclose, the investor to whom the duty was owed need not provide specific proof of reliance.")).

119. *Id.*

120. *Id.*

121. *Id.* at 525-26.

122. *Id.* at 526.

Reprinted with the Permission of the New York University Law School

rily liable."[123] The court reasoned that Parmalat's disclosures did not describe the defendants' conduct, and as such, plaintiffs could only establish that "investors relied on Parmalat's deceptive disclosures concerning transactions to which defendants were parties."[124] Anything more, Judge Kaplan found, would be "an indirect chain" which the Supreme Court found was "too remote for liability."[125]

D. *In re Refco, Inc. Securities Litigation*

In *Refco*[126] the court took up a question similar to the *DVI*, *Lopes*, and *Parmalat II* courts—namely, whether a law firm, Mayer Brown, and one of its partners, Joseph Collins (collectively, "Mayer Brown"), could be liable to investors under Rule 10b-5(a) and (c) for drafting deal documents in furtherance of allegedly fraudulent transactions and drafting Refco's public disclosures, which allegedly contained misstatements and omissions of material fact.[127]

Refco was a brokerage and clearing service that provided, among other things, credit to customers so they could trade on margin.[128] In the 1990s, Refco began making loans to customers without assessing their credit-worthiness.[129] When those customers suffered massive trading losses, they were unwilling or unable pay back the loans, which became uncollectible receivables on Refco's books.[130] Rather than disclose the uncollectible receivables, Refco transferred them to an entity, RHGI, controlled by Refco's President.[131] To avoid disclosing this related-party receivable, which was larger than Refco's net income, Refco began a series of "round-trip loans" to make the receivable "disappear from Refco's books."[132] Several days before the close of a financial period, a Refco subsidiary would loan hundreds of millions of dollars to third-party customers

123. *Id.* (emphasis in original).
124. *Id.*
125. *Id.* (quoting *Stoneridge*, 128 S.Ct. at 769).
126. In re Refco, Inc. Sec. Litig., 609 F. Supp. 2d 304 (S.D.N.Y. 2009).
127. *Id.* at 309.
128. *Id.* at 306.
129. *Id.*
130. *Id.*
131. *See id.*
132. *Id.* at 307.

Reprinted with the Permission of the New York University Law School

who would then loan the money to RHGI.[133] RHGI would then use the loan to pay down the money it owed to Refco.[134] After the financial period closed, the transactions were unwound, the loans would be repaid, and the uncollectible receivables returned to Refco's books.[135] In this manner, Refco was able to hide its losses from investors. Mayer Brown's alleged involvement in the round-trip transactions included negotiating the loans, drafting and revising the documentation for the transactions, and marking the promissory notes as "paid in full" when the transactions were unwound.[136]

Refco later issued a $600 million public debt offering in connection with a leveraged buy-out and then $670 million in equity as an IPO.[137] Plaintiffs alleged that the portions of the debt offering memorandum regarding Management Discussion and Analysis ("MD&A") and Risk Factors, drafted by Mayer Brown and discussing Refco's business and financial condition, were false.[138] Plaintiffs further alleged that given Mayer Brown's role in the round-trip transactions and the extent of their knowledge of the RHGI receivables, Mayer Brown knew that those portions of the offering memorandum were false.[139] Mayer Brown was also involved in the drafting and review of the IPO documentation, which plaintiffs alleged misrepresented Refco's financial condition and failed to disclose the receivable concealed by the round-trip loans.[140]

Plaintiffs argued that Mayer Brown could be liable under Rule 10b-5(a) and (c) because Mayer Brown "designed and implemented sham transactions used by Refco to fraudulently transfer uncollectible debt and designed and participated in blatantly fraudulent sham loan transactions."[141] The plaintiffs further argued that reliance could be established through the *Affiliated Ute* presumption, the fraud-on-the-market presump-

133. *See id.* The loans to the third-parties were "meticulously structured so that they were essentially risk-free to the third party." The third-parties profited on these loans through the interest they earned on their loans to RHGI.

134. *See id.*

135. *See id.*

136. *Id. at* 308.

137. *Id.*.

138. *See id.*

139. *See id.* at 309.

140. *See id.*

141. *Id.* at 314 (alternations omitted).

Reprinted with the Permission of the New York University Law School

tion, or the fraud-created-the-market presumption.[142] Mayer Brown argued that, because plaintiffs had no knowledge of its alleged deceptive conduct and it otherwise owed plaintiffs no duties, plaintiffs could not have relied on any of Mayer Brown's deceptive conduct and, under *Stoneridge*, the firm was not liable.[143] The court agreed with Mayer Brown.

Significantly, the *Refco* court found that plaintiffs:

> *clearly alleged facts, including the suspicious timing and the 'risk-free' quality of the loans, that give rise to a strong inference of scienter, that is, that the Mayer Brown defendants knew or acted in reckless disregard of Refco's intention to use transactions to inflate its revenues,* and knew or should have known that the resulting financial statements issued would be relied upon by research analysts and investors. *Plaintiffs allege, moreover, that acting with such knowledge, the Mayer Brown Defendants engaged in conduct that materially aided Refco's fraud.* Such allegations if proven true, are adequate to establish liability for aiding and abetting securities fraud, but are not enough to establish civil liability as a primary actor.[144]

Following *Stoneridge*, however, the *Refco* court held that such allegations established only that Mayer Brown aided and abetted Refco's fraud and were not enough to sustain a prima facie claim against Mayer Brown under 10b-5(a) and (c).[145] In reaching this conclusion, the court looked to the holdings in *Parmalat II*[146] and *In re DVI, Inc. Securities Litigation.*[147] Here, the court found, as in *Parmalat II*, "even assuming the truth of plaintiffs' factual allegations and granting every reasonable inference therefrom, plaintiffs' evidence would establish only that investors relied on *Refco's* deceptive disclosures concerning transactions in which the Mayer Brown Defendants were involved."[148]

---

142. *Id.* at 317-18.

143. *See id.* at 318-19.

144. *Id.* at 316 (emphasis added).

145. *See id.* at 317.

146. *In re* Parmalat Sec. Litig. (*Parmalat II*), 570 F.Supp.2d 521.

147. In re DVI, Inc. Sec. Litig., 249 F.R.D. 196 (E.D. Pa. 2008).

148. In re Refco, 609 F. Supp. 2d at 317 (emphasis added; internal brackets and quotations omitted).

Reprinted with the Permission of the New York University Law School

Of particular significance, footnote to his opinion, Southern District Judge Gerard Lynch—a well-respected jurist, who has since been nominated to the U.S. Court of Appeals for the Second Circuit—issued an unusually frank call for legislative action to correct what he saw as the "dismaying" result required by the application of *Stoneridge*:

> It is perhaps dismaying that participants in a fraudulent scheme who may even have committed criminal acts are not answerable in damages to the victims of the fraud. *However, as the Court noted in* Stoneridge, *the fact that the plaintiff-investors have no claim is the result of a policy choice by Congress . . . This choice may be ripe for legislative reexamination.* While the impulse to protect professionals and other marginal actors who may too easily be drawn into securities litigation may well be sound, a bright line between principals and accomplices may not be appropriate. . . Perhaps a provision authorizing the SEC not only to bring actions in its own right but also to permit private plaintiffs to proceed against accomplices after some form of agency review would provide the necessary flexibility without involving the courts in standardless and difficult-to-administer line-drawing exercises.[149]

The *DVI, Parmalat II,* and *Refco* line of cases suggest that lower courts are construing *Stoneridge* effectively to limit, and to eliminate altogether in most cases, potential 10b-5 liability for law firms that participate in their clients' allegedly false statements, either by drafting clients' false statements or by assisting clients with transactions that are designed for an improper or fraudulent purpose.

E. *Newby v. Enron Corporation*

The issue in *Newby v. Enron Corp.*[150] was whether Merrill Lynch, Barclays, and Credit Suisse (the "Investment Banks") could be liable to Enron's shareholders under Rule 10b-5(a) and (b) for entering into transactions with Enron that were designed falsely to inflate Enron's reported financial performance. In *Newby,* the plaintiff alleged that the investment banks,

149. *Id.* at *13, n. 15 (emphasis added).

150. Newby v. Enron Corp., 2009 WL 565512 (S.D.Tex. March 5, 2009).

Reprinted with the Permission of the New York University Law School

with knowledge of Enron's illicit purpose, entered into various transactions and partnerships with the company that allowed it to misstate its financial condition.[151] The case went before District Judge Melinda Harmon on remand from the U.S. Court of Appeals for the Fifth Circuit, which had rejected certification of a plaintiff class on grounds that the Investment Banks had no duty to disclose information to Enron's investors regarding these transactions, and therefore, there was no basis to presume reliance by all class members upon the Investment Banks' failure to make such disclosures.[152]

On remand, the Investment Banks renewed their motions for summary judgment, arguing that plaintiff's inability to establish reliance on the Investment Banks' allegedly deceptive conduct, following *Stoneridge*, was dispositive of plaintiff's claims.[153] In their opposition, the plaintiff attempted to distinguish between the Investment Banks who sought to nurture extensive and ongoing contacts and relationships with the marketplace in which Enron securities were traded and the vendors in *Stoneridge* who had little if any contact with the marketplace in which Charter Communications securities were traded. The main thrust of the plaintiff's reliance theory was that when the Investment Banks engaged the market for Enron's securities by trading, underwriting, and recommending those securities, they had established a "special relationship" with the entire market for Enron—even with those investors with whom the Investment Banks had no direct contact.[154] Thus, plaintiff alleged, the Investment Banks were "constructive fiduciaries" and had a duty to disclose to the market any material adverse information about Enron—including that they had assisted Enron's illicit conduct).[155]

Specifically, plaintiff's contention that the Investment Banks were under a duty to disclose was premised on the 30-year-old Fifth Circuit case of *First Virginia Bankshares v. Benson*.[156] Under *Virginia Bankshares*:

---

151. *See id.* at *1.

152. *See* Regents, 482 F.3d at 384, 390 ("Enron had a duty to its shareholders, but the banks did not.").

153. *See id.* at *23.

154. *See id.*

155. Newby, 2009 WL 565512 at *31.

156. First Va. Bankshares v. Benson, 559 F.2d 1307 (5th Cir. 1977).

Reprinted with the Permission of the New York University Law School

> In determining whether the duty to speak arises, we consider the relationship between the plaintiff and defendant, the parties' relative access to the information to be disclosed, the benefit derived by the defendant from the purchase or sale, defendant's awareness of plaintiff's reliance on defendant in making its investment decisions, and defendant's role in initiating the purchase or sale.[157]

The district court disagreed and held that the Fifth Circuit's prior ruling on class certification and *Stoneridge* barred Plaintiffs from asserting that the Investment Banks had a duty to disclose and, concomitantly, prevented Plaintiffs from establishing reliance on any deceptive conduct.[158] The court further concluded that the development of Supreme Court case law on Section 10(b)—including subsequent Supreme Court precedent such as *Chiarella v. United States,*[159] which declined to impose a duty to disclose on parties acting at arm's-length based solely on their receipt of corporate information—impliedly overruled much of the multifactor test of *Virginia Bankshares.* And, the district court went on to find that the Investment Banks were not quasi-fiduciaries of, or in a confidential relationship with, the plaintiff. Thus, the *Virginia Bankshares* test could not be satisfied.

* * *

One question that the cases discussed above fail to address is whether, under *Stoneridge,* an employee or other corporate insider who is not identified as a speaker can be liable for securities fraud. The two cases discussed below examine this question in depth.

157. Newby, 2009 WL 565512 at *26.

158. *See id.* at *23-25.

159. Chiarella v. United States, 445 U.S. 222 (1980). Chiarella found that "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.'" *Id.* at 226 (quoting Restatement (Second) of Torts § 551(2)(a) (1976)).

Reprinted with the Permission of the New York University Law School

F. *Pugh v. Tribune Company*

In *Pugh v. Tribune Company*,[160] plaintiffs alleged that several employees of Newsday, a New York subsidiary of the Tribune Company ("Tribune"), had participated in a scheme to report falsely inflated circulation numbers for the newspapers *Newsday* and *Hoy*, thereby increasing the amount they were able to charge advertisers and inflating reported revenues. The scheme came to light when, in February 2004, advertisers in *Newsday* and *Hoy* sued Tribune, alleging a variety of fraudulent schemes to inflate circulation numbers. The schemes included bogus deliveries and wholesale dumping of newspapers, which were then falsely certified by Newsday employees and reported as paid circulation to the Audit Bureau of Circulation, an independent nonprofit monitoring organization. Internal and government investigations followed. Tribune ultimately recorded a $90 million charge to cover expected refunds to advertisers. Several Newsday and Tribune employees also pled guilty to fraud charges in connection with the scheme.[161]

Investors subsequently brought claims against Tribune and several individuals under Sections 10(b) and 20(a) of the Securities Exchange Act, seeking to hold them responsible for, among other things, losses caused by the disclosure of overstated revenues attributable to the fraudulent circulation scheme. The district court, finding a variety of pleading deficiencies, dismissed each of plaintiffs' claims with prejudice.[162]

The Seventh Circuit affirmed.[163] It is particularly noteworthy how the court viewed the claims asserted against Tribune and Louis Sito ("Sito"), a Tribune employee and Vice President for Hispanic Media for Tribune. Sito—who had since pled guilty to criminal charges for certifying false circulation figures—was the alleged "mastermind" of the circulation fraud scheme in his role as the publisher of *Newsday* and *Hoy*.[164] The Court found that Sito's state of mind in masterminding the

160. Pugh v. Tribune Co., 521 F.3d 686 (7th Cir. 2008).

161. *See generally, Anatomy of a Circulation Fabrication*, NEWSDAY, Sept. 12, 2004, *available at* http://www.newsday.com/news/local/longisland/nybzcirc123964647sep12,0,1288951.story.

162. *See* Hill v. The Tribune Co., 2006 WL 2861016 (N.D.Ill. Sep 29, 2006).

163. 521 F.3d at 697.

164. *Id.* at 696.

Reprinted with the Permission of the New York University Law School

fraud could not be imputed to Tribune under *respondeat superior* principles.[165] Applying *Stoneridge*, the Seventh Circuit further found that because Sito had not personally participated in the preparation or dissemination of a false statement on which investors could have relied, he could not be liable under Section 10(b). As the Seventh Circuit noted:

> Sito may have foreseen (or even intended) that the advertising scheme would result in improper revenue for *Newsday* and *Hoy*, which would eventually be reflected in Tribune's revenues and finally published in its financial statements. But *Stoneridge* indicates that an indirect chain to the contents of false public statements is too remote to establish primary liability. Without allegations establishing the requisite proximate relation between the *Newsday* and *Hoy* advertiser fraud and the Tribune investors' harm, we cannot uphold the complaint.[166]

The Seventh Circuit's holding in *Pugh* extended *Stoneridge* to protect not only third-party commercial entities that participate in a scheme through transactions with the issuer, but also employees of an issuer, as long as those employees do not themselves participate in the preparation of a published false statement and the issuer's investors are otherwise unaware of their involvement. Thus, *Pugh's* application of *Stoneridge* suggests that as long as the fraud takes place at the subsidiary level, without parent knowledge, all may escape Section 10(b) liability.

It does not appear that plaintiffs alleged that Sito had a duty to disclose based on his status as the Vice President of Hispanic Media for Tribune (*i.e.*, at the corporate parent level). If it were the case that such a position had a concomitant duty to disclose, reliance could have been presumed. Such was the situation in the case we discuss next.

165. *Id.* at 698.
166. *Id.* at 697.

Reprinted with the Permission of the New York University Law School

G. *In re Bristol Myers Squibb Co. Securities Litigation*

In re Bristol Myers[167] was a securities class action premised on a patent dispute between Bristol Myers Squibb ("Bristol-Myers") and Apotex, Inc. over the blood-thinning medication Plavix, Bristol-Myers's most lucrative drug. Apotex sought permission from the FDA to introduce a generic version of Plavix, claiming that Bristol-Myers's patent was invalid and unenforceable.[168] Bristol-Myers sued Apotex for infringement but also entered into settlement discussions.[169] Bristol-Myers and Apotex eventually reached an initial settlement in which Bristol-Myers, among other concessions, agreed (a) to wait five days before seeking any temporary restraining order and (b) to limit the amount of damages it could seek through litigation against Apotex.[170] However, in announcing the settlement, Bristol-Myers stated that it would still "vigorously pursue" any litigation if necessary and that Apotex could launch their product "at risk."[171] These statements were repeated in various public filings.[172]

After regulators did not approve the initial settlement, Bristol-Myers and Apotex then "quietly renegotiate[d]" the terms in order to gain regulatory approval.[173] However, the proposed renegotiated settlement that was eventually submitted to regulators did not contain all of the agreed terms.[174] In fact, Bristol-Myers and Apotex reached a side-agreement, which, among other points, required Bristol-Myers to pay Apotex a "large cash sum."[175] Eventually, after running into further problems regarding the settlement with government regulators, Bristol-Myers was forced to disclose all of its material terms.

Plaintiffs brought a suit against Bristol-Myers, its CEO and Chairman Peter Dolan, and the Senior Vice President for Strategy and Medical and External Affairs Andrew Bodnar

---

167. *In re* Bristol Myers Squibb Co. Sec. Litig., 586 F. Supp. 2d 148, 151 (S.D.N.Y. 2008).
168. *See id.* at 152.
169. *See id.* at 152-53.
170. *See id.*
171. *Id.* at 154.
172. *See id.*
173. *Id.*
174. *See id.*
175. *Id.*

Reprinted with the Permission of the New York University Law School

("Bodnar"), alleging violations of Section 10(b). With respect to Bodnar, plaintiffs alleged that he was responsible for negotiating the settlement and an illegal oral side agreement; that he withheld information with respect to the settlement and the side agreement from shareholders, the Board of Directors, and the government; and that he did not correct material misstatements regarding the settlement, despite his duty to do so as a senior executive of Bristol-Myers.[176] Relying on *Stoneridge*, Bodnar argued, among other things, that plaintiffs could not prove that they relied on his actions when purchasing securities.[177] The court rejected this argument, finding:

> Bodnar's behavior is at the heart of Bristol-Myers's false and misleading conduct. It is neither implausible, nor too remote to find that the investing public relied on the announcement of the Apotex litigation settlement in deciding whether or not to invest in Bristol-Myers stock, and Bodnar was directly responsible for the settlement agreements.[178]

The court continued, stating that although Bodnar did not make public statements, "investors relied on his good faith in negotiating the Apotex settlement agreement and committing the Company to its terms."[179] The court then distinguished the case from *Stoneridge*, stating that unlike in *Stoneridge*, where the "defendants' deceptive acts were not communicated to the public," Bodnar's misconduct was communicated to the public through "the disclosure of the amended settlement's terms and the revelation of the secret oral side agreement."[180] As such, the court found that plaintiffs' allegations were "more than adequate to satisfy Section 10(b) and the requirements of the *Stoneridge* decision."[181] The court's route in reaching that conclusion is novel given that Bodnar did not make any false statements directly to investors. Instead, the court stated that "investors relied on his good faith in negotiating . . . and committing the Company to [the settlement]

176. *See id.* at 170.

177. *See id.* at 170-71.

178. *Id.*

179. *Id.*

180. *Id.* (internal quotations omitted).

181. *Id.*

Reprinted with the Permission of the New York University Law School

terms,"[182] which appears to be more akin to a breach of a fiduciary duty in carrying out his obligations as an officer of the Company—misconduct that is not actionable under Section 10(b).[183]

CONCLUSION

Recent 10b-5 cases construing *Stoneridge* have tended to focus not on whether a defendant is a "primary" or "secondary" actor, but on plaintiffs' ability to demonstrate reliance based on the specific alleged conduct of the defendant. In *In re DVI, Refco, Pugh, Parmalat II,* and *Newby,* defendants were alleged to have been engaged in deceptive conduct. However, in each of those cases, because their conduct was not publicly disclosed and they were not under a duty to disclose their deceptive conduct to the Company's shareholders, there could be no reliance under *Stoneridge. Lopes,* which was not a class action, suggests that secondary actors, specifically attorneys, have a duty to investors not to draft false disclosures and that a breach of that duty could be enough to satisfy the element of reliance—a result that was expressly (and correctly) rejected in *Refco.* In *Bristol-Myers,* the element of reliance was satisfied even though Defendant Bodnar did not make any public statements. His deceptive conduct was subject to Section 10(b) liability because his false acts were communicated to the public, and as a corporate executive responsible for negotiating material transactions, he had, in essence, a duty to disclose accurate information to investors.

182. *Id.*
183. *See* Santa Fe v. Green, 430 U.S. at 473.

Reprinted with the Permission of the New York University Law School