STONERIDGE AND THE SHORT-LIVED EXPERIMENT OF SCHEME LIABILITY

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I.
INTRODUCTION

In a landmark decision, the Supreme Court held in *Stoneridge Investment Partners v. Scientific-Atlanta* that a silent partner in a scheme to defraud cannot be liable to the shareholders of the primary firm.[1] This decision forecloses plaintiffs from premising a suit on scheme liability and the holding will likely be dispositive in the appeals of several major cases, including *Simpson v. AOL Time Warner.*[2]

Scheme liability is a theory of liability in which secondary actors could be liable as primary violators for their role in furthering a fraudulent scheme. In this note I discuss scheme liability and the legal theory upon which it is based. I begin by providing a brief background of the securities laws relevant to scheme liability, including the causes of action for violations of Rule 10b-5 and the legal distinctions between primary and secondary actors that resulted from *Central Bank v. First Interstate Bank.* I argue that *Central Bank* was decided incorrectly and describe how a literal interpretation of its holding yields inequitable treatment of 10b-5 defendants. Scheme liability is a potential remedy for this unfairness. In light of *Central Bank*'s shortcomings, I analyze the Court's decision in *Stoneridge* and the likely effect of this decision on *Simpson.* Finally, I argue

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1. Stoneridge Investment Partners, LLS v. Scientific-Atlanta, Inc., 552 U.S. (2008) (slip op.) [hereinafter Stoneridge 2008].

2. Simpson v. AOL Time Warner Inc., 452 F.3d 1040 (9th Cir. 2006).

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that while *Stoneridge* may be inequitable, it will have a positive effect on the economy of the United States.

II.
PRIVATE SECURITIES ACTIONS

Scheme liability provides a means of holding secondary actors liable as a primary violator, based on their activities in furtherance of a fraudulent scheme. This theory relies on particular interpretations of § 10(b), Rule 10b-5 and the interplay of numerous Supreme Court holdings. In order to clarify these interpretations, a brief description of the antifraud litigation framework follows.

A. *Private antifraud litigation derives from Federal legislation, SEC rules, and Supreme Court rulings*

Federal legislation against fraudulent securities transactions appears primarily in the Securities Act of 1933 (the '33 Act or the Securities Act),[3] the Securities Exchange Act of 1934 (the '34 Act or the Exchange Act)[4] and the Private Securities Litigation Reform Act of 1995 (the "PSLRA").[5] Section 10(b) of the Exchange Act provides the framework for antifraud litigation.[6] It specifically proscribes "the use or employ[ment of]. . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary."[7]

In response to the mandate of § 10(b), the SEC drafted Rule 10b-5,[8] which prohibits acts falling in three categories: (a) "any device, scheme, or artifice to defraud,"[9] (b) making "any untrue statement of a material fact or to omit[ting] to state a material fact necessary in order to make the statements made. . . not misleading,"[10] and (c) engaging "in any act, prac-

3. Securities Act of 1933, Pub. L. No. 22, 48 Stat. 74, codified at *15 U.S.C. sections 77a-77z* (2002) [hereinafter Securities Act].

4. Securities Exchange Act of 1934, Pub. L. No. 291, 48 Stat. 881, codified at *15 U.S.C. sections 78a et seq.* (2002) [hereinafter Exchange Act].

5. Private Securities Litigation Reform Act of 1995, Pub. L. 104-67, 109 Stat. 737, codified at *15 U.S.C. sections 78u et seq.* [hereinafter PSLRA].

6. Exchange Act, Section 10, 15 U.S.C. § 78j.

7. Exchange Act, Section 10(b), 15 U.S.C. § 78j-(b).

8. 17 C.F.R. § 240.10b-5 (1979) [hereinafter Rule 10b-5].

9. Rule 10b-5(a).

10. Rule 10b-5(b).

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tice, or course of business which operates or would operate as a fraud or deceit upon any person."[11] Rule 10b-5 has been limited such that a "private plaintiff may not bring a 10b-5 suit against a defendant for acts not prohibited by the text of § 10(b)."[12] As a result, private suits under Rule 10b-5 must satisfy the requirements of § 10(b).

Congress did not provide a private cause of action for plaintiffs under § 10(b), and it offered very little insight as to how the requirements for litigation should be formulated.[13] Most courts, however, implied Congressional intent for this cause of action and thus read it into the statute. When the Supreme Court eventually ruled on the matter, the private cause of action was upheld with little discussion.[14] Subsequent distillations of this cause of action based their holdings upon inferences as to how the Congress of 1934 would have addressed the issue had it chosen to explicitly include the cause of action in the Act.[15]

B. *The judiciary has created several requirements that must be satisfied by a section 10(b) cause of action*

The judiciary has created numerous requirements for § 10(b) litigation.[16] As scheme liability derives from § 10(b), it must satisfy these criteria. This section presents the requirements for any § 10(b) cause of action. The manner in which scheme liability may or may not accord with these requirements is discussed *infra* in sections V and VI.

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11. Rule 10b-5(c).

12. Cent. Bank, N.A. v. First Interstate Bank, N.A., 511 U.S. 164, 173 (1994).

13. Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 748-49 (1975) (stating "but as we have pointed out, we are not dealing here with any private right created by the express language of § 10 (b) or of Rule 10b-5. No language in either of those provisions speaks at all to the contours of a private cause of action for their violation.").

14. Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 13 n. 9 (1971) (stating only that "[i]t is now established that a private right of action is implied under § 10 (b).").

15. Musick, Peeler & Garrett v. Employers Ins., 508 U.S. 286, 294 (1993) (noting that "[o]ur task is . . . to attempt to infer how the 1934 Congress would have addressed the issue had the 10b-5 action been included as an express provision in the 1934 Act").

16. *See* Dura Pharms., Inc. v. Broudo, 544 U.S. 336, 341 (2005) (setting forth a list of the basic elements of § 10(b) causes of action).

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Private causes of action require the use or employment of a deceptive device or contrivance. The majority of § 10(b) cases deal with deception in the form of misstatements or omissions, yielding ample jurisprudence defining which statements are deceptive.[17] Most notably, *Basic v. Levinson* provided a baseline requirement of materiality, stating that "there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."[18]

Plaintiffs must allege fraud "in connection with a purchase or sale" of a security, thereby necessitating that a transaction actually transpire.[19] The plaintiffs in Rule 10b-5 class actions must therefore be buyers or sellers of a security.[20] The initial "in connection with" criteria has been expanded, however, to include actors who neither bought nor sold, but

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17. *E.g.* Virginia Bankshares, Inc. v. Sandberg, 501 U.S. 1083, 1087-88 (1991) (holding that knowingly false statements, though conclusory in form, could be actionable, for example in a commercial context where statements such as "high value" of "fair to shareholders" are reasonably understood to rest on a factual basis that justifies them as accurate, the absence of which renders them misleading); *In re* Convergent Technologies Sec. Litig., 948 F.2d 507, 512 (9th Cir. 1991) (holding "some statements, although literally accurate, can become, through their context and manner of presentation, devices which mislead investors").

Forward-looking statements have been determined to implicitly include an assumption that the statement is actually believed by the source; that the speaker's belief is reasonable; and that he or she does not know of any undisclosed facts that could undermine the accuracy of the forward-looking statement. *In re* Apple Computer Secur. Litig. 886 F.2d 1109, 1113 (9th Cir. 1989) (citing Marx v. Computer Sciences Corp., 507 F.2d 485, 490 (9th Cir. 1974)). *See generally* Jennifer O'Hare, *The Resurrection of the Dodo: The Unfortunate Re-emergence of the Puffery Defense in Private Securities Fraud Actions*, 59 OHIO ST. L.J. 1697, 1707-15 (1998).

18. Basic Inc. v. Levinson, 485 U.S. 224, 231-32 (1988) (citing TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438 (1976)). *See also* Levitin v. Painewebber, Inc., 159 F.3d 698, 702 (2d Cir. 1998) *cert. denied*, 525 U.S. 1144 (1999) (providing a baseline of investor knowledge); Ganino v. Citizens Utilities Co., 228 F.3d 154, 162 (2d Cir. 2000) (same).

19. *See* Exchange Act, Section 10(b), *codified at* 15 U.S.C. § 78j(b) (2000) (requiring that the fraud be in connection with a purchase or sale).

20. Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 730-33 (1975) (affirming a rule initially set forth by the Second Circuit over twenty years earlier, in Birnbaum v. Newport Steel Corp., 193 F.2d 461, 462-64 (2d Cir. 1952)).

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were participants in more complicated deceptions that "coincided" with the sale of securities.[21]

Courts require that the plaintiff demonstrate reliance upon the deception,[22] providing "the requisite causal connection between a defendant's misrepresentation and a plaintiff's injury."[23] In other words, the plaintiff must "demonstrate that defendants' conduct caused him to engage in the transaction in question."[24] When a plaintiff alleges an omission, the Supreme Court held in *Affiliated Ute Citizens v. United States* that the failure to disclose information establishes the requisite causation only if defendant had a duty to disclose to the plaintiffs and if the undisclosed information was material.[25] Where a security is traded in an efficient market, each plaintiff need not make an individual showing of reliance. Instead, there is a "fraud-on-the-market" presumption that the price has incorporated any material misrepresentation that has been made public and that, in purchasing the share, the plaintiff relied upon that misrepresentation through the market's valuation.[26]

Loss causation is required by § 21D(b)(4) of the PSLRA.[27] A plaintiff must show that his or her loss was caused by the misstatement or omission, rather than "changed economic circumstances, changed investor expectations, new industry-spe-

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21. SEC v. Zandford, 535 U.S. 813, 820-22 (2002) (holding in part "It is enough that the scheme to defraud and the sale of securities coincide.").

22. *See* Dura Pharms., Inc. v. Broudo, 544 U.S. 336, 341 (2005) (using "transaction causation" for fraud-on-the-market cases).

23. *Basic*, 485 U.S at 243.

24. Newton v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 259 F.3d 154, 174 (3d Cir. 2001).

25. Affiliated Ute Citizens v. United States, 406 U.S. 128, 151-55 (1972).

26. *Basic*, 485 U.S. at 247 (stating that "[a]n 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 market price, an investor's reliance on any public material misrepresentations, therefore, may be presumed for purposes of a Rule 10b-5 action."). Reliance may alternatively be established if the investor can prove that they have read and relied upon a document containing the misleading statement. *See generally* Robert A. Prentice, Vernon J. Richardson & Susan Scholz, *Corporate Web Site Disclosure and Rule 10b-5: An Empirical Evaluation*, 36 AM. BUS. L.J. 531 (Summer 1999).

27. PSLRA § 21D(b)(4) ("In any private action arising under this title, the plaintiff shall have the burden of proving that the act or omission of the defendant alleged to violate this title caused the loss for which the plaintiff seeks to recover damages.").

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cific or firm-specific facts, conditions, or other events, which taken separately or together account for some or all of that lower price."[28]

Finally, a plaintiff in securities litigation must plead scienter with particularity.[29] The required state of mind is intent to "deceive, manipulate, or defraud."[30] This standard bars cases alleging mere negligence.[31] *Stoneridge* held that scheme liabil-

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28. Dura Pharms., Inc. v. Broudo, 544 U.S. 336, 343 (2005). *See also* Tse v. Ventana Medical Systems, Inc., 297 F.3d 210, 218-21 (3d Cir. 2002) (holding for summary judgment against the plaintiffs because they could not show anything but a "wholly speculative" loss); Bastian v. Petren Resources Corp., 892 F.2d 680 (7th Cir. 1990) (denying plaintiffs recovery where industry-wide problems ruined most similar ventures. Had the plaintiffs invested in another firm in this industry, as the evidence showed they would, they most likely would have still lost money). A misstatement or omission must do more than merely inflate the price of a company's stock. Should the price mere be artificially increased, the holders of the security could simply sell their position without sustaining any economic loss. *Dura*, 544 U.S. at 342 (holding that "Normally, in cases such as this one (i.e., fraud-on-the-market cases), an inflated purchase price will not itself constitute or proximately cause the relevant economic loss.").

29. PSLRA § 21D (b)(1) (stating that "the complaint shall specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed."). *See also* Florida State Bd. of Admin. v. Green Tree Financial Corp., 270 F.3d 645, 654-60 (8th Cir. 2001) (disagreeing with the "motive and opportunity" standard of scienter from); *In re* Comshare, Inc. Sec. Litig., 183 F.3d 542, 551 (6th Cir. 1999) (citing substantial legislative history, the Court found "a showing of unusual or heightened motive will often form an important part of a complaint that meets the Reform Act standard," that "circumstantial allegations that establish motive and opportunity also give additional reason to believe the defendant's misrepresentation was knowing or reckless" then if "the complaint does not show motive and opportunity of any sort — either the unusual, heightened motive highlighted in the Second Circuit cases, or even an everyday motive such as keeping one's job — then other allegations tending to show scienter would have to be particularly strong in order to meet the Reform Act standard.").

30. *Id.*

31. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 200-01 (1976) (describing other elements of the Securities Act and the Exchange Act in which Congress expressly created a standard of liability for negligence. Finding no such language in § 10(b), the court held that "the language of § 10(b), . . . clearly connotes intentional misconduct"). Some courts have allowed the plaintiff to plead recklessness instead of intent, where such conduct is "[that which] may be defined as a highly unreasonable omission, involving not merely sim-

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ity could not be used for claims based on § 10(b) because it fails to meet several of the above requirements, as is discussed in greater detail *infra* in section V-D.

III.
PRIMARY AND SECONDARY LIABILITY

A. *Liability for secondary actors has been foreclosed by* Central Bank *and the PSLRA*

In *Central Bank N.A. v. First Interstate Bank, N.A.*, the Supreme Court held that liability under § 10(b) extends only to primary violators. This barred all claims of secondary liability, such as aiding and abetting.[32] The court "emphasized adherence to the statutory language,"[33] and used a strict interpretation of the text. Because § 10(b) of the Exchange Act did not mention "aiding and abetting," *Central Bank* denied liability.[34]

The Court used a multifaceted approach to justify this holding. The majority in *Central Bank* claimed that, in refusing to extend liability to aiders and abettors, they reinforced the requirement of reliance for all fraud cases. Otherwise, such secondary liability could provide recovery to a plaintiff otherwise unable to show reliance.[35] In addition, although the Exchange Act prohibits acts that deceive "directly or indirectly,"[36] *Central Bank* found that aiding and abetting liability would broaden the scope of liability beyond even those who "indirectly" participated in the prohibited activity. The Court also reasoned that Congress could have easily included aiding and

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ple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it." Hollinger v. Titan Capital Corp., 914 F.2d 1564, 1569 (9th Cir. 1990) (quoting Sundstrand Corp. v. Sun Chem. Corp., 553 F.2d 1033, 1045 (7th Cir.)).

32. Cent. Bank, N.A. v. First Interstate Bank, N.A., 511 U.S. 164, 191 (1994).

33. *Id.* at 173.

34. *Id.* at 175-76.

35. *Id.* at 180.

36. Exchange Act, Section 10, 15 U.S.C. § 78j ("It shall be unlawful for any person, directly or indirectly. . . to use or employ . . . 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.").

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abetting liability in the statute had it wanted to, but chose not to.

Though *Central Bank* explicitly foreclosed secondary liability, it left the door open for liability against secondary actors. Notably, the Court remarked that:

> [t]he absence of § 10(b) aiding and abetting liability does not mean that secondary actors in the securities markets are always free from liability under the securities Acts. 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.[37]

This limited secondary actor liability to only those engaged in violations meeting all of the elements of a § 10(b) cause of action. Because *Central Bank* did not rigorously define the requirements for the types of deceptive acts described in Rule 10b-5, circuit courts developed conflicting standards.[38]

One year after *Central Bank*, Congress enacted the PSLRA to substantively regulate securities class action litigation. The PSLRA included § 21D(f), which set forth a scheme of proportionate liability for cases where there are multiple guilty defendants.[39] Congress declared that the introduction of proportionate liability must not "be construed to create, affect, or in any manner modify, the standard for liability associated with any action arising under the securities laws."[40] This language explicitly approved the judicially-created elements of a § 10(b) cause of action, including the prohibition against aiding and abetting liability.[41]

Though the general issue surrounding the liability of control persons is beyond the scope of this paper, it is important to note that in 1995, Congress amended Section 20 of the Exchange Act to provide for aiding and abetting liability to con-

37. *Id.* at 191 (emphasis in original).

38. See *infra* section III.B for a discussion of the bright line rule, substantial participation, and the increasingly blurry line between the two.

39. PSLRA § 21D(f).

40. PSLRA § 21D(f)(1).

41. *E.g.* PSLRA § 21D(f).

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trol persons.[42] This section states that "any person that knowingly provides substantial assistance to another person in violation [of the Exchange Act]. . ., shall be deemed to be in violation. . . to the same extent as the person to whom such assistance is provided."[43] By design, only the SEC was granted the use of aiding and abetting liability, and only where it was pursuing control persons. Private litigants were not allowed to take advantage of this amendment and were implicitly denied the use of aiding and abetting liability.[44]

The SEC implored Congress to statutorily provide that private litigants may pursue claims against those aiding and abetting. stating that it was "critically important in deterring individuals from assisting possible fraudulent acts by others."[45] Congress considered whether to reinstitute secondary liability, but ultimately decided that significant abuse in private lawsuits, including strike suits and litigation predicated merely on the change of a stock price threatened serious injury to the U.S. economy and the investing public and so did not allow the resumption of these private suits.[46]

B. *All private litigation must satisfy one of the two forms of primary liability*

Central Bank limited liability to primary violators. The boundary between primary and secondary violators remains a matter of dispute between different circuits. The Second Circuit, among others, has set forth a strict bright line test. In

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42. Exchange Act, Section 20, codified at *15 U.S.C. section 78t.*

43. Exchange Act, Section 20(e), codified at *15 U.S.C. section 78t(e).*

44. *Id.*

45. *See* Securities Litig. Reform Proposals—S.240, S.667, and H.R. Res. 1058, 104th Cong. (1995) (enacted); *Hearings Before the Subcomm. on Sec., Senate Comm. on Banking, Hous., and Urban Affairs,* 104th Cong. 210-11 (1995) (S. Rep. No. 104-98, at 49 (1995), *as reprinted in* 1995 U.S.C.C.A.N. 679, 727) (statement of Sen. Dodd, Chairman, U.S. Sen. Comm. on Banking, Hous. and Urban Affairs, repeated also by Arthur Levitt, Chairman, Securities and Exchange Commission).

46. Joel Seligman, *Rethinking Private Securities Litigation,* 73 U. CIN. L. REV. 95, 108 (Fall 2004) (citing Private Securities Act of 1995, H.R. Conf. Rep. No. 104-369 [1995-1996 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 85,710, at 87,200 (Dec. 1995)). Many claims based on aiding and abetting liability were upheld prior to *Central Bank,* such as Brennan v. Midwestern United Life Ins. Co., 259 F. Supp. 673 (N.D. Ind. 1966); McCown v. Heidler, 527 F.2d 204 (10th Cir. 1975); Armstrong v. McAlpin, 699 F.2d 79 (2d Cir. 1983).

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stark contrast to the simplicity and predictability of the bright line test, the Ninth Circuit has developed the "substantial participation" test. Scheme liability can only exist in a substantial participation jurisdiction.

1. *The bright line test*

The bright line test uses a strict interpretation of *Central Bank* to clearly delineate the point at which one becomes a primary violator. The threshold for liability, as announced in *Shapiro v. Cantor*, is that "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)."[47] Allegations of "assisting," "participating in," and "complicity in" do not meet the standard of "actually making the statement," and therefore are not actionable.[48]

In *Wright v. Ernst & Young LLP*, the Second Circuit specified another requirement for liability under the bright line test.[49] In defining what it meant to "make" a statement, the Court wrote:

> A secondary actor cannot incur primary liability under the Act for a statement not attributed to that actor at the time of its dissemination. Such a holding would circumvent the reliance requirements of the Act, as 'reliance only on representations made by others cannot itself form the basis of liability.' Thus, the misrepresentation must be attributed to that specific actor *at the time of public dissemination*, that is, in advance of the investment decision.[50]

The Second Circuit thus confined liability to situations where the misstatement or omission in question is clearly attributed, at the time of its release, to the individual or corporation that made the misstatement or omission. In addition, a

47. Shapiro v. Cantor, 123 F.3d 717, 720 (2d Cir. 1997) (quoting *In re* MTC Elec. Techs. Shareholders Litig., 898 F. Supp. 974, 987 (E.D.N.Y. 1995)).

48. *Shapiro*, 123 F.3d at 720.

49. Wright v. Ernst & Young LLP, 152 F.3d 169 (2d Cir. 1998), *cert. denied*, 525 U.S. 1104 (1999).

50. *Id.* at 175 (emphasis added).

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defendant must have known or should have known that his or her misrepresentation would be conveyed to potential investors, and therefore could influence a purchase or sale.[51]

The bright line test has received broad support. At least one district court in nearly every circuit has affirmed some version of the bright line test.[52] Despite this substantial judicial support, the bright line test has its detractors.[53] Commentators have claimed that the bright line test ignores the use of the words "directly or indirectly" in § 10(b). For example, for a violator to be "indirectly" responsible, he or she cannot have personally made the misstatement. By requiring direct attribution, the bright line test cannot possibly accord with the "indirectly" language of § 10(b).[54] Commentators also argue that the bright line test focuses entirely on misstatements, and thus ignores the prohibition against manipulative devices in both § 10(b) and Rule 10b-5.[55] Finally, commentators note that Congress may have aspired to ground liability in *respondeat superior* when it drafted the Exchange Act.[56] In effect, the bright line rule may preclude this form of liability as a means for deterrence, thereby undermining Congressional intent.[57]

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51. *Shapiro*, 123 F.3d at 720 (holding ". . . in order for accountants to 'use or employ' a 'deception' actionable under the antifraud law, they must themselves make a false or misleading statement (or omission) that they know or should know will reach potential investors.") (quoting Anixter v. Home-Stake Prod. Co., 77 F.3d 1215, 1226-27 (10th Cir. 1996)).

52. *E.g.* SEC v. Tambone, 417 F. Supp. 2d 127, 132 (D. Mass. 2006); SEC v. Lucent Techs., Inc., 363 F. Supp. 2d 708, 721 (D.N.J. 2005); *In re* Safety-Kleen Corp. Bondholders Litig., 2004 U.S. Dist. LEXIS 30096 (D.S.C. 2004); McNamara v. Bre-X Minerals, Ltd., 57 F. Supp. 2d 396, 428 (D. Tex. 1999); D.E. & J.L.P. v. Conaway, 284 F. Supp. 2d 719, 730 (D. Mich. 2003); In re Transcrypt Int'l Sec. Litig., 1999 U.S. Dist. LEXIS 17540 (D. Neb. 1999); Bruhl v. Conroy, 2007 U.S. Dist. LEXIS 21886 (D. Fla. 2007).

53. *See e.g.* Robert A. Prentice, *Locating that "Indistinct" and "Virtually Non-existent" Line between Primary and Secondary Liability under Section 10(b)*, 75 N.C.L. REV. 691, 731-32 (March 1997) ("The bright-line, narrow approach is not only terribly unfair and disruptive of existing precedent, but it cannot be justified as a matter of statutory interpretation either.").

54. *Id.* (citing Thomas L. Riesenberg, *Fraud Claims Against Professionals after Central Bank*, INSIGHTS, Feb. 1995, at 9, 13).

55. Prentice, *supra* note 53, at 731.

56. Donald C. Langevoort, *Words from on High about Rule 10b-5:* Chiarella*'s History,* Central Bank*'s Future*, 20 DEL. J. CORP. L. 865, 893 (1995).

57. Prentice, *supra* note 53, at 731.

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Several courts have substantially eroded the bright line rule set forth by the Second Circuit. In *In re Lernout & Hauspie Securities Litigation*, the district court questioned whether "public attribution at the time the statement is issued [is a necessary] predicate to primary liability."[58] Courts technically bound by the jurisprudence of the Second Circuit have noted that the requirement of public attribution, instead of furthering the effect of the securities laws, merely "places a premium on concealment and subterfuge."[59] The SEC, to which the original rule-making authority of § 10(b) was delegated and which is thus afforded significant deference by the judiciary, also opposes this standard and has submitted *amicus curiae* briefs to this effect.[60] Finally, scheme liability, as discussed below, was advanced by the Southern District of New York before *Stoneridge*, and would have undermined the Second Circuit's adherence to the bright line test by holding liable even silent members of a scheme to defraud.

2. *Substantial Participation*

The substantial participation test, set forth originally by the Ninth Circuit, presents a far less precise boundary for liability than the bright line rule. While the bright line test requires that the actor actually use or employ deception, the Ninth Circuit held that "substantial participation or intricate involvement in the preparation of fraudulent statements is grounds for primary liability even though that participation might not lead to the actor's actual making of the statements."[61] In *Howard v. Everex Systems, Inc.*, the Court remarked that merely attesting to the veracity of a document, even without participating in its drafting, provides the requisite level of

58. *In re* Lernout & Hauspie Secs. Litig., 230 F. Supp. 2d 152, 162 (D. Mass. 2002).

59. *In re* Global Crossing, Ltd. Sec. Litig., 322 F. Supp. 2d 319, 333 (S.D.N.Y. 2004) (stating that "a strict requirement of public attribution would allow those primarily responsible for making false statements to avoid liability by remaining anonymous, and thus 'would place a premium on concealment and subterfuge rather than on compliance with the federal securities laws.'" (quoting *In re* Enron Corp. Secs., Derivative & ERISA Litig., 235 F. Supp. 2d 549, 587 (S.D. Tex. 2003))).

60. *See e.g. In re* Enron Corp. Sec., Deriv. and ERISA Litig., 235 F. Supp. 2d 549, 588 (S.D. Tex. 2002).

61. Howard v. Everex Sys., Inc., 228 F.3d 1057, 1061 n.5 (9th Cir. 2000).

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"substantial participation" for liability.[62] In *In re Software Toolworks,* the court found an accounting firm liable as a primary violator despite its lack of public attribution at the time that the statement was made. By playing a significant role in the drafting and editing of letters that the accountants knew would be distributed, they had participated sufficiently enough for the Court to hold the accounting firm liable as a primary violator.[63]

Substantial participation has received unfavorable treatment in district courts within the Third,[64] Fourth[65] and Sixth Circuits,[66] and from the Court of Appeals of the Eleventh Circuit.[67] The Second Circuit affirmed its use of the bright line test, and explicitly disagreed with the logic of *Software Toolworks.*[68] A Third Circuit panel distinguished the substantial participation test in *Klein v. Boyd.*[69] The Court stated that, rather than "substantial participation," a defendant's participation in a fraud would have to reach the level of co-authorship for the court to impose liability.[70] The Third Circuit did not have opportunity to elaborate on the precise point at which participation becomes sufficient for attribution.

Substantial participation is often criticized for allowing liability to attach where strict interpretations of *Central Bank*

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62. *Id.* at 1061.

63. *In re* Software Toolworks Inc. Sec. Litig., 50 F.3d 615, 628-29 & n.3 (9th Cir. 1994).

64. *In re* Rent-Way Secs. Litig., 209 F. Supp. 2d 493, 503 (D. Pa. 2002).

65. *In re* Royal Ahold N.V. Sec. & ERISA Litig., 351 F. Supp. 2d 334, 371 (D. Md. 2004).

66. Picard Chem. Profit Sharing Plan v. Perrigo Co., 940 F. Supp. 1101, 1120 (D. Mich. 1996).

67. Ziemba v. Cascade Int'l, Inc., 256 F.3d 1194, 1205 (11th Cir. 2001).

68. Wright v. Ernst & Young LLP, 152 F.3d 169, 176 (2d Cir. 1998), *cert. denied,* 525 U.S. 1104 (1999) ("Wright argues that we should follow other jurisdictions that have adopted the substantial participation test. We decline to do so.") (internal citations omitted).

69. Klein v. Boyd, 1998 U.S. App. LEXIS 2004 (3d Cir. 1998) vacated *en banc* in 1998 U.S. App. LEXIS 4121 (3d Cir. 1998). The case settled between the parties before the Third Circuit reheard the case, but because it was vacated by the court, it is not in the reporters. *See* Elizabeth A. Nowicki, *10(b) or Not 10(b)?: Yanking the Security Blanket for Attorneys in Securities Litigation,* 2004 COLUM. BUS. L. REV. 637, 660-64 (2004) (describing the facts and the history of *Klein v. Boyd*).

70. *Nowicki, supra* note 69, at 663-64.

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would dictate otherwise.[71] Opponents of this theory often cite its failure to prove all the elements of a § 10(b) cause of action. In particular, defendants can be liable without making a misstatement and without the plaintiff proving any reliance.[72] Both are legitimate concerns. The defendant in *Everex* never made a misstatement, he merely signed an SEC filing that contained the misstatements.[73] In *Software Toolworks*, the Ninth Circuit sustained liability against a secondary actor whose name did not appear on deceptive documents and upon whom the plaintiffs could not have directly relied.[74] As is discussed below, the Supreme Court rejected scheme liability in *Stoneridge* for similar reasons.

IV.
THE SHORTCOMINGS OF THE *CENTRAL BANK* DECISION

A. *The rejection of aiding and abetting in Central Bank may be inconsistent with Congress's intent when originally passing securities fraud legislation*

As discussed above, the Supreme Court decided *Central Bank* using a strict textualist approach.[75] Commentators have expressed their doubts about the propriety of the Court's analysis.[76] For example, in defining the terms "directly or indirectly," the court compared numerous other sections of the securities acts that used similar terms. These sections, however, did not refer to actions by an individual or a corporation, but rather to descriptions of intangibles such as control of an or-

71. *E.g.* Anixter v. Home-Stake Prod. Co., 77 F.3d 1215, 1226 n.10 (10th Cir. 1996) ("To the extent these cases allow liability to attach without requiring a representation to be made by defendant, and reformulate the 'substantial assistance' element of aiding and abetting liability into primary liability, they do not comport with Central Bank of Denver.").

72. Joseph F. Morrissey, *Catching the Culprits: Is Sarbanes-Oxley Enough?*, 2003 COLUM. BUS. L. REV. 801, 823 (2003) (citing *In re* ZZZZ Best Securities Litigation, 864 F. Supp. 960 (C.D. Cal. 1994)).

73. Howard v. Everex Sys., Inc., 228 F.3d 1057, 1061 (9th Cir. 2000).

74. *In re* Software Toolworks Inc. Sec. Litig., 50 F.3d 615, 628-29 & n.3 (9th Cir. 1994).

75. Cent. Bank, N.A. v. First Interstate Bank, N.A., 511 U.S. 164, 175-77 (1994).

76. *See* T. James Lee, Jr., *Central Bank v. First Interstate Bank: Plain Language and the Implied Private Right of Action Under Section 10(b) and Rule 10b-5*, 1995 B.Y.U. L. REV. 269, 284-85 (1995).

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ganization or ownership of stock.[77] Analogizing the technical requirements of indirect stock ownership, for example, to indirect participation in a scheme to defraud was specious because the legal formalities of indirect control do not readily apply to the myriad of opportunities to indirectly participate in a fraud. The Court neglected to define the "indirectly" aspect of "directly or indirectly." Instead it simply found that "indirectly" could be satisfied through aiding and abetting. Commentators have thus argued that *Central Bank*, using this textualist analysis, essentially ignored the term "indirectly."[78]

In contrast, a leading case that imposed aiding and abetting liability before *Central Bank*, *Brennan v. Midwestern United Life Insurance*, conducted a thorough investigation of the legislative history of the '34 Act.[79] Several proposed amendments to the Exchange Act would have included liability for aiding and abetting, but were ultimately never included.[80] The *Brennan* case suggested that Congress failed to ratify such amendments, not because they lacked support, but because they would be unnecessary given the existing judicial recognition of this form of liability.[81]

The Supreme Court has determined that questions about the § 10(b) implied cause of action must be addressed through an "attempt to infer how the 1934 Congress would have addressed the issue had. . . [it been] an express provision in the 1934 Act."[82] Legislative history and context should be used extensively to resolve ambiguity about how the 1934 Congress would have considered any given issue.[83] When Congress drafted the 1934 Act, courts often construed terms in legislation more liberally than would their modern counterparts,[84]

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77. *Central Bank*, 511 U.S. at 176-77 (comparing "directly or indirectly" in conjunction with aiding and abetting, with "direct or indirect" ownership of stock, interests in options, ownership, or control of a person violating an act).

78. Prentice, *supra* note 53, at 731-32.

79. Brennan v. Midwestern United Life Ins. Co., 259 F. Supp. 673 (N.D. Ind. 1966).

80. *Id.* at 677-78.

81. *Id.* at 678.

82. Musick, Peeler & Garrett v. Employers Ins., 508 U.S. 286, 294 (1993).

83. *See* Lee, *supra* note 76, at 284-85.

84. *E.g.* Piedmont & N. R. Co. v. Interstate Commerce Com., 286 U.S. 299, 310 (1932) ("The Transportation Act was remedial legislation and should therefore be given a liberal interpretation"); Pigeon River Improv-

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so it is likely that the Congress in that period was writing with the expectation of liberal construction.[85] Subsequently, the Court wrote that "Section 10(b) must be read flexibly, not technically and restrictively."[86] It could be argued that, prior to *Central Bank*, Congress assumed aiding and abetting liability could fall within a flexible interpretation of § 10(b), and thus did not enact any relevant legislation.

In his *Central Bank* dissent, Justice Stevens, citing the general agreement within the judiciary, approving aiding and abetting liability, stated that a "settled construction of an important federal statute should not be disturbed unless and until Congress so decides."[87] The Supreme Court made a similar assertion about the implied 10b-5 right of action in *Herman & MacLean v. Huddleston*, stating that because it had been consistently recognized for so long, it was "beyond peradventure."[88] So engrained was the notion of aiding and abetting liability for 10b-5 cases that, in presenting its case, the defendant, the Central Bank of Denver, had actually assumed that it could be liable for aiding and abetting and did not argue the issue.[89] Demonstrating general Congressional acceptance of aiding and abetting, Justice Stevens cites non-legislative Congressional approval of the continuing use of aiding and abetting liability. For example, he points to "an approving reference to '[the] judicial application of the concept of aiding and abetting liability to achieve the remedial purposes of the securities laws.'"[90] He claims it is not the place of the judiciary to interpose itself, without a mandate from Congress, in important

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ment, Slide & Boom Co. v. Charles W. Cox, Ltd., 291 U.S. 138 (1934) ("Liberal interpretation of the treaty demands this construction."); Butte, A. & P. R. Co. v. United States, 290 U.S. 127 (1933); Todok v. Union State Bank, 281 U.S. 449, 452 (1930).

85. *See* Lee, *supra* note 76, at 291.

86. Superintendent of Ins. v. Bankers Life & Casualty Co., 404 U.S. 6, 12 (1971).

87. Cent. Bank, N.A. v. First Interstate Bank, N.A., 511 U.S. 164, 197 (1994) (Stevens, J., dissenting).

88. Herman & MacLean v. Huddleston, 459 U.S. 375, 380 (1983).

89. *Central Bank*, 511 U.S. at 194-95 (Stevens, J., dissenting).

90. *Id.* at 198 n.8 (citing The House Report accompanying an aiding and abetting provision of the 1983 Insider Trading Sanctions Act, *see* 15 U.S.C. § 78u(d)(2)(A) (1982 ed., Supp. V), H. R. Rep. No. 98-355, p. 10 (1983)).

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matters of how to construe a federal statute when there is a settled construction.[91]

A final critique of *Central Bank* questions whether the Court failed to sufficiently consider public policy. In *Virginia Bankshares v. Sandberg*, the Supreme Court wrote:

> Where a legal structure of private statutory rights has developed without clear indications of congressional intent, the contours of that structure need not be frozen absolutely when the result would be demonstrably inequitable to a class of would-be plaintiffs with claims comparable to those previously recognized. Faced in that case with such a claim for equality in rounding out the scope of an implied private statutory right of action, we looked to policy reasons for deciding where the outer limits of the right should lie. We may do no less here, in the face of respondents' pleas for a private remedy. . . .[92]

In stressing the importance of public policy where litigants may have their claims revoked in the face of Congressional ambiguity, the *Virginia Bankshares* Court suggests that, in eliminating aiding and abetting liability, the *Central Bank* Court should have given public policy significant consideration. The majority in *Central Bank*, however, did not undertake a lengthy policy debate. Instead, the Court stated that the SEC, in arguing for the opposite conclusion, made policy arguments that would make civil remedies more far-reaching. Despite the ambiguity of the text and the absence of conclusive legislative intent supporting either side, the *Central Bank* Court asserted that "policy considerations cannot override. . . the text and structure. . . , except to. . . show that adherence to the text and structure would lead to a result 'so bizarre' that Congress could not have intended it."[93] As a result, the majority considered policy only where it would support their position, despite obvious policy considerations favoring the dissent. Specifically, it found that reducing aiding and abetting liability would limit vexatious litigation.[94] Rather than considering whether this furthered Congressional intent, the Court fo-

91. *Id.* at 197.
92. Va. Bankshares v. Sandberg, 501 U.S. 1083, 1104-1105 (1991).
93. *Central Bank*, 511 U.S. at 188.
94. *Id.* at 188-89.

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cused on justifications of how foreclosing aiding and abetting liability would only nominally affect deterrence.[95] Mentioning policy only as an aside, and only where it supports the opinion, the Court fell well short of the standard discussed in *Virginia Bankshares* of looking to policy as a substantial source of judicial guidance.

B. Central Bank's *legacy may be one of inequity and inefficiency*

Public policy considerations dictate that the antifraud regime be equitable to potential plaintiffs. *Central Bank* eliminates liability for certain classes of defendants that equity alone would find liable. The SEC set forth the point at which participants in a fraudulent transaction should equitably be subject to liability through the following five hypotheticals: (1) If a bank makes a loan to a borrower, even if it knows that the borrower will use the funds to commit securities fraud, the bank should not be liable; (2) If the bank provides the means by which a borrower can obtain funds to commit its fraud, the bank should not be liable; (3) If party A enters into an arms-length transaction with party B, knowing that B will use some aspect of this transaction to commit fraud, party A should not be liable; (4) If party A enters into that transaction with party B where the primary purpose and effect of both parties in implementing the transaction is to enable fraud by B, A should be liable; (5) The final hypothetical involves the two firms, A and B, which reach an ostensibly legitimate agreement where A will deliver goods to B in exchange for money or services, but have a side understanding that A will never deliver the goods, and B will never perform its obligations. This makes the transaction fraudulent, and if the two firms carry out the transaction in this fraudulent manner, both A and B should be primary violators.[96] In every example above, B will necessarily be liable as a primary violator. *Central Bank* does not affect the liability of A in the first three examples, nor does the SEC argue that it should. However, *Central Bank* precludes liability against A for the final two. As discussed below, this inequitable judicial treatment for A has led to distinctions of liability based

95. *Id.*

96. Newby v. Enron Corp. (*In re* Enron Corp. Secs.), 2006 U.S. Dist. LEXIS 88121, *15 n.9 (S.D. Tex. 2006) (citing #4847).

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simply on the legal structure of a transaction without considerations of its substance.

The SEC described the purpose of private actions as twofold: to make whole an injured investor and to deter violations of the securities laws.[97] Foreclosing liability to aiders and abettors potentially limits the ability of a plaintiff to become whole where, for example, the primary violator becomes insolvent. Additionally, deterrence cannot be effective if the securities laws do not allow the prosecution of the people who mastermind, control or guide the fraud behind-the-scenes, such as law firms, accountants, and investment banks. For example, creating immunity for law firms could drastically reduce their incentives to ensure that their clients conform to the law. Even worse, a guaranteed exemption could encourage law firms to actively participate in and engineer fraudulent schemes while obeying the mere formalities that would prevent them from being considered a primary violator.[98]

The hypothetical situation in which a bank employee agrees with a manager to structure illicit transactions that further the fraud, knowing full well that the transactions are fraudulent and that the manager stands to gain at the expense of the firm's shareholders,[99] presents an exemplary case in which *Central Bank*, when strictly construed, exculpates individuals intimately involved in the fraud. In this situation, only the manager would have a duty to disclose to the firm's shareholders. As long as the bank makes no public disclosures about the deception that it facilitates, a strict interpretation of *Central Bank* would effectively grant the bank immunity from Rule 10b-5.[100]

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97. Brief for the SEC as Amicus Curiae in Support of Respondents, *Cent. Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164 (1994) (No. 92-854), 1993 WL 13006275.

98. Note, *Developments in the Law – Lawyers' Responsibilities and Lawyers' Responses*, 107 HARV. L. REV. 1547, 1621 (May 1994).

99. *See* Donald C. Langevoort, *Lessons from Enron, How Did Corporate and Securities Law Fail? Managing the "Expectations Gap" in Investor Protection: The SEC and the Post-Enron Reform Agenda*, 48 VILL. L. REV. 1139, 1162 (2003). This example is not completely hypothetical. As will be described below, the facts and holding of *Regents* comport with the inequities described here.

100. *Id.* at 1162. Compare the bright line and substantial participation discussed above. The bright line test would foreclose liability to the bank whereas substantial participation could provide the defrauded investors opportunity for recovery from the bank.

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The allocation of liability discussed above, if enforced consistently by the courts, could encourage a race to the bottom. Law firms, accountants and banks might be motivated to engage in fraudulent transactions whenever demanded by their clients. Otherwise, unscrupulous clients may find other providers that are more willing and equally immune. Fraudulent transactions could grow in complexity as these service providers develop the experience to engineer increasingly sophisticated and better-concealed fraud. Naturally, such a scenario threatens the efficiency of the public markets as well as public policy.[101]

V.
SCHEMES TO DEFRAUD

Scheme liability can be considered a judicial invention that enables plaintiffs to circumvent the equitable and economic shortcomings of *Central Bank.* Because scheme liability grows out of Rule 10b-5, the manner in which, if upheld, it would have accorded with the holding of *Central Bank* and still satisfied the requirements of Rule 10b-5 requires precise interpretations of a substantial corpus of jurisprudence.

A. *Scheme liability must meet the judicial requirements of deceptive devices*

1. Ernst & Ernst *defined "device"*

Section 10(b) makes it unlawful "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."[102] As discussed above, securities litigation pursuant to Rule 10b-5 must allege an act prohibited by § 10(b). *Ernst & Ernst* defined "device" in § 10(b) as "an invention; project; scheme; often, a scheme to deceive."[103] Rule 10b-5 states that "[i]t shall be unlawful for any person, directly or indirectly. . . (a) to employ any device, scheme, or artifice to defraud, (b) to make any untrue statement of a ma-

101. The likelihood of this unfortunate scenario is substantially mitigated by the Sarbanes-Oxley Act of 2002 Pub. L. No. 107-204, 116 Stat. 745.

102. Exchange Act, Section 10(b), 15 U.S.C. § 78j-(b) (emphasis added).

103. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 199 n.20 (1976) (quoting Webster's New International Dictionary 580, 713 (2d ed. 1934)).

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terial fact,. . . 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."[104] By defining device in § 10(b) to include schemes, the Supreme Court allowed claims based on 10b-5(a) and (c) to allege fraudulent "schemes" or "courses of business" as long as they were either manipulative or deceptive.

2. Santa Fe Industries, Inc. v. Green *limited the conduct which can be considered "deceptive"*

Santa Fe Industries, Inc. v. Green provided meaning to the words "manipulative" and "deceptive" as used in § 10(b).[105] In *Santa Fe Industries*, the defendant completed a short-form merger[106] and the plaintiffs alleged that the defendant had fraudulently hired an investment bank to provide an unfairly low appraisal of its assets.[107] The plaintiffs alleged that the firm violated Rule 10b-5. Liability predicated on misstatements proved untenable as the plaintiffs admitted that they never relied on the defendant's representations.[108] The Second Circuit court held that "whether full disclosure has been made is not the crucial inquiry since it is the merger and the undervaluation which constituted the fraud, and not whether or not the majority determines to lay bare their real motives. If there is no valid corporate purpose for the merger, then even the most brazen disclosure of that fact to the minority shareholders in no way mitigates the fraudulent conduct."[109]

The Supreme Court reversed the holding of the Second Circuit. It found that an expansion of Rule 10b-5 to cover all breaches of fiduciary duty would deviate too significantly from the commonly accepted meaning of the antifraud provi-

104. 17 C.F.R. § 240.10b-5.

105. Santa Fe Industries, Inc. v. Green, 430 U.S. 462 (1977).

106. DEL. CODE ANN., TIT. 8, § 253 (1975 ed. and Supp. 1976) (". . . any case in which at least 90% of the outstanding shares of each class of the stock of a corporation . . . is owned by another corporation . . . the corporation having such stock ownership may . . . merge the other corporation . . . into itself"). DEL. CODE ANN., TIT. 8, § 262(b)(3) (1975 ed. and Supp. 1976) (". . . in the event . . . [of a] merger effected under § 253 of this title . . ., appraisal rights shall be available for the shares. . .").

107. *Santa Fe Industries*, 430 U.S. at 466-67.

108. *Id.* at 467-74.

109. *Id.* at 470 n.8 (quoting Green v. Santa Fe Industries, Inc., 533 F.2d 1283, 1292 (2d Cir. 1976) *rev'd*, 430 U.S. 462 (1978)).

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sions.[110] Although precedent encouraged a flexible construction of the securities laws,[111] the Court found no proposition that supported an interpretation by which a breach of fiduciary duty, without misrepresentation or deception, would violate 10b-5.[112] In addition, the Court noted that the principal purpose of the Exchange Act was to implement a philosophy of full disclosure. Expanding the scope of what would be considered a misstatement to include breaches of fiduciary duty would be, at best, tangential to the purpose of the legislation. The Supreme Court declined to adopt a construction this liberal.[113]

Additionally, in *Santa Fe Industries* the Court affirmed a limitation on the judicial meaning of the word "manipulative." In *Ernst & Ernst* it previously held that in the securities context manipulative was basically a term of art.[114] The *Santa Fe Industries* decision expanded on this holding, stating that the term "manipulative" referred to certain practices in particular, "such as wash sales, matched orders, or rigged prices, that are intended to mislead investors by artificially affecting market activity."[115] Therefore, unless a plaintiff can allege activity that falls within the rubric of "manipulative" conduct, plaintiffs after *Santa Fe Industries* generally have resorted to accusations of "deceptive" conduct.[116] Claims of scheme liability generally must comport with the *Santa Fe Industries* definition of deceptive conduct.

3. *Insider trading cases added more requirements to claims of deceptive conduct*

The definition of deception, and thus the criteria which scheme liability must meet, was refined by the Supreme Court in *Chiarella v. United States.*[117] Ruling on an insider trading scandal, the Court held that liability for fraud could only at-

110. *Santa Fe Industries*, 430 U.S. at 472-73.

111. *E.g.* Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 12 (1971).

112. *Santa Fe Industries*, 430 U.S. at 474-76.

113. *Id.* at 477-78.

114. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 199 (1976).

115. *Santa Fe Industries*, 430 U.S. at 476.

116. *See generally* Daniel A. McLaughlin, *Liability under Rules 10b-5(a) & (c)*, 31 DEL. J. CORP. L. 631, 636 (2006).

117. Chiarella v. United States, 445 U.S. 222 (1980).

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tach in the case of nondisclosure where a duty required that the perpetrator of the fraud disclose the material information to the plaintiff.[118] This duty was enlarged in *United States v. O'Hagen.*[119] Here, the Supreme Court held that "a fiduciary's undisclosed, self-serving use of. . . [insider] information. . ., in breach of a duty of loyalty. . ., defrauds the principal of the exclusive use of that information. [In addition, without relying on a fiduciary relationship,] the misappropriation theory premises liability on a fiduciary-turned-trader's deception of those who entrusted him with access to confidential information."[120] The liability that arose from *O'Hagan* was premised on a corporate outsider owing a duty of confidentiality to its source of information. The subsequent misappropriation of information for personal benefit violated that duty.[121] The misappropriation theory applies only "for securities trading purposes."[122] A bank cannot be accused of misappropriating insider information if it merely facilitates fraudulent transactions for the firm. To be liable under *Chiarella,* the bank must have a duty to the shareholders of the firm to disclose material information.

B. *The framework of scheme liability appeared in* In re Parmalat Securities Litigation

The district court in the Southern District of New York, in *In re Parmalat Securities Litigation,* provided much of the framework for the now-rejected theory of scheme liability as a means by which secondary actors could be liable as primary violators for their role in a scheme.[123] Before *Stoneridge,* a number of district courts had affirmed their own version of scheme liabil-

118. *Id.* at 234-35.

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

120. *Id.* at 652.

121. *See* Barbara Bader Aldave, *Misappropriation: A General Theory of Liability for Trading on Nonpublic Information,* 13 HOFSTRA L. REV. 101, 119 (Fall 1984) (explaining the misappropriation theory).

122. *O'Hagan,* 521 U.S. at 653. *See generally Id.*

123. *In re* Parmalat Sec. Litig., 376 F. Supp. 2d 472 (S.D.N.Y. 2005). Various forms of scheme liability existed well before *Central Bank. See* Richard R. Howe, *The Duties and Liabilities of Attorneys in Rendering Legal Opinions,* 1989 COLUM. BUS. L. REV. 283, 300-01 (1989).

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ity.[124] *Parmalat* separated the three subsections of Rule 10b-5.[125] It stated that most decisions had not adequately distinguished the distinct categories of prohibited acts.[126] *Parmalat* accused courts of finding liability for schemes to defraud as if they were misstatements within the ambit of 10b-5(b). It proceeded to identify two prototypical cases. The first, *SEC v. First Jersey Sec., Inc.* presented a situation in which only the sales force of a brokerage communicated with the defrauded customers. The salespeople, however, were personally unaware of the fraud.[127] The Second Circuit held that the owner of First Jersey Securities was liable for violations of § 10(b) for making false statements. The owner, however, never actually contacted any of the defrauded customers.[128] The second example cited

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124. *E.g.* SEC v. Hopper, 2006 U.S. Dist. LEXIS 17772, *39 (S.D. Tex. Mar. 24, 2006) (". . .it could be inferred that the . . . scheme was fraudulent . . . given that the trades themselves were sham transactions that generated massive volumes, which Pallas knew would be reported [widely], . . . making the companies appear . . . to be robust traders . . . when, in fact, they were not. Because the round-trip trades were sham transactions, and therefore had an inherent tendency to deceive, it cannot be said that the alleged fraud or deception only occurred when the trades were misreported in the companies' SEC filings. Thus, the SEC has adequately alleged that . . . [the] scheme was a "device" or "scheme" to defraud, or at least a "practice" or "course of business" which operated as a fraud or deceit upon the investing public, that encompassed conduct beyond mere misstatements.") (internal citations omitted); *In re* Global Crossing Ltd. Sec. Litig., 322 F. Supp. 2d 319 (S.D.N.Y. 2004); *In re* AOL Time Warner, Inc. Sec. & ERISA Litig., 381 F. Supp. 2d 192, 248 (S.D.N.Y. 2004) ("[plaintiff] is entitled [survive summary judgment because it alleged a]. . . systematic and fraudulent scheme to inflate the advertising revenue reported in the companies' publicly disclosed financial statements and, in turn, the value of AOL and AOLTW securities).

125. Rule 10b-5 states in full: "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."

126. *Parmalat*, 376 F. Supp. 2d at 497.

127. SEC v. First Jersey Sec., Inc., 101 F.3d 1450, 1456-68 (2d Cir. 1996).

128. *Id.* at 1471-72 (stating that ". . . any person or entity . . . 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

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by *Parmalat, SEC v. U.S. Environmental, Inc.*, was also delivered by the Second Circuit.[129] In this case, a stock trader was held to be a primary violator for his participation in a scheme to inflate the price of a security. The trader, however, did not personally share the same purpose.[130] The *Parmalat* Court highlighted both *First Jersey* and *U.S. Environmental* as deficient for relying on pre-*Central Bank* aiding and abetting jurisprudence to find liability as a Rule 10b-5(b) misstatement.[131] *Parmalat* contends that liability in both cases should have instead been premised on a Rule 10b-5(a) "device, scheme, or artifice to defraud."[132] The Court considered *First Jersey* and *U.S. Environmental* to be exemplary of the systematic judicial shortcoming in identifying scheme liability.[133]

The *Parmalat* Court therefore distinguished the bright line test, discussed in Section III.B.i above, which would require that an actor personally make the misstatement for liability to attach and, if applied broadly would foreclose scheme liability, by limiting its application only to misstatements falling under 10b-5(b).[134] It stressed that misstatements or omissions must be construed within a separate framework from conduct in relation to a fraudulent scheme.

In *Parmalat*, the defendant banks claimed that under *Central Bank*, at worst, they were aiders and abettors that could not

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violator under [federal securities law], assuming all of the requirements for primary liability . . . are met. Primary liability may be imposed not only on persons who made fraudulent misrepresentations but also on those who had knowledge of the fraud and assisted in its perpetration." The court thereby accused a person who had knowledge of and assisted in its perpetration of making a material misstatement even though he never made any misstatements.) (internal citations omitted).

129. SEC v. U.S. Environmental, Inc., 155 F.3d 107 (2d Cir. 1998).

130. *Id.* at 112.

131. *Parmalat*, 376 F. Supp. 2d at 499-501. *Parmalat* also criticizes the court in *SEC v. U.S. Environmental* for citing to a pre-*Central Bank* case for a proposition very similar to aiding and abetting liability.

132. Rule 10b-5(a).

133. *Id.* at 503.

134. *Id.* at 503 (distinguishing its holding from that of the bright line test, and confining the bright line test to 10b-5(b) by stating that ". . . this analysis is not a back door into liability for those who help others make a false statement or omission in violation of subsection (b) of Rule 10b-5. The Second Circuit has made clear that to "make" a statement for purposes of Rule 10b-5(b) requires that the statement be attributed to its maker at the time it is made.").

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be found liable as primary violators.[135] The Court held otherwise, concluding that the arrangements made by the banks, including the factoring and securitization of worthless invoices, "were deceptive devices or contrivances for purposes of Section 10(b). These. . . [were] schemes with the tendency to deceive. . . [T]he alleged factoring and securitization schemes would have created the appearance of revenue or assets where there was none and thus distorted the prices of Parmalat's securities."[136] The Court found the defendants liable as primary violators for scheme liability.

To hold the banks liable as primary violators, the *Parmalat* Court needed to find that the plaintiff had satisfied all of the required elements of a cause of action. While the decision addressed all of the five elements, only two are discussed here. The requirement that the fraud be "in connection with a purchase or sale" was demonstrated in the context of Parmalat securities. The Southern District established that "a plaintiff makes out a sufficient nexus with the purchase or sale of securities when the defendants' deceptive conduct affects a market for securities."[137] To find sufficient reliance against the banks, the Court again pointed to the distinct nature of those claims premised on 10b-5(b) misstatements compared to those predicated on 10b-5(a) and (c) schemes and courses of business. It found that reliance existed as a causal connection in which the banks knew that their transactions would allow Parmalat to make the misrepresentations upon which the plaintiffs relied.[138]

C. *Scheme liability could have been upheld had the Supreme Court used particular interpretations for each requirement of the section 10(b) cause of action*

Scheme liability rests on a strong equitable foundation by treating silent partners of a scheme to defraud consistently within the five SEC hypothetical situations discussed above. Legally, however, its foundation is more tenuous. The courts that have attacked scheme liability, including the Supreme Court in *Stoneridge*, undermine its legitimacy by highlighting its defi-

135. *Id.* at 493.
136. *Id.* at 506.
137. *Id.* at 505-06.
138. *Id.* at 509.

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cient satisfaction of the § 10(b) causes of action. Commentators have suggested that aiding and abetting liability is merely relabeled as scheme liability.[139] In response, the following presents a framework by which scheme liability could satisfy the § 10(b) causes of action in accordance with the requirements of *Central Bank, Santa Fe Industries,* and *Chiarella.*

1. *Silent partners in a scheme use or employ a deceptive device because all fraudulent schemes are prohibited by section 10(b)*

The silent party in a fraudulent scheme has necessarily not made a material misstatement. The claim will therefore derive from an allegation of a material omission or participation in a scheme. *Ernst & Ernst* defines device to include schemes.[140] This conclusion was buttressed by the Supreme Court's subsequent comment "that § 10(b) and Rule 10b-5 prohibit all fraudulent schemes in connection with the purchase or sale of securities, whether the artifices employed involve a garden type variety of fraud, or present a unique form of deception."[141] Therefore, the use of a fraudulent scheme could satisfy the requirement of the use or employment of a deceptive device or contrivance.

2. *A silent member of a scheme is sufficiently connected to the sale or purchase of a security because the scheme affects the market for that security*

To affirm scheme liability, the Supreme Court would have had to agree that the connection with a purchase or sale is adequately demonstrated when "a plaintiff makes out a sufficient nexus with the purchase or sale of securities when the defendants' deceptive conduct affects a market for securities."[142] The *Birnbaum* rule, formally accepted by the *Blue Chip Stamps,* states only that class plaintiffs must be actual purchas-

139. *E.g.* Rodney D. Chrisman, *"Bright Line," "Substantial Participation," or Something Else: Who is a Primary Violator Under Rule 10b-5?,* 89 Ky. L.J. 201, 217 (Fall 2000) ("the 'substantial participation' test seems to be aiding and abetting liability in primary violator's clothing").

140. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 197 n.20 (1976).

141. Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 10 n.7 (1971).

142. *Parmalat,* 376 F. Supp. 2d at 505-506.

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ers or sellers.[143] The Supreme Court has endorsed a broader prohibition against fraud, stating "that § 10(b) and Rule 10b-5 prohibit all fraudulent schemes in connection with the purchase or sale of securities, whether the artifices employed involve a garden type variety of fraud, or present a unique form of deception."[144] Indeed, non-speaking actors engaged in a "scheme to defraud" have previously been deemed by the Supreme Court to have used or employed a deceptive device within the meaning of § 10(b).[145] Thus the Court could have held that allegations of scheme liability satisfy this cause of action. It must be noted that some courts have conflated the "in connection with" requirement with reliance.[146] A court's decision to weigh the two causes of action concurrently is immaterial, as both must be individually demonstrated.

3. *The Supreme Court would probably have needed to depart from its previous course of jurisprudence to find transaction causation or reliance in scheme liability*

The standard of reliance for an omission, set forth in *Affiliated Ute*, requires a "duty to disclose."[147] Both *Affiliated Ute* and the case that it draws upon, *Chasins v. Smith, Barney & Co.*,[148] involve brokers concealing secondary markets. Neither stands for the broad proposition that a "duty to disclose" exists *only* when there is a *fiduciary* duty to disclose. Instead, they state that a duty to disclose does exist when there is a fiduciary or similar duty. *Chiarella* affirmed this position, holding that "the

143. Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 730-33 (1975).

144. Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 10 n.7 (1971) (quoting A. T. Brod & Co. v. Perlow, 375 F.2d 393, 397 (2d Cir. 1967)).

145. See SEC v. Zandford, 535 U.S. 813, 821-22 (2002).

146. *E.g. In re* Carter-Wallace, Inc. Sec. Litig., 150 F.3d 153, 156 (2d Cir. 1998) ("We have broadly construed the phrase 'in connection with,' holding that Congress, in using the phrase 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."); SEC v. Terry's Tips, Inc., 409 F. Supp. 2d 526, 533 (D. Vt. 2006) ("The 'in connection with' element is satisfied when the misrepresentation or omission or use of a device would be the sort of conduct on which a reasonable investor would rely, and, so relying, would purchase or sell securities.").

147. Affiliated Ute Citizens v. United States, 406 U.S. 128, 154 (1972).

148. Chasins v. Smith, Barney & Co., 438 F.2d 1167, 1173 (2d Cir. 1970).

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other [party] is entitled to know because of a fiduciary or other similar relation of trust and confidence between them."[149]

Before *Stoneridge*, the district court of Southern District of Texas in *Newby v. Enron* found that a duty existed not to engage in a fraudulent scheme.[150] This was a significant departure from prior Supreme Court jurisprudence. Indeed, the Supreme Court has been reluctant to adopt duties in this context beyond fiduciary ones. For example, in *Mertens v. Hewitt Associates*, a case based upon ERISA, the Supreme Court addressed the question of "whether a nonfiduciary who knowingly participates in the breach of a fiduciary duty imposed [law]. . . is liable for losses. . . as a result of the breach."[151] The Court held the damages against the nonfiduciaries to be inappropriate and thus denied relief.[152] In *Mertens*, the Supreme Court demonstrated its continuing reluctance to expand the rubric of judicially divined duties.

Scheme liability would have required at least some expansion of the duties recognized by the Supreme Court. The Court could have embraced a new duty, such as a whistle-blowing duty,[153] or it could have adopted a more liberal standard for reliance upon omissions. One proposed standard would grant rebuttable presumption of reliance to the plaintiff in

149. Chiarella v. United States, 445 U.S. 222, 228 (1980).

150. Newby v. Enron Corp. (*In re* Enron Corp. Secs.), 2006 U.S. Dist. LEXIS 88121, *102 (S.D. Tex. 2006) (quoting Smith v. Ayres, 845 F.2d 1360, 1363 & n.8 (5th Cir.1988)).

151. Mertens v. Hewitt Assocs., 508 U.S. 248, 249-50 (1993).

152. *Id.* at 255-61.

153. *See* Robert A. Prentice, *supra* note 53, at 765 (discussing whistleblowing liability and the fact that it is unlikely to have survived *Central Bank*). Though not supported by much jurisprudence, this duty may find support in the Sarbanes-Oxley Act. The Sarbanes-Oxley Act of 2002 (Pub. L. No. 107-204, 116 Stat. 745). For example, § 307 requires that any attorney preparing documents to be submitted to the SEC must ". . . report evidence of a material violation of securities law or breach of fiduciary duty . . . by the company or any agent thereof, to the chief legal counsel or the chief executive officer of the company (or the equivalent thereof); and . . . if the counsel or officer does not appropriately respond to . . . the attorney . . . [must] report the evidence to the audit committee of the board of directors of the issuer or to another committee of the board of directors comprised solely of directors not employed directly or indirectly by the issuer, or to the board of directors."

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cases of material omissions.[154] The presumption is overcome only by showing that the total mix of available information would not have been affected had the omitted facts been revealed.[155] This standard effectively limits *Chiarella* to insider trading cases. Additionally, it retreats from the *Affiliated Ute* requirement of a duty. In fact, this provides for a virtually limitless threat of litigation and thus is unlikely to ever be adopted. Given the degree to which both *Chiarella* and *Affiliated Ute* have become seminal in securities law as well as the Supreme Court's aversion to strike suits, neither presented a likely option.

The substantial participation test provided a workable standard by which reliance upon omissions could be demonstrated without regard to privity. As discussed above, liability would be triggered where there is "substantial participation or intricate involvement in the preparation of fraudulent statements. . . even though that participation might not lead to the actor's actual making of the statements."[156] This clearly circumvents the question of duties. The Supreme Court could have constrained the traditional requirement that liability from an omission derive from a fiduciary duty to Rule 10b-5(b) omissions. This could have provided for claims predicated on substantial participation for Rule 10b-5(a) schemes.

Substantial participation originated in common law fraud liability.[157] It derives from situations where an individual used fraudulent representations to induce the other to act. Under common law, the former was liable for damages whether or not there was privity of contract or personal dealings. The liability depends upon whether the individual made the misrepresentation, authorized it, or participated in it.[158] *Central Bank*, however, rejected substantial assistance, even where an actor "knows that the other's conduct constitutes a breach of duty

154. *See* Smith v. Ayres, 845 F.2d 1360, 1363 (5th Cir.1988) (granting a rebuttable presumption of reliance when allegations of fraud are based on a failure to disclose, as opposed to a fraudulent misrepresentation), *cert. denied*, 508 U.S. 910 (1993).

155. *See* Akin v. Q-L Investments, Inc., 959 F.2d 521, 530 (5th Cir. 1992) (citing Rifkin v. Crow, 574 F.2d 256, 262 (5th Cir. 1978)).

156. Howard v. Everex Sys., Inc., 228 F.3d 1057, 1061 n.5 (9th Cir. 2000).

157. *See* Prentice, *supra* note 53, at 751-52.

158. 37 C.J.S. FRAUD 61, at 346 (1943). *See also* 37 AM. JUR. 2D FRAUD AND DECEIT 305, at 403 (1968).

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and gives substantial assistance or encouragement to the other."[159] Therefore, any support of scheme liability through substantial participation would have to take into account the above, non-binding dicta.

In *In re ZZZZ Best Securities Litigation*, a district court in California justified reliance in a scheme-liability class-action on the grounds that,"[w]hile the investing public may not be able to reasonably attribute the additional misstatements and omissions to [the defendant], the securities market still relied on those public statements and anyone intricately involved in their creation and the resulting deception should be liable under Section 10(b)/Rule 10b-5."[160] This skirts questions of duties to disclose and focuses squarely on fraud-on-the-market. Satisfying reliance in scheme liability with fraud-on-the-market has been criticized.[161] Fraud-on-the-market requires public disclosure of the deception.[162] Since the silent partner did not author the deceptive documents, its participation in their creation must suffice for liability to attach. Because reliance for class actions requires fraud-on-the-market, class actions alleging scheme liability additionally would have required that the Supreme Court accept the application of substantial participation in fraud-on-the-market cases.

The rejection of substantial assistance by *Central Bank* was based on the Court's fear of uncertainty in its application.[163] The Court also considered substantial assistance to be analogous to aiding and abetting.[164] Acceptance of substantial participation therefore would have required that the Supreme Court withdraw from its previous rejection of theory. Perhaps the Supreme Court would have been more likely to accept this position if they had chosen to outline the extent to which substantial assistance requires more active participation in the scheme than mere aiding and abetting. The five examples

159. Cent. Bank, N.A. v. First Interstate Bank, N.A., 511 U.S. 164, 181 (U.S. 1994) (quoting RESTATEMENT 2D OF TORTS, § 876).

160. *In re* ZZZZ Best Sec. Litig., 864 F. Supp. 960, 970 (C.D. Cal. 1994).

161. Regents of the Univ. of Cal. v. Credit Suisse First Boston, 482 F.3d 372, 382-83 (5th Cir. 2007).

162. Basic Inc. v. Levinson, 485 U.S. 224, 248 n.27 (1988).

163. *Central Bank*, 511 U.S. at 181 (stating ". . . the doctrine [of substantial participation] has been at best uncertain in application, however.").

164. *Id.* ("The Restatement of Torts, under a concert of action principle, accepts a doctrine with rough similarity to criminal aiding and abetting.").

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cited by the SEC above could have helped to demonstrate the threshold between mere aiding and abetting and the necessary level of activity that should be required under substantial participation. The boundaries of liability suggested by the SEC may have provided the fundamentals for a framework that would have improved predictability and equity in its application, which would have allowed the Court to overcome the problems that it had associated with substantial participation in *Central Bank.*

Assuming arguendo that the Supreme Court had decided in *Stoneridge* that *Chiarella* and *Santa Fe Industries* apply only to Rule 10b-5(b), and that it had embraced some form substantial participation, the Supreme Court would still have had to decide the precise meaning of transaction causation. Opposing courts have either required that the plaintiff "demonstrate that defendant's conduct caused him to engage in the transaction in question,"[165]or stated that "the plaintiff is not required to prove that the defendant's act was the sole and exclusive cause of his injury; he need only show that it was substantial, i.e., a significant contributing cause."[166] Scheme liability would have required an adoption of the latter standard. Schemes generally involve numerous parties that all contribute to the fraud, thus the plaintiff could not possibly demonstrate that the behavior of each individually caused him to engage in the transaction. The former definition of transaction causation forecloses the availability of scheme liability.

4. *Showing economic loss and loss causation for silent partners in a scheme would be trivial if the Supreme Court had found that scheme liability satisfies reliance*

The requirement of loss causation applies to violations of Rule 10b-5(a) and (c) as well as to Rule 10b-5(b).[167] Proof that the loss derived from the deception is generally factual. If the Supreme Court had found that scheme liability can satisfy reliance, the proof of loss causation would not have posed a signif-

165. Newton v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 259 F.3d 154, 174 (3d Cir. 2001).

166. Wilson v. Comtech Telecomms. Corp., 648 F.2d 88, 92 (2d Cir. 1981) (internal quotation marks and citation omitted).

167. *See* 15 U.S.C. § 78u-4(b)(4); *see also* Dura Pharms., Inc. v. Broudo, 544 U.S. 336, 341 (2005).

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icant challenge. As long as the plaintiff can have shown that the fraud in question, upon its revelation to the market, caused a decrease in the value of the investment, the plaintiff should have proved loss causation.

5. *Scienter could have been demonstrated with a showing of deceptive purpose by the silent partner in a scheme*

Scienter requires intent to "deceive, manipulate, or defraud."[168] Scheme liability does not effect the requirement of scienter. To be liable in the SEC's examples, an actor must not only have scienter, but explicitly act with the purpose of furthering the fraud. While substantial participation may not itself require scienter, the Ninth Circuit established a requirement of scienter in accordance with the current standards in *Simpson.* It stated that "the defendant's own conduct. . . must have had a deceptive purpose and effect."[169] Had the Supreme Court approved this standard, the requirement of deceptive purpose would have been sufficient to prove scienter.

D. *The Supreme Court rejected scheme liability in* Stoneridge Investment Partners v. Scientific-Atlanta

1. *Factual Background*

Stoneridge Investment Partners, LLC. v. Scientific-Atlanta, Inc. formally tested scheme liability.[170] The plaintiffs in *Stoneridge,* led by Stoneridge Investment Partners, consist of the class of shareholders in Charter Communications, a large cable company. The defendants originally included Charter, its executives, its accounting firm, and two cable box manufacturing firms – Scientific-Atlanta and Motorola (the "Vendors").[171] The question of scheme liability applies only to the vendors and therefore they are the only named defendants on this appeal.[172]

168. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976).

169. Simpson v. AOL Time Warner Inc., 452 F.3d 1040 (9th Cir. 2006).

170. Stoneridge 2008. *See also* Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., 127 S. Ct. 1873 (2007) (granting petition of writ for certiorari to Stoneridge Investment Partners, LLS v. Scientific-Atlanta, Inc. (*In re* Charter Communs., Inc.), 443 F.3d 987 (8th Cir. 2006)).

171. Stoneridge Investment Partners, LLS v. Scientific-Atlanta, Inc. (*In re* Charter Communs., Inc.), 443 F.3d 987, 989 (8th Cir. 2006).

172. *Id.*

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The plaintiffs allege a complex and prolonged scheme to defraud investors where fraudulent accounting techniques artificially inflated Charter's cash flow growth from 6% to 12-14% annually.[173] The plaintiffs additionally claim that the vendors colluded with Charter to fraudulently alter their existing supply contract. In the original version, the vendors would supply the cable boxes to Charter at a fixed price. It is claimed that Charter agreed with the vendors to pay an additional $20 fee per box.[174] In exchange for the supplemental cost, the vendors would provide an additional $20 of advertising fees.[175]

The plaintiffs claimed that this was not a legitimate, arms-length transaction. Instead, the supplemental fee arrangement was a wash with no economic purpose. The agreement existed solely to inflate Charter's short term cash flow, which it did by $17 million. Charter, possibly with the help of its accountant, Arthur Anderson, fraudulently recorded the transactions by capitalizing the increased cost of the cable boxes as an equipment expense. This expense would be depreciated gradually over time, and would impact the current year's earnings at only a fraction of the actual cost to the company. Concomitantly, Charter recorded the advertising revenue as an "advertising fee," which was immediately included as revenue in its entirety. Charter's accounting balance for the current fiscal quarter thereby increased markedly, creating the illusion of growth and fraudulently increasing the stock price.[176]

The plaintiffs did not contend that the vendors prepared or disseminated fraudulent financial statements on behalf of Charter or themselves, or that they issued any public statements that could have fraudulently affected Charter's stock price.[177] Instead, "[p]laintiffs alleged that the [v]endors entered into these sham transactions knowing that Charter intended to account for them improperly and that analysts would rely on the inflated revenues and operating cash flow in

173. Stoneridege Inv. Partners LLC v. Charter Communs., Inc. (*In re* Charter Communs., Inc.), 2005 U.S. Dist. LEXIS 14772, *12 (D. Mo. 2005).

174. *See* Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., 128 S. Ct. 761, 766-77 (2008).

175. *Id.*

176. Stoneridge Investment Partners, LLS v. Scientific-Atlanta, Inc. (*In re* Charter Communs., Inc.), 443 F.3d 987, 989-90 (8th Cir. 2006).

177. *Id.*

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making stock recommendations."[178] The plaintiffs therefore claimed that the vendors participated in a scheme to defraud investors, not that they actually took part in the fraud. This situation parallels the SEC's fourth hypothetical scenario, listed in section IV.B above.

2. *The Supreme Court found that scheme liability failed to meet the requirements of a section 10(b) cause of action*

The *Stoneridge* plaintiffs relied on *Parmalat* to formulate their complaint. Like *Parmlat*, they claimed that Rules 10b-5(a) and (c) should not be bound by a *Central Bank*-inspired bright line test.[179] The Supreme Court rejected this contention, stating that "reliance. . . is an essential element of the § 10(b) private cause of action."[180] The Court stated that only two exceptions exist: omissions by those with a duty to disclose, and fraud on the market.[181] Because the defendants did not have a duty to disclose, they cannot be liable for their omission. Likewise, because no investor had knowledge of their deceptive acts at the relevant time, fraud on the market does not apply.[182]

The plaintiffs also attempted to extend the reach of fraud on the market, claiming that in efficient markets, investors rely "not only on the public statements relating to a security but also upon the transactions those statements reflect."[183] The Court likewise rejected this claim, fearing that this looser standard of reliance could effectively reach the entire marketplace in which the issuing company conducts is business.[184] The opinion also detailed its concerns of an overly broad expansion of federal power into issues that could presently be prosecuted under state law.[185]

178. *Id.* at 990.
179. *Id.* at 991.
180. Stoneridge 2008 (slip op. at 8).
181. *Id.*
182. *Id.*
183. *Id.* at 9.
184. *Id.*
185. *Id.* at 10.

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3. *The dissent argues that* Stoneridge *uses overly strict interpretations of section 10(b) jurisprudence to reject scheme liability*

Many members of the dissent in *Stoneridge* also joined the dissent of *Central Bank.* Bound by the precedential value of *Central Bank,* however, the *Stoneridge* dissent based its opposition on several other grounds. The dissent highlights the factual distinction between the two cases: in *Central Bank,* the bank did not engage in deceptive conduct; in *Stoneridge,* however, the defendant knowingly engaged in fraudulent transactions.[186] In addition, the dissent questions the level of reliance required by the *Stoneridge* majority. It is also argued that requiring the defendants to provoke a "necessary or inevitable" action by the issuer to satisfy causation is belied by the Court's continuing support of the fraud-on-the-market theory.[187] The dissent argues that the majority conflates disallowing fraud-on-the-market for this particular case with the general requirements of causation.[188] The dissent disagrees most vigorously with the majority on the issue of reliance. It opts for the "transaction causation" definition espoused in *Dura,* and argues that this requirement may be met with "but for" causality.[189] In the alternative, the dissent claims that proximate cause would be satisfied in the present case. Neither suffices for the majority, however, whose standard of reliance is described by the dissent as "unduly stringent and unmoored from authority."[190]

4. *The* Stoneridge *majority agrees with much existing jurisprudence and academic literature*

A wealth of jurisprudence exists to support the Supreme Court's rejection of scheme liability.[191] *Parmalat* is not sup-

186. *Stoneridge,* 128 S. Ct. at 775 (Stevens, J. dissenting).
187. *Id.* at 4-5.
188. *Id.* at 5.
189. *Id.*
190. *Id.* at 6.
191. Supporting cases include Fidel v. Farley, 392 F.3d 220, 235 (6th Cir. 2004); Ziemba v. Cascade Int'l, Inc., 256 F.3d 1194, 1204-06 (11th Cir. 2001); Wright v. Ernst & Young LLP, 152 F.3d 169, 175 (2d Cir. 1998), *cert. denied,* 525 U.S. 1104 (1999); Anixter v. Home-Stake Prod. Co., 77 F.3d 1215, 1225-27 (10th Cir. 1996); Dannenberg v. PaineWebber Inc. (*In re* Software Toolworks Sec. Litig.), 50 F.3d 615, 628 n.3 (9th Cir. 1994); Pirelli Armstrong Tire Corp. Retiree Med. Bens. Trust v. Dynegy, Inc. (*In re* Dynegy, Inc.), 339

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ported by the same abundance of opinions. This discrepancy could be understood as evidence that *Stoneridge* ruled correctly and that *Parmalat* overlooked precedent. To this end, commentators have suggested that *Santa Fe Industries* and *Chiarella* define "deceptive" to apply to all three subsections of Rule 10b-5. Therefore, it is claimed that any judicial approval of scheme liability would necessarily have overlooked at least one element of the precedent in these cases.[192] Indeed, *Parmalat* only cited *Chiarella* once, relying in this instance on its requirement of a duty to disclose to deny liability for a particular defendant.[193] Other commentators have suggested that *Parmalat* elected to use scheme liability as a thinly veiled attempt to circumvent *Central Bank*'s proscription against aiding and abetting liability.[194]

5. Parmalat *may provide a more sensible interpretation of precedent than* Stoneridge

It is important to note that *Chiarella* was decided in 1980, while *Central Bank* was not published until 1994. The Supreme Court decided *Chiarella* at a time when courts routinely found liability for aiding and abetting.[195] Indeed, nearly every lower court favored such secondary liability before *Central Bank*.[196] In his dissent in Central Bank, Justice Stevens, joined by Justices Blackmun, Souter, and Ginsberg, noted that the decision marked a notable departure from longstanding securities jurisprudence.[197] Therefore, it may be the case that when *Chiarella* was decided, the Supreme Court had not considered a securi-

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F. Supp. 2d 804, 914-16 (S.D. Tex. 2004); *In re* Homestore.com, Inc. Sec. Litig., 252 F. Supp. 2d 1018, 1040-41 (C.D. Cal. 2003).

192. *E.g.* McLaughlin, *supra* note 116, at 644-46.

193. *In re* Parmalat Sec. Litig., 376 F. Supp. 2d 472, 515 n.213 (S.D.N.Y. 2005) (quoting Grandon v. Merrill Lynch & Co., 147 F.3d 184, 189 (2d Cir. 1998) (quoting Chiarella v. United States, 445 U.S. 222, 228 (1980) (internal quotation marks omitted))).

194. Nicholas Fortune Schanbaum, *Scheme Liability: Rule 10b-5(a) and Secondary Actor Liability After Central Bank*, 26 REV. LITIG. 183, 205-07 (Winter 2007). *See also In re* Dynergy, 339 F. Supp. 2d 804, 916 (S.D. Tex. 2004).

195. *E.g.* H. L. Federman & Co. v. Greenberg, 405 F. Supp. 1332 (S.D.N.Y. 1975); Tucker v. Janota, 1978 U.S. Dist. LEXIS 14603 (N.D. Ill. 1978).

196. Donald C. Langevoort, *Agency Law Inside the Corporation: Problems of Candor and Knowledge*, 71 U. CIN. L. REV. 1187, 1227 (Summer 2003).

197. *Central Bank*, 551 U.S. 196-98 (Stevens, J., dissenting).

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ties regime in which aiding and abetting liability would be foreclosed.

In a post-*Chiarella*, pre-*Central Bank* world, an actor that did not have a duty to disclose could still be liable for its misstatements through aiding and abetting. The argument that the Supreme Court never intended *Chiarella*'s requirement of a duty to disclose to apply broadly to all 10b-5 violations, but rather only to 10b-5(b), was refuted by *Central Bank*.[198] Although it ratified *Chiarella* in the context of *Central Bank*, it is unclear whether the Supreme Court meant that the requirement of a duty should apply broadly to all Rule 10b-5 subsections, or if it anticipated a more limited application, like that of the *O'Hagan* misappropriation theory impacting only the actual trading of securities.

Instead of attempting to utilize *Chiarella* and *Santa Fe Industries* in a complementary fashion, *Parmalat* instead sought to avoid their restrictive application in light of *Central Bank* altogether. The *Parmalat* Court pointed to the fact that aiding and abetting had been legitimate sources of liability as the reason that most pre-*Central Bank* cases simply considered misstatements or omissions of primary violators and the associated aiders and abettors through 10b-5(b), but that since *Central Bank*, most courts have not thoroughly considered the differences between subsections (a), (b) and (c) of Rule 10b-5.[199] The Court argued that pre-*Central Bank* plaintiffs generally chose to make 10b-5(b) claims, even when the fraud actually constituted a device or scheme, because subsection (b) represented "the path of least resistance for the plaintiff" when used in conjunction with the plaintiff's ability to make an aiding and abetting claim.[200] Therefore, *Parmalat* may be asserting that only post-*Central Bank* jurisprudence on scheme liability should serve as precedent, because the very nature of the claims changed after aiding and abetting liability was no longer available. Indeed, courts and commentators have noted a dearth of precedent on scheme liability. Some have claimed

198. *Central Bank*, 511 U.S. at 174 (quoting *Chiarella*, 445 U.S. at 232).
199. *Parmalat*, 376 F.Supp. 2d at 493-95.
200. *Id.* at 497.

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that this lack of established jurisprudence may be contributing to the reluctance of the courts to embrace it.[201]

E. Simpson v. AOL Time Warner *provides conditional support to* Parmalat

1. *Factual Background*

Simpson v. AOL Time Warner Inc., decided by the Ninth Circuit before the Supreme Court heard *Stoneridge*, presents conditional support for scheme liability as discussed in *Parmalat*.[202] Though the case was remanded for further hearings, a petition for certiorari has been filed based on the legal finding. The Supreme Court has yet to grant or deny this appeal. In *Simpson*, the plaintiffs, shareholders in Homestore.com ("Homestore"), alleged that the company engaged in a series of sham transactions with the defendants, which consist of a number of companies, including AOL Time Warner and Cendant. In these fraudulent dealings, Homestore would overpay for an asset. The counterparty, in turn, agreed to funnel the money back to Homestore through an affiliated entity. For example, Homestore would purchase services or products that it did not need, or at an inflated price. The seller would agree to purchase a certain amount of advertising from AOL. Finally, AOL would pay Homestore a commission on this advertising revenue. These transactions allegedly violated SEC regulations against the purchase of revenue, were improper barter transactions, and were hidden from the firm's auditor.[203] Like Charter Communications in *Stoneridge*, Homestore accounted for the costs as capital expenses and recognized the advertising revenue immediately as income.[204]

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201. *E.g.* Benzon v. Morgan Stanley Distribs., 420 F.3d 598, 611 (6th Cir. 2005) (stating that ". . . there is very little case law explaining more specifically what types of claims are actionable under these provisions, which would assist the Court in determining whether Plaintiffs have properly stated a claim that Defendants violated 10b-5(a) and (c). It is perhaps not surprising, then, that Plaintiffs cite only one case in support of their argument. . . ."). *See also* Schanbaum, *supra* note 194, at 209.

202. Simpson v. AOL Time Warner Inc., 452 F.3d 1040 (9th Cir. 2006).

203. *Id.* at 1042-44.

204. *Id.*

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2. *The Ninth Circuit reasoned that deceptive purpose and effect could provide a legal basis for scheme liability*

In *Simpson*, the Ninth Circuit focused on the point made by *Central Bank* - that secondary actors may be subject to primary liability if they satisfy all the requirements for primary liability.[205] The Ninth Circuit found that scheme liability could technically be the basis for primary liability. It stated that "to be liable for a scheme to defraud, each defendant [must have] committed a manipulative or deceptive act in furtherance of the scheme. The relevant inquiry is: what conduct constitutes a manipulative or deceptive act in the furtherance of a scheme to defraud sufficient to render the defendant a primary violator of § 10(b)?"[206] The *Simpson* Court subsequently explained that:

> engaging in a transaction, the principal purpose and effect of which is to create the false appearance of fact, constitutes a deceptive act. Participation in a fraudulent transaction by itself, however, is insufficient to qualify the defendant as a primary violator if the deceptive nature of the transaction or scheme was not an intended result, at least in part, of the defendant's own conduct. . .To be liable as a primary violator of § 10(b) for participation in a scheme to defraud, the defendant must have engaged in conduct that had the principal purpose and effect of creating a false appearance of fact in furtherance of the scheme. It is not enough that a transaction in which a defendant was involved had a deceptive purpose and effect; the defendant's own conduct contributing to the transaction or overall scheme must have had a deceptive purpose and effect.[207]

This ensures that the secondary defendant had the requisite scienter for § 10(b) liability.

Applying its holding to the facts, the Court found that because AOL intended to enter into legitimate transactions, no liability could attach if its dealings were fraudulently misused

205. Cent. Bank, N.A. v. First Interstate Bank, N.A., 511 U.S. 164, 191 (1994).

206. *Simpson*, 452 F.2d at 1048 (internal quotations omitted).

207. *Id.*

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by Homestore.[208] Despite exculpating AOL, *Simpson* provided a general affirmation of scheme liability. Significantly, the Ninth Circuit added the caveat to *Parmalat* that there must be "deceptive purpose and effect."[209] This provides a new boundary for liability between the Second Circuit's bright line, public attribution rule and general aiding and abetting. By requiring deceptive purpose and effect, this alternative limit may address the shortcomings of aiding and abetting described in *Central Bank,* that "aiding and abetting liability extends beyond persons who engage, even indirectly, in a proscribed activity; aiding and abetting liability reaches persons who do not engage in the proscribed activities at all, but who give a degree of aid to those who do."[210]

3. *The Supreme Court will probably deny certiorari*

The *Simpson* Court found for the defendants. In doing so, however, it validated scheme liability in a manner at odds with the holding of *Stoneridge.* Having found that the plaintiffs failed to meet the substantially more lenient standards of the Ninth Circuit, and that defendants did not have a deceptive purpose, the Supreme Court is unlikely hear an appeal. This case underscores the concern expressed in *Stoneridge* that scheme liability could subject companies in the ordinary course of their legitimate business transactions to liability. Because a denial of certiorari does not constitute an expression of any opinion on the merits,[211] the Court would not be tacitly approving the language used by the Ninth Circuit. It is thus very likely that the Supreme Court will deny certiorari.

F. Stoneridge *will likely have a positive effect on the economy*

Perhaps the most the important concern for the Supreme Court in *Stoneridge* was that "the. . . cause of action would reach the whole market-place in which the issuing company does business."[212] In response, the dissent argues that "liability only [would attach] when the company doing business with the is-

208. *Id.* at 1053.
209. *Id.* at 1048.
210. *Central Bank,* 511 U.S. at 176.
211. *See* Boumediene v. Bush, 127 S. Ct. 1478, 1478 (2007).
212. Stoneridge 2008 (slip op. at 9).

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suing company has *itself* violated § 10(b)."[213] The dissent, however, misses the point. The question is not only of liability in the case of actual fraudulent dealings, but also of the uncertainty that would extend to the marketplace in a scheme liability regime.[214] For example, "a manufacturer would not know when an issuer's shareholder might allege that the issuer misrepresented details about a transaction with the manufacturer."[215] This could lead to a dramatic increase in the number of suits premised on scheme liability. Nearly every company that deals with publicly listed firms would need to insure itself against the increased risk of litigation, and bear increased accounting and due diligence expenses.[216] This would be a direct cost to those companies that are exchange listed in the United States and "would. . . decrease the incentive to remain or list on a U.S. public exchange in the first place."[217] Given the already substantial costs of listing in the United States, approving scheme liability would have dramatically reduced the competitiveness of the American equity markets.

VI.
CONCLUSION

Embracing scheme liability against silent partners in a fraudulent scheme would have significantly reduced the inequitable treatment of these players. Any formal approval of scheme liability in *Stoneridge* would have required that the Supreme Court deviate substantially from prior holdings, especially those concerning reliance and causation. *Stoneridge* has the likely effect of foreclosing any legal questions on scheme liability that remain, as will probably be seen in the appeal of

213. *Id.* at 6 (Stevens, J., dissenting).

214. *See* Brief of the National Association of Manufacturers as Amicus Curiae in Support of Respondents, *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 128 S. Ct. 761 (2008) (No. 06-43), 2007 WL 2363258, *available at* http://stoneridgeappeal.com/wp-content/uploads/2007/08/resp-amicus-nam.pdf.

215. *Id.* at 18.

216. *See* Brief for the NASDAQ Stock Market, Inc. and NYSE EuroNext as Amici Curiae in Support of Respondents, *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 128 S. Ct. 761 (2008) (No. 06-43), 2007 WL 2958946, *available at* http://stoneridgeappeal.com/wp-content/uploads/2007/08/resp-amicus-exchanges.pdf.

217. *Id.* at 12.

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Simpson. Given the increasing international competition for listing issuers, the decision is most likely in the best interest of the American economy.

From a strictly equitable perspective, however, the position of the Ninth Circuit should be adopted. A defendant must be liable if its own intentional conduct has contributed to the transaction or overall scheme. While concern about "vexatious litigation" is justified, Congress could again pass litigation limiting the nature of suits predicated on scheme liability, just as it did in the PSLRA, and so reduce strike suits. Public outcry over how a ruling against scheme liability will limit the efficacy of cases against Enron, WorldCom, Tyco and others may provide the incentive for Congress to pass such legislation, though hopefully constrained by the economic concerns that justified *Stoneridge.*

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