

SECURITIES LAW

Scope of Primary Liability

THE MOST IMPORTANT securities case in decades will be decided in the next U.S. Supreme Court term. *Stoneridge Investment Partners v. Scientific Atlanta Inc.*, No. 06-43, on appeal from the 8th U.S. Circuit Court of Appeals, should eliminate the ambiguity that has prevented courts from consistently applying the holding of *Central Bank of Denver N.A. v. First Interstate Bank N.A.*, 511 U.S. 164 (1994), that there is no private cause of action for aiding and abetting a violation of § 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5.

Stoneridge was accepted for certiorari in the face of a split between the 8th Circuit's decision in that case, *In re Charter Communications Inc. Securities Litigation*, 443 F.3d 987 (8th Cir. 2006), and the 9th Circuit's decision in *Simpson v. AOL Time Warner*, 452 F.3d 1040 (9th Cir. 2006), that dealt with the question of how *Central Bank* applied to the allegations of third-party liability for alleged fraudulent "schemes" or "practices" under Rule 10b-5(a) and (c).

'Central Bank' has failed to provide promised clarity

How the Supreme Court will resolve this circuit split has enormous consequences. Consider the fact that before the 5th Circuit held in *Regents v. Credit Suisse First Boston (USA) Inc.*, 482 F.3d 372 (5th Cir. 2007), that the plaintiffs' "scheme" theory was not actionable pursuant to *Central Bank*, several defendants settled for a total of nearly \$7 billion. In the face of such legal uncertainty, the irony is that a central concern of *Central Bank* was producing a rule of law

By Daniel Tyukody
and Michael Hefter



that could achieve consistent and predictable results. *Central Bank*, 511 U.S. at 188-89 ("[A] shifting and highly fact-oriented disposition is not a satisfactory basis for a rule of liability.").

One reason for the circuit split is that *Central Bank's* facts were very different from those in the 5th, 8th and 9th circuits' cases, where the essential allegations are that the issuer "schemed" with third parties to engage in transactions that the issuer accounted for fraudulently. In contrast, the defendant in *Central Bank* was a bank that served as a trustee for a bond offering secured by real estate, and that decided not to get new appraisals during a period of real estate decline. When the bonds went into default, the plaintiff sued the bank as an aider and abettor. While concluding that aiding and abetting liability was inconsistent with the text of § 10(b) and congressional intent, the court also stated that third parties could be liable as primary violators: "Any person or entity, including a lawyer, accountant or bank, who employs a manipulative device or makes a material statement (or omission) on which a purchaser or seller of securities relies may be lia-

ble as a primary violator under 10b-5, assuming all of the requirements for primary liability under Rule 10b-5 are met." 511 U.S. at 191.

In *Stoneridge*, Charter Communications allegedly engaged in "sham or wash transactions" with its set top box suppliers whereby Charter agreed to pay an additional \$20 per box in exchange for the suppliers' agreement to recycle that money back to Charter as advertising. The plaintiffs alleged that the suppliers were liable as primary violators under parts (a) and (c) of Rule 10b-5, which respectively prohibit any "scheme or artifice to defraud" and any "act, practice or course of business" that would operate as a "fraud or deceit." The 8th Circuit disagreed and held that under *Central Bank*, the suppliers had no § 10(b) liability based upon the "governing principle" that the prohibitions of Rule 10b-5 are limited to acts " 'prohibited by the text of § 10(b).' " *Charter*, 443 F.3d at 992 (quoting *Central Bank*, 511 U.S. at 173).

This analysis posits a distinction between the statute and its promulgating rule. Section 10(b) prohibits "any manipulative and deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe." The court in *Charter* concluded that the words "manipulative" and "deceptive" in § 10(b) are terms of art. As to "manipulative," which under Supreme Court precedent refers to "wash sales, matched orders or rigged bids" (*Santa Fe Indus. v. Green*, 430 U.S. 462, 476 (1977)), this analysis is well-supported.

As to the word "deceptive," however, the case for a similarly constrained meaning is less persuasive. In *Charter*, the 8th Circuit held that "[a] device is not 'deceptive' within the meaning of § 10(b), absent some misstatement or a failure to disclose by one who has a duty to disclose." 443 F.3d at 992. (The 5th Circuit reached an identical conclusion in *Regents*. 482 F.3d at 384.) This narrow interpretation of § 10(b) means that Rule

Daniel Tyukody and **Michael Hefter** are partners at Orrick, Herrington & Sutcliffe based, respectively, in Los Angeles and New York. Tyukody was the lead counsel for one of the settling defendants in *Simpson v. AOL Time Warner*. Oren Lazar and Hilarie Link, summer clerks at the firm, provided assistance with this article.

10b-5 is limited to regulating speaking or the failure to speak when one has a duty to do so, a topic that is completely covered by subsection (b) of Rule 10b-5. The implied holdings of *Charter* and *Regents* is that subsections (a) and (c) of Rule 10b-5 are either superfluous or beyond the scope of their enabling statute.

There are three reasons why this analysis is questionable. First, Supreme Court precedent does not support such a narrowly circumscribed interpretation of the word “deceptive.” In *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), the court emphasized that apart from the term “manipulative,” the words in § 10(b) were to be given their “commonly accepted meaning[s]” and read “according to the sense of the...ordinary man.” *Id.* at 199 & n.19. Second, in other areas the court has upheld comprehensive administrative agency rules adopted pursuant to similarly generalized statutory authorizations. See, e.g., *NBC v. U.S.*, 319 U.S. 190 (1943) (upholding the Federal Communications Commission’s authority to promulgate rules in the “public interest, convenience or necessity”). Third, the court has repeatedly cited all of the subparts of Rule 10b-5 without ever giving an indication that some were beyond the reach of the statute. E.g., *Ernst*, 425 U.S. at 196; *Tellabs Inc. v. Makor Issues & Rights Ltd.*, 127 S. Ct. 2499, 2507 (2007).

If *Charter* and *Regents* are problematic as useful tests because they take too narrow a view of the statute, the Securities and Exchange Commission’s alternative test, which the 9th Circuit adopted in *Simpson*, is also problematic because it is difficult to reconcile with *Central Bank*’s directive to produce a rule capable of consistent application. According to that test, “to be liable as a primary violator of Section 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.” This test is virtually guaranteed to produce inconsistent results. Consider the Nigerian barge deal discussed in the *Regents* case, in which Merrill Lynch

reportedly agreed to purchase a barge from Enron in return for a guaranteed profit on repurchase. Was Merrill’s “principal purpose” assisting Enron in its fraud, accommodating a valued client or making a guaranteed profit?

Advantages to focusing on the reliance element

How then to separate on a consistent basis nonactionable aiding and abetting liability from actionable primary liability? The best approach would seem to be to focus on the “critical” element of reliance as the court did in *Central Bank*: “Our reasoning is confirmed by the fact that respondents’ arguments would impose 10b-5

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aiding and abetting liability when at least one element critical for recovery is absent: reliance.” 511 U.S. at 180.

The fact that a focus upon the reliance element would result in fewer viable cases against secondary actors is probably one reason why it has not received favorable treatment by some courts. When confronted with a massive fraud and an inability to see how plaintiffs could have relied on some parts of the “scheme,” the court in *Parmalat* simply eliminated reliance as an element of Rule 10b-5(a) and (c). See *In re Parmalat*

Sec. Litig., 376 F. Supp. 2d 472, 491-92, 509 (S. D.N.Y. 2005). However, nothing in Supreme Court precedent suggests that the elements of a Rule 10b-5 violation are different for some parts of the rule than they are for others.

Other courts treat reliance as something to be presumed under *Basic Inc. v. Levinson*, 485 U.S. 224 (1988). But the logical flaw is that the presumption of reliance in *Basic* is based upon the assumption that an efficient market incorporates all known information into a stock’s price, whereas in “scheme” cases the market is necessarily unaware of the scheme. And unlike the presumption of reliance for material omissions adopted in *Affiliated Ute Citizens v. U.S.*, 406 U.S. 128 (1972), the counterparties in “scheme” cases have no legally recognized duty to speak. *Central Bank* requires that “[a] plaintiff must show reliance on the defendant’s misstatement or omission.” 511 U.S. at 180. In the typical scheme case, the plaintiff will not even have known of the existence of the “scheme” counterparty, much less have relied on it for anything.

Focusing upon the element of reliance would limit the transactions that could give rise to primary liability, giving third parties some assurance that they will not face huge exposure. On the other side, it could also limit the liability of morally culpable actors. As the Supreme Court recognized in *Central Bank*, both positions have policy merit, and rather than legislating, courts should focus upon the text of the statute. A focus upon the “critical” element of reliance has the ability to produce consistent results across courts, which would also be faithful to the statute, the rule and existing Supreme Court precedent. **NLJ**

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