Who Does the Catch-All Antifraud Provision Catch?
Central Bank, Stoneridge and Scheme Liability In The Supreme Court

By
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I. INTRODUCTION

A. Next term, the Supreme Court will decide Stoneridge Inv. Partners, LLC. v. Scientific-Atlanta, Inc. and Motorola, Inc., No. 06-43.

1. The case will distinguish between primary and secondary liability under Section 10(b) of the Securities Exchange Act of 1934.

2. The decision is key to who may be named in, and ultimately held liable in, securities fraud damage actions.

3. The scope of the decision may be impacted by whether the Supreme Court decides to consider the appeals from the Fifth Circuit in the Enron litigation, which raises an issue similar to that of Stoneridge.

B. Central Bank Overruled Every Circuit: Prior to 1994, every Circuit Court had concluded that there was liability for aiding and abetting under Section 10(b). Central Bank of Denver, N.A. v. First Interstate Bank of Denver, 511 U.S. 164 (1994) held that claims for aiding and abetting violations of Section 10(b) could not be brought.

C. Post Central Bank: Since Central Bank, Congress amended the Exchange Act, authorizing the SEC to bring fraud actions for aiding and abetting, but not against private litigants. The Circuit Courts have struggled to define the line between primary and secondary violations.

1. In 1995, Congress added Section 20(e) to the Exchange Act, authorizing the SEC to bring actions for aiding and abetting.

2. The Circuit Courts have split over what constitutes a primary and secondary violation of the federal securities laws.

a. The "bright line" test: The Second, Fifth, Eighth and Eleventh Circuits have adopted the so-called bright line test which essentially requires a determination of whether each defendant engaged in a deceptive act relied on by the plaintiff.

b. The "substantial participation" test: The Ninth Circuit and some District Courts required that the defendant substantially participate

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in the preparation of the fraudulent statements relied on by the plaintiffs.

3. Scheme liability. Recently, the Ninth Circuit broadened its substantial participation test into scheme liability, focused on the language of subsections (a) and (c) of Rule 10b-5. Under that test, defendant must participate in a scheme to defraud and undertake conduct which had a "purpose and effect" of creating a false appearance of fact in furtherance of the scheme.

4. The SEC: In an amicus brief filed in Ninth Circuit case the SEC advocated a variation of scheme liability which the court declined to adopt.

D. Cert. granted: On March 26, 2007 the Supreme Court granted *certiorari in* Stoneridge Investment Partners, LLC. V. Scientific-Atlanta, Inc. and Motorola, Inc., No. 06-43 to resolve the conflict in the Circuits. This case will be heard next term.

E. Stoneridge has to potential to reshape the landscape in private securities litigation. At stake is who can be held libel in those actions. The test of liability established by the Court in this case can significantly impact the liability of corporate directors and officers, outside auditors and lawyers and vendors.

II. PRE-CENTRAL BANK: ALL CIRCUITS RECOGNIZE AIDING AND ABETTING

A. Central Bank: The End of Aiding and Abetting. In 1994, the Supreme Court decided Central Bank. There, the court held that that a claim could not be brought for aiding and abetting a fraud under Section 10(b) of the Exchange Act and Rule 10b-5 there-under. Rather, only a primary violator could be held liable under the Section. The court did not define the line between primary and secondary violations.

B. Previously, every Court had concluded that there was liability for aiding and abetting under Section 10(b). *See, e.g.*:

1. Cleary v. Perfectune, Inc., 700 F.2d 774 (1st Cir. 1983);

2. Monsen v. Consol. Dressed Beef Co., 579 F.2d 793 (3rd Cir. 1978);

3. Schatz v. Rosenberg, 943 F.2d 485 (4th Cir. 1991);

4. Fine v. Am. Solar King Corp., 919 F.2d 290 (5th Cir. 1990);

5. Moore v. Fenex, Inc., 809 F.2d 297 (6th Cir. 1987);

6. Schlifke v. Seafirst, Corp., 866 F.2d 935 (7th Cir. 1989);

7. K & S P'ship. v. Cont'l Bank, N.A., 952 F.2d 971 (8th Cir. 1991);

8. Levine v. Diamanthushet, Inc., 950 F.2d 1478 (9th Cir. 1991);

9. Farlow v. Peat, Marwick, Mitchell & Co., 956 F.2d 982 (10th Cir. 1992);

10. Schneberger v. Wheeler, 859 F.2d 1477 (11th Cir. 1988);

11. *See also* Dirks v. SEC, 681 F.2d 824 (D.C. Cir. 1982).

C. Although there were variations in the precise formulation, generally the courts agreed that the elements of aiding and abetting were:

1. the existence of a primary violation of Section 10(b);

2. the defendant's knowledge of the primary violation (or reckless disregard); and

3. substantial assistance of the violation by the defendant.

D. Prior to Central Bank, the Supreme Court had acknowledged that there is an implied cause of action for damages under Section 10(b) and Rule 10b-5, although one was not expressly provided for in the text of the statute by Congress. Essentially, the Court acquiesced in the unanimous verdict of the lower federal courts. Herman & McLean v. Huddleston, 459 U.S. 375, 380, n. 10 (1983).

III. THE DECISION IN CENTRAL BANK

A. The facts: Central Bank was the indenture trustee for $26 million in bonds secured by landowner assessment liens. The bonds had been issued by a public building authority. The land subject to the liens was required to be worth at least 160% of the outstanding principal and interest amount of the bonds. The developer was required to provide the bank with evidence that the proper ration had been maintained. Although the bank learned that the property was declining in value and that the developer's assurances of value were suspect, it postponed an independent review of the developer's appraisal until after new bonds were issued. Subsequently the building authority defaulted. Bond holders sued the bank as an aider and abettor of the fraud perpetrated by the building authority, the underwriter and the developer.

B. Procedural history: The District Court granted summary judgment in favor of the defendants. The Tenth Circuit Court of Appeals reversed, finding that there was a genuine issue of material fact regarding the recklessness element of aiding and abetting liability which precluded liability. The Supreme Court granted certiorari on the question of whether there was aiding and abetting liability under Section 10(b) and Rule 10b-5 there-under, although that issue was not raised by the parties.

C. The Supreme Court's Decision:

1. Justice Kennedy wrote the opinion for the court which was joined by Chief Justice Rehnquist and Justices O'Connor, Scalia and Thomas. Justice Kennedy began by noting: "As we have interpreted it, Section 10(b) ... imposes private civil liability on those who commit a manipulative or deceptive act in connection with the purchase or sale of securities. In this case, we must answer a question ... whether private civil liability ... extends ... to those who do not engage in the manipulative or deceptive practice, but who aid and abet the violation." Central Bank, 511 U.S. at 166-167. The Court held that it does not.

2. The Court began by noting that its prior decisions focused on two key questions: First, the scope of conduct prohibited, and second, the elements of a private claim. Decisions on the second question have been guided by inferring how the 1934 Congress would have resolved the issue. Decisions on the former have been guided by the statutory text.

3. The Court's prior cases, such as Santa Fe Indus.v. Green, 430 U.S. 462 (1977) and Ernst & Ernst v. Hochfelder, 425 U.S 185 (1976), emphasized that the "'language of Section 10(b) gives no indication that Congress meant to prohibit any conduct not involving manipulation or deception.'" (citation omitted) Central Bank at 174. The Court emphasized its often-stated position that not every instance of financial unfairness is prohibited by the statute. Rather "Section 10(b) is aptly described as a catchall

provision, but what it catches must be fraud. When an allegation of fraud is based upon nondisclosure, there can be no fraud absent a duty to speak." (citation omitted) Id.

4. The Court noted that the phrase "directly or indirectly" does not support aiding and abetting liability. Indeed, aiding and abetting liability extends far beyond the meaning of that phrase to reach persons "who did not engage in the proscribed activities at all, but who give a degree of aid to those who do." Id. at 176.

5. Based on the statutory text the Court held: "We reach the uncontroversial conclusion, accepted even by those courts recognizing a Section 10(b) aiding and abetting cause of action, that the text of the 1934 Act does not itself reach those who aid and abet a Section 10(b) violation." Id. at 177.

6. Although the statutory language was sufficient to resolve the case the Court also considered the express causes of action in the 1934 Act. Each designated specific conduct, like Section 10(b), that was prohibited. None included in the original statute included aiding and abetting.

7. The Court noted that its reasoning was confirmed by the fact that imposing Section 10(b) aiding and abetting liability would circumvent the key element of reliance required to establish a cause of action. A plaintiff must show reliance to recover. Proof of that element is not necessary for aiding and abetting, however, the Court concluded.

8. In rejecting various policy arguments made by the SEC in favor of aiding and abetting, the Court noted that such liability is unclear and that there must be "certainty and predictability" in this area. Otherwise it could inhibit those who provide services to participants in the securities business.

9. The Court concluded by noting that: "The absence of Section 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-05 are met. ... In any complex securities fraud, moreover, there are likely to be multiple violators ... ." Id. at 191.

D. The dissent: Justice Stevens, joined by Justices Blackmun, Souter and Ginsburg, dissented. Essentially, Justice Stevens argued that the question of aiding and abetting, like the existence of an implied cause of action, has long been settled. Every Circuit Court has long held that there is aiding and abetting liability under Section 10(b) and the court should defer to and respect those long standing

decisions. He also argued that while the case before the Court was a private damage action, its holding would apply to the SEC.

IV. POST CENTRAL BANK: CONGRESS AMENDS THE EXCHANGE ACT, ADDING SECTION 20(e).

A. Following Central Bank, it was clear that not only had aiding and abetting liability been eliminated in private damage actions, but also in SEC enforcement cases. Compare Ernst & Ernst, 425 U.S. 185 (holding based on the statutory language that in a private damage action under Section 10(b), plaintiff must prove scienter) with Aaron v. SEC, 446 U.S. 680 (1980) (holding that the SEC must prove scienter in a Section 10(b) enforcement action based on the statutory text and in view of Hochfelder).

B. In 1995, Congress enacted the Private Securities Litigation Reform Act ("PSLRA" or "Reform Act"). The Reform Act created certain procedural protections for defendants in private securities actions. For example, under the Act, plaintiffs are required to meet stringent pleading standards to state a cause of action. 15 U.S.C. §78u-4(b)(2). In addition, a stay of all discovery would typically be required pending a resolution of any motion to dismiss. 15 U.S.C. §78u-4(b)(3)(B).

C. In the 1995 Amendments, Congress also added Section 20(e) to the Exchange Act. That Section restored the authority of the SEC to bring Section 10(b) enforcement actions based on aiding and abetting.

D. Although the SEC urged Congress to permit private plaintiffs to bring actions for aiding and abetting, that authority was not enacted.

V. THE INITIAL DECISIONS BY THE CIRCUIT COURTS: THE "SUBSTANTIAL PARTICIPATION" AND "BRIGHT LINE" TESTS.

A. Shortly after Central Bank, the Ninth Circuit and the Second Circuit considered the impact of the decision. Each Circuit developed its own test of primary liability. The Ninth Circuit opted for a "substantial participation" test, while the Second Circuit created what later came to be known as the "bright line" test.

B. The substantial participation test. This test was created by the Ninth Circuit in its 1995 decision in In re Software Toolworks, Inc., 50 F.3d 615 (9th Cir. 1994). Essentially the test provides that anyone who substantially participates in the preparation of a fraudulent document is a primary violator.

1. The case was brought by investors in Software Toolworks against the outside auditors of the company, Deloitte & Touche, and underwriters Montgomery Securities and Paine Webber, Inc.

2. The complaint followed a secondary public offering and the rapid decline of the share price. It contained claims under Sections 11 and 12 of the Securities Act and Section 10(b) of the Exchange Act. Essentially, the complaint alleged that the defendants had issued a false and misleading prospectus containing false audited financial statements. The complaint also alleged that the defendants lied to the SEC in response to inquiries made before the effective date of the registration statement.

3. The Ninth Circuit affirmed in part and reversed in part the order of the District Court which had granted summary judgment in favor of defendant. The Court reversed in part the grant of summary judgment on the Section 11 and 12 claims. The District Court had concluded as a matter of law that the defendants had established a due diligence defense.

4. Plaintiffs essentially reiterated their Section 11 and 12 claims regarding the financial statements as a Section 10(b) claim. The court affirmed the District Court decision finding plaintiffs had failed to establish scienter.

5. Plaintiff's also alleged that Deloitte violated Section 10(b) by participating in the drafting of two letters that Toolworks sent to the SEC which contained false statements. Specifically, plaintiffs claimed that the letters falsely stated that the company did not have preliminary financial data available for the June quarter and misleadingly described the nature of certain contracts.

6. The Ninth Circuit reversed the grant of summary judgment in favor of the auditors as to the SEC letters noting: "we conclude that 'a reasonable factfinder could infer that, as members of the grafting group, [Deloitte] had access to all information that was available and deliberately chose to conceal the truth' about Toolworks' poor June quarter performance ..." quoting the District Court decision. Id. at 629. In reaching this conclusion

the Court found that the auditors participated in the drafting of the letters and that their names were listed as persons to call.

7. The only analysis of Central Bank in the Court's opinion is in a footnote which states: "Despite Central Bank, we nevertheless consider this issue [about the letters to the SEC] because the plaintiff's complaint clearly alleges that Deloitte is primarily liable under section 10(b) for the SEC letters. In fact, the July 1 SEC letter stated that it 'was prepared after extensive review and discussions with ... Deloitte' and actually referred the SEC to two Deloitte partners for further information ... Similarly, the plaintiffs presented evidence that Deloitte played a significant role in drafting and editing the July 4 SEC letter ... This evidence is sufficient to sustain a primary cause of action under section 10(b) and, as a result, Central Bank does not absolve Deloitte on these issues." Id. at 628, n. 3. The opinion does dot discuss reliance.

8. The Ninth Circuit, relying on Software Tools, reaffirmed the "substantial participation" test in Howard v. Everex Sys., Inc., 228 F.3d 1057, 1061 n. 5 (9th cir. 2000) (signing and attesting to a statement so that, for all practical purposes, the signor made the statement, can constitute a violation of the antifraud provisions).

C. The bright line test. This test was first articulated by the Tenth Circuit and later followed by the Second, Eleventh, Eighth and Fifth Circuits.

1. Anixter v. Home-Stake Prod. Co., 77 F.3d 1215 (10th Cir. 1996) first used the test. The test required that the defendant engage in deceptive conduct which is relied on by the defendant.

   a. A shareholders suit was brought against Home-Stake Production Company and its outside auditors. The complaint alleged that the company was a classic Ponzi swindle. A jury found the auditors liable based on instructions which permitted them to find liability as either a primary participant or an aider and abettor. The Tenth Circuit reversed because the verdict may have been based on aiding and abetting, which is precluded by Central Bank.

   b. Auditor Cross was alleged to have issued false opinions on the company's balance sheets and false audit opinions on their financial statements. In addition, Cross' opinions and certification letters were reproduced in prospectuses, annual reports, registration statements and other Home-Stake promotional material. At trial, an expert testified that Cross must have know about the fraud and that his opinions and certifications were false.

   c. After carefully reviewing Central Bank, the Court crafted a test for delineating primary and secondary liability. The court held that

"[t]he critical element separating primary from aiding and abetting violations is the existence of a representation, either by statement or omission, made by the defendant, that is relied upon by the plaintiff. Reliance only on representations made by others cannot itself form the basis of liability." Id. at 1225.

d. According to the Court, the alleged violator need not communicate the misrepresentation directly to the plaintiffs. However, "for an accountant's misrepresentation to be actionable as a primary violation, there must be a showing that he knew or should have known that his representation would be communicated to investors because Section(s) 10(b) and Rule 10b-5 focus on fraud made 'in connection with the sale or purchase' of a security.'" Id. at 1226.

e. The Court went on to specify the test for primary liability: "Reading the language of Section(s) 10(b) and 10b-5 through the lens of *Central Bank*, we conclude that 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 knew or should know will reach potential investors. In addition to being consistent with the language of the statute, this rule, though far from a bright line, provides more guidance to litigants than a rule allowing liability to attach to an accountant or other outside professional who provided 'significant' or 'substantial' assistance to the representations of others." Id. at 1226-1227.

f. Citing Software Toolworks, the Court noted that "[t]o 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*.. Id. at 1226, n. 10.

g. The Court concluded that the facts here were sufficient to establish primary liability, but reversed because of the ambiguity in the jury instructions.

2. The Second Circuit adopted the reasoning of Anixter in two cases, while rejecting Software Toolworks.

a. Shapiro v. Cantor, 123 F.3d 717 (2nd Cir. 1997) was based on a suit brought by purchasers of limited partnership interests purchased in a failed chain of Video USA stores. The complaint alleged that the principles created three private placement offering memoranda which were false and misleading. The District Court dismissed all claims against defendant accountant, Touche Ross.

i. The amended complaint alleged that the principal defendants together with all other defendants developed a plan to sell interests in Video USA. That plan was developed with the participation and active aid and assistance of Touche Ross. According to the complaint, all of the defendants made misrepresentation to investors without disclosing that the principle of the company was a convicted felon. Touche Ross also provided financial projections which were included in the offering memos.

ii. Citing Anixter, the Court affirmed the dismissal as to Touche Ross. First, as to the disclosure of the felony conviction, the Court held that the accountants could only be liable for a failure to disclose if they had a duty to do so. Here they did not.

iii. Second, as to the financial projections, the Court held that "Touche Ross's specific 'participating' role in selling interests in Video USA was only in providing the financial projections that were included with the offering memoranda. Because this is consistent with the role of an accountant, and because the plaintiffs otherwise failed to articulate a 'fiduciary or other similar relation of trust and confidence' between themselves and Touche Ross we hold Touche Ross had no duty to disclose David Greenberg's criminal conviction ... ." Id. at 722.

b. In Wright v. Ernst & Young LLP, 152 F.3d 169 (2nd Cir. 1998) the court affirmed the dismissal of a class action securities suit against an accounting firm.

i. A class action complaint was brought by the shareholders of BT Office Products against the company's outside auditors, Ernst & Young. The complaint alleged that the accounting firm engaged in a fraud in violation of Section 10(b). Specifically, the complaint alleged that at year end 1995 Ernst & Young signed off on BT Office Products financial statements and authorized the company to release its results with full knowledge that the market would interpret the release as having been approved by the accounting firm. Based on oral assurances by Ernst & Young, the fraudulent financial statements were released. The press release stated that the figures were not audited and did not mention Ernst & Young.

ii. The District Court granted defendant's motion to dismiss.

iii. The Second Circuit affirmed. After reviewing the Supreme Court's decision in Central Bank, the Court essentially reiterated its earlier holding in Shapiro. Citing Software Toolworks, the Court noted that other courts "have held that third parties may be primarily liable for statements made by others in which the defendant had significant participation. ... These two differing approaches [Shapiro and Software Toolworks] have been characterized respectively as the 'bright line' test and the 'substantial participation" test. Wright, supra, at 175. The court again rejected the "substantial participation" test as inconsistent with Central Bank.

iv. The Court went on to hold that in "Shapiro, we followed the 'bright line'; test after observing that 'if Central Bank is to have any real meaning, a defendant must actually make a false or misleading statement in order to be held liable under section 10(b). Anything short of such conduct is merely aiding and abetting, and no matter how substantial that aid may be, it is not enough to trigger liability under Section 10(b).'" (citation omitted) Id..

v. The court went on to hold that "a secondary actor cannot incur primary liability under the Act for a statement not attributed to that actor as the time of its dissemination." Id..

3. The Eleventh Circuit adopted the bright line test in Ziemba v. Cascade Int'l, Inc., 256 F.3d 1194 (11th Cir. 2001).

a. Plaintiff shareholders of Cascade International, Inc. brought a securities fraud suit against the company's directors and officers, its auditors Coopers & Lybrand and its law firm, Gunster, Yoakley. The District Court granted several motions to dismiss, including one filed by the law firm, but generally denied the motion of the accounting firm.

b. Plaintiffs claimed that the law firm played a significant role in creating, drafting, reviewing or editing allegedly fraudulent letters or press releases. The accountants, according to plaintiffs are liable because they incorrectly advised Cascade that its financial statements need not be consolidated with those of a subsidiary, failed to include a "going concern" qualification in its reports for subsidiaries and failed to disclose a claimed fraud in Cascade's 10-K.

c. The Eleventh Circuit rejected plaintiff's claims. After reviewing Central Bank the Court noted that the federal courts have split over "the threshold requirement to show that a secondary actor, such as a lawyer or an accountant, is primarily liable under Section 10(b)." Id. at 1205. That split, the Court noted, is between the substantial participation test of Software Toolworks and the bright line test of Anixter and Wright.

d. The Court then noted that "[i]n order for a secondary actor, such as a law firm or accounting firm, to be primarily liable under Section 10(b), the Plaintiffs 'must show reliance on the defendant's misstatement or omission to recover under 10b-5.'" (citation omitted) Id.

e. The Court went on to adopt the bright line test: "Following the Second Circuit, we conclude that, in light of *Central Bank*, in order for the defendant to be primarily liable under Section 10(b) and Rule 10b-5, the alleged misstatement or omission upon which a plaintiff relied must have been publicly attributable to the defendant at the time that the plaintiff's investment decision was made." Id.

f. As to the law firm, the Court held that it could not be liable because "[p]laintiffs have not alleged any misstatements by ... [the law firm] upon which Plaintiffs relied." Id.. The Court went on to hold that Section 10b liability can not attach to those who were never identified to investors as playing any role in the misrepresentations. In addition, the court rejected any claim that the law firm should have disclosed material it knew about the company but was not in the releases because the firm did not have a duty to disclose to the plaintiffs.

g. The Court rejected plaintiff's arguments as to Coopers & Lybrand for essentially the same reasons. As to the advice about consolidation, the Court noted that plaintiffs "do not allege that any audit report prepared by [Coopers & Lybrand] was ever contained in any of Cascade's public documents filed with the SEC." Id. at 1207. As to the other claims, the Court held that plaintiffs failed to plead fraud with particularity as required by the PSLRA.

h. The Court also affirmed the District Court's refusal to grant leave to amend in view of the requirements of Central Bank and Rule 9(b) requiring fraud to be pled with particularity.

VI. SCHEME LIABILITY.

A. "Scheme liability" is premised on the theory that Section 10(b) prohibits any "scheme to defraud."

1. The phrase appears in subsections of Rule 10b-5, but not in the text of the statute. *See, e.g.*, Rule 10b-5(a) which provides in part that it is unlawful to "employ any device, scheme, or artifice to defraud… ."

2. A similar phrase appears in Rule 10b-5 (c) which prohibits "any act, practice, or course of business which operates or would operate as a fraud … ."

3. The rule, however, as Central Bank notes, can be no broader that the statute.

4. The phrase also appears in a number of Supreme Court decisions construing Section 10(b). *See, e.g.*, SEC v. Zandford, 535 U.S. 813, 821-22 (2002) (Section prohibits engaging in a "scheme to defraud …"); Ernst & Ernst, 425 U.S. at 199 n. 20 (defining "device" to include a scheme to deceive); Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 10 n. 7 (1971) (noting that the Section and Rule prohibit "all fraudulent schemes …").

B. Stoneridge in the lower court – the Eighth Circuit rejected scheme liability and adopted the bright line test in In re Charter Commc'n, Inc., Sec. Litig., 443 F.3d 987 (8th Cir. 2006).

C. The Ninth Circuit adopted "scheme liability" in its decision in Simpson v. AOL Time Warner, Inc., 452 F.3d 1040 (9th Cir. 2006). In doing so, the Court did not adopt a test offered in an amicus brief by the SEC (although it adopted some terms) and held that the allegations concerning third party vendors were insufficient to meet the test.

1. Simpson is a class action securities fraud case based on claims involving a scheme to overstate the reported revenues of Homestore.com. Following dismissal of the claims against six outside defendants called the Third Party Vendors (AOL Time Warner and two of its officers, Cendant corporation and one of its officers and L90 Inc.), plaintiff appealed.

2. According to the complaint Homestore, its officers, its auditors and the Third Party Vendors engaged in round-trip barter transactions whereby Homestore recorded revenues from the receipt of money that came from its cash reserves. Suits were filed after Homestore announced a $170 million restatement of its financial statements.

a. AOL and its officers were alleged to have played a role in the scheme to overstate the revenues of Homestore by arranging

triangular transactions. Those transactions according to the plaintiffs were necessary for Homestore to overstate its revenues. There are no allegations that AOL and its officers engaged in sham transactions or which were "completely illegitimate or in themselves created a false appearance." Id. at 1052.

b. Cendant is alleged to have participated in triangular transactions which Homestore used to improperly inflate its income. There is no allegation that Cendant created a false appearance with these transactions aside from the claim that Homestore improperly accounted for them. While there is a claim that Cendant participated in actions to conceal the transactions, they are not alleged with sufficient particularity, according to the court.

c. Plaintiffs claim that an officer of L90 signed a false statement concerning key transactions. There is no allegation that the claimed false statement was introduced into the securities market as part of a scheme to defraud. To the contrary, the day after the statement was signed, Homestore's CFO refused to sign the financial report based on the misstatements within the report.

3. The Circuit Court affirmed the dismissal of the claims and remanded the case to the District Court to consider whether leave should be granted to amend.

a. The court considered three key elements of a Section 10(b) cause of action:

i. the use or employment of a deceptive device or contrivance;

ii. the "in connection with" requirement; and

iii. reliance.

b. The court began its analysis of the first element by noting that Section 10(b) is "intended to prohibit the use or employment of any deceptive device in connection with the purchase or sale of securities, including deception as part of a larger scheme to defraud the securities market." Id. at 1047.

i. Central Bank held that Section 10(b) liability only extends to primary violators. Quoting its earlier decision in Howard, the Court noted 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." (citation omitted) Id. at 1048.

ii. After noting that the question of what must be alleged to be a primary violation in a scheme to defraud has not been extensively discussed the Court, borrowing in part from an amicus brief filed by the SEC stating: "We hold that to be liable as a primary violator of Section 10(b) 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." Id. (emphasis original).

iii. The Court distinguished the "principal purpose" prong of its test from the element of scienter. According to the Court, "the 'purpose and effect' test is focused on differentiating conduct that may form the basis of a primary violation ... from mere aiding and abetting. ... A defendant may intend to deceive the public by substantially assisting another's misconduct as part of a scheme to defraud, but fail to perform personally any action that created a false appearance as part of this scheme. The scienter requirement, therefore, will not in all cases distinguish aiding and abetting from primary liability." Id. at n. 5.

iv. The Court rejected defendants' argument that "imposing liability for participation in an overall scheme to defraud would impose liability for conduct other than the making of a material misstatement or omission and would conflict with *Central Bank.* ... We see no justification to limit liability under section 10(b) to only those who draft or edit the statements released to the public. To the contrary, Section 10(b) prohibits any person or entity from using or employing any deceptive device, directly or indirectly, in connection with the purchase and sale of securities. ... Nor is 'scheme to defraud' liability a substitute for aiding and abetting. ... The focus of the inquiry on the deceptive nature of the defendant's own conduct ensures that only primary violators (that is, only those defendants who use or employ a manipulative or deceptive device) are held liable under the Act." Id. at 1049.

c. The in connection with requirement is met where the fraudulent financial information is introduced into the securities markets.

d. Similarly, the reliance requirement is met where the fraudulent information is introduced into the trading market which is the "end result of a scheme to misrepresent revenue." Id. at 1051.

e. The Court summarized its holding as follows: "We conclude that conduct by a defendant that had the principal purpose and effect of creating a false appearance in deceptive transactions as part of a scheme to defraud is conduct that uses or employees a deceptive device within the meaning of Section 10(b). Furthermore, such conduct may be in connection with the purchase or sale of securities if it is part of a scheme to misrepresent public financial information where the scheme is not complete until the misleading information is disseminated into the securities markets. Finally, a plaintiff may be presumed to have relied on this scheme to defraud if a misrepresentation, which necessarily resulted from the scheme and the defendant's conduct therein, was disseminated into an efficient market and was reflected in the market price." Id. at 1052.

f. The Court held that plaintiffs failed to plead sufficient facts here as to each of the defendants. Specifically, the Court held that plaintiffs failed to allege specific deceptive conduct by each of the defendants to satisfy the "purpose and effect" test.

4. The SEC. The SEC filed an amicus brief in Simpson on behalf of the plaintiffs. The brief argues for a two part test for scheme liability.

a. A "person can be primarily liable ... for engaging in a scheme to defraud, so long as he himself, directly or indirectly, engages in a manipulative or deceptive act as part of the scheme." SEC Amicus brief at 15.

b. A deceptive act in this context is "[e]ngaging in a transaction whose principal purpose and effect is to create a false appearance of corporate revenue ... ." Id. at 18.

c. Reliance is established "where a plaintiff relies on a material deception flowing from a defendant's deceptive act, even though the conduct of other participants in the fraudulent scheme may have been a subsequent link in the causal chain leading to the plaintiff's securities transaction. SEC Reply brief at 12.

5. In Regents of the Univ. of Cal. v. Credit Suisse First Boston (USA), Inc., 482 F.3d 372 (5th Cir. 2007); *Pet. For Cert. filed*, 75 U.S.L.W. 3557 (March 5, 2007) (No. 06-13), the Fifth Circuit reversed a District Court decision based on scheme liability drawn from the SEC's brief in Simpson.

a. Credit Suisse is a securities class action arising out of the demise of Enron Corporation. The defendants are Credit Suisse First Boston, Merrill Lynch & Company, Inc. and Barclays Bank PLC.

b. Plaintiffs claimed that defendants entered into irrational transactions with undisclosed terms which permitted Enron to book sums as revenue which were not revenue.

   i. In essence, the complaint alleged that the defendants entered into partnerships and transactions that permitted Enron to take liabilities off of its books temporarily and to book revenue when it was actually incurring debt.

   ii. This happened, for example, by entering into transactions which appeared to be sales, but in which there was a secret side agreement between Enron and a defendant under which Enron would repurchase the "sold" assets – in effect the sale was not a sale.

   iii. The purpose of the transactions was to permit Enron to misstate its financial condition.

c. According to plaintiffs, while each defendant may not have known exactly how the others were aiding Enron, each knew that Enron was engaged in a long term scheme to defraud investors by inflating revenue and disguising risk and liabilities through its transactions with defendants. This suit was filed after Enron's collapse.

d. The District Court concluded that there was a "deceptive act" within the meaning of Section 10(b) based on the conclusion that defendants participated in a transaction whose principal purpose and effect was to create a false appearance of revenue. The District Court supported this conclusion with the theory that the defendants had a duty not to engage in a fraudulent scheme. The District Court also held that there was a class wide presumption of reliance for omissions and using the fraud on the market theory. Id. at 378.

e. The case was before the Circuit Court on an appeal from the District Court's order certifying the class. The District Court had previously denied defendants' motions to dismiss.

f. The Fifth Circuit reversed the finding of the District Court.

   i. Initially, the Court held that the District Court incorrectly premised liability on a failure to disclose. The defendants

did not have any duty to Enron's shareholders and thus no duty to disclose.

ii. The Court went on to hold that the District Court's concept of a "deceptive act" based on scheme liability is inconsistent with Central Bank: "An act cannot be deceptive within the meaning of Section 10(b) where the actor has no duty to disclose ... Enron committed fraud by misstating its accounts, but the ... [defendants] only aided an [sic] abetted that fraud by engaging in transactions to make it more plausible; they owed no duty to Enron's shareholders." Id. at 386.

iii. Here, the District Court adopted a rule for determining primary liability using a version of scheme liability that is broader, that that adopted in Simpson. The District Court appears to have adopted the position of the SEC. The Fifth Circuit rejected this theory as being beyond the limitations of Central Bank and Section 10(b).

iv. Rather, the Court held that the defendants had to engage in deceptive conduct or manipulation within the meaning of Section 10(b).

(a) Citing the Eighth Circuit's holding in In re Charter, the Court noted that deceptive conduct "involves either a misstatement or a failure to disclose by one who has a duty to disclose." Id. at 388.

(b) Manipulation is a virtual term of art in securities cases, the court noted, requiring that "a defendant act directly in the market for the relevant security." Id. at 390.

v. In this case, plaintiffs had not alleged facts demonstrating that defendants engaged in deceptive conduct or manipulation.

vi. The Court also concluded that plaintiffs could not rely on the fraud on the market theory to establish reliance because to do so requires that they establish deceptive conduct which they had failed to do.

vii. The court concluded by noting that it would be inappropriate to impose liability for securities fraud on one party to an arm's length business transaction because that party knew or should have known that the other party would use the transaction to mislead investors. Such

uncertain duties should only be imposed by Congress, according to the Court.

VII. SELECTED DISTRICT COURT CASES: IN PRACTICE THE LINES ARE NOT SO BRIGHT.

A. The Circuit Court cases suggest stark lines of demarcation between the bright line test and the substantial participation test which later turned into scheme liability. In the District Courts, however, the lines are not always starkly drawn.

1. Substantial participation test: This test is the pre-cursor to the "scheme liability" adopted by the Ninth Circuit and rejected by the Fifth and Eighth Circuits. In application it can look like the bright line test which focused on the individual actions of defendants and their identification.

a. Under this theory, District Courts have denied motions to dismiss where the defendant made a direct misrepresentation.

b. For example, in Adam v. Silicon Valley Bancshares, 884 F. Supp. 1398 (N.D. Cal 1995), the Court, citing Software Toolworks for the proposition that participants in a scheme to defraud can be primary violators, denied a motion to dismiss claims against an outside accounting firm where there were allegations that its opinion issued on the company's financial statements was false and that the opinion and false financial statements had been distributed to investors. The court had previously dismissed the claims against the auditors as mere aiding and abetting but permitted plaintiff to replead.

2. The bright line test: The test, as developed in Anixter, Shapiro and other cases, focused on the acts of the individual defendant in determining whether deception and reliance have been pled. Under the test articulated by these Circuit Courts, substantial participation in a fraudulent scheme is not sufficient to be a primary violator, unless the actor actually engaged in deceptive conduct and that conduct was relied on by investors. Some courts in these Circuits, however, have adopted more expansive standards and/or scheme liability.

a. Some courts have permitted claims to go forward where the defendant was not alleged to have actually made the false statement. *See, e.g.*:

i. In re Vivendi Univ. S.A. Sec. Litig., 2003 U.S. Dist. LEXIS 19431 (S.D. N.Y. Nov. 3, 2003) (claim against CFO where public statements made by company and not specifically attributed to him);

ii. In re Lernout & Hauspsie Sec. Litig., 230 F. Supp. 2d 152, 166-67 (D. Mass. 2002) (refusing to dismiss claims against auditor where it could be inferred that public attributed the statements to the auditor).

b. Others have eased the requirement that regarding specific identification of the defendant. For example, in Lernout, supra, where claims were asserted against the company's outside auditor, KPMG Belgium, who was assisted by affiliates in other countries that did not sign the reports, the Court declined to permit claims against a Singapore affiliate that only communicated a clean opinion to the Belgian affiliate but permitted the claim against the U.S. affiliate to go forward where investors had reasonably attributed the quarterly report to the U.S. firm. *See also*, In re Elan Corp. Sec. Litig., 02-865, 2004 WL 1305845 (S.D.N.Y. May 18, 2004) (citing Lernout with approval); In re Parmalat Sec. Litig., 376 F. Supp 2d 472 (S.D.N.Y. 2005) (limiting this requirement to claims under Rule 10b-5(b)).

c. Some cases have adopted scheme liability.

i. In In re Global Crossing, Ltd. Sec. Litig., 313 F. Supp. 2d 189 (S.D.N.Y. 2003) the Court held that an outside auditor can be liable for a scheme to defraud where it was alleged to be the masterminded behind it, but could not be held liable for specific misrepresentations made by others as part of the scheme. In reaching this conclusion the Court also rejected a defense argument that subsections (a) and (c) of the Rule are limited to market manipulation. The Court went on to seemingly expand the bright line rule requiring attribution of the statements to the defendant noting that a "plaintiff may state a claim for primary liability ... for a false statement (or omission), even where the statement is not publicly attributed to the defendant, where the defendant's participation is substantial enough that s/he may be deemed to have *made* the statement, and where investors are sufficiently aware of defendant's participation that they may be found to have *relied* on it as if the statement had been attributed to the defendant." Id. at 333 (emphasis original). *See also* In re Lernout, supra, at 166-67.

ii. Parmalat, supra, also adopted scheme liability.

(a) In this case the court concluded that Central Bank, as well as the Second Circuit's bright line cases, were based on Rule 10b-5(b) and neither considered subsections (a) and (c) in a case where a group of bank defendants were alleged to have participated in securities fraud with its public company client. The Court reached this conclusion by noting that Central Bank did not alter the scope of liability

under Section 10(b). Rather, it held only that aiding and abetting was not within the text of the statute, while reaffirming the fact that a lawyer, accountant or bank that employs a manipulative device or makes a material misstatement can be a primary violator.

(b) In defining scheme liability the Court declined to follow the decision in In re Lernout & Hauspie Sec. Litig., 236 F. Supp. 2d 161, 173 (D. Mass. 2003), which concluded that a person could be liable under the section for "substantially" participating in a manipulative or deceptive scheme, finding that the word "substantially" does not appear in the section or rule. Rather, the Court adhered to the text holding that those who engage directly or indirectly in such a scheme are liable.

(c) In ruling on the a motion to dismiss by the bank defendants, the Court distinguished between substantive business transactions which were later booked incorrectly by the company to mislead the markets and its shareholders, and those which were intended from the beginning to be deceptive and had little or no economic substance. Claims based on the former against the banks were dismissed while those based on the latter were permitted to go forward.

(d) The Court concluded that the bright line test of requiring the individual identification of party was limited to claims under 10b-5(b). For claims made under subsections (a) and (c) the court held that where "the banks and Parmalat are alleged causes of the loss in question ... both committed acts in violation of statute and rule, both may be liable." Id. at 48.

iii. Shriners Hosp. For Children v. Qwest Comm. Int'l, No. 04-CV-0781, 2005 WL 2350569 (D. Colo. Sept. 23, 2005). Here the court held that individual defendants who manipulated transactions in an effort to improperly recognize revenue could be held liable as part of a scheme in violation of 10b-5(a) and (c) even though they had not made false statements. The court dismissed the claims against the individuals, however, for failure to adequately plead scienter. *See also* In re Nature's Sunshine Prod. Sec.

Litig., Case No. 2:06-CV-267 TS, 2007 WL 1462436 (D. Utah May 21, 2007) (concluding that scheme liability is not precluded by Anixter).

VIII. STONERIDGE IN THE SUPREME COURT

A. In an order dated March 26, 2007, the Supreme Court granted certiorari in Stoneridge Investment v. Scientific-Atlanta, Inc., No. 06-43 (In re Charter Communications from the Eighth Circuit).

B. The question presented for review is: "Whether this court's decision in Central Bank, N.A., forecloses claims for deceptive conduct under Section 10(b) of the Securities Exchange Act ... and Rule 10b-5(a) and (c) ... where Respondents engaged in transactions with a public corporation with no legitimate business or economic purpose except to inflate artificially the public corporation's financial statements, but where Respondents themselves made no public statements concerning those transactions." Stoneridge Investment v. Scientific-Atlanta, Inc., 127 S.Ct. 1873 (March 26, 2007)

C. The Eighth Circuit's Decision rejected scheme liability and adopted the bright line test. In re Charter Commc'n, Inc., Sec. Litig., 443 F.3d 987 (8th Cir. 2006).

1. This is a class action securities fraud suit against Charter Communications, Inc., several of its executives, its outside auditors Arthur Anderson & Co., and two of its equipment vendors, Scientific-Atlanta, Inc. and Motorola, Inc.

2. According to plaintiffs, the defendant vendors entered into sham transactions with Charter which had no economic substance but were contrived to inflate Charter's operating cash flow to meet the expectations of Wall Street analysts.

   a. Charter entered into agreements with each vendor to increase the purchase price of television set top cable boxes it purchased by $20 each with the understanding that the sum would be returned in the form of advertising revenue.

   b. Charter improperly capitalized the increased equipment expenses while treating the advertising revenue as operating cash flow thus increasing revenue.

   c. The vendors entered into the sham transactions, according to plaintiffs, knowing that Charter intended to account for them improperly and inflate its revenues and operating cash flow that stock market analysts would rely on.

   d. There is no allegation that the vendors played any role in the preparation of, or dissemination of, the fraudulent financial statements and press releases of Charter.

3. The District Court dismissed the claims against the two vendors. The Eighth Circuit affirmed.

4. Plaintiff, Stoneridge Investment Partners, urged the Circuit Court to reverse the decision of the District Court, arguing that it had alleged a primary violation of Section 10(b) against the two vendors based on "scheme liability" within the meaning of Rule 10(b)-5(a) or a "course of business with operates as a fraud or deceit" within the meaning of Rule 10(b)-5(c). This argument was premised on the assumption that Central Bank did not impact the scope of liability under these two subsections.

5. The Eighth Circuit rejected the claims of the plaintiff. Rather, the court held: "We conclude that *Central Bank* and the earlier cases on which it relied stand for three governing principles: (1) The court's categorical declaration that a private plaintiff 'may not bring a 10b-5 suit against a defendant for acts not prohibited by the text of Section 10(b), ...' [citation omitted] included claims under Rule 10b-5(a) and (c), as well as Rule 10b-5(b). (2) A device or contrivance is not 'deceptive,' within the meaning of Section 10(b), absent some misstatement or a failure to disclose by one who has a duty to disclose ... (3) The term 'manipulative' in Section 10(b) has the limited contextual meaning ascribed in *Santa Fe* ..." Id. at 992.

6. The Court went on to note that "any defendant who does not make or affirmatively cause to be made a fraudulent misstatement or omission, or who does not directly engage in manipulative securities trading practices, is at most guilty of aiding and abetting and cannot be held liable under Section 10(b) or any subpart of Rule 10b-5." Id.

7. Finally, the Court noted that it was not aware of any case imposing Section 10(b) or Rule 10b-5 liability "on a business that entered into an arm's length non-securities transaction with an entity that then used the transaction to publish false and misleading statements to its investors and analysts ... to impose liability for securities fraud on one party to an arm's length business transaction in goods or services other than securities because that party knew or should have known that the other party would use the transaction to mislead investors in its stock would introduce potentially far-reaching duties and uncertainties for those engaged in day-to-day business dealings. Decisions of this magnitude should be made by Congress." Id. at 992-993.

8. The Court also affirmed the District Court's refusal to permit plaintiffs to amend their complaint.

D. The Briefs during the Cert Petition Process.

1. The petition seeking review asserted four key points:

   a. The ruling by the Eighth Circuit disregarded the statutory text, the congressional intent and the prior rulings of the Supreme Court. Essentially petitioner argued that Rule 10b-5 has always been held

to be coextensive in scope with Section 10(b). The prior decisions of the court have repeatedly described the Section as a "catch all" which prohibits every type of scheme to defraud in connection with a securities transaction.

b. Petitioners claim that the Eighth Circuit misread Central Bank by concluding that it precluded scheme liability. According to Petitioners, Central Bank was based on a record where the plaintiffs had conceded that defendant had not engaged in manipulative or deceptive conduct but only aiding and abetting. Accordingly, the court only ruled on the question of aiding and abetting.

c. Citing primarily the District Court opinions in Simpson and Credit Suisse (neither of which had been decided at the Circuit level at the time of the petition) Petitioners argued that other courts had properly recognized scheme liability.

d. Finally petitioner argued that the Eighth Circuit's comments concerning legitimate business transactions were not applicable here. The transactions involved in this case were sham transactions with no legitimate business purposes. Indeed they were part of a scheme to defraud. This conduct constitutes a primary violation of Section 10b within the test espoused by the SEC in its amicus brief in Simpson.

2. Respondent Scientific-Atlanta, Inc.'s Opposition to the Petition for cert argued three key points.

a. "Deceptive conduct" requires a misstatement or failure to disclose by one who has a duty to speak. Similarly, manipulation as used in the statute is limited to securities trading practices and not business transactions. Here defendants did not engage in deceptive or manipulative conduct.

b. Scheme liability as argued by petitioners fails to satisfy the statutory requirements and the purposes of the Act. A commercial transaction unconnected to the purchase and sale of a security cannot come within Section 10(b) because it fails the "in connection with" test. Likewise, petitioner has failed to demonstrate reliance. Indeed, petitioner has conceded that it relied only on the public statements of Charter, not the defendants. The fraud on the market theory does not resolve this problem for petitioners since defendants did not make any public statements.

c. The decision of the Eighth Circuit is consistent with those of other Circuit Court and is consistent with Central Bank.

3. Petitioner's reply brief regarding cert raised two key points:

   a. Simpson, which had just been decided, created a conflict in the Circuits.

   b. Respondents are alleged to have directly engaged in deceptive conduct by backdating contracts and otherwise employing false and deceptive documents as part of the overall scheme. This falls squarely within Section 10(b).

E. In addition, a petition for a writ of certiorari was filed in Credit Suisse. Although the SEC requested leave to file an amicus brief in support of Petitioners, the solicitor general apparently chose not to file a brief.

IX. ANALYSIS: STONERIDGE BEFORE THE SUPREME COURT

A. Any analysis of the issues in Stoneridge can be expected to begin with the text of Section 10(b). This approach has been repeatedly used by the Court in securities fraud cases.

B. Stoneridge can be expected to follow the construction of Section 10(b) in Central Bank which did not alter the scope of liability under Section 10(b) or Rule 10b-5. While the bright line test adopted by the Eighth Circuit is consistent with the Central Bank opinion, scheme liability, if properly defined is not necessarily inconsistent with the Court's approach.

1. The Central Bank opinion makes it clear that it is simply interpreting the plain language of Section 10(b) as it had many times in the past. Indeed, the only question before the Court was whether that statutory text encompassed aiding and abetting liability, since it was conceded that the bank was at most liable for aiding and abetting. While the lower federal courts had uniformly held prior to Central Bank that there was such liability under the statute, none had done so based exclusively on the language in the section. The SEC in its brief conceded that the text of the statute does not cover aiding and abetting. It is in this context that the Court termed its conclusion "uncontroversial." This approach will possibly be utilized in resolving Stoneridge.

2. Central Bank also reaffirmed that Section 10(b) is a "catchall," but that it must catch fraud. In earlier decisions cited by the Court, it had described the section as precluding "all fraudulent schemes ..." Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. at 10 n. 7. Subsequently in Ernst & Ernst, 425 U.S. at 199 n. 20, the court defined the word "device" used in the text of Section 10(b) to include "an invention; project; scheme; often, a scheme to deceive"). Stoneridge should follow this long established trend.

   a. Some courts have held that Central Bank is limited to a construction of Rule 10b-5(b). *See, e.g.*, In re Parmalat Securities Litigation, 376 F. Supp. 2d 472 (S.D.N.Y).

   b. The text of the opinion, however, focuses on the statutory language, not the rule. In Stoneridge the focus should be the language of Section 10(b), not the rule. That language is broad enough to support the bright line test and scheme liability as discussed below. While Santa Fe spoke of manipulation as a term of art, other cases, such as Hochfelder, have noted the breath of Section 10(b)'s language.

C. A key in Stoneridge which underlies Central Bank and the Circuit Court decisions following that case is the notice to the business community of what is prohibited by Section 10(b) and Rule 10b-5 verses the "catch-all" nature of the section and rule discussed above.

1. A key theme which underlies Central Bank, Santa Fe, Hochfelder and other supreme court decisions interpreting the section and rule is the havoc securities litigation can play on business transactions.

2. Central Bank points to the fact that aiding and abetting liability can increase the difficulties from for business from securities litigation because of the lack of certainty, that is where is the dividing line between liability and non-liability. Citing a number of its prior decision, the Court notes: "As an initial matter, the rules for determining aiding and abetting liability are unclear, in 'an area that demands certainty and predictability.' (quoting *Pinter v. Dahl*, 486 U.S. 622, 652 (1988)). That leads to the undesirable result of decisions 'made on an ad hoc basis, offering little predictive value' to those who provide services to participants in the securities business. *Ibid.* '[S]uch a shifting and highly fact-oriented disposition of the issue of who may [be liable] for damages claim for violation of Rule 10b-5' is not a 'satisfactory basis for a rule of liability imposed on the conduct of business transactions.' (quoting *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 755 (1975)); *see also* Virginia Bankshares v. Sandberg, 501 U.S. 1083, 1106 (1991). ... Because of the uncertainty of the governing rules, entities subject to secondary liability as aiders and abettors may find it prudent and necessary, as a business judgment, to abandon substantial defenses and to pay settlements in order to avoid the expense and risk of going to trial." Id. at 188-189.

3. While the Central Bank Court acknowledged that there are a number of policy arguments in favor of aiding and abetting liability, no doubt the lack of predictability and the potential for plaintiffs to extract large settlements in securities cases based on that uncertainty rather than the merits of the case clearly influenced the court.

4. Similar concerns were expressed to Congress the next year when the PSLRA was passed, restoring the SEC's authority to bring cases based on aiding and abetting but declining to adopt the agency's suggestion that a provision similar to Section 20(e) be added for private litigants. Indeed, the legislative hearing leading to the passage of the statute are riddled with tales of abusive securities actions. H.R. Conf. Rep. No. 369, 104th Cong., 1st Sess. 31 (1995).

5. These concerns also are implicit in many of the Circuit Court decisions following Central Bank.

D. The Stoneridge Court need not chose between the bright line test and scheme liability – the concepts can be harmonized.

1. The bright line test requires deceptive conduct by each defendant in addition to reliance on that conduct.

2. Scheme liability as applied in some decisions has similar requirements. The Ninth Circuit, since its early formulation of the "substantial participation" test has required deceptive conduct by the defendant. That is consistent with the bright line test. In addition, the scheme test as used in In re Parmalat relies only on the text of the statute, eliminating the "substantial participation" element of scheme liability in favor of following the strict Section 10(b) text, an approach which is consistent with that of the Supreme Court's approach in interpreting Section 10(b).

3. The reliance requirement of the bright line test differ significantly from that of scheme liability. Initially, the bright line test required that the defendant be identified and the conduct specifically relied on. Some District Courts have broadened this requirement and suggested that where the participation of the defendant is widely known and there is reliance that is sufficient. The causation requirement utilized in In re Parmalat appears to bridge the difference.

4. The certainty test may be key. Scheme liability appears to be a potentially opened ended test which would negatively impact those engaged in business transactions because of the uncertainty of its application. The line drawn by Judge Kaplan in Parmalat suggests type of "bright line" scheme liability test which could allay the Court's concerns. Under that test participation in an otherwise arms length and valid business transaction which is later used in some fashion by another to commit fraud is not deceptive conduct or scheme liability within the meaning of Section 10(b). In contrast, when a defendant engages in a transaction which has not only a deceptive purpose from the beginning but substantially lacks economic substance and a valid business purpose, it is a deceptive act for which liability can be imposed if all the other elements of a cause of action are established.

5. The proposed test of the SEC appears to be overly broad. It does not address the certainty requirement inherent in Central Bank and appears to be sufficiently open ended to permit conduct which would otherwise be classified as "substantial assistance" or aiding and abetting.

E. The Court

1. Only three of the justices who made up the Central Bank majority remain on the court: Justices Kennedy, Scalia and Thomas.

2. Three of the justices who dissented in Central Bank remain on the Court: Justices Stevens, Souter and Ginsburg.

3. Stoneridge will thus be decided by the three Justices added since Central Bank: Chief Justice Roberts and Justices Breyer and Alito. However, the order granting certiorari in Stoneridge states that the Chief Justice and Justice Breyer did not participate in the decision.

   a. It may be that Chief Justice Roberts and Justice Breyer have recused themselves from the case. If so, then the swing vote is Justice Alito.

   b. In securities cases decided while he was on the Court of Appeals, Justice Alito took a "workmanlike approach" according to an analysis by Professor J. Robert Brown, Jr. on the Harvard Law School Corporate Governance Blog (May 30, 2007, available at http://blogs.law.harvard.edu/corpgov/2007/05/30/the-sec-the-supreme-court-and-enron/#more-143). Those decisions offer little predictive value for the outcome of Stoneridge.

   c. In Tellabs, Inc. v. Makor Issues & Rights, Ltd., No. 06-484, 2007 WL 1773208 (June 21, 2007) , Justice Alito concurred in the result. However, he argued for the construction of PSLRA Section 21D(b)(2) (requiring that a "strong inference" of scienter be pled) suggested by Justice Scalia in his concurring opinion. In addition, Justice Alito proposed another limitation which made his proposed construction of the section by far the most restrictive. If he is the swing vote the decision will clearly hew very closely to the statutory language.

4. If, however, the Court grants certiorari in the Credit Suisse case arising from the demise of Enron then the composition of the Court may be different. The Chief Justice and Justice Breyer may participate in that decision creating a clear conservative majority that would not appear to be sympathetic to the potentially opened-ended nature of scheme liability or the expansive test the SEC has previously urged. In that instance, the Court may affirm the Eighth Circuit in Stoneridge and the Fifth Circuit in Credit Suisse.

X. CONCLUSION

A. Stoneridge and perhaps Credit Suisse have the potential to reshape the landscape in private securities litigation. At issue is who may be held liable in such litigation. This can include corporate directors and officers, outside auditors, lawyers and vendors.

B. While the Court can be expected to adhere to long time themes such as carefully construing the statutory language and looking for a clear line of demarcation to give business organizations certainty, competing interests before the Court are vying for different configurations of liability which can have a significant impact in the markets.

1. Petitioners are advocating a "scheme liability" theory which potentially can almost subsume prior aiding and abetting liability.

2. The SEC, if it participates, has in the past advocated an expansive view of liability. However, in Tellabs critics claimed it abandoned its usual shareholder friendly view. There is little doubt that the SEC did adopt a more view on the issues in that case. At the same time it sought to support the plaintiffs in Credit Suisse/Enron but was denied an opportunity by the solicitor general, reportedly at the behest of the Treasury Department and President Bush. What position, if any the agency will take is difficult to project.

3. Respondents can be expected to support the bright line test used by the Eighth Circuit.

C. The ultimate outcome in the case may well be decided by whether the Court grants certiorari in Credit Suisse.