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The Line between Primary and Secondary Liability in Private Securities Fraud Cases

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Secondary Liability Under The Federal Securities Laws

Stoneridge, Scheme Liability and the Supreme Court

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Introduction

- Next term the Supreme Court will decide Stoneridge
- It will determine the scope of securities law antifraud liability in private damages actions
- The decision is key to potential liability of
  - directors and officers
  - auditors
  - attorneys
  - vendors and
  - business partners

Introduction

Overview: Five Points Will Be Reviewed

1. The decision in Central Bank ending aiding and abetting
2. Secondary Liability after Central Bank

- The initial circuit court decisions
  - Substantial participation test
  - The bright line test
- The rise of scheme liability
  - The Ninth Circuit
  - The SEC

Introduction

Overview (cont.)

3. Stoneridge before the Supreme Court
   - The Eighth Circuit decision
   - In the Supreme Court
4. Analysis
   - Key points and issues before the Supreme Court
   - The composition of the Supreme Court
5. Conclusion
   - Define liability in private securities damage cases
   - Key for directors, officers, auditors, attorneys and others

The Central Bank Decision

Background To The Decision

- The 1994 decision ended aiding and abetting
- Previously every circuit accepted aiding and abetting for securities fraud
  - Typically a three part test was used
    1. The existence of a primary violation
    2. Defendant's knowledge/reckless disregard of violation
    3. Substantial participation
- Previously, the Supreme Court had acquiesced to lower court rulings on Section 10(b)

The Central Bank Decision

The Decision, 511 U.S. 164 (1994)

- The claim
  - Securities fraud suit by bond holders against developer
  - Collateral to be maintained at 160% of value of bonds
  - Bank fails to maintain collateral ratios
  - Central Bank sued as an aider & abettor to securities fraud
- District court: summary judgment for Bank
- Circuit court: reversed re dispute of fact

The Central Bank Decision

The Decision

- Question the Court agreed to hear: Is there aiding & abetting under Section 10(b)
- The holding: No

"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 …"

The Central Bank Decision

The Decision - Key Points

- The only question considered: does liability extend to aiding and abetting
- Prior decisions emphasize statutory text
- Section 10(b) imposes private civil liability on those who

"commit a manipulative or deceptive act …"

The Central Bank Decision

The Decision - Key Points (cont.)

- Statutory language “It shall be unlawful for any person directly or indirectly …” is not aiding and abetting
- Limits of aiding and abetting liability are vague
- There must be “certainty and predictability” for business

The Central Bank Decision

The Decision – Key Points (cont.)

- Secondary actors can be primary violators:

  "Any person … including a lawyer, accountant, or bank, who employs a manipulative device or makes a material misstatement … on which a purchaser or seller relies may be liable as a primary violator … assuming *all* …" elements are established (emphasis original)

The Central Bank Decision

The Dissent

- Every circuit had accepted aiding and abetting
- Previously, Court had respected unanimous views of lower courts
- Ruling will apply to the SEC

Post Central Bank

Congress

- In 1995 Congress passed PLSRA
- SEC requested restoration of aiding and abetting for all actions
- Section 20(e) added to SEA, restoring aiding and abetting for SEC only

Circuit Court Decisions

Overview

- All elements of a Section 10b private damage cause of action must be established
- Split over elements of “deception” and “reliance”
  - The 9th Cir: “substantial participation” test
  - The 10th Cir: “bright line” test
  - 2nd, 5th, 8th and 11th Circuits adopted the “bright line” test
- Variations of the "bright line” test have evolved
- The 9th Circuit adopted a modified version of SEC’s “scheme” liability theory

Circuit Court Decisions

Overview – Elements of a claim

- These cases typically focus on two elements of a Section 10(b) cause of action
- Elements of a Section 10(b) cause of action:
  1. A material misrepresentation or omission (must have a duty to speak)
  2. Scienter, that is wrongful state of mind
  3. A connection with the purchase or sale of a security
  4. Reliance, frequently called transaction causation
  5. Economic loss
  6. Loss causation, that is a causal connector between the misrepresentation and the loss
- Stoneridge and the other cases here focus only on elements 1 & 4.

Circuit Court Decisions

The Substantial Participation Test

- Software Toolworks, 50 F.3rd 615 (9th Cir. 1995)
  - Claim: outside auditor approved company letter to SEC containing misrepresentations prior to secondary offering
  - District Court: Summary judgment for auditor
  - Ninth Circuit reversed:
    "as members of the drafting group … [auditors] had access to all information that was available and deliberately chose to conceal the truth …"
  - Auditors "substantially participated" in drafting
  - No discussion of reliance

Circuit Court Decisions

Substantial participation test (cont.)

- Reaffirmed in Everex Systems, 228, F.3d 1057 (9th Cir. 2000)
  - Primary liability can be established by substantial participation
  - Substantial participation is:
    - Signing and attesting to statement
    - Essentially adopting as your own

Circuit Courts

The Bright Line Test

- Anixter, 77 F.3d 1215 (10th Cir. 1996)
  - The claims: auditor sued for issuing false opinions & letters re failed ponzi scheme
  - The test:

    "the critical element separating primary from aiding and abetting … [is] a representation … by the defendant, that is relied upon …"

Circuit Courts

The Bright Line Test – Anixter (cont.)

- Reliance
  - Auditor need not communicate the statement himself
  - Sufficient if auditor knew or should have known representation communicated to shareholders
  - Rule provides more guidance that “substantial assistance” or similar tests
  - Rejects Software Toolworks as aiding & abetting

Circuit Courts

Bright Line Test (cont.)

- The 2nd Cir. refined the test in two cases
- Shapiro, 123 F.3d 717 (2nd cir.1997)
  - Claims: auditors of failed video chain sued for not disclosing chain owner's felony conviction & for financial projections included in offering memos
  - Held:
    - No misrepresentation because no duty to disclose conviction
    - Financial projections are "consistent with the role of an accountant"

Circuit courts

Bright Line Test – 2nd Cir. (cont.)

- Wright, 152 F.3d 169 (2nd Cir.1998)
  - Claims: Auditor orally approved release of financial data/results included in press release which said data not audited
  - Holding:
    - "In Shapiro we followed the 'bright line' test"
    - "If Central Bank is to have any real meaning, a defendant must actually make a false or misleading statement …"

Circuit Courts

Bright Line Test - Wright (cont.)

- Holding: (cont.)
  - "[A] secondary actor cannot incur primary liability … for a statement not attributed to that actor at the time of its dissemination."
  - Rejects Software Toolworks

Circuit Courts

Bright Line Test (cont.)

- The 11th and 5th Cir. followed
- Cascade Int., 256 F.3d 1194 (11th Cir. 2001)
  - Claims: against company, law firm and auditors
  - Law firm: participated in drafting false letters/press releases issued by company
  - Auditors: incorrect advice on consolidating subs and failed to give sub "going concern" limitation

Circuit Courts

Bright Line Test - Cascade Int. (cont.)

- Holding
  - Noting the split between 9th and 2nd Cir., follows Wright
  - Test: "misstatement or omission upon which a plaintiff relied must have been publicly attributed to the defendant" at time of investment decision
  - Law firm: no misstatement because no duty to disclose
  - Auditors: no misstatement because opinion never disseminated to investors

Circuit Courts

Bright Line Test (cont.)

Credit Suisse, 482 F.3d 372 (5th Cir. 2007)

- Claims: Against a group of banks
  - assisted Enron in falsifying its financial statements
  - Essentially, banks entered into business arrangements that permitted Enron to either book revenue or keep liabilities off books
  - Each bank knew Enron engaged in long term financial fraud
- District Court: Adopted SEC position on scheme liability and denies motions to dismiss

Circuit Courts

Bright Line Test - Credit Suisse (cont.)

- The ruling:
  - No misrepresentation because the banks have no duty to Enron's shareholders to disclose
  - Enron committed fraud, but banks, at most, were aiders and abettors
  - It is inappropriate to impose liability for securities fraud on one party to a business deal
- A cert petition has been filed
- The SEC has asked to file an amicus brief supporting plaintiffs

Circuit Courts

The Rise of Scheme Liability

- Premised on Rule 10b-5(a) & (c)
  - (a) unlawful to "employ any device, scheme or artifice to defraud …"
  - (c) prohibits "any act, practice, or course of business
  - Phrases are not in text of Section 10(b)
  - Supreme Court has defined statutory term "device" to include scheme. Hochfelder, 425 U.S. at 119 n. 20.
  - Supreme Court has repeatedly used "scheme" in discussing statute, e.g. Zandford, 535 U.S. 813, 821-22 (section prohibits "scheme to defraud …")

Circuit Courts

Scheme Liability (cont.)

- Simpson, 452 F.3d 1040 (9th Cir. 2006)
  - "Substantial participation" becomes "scheme"
  - Claims: Four 3rd party vendors engaged in "round trip" barter transactions to assist Homestore in falsifying its financial statements

Circuit Courts

Scheme Liability - Simpson (cont.)

- The SEC filed an amicus brief for plaintiffs arguing scheme liability
  - Person is liable **"for engaging in a scheme to defraud … [if he] directly or indirectly, engages in a manipulative or deceptive act as part of scheme"**
  - A deceptive act is engaging **"in a transaction whose principle purpose and effect is to create a false appearance of corporate revenue …"**
  - Reliance is established if plaintiff **"relies on a material deception flowing from"** defendant's deceptive act

Circuit Courts

Scheme liability - Simpson (cont.)

- The ruling:
  - Substantial participation is enough "even though that participation might not lead to … [making] actual statements."
  - **"We hold that … [a person is liable for] participation in a 'scheme to defraud,' [where he] engaged in conduct that had the principal purpose and effect of creating a false appearance of fact in furtherance of the scheme"**

Circuit Courts

Scheme Liability: Simpson (cont.)

- The ruling (cont.)
  - Defendants' **"*own conduct* contributing to the transaction or overall scheme must have had a deceptive purpose and effect"** (emphasis original)
  - Purpose and effect test differentiates conduct and scienter
  - Reliance: based on fraud on the market theory

Selected District Court Cases

The “Bright Line” Is Not So Bright

- District Courts applying the “bright line” to complex business transactions have varied the test
- Some cases relax the “specific identification” requirement
- Some employ scheme liability

Selected District Court Cases

The Bright Line Is Not So Bright: Examples

- Some courts have permitted the claim to proceed where the defendant did not actually make the statement
  - In re Vivendi Univ., 2003 U.S. Dist LEXIS 19431 (S.D.N.Y. Nov. 3, 2003) (CFO defendant where company made statements)
  - In re Lernout & Hauspie, 230 F. Supp. 2d 166 (D. Mass. 20022) (it could be inferred that auditor made statements)

Selected District Court Cases

The Bright Line Is Not So Bright: Examples

- Scheme liability but not the Simpson version
  - In re Global Crossing, 313 F. Supp. 2d 189 (S.D.N.Y. 2003) (outside auditor liable for scheme he masterminded, but not specific of others representations)
  - In re Parmalat Sec. Lit., 376 F. Supp. 2d 472 (S.D.N.Y. 2005) (scheme liability in case involving banks; deception from sham transactions and reliance established by demonstrating causal connection; no deception by participation in business transaction later booked incorrectly by company).

Stoneridge

Background: Certiorari Is Accepted

- The Supreme Court granted cert. in March 2007
- The question presented:
  "Whether [Central Bank] forecloses claims … under Section 10(b) … 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] made no public statements concerning the transactions."
- The case is being briefed by the parties

Stoneridge

Background: The District Circuit

- The claims:
  - Class action against Charter Communications, its executives, auditors and two equipment vendors
  - Charter entered into barter agreements with vendors which increased equipment prices it paid, but under which price increases were returned to company
  - Charter capitalized the equipment costs and recognized the revenue as income
  - The District Court: dismissed as to the vendors

Stoneridge

Background: The Eighth Circuit Decision

- The ruling: affirmed
  - The court rejected plaintiffs' scheme liability argument
  - Held that "any defendant who does not make or affirmatively cause to be made a fraudulent misstatement or omission … is at most guilty of aiding and abetting …"

Stoneridge

Background: The Eighth Circuit Decision (cont.)

- The ruling: (cont.)
  - The Court noted it was not aware of any case imposing liability
    "[O]n 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 … imposing such liability 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."

Stoneridge

The Supreme Court: The Petition

- Petition for certiorari: four key arguments
  1. The Eighth Circuit disregarded the statutory text - prior Supreme Court cases emphasized its catch-all nature
  2. Central Bank did not delimit the scope of Section 10(b)
  3. Other courts have recognized scheme liability
  4. The Circuit Court comments re legitimate business transactions do not apply here

Stoneridge

The Supreme Court: Oppositions

- Respondents' Oppositions: three key points
  1. Deceptive conduct requires a misstatement or failure to disclose, neither of which apply here
  2. Scheme here fails the "in connection with" test because it involves a commercial transaction unconnected to a a securities transaction
  3. There is no reliance

Stoneridge

The Supreme Court: Petitioner's Reply

- Reply Brief: two key points
  1. Simpson, which was just decided, creates a conflict in the Circuits
  2. Defendants directly engaged in deceptive conduct by
     - Backdating contracts
     - Using deceptive/false documents
     - Participating in the scheme

Analysis

Key Points And Issues Before The Court

- The statutory text – Central Bank and virtually every other decision of the Court has hewed carefully to the literal text
  - Central Bank did not alter the scope of Section 10(b). It only described what was not in the text
  - Prior Court decisions focus on the statutory section and its language which does not include "scheme to defraud"
  - The statutory text does use the word "device" which has been interpreted by the Court to include schemes
  - The Court has repeatedly described the section as a "catch-all" for "fraudulent schemes"

Analysis

Key Points (cont.)

- Certainty and interference with legitimate business transaction is a key underlying theme
- There is a tension between the Section 10(b) "catch-all" and a search for "certainty"
  - Central Bank suggests, and several courts have noted, that certainty is key for business
  - Central Bank notes that the line between the permitted and prohibited conduct is blurry under aiding and abetting principles
  - The Supreme Court has repeatedly decried the potential negative impact of securities litigation on business

Analysis

Key Points (cont.)

- The “bright line test” may be too narrow, particularly if reliance requires personal identification
- Scheme liability per SEC or in Simpson may be viewed as too open ended
- A possible compromise: In re Parmalat
  - Scheme liability using statutory phrase “participation directly or indirectly” rather than judge authored phrases such as “purpose and effect” or “substantial participation”
  - Legitimate business transactions later misused distinguished from sham transactions with no economic substance
  - Reliance based on causation

Analysis

The Composition Of The Court

- Only three of the Justices in the Central Bank majority remain on the Court: Justices Kennedy (author), Scalia and Thomas
- Three of the dissenting Justices in Central Bank remain on the Court: Justices Stevens, Souter and Ginsburg.
- Chief Justice Roberts and Justice Bryer did not participate in the order granting certiorari in Stoneridge, suggesting they are recused

Analysis

The Composition Of The Court (cont.)

- Justice Alito may be the swing vote
  - In securities cases decided at the circuit court level then Judge Alito took a “workmanlike approach” not evidencing any specific doctrinal approach which gives little indication of his leanings, according to Professor J. Robert Brown, Harvard Law School Corporate Governance Blog, post May 30, 2007.
  - Votes as a Circuit Court judge do not, of course, presage those as a Supreme Court Justice

Analysis

The Composition Of The Court (cont.)

- If the petition in Credit Suisse is granted, the composition may change
  - In that event, Chief Justice Roberts and Justice Bryer along with Justice Alito may swing the vote
  - This may create a more conservative six member majority

Conclusion

Stoneridge and perhaps Credit Suisse will define the scope of liability in private damages securities fraud actions

- At stake: the liability of
  - corporate directors
  - corporate officers
  - outside auditors
  - in-house and outside lawyers
  - vendors and
  - partners to business transactions

Conclusion

The Court can be expected to

- echo familiar themes on the text of the statute
- struggle with where to draw the line to give business certainty vs. the catch-all statute

The ultimate outcome may be decided by whether certiorari is granted in Credit Suisse