

2009

## Is There Any Viability to Scheme Liability for Secondary Actors after Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.?

Joanna B. Apolinsky

Follow this and additional works at: <https://scholarship.law.edu/lawreview>

---

### Recommended Citation

Joanna B. Apolinsky, *Is There Any Viability to Scheme Liability for Secondary Actors after Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.?*, 58 Cath. U. L. Rev. 411 (2009).

Available at: <https://scholarship.law.edu/lawreview/vol58/iss2/4>

This Article is brought to you for free and open access by CUA Law Scholarship Repository. It has been accepted for inclusion in Catholic University Law Review by an authorized editor of CUA Law Scholarship Repository. For more information, please contact [edinger@law.edu](mailto:edinger@law.edu).

# IS THERE ANY VIABILITY TO SCHEME LIABILITY FOR SECONDARY ACTORS AFTER *STONERIDGE INVESTMENT PARTNERS, LLC V. SCIENTIFIC- ATLANTA, INC.*?

*Joanna B. Apolinsky*<sup>†</sup>

I. INTRODUCTION .....	411
II. THE DEVELOPMENT OF LIABILITY FOR SECONDARY ACTORS.....	416
A. <i>The Scope of Conduct Prohibited by § 10(b) and Rule 10b-5</i> .....	416
B. <i>The Reliance Element of the 10b-5 Claim</i> .....	419
C. <i>Secondary Actor Liability Prior to the Supreme Court’s Decision in Central Bank</i> .....	421
D. <i>The Central Bank Decision</i> .....	422
E. <i>Cases After Central Bank</i> .....	425
1. <i>Simpson v. AOL Time Warner, Inc.</i> .....	426
2. <i>Regents of the University of California v. Credit Suisse First Boston</i> .....	429
III. THE <i>STONERIDGE</i> DECISION.....	434
A. <i>Factual Background</i> .....	434
B. <i>The Supreme Court’s Analysis of a Scheme to Defraud and a Plaintiff’s Reliance</i> .....	436
C. <i>Analysis of the Supreme Court’s Stoneridge Decision: Does Scheme Liability for Secondary Actors Remain a Viable Theory for Recovery?</i> .....	438
IV. CONCLUSION.....	442

## I. INTRODUCTION

Imagine that a company is having trouble meeting the earnings projections of Wall Street analysts. If the company does not meet the projections by the time it reports its earnings, its stock price will slump. Should it take the hit and watch the fallout? Or should it somehow manipulate its earnings so they are more in line with the analysts’ projections? Then it could report inflated revenues, thereby keeping the stock afloat and encouraging investors to purchase its stock. If a troubled company’s management chooses this path, the company probably will not be able to go it alone. It would need the assistance of other entities—lawyers, investment bankers, accountants, and possibly

---

<sup>†</sup> Assistant Professor, John Marshall Law School, Atlanta, Georgia. Many thanks to Professors Jeffrey Van Detta and Lisa Taylor for reading early drafts of this Article and providing invaluable suggestions. Thanks also to Amelia Ragan for her outstanding research assistance.

contractual third parties—that would play an integral role in accomplishing this fraud. Maybe these other entities would agree to falsify transaction documents for the company. Maybe they would enter into transactions with the company that look like sales of the company’s money-losing assets so the company could report earnings. Or perhaps they could simply “round-trip” money between them and the company and use a trumped-up transaction as a front. All of this would be done in an attempt to generate phantom revenue for the company so it could meet its earnings projections, which it would then report to investors in its financial statements. The company would most assuredly be liable under § 10(b) of the Securities Exchange Act of 1934<sup>1</sup> and Rule 10b-5<sup>2</sup> for misrepresenting its financial status to investors. But if another entity helped the company to create revenue that did not truly exist, should that entity also be liable for securities fraud to investors who bought the stock of the company?

A preliminary question may be *why* should the entity that helped effectuate the troubled company’s fraud be liable to the investors who bought stock in the company. Presumably, one goal is to punish as many wrongdoers who participated in the scheme as possible. A more fundamental reason for rounding up all culpable actors, however, is that the troubled company is likely bankrupt.<sup>3</sup> As a result, investors of that company will see no recovery from a Rule 10b-5 action against it. Therefore, an investor’s only means of recovery may be pursuing liability against the other entities for securities fraud. This is especially important if, for example, an investor has lost all of his retirement savings because his 401(k) portfolio was made up mostly, if not entirely, of stock in the troubled company.<sup>4</sup> Because that company may be in bankruptcy, the stock is worth nothing and the investor has lost everything.

Whether a so-called “secondary actor” can actually be held liable under Rule 10b-5 has been debated in the courts,<sup>5</sup> but the answer is still unclear. The Supreme Court recently had an opportunity to determine this question when it decided *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.* on January 15, 2008.<sup>6</sup> Unfortunately, its opinion was not as decisive as it could have, or arguably, should have been. The Court’s opinion has been read to

---

1. 15 U.S.C. § 78j (2000).

2. 17 C.F.R. § 240.10b-5 (2007). Per the Supreme Court in *SEC v. Zandford*, the scope and coverage of § 10(b) and Rule 10b-5 is coextensive; thus, they are used interchangeably in this Article. *SEC v. Zandford*, 535 U.S. 813, 816 n.1 (2002).

3. *E.g.*, *In re DVI Inc. Sec. Litig.*, 249 F.R.D. 196, 198 (E.D. Pa. 2008); *In re Enron Corp. Sec., Derivative & ERISA Litig.*, 235 F. Supp. 2d 549, 637 (S.D. Tex. 2002); *see also* Motion for Leave to File Brief Out of Time and Brief *Amici Curiae* of Former SEC Commissioners in Support of Petitioner at 8, *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 128 S. Ct. 761 (2008) (No. 06-43).

4. *See* Peter T. Kilborn, *In 401(k) Plans, a New Rush to Diversify*, N.Y. TIMES, Jan. 23, 2002, at C6.

5. *See infra* note 18; *infra* Part II.E and accompanying notes.

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

reject liability for secondary actors,<sup>7</sup> yet this Article suggests that it left open the possibility for such liability, not to mention the possibility of additional protracted litigation on the meaning of its language.

The *Stoneridge* decision was highly anticipated because of the effect it would potentially have on private securities litigation; specifically, the standards of acceptable conduct for corporate directors and officers, as well as outside third parties.<sup>8</sup> The case followed in the wake of the Court's pivotal 1994 decision in *Central Bank of Denver v. First Interstate Bank of Denver*,<sup>9</sup> a case that partially answered the scope of liability for secondary actors, yet spawned confusion in the lower courts.<sup>10</sup> The Court in *Central Bank* held that § 10(b) does not prohibit "aiding and abetting" another's securities fraud.<sup>11</sup> As a result, secondary actors, such as lawyers, accountants, banks, and contractual third-parties, cannot be held liable under § 10(b) for "secondary violations" of the securities laws.<sup>12</sup> Liability under § 10(b) and Rule 10b-5 requires the use of a "manipulative or deceptive device," to perpetrate fraud on the investing public.<sup>13</sup> The Court reasoned in *Central Bank* that an entity's mere aiding and abetting of another's fraud does not present the requisite scienter necessary to be manipulative or deceptive.<sup>14</sup> Moreover, the Court concluded, without explanation, that the plaintiffs had not established the requisite reliance on the secondary actor's conduct to recover.<sup>15</sup> It did note, however, that any person or entity, in the capacity of a secondary actor, may be primarily liable under § 10(b) and Rule 10b-5 "assuming all of the requirements [of the claim] for primary liability . . . are met,"<sup>16</sup> but it did not explore this statement in its opinion. Thus, two critical elements that a plaintiff asserting a 10b-5 claim against a secondary actor must establish are (1) that the

---

7. See Eric Berry, *Stoneridge and the Short-Lived Experiment of Scheme Liability*, 4 N.Y.U. J.L. & BUS. 355, 387-89 (2007); Barbara Black, *Stoneridge Investment Partners v. Scientific-Atlanta, Inc.: Reliance on Deceptive Conduct and the Future of Securities Fraud Class Actions*, 36 SEC. REG. L.J. 330, 330 (2008); Matthew L. Mustokoff, *Fraud Not on the Market: Rebutting the Presumption of Classwide Reliance Twenty Years After Basic Inc. v. Levinson*, 4 HASTINGS BUS. L.J. 225, 242-43 (2008).

8. Thomas O. Gorman, *Who Does the Catch-All Antifraud Provision Catch? Central Bank, Stoneridge, and Scheme Liability in the Supreme Court*, in SEC. LITIG. & ENFORCEMENT INST. 2007, at 189, 198 (PLI Corp. Law and Practice, Course Handbook Series No. B-1620, 2007); Gregory A. Markel & Gregory G. Ballard, *The Importance of Stoneridge*, in 39TH ANNUAL INST. ON SEC. REG., at 879, 881 (PLI Corp. Law and Practice, Course Handbook Series No. B-1635, 2007).

9. 511 U.S. 164 (1994).

10. See *infra* note 18; *infra* Part II.D and accompanying notes.

11. *Cent. Bank*, 511 U.S. at 191.

12. *Id.*

13. 15 U.S.C. § 78j(b) (2000).

14. See *Cent. Bank*, 511 U.S. at 176-77.

15. *Id.* at 180.

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

secondary actor engaged in manipulative or deceptive conduct, and (2) that the plaintiff relied on that manipulative or deceptive conduct.<sup>17</sup>

The holding from *Central Bank* has been difficult for the lower courts to apply.<sup>18</sup> The difficulty arises from the varying interpretations of what § 10(b) and Rule 10b-5 actually prohibit.<sup>19</sup> In other words, what is a “manipulative or deceptive device,” and thus, at what point does a secondary actor’s involvement in another company’s scheme to defraud its investors rise to the level of a primary violation of § 10(b)? Moreover, whether a plaintiff can establish reliance on that conduct has been subject to debate.<sup>20</sup> These two concepts have collectively come to be known as “scheme liability.”<sup>21</sup> Lower courts have struggled to determine whether scheme liability meets the requirements for a Rule 10b-5 claim. Two recent circuit court decisions, *Simpson v. AOL Time Warner Inc.*<sup>22</sup> and *Regents of the University of California v. Credit Suisse First Boston*,<sup>23</sup> both discussed in greater detail in this Article, addressed this issue with differing results.<sup>24</sup> These two cases, notable for their contrary interpretations of scheme liability in the context of Rule 10b-5’s requirements, arguably set the stage for the Supreme Court’s *Stoneridge* decision.

In *Stoneridge*, the Supreme Court determined that the plaintiffs could not recover against certain secondary actors for securities fraud.<sup>25</sup> While the Court arguably determined that participation in a scheme to defraud is deceptive conduct,<sup>26</sup> it held that the plaintiffs could not establish reliance on that

17. For a more complete discussion of the elements of a Rule 10b-5 claim, see *infra* notes 33–42 and accompanying text.

18. See, e.g., *Regents of Univ. of Cal. v. Credit Suisse First Boston*, 482 F.3d 372, 386 (5th Cir. 2007), cert. denied sub. nom., *Regents of Univ. of Cal. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 128 S. Ct. 1120 (2008); *Simpson v. AOL Time Warner Inc.*, 452 F.3d 1040, 1043 (9th Cir. 2006); *In re Charter Commc’ns, Inc., Sec. Litig.*, 443 F.3d 987, 991–92 (8th Cir. 2006); *In re Enron Corp. Sec. Derivative & “ERISA” Litig.*, 529 F. Supp. 2d 644, 705 (S.D. Tex. 2006); *In re Global Crossing, Ltd. Sec. Litig.*, 322 F. Supp. 2d 319, 330–32 (S.D.N.Y. 2004); *In re Lernout & Hauspie Sec. Litig.*, 236 F. Supp. 2d 161, 171 (D. Mass. 2003).

19. See Markel & Ballard, *supra* note 8, at 885–86.

20. See *Regents*, 482 F.3d at 382–84; *Simpson*, 452 F.3d at 1051.

21. See *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 128 S. Ct. 761, 770 (2008); *Regents*, 482 F.3d at 378. This Article discusses the viability of scheme liability for secondary actors that participate in another entity’s scheme to defraud, as opposed to scheme liability generally where there is simply one actor that has engaged in a scheme to defraud. See, e.g., *SEC v. Zandford*, 535 U.S. 813, 815, 822 (2002) (holding that a securities broker’s scheme to defraud an elderly man and his mentally handicapped daughter by misappropriating their securities without their knowledge and consent violated § 10(b) and Rule 10b-5).

22. 452 F.3d 1040.

23. 482 F.3d 372.

24. *Regents*, 482 F.3d at 394; *Simpson*, 452 F.3d at 1055.

25. *Stoneridge*, 128 S. Ct. at 773–74.

26. *Id.* at 769.

conduct.<sup>27</sup> In effect, the Court reasoned that the defendants' conduct—falsification and backdating of commercial documents by customers of and suppliers to Charter Communications, Inc.—was too remote to the injury suffered by Charter's investors to establish reliance thereon.<sup>28</sup> The *Stoneridge* decision signals, at the very least, another move by the Supreme Court away from liability for secondary actors,<sup>29</sup> and, at most, a rejection of scheme liability for secondary actors as a potential theory of liability. Yet a broad reading of the opinion suggests there may be some flexibility for plaintiffs and courts to maneuver within its confines.

The Court had the opportunity to illuminate for the lower courts whether a secondary actor's participation in a company's scheme to defraud its investors is prohibited conduct under § 10(b), yet the opinion neither accepted nor rejected this contention and provided little guidance for answering the question one way or the other. Moreover, its reliance analysis is less than definitive as well. While arguably the Court eliminated the possibility that a plaintiff can establish reliance on a scheme to defraud, given the relatively open-ended nature of its language, the potential to craft a plausible reliance argument still exists. A secondary actor's conduct must simply fall within the parameters the Court set as a means of denying that reliance existed in *Stoneridge* itself. The Court could have expressly rejected scheme liability, much as it expressly rejected aiding and abetting liability in *Central Bank*. However, it did not, and thus opportunities may exist for varying interpretations by lower courts of the Court's language, thereby negating any exactitude with regard to this issue.

This assertion necessarily depends on a plaintiff's ability to distance the conduct being complained of from aiding and abetting. Part II of this Article examines the development in the courts of liability for secondary actors and discusses in greater detail the Supreme Court's decision in *Central Bank*. Part II also addresses the Supreme Court's determination of how a plaintiff establishes reliance on conduct prohibited by § 10(b). This determination took on extreme importance in *Stoneridge*, because the Court used its reliance analysis to seemingly shut down any opportunity for a plaintiff to assert that participation in a scheme to defraud violates § 10(b) and Rule 10b-5. Yet this Article posits that a secondary actor's conduct could potentially fit within the confines the Court used to refute the existence of reliance in *Stoneridge*.

Part II also addresses cases such as *Simpson* and *Regents*, wherein the Ninth and Fifth Circuits, respectively, examined the viability of scheme liability, but with conflicting results. The courts in those cases disagreed as to whether a secondary actor's participation in a scheme to defraud is conduct prohibited by § 10(b) and Rule 10b-5. Moreover, they disagreed as to whether a plaintiff

---

27. *Id.* at 774.

28. *Id.* at 770.

29. *See* Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164, 191–92 (1994).

could establish reliance on such conduct. Part III addresses in more depth the Court's opinion in *Stoneridge*. The factual context of scheme liability has become a fairly common theme in § 10(b) cases.<sup>30</sup> It involves a design or plan whereby secondary actors—who otherwise have no duty to the investors of a particular company—assist the company in a scheme to defraud the investors of that company.<sup>31</sup> Thus, the need to establish whether such conduct can form the basis of a § 10(b) claim is of extreme importance. Part III also analyzes the Court's decision in *Stoneridge*, particularly in light of the *Simpson* and *Regents* decisions, and suggests that scheme liability may remain a feasible weapon in a plaintiff's arsenal of claims against the secondary actors that helped perpetrate the fraud. Given the possibility for varying interpretations of the *Stoneridge* decision that could maintain scheme liability's viability, this Article concludes with a discussion of what, if anything, is to be done to illuminate this issue anew.

## II. THE DEVELOPMENT OF LIABILITY FOR SECONDARY ACTORS

If a secondary actor is ever to be liable under § 10(b), it is necessary to understand how the statute has been interpreted to apply to a primary violator.<sup>32</sup> The Supreme Court cases interpreting when § 10(b) liability is appropriate have focused on two issues: the scope of prohibited conduct, and what the elements of the claim should be.<sup>33</sup> The reliance element of a § 10(b) claim is one element that has created considerable confusion regarding secondary actors and scheme liability.<sup>34</sup>

### A. The Scope of Conduct Prohibited by § 10(b) and Rule 10b-5

In pertinent part, § 10(b) of the Securities Exchange Act prohibits any person from “us[ing] or employ[ing], in connection with the purchase or sale of any security, . . . any manipulative or deceptive device or contrivance.”<sup>35</sup>

30. *E.g.*, *Quaak v. Dexia*, 445 F. Supp. 2d 130, 141–42, 144–46 (D. Mass. 2006); *In re Parmalat Sec. Litig.*, 376 F. Supp. 2d 472, 503–15 (S.D.N.Y. 2005); *SEC v. Lucent Tech. Inc.*, 363 F. Supp. 2d 708, 715–18 (D.N.J. 2005).

31. *See Regents of Univ. of Cal. v. Credit Suisse First Boston*, 482 F.3d 372, 382–83, 386–90 (5th Cir. 2007); *Simpson v. AOL Time Warner Inc.*, 452 F.3d 1040, 1047–50 (9th Cir. 2006).

32. *See generally Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 171–72 (1994) (noting that the statutory text is important in defining the scope of the conduct prohibited by § 10(b)); *Santa Fe Indus. v. Green*, 430 U.S. 462, 472 (1977) (stating that in deciding what is “‘fraud’ under Rule 10b-5, ‘we turn first to the language of § 10(b), for [t]he starting point in every case involving construction of a statute is the language itself’” (alteration in original) (second internal quotation marks omitted) (quoting *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 197 (1976))).

33. *Cent. Bank*, 511 U.S. at 172.

34. *See, e.g., Regents*, 482 F.3d at 385–87, 390; *Simpson*, 452 F.3d at 1051–52; *In re Charter Commc'ns, Inc., Sec. Litig.*, 443 F.3d 987, 991–92 (8th Cir. 2006).

35. 15 U.S.C. § 78j(b) (2000). The pertinent text of the statute is as follows:

The Securities and Exchange Commission, pursuant to the authority granted to it under § 10(b), promulgated Rule 10b-5, which states that it is unlawful

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.<sup>36</sup>

While the statute prohibits conduct that is “manipulative or deceptive,” the Rule attempts to delineate what that conduct might be. Subsection (b) of the Rule prohibits the making of material misstatements of fact or any omissions thereof. This prohibition has become the cornerstone of the securities fraud action and is the subsection most relied upon by plaintiffs in such an action.<sup>37</sup> Thus, in a typical action brought under § 10(b) and Rule 10b-5(b), “a plaintiff must prove (1) a material misrepresentation or omission by the defendant; (2) scienter; (3) a connection between the misrepresentation or omission and the purchase or sale of a security; (4) reliance upon the misrepresentation or omission; (5) economic loss; and (6) loss causation.”<sup>38</sup> Importantly, however, the Supreme Court has made clear that conduct—as opposed to a misrepresentation or omission—may also violate § 10(b).<sup>39</sup> This concept implicates subsections (a) and (c) of the Rule. Rule 10b-5(a) and (c) are more general and prohibit any “scheme” to defraud, in addition to any “act, practice,

---

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

....

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, . . . any manipulative or deceptive device or contrivance in the contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

*Id.*

36. 17 C.F.R. § 240.10b-5 (2007).

37. See *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 152–53 (1972); see also *Markel & Ballard*, *supra* note 8, at 883 (discussing what a typical plaintiff’s § 10(b) claim looks like); *Berry*, *supra* note 7, at 358 (“The majority of § 10(b) cases deal with deception in the form of misstatements or omissions . . .”).

38. *Stoneridge Inv. Partners, LLC v. Scientific Atlanta, Inc.*, 128 S. Ct. 761, 768 (2008) (citing *Dura Pharms., Inc. v. Broudo*, 544 U.S. 336, 341 (2005)).

39. See *id.* at 769 (stating that conduct can also be deceptive and thus violate § 10(b)); *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 177 (1994) (stating that § 10(b) prohibits not only the making of a misstatement or omission, but also “the commission of a manipulative act”).



or course of business which operates . . . as a fraud.”<sup>40</sup> Various courts have asserted that to state a claim under subsections (a) or (c), a “plaintiff must assert that the defendant (1) committed a deceptive or manipulative act, (2) with scienter, that (3) the act affected the market for securities or was otherwise in connection with their purchase or sale, and (4) that the defendant’s actions caused the plaintiff’s injuries.”<sup>41</sup>

In order to violate § 10(b), participation in a scheme to defraud must fall within the proscriptions of the statute itself. In addressing the scope of conduct prohibited by the statute, the Supreme Court in *Ernst & Ernst v. Hochfelder* held that the language of § 10(b) regarding a “manipulative or deceptive device or contrivance” does not proscribe negligent conduct, but rather imposes a requirement that acts done in violation of § 10(b) must be done with scienter—generally an “intent to deceive, manipulate or defraud.”<sup>42</sup> *Ernst* was a case involving a claim against a secondary actor—an accounting firm—for its failure to discover major fraud in its audits of a securities firm.<sup>43</sup> The president of the securities firm, Nay, “induced the [plaintiffs] to invest funds in ‘escrow’ accounts that he represented would yield a high rate of return.”<sup>44</sup> But in fact the escrow accounts did not exist, and Nay took the funds for himself.<sup>45</sup> The plaintiffs contended that if the accountants had conducted a proper audit, they would have discovered certain irregular internal practices,<sup>46</sup> thereby illuminating the fraud.<sup>47</sup> Although *Ernst* was a case involving a secondary actor, there was no necessity for the Court to answer whether secondary actors could be held liable under § 10(b), because the plaintiffs could not establish the requisite scienter necessary to state a claim.<sup>48</sup>

Similarly, in *Santa Fe Industries v. Green*,<sup>49</sup> the Supreme Court construed § 10(b) and Rule 10b-5 to mean that claims brought thereunder must involve either a misrepresentation or omission on the one hand, or manipulative or

40. 17 C.F.R. § 240.10b-5(a), (c).

41. *In re Enron Corp. Sec. Derivative & “ERISA” Litig.*, 529 F. Supp. 2d 644, 678 n.45 (S.D. Tex. 2006) (citing *In re Parmalat Sec. Litig.*, 376 F. Supp. 2d 472, 491–92 & n.90 (S.D.N.Y. 2005)).

42. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193, 197 (1976).

43. *Id.* at 188–90.

44. *Id.* at 189.

45. *Id.*

46. *Id.* at 190. The practice relied on was Nay’s rule that only he could open mail either addressed to him or his firm, or to his attention, even if he was not in the office. *Id.* The plaintiffs alleged that if the accounting firm had conducted a non-negligent audit, it would have discovered this “mail rule,” and then disclosed in the firm’s SEC reports that the rule prevented a proper audit. *Id.* It was their contention that this disclosure would have led to an investigation that would have uncovered the fraud. *Id.*

47. *Id.*

48. *See id.* at 212, 214.

49. 430 U.S. 462 (1977).

deceptive conduct on the other.<sup>50</sup> The Court defined “manipulative” to denote manipulation of the securities market, and thus “refers generally to practices, such as wash sales, matched orders, or rigged prices, that are intended to mislead investors by artificially affecting market activity.”<sup>51</sup> Absent an allegation of manipulation, a plaintiff must allege deception, which the Court said involves a misrepresentation or omission.<sup>52</sup> In other words, to deceive an investor, one must make a misrepresentation of a material fact, or fail to disclose a material fact to the investor in violation of a duty to that investor to disclose the same. *Ernst* and *Santa Fe* make clear that § 10(b) liability should be based on prohibited conduct intended to deceive investors.

The question thus becomes, and the question the Supreme Court addressed, albeit only implicitly in *Stoneridge*, whether a secondary actor’s participation in a scheme to defraud falls within these confines. Arguably, the Court has accepted that assertion, because it simply stated in *Stoneridge* that conduct is also deceptive.<sup>53</sup> It was fairly easy for the Court to acknowledge that fact, however, because its analysis hinged on whether a plaintiff could ever establish reliance on that deceptive conduct, thereby causing injury. But the Court should have determined the boundaries of such conduct in the event a plaintiff could ever establish that reliance exists.

#### *B. The Reliance Element of the 10b-5 Claim*

Not only is the scope of prohibited conduct relevant to the inquiry of whether secondary actors can be primarily liable for a scheme to defraud, but also whether a plaintiff can establish reliance on that conduct sufficient to state a claim. Reliance by an investor establishes the causal link between a defendant’s deceptive act and a plaintiff’s resulting injury.<sup>54</sup> The Supreme Court has acknowledged, however, that reliance in the classic sense may be difficult for a plaintiff to establish and “would place an unnecessarily unrealistic evidentiary burden on the Rule 10b-5 plaintiff who has traded on an impersonal [securities] market.”<sup>55</sup> For example, it would be very difficult for a plaintiff to establish whether he would have bought or sold securities of a company if omitted material information regarding the company had been disclosed, or if a misrepresentation about the company had not been made. As such, the Court has adopted presumptions of reliance in certain instances, thereby relaxing the proof requirement thereof.<sup>56</sup>

---

50. *Id.* at 473–76.

51. *Id.* at 476.

52. *See id.* at 473–76; *see also* Markel & Ballard, *supra* note 8, at 885 (asserting that because the *Santa Fe* definition of manipulative was not often challenged, a plaintiff’s claim seemed to focus on showing a misstatement or omission).

53. *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 128 S. Ct. 761, 769 (2008).

54. *Basic Inc. v. Levinson*, 485 U.S. 224, 243 (1988).

55. *Id.* at 245.

56. *Id.* at 245, 247.

As discussed above, most 10b-5 claims relate to 10b-5(b), which prohibits making a misrepresentation or misstatement of a material fact or an omission thereof.<sup>57</sup> In the context of omissions of information, where one with a duty to disclose information fails to do so, the Supreme Court held in *Affiliated Ute Citizens of Utah v. United States*<sup>58</sup> that the necessary nexus between a defendant's wrongful conduct and a plaintiff's injury is presumed, assuming the omitted information was "material."<sup>59</sup> Thus, plaintiffs whose claims are based on nondisclosure of material information can satisfy the reliance element of a 10b-5 claim by asserting this presumption. On the other hand, where there have been false or misleading misrepresentations about a company in the market, the Supreme Court, in *Basic Inc. v. Levinson*, adopted a rebuttable presumption of reliance based on a "fraud-on-the-market" theory of reliance.<sup>60</sup> The fraud-on-the-market theory flows from the premise that a company's stock price reflects all material information available in the market for that company.<sup>61</sup> Therefore, "[m]isleading statements . . . defraud purchasers of stock even if the purchasers do not directly rely on the misstatements," because the misleading statements affect the market price of the company's stock.<sup>62</sup> The fraud-on-the-market theory posits that investors buy or sell stock based on the integrity of the market and the price of the stock; if the misleading information has in some way affected the market price of the stock, courts presume that there has been reliance on the misinformation by the plaintiff.<sup>63</sup> Thus, although reliance is still a required element in the plaintiff's case, the proof requirement has been significantly relaxed in these contexts.<sup>64</sup>

In the context of secondary actors and scheme liability, the relevant inquiry is whether the plaintiff can establish either of these two presumptions of reliance in the absence of actual reliance on the scheme to defraud. It has been unclear in the lower courts whether a secondary actor's participation in a scheme to defraud should be construed as a misrepresentation or omission under subsection (b) of the Rule, or as some other conduct under subsections (a) or (c).<sup>65</sup> This inquiry is acutely relevant because its answer dictates which

---

57. See *supra* notes 37–38 and accompanying text.

58. 406 U.S. 128 (1972).

59. See *id.* at 153–54 (defining information as "material" if "a reasonable investor might have considered them important in the making of [an investment] decision"); see also *TSC Indus. v. Northway, Inc.*, 426 U.S. 438, 449 (1976) (defining information as "material, if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote").

60. See *Basic*, 485 U.S. at 229–30.

61. *Id.* at 241.

62. *Id.* at 241–42 (quoting *Peil v. Speiser*, 806 F.2d 1154, 1160–61 (3d Cir. 1986)).

63. *Id.* at 246–47.

64. See *id.* at 248. A defendant may rebut this presumption of reliance by introducing evidence that the misrepresentation did not distort the stock price or that the "plaintiff traded or would have traded [the stock] despite . . . knowing the statement was false." *Id.*

65. See *Markel & Ballard*, *supra* note 8, at 885–86.

presumption, if any, applies for a plaintiff to establish reliance in the context of scheme liability.<sup>66</sup> Moreover, once a court determines which presumption applies, the *Stoneridge* decision makes clear that the plaintiff may not always be entitled to rely on the presumption because of the factual context of the case: specifically, whether the conduct engaged in by a secondary actor is prohibited by § 10(b).<sup>67</sup> But the factual context of a particular case is precisely where the Court's opinion leaves room for an assertion of reliance on a scheme to defraud. Assuming the facts can fit within the restrictions delineated by the Court, a plaintiff might successfully mount a reliance argument.

### C. Secondary Actor Liability Prior to the Supreme Court's Decision in Central Bank

Notwithstanding the requirements for § 10(b) liability of establishing a manipulative device and reliance thereon, lower courts continually held that secondary actors could be liable for aiding and abetting another's fraud.<sup>68</sup> These courts often presumed that a plaintiff could successfully state a claim against secondary actors under § 10(b) and Rule 10b-5 without necessarily establishing the elements of the claim as set forth above.<sup>69</sup> Notably, liability was premised on Rule 10b-5(b):

plaintiffs rarely invoked subsections (a) and (c), because, as District Judge Kaplan has surmised, during the pre-*Central Bank* era of aiding and abetting liability, the "path of least resistance" for a plaintiff alleging a fraud involving multiple actors was to plead that one defendant misrepresented or omitted a material fact and that the other defendants aided and abetted the making of that misrepresentation or omission.<sup>70</sup>

The courts adopted variations of a rule to establish "secondary liability" under § 10(b), which required fraud in the sale of securities by the primary violator, knowledge of that fraud or recklessness by a secondary actor, and substantial

---

66. *In re Enron Corp. Sec. Derivative & "ERISA" Litig.*, 529 F. Supp. 2d 644, 678–79 (S.D. Tex. 2006) (discussing that proving the applicability of a presumption of reliance relaxes the requirement of demonstrating individual reliance on material misrepresentations or omissions and makes class certification more available).

67. *See Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 128 S. Ct. 761, 770 (2008).

68. *E.g.*, *Monsen v. Consol. Dressed Beef Co.*, 579 F.2d 793, 802–03 (3d Cir. 1978); *Rolf v. Blyth, Eastman Dillon & Co.*, 570 F.2d 38, 47–48 (2d Cir. 1978); *Woodward v. Metro Bank of Dallas*, 522 F.2d 84, 98–99 (5th Cir. 1975); *SEC v. Coffey*, 493 F.2d 1304, 1316 (6th Cir. 1974).

69. *E.g.*, *First Interstate Bank of Denver, N.A. v. Pring*, 969 F.2d 891, 898 & n.13 (10th Cir. 1992), *rev'd sub nom. Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994); *Farlow v. Peat, Marwick, Mitchell & Co.*, 956 F.2d 982, 986 (10th Cir. 1992); *accord K & S P'ship v. Cont'l Bank*, 952 F.2d 971, 977 (8th Cir. 1991); *Schatz v. Rosenberg*, 943 F.2d 485, 495 (4th Cir. 1991); *Ross v. Bolton*, 904 F.2d 819, 824 (2d Cir. 1990).

70. *Mustokoff*, *supra* note 7, at 239 n.60 (citing *In re Parmalat Sec. Litig.*, 376 F. Supp. 2d 472, 497 (S.D.N.Y. 2005)).

assistance given to the primary violator by the secondary actor.<sup>71</sup> Thus, these lower courts effectively sidestepped the requirements that a secondary actor engage in manipulation or deception.<sup>72</sup> Moreover, there was no need for a plaintiff to assert reliance on the secondary actor's conduct, as that element was not part of the secondary liability claim.<sup>73</sup>

Thus, aiding and abetting another's primary violation of the securities laws remained a viable theory on which to base liability. Yet courts and commentators began to question whether aiding and abetting was an appropriate theory on which to base liability, given these more restrictive decisions.<sup>74</sup> As Professor Fischel posited in his 1981 article, cases such as *Ernst* and *Santa Fe* made it apparent that the determination of liability for any wrongdoer—whether a primary violator or a secondary actor—must be established by looking at the “language, structure, and legislative history of the relevant [securities] statutes.”<sup>75</sup> Against this backdrop, the Supreme Court decided *Central Bank*.

#### D. The Central Bank Decision

The *Central Bank* decision marked the end of aiding and abetting liability as a theory on which secondary actors could be held liable for securities fraud. The plaintiffs in *Central Bank* purchased bonds that the issuer ultimately defaulted on.<sup>76</sup> The plaintiffs filed suit against the issuing building authority, the underwriters of the bonds, the developer of the property the bonds were issued to finance, and the indenture trustee, Central Bank.<sup>77</sup> The plaintiffs alleged that the first three defendants violated § 10(b) by issuing the bonds and that Central Bank “secondarily” violated § 10(b) for aiding and abetting the other defendants’ fraud.<sup>78</sup> The Court of Appeals for the Tenth Circuit delineated what it considered to be the elements of a § 10(b) aiding and abetting claim: “(1) a primary violation of § 10(b); (2) recklessness by the aider and abettor as to the existence of the primary violation; and (3) substantial assistance given to the primary violator by the aider and abettor.”<sup>79</sup>

Applying that standard, the Tenth Circuit found that Central Bank could be liable for aiding and abetting under § 10(b): it was aware of alleged

---

71. See *supra* notes 69–70.

72. See *supra* notes 69–70.

73. See, e.g., *Pring*, 969 F.2d at 898.

74. See *Cent. Bank*, 511 U.S. at 169; *Little v. Valley Nat'l Bank of Ariz.*, 650 F.2d 218, 220 n.3 (9th Cir. 1981); Daniel R. Fischel, *Secondary Liability under Section 10(b) of the Securities Act of 1934*, 69 CAL. L. REV. 80, 82 (1981).

75. Fischel, *supra* note 74, at 82.

76. *Cent. Bank*, 511 U.S. at 168.

77. *Id.*

78. *Id.*

79. *Id.* (citing *First Interstate Bank of Denver, N.A. v. Pring*, 969 F.2d 891, 898–903 (10th Cir. 1992)).

inadequacies regarding an appraisal for real property that was to serve as collateral for the bonds; it knew that the issuance of the bonds was imminent; and it further knew that the purchasers of the bonds would use the appraisal to evaluate the collateral used to secure payment on the bonds in deciding whether to purchase the bonds.<sup>80</sup> Thus, the Tenth Circuit determined that the plaintiffs had established a genuine issue of material fact concerning whether Central Bank acted recklessly under that court's test for § 10(b) aiding and abetting liability, and could thus survive a motion for summary judgment.<sup>81</sup>

On appeal, the Supreme Court first noted that while § 10(b) does not expressly create a private right of action,<sup>82</sup> the Court has previously implied that such a private right does exist.<sup>83</sup> Nevertheless, the Court ultimately concluded that the implied private right of action does not extend to aiding and abetting<sup>84</sup> and thus, liability was not appropriate for Central Bank under an aiding and abetting theory.<sup>85</sup> The Court reasoned that the scope of prohibited conduct must be dictated by the statutory language;<sup>86</sup> thus, a plaintiff cannot successfully bring a § 10(b) claim against a defendant for acts not prohibited by the language of the statute itself.<sup>87</sup> In its adherence to the text of § 10(b), the Court first posited that § 10(b) does not prohibit aiding and abetting because the plain language of the statute does not mention it.<sup>88</sup> Further, the Court rejected the plaintiffs' argument that the words "directly or indirectly" in the text of the statute suggest congressional intent to prohibit indirect violations of § 10(b), such as aiding and abetting a primary violation thereof.<sup>89</sup> The Court reasoned that to extend the scope of the statute that far would reach "persons who do not engage in the proscribed activities at all, but who give a degree of aid to those who do."<sup>90</sup> The Court concluded that if Congress had intended § 10(b) to reach aiders and abettors, it would have used the words "aid" and "abet" in the statute itself.<sup>91</sup> Rather, as the statute clearly prohibits manipulation and deception, the Court was unwilling to extend the statute's

---

80. *Id.* at 168–69 (citing *Pring*, 969 F.2d at 904).

81. *Id.* at 169 (citing *Pring*, 969 F.2d at 904).

82. *Id.* at 171.

83. *Id.* (citing *Superintendent Ins. of N.Y. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 13 n.9 (1971)); *cf.* *J.I. Case Co. v. Borak*, 377 U.S. 426, 430–35 (1964) (implying a private right of action under § 14(a) of the Securities Exchange Act of 1934).

84. *Cent. Bank*, 511 U.S. at 191.

85. *Id.*

86. *Id.* at 173.

87. *Id.*

88. *Id.* at 175.

89. *Id.* at 175–76.

90. *Id.* at 176.

91. *Id.* at 177.

reach to a party who simply aids another who commits a manipulative or deceptive act.<sup>92</sup>

In accordance with this interpretation, the Court determined that § 10(b) prohibits the making of a material misrepresentation or omission, or the commission of a manipulative act, but not the giving of aid to a person who commits a manipulative or deceptive act.<sup>93</sup> According to the Court, the mere “giving of aid” would not involve the commission of a manipulative or deceptive act.<sup>94</sup> However, the Court did not appear to limit the word “manipulative” to include only conduct that technically manipulated the securities markets, such as rigged prices and the like; rather, it appeared that any activity that somehow affected the market price of a security would qualify, so long as it was “manipulative.” Yet the Court ultimately concluded that Central Bank had not engaged in any manipulative or deceptive act, nor had it made a misstatement or omission.<sup>95</sup> This was a situation, according to the Court, wherein Central Bank had merely aided and abetted another’s fraud.

In closing, however, the Court did state that

[t]he absence of § 10(b) aiding and abetting liability does not mean that secondary actors in the securities markets are always free from liability under the securities Acts. Any person or entity, including a lawyer, accountant, or bank, who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator under 10b-5, assuming *all* of the requirements for primary liability under Rule 10b-5 are met.<sup>96</sup>

While this statement firmly rejected aiding and abetting liability,<sup>97</sup> at the same time it opened the door for a broadening of the scope of conduct relevant for a § 10(b) claim against a secondary actor.<sup>98</sup>

*Central Bank’s* holding has proven difficult for the lower federal courts to apply.<sup>99</sup> The difficulty arises from the lack of parameters given by the Court

---

92. *Id.* at 177–78. The plaintiffs “concede[d] that Central Bank did not commit a manipulative or deceptive act within the meaning of § 10(b)”; rather, it should be held “secondarily liable . . . for its conduct in aiding and abetting the fraud.” *Id.* at 191 (internal quotation marks omitted).

93. *Id.* at 191.

94. *Id.* at 177–78.

95. *Id.* at 191.

96. *Id.* (emphasis in original).

97. *Id.*

98. *See id.* Although the Court stated that the language of the statute was dispositive, it further reasoned that even if the statutory language did not resolve the case, there would nonetheless be no private right of action. *Id.* at 178. One of the critical elements necessary for recovery under § 10(b) was missing from the plaintiffs’ case; the Court concluded, without explanation, that the plaintiffs had not established the requisite reliance necessary to recover under § 10(b). *Id.* at 180.

99. *See supra* note 18.

on what conduct suffices for liability to attach,<sup>100</sup> particularly given that Rules 10b-5(a) and (c) prohibit schemes or acts, practices, or courses of business that operate as a fraud.<sup>101</sup> In fact, at least one court has suggested that *Central Bank* should be limited only to claims brought under subsection (b) of Rule 10b-5.<sup>102</sup> Although repudiating aiding and abetting liability, the *Central Bank* decision provided scant guidance for determining when a secondary actor had merely aided or abetted another's fraud, as opposed to having engaged in fraud itself. As a result, after *Central Bank*, courts began expanding the meaning of "manipulative device" to include more than market manipulation, or have asserted that deception means something other than a misstatement or omission.<sup>103</sup> And scheme liability premised on subsections (a) and (c) of Rule 10b-5 emerged as a viable theory for liability.<sup>104</sup> Yet the theory had no definitive test for determining primary liability for secondary actors, and contrasting opinions among circuits surfaced.<sup>105</sup>

### *E. Cases After Central Bank*

Following *Central Bank*, courts labored to define the parameters of scheme liability under Rule 10b-5. As one commentator has noted:

Courts that have rejected scheme liability arguments have generally held that conduct is actionable under Section 10(b) or any subpart of Rule 10b-5 only if it (a) involved a material misstatement or omission or (b) it involved manipulative securities trading practices that artificially affect market activity and are therefore "manipulative" within the meaning of the *Santa Fe* definition. . . .

---

100. The circuits developed their own tests for determining primary liability after *Central Bank*. The two that emerged were the "bright-line" and "substantial participation" tests. Gorman, *supra* note 8, at 202. The bright-line test required the violator to actually make a misrepresentation or omission. *Id.* at 203–04 (citing *Anixter v. Home-Stake Prod. Co.*, 77 F.3d 1215, 1225–27 (10th Cir. 1996)). However, the violator need not make the statement directly to investors; rather, it was sufficient that they knew or should have known that the statement (or omission) would reach investors. *Id.* at 204. The Eleventh Circuit also adopted the bright-line test, requiring that the statement be attributed to the actor at the time of its dissemination. *Id.* at 207 (citing *Ziembra v. Cascade Int'l, Inc.*, 256 F.3d 1194, 1205 (11th Cir. 2001)).

The substantial participation test, on the other hand, allowed liability for anyone who substantially participated in the preparation of a fraudulent document. *Id.* at 202 (citing *In re Software Toolworks, Inc. Sec. Litig.*, 50 F.3d 615 (9th Cir. 1994)). These tests focus on liability premised on Rule 10b-5(b), whereas scheme liability emerged later and was premised on Rule 10b-5(a) and (c). See Travis S. Souza, Note, *Freedom to Defraud: Stoneridge, Primary Liability, and the Need to Properly Define Section 10(b)*, 57 DUKE L.J. 1179, 1187–88 (2008).

101. See 17 C.F.R. § 240.10b-5 (2007).

102. See *In re Parmalat Sec. Litig.*, 376 F. Supp. 2d 472, 499 (S.D.N.Y. 2005).

103. Markel & Ballard, *supra* note 8, at 885–86; e.g., *Simpson v. AOL Time Warner Inc.*, 452 F.3d 1040, 1047–50 (9th Cir. 2006); *In re Enron Corp. Sec. Derivative & "ERISA" Litig.*, 529 F. Supp. 2d 644, 704–06 (S.D. Tex. 2006).

104. See Souza, *supra* note 100, at 1180.

105. See *id.* at 1189–93.



....

On the other hand, [other] courts . . . have embraced the idea of scheme liability. Some courts . . . have held that active participation in a fraudulent scheme, through actions other than material misstatement or omission or manipulation, can be actionable because “deceptive” [is] within the meaning of Section 10(b). Other courts have held that active participation in a fraudulent scheme can be actionable because it is “manipulative” within the meaning of Section 10(b). Finally, there are courts that have not differentiated between the two concepts and have merely held that such conduct is actionable because it is “manipulative or deceptive.” All of these decisions, however, have difficulty distinguishing between aiding and abetting, which is not actionable under *Central Bank*, and being a primary violator in a fraudulent scheme.<sup>106</sup>

The Ninth and Fifth Circuits’ decisions in the *Simpson* and *Regents* cases, respectively, are two that have addressed the scheme liability theory with differing results. Just as the courts’ conclusions conflict regarding whether participation in a scheme to defraud another company’s investors is appropriate conduct on which to base securities fraud liability, so do their analyses regarding whether subsequent reliance on those schemes has been established.

### 1. *Simpson v. AOL Time Warner, Inc.*

In *Simpson v. AOL Time Warner, Inc.*, Homestore.com, an online real estate company, engaged in a series of triangular transactions that were sham “round-trip” or “barter” transactions.<sup>107</sup> Homestore would purchase shares, products, or services from a third-party company, which in turn would buy advertising from AOL Time Warner using all or most of the money Homestore paid the third-party company.<sup>108</sup> AOL, after taking a commission, would pass the money from this sale back to Homestore in accordance with an advertising reseller agreement between Homestore and AOL.<sup>109</sup> Additional transactions involving L90, Inc. mirrored those involving AOL.<sup>110</sup> The plaintiffs also alleged that Homestore “grossly overpaid” Cendant Corporation for a real estate website,<sup>111</sup> the purchase of which was contingent on a promise by Cendant to “recycle” some of the money it received from the sale of the website back to Homestore for transactions to be entered into over the next two

---

106. Markel & Ballard, *supra* note 8, at 885–86 (referring to the Eighth Circuit in *Charter*, the Fifth Circuit in *Regents*, the Ninth Circuit in *Simpson*, the district court in *Enron*, and the SEC).

107. *Simpson*, 452 F.3d at 1043.

108. *Id.*

109. *Id.* at 1044.

110. *Id.* at 1045.

111. *Id.* at 1044–45.

years.<sup>112</sup> In violation of an SEC accounting standard requiring companies to report only the net revenue from these barter transactions, Homestore recorded the money it received as gross revenue in order to meet its revenue expectations, thereby deceiving its auditor, PriceWaterhouseCoopers.<sup>113</sup>

The California State Teachers' Retirement System (CalSTRS), the lead plaintiff in the class action litigation, brought a securities fraud claim against AOL and two of its officers, Cendant and one of its officers, and L90.<sup>114</sup> Relying on the Supreme Court's decision in *Central Bank*, the United States Court of Appeals for the Ninth Circuit affirmed the district court's dismissal of the claims, ruling that CalSTRS failed to allege a valid claim for primary liability under § 10(b).<sup>115</sup> The court held that, although the scope of § 10(b) includes deceptive conduct in furtherance of a scheme to defraud, to be liable as a primary violator under § 10(b), a defendant's conduct must have had the "principal purpose and effect of creating a false appearance of fact in furtherance of the scheme [to defraud]."<sup>116</sup> The court reasoned that being involved in a deceptive transaction did not give rise to liability; rather, a party must have contributed his own deceptive conduct to the "transaction or overall scheme" to impose liability.<sup>117</sup> If the party's "[c]onduct [was] consistent with the . . . normal course of business," then that conduct could not normally have a deceptive purpose.<sup>118</sup>

The court determined that CalSTRS had not alleged that any of the defendants acted with the purpose and effect of creating a false appearance in furtherance of a scheme to defraud.<sup>119</sup> There was no indication that the advertisements AOL sold and for which it received a commission "contained a false appearance or other deceptive qualities," because they complied with the legal advertising reseller agreement between Homestore and AOL.<sup>120</sup> Further, there were no allegations that showed how the funding set aside by Cendant for the future transactions with Homestore in conjunction with Homestore's acquisition of Cendant's website had any potential for misrepresentation or false appearance when the future transactions were acknowledged and made public in a press release by Cendant.<sup>121</sup> Finally, there was no assertion that L90 helped create the scheme or misrepresented its transactions with Homestore.<sup>122</sup> Rather, L90 simply entered a legal transaction that Homestore

---

112. *Id.*

113. *Id.* at 1043.

114. *Id.* at 1042.

115. *Id.* at 1054–55.

116. *Id.* at 1048.

117. *Id.*

118. *Id.* at 1049.

119. *Id.* at 1052–54.

120. *Id.* at 1053.

121. *Id.* at 1053–54.

122. *Id.* at 1054.

manipulated as part of its scheme.<sup>123</sup> According to the court, each of these transactions merely gave Homestore the opportunity to record its revenue in violation of SEC accounting standards.<sup>124</sup> The court refused to hold the defendants liable for participating in legitimate transactions that were distorted by Homestore's fraud.<sup>125</sup>

Although the court held that a secondary actor's participation in a scheme to defraud is prohibited conduct, it ultimately concluded there had been no true scheme to "defraud" here, because the defendants lacked the requisite culpability, or scienter. Nonetheless, the court set forth what it considered to be the requisites for determining reliance, assuming a true scheme to defraud had existed. The court determined that reliance is satisfied if "the introduction of misleading statements into the securities market was the intended end result of a scheme to misrepresent revenue."<sup>126</sup> Therefore, although the defendants in *Simpson* themselves had not made any misrepresentations to Homestore's investors directly, their participation in transactions to inflate Homestore's revenues brought about the misrepresentations that the plaintiffs relied on.<sup>127</sup> Regardless of the fact that Homestore was the one that subsequently misrepresented the revenues to its investors, the Defendants' conduct made those misrepresentations possible.<sup>128</sup> The roadmap used by that court operates as follows: (1) "conduct by a defendant that ha[s] the principal purpose and effect of creating a false appearance . . . as part of a scheme to defraud" is deceptive conduct for purposes of § 10(b) liability; and (2) "a plaintiff may be presumed to have relied on th[e] scheme to defraud if a misrepresentation, which . . . resulted from the scheme . . . was disseminated into [the] market and was reflected in the market price" for a security.<sup>129</sup> The court would thereby allow a fraud-on-the-market presumption of reliance to be established on the basis of a misrepresentation that was one step removed from the defendants' participation in the scheme. However, having determined that the defendants had not engaged in any prohibited conduct, the court had no occasion to determine whether reliance existed.<sup>130</sup>

---

123. *Id.* at 1045, 1054.

124. *See id.* at 1053.

125. *Id.* at 1053–54.

126. *Id.* at 1051.

127. *Id.*

128. *Id.* at 1051–52.

129. *Id.* at 1052 (stating that conduct is in connection with the purchase or sale of a security, as required by § 10(b), 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 market").

130. *See id.* at 1053–54.

## 2. Regents of the University of California v. Credit Suisse First Boston

The Fifth Circuit Court of Appeals' decision in *Regents of the University of California v. Credit Suisse First Boston*<sup>131</sup> is in sharp contrast with the decision in *Simpson*. The *Regents* court determined that a secondary actor's participation in a scheme to defraud is not prohibited conduct under § 10(b), nor could a plaintiff establish reliance on that conduct.<sup>132</sup> *Regents* involved more than thirty actions filed against Enron Corporation and later consolidated, with the Regents of the University of California designated as the lead plaintiff.<sup>133</sup> The lawsuit arose because of the spectacular, and now all too familiar, rise and fall of Enron. Before its 2001 collapse, Enron entered into a series of partnerships and transactions that allowed it to remove liabilities from its books and record revenue from certain transactions, thereby inflating its financial condition.<sup>134</sup> The plaintiffs alleged that the banks Merrill Lynch & Company, Inc., Credit Suisse First Boston, and Barclays, each entered into these transactions, thereby allowing Enron to misstate its financial condition.<sup>135</sup> An example of one such transaction occurred when Merrill Lynch agreed to buy Enron's electricity-generating barges off the Nigerian coast.<sup>136</sup> Enron sold to Merrill Lynch because it had not been able to sell to a legitimate purchaser and needed to meet analyst estimates for the fiscal quarter.<sup>137</sup> An Enron-controlled entity bought the barges back from Merrill Lynch within six months.<sup>138</sup> Although in effect a loan, Enron recorded the transaction as a sale, and recorded the revenue from the transaction in its 1999 year-end financial statements.<sup>139</sup>

The plaintiffs filed a § 10(b) claim against the banks for their part in effectuating Enron's financial statement fraud.<sup>140</sup> The banks filed motions to dismiss the claims, but those were denied by the district court.<sup>141</sup> However, the district court reconsidered some of the issues raised by the motions to dismiss when it addressed whether to grant the plaintiffs' motion for class certification.<sup>142</sup> The district court adopted the SEC's position that participation in a "transaction whose principal purpose and effect is to create a false

---

131. 482 F.3d 372 (5th Cir. 2007), *cert. denied sub nom.* Regents of Univ. of Cal. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 128 S. Ct. 1120 (2008).

132. *Id.* at 390, 392–94.

133. *Id.* at 377–78.

134. *Id.* at 377.

135. *Id.*

136. *Id.*

137. *Id.*

138. *Id.*

139. *Id.*

140. *Id.* at 377–78.

141. *Id.*

142. *Id.*

appearance of revenues” is a deceptive act as required by Rule 10b-5(c).<sup>143</sup> Because the court determined that the plaintiffs’ claims involved an

overarching, concealed scheme to defraud, which involve[d] a large number of alleged material misrepresentations or omissions, . . . primarily aim[ed] at wrongful conduct by key participants that allegedly employed a device, scheme or artifice to defraud or engaged in an act, practice or course of business that operated as a fraud, under Rule 10b-5(a) and (c)[,]

the plaintiffs had successfully alleged a deceptive act.<sup>144</sup> The district court further reasoned that a defendant who commits such a deceptive act can be jointly and severally liable based on Rule 10b-5(a)’s prohibition against any scheme to defraud.<sup>145</sup> Moreover, because the banks had engaged in deceptive acts, the plaintiffs could also establish reliance on those acts; the district court concluded that the plaintiffs were entitled to rely on the class-wide presumptions of reliance for both omissions and fraud-on-the-market.<sup>146</sup> With

143. *In re Enron Corp. Sec. Derivative & “ERISA” Litig.*, 529 F. Supp. 2d 644, 705 (S.D. Tex. 2006) (quoting SEC exhibit); *id.* at 707 (adopting SEC interpretation). The district court noted that:

Determining when secondary actors are liable as primary violators of [§ 10(b)] is especially difficult where the allegations are of scheme liability based on concealed conduct under Rule 10b-5(a) and (c). [The Banks] have argued that pleading scheme liability under Rule 10b-5(a) and (c), when a scheme participant that has engaged in a sham transaction or fraudulent conduct that allows a securities issuer to submit false and misleading financial statements but makes no statement itself, is no longer viable in the wake of *Central Bank*, but is merely an attempt to circumvent its holding that aiding and abetting is not actionable under the statute.

*Id.* at 701. The district court did not agree with the banks. *See id.* at 705–06.

144. *Id.* at 739.

145. *Id.* at 722–23.

146. *Id.* at 683, 739. The district court discussed that reliance may be presumed using the *Affiliated Ute* presumption in cases based on material omissions. *Id.* at 679. On the other hand, reliance may be presumed using *Basic*’s fraud-on-the-market theory when the plaintiff alleges there has been a material misrepresentation. *Id.* at 680. The court explained that “[t]o determine whether an action is ‘primarily a nondisclosure case or a positive misrepresentation case’ for the applicability of the [*Affiliated Ute*] presumption or the fraud-on-the-market theory, the Fifth Circuit focuses on under which subsection of Rule 10b-5 the misconduct alleged by the plaintiff falls.” *Id.* at 681–82 (quoting *Finkel v. Docutel/Olivetti Corp.*, 817 F.2d 356, 359–60 (5th Cir. 1987)). Thus, although Rule 10b-5(b) focuses on misrepresentations and omissions (“a failure to state a fact necessary to make the statements made not misleading”), the Fifth Circuit has determined that omissions also exist in the context of “any device, scheme, or artifice to defraud” under Rule 10b-5(a) or an “act, practice, or course of business which operates or would operate as a fraud or deceit” in the context of Rule 10b-5(c). *Id.* at 682 (citing *Finkel*, 817 F.2d at 360 (“Cases involving primarily a failure to disclose implicate the first and third subsections of Rule 10b-5; cases involving primarily a misstatement or a failure to state a fact necessary to make the statements made not misleading implicate the second subsection . . .”). As such, the Fifth Circuit has limited the *Affiliated Ute* presumption to cases with claims primarily based on alleged omissions under subsections (a) and (c) of Rule 10(b)-5, and the fraud-on-the-market presumption to cases with claims primarily based on alleged “misstatements or failure to state a fact necessary

respect to the *Affiliated Ute* presumption of reliance regarding omissions, the court concluded that the banks did have a duty to the plaintiffs; the “duty [was] not a duty to disclose, but [rather,] a . . . duty not to engage in a fraudulent scheme.”<sup>147</sup> Moreover, the district court found that *Basic*’s fraud-on-the-market presumption of reliance was also available to the plaintiffs.<sup>148</sup> According to the court, where a scheme to deceive investors exists, a fraud on the market exists as well and thus reliance is established because the scheme disseminates false or misleading statements into the securities markets.<sup>149</sup> As a result, the district court held that the plaintiffs had stated a claim against the banks for a primary violation of § 10(b), even though they were secondary actors.<sup>150</sup>

The banks appealed to the United States Court Appeals for the Fifth Circuit.<sup>151</sup> The issue on appeal centered on whether the district court’s determination of a “deceptive act” could support “its application of the classwide presumption of reliance.”<sup>152</sup> In other words, for a class to be certified, the court must find that “questions of law or fact common to members of the class predominate over any questions affecting individual members.”<sup>153</sup> As such, each plaintiff must be able to prove all of the elements of a § 10(b) claim, including that fraud occurred and that the fraud proximately caused the plaintiff’s loss.<sup>154</sup> Yet without the district court’s “broad conception of liability for ‘deceptive act,’” which includes a scheme to defraud, it could not have found that the entire class of plaintiffs could establish a presumption of reliance.<sup>155</sup>

---

to make statements made therein not misleading” under subsection (b). *Id.* However, the Fifth Circuit, according to the district court, has at times “intermingled the two presumptions of class-wide reliance under [*Affiliated Ute* and *Basic*]” where allegations of schemes to defraud exist. *Id.* at 684, 689. According to the court, schemes to defraud can implicate not only the withholding of material information from the market, but also the dissemination of false or misleading information. *Id.* at 686.

147. *Id.* at 683, 739 (internal quotation marks omitted).

148. *Id.* at 689, 739.

149. *See id.* at 686.

150. *Id.* at 744–45.

151. *Regents of Univ. of Cal. v. Credit Suisse First Boston*, 482 F.3d 372, 379 (5th Cir. 2007), *cert. denied sub nom. Regents of Univ. of Cal. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 128 S. Ct. 1120 (2008).

152. *Id.* at 381–82. A related issue was whether the district court’s acceptance of scheme liability as a valid theory would “allow[] it to certify a single class of plaintiffs whose losses were [commonly] caused . . . by” many unconnected schemes, “rather than to certify subclasses whose losses were caused by the actions of individual defendants.” *Id.* at 382. The circuit court, however, addressed only the definition of “deceptive act,” because it was the dispositive issue on appeal. *Id.*

153. *Id.* at 382.

154. *Id.* (citing *Dura Pharms., Inc. v. Broudo*, 544 U.S. 336, 346 (2005) (stating that a private securities fraud action can only be permitted where the plaintiff can prove “the traditional elements of proximate causation and loss”)).

155. *Id.*

The Fifth Circuit noted that a collective interpretation of the relevant Supreme Court securities fraud decisions would lead to the conclusion that § 10(b) prohibits acts involving manipulation or deception.<sup>156</sup> Further, the Supreme Court has held that an act is not deceptive under § 10(b) unless the actor had a duty to disclose to the investors.<sup>157</sup> Nor is an act manipulative unless the act occurred directly in the market for the relevant security.<sup>158</sup> Having determined that the banks did not owe the plaintiffs any duty of disclosure, the banks' acts could not be considered deceptive under § 10(b).<sup>159</sup> Moreover, because the banks did not act directly in the market for the Enron securities, but rather engaged in a transaction with Enron, the banks' acts also could not be considered manipulative.<sup>160</sup> Using a narrow construction of the scope of conduct prohibited by § 10(b), the court concluded that the banks' acts were neither deceptive nor manipulative, and thus did not violate the statute.<sup>161</sup>

To determine if reliance existed, the *Regents* court again looked to whether the banks engaged in conduct prohibited by § 10(b) by examining the relevant presumptions of reliance.<sup>162</sup> In other words, a presumption of reliance exists only where there is either a misrepresentation of a material fact or an omission thereof in violation of a duty to disclose. On the one hand, the court determined that the district court's application of the *Affiliated Ute* presumption of reliance with respect to omissions was incorrect.<sup>163</sup> The banks' acts of entering into fraudulent documentation were deemed to be nondisclosure by the district court, and thus, an omission. However, the Fifth Circuit determined that—an omission notwithstanding—the plaintiffs in *Regents* nevertheless failed to establish reliance because the banks owed the plaintiffs no specific duty of disclosure.<sup>164</sup> As a result, there had been no deceptive act. Nor could the plaintiffs establish reliance on the basis of the

---

156. *Id.* at 387. The court discussed the Supreme Court decisions in *Central Bank, Ernst*, and *Santa Fe*, as well as *Chiarella v. United States*, wherein the Court stated, “[w]hen an allegation of fraud is based upon non-disclosure, there can be no fraud absent a duty to speak.” *Id.* at 387 (quoting *Chiarella v. United States*, 445 U.S. 222, 234 (1980)). The court interpreted *Chiarella* to stand for the proposition that conduct relating to omissions, or a nondisclosure of information, is only fraudulent when there is a duty to disclose the information. Thus, the court rejected the district court's determination that engaging in a scheme replete with withholding of information from the market violates a duty not to engage in the scheme, as opposed to a duty to disclose. *Id.* at 384.

157. *Id.* at 387 (citing *Chiarella*, 445 U.S. at 234).

158. *Id.* at 390 (citing *Hundahl v. United Benefit Life Ins. Co.*, 465 F. Supp. 1349, 1360 (N.D. Tex. 1979) (Higginbotham, J.)).

159. *Id.*

160. *Id.* at 392.

161. *Id.*

162. *Id.* at 393–94.

163. *Id.* at 383.

164. *Id.* at 384–85.

fraud-on-the-market theory without an overly broad reading of liability for deceptive acts.<sup>165</sup> To accept the fraud-on-the-market presumption of reliance would have required a misrepresentation made by the banks, not an omission. Because a deceptive act only includes omissions in violation of a duty to disclose, allowing the fraud-on-the-market presumption of reliance was inappropriate as well.<sup>166</sup>

While the courts in both *Simpson* and *Regents* concurred that an act prohibited by § 10(b) must be one that is “manipulative” or “deceptive,” they interpreted differently what that act might be. The court in *Simpson* held that a scheme to defraud investors is conduct prohibited by § 10(b), however, it required some level of culpability on the part of the secondary actor in order for the conduct to be manipulative or deceptive.<sup>167</sup> As such, the secondary actor’s conduct must be for the “principal purpose and effect of creating a false appearance of fact in furtherance of the scheme.”<sup>168</sup> The court in *Regents*, however, rejected a scheme to defraud as manipulative or deceptive conduct.<sup>169</sup> It held that manipulative conduct under § 10(b) is only an act done directly in the market for a particular security, whereas a secondary actor’s conduct is deceptive only if it owed to investors a duty to disclose.<sup>170</sup> Consequently, the courts in *Simpson* and *Regents* each accepted a different premise on which reliance either could or could not be based. The court in *Simpson* determined that reliance could be established on a showing of a scheme to defraud (including entering into documentation to create the fraud) and a subsequent misrepresentation of material fact by the primary violator to the market that resulted from the scheme.<sup>171</sup> Because an affirmative misrepresentation would exist, albeit one step removed from the secondary actor’s participation in the scheme, the fraud-on-the-market presumption of reliance would be appropriate. The court in *Regents*, on the other hand, determined that entering into documentation is an omission of material fact, rather than an affirmative misrepresentation.<sup>172</sup> Thus, without a duty to disclose the information, there has been no deceptive act, and a presumption of reliance is inappropriate.<sup>173</sup>

Given the conflict at the circuit court level, the time was ripe for the Supreme Court to decisively resolve these issues among the courts. Against this backdrop, the Supreme Court in *Stoneridge* affirmed the dismissal of Stoneridge’s claim; it concluded that Stoneridge did not state a claim for liability under § 10(b) and Rule 10b-5 because Stoneridge could not establish

---

165. *Id.* at 382.

166. *Id.* at 385–86.

167. *Simpson v. AOL Time Warner Inc.*, 452 F.3d 1040, 1050 (9th Cir. 2006).

168. *Id.* at 1049.

169. *Regents*, 482 F.3d at 384.

170. *Id.* at 386, 390.

171. *Simpson*, 452 F.3d at 1051.

172. *See Regents*, 482 F.3d at 384–86.

173. *Id.* at 382, 390.



reliance on the secondary actors' participation in a scheme to defraud.<sup>174</sup> Yet while the Court rejected scheme liability for this particular case, the language it used arguably allows for scheme liability in certain other factual settings.

### III. THE *STONERIDGE* DECISION

#### A. *Factual Background*

The *Stoneridge* case involved a securities fraud claim against Charter Communications, Inc., Scientific-Atlanta, Inc., and Motorola, Inc.<sup>175</sup> Scientific-Atlanta and Motorola were Charter's secondary actors. The plaintiffs in this lawsuit were investors who had purchased Charter stock during the relevant period.<sup>176</sup> Stoneridge Investment Partners, LLC, as the lead plaintiff in the class action, claimed that Scientific-Atlanta and Motorola assisted Charter in misrepresenting certain transactions between the entities in order to inflate Charter's revenues in its publicly filed financial statements.<sup>177</sup> Stoneridge "filed a securities fraud class action on behalf of purchasers of Charter stock" and sought to hold Charter, Scientific-Atlanta, and Motorola liable under § 10(b) and Rule 10b-5.<sup>178</sup> Charter ultimately entered into a settlement with Stoneridge for \$146,250,000 in connection with its violation of § 10(b) for filing fraudulent and misleading financial statements.<sup>179</sup> But Stoneridge sought damages from the secondary actors as well for their part in enabling Charter's financial statement fraud,<sup>180</sup> on the theory that without their help in falsifying transaction documents, Charter could not have fraudulently misrepresented its financial status to the public.<sup>181</sup> The Supreme Court ultimately determined that Stoneridge could not recover.<sup>182</sup> Without explicitly rejecting scheme liability as a viable theory of liability, the Court concluded that Stoneridge could not state a claim under § 10(b) or Rule 10b-5 against either Scientific-Atlanta or Motorola, because it could not establish reliance on either secondary actor's conduct.<sup>183</sup>

Charter, a cable operator, was concerned with the effect that lower-than-expected quarterly earnings would have on Wall Street's expectations

---

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

175. *Id.*

176. *Id.*

177. *Id.*

178. *Id.* at 767.

179. *In re Charter Commc'ns, Inc., Sec. Litig.*, No. MDL 1506, 4:02-CV-1186 CAS, 2005 WL 4045741, at \*1 (E.D. Mo. June 30, 2005). The district court noted that, "according to a study by *Bloomberg News*, the settlement falls within the top 25 securities fraud class action settlements of all time." *Id.*

180. *See id.* at \*5.

181. *Stoneridge*, 128 S. Ct. at 767.

182. *Id.* at 774.

183. *Id.*

regarding Charter's performance.<sup>184</sup> By late 2000, Charter realized that the fraudulent activity it had already engaged in would be insufficient to meet projected earnings by a margin of \$15 to \$20 million.<sup>185</sup> Charter's prior fraud included "misclassification of its customer base; delayed reporting of terminated customers; improper capitalization of costs that should have been shown as expenses; and manipulation of the company's billing cutoff dates to inflate reported revenues."<sup>186</sup> To right this shortfall, Charter approached the secondary actors with a plan to alter some of their respective transactions, with the actors' full complicity.<sup>187</sup> The scheme worked as follows: both Scientific-Atlanta and Motorola supplied Charter with cable converter boxes to provide its customers.<sup>188</sup> Charter agreed to overpay for each cable box by \$20 until year's end, and the secondary actors would use that overpayment to buy advertising from Charter.<sup>189</sup> Though in reality a net wash, Charter recorded the advertising purchases as revenue and capitalized its purchase of the cable boxes, resulting in Charter's financial statements reflecting that it met its projected revenue and operating cash flows.<sup>190</sup> Although this scheme violated generally accepted accounting principles, Charter's auditors<sup>191</sup> approved Charter's financial statements because Charter and its secondary actors "de-linked" the two transactions: at Charter's request, Scientific-Atlanta sent documents to Charter that falsely stated that Scientific-Atlanta was increasing its prices for cable boxes by \$20 per box.<sup>192</sup> Charter and Motorola, on the other hand, agreed to language in Charter's purchase contract for cable boxes that specified a certain quantity of cable boxes Charter was to purchase, yet provided for liquidated damages of \$20 per cable box in the event Charter failed to purchase the specified amount.<sup>193</sup> It was fully expected when the contract was entered into that Charter would fail to purchase all the units and pay the \$20 per box to Motorola.<sup>194</sup> Both of these contracts were backdated to appear they had been entered into a month before the advertising purchase agreements.<sup>195</sup> The accounting effect allowed Charter to record revenue and

---

184. *Id.* at 766.

185. *Id.*

186. *Id.*

187. *Id.*

188. *Id.*

189. *Id.*

190. *Id.*

191. Charter's independent auditor was Arthur Andersen LLP. *Id.* Arthur Andersen was also named as a defendant in this litigation; the Court, however, noted that it was unclear whether Arthur Andersen was misled by Charter and the secondary actors or whether Arthur Andersen was complicit in the fraud. *Id.* Ultimately, however, the Court concluded that Arthur Andersen's involvement, or lack thereof, was neither controlling nor significant for purposes of the case. *Id.*

192. *Id.* at 767.

193. *Id.*

194. *Id.*

195. *Id.*

operating cash flow from the advertising purchases of approximately \$17 million, enough to close the gap on the shortfall it anticipated.<sup>196</sup>

Stoneridge, the lead plaintiff on behalf of investors who alleged losses after they bought Charter stock, filed a securities fraud class action lawsuit against Charter, Scientific-Atlanta, Motorola, and others under § 10(b) and Rule 10b-5.<sup>197</sup> Stoneridge alleged that not only did Charter violate the securities laws, but that its secondary actors did as well by participating in the scheme, resulting in the fraudulent financial statements Stoneridge relied on in making investment decisions.<sup>198</sup> The district court granted Scientific-Atlanta and Motorola's motion to dismiss, and the Court of Appeals for the Eighth Circuit affirmed.<sup>199</sup> The Eighth Circuit noted that, at most, the secondary actors aided and abetted Charter's financial statement fraud, and according to the holding in *Central Bank*, there is no private right of action for aiding and abetting under § 10(b).<sup>200</sup> Rather, to recover for a § 10(b) violation against the secondary actors, Stoneridge would have to show more than mere aiding and abetting of Charter's primary violation of § 10(b); Stoneridge would have to show a primary violation by the secondary actors.<sup>201</sup> The circuit court's view was that the allegations failed to show a primary violation of § 10(b) by Scientific-Atlanta and Motorola because Stoneridge made no showing of misstatements made by the secondary actors to the investing public that induced reliance, nor did it show that the secondary actors failed to disclose material information in violation of a duty to disclose.<sup>202</sup> The Supreme Court granted certiorari to resolve the conflict among the circuits for when an investor may recover from a secondary actor under § 10(b).<sup>203</sup>

### *B. The Supreme Court's Analysis of a Scheme to Defraud and a Plaintiff's Reliance*

The Court first noted that § 10(b) liability does not extend to aiding and abetting liability.<sup>204</sup> Rather, in order to show liability, a plaintiff must establish a primary violation of § 10(b) against a secondary actor.<sup>205</sup> Against this backdrop, the Court of Appeals affirmed the dismissal of Stoneridge's case against the Charter secondary actors, concluding that Stoneridge had not alleged any deceptive act prohibited by § 10(b), and "that only misstatements, omissions by one who has a duty to disclose, and manipulative trading

---

196. *Id.*

197. *Id.* at 766–67.

198. *Id.* at 767.

199. *In re Charter Commc'ns, Inc., Sec. Litig.*, 443 F.3d 987, 989 (8th Cir. 2006).

200. *Id.* at 992.

201. *Id.* at 992–93.

202. *Id.* at 992.

203. *Stoneridge*, 128 S. Ct. at 767–68.

204. *Id.* at 769.

205. *Id.*

practices . . . are deceptive within the meaning of the rule.”<sup>206</sup> The Supreme Court noted that if the Court of Appeals meant that only statements, oral or written, can form the basis for § 10(b) liability, that interpretation would result in an erroneous application of the law.<sup>207</sup> Rather, conduct can also be deceptive and provide such a basis.<sup>208</sup> As such, the Court interpreted the Court of Appeals’ holding to suggest that, although Charter’s secondary actors may have engaged in deceptive acts prohibited under § 10(b) by virtue of their assistance in altering certain documents, Stoneridge did not rely on those acts.<sup>209</sup> And because reliance is one of the required elements of a § 10(b) claim, Stoneridge failed to state a claim.<sup>210</sup>

Further, in light of the presumptions of reliance discussed above, the Court determined that neither presumption applied to the facts of the case.<sup>211</sup> First, neither Scientific-Atlanta nor Motorola had a duty to disclose the fraudulent transactions to Stoneridge.<sup>212</sup> Thus, their failure to disclose the falsified documentation could not form the basis of any presumption of reliance on the part of Stoneridge, because there had been no omission in breach of a duty owed to them.<sup>213</sup> Second, the secondary actors’ conduct was not communicated to the public. The Court reasoned that “[n]o member of the investing public had knowledge, either actual or presumed, of respondents’ deceptive acts during the relevant times.”<sup>214</sup> As a result, reliance could not be established using the fraud-on-the-market theory. In other words, Scientific-Atlanta and Motorola’s acts were not communicated to the public; rather, Charter made misrepresentations regarding its financial status in its own publicly filed financial statements. The secondary actors did not make any such statements, even though by falsifying documents they had formed the basis for Charter to make its misrepresentations. Thus, the Court concluded that Stoneridge could not establish the requisite element of reliance.<sup>215</sup>

Stoneridge asserted reliance as follows: Had Scientific-Atlanta and Motorola not helped Charter falsify its financial statements, Charter’s auditor would not have been deceived, and Charter’s publicly filed financial statements would have reflected its true financial condition more accurately.<sup>216</sup> And by virtue of their scheme with Charter, Scientific-Atlanta and Motorola made an indirect misrepresentation to the public that Stoneridge relied on when making its

---

206. *Id.* (citation omitted).

207. *Id.*

208. *Id.*

209. *Id.*

210. *See id.*

211. *Id.*

212. *Id.*

213. *Id.*

214. *Id.*

215. *Id.*

216. *Id.* at 770.

investment decision to purchase Charter's stock.<sup>217</sup> The Court rejected this argument, asserting that adopting this concept of reliance would cast the net of potential liability to the marketplace at large, and the Court was unwilling to so broaden the scope of § 10(b).<sup>218</sup> The Court's argument rested on the principle of reliance being closely linked to causation: a defendant's deceptive acts and a plaintiff's reliance thereon must be linked "immediate[ly]"<sup>219</sup> rather than remotely, insofar as the deceptive acts must be "'in connection with the purchase or sale of a security.'"<sup>220</sup> Although the reliance requirement and the "in connection with the purchase or sale of any security" requirement are distinct from each other, the Court found them related enough to conclude that Stoneridge's reliance on the secondary actors' deception was too far removed from its purchase of Charter's securities.<sup>221</sup> The Court reasoned that although § 10(b) is "not limited to preserving the integrity of the securities markets," it does not reach all commercial transactions that are fraudulent and affect the price of a security in some attenuated way.<sup>222</sup> The Court also raised the concern that extending the scope of liability to include generic "contracting parties" might necessarily increase the cost of doing business out of fear of § 10(b) liability.<sup>223</sup> Similarly, overseas firms may shy away from doing business in this country which could "raise the cost of being a publicly traded company . . . and shift securities offerings away from domestic capital markets."<sup>224</sup> The Court concluded its opinion by signaling the SEC's role in enforcement of § 10(b) claims against secondary actors.<sup>225</sup>

*C. Analysis of the Supreme Court's Stoneridge Decision: Does Scheme Liability for Secondary Actors Remain a Viable Theory for Recovery?*

Various commentators have suggested that the Supreme Court rejected scheme liability in *Stoneridge*.<sup>226</sup> However, the Court never expressly rejected scheme liability in the opinion, unlike its explicit rejection of aiding and abetting in *Central Bank*.<sup>227</sup> Moreover, the Court's rather indistinct language in the opinion suggests that plaintiffs may be able to assert scheme liability for

217. *Id.*

218. *Id.* at 770–71.

219. *Id.* at 770.

220. *Id.* (quoting 15 U.S.C. § 78j(b) (2000)).

221. *Id.*

222. *Id.* at 771 (citation omitted) (quoting Superintendent of Ins. of N.Y. v. Bankers Life & Casualty Co., 404 U.S. 6, 12 (1971)).

223. *Id.* at 772.

224. *Id.*

225. *Id.* at 773–74. The Court noted that allowing Stoneridge's theory of liability to extend to these secondary actors would undermine Congress's determination that the SEC is solely responsible for pursuing aiders and abettors. *Id.* at 773.

226. *See supra* note 7.

227. *See supra* Part II.D.

some secondary actors that participate in a scheme to defraud. The first example of its somewhat open-ended language is the Court's assertion that "conduct," in addition to misrepresentations and omissions, can also be a "deceptive act" prohibited under § 10(b).<sup>228</sup> The Court thus appears to have casually accepted that participation in a scheme to defraud is, at least, deceptive, and can therefore be violative of § 10(b), which offered some credence to the separation of subsections (a) and (c) from subsection (b) of Rule 10b-5. Yet the Court gave very little guidance as to what types of acts are relevant in this context. It merely concluded that in this case, entering into backdated contracts is a "course of conduct [that] include[s] both oral and written statements."<sup>229</sup> Thus, a "course of conduct" might include other types of conduct not engaged in by Scientific-Atlanta and Motorola. Moreover, the Court described the secondary actors' conduct as "ordinary business operations" and an "arrangement . . . in the marketplace for goods," as opposed to conduct in the "investment sphere."<sup>230</sup> In other words, Motorola's and Scientific-Atlanta's conduct was simply that of a customer or supplier entering into a business transaction. In the context of their deceptive acts, neither was engaged in any conduct directly involving the securities markets. This posture provides a potential basis for secondary actor scheme liability: to the extent a secondary actor has engaged in fraudulent conduct that is within the investment sphere, the court could determine the secondary actor has engaged in manipulative or deceptive conduct that violates § 10(b).

Yet there is no discussion in the opinion, like there was in the *Simpson* decision, regarding the extent to which such conduct would rise to the level of being manipulative or deceptive.<sup>231</sup> Rather, the Court clung to the concept that any assistance given by a secondary actor to a primary violator is merely aiding and abetting, regardless of the deceptive nature of such conduct.<sup>232</sup> Importantly, however, the Court's rejection of aiding and abetting liability in *Central Bank* was not based simply on an actor's participation in a scheme, but rather on the culpability, or scienter, attributable to the actor.<sup>233</sup> Thus, the Court's implicit recognition of conduct as potentially deceptive in *Stoneridge* creates an opportunity for a secondary actor's conduct to be deemed manipulative or deceptive, despite the role such conduct may have played in effectuating another company's securities fraud. Notwithstanding the Court's connection in *Stoneridge* between participation in a scheme and aiding and abetting, this association is seemingly linked in the opinion to the notion of secondary actors as commercial actors, as opposed to actors in the securities

---

228. *Stoneridge*, 128 S. Ct. at 769.

229. *Id.* at 769.

230. *Id.* at 770, 774.

231. See *Simpson v. AOL Time Warner Inc.*, 452 F.3d 1040, 1046 (9th Cir. 2006).

232. *Stoneridge*, 128 S. Ct. at 771.

233. *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 191 (1994).

markets.<sup>234</sup> Thus, if a court could find that a secondary actor has engaged in manipulative or deceptive conduct in the investment sphere, the Court has left a potential opening between where aiding and abetting ends and primary liability for a secondary actor begins.

Yet this opportunity may be much ado about nothing, because arguably a plaintiff could never establish reliance on a scheme to defraud using either presumption of reliance. The Court reasoned that to establish reliance on the basis of conduct, the existing presumptions are the only means to establish reliance, absent actual reliance.<sup>235</sup> According to the Court, the secondary actor must therefore have a duty to investors to disclose information to apply the *Affiliated Ute* presumption.<sup>236</sup> Alternatively, the fraud-on-the-market presumption would require that the secondary actor's deceptive conduct be communicated to the public.<sup>237</sup> The Court also imposed a more immediate connection between the secondary actor's conduct and the plaintiff's injury to survive a remoteness claim. In other words, the deceptive conduct must not be too remote from the injury in order to be "in connection with the purchase or sale" of a security.<sup>238</sup>

Although conduct must be communicated to the public in order to establish fraud-on-the-market reliance, the Court never made clear who must communicate the deceptive acts, because the Court's language was vague with each reference to this requirement.<sup>239</sup> Although the Court did state that the "implied right of action does not reach [the secondary actors] because the investors did not rely upon *their* statements or representations,"<sup>240</sup> that statement is rendered ambiguous by the Court's reference to conduct as a statement.<sup>241</sup> In other words, if conduct can include statements, as well as other behavior, so long as the conduct in whatever form is publicly communicated, the fraud-on-the-market presumption should be appropriate.

At least one court has interpreted *Stoneridge's* holding as requiring the secondary actor to communicate its conduct to the investing public.<sup>242</sup> If this is

---

234. See *Stoneridge*, 128 S. Ct. at 772.

235. See *id.* at 769.

236. *Id.*

237. *Id.*

238. *Id.* at 770.

239. See *id.* at 766, 769.

240. *Id.* at 766 (emphasis added). The Court later stated that the secondary actors' "acts or statements were not relied upon by the investors." *Id.* at 769 (emphasis added).

241. *Id.* at 769.

242. See *Burnett v. Rowzee*, 561 F. Supp. 2d 1120, 1128 (C.D. Cal. 2008). In *Burnett*, defendant Halstead was the "pitch man" for a financing transaction. *Id.* at 1123. The plaintiff agreed to invest funds in short-term loans to companies in the process of obtaining the financing. *Id.* No financing was ever arranged; rather, the principals of the scheme simply solicited additional investments from subsequent investors and used those investments to pay returns to earlier investors—in essence, a Ponzi scheme. *Id.* The court held that the plaintiff had established reliance on this scheme because the plaintiff had direct contact with the principals of

so, there might be more opportunity for courts to require less in the way of immediacy between the conduct and the injury. Because the secondary actor would have effectuated a fraud on the market by disclosing its conduct itself to the market, that actor would now presumably be in the “investment sphere” for having made the statement. Unfortunately, however, if a plaintiff is able to establish fraud by the secondary actor on the basis of a public statement, then the plaintiff has not availed itself of scheme liability for secondary actors at all; rather it has merely established fraud on the basis of a statement under Rule 10b-5(b), and has arguably established reliance on the basis of actual reliance.

The question then becomes whether the possibility exists to establish fraud-on-the-market reliance on the basis of a communication made by the primary violator to its shareholders regarding the secondary actor’s conduct. Assuming Charter had included in its publicly filed financial statements a description of the transactions entered into with Motorola and Scientific-Atlanta, instead of including merely the effect these transactions had on Charter’s revenues, would that have changed the landscape? Arguably not in *Stoneridge*, because the Court deemed their conduct too remote from the plaintiff’s injury. Because their actions were ordinary course of business transactions, as opposed to securities transactions, there was insufficient immediacy between their actions and *Stoneridge*’s injury. But how “direct” must this connection be? This is where the secondary actor’s conduct could become relevant in determining how remote its conduct is to the plaintiff’s injury. The Court did provide that actions in the “realm of ordinary business operations” are generally too remote to be considered “in connection with” a securities transaction.<sup>243</sup> Again, arguably, there is an opportunity for varying interpretations as to what actions take place in the “investment sphere,” versus the “marketplace for goods.”

Similarly, the prospect exists for plaintiffs to take advantage of the Court’s analysis of the remoteness of a secondary actor’s conduct. For example, had Charter and Motorola engaged in a fraudulent securities transaction, as opposed to an ordinary course of business transaction, and had Charter reported the transaction in its financial statements, would a plaintiff have established an immediate connection sufficient to assert fraud-on-the-market reliance? Presumably, the fraudulent securities transaction between the secondary actor and the primary violator need not be the transaction that a plaintiff participates in to satisfy the “in connection with” requirement.<sup>244</sup>

---

the scheme and directly relied on the interest to be paid in making their investment. *Id.* at 1128. *But see* Pugh v. Tribune Co., 521 F.3d 686, 696–97 (7th Cir. 2008) (holding that where the defendant was the “mastermind” of a scheme to defraud, yet did not prepare press releases, the causal chain was too indirect to establish reliance on the scheme).

243. *Stoneridge*, 128 S. Ct. at 770.

244. *See* United States v. O’Hagan, 521 U.S. 642, 655–56 (1997). The Supreme Court in *O’Hagan* determined in the context of the misappropriation theory of insider trading that the “in connection with” requirement is satisfied “even though the person or entity defrauded is not the other party to the trade, but is, instead, the source of the nonpublic information.” *Id.* at 656. The Court went on to note that “[t]he misappropriation theory comports with § 10(b)’s language,



Thus, that requirement may have a better chance of being established if there is some communication of the deceptive act. Moreover, the Court suggested that Scientific-Atlanta and Motorola's acts were too remote from Stoneridge's injury to satisfy reliance because "nothing [they] did made it necessary or inevitable for Charter to record the transactions as it did."<sup>245</sup> Arguably, a court could thus allow reliance to exist if the secondary actor somehow made it "necessary or inevitable" for the transaction to become public information. Again, this language, while limiting Stoneridge's ability to assert scheme liability, could be relevant in another context, given its ambiguity. Presumably the *Stoneridge* Court used it to suggest that Scientific-Atlanta and Motorola could have backdated or falsified numerous transaction documents at Charter's request, but ultimately Charter could have decided to report its income correctly. However, the words "necessary or inevitable" could give rise to another interpretation by a court in a different context.

Thus, the vagueness of some of the Court's language creates the possibility that an entrepreneurial plaintiff and a willing court may interpret the holding from *Stoneridge* to find a secondary actor liable on the basis of scheme liability. The true stumbling block for a plaintiff would be whether he could establish fraud-on-the-market reliance in the absence of actual reliance on the scheme.

#### IV. CONCLUSION

The Supreme Court in *Stoneridge* may have thought it closed the door on scheme liability for secondary actors as a viable theory of liability in the absence of actual reliance. However, what the Court may have intended and what the Court actually wrote are two different things. Within the confines of its opinion, a broad reading suggests there may still be room for plaintiffs to construct a plausible argument, particularly in light of the fact that the Court did not expressly reject the theory. It is doubtful that the Court will revisit the issue of § 10(b) liability for secondary actors anytime soon because it denied certiorari in the *Regents* case a week after deciding *Stoneridge*.<sup>246</sup> The Court's refusal of an opportunity to further hone this difficult—but important—issue of the precise scope of secondary actor liability may well have injurious effects. On one hand, lower courts may read the opinion as rejecting scheme liability entirely, thereby eradicating any possible recovery for wronged plaintiffs in this context. On the other hand, the absence of any definitive rejection of scheme liability may allow courts to impose liability on secondary actors. Or at the very least, such absence may allow a court not to dismiss the case in the early stages of a proceeding.

---

which requires deception 'in connection with the purchase or sale of any security,' not deception of an identifiable purchaser or seller." *Id.* at 658.

245. *Stoneridge*, 128 S. Ct. at 770.

246. *Regents of Univ. of Cal. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 128 S. Ct. 1120 (2008) (mem.).

Yet the Court's refusal to extend Rule 10b-5's implied private right of action to allow scheme liability in all cases is due in large part, if not entirely, to a lack of congressional intent to extend it.<sup>247</sup> Thus, Congress could act to clarify whether scheme liability for secondary actors is in the purview of § 10(b), but its doing so would likely depend on a variety of factors, including the goals of the new presidential administration.<sup>248</sup> But as the Supreme Court's decision in *Stoneridge* is certainly one extolling the public policy concern of increased litigation beyond the realm of the securities laws, Congress may wish to advance a competing policy concern of deterring culpable conduct.

SEC rulemaking is another means by which the securities laws may be changed. Certainly, the SEC could not disregard clear Supreme Court precedent interpreting a Rule 10b-5.<sup>249</sup> Thus, the SEC could not, for example, adopt a rule that states a new method by which a plaintiff could establish reliance on a scheme to defraud. Yet because the Court did not expressly reject scheme liability as a viable theory on which to base liability, the SEC could adopt rules that supplement Rule 10b-5 to elucidate the contours of scheme liability for secondary actors.<sup>250</sup> Specifically, it could clarify what it means for conduct to be "immediate" as opposed to remote. Similarly, it could identify when conduct is in the investment sphere or not, or when it is sufficiently in connection with a purchase or sale of a security for the causal connection between the deceptive conduct and the injury to bolster reliance. Having rules in place to determine the boundaries of scheme liability would arguably be beneficial, both to the regulated as well as to the investor, even if

---

247. See *Stoneridge*, 128 S. Ct. at 771-73; see also Joseph A. Grundfest, *Disimplying Private Rights of Action Under the Federal Securities Laws: The Commission's Authority*, 107 HARV. L. REV. 961, 998 (1994) (citing *Musick, Peeler & Garrett v. Employers Ins.*, 508 U.S. 286, 299-300 (1993) (Thomas, J., joined by Blackmun and O'Connor, JJ., dissenting)) (stating that certain members of the Supreme Court have expressed concern over the Court's continued acceptance of Rule 10b-5's implied private right and that it should not be extended absent any congressional support).

248. See Black, *supra* note 7, at 339-40. Professor Black suggests that Congress could be persuaded to amend the securities laws because of the purported lack of effectiveness of the Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737-65 (codified in scattered sections of 15 U.S.C.), which was enacted after *Central Bank* "to curb the abuses of securities fraud class actions," as well as the reduced liability after *Central Bank*, which "may have led to participation by accounting firms and investment banks" in the Enron and WorldCom financial scandals. Black, *supra* note 7, at 339.

249. See Grundfest, *supra* note 247, at 984 (stating that while the SEC has the authority to define the conduct that violates § 10(b), the doctrine of *stare decisis* would preclude it from disregarding the Supreme Court's prior interpretation of a statute).

250. See *id.* at 1011-12. The main premise of Professor Grundfest's article is that, notwithstanding judicial acceptance of a plaintiff's private right of action for securities fraud, the SEC's rulemaking authority would allow it to "disimply" such a right. *Id.* at 976-78. Absent complete disimplication, however, the SEC also has the authority to tighten the elements a plaintiff must establish in a 10b-5 claim. *Id.* at 1011.

that benefit was simply certainty of the law.<sup>251</sup> If any such adopted SEC rule withstood judicial scrutiny, scheme liability for secondary actors could potentially be more readily established.

However, the likely result of *Stoneridge* will be that the lower courts must make determinations as to when—if ever—a plaintiff has established fraud-on-the-market reliance based on a secondary actor's deceptive act in the context of a scheme to defraud. And thus, expensive and protracted litigation will continue; not necessarily over whether a secondary actor has wronged investors in cases of corporate crisis, but rather over whether the laws in place even cover the conduct asserted by plaintiffs.

---

251. See James J. Park, *The Competing Paradigms of Securities Regulation*, 57 DUKE L.J. 625, 663 (2007).