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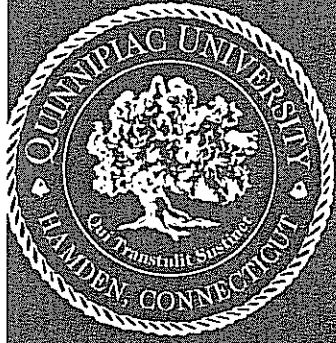


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*STONERIDGE V. SCIENTIFIC-ATLANTA: DO SECTION 10(B)
AND RULE 10B-5 REQUIRE A MISSTATEMENT OR
OMISSION?*

*Rodney D. Chrisman**

INTRODUCTION

On March 26, 2007, the Supreme Court granted certiorari in *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*,¹ a case that many viewed as having the potential to produce the most important Supreme Court securities law decision since the landmark case of *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*² Prior to the opinion coming down, and even prior to oral arguments, *Stoneridge* drew an unusual amount of attention for a rather technical securities law case.³ Commentators described *Stoneridge* as “the most

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1. *In re Charter Commc'ns, Inc.*, 443 F.3d 987, 992 (8th Cir. 2006), *cert. granted*, 127 S. Ct. 1873 (2007), and *aff'd sub nom. Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 128 S. Ct. 761 (2008).

2. *Cent. Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164 (1994).

3. See, e.g., *Supreme Court to Hear Third-Party Securities Suit*, WALL ST. J. NEWSWIRE, Oct. 5, 2007, <http://online.wsj.com/public/article/SB119160737138050333.html> (calling the case “high-profile” and noting that it “has drawn an unusual amount of politically charged interest”) (published before oral arguments); Kara Scannell, *Big-Money Battle Pits Business vs. Trial Bar*, WALL ST. J., Oct. 9, 2007, at A1 (“The Supreme Court is wading into one of the most intense battles ever waged between two deep-pocketed enemies: the trial bar and big business.”) (published on the day of oral arguments); Richard Brust et al., *The Company Line*, A.B.A. J., Oct. 2007, at 50, 52 (“Few business cases have been as highly anticipated as *Stoneridge*, which could become one of the court’s most important securities cases in at least a decade.”) (published after oral arguments).

important securities case in a decade, with ripple effect in the billions,”⁴ “securities law’s *Roe v. Wade*,”⁵ “[maybe] the business case of the year,”⁶ and “the biggest securities-litigation court clash in a generation.”⁷ The case garnered such attention not only for its extremely important implications for securities law in general, but for its implications for the defrauded shareholders in the Enron debacle.⁸ In this regard, Senator Arlen Specter (R., PA) stated, “[t]he outcome of *Stoneridge* will determine whether tens of thousands of Enron investors will secure a day in court.”⁹

As noted in the Supreme Court’s grant of certiorari, the issues presented in *Stoneridge* arise in the wake of the Court’s opinion in

4. Nina Totenberg, *Detainee Rights to Top Supreme Court Docket*, NATIONAL PUBLIC RADIO, Oct. 1, 2007, <http://www.npr.org/templates/story/story.php?storyId=14820563> (citing Professor Donald Langevoort).

5. *Id.* (quoting Professor Langevoort, who said that calling *Stoneridge* “securities law’s *Roe v. Wade*” is “only a little bit of hyperbole”).

6. Op-Ed., *A Class Action Scheme*, WALL ST. J., Oct. 6, 2007, at A20.

7. Op-Ed., *Can Shareholders Sue Third Parties?*, WALL ST. J., Oct. 6, 2007, at A19.

8. *See Regents of the Univ. of Cal. v. Credit Suisse First Boston (USA), Inc.*, 482 F.3d 372 (5th Cir. 2007) (ruling that the Enron shareholders cannot recover against Enron’s banks because a misstatement or omission is required for liability under § 10(b) and Rule 10b-5), *cert. denied*, 128 S. Ct. 1120 (2008); *see also* Daniel A. McLaughlin, *Liability Under 10b-5(a) & (c)*, 31 DEL. J. CORP. L. 631, 645 (2006) (stating that *In re Enron Corp. Sec., Derivative & ERISA Litig.*, 235 F. Supp. 2d 549 (S.D. Tex. 2002), has served as the “template for theories of ‘scheme’ liability”).

9. *See Can Shareholders Sue Third Parties*, *supra* note 7. Senator Specter’s sympathy for the Enron shareholders is in many ways understandable; however, relying upon that alone to rule in favor of the plaintiffs in *Stoneridge* would have epitomized the old adage “bad facts make bad law.” In explaining its ruling against the same Enron shareholders mentioned by Senator Specter, despite the difficult and sympathetic factual situation, the Fifth Circuit stated:

We recognize, however, that our ruling on legal merit may not coincide, particularly in the minds of aggrieved former Enron shareholders who have lost billions of dollars in a fraud they allege was aided and abetted by the defendants at bar, with notions of justice and fair play. We acknowledge that the courts’ interpretation of § 10(b) could have gone in a different direction and might have established liability for the actions the banks are alleged to have undertaken. Indeed, one of our sister circuits - the Ninth - believes that it did. We have applied the Supreme Court’s guidance in ascribing a limited interpretation to the words of § 10, viewing the statute as the result of Congress’s balancing of competing desires to provide for some remedy for securities fraud without opening the floodgates for nearly unlimited and frequently unpredictable liability for secondary actors in the securities markets.

Regents, 482 F.3d at 393. The Supreme Court in its opinion in *Stoneridge* does not address its implications for the Enron investors. Seven days later, however, the Supreme Court relied on *Stoneridge* to deny certiorari in the Enron case, thereby allowing the decision of the Fifth Circuit to stand and effectively ending the bid of the Enron shareholders to hold the investment banks in the Enron debacle liable. *Regents of the Univ. of Cal. v. Merrill Lynch*, 128 S. Ct. 1120 (2008).

Central Bank.¹⁰ In that case, the Court shocked most observers of and commentators¹¹ on securities law by overturning long-standing, unanimous circuit court precedent by holding that, based upon the statutory language of § 10(b) of the Securities Exchange Act of 1934 (“§ 10(b)”)¹² there exists no private cause of action for aiding and abetting a primary violation of Securities and Exchange Commission (“SEC”) Rule 10b-5 (“Rule 10b-5”).¹³ Since all of the circuits had adopted aiding and

10. *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 127 S. Ct. 1873 (2007).

11. While most commentators before and since *Central Bank* have embraced and argued for aiding and abetting liability, Professor Fischel correctly anticipated that the rulings in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), and *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462 (1977), would ultimately lead to the rejection of aiding and abetting liability under § 10(b). Daniel R. Fischel, *Secondary Liability Under Section 10(b) of the Securities Act of 1934*, 69 CAL. L. REV. 80, 82 (1981). The *Central Bank* ruling made Professor Fischel out to be a prophet. See also *W.O. Akin v. Q-L Invs., Inc.*, 959 F.2d 521, 525 (5th Cir.1992) (“There is a powerful argument that . . . aider and abettor liability should not be enforceable by private parties pursuing an implied right of action.”); *Barker v. Henderson, Franklin, Starnes & Holt*, 797 F.2d 490, 495 (7th Cir. 1986) (holding that a defendant must commit a manipulative or deceptive act in order to be liable under § 10b and Rule 10b-5, which essentially forecloses any liability for aiders and abettors); *SEC v. Seaboard Corp.*, 677 F.2d 1301, 1311 n.12 (9th Cir. 1982) (stating that a broad expansive reading of Rule 10b that incorporates “add-on” theories of liability, such as aiding and abetting, has been rejected by the Supreme Court, and that the court must apply a strict statutory construction); *Little v. Valley Nat’l Bank of Ariz.*, 650 F.2d 218, 220 n.3 (9th Cir. 1981) (“The status of aiding and abetting as a basis for liability under the securities laws [was] in some doubt.”); *Benoay v. Decker*, 517 F. Supp. 490, 495 (E.D. Mich. 1981) (“It is also doubtful that a claim for ‘aiding and abetting’ . . . will continue to exist under 10(b).”), *aff’d*, 735 F.2d 1363 (6th Cir. 1984).

12. 15 U.S.C. § 78j (2000). Section 10(b) states:

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 contravention of such rules and regulations as the [SEC] may prescribe . . .

Id.

13. 17 C.F.R. § 240.10b-5 (2007). Section 10(b) is not self-executing, but instead depends upon “such rules and regulations as the [SEC] may prescribe,” 15 U.S.C. § 78j, to carry it into action. Accordingly, the SEC promulgated Rule 10b-5 which provides as follows:

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

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

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

abetting liability,¹⁴ there had been no serious consideration prior to *Central Bank* as to the contours of primary liability as opposed to secondary liability¹⁵ under Rule 10b-5 because secondary actors were almost always held liable as aiders and abettors of the primary violation.¹⁶ Accordingly, the decision in *Central Bank* created a great

(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.

17 C.F.R. § 240.10b-5.

14. See, e.g., *Levine v. Diamantheset, Inc.*, 950 F.2d 1478, 1483 (9th Cir. 1991); *K & S P'ship v. Cont'l Bank, N.A.*, 952 F.2d 971, 977 (8th Cir. 1991); *Schaitz v. Rosenberg*, 943 F.2d 485, 495 (4th Cir. 1991); *Fine v. Am. Solar King Corp.*, 919 F.2d 290, 300 (5th Cir. 1990); *Schilke v. Seafirst Corp.*, 866 F.2d 935, 947 (7th Cir. 1989); *Schneberger v. Wheeler*, 859 F.2d 1477, 1480 (11th Cir. 1988); *Moore v. Fenex, Inc.*, 809 F.2d 297, 303 (6th Cir. 1987); *Cleary v. Perfectunc, Inc.*, 700 F.2d 774, 777 (1st Cir. 1983); *IT, Int'l Inv. Trust v. Cornfeld*, 619 F.2d 909, 922 (2d Cir. 1980); *Monsen v. Consol. Dressed Beef Co.*, 579 F.2d 793, 799 (3d Cir. 1978); *Kerbs v. Fall River Indus., Inc.*, 502 F.2d 731, 740 (10th Cir. 1974). The Federal Circuit for the District of Columbia never directly recognized aiding and abetting liability, but suggested that it would likely do so in *Zoelsch v. Arthur Andersen & Co.*, 824 F.2d 27, 35-36 (D.C. Cir. 1987). The Seventh Circuit applied a test different from those used in the other circuits in that it required that the aider and abettor "commit one of the 'manipulative or deceptive' acts prohibited under section 10(b) and rule 10b-5 . . ." *Robin v. Arthur Young & Co.*, 915 F.2d 1120, 1123 (7th Cir. 1990).

15. Generally, the issuer of a security is termed the "primary actor." The term "secondary actor" can include a multitude of parties who are in some way connected to the alleged fraud, including officers, directors, indenture trustees, lawyers, accountants, underwriters, investment bankers, and, now, even vendors, among others. For purposes of this Article, "secondary actors" can encompass any of these parties. A "primary violator" is any person who has violated § 10(b) and Rule 10b-5. These so-called "secondary actors" traditionally have been held liable under various theories of secondary liability, characterized by Professor Daniel Fischel as "judicially implied civil liability which has been imposed on defendants who have not themselves been held to have violated the express prohibition of the securities statute at issue, but who have some relationship with the primary wrongdoer." Fischel, *supra* note 11, at 80 n.4. Following *Central Bank*, in civil liability cases, there appears to be no such thing as "secondary liability" under § 10(b) and Rule 10b-5; instead, for a primary or secondary actor to be liable, both primary and secondary actors must be primary violators. See Rodney D. Chrisman, Note, "*Bright Line*," "*Substantial Participation*," or *Something Else: Who Is A Primary Violator Under Rule 10b-5?*, 89 KY. L.J. 201, 201 n.2 (2001).

16. Before this decision, the question whether a secondary actor was a primary violator or merely an aider and abettor was "largely academic," because every federal circuit recognized the aiding and abetting cause of action. Chrisman, *supra* note 15, at 202 (quoting *In re MTC Elecs. Tech. S'holders Litig.*, 898 F. Supp. 974, 985 (E.D.N.Y. 1995), *vacated in part on reconsideration by*, 993 F. Supp. 160 (E.D.N.Y. 1997)); *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 192 (1994) (Stevens, J., dissenting). Accordingly, the courts had not developed a clear standard for determining when a secondary actor's conduct rose to the level of a primary violation.

deal of uncertainty with regard to the liability of secondary actors under Rule 10b-5.¹⁷

Therefore, following *Central Bank*, commentators and the lower courts have struggled mightily to delineate the line between primary and secondary liability.¹⁸ While the emerging conflict came in two separate waves, the primary issue throughout has been whether § 10(b) requires that a defendant actually make a misstatement or omission in order to be held liable as a primary violator under Rule 10b-5.¹⁹ This issue was first

17. Compare *In re Charter Commc'ns, Inc.*, 443 F.3d 987, 992 (8th Cir. 2006) (“[T]he district court properly dismissed the claims against the Vendors as nothing more than claims, barred by *Central Bank*, that the Vendors knowingly aided and abetted the Charter defendants in deceiving the investor plaintiffs.”), with *Simpson v. AOL Time Warner, Inc.*, 452 F.3d 1040, 1048 (9th Cir. 2006) (“[T]o be liable as a primary violator of § 10(b) for participation in a ‘scheme to defraud,’ the defendant must have engaged in conduct that had the *principal purpose and effect* of creating a false appearance of fact in furtherance of the scheme.” (emphasis added)), *overruled in part* by *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 128 S. Ct. 761 (2008), and *disagreed with in In re Parmalat*, 414 F. Supp. 2d 428, 433 (S.D.N.Y. 2006) (holding that a misrepresentation or omission is not necessary when the plaintiffs are proceeding under Rule 10b-5(a) or (c)). In *Stoneridge*, the Supreme Court affirmed the opinion of the Eighth Circuit, albeit arguably on different grounds. Compare *Stoneridge*, 128 S. Ct. at 769, with *Stoneridge*, 128 S. Ct. at 774 (Stevens, J., dissenting). Further, the Court appears to overrule *Parmalat* by citing it as an example of reasoning that the Court rejected. *Id.* at 770.

18. See discussion *infra* Part II and note 61. See also Nicholas Fortune Schanbaum, Note, *Scheme Liability: Rule 10b-5(a) and Secondary Actor Liability After Central Bank*, 26 REV. LITIG. 183, 184 (2007); Taavi Annus, *Scheme Liability Under § 10(b) of the Securities Exchange Act of 1934*, 72 MO. L. REV. 855 (2007); Jill E. Fisch, *The Scope of Private Securities Litigation: In Search of Liability Standards For Secondary Defendants*, 99 COLUM. L. REV. 1293 (1999); Robert S. De Leon, *The Fault Lines Between Primary Liability and Aiding and Abetting Claims Under Rule 10b-5*, 22 J. CORP. L. 723, 729-33 (1997); Robert A. Prentice, *Locating that “Indistinct” and “Virtually Nonexistent” Line Between Primary and Secondary Liability Under Section 10(b)*, 75 N.C. L. REV. 691, 723-26 (1997); Fischel, *supra* note 11, at 82 (interpreting pre-1981 Supreme Court decisions as indicating “that the theory of secondary liability is no longer viable”). See also *Regents of the Univ. of Cal. v. Credit Suisse First Boston (USA), Inc.*, 482 F.3d 372 (5th Cir. 2007) (adopting the test); *Charter*, 443 F.3d at 992 (essentially adopting the bright-line test by concluding that the only conduct proscribed by § 10(b) is a misstatement or an omission with a duty to disclose); *Simpson*, 452 F.3d at 1040 (adopting the scheme liability test); *Wright v. Ernst & Young LLP*, 152 F.3d 169, 175 (2d Cir. 1998) (adopting the bright line test), *cert. denied*, 525 U.S. 1104 (1999); *Dannenberg v. PaineWebber Inc. (In re Software Toolworks Inc.)*, 50 F.3d 615, 628 n.3 (9th Cir. 1994) (adopting the substantial participation test); *In re Kendall Square Research Corp.* 868 F. Supp. 26, 28 (D. Mass. 1994) (adopting the bright line test); *Vosgerichian v. Commodore Int’l*, 862 F. Supp. 1371, 1378 (E.D. Pa. 1994) (holding that the accountant made a misstatement, which is a violation of § 10(b) and Rule 10b-5, and seemingly adopting the bright line test); *In re ZZZZ Best*, 864 F. Supp. 960, 967-68 (C.D. Cal. 1994) (citing *Central Bank*).

19. See *infra* Part II.B. I do not include the rule here because it is clear that Rule 10b-5(a) and (c) by their plain language reach beyond just misstatements and omissions. It is also

addressed immediately following *Central Bank* in the context of deciding upon a test for primary liability of secondary actors under § 10(b) and Rule 10b-5.²⁰ The circuits split on this issue.²¹ Then, corporate securities scandals such as Enron rocked the securities world.²² These scandals shined a bright light on the issue of secondary actor liability because they involved numerous secondary actors exhibiting varying degrees of culpability, and the corporations themselves were typically insolvent.²³ This gave rise to a strong desire on the part of the plaintiffs' bar to find someone with "deep pockets" and some form of recovery for jilted shareholders. The search inevitably led to secondary actors such as lawyers, accountants, investment banks, and, as in the *Stoneridge* case, even vendors finding themselves in the crosshairs of the plaintiffs' bar.²⁴

Out of this environ emerged a new theory of liability seeking primary liability for secondary actors who have not made misstatements or omissions.²⁵ This theory, commonly known as "scheme liability," relies on Rule 10b-5(a) and (c) to hold secondary actors primarily liable even when they have not made misstatements or omissions.²⁶ Scheme liability is not premised upon misstatements or omissions made by the defendants, but rather upon the secondary actor's alleged involvement in a scheme to defraud.²⁷ Accordingly, scheme liability requires an answer to the question whether § 10(b) requires a misstatement or omission for primary liability. The circuits again split over this issue,²⁸ and the Supreme Court granted certiorari in *Stoneridge* to answer the question:

clear, however, that the plain language of the rule goes beyond the reach of the statute. Accordingly, the focus is on the statute. See *infra* notes 47-53 and accompanying text.

20. See *infra* notes 64-66 and accompanying text.

21. See *supra* note 18.

22. See McLaughlin, *supra* note 8, at 644 (opining that the Enron situation is the most sensational securities fraud case ever).

23. *Id.* See *infra* notes 188-190 and accompanying text.

24. Scannell, *supra* note 3.

25. See *infra* Part II.B.

26. See *infra* Part II.B.

27. See *infra* Part II.B.

28. See *supra* note 18. The Ninth Circuit purports that its opinion in *Simpson* is consistent with the Eighth Circuit's opinion in *Charter*. The Eighth Circuit, however, purports to reject scheme liability while the Ninth Circuit embraces it and even proposes a test for it. Further, as the Fifth Circuit noted in *Regents of the University of California*, "the Eighth and Ninth Circuits have split with respect to the scope of primary liability for secondary actors." *Regents of the Univ. of Cal. v. Credit Suisse First Boston (USA), Inc.*, 482 F.3d 372, 386 (5th Cir. 2007). In a footnote to the quoted sentence, the Court compared the Ninth and Eighth Circuit opinions as follows:

[w]hether [*Central Bank*] forecloses claims for deceptive conduct under § 10(b) . . . and Rule 10b-5(a) and (c) . . . where [the secondary actors] engaged in transactions with a public corporation with no legitimate business or economic purpose except to inflate artificially the public corporation's financial statements, but where [the secondary actors] themselves made no public statements concerning those transactions.²⁹

With the issue framed in this way, *Stoneridge* presented the central issue plaguing the lower courts since *Central Bank*: does § 10(b) require that a secondary actor actually make a misstatement or omission in order to be held liable as a primary violator under the Rule 10b-5 implied cause of action?³⁰

Accordingly, in *Stoneridge*, the Court had an opportunity to resolve much of the uncertainty resulting from *Central Bank* by answering the question presented in the affirmative. This certainly would have invalidated scheme liability. Further, the Court's answer would have provided a great deal of clarity and guidance for the lower courts as to the proper test for determining the line between secondary and primary

Compare Simpson v. AOL Time Warner Inc., 452 F.3d 1040, 1048 (9th Cir. 2006) (“[T]o be liable as a primary violator of § 10(b) for participation in a ‘scheme to defraud,’ the defendant must have engaged in conduct that had the principal purpose and effect of creating a false appearance of fact in furtherance of the scheme”), with *In re Charter Commc’ns, Inc.*, 443 F.3d 987, 992 (8th Cir. 2006) (“[A]ny defendant who does not make or affirmatively cause to be made a fraudulent statement or omission, or who does not directly engage in manipulative securities trading practices, is at most guilty of aiding and abetting and cannot be held liable under § 10(b) or any subpart of Rule 10b-5”).

Id. at 387 n.24.

Further, in discussing the Ninth Circuit's attempt to distinguish *Charter* from its own opinion, the Fifth Circuit stated, “[i]f there is a distinct difference between the culpability of defendants' actions based on the pleadings in those two cases, it is not apparent to us.” *Id.* at 392. The Supreme Court agreed, noting, “[d]ecisions of the Courts of Appeals are in conflict respecting when, if ever, an injured investor may rely upon § 10(b) to recover from a party that neither makes a public misstatement nor violates a duty to disclose but does participate in a scheme to violate § 10(b).” *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 128 S. Ct. 761, 767 (2007).

Obviously, the Supreme Court attempted to resolve this split in favor of the Fifth and Eighth Circuits in *Stoneridge*. The Court in *Stoneridge* affirmed the Eighth Circuit's opinion in *Charter*, and in a matter of days denied certiorari in *Regents* (allowing the Fifth Circuit's opinion to stand) and vacated the Ninth Circuit's opinion in *Simpson*, remanding it for further consideration in light of *Stoneridge*. *Id.*; *Regents of the Univ. of Cal. v. Merrill Lynch*, 128 S. Ct. 1120 (2008); *Avis Budget Group, Inc. v. Cal. State Teachers' Retirement Sys.*, 128 S. Ct. 1119 (2008).

29. Petition for Writ of Certiorari, *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 128 S. Ct. 761 (2008) (No. 06-43) (emphasis added). The Court granted the petition and accepted the issue as stated in *Stoneridge*'s Petition.

30. See discussion *infra* Part II.

liability under § 10(b) and Rule 10b-5. Such an answer would also have been in agreement with the understanding of many commentators and members of the securities bar prior to the rise of scheme liability. But, alas, the Court chose instead to ignore much of its own precedent, and issued a rather tortured opinion arguably arriving at the same result, albeit relying upon a strained analysis of the reliance element.

This Article begins by discussing the *Central Bank* decision as it gives rise to the question presented in *Stoneridge*.³¹ The next part analyzes the tests initially adopted by the lower courts immediately following *Central Bank*.³² In light of Supreme Court precedent and the lower courts differing interpretations, this Article analyzes the circuit court cases addressing scheme liability before considering scheme liability in light of the Supreme Court's opinion in *Stoneridge*. This Article then considers whether § 10(b) and related authority prior to *Stoneridge* required that a secondary actor actually make a misstatement or omission in order to be held liable as a primary violator of Rule 10b-5.³³ Finally, this Article discusses how the Supreme Court's opinion in *Stoneridge* answered this question, and the reasoning behind the answer given.³⁴

I. CENTRAL BANK AND ITS WAKE

Central Bank is arguably the most influential Supreme Court case regarding the liability of secondary actors in private securities lawsuits.³⁵ This landmark opinion caused seismic shifts in private securities litigation, and raised many issues that remain the topic of much debate and disagreement among commentators and the lower courts.³⁶ The

31. See *infra* Part I.

32. See *infra* Part II.A.

33. See *infra* Part III.

34. See *infra* Part IV.

35. See, e.g., R. Bret Beattie, *The New Minefield: The Scheme Theory of Primary Liability Comes of Age in the Post-Enron Era*, 34 SEC. REG. L.J. 2 (2006) (describing *Central Bank* as a "watershed decision . . . sending a happy shockwave through the securities bar by eliminating liability against so-called secondary actors"); Celia R. Taylor, *Breaking the Bank: Reconsidering Central Bank of Denver After Enron and Sarbanes-Oxley*, 71 MO. L. REV. 367, 370 (2006) ("*Central Bank* changed the playing field dramatically and marked the end of straight-forward aiding and abetting liability."); Scott Siamas, *Primary Securities Fraud Liability for Secondary Actors: Revisiting Central Bank of Denver in the Wake of Enron, Worldcom, and Arthur Anderson*, 37 U.C. DAVIS L. REV. 895 (2004); Fisch, *supra* note 18.

36. See Andrew S. Gold, *Reassessing the Scope of Conduct Prohibited by Section 10(b) and the Elements of Rule 10b-5: Reflections on Securities Fraud and Secondary Actors*, 53 CATH. U. L. REV. 667, 667 (2004) ("[The Court's decision in *Central Bank*] produced a major

issue presented in *Stoneridge* forces the Court to confront the application of *Central Bank* to scheme liability under § 10(b) and Rule 10b-5(a) and (c). Accordingly, this Article begins by discussing the Court's opinion in *Central Bank*.³⁷

In *Central Bank*, Central Bank of Denver was an indenture trustee³⁸ for a bond issue by the Colorado Springs-Stetson Hills Public Building Authority ("Authority").³⁹ The bonds required that certain land held subject to their assessment liens be worth at least 160% of the total outstanding principal and interest on the bonds.⁴⁰ The bond also required AmWest Development to give Central Bank of Denver an annual report evincing satisfaction of the 160% test.⁴¹ After several unchanged reports during a period of generally declining property values, Central Bank of Denver became aware that there was a substantial possibility that the test was not being met. However, Central Bank, on the encouragement of AmWest, waited to perform an independent review of the appraisals until after the closing of a subsequent bond issue.⁴² Before Central Bank of Denver's auditor performed that independent review,⁴³ the Authority defaulted on its bonds.⁴⁴ In addition to Central Bank of Denver, the plaintiff bond purchasers sued the Authority, an AmWest director, an underwriter, and others, but the case before the Supreme Court primarily involved the issue of whether Central Bank of Denver could be held liable as an aider and abettor.⁴⁵

upheaval in securities law . . . upend[ing] decades of lower court decisions that recognized aiding and abetting claims, and engender[ing] substantial scholarly criticism."). *See supra* notes 16-18 and accompanying text.

37. Much of the following discussion is drawn and adapted from my earlier article on secondary liability under Rule 10b-5. Chrisman, *supra* note 15, at 203-06.

38. An indenture trustee can be thought of as a "third party administrator" of the indenture, or debt contract. The indenture sets out the rights and duties of all the parties involved, including the duties of the indenture trustee, which is usually a bank that acts as the agent for the individual public bond holders handling such duties as monitoring the terms of the indenture. THOMAS LEE HAZEN, *THE LAW OF SECURITIES REGULATION* § 19.1, at 726-27 (5th ed. 2005).

39. *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver*, 511 U.S. 164, 167 (1994).

40. *Id.*

41. *Id.*

42. *Id.* at 167-68.

43. *Central Bank*, 511 U.S. at 168.

44. *Id.*

45. *Id.* at 167-69. Interestingly, the issue of the validity of aiding and abetting was not initially challenged by either party in the petition for certiorari. *Id.* at 194-95 (Stevens, J., dissenting). Apparently, Central Bank of Denver had concluded that it could not prevail by

The Supreme Court began its analysis by noting that in § 10(b) and Rule 10b-5 cases, the Court “confront[s] two main issues.”⁴⁶ In stating and confronting these issues, the Court divided its § 10(b) and Rule 10b-5 methodology into a two-part analysis. The first part of the analysis involves determining whether the complained of actions fall within “the scope of conduct prohibited by § 10(b).”⁴⁷ For this part, “the text of the statute controls . . . [because] adherence to the statutory language . . . [is] ‘[t]he starting point in every case involving construction of a statute.’”⁴⁸ However, “[w]hen the text of § 10(b) does not resolve a particular issue, [the Court] attempt[s] to infer ‘how the 1934 Congress would have addressed the issue had the 10b-5 action been included as an express provision in the 1934 Act.’”⁴⁹ Before the Court could address the second issue, it had to determine whether the conduct fell within the scope of prohibited conduct under § 10(b).

Since § 10(b) is not self-executing but requires “such rules and regulations as the [SEC] may prescribe”⁵⁰ to carry it into action, “in cases where the defendant has committed a violation of § 10(b),” the second part of the analysis requires determining whether the defendant’s conduct satisfies the remaining elements of the Rule 10b-5 cause of action.⁵¹ Clearly, the language of the statute also informs the elements

challenging aiding and abetting, but was instead arguing that “an indenture trustee could [not] be found liable as an aider and abettor absent a breach of an indenture agreement or other duty under state law, and [that] it could [not] be liable as an aider and abettor based only on a showing of recklessness.” *Central Bank*, 511 U.S. at 194. In the grant of certiorari, however, the Supreme Court stated, “[i]n addition to [a question presented in the petition for certiorari], the parties are directed first to brief and argue the following question: ‘Whether there is an implied private right of action for aiding and abetting violations of Section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5.’” *Cent. Bank of Denver, N.A., v. First Interstate Bank of Denver, N.A.*, 508 U.S. 959, 959 (1993).

46. *Central Bank*, 511 U.S. at 172.

47. *Id.*

48. *Id.* at 173 (quoting *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 197 (1976)).

49. *Id.* at 178 (quoting *Musick, Peeler, & Garrett v. Employers Ins. of Wausau*, 508 U.S. 286, 294 (1993)). The Court went on to state that in determining how the 1934 Congress would have addressed the issue, the Court

use[s] the express causes of action in the securities Acts as the primary model for the § 10(b) action. The reason is evident: Had the 73d Congress enacted a private § 10(b) right of action, it likely would have designed it in a manner similar to the other private rights of action in the securities Acts.

Id. (citing *Musick, Peeler*, 508 U.S. at 294-97).

50. 15 U.S.C.A. § 78j(b) (West 2006).

51. *Central Bank*, 511 U.S. at 172.

of the implied private cause of action under the rule.⁵² However, the language of the rule cannot extend the reach of the statute.⁵³

In applying this methodology to the facts of the case, Justice Kennedy, writing for the Court, held:

In § 10(b), Congress prohibited manipulative or deceptive acts in connection with the purchase or sale of securities. It envisioned that the SEC would enforce the statutory prohibition through administrative and injunctive actions. Of course, a private plaintiff now may bring suit against violators of § 10(b). But *the private plaintiff may not bring a 10b-5 suit against a defendant for acts not prohibited by the text of § 10(b).* . . . We have refused to allow 10b-5 challenges to conduct not prohibited by the text of the statute.⁵⁴

Following this logic, the Court reasoned that because the text of § 10(b) does not reach aiding and abetting, there is no aiding and abetting cause of action under § 10(b).⁵⁵ Consequently, there could be no aiding and abetting under Rule 10b-5 because a rule cannot exceed the authority of its enabling statute.

Although unnecessary to the resolution of the case, the Court also compared the implied cause of action under Rule 10b-5 with the express causes of action in the 1934 Act. Based upon this comparison, the Court concluded:

From the fact that Congress did not attach private aiding and abetting liability to any of the express causes of action in the securities Acts, we can infer that Congress likely would not have attached aiding and abetting liability to § 10(b) had it provided a private § 10(b) cause of action.⁵⁶

Even though the Supreme Court unambiguously eliminated the private cause of action for § 10(b) aiding and abetting violations, and, by

52. See, e.g., *Ernst & Ernst*, 425 U.S. at 199-201 (looking at the statute in order to develop the scienter requirement).

53. *Id.* at 213-14 (“The rulemaking power granted to an administrative agency charged with the administration of a federal statute is not the power to make law. Rather, it is the power to adopt regulations to carry into effect the will of Congress as expressed by the statute. Thus, despite the broad view of the Rule advanced by the Commission in this case, [the rule’s] scope cannot exceed the power granted the Commission by Congress under § 10(b).” (citations omitted)). See also *United States v. O’Hagan*, 521 U.S. 642, 651 (1997) (“Liability under Rule 10b-5, our precedent indicates, does not extend beyond conduct encompassed by § 10(b)’s prohibition.”) (citing *Ernst & Ernst*, 425 U.S. at 213-14; *Central Bank*, 511 U.S. at 173).

54. *Central Bank*, 511 U.S. at 173 (emphasis added) (internal quotation marks omitted).

55. *Id.* at 177 (“It is inconsistent with settled methodology in § 10(b) cases to extend liability beyond the scope of the conduct prohibited by the statutory text.”).

56. *Id.* at 179.

extension, eliminated all forms of secondary liability under § 10(b),⁵⁷ the Court did not let secondary actors off the hook altogether. In summarizing its holding, the Court stated:

Because the text of § 10(b) does not prohibit aiding and abetting, we hold that a private plaintiff may not maintain an aiding and abetting suit under § 10(b). The 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. In any complex securities fraud, moreover, there are likely to be multiple violators⁵⁸

Thus, while the Court by its holding in *Central Bank* seemed to provide a definitive answer that there is no secondary liability under § 10(b) and Rule 10b-5,⁵⁹ its conclusion raised another question that proved to be more perplexing for the lower courts: when does a secondary actor's conduct rise to the level of a primary violation?⁶⁰ To answer this

57. *Id.* at 200-01 (Stevens, J., dissenting) (noting that the reasoning of the Court with regard to aiding and abetting "would sweep away" other forms of secondary liability not expressly provided for in the statutes, such as conspiracy, respondeat superior, and other common law agency principles). Congress apparently agreed and in the Private Securities Litigation Reform Act added § 20(e) to the 1934 Act, specifically authorizing SEC enforcement actions against knowing aiders and abettors. 15 U.S.C.A. § 78t (West 2006). *See also* Regents of the Univ. of Cal. v. Credit Suisse First Boston (USA), Inc., 482 F.3d 372, 386 (5th Cir. 2007) (noting that in *Central Bank*, "the Court conclusively foreclosed the application of secondary liability under § 10(b) [but] stated that secondary actors can be liable as primary violators in some circumstances"). The problem arises in that "[t]he Court has never . . . precisely delineated the boundary between primary and secondary liability" and "the lower courts have struggled to do so . . ." *Id.*

58. *Central Bank*, 511 U.S. at 191 (first emphasis added) (citing Fischel, *supra* note 11, at 107-08).

59. Controlling person liability, a special type of secondary liability, survives *Central Bank*. Section 20 of the 1934 Act holds a "controlling person" jointly and severally liable for doing an "act or thing which it would be unlawful for such person to do under the provisions of this chapter or any rule or regulation thereunder through or by means of any other person." Securities Exchange Act of 1934 § 20(b) (codified as amended at 15 U.S.C. § 78t(b)). *See also* 9 LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION § 11-D-1 (3d ed. 2004) (discussing how control person liability survives *Central Bank*).

60. That this question has proved more perplexing than secondary liability in general is illustrated by the relative difficulties that courts have encountered in answering the two questions. Prior to *Central Bank*, every federal circuit had concluded that an aiding and abetting cause of action existed under § 10(b) and Rule 10b-5. *Central Bank*, 511 U.S. at 192 (Stevens, J., dissenting). Further, prior to *Central Bank*, the federal circuits and the SEC had long recognized actions for conspiracy and other forms of secondary liability as well. *Id.* at

question, one must address the question presented in *Stoneridge* and discussed herein: does § 10(b) require that a secondary actor actually make a misstatement or omission in order to be held liable as a primary violator under the Rule 10b-5 implied cause of action?

II. STILL FLOUNDERING IN THE WAKE OF *CENTRAL BANK*'

After *Central Bank*, “the lower courts and commentators struggled to delineate the point at which a secondary actor’s conduct rises to the level of a primary violation.”⁶¹ Some fourteen years after *Central Bank* and six years after this author wrote those words,⁶² the lower courts and commentators are still struggling to determine when the actions of a secondary actor give rise to primary liability under § 10(b) and Rule 10b-5. Further, this struggle, although not always stated in these terms, centers upon the question set forth above.⁶³ The following discusses the development of the case law following *Central Bank*, first as it relates to the initial tests proposed for determining whether a secondary actor’s actions amounted to a primary violation, and then turning to scheme liability.

A. “Bright Line,” “Substantial Participation,” or Something Else?

After *Central Bank*, the courts initially focused on the proper test to apply to determine when a secondary actor’s conduct amounted to a primary violation.⁶⁴ Courts and commentators addressing this issue have most commonly applied one of two tests: the “bright line” test⁶⁵ or the

200-01 (Stevens, J., dissenting). Conversely, the federal circuits have had a much more difficult time agreeing when a secondary actor’s conduct rises to the level of a primary violation. See *supra* note 18.

61. Chrisman, *supra* note 15, at 202. See, e.g., *Regents*, 482 F.3d at 386.

62. Chrisman, *supra* note 15.

63. See *supra* Part I.

64. Much of the following discussion is drawn and adapted from my earlier article on secondary liability under Rule 10b-5. Chrisman, *supra* note 15, at 207-19.

65. See, e.g., *Wright v. Ernst & Young LLP*, 152 F.3d 169, 175 (2d Cir. 1998), cert. denied, 525 U.S. 1104 (1999); *Dannenberg v. PaineWebber Inc.* (*In re Software Toolworks Inc.*), 50 F.3d 615, 628 n.3 (9th Cir. 1994); *In re Kendall Square Research Corp.*, 868 F. Supp. 26, 28 (D. Mass. 1994); *Vosgerichian v. Commodore Int’l*, 862 F. Supp. 1371, 1378 (E.D. Pa. 1994); *In re ZZZZ Best*, 864 F. Supp. 960, 966 (C.D. Cal. 1994); De Leon, *supra* note 18, at 729-33; Prentice, *supra* note 18, at 725.

“substantial participation” test.⁶⁶ The following discusses these two tests.

1. The “Bright Line” Test

Many courts have interpreted *Central Bank* to mean that, to be a primary violator under § 10(b) and Rule 10b-5, the secondary actor must actually make the material misstatement or omission.⁶⁷ This view reflects the “bright line” test.⁶⁸

66. Courts and commentators have not consistently used the same nomenclature for these tests. This Article’s use of “bright line” and “substantial participation” was inspired by the Second Circuit’s discussion in *Wright*, 152 F.3d at 175. Further, the SEC has proposed a third test that purports to be a compromise between the other two tests. However, no circuit court of appeals has yet adopted the SEC’s test and therefore it is not addressed herein. The closest call came when a panel of the Third Circuit was apparently ready to adopt the SEC’s test. See Stephen Poss, *Klein v. Boyd: Holding Securities Lawyers Liable Under Rule 10b-5*, INSIGHTS: THE CORP. & SEC. LAW ADVISOR, May 1998, at 2. However, the court then granted review en banc vacating the prior decision, and the parties settled prior to the en banc hearing. *Klein v. Boyd*, Nos. 97-1143, 97-1261, 1998 WL 55245 (3d Cir. Feb. 12, 1998). See Schanbaum, *supra* note 18, at 202-05 (discussing the co-creator test and noting that some district court’s have adopted the test). Finally, the SEC test seems closer to substantial participation than the bright line test, and would likely rise or fall with the fate of the substantial participation test.

67. See *Wright*, 152 F.3d at 175 (“[I]f *Central Bank* is to have any real meaning, a defendant must actually make a false or misleading statement in order to be held liable under Section 10(b). Anything short of such conduct is merely aiding and abetting, and no matter how substantial that aid may be, it is not enough to trigger liability under Section 10(b).” (citation omitted)). See also *Lattanzio v. Deloitte & Touche LLP*, 476 F.3d 147, 153 (2d Cir. 2007) (“The starting point for analysis is [*Central Bank*], which held that § 10(b) imposes liability only on a person who makes a material misstatement or omission, and that there is therefore no liability for aiding and abetting.”); *Overton v. Todman & Co., CPAs, P.C.*, 478 F.3d 479, 487 (2d Cir. 2007) (“[W]e remain true to [*Central Bank*’s] prohibition on aiding and abetting liability because we require that an accountant make its own misleading omission by failing to correct its certified opinion.”); *Ziemba v. Cascade Int’l, Inc.*, 256 F.3d 1194, 1205 (11th Cir. 2001) (“[W]e conclude that, in light of *Central Bank*, in order for the defendant to be primarily liable under § 10(b) and Rule 10b-5, the alleged misstatement or omission upon which a plaintiff relied must have been publicly attributable to the defendant at the time that the plaintiff’s investment decision was made.”); *Shapiro v. Cantor*, 123 F.3d 717, 720-21 (2d Cir. 1997) (“A claim under § 10(b) must allege a defendant has made a material misstatement or omission indicating an intent to deceive or defraud in connection with the purchase or sale of a security.”); *Anixter v. Home-Stake Production Co.*, 77 F.3d 1215, 1224 (10th Cir. 1996) (“In [*Central Bank*], the Supreme Court concluded that 10(b) prohibits only the making of a material misstatement (or omission) or the commission of a manipulative act.” (internal quotation marks omitted)); *S.E.C. v. Lucent Technologies, Inc.*, 363 F. Supp. 2d 708, 720 (D. N.J. 2005) (discussing “bright line” and “substantial participation,” applying the former and requiring “that a [violator] must actually make the material misstatement or omission”); *Copland v. Grumet*, 88 F. Supp. 2d 326, 332 (D. N.J. 1999) (holding that for claims based on misrepresentations, the misrepresentations must be attributable to the defendant); *Kendall Square*, 868 F. Supp. at 28 (“Only primary violators, i.e., those who *make* a material

*In re Kendall Square Research Corporation Securities Litigation*⁶⁹ exemplifies the use of the “bright line” test. In *Kendall Square*, plaintiffs brought suit against several defendants, alleging “losses as a result of materially misleading statements of revenues from the sale of [Kendall Square Research Corporation’s] high performance parallel computer systems.”⁷⁰ All of the defendants settled except for Price Waterhouse, one of the then “big five” accounting firms,⁷¹ and the company’s auditor.⁷² The complaint alleged that Price Waterhouse violated § 10(b) and Rule 10b-5 by: (1) reviewing and approving quarterly financial reports for the company, (2) issuing an unqualified audit opinion⁷³ on the company’s financial statements, and (3) reviewing and approving representations made in the company’s prospectuses for stock offerings.⁷⁴

The United States District Court for the District of Massachusetts refused to dismiss the claim that Price Waterhouse could be held liable as a primary violator of § 10(b) and Rule 10b-5 for its unqualified audit opinion on financial statements containing material misstatements of revenues.⁷⁵ Although the court failed to fully explain why it refused to dismiss the claim,⁷⁶ it seems logical that if Price Waterhouse’s statements in its unqualified audit opinion suggesting that Kendall Square’s financial statements were prepared in accordance with Generally Accepted Accounting Principles (“GAAP”) turned out to be false, then Price Waterhouse could be held liable as a primary violator, provided the other elements of a primary violation are present.⁷⁷

misstatement or omission or commit a manipulative act, are subject to private suit under Section 10(b)” (emphasis in original); *Vosgerichian*, 862 F. Supp. at 1378 (concluding that § 10(b) liability requires a manipulation, misrepresentation, or omission).

68. See *Wright*, 152 F.3d at 175.

69. 868 F. Supp. 26 (D. Mass. 1994).

70. *Id.* at 27.

71. The “big five” accounting firms were reduced to the “big four” by the implosion of Arthur Andersen following Enron and other securities fraud debacles.

72. *Kendall Square*, 868 F. Supp. at 27.

73. This is a type of audit opinion that basically states that the audit was performed in accordance with Generally Accepted Auditing Standards (GAAS), and that the company’s financial statements comply with Generally Accepted Accounting Principles (GAAP). It is also known as a “clean” audit opinion. See *S.E.C. v. Price Waterhouse*, 797 F. Supp. 1217, 1223, n.17 (S.D.N.Y. 1992). See generally American Institute of Certified Public Accountants, www.aicpa.org (last visited Feb. 25, 2008).

74. *Kendall Square*, 868 F. Supp. at 26-28.

75. *Id.* at 281.

76. *Id.*

77. A major element in such a case would likely be scienter.

On the other hand, the court found Price Waterhouse immune from liability for reviewing and approving the company's quarterly financial reports and prospectuses for stock offerings, and consequently dismissed that claim.⁷⁸ In so holding, the court stated:

The Supreme Court's decision in *Central Bank* makes clear that the policy undergirding it is to constrict the ambit of private actions under Section 10(b) and to thereby reduce the number of parties implicated by that statute. *Only primary violators, i.e., those who make a material misstatement or omission or commit a manipulative act, are subject to private suit under Section 10(b).* . . .

The Court rules that the [complaint]'s allegations that Price Waterhouse reviewed and approved the quarterly financial statements and the Prospectuses do not constitute the *making* of a material misstatement; at most, the conduct constitutes aiding and abetting and is thus not cognizable under Section 10(b). Because Price Waterhouse did not actually engage in the reporting of the financial statements and Prospectuses, but merely reviewed and approved them, the statements are not attributable to Price Waterhouse and thus Price Waterhouse cannot be found liable for *making* a material misstatement.⁷⁹

Relying on the Supreme Court's holding in *Central Bank* that Section 10(b) "prohibits only the making of a material misstatement (or omission),"⁸⁰ the court concluded that, in order to be liable as a primary violator, the defendant must actually make a material misstatement or omission.⁸¹ The court concluded that Price Waterhouse did not make the misstatements contained in the financial statements and prospectuses because those documents, and the misstatements contained therein, were not "attributable" to Price Waterhouse.⁸² Accordingly, the court held that the plaintiffs' claims based on the financial statements and prospectuses could not go forward.⁸³

In *Wright v. Ernst & Young LLP*,⁸⁴ the plaintiffs brought suit against Ernst & Young, another of the then "big five" accounting firms, for an alleged primary violation of § 10(b). The violation alleged was that Ernst & Young gave "private approval of the information contained in a press release"⁸⁵ that was issued "with a notation that the information

78. *Kendall Square*, 868 F. Supp. at 28.

79. *Id.* at 28 (citations omitted) (emphasis added).

80. *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 177 (1994).

81. *Kendall Square*, 868 F. Supp. at 28.

82. *Id.*

83. *Id.*

84. 152 F.3d 169 (2d Cir. 1998), *cert. denied*, 525 U.S. 1104 (1999).

85. *Id.* at 171.

[was] unaudited and without mention of [the company's] outside auditor."⁸⁶ The Second Circuit began by reviewing the approaches taken by several courts since the Supreme Court's decision in *Central Bank*.⁸⁷ The court concluded that *Central Bank* requires that the defendant actually make the misstatement or omission to be held liable under § 10(b) and Rule 10b-5.⁸⁸ The court determined that, of the two tests, only the bright line test actually imposes such a requirement.⁸⁹

After concluding that *Central Bank* mandates the use of the "bright line" test,⁹⁰ the court stated:

We therefore agree with the district court that holding Ernst & Young primarily liable under the Act "in spite of its clearly tangential role in the alleged fraud would effectively revive aiding and abetting liability under a different name, and would therefore run afoul of the Supreme Court's holding in *Central Bank*."⁹¹

Like the district court in *Kendall Square*, the Second Circuit held that a secondary actor must actually make the material misstatement or omission in order for its conduct to rise to the level of a primary violation.⁹² In addition, the court concluded that "the misrepresentation must be attributed to that specific actor at the time of public dissemination"⁹³ before that actor could be liable as a primary violator.

While attempting to answer what it means to make a misstatement or omission, the Second Circuit left unanswered another question: how does one determine whether the misrepresentation has been "attributed" to the secondary actor? To say that the misstatement or omission must be "attributed" to the secondary actor provides no more guidance than to simply reiterate that the secondary actor must actually make the misstatement or omission in order to be held liable. Again, like *Kendall Square*, the court seems to have intuitively determined which statements were actually made by the defendants without articulating a test by which it arrived at its determination.⁹⁴

86. *Id.*

87. *Id.* at 174-75.

88. *Wright v. Ernst & Young, LLP*, 152 F.3d 169, 174-75 (2d Cir. 1998).

89. *Id.*

90. *Id.* at 175.

91. *Id.* (quoting *Wright v. Ernst & Young, LLP*, No. 97 CIV. 2189(SAS), 1997 WL 563782, at *3 (S.D.N.Y. Sept. 10, 1997)).

92. *Wright*, 152 F.3d at 175.

93. *Id.*

94. The issue of the proper test for whether a secondary actor has made a misstatement or omission is not the primary focus of this Article. However, in *Chrisman*, *supra* note 15, at

Other courts have applied the “bright line” test.⁹⁵ In *In re MTC Electronic Technologies Shareholders Litigation*,⁹⁶ plaintiff shareholders brought suit in the United States District Court for the Eastern District of New York, alleging that MTC had made misrepresentations.⁹⁷ Specifically, plaintiffs alleged that the company falsely stated in press statements and SEC filings that the company had secured agreements to provide cellular phone service and related equipment to customers in China.⁹⁸ When it was revealed that no such agreements existed, MTC Electronics’ stock price plummeted,⁹⁹ and those shareholders injured by the price drop sued various officers, the underwriters of the company’s stock offerings (H.J. Meyers), and the company’s accounting firm (DBO Dunwoody).¹⁰⁰

The plaintiffs alleged that H.J. Meyers was a primary violator of § 10(b) and Rule 10b-5 for having participated in the drafting and dissemination of the company’s November 1991 prospectus for its public offering, and for the dissemination of a research report on the company that contained allegedly false statements made by H.J. Meyers.¹⁰¹ The court held that a suit could not be maintained against H.J. Meyers for having participated in the drafting and dissemination of the prospectus, but that a suit could be maintained against H.J. Meyers for its allegedly false statements made in a research report that it had disseminated.¹⁰² Again, like the courts in *Kendall Square*¹⁰³ and *Wright*,¹⁰⁴ the *MTC Electronics* court determined that the secondary

219-22, I suggest a “reasonable investor” test. Regardless of the test, it is much more important to note as a primary concern that the Second Circuit clearly concluded that a misstatement or omission is required for primary liability.

95. See *Wright v. Ernst & Young*, 152 F.3d 169 (2d Cir. 1998), *cert. denied*, 525 U.S. 1104 (1999); *Anixter v. Home-Stake Prod. Co.*, 77 F.3d 1215 (10th Cir. 1996); *Picard Chem. Inc. Profit Sharing Plan v. Perrigo Co.*, 940 F. Supp. 1101 (W.D. Mich. 1996); *Aetos Corp. v. Tycom Foods, Inc.*, No 04-3305, 2005 U.S. App. LEXIS 24165 (3d Cir. Nov. 9, 2005), *cert. denied*, 525 U.S. 1104 (1999).

96. 898 F. Supp. 974 (E.D.N.Y. 1995), *vacated in part*, 993 F. Supp. 160 (E.D.N.Y. 1997).

97. *Id.* at 977.

98. *Id.* at 977-78 (noting that the price of the stock went from \$5 per share to \$30 per share after the public statements).

99. *Id.* at 978.

100. *MTC Elecs.*, 898 F. Supp. at 978.

101. *Id.* at 984.

102. *Id.* at 987.

103. See *supra* notes 69-83 and accompanying text.

104. See *supra* notes 84-93 and accompanying text.

actor must actually make the misstatement or omission to be held liable.¹⁰⁵

Similarly, the court ruled that a suit could be maintained against DBO Dunwoody based on its issuance of an unqualified audit opinion.¹⁰⁶ Like the court in *Kendall Square*,¹⁰⁷ the court in *MTC Electronics* concluded that because an auditor actually makes statements in its audit opinion, the auditor could be held liable as a primary violator if those statements turn out to be false or misleading.¹⁰⁸

In analyzing the various claims against these parties and the confusion of the lower courts regarding what constitutes a primary violation, the court made the following statement, which has been used by courts¹⁰⁹ and commentators¹¹⁰ to articulate the “bright line” test and the reasoning behind it.

[I]f *Central Bank* is to have any real meaning, a defendant must actually make a false or misleading statement in order to be held liable under Section 10(b). Anything short of such conduct is merely aiding and abetting, and *no matter how substantial that aid may be, it is not enough to trigger liability under Section 10(b)*.¹¹¹

Like the courts in *Kendall Square* and *Wright*,¹¹² the court asserted that the misstatement or omission must be made by the secondary actor for primary liability to attach. Anything short of that is “merely aiding and abetting.”¹¹³

In summary, the “bright-line” test is not really a test at all. Instead, it is more of a statement: *in order to be a primary violator of Rule 10b-5, the secondary actor must actually make the misstatement or omission in question*. For example, in *MTC Electronics*, the court stated, “a defendant must actually make a false or misleading statement in order to be [a primary violator].”¹¹⁴ Further, in *Kendall Square*, the court held that “[o]nly primary violators, i.e., those who make a material misstatement or omission . . . are subject to private suit under Section

105. *MTC Elecs.*, 898 F. Supp. at 989.

106. *Id.*

107. *See supra* notes 69-83 and accompanying text.

108. *MTC Elecs.*, 898 F. Supp. at 989.

109. *See, e.g.*, *Wright v. Ernst & Young, LLP*, 152 F.3d 169, 175 (2d Cir. 1998).

110. *See, e.g.*, Prentice, *supra* note 18, at 725.

111. *MTC Elecs.*, 898 F. Supp. at 987 (emphasis added).

112. *See supra* notes 84-93 and accompanying text.

113. *MTC Elecs.*, 898 F. Supp. at 987.

114. *Id.*

10(b).”¹¹⁵ These cases demonstrate that the courts adopting the bright line test have done so based in large part upon the understanding that *Central Bank* and the language of § 10(b) require that a secondary actor must actually make the misstatement or omission in order to be held primarily liable. As described below, the “substantial participation” test and scheme liability both require the rejection of this understanding of *Central Bank* and § 10(b).

2. The “Substantial Participation” Test

Following *Central Bank*, some courts held that in order to be a primary violator under § 10(b) and Rule 10b-5, the secondary actor need not actually make the material misstatement or omission (as in the “bright line” test), but may be held liable for participating in the fraud in some “substantial” way.¹¹⁶ This became known as the “substantial participation” test.¹¹⁷

A famous case applying the “substantial participation” test is *In re ZZZZ Best Securities Litigation*,¹¹⁸ which resulted from the bankruptcy of ZZZZ Best Co., once regarded as the nation’s largest carpet cleaning company. The company’s founder and largest shareholder perpetrated a scam to pass the company off as being extremely successful; he was “ultimately convicted and imprisoned for fraud and embezzlement.”¹¹⁹ The plaintiffs in *ZZZZ Best* sued, among many others, the company’s auditor, Ernst & Young. They alleged that Ernst & Young violated § 10(b) and Rule 10b-5 by issuing a review report¹²⁰ on certain interim

115. *In re Kendall Square Research Corp.*, 868 F. Supp. 26, 28 (D. Mass. 1994).

116. *See* *Dannenberg v. PaineWebber, Inc. (In re Software Toolworks, Inc.)*, 50 F.3d 615, 628 n.3 (9th Cir. 1994); *Cashman v. Coopers & Lybrand*, 877 F. Supp. 425 (N.D. Ill. 1995); *In re U.S.A. Classic*, No. 93-6667, 1995 WL 363841 (S.D.N.Y. June 19, 1995); *In re ZZZZ Best*, 864 F. Supp. 960, 971 (C.D. Cal. 1994).

117. *See* *Wright v. Ernst & Young, LLP*, 152 F.3d 169, 175 (2d Cir. 1998).

118. 864 F. Supp. 960 (C.D. Cal. 1994).

119. *Id.* at 963.

120. A review report is a report issued on some type of financial information when less than an audit has been performed. A review report provides less assurance than does an audit and accompanying opinion.

For a *review report*, the accountant must make the following statements:

The service provided—a review—was performed in accordance with the SSARS standards established by the AICPA.

All information included in the financial statements is the representation of the entity’s management.

A review consists principally of inquiries of entity personnel and analytical procedures applied to financial data.

financial information released by the company, and by its involvement in the creation, review, and issuance of some thirteen other public statements released by the company and others.¹²¹ These statements did not contain any indication that Ernst & Young assisted ZZZZ Best Co. in the creation, review, or issuance of these public statements.¹²²

Ernst & Young conceded that it made the review report and that it could be liable as a primary violator provided the other elements were met; however, Ernst & Young argued that it did not make the other thirteen statements, and thus those statements could not lead to a primary violation.¹²³ The United State District Court for the Central District of California began its analysis by noting, “in *Central Bank*, the Supreme Court’s opinion makes clear that *more than simply knowing assistance with the underlying fraudulent scheme* is required for Section 10(b) liability.”¹²⁴ However, relying on pre-*Central Bank* authority, the court disagreed with Ernst & Young’s position¹²⁵ and ruled, “anyone intricately involved in [the] creation [of public statements such as those at issue] . . . should be held liable under Section 10(b)/Rule 10b-5.”¹²⁶

*In re Software Toolworks Inc. Securities Litigation*¹²⁷ is another case in which the court applied the “substantial participation” test. *Software Toolworks* involved disappointed investors who brought suit

A review is substantially narrower in scope than an audit, the objective of which is the expression of an opinion on financial statements taken as a whole, and that, accordingly, no opinion is expressed.

The accountant is not aware of any material modifications that should be made to the financial statements in order for them to be in conformity with generally accepted accounting principles (GAAP)—other than those modifications, if any, indicated in his report.

D. EDWARD MARTIN, ATTORNEY’S HANDBOOK OF ACCOUNTING, AUDITING & FINANCIAL REPORTING § 13.04 (2007).

121. *ZZZZ Best*, 864 F. Supp. at 964.

122. *Id.* at 965.

123. *Id.*

124. *Id.* at 969 (emphasis added). This statement by the Ninth Circuit is wholly contradicted by the *Ninth Circuit’s decision in Simpson v. AOL Time Warner Inc.*, 452 F.3d 1040 (9th Cir. 2006). See *infra* note 153 and accompanying text. In *ZZZZ Best*, the Ninth Circuit recognized that knowing assistance is not enough under *Central Bank*; however, under *Simpson*, the Ninth Circuit imposed the principal purpose and effects test. Under both “knowing assistance” and “principal purpose and effects” tests, the focus is not on the actions, which may be innocent in and of themselves, but on the intent. In other words, secondary actors can assist under both tests, but they cannot have the intent to defraud. The Ninth Circuit’s jurisprudence is wholly inconsistent and is not in the least persuasive.

125. Ernst & Young essentially argued for the “bright line” test. *ZZZZ Best*, 864 F. Supp. at 968.

126. *Id.* at 970.

127. 50 F.3d 615 (9th Cir. 1994).

against Deloitte & Touche (another of the then “big five” accounting firms), underwriters, and others for alleged violations of § 10(b) and Rule 10b-5 after the company’s stock lost substantially all its value.¹²⁸ The complaint alleged that the accountants were primary violators because they reviewed a duplicitous letter to the SEC, consulted the company about the letter, and drafted and edited another such letter.¹²⁹ Though both letters were issued by the company and not by Deloitte & Touche, the Ninth Circuit concluded, “[t]his evidence is sufficient to sustain a primary cause of action under section 10(b) and, as a result, *Central Bank* does not absolve Deloitte”¹³⁰ In a later case, in citing and discussing its holding in *Software Toolworks*, the Ninth Circuit stated, “we have held that substantial participation or intricate involvement in the preparation of fraudulent statements is grounds for primary liability even though that participation might not lead to the actor’s actual making of the statements.”¹³¹

A fair statement of the “substantial participation” test is as follows: *a secondary actor who substantially participates in the production of documents or other materials that contain misstatements or omissions may be held liable as a primary violator of Rule 10b-5 even though the actor does not actually make a misstatement or omission.* This characterization of Rule 10b-5 liability is at great variance with the “bright line” test, with the critical distinction being whether the secondary actor must actually make a misstatement or omission to be held liable. Nevertheless, this statement of the rule consistently requires that someone must make a misstatement or omission; the only question left is who made it? Or, more specifically, who is liable for making it? The “substantial participation test” presumes that someone made a misstatement but imputes the misstatement of the primary actor to the secondary actor. Partly building upon this foundation, scheme liability

128. *Id.* at 620.

129. *Id.* at 627-29.

130. *Id.* at 628 n.3.

131. *Howard v. Everex Sys.*, 228 F.3d 1057, 1061 n.5 (9th Cir. 2000). Other cases have also concluded that substantial participation constitutes a primary violation. In *Cashman v. Coopers & Lybrand*, the United States District Court for the Northern District of Illinois held that Coopers & Lybrand (another of the then “big-five”) could be liable under § 10(b) and Rule 10b-5 for “play[ing] a central role in the drafting and formation of the alleged misstatements.” *Cashman v. Coopers & Lybrand*, 877 F. Supp. 425, 432 (N.D. Ill. 1995). Further, in *Phillips v. Kidder, Peabody & Co.*, the District Court for the Southern District of New York held that the underwriter could be liable for “actively participat[ing] in formulating the language of the prospectus . . . even though the prospectus was published in the name of the issuer.” 933 F. Supp. 303, 316 (S.D.N.Y. 1996), *aff’d*, 108 F.3d 1370 (2nd Cir. 1997).

purports that a secondary actor can be a primary violator under Rule 10b-5(a) and (c) without making a misstatement or omission, because these subsections by their words do not require a misstatement or omission.

B. The Rise (and Fall?) of Scheme Liability

As the preceding demonstrates, the real issue underlying the circuit split on the liability of secondary actors is a disagreement as to whether *Central Bank* and § 10(b) require that a defendant actually make a misstatement or omission, or whether it is sufficient merely that some party, somewhere, makes a misstatement or omission. A new argument forwarded by the plaintiffs' bar brought this issue to a head. Following in the vein of the substantial participation test, some plaintiffs, unhappy with judgments against insolvent primary actors, began arguing that a secondary actor who had not made a misstatement or omission should be liable as a primary violator pursuant to Rule 10b-5(a) and (c) for participation in a "scheme to defraud" (referred to as "scheme liability"). These plaintiffs agree that Rule 10b-5(b) requires a misstatement or omission, but argue that subsections (a) and (c) do not. Therefore, they argue that a defendant's participation or assistance in the preparation of the misstatement is not required (as under substantial participation) but that only participation in a scheme to defraud should be sufficient to establish liability. The following first discusses scheme liability as it developed in three opinions in the circuit courts of appeals, and then discusses the Supreme Court's attempt to resolve the issue in *Stoneridge*.

1. Scheme Liability in the Circuit Courts of Appeals

Like "bright line" and "substantial participation," scheme liability split the circuits.¹³² The Ninth Circuit endorsed scheme liability and even propounded a test to determine when a secondary actor may be liable thereunder.¹³³ On the other hand, the Fifth and Eighth Circuits rejected scheme liability, branding it, like the substantial participation test, nothing more than aiding and abetting by another name.¹³⁴ Again,

132. See *supra* note 18 and accompanying text for sources supporting a split in the circuits.

133. See *supra* note 18 for sources, including the test propounded by the Ninth Circuit.

134. *In re Charter Communications, Inc.*, 443 F.3d 987 (8th Cir. 2006) (rejecting a claim of scheme liability); *Regents of the University of California v. Credit Suisse First Boston (USA), Inc.*, 482 F.3d 372 (5th Cir. 2007) (rejecting a claim of scheme liability). See also

as the following demonstrates, the critical issue in these cases is whether § 10(b) requires that a secondary actor actually make a misstatement or omission in order to be held liable as a primary violator of § 10(b) and Rule 10b-5.

In *In re Charter Communications, Inc., Securities Litigation*,¹³⁵ the initial circuit court case addressing scheme liability, the plaintiffs essentially alleged that Charter, “one of the nation’s largest cable television providers,” engaged in various fraudulent activities designed to inflate its financial statements.¹³⁶ However, while the plaintiffs named several defendants, including Charter, Charter executives, and Arthur Andersen, LLP (Charter’s auditor), the opinion centered upon the liability of “two equipment vendors, Scientific-Atlanta, Inc., and Motorola, Inc. (collectively, ‘the Vendors’).”¹³⁷ The plaintiffs alleged that the Vendors violated § 10(b) and Rule 10b-5 by engaging in a scheme to defraud whereby they “enter[ed] into sham transactions with [Charter] that improperly inflated Charter’s reported operating revenues and cash flow.”¹³⁸

In describing the alleged scheme, the Eighth Circuit stated:

At the time in question, Charter delivered cable services through set-top boxes installed on customers’ TV sets. Charter purchased the set-top boxes from third-parties, including the Vendors. In August 2000, although Charter had firm contracts with the Vendors to purchase set-top boxes at a set price sufficient for its present needs, Charter agreed to pay the Vendors an additional \$20 per set-top box in exchange for the Vendors returning the additional payments to Charter in the form of advertising fees.

Plaintiffs alleged that these were sham or wash transactions with no economic substance, contrived to inflate Charter’s operating cash flow by some \$17,000,000 in the fourth quarter of 2000 in order to meet the revenue and operating cash flow expectations of Wall Street analysts. Charter accomplished the deception with fraudulent accounting by improperly capitalizing the increased equipment expenses while treating the returned advertising fees as immediate revenue. Plaintiffs alleged that the Vendors entered into these sham transactions knowing that Charter intended to account for them improperly and that analysts would rely on the inflated revenues and operating cash flow in making stock recommendations. Plaintiffs did not allege that the Vendors played any role in preparing or disseminating the

Taylor, *supra* note 35, 385 (arguing that the lower courts’ acceptance of either the substantial participation test or scheme liability as illustrated by the *Enron* court would have the same effect as reinstating aider and abettor liability in suits by private plaintiffs).

135. 443 F.3d 987 (8th Cir. 2006).

136. *Id.* at 989.

137. *Id.*

138. *Id.*

fraudulent financial statements and press releases through which Charter published its deception to analysts and investors.¹³⁹

The plaintiffs alleged that the Vendors were primary violators of “Rule 10b-5(a) and (c) by participating in a ‘scheme or artifice to defraud’ and by engaging in a ‘course of business which operates . . . as a fraud or deceit.’”¹⁴⁰ Many courts and commentators call this theory “scheme liability.”¹⁴¹

The plaintiffs’ argument in favor of scheme liability emphasizes the difference between the wording of Rule 10b-5(b), which plainly requires a misstatement, and subsections (a) and (c), which are much broader and do not plainly require a misstatement or omission.¹⁴² Further, the court noted that the plaintiff’s theory of scheme liability “depends on the assertion that *Central Bank*’s analysis did not affect the scope of primary liability under subparts (a) and (c).”¹⁴³

In rejecting these arguments and scheme liability, the court stated:

We conclude that *Central Bank* and the earlier cases on which it relied stand for three governing principles: (1) The Court’s categorical declaration that a private plaintiff “may not bring a 10b-5 suit against a defendant for acts not prohibited by the text of § 10(b)” included claims under Rule 10b-5(a) and (c), as well as Rule 10b-5(b). (2) A device or contrivance is not “deceptive,” within the meaning of § 10(b), absent some misstatement or a failure to disclose by one who has a duty to disclose. (3) The term “manipulative” in § 10(b) has the limited contextual meaning ascribed in *Santa Fe*. Thus, any defendant who does not make or affirmatively cause to be made a fraudulent misstatement or omission, or who does not directly engage in manipulative securities trading practices, is at most guilty of aiding and abetting and cannot be held liable under § 10(b) or any subpart of Rule 10b-5.¹⁴⁴

The court concluded that accepting scheme liability would violate *Central Bank* and related authority by allowing secondary actors to be held liable without their making a misstatement or omission, and would therefore be an unwarranted extension of securities fraud liability.¹⁴⁵

139. *Charter*, 443 F.3d at 989-90.

140. *Id.* at 991.

141. See Beattie, *supra* note 35 (dubbing “scheme liability” the “new risk on the [securities law] horizon”).

142. *Charter*, 443 F.3d at 991.

143. *Id.* (stating that the argument relies primarily upon “a recent district court decision,” *In re Parmalat*, 376 F. Supp. 2d 472, 492-503 (S.D.N.Y. 2005)).

144. *Id.* at 992 (citations omitted).

145. *Id.* at 992-93. The court found there to be no cases so extending the reach of § 10(b) and rule 10b-5 to include “a business that entered into an arm’s length non-securities

Further, the court noted that any decision so extending liability “should be made by Congress.”¹⁴⁶

Just two and a half months after *Charter*, the Ninth Circuit¹⁴⁷ issued its opinion in *Simpson v. AOL Time Warner Inc.*¹⁴⁸ The facts of *Simpson* are virtually indistinguishable from those in *Charter*.¹⁴⁹ In *Simpson*, the plaintiffs alleged that AOL Time Warner, Inc. and certain other outside parties and vendors (referred to herein collectively as “AOL”) engaged in a scheme to defraud in violation of § 10(b) and Rule 10b-5 by engaging in certain “round-trip transactions” that had no economic purpose other than to inflate the revenues of an Internet company, Homestore.com.¹⁵⁰ Despite virtually identical facts,¹⁵¹ the Ninth Circuit

transaction with an entity that then used the transaction to publish false and misleading statements.” *Id.* at 992. Further, the court stated that such an extension would “introduce potentially far-reaching duties and uncertainties for those engaged in day-to-day business dealings.” *Charter*, 443 F.3d at 993. Indeed, it would seem to extend liability to or perhaps even beyond its reach in the heyday of aiding and abetting liability. As one commentator stated, hopefully “scheme liability is likely to either overlap or supersede the coverage of fraudulent statement liability under Rule 10b-5(b).” Schanbaum, *supra* note 18, at 236.

146. *Charter*, 443 F.3d at 993; *see also* Joseph A. Grundfest, *Scheme Liability: A Question for Congress, Not the Courts* (Stanford Law and Econ. Olin Working Paper No. 344, 2007), available at <http://ssrn.com/abstract=1005524> (although an ardent opponent of judicially created “scheme liability,” respondents in *Stoneridge* retained Professor Grundfest to provide counsel in connection with that case).

147. The Ninth Circuit Court of Appeals has the dubious honor of being the circuit court most often overruled by the Supreme Court. *See* Grundfest, *supra* note 146, at 5 (citing *The Supreme Court, 2005 Term—The Statistics*, 120 HARV. L. REV. 372, 381 (2006) (indicating that the Supreme Court reversed or vacated the Ninth Circuit in fifteen out of eighteen cases during the 2005 term)).

148. 452 F.3d 1040 (9th Cir. 2006).

149. *Regents of the Univ. of Cal. v. Credit Suisse First Boston (USA), Inc.*, 482 F.3d 372, 386 n.24, 392 (5th Cir. 2007), *cert. denied*, 128 S. Ct. 1120 (2008). In an effort to distinguish its holding in *Simpson* from *Charter*, the Ninth Circuit cites *Charter* only once, stating that the primary factual difference is that *Charter* involved legitimate, arms-length transactions whereas *Simpson* did not. *Simpson v. AOL Time Warner Inc.*, 452 F.3d 1040, 1050 (9th Cir. 2006). The Supreme Court noted in its grant of certiorari, however, that the transactions in *Charter* involved “no legitimate business or economic purpose.” Further, the plaintiffs in *Charter* described the transactions as shams with “no economic substance” other than inflating *Charter*’s financial statements. *Charter*, 443 F.3d at 989-90. Accordingly, the Ninth Circuit’s attempt to distinguish *Charter* and thereby reconcile it with *Simpson* are wholly unpersuasive because the situations are essentially identical. *See Regents*, 482 F.3d at 392. The Supreme Court in *Stoneridge* noted that the “[d]ecisions of the Courts of Appeals are in conflict” with regard to scheme liability. *Stoneridge Inv. Partners, LLC v. ScientificAtlanta, Inc.*, 128 S. Ct. 761, 767 (2008).

150. *Simpson*, 452 F.3d at 1042-43.

151. In both cases, outside vendors entered into transactions with no business or economic purpose other than to aid the primary actor in overstating its financial condition, with no public misstatements by the vendor and no duty to disclose.

reached the polar opposite conclusion, holding that the plaintiffs could recover in such situations upon proper pleading under the theory of scheme liability pursuant to Rule 10b-5(a) and (c).¹⁵²

The Ninth Circuit rejected the notion that liability under Rule 10b-5 requires a misstatement or omission. Relying upon its formulation of the substantial participation test, the court stated, “[w]ith respect to the making of false statements or omissions, we have held that ‘substantial participation or intricate involvement in the preparation of fraudulent statements is grounds for primary liability even though that participation might not lead to the actor’s actual making of the statements.’”¹⁵³ Further, in response to the defendants’ argument “that imposing liability for participation in an overall scheme to defraud would impose liability for conduct other than the making of a material misstatement or omission and would conflict with *Central Bank*[.]” the court merely responds, “[w]e disagree.”¹⁵⁴ While not entirely clear from the court’s opinion, it appears that the court disagrees with the assertion that *Central Bank* stands for the premise that 10b-5 requires a misstatement or omission. This is not surprising and is entirely consistent with the court’s understanding of *Central Bank* that has previously led to its adoption of the “substantial participation” test.

The Ninth Circuit appears to rely again on the “substantial participation” test when it states, “[w]e see no justification to limit liability under § 10(b) to only those who draft or edit the statements released to the public.”¹⁵⁵ This assertion seems to fly in the face of *Central Bank*, a Supreme Court opinion, and, therefore, purportedly binding on the Ninth Circuit, which other courts had determined *would require that the defendants actually make the misstatements or omission*, not just “draft or edit” them.¹⁵⁶ Seeming to switch arguments in mid-stream, the Ninth Circuit cites Professor Prentice for the proposition that a defendant might be liable for the misstatements of another based upon the phrase “directly or indirectly” found in § 10(b) and Rule 10b-5.¹⁵⁷

152. *Simpson*, 452 F.3d at 1042-43, 1047-55. In *Simpson*, however, the Court found that the plaintiff’s complaint did not sufficiently allege scheme liability, and the Court affirmed the lower court opinion and remanded for further proceedings, presumably giving the plaintiffs the opportunity to amend their complaint in accordance with the Court’s opinion. *Id.* at 1043, 1055.

153. *Id.* at 1048 (quoting *Howard v. Everex Sys., Inc.*, 228 F.3d 1057, 1061 n.5 (9th Cir. 2000)).

154. *Id.* at 1049.

155. *Simpson*, 452 F.3d at 1049.

156. *See supra* Part II.A.

157. *Simpson*, 452 F.3d at 1049 (citing and quoting Prentice, *supra* note 18, at 731).

However, the Supreme Court already rejected a similar argument for aiding and abetting made by the plaintiffs in *Central Bank*.¹⁵⁸ As a result of this rather tortured reasoning, the court held that a secondary actor may be a primary violator “for participation in a ‘scheme to defraud’” so long as the secondary actor “engaged in conduct that had the *principal purpose and effect* of creating a false appearance of fact in furtherance of the scheme [to defraud].”¹⁵⁹

Further, scheme liability and its “principal purpose and effect test” is arguably just another form of secondary liability. Much like substantial participation, aiding and abetting, and conspiracy, scheme liability focuses on the actions and intent of the secondary actor rather than on whether the secondary actor has engaged in conduct upon which a plaintiff could presumptively or actually rely. Under all four theories of liability, some combination of act and scienter is required, but those acts need not be communicated to the market or the individual plaintiffs. For substantial participation, the secondary actor must substantially participate in the production of documents that contain a misstatement or omission that operates as a fraud.¹⁶⁰ For aiding and abetting, the plaintiff must prove “(1) a primary violation of § 10(b), (2) recklessness [or knowledge of the existence of a primary violation], and (3) substantial assistance given to the primary violator by the aider and abettor.”¹⁶¹ “Accordingly, the distinction between aiding and abetting and the ‘substantial participation’ test hinges on the difference between ‘substantial assistance’ and ‘substantial participation,’”¹⁶² a distinction that is markedly without a difference. Conspiracy is nothing more than a combination of two or more individuals to commit an unlawful act.¹⁶³ This form of secondary liability imputes liability to secondary actors not for their actions, but for the actions of others.¹⁶⁴ And lastly, for scheme liability to apply, the plaintiff must prove that the defendant committed

158. *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver*, 511 U.S. 164, 175-77 (1994). The Supreme Court responded to a similar argument there in part by noting that the person must still be engaged in one of the proscribed activities in order to be held liable. Accordingly, the argument made by the Ninth Circuit would seem to fail as well because one must actually make a misstatement or omission to be held liable as a primary violator.

159. *Simpson*, 452 F.3d at 1048 (emphasis added).

160. *See supra* note 131 and accompanying text.

161. *Central Bank*, 511 U.S. at 168 (citing *First Interstate Bank of Denver, N.A. v. Pring*, 969 F.2d 891, 898-903 (10th Cir. 1992)).

162. Chrisman, *supra* note 15, at 216.

163. *Cf.* 18 U.S.C.A. § 371 (West 2007).

164. *Pinkerton v. United States*, 328 U.S. 640 (1946) (propounding a new rule that the act of one is the act of all).

an act, which may be innocent in and of itself, but which had the principal purpose and effect of creating a false appearance of fact and thereby furthering a scheme to defraud. While the courts applying the “substantial participation” test and scheme liability purport to be using these theories to determine whether a secondary actor is a primary violator, in actuality these theories are both nothing more than secondary liability by a different name.

In its rejection of secondary liability absent congressional action,¹⁶⁵ the Supreme Court necessarily rejected aiding and abetting and conspiracy liability in *Central Bank*.¹⁶⁶ This holding of *Central Bank* was left undisturbed and perhaps even reinforced by the Court’s holding in *Stoneridge*. Further, scheme liability, as it was argued by the plaintiffs in *Stoneridge* and *Simpson*, is essentially identical to the “substantial participation” test, aiding and abetting, and conspiracy in many ways.¹⁶⁷ For example, all four theories do not require a

165. *Central Bank*, 511 U.S. at 184 (“The fact that Congress chose to impose some forms of secondary liability, but not others, indicates a deliberate congressional choice with which the courts should not interfere.”).

166. *Central Bank*, 511 U.S. at 184, 190-91. See also *Dinsmore v. Squadron, Ellenoff, Plesent, Sheinfeld & Sorkin*, 135 F.3d 837, 843 (2d Cir. 1998); *Decker v. Glenfed, Inc. (In re Glenfed, Inc.)*, 60 F.3d 591, 592 (9th Cir. 1995); *Kidder Peabody & Co. v. Unigestion Int’l Ltd.*, 903 F. Supp. 479, 496-98 (S.D.N.Y. 1995); *Van de Velde v. Coopers & Lybrand*, 899 F. Supp. 731, 738 (D. Mass. 1995); *Upton v. McKerrow*, 887 F. Supp. 1573, 1580 (N.D. Ga. 1995); *In re Syntex Corp.*, 855 F. Supp. 1086, 1098 (N.D. Cal. 1994). But cf. *Cooper v. Pickett*, 137 F.3d 616, 624 (9th Cir. 1997).

167. The petitioners in *Stoneridge* essentially argued for the Court to apply the “principal purpose and effect” test in order to determine scheme liability. They also argued that recklessness could be an appropriate level of scienter for scheme liability. See Transcript of Oral Argument at 17-18, 24, *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 128 S. Ct. 761 (2008) (No. 06-43).

JUSTICE ALITO: Then I see absolutely no difference between your test and the elements of aiding and abetting.

MR. GROSSMAN: The difference is conceptual.

JUSTICE ALITO: Because you said it’s not necessary for there to be an actual deceptive act on the part of the Respondents.

MR. GROSSMAN: There has to be a deception—there is deception. The deception is you’re entering into an advertising contract that presents the illusion that you were purchasing advertising, when in fact you were not purchasing advertising.

CHIEF JUSTICE ROBERTS: But that’s—but that’s not the fraud that was imposed upon the market. The fraud imposed upon the market was Charter’s accounting for the transaction on its books. Nobody bought or sold stocks in the reliance upon the way that Scientific-Atlanta and Charter structured their deal. They did so in reliance upon the way Charter communicated its accounting to the marketplace.

misstatement or omission by the secondary actor, all four theories would find reliance upon the misstatements or omissions of another as satisfying the reliance requirement, and all four theories would impose liability on the secondary actor even in instances where the secondary actor has not satisfied all of the requirements for a primary violation as articulated by the Supreme Court. Therefore, it is fair to characterize all four as theories of secondary liability, and to presume that they have no continuing viability after *Stoneridge*.

The Ninth Circuit closes in *Simpson* by examining a couple of the elements of the Rule 10b-5 cause of action in light of its holding with regard to scheme liability.¹⁶⁸ With regard to the reliance requirement, the court reasons that there should be a presumption in favor of reliance in a scheme liability case.

We may presume, absent persuasive conflicting evidence, that purchasers relied on misstatements produced by a defendant as part of a scheme to

MR. GROSSMAN: There was no way—no way that that could properly be accounted for, and the Respondents understood that. And that’s why they did what they did, that’s what –

....

JUSTICE KENNEDY: Well, I agree with Justice Scalia’s earlier comment, I don’t think that Scientific-Atlanta or Motorola really cared anything of—one way or the other about the investors. For them the scheme made a certain amount of sense, they didn’t really care.

MR. GROSSMAN: They may not have cared, but that would be reckless because they certainly understood—

JUSTICE KENNEDY: But that’s far different from having a purpose. You said they have to have a purpose.

....

JUSTICE SCALIA: Is it fair to say that all aiders and abettors who commit deceptive acts are principals?

MR. GROSSMAN: No.

JUSTICE SCALIA: What’s the difference? What separates the two?

MR. GROSSMAN: You have to take it the next step further, whether or not that deceptive act had the purpose and effect for furthering a scheme of an investor.

....

MR. GROSSMAN: If you facilitate with a deceptive act, then you’re a primary violator. That’s what Section 10(b) prohibits. If you facilitate without a deceptive act, then you are an aider and abetter [sic].

Id. at 17-18, 22-24. Requiring a deceptive act and reducing the level of scienter to recklessness makes scheme liability virtually identical to aiding and abetting liability that was expressly rejected in *Central Bank*. See *supra* note 166. Further, even raising the scienter requirement to actual knowledge would provide little help and lead inexorably to non-value-adding activity such as representations and warranties regarding accounting treatment in virtually every vendor contract with a publicly-traded company. *Stoneridge*, 128 S. Ct. at 772.

168. *Simpson v. AOL Time Warner Inc.*, 452 F.3d 1040, 1052 (9th Cir. 2006).

defraud, even if the defendant did not publish or release the misrepresentations directly to the securities market.

We conclude that conduct by a defendant that had the *principal purpose and effect* of creating a false appearance in deceptive transactions as part of a scheme to defraud is conduct that uses or employs a deceptive device within the meaning of § 10(b). . . . [Further], a plaintiff may be presumed to have relied on this scheme to defraud if a misrepresentation, which necessarily resulted from the scheme and the defendant's conduct therein, was disseminated into an efficient market and was reflected in the market price.¹⁶⁹

It appears that in *Stoneridge* the Supreme Court rejected this formulation of reliance, which seems contrary to *Central Bank* as well.¹⁷⁰ The Supreme Court in *Central Bank* stated that the application of the reliance requirement supports the holding that a secondary actor cannot be liable for aiding and abetting.¹⁷¹ “Were we to allow the aiding and abetting action proposed in this case, the defendant could be liable without any showing that the plaintiff relied upon *the aider and abettor’s statements or actions.*”¹⁷² Thus, pursuant to aider and abettor liability, a secondary actor could be held liable via reliance on someone else’s misstatement merely because the secondary actor gave “substantial assistance” to the

169. *Id.* (emphasis added).

170. The *Stoneridge* dissent, as well as some commentators, have interpreted the Supreme Court’s majority opinion in *Stoneridge* as adopting a standard similar to *Simpson’s* efficient market presumption of reliance established in *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988). Specifically, the dissent in *Stoneridge* interprets the majority’s opinion to require the secondary actors deceptive conduct make the primary actors disclosure to the public “necessary or inevitable.” *Stoneridge*, 128 S. Ct. at 776 (Stevens, J. dissenting). The Supreme Court leaves this question of reliance unanswered. Does this necessary and inevitable standard create another presumption of reliance? Is that presumption of reliance inherently unobtainable? See Evan A. Davis, Mitchell A. Lowenthal, & Nancy I. Ruskin, *On Stoneridge Investment Partners, LLC v. Scientific Atlanta, Inc.*, LEXISNEXIS EXPERT COMMENTARIES (Feb. 8, 2008). Perkins Coie, *Another Blow to Securities-Litigation Plaintiffs: The Supreme Court Knocks Down Scheme Liability*, http://www.perkinscoie.com/news/pubs_detail.aspx?op=updates&publication=1585 (Jan. 17, 2008) (“This ‘necessary and inevitable’ standard provides significant protection to entities who engage in transactions with parties who subsequently choose to misrepresent those transactions. It is unlikely that such misrepresentations will be found to be the ‘necessary and inevitable’ results of the transactions themselves.”). Or is reliance only premised on (1) actual reliance, (2) presumed reliance under *Basic v. Levinson*, or (3) presumed reliance under *Affiliated Ute* and the Supreme Courts use of “necessary and inevitable” just hyperbole? See *Basic, Inc.*, 485 U.S. 224; *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128 (1972). These questions are pivotal to a complete understanding of reliance; however, they are beyond the scope of this Article. Further, they demonstrate why a ruling that deceptive conduct requires a misstatement or omission would have provided a great deal more clarity than the ruling in *Stoneridge*.

171. *Central Bank*, 511 U.S. at 180.

172. *Id.*

primary violator—a result the Supreme Court in *Central Bank* found untenable. Similarly, scheme liability, as here articulated, would permit a defendant to be held liable via reliance on someone else's misstatements or omissions merely because the secondary actor in some way participated in a scheme to defraud—a result that appears contrary to the Supreme Court's opinion in *Stoneridge*.¹⁷³

The Ninth Circuit's formulation of scheme liability, much like its formulation of the substantial participation test, seems to be nothing more than aiding and abetting by another name.¹⁷⁴ The Fifth Circuit reached this conclusion in *Regents of the University of California v. Credit Suisse First Boston (USA), Inc.*,¹⁷⁵ a case arising from the Enron debacle and reported only months after *Charter* and *Simpson*. In *Regents*, the plaintiffs sought a class certification claiming that Enron and the defendant banks engaged in various fraudulent activities, such as the “Nigerian Barges Transaction,” that allowed Enron to overstate its revenues and inflate its financial statements.¹⁷⁶ The plaintiffs characterized these transactions as “irrational,” and alleged that the defendant banks were liable for their involvement in these transactions under a theory of scheme liability.¹⁷⁷ The plaintiffs, however, did not allege that the defendant made any public misrepresentations or had any duty to disclose information that the plaintiffs would consider material in making investment decisions.¹⁷⁸

In finding for the defendants, the Fifth Circuit noted, “[t]he district court's conception of ‘deceptive act’ liability [which follows *Simpson*] is inconsistent with the Supreme Court's decision that § 10(b) does not give rise to aiding and abetting liability.”¹⁷⁹ The court continued:

An act cannot be deceptive within the meaning of § 10(b) where the actor has [made no misstatement or has] no duty to disclose. Presuming plaintiffs'

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

174. See, e.g., *In re Charter Commc'ns, Inc.*, 443 F.3d 987 (8th Cir. 2006); *In re MTC Elecs. Tech. S'holders Litig.*, 898 F. Supp. 974, 985 (E.D.N.Y. 1995), *vacated in part on reconsideration by*, 993 F. Supp. 160 (E.D.N.Y. 1997).

175. 482 F.3d 372 (5th Cir. 2007).

176. *Id.* at 377. The “Nigerian Barges Transaction” was a complex transaction wherein the defendant banks purchased assets—“electricity-generating barges off the coast of Nigeria”—from Enron, based on Enron's secret guarantee to repurchase the barges after it met upcoming stock analysts' estimates. *Id.* The secret agreement allowed Enron to “book[] the transactions as a sale and accordingly list[] the revenue therefrom in its year-end financial statement.” *Id.*

177. *Regents*, 482 F.3d at 377-78.

178. *Id.* at 385.

179. *Id.* at 386.

allegations to be true, Enron committed fraud by misstating its accounts, but the banks only aided an [sic] abetted that fraud by engaging in transactions to make it more plausible; they owed no duty to Enron's shareholders.¹⁸⁰

Following the Eighth Circuit's reasoning in *Charter*, the Fifth Circuit concluded that § 10(b) prohibits only two types of conduct: manipulation and deception.¹⁸¹ The court gave short shrift to any claim that defendant's conduct might involve manipulation.¹⁸² In doing so, the court adopted the Supreme Court's narrow definition of manipulative conduct in the context of securities law.¹⁸³ In essence, because the defendants did not "act directly in the market for the relevant security[.]" the complained of conduct could not constitute manipulation.¹⁸⁴

The *Regents* opinion focused more closely on the meaning of "deceptive act." On this point, the lower court adopted a broad definition, concluding that a "deceptive act . . . includes participating in a transaction whose principal purpose and effect is to create a false appearance of revenues"¹⁸⁵—essentially scheme liability. Further, the district court found that participation in a "scheme to defraud" by individual "deceptive acts" gives rise to joint and several liability for the entire scheme.¹⁸⁶ The Fifth Circuit responded, "[a]lbeit with the best of intentions and after Herculean effort, the district court arrives at an erroneous understanding of securities law"¹⁸⁷

In a wholesale rejection of the district court's broad understanding of "deceptive act," the Fifth Circuit concluded that "'deception' within the meaning of § 10(b) requires that a defendant fail to satisfy a duty to disclose material information to a plaintiff" or make a material misrepresentation upon which the plaintiff may reasonably rely.¹⁸⁸ As mentioned above, the plaintiff alleged neither misrepresentations nor omissions by the defendants.¹⁸⁹ The court, however, assumed

180. *Id.*

181. *Regents*, 482 F.3d at 388.

182. *Id.* at 390.

183. The Fifth Circuit notes, however, that the Supreme Court has yet to give an exhaustive list of manipulative conduct. On this point, the Fifth Circuit cites to then-District Judge Higgenbotham's opinion in *Hundahl v. United Benefit Life Ins. Co.*, 465 F. Supp. 1349, 1360 (N.D. Tex. 1979), describing his analysis of the meaning of manipulation as "exhaustive" and "influential."

184. *Regents*, 482 F.3d at 390.

185. *Id.* at 378 (internal quotation marks omitted).

186. *Id.*

187. *Id.* at 380.

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

189. *Id.* at 386.

“*arguendo* that plaintiffs’ case primarily concern[ed] improper omissions.”¹⁹⁰ The court then recognized the close connection between the requirement of a misstatement or omission and the essential element of reasonable reliance under § 10b.¹⁹¹ The court held, “[w]ithout its broad conception of liability for deceptive acts, the district court could not have found [reliance].”¹⁹² Underlying the court’s conclusion is the fact that it would be unreasonable for an investor to rely on disclosure from a party owing no duty to make such disclosures.¹⁹³ Therefore, the court held, “[i]f the banks’ actions were non-public, immaterial, or not misrepresentative because the market had no right to rely on them (in other words the banks owed no duty), the banks should be able to [escape liability in a private action].”¹⁹⁴

In summary, the circuit courts first considered whether the “bright line” or the “substantial participation” test should be used to determine whether a secondary actor’s conduct rises to the level of a primary violation under § 10(b) and Rule 10b-5 following *Central Bank*. They split on that issue. Then, the circuits considered the issue of scheme liability, and they split on that issue as well. In addressing both of these issues, the circuits actually split over the question of whether § 10(b) requires that a secondary actor actually make a misstatement or omission in order to be held liable as a primary violator under the Rule 10b-5 implied cause of action. In *Stoneridge*, the Supreme Court had the opportunity to do more than decide the merits of scheme liability by ruling on this more fundamental question.

190. *Id.* at 384.

191. *Id.* at 385 (citing *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 180 (1994) for the proposition that aiding and abetting would allow plaintiffs to “circumvent the reliance requirement” of the private cause of action under § 10(b)).

192. *Regents*, 482 F.3d at 382. Although the *Regents* decision takes place in the context of a class certification dispute, the principles recognized by the court in reaching its conclusion apply with equal force in situations involving individual plaintiffs. As the court of appeals noted, the district court’s certification of the class rested on “erroneous presumptions of reliance.” *Id.* at 383. Reliance is both an element of the class certification and an essential element of the § 10(b) private cause of action. Just as the class of plaintiffs in *Regents* would not be entitled to rely on the fraud-on-the-market theory to prove reliance, neither would an individual plaintiff. An individual plaintiff would have to prove they reasonably and justifiably relied on the bank’s duty to disclose information material to the plaintiff’s investment decision—an unlikely event absent some special relationship between one of the defendant banks and an Enron shareholder.

193. *Id.* at 385 (“Here, however, where the plaintiffs had no expectation that the banks would provide them with information, there is no reason to expect that the plaintiffs were relying on their candor.”).

194. *Id.* at 383.

2. *Stoneridge and the Fall of Scheme Liability?*

The opinions in *Charter*, *Simpson*, and *Regents* were all appealed to the Supreme Court.¹⁹⁵ The Supreme Court granted certiorari in *Charter*, the first of the three chronologically, under the name *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.* and delayed ruling on the petitions for certiorari in the other two until after its opinion in *Stoneridge*.

Justice Kennedy,¹⁹⁶ writing for the Court in *Stoneridge*, adopted the facts as alleged by the petitioner.¹⁹⁷ After quoting § 10(b) and Rule 10b-5, Justice Kennedy writes, “[t]hrough the text of . . . [§ 10(b)] does not provide for a private cause of action for § 10(b) violations, the Court has found a right of action implied in the words of the statute and its implementing regulation.”¹⁹⁸ Listing the elements of “a typical § 10(b) private action,”¹⁹⁹ Justice Kennedy writes:

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.²⁰⁰

After setting forth the elements, the Court notes that *Central Bank* abolished aiding and abetting liability as beyond the reach of the statute.²⁰¹ Further, Congress was asked to overturn *Central Bank* but chose to provide only the SEC with the power to pursue secondary actors for aiding and abetting in the Private Securities Litigation Reform Act.²⁰² Therefore, the Court concludes that “[t]he conduct of a secondary actor must satisfy each of the elements or preconditions for

195. See *In re Charter Commc'ns Inc.*, 443 F.3d 987 (8th Cir. 2007), *cert. granted sub nom.*, *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 127 S. Ct. 1873 (2007); *Regents*, 482 F.3d 372, *cert. denied*, 128 S. Ct. 1120 (2008); *Simpson v. AOL Time Warner Inc.*, 452 F.3d 1040 (9th Cir. 2006), *cert. granted sub nom.*, *Avis Budget Group, Inc. v. Cal. State Teachers' Retirement Sys.*, 128 S. Ct. 1119 (2008).

196. Justice Kennedy also wrote the opinion for the Court in *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*

197. *Stoneridge*, 128 S. Ct. at 766. The facts as stated by Justice Kennedy are nearly identical to the facts stated by the Eighth Circuit and discussed *supra* at notes 133-138 and accompanying text. Therefore, those facts are not restated here.

198. *Id.* at 768 (citing *Superintendent of Ins. of N.Y. v. Bankers Life & Casualty Co.*, 404 U.S. 6, 13 n.9 (1971)).

199. *Id.* (citing *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336, 341-42 (2005)).

200. *Id.*

201. *Stoneridge*, 128 S. Ct. at 768.

202. *Id.* at 768-69.

liability” to attach.²⁰³ In other words, in order to be held liable under § 10(b) and Rule 10b-5, a secondary actor must be a primary violator satisfying all of the elements of a § 10(b) private cause of action.

The Court begins its analysis of whether these elements are satisfied in *Stoneridge* by addressing the first element—“a material misrepresentation or omission by the defendant.”²⁰⁴ In addressing the misrepresentation or omission requirement, the Eighth Circuit in *Charter* had stated that “any defendant who does not make or affirmatively cause to be made a fraudulent misstatement or omission . . . is at most guilty of aiding and abetting and cannot be held liable under § 10(b) or any subpart of Rule 10b-5.”²⁰⁵ Of this statement by the Eighth Circuit, Justice Kennedy opines:

If this conclusion were read to suggest there must be a specific oral or written statement before there could be liability under § 10(b) or Rule 10b-5, it would be erroneous. Conduct itself can be deceptive, as respondents concede. In this case, moreover, respondents’ course of conduct included both oral and written statements, such as the backdated contracts agreed to by Charter and respondents.

A different interpretation of the holding from the Court of Appeals opinion is that the court was stating only that any deceptive statement or act respondents made was not actionable because it did not have the requisite proximate relation to the investors’ harm. That conclusion is consistent with our own determination that respondents’ acts or statements were not relied upon by the investors and that, as a result, liability cannot be imposed upon respondents.²⁰⁶

Based upon the preceding statement, it appears that the Court determined (1) that a misstatement (or omission by one with a duty to disclose) is not required for “liability under § 10(b) or Rule 10b-5” because “[c]onduct itself can be deceptive,” and (2) that the conduct engaged in by the respondents, “include[ing] both oral and written statements, such as the backdated contracts agreed to by Charter and

203. *Id.* at 769.

204. *Id.*

205. *In re Charter Commc’ns Inc.*, 443 F.3d 987, 992 (8th Cir. 2006). Interestingly, none of the parties before the Court in *Stoneridge* actually argued that a defendant must make a misstatement or omission in order to satisfy the first element of the § 10(b) and Rule 10b-5 cause of action. However, that clearly seems to be the plain meaning of the statement made by the Eighth Circuit. Further, to arrive at this conclusion, the Eighth Circuit cited and discussed, among other authorities, Justice Kennedy’s majority opinion in *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*

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

respondents” was deceptive.²⁰⁷ Accordingly, based solely upon this reasoning, a better statement of the first element would be *a misstatement, omission by one with a duty to disclose, or deceptive conduct which is material*, with the operative part of the element being the requirement of materiality as opposed to the requirement of a misstatement or omission.

Finding the portion of the first element relating to a misstatement, omission, or conduct satisfied (or irrelevant), and without considering materiality, the Court turned to the central basis for its ruling: the element of reliance.²⁰⁸ Reliance, according to the Court, “ensures that, for liability to arise, the ‘requisite causal connection between a defendant’s misrepresentation and a plaintiff’s injury’ exists as a predicate for liability.”²⁰⁹ This rationale for the reliance requirement has caused many, including Justice Stevens in his dissent,²¹⁰ to liken the reliance requirement at least in part to transaction or “but-for” causation.²¹¹ The Court seems to assume, rather logically, that the petitioner could not have *actually* relied upon the respondents’ conduct

207. *Id.* Given the Court’s statement here, one might be given to wonder whether “a material misrepresentation or omission by the defendant” as an element of a “typical § 10(b) private action” actually has any meaning beyond just the materiality requirement. *Id.* at 764. Further, one might question whether the Court should have even reached this conclusion given that it concluded that Charter had made misstatements, albeit it ones that had not been communicated to the petitioner nor the market, thereby arguably rendering the question in this case moot. *See, e.g.,* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 194 (1976) (where the Court reserved the issue of scienter as unnecessary to the resolution of the case at bar).

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

209. *Id.* (quoting *Basic Inc. v. Levinson*, 485 U.S. 224, 243 (1988) and citing *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 154 (1972)).

210. *Id.* at 776 (Stevens, J., dissenting) (citing *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336, 341-42 (2005)).

211. *See* Mark D. Wood & Katten Muchin Rosenman, *Liability for Securities Law Violations*, 1618 PLI/CORP 587, 609-10 (2008) (“Reliance is often referred to as ‘transaction causation.’ To satisfy the element, a plaintiff must prove that he or she would not have bought the security if not for the misstatement.”); Roberta S. Karmel, *When Should Investor Reliance be Presumed in Securities Class Actions?*, 63 BUS. LAW 25, 33 (2007) (“What is frequently considered ‘transaction causation’ is in fact a variant of the reliance requirement.”); *Currie v. Cayman Res. Corp.*, 835 F.2d 780, 785 (11th Cir. 1988) (“Reliance is a *causa sine qua non*, a type of ‘but for’ requirement: had the investor known the truth he would not have acted.”). Others, however, have noted that reliance is broader, including not only transaction causation but also justifiable reliance on the part of the plaintiff. *See, e.g.,* Chrisman, *supra* note 15, at 223-24 (“[T]he already overburdened reliance element should not be given the additional task (which is one that it cannot complete satisfactorily) of determining when a secondary actor’s conduct rises to the level of a primary violation of section 10(b) and rule 10b-5.”); Rutheford B. Campbell, Jr., *Elements of Recovery Under Rule 10b-5: Scienter, Reliance, and Plaintiff’s Reasonable Conduct Requirement*, 26 S.C. L. REV. 653, 664-69, 674-83, 689-93, 700-01 (1975).

in making its investment decision because it did not know about the respondents' conduct at that time.

Therefore, being unable to show actual reliance, the petitioner would have to be able to use a presumption of reliance to be able to prevail in this case. Thus, the Court stated:

We have found a rebuttable presumption of reliance in two different circumstances. First, if there is an omission of a material fact by one with a duty to disclose, the investor to whom the duty was owed need not provide specific proof of reliance. Second, under the fraud-on-the-market doctrine, reliance is presumed when the statements at issue become public. The public information is reflected in the market price of the security. Then it can be assumed that an investor who buys or sells stock at the market price relies upon the statement.²¹²

The first presumption (or the "*Affiliated Ute*" presumption) is not applicable because the "[r]espondents had no duty to disclose."²¹³ The second presumption (or the "fraud-on-the-market" presumption) is not applicable because the respondents' "deceptive acts were not communicated to the public [and therefore n]o member of the investing public had knowledge, either actual or presumed, of respondents acts during the relevant times."²¹⁴ Accordingly, the Court concluded, "[p]etitioner . . . cannot show reliance upon any of respondents' actions except in an indirect chain that we find too remote for liability."²¹⁵

The petitioner argued, based upon the reasoning in *Simpson* and *In re Parmalat Securities Litigation*,²¹⁶ that the respondents actions were such that the fraud-on-the-market presumption should apply because the "conduct [had] the purpose and effect of creating a false appearance of material fact to further a scheme to misrepresent Charter's revenue."²¹⁷ Apparently rejecting scheme liability,²¹⁸ the Court disagreed,

212. *Stoneridge*, 128 S. Ct. at 769 (citations omitted).

213. *Id.* The *Affiliated Ute* presumption rests upon the idea that a plaintiff cannot be said to actually rely upon statements that were in fact not made by the defendant. Reliance, therefore, is presumed in such instances where the person was under a duty to speak and did not do so.

214. *Id.*

215. *Id.* The Court's statement here demonstrates its view of the relationship between reliance and causation. What the Court is really saying is that it is unwilling to create a new presumption of reliance in this case and the current two do not apply. Therefore, the petitioner cannot recover.

216. 376 F. Supp. 2d 472 (S.D.N.Y. 2005).

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

218. One might have preferred a more definite statement with regards to the viability of scheme liability. However, it does seem clear that the Court intended to reject the notion by

characterizing the petitioner's argument as "contend[ing] that in an efficient market investors rely not only upon the public statements relating to a security but also upon the transactions those statements reflect."²¹⁹ The Court asserts that such a broad definition of reliance would be unacceptable because it would lead to "the implied [Rule 10b-5] cause of action . . . reach[ing] the whole marketplace in which the issuing company does business."²²⁰

Following this, Justice Kennedy turns to the relationship between reliance and causation "leading to the inquiry whether respondents' acts were immediate or remote to the injury."²²¹ In what may well become one of the most frequently quoted portions of the opinion, Justice Kennedy writes:

In all events we conclude respondents' deceptive acts, which were not disclosed to the investing public, are too remote to satisfy the requirement of reliance. It was Charter, not respondents, that misled its auditor and filed fraudulent financial statements; *nothing respondents did made it necessary or inevitable for Charter to record the transactions as it did.*²²²

Thus, the Court seems to state that, in order to establish reliance in a case such as this, the plaintiff must show that the defendant's conduct (or possibly misstatements not communicated to the plaintiff or the market) "made it necessary or inevitable for" the primary actor to make a misstatement upon which the plaintiff relies or about which one of the presumptions mentioned herein applies.²²³

citing and rejecting *Simpson v. AOL Time Warner Inc.*, 452 F.3d 1040 (9th Cir. 2006); *In re Parmalat*, 414 F. Supp. 2d 549 (S.D.N.Y. 2006); and *In re Enron Corp. Sec., Derivative, & "ERISA" Litig.*, 439 F. Supp. 2d 692 (S.D. Tex. 2006), the three of which constitute the major opinions in support of the theory.

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

220. *Id.*

221. *Id.*

222. *Id.* (emphasis added).

223. *Stoneridge*, 128 S. Ct. at 770. Whether Justice Kennedy actually intended to create such a test is certainly debatable. Still, the words of the opinion seem to suggest that if the conduct of the vendors had of been such that it made Charter's misstatements necessary or inevitable, then liability would have been found. Justice Stevens in the dissent seems to agree. He states:

The Court's next faulty premise is that petitioner is required to allege that Scientific-Atlanta and Motorola made it "necessary or inevitable for Charter to record the transactions in the way it did," in order to demonstrate reliance. Because the Court of Appeals did not base its holding on reliance grounds, the fairest course to petitioner would be for the majority to remand to the Court of Appeals to determine whether petitioner properly alleged reliance, under a correct view of what § 10(b) covers.

While the Court couched its holding in terms of reliance, the majority seems much more concerned about whether its ruling would expand the § 10(b) and Rule 10b-5 cause of action than about proposing a workable standard for the reliance element. For example, the Court stated, “[c]oncerns with the judicial creation of a private cause of action caution against its expansion. The decision to extend the cause of action is for Congress, not for [the Court]. Though it remains the law, the § 10(b) private right should not be extended beyond its present boundaries.”²²⁴ Later in the opinion, the Court reasoned, “[i]t is appropriate for us to assume that when [the PSLRA] was enacted, Congress accepted the § 10(b) private cause of action as then defined but chose to extend it no further.”²²⁵ Finally, of its holding, the Court asserts, “[t]his conclusion is consistent with the narrow dimensions we must give to a right of action Congress did not authorize when it first enacted the statute and did not expand when it revisited the law.”²²⁶

In conclusion, it is clear that the Court intended to eliminate scheme liability because the Court was concerned that it would expand the implied cause of action. In accomplishing its goal, the Court rejected the idea that a misstatement or omission is required, instead holding that

Id. at 775-76 (Stevens, J., dissenting) (citations omitted). However, whether this is a standard, upon which future courts may rely, is debatable. The majority did not state that the petitioner is required to plead that it was “necessary or inevitable for Charter to record the transactions in the way it did”; rather, the majority simply observed that the respondents did not make it necessary or inevitable. *Id.* at 770. This statement may simply be in response to the petitioners argument that Charter’s actions were the natural and expected consequence of the respondents conduct. *Id.*

224. *Id.* at 773. This is a rather astonishing statement. The Court seems to regret or lament the original creation of the cause of action. Of course, this is consistent with Justice Robert’s comments during the oral arguments. However, for the majority to so clearly state its intention not to extend the private cause of action beyond its present point is interesting and raises numerous questions—the most obvious of which is what are those “present boundaries?”

CHIEF JUSTICE ROBERTS: I mean, we don't get in this business of implying private rights of action any more. And isn't the effort by Congress to legislate a good signal that they have kind of picked up the ball and they are running with it and we shouldn't?

....

CHIEF JUSTICE ROBERTS: [M]y suggestion is not that we should go back and say that there is no private right of action. My suggestion is that we should get out of the business of expanding it, because Congress has taken over and is legislating in the area in the way they weren't back when we implied the right of action under 10(b).

Transcript of Oral Arguments at 6-7, *Stoneridge*, 127 S. Ct. 1873 (2007) (No. 06-43).

225. *Stoneridge*, 128 S. Ct. at 773.

226. *Id.* at 774.

conduct as well may be deceptive for the purpose of the § 10(b) implied cause of action. The Court then reasoned that the element of reliance is not met and no presumption of reliance should apply in the present situation. However, it seems the Court's goal of limiting the § 10(b) implied cause of action would have been better served by ruling for the respondents on the same grounds that the Eighth Circuit did—namely, that § 10(b) requires that a secondary actor actually make a misstatement or omission in order to be held liable as a primary violator. The following Section considers whether, prior to the *Stoneridge* opinion, there would have been support for such a holding.

III. IN THE WAKE OF *CENTRAL BANK* AND PRIOR TO *STONERIDGE*, WAS THERE AN ARGUMENT THAT SECTION 10(B) REQUIRED THAT A SECONDARY ACTOR ACTUALLY MAKE A MISSTATEMENT (OR OMISSION) IN ORDER TO BE HELD LIABLE AS A PRIMARY VIOLATOR UNDER RULE 10B-5?

Even prior to *Central Bank*, most courts and commentators seemed to agree that a violation of § 10(b) for deceptive conduct required either a misstatement or an omission when there was a duty to disclose.²²⁷ Opinions such as *Ernst & Ernst v. Hochfelder*²²⁸ and *Santa Fe Industries, Inc. v. Green*²²⁹ were understood to establish that a secondary actor must actually (1) make a misstatement or omission coupled with a duty to disclose (i.e., deceptive conduct),²³⁰ or (2) employ a

227. See *supra* notes 114-15 and accompanying text. While most commentators and some courts seemed to waver, the practicing bar appeared to be convinced that the Supreme Court's precedent on this issue required a manipulation, misstatement, or omission.

Some recent decisions have treated the issue of liability under Securities Exchange Act Rule 10b-5(a) or Rule 10b-5(c) as if it were a novel or unsettled question of federal securities law. . . . [However,] the U.S. Supreme Court's Section 10(b) cases [and other authority demonstrates] that existing precedent already compels the conclusion that liability under any subpart of Rule 10b-5 requires a misrepresentation, [an omission coupled with] a duty to disclose, or a manipulative transaction in the issuer's securities.

McLaughlin, *supra* note 8, at 631. See also Gregory A. Markel & Gregory G. Ballard, In re Charter Communications, Inc. Securities Litigation and Simpson v. AOL Time Warner, Inc.: *Circuits Split Over the Validity of "Scheme" Liability Under Section 10(b)*, 34 SEC. REG. L. J. 1 (2006) (noting that there is practically very little difference between scheme liability and aiding and abetting).

228. 425 U.S. 185 (1976).

229. 430 U.S. 462 (1977).

230. *Chiarella v. United States*, 445 U.S. 222, 235 (1980) (requiring a duty to disclose before an omission is actionable under § 10(b) and Rule 10b-5). For a full discussion of

manipulation in order to be held liable as a primary violator under § 10(b) and Rule 10b-5.²³¹ The subsection of Rule 10b-5 relied upon was thought to make little difference because “the language of the statute [was thought to be] dispositive.”²³² *Central Bank* seemed to lend further support to this assumption.²³³ However, following *Central Bank*, theories such as the substantial participation test and scheme liability have arisen that challenged this understanding of § 10(b) and Rule 10b-5 liability.²³⁴ The following examines Supreme Court precedent and other authority to determine whether there existed sufficient grounds for the Court in *Stoneridge* to rule that a misstatement or omission is required for conduct to be deceptive under § 10(b).

First, following the methodology elucidated in *Ernst & Ernst v. Hochfelder*,²³⁵ and affirmed and followed by *Santa Fe Industries, Inc. v. Green*²³⁶ and *Central Bank*, the analysis must begin with the language of the statute itself.²³⁷ Section 10(b), in relevant part, provides, “[i]t shall be unlawful for any person, directly or indirectly, . . . [t]o use or employ, in connection with the purchase or sale of any security . . . any *manipulative or deceptive device or contrivance* in contravention of such rules and regulations as the commission may prescribe.”²³⁸ Section 10(b) prohibits only “manipulative or deceptive device[s] or contrivance[s].”²³⁹ The Supreme Court adopted broad definitions of “device” and “contrivance” by relying upon their dictionary definitions.²⁴⁰ Accordingly, because the Supreme Court has stated that § 10(b) “prohibits only the making of a material misstatement (or omission) or the commission of a manipulative act,”²⁴¹ the operative terms are not “device or contrivance” but “manipulative or deceptive.” Therefore, this Section and much of this Article focuses on these latter two terms.

insider trading, see 1 WILLIAM K.S. WANG & MARC I. STEINBERG, *INSIDER TRADING* § 5:2.6[C] (2d ed. 2006).

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

232. *Santa Fe*, 430 U.S. at 477. Again, this demonstrates that the language of the rule is far more expansive than the language of the statute.

233. *Central Bank*, 511 U.S. at 177.

234. *See supra* Part II.

235. 425 U.S. 185, 197 (1976).

236. 430 U.S. 462, 472-74 (1977).

237. *Central Bank*, 511 U.S. at 173.

238. 15 U.S.C.A. § 78j(b) (West 2007) (emphasis added).

239. *Id.*

240. *Ernst & Ernst*, 425 U.S. at 199 n.20.

241. *Central Bank*, 511 U.S. at 177.

The case most clearly addressing the definition of the terms in § 10(b) is *Ernst & Ernst v. Hochfelder*. *Ernst* involved a securities fraud perpetrated by Leston B. Nay, the president and 92% owner of First Securities Company of Chicago.²⁴² Nay defrauded certain investors who became the plaintiffs in *Ernst* by persuading them to invest funds in certain “escrow” accounts that he promised would yield high rates of return.²⁴³ Nay committed suicide some years after the fraud, and his suicide letter indicated that First Securities was bankrupt and that the escrow accounts were frauds.²⁴⁴

An investigation followed, and the plaintiffs subsequently filed suit against Ernst & Ernst, First Securities’ auditor and accountant, alleging that Ernst & Ernst violated § 10(b) and Rule 10b-5 by failing to discover and report irregularities at First Securities that would have led to the discovery of the fraud.²⁴⁵ The Court stated that discovery revealed that plaintiffs’ “cause of action rested solely on a theory of negligent nonfeasance.”²⁴⁶

The District Court granted Ernst & Ernst’s motion for summary judgment, but disagreed with its “contention that a cause of action for aiding and abetting a securities fraud could not be maintained under § 10(b) and Rule 10b-5 merely on allegations of negligence.”²⁴⁷ The Seventh Circuit Court of Appeals reversed and remanded, seemingly holding that negligence would suffice for aiding and abetting liability under § 10(b) and Rule 10b-5.²⁴⁸ The Supreme Court “granted certiorari to resolve the question whether a private cause of action for damages will lie under § 10(b) and Rule 10b-5 in the absence of any allegation of ‘scienter.’”²⁴⁹

In determining that the language of the statute required more than mere negligence, the Supreme Court focused on the statutory language itself as opposed to tort or criminal law. “[W]e turn first to the language of § 10(b), for ‘[t]he starting point in every case involving construction

242. *Ernst & Ernst*, 425 U.S. at 189.

243. *Id.*

244. *Id.*

245. *Id.* at 190.

246. *Ernst & Ernst*, 425 U.S. at 190.

247. *Id.* at 191.

248. *Id.* at 191-93.

249. *Id.* at 193 (limiting the issue before the Court to the scienter requirement, and reserving the aiding and abetting issue which it later addressed in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994)).

of a statute is the language itself.”²⁵⁰ To determine the definitions for the terms of the statute, the Court cited the 1934 *Webster’s International Dictionary*.²⁵¹ As to “device” and “contrivance,” the Court cited the dictionary’s rather broad definitions without gloss.²⁵² However, as to “manipulative,” the Court cited the dictionary definition but then went on to limit the definition with regard to the § 10(b) cause of action.²⁵³ Of manipulative, the Court stated, “[i]t is and was virtually a term of art when used in connection with the securities markets. It connotes intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities.”²⁵⁴ This definition of “manipulative” has been cited and quoted with approval by the Supreme Court and other federal courts on numerous occasions.²⁵⁵ Accordingly, it is well settled that conduct must involve some form of manipulative trading practices in the issuer’s securities, such as wash sales, matched orders, rigged prices, or the like in order to be “manipulative” within the meaning of § 10(b).²⁵⁶ In *Stoneridge*, the issue of “manipulative” conduct under § 10(b) was not addressed by the question on appeal. Rather, the question on appeal focused on the other operative term that the Supreme Court has yet to define—“deceptive.”²⁵⁷

250. *Ernst & Ernst*, 425 U.S. at 197 (quoting *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 756 (1975)). The Court in *Stoneridge* followed this pattern of not using criminal or tort law principles to inform § 10(b) and Rule 10b-5 jurisprudence, but, perhaps surprisingly, did not cite *Ernst & Ernst*. “Section 10(b) does not incorporate common-law fraud into federal law.” *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 128 S. Ct. 761, 771 (2008) (citing *SEC v. Zandford*, 535 U.S. 813 (2002); *Central Bank*, 511 U.S. 164; *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336 (2005)).

251. *Ernst & Ernst*, 425 U.S. at 199, nn.20-21.

252. *Id.* at 199 n.20.

253. *Id.* at 199.

254. *Id.* at 199 (quoting WEBSTER’S INTERNATIONAL DICTIONARY (2d ed. 1934) in note 21, which defines manipulate with regard to “exchanges” as “[t]o force (prices) up or down, as by matched orders, wash sales, fictitious reports . . . ; to rig”). Interestingly, the Court did not discuss or define “deceptive” in its discussion of the statute. Further, to date, the Court has not done so. *See also Regents of the Univ. of Cal. v. Credit Suisse First Boston (USA), Inc.*, 482 F.3d 372, 389 (5th Cir. 2007).

255. *See United States v. O’Hagan*, 521 U.S. 642 (1997); *Schreiber v. Burlington Northern, Inc.*, 472 U.S. 1 (1985); *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462 (1977); *In re Citigroup, Inc.*, 330 F. Supp. 2d 367 (S.D.N.Y. 2004); *S.E.C. v. Cavanagh*, 1 F. Supp. 2d 337 (S.D.N.Y. 1998); *Arioli v. Prudential-Bache Sec., Inc.*, 792 F. Supp. 1050 (E.D. Mich. 1992); *Pross v. Baird, Patrick & Co., Inc.*, 585 F. Supp. 1456 (S.D.N.Y. 1984); *In re Commonwealth Oil/Tesoro Petroleum Corp.*, 467 F. Supp. 227 (W.D. Tex., 1979).

256. *Santa Fe*, 430 U.S. at 476, 477.

257. *Ernst & Ernst*, 425 U.S. at 193.

Further, the Court rejected the SEC's arguments that subsection (b) or (c) of Rule 10b-5 would encompass negligent conduct if standing alone.²⁵⁸ In responding to the SEC's arguments, the Court stated:

Rule 10b-5 was adopted pursuant to authority granted the Commission under § 10(b). The rulemaking power granted to an administrative agency charged with the administration of a federal statute is not the power to make law. Rather, it is "the power to adopt regulations to carry into effect the will of Congress as expressed by the statute." Thus, despite the broad view of the Rule advanced by the Commission in this case, its scope cannot exceed the power granted the Commission by Congress under § 10(b).²⁵⁹

Here, the Supreme Court applied the axiomatic principle that an administrative regulation or rule cannot exceed the scope of the statute under which it is enacted.²⁶⁰ However, that being said, the language of Rule 10b-5(a) and particularly (c) is exceptionally broad and would seem to cover negligence in addition to various other types of "fraud," and is therefore plainly beyond the scope of the statute. One is therefore left to conclude that the Court is actually stating that Rule 10b-5 extends liability all the way to the limits of § 10(b) but no further.

Most courts and commentators have assumed that the definition of "deceptive" was a relatively settled matter as well, requiring either a misstatement or omission.²⁶¹ Generally, courts and commentators had

258. *Id.* at 201, 212 (finding that negligence is not sufficient, the Court declined to rule on whether intent is required or whether some lesser degree of culpability, such as recklessness, would suffice).

259. *Id.* at 212-14 (citing *Dixon v. United States*, 381 U.S. 68, 74 (1965)). Again, note that *Ernst & Ernst* was not cited by the Court in *Stoneridge*.

260. *See supra* note 53 and accompanying text.

261. *See supra* note 188 and *infra* notes 302-03 and accompanying text. *See, e.g., HAZEN, supra* note 38, § 12.4 ("Since section 10(b) speaks in terms of deceptive acts, 'deception' is a necessary element of any Rule 10b-5 violation. Thus, *Rule 10b-5 focuses on disclosure and misrepresentation and does not cover all transactions that cause injury or otherwise result in unfairness to investors.*") (footnotes omitted and emphasis added) (citing *Schreiber v. Burlington Northern, Inc.*, 472 U.S. 1 (1985); *Santa Fe*, 430 U.S. 462; *Ernst & Ernst*, 425 U.S. 185). *See also* *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 177 (1994) ("As in earlier cases considering conduct prohibited by § 10(b), we again conclude that the statute prohibits only the making of a material misstatement (or omission) or the commission of a manipulative act."); *Plotkin v. IP Axess Inc.*, 407 F.3d 690, 702 (5th Cir. 2005) (concluding that the plaintiff successfully pleaded "the first element of a rule 10b-5 claim (material misstatement or omission)"); *Fidel v. Farley*, 392 F.3d 220, 235 (6th Cir. 2004) ("[B]ecause *Ernst & Young* itself did not make a *material misstatement or omission* with regard to the unaudited financials, it cannot be held liable under Section 10(b) even if its failure to insist on revisions to the figures or its consent to the inclusion of the audit report of 1998 financial data can be construed as assisting *Fruit of the Loom* in engaging in securities fraud with respect to the 1999 unaudited figures. *Central Bank* simply does not

concluded that anyone who does not employ a manipulation must make a misstatement or omission to be held liable under § 10(b) for deceptive conduct.²⁶² For example, this author has previously noted that “[t]he Supreme Court has seemingly categorized anything that is not a misstatement or an omission as a manipulation, which has been defined as a term of art that covers wash sales, matched orders, and the like. Consequently, courts and commentators focus on misstatements and omissions as the two main categories of primary violations by secondary actors.”²⁶³ Now, at least on the part of some, there seems to be

allow the result that the class members urge us to reach.” (emphasis added)); *Olkey v. Hyperion 1999 Term Trust, Inc.*, 98 F.3d 2, 9 (2d Cir. 1996) (“[Plaintiffs’] expectations were not deceptively manipulated but were simply unmet. The prospectuses contained no material misstatements or omissions of fact, and the plaintiffs fail to state a claim under either the 1933 or 1934 Acts, or under common law fraud.”); *Ziembra v. Cascade Int’l, Inc.*, 256 F.3d 1194, 1205 (11th Cir. 2001) (“[I]n light of *Central Bank*, in order for the defendant to be primarily liable under § 10(b) and Rule 10b-5, the alleged misstatement or omission upon which a plaintiff relied must have been publicly attributable to the defendant at the time that the plaintiff’s investment decision was made.”); *Wright v. Ernst & Young LLP*, 152 F.3d 169, 175 (2d Cir. 1998), *cert. denied*, 525 U.S. 1104 (1999) (“If *Central Bank* is to have any real meaning, a defendant must actually make a false or misleading statement in order to be held liable under Section 10(b). Anything short of such conduct is merely aiding and abetting, and no matter how substantial that aid may be, it is not enough to trigger liability under Section 10(b).”); *Anixter v. Home-Stake Prod. Co.*, 77 F.3d 1215, 1226 (10th Cir. 1996) (“[I]n order for accountants to ‘use or employ’ a ‘deception’ actionable under the antifraud law, they must themselves make a false or misleading statement (or omission) that they know or should know will reach potential investors.”).

262. *Chrisman*, *supra* note 15, at 221.

263. *Id.* at 219 n.114 (citing *Prentice*, *supra* note 18; *Santa Fe*, 430 U.S. 462 (1977); *Ernst & Ernst*, 425 U.S. 185 (1976); and several cases following *Central Bank*, 511 U.S. 164 (1994)). *Prentice* notes that “the Supreme Court has tended to lump all deceptive activity not involving misrepresentations or omissions into the ‘manipulation’ category, and then to hold that ‘manipulation’ is a virtual term of art for practices such as wash sales, matched orders, or rigged prices that are intended to mislead investors.” *Prentice*, *supra* note 18, at 699 n.30 (citing *Santa Fe*, 430 U.S. at 472-74; *Ernst & Ernst*, 425 U.S. at 199). *Taavi Annus* calls this approach the “restrictive view.” *Annus*, *supra* note 18, at 878. He states that “some courts, including the Fifth and Eighth Circuits, hold that there are only three bases for liability under § 10(b): misrepresentation, omission when there is a duty to speak, and market manipulation.” *Id.* at 877. *Annus* proceeds to reject this view by claiming, “[t]he restrictive view is clearly not firmly founded on the language of Rule 10b-5.” *Id.* at 883. Then *Annus* recognizes the argument made herein that the scope of Rule 10b-5 exceeds the scope of § 10(b) only to reject it because the statute proscribes “any” device or contrivance, not merely fraudulent misstatements or omissions. *Id.* at 884. *Annus* does not seek to discover the meaning of deceptive and manipulative, and in fact ignores the common categorization spelled out by *Prentice* above. Interestingly enough, Professor *Fischel* predicted that some would find this approach too restrictive and insensitive to the needs of unprotected investors; however, Professor *Fischel* reminds the reader that it is Congress’ job to define the scope of proscribed conduct, not the courts, and the courts should recognize this delegation of authority and refuse

significant uncertainty about this question.²⁶⁴ Further, *Stoneridge* puts this question squarely before the Court: does § 10(b) require a misstatement or omission?²⁶⁵

The 1934 *Webster's New International Dictionary* defines "deceptive" as "[t]ending to deceive; having power to mislead."²⁶⁶ Clearly, this language is extremely broad and would include misstatements and omissions as well as conduct without a misstatement or omission. In fact, this definition, coupled with the broad definitions of device and contrivance, would encompass nearly any fraudulent activity imaginable as long as it is "in connection with the purchase or sale of any security."²⁶⁷ The Supreme Court, however, has clearly stated that not all instances of financial unfairness amount to a violation of Rule 10b-5.²⁶⁸ Perhaps not surprisingly, the Court has never turned to this definition in interpreting the meaning of the term "deceptive" in § 10(b). Rather, the Court seems to have preferred to define the term "deceptive" over time through case law.

The Supreme Court in *Stoneridge* did not cite or quote this dictionary definition of deception, but it apparently adopted such a definition by its conclusion that "deceptive" encompasses conduct not involving misstatements or omissions.²⁶⁹ This left the Court with the option of either ruling in favor of the petitioner and thereby endorsing scheme liability, or ruling for the respondents on other grounds. Rightly concerned that endorsing scheme liability would create a huge expansion of the potential defendant class under § 10(b) and Rule 10b-5, possibly

to imply private rights of action or expand private rights of action. Fischel, *supra* note 11, at 111.

264. See Annus, *supra* note 18, at 884 ("[T]he use of 'any' deceptive device or contrivance is prohibited, not only the use of fraudulent misrepresentations and omissions."). Compare *In re Charter Commc'ns*, 443 F.3d 987, 992 (2006) ("[T]he district court properly dismissed the claims against the Vendors as nothing more than claims, barred by *Central Bank*, that the Vendors knowingly aided and abetted the Charter defendants in deceiving the investor plaintiffs."), with *Simpson v. AOL Time Warner Inc.*, 452 F.3d 1040, 1048 (9th Cir. 2006) ("[T]o be liable as a primary violator of § 10(b) for participation in a 'scheme to defraud,' the defendant must have engaged in conduct that had the *principal purpose and effect* of creating a false appearance of fact in furtherance of the scheme." (emphasis added)), and *In re Parmalat*, 414 F. Supp. 2d 428 (S.D.N.Y. 2006) (holding that a misrepresentation or omission is not necessary when the plaintiffs are proceeding under the theory 10b-5(a) or (c)).

265. See *supra* note 29 and accompanying text.

266. WEBSTER'S INTERNATIONAL DICTIONARY (2d ed. 1934).

267. 15 U.S.C.A. § 78j(b) (West 2006).

268. *Central Bank*, 511 U.S. at 174.

269. *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 128 S. Ct. 761, 769 (2008) ("Conduct itself can be deceptive, as respondents concede.").

expanding it beyond even what it was under aiding and abetting,²⁷⁰ the Court took the second option and ruled for the respondents on other grounds, that is reliance.²⁷¹ Chief Justice Roberts's statements during oral arguments foreshadowed the expected direction of the Court, and probably voiced the ultimate reasoning behind the decision, when he stated, "we don't get in this business of implying private rights of action any more. [M]y suggestion is not that we should go back and say that there is no private right of action. My suggestion is that we should get out of the business of expanding it."²⁷² Ruling that a misstatement or omission is required for liability under § 10(b) would have certainly accomplished this goal of not expanding the Rule 10b-5 private right of action. It remains to be seen, however, whether the Court's ruling based upon reliance will have the same result.

Further, there is a plausible argument based upon the precedent of the Court and other authority that the Court could have relied upon the rule that a misstatement or omission is required by § 10(b). The Supreme Court could have decided that "deceptive," like manipulative, is a virtual "term of art" within the securities statutes.²⁷³ In fact, the Court seems to have done just that in *Santa Fe Industries, Inc. v. Green*.²⁷⁴ *Santa Fe* involved a Delaware short-form merger whereby Santa Fe Industries merged with its subsidiary, Kirby Lumber Corp.

270. *Id.* at 771 ("Were we to adopt this construction of § 10(b), it would revive in substance the implied cause of action against all aiders and abettors except those who committed no deceptive act in the process of facilitating the fraud; and we would undermine Congress' determination that this class of defendants should be pursued by the SEC and not by private litigants."). Further, this author is aware of no instance where aiding and abetting liability was used to reach vendors who dealt with the primary violator as proposed in scheme liability. Therefore, arguably, scheme liability would actually extend liability beyond even the scope of aiding and abetting to "the entire marketplace in which the issuing company operates." *Id.* at 777 n.4. See, e.g., Schanbaum, *supra* note 18, at 185 (noting that prominent cases endorsing scheme liability "appear to extend the reach of secondary actor liability under section 10(b) back to its pre-*Central Bank* limits").

271. *Id.* at 774 ("In these circumstances the investors cannot be said to have relied upon any of respondents' deceptive acts in the decision to purchase or sell securities; and as the requisite reliance cannot be shown, respondents have no liability to petitioner under the implied right of action.").

272. Transcript of Oral Arguments at 6-7, *Stoneridge*, 127 S. Ct. 1873 (2007) (No. 06-43).

273. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 199 (1976) ("It is and was virtually a term of art when used in connection with securities markets. It connotes intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities.").

274. 430 U.S. 462 (1977).

(“Kirby”).²⁷⁵ The Delaware short-form merger statute provides that a parent company owning at least ninety percent of the stock of its subsidiary company may cause the subsidiary to be merged with the parent upon the vote of the parent’s board of directors and without the approval or even the prior notification of the minority shareholders of the subsidiary.²⁷⁶ Notice of the merger must be given to the minority shareholders within ten days following the consummation of the merger, and the minority shareholders may take the payment of cash offered for their stock in the subsidiary, or they may pursue an appraisal remedy in the Delaware Court of Chancery.²⁷⁷

Santa Fe, over a period of time, acquired ninety-five percent of the outstanding shares of Kirby through a wholly-owned subsidiary, Santa Fe Natural Resources, Inc.²⁷⁸ In order to acquire the remaining five percent, Santa Fe engaged in a short-form merger with Kirby whereby Santa Fe Natural Resources, Inc. transferred the Kirby stock along with cash to a new wholly-owned subsidiary, Forest Products, Inc., in exchange for all of the Forest Products stock.²⁷⁹ Forest Products and Kirby were then merged with Kirby as the surviving corporation.²⁸⁰ The cash that was contributed to Forest Products was used to make the purchase offer of \$150 per share to the Kirby minority shareholders.²⁸¹ In order to arrive at the \$150 per share price, Santa Fe obtained independent appraisals of the Kirby assets (which consisted primarily of various natural resources and assets related thereto).²⁸² These appraisals, along with other financial information about Kirby, were submitted to an investment banking firm charged with appraising the fair market value of the Kirby stock.²⁸³ Kirby’s physical assets were appraised at \$640 per share, and Kirby’s stock was appraised at \$125 per share.²⁸⁴ Santa Fe then decided to offer the minority shareholders of Kirby \$150 per share.²⁸⁵ Santa Fe fully complied with all of the requirements of the

275. *Id.* at 465.

276. *See* DEL. CODE ANN. tit. 8, § 263 (2008) (also called a § 263 merger).

277. *See* § 262.

278. *Santa Fe*, 430 U.S. at 465, 466 n.2.

279. *Id.* at 466 n.3.

280. *Id.*

281. *Id.* at 466.

282. *Santa Fe*, 430 U.S. at 466.

283. *Id.*

284. *Id.*

285. *Id.*

Delaware short form merger statute, and the merger was ultimately consummated.²⁸⁶

The plaintiffs in *Santa Fe* alleged that their stock was worth at least \$772 per share.²⁸⁷ Rather than pursuing their state-law appraisal remedy, however, they sued in federal court under § 10(b) and Rule 10b-5.²⁸⁸ Among other allegations,²⁸⁹ the plaintiffs primarily alleged that Santa Fe engaged in a “course of conduct . . . [in] violation of Rule 10b-5 because defendants employed a device, scheme, or artifice to defraud and engaged in an 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.”²⁹⁰ The quoted language is drawn directly from Rule 10b-5(a) and (c).²⁹¹ As the Court also noted, the plaintiffs’ “principal argument . . . alleges a fraud under clauses (a) and (c) of Rule 10b-5.”²⁹²

The District Court dismissed the complaint for failure to state a claim under Rule 10b-5.²⁹³ The Second Circuit Court of Appeals reversed in part, holding that even “without any misrepresentation or failure to disclose relevant facts, the merger itself constitutes a violation of Rule 10b-5’ because it was accomplished without any corporate purpose and without prior notice to the minority stockholders.”²⁹⁴ In

286. *Santa Fe*, 430 U.S. at 466 n.3.

287. *Id.* at 467.

288. *Id.*

289. The plaintiffs also alleged misstatements or omissions as they relate to the majority’s failure to give them advance notice of the merger. However, the opinion only tangentially addresses this secondary argument. *Id.* at 474 n.14.

290. *Santa Fe*, 430 U.S. at 467-68 (internal quotation marks omitted).

291. *See supra* note 13 and accompanying text.

292. *Santa Fe*, 430 U.S. at 474 n.14. By reading commentators’ articles, one would be inclined to think that scheme liability is the first attempt at using Rule 10b-5(a) to impose liability on a secondary actor. *See, e.g.*, Schanbaum, *supra* note 18. However, the shareholders in *Santa Fe* had the same idea that the plaintiff’s bar conjured up after *Central Bank*, that is to hold secondary actors liable when the secondary actor did not make a misstatement or omission. Given the obvious relevance of the analysis in *Santa Fe* and the conceptual similarity of the arguments offered by the plaintiffs in *Santa Fe* and *Stoneridge*, it is somewhat astonishing that the Court in *Stoneridge* only cites *Santa Fe* twice and neither time for any of its central holdings discussed in this Article. *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 128 S. Ct. 761, 769 (2008) (citing *Santa Fe*, rather than *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), for the proposition that “manipulative” is a term of art). *See also Stoneridge*, 128 S. Ct. at 771 (citing *Santa Fe* for the proposition that § 10(b) and Rule 10b-5 should not be expanded to “cover the corporate universe”).

293. *Santa Fe*, 430 U.S. at 468.

294. *Id.* at 469.

further commenting on the Second Circuit's opinion, the *Santa Fe* Court stated:

The Court of Appeals' view was that, although the Rule plainly reached material misrepresentations and nondisclosures in connection with the purchase or sale of securities, *neither misrepresentation nor nondisclosure was a necessary element of a Rule 10b-5 action*; the Rule reached "breaches of fiduciary duty by a majority against minority shareholders without any charge of misrepresentation or lack of disclosure." . . . We granted the petition for certiorari challenging this holding because of the importance of the issue involved to the administration of the federal securities laws. *We reverse.*²⁹⁵

In reversing, the Court relied almost entirely upon the language of the statute itself, holding that "[t]he language of § 10(b) gives no indication that Congress meant to prohibit any conduct not involving manipulation or deception."²⁹⁶ Therefore, the Court concludes, a "complaint states a cause of action under any part of Rule 10b-5 only if the conduct alleged can be fairly viewed as 'manipulative or deceptive' within the meaning of the statute."²⁹⁷

Turning to the issue of manipulative conduct first,²⁹⁸ the Supreme Court had no trouble finding that there was no manipulation within the meaning of § 10(b).²⁹⁹ Relying on and quoting *Ernst*, the Court stated:

It is . . . readily apparent that the conduct alleged in the complaint was not "manipulative" within the meaning of the statute. "Manipulation" is "virtually a term of art when used in connection with securities markets." The term refers generally to practices, such as wash sales, matched orders, or rigged prices, that are intended to mislead investors by artificially affecting market activity.³⁰⁰

As noted in the discussion of *Ernst* herein, manipulation is used in a technical sense in the securities acts, and relates only to activities that tend to artificially affect the market activity in an issuer's securities in order to deceive investors.³⁰¹

295. *Id.* at 470-71 (emphasis added) (citations omitted).

296. *Id.* at 473.

297. *Santa Fe*, 430 U.S. at 473-74.

298. The Court actually dealt with the issue of deception first, but, for the purposes of this Article, the more straightforward analysis regarding manipulation is first discussed.

299. *Santa Fe*, 430 U.S. at 476.

300. *Id.* (quoting *Ernst & Ernst*, 425 U.S. at 199).

301. See *supra* notes 254-56 and accompanying text.

In discussing the issue of deceptive conduct, the Supreme Court noted that the case came to the Court on the premise that the complaint failed to allege a material misrepresentation or material failure to disclose.³⁰² The Court went on to state that the cases cited by the plaintiffs stated the principle that § 10(b) should be interpreted flexibly and not technically, “[b]ut the cases do not support the proposition, adopted by the Court of Appeals below and urged by [the plaintiffs] here, that a breach of fiduciary duty by majority stockholders, without any deception, misrepresentation, or nondisclosure, violates the statute and the Rule.”³⁰³

While undoubtedly relevant to the issues in *Stoneridge*, the concluding portion of the above quote is somewhat ambiguous. It appears to create a three part list that includes deception, misstatements, and omissions. However, the Court in this section of the opinion appears to discuss what amounts to deception. Therefore, the choice to structure the sentence to include deception in the list of items, apparently explaining what deception consists of, is ambiguous, unhelpful, and unfortunate.³⁰⁴

302. *Santa Fe*, 430 U.S. at 474.

303. *Id.* at 476. *Accord* HAZEN, *supra* note 38, § 12.8[1] (“‘Manipulation’ is a term of art that is limited to certain specific types of trading practices and thus is not applicable in most antifraud cases.”).

304. Justice Kennedy in *Stoneridge* is even less careful in discussing these two operative terms in the statute. In discussing the Eighth Circuit’s opinion, he seems to conflate “deceptive” and “manipulative,” and seems to conclude that “deceptive” is the only operative term, and thus for liability for a manipulation to attach it too would have to be “deceptive.” Of the Eighth Circuit’s opinion, he writes:

The Court of Appeals concluded petitioner had not alleged that respondents engaged in a deceptive act within the reach of the § 10(b) private right of action, noting that only misstatements, omissions by one who has a duty to disclose, and manipulative trading practices (where “manipulative” is a term of art, *see, e.g.*, *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462, 476-77 (1977)) are deceptive within the meaning of the rule.

Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., 128 S. Ct. 761, 769 (2008). However, Justice Kennedy’s characterization of the Eighth Circuit’s position is not correct, as the Eighth Circuit did not conflate the two operative terms “manipulative” and “deceptive.” Rather, the Eighth Circuit maintained a rather clear understanding of the distinction of the two terms. For instance, the Court of Appeals wrote, “[a] device or contrivance is not ‘deceptive,’ within the meaning of § 10(b), absent some misstatement or a failure to disclose by one who has a duty to disclose.” *In re Charter Commc’ns, Inc.*, 443 F.3d 987, 992 (8th Cir. 2006) (citing *Santa Fe*, 430 U.S. at 474-75). The Court of Appeals goes on to state, “[t]hus, any defendant who does not make or affirmatively cause to be made a fraudulent misstatement or omission [i.e., engage in “deceptive” conduct], or who does not directly engage in manipulative securities trading practices, is at most guilty of aiding and abetting and cannot be held liable under § 10(b) or any subpart of Rule 10b-5.” *Id.* (citing a long list of cases as

Despite this unfortunate sentence structure, commentators (and indeed the Supreme Court in *Central Bank*) have understood this portion of *Santa Fe* in conjunction with *Ernst* to require that a secondary actor must either engage in a deception (i.e., make a material misstatement or omission) or employ a manipulation (i.e., wash sales, matched orders, or other activities tending to artificially affect trading in an issuer's securities) in order for its conduct to constitute a violation of the statute.³⁰⁵ Later, in *Central Bank*, the Supreme Court repeatedly and with approval cited Professor Daniel R. Fischel's article entitled *Secondary Liability Under Section 10(b) of the Securities Act of 1934*, where Professor Fischel had reached a similar conclusion.³⁰⁶ In a portion of his article cited by the Supreme Court as support for its central holding in *Central Bank*, Professor Fischel applies his understanding of the Supreme Court precedent on § 10(b), including *Santa Fe* and *Ernst*, to a number of factual situations. He notes that the central issue is "whether the [secondary actor] engaged in a 'manipulative or deceptive' practice within the meaning of section 10(b) as those terms have been interpreted by the Supreme Court."³⁰⁷ Earlier in his article, with regard to the definition of those terms, he stated that "[r]ecent decisions make clear that in order to fall within the statutory prohibition, a defendant . . . must make a material misrepresentation or wrongfully fail to disclose despite a fiduciary duty to do so . . . or engage in a manipulative practice designed to mislead investors by artificially

being in accord with this understanding). Finally, in a footnote to the opinion, the Court of Appeals makes a clear distinction between the two operative terms when it states, "[w]e agree with then-district judge Patrick Higginbotham that the Supreme Court in *Santa Fe* intended to limit § 10(b) claims of *unlawful manipulation (as opposed to deception)* to 'transactions in the [securities] marketplace, the effects of which were to prevent the market price from accurately reflecting the market's unimpeded judgment of the stock's value.'" *Id.* at 992 n.2 (emphasis added) (quoting *Hundahl v. United Benefit Life Ins. Co.*, 465 F. Supp. 1349, 1360 (N.D. Tex. 1979)). It is unfortunate that Justice Kennedy's analysis lacked the clarity of the Eighth Circuit's on this issue.

305. See *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994); *Santa Fe*, 430 U.S. at 474-75; *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 153-54 (1972); *United States v. O'Hagan*, 521 U.S. 642, 653-55 (1997); *Fidel v. Farley*, 392 F.3d 220, 235 (6th Cir. 2004); *Ziamba v. Cascade Int'l, Inc.*, 256 F.3d 1194, 1204-06 (11th Cir. 2001); *Wright v. Ernst & Young LLP*, 152 F.3d 169, 175 (2d Cir. 1998), *cert. denied*, 525 U.S. 1104 (1999); *Anixter v. Home-Stake Prod. Co.*, 77 F.3d 1215, 1225-27 (10th Cir. 1996); *In re Software Toolworks*, 50 F.3d 615, 628 n.3 (9th Cir. 1994); *In re Dynege, Inc.*, 339 F. Supp. 2d 804, 914-16 (S.D. Tex. 2004); *In re Homestore.com, Inc.*, 252 F. Supp. 2d 1018, 1040-41 (C.D. Cal. 2003). See also *infra* notes 322-28 and accompanying text.

306. 69 CAL. L. REV. 80 (1981), cited in *Central Bank*, 501 U.S. at 169, 184, and 191.

307. *Id.* at 106.

affecting market activity.”³⁰⁸ Since *Central Bank*, other commentators have reached similar conclusions.

The Supreme Court has seemingly categorized anything that is not a misstatement or an omission as a manipulation, which has been defined as a term of art that covers wash sales, matched orders, and the like. . . . Consequently, [prior to the introduction of scheme liability], courts and commentators [had] focus[ed] on misstatements and omissions as the two main categories of primary violations by secondary actors.³⁰⁹

Schreiber v. Burlington Northern, Inc.,³¹⁰ while not addressing § 10(b) and Rule 10b-5, provides some support for the argument that a misstatement or omission is required as well. *Schreiber* involved a hostile tender offer turned friendly merger agreement. It was decided under § 14(e) as opposed to 10(b). However, the Court noted, “Section 14(e) adds a ‘broad antifraud prohibition’ modeled on the antifraud provisions of § 10(b) of the Act and Rule 10b-5.”³¹¹ Further, the language of sections 10(b) and 14(e) are very similar.³¹² Thus, an interpretation of 14(e), while not dispositive of the issue with regard to 10(b), is at least instructive.

The issue before the Court in *Schreiber* was whether a misrepresentation or omission was required for liability to attach for an allegedly manipulative trading practice.³¹³ In that regard, the Court held “that the term ‘manipulative’ as used in § 14(e) requires misrepresentation or nondisclosure. It connotes ‘conduct designed to deceive or defraud investors by controlling or artificially affecting the

308. *Id.* at 102-03 (citing *Santa Fe*, 430 U.S. 462 (1977); *Ernst & Ernst*, 425 U.S. 185 (1976)).

309. Chrisman, *supra* note 15, at 219 n.114 (citations omitted).

310. 472 U.S. 1 (1985).

311. *Id.* at 10 (quoting *Piper v. Chris-Craft Indus., Inc.*, 430 U.S. 1, 24 (1977)).

312. Compare § 10(b), *supra* note 12, with § 14(e):

(e) Untrue statement of material fact or omission of fact with respect to tender offer

It shall be unlawful for any person to make any untrue statement of a material fact or omit to state any material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading, or to engage in any fraudulent, deceptive, or manipulative acts or practices, in connection with any tender offer or request or invitation for tenders, or any solicitation of security holders in opposition to or in favor of any such offer, request, or invitation. The Commission shall, for the purposes of this subsection, by rules and regulations define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative.

15 U.S.C.A. § 78n(e) (West 2008).

313. *Schreiber*, 472 U.S. at 2.

price of securities.’ Without misrepresentation or nondisclosure, § 14(e) has not been violated.”³¹⁴ Further, earlier in its analysis, the Court stated that “we have interpreted ‘manipulative’ in th[e § 10(b)] context to require misrepresentation.”³¹⁵ One might argue that, if “manipulative” requires a misstatement or omission, certainly “deceptive” would require the same. In fact, the Court in *Schreiber* seems to base its conclusion in part on the idea that a manipulation must also be deceptive or fraudulent, and to be deceptive or fraudulent it must include a misstatement or omission.³¹⁶ The Court reasons that the purpose of the Securities Acts is to mandate disclosure, not to police the soundness or fairness of investments, and therefore there is no violation absent a failure of disclosure (i.e., a misstatement or omission).³¹⁷

Schreiber, however, certainly is not dispositive and is not the strongest case in support of the proposition stated herein. Even prior to *Stoneridge*, *Schreiber* had been questioned. Professor Hazen describes it as a “highly questionable opinion,”³¹⁸ and that if it were to “be extended to section 10(b) of the Act . . . [it] would [cause] some question as to the Commission’s ability to regulate [manipulative trading practices] where all of the terms are fully disclosed.”³¹⁹ Further, the Court’s holding in

314. *Id.* at 12 (quoting *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 199 (1985)).

315. *Id.* at 8-9 (citing *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 476-77 (1977); *Piper v. Chris-Craft Industries, Inc.*, 430 U.S. 1, 43 (1977); *Ernst & Ernst*, 425 U.S. at 199).

316. *Id.* at 6-11.

317. *Schreiber*, 471 U.S. at 6-11.

318. HAZEN, *supra* note 38, § 6.1.

319. *Id.* § 6.4. Further discussing the *Schreiber* opinion, Professor Hazen writes:

In what could be a very far-reaching decision, the Supreme Court in *Schreiber v. Burlington Northern, Inc.*, limited the scope of § 14(e). *Schreiber* involved a claim that the defendant target company’s renegotiation of the terms of a tender offer was manipulative and hence in violation of section 14(e). Rather than directly face the issue of defining manipulative conduct, the Court held that “[w]ithout misrepresentation or nondisclosure section 14(e) has not been violated.”

The Court reached this conclusion by a tortured reading of the statutory text and a rather unusual view of the section’s legislative history. When enacted in 1968, section 14(e) prohibited material misrepresentations and omissions of material fact as well as “fraudulent, deceptive, or manipulative acts or practices” in connection with a tender offer. The Court’s interpretation ignores the disjunctive use of “or” in the express statutory language. In reviewing the legislative history, the Court viewed disclosure as the sole thrust of the section. In 1970, the statute was amended to give the SEC rulemaking power with regard to “fraudulent, deceptive, or manipulative” acts. The Court did not view this amendment as broadening the disclosure thrust of section 14(e). As a result of the *Schreiber* decision, unless the Court retrenches from its unwarranted broad-brush approach, it seems clear that not only is section 14(e) on its face limited to disclosure but also any rules promulgated thereunder are invalid to the extent that they go beyond

Stoneridge that even the term “deceptive” does not require a misstatement or omission would seem to greatly call into question the holding in *Schreiber*, and arguably could lead to additional litigation under § 14(e) to determine the new scope of § 14(e) following *Stoneridge*.³²⁰

In further support of the proposition that a misstatement or omission is required, the Court in *Stoneridge* could have turned to the legislative history of the express civil liabilities provided for in the 1934 Act. The Supreme Court has held that analysis of the express causes of action can be relevant to determining Congress’s intent as to the implied causes of action.³²¹ In *Ernst*, the Court quotes the following from the legislative history of the express civil liabilities provided in the 1934 Act.

[T]he bill provides that any person who unlawfully manipulates the price of a security, or who induces transactions in a security by means of false or misleading statements, or who makes a false or misleading statement in the report of a corporation, shall be liable in damages to those who have bought or sold the security at prices affected by such violation or statement. In such case the burden is on the plaintiff to show the violation or the fact that the statement was false or misleading, and that he relied thereon to his damage.³²²

This excerpt seems to recognize a dichotomy in the express civil liabilities provided for under the 1934 Act between liabilities attaching for manipulations and liabilities attaching for misstatements

disclosure. This would result in a significant cut-back on Regulation 14E and also would be a most questionable narrowing of the scope of the section. The statute expressly talks in terms of manipulative in addition to fraudulent and deceptive conduct, and the Supreme Court cannot properly excise that term from the statute.

Even beyond the section 14(e) and Regulation 14E ramifications . . . , the impact of the *Schreiber* decision could arguably be carried over to section 10(b), which predates section 14(e) and empowers the SEC to promulgate rules declaring unlawful conduct that constitutes a “manipulative or deceptive device or contrivance.” Extending the *Schreiber* rationale too liberally to section 10(b) would lead to the unwise and unfortunate result of invalidating a number of the section 10(b) rules dealing with manipulative conduct.

Id. § 11.6[1] (footnotes omitted).

320. The Court in *Schreiber* suffered in part from the same mistake that Justice Kennedy made—confusing and conflating manipulation and deception, and ignoring the disjunctive “or” between the two terms. Still, *Schreiber* is illustrative of the vast majority of courts and commentators that had concluded that § 10(b) required a misstatement or manipulation prior to *Stoneridge* and scheme liability.

321. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 200-01 (1985).

322. *Id.* at 205-06 (quoting S. REP. NO. 73-792, at 12-13 (1934)).

(deceptions).³²³ In other words, in the express civil liability provisions, a person can generally be held liable for “manipulat[ing] the price of a security” or “induc[ing] transactions in a security by means of false or misleading statements.”³²⁴ Similarly, under § 10(b), a person can be held liable for a manipulative or deceptive (“false or misleading statements”) device or contrivance. This exact dichotomy is what the *Santa Fe* Court seems to be establishing³²⁵ and what the *Central Bank* Court would later endorse.³²⁶ Surprisingly, this excerpt is not cited in *Santa Fe* or *Central Bank*, but it does lend some support to the arguments proffered therein.³²⁷

Accordingly, based upon the foregoing and despite statements to the contrary, there was a solid argument prior to *Stoneridge* that a secondary actor must make a misstatement or omission or engage in a manipulation to commit a primary violation of § 10(b) and Rule 10b-5, regardless of the subsection of the rule relied upon.³²⁸ Unfortunately, no party seems to have argued this position before the Court. Further, recognizing at least in part that most commentators would conclude that the Eighth Circuit held for the respondents based upon this argument, the Court rejects it with little or no analysis, simply stating that “[i]f [the ruling of the Eighth Circuit] were read to suggest there must be a specific oral or written statement before there could be liability under § 10(b) or Rule 10b-5, it would be erroneous . . . [because c]onduct itself can be deceptive, as respondents concede.”³²⁹

As discussed in Part I of this Article, *Central Bank* clearly rejected private aiding and abetting causes of action “because the text of § 10(b) does not prohibit aiding and abetting” and by implication rejected all

323. Interestingly, the language of Rule 10b-5 was hurriedly drafted and based upon § 17 of the 1933 Act to which this legislative history would not apply. See *infra* Part IV. Perhaps much of the confusion results from that. However, this should not affect the ruling of the Court in light of its clear holdings that the rule cannot exceed the scope of the statute. See *supra* notes 53, 259-60 and accompanying text.

324. *Ernst & Ernst*, 425 U.S. at 205-06 (quoting S. REP. NO. 73-792, at 12-13 (1934)).

325. *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 476 (1977).

326. *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994); see *infra* notes 336-38 and accompanying text.

327. Of course, this excerpt was not cited or discussed in *Stoneridge* either.

328. There is no need for specific analysis of the elements here because the statute is dispositive. Further, as noted previously, the language of the rule is so broad that the statute becomes the limiting factor. See Grundfest, *supra* note 146.

329. *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 128 S. Ct. 761, 769 (2008). This causes one to wonder what parts of *Santa Fe*, *Ernst & Ernst*, and *Central Bank* might have been impliedly overruled by *Stoneridge*.

secondary liability (except controlling person liability).³³⁰ However, proponents of scheme liability frequently ignored the central holding of *Central Bank*, instead focusing on the Court's statement that "[t]he absence of § 10(b) aiding and abetting liability does not mean that *secondary actors* . . . are always free from liability under the securities Acts."³³¹ Here, the usage of the term "secondary actor" caused some to confuse "secondary actor" with "secondary violator."³³² Specifically, the use of the term "secondary actor" led some to assert that secondary actors may be somehow liable for something less than a primary violation, which is a secondary violation. However, this misses the central point of *Central Bank*, that is that a primary or secondary actor must be a primary violator in order to be held liable under § 10(b). The use of the term "secondary actor" relates only to the party's role in the transaction, not secondary or imputed liability. This becomes clear when one looks just beyond the selective quotation to see that *the* prerequisite for "secondary actor" liability is the use of "a manipulative device or [the making of] a material misstatement (or omission) on which the purchaser or seller of securities relies . . . assuming *all* of the requirements for *primary liability* under rule 10b-5 are met."³³³ Finally, the Court notes that the plaintiffs in *Central Bank* "named four

330. *Central Bank*, 511 U.S. at 191. See also *supra* notes 165-66 and accompanying text.

331. *Id.* at 191 (emphasis added). Petitioners in *Stoneridge* cite the "secondary actor" statement at page 191 of the *Central Bank* four times in their Supreme Court Brief. See Brief for Petitioners at 14, 15, 27, and 42, *In Re Charter Comm. Securities Litigation*, 443 F.3d 987 (8th Cir. 2006) (No. 06-43). The most notable and deliberate use of the selective quotation comes in Petitioners' conclusion: "Respondents must not 'be free from liability.'" *Id.* at 42 (citation omitted).

332. A good example of the ambiguity surrounding the *Central Bank* "secondary actor" statement came during oral arguments before the Supreme Court in *Stoneridge*, where Justice Ginsburg engaged both parties with the question of whether there is "a middle category between *Charter*, who is clearly primarily liable, and *Central Bank*, that didn't do anything deceptive?" Transcript of Oral Argument at 26, *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 128 S. Ct. 761 (2008) (No. 06-43). This question clearly misses the point. The Court based its holding in *Central Bank* on the language of § 10(b), which provides liability for manipulations and deceptions, exclusively. Therefore, there can be no middle ground of liability between a clear primary violator and one who does nothing manipulative or deceptive. This is so, notwithstanding the extremely broad language found in Rule 10b-5. One either engages in manipulative or deceptive conduct, becoming a primary violator, or does not, remaining immune to private suit.

333. *Central Bank*, 511 U.S. at 191 (emphasis added). It is truly amazing that Justice Kennedy, who wrote both *Central Bank* and *Stoneridge*, did not cite or discuss this quotation in *Stoneridge*. Since he did not, and based upon the statement in *Stoneridge* that conduct can be deceptive as well, one is left to conclude that this portion of the *Central Bank* opinion is likely overruled by *Stoneridge*.

defendants as primary violators” and that “multiple [primary] violators” are likely “[i]n any complex securities fraud.”³³⁴ Therefore, *Central Bank* totally foreclosed liability for secondary violators by clearly holding that secondary actors (and all other parties) must be primary violators to be liable under § 10(b) and Rule 10b-5.³³⁵

The majority of the Court’s opinion in *Central Bank* supports the understanding that § 10(b) liability requires a manipulation or deception, and liability under deception requires the plaintiff to plead a material misstatement or omission. First, reaffirming its own precedent, the Court states, “the language of § 10(b) gives no indication that Congress meant to prohibit any conduct not involving manipulation or deception.”³³⁶ Second, the Court holds that “the statute prohibits only the making of a material misstatement (or omission) or the commission of a manipulative act.”³³⁷ The word “only” indicates that this is an exhaustive list including only misrepresentations, omissions, and manipulations. When viewed in tandem, these statements appear to enumerate all possible violations under the statutory language of § 10(b). The first statement establishes that there are only two categories of violations—manipulations and deceptions. Further, the reuse of “manipulation” and the absence of “deception” in the second statement suggest that the Court divides deception into two sub-categories: material misrepresentations and omissions. Thus, apparently a violation for deceptive conduct under § 10(b) and Rule 10b-5 requires the making of a material misstatement or an omission coupled with a breach of a duty to disclose.³³⁸

The Supreme Court in *Stoneridge*, however, did not even discuss these provisions of the *Central Bank* opinion or the authority behind them. The Eighth Circuit had clearly relied upon these sections of *Central Bank* to reach the conclusion that follows logically therefrom, that is that a secondary actor must actually make a misstatement or omission in order to be held liable as a primary violator under § 10(b)

334. *Id.*

335. Again, it should be noted that the special form of secondary liability known as controlling person liability persists after *Central Bank*. See *supra* note 59.

336. *Central Bank*, 511 U.S. at 174 (quoting *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 464 (1977), and reaffirming *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 473 (1976)) (citations omitted).

337. *Id.* at 177 (citing *Santa Fe*, 430 U.S. at 473).

338. *Id.* See also *Chiarella v. United States*, 445 U.S. 222 (1980) (holding that a duty to disclose is required before an omission is actionable under § 10(b)).

and Rule 10b-5.³³⁹ In response to this possible “reading” of the Eighth Circuit’s opinion, Justice Kennedy in *Stoneridge* responds:

If this conclusion were read to suggest there must be a specific oral or written statement before there could be liability under § 10(b) or Rule 10b-5, it would be erroneous. Conduct itself can be deceptive, as respondents concede.³⁴⁰

Thus, the opinion in *Stoneridge*, at a minimum, calls these statements in *Central Bank* into question and arguably overrules them outright. As noted by the Second Circuit in *Wright*, “‘if *Central Bank* is to have any real meaning, a defendant must actually make a false or misleading statement in order to be held liable under Section 10(b).’”³⁴¹ If the Second Circuit in *Wright* is correct, *Central Bank* has no real meaning after *Stoneridge*! This is a rather astonishing development, especially given that the same Justice wrote both opinions.

However, perhaps the Supreme Court had begun to move away from these statements in *Central Bank* prior to the opinion in *Stoneridge*. Proponents of scheme liability had attempted to use a certain passage from *United States v. O’Hagan* to limit the holding of the Court in *Central Bank*.³⁴² However, *O’Hagan* has been radically criticized by commentators and, prior to *Stoneridge*, there was a good argument that it should not be viewed as limiting *Central Bank*.³⁴³ *O’Hagan* involved an

339. *In re Charter Commc’ns, Inc.*, 443 F.3d 987, 992 (2006).

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

341. *Wright v. Ernst & Young, LLP*, 152 F.3d 169, 175 (2d Cir. 1998) (quoting Shapiro v. Cantor, 123 F.3d 717, 720 (2d Cir. 1997)).

342. 521 U.S. 642 (1997).

343. Commentators describe the Court’s opinion in *O’Hagan* with varying degrees of criticism. Possibly the most scathing attack on *O’Hagan* came from Stephen Bainbridge during a recent panel discussion hosted by Case Western School of Law. During his remarks, Professor Bainbridge described *O’Hagan* as “a cut and paste pot job, where [Justice Ginsberg] clipped out key provisions of the . . . solicitor general’s brief, reworded a few of them, but for the most part quoted it.” Professor Bainbridge went on to quip, “I assume one of the clerks called up the [Solicitor General’s] office and said, ‘it’s very nice to have this printed brief, but we need the word doc copy, you know, so we can do some cutting and pasting.’” Stephen Bainbridge, William D. Warren Professor of Law at UCLA, Panel Discussion: Case Western Reserve School of Law Symposium on Scheme Liability, Section 10b-5, and *Stoneridge Investment Partners v. Scientific-Atlanta*, available at http://law.case.edu/centers/business_law/webcast.asp?dt=20071005 (archived webcast) and http://law.case.edu/lectures/index.asp?lec_id=157 (general information). In the same discussion, Professor Bainbridge alluded to an earlier article he published criticizing the lack of business expertise on the Court. There he wrote:

In our view, this [lack of expertise] is the best explanation for the Supreme Court’s widely criticized decision in *United States v. O’Hagan*, which addressed the

attorney who was a partner for a law firm that represented Grand Met in a potential tender offer in which Grand Met intended to buy Pillsbury stock.³⁴⁴ James O'Hagan did not work on the case but he knew details of the tender offer from a conversation with a partner who was assigned to that case.³⁴⁵ Because of this information, O'Hagan bought 5000 shares of Pillsbury common stock and 2500 call options, and after Grand Met announced its tender offer, O'Hagan sold all of his interest, netting a gain of approximately \$4.3 million.³⁴⁶ Again, as with the *Central Bank* opinion itself, the plaintiffs attacked by isolating a quote from *O'Hagan* to support the contention that “[courts should] not draw undue

validity of the so-called misappropriation theory as a basis for imposing insider trading liability under SEC Rule 10b-5. The misappropriation theory was almost two decades old before the Court got around finally to resolving its validity. It did so only after a major circuit split had emerged. In resolving the case, the majority did essentially what the government told it to do—the misappropriation section of Justice Ginsburg’s opinion repeatedly quoted from or cited to the government’s brief and oral argument, almost always approvingly. She framed the case as one involving a “theory of liability for which the Government seeks recognition,” and adopted the central element of the government’s theory. In other words, she quite blatantly deferred to expert opinion.

Stephen M. Bainbridge & Mitu Gulati, *How do Judges Maximize? (The Same Way Everybody Else Does—Boundedly): Rules of Thumb in Securities Fraud Opinions*, 51 EMORY L. J. 83, 143 (2002). While perhaps not a “cut and paste job,” the *Stoneridge* opinion dutifully adopts every part of the Solicitor General’s argument, once again doing “what the government told it to do.” In its summary of arguments, the Solicitor General’s Brief states that:

A. The court of appeals in this case erred to the extent it held that Section 10(b) of the 1934 Act, 15 U.S.C. 78j(b), reaches only misstatements, omissions made while under a duty to disclose, or manipulative trading practices. . . .

....

B. Although the court of appeals erred by concluding that petitioner had failed to satisfy Section 10(b)’s deception requirement, it nevertheless correctly upheld the district court’s dismissal of petitioner’s complaint, because petitioner did not sufficiently plead reliance on respondents’ deceptive conduct. . . .

....

C. Allowing liability for a primary violation under the circumstances presented here would constitute a sweeping expansion of the judicially inferred private right of action in Section 10(b) and Rule 10b-5, potentially exposing customers, vendors, and other actors far removed from the market to billions of dollars in liability when issuers of securities make misstatements to the market. . . .

Brief for the United States as Amicus Curiae Supporting Affirmance at 8-9, *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 128 S. Ct. 761 (2008) (No. 06-43). Perhaps Professor Bainbridge is correct that the Supreme Court does simply lack the institutional expertise to decide securities law cases, and therefore “quite blatantly defer[s] to expert opinion.” Bainbridge & Gulati, *supra*, at 143.

344. *O'Hagan*, 521 U.S. at 647.

345. *Id.* at 648 n.1.

346. *Id.* at 648.

conclusions from [the text of *Central Bank*].”³⁴⁷ The specific quotation normally cited reads:

The Eighth Circuit isolated the [“secondary actor”] statement just quoted and drew from it the conclusion that § 10(b) covers only deceptive statements or omissions on which purchasers and sellers, and perhaps other market participants, rely. It is evident from the question presented in *Central Bank*, however, that this Court, in the quoted passage, sought only to clarify that secondary actors, although not subject to aiding and abetting liability, remain subject to primary liability under § 10(b) and Rule 10b-5 for certain conduct.³⁴⁸

As discussed above, the Court’s “secondary actor” statement in *Central Bank*, when read in context, provides no basis for the conclusion that deceptive conduct liability under § 10(b) lies for anything other than a material misrepresentation or omission. Further, the *O’Hagan* Court did not disagree that § 10(b) requires a misstatement or omission. To the contrary, the Court merely noted that the Eighth Circuit misapprehended the misappropriation theory, believing it required “neither misrepresentation nor nondisclosure.”³⁴⁹ Moreover, when one reads *O’Hagan* in context, one clearly finds that “deceptive nondisclosure [was] essential to the § 10(b) liability [at issue]. Concretely, in [*O’Hagan*,] it was O’Hagan’s failure to disclose his personal trading to Grand Met and Dorsey, in breach of his duty to do so, that made his conduct ‘deceptive’ under § 10(b).”³⁵⁰ Still, this dicta from *O’Hagan*, in some ways, foreshadowed the Court’s willingness to depart from portions of its opinion in *Central Bank*.

Further, some commentators had also suggested that the Supreme Court’s recent holding in *SEC v. Zandford* required the conclusion that a misstatement or omission was not required under § 10(b) and Rule 10b-5.³⁵¹ In *Zandford*, the respondent, a stock broker, sold his clients stock

347. Brief for Petitioners at 27, *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc. & Motorola, Inc.*, 128 S. Ct. 761 (2008) (No. 06-34).

348. *O’Hagan*, 521 U.S. at 664 (citations omitted).

349. *Id.* at 660.

350. *Id.* at 644. One might also wonder whether the *Stoneridge* opinion has negative implications for the validity of *O’Hagan* and the misappropriation theory given that *O’Hagan* came after the PSLRA and arguably expanded the reach of liability under Rule 10b-5. “It is appropriate for us to assume that when the [PSLRA] was enacted, Congress accepted the § 10(b) private cause of action [which at that time only included the misappropriation theory in the lower courts] as then defined but chose to extend it no further.” *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 128 S. Ct. 761, 773 (2008).

351. *SEC v. Zandford*, 535 U.S. 813 (2002).

without the approval of or disclosure to the client.³⁵² The respondent took the money from the stock sales and transferred it into his own account.³⁵³ The issue in *Zandford* was “whether the alleged fraudulent conduct was ‘in connection with the purchase or sale of any security’ within the meaning of the statute and the Rule.”³⁵⁴ Admittedly, the respondents conduct involved a misstatement or omission.³⁵⁵

Ignoring this critical fact from the analysis, commentators used *Zandford* for support that there is no requirement under § 10(b) that a misstatement or omission be present.³⁵⁶ However, *Zandford* merely stands for the proposition that § 10(b) should not be read restrictively, but rather, it should be read flexibly.³⁵⁷ The Court used that language to support the proposition that “[n]either the SEC nor this Court has ever held that there must be a misrepresentation *about the value* of a particular security in order to run afoul of the Act.”³⁵⁸ The Court did not say that a misrepresentation is not required; it simply said that a misrepresentation *about a particular security’s value* is not required. While there is no requirement that there be a misstatement about the value of a particular security, there still is a requirement that there be a misstatement or omission (or, after *Stoneridge*, deceptive conduct) in order for conduct to be actionable under § 10(b) and Rule 10b-5.

352. *Id.* at 815.

353. *Id.*

354. *Id.*

355. *Zandford*, 535 U.S. at 820-21. The Court specifically stated that the respondent engaged in a scheme to defraud that “was deceptive because it was neither authorized by, nor disclosed to, the Woods.” *Id.* The Court further stated that the Woods “were duped into believing respondent would ‘conservatively invest’ their assets in the stock market and that any transactions made on their behalf would be for their benefit for the ‘safety of principal and income.’” *Id.* at 822. While discussing the implications of the respondent’s actions, the Court affirmed its precedent by asserting that any distinction between misstatements and omissions is illusory in the stockbroker/client relationship. The Court affirmed that an omission is only actionable when there is a duty to disclose. *Id.* at 823 (citing *Chiarella v. United States*, 445 U.S. 222 (1980)). Since there was an omission in this case, and thus a deception, § 10(b) and Rule 10b-5 proscribed the respondents conduct.

356. See, e.g., Kimberly Bame, Comment, *Beyond Misrepresentations: Defining Primary and Secondary Liability Under Subsections (A) and (C) of Rule 10b-5*, 67 LA. L. REV. 935, 941 (2007) (noting that “[i]n *SEC v. Zandford*, the Court stated that it had never held that there must be a misrepresentation to violate Rule 10b-5 fraud provisions,” but failing to include the Court’s important qualifying phrase “about the value of a particular security”); see also *Zandford*, 535 U.S. at 820 (“[N]either the SEC nor this Court has ever held that there must be a misrepresentation *about the value of a particular security* in order to run afoul of the Act.” (emphasis added)).

357. *Zandford*, 535 U.S. at 819.

358. *Id.* at 814 (emphasis added).

As the preceding demonstrates, there existed in Supreme Court precedent ample grounds for concluding that § 10(b) requires that a defendant actually make a misstatement or omission in order to be held liable under the Rule 10b-5 private cause of action. While only time will tell, the Court's conclusion to the contrary seems to have severely restricted or partially overruled the Court's opinion in *Central Bank*. Further, the reasoning in *Stoneridge* may well in time make way for other cunning arguments that might extend the reach of liability under the implied cause of action, the very result that the Court seemed so concerned with avoiding.

IV. IN THE WAKE OF *STONERIDGE*, DOES SECTION 10(B) REQUIRE THAT A SECONDARY ACTOR ACTUALLY MAKE A MISSTATEMENT (OR OMISSION) IN ORDER TO BE HELD LIABLE AS A PRIMARY VIOLATOR UNDER RULE 10B-5?

Rule 10b-5 and its attendant implied private cause of action continues to engender great debate and discussion in the securities world.³⁵⁹ While one has difficulty imagining securities regulation without the Rule 10b-5 private right of action, it is entirely probable that the 1934 Congress never dreamt of such a private right of action when enacting § 10(b), let alone one so expansive.³⁶⁰ Louis Loss and Joel Seligman in their influential treatise, *Securities Regulation*, write:

The Rule 10b-5 story tempts the pen. For it is difficult to think of another instance in the entire *corpus juris* in which the interaction of the legislative, administrative rulemaking, and judicial processes has produced so much from so little. What is more remarkable is that the whole development was

359. See The Federalist Society Online Debate Series: *Stoneridge Investment v. Scientific Atlanta*, THE FEDERALIST SOCIETY, Feb. 19, 2008, <http://www.fed-soc.org/debates/dbtid.16/default.asp> (including commentary from Stephen Bainbridge, UCLA Law professor; Jay Brown, Denver Sturm College of Law professor; Ted Frank, American Enterprise Institute; Andrew Pincus, Mayer Brown; Robert Prentice, University of Texas at Austin – McCombs School of Business professor; and Andrea Seidt, Ohio Assistant Attorney General).

360. “In § 10(b), Congress prohibited manipulative or deceptive acts in connection with the purchase or sale of securities. *It envisioned that the SEC would enforce the statutory prohibition through administrative and injunctive actions.* Of course, a private plaintiff now may bring suit against violators of § 10(b).” *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 173 (1994).

unplanned . . . [T]he Rule [is] “a horse of dubious pedigree but very fleet of foot.”³⁶¹

Then Justice Rehnquist stated in *Blue Chip Stamps v. Manor Drug Stores* that the private right of action under Rule 10b-5 is “a judicial oak which has grown from little more than a legislative acorn.”³⁶² Of the origins of Rule 10b-5, Milton V. Freeman, its primary author, has said:

[S]ince people keep talking about 10b-5 as my rule, and since I have told a lot of people about it, I think it would be appropriate for me now to make a brief statement of what actually happened when 10b-5 was adopted, where it would be written down and be available to everybody, not just the people who are willing to listen to me.

It was one day in the year 1943, I believe. I was sitting in my office in the S.E.C. building in Philadelphia and I received a call from Jim Treanor who was then the Director of the Trading and Exchange Division. He said, “I have just been on the telephone with Paul Rowen,” who was then the S.E.C. Regional Administrator in Boston, “and he has told me about the president of some company in Boston who is going around buying up the stock of his company from his own shareholders at \$4.00 a share, and he has been telling them that the company is doing very badly, whereas, in fact, the earnings are going to be quadrupled and will be \$2.00 a share for this coming year. Is there anything we can do about it?” So he came upstairs and I called in my secretary and I looked at Section 10(b) and I looked at Section 17 [of the Securities Act of 1933], and I put them together, and the only discussion that we had there was where “in connection with the purchase or sale” should be, and we decided it should be at the end.

We called the Commission and we got on the calendar, and I don’t remember whether we got there that morning or after lunch. We passed a piece of paper around to all the commissioners. All of the commissioners read the rule and they tossed it on the table, indicating approval. Nobody said anything except Sumner Pike who said, “Well,” he said, “we are against fraud, aren’t we?” That is how it happened.

361. LOSS & SELIGMAN, *supra* note 59, § 9-B-3. Justice Stevens in the dissent disagrees and argues that the 1934 Congress did indeed intend such a cause of action. He argues:

In light of the history of court-created remedies and specifically the history of implied causes of action under § 10(b), the Court is simply wrong when it states that Congress did not impliedly authorize this private cause of action “when it first enacted the statute.” Courts near in time to the enactment of the securities laws recognized that the principle in [*Tex. & Pac. Ry. Co. v. Rigsby*, 241 U.S. 33 (1916),] applied to the securities laws. Congress enacted § 10(b) with the understanding that federal courts respected the principle that every wrong would have a remedy. Today’s decision simply cuts back further on Congress’ intended remedy. I respectfully dissent.

Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, 128 S. Ct. 761, 781-82 (Stevens, J., dissenting) (footnote and citation omitted).

362. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 737 (1975).

Louis [Loss] is absolutely right that I never thought that twenty [now sixty]-odd years later it would be the biggest thing that had ever happened. It was intended to give the Commission power to deal with this problem. It had no relation in the Commission's contemplation to private proceedings. How it got into private proceedings was by the ingenuity of members of the private Bar starting with the *Kardon* case.³⁶³

Still today, Rule 10b-5 develops and grows in this same undisciplined and often unpredictable way. First, the Supreme Court or Congress acts in rather limited ways to either expand or contract Rule 10b-5. Then, in response to judicial or congressional action, the plaintiffs' bar invents a "new" theory of liability. Finally, the defense bar demurs, sending the matter back to the courts for another cycle. Initially, Rule 10b-5 seemed only to expand as it passed through these machinations, growing ever larger and spreading its boughs like a "cedar [of] Lebanon" or a tree planted by the "abundant waters."³⁶⁴ However,

363. Milton V. Freeman, *Administrative Procedures*, 22 BUS. LAW. 891, 922 (1967).

364. The cedar of Lebanon is an important symbol throughout the history of many cultures. One familiar example comes from the book of Ezekiel, where Ezekiel compares Egypt to Assyria, calling Assyria a great cedar tree:

Who can be compared to your majesty?
 Consider Assyria, once a great cedar in Lebanon,
 with beautiful branches overshadowing the forest;
 it towered on high,
 its top above the thick foliage.
 The waters nourished it,
 deep springs made it grow tall;
 their streams flowed all around its base
 and sent their channels
 to all the trees of the field.
 So it towered higher
 than all of the other trees on the field;
 its boughs increased
 and its branches grew long,
 all of the birds in the air
 nested in its boughs, and all of the beasts of the field
 gave birth under its branches;
 all of the nations lived in its shade.
 It was majestic in beauty,
 with its spreading boughs,
 for its roots went down to abundant waters.

Ezekiel 31:2-7 (New International Version). However, the passage does not end well for the majestic cedar. It was proud of its height and, "according to its wickedness[, God] cast it aside, and the most ruthless of foreign nations cut it down and left it. . . . [i]ts branches lay broken in all the ravines of the land." *Id.* at 10-12. "Therefore, no other trees by the water are to ever tower so proudly on high, lifting their tops above the thick foliage. No other trees by the water reach such height; they are destined for death, for the earth below, among mortal

with *Blue Chip Stamps*, *Ernst*, *Santa Fe*, and related cases, the Supreme Court began pruning the judicial oak. Congress joined in the pruning with the Private Securities Litigation Reform Act (“PSLRA”) and similar legislative enactments.

Perhaps the most significant “pruning” to date occurred in *Central Bank*, where the Supreme Court sawed off the huge limb of secondary liability and aiding and abetting. In response, a new cycle began with the plaintiffs’ bar ingeniously attempting to “graft” a new limb of secondary liability onto the nub left by *Central Bank*. As discussed above, this new silviculture goes by the name of “substantial participation” and now “scheme liability.” The Ninth Circuit cultivated this new limb of liability.

In *Stoneridge*, however, the Supreme Court appears to have removed this unnecessary growth. Further, the Court has essentially pronounced that this “mighty oak” should grow no more. Its reach, according to *Stoneridge*, is no greater than what it was in 1995 when Congress enacted the PSLRA. Given the Court’s obvious concern that the Rule 10b-5 private right of action not be expanded, this may be the most important and enduring holding of *Stoneridge*. One is left to wonder whether in the future courts may be forced to spend a great deal of time figuring out the contours of the private right of action as it existed in 1995, when Congress “accepted the § 10(b) private cause of action . . . but chose to extend it no further,”³⁶⁵ in order to determine whether imposing liability for the specific acts alleged would impermissibly expand the private right of action.

This, of course, introduces incredible uncertainty and presents a host of issues with which the lower courts will be forced to grapple. For example, did Congress “accept . . . the private cause of action” as defined by the Supreme Court only, or did Congress “accept” rulings of the lower courts as well? If the lower courts as well, which opinions did Congress accept? If Congress did not accept any of the opinions of the lower courts, then what of issues that had not yet come before the Supreme Court, or issues, such as scienter, that had been specifically reserved by the Court?

The case of scienter may be particularly instructive as to issues that may arise following *Stoneridge*. Professor Hazen, in his excellent

men, with those who go down to the pit.” *Id.* at 14. Perhaps *Stoneridge* indicates that the § 10(b) private cause of action is headed for a similar fate unless rescued by Congress.

365. *Stoneridge*, 128 S. Ct. at 765.

Treatise on the Law of Securities Regulation, writes of the scienter requirement:

It is clear that the scienter requirement is satisfied by a showing of intentional misrepresentation made with the intent to deceive. But what about conduct that falls short of willful misrepresentation? In reaching its decisions in *Hochfelder* and *Aaron* the Court did not decide whether a showing of reckless conduct would satisfy the scienter requirement. It has long been the rule at common law that, at least under certain circumstances, the showing of reckless disregard of the truth or the making of a statement with no belief in its truth constitutes scienter in an action for deceit. While the recklessness question remains unsettled at the Supreme Court level, the vast majority of the circuit and district court decisions have found that recklessness is sufficient to state a claim under 10b-5.³⁶⁶

Since, as Professor Hazen notes, “the recklessness question remains unsettled at the Supreme Court level,”³⁶⁷ what did Congress accept in 1995 with the enactment of the PSLRA? Did Congress accept the decisions of “the vast majority of the circuit and district court[s]” in favor of recklessness? Or, did Congress merely accept the conclusion of *Ernst* and leave the question of “recklessness” for a future Supreme Court to decide?

The language of the PSLRA on scienter is no help in resolving this issue. It merely provides:

Required state of mind – In any private action arising under this chapter in which the plaintiff may recover money damages only on proof that the defendant acted with a particular state of mind, the complaint shall, with respect to each act or omission alleged to violate this chapter, state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.³⁶⁸

While “accepting” the holding in *Ernst* that scienter or a “state of mind” is required, the PSLRA in no way indicates what that state of mind should be. Further, the fact that the recklessness standard is accepted in common law fraud would likely prove of little value as well, because “[s]ection 10(b) does not incorporate common-law fraud into federal law.”³⁶⁹

366. HAZEN, *supra* note 38, § 12.8[3].

367. *Id.*

368. 15 U.S.C.A. § 78u-4(b)(2) (West 2008).

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

Thus, would it be an expansion of the implied cause of action for the Court to hold that a plaintiff in a § 10(b) case need only show recklessness? If the PSLRA accepted the “vast majority of” lower court opinions, then the answer would appear to be in the negative, as the “accepted” cause of action would include recklessness. However, if the PSLRA accepted the implied cause of action as developed by Supreme Court opinions only, it seems that endorsing a standard less than intent would expand the cause of the action and would therefore run afoul of *Stoneridge*. At the rate that the Supreme Court accepts Rule 10b-5 cases, it may well take decades for this and similar issues to be resolved absent Congressional action.

Returning to the topic of this Article, *Stoneridge* brings less clarity than promised by the words of the opinion to the question whether § 10(b) and Rule 10b-5 require a misstatement or omission coupled with a duty to disclose. Justice Kennedy seems to address this question at the very outset of the opinion with an answer of “obviously not.” He writes:

The Court of Appeals concluded petitioner had not alleged that respondents engaged in a deceptive act within the reach of the § 10(b) private right of action, noting that only misstatements, omissions by one who has a duty to disclose, and manipulative trading practices (where “manipulative” is a term of art) are deceptive within the meaning of the rule. *If this conclusion were read to suggest there must be a specific oral or written statement before there could be liability under § 10(b) or Rule 10b-5, it would be erroneous. Conduct itself can be deceptive, as respondents concede.* In this case, moreover, respondents’ course of conduct included both oral and written statements, such as the backdated contracts agreed to by Charter and respondents.

A different interpretation of the holding from the Court of Appeals opinion is that the court was stating only that any deceptive statement or act respondents made was not actionable because it did not have the requisite proximate relation to the investors’ harm. That conclusion is consistent with our own determination that *respondents’ acts or statements were not relied upon by the investors and that, as a result, liability cannot be imposed upon respondents.*³⁷⁰

In two rather short paragraphs, the Court dismisses the relatively settled understanding that a misstatement or omission is required as “erroneous,” establishes that conduct can also be deceptive within the meaning of § 10(b), notes that the “respondents’ course of conduct included both oral and written statements,” and concludes that liability will not lie under § 10(b) and Rule 10b-5 because there is not the

370. *Id.* at 769 (emphasis added and citations omitted).

“requisite proximate relation” between the respondents’ course of conduct and “the investors’ harm,” that is there was no reliance. Thus, it would seem that the answer is clear: a misstatement or omission is not required because conduct can also satisfy the deceptive requirement in § 10(b).

However, as noted herein, the Court goes on to discuss reliance, the ostensible basis for its ruling.³⁷¹ Consistent with its precedent, the Supreme Court first found that the conduct alleged was proscribed by the statute,³⁷² and then proceeded to the essential element of reliance.³⁷³ Accordingly, the Court evidenced a three-prong understanding of reliance, in that reliance may be based only on (1) proof of actual reliance, (2) “an omission of a material fact by one with a duty to disclose,”³⁷⁴ or (3) “the fraud-on-the-market doctrine, [where] reliance is presumed when the statements at issue become public.”³⁷⁵ Under this framework for reliance, the Court held:

Neither presumption applies here. Respondents had no duty to disclose; and their deceptive acts were not communicated to the public. No member of the investing public had knowledge, either actual or presumed, of respondents’ deceptive acts during the relevant times. Petitioner, as a result, cannot show reliance upon any of respondents’ actions except in an indirect chain that we find too remote for liability.³⁷⁶

After holding that none of the three methods of reliance were sufficiently alleged by the petitioner, the Court continued its analysis by reviewing the petitioner’s argument that scheme liability provides a

371. Not expanding the § 10(b)/Rule 10b-5 private right of action seems to be the Court’s real concern. Reliance appears to be merely the means to accomplishing that end in this case.

372. *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 172 (1994) (“First, [the court has to] determine[] the scope of conduct prohibited by § 10(b).”) The Court in *Stoneridge* did in fact determine that § 10(b) proscribes the conduct engaged in by the respondents when it held, “[c]onduct itself can be deceptive . . . [R]espondents’ course of conduct included both oral and written statements, such as the backdated contracts agreed to by Charter and respondents.” *Stoneridge*, 128 S. Ct. at 769. Unfortunately, the Court came to this conclusion in two short paragraphs without any significant analysis. The next question is whether “all of the requirements for primary liability under Rule 10b-5 are met.” *Central Bank*, 511 U.S. at 191.

373. *Stoneridge*, 128 S. Ct. at 769 (“[T]he ‘requisite causal connection between a defendant’s misrepresentation and a plaintiff’s injury’ exists as a predicate for liability.” (quoting *Basic, Inc. v. Levinson*, 485 U.S. 224, 243 (1988))).

374. *Id.* (citing *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 153-54 (1972)).

375. *Id.* (citing *Basic*, 485 U.S. at 247).

376. *Id.*

sufficient basis for proving reliance.³⁷⁷ The petitioners argued that “the financial statement Charter released to the public was a *natural and expected consequence* of respondents’ deceptive acts; had respondents not assisted Charter, Charter’s auditor would not have been fooled, and the financial statement would have been a more accurate reflection of Charter’s financial condition”; therefore, liability is appropriate under the third method of reliance based on public statements.³⁷⁸ The Court simply responded by stating that “this approach does not answer the objection that petitioner did not in fact rely upon the *respondents’ own deceptive conduct*.”³⁷⁹

In all events we conclude respondents’ deceptive acts, which were not disclosed to the investing public, are too remote to satisfy the requirement of reliance. It was Charter, not respondents, that misled its auditor and filed fraudulent financial statements; *nothing respondents did made it necessary or inevitable for Charter to record the transactions as it did*.³⁸⁰

Justice Stevens, in his dissenting opinion in *Stoneridge*, seems to think that the majority propounded a new rule that, in order to establish reliance in a case such as this, the plaintiff must show that the defendant’s conduct (or possibly misstatements not communicated to the plaintiff or the market) “made it necessary or inevitable for” the primary actor to make a misstatement upon which the plaintiff relies or about which one of the presumptions mentioned herein applies.³⁸¹ Thus, following *Stoneridge*, in order to be held liable as a primary violator, a secondary actor must either (1) make a misstatement or omission

377. *Stoneridge*, 128 S. Ct. at 770-71.

378. *Id.* at 770 (emphasis added). In other words, the respondents should be liable because of another’s misstatement or omission, a result that was specifically eliminated in *Central Bank*. See *supra* notes 157-58 and accompanying text.

379. *Id.* (emphasis added).

380. *Id.* (emphasis added).

381. Whether Justice Kennedy actually intended to create such a test is certainly debatable. Still, the words of the opinion seem to suggest that if the conduct of the vendors had been of such that it made Charter’s misstatements necessary or inevitable, then liability would have been found. Justice Stevens in the dissent seems to agree. He states:

The Court’s next faulty premise is that petitioner is required to allege that Scientific-Atlanta and Motorola made it “necessary or inevitable for Charter to record the transactions as it did” in order to demonstrate reliance. Because the Court of Appeals did not base its holding on reliance grounds, the fairest course to petitioner would be for the majority to remand to the Court of Appeals to determine whether petitioner properly alleged reliance, under a correct view of what § 10(b) covers.

Stoneridge, 128 S. Ct. at 775-76 (Stevens, J., dissenting) (citations omitted).

(thereby making actual reliance possible or one of the presumptions applicable), or (2) engage in deceptive conduct, which can include misstatements or omissions that are not communicated to the plaintiff or the market, that makes it “necessary or inevitable” that the primary actor will make a misstatement upon which the plaintiff relies (either actually or via one of the presumptions of reliance).

The first option is undisputed and the result would be the same under any of the tests discussed herein. However, in many cases involving secondary actors, the issue is that there are no misstatements (or omissions coupled with a duty to disclose) that have been communicated to the plaintiffs or the market. Therefore, according to Justice Stevens, it appears that the issue is not whether the secondary actor actually made a misstatement or omission, but rather whether the secondary actor’s deceptive conduct makes it “necessary or inevitable” that the primary actor will make a misstatement or omission upon which the plaintiff can rely or establish a presumption. As the following will clarify, however, this author wonders whether this is a distinction without a difference.

In order to apply the purported “necessary or inevitable” test of reliance, the first thing a court must do is define the terms necessary and inevitable. “Inevitable” is defined as “incapable of being avoided or evaded.”³⁸² What secondary actor conduct would make it such that the primary actor’s making a misstatement would be “incapable of being avoided?” Among other things, “necessary” is defined as “having the character of something that is logically required or logically inevitable or that cannot be denied without involving contradiction,” “that is inevitably fixed or determined or produced by a previous condition of things,” “acting under compulsion,” or “absolutely required.”³⁸³ “Necessary” is seemingly the more permissive of the two terms, and one might speculate that any conduct by a secondary actor that makes a misstatement by the primary violator inevitable would also make it necessary. Thus, a more important question might ask what conduct by a secondary actor would make it *necessary* that the primary actor make a misstatement. What sort of conduct by a secondary actor would make a misstatement by the primary violator “logically required or logically inevitable” or “absolutely required?”

382. WEBSTER’S THIRD NEW INTERNATIONAL DICTIONARY UNABRIDGED 1157 (2002).

383. WEBSTER’S THIRD NEW INTERNATIONAL DICTIONARY UNABRIDGED 1510-11 (2002).

The Supreme Court gave no hint as to the application of this purported test, or even that it was establishing a test, in the *Stoneridge* opinion. Regardless, given the Court's statement in *Stoneridge*, the standard must require more than the conduct of the Vendors in that case. Further, based upon its reversal and remand of *Simpson*, the Supreme Court has ruled that the conduct of the defendants there did not make a misstatement by Homestore.com necessary or inevitable either. Even the egregious facts of the Enron debacle that formed the basis of the *Regents* case apparently do not satisfy the necessary or inevitable standard, given that the Supreme Court denied certiorari in that case just seven days after *Stoneridge* and on the same day that it reversed and remanded *Simpson*. Further, based upon the Court's ruling that § 10(b) liability is not to be expanded, whatever secondary actor conduct alleged to have made it necessary or inevitable that a primary violator make a misstatement must also be such a character that it not expand § 10(b) liability beyond its limits at the time of the PSLRA in 1995.

Is it possible that the only conduct by a secondary actor that makes it necessary or inevitable that a primary violator will make a misstatement is when the secondary actor somehow makes that misstatement itself and thereby becomes a primary violator? If so, does the *Stoneridge* opinion create what mathematicians call a "null set"—a group that actually contains nothing? Or, to put it another way, did the *Stoneridge* opinion in fact require that a secondary actor actually make a misstatement or omission in order to be held liable under § 10(b) and Rule 10b-5 while professing to do the very opposite? Or is the "necessary and inevitable" standard criticized by Justice Stevens a requirement at all?³⁸⁴ Could it be that the majority simply responded to the petitioner's argument that Charter's inflated financial statements were the "natural and expected consequence of respondents' deceptive acts?"³⁸⁵ Unfortunately, absent Congressional action, these questions will only be answered through slow and costly securities litigation.

This result is regrettable and could have been avoided if the Court had been careful to issue a principled ruling based upon precedent. However, instead of issuing a ruling based upon principle and precedent, the Court in *Stoneridge* violated its own admonition in *Central Bank* and based its ruling primarily on policy grounds. Ironically, the calls for securities litigation rulings based upon policy grounds are usually made by those extending liability more than by those looking to limit it.

384. *Stoneridge*, 128 S. Ct. at 775 (Steven, J., dissenting).

385. *Id.* at 770.

Frequently, the plaintiffs in securities fraud cases are very sympathetic, such as the Enron shareholders in *Regents*, and the deep-pocketed secondary actors often appear less than noble, such as the banks in *Regents*. Accordingly, these cases often present a situation where there is a strong feeling on the part of many that fairness demands that someone should be held liable, a feeling that can often override a faithful application of the law.

Indeed, lower courts applying the “substantial participation” test and scheme liability have not done so in fidelity to Supreme Court precedent. Rather, the rulings often seem to be based upon policy considerations and feelings regarding what is fair in a given situation. One illustration was the *ZZZZ Best* court’s statement that Ernst & Young “should be liable under Section 10(b)/Rule 10b-5.”³⁸⁶ Surely to arrive at this conclusion, the court used some sort of policy considerations. Further, the commentators who argue for an expansive test such as the “substantial participation” test or scheme liability argue mainly on policy grounds.³⁸⁷ However, the Supreme Court specifically foreclosed reliance on such policy considerations in *Central Bank*.³⁸⁸

The SEC points to various policy arguments in support of the 10b-5 aiding and abetting cause of action. It argues, for example, that the aiding and abetting cause of action deters secondary actors from contributing to fraudulent activities and ensures that defrauded plaintiffs are made whole.

Policy considerations cannot override our interpretation of the text and structure of the Act, except to the extent that they may help to show that adherence to the text and structure would lead to a result “so bizarre” that Congress could not have intended it. That is not the case here.

Extending the 10b-5 cause of action to aiders and abettors no doubt makes the civil remedy more far reaching, but it does not follow that the objectives of the statute are better served. Secondary liability for aiders and abettors exacts costs that may disserve the goals of fair dealing and efficiency in the securities markets.³⁸⁹

Further, the Court states that “[t]he issue . . . is not whether imposing private civil liability on aiders and abettors is good policy but whether aiding and abetting is covered by the statute.”³⁹⁰ However, in *Stoneridge*, Justice Kennedy, also the author of *Central Bank*, ignored

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

387. *See* Prentice, *supra* note 18, at 727-32.

388. *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 188 (1994).

389. *Id.* (citations omitted).

390. *Id.* at 177.

his own admonition not to rule primarily on policy grounds and crafted an opinion that exhibits strained and unprincipled reasoning that hardly addresses the language of the statute, and rather seemed entirely motivated by the majority's conclusion that liability under § 10(b) should not be extended.³⁹¹ This is somewhat ironic given that most of the calls for a decision based upon policy are made by people who view

391. The following comments made to a recent online debate about *Stoneridge* echo these complaints about the opinion and demonstrate that it will likely be castigated in years to come.

Jay Brown

....

The Court's reasoning had nothing to do with the language of the statute or with common law notions of fraud. In fact, the Court made clear that neither controlled. Instead, the decision arose because of the Court's dislike for the implied right of action under Rule 10b-5. Unwilling to do away with the cause of action, the Court concluded that it would not extend the reach any further than was already the case. To the Court, allowing vendors to be sued was an extension. As a result, the use of reliance was merely an expediency designed to exonerate the vendors in this case (as evidenced by the refusal of the Court to remand on the issue of reliance).

The use of an expediency rather than thoughtful analysis based upon the language of the provision will ultimately be counterproductive. It does not, in fact, result in the exoneration of all vendors. For example, while the Court denied cert in the Enron case, it is back at the District Court (the case was on appeal from the district court's decision to grant class certification) and the plaintiffs will try to show reliance on the statements of the investment bankers (apparently through reliance on analyst reports and recommendations). In other circumstances, issuers will make disclosure of vendor contracts (see Item 1.01 of Form 8-K, requiring companies to report any "material definitive agreement not made in the ordinary course of business"), presumably creating a strong basis for arguing reliance.

The case is sloppy, not controlled by legal principles, and likely to result in more rather than less litigation.

Robert Prentice

If we truly dislike courts that make law, we cannot be happy with *Stoneridge*, which is an activist, policy-driven decision.

....

The Court's true policy-driven motives shine through clearly in the opinion. After holding in previous cases that policy considerations should be considered only to ensure that a particular statutory interpretation is not "bizarre," the *Stoneridge* majority ignored that self-imposed limitation and reached its preferred result with completely one-sided policy analysis. There is certainly a case to be made that private litigation under Sec. 10(b) carries more disadvantages than benefits, but there is also substantial empirical evidence to the contrary. Given the Court's concession that Congress has approved and ratified the private right to sue, that policy debate should have been left to Congress rather than resolved by the Court.

The Federalist Society Online Debate Series: *Stoneridge Investment v. Scientific Atlanta*, THE FEDERALIST SOCIETY, Feb. 19, 2008, <http://www.fed-soc.org/debates/dbtid.16/default.asp>.

the plaintiffs, not the defendant-secondary actors, as sympathetic parties deserving of the benefits of a policy ruling.

That being said, the Court should have followed its own statements in *Central Bank* and faithfully applied the text of the statute, consulting policy considerations as little as possible, and only then to elucidate the consideration of the statute and its own precedent. Both parties, as the Court noted in *Central Bank*, can often forward policy arguments. For example, in *Stoneridge*, an oft-heard policy argument for the plaintiffs is compensation of the Enron shareholders. In addition to that argument, many of the same policy arguments offered in *Central Bank* were again put forward in *Stoneridge*, such as both deterrence and the fairness in holding parties who participated in some way responsible.

Significant policy arguments were also made against scheme liability. The Court set forth many of these in the *Stoneridge* opinion. For example, the Court suggests that rampant securities litigation undermines the efficiency and competitiveness of the U.S. capital markets, causing a loss of capital to overseas markets.³⁹² In addition, the Court seems concerned that the adoption of scheme liability will cause parties dealing with publicly-traded companies to engage in redundant, cost-increasing behavior without any corresponding reduction in fraudulent activity or other societal benefits.³⁹³ The Court suggests that parties dealing with publically-traded companies would likely begin requiring the other company to attest to the accounting treatment of the deal.³⁹⁴ Further, arguably, this would then be the subject of audits for the vendor.³⁹⁵

392. Some have also argued that vexatious securities litigation provides a windfall for plaintiff's attorneys, while doing little to benefit those truly harmed by securities fraud. *See, e.g.,* Panel Discussion: Case Western Reserve School of Law Symposium on Scheme Liability, Section 10b-5, and *Stoneridge Investment Partners v. Scientific-Atlanta*, *supra* note 343.

393. *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta*, 128 S. Ct. 761, 772 (2008) ("As noted in *Central Bank*, contracting parties might find it necessary to protect against these threats, raising the costs of doing business.").

394. *Id.* Stephen Bainbridge, author of *THE COMPLETE GUIDE TO SARBANES-OXLEY: UNDERSTANDING HOW SARBANES-OXLEY AFFECTS YOUR BUSINESS* (2007), agrees and notes that:

If scheme liability is imposed, however, the risks associated with these practices will escalate significantly. To be sure, there are already some risk that the SEC or Justice Department will pursue these roundtrip transactions, but it seems safe to assume that private party liability exposure would raise the stakes significantly.

The net effect will be to bring significant pressure to bear on the Motorola's of the world to subject these sort of contracts to effective internal audits. In turn,

The important point of this discussion is not that policy arguments must dictate one result or the other, as such arguments can be forwarded by both sides, but rather that the Supreme Court should have followed its own statements in *Central Bank* and should not have ruled in *Stoneridge* on policy grounds.³⁹⁶ The proper role of the courts is to interpret laws as written; if policy arguments are helpful in that context, then they should be considered. However, when the language of the statute is clear on its face, then the courts are duty bound to interpret the statute as written, and the proper place for those who are disappointed with the application of the statute to voice their policy arguments is to the legislature.³⁹⁷ As Alexander Hamilton appropriately stated in the Federalist Paper No. 78, “[t]he courts must declare the sense of the law; and if they should be disposed to exercise WILL instead of JUDGMENT, the consequence

because nobody will want to sign off on the accounting treatment for transactions that might push the edge of the envelope without clearing it with their auditors, there will be even greater involvement of external auditors in the contracting process.

You might say, well, so what? After all, aren't internal controls supposed to crack down on wrongdoing? Well, yes, but. Remember Motorola didn't issue the misleading financial statements. It didn't help prepare them. We're not talking about Charter's 404 duties. We're talking about imposing more extensive and demanding 404 requirements on firms in connection with somebody else's disclosures.

There's a reason, after all, that firms seldom put internal control performance provisions in contracts with customers or suppliers. It's bad enough trying to monitor your own internal controls. Trying to monitor somebody else's can be orders of magnitude more difficult and expensive.

Posting of Stephen Bainbridge to BusinessAssociationsBlog.com, <http://www.businessassociationsblog.com> (Oct. 3, 2007).

395. *Stoneridge*, 128 S. Ct. at 772.

396. Justice Stevens would disagree with this statement in that he appears to consider *Central Bank*, as well as *Stoneridge*, an example of the Court engaging in judicial policy making. In his dissent in *Stoneridge*, he states, “while I recognize that the *Central Bank* opinion provides a precedent for judicial policymaking decisions in this area of the law, I respectfully dissent from the Court’s continuing campaign to render the private cause of action under § 10(b) toothless.” *Id.* at 779 (Stevens, J., dissenting). However, the *Central Bank* opinion, while later noting policy arguments, first proffered solid legal arguments based upon the language of § 10(b), and compelled the conclusion that aiding and abetting should not be a part of the implied cause of action. Unlike *Central Bank*, *Stoneridge* does not exhibit such thoughtful consideration of the law. Further, Justice Stevens, who also wrote the dissent in *Central Bank*, seems motivated primarily by the concern that § 10(b) not be “rendered toothless,” and it is difficult for this author to see how expanding the reach of a judicially created cause of action demonstrates any more judicial restraint than limiting one would. Judicial restraint is only demonstrated when the Court limits itself to ruling based upon the law.

397. See Grundfest, *supra* note 146, at 15.

would equally be the substitution of their pleasure to that of the legislative body.”³⁹⁸

Those who advocate expansion of the implied cause of action under § 10(b) and Rule 10b-5 using the “substantial participation” test or scheme liability based on policy grounds essentially argue that the courts should “substitut[e] . . . their pleasure to that of the legislative body.”³⁹⁹ Equally, the Court, when rejecting scheme liability without careful legal analysis and based upon the conviction that the implied cause of action not be expanded, subjects itself to the assertion that it engaged in judicial policy-making. This result, however, cannot be tolerated in a government that relies on the separation of powers, which envisions different bodies in the government with distinct roles. Unlike the legislature, the courts do not have the resources or the time to thoroughly examine these policy arguments. The current security statutes represent the legislature’s position on these issues, and thus, while it is desirable that securities fraud be punished, the Supreme Court rightly concluded in *Central Bank*, based on the text of the statute, that “not every instance of financial unfairness constitutes fraudulent activity under § 10(b).”⁴⁰⁰ If the Court in *Stoneridge* had focused more on the text of the statute and less on crafting and considering policy arguments, perhaps a better reasoned opinion would have resulted.

The preceding is not put forward to argue that the Court reached the wrong result. As this Article endeavors to make clear, the rejection of scheme liability was the correct decision. Rather, the preceding is meant to demonstrate that even reaching the right conclusion with careless legal reasoning is not good for a government based upon the separation of powers where the roles of the judiciary and the legislature are well defined. Further, as demonstrated herein, decisions based upon policy rather than legal argument frequently bring about uncertainty and unintended consequences that inexorably lead to more litigation—arguably, in *Stoneridge*, the very result the Supreme Court seemed so desperate to avoid.

In conclusion, one is left to wonder why the majority would engage in such clear policy-based analysis, especially given that most of the justices forming the majority have expressed their desires to avoid such analysis. One reason is made abundantly clear in the opinion and herein: the majority’s dislike for the § 10(b)/Rule 10b-5 private right of action

398. THE FEDERALIST NO. 78, at 392 (Alexander Hamilton).

399. *Id.*

400. *Chiarella v. United States*, 445 U.S. 222, 232 (1980).

and desire that it not be expanded.⁴⁰¹ However, there is perhaps another reason that is not as clear from the opinion. Perhaps the Court chose to use the reliance element rather than interpreting “deceptive” in § 10(b) in order to preserve the right of the SEC to pursue the Vendors and similarly-situated defendants.⁴⁰² Private plaintiffs must establish reliance in order to prevail in a § 10(b)/Rule 10b-5 action, but the SEC, on the other hand, need not show reliance in a criminal or civil enforcement action.⁴⁰³ Both the SEC and private plaintiffs, however, must establish either manipulation or deception.⁴⁰⁴ A ruling based upon the statutory language of § 10(b), therefore, would have insulated the Vendors and those similarly situated from actions by both the SEC and private plaintiffs.⁴⁰⁵ By contrast, the ruling in *Stoneridge* preserves the right of the SEC to proceed against such actors.⁴⁰⁶ Perhaps the Court did feel that the Vendors really were bad actors but felt that the SEC was the proper party to pursue such actors. On the other hand, perhaps the Court felt that the PSLRA demanded such a conclusion. Due to the nature of the opinion, however, many more questions are raised than answers given, and courts and commentators will likely speculate about the meaning and motivation of this opinion for years to come.

CONCLUSION

Central Bank took securities litigation under § 10b-5 to the threshold of clarity but no further. In doing so, the Court created a great deal of uncertainty with regard to the scope of primary liability under § 10(b) and Rule 10b-5.⁴⁰⁷ The lower courts continued to struggle to define the proper scope of primary liability, and the circuit courts of appeal split over this issue on two separate occasions.⁴⁰⁸ Both of these splits related specifically to the question whether § 10(b) requires that a

401. See *supra* note 224 and accompanying text.

402. Or, perhaps more accurately, the Solicitor General argued this for these reasons and the Court dutifully adopted the government’s arguments. See *supra* note 343.

403. HAZEN, *supra* note 38, § 12.10 (“Reliance is an element of a private claim under Rule 10b-5, but not in enforcement actions brought by the government.”) (citing SEC v. Alliance Leasing Corp., 28 Fed. Appx. 648 (9th Cir. 2002); S.E.C. v. McCaskey, No. 98 CIV. 6153(SWK), 2001 WL 1029053 (S.D.N.Y. 2001)). Cf. *United States v. Davis*, 226 F.3d 346, 358 (5th Cir. 2000).

404. See generally HAZEN, *supra* note 38, § 12.

405. See *supra* Part III.

406. See *supra* note 403 and accompanying text.

407. See *supra* note 18 and accompanying text.

408. See *supra* notes 18 and 28 and accompanying text.

secondary actor actually make a misstatement or omission in order to be held liable as a primary violator under Rule 10b-5.⁴⁰⁹ In *Stoneridge*, this issue was specifically presented to the Supreme Court for its resolution.⁴¹⁰

As demonstrated herein, there existed adequate legal grounds for concluding that § 10(b) and Rule 10b-5 require a manipulation, misstatement, or omission by one with a duty to disclose.⁴¹¹ However, the Supreme Court in *Stoneridge* rejected this argument without even discussing the relevant authority, and ruled instead based upon the reliance requirement.⁴¹² While the Court reached what is arguably the right result, it did so in an opinion that is clearly driven by policy considerations more than a careful and thoughtful analysis of the law. This attempt at policymaking seems to be motivated by a dislike for the implied private right of action under § 10(b) and Rule 10b-5, and clearly states that the private right of action should not be expanded.⁴¹³ Whether this decision will have its intended effect, only time and litigation will tell; but, as noted herein, the opinion raises many more questions than it answers, and is therefore likely to create more uncertainty and litigation in the future as the lower courts attempt to decipher and apply the Court's decision in *Stoneridge*.

409. See *supra* Part II herein.

410. See *supra* note 29 and accompanying text.

411. See *supra* Part III.

412. See *supra* Part IV.

413. See *supra* note 224 and accompanying text.