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FREEDOM TO DEFRAUD: *STONERIDGE*, PRIMARY LIABILITY, AND THE NEED TO PROPERLY DEFINE SECTION 10(B)

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ABSTRACT

In Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc., *the Supreme Court determined that primary liability under section 10(b) of the Securities Exchange Act does not extend to third-party actors engaged in sham transactions, even when such transactions have the purpose and effect of deceiving investors. The Court reasoned that there is no liability when an actor's deceptive conduct is not communicated directly to investors. This Note argues that the Supreme Court misinterpreted section 10(b) and Rule 10b-5 and that policy considerations weigh in favor of using securities fraud litigation to deter culpable actors. It argues both for the substantial participation standard and the revitalization of scheme liability in order to best comply with the language and policies of section 10(b) and Rule 10b-5.*

INTRODUCTION

"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)."[1] In 1994, the Supreme Court declared that only primary violators—not aiders and abettors—could be held liable for federal securities fraud under the Securities

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† Duke University School of Law, J.D. expected 2008; Michigan State University, B.A. 2005. I thank James D. Cox for his advice and guidance and the editors of the *Duke Law Journal* for their work editing this Note. Special thanks to my fiancée, Morgan, for her never-ending love, encouragement, and support.

1. Cent. Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164, 191 (1994).

Exchange Act of 1934.[2] Subsequently, lower courts struggled to reach a consensus regarding who qualifies as a primary violator. Adding to the confusion was another wrinkle: scheme liability emerged to increase the potential liability for third parties. In *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*,[3] the Supreme Court attempted to answer many of these questions when it held that liability is inappropriate even if an actor "engaged in conduct with the purpose and effect of creating a false appearance of material fact to further a scheme to [deceive investors]."[4]

This Note addresses the debate over primary liability under section 10(b) and Rule 10b-5 in the context of private securities class actions. Unsurprisingly, the arguments surrounding *Central Bank of Denver v. First Interstate Bank of Denver*,[5] and its subsequent effect, are well documented.[6] Therefore, this Note does not weigh in on the issues specific to aiding and abetting liability. Instead, it focuses on the limits of primary liability in securities fraud with an emphasis on the developments surrounding scheme liability.

Among traditional approaches to primary liability, the substantial participation approach is more appropriate than the bright-line approach because it better advances the policy objective of deterring culpable actors. The Supreme Court should have used scheme liability to achieve deterrence in *Stoneridge*, especially because many circuits refuse to move from the bright-line to the substantial participation approach. Important to both of these arguments is the recognition that both scheme liability and substantial

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2. *Id.*

3. Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., No. 06-43, slip op. at 1 (U.S. Jan. 15, 2008).

4. *Id.*, slip op. at 9.

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

6. *E.g.*, 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, 671–85 (2004) (analyzing the *Central Bank* decision and the tests that have emerged in the lower courts as a result); Edward Labaton, Commentary, *The Gatekeepers Are Still Accountable Even After* Central Bank *and the Contract with America*, 38 ARIZ. L. REV. 547, 547–51 (1996) (discussing a federal district court case, *In re ZZZZ Best Sec. Litig.*, 864 F. Supp. 960 (C.D. Cal. 1994), which relied heavily on the penultimate paragraph of the Court's decision in *Central Bank*); Donald C. Langevoort, *Words from on High About Rule 10b-5:* Chiarella*'s History,* Central Bank*'s Future*, 20 DEL. J. CORP. L. 865, 885–93 (1995) (discussing *Central Bank* and predicting how lower courts will react to its holding); David S. Ruder, *The Future of Aiding and Abetting and Rule 10b-5 After* Central Bank of Denver, 49 BUS. LAW. 1479, 1479 (1994) (discussing the historical background of Rule 10b-5 and urging an amendment of section 10 of the Securities Exchange Act of 1934 "to provide aider and abettor liability").

participation are completely consistent with the Supreme Court's decision in *Central Bank*. Part I discusses the development of liability under section 10(b) and Rule 10b-5, culminating in an examination of the traditional approaches to primary liability. It argues that under the language of the statute, the substantial participation approach is appropriate. Part II introduces the issues surrounding scheme liability. It addresses the *Stoneridge* decision and argues that the Court's reasoning in that case is flawed. Part III examines the possible policy objectives underlying section 10(b) liability, concluding that such liability should be imposed with a focus on deterring culpable actors. It then utilizes the deterrence objective and offers suggestions for courts to reach culpable conduct while critically examining the approaches to primary and scheme liability.

I. DEVELOPMENT OF SECTION 10(B) AND RULE 10B-5 LIABILITY

A. *Aiding and Abetting Pre-*Central Bank

Section 10(b) of the Securities Exchange Act of 1934 prohibits any person from directly or indirectly using or employing "in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance."[7] More specifically, Rule 10b-5 prohibits: (a) employing "any device, scheme, or artifice to defraud"; (b) making "any untrue statement of a material fact or . . . omit[ting] to state a material fact necessary . . . to make the statements made . . . not misleading"; and (c) engaging "in any act, practice, or course of business which operates . . . as a fraud or deceit."[8]

A perpetual issue arising under section 10(b) and Rule 10b-5 is the proper method for determining who can be held liable for a false or misleading statement.[9] Prior to *Central Bank*, lower courts in 1966

7. Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (2000).

8. 17 C.F.R. § 240.10b-5 (2007).

9. Section 10(b) and Rule 10b-5 do not expressly provide for a private right of action. Yet federal courts implied a private right of action early as 1946. *See* Kardon v. Nat'l Gypsum Co., 69 F. Supp. 512, 514 (E.D. Pa. 1946) ("[T]he legislature may withhold from parties injured the right to recover damages arising by reason of violation of a statute but the right is so fundamental and so deeply ingrained in the law that where it is not expressly denied the intention to withhold it should appear very clearly and plainly."). To find such a cause of action, courts looked beyond the statutory language to principles of tort law, finding that the purpose of the statute was to protect the interests of private parties, and "the mere omission of an express

began to read these rules as containing an implied private right of action against aiders and abettors.[10] Courts used aiding and abetting liability for actors such as banks[11] and accountants[12]

B. A New Direction: The Central Bank *Decision*

Central Bank of Denver served as the indenture trustee for bonds issued to finance improvements for a local public building authority.[13] While it was trustee, Central Bank became aware that the appraisals of the land securing the bonds were potentially inaccurate.[14] When the building authority defaulted, purchasers of the bonds sought to hold the bank liable for aiding and abetting under section 10(b).[15] In a 5–4 decision, the Supreme Court held that section 10(b) of the Securities Exchange Act of 1934 does not include a cause of action for aiding and abetting.[16]

> [T]he statute prohibits only the making of a material misstatement (or omission) or the commission of a manipulative act. The proscription does not include giving aid to a person who commits a manipulative or deceptive act. We cannot amend the statute to create liability for acts that are not themselves manipulative or deceptive within the meaning of the statute.[17]

Yet the Supreme Court provided no additional guidance regarding what it meant to make a "material misstatement." As a result, it was left to the lower courts to determine when the conduct of an actor qualifies that actor as a primary violator under section 10(b) and Rule 10b-5. Because a cause for aiding and abetting

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provision for civil liability is not sufficient to negative what the general law implies." *Id.* Subsequently, the Supreme Court explicitly recognized the existence of a private right of action. Herman & MacLean v. Huddleston, 459 U.S. 375, 380 (1983) ("[A] private right of action under § 10(b) of the 1934 Act and Rule 10b-5 has been consistently recognized for more than 35 years. The existence of this implied remedy is simply beyond peradventure.") (footnote omitted).

10. *E.g.*, Brennan v. Midwestern United Life Ins. Co., 259 F. Supp. 673, 681 (N.D. Ind. 1966), *aff'd*, 417 F.2d 147, 155 (7th Cir. 1969).

11. Metge v. Baehler, 762 F.2d 621, 624–30 (8th Cir. 1985).

12. Rudolph v. Arthur Andersen & Co., 800 F.2d 1040, 1045–46 (11th Cir. 1986).

13. Cent. Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164, 167 (1994).

14. *Id.*

15. *Id.* at 168.

16. *Id.* at 191. The majority opinion was delivered by Justice Kennedy and was joined by Chief Justice Rehnquist and Justices O'Connor, Scalia, and Thomas. *Id.* at 166. Only Justices Kennedy, Scalia, and Thomas remained on the Court in 2008.

17. *Id.* 177–78 (emphasis added) (citations omitted).

provided litigants with easier claims to establish, however, courts seldom examined the scope of primary liability prior to *Central Bank*.[18] Since *Central Bank*, courts have been flooded with litigation questioning the boundaries of primary liability. The next Section outlines the methods that federal courts are using to grapple with primary liability.

C. Approaches to Primary Liability

Courts have developed multiple approaches to clarify the scope of primary liability with regards to false or misleading statements under Rule 10b-5. Three distinct approaches have surfaced: a bright-line test, a substantial involvement test, and liability for a "scheme to defraud." This Note examines each of these approaches in turn. This Section focuses on the first two, both of which developed soon after the *Central Bank* decision. The third approach, scheme liability, developed later and its possible impact warrants greater emphasis. As a result, it is discussed in great detail in Part II.

1. *Bright-Line Approach.* Under the first approach, to have actually made a false or misleading statement, that statement must be attributable to the actor, by the public, at the time of dissemination.[19] Several cases adopting the bright-line test illustrate this approach to determining when secondary actors are primarily liable.

In *Wright v. Ernst & Young, L.L.P.*,[20] a stockholder in BT Office Products brought suit for allegedly materially false representations in connection with the corporation's sale of common stock.[21] The class action sought to hold the corporation's independent auditor, Ernst & Young, liable for its oral approval of BT's financial statements.[22] The investor claimed that the accounting firm was reckless in its review of the financial statements and that the market relied on the fact that Ernst & Young approved the statements.[23]

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18. *See* James D. Cox, *Just Deserts for Accountants and Attorneys After* Bank of Denver, 38 ARIZ. L. REV. 519, 521 (1996) ("[T]he overbreadth of the courts' construction of the earlier aiding and abetting standard prevented any clear development of the scope of primary participant liability.").

19. Wright v. Ernst & Young L.L.P., 152 F.3d 169, 175 (2d Cir. 1998).

20. Wright v. Ernst & Young L.L.P., 152 F.3d 169 (2d Cir. 1998).

21. *Id.* at 171.

22. *Id.* at 172.

23. *Id.*

After recognizing the varying approaches to primary liability,[24] the Second Circuit used a bright-line test to determine that anything short of a defendant actually making a false or misleading statement is insufficient to trigger primary liability.[25] Furthermore, under this test, a statement is not made for section 10(b) purposes unless it is "attributed to that specific actor at the time of public dissemination, that is, in advance of the investment decision."[26] The court stated that because BT's public statements did not mention Ernst & Young, the auditor was not responsible for making a material misrepresentation.[27]

The Eleventh Circuit adopted the Second Circuit's bright-line approach in *Ziemba v. Cascade International, Inc.*[28] In *Ziemba*, the plaintiffs filed a class action on behalf of purchasers of Cascade International's common stock.[29] The plaintiffs sought to hold Cascade's legal counsel liable for its significant participation in drafting, creating, and reviewing Cascade's allegedly fraudulent letters and press releases.[30] Similarly, the plaintiffs alleged that Cascade's accountants incorrectly advised Cascade that its financial statements did not need to be consolidated, failed to include "going concern" qualifications in its audit reports, and failed to disclose the fraud suggested by Cascade's periodic reports.[31] The court adopted the bright-line test, however, requiring that "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."[32] The attorneys and accountants were not primarily liable under 10(b) because the allegations did not reach this level.[33]

The primary argument in favor of the bright-line approach involves the issue of reliance.[34] Proponents of the bright-line test find

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24. *Id.* at 174–75 (recognizing the "bright-line" and "substantial participation" tests).

25. *Id.* at 175.

26. *Id.*

27. *Id.*

28. Ziemba v. Cascade Int'l, Inc., 256 F.3d 1194, 1205 (11th Cir. 2001).

29. *Id.* at 1197.

30. *Id.* at 1205.

31. *Id.* at 1207.

32. *Id.* at 1205.

33. *Id.* at 1213.

34. For a discussion of the counterarguments to this approach and the arguments in favor of the "substantial participation" approach, see *infra* notes 41–42 and accompanying text. For a

it necessary to prevent *Central Bank* from becoming obsolete. "[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)."[35] The concern over *Central Bank*'s continuing application is most evident with regard to the element of reliance. Courts have long said that reliance is an essential element of a securities action.[36] *Wright* explicitly represented a commitment to reliance focused on by the *Central Bank* court.[37] Requiring attribution of statements to an actor at the time of dissemination would ensure that those statements were in fact relied upon. Thus, the fear is that if liability lies when statements are not attributable to an actor, then it is unclear whether those injured truly relied on the conduct of that actor.

2. *Substantial Participation Approach.* The Ninth Circuit has championed a second method for determining primary liability: "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."[38]

Deciding *In re Software Toolworks Inc. Securities Litigation*,[39] the court held that underwriters and accountants who participated in the drafting and review of letters to the Securities and Exchange Commission could be held liable as primary violators of section 10(b) because of their "significant role in drafting and editing the . . . letter[s]."[40] The primary argument in favor of the substantial

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discussion regarding the appropriate rationale supporting securities regulation and possible avenues using the development of scheme liability, see *infra* Part III.

35. 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)).

36. *See, e.g.*, List v. Fashion Park, Inc., 340 F.2d 457, 462–63 (2d Cir. 1965) ("Disagreement centers on the applicability and meaning of the requirement that reliance be placed upon the misrepresentation. Our examination of the authorities satisfies us that this requirement also is carried over into civil suits under Rule 10b–5.").

37. *See Wright*, 152 F.3d at 174 ("[A] § 10(b) cause of action based on aiding and abetting would circumvent the 'reliance' requirement of Rule 10b–5 . . . ." (citing Cent. Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164, 180 (1994))).

38. Howard v. Everex Sys., Inc., 228 F.3d 1057, 1061 n.5 (9th Cir. 2000); *see also In re* Software Toolworks Inc. Sec. Litig., 50 F.3d 615, 628–29 & n.3 (9th Cir. 1994) (holding that drafting or editing false statements that the drafter-editor knows will be publicly disseminated is sufficient for primary liability).

39. *In re* Software Toolworks Inc. Sec. Litig., 50 F.3d 615 (9th Cir. 1994).

40. *Id.* at 628 n.3.

participation approach, and the primary objection to the bright-line approach, is as follows: Holding actors with intricate involvement in wrongdoing liable deters culpable individuals and prevents injuries from going uncompensated.[41] Punishing this wrongdoing prevents the bizarre result of culpable actors avoiding liability simply because their name was not attached to the public misstatement.[42]

3. *Blended Approach.* Possibly aware of the unsettling outcome of the bright-line test, the Tenth Circuit appears to combine aspects of both the bright-line and the substantial participation approach. In *Anixter v. Home-Stake Production Co.*,[43] the court considered liability of an independent auditor for his alleged participation in the preparation of registration statements, prospectuses, and opinion letters in regards to the corporation's financial health.[44] The investors claimed the auditor made statements with knowledge that they were false or at least with reckless disregard to their truthfulness.[45] In a similar vein as *Wright*, the court determined that secondary actors "must themselves make a false or misleading statement (or omission) that they know or should know will reach potential investors."[46] Furthermore, the Tenth Circuit rejected a rule that would attach liability to actors who provided substantial assistance in the representations of others.[47] Yet the court conceded that its approach was "far from a bright line."[48] The Tenth Circuit's standard does not require that the statement actually be attributable to the actor. It instead focuses on whether the investor relied upon the statement.[49]

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41. 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, 727–28 (1997) ("The principal weakness of the narrow approach lies in its potential to allow egregious wrongdoing to go unpunished and serious fraud-inflicted injuries to go uncompensated.") (footnote omitted).

42. *See id.* at 728 ("It is silly to conclude, in a case in which an accountant (or lawyer or investment banker) has this level of involvement, scienter, and motivation, that the communication is solely the client's simply because it is issued under the client's name."). For a full discussion of this argument in the context of scheme liability, see *infra* Part II.C.

43. Anixter v. Home-Stake Prod. Co., 77 F.3d 1215 (10th Cir. 1996).

44. *Id.* at 1219.

45. *Id.*

46. *Id.* at 1226.

47. *Id.* at 1226–27.

48. *Id.* at 1227.

49. *Id.* at 1225 ("The critical element separating primary from aiding and abetting violations is the existence of a representation . . . made by the defendant, that is relied upon by the plaintiff.").

Moreover, the court differed from the bright-line approach by holding that an accountant who produces false opinions and certification letters may be primarily liable if corporate materials reproduce those statements.[50]

D. The Plain Language: To "Make" an Untrue Statement

Rule 10b-5(b) provides that it is unlawful for any person "[t]o *make* any untrue statement of a material fact."[51] It seems logical then, when considering whether an actor is a primary violator, that the boundaries would depend on whether an actor *made* the statement in issue.

The implementation of the bright-line and substantial participation tests illustrate two potential meanings of the word "make." The bright-line approach appears to equate "make" with attribution by shareholders, or more specifically, an actor's name or signature on the statement.[52] Conversely, the substantial participation approach equates "make" with the creation of the statement.[53] The issue is which of these approaches stays truer to the language of Rule 10b-5.

The dictionary definition of the word "make" supports the substantial participation approach. According to Webster's Unabridged Dictionary, "make" means "to bring into existence by shaping or changing material, combining parts, etc.," or "to produce; cause to exist or happen; bring about."[54] Inquiring into whether an actor played a sufficiently significant role in drafting and editing a statement is quite similar to determining whether the actor produced or caused the statement to exist. Alternatively, the bright-line approach, which requires public attribution, cannot be supported by the common understanding of what it means to make a statement.

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50. *Id.* at 1226.

51. 17 C.F.R. § 240.10b-5(b) (2007) (emphasis added).

52. *See* Wright v. Ernst & Young LLP, 152 F.3d 169, 175 (2d Cir. 1998) ("[T]he misrepresentation must be attributed to that specific actor at the time of public dissemination . . . .").

53. *See In re* Software Toolworks Inc. Sec. Litig., 50 F.3d 615, 628–29 & n.3 (9th Cir. 1994) (finding liability because of the actor's role in drafting and editing statements).

54. WEBSTER'S UNABRIDGED DICTIONARY 1161 (Random House, 2d ed. 2005).

II. SCHEME LIABILITY: A BATTLEGROUND FOR PRIMARY LIABILITY

As the existence of two approaches indicates, the scope of primary liability is far from settled. A third possible avenue has been introduced, further muddying the waters. Litigants have drawn on language in Rule 10b-5 prohibiting "any . . . scheme . . . to defraud,"[55] claiming that defendants are primarily liable for their involvement in such a scheme regardless of whether they actually made a false or misleading statement.[56] Once again, the lingering effect of *Central Bank* influences the debate. As a result, the issue regarding whether banks, accountants, attorneys, or other third parties may (or should) be held liable under the antifraud provisions of the securities laws is as alive as ever. This Part discusses the developments surrounding scheme liability under section 10(b) and Rule 10b-5. First, it looks at the origins of scheme liability and highlights the stakes for all involved. Second, this Part considers the cases in the only two circuits to have weighed in on the scheme liability debate. Finally, it examines the Supreme Court's decision in *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*[57]

A. Origins of Scheme Liability

One of the earliest cases, and likely the most notable one, to employ scheme liability was *In re Enron Corporation Securities, Derivative & ERISA Litigation*.[58] In *Enron*, the district court held that "secondary actors may be liable for primary violations under an alleged scheme to defraud if all the requirements for liability under Rule 10b-5 have been satisfied as to each secondary-actor defendant and any additional heightened pleading requirements have been met."[59] The plaintiffs tried to use scheme liability to capture actors who may not be liable under other post-*Central Bank* approaches to

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55. 17 C.F.R. § 240.10b-5(a) (2007).

56. *See*, *e.g.*, Quaak v. Dexia, S.A., 357 F. Supp. 2d 330, 342 (D. Mass. 2005) ("[P]laintiffs allege that defendant's actions were integral to the fraudulent scheme, and that defendant was a primary architect of the scheme to finance the sham entities. Therefore, plaintiffs have alleged facts sufficient to establish primary liability by defendant under Section 10(b).").

57. Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., No. 06-43, slip op. at 1 (U.S. Jan. 15, 2008).

58. *In re* Enron Corp. Sec., Derivative & ERISA Litig., 235 F. Supp. 2d 549 (S.D. Tex. 2002).

59. *Id.* at 592.

primary liability. *Enron* was not alone. Several courts across the country soon faced similar arguments regarding scheme liability.[60] It was only a matter of time before the cases moved up the ladder for the federal circuit courts to weigh in on the blossoming debate. The next Section discusses the first two circuit court cases to consider scheme liability.

B. Circuit Court Approaches to Scheme Liability

1. *In re* Charter Communications—*The Narrow View*. In the case of *In re Charter Communications, Inc., Securities Litigation*,[61] stockholders of Charter Communications brought a class action alleging that Charter, a national cable television provider, employed a scheme to artificially inflate its financial statements.[62] Furthermore, the plaintiffs alleged that Charter's vendors were liable for their role in the sham transactions, deliberately delayed customer disconnections, and improperly capitalized labor costs.[63] The end result was to create artificial operating revenues and cash flows.[64]

In the alleged scheme, the vendors sold set-top boxes to Charter, which then delivered the boxes to its cable customers.[65] In addition to purchasing the boxes, Charter paid the vendors an additional twenty dollars per box.[66] In return, the vendors spent the extra payments on advertising with Charter.[67] The complaint alleged that these were

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60. *See*, *e.g.*, *In re* Parmalat Sec. Litig., 376 F. Supp. 2d 472, 510 (S.D.N.Y. 2005) ("[W]here, as alleged here, a financial institution enters into deceptive transactions as part of a scheme in violation of Rule 10b–5(a) and (c) that causes foreseeable losses in the securities markets, that institution is subject to private liability under Section 10(b) and Rule 10b–5."); *Quaak*, 357 F. Supp. 2d at 341 ("[P]rimary liability under Section 10(b) and Rule 10b–5 may in some cases be found where a person 'substantially participates in a manipulative or deceptive scheme . . . even if a material misstatement by another person creates the nexus between the scheme and the securities market.'" (quoting *In re* Lernout & Hauspie Sec. Litig., 236 F. Supp. 2d 161, 173 (D. Mass. 2003))); *In re* Homestore.com Inc. Sec. Lit., 252 F. Supp. 2d. 1018, 1039–40 (C.D. Cal. 2003) (interpreting the Ninth Circuit to have held that "a person may be liable for participation in a 'scheme' even after *Central Bank*").

61. *In re* Charter Commc'ns, Inc. Sec. Litig., 443 F.3d 987 (8th Cir. 2006), *aff'd sub nom. Stoneridge Inv. Partners*, slip op. at 1. The Supreme Court's decision affirming *Charter Communications* is discussed in Part II.C.

62. *In re Charter Commnc'ns,* 443 F.3d at 989.

63. *Id.*

64. *Id.*

65. *Id.*

66. *Id.*

67. *Id.*

sham transactions that lacked any economic substance, intended only to artificially inflate revenues and cash flows.[68] The fraudulent financial statements resulted when Charter capitalized the additional equipment expenses while recognizing the advertising as current revenue.[69] The plaintiffs alleged that the vendors knew of Charter's intention to artificially inflate their financials.[70] Yet they did not allege that that the vendors were involved in preparing or releasing the fraudulent statements.[71]

The Eighth Circuit addressed the issue of how and whether scheme liability applied to Charter's vendors as primary violators. The court returned to the analysis of *Central Bank* and read that case broadly to deny scheme liability:

> 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.[72]

Here, according to the court, the vendors simply entered into an arm's-length transaction, and Charter was responsible for using the transaction to mislead shareholders.[73] The vendors did not issue any fraudulent statement to the public, and they were under no duty to disclose the transaction or Charter's financial status.[74] As a result, the vendors were not liable under section 10(b) or Rule 10b-5 because scheme liability did not exist.[75]

2. Simpson v. AOL Time Warner—*The Expansive View*. The Ninth Circuit considered a similar legal question in *Simpson v. AOL Time Warner Inc.*,[76] but reached a fundamentally different conclusion, recognizing that scheme liability may exist. In *Simpson*, investors brought a class action against Homestore.com, an Internet company, and outside defendants, including AOL Time Warner, Cendant

68. *Id.* at 989–90.
69. *Id.* at 990.
70. *Id.*
71. *Id.*
72. *Id.* at 992.
73. *Id.*
74. *Id.*
75. *Id.* at 992–93.
76. Simpson v. AOL Time Warner, Inc., 452 F.3d 1040 (9th Cir. 2006).

Corporation, and L90, Inc.[77] The plaintiffs claimed that the defendants were liable as primary participants under a theory of scheme liability.[78]

In 1996, Homestore created an online real estate website.[79] Because many other internet startup companies at that time were recording net losses and negative cash flows, financial analysts placed emphasis on revenues as an indicator of future financial success of online companies.[80] To meet revenue expectations, Homestore developed a series of complex transactions, and these "triangular" transactions were at issue in *Simpson*.[81]

In the triangular transactions, Homestore would identify a third party in need of capital and agree to purchase that company's shares at an inflated value.[82] That company, instead of returning the excess payments to Homestore, would agree to purchase advertising from AOL for most or all of the total value Homestore initially paid.[83] AOL then pocketed a commission and shared the advertising revenue with Homestore.[84]

The plaintiffs did not allege that AOL's advertising agreements were sham transactions.[85] They did, however, allege that one of AOL's officers helped developed these transactions with Homestore and even sought out third parties for the deals.[86] Additionally, plaintiffs claimed that a second AOL officer was liable for approving the transactions.[87]

Plaintiffs also brought suit against Cendant and L90 for their role in alleged sham transactions.[88] According to the allegations, Homestore bought Move.com, another real estate internet website, from Cendant at a grossly inflated amount.[89] Cendant in turn recycled

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77. *Id.* at 1042.
78. *Id.* at 1043.
79. *Id.*
80. *Id.*
81. *Id.*
82. *Id.*
83. *Id.*
84. *Id.* at 1043–44. AOL became a party to these deals because Homestore in 1998 purchased the right to be the only online real estate listing company on AOL. *Id.* at 1044.
85. *Id.*
86. *Id.*
87. *Id.*
88. *Id.* at 1044–45.
89. *Id.* at 1044.

payments back to Homestore through a separate corporate entity set up by Cendant.[90] Finally, plaintiffs alleged that L90 was a culpable third party for a similar role in a triangular transaction.[91] In contrast with AOL and Cendant, there were no allegations that L90 was involved in developing the deals.[92]

The Ninth Circuit faced the standard arguments that had been accompanying "scheme to defraud" cases. On the one hand, defendants argued that this was a dead issue: "*Central Bank* limited primary liability under § 10(b) to defendants who personally made a public misstatement, violated a duty to disclose or engaged in manipulative trading activity, and not to those engaged in a broader scheme to defraud."[93] Alternatively, plaintiffs sought a reading of section 10(b) and Rule 10b-5 that held actors involved in a scheme to defraud liable as primary violators for involvement, whether direct or indirect, in a scheme to defraud.[94] The Ninth Circuit adopted the broader reading of Rule 10b-5:

> [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. It is not enough that a *transaction* in which a defendant was involved had a deceptive purpose and effect; the defendant's *own conduct* contributing to the transaction or overall scheme must have had a deceptive purpose and effect.[95]

Following this rule, the court determined that even using a scheme liability approach, the allegations were not sufficient to state a claim against the defendants as primary violators.[96] The claims were

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90. *Id.* at 1044–45. Over the course of two years, Cendant returned eighty million dollars to Homestore in exchange for products and services. *Id.*

91. *Id.*

92. *Id.*

93. *Id.* at 1043.

94. *Id.* The court also noted:

> The SEC argues in its amicus brief that "Any person who directly or indirectly engages in a manipulative or deceptive act as part of a scheme to defraud can be a primary violator." The SEC defines 'a deceptive act' as "engaging in a transaction whose principle purpose and effect is to create a false appearance of revenues."

Id. at 1048.

95. *Id.*

96. *See id.* at 1054 ("Because the [plaintiffs] do[] not allege a valid claim for primary liability under any theory of liability, the district court properly dismissed the claims . . . against the Defendants.").

inadequate because they failed to allege that AOL and its officers were engaged in deceptive activity. The claims did allege that AOL assisted in the creation of the sham transactions and acted as a conduit for the return of revenue; yet they did not allege that AOL "created sham entities or engaged in deceptive conduct as part of illegitimate transactions."[97] Furthermore, there was no allegation that AOL entered into a transaction that lacked economic value.[98] Because actual advertisements were purchased and sold, the leg of the transaction involving AOL was not deceptive.[99] Ultimately, because AOL's conduct was suspect only when viewed in conjunction with Homestore's actions, AOL was not liable as a primary violator.[100]

Similarly, the Cendant and L90 transactions did not give rise to liability because they did not create a false appearance.[101] The plaintiffs failed to allege that Cendant concealed reality by agreeing to engage in future deals.[102] In fact, according to the court, there was no false appearance independent of the fraudulent accounting by Homestore.[103] As a result, Cendant was not a primary actor in a scheme to defraud.[104] Likewise, L90 was not primarily liable for its actions because it did not help create the scheme, and it did not act with the primary purpose of creating a false appearance and therefore without a principal legitimate business purpose.[105]

Consequently, according to the Ninth Circuit, scheme liability should be available to hold actors liable for those actions that do not have a "principal legitimate business purpose."[106]

C. The Supreme Court Weighs In: Stoneridge Investment Partners

In 2008, the Supreme Court reviewed the Eighth Circuit's decision in *Charter Communications*.[107] In *Stoneridge*, the Court

97. *Id.* at 1052–53.
98. *Id.* at 1053.
99. *Id.*
100. *See id.* ("While AOL would be liable under § 10(b) for its deceptive conduct as part of a scheme to defraud if AOL engaged in deceptive conduct, it may not be held liable for participating in legitimate transactions that became 'deceptive' only when distorted by the willful or intentional fraud of another party.").
101. *Id.* at 1053–54.
102. *Id.* at 1053.
103. *Id.* at 1054.
104. *Id.*
105. *Id.*
106. *Id.* at 1050.

affirmed the Eighth Circuit's narrow view and held that investors do not have a cause of action against third-party actors who take part in sham transactions with the purpose and effect of furthering a scheme to defraud.[108]

The Court reasoned that reliance by investors is necessary to establish the liability of a particular vendor.[109] Because the vendors were under no duty to disclose the truth regarding the transactions and the deceptive acts were not communicated to the public, investors did not specifically rely on the vendors' role in the sham transaction and liability under section 10(b) and Rule 10b-5 did not exist.[110]

Explicitly addressing the issue of scheme liability, the Court rejected the argument that deceptive acts in furtherance of fraudulent transactions are sufficient to create liability.[111] Although those transactions are reflected in financial statements disseminated to the public and relied upon by investors, such a causal link is "too remote."[112] Therefore, unless an actor makes it "necessary or inevitable" that a transaction will become a fraudulent public statement, scheme liability is unavailable as a tool for primary liability in securities fraud cases.[113]

The following Section responds to key misconceptions surrounding primary and scheme liability. Part III offers an approach to primary liability that is consistent with the landmark decision of *Central Bank*, follows the language of section 10(b) and Rule 10b-5, and provides a socially optimal outcome.

D. *Scheme Liability: A Misinterpretation of Section 10(b) and* Central Bank

Two arguments have been levied against scheme liability. First, because an actor is not responsible for making statements available to

107. Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., No. 06-43, slip op. at 1 (U.S. Jan. 15, 2008).

108. *Id.*

109. *Id.*, slip op. at 8.

110. *Id.*, slip op. at 8–9.

111. *Id.*

112. *Id.*, slip op. at 10.

113. *See id.* ("[N]othing respondents did made it necessary or inevitable for Charter to record the transactions as it did.").

the public, investors cannot claim to have relied on such actions.[114] Second, the *Central Bank* decision precludes liability for secondary actors engaging in sham transactions with the purpose and effect of misleading investors. The flaws of these arguments are addressed in turn.

1. *Reliance*. In *Stoneridge*, the Court denied liability on the grounds that investors failed to rely on the deceptive acts of third-party vendors engaged in sham transactions with a publicly traded company.[115] The argument is as follows: in the absence of a duty to disclose or the making of a public statement, an investor must show direct reliance. Because it was the publicly traded company that issued the statements as opposed to the vendors, investors could not show the requisite reliance.[116] The Court reasoned that allowing such a broad reading of the reliance requirement would create a "cause of action [that] would reach the whole marketplace in which the issuing company does business."[117] Consequently, as long as the third party's actions do not make the fraudulent statement "necessary or inevitable," investors did not rely on those actions.[118]

The Court's application of the reliance requirement is flawed. It is widely accepted that reliance is an element of actions brought under section 10(b) to ensure that there is a sufficient causal connection between an actor's conduct and an investor's injury.[119] The Court has never held that an investor must be aware of the specific acts that create the misstatement in order to meet the reliance requirement. In fact, it has expressly held that reliance can be satisfied indirectly.[120] Specifically, the Court has determined that reliance on the integrity of an efficient market into which a misrepresentation is disseminated is sufficient.[121]

The Court in *Stoneridge* recognized this "fraud-on-the-market" theory, but concluded that it only extends liability to the party that

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114. *See id.*, slip op. at 8 ("Respondents had no duty to disclose; and their deceptive acts were not communicated to the public. . . . Petitioner, as a result, cannot show reliance upon any of respondents' actions except in an indirect chain that we find too remote for liability.").

115. *Id.*, slip op. at 1.

116. *Id.*, slip op. at 10–11.

117. *Id.*, slip op. at 9.

118. *Id.*, slip op. at 9–10.

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

120. *Id.*

121. *Id.*

disseminates the public statement. This conclusion is faulty for two reasons. First, as discussed in Part I.D, it misconstrues the language of Rule 10b-5. Parties should be viewed as making public statements if they are intimately involved in the acts that create those statements. Consequently, if third-party actors engage in sham transactions that are the basis of the public misstatements, and they do so with the purpose and effect of defrauding investors, the reliance requirement should be met.

Second, the "fraud-on-the-market" theory is not intended to limit reliance as the Court purports. To the contrary, the underlying purpose for the theory is to establish reliance when a party causes a misstatement that injures investors.[122] Consequently, a finding of reliance in cases of scheme liability requires an inquiry into whether an actor's deceptive acts sufficiently caused such statements to be made. Without such an inquiry, the Court in *Stoneridge* should not have concluded that the reliance requirement was absent.

2. *Keeping* Central Bank *alive.* Another theme runs beneath the list of arguments set forth by opponents of scheme liability. It is argued that scheme liability serves as an effort to overrule, or at least skirt, the holding in *Central Bank*.[123] The argument is premised on the Supreme Court's rejection of aiding and abetting liability. The Court reasoned that in light of the statute's silence regarding aiding and abetting liability, such liability did not exist.[124] Opponents argue that allowing liability for a scheme to defraud would subvert this decision:

> The arguments made [in favor of scheme liability] should thus be seen for what they are: an ill-conceived third bite at the apple and an attempt to achieve through the back door—by redefining "primary" liability to include aiding and abetting claims—that which the[y] could not accomplish through the front door. Indeed . . . [proponents] articulat[e] a position here that is diametrically opposed to the Supreme Court's holding in *Central Bank*.[125]

This argument assumes that scheme liability is essentially equivalent to historical claims for aiding and abetting liability because

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122. *Id.*

123. *See, e.g.*, Answering Brief of Defendant-Appellee Time Warner Inc. at 36, Simpson v. AOL Time Warner, Inc., 452 F.3d 1040 (9th Cir. 2006) (No. 04-55665) ("[T]his effort [to use scheme liability] flies in the face of *Central Bank* and should be firmly rejected.").

124. Cent. Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164, 187–88 (1994).

125. Answering Brief of Defendant-Appellee Time Warner Inc., *supra* note 123, at 38.

both claims attempt to hold actors liable when the actor did not make or substantially participate in creating a false or misleading statement.[126] Accordingly, opponents argue that there is no practical difference between assisting in the primary violation, the aiding and abetting definition of liability, and engaging in a deceptive act as part of a scheme.[127] "Put another way, the SEC has simply redefined 'primary' liability to include 'aiding and abetting.'"[128]

This argument, however, misunderstands the statutory language of section 10(b) and the central reasoning of *Central Bank*. The language of section 10(b) and Rule 10b-5 does not provide conclusive insight into the proper scope of primary liability. According to the Supreme Court, the text of the statute, not the underlying rule, initially governs the boundaries of liability in securities fraud litigation.[129] Yet nothing in the language of section 10(b) suggests that liability is limited to actors who actually make a false statement or even to those who substantially participate in the preparation of the false statement. On the contrary, section 10(b) is worded broadly to prohibit any person from using or employing any deceptive device, *directly or indirectly*, in connection with the purchase or sale of securities.[130] The Supreme Court provided only two reasons for not reading such language to include aiding and abetting. First, aiding and abetting goes beyond even those that are indirectly involved and reaches actors not engaged in the prohibited activity.[131] Second, several other provisions in the same Act use the "directly or indirectly" language without imposing aiding and abetting liability.[132]

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126. Cases in the years following *Central Bank* have also reacted unfavorably toward finding third party actors liable as primary violators, citing *Central Bank* as a limitation on the reach of section 10(b). *See, e.g.*, Anixter v. Home-Stake Prod. Co., 77 F.3d 1215, 1226 n.10 (10th Cir. 1996) ("Some post-*Central Bank of Denver* cases have held that third party defendants can be liable for statements made by others, where the defendant substantially participated in preparing the statements. To the extent these cases allow liability to attach without requiring a representation to be made by defendant, and reformulate the 'substantial assistance' element of aiding and abetting liability into primary liability, they do not comport with *Central Bank of Denver*.") (citations omitted).

127. Answering Brief of Defendant-Appellee Time Warner Inc., *supra* note 123, at 42.

128. *Id.*

129. *Central Bank*, 511 U.S. at 173 ("With respect, however, to the first issue, the scope of conduct prohibited by § 10(b), the text of the statute controls our decision.").

130. 15 U.S.C. § 78j(b) (2000).

131. *Central Bank*, 511 U.S. at 176.

132. *Id.*

These arguments, however, are inapplicable to the issue of primary liability.

Instead, the Supreme Court in *Central Bank* offered no guidance as to the outer limits of primary liability. Quite to the contrary, the Court explicitly recognizes that its holding bears only on secondary liability:

> 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.[133]

This language recognizes that the question of aiding and abetting liability, addressed in *Central Bank*, is distinct from the issue of primary liability. Consequently, the Supreme Court left the scope of primary liability completely unaddressed.

At the heart of the *Central Bank* opinion is the point that the plain language of section 10(b) and Rule 10b-5 does not prohibit aiding and abetting. The Supreme Court determined that private suits under section 10(b) "have emphasized adherence to the statutory language . . . ."[134] Furthermore, essential to the Court's holding was the fact that any mention of aiding and abetting liability was absent from the language of section 10(b) and Rule 10b-5.[135] As a result, the Supreme Court addressed the statutory language regarding aiding and abetting liability, but offered no analysis of the language as it pertains to primary liability.[136]

Central Bank, as a result, does not preclude the issues that subsequently presented themselves in cases involving liability for a scheme to defraud. Opponents to the use of scheme liability miss this point. A scheme to defraud involves primary liability, not aiding and abetting liability. That there may be factual similarities in the pre–

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133. *Id.* at 191 (emphasis removed).

134. *Id.* at 173.

135. *See id.* at 177 ("If, as respondents seem to say, Congress intended to impose aiding and abetting liability, we presume it would have used the words 'aid' and 'abet' in the statutory text. But it did not.").

136. *See id.* at 191 ("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).").

Central Bank aiding and abetting cases and later scheme to defraud cases does not mean that the Supreme Court has answered both sets of questions. On the contrary, following *Central Bank*, the first step in analyzing liability for a scheme to defraud is the language of Rule 10(b). The statute is not silent regarding primary liability, unlike aiding and abetting liability. The statute necessarily refers to primary violators, because otherwise the statute would be useless. Yet the language does not address the scope of primary liability. Therefore, at a minimum, it appears that the language of the statute is ambiguous as to the definition of primary liability.

Additionally, considering the language of Rule 10b-5 in conjunction with section 10(b) reveals that primary liability for a scheme to defraud *does* exist. Unlike liability for aiding and abetting, liability for a scheme to defraud is expressly stated under Rule 10b-5.[137] Section 10(b) explicitly delegated authority to prescribe this rule.[138] Accordingly, the rule makes it "unlawful for any person, directly or indirectly . . . [t]o employ any device, *scheme*, or artifice *to defraud* . . . ."[139] As a result, scheme liability has a hook in both the language of section 10(b) and Rule 10b-5, making it distinct from past aiding and abetting theories.

Finally, the Supreme Court has stated that section 10(b) is to be interpreted flexibly, as opposed to technically and restrictively, to fulfill the purposes of the statute.[140] Thus, the Court's conclusion in *Stoneridge* was not mandated by the language of the statute or the Court's prior precedent. To understand who should be held liable as a primary violator, it is necessary to examine the appropriate policy objective of regulating securities fraud.

III. THE APPROPRIATE POLICY OBJECTIVE: DETERRING CULPABLE ACTORS

The boundaries of primary liability and scheme liability are unsettled and continuously developing. There is a lack of clarity in the statutory language with regard to what constitutes a primary violator, and courts were unable to agree on any useful guidelines for scheme

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137. 17 C.F.R. § 240.10b-5(a) (2007).

138. 15 U.S.C. § 78j(b) (2000) (making section 10(b) subject to "such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors").

139. 17 C.F.R. § 240.10b-5(a) (2007) (emphasis added).

140. SEC v. Zandford, 535 U.S. 813, 819 (2002).

liability. In uncertain situations like this one, the policy objectives behind the statute become especially important. In this case, it is necessary to interpret the statute broadly to fulfill its purposes.

This Part evaluates the approaches of primary and scheme liability in light of policy objectives. First, it determines that the appropriate policy objective behind securities litigation is the deterrence of culpable actors. Second, it uses this objective to evaluate the approaches. In doing so, this Part concludes that both the substantial participation approach and scheme liability are more in line with the deterrence objective than is the bright-line approach. Yet in the absence of reconsideration by the Court, *Stoneridge* has effectively stripped private litigants of the necessary tools to reach culpable actors.

A. *The Policy Debate: Compensation versus Deterrence*

Two policy objectives are commonly offered as the underlying rationale for securities litigation: compensation and deterrence.[141] This Section briefly explains the arguments for each approach and determines that deterrence is the appropriate rationale for securities regulation in general.

1. *Compensation.* The compensatory rationale is that those who have been unjustly injured should be entitled to repayment for the loss.[142] In the context of securities litigation, critics have attacked this goal from many different angles, revealing substantial flaws. First, a number of commentators have criticized securities litigation for the amount of nonmeritorious litigation that results in a loss to shareholders.[143] Additionally, others have criticized the compensation

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141. John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation* 7, 14–25 (Columbia Law Sch. Ctr. for Law and Econ. Studies, Working Paper No. 293, 2006), *available at* http://www.law.columbia.edu/center_program/law_economics/wp_listing_1/wp_listing/291-300#942287; *see also* James D. Cox, *Private Litigation and the Deterrence of Corporate Misconduct*, 60 LAW & CONTEMP. PROBS. 1, 1 (1997) ("Compensating the injured and deterring future violations are frequently seen as complementary objectives of private suits.").

142. *See* James D. Cox, *Making Securities Fraud Class Actions Virtuous*, 39 ARIZ. L. REV. 497, 497 (1997) ("Securities class actions proceed with the objective of permitting those separated wrongfully from their wealth to get some of it back.").

143. *See, e.g.*, Stephen J. Choi, *The Evidence on Securities Class Actions*, 57 VAND. L. REV. 1465, 1469–74 (2004) (arguing that securities class actions are often frivolous).

rationale on the basis that securities litigation overcompensates.[144] As a result, some academics have argued for caps on securities damages.[145] Finally, from the opposite point of view, some have argued that securities class actions are failing to adequately compensate investors.[146] For example, empirical evidence reveals that settlement amounts in securities class actions represent less than 3 percent of the overall investor losses in stock price decline.[147]

This Note does not address the validity of such arguments, but provides them only to illustrate that there is little support for the efficacy of compensation as a rationale for securities litigation. Instead, it seeks to illustrate a more fundamental flaw in the compensatory rationale, which, in combination with the arguments in this Section, shows that compensation is not the appropriate objective of securities litigation.

The principal problem with compensation is that a vast majority of the money paid out as compensation to injured investors, whether from judgments or settlements, is funded by the investors themselves.[148] As a result, instead of compensating investors for their losses, securities litigation simply takes money out of the pocket of one investor and places it in the pocket of another.

If the details of this phenomenon are not initially obvious, consider the following "pocket-shifting"[149] explanation: A

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144. *See* Donald C. Langevoort, *Capping Damages for Open-Market Securities Fraud*, 38 ARIZ. L. REV. 639, 646 (1996) ("[T]here will be systematic overcompensation over time to many investors.").

145. *See, e.g.*, *id.* at 657–62 (examining the possibility of capping recovery in securities litigation).

146. *E.g.*, Coffee, *supra* note 141, at 14 ("From a compensatory perspective, the conclusion seems inescapable that the securities class action performs poorly.").

147. *Id.* at 14–15. These numbers, however, are computed according to the total loss in stock price as opposed to the loss attributed to the alleged fraud. *Id.* Additionally, the statistics focus solely on settlements of securities class actions. *See id.* at 14 ("*Settlements* recover only a very small share of investor losses.") (emphasis added).

148. *Id.* at 26 ("As a result, at least in the aggregate, diversified investors are making wealth transfers to themselves . . . .").

149. The notion of the pocket shifting is far from a novel idea. In fact, it has been recognized quite often by academics in the securities field. *E.g.*, Jennifer H. Arlen & William J. Carney, *Vicarious Liability for Fraud on Securities Markets: Theory and Evidence*, 1992 U. ILL. L. REV. 691, 698–700; Coffee, *supra* note 141, at 26 ("[D]iversified investors are making wealth transfers to themselves, shifting money, as it were, from one pocket to the other—minus, of course, the considerable transaction costs that both sides pay to the legal profession."); Langevoort, *supra* note 144, at 649 ("Thus, we can say with some confidence that investors fund a very sizable portion (perhaps nearly all) of their own compensatory system."); Paul G. Mahoney, *Precaution Costs and the Law of Fraud in Impersonal Markets*, 78 VA. L. REV. 623, 635 (1992); Roberta

fundamental feature of corporate existence is the separation of control and ownership.[150] Additionally, ownership is typically held in the hands of numerous investors, each owning a relatively small portion.[151] In the typical securities class action, all investors who purchased stock while a fraudulent misstatement affected the market bring suit for their losses.[152] In the event that they do recover, either by judgment or settlement, the corporation will pay the compensation.[153] Yet a group of current investors owns the corporation. It is these investors, therefore, that bear the burden of the judgment or settlement. Consequently, money shifts from one group of investors, who currently owns the corporate stock, to a second group, who purchased stock in the affected period.[154]

This transfer, from one group of investors to another, does not itself reveal the flaw of shifting money from one pocket to another. If this was the end of the story, only one group of investors would receive compensation. Yet imagine the problem if an investor was part of *both* groups. In such a case, the pocket-shifting phenomenon becomes evident, and there is no compensation for loss. The investor is both paying out the judgment and receiving it. This is not a hypothetical problem. The vast majority of shareholders are institutional investors.[155] These investors are quite diversified, owning stock in a multitude of corporations and investing at several different times.[156] As a result, pocket shifting not only *could* occur, but most often *does* occur. It happens in either of the following situations: First, investors buy shares in a company during both time periods involved in a suit, meaning they fall in the group bringing suit and in the group

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Romano, *The Shareholder Suit: Litigation Without Foundation?*, 7 J.L. ECON. & ORG. 55, 62–63 (1991).

150. *E.g.*, Ira M. Millstein & Paul W. MacAvoy, *The Active Board of Directors and Performance of the Large Publicly Traded Corporation*, 98 COLUM. L. REV. 1283, 1291 (1998) (discussing "the separation of the roles of owner and management").

151. Coffee, *supra* note 141, at 25–26 ("Because of the long-established separation of ownership and control in the United States, the vast majority of the stock in 'public' companies will be owned by dispersed shareholders holding relatively small percentage stakes.").

152. *Id.* at 26.

153. *Id.*

154. *Id.*

155. *See* Langevoort, *supra* note 144, at 647 (recognizing "the growing institutionalization of the markets").

156. Thomas A. Smith, *Institutions and Entrepreneurs in American Corporate Finance*, 85 CAL. L. REV. 1, 18 (1997) ("One fundamental means by which institutions manage risk is through diversification—building a portfolio consisting of relatively small ownership stakes in many different companies.").

that will bear the financial burden of the judgment or settlement.[157] Second, even if not on both sides of the litigation, the investors may still own stock in several corporations involved in securities litigation. In some of these suits, they are in the group bringing the securities claim. In other cases, they are in the current ownership group. Therefore, on the whole, these investors will be on both sides of the lawsuit. Consequently from a compensation perspective, securities litigation often results in nothing more than investors bearing the burden for their own losses—a result wholly inconsistent with the underlying goal of compensation.

The problem of pocket shifting, combined with the numerous other arguments against compensation, shows that compensation is an inappropriate rationale in the securities litigation context. Because the means for achieving the compensation rationale are fundamentally flawed, any reform that ignores other rationales is likely to be futile. Even if some justification for compensation still exists, there is a more appropriate rationale: deterrence.

2. *Deterrence.* The second rationale for securities regulation is deterrence of culpable actors. The baseline argument for this rationale is that by imposing financial burdens upon actors for specified conduct, those and other actors will be less likely to continue or repeat that conduct in the future.[158] This line of reasoning is grounded in an economic approach. Ultimately, assuming that actors are rational, their misconduct will be deterred at the point that the potential gain from the given action is outweighed by the expected loss.[159] This loss is a product of the size of the fine and the probability of detection.[160]

Deterrence, however, is not without its drawbacks. To be effective, deterrence must focus on the culpable actors. One of the problems with a deterrence rationale relates to the discussion of compensation: The financial burden is borne by the shareholders of the corporation, none of whom are generally culpable for the

157. Coffee, *supra* note 141, at 26–27.

158. *See* Langevoort, *supra* note 144, at 651–52 (“Usually, the out-of-pocket regime is defended instead because of its deterrence capacity: it is what is necessary to get selfish managers to behave.”).

159. Cox, *supra* note 142, at 2.

160. *Id.*

wrongdoing.[161] Moreover, even when culpable actors face personal lawsuits for their wrongdoing, they often have insurance against the financial penalties, further minimizing any deterrent effect.[162]

It is evident that the existing securities laws must be reformed to effectively deter wrongful conduct. Yet the numerous possible reforms[163] are not the issue here; this Note only focuses on the issue of scheme liability. As a means of supplementing other reforms, courts should refocus their analysis on deterring the culpable actors when considering the boundaries of primary liability and, more specifically, liability for a scheme to defraud.

B. *Deterring Culpable Conduct: Focus on Culpability of the Conduct, Not Identity of the Actor*

Even in the wake of *Stoneridge*, scheme liability—and, more broadly, primary liability under section 10b-5—remains unsettled. This Note argues that in determining the boundaries of scheme liability, courts should focus on deterring culpable actors. Such a suggestion seems obvious, but is not always followed in practice. This Section highlights situations in which the approaches to primary liability and scheme liability stray from this basic premise.

In analyzing primary liability in the wake of *Central Bank*, many courts have focused on the identity of the actors, as opposed to the culpability of their actions.[164] This analysis often produces unfortunate

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161. Langevoort, *supra* note 144, at 648 ("[N]early all the money paid out as compensation in the form of judgments and settlements comes, one way or another, from investors themselves. Little if any of the sum is contributed by those who were the primary authors of the fraud . . . .").

162. *See* FREDERICK C. DUNBAR ET AL., NAT'L ECON. RESEARCH ASSOCS., RECENT TRENDS III: WHAT EXPLAINS SETTLEMENTS IN SHAREHOLDER CLASS ACTIONS? 9 (1995) (stating that in the average settlement, 68.2 percent comes from the insurer, 31.4 percent from the issuer, and only 0.4 percent from the individual defendants).

163. *See* Coffee, *supra* note 141, at 39–50 (discussing various possible remedies).

164. *See* Ziemba v. Cascade Int'l, Inc., 256 F.3d 1194, 1205 (11th Cir. 2001) (examining "the threshold requirement to show that a secondary actor, *such as a lawyer or an accountant*, is primarily liable under § 10(b)" (emphasis added)); Anixter v. Home-Stake Prod. Co., 77 F.3d 1215, 1226–27 (10th Cir. 1996) (rejecting "a rule allowing liability to attach to *an accountant or other outside professional* who provided 'significant' or 'substantial' assistance to the representations of others" and holding that to be liable, secondary actors "must themselves make a false or misleading statement (or omission) that they know or should know will reach potential investors" (emphasis added)); *In re* Software Toolworks Inc. Sec. Litig., 50 F.3d 615, 628 n.3 (9th Cir. 1994) (holding that accountants may be primarily liable for statements made by others when the accountants reviewed the statements and played a significant role in the drafting and editing of the statements).

results. This is most evident in the bright-line approach to primary liability.[165] In the leading case adopting that approach, the Second Circuit determined that primary liability turned on whether the statement could be "attributed to that specific actor at the time of public dissemination, that is, in advance of the investment decision."[166] Furthermore, if an actor's name is absent from the statement, that statement cannot be "attributed to that specific actor."[167] Consequently, the bright-line approach focuses solely upon the statement and those names attached to that public statement. Under this rule, actors who mastermind a plan, put all the pieces in place, and even create the written statement are not primary violators under section 10(b) as long as their names are absent from the statement. One might think that such a ludicrous result cannot possibly be the law, yet it appears to be under the bright-line approach.

The result of a focus on attribution of the statement is a disconnect between the purpose of securities regulation and the rhetoric of the courts analyzing primary liability. As discussed in Section A.2, the driving rationale of securities regulation should be deterrence, and in the context of section 10(b), the deterrence purpose should be cabined with a measure of predictability. Yet the case law surrounding the bright-line approach lacks any discussion of such goals.

The substantial participation approach to primary liability is much more likely to address the deterrence objective.[168] As enunciated by the Ninth Circuit, actors may be liable as primary violators if they have a significant enough role in the creation of the statement.[169] Under this approach, specific conduct is examined to determine whether or not the actors undertook significant efforts in the statement's drafting and editing.[170] As a result of its focus on conduct, the substantial participation approach actually deters culpable actors by holding them liable as primary violators.

Because most circuits do not subscribe to the substantial participation approach, however, section 10(b) remains detached from its underlying objectives. Scheme liability appeared to provide

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165. For a full discussion of the bright-line approach, see *supra* Part I.C.1.

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

167. *Id.*

168. For a full discussion of the substantial participation approach, see *supra* Part I.C.2.

169. *In re Software Toolworks Inc.*, 50 F.3d at 628 n.3.

170. *Id.*

the opportunity for needed reform. Under scheme liability, liability would turn on the conduct rather than the identity of the actor. Because liability turns on conduct, scheme liability could have been more successful than the bright-line approach in deterring culpable conduct. Yet the Court's decision in *Stoneridge* appears to deliver a blow to the objectives of securities litigation. The Court denied liability for deceptive acts of third-party vendors engaged in sham transactions with a publicly traded company.[171] Although it left open the possibility of scheme liability in cases in which reliance can be established, this is unlikely when a third-party actor does not disseminate the statements directly to the public. As a result, scheme liability may not be the ultimate tool for deterring culpable actors.

CONCLUSION

The decision in *Central Bank* resolved the issue of whether aiding and abetting liability exists under section 10(b).[172] Not until *Stoneridge*, however, did the Supreme Court resolve the limits of primary liability and scheme liability.

Unfortunately, the Supreme Court appears to have missed the mark. It neglected to recognize that the language of section 10(b) and Rule 10b-5 is vastly different as it pertains to primary liability—especially scheme liability—than it is in relation to aiding and abetting liability. Section 10(b) and Rule 10b-5 appear to allow primary liability for a variety of actors. At the very least, the language is ambiguous to this effect.

As a result of this ambiguity, the objectives of securities regulation and section 10(b) are paramount. Accordingly, the Court appears to have lost sight of the importance of deterring the culpable actors behind fraudulent statements and deceitful schemes. Its flawed application of the reliance requirement in securities litigation will likely stunt the development of scheme liability as a means of holding culpable actors responsible for their actors. This Note does not intend to provide the only approaches or tests for outlining primary and scheme liability. Instead, it offers suggestions within the framework of the deterrence essential to section 10(b) liability. Many more reforms may be possible to accomplish such objectives. If courts continue to

171. Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., No. 06-43, slip op. at 1 (U.S. Jan. 15, 2008).

172. Cent. Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164, 191 (1994).

lose sight of the language of section 10(b) and Rule 10b-5, as well as their underlying purposes, the resulting doctrines for primary and scheme liability will be little more than empty rhetoric.