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§10(b) Secondary Actor Liability: High Court to Resolve

Since the U.S. Supreme Court abolished private aiding and abetting actions under §10(b) in *Central Bank*, the federal courts have struggled to define the boundaries of primary liability for secondary actors, persons doing business with issuers such as lawyers, accountants, bankers and suppliers.

Now, the U.S. Supreme Court has granted certiorari in a case that may define the standards for imposing §10(b) primary liability on secondary actors engaging in transactions that allegedly constitute deceptive devices, acts or schemes under Rule 10b-5. *In re Charter Communications Inc. Securities Litigation*, 443 F3d 987 (8th Cir. 2006), cert. granted sub nom. *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, 2007 WL 879583 (March 26, 2007). The three appellate courts to address the issue have created a split of authority. The U.S. Court of Appeals for the Eighth Circuit and, most recently, the U.S. Court of Appeals for the Fifth Circuit in *Regents of Univ. of Calif. v. Credit Suisse First Boston (USA), Inc.*, 2007 WL 816518 (5th Cir. March 19, 2007), have barred liability unless the secondary actor made misrepresentations, had a duty to disclose, or engaged in market manipulation. The U.S. Court of Appeals for the Ninth Circuit adopted a broad scheme liability standard in *Simpson v. AOL Time Warner Inc.*, 452 F3d 1040 (9th Cir. 2006). Both the Supreme Court and Congress have recognized it is essential to have a uniform and decisive liability standard.

Background

In abolishing aiding and abetting claims by private litigants under §10(b) of the Securities Exchange Act of 1934, *Central Bank* held that "the 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."[1] A secondary actor may only be subject to liability if that party "employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies…, assuming all of the requirements for primary liability under Rule 10b-5 are met."[2]

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Private plaintiffs have since pressed creative arguments couching claims against secondary actors as primary liability, often alleging deceptive devices, schemes, or acts under Rules 10b-5(a) or (c), rather than material misrepresentations or omissions under Rule 10b-5(b).[3] Courts have formulated conflicting tests for primary liability under those rules, seeking to define what it means to "indirectly" employ a "deceptive device" under §10(b).

The Circuits' Conflicting Standards

The Eighth and Fifth circuits have rejected §10(b) claims asserted against, respectively, vendors and banks that allegedly engaged in sham transactions allowing the issuer to misstate its financial condition. Both courts held, in the words of the Eighth Circuit, that the defendant must "make or affirmatively cause to be made a fraudulent misstatement or omission, or…directly engage in manipulative securities trading practices …[to] be held liable under §10(b) or any subpart of Rule 10b-5." *In re Charter Communications*, 443 F3d at 992. As the Eighth Circuit explained, "[t]o impose liability for securities fraud on one party to an arm's-length business transaction in goods or services other than securities because that party knew or should have known that the other party would use the transaction to mislead investors in its stock would introduce potentially far-reaching duties and uncertainties for those engaged in day-to-day business dealings. Decisions of this magnitude should be made by Congress." Id. at 992-93.

Similarly, the Fifth Circuit recently issued a decision in which the majority rejected §10(b) liability for banks alleged to have engaged in "irrational" transactions with Enron to inflate Enron's revenues. Agreeing with the Eighth Circuit, the majority concluded that primary liability exists only where a party engaged in "deceptive" conduct, requiring either a misstatement or a failure to disclose by one with a duty to disclose or manipulation, a "term of art" requiring that a defendant directly engage in manipulative securities trading practices. *Regents of Univ. of Calif.*, 2007 WL 816518 at *10, 12, 13. Since the banks made no misstatements, primary liability could attach only if the banks owed a duty of disclosure to the public (which they did not), since an act cannot be "deceptive" under §10(b) where the actor has no duty to disclose. Id. at *8, 9.

In contrast, the Ninth Circuit and other federal judges have struggled to establish a "deceptive device" standard not demanding either a misstatement or omission by the defendant which could be used to allege a broad "scheme to defraud." *Simpson*, 452 F3d at 1049-50. In *Simpson*, as in *Charter*, the secondary actors were vendors engaging in allegedly sham transactions allowing Homestore.com to overstate revenues. Id. at 1042-43. The SEC advocated defining a deceptive act broadly: "engaging in a transaction whose principal purpose and effect is to create a false appearance of revenues." Id. at 1048. The Ninth Circuit adopted a variant of that test: "to 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." The

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Court emphasized "[i]t is not enough that a transaction…had a deceptive purpose and effect; the defendant's own conduct contributing to the transaction or overall scheme must have had a deceptive purpose and effect." Id. What types of secondary actor conduct might meet that test (which would obviously necessitate a fact-intensive inquiry) remains unclear, as the complaint was found not to state a claim under this standard? Id. at 1054.

The Fifth Circuit in *Regents* specifically rejected the Ninth Circuit's theory of "scheme" liability as contrary to Supreme Court precedents establishing that "a device, such as a scheme, is not 'deceptive' unless it involves breach of some duty of candid disclosure." 2007 WL 816518 at *12 & n.30. Judge James L. Dennis, concurring, found the Court's narrow interpretation "neither compelled nor justified by Supreme Court precedent." Observing that the Court's test "immunizes a broad array of undeniably fraudulent conduct…effectively giving secondary actors license to scheme with impunity, as long as they keep quiet," he favored the broad scheme liability standard of the Ninth Circuit, the SEC, and District Judge Lewis Kaplan in *In re Parmalat Securities Litigation*, 376 FSupp2d 472 (SDNY 2005). Id. at *21, 22.

Crafting a Proper Standard

Although some courts have been concerned that participants in sham transactions entered into with scienter and a deceptive "purpose and effect" not escape §10(b) liability, the Supreme Court in *Central Bank* made clear that, regardless of policy arguments, the language of the statute controls. 511 US at 173-75, 188. Given the statutory language, the only way to craft a standard of primary liability for those who have not themselves made a misstatement and who have no duty to speak would be to posit that the "directly or indirectly" language of §10(b) allows liability for those who "indirectly" employ a "deceptive device." However, that argument is no more effective for primary claims than it was when raised in support of aiding and abetting liability. *Central Bank* rejected that very argument because for a secondary actor to have primary liability, that party must engage in the proscribed acts (at least indirectly) but aiding and abetting liability "extends beyond persons who engage, even indirectly, in a proscribed activity; [it] reaches persons who do not engage in the proscribed activity at all, but who give a degree of aid to those who do." 511 US at 176. And, it would allow liability without the requisite reliance upon the secondary actor's own statements or actions. Id. at 180. The same analysis is equally true for the allegedly sham business transactions at issue in these secondary actor cases.

Consequently, scheme liability seems to run afoul of the *Central Bank* principles, as it would allow liability against third parties who did not engage in the proscribed activity of making a material misrepresentation or actionable omission and the investing public could not have relied on any statements or omissions of those parties. The only sure way to follow *Central Bank* is the bright-line rule of the Fifth and Eighth circuits —that a defendant cannot be liable in a private action under §10(b) without making a misstatement or actionable omission.[4]

Supreme Court Resolution

The question of secondary actor liability under §10(b) is now squarely (once again) before the Supreme Court in *Charter*. The question presented is whether *Central Bank* forecloses claims of deceptive conduct where, although the vendors made no public statements, they engaged in transactions with no legitimate business or economic purpose except to inflate artificially Charter's financial statements. The answer will be dispositive of the Ninth and Fifth circuit cases as well, as the secondary actor defendants in each of those cases also did not participate in making the misstatement constituting the alleged violation, did not owe any duty to the investing public, and engaged in nonsecurities transactions with issuers that made the statements constituting the violation.

The Supreme Court is likely to conclude that an expansion of the 'Central Bank' standard to permit broad scheme liability encompassing such secondary actors is undesirable.

Given *Central Bank's* misrepresentation or omission requirement, the question is whether an alleged sham business transaction by a secondary actor can ever, even "indirectly," be deemed to be the proscribed activity—the misstatement or omission. The answer is it likely cannot be, as the Eighth and Fifth circuits held. Broadening the scope of liability for secondary actors would encompass all manner of conduct unconnected to the actual misstatement constituting the statutory violation, creating uncertainty and unpredictability likely unacceptable to the Supreme Court (and Congress). It would force persons doing business with public companies to investigate and guarantee the integrity of every issuer with whom they do business. It is noteworthy that, shortly after *Central Bank*, Congress rejected the SEC's effort to permit private aiding and abetting actions, allowing only the SEC to bring such actions. See §20(e) of the Exchange Act, 15 USC §78t(e). Debating changes to the statute in what became the Private Securities Litigation Reform Act of 1995, Congress concluded that private aiding and abetting actions were contrary to its goal of reducing meritless securities litigation. S. Rep. No. 104-98, at 19, reprinted in 1995 USCCAN 679, 698. Despite losing that battle, the SEC is still advocating the functional equivalent of its legislative proposal with its broad scheme liability standard.

Conclusion

Central Bank's analysis of the aiding and abetting rules is predictive of the Supreme Court's likely ruling. Calling them "unclear" and subject to ad hoc decisions with little predictive value, the Court found such "highly fact-oriented disposition[s]" were not a "satisfactory basis for a rule of liability imposed on the conduct of business transactions." 511 US at 188.

Scheme liability standards could be identically described. For example, the *Simpson* standard "focuses on differentiating conduct," requiring an analysis of the "principal" business purpose of a transaction to determine if it is "sufficiently deceptive to justify primary liability." 452 F3d at 1048 n.5. Addressing *Simpson's* effort to distinguish the *Charter* facts, the Fifth Circuit observed: "If 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 and is likely beyond the understanding of good-faith financial professionals who are attempting to avoid liability." 2007 WL 816518 at *14.

The Supreme Court is likely to conclude that an expansion of the *Central Bank* standard to permit broad scheme liability encompassing such secondary actors is undesirable. As signaled in *Central Bank*: "[t]he issues would be hazy, their litigation protracted, and their resolution unreliable. Given a choice, we would reject any theory…that raised such prospects." 511 US at 189.

1. *Central Bank of Denver v. First Interstate Bank of Denver*, 511 US 164, 177 (1994).

2. Id. at 191.

3. Rule 10b-5(a) prohibits "any device, scheme, or artifice to defraud" in connection with the purchase or sale of securities. Rule 10b-5(c) prohibits "any act, practice, or course of business which operates…as a fraud or deceit" in connection with the purchase or sale of any security.

4. In nontransactional cases, the Second, Tenth and Eleventh circuits have also refused to extend primary liability to secondary actors. *Regents*, 2007 WL 816518 at *11 n.28.