The Scope of Scheme Liability under the Federal Securities Laws

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Introduction

The scope of liability under Section 10(b) of the Securities Exchange Act of 1934 (Exchange Act) and Rule 10b-5 thereunder is an important issue that has been the subject of litigation for years.¹ In an attempt to clarify the issue, the Supreme Court rendered its landmark Central Bank decision in 1994, which held that there is no private right of action for aiding and abetting a violation of Section 10(b).² In Central Bank, the Supreme Court explained, however, that persons typically considered to be secondary actors could still face liability to the extent they were primary violators of Section 10(b). The Supreme Court has never defined the term “primary violator,” and lower courts have struggled with different tests.

In an effort to circumvent Central Bank’s proscriptions on aiding and abetting liability, plaintiffs have been pursuing defendants typically thought of as secondary actors by alleging that they participated in a “scheme to defraud.” The issue is one of immense importance to lawyers, accountants, banks, counterparties and others traditionally thought of as “secondary actors” and who may be or have become targets of plaintiffs seeking recovery from what plaintiffs hope are deep-pocketed defendants. While Supreme Court precedent favors a narrow, bright line test for determining the scope of liability under Section 10(b) and Rule 10b-5, several courts have been utilizing vague tests with little predictive value, thereby injecting confusion into this very important area.

With a split in the circuits regarding whether plaintiffs can essentially do an end-run around Central Bank, the Supreme Court recently agreed to review an Eighth Circuit decision regarding the scope of scheme liability for secondary actors.

Legal Framework

Section 10(b) of the Exchange Act forbids (1) the use or employment of any manipulative or deceptive device or contrivance, (2) in connection with the purchase or sale of a security. To implement Section 10(b), the SEC promulgated Rule 10b-5, which makes it unlawful for any person, directly or indirectly:

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

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

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

Until recently, courts had rarely distinguished among Rule 10b-5’s three subsections. Courts tended to focus on whether there was a material misstatement or omission. In the wake of Central Bank, however, plaintiffs have focused on the distinctions among Rule 10b-5’s subsections. While subsection (b) is aimed at statements and omissions, subsections (a) and (c) are broadly aimed at participation in fraudulent securities schemes.³ Not surprisingly, plaintiffs have seized upon the arguably broad wording of subsections (a) and (c) as a basis for engaging in creative pleading in securities fraud actions.

In the typical case, a lawyer, accountant, bank, counterparty or other secondary actor bears some connection to an allegedly fraudulent statement misrepresenting an issuer’s financial position, though the secondary actor did not actually make the statement in question. The Fifth, Eighth and Ninth Circuits are...
the only federal circuit courts that have addressed the application of Rule 10b-5(a) and (c) to this type of fact pattern, and there has been a split in the analysis used. Several district courts in other circuits have also been struggling with how to analyze the issue.

Circuit Court Decisions

In re Charter Communications

The Eighth Circuit addressed the scope of scheme liability for secondary actors in In re Charter Communications, Inc. Charter Communications involved a class action in which plaintiffs alleged that Charter, one of the nation’s largest cable television providers, engaged in a fraudulent scheme intended to artificially boost the company’s reported financial results. Plaintiffs alleged, among other things, that Charter and two equipment vendors entered into sham transactions that improperly inflated Charter’s reported operating revenues and cash flow. With respect to the vendor defendants, plaintiffs alleged that Charter agreed to pay them an additional $20 per cable set-top box in exchange for the vendors returning the additional payments to Charter in the form of advertising fees. Plaintiffs charged that these were sham or wash transactions with no economic substance, contrived to inflate Charter’s operating cash flow in order to meet the revenue and operating cash flow expectations of Wall Street analysts.

The district court dismissed plaintiffs’ Section 10(b) and Rule 10b-5 claims against the vendors, reasoning that the allegations were no more than aiding and abetting allegations that were precluded by the Supreme Court’s Central Bank decision. On appeal, plaintiffs argued that they had properly alleged that the vendors had violated Rule 10b-5(a) and (c) by participating in a scheme or artifice to defraud and by engaging in a course of business which operated as a fraud or deceit. The Eighth Circuit rejected the plaintiffs’ claims. The court reasoned that Central Bank and the earlier cases on which it relied stood for three governing principles: (1) a private plaintiff may not bring a Rule 10b-5 suit against a defendant for acts not prohibited by the text of Section 10(b); (2) a device or contrivance is not “deceptive” within the meaning of Section 10(b) absent some misstatement or a failure to disclose by one who has a duty to disclose; and (3) the term “manipulative” has the limited contextual meaning ascribed to it in the Supreme Court’s decision in Santa Fe Indus., Inc. v. Green, i.e., illegal trading practices such as wash sales, matched orders, or rigged prices, that are intended to mislead investors by artificially affecting market activity.

The Eighth Circuit explained that the focus of plaintiffs’ complaint was an alleged continuous course of conduct in which Charter allegedly made and/or failed to correct public representations which were or had become materially false and misleading regarding Charter’s financial results and operations. The Court explained that the vendors did not issue any misstatement relied upon by the investing public and were not under a duty to Charter investors and analysts to disclose information useful in evaluating Charter’s true financial condition. Moreover, none of the alleged financial misrepresentations by Charter was made by or even with the approval of the vendors. Consequently, the Eighth Circuit affirmed the dismissal of the complaint against the vendor defendants.

The Eighth Circuit noted that imposing liability for securities fraud on one party to an arm’s length business transaction because that party knew or should have known that the other party would use the transaction to mislead investors would introduce potentially far-reaching duties and uncertainties for those engaged in day-to-day business dealings. The court expressed the opinion that decisions of this magnitude should be made by Congress.

Regents of University of California v. Credit Suisse USA

In a recent decision resulting out of the Enron litigation, the Fifth Circuit also took a narrow view of the scope of scheme liability for secondary actors. The decision came in the context of an interlocutory appeal by defendants challenging class certification. The court reversed and remanded the district court’s decision to certify the class, in part because of the district court’s interpretation of the scope of
Section 10(b). Plaintiffs alleged that defendant investment banks, Credit Suisse First Boston, Merrill Lynch & Company, Inc., and Barclays Bank PLC, entered into partnerships and transactions that allowed Enron to take liabilities off of its books temporarily and to book revenue from the transactions when it was actually incurring debt. The common feature of the transactions was that they enabled Enron to misstate its financial condition.

The court explained that the appropriate starting point for interpreting the scope of scheme liability is the text of the statute. The court cited approvingly the Eighth Circuit’s statement in Charter Communications that “any 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.” Thus, the court rejected the idea that the investment banks had engaged in deceptive acts. It explained that “Enron had a duty to its shareholders, but the banks did not. The transactions in which the banks engaged at most aided and abetted Enron’s deceit by making its misrepresentations more plausible.”

Finally, the court, like the Supreme Court in Central Bank, took into account certain policy considerations to determine whether its decision was in accord with the will of Congress. It explained that strict construction of Section 10(b) against inputting aiding and abetting liability for secondary actors under the rubric of “deceptive acts” or “schemes” gives rise to the type of certainty that the Supreme Court sought in Central Bank. Finally, the court concluded that Section 10(b) was the result of Congress’ balancing of competing desires to provide some remedy for securities fraud without opening the floodgates for nearly unlimited and frequently unpredictable liability for secondary actors in the securities markets.

Simpson v. AOL Time Warner

In Simpson v. AOL Time Warner, the Ninth Circuit took a different approach with respect to defining the boundaries of scheme liability. Simpson involved a consolidated class action in which plaintiffs alleged that multiple actors engaged in a scheme to overstate the reported revenues of Homestore.com (“Homestore”). Homestore eventually restated its revenues downward by over $170 million. Plaintiffs alleged that Homestore engaged in “triangular” transactions whereby Homestore entered into sham transactions with the third party vendor defendants who returned money to Homestore through contracts with two of the other outside defendants. Plaintiffs further alleged that Homestore overpaid for an asset owned by an outside defendant in return for an agreement to funnel some of the money back to Homestore through a related business entity. Plaintiffs contended that the recording of gross revenue from these transactions was improper.

Plaintiffs alleged that the outside defendants engaged in a “scheme to defraud” in violation of Rule 10b-5(a) and (c). The district court dismissed the complaint against the outside defendants, holding that liability for participation in a scheme could not extend beyond corporate officers and those with a special relationship to the corporation.

On appeal, the Ninth Circuit affirmed the district court’s dismissal under a different theory and then granted plaintiffs leave to amend the complaint. The Ninth Circuit held that to be liable as a primary violator of Section 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 court explained that it is not enough that a transaction in which the defendant was involved had a deceptive purpose and effect.

The court further explained that its new principal purpose and effect test is focused on differentiating conduct that may form the basis of a primary violation under Section 10(b) from mere aiding and abetting activity. The court reasoned that the focus of the inquiry on the deceptive nature of the defendant’s own conduct ensures that only primary violators will be held liable under Rule 10b-5(a) and (c). As an example, the court noted that conduct that does not have a principal legitimate business purpose, such as the invention of sham corporate entities to misrepresent the flow of income, may have a principal purpose of creating a false appearance, while conduct that is consistent with the defendants’ normal course of business would not typically be considered to have the purpose and effect of creating a
misrepresentation. The court did not articulate a clear standard for evaluating what constitutes a principal legitimate business purpose and when a third party crosses the line between aiding and abetting and primary liability.

**Key District Court Decisions**

Several district courts have also addressed the scope of scheme liability under Rule 10b-5(a) and (c), often applying their own unique tests.

For example, in *In re Parmalat*, plaintiffs sought to hold financial institutions liable under Rule 10b-5(a) and (c) for, among other things, structuring and participating in transactions that were allegedly hidden or mischaracterized on Parmalat's financial statements. The court held that primary liability may be imposed on any person who directly or indirectly uses or employs any device or contrivance with the capacity or tendency to deceive. The court concluded that allegations that the financial institution defendants had securitized and factored invoices that were worthless amounted to deceptive devices or contrivances for purposes of Section 10(b).

In *In re Lernout & Hauspie*, plaintiffs alleged that defendants participated in a scheme and course of business to defraud the securities market by establishing, funding, and operating sham entities that entered into bogus software licensing agreements with Lernout & Hauspie, thereby inflating Lernout & Hauspie's profits. The court held that Section 10(b) and Rule 10b-5 impose primary liability on any person who substantially participates in a manipulative or deceptive scheme by directly or indirectly employing a manipulative or deceptive device (like the creation or financing of a sham entity) intended to mislead investors, even if a material misstatement by another person creates the nexus between the scheme and the securities market. Accordingly, the court denied the motions to dismiss.

**Supreme Court Precedent Regarding the Scope of Section 10(b)**

The issue of whether Rule 10b-5(a) and (c) permit plaintiffs to sue traditional secondary actors under a theory of “scheme liability” is one of extraordinary importance. With the current muddled state of the law, lawyers, accountants, banks, counterparties, and others traditionally considered to be secondary actors are operating in a zone of uncertainty, unsure of the consequences of their actions or inactions. In *Central Bank*, the Supreme Court recognized that the scope of Section 10(b) liability is an issue that “demands certainty and predictability.” The Supreme Court warned that with unclear rules come “decisions made on an ad hoc basis, offering little predictive value to those who provide services to participants in the securities business.” Thus, a bright line analysis is the only practical way to address the Supreme Court's overarching desire to prevent the use of amorphous, unpredictable tests regarding the scope of liability under Section 10(b) and Rule 10b-5.

Section 10(b) proscribes the use of “any manipulative or deceptive device or contrivance in contravention of the rules implemented by the SEC for the protection of investors. In construing the scope of the conduct covered by Section 10(b), the statutory text must control. Thus, in order to assert a cause of action under Section 10(b), a plaintiff must allege facts that “can be fairly viewed as ‘manipulative or deceptive’ within the meaning of the statute.”

The Supreme Court has concluded that the term “deception,” when used in connection with Section 10(b), requires a material misstatement or omission. The term “manipulation” is “virtually a term of art when used in connection with securities markets.” The Supreme Court has defined manipulation for purposes of Section 10(b) as acts “intended to mislead investors by artificially affecting market activity.” At its core, manipulation “is [the] intentional interference with the free forces of supply and demand.”

As a matter of law, Rule 10b-5 cannot be broader in scope than Section 10(b). "While Section 10(b) is aptly described as a catchall provision . . . what it catches must be fraud." Similarly, "not every action deserving the punishment of conscience invokes the punishment of the law.” The Supreme Court clearly requires a misstatement (or omission) or artificial securities market activity as a predicate for
10(b) liability. Trying to circumvent those predicates by couching conduct as a “scheme” is legally insufficient.

Using a broader, more flexible test for liability under Rule 10b-5(a) and (c) not only ignores Supreme Court precedent regarding the scope of Section 10(b) and the meaning of deception and manipulation, but it runs afoul of policy concerns regarding predictability that the Supreme Court has considered significant. The Supreme Court has explained that “litigation under Rule 10b-5 presents a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general.” Vague, amorphous and unpredictable tests necessarily create a state of confusion about the type of conduct that can fall within the scope of Section 10(b) and Rule 10b-5.

As the Supreme Court explained in Central Bank, such unpredictability can cause defendants to abandon substantial defenses and to pay settlements in order to avoid the expense and risk of going to trial. These are not insignificant concerns. Increased costs incurred by professionals due to litigation, the threat of litigation, and settlements are generally passed on to their company clients and ultimately to investors. This result is especially disconcerting because investors are the intended beneficiaries of Section 10(b)’s and Rule 10b-5’s protections.

Conclusion

The Fifth and Eighth Circuits’ approaches to defining the scope of scheme liability attempt to follow Supreme Court precedent regarding the proper interpretation of Section 10(b) and Rule 10b-5 as well as the Supreme Court’s recognition of the need for certainty and predictability in the application of those provisions. The Ninth Circuit’s vague “principal purpose and effect” test, as well as several of the broad and creative formulations used by various district courts, provide ample room for artful pleading by plaintiffs that want to make an end-run around Central Bank, thereby improperly subjecting secondary actors to liability. Such tests do not properly apply the Supreme Court’s guidance regarding the scope of Section 10(b).

A narrower test which recognizes that Rule 10b-5 cannot be broader in scope than Section 10(b) would be consistent with the Supreme Court’s prior guidance. Such a test would enable secondary actors to understand the potential consequences of their actions and conduct their business accordingly. Now that the Supreme Court has agreed to review the Eighth Circuit’s decision in Charter Communications, it will have the opportunity to specifically address the scope of liability under Section 10(b) and Rule 10b-5 for secondary actors and thereby bring much needed clarity to this very important issue.

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Section 10(b) is the general anti-fraud provision of the Exchange Act.


United States v. Bongiorno, No. 05 Cr. 390 (S.D.N.Y. May 1, 2006).


Id. at 989.

Id.

Id.

Id. at 990.

Id. at 991.

Id.

Id. at 992.


Id. at 992.

Id.

Id. at 992-993.

Id.

Id. at 993.

Regents of Univ. CA vs. Credit Suisse First Boston USA, No. 06-20856 (5th Cir. Mar. 19, 2007).

Id.

Id.

Id.

Id.

Id.

Id., quoting Charter Commc'n, 443 F. 3d at 992.

Id.

Id.

Id.

Id.

Id.

Simpson v. AOL Time Warner Inc., 452 F.3d 1040 (9th Cir. 2006), petition for cert. filed (Oct. 19, 2006) (No. 06-560).

Id. at 1042

Id.

Id.

Id. at 1042.

Id. at 1042.

Id. at 1043.


Simpson, 452 F.3d at 1055.

Id. at 1048.

Id.

Id. at 1048, n.5.

Id. at 1049.

Id. at 1050.


Id. at 504.

Id.


Id. at 173.

Id. at 177.

Central Bank, 511 U.S. at 188 (quoting Pinter v. Dahl, 486 U.S. 622, 652 (1988)).

Id.

Id. at 175.

Central Bank, 511 U.S. at 177 (Section 10(b) “prohibits only the making of a material misstatement (or omission) or the commission of a manipulative act.”). A defendant is only liable for material omissions if the defendant had a legal duty to disclose the information. Basic, Inc. v. Levinson, 485 U.S. 224, 239 n.17 (1988) (“Silence, absent a duty to disclose, is not misleading under Rule 10b-5.”). A duty to disclose arises only from a “fiduciary or other similar relation of trust and confidence.” Chiarella v. United States, 445 U.S. 222, 228 (1980).


Santa Fe, 430 U.S. at 476; Schreiber v. Burlington Northern, Inc., 472 U.S. 1, 6 (1985) (manipulation “refers generally to practices, such as wash sales, matched orders, or rigged prices, that are intended to mislead investors by artificially affecting market activity”).


SEC v. Zandford, 535 U.S. 813, 816 n.1 (2002) (“The scope of Rule 10b-5 is coextensive with the coverage of § 10(b) . . . .”).


Central Bank, 511 U.S. at 189.

Id.