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Scheme Liability under Section 10(b) of the Securities Exchange Act of 1934

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NOTES

Scheme Liability Under Section 10(b) of the Securities Exchange Act of 1934

I. INTRODUCTION

The corporate scandals of recent years have brought the accountability of corporate officers, and other related actors into the limelight. Civil litigation, particularly securities litigation, is one of the mechanisms helping to keep corporate actors in check. Investors who have purchased securities at a time when a corporation seemed to be financially successful have lost substantial amounts of money when the corporation's success turns out to be a mere sham and the investments have lost their value. While the necessity of holding corporations themselves liable for committing securities fraud is hardly questioned, such actions are often not successful – those corporations may be bankrupt, and securities action against them is often fruitless. Thus, plaintiffs often turn against actors who participated in various ways in the securities fraud of the company. Such actors include corporate officers, law firms, accountants/auditors, investment banks, as well as business partners.

The main vehicle for such actions is section 10(b) of the Securities Exchange Act of 1934¹ and the corresponding Securities and Exchange Commission Rule 10b-5.² However, this path has not been easy since the Supreme Court held in 1994 that there is no private right of action against parties aiding and abetting securities law violations under section 10(b).³ In the last few years, plaintiffs have tried to avoid this limitation by using a theory called “scheme liability,”⁴ a “quite cutting edge” theory as one district court recently put it.⁵ In relatively few years, the scope of scheme liability may well have become “the single most important issue being litigated in securi-

1. 15 U.S.C. § 78a-nn (2000).

2. 17 C.F.R. § 240.10b-5 (2006).

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

4. On the nature of “scheme liability,” *see infra* Part II.B. “Scheme liability” has become the term of the art. *See, e.g.,* *Quaak v. Dexia, S.A.*, 445 F. Supp. 2d 130, 134 (D. Mass. 2006) (stating that the law regarding “scheme liability” was not settled at previous stages of the case).

5. *Quaak*, 445 F. Supp. 2d at 134. *See also* *United States v. Finnerty*, Nos. 05 Cr.393 DC, 05 Cr. 397 DC, 2006 WL 2802042, at *3 (S.D.N.Y. Oct. 2, 2006) (“[T]he law with respect to subsections (a) and (c) is not very refined.”).

ties class actions today.”⁶ Unsurprisingly, the Supreme Court has recently granted certiorari in order to bring some clarity into law.⁷

This law summary analyzes the recent cases where plaintiffs have tried to utilize the scheme liability theory.⁸ Even though courts have frequently analyzed claims based on this theory, they approach the issue rather unsystematically, reach inconsistent results, and do not employ a similar analytic structure.⁹ Part of this inconsistency is based on the fact that scheme liability is applied in cases involving very different fraudulent practices and against actors with very different functions. Due to this wide range of circumstances, the different approaches of courts may actually be justified. It is probably inappropriate to formulate a single test or rule for deciding scheme liability cases. Instead, courts should approach each case separately, based on the type of defendant and the type of claim.

6. Brooke Masters & Patti Waldmeir, *Courts to Rule on Liability for Fraud Losses*, FIN. TIMES, Feb. 5, 2007, at 10 (quoting Bob Giuffra, an attorney with law firm Sullivan & Cromwell).

7. Stoneridge Inv. Partners, LLS v. Scientific-Atlanta, Inc. (*In re Charter Commc'ns, Inc.*, Sec. Litig.), 443 F.3d 987 (2006), *cert. granted*, 75 U.S.L.W. 3034 (U.S. Mar. 26, 2007) (No. 06-43).

8. Very few articles in scholarly and professional journals have so far devoted significant attention to this topic, usually providing a descriptive account of a few recent cases. The most extensive treatments are Nicholas Fortune Schanbaum, Note, *Scheme Liability: Rule 10b-5(a) and Secondary Actor Liability After Central Bank*, 26 REV. LITIG. 183 (2007); Daniel A. McLaughlin, *Liability Under Rules 10b-5(a) & (c)*, 31 DEL. J. CORP. L. 631 (2006); Gregory A. Markel & Gregory G. Ballard, *The Evolution of "Scheme" Liability Under Section 10(b)*, 1571 PLI/CORP 991 (2006); and Matthew L. Mustokoff, *"Scheme" Liability Under Rule 10b-5: The New Battleground in Securities Fraud Litigation*, FED. LAW., June 2006, at 20. Even those articles, however, focus on few recent cases only, mostly from the appeals courts. See also Jeffrey Q. Smith & James K. Goldfarb, *An Emerging Standard for Secondary Actor Liability Under the Federal Securities Law*, ANDREWS SEC. LITIG. & REG. REP., Oct. 4, 2006, at 2; Sarah S. Gold & Richard L. Spinogatti, *Secondary Actor Liability Under Rule 10b-5*, N.Y. L. J. at 3 (June 13, 2006) (comparing two cases); Tracy A. Nichols & Stephen P. Warren, *Gatekeepers Under Fire from Securities Plaintiffs and Regulators: When Doing Your Job Can Amount to "Scheme Liability" Under Rule 10b-5(a) and (c) or Constitute Aiding and Abetting According to the SEC*, 1562 PLI/CORP 611 (2006) (discussing two cases).

9. See, e.g., Newby v. Enron Corp. (*In re Enron Corp. Sec., Derivative & ERISA Litig.*), No. H-01-3624, 2006 U.S. Dist. LEXIS 43146, at *173 (S.D. Tex. June 5, 2006) (“It is obvious that courts are divided over the scheme liability issue.”); Markel & Ballard, *supra* note 8, at 999 (“[T]he state of the law as reflected in circuit court and district court opinions on scheme liability can only be described as confusing.”).

II. LEGAL BACKGROUND

The United States Congress enacted the Securities Exchange Act of 1934 in order to, among other goals, “insure the maintenance of fair and honest markets.”¹⁰ One of the most important provisions of the Act is section 10(b), which provides:

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

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered . . . , any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.¹¹

Under section 10(b), the Securities and Exchange Commission promulgated more detailed rules outlining the duties of participants in securities transactions. According to Rule 10b-5, it is prohibited, in connection with the purchase or sale of a security, to employ a “device, scheme or artifice to defraud;”¹² to make “any untrue statement of a material fact” or to fail to “state a material fact necessary in order to make the statements made . . . not misleading;”¹³ and to engage in “any act, practice or course of business which operates or would operate as a fraud or deceit upon any person.”¹⁴

In 1994, the Supreme Court limited litigation possibilities under section 10(b) and Rule 10b-5 in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*¹⁵ In that case, a public building authority had twice (in 1986 and in 1988) issued bonds for public improvements in a commercial and residential development.¹⁶ According to the bond covenants, the bonds were secured by land, which had to be worth at least 160% of the bonds’ outstanding principal and interest.¹⁷ The land securing the 1986 issue was properly valued.¹⁸ Before the 1988 issue, real estate values had plummeted and

10. 15 U.S.C. § 78b (2000).

11. 15 U.S.C. § 78j(b) (2000).

12. 17 C.F.R. § 240.10b-5(a) (2006).

13. *Id.* § 240.10b-5(b).

14. *Id.* § 240.10b-5(c).

15. 511 U.S. 164 (1994).

16. *Id.* at 167.

17. *Id.*

18. *Id.*

thus old land appraisals became significantly inflated.¹⁹ Central Bank, the bond indenture trustee,²⁰ allegedly knew that the land appraisals were incorrect but delayed an updated and independent review of the land values.²¹ After the building authority defaulted on the bonds, investors sued not only the building authority and some other defendants, but also Central Bank.²²

The Supreme Court held that the bank was engaged at most in aiding and abetting the building authority, but that there is no private right of action against parties aiding and abetting securities law violations.²³ This case was especially comforting for entities such as investment banks, attorneys, auditors and others who consult or otherwise provide help to companies offering public securities. Other entities that directly benefited from the Supreme Court decision were the contractual partners of the securities law violators, whose transactions with the primary actors could be used for securities fraud, usually through misleading reporting by the securities' issuer.

However, the Supreme Court did not absolve the secondary actors of all liability. In *Central Bank*, the court itself warned that "any person or entity . . . 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 Rule 10b-5."²⁴ Encouraged by this statement, plaintiffs have been creative in finding ways to characterize the behavior of secondary actors as not amounting to merely aiding and abetting, but as active involvement as a primary participant in the securities fraud.

A. Liability Based on Misrepresentation Under Rule 10b-5(b)

In the wake of *Central Bank*, the main avenue for imposing liability on parties such as accountants, lawyers, underwriters, and investment banks ("secondary actors")²⁵ was by applying Rule 10b-5(b), which prohibited the

19. *Id.*

20. Bond indenture trustee is an impartial entity charged with carrying out the terms of the bond, and resolve conflicts between the bond issuer and bondholders who may have adverse interests. See Carrie E. Goodwin, Note, *Central Bank v. First Interstate Bank: Not Just the End of Aiding and Abetting Under Section 10(b)*, 52 WASH. & LEE L. REV. 1387, 1399 n.51 (1995).

21. *Cent. Bank*, 511 U.S. at 167-68.

22. *Id.* at 168.

23. *Id.* at 191. The SEC regained the right to bring aiding and abetting claims when Congress passed the Private Securities Litigation Reform Act of 1995. See 15 U.S.C. § 78t(e) (2000) (providing that "any person that knowingly provides substantial assistance to another person in violation of a provision of this title, or of any rule or regulation issued under this title, shall be deemed to be in violation of such provision to the same extent as the person to whom such assistance is provided").

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

25. The term "secondary actor" could refer to anybody who is not the issuer of securities. The term is somewhat misleading, since the Supreme Court in *Central*

making of untrue statements of material fact. These plaintiffs have alleged that secondary actors have been so closely involved in drafting financial and other corporate statements that they have actually made those statements in violation of Rule 10b-5(b). Recognizing that such liability could easily run afoul of the restrictive standard of *Central Bank*, courts have adopted three theories in order to delineate when the decisions have been “made” by the secondary actors and when the secondary actors only assist in making the statements, thus being at most aiders and abettors.²⁶ The three tests are the “bright line” test, the “substantial participation” test, and the “creation of misrepresentation” tests.

The courts applying the “bright line” test require that the secondary actor make the fraudulent statements, and that the statements be attributed to the secondary actor.²⁷ The secondary actor can then be liable when its misstatements have been actually released to a purchaser of securities.²⁸ However, it is rarely the case that those types of secondary actors actually make misleading statements themselves. It is much more common that they participate in drafting, reviewing and editing documents that are later released in the name of the primary actor. Thus, the “bright line” test is usually fatal for securities fraud claims against secondary actors.²⁹ A somewhat more relaxed version

Bank held that there is only “primary” liability for securities fraud. *See supra* text accompanying note 24. Thus, according to the Supreme Court “secondary actors” cannot by definition be liable for securities fraud, but can only be liable if they actually are “primary” actors. The term “secondary actor” is, however, used almost universally and it usually denotes any actor who did not issue the security in question.

26. *See generally*, Cecil C. Kuhne, III, *Expanding the Scope of Securities Fraud? The Shifting Sands of Central Bank*, 52 *DRAKE L. REV.* 25, 33-41 (2003) (describing two of the three tests); Celia R. Taylor, *Breaking the Bank: Reconsidering Central Bank of Denver after Enron and Sarbanes-Oxley*, 71 *MO. L. REV.* 367, 373-78 (2006) (describing three tests).

27. *See, e.g.*, *Wright v. Ernst & Young LLP*, 152 F.3d 169, 175 (2d Cir. 1998) (dismissing a claim against an auditor when the fraudulent statement by the company never mentioned the auditor and even declared that the information was unaudited, even though the auditor had in fact approved the statements); *Ziemba v. Cascade Int'l, Inc.*, 256 F.3d 1194, 1205 (11th Cir. 2001) (“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”).

28. For example, auditors can be liable for signing financial statements, attesting to their truthfulness. *See In re Global Crossing, Ltd. Sec. Litig.*, 322 F. Supp. 2d 319, 331 (S.D.N.Y. 2004).

29. The “bright line” test struggles in its handling of the liability of corporate officers or other employees who drafted corporate statements, since those statements might not be directly and publicly attributable to them. The Second Circuit, normally adhering to the “bright line” test, found it to be crucial in one case that the particular officer was “primarily responsible for [Defendant’s] communications with investors and industry analysts” and that the officer “was involved in the drafting, producing, reviewing and/or disseminating of the false and misleading statements.” *Hollin v. Scholastic Corp. (In re Scholastic Corp. Sec. Litig.)*, 252 F.3d 63, 76 (2d Cir. 2001).

of the “bright line” test allows the attribution to be indirect, e.g. when the investors know that the secondary actor, such as an auditor, is behind the statements.³⁰ Still, the auditor itself needs to make the statement.

The Ninth Circuit adopted a more lenient “substantial participation” theory.³¹ For the courts applying this theory, even when the secondary actor does not directly make the misleading statements itself, “substantial participation or intricate involvement” in making the statements is sufficient.³²

The third theory follows a “creation of misrepresentation” test. Under this test, following a suggestion of the SEC, a person can be liable as a primary violator if he or she, “acting alone or with others, creates a misrepresentation [and] acts with the requisite scienter.”³³ One of the most notorious

In that case, the Second Circuit held that a book publisher’s vice president for finance and investor relations was sufficiently responsible for the company’s communications with investors and analysts to be held liable for corporate misstatements. *See id.* However, there is yet no coherent theory for holding corporate officers and other employees liable for fraudulent statements attributable to the corporation. *See, e.g., In re Qwest Commc’ns Int’l Sec. Litig.*, 387 F. Supp. 2d 1130, 1144-45 (D. Colo. 2005) (stating that corporate directors and officers can be held liable under the “group publication doctrine”). If, but only if, officers have “possession, direct or indirect, of the power to direct or cause the direction of the management and policies” of a corporation, they can be held liable as “control persons” under section 20(a) of the Securities Exchange Act. *See Maher v. Durango Metals, Inc.*, 144 F.3d 1302, 1305 (10th Cir. 1998).

30. *See Filler v. Lernout (In re Lernout & Hauspie Sec. Litig.)*, 230 F. Supp. 2d 152, 166-67 (D. Mass. 2002) (sustaining claims against affiliates of the auditing firm KPMG whose role was widely disseminated to the public and where investors reasonably attributed some statements to it, even though the auditor itself was not publicly disclosed to be the author of the fraudulent statements); *see also In re Global Crossing, Ltd. Sec. Litig.*, 322 F. Supp. 2d 319, 334 (S.D.N.Y. 2004) (“investors . . . could easily have relied on the accounting firm’s involvement in making any public financial reports, even where a particular statement was not publicly attributed to it”).

31. *See, e.g., Scott Siamas, Comment, Primary Securities Fraud Liability for Secondary Actors: Revisiting Cental Bank of Denver in the Wake of Enron, Worldcom and Arthur Andersen*, 37 U.C. DAVIS L. REV. 895, 906-07 (2004) (describing the substantial participation test).

32. *Howard v. Everex Sys., Inc.*, 228 F.3d 1057, 1061 n.5 (9th Cir. 2000) (discussing liability of corporate officers); *see also Dannenberg v. Painewebber Inc. (In re Software Toolworks Inc. Sec. Litig.)*, 50 F.3d 615, 628 n.3 (9th Cir. 1994); *In re ZZZZ Best Sec. Litig.*, 864 F. Supp. 960, 970 (C.D. Cal. 1994) (accounting firm can be liable if it was “intricately involved” in preparing the fraudulent documents). Some circuits have expressly rejected this test. *See, e.g., Anixter v. Home-Stake Prod. Co.*, 77 F.3d 1215, 1226 n.10 (10th Cir. 1996) (refusing to follow case-law employing the substantial participation test “[t]o the extent these cases allow liability to attach without requiring a representation to be made by defendant”).

33. *Newby v. Enron Corp. (In re Enron Corp. Sec., Derivative & ERISA Litig.)*, 235 F. Supp. 2d 549, 588 (S.D. Tex. 2002) (citing approvingly a test proposed by the SEC); *see also Carley Capital Group v. Deloitte & Touche, L.L.P.*, 27 F. Supp. 2d

instances where a district court has adopted the “creation of misrepresentation” standard is the assessment of the participation of the law firm Vinson & Elkins in the Enron accounting fraud.³⁴ In that case, the district court refused to dismiss claims against Vinson & Elkins, who had allegedly prepared the transactions for, and participated in the structuring of various sham entities employed by Enron to conceal its financial position.³⁵

Reliance on Rule 10b-5(b) has thus produced a clear split between different jurisdictions. The Second Circuit follows the “bright line” test requiring attribution of statements (or at least, likely attribution). The Ninth Circuit employs the “substantial participation” test, requiring that the secondary actor be substantially involved in making the misstatements. Finally, a few district courts follow the SEC-favored “creation of misrepresentation” test. Rule 10b-5(b) case law, even though conflicting, is relatively well delineated.

B. Scheme Liability

Unlike the courts’ reactions to the preceding three theories of liability, their differences with respect to the scheme liability theory have been more obscure. This theory relies not on Rule 10b-5(b), which prohibits making fraudulent statements and refraining from certain omissions, but on Rule 10b-5(a) and (c). Under these provisions, a defendant can be held liable for employing a “device, scheme or artifice” to defraud, and for engaging in “any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.”³⁶

Traditionally (and before *Central Bank*), scheme liability has been applied in very limited circumstances involving market manipulation.³⁷ Because of the availability of the aiding and abetting of misrepresentation claim, there was no need to allege scheme liability separately. However, when aid-

1324, 1334 (N.D. Ga. 1998) (“a secondary actor can be primarily liable when it, acting alone or with others, creates a misrepresentation even if the misrepresentation is not publicly attributed to it”).

34. In re *Enron*, 235 F. Supp. 2d at 656-69 (refusing to dismiss the 10b-5 claim against Vinson & Elkins).

35. *Id.*

36. 17 C.F.R. § 240.10b-5(a), (c).

37. Market manipulation refers to practices such as “wash sales, matched orders, or rigged prices, that are intended to mislead investors by artificially affecting market activity.” *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 476-77 (1977). For example, wash sale takes place when an individual is both the buyer and the seller of the security. Such transaction might create a “buzz” about the security, inducing other, unsuspecting investors to purchase the security, usually at an artificially elevated price level. See generally Damian Moos, Note, *Pleading Around the Private Securities Litigation Reform Act: Reevaluating the Pleading Requirements for Market Manipulation Claims*, 78 S. CAL. L. REV. 763, 765-69 (2005) (describing the various market manipulation schemes).

ing and abetting claims were foreclosed by *Central Bank*, scheme liability rose to prominence.³⁸

In 2002, the Supreme Court issued a decision that drew additional attention to scheme liability. *SEC v. Zandford* is the primary case interpreting Rule 10b-5(a) and (c) in the post-*Central Bank* era.³⁹ In that case, a stock broker sold his customer's securities but then used the proceeds for his own benefit.⁴⁰ The Supreme Court held that the broker violated Rule 10b-5(a) and (c)⁴¹ and thus committed securities fraud against his own customer.⁴²

Case law regarding scheme liability started to develop even more quickly after the first substantive decision in the Enron litigation⁴³ serving "as a template for theories of 'scheme' liability."⁴⁴ In that case, not only did the district court utilize the "creation of misrepresentation" test,⁴⁵ but it also referred to the scheme liability of various secondary actors such as law firms,

38. See, e.g., *SEC v. Jakubowski*, 912 F. Supp. 1073, 1079 n.3 (N.D. Ill. 1996) ("Most cases concerning Rule 10b-5 focus on subpart (b) and largely ignore subpart (a) . . . and subpart (c) Notwithstanding the relatively vague language of subparts (a) and (c), the courts, the Commission, and private parties might look more closely at subparts (a) and (c) in future cases, especially those involving 'novel' forms of fraud.").

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

40. *Id.* at 815.

41. See *id.* at 819 (citing provisions from subsections (a) and (c), but not from subsection (b)).

42. *Id.* at 820.

43. *Newby v. Enron Corp. (In re Enron Corp. Sec., Derivative & ERISA Litig.)*, 235 F. Supp. 2d 549 (S.D. Tex. 2002). This case has prompted various authors to examine secondary actor liability in depth. See, e.g., Gary J. Aguirre, *The Enron Decision: Closing the Fraud-Free Zone on Errant Gatekeepers?*, 28 DEL. J. CORP. L. 447 (2003); Aegis J. Frumento, *Misrepresentations of Secondary Actors in the Sale of Securities: Does In re Enron square with Central Bank?*, 59 BUS. LAW. 975 (2004); Taylor, *supra* note 26; Siamas, *supra* note 31.

44. Daniel A. McLaughlin, *Liability Under Rules 10b-5(a) & (c)*, 31 DEL. J. CORP. L. 631, 645 (2006). See also Matthew L. Mustokoff, "Scheme" Liability Under Rule 10b-5: The New Battleground in Securities Fraud Litigation, FED. LAW., June 2006, at 20, 21 ("[P]laintiffs – presumably inspired by . . . invocation of Rule 10b-5(a) and (c) in Enron . . . began to premise their claims against secondary actors on theories of 'scheme' liability."). Even though Enron was certainly a famous case adopting the scheme liability theory, it was not the first case where plaintiffs were successful in using the theory in a case involving accounting fraud. See *In re ZZZZ Best Sec. Litig.*, 864 F. Supp. 960, 972 (C.D. Cal. 1994) (accounting firm can be liable for its participation in a fraudulent scheme, not only for the misrepresentations regarding the accounting fraud). Nor was Enron the first case where plaintiffs had tried to hold accountants liable under Rule 10b-5(a) and (c). See, e.g., *Filler v. Lernout (In re Lernout & Hauspie Sec. Litig.)*, 230 F. Supp. 2d 152, 174-75 (D. Mass. 2002) (rejecting scheme liability claims against an auditor for its role in creating misleading financial statements).

45. See *supra* notes 33-35 and accompanying text.

accountants, and investment banks. More specifically, law firms, accountants and investment banks were held to be direct participants in a scheme to defraud investors because of their assistance, and sometimes their central role, in creating various illicit special purpose entities employed to conceal Enron's debt.⁴⁶

The Enron decision, especially its discussion of scheme liability, provided an additional option for plaintiffs to raise charges against the lawyers, accountants, and investment bankers that helped to create misleading statements. However, Enron's effect turned out to be even broader. Namely, the plaintiffs started to allege that the contractual partners of the primary violators could also be held liable if the transactions entered into could be considered as part of the scheme to defraud.⁴⁷ Courts have tried to restrict the extent of scheme liability in the absence of aiding and abetting liability, but the broad range of claims based on scheme liability has made it difficult. The next section of this law summary provides an overview of those struggles.

III. RECENT DEVELOPMENTS

There are various types of actors whom plaintiffs have recently tried to hold liable under Rule 10b-5(a) and (c): accountants, attorneys, investment banks (in their capacity as financiers, advisors, underwriters, and analysts), brokers and dealers, business partners, corporate directors, officers, and employees, and sometimes even the corporation itself where fraud was committed.⁴⁸ Since cases involving each group of defendants have their own peculiarities, this summary provides a separate overview of cases for each group of defendants.

A. Accountants

In recent years, at least one court has agreed with the outcome of the Enron litigation, holding that accountants who provide advising services can be liable under scheme liability theory when they are extensively involved in devising fraudulent accounting schemes. *In re Global Crossing, Ltd. Securi-*

46. See generally, Aguirre, *supra* note 43, at 488-92 (describing the court's standard in *Enron* when holding several secondary actors liable).

47. See *infra* Part III.E.

48. See *infra* Parts III.A-G. One also has to keep in mind that these actors provide a very different range of services to corporations. For example, accountants not only prepare financial statements but also provide advising services. Financial institutions are involved in advising, underwriting, research analysis, brokering, as well as financing itself. Financing can be in the form of straightforward commercial loan as well as a complex structured finance transaction. Such transactions may have the purpose of not only the raising of funds, but also the achievement of a favorable and perfectly legal tax or accounting results. The above list only includes some services that are very well-known.

*ties Litigation*⁴⁹ involved claims filed against accountants who allegedly “dictat[ed] incorrect and misleading accounting systems” for certain transactions that inflated the reported earnings of the company audited.⁵⁰ The problem with attaching Rule 10b-5(b) liability to the accountants was that they helped to create only some of the financial statements, whereas much of the damage was done by statements issued after the accountants were not involved with the company anymore.⁵¹ The court nevertheless held that it was sufficient that the accountant “masterminded” the misleading accounting practices used to inflate reported revenue by being their “chief architect and executor.”⁵² This gave rise to the scheme liability of the accountants.⁵³

Although auditors are usually not held liable under scheme liability for simple auditing mistakes, such liability for accountants is not completely ruled out, at least in the motion to dismiss stage. In *WM High Yield Fund v. O’Hanlon*,⁵⁴ the accounting firm Deloitte & Touche allegedly issued erroneous opinions on financial statements that improperly inflated revenues of the audited company.⁵⁵ There were no allegations that the auditors were involved in devising the schemes. After the fraud was disclosed, the investors brought suit under both misrepresentation theory as well as under scheme liability theory.⁵⁶ The court allowed scheme liability claims to stand against all defendants, including Deloitte, and misrepresentation claims to stand against Deloitte and other defendants who had made any public statements.⁵⁷

In another case, the auditors were successful in the motion to dismiss stage.⁵⁸ The case was brought against the oil conglomerate Shell Group who in several occasions misrepresented its oil reserves, as well as some of its financial results.⁵⁹ After the results were later corrected downwards, the

49. 322 F. Supp. 2d 319 (S.D.N.Y. 2004).

50. *Id.* at 325. The misleading accounting practices involved reporting of long-term revenue as immediate cash revenue and of “reciprocal swaps” that yielded no actual revenue as producing reportable income. *Id.* at 325-26.

51. *Id.* at 335.

52. *Id.* at 336.

53. *Id.* at 337 n.17 (stating that the accountant “may be held liable for the underlying fraudulent scheme to inflate the price of the Companies’ stocks, [even though] it may only be held liable for specific false statements to the extent that it can be said to have made those statements under Rule 10b-5(b)”).

54. No. Civ. A. 04-3423, 2005 WL 1017811 (E.D. Pa. Apr. 29, 2005).

55. *Id.* at *2.

56. *Id.* at *3, *8.

57. *Id.* at *7. The reasoning for sustaining the scheme liability claim was not very thorough. *See id.* at *8 (“Indeed, given the massive fraudulent scheme set forth by Plaintiffs in their Complaint, . . . it appears that they have set forth sufficient facts to survive a Motion to Dismiss . . .”).

58. *In re Royal Dutch/Shell Transp. Sec. Litig.*, No. 04-374 (JAP), 2006 WL 2355402 (D.N.J. Aug. 14, 2006) (mem., not for publication).

59. *Id.* at *1-2.

value of its stock decreased significantly.⁶⁰ The investors alleged that Shell Group's auditor, KPMG, actively participated in the improper accounting of the reserves. Namely, the plaintiffs alleged that KPMG knew or at least recklessly failed to discover that the financial statements were fraudulent.⁶¹ The court held that issuing unqualified audit opinions was at best a misrepresentation claim, and thus not actionable under Rule 10b-5(a) and (c).⁶²

B. Attorneys

There is only one recent reported district court case involving attorneys against whom scheme liability claims have been raised. That case involves an attorney who allegedly coauthored various statements that contained misrepresentations about a company that was selling securities.⁶³ The alleged fraudulent scheme was simple – selling shares that were in reality worth much less than one could predict from the representations, as well as hiding real economic results from the investors.⁶⁴ The court dismissed the scheme liability claims against the attorney on the ground that the complaint failed to plead with sufficient particularity the fraudulent acts attributable to each participant.⁶⁵ Despite the lack of reported cases, attorneys are clearly potential targets in securities fraud cases, including under the scheme liability theory.⁶⁶

C. Investment Banks

The liability of financial institutions providing loans, disguised by the issuer as revenue or equity contributions, has been a central topic in the Enron

60. *Id.*

61. *Id.* at *6.

62. *Id.* at *10. The court also rejected the plaintiff's claim that the fraudulent scheme consisted of KPMG International taking over the lucrative practice of KPMG Nigeria (the accounting fraud was committed in Nigeria). Such merger is not, "in and of itself, manipulative or deceptive." *Id.*

63. *Shoberg v. Clearmediaone, Inc.*, No. H-05-2122, 2006 WL 2709269, at *1-2 (S.D. Tex. Sept. 20, 2006).

64. *Id.* In one instance, the financial data presented to the investors were simply data about another company. *Id.* at *2.

65. *Id.* at *4 (noting that "Plaintiffs' theory as to each defendant is unclear from the face of the complaint").

66. See, e.g., Marc I. Steinberg, *The Corporate/Securities Attorney as a "Moving Target" – Client Fraud Dilemmas*, 46 WASHBURN L.J. 1, 1 (2006) ("When an attorney's client commits fraud or other illegality, the attorney may be held liable as a direct or indirect participant."); Marianne J. Jennings, *Fraud Is the Moving Target, Not Corporate Securities Attorneys: The Market Relevance of Firing Before Being Fired Upon and Not Being "Shocked, Shocked" That Fraud Is Going On*, 46 WASHBURN L.J. 27, 28-29 (2006) (indicating that attorneys' potential liability has expanded after *Simspon v. AOL Time Warner, Inc.*, a scheme liability case discussed *infra*).

litigation.⁶⁷ A few other cases, described below, have followed the initial Enron cases in supporting scheme liability claims against investment banks. As the cases will show, such liability may be based on the status of the investment bank both as an advisor as well as a provider of finances. In both cases the courts may impose liability on the banks, even though it was the issuer who deceived the investors in the most direct way through fraudulent financial and other statements.

In securities litigation involving the now bankrupt international dairy conglomerate Parmalat,⁶⁸ plaintiffs alleged securities fraud claims against various banks providing services to the company.⁶⁹ Parmalat engaged in sham transactions with different banks, improving the reported financial results.⁷⁰ Most importantly, the banks securitized duplicate invoices despite knowing that the invoices were worthless.⁷¹ The District Court for the Southern District of New York held that by engaging in those sham transactions, the banks had themselves employed “deceptive devices or contrivances for purposes of Section 10(b).”⁷²

At the same time, the court dismissed a claim against Bank of America for a transaction involving investments in one of Parmalat’s subsidiaries.⁷³ Bank of America, through two special purpose entities controlled by the bank, bought 18.8% of the shares of the subsidiary for \$300 million (allegedly a great overvaluation), while retaining the right to sell shares back to Parmalat group.⁷⁴ This created the appearance of a significant equity investment while, in essence, it was nothing more than a loan.⁷⁵ The court held that the transaction was not deceptive because the false appearance was created not from the transactions, but from “the manner in which Parmalat or its auditors described the transactions on Parmalat’s balance sheets and elsewhere.”⁷⁶

67. See *supra* notes 43-46 and accompanying text.

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

69. *Id.* at 481.

70. *Id.*

71. *Id.* Parmalat sold products to retailers through wholesale dealers in two different ways. In both cases, dealers paid Parmalat at once. In some cases, the dealers then sold to the retailers on their own account, sometimes acted on behalf of Parmalat. In the latter case, Parmalat would issue an invoice to the retailer and later reimburse the dealer the amounts already paid. The transaction in question involved the securitization of the invoices issued to the retailers – the invoices were actually worthless since the revenue from those invoices was immediately paid to the wholesalers. See *id.* at 481-82.

72. *Id.* at 504.

73. *Id.* at 485.

74. *Id.* The parties had an agreement that such right would arise only if the subsidiary would not be publicly listed, but both parties knew that this would not happen. *Id.* The actual purchase of shares was financed by notes issued by the SPEs. *Id.*

75. *Id.*

76. *Id.* at 505.

Half a year later, after allowing plaintiffs to replead, the court allowed claims against the same bank for its participation in the same transaction to stand, while calling it “a close question.”⁷⁷ The new allegation that persuaded the court was that Bank of America’s participation in the transaction led investors to believe that Bank of America put significant value to the subsidiary, and thus, to Parmalat as a whole.⁷⁸ The decision thus provides a good illustration of the ambiguous nature of scheme liability and the importance of carefully pleading allegations.

In 2005, the District Court for the District of Massachusetts refused to dismiss claims against a bank that provided financing and advice to a voice recognition company.⁷⁹ The bank allegedly knew that the money would be used for engaging in transactions that would allow accounting for fictitious revenue.⁸⁰ The plaintiffs also alleged that the bank structured the loans so that the fraud could succeed, and took affirmative steps to conceal the fraud from the debtor’s audit committee.⁸¹ The court held that the bank’s actions were “integral to the fraudulent scheme,” and that the bank was “a primary architect of the scheme to finance the sham entities.”⁸² Therefore, the bank could be liable under section 10(b).⁸³

Several decisions restrict the imposition of scheme liability on investment banks that are engaged in financing transactions. An early post-Enron case taking a restrictive approach arose out of fraud in energy management company Dynegy, Inc.⁸⁴ In that case, Citigroup allegedly structured and financed transactions that allowed Dynegy to disguise loans from Citigroup as equity investments or even as cash flow from operations.⁸⁵ The court dismissed the Rule 10b-5 claim against Citigroup, finding that it was Dynegy that improperly reported the transactions on its financial statements and that Citigroup only helped Dynegy do so.⁸⁶

Already in the case involving Parmalat, the court indicated that not all legally questionable transactions amount to actionable securities fraud.⁸⁷

77. *In re Parmalat Sec. Litig.*, 414 F. Supp. 2d 428, 435 (S.D.N.Y. 2006).

78. *Id.*

79. *Quaak v. Dexia S.A.*, 357 F. Supp. 2d 330, 333 (D. Mass. 2005).

80. *Id.* at 342.

81. *Id.*

82. *Id.*

83. *Id.* (refusing to reconsider its holding in *In re Lernout & Hauspie Sec. Litig.*, 236 F. Supp. 2d 161 (D. Mass. 2003)).

84. *Pirelli Armstrong Tire Corp. v. Dynegy, Inc.* (*In re Dynegy, Inc. Sec. Litig.*), 339 F. Supp. 2d 804 (S.D. Tex. 2004).

85. *Id.* at 819-21.

86. *Id.* at 916.

87. *See In re Parmalat Sec. Litig.*, 376 F. Supp. 2d 472, 505 (S.D.N.Y. 2005) (stating the general principle that when the bank “design[s] and enter[s] into . . . transactions knowing or even intending” that the transactions would be misrepresented by the other party, they engage at most in aiding and abetting fraud).

More recently, the district court in charge of the Enron litigation has also had second thoughts.⁸⁸ In two decisions made in the summer of 2006, the district court dismissed claims against two investment banks for their role in the Enron accounting fraud.

In June 2006, the court dismissed claims against Deutsche Bank.⁸⁹ Deutsche Bank allegedly structured and later financed special purpose entities (SPE) that were created in order to artificially and illegally inflate Enron's reported earnings.⁹⁰ In return, Deutsche Bank received extraordinary and rapid returns from the financing, along with high consulting fees for its services.⁹¹ The court held that this was not sufficient – the plaintiffs failed to allege that Deutsche Bank was “involved in the operation” of the SPE, and thus its behavior, at most, amounted to aiding and abetting.⁹² The court further explained that there were no allegations that “Deutsche Bank established an innately illicit deceptive entity or device.”⁹³

In July 2006, the court dismissed some claims against Barclays Bank for its role in financing a SPE created by Enron to hide its debt.⁹⁴ The court held that the fraud was based on the fact that the SPE's debts (including the one to Barclays) should have been consolidated into Enron's accounting but were not.⁹⁵ Even though Barclays was well aware of this fraud and even helped to structure transactions related to the SPE, the court held that “fraud occurred not in funding an entity that did not qualify as an SPE for nonconsolidation on Enron's balance sheet; it occurred in the improper accounting by Enron and others that did not consolidate.”⁹⁶ Thus, Barclays did not commit fraud against shareholders in connection with that particular transaction.⁹⁷

88. *Newby v. Enron Corp. (In re Enron Corp. Sec., Derivative & “ERISA” Litig.)*, 439 F. Supp. 2d 692, 721 (S.D. Tex. 2006) (“In the course of this litigation, the relevant law has evolved and been modified and clarified, often in different ways by different courts [T]he court . . . re-examines the allegations against Barclays [banking entities] under *Central Bank*'s preclusion of aiding and abetting claims.”).

89. *In re Enron Corp. Sec., Derivative & ERISA Litig.*, No. H-01-3624, 2006 U.S. Dist. LEXIS 43146, at *390 (S.D. Tex. June 5, 2006).

90. *See id.* at *385.

91. *Id.*

92. *Id.* at *388.

93. *Id.* at *389.

94. *Newby v. Enron Corp. (In re Enron Corp. Sec., Derivative & “ERISA” Litig.)*, 439 F. Supp. 2d 692 (S.D. Tex. 2006). The ruling was based on a Rule 12(c) motion for judgment on the pleadings, and thus the standard for ruling was the same as on the Rule 12(b)(6) motion to dismiss. *Id.* at 695.

95. *Id.* at 721.

96. *Id.*

97. *Id.* In the first Enron decision, the court had held that “allegations about Barclays' direct involvement in the formation and funding of [the SPE] are sufficient by the very nature of the transactions to state a claim under section 10(b) and Rule 10b-5.” *Newby v. Enron Corp. (In re Enron Corp. Sec., Derivative & ERISA Litig.)*, 235 F. Supp. 2d 549, 703 (S.D. Tex. 2002). Not all of the third-party defendants have

After these decisions, the Fifth Circuit Court of Appeals indicated that it would restrict the scope of scheme liability even further.⁹⁸ The court first established that the banks had not made any material misstatements in the instances of fraud alleged in the pleadings, nor had the banks a duty to disclose to investors the fraudulent schemes.⁹⁹ Based on these allegations, the court held that the banks could at best be aiders and abettors to Enron, but not primary violators.¹⁰⁰ If the Fifth Circuit's decision is not reversed by the Supreme Court, it is very likely that most of the banks will not be held liable under scheme liability theory for fraud leading to Enron's demise.

As is evident from these cases, it is more likely that investment banks could be held liable under Rule 10b-5 when they disseminate information to the market. However, those claims are usually ordinary misrepresentation claims and scheme liability seems redundant. It is unclear, however, whether there is a place for scheme liability when misrepresentation claims prove unsuccessful. In *Lentell v. Merrill Lynch & Co.*,¹⁰¹ investors brought action against an investment brokerage firm (who also acted as an investment bank), and its former analyst alleging that the defendants committed securities fraud by issuing research reports artificially inflating stock prices.¹⁰² The defendants allegedly benefited from the behavior since the companies whose stock

successfully defended against scheme liability claims in recent Enron cases. For example, the court has kept alive claims against JP Morgan based on commodity trades where no commodity was actually ever transferred, and claims against Credit Suisse First Boston based on its "repeated involvement in structuring SPEs for Enron." *In re Enron Corp. Sec., Derivative & ERISA Litig.*, No. H-01-3624, 2006 U.S. Dist. LEXIS 43146, at *170 (S.D. Tex. June 5, 2006). Of course, the Fifth Circuit's class decertification decision reduces the viability of the claims significantly. For another case where investment banks were dismissed from a case, see *Filler v. Hanvit Bank*, 156 F. Appx. 413, 415-16 (2d Cir. 2005) (not selected for publication) (without explicitly discussing scheme liability under Rule 10b-5(a) and (c), dismissing claims against an investment bank for allegedly engaging in sham transactions with the issuer, since investment bank made no misrepresentations on which plaintiffs relied upon).

98. *Regents of the Univ. of Cal. v. Credit Suisse First Boston (USA), Inc.*, No. 06-20856, 2007 WL 816518 (5th Cir. Mar. 19, 2007). The court of appeals decided the case based on an interlocutory appeal from the district court's decision to certify the plaintiffs as a single class in an action against three banks. *Id.* at *1. The court analyzed the scope of scheme liability, or more accurately, the meaning of the term "deceptive" as used in section 10(b), as one of the issues to determine the commonality of the plaintiffs' claim. *Id.* at *6.

99. *Id.* at *1. The court focused on the banks' absence of the duty to disclose to investors fraudulent schemes. *Id.* at *8 (assuming that the "case primarily concerns improper omissions").

100. *Id.* at *9. The court split 2-1 on that question. *See id.* at *21 (Dennis, C.J., concurring) ("[T]he majority errs by defining the term 'deceptive' in Section 10(b) in an unduly restrictive fashion.").

101. 396 F.3d 161 (2d Cir. 2005).

102. *Id.* at 164.

prices were inflated were the bank's clients, and the bank was interested in obtaining and maintaining investment banking business.¹⁰³ The court dismissed the scheme liability claim under Rule 10b-5(a) and (c), arguing that the claims were essentially undistinguishable from (unsuccessful) misrepresentation claims.¹⁰⁴

In a factually similar case, the District Court for the District of Massachusetts came to a contrary conclusion.¹⁰⁵ In that case, an investment banking firm, through its analyst, allegedly issued false and misleading research reports concerning another company.¹⁰⁶ Investors in that company brought suit both under Rule 10b-5(b) for misrepresentation, as well as under Rule 10b-5(a) and (c) for scheme liability.¹⁰⁷ The court refused to dismiss the scheme liability claims, since the analyst did not just issue "one or two misleading research reports," but worked "over time" and "extensively" with the CEO of the corporation.¹⁰⁸ This extensive cooperation amounted to participation in a scheme to defraud.¹⁰⁹

D. Brokers and Dealers

Brokers and dealers are by definition closely involved in securities transactions. The following cases have discussed the application of scheme liability to brokers and dealers in various other types of cases, both in their capacity as a participant in a wider scheme as well as a primary violator of securities laws.¹¹⁰

In *SEC v. Santos*,¹¹¹ the defendants were a city treasurer and two brokers.¹¹² Through paying bribes and making campaign contributions as demanded by the treasurer, the brokers received the city's investment business (amounting in total to approximately \$2.5 billion).¹¹³ The SEC brought suit, alleging that the brokers and the treasurer were involved in a scheme that

103. *Id.* at 165.

104. *Id.* at 177. The misrepresentation claims failed because plaintiffs could not show that the misrepresentations by Merrill Lynch caused their harm. *Id.*

105. *Swack v. Credit Suisse First Boston*, 383 F. Supp. 2d 223 (D. Mass. 2004).

106. *Id.* at 229-30 n.5.

107. *Id.* at 236-38.

108. *Id.* at 239.

109. *Id.*

110. For a discussion of the Supreme Court case in *SEC v. Zandford*, involving a broker stealing funds from the client, see *supra* notes 39-42 and accompanying text.

111. 355 F. Supp. 2d 917 (N.D. Ill. 2003).

112. *Id.* at 918-19.

113. *Id.*

deceived the city in violation of Rule 10b-5(a) and (c).¹¹⁴ The court agreed with the SEC, refusing to dismiss claims against the defendants.¹¹⁵

In *United States v. Bongiorno*,¹¹⁶ a criminal case applying Rule 10b-5,¹¹⁷ the brokers were charged for selling and purchasing stock from their own accounts when they should have simply matched the orders they received from investors.¹¹⁸ Thereby the brokers decreased the price that the sellers could have received (and increased the price for the buyers), while reaping profit for themselves.¹¹⁹ This behavior would be sufficient to trigger scheme liability, despite the fact that it was only the brokers' conduct – "taking positions as specialists" – that was fraudulent.¹²⁰ The government is still obliged to prove that the customers were deceived – essentially, that the customers expected the broker to match the orders and not trade from the broker's own account.¹²¹

In *Siemers v. Wells Fargo & Co.*,¹²² the defendants were mutual funds and their investment advisors who allegedly paid undisclosed kickbacks to brokers-dealers who steered investors towards the mutual funds.¹²³ Investors sued, alleging that the defendants violated section 10(b) by failing to disclose to the public this kickback scheme.¹²⁴ The court disagreed, since the defendants themselves had not made misleading statements and allegedly had no duty to disclose their participation in the scheme to the public.¹²⁵

114. *Id.* at 919.

115. *Id.* The court also held that the brokers had the duty to disclose their bribes, since concealing illegal activity is "intrinsically misleading" and "always violative of Rule 10b-5(b)." *Id.* at 920.

116. No. 05 Cr. 390(SHS), 2006 WL 1140864 (S.D.N.Y. May 1, 2006).

117. Rule 10b-5 is interpreted in the same way in criminal and civil cases. *See In re Initial Pub. Offering Sec. Litig.*, 241 F. Supp. 2d 281, 388 n.164 (S.D.N.Y. 2003).

118. *Bongiorno*, 2006 WL 1140864, at *2.

119. *Id.*

120. *Id.* at *7. The court explicitly left it open whether the brokers owed fiduciary duties to investors requiring brokers to disclose their actions. The court thus based the brokers' liability on their conduct only, and not on omissions. *Id.* *See also* *United States v. Finnerty*, Nos. 05 Cr.393 DC, 05 Cr. 397 DC, 2006 WL 2802042, at *4 (S.D.N.Y. Oct. 2, 2006) (same).

121. *See* *United States v. Finnerty*, 474 F. Supp. 2d 530, 537-42 (S.D.N.Y. 2007) (acquitting a broker after a guilty jury verdict on the basis that government provided no evidence of customer expectations).

122. No. C 05-04518 WHA, 2006 WL 3041090 (N.D. Cal. Oct. 24, 2006).

123. *Id.* at *1.

124. *Id.* at *10.

125. *Id.* at *11 ("[M]isleading statements *about* a company's role in a scheme is not the same as that company itself misleading investors.").

E. Business Partners

Plaintiffs have also tried to impose scheme liability on business partners other than providers of capital. One district court has refused to dismiss such claims.¹²⁶ In that case, Lernout & Hauspie, a speech recognition device manufacturer, used “strategic partners” to fraudulently inflate its revenues.¹²⁷ The plaintiffs brought suit against two legitimate business partners of Lernout & Hauspie, who created and sometimes funded the sham “strategic partners.”¹²⁸ The court refused to dismiss scheme liability claims against the defendants, arguing that the partners “substantially participated in the strategic-partner scheme.”¹²⁹

Two recent cases from the Eighth and Ninth Circuits have refused to impose scheme liability on business partners, even in cases where the partners know of the deception by the primary violator. In a case involving inflation of revenues by Charter Communications,¹³⁰ the allegations were made among other defendants against Charter’s suppliers.¹³¹ Charter Communications is a cable service provider who uses set-top boxes for providing service.¹³² It had contracted with manufacturers of such boxes on a fixed price basis for a foreseeable future when the deceptive transactions occurred.¹³³ Despite having all its needs regarding the boxes met, Charter allegedly agreed with its set-top box providers that it would pay an extra \$20 for each box, and in return would receive the money back in advertisement fees.¹³⁴ The plaintiffs alleged that such transactions were a sham since they had no economic substance.¹³⁵ Charter then reported the extra \$20 per box (a total of \$17 million) as extra operating cash flow and revenue.¹³⁶ These sham transactions enabled Charter to meet the expectations of financial analysts with regards to its

126. *Filler v. Lernout (In re Lernout & Hauspie Sec. Litig.)*, 236 F. Supp. 2d 161 (D. Mass. 2003).

127. *Id.* at 166. There were two main elements to the fraud. First, the outside world was led to believe that the partners were independent, start-up software companies, while they were actually entities controlled by Lernout & Hauspie and its other business partners. *Id.* Second, Lernout & Hauspie created sham revenue by licensing its software to the “strategic partners” who were actually mere shells, without any ability to conduct business. *Id.*

128. *Id.* at 167.

129. *Id.* at 175-76.

130. *Stoneridge Inv. Partners, LLS v. Scientific-Atlanta Inc. (In re Charter Communications, Inc., Sec. Litig.)*, 443 F.3d 987 (8th Cir. 2006), *cert. granted*, 75 U.S.L.W. 3034 (U.S. Mar. 26, 2007) (No. 06-43).

131. *Id.* at 989.

132. *Id.*

133. *Id.*

134. *Id.*

135. *Id.* at 989-90.

136. *Id.*

revenues and operating cash flow.¹³⁷ The plaintiffs alleged that the manufacturers knew that Charter intended to account for the sham transactions improperly and that analysts would rely on the inflated revenues and operating cash flow in making stock recommendations.¹³⁸

The Eighth Circuit Court of Appeals affirmed the decision of the district court, dismissing the Rule 10b-5 actions against the manufacturers of the set-top boxes. The court based its decision on the fact that the manufacturers “did not issue any misstatement relied upon by the investing public, nor were they under a duty to Charter investors and analysts to disclose information useful in evaluating Charter’s true financial condition.”¹³⁹ Thus, there can be no Rule 10b-5 liability absent a material misrepresentation or omission by the defendant. The court further warned against imposing Rule 10b-5 liability on a business partner “to an arm’s length business transaction,” since this could “introduce potentially far-reaching duties and uncertainties for those engaged in day-to-day business dealings.”¹⁴⁰

In a similar case from the Ninth Circuit, *Simpson v. AOL Time Warner Inc.*,¹⁴¹ plaintiffs sued, among others, the business partners of Homestore.com, an online real estate company.¹⁴² The defendants were engaged in complex three-way transactions. In one type of transaction, Homestore.com would purchase services or products that it did not need from third companies, in return for that company’s promise to purchase advertising on Homestore.com’s website through AOL.¹⁴³ AOL retained a commission and delivered the rest of the advertisement money to Homestore.com.¹⁴⁴ Homestore.com accounted for those proceeds as revenue, inflating its reported income to the public.¹⁴⁵ The court dismissed the claims against both AOL and the third parties.¹⁴⁶ AOL was held to be at most an aider and abettor in its role of simply helping Homestore.com in organizing and creating the

137. *Id.* at 990.

138. *Id.* at 989-90.

139. *Id.* at 992.

140. *Id.* at 992-93. See also *Dutton v. D & K Healthcare Res.*, No. 4:04CV147SNL, 2006 WL 1778863, at *6-8 (E.D. Mo. June 23, 2006) (adopting the *Charter Communications* standard and dismissing claims against pharmaceutical manufacturer who allegedly sold excessively large quantities of drugs to the defendant allowing both entities to state large transaction volumes, while the correct accounting should have indicated that the “sales” were actually consignments).

141. 452 F.3d 1040 (9th Cir. 2006), *aff’g In re Homestore.com, Inc. Sec. Litig.*, 252 F. Supp. 2d 1018 (C.D. Cal. 2003).

142. *Id.* at 1043.

143. *Id.* at 1044. The parties did not engage in direct barter transactions because it would have been obvious to the accountants and auditors that Homestore.com could not account for advertisement proceeds as revenue. *Id.* at 1043.

144. *Id.* at 1044.

145. *Id.*

146. *Id.* at 1052.

three-way transactions.¹⁴⁷ Also, the court determined that AOL did not engage in fraudulent activities itself, since there was no indication that the transactions it was involved in were “completely illegitimate or in themselves created a false appearance.”¹⁴⁸ There were no allegations that AOL entered into a “transaction that had no legitimate economic value” since advertisements were actually purchased and sold.¹⁴⁹

The Ninth Circuit’s test of scheme liability differed from that of the Eighth Circuit, though. A material misrepresentation or omission is not an absolute precondition for imposing scheme liability. It is sufficient when the defendant “engaged in conduct that had the principal purpose and effect of creating a false appearance of fact in furtherance of the scheme.”¹⁵⁰ Not all participants in fraudulent transactions are liable, though. The fact that a transaction is fraudulent is not enough; it is necessary that the defendant itself engaged in conduct having deceptive purpose and effect.¹⁵¹

F. Corporate Directors, Officers, and Employees

The courts rarely refuse to dismiss claims against corporate directors, officers, and employees who are very closely associated with the corporate statements, even though the courts cannot converge on the legal basis for allowing such claims.¹⁵² Therefore, it is not surprising that some courts resort to scheme liability.

For example, in *SEC v. Hopper*,¹⁵³ a company had made false statements regarding transaction volumes and revenues of one of its subsidiaries.¹⁵⁴ The District Court for the Southern District of Texas refused to dismiss the lawsuit against the CEO of the corporation and the CEO of the subsidiary.¹⁵⁵ In addition to sustaining misrepresentation claims against them, the court also held that they were sufficiently involved in the transactions that led to the fraudulent statements that they could be liable under Rule 10b-5(a) and (c).¹⁵⁶ The court relied on the fact that the transactions were a sham, and had “an inherent tendency to deceive.”¹⁵⁷ Therefore, those transactions were

147. *Id.*

148. *Id.*

149. *Id.* at 1053. The claims against the third parties were dismissed for similar reasons – the plaintiff had not alleged that the third parties “acted with the purpose and effect of creating a false appearance” in the transactions. *Id.* at 1054.

150. *Id.* at 1048.

151. *Id.*

152. *See supra* note 29.

153. No. Civ.A. H-04-1054, 2006 WL 778640 (S.D. Tex. Mar. 24, 2006).

154. *Id.* at *10.

155. *Id.*

156. *Id.* at *11.

157. *Id.*

not only the basis for fraudulent statements, but also fraudulent and deceptive themselves.¹⁵⁸

Similarly, scheme liability was invoked in a case where corporate officers implemented a fraudulent billing scheme, with the effect being that the company overcharged its customers and thus illegally obtained additional revenue.¹⁵⁹ Besides sustaining an ordinary misrepresentation claim based on Rule 10b-5(b), the court held that the plaintiff had “adequately pleaded scheme liability” under section 10(b).¹⁶⁰ In another case, the defendant was the CEO of the investment banking division of Citigroup.¹⁶¹ The division was responsible, among other duties, for preparing research analysis reports on various corporations.¹⁶² The alleged fraud involved issuing false reports about a particular corporation in order to inflate the value of that corporation’s stock, but also to secure lucrative investment banking business from it.¹⁶³ Since the CEO did not make any statements himself, the plaintiffs based their claim on scheme liability.¹⁶⁴ The District Court for the Southern District of New York refused to dismiss the scheme liability claim, agreeing with the plaintiffs that the CEO was “a central and knowing participant in, and possible orchestrator of” the scheme, and thus a primary violator of Rule 10b-5.¹⁶⁵

158. *Id.*

159. *Steiner v. Medquist Inc.*, No. 04-5487 (JBS), 2006 WL 2827740, at *21-22 (D.N.J. Sept. 29, 2006).

160. *Id.* at *21.

161. *In re Salomon Analyst AT & T Litig.*, 350 F. Supp. 2d 455, 458-59 (S.D.N.Y. 2004).

162. *Id.* at 459.

163. *Id.*

164. *Id.* at 472-73.

165. *Id.* at 474. *See also In re Royal Ahold N.V. Sec. & ERISA Litig.*, 351 F. Supp. 2d 334, 377 (D. Md. 2004) (applying scheme liability theory alongside a simple misrepresentation claim when the corporate officer was involved in artificially inflating corporation’s revenues); *In re Qwest Commc’ns Int’l Sec. Litig.*, 387 F. Supp. 2d 1130, 1143, 1145 (D. Colo. 2005) (noting that plaintiffs’ claim against corporate officers was also based on scheme liability, and refusing to dismiss those claims despite the fact that the officers themselves did not make any misstatements since the officers were part of the group drafting the documents); *Teachers’ Ret. Sys. of La. v. Qwest Commc’ns Int’l Inc.*, No. Civ. 04CV0782REBCBS, 2005 WL 2359311, at *9 (D. Colo. Sept. 23, 2005) (refusing to dismiss claims against corporate officers who allegedly manipulated corporation’s transactions resulting in improperly recognized revenue, despite the fact that the officers never made any false statements); *SEC v. PIMCO Advisors Fund Mgmt. LLC*, 341 F. Supp. 2d 454, 466 (S.D.N.Y. 2004) (noting that “there may be circumstances under which [an] . . . executive . . . could be charged with primary liability for false or misleading statements formally made by another,” while discussing participation in a fraudulent scheme under Rule 10b-5 generally); *WM High Yield Fund v. O’Hanlon*, No. Civ.A. 04-3423, 2005 WL 1017811, at *8 (E.D. Pa. Apr. 29, 2005) (refusing to dismiss claims against corporate

G. Issuers

Usually, it is unnecessary to resort to scheme liability theories against issuers of securities, since the fraud is normally committed by the issuer through its misrepresentations, omissions or manipulations. However, when the issuer has not itself made the fraudulent misrepresentation, courts have resorted to scheme liability against them as well. The primary scheme liability case against an issuer, *Cooper v. Pickett*,¹⁶⁶ in fact pre-dates *Enron* and *Zandford*. In *Cooper*, corporate officers allegedly told securities analysts that the corporation's business was strong.¹⁶⁷ The analysts, based on these communications, issued favorable research reports.¹⁶⁸ When it turned out that the business was actually rather weak and the corporation's stock plummeted, shareholders sued.¹⁶⁹ The defendant argued that it did not make any public statements on its own and thus *Central Bank* would preclude its liability under Rule 10b-5.¹⁷⁰ The court, holding that *Central Bank* did not preclude the claim against the corporation, stated that the corporation and analysts "together engaged in a scheme to defraud the shareholders."¹⁷¹ Thus, claims against an issuer may stand even when the issuer has not made a public misrepresentation or omission.¹⁷²

officers for scheme liability despite dismissing claims against them for misrepresentations since the officers did not make any statements).

166. 137 F.3d 616 (9th Cir. 1998) (en banc).

167. *Id.* at 620.

168. *Id.*

169. *Id.*

170. *Id.* at 624.

171. *Id.* at 625. The court explicitly referred to Rule 10b-5(a). *Id.* at 624. However, it also stated that the corporation was "liable for its own false statements to the analysts." *Id.* (citing *Dannenberg v. Painewebber Inc. (In re Software Toolworks Inc. Sec. Litig.)*, 50 F.3d 615, 628 n.3 (9th Cir. 1995)). This reasoning is unclear. The court clearly did not want to imply that statements between participants in the fraudulent schemes should in themselves give rise to a misrepresentation claims under Rule 10b-5(b). Moreover, the authority the court cites stands for the proposition that substantial participation in creating misrepresentations are sufficient for holding a secondary actor liable. See *supra* note 32. This theory is discredited in most circuits that have considered the issue. See *supra*, notes 27-32 and accompanying text.

172. More recent decisions cite *Cooper* favorably. See, e.g., *In re Splash Tech. Holdings, Inc. Sec. Litig.*, No. C 99-00109 SBA, 2000 WL 1727377, at *17 (N.D. Cal. Sept. 29, 2000) ("[I]f the corporate insider provides false or misleading information to the security analyst, then he may be directly liable under 10b-5.").

IV. DISCUSSION

After the *Central Bank* case in 1994,¹⁷³ the Supreme Court has not provided more extensive guidelines for determining the limits of secondary actor liability under Rule 10b-5. The Supreme Court has also provided very little guidance as to the proper interpretation of Rule 10b-5(a) and (c). Therefore, as the above summary shows, it is unsurprising that lower courts have come to different conclusions regarding the scope of scheme liability under Rule 10b-5.

The following discussion starts with outlining the central controversy regarding scheme liability claims – whether the defendant must have made a material misrepresentation or omission to be liable under Rule 10b-5.¹⁷⁴ To resolve this controversy, the discussion first addresses the policy goals of Securities Exchange Act of 1934.¹⁷⁵ Thereafter, it will be shown that the restrictive approach of the Fifth and Eighth Circuits has serious shortcomings.¹⁷⁶ However, the tests utilized by courts taking a broader approach are far from perfect as well.¹⁷⁷ Therefore, this summary concludes that a more nuanced approach should be taken, depending on the types of defendants against whom scheme liability is alleged. The courts should refrain from searching for an all-encompassing test of scheme liability.¹⁷⁸

A. Relationship Between Scheme Liability and Misrepresentation/Omission Liability

Even though the cases summarized above are based on different fact patterns, the overarching controversy where the courts' opinions differ is the same. Some courts, including the Fifth and Eighth Circuits, hold that there are only three bases for liability under section 10(b): misrepresentation, omission when there is a duty to speak, and market manipulation.¹⁷⁹ Some courts

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

174. *See infra* Part IV.A.

175. *See infra* Part IV.B.

176. *See infra* Part IV.C.

177. *See infra* Part IV.D.

178. *See infra* Part IV.E.

179. *See Regents of the Univ. of Cal. v. Credit Suisse First Boston (USA), Inc.*, No. 06-20856, 2007 WL 816518, at *10 (5th Cir. Mar. 19, 2007); *Stoneridge Inv. Partners, LLS v. Scientific-Atlanta Inc. (In re Charter Communications, Inc., Sec. Litig.)*, 443 F.3d 987, 992 (2006), *cert. granted*, 75 U.S.L.W. 3034 (U.S. Mar. 26, 2007) (No. 06-43); *In re Lake States Commodities, Inc.*, 936 F. Supp. 1461, 1472 (N.D. Ill. 1996), *abrogated on other issues by Damato v. Hermanson*, 153 F.3d 464 (7th Cir. 1998) (stating that “10b- 5 claims must allege either (1) material misstatements or (2) material omissions by a person having a duty to disclose”); *Dutton v. D & K Healthcare Resources*, No. 4:04CV147SNL, 2006 WL 1778863, at *6-8 (E.D.

reach essentially the same result in cases where scheme liability is alleged alongside misrepresentation liability. These courts argue that there is no claim under Rule 10b-5(a) and (c) when the claim is essentially based on misrepresentations or omissions.¹⁸⁰ Thus, according to those courts, scheme liability has no independent existence outside the misrepresentation claim.

Other courts, including the Ninth Circuit, reject this restrictive view, and find that section 10(b) does not require that a defendant make a material misrepresentation or omission, or that it engage in market manipulation.¹⁸¹ The courts require only that the conduct be deceptive.¹⁸² Thus, scheme liability claims may proceed alongside misrepresentation claims.¹⁸³ Some courts base

Mo. June 23, 2006) (dismissing claims against business partners who made no public statements); see generally *McLaughlin*, *supra* note 44, at 631 (advocating the adoption of this restrictive approach).

180. See *Lentell v. Merrill Lynch & Co.*, 396 F.3d 161, 177 (2d Cir. 2005) (rejecting scheme liability when “the sole basis for such claims is alleged misrepresentations or omissions”); *SEC v. KPMG LLP*, 412 F. Supp. 2d 349, 378 (S.D.N.Y. 2006) (it would be improper to impose scheme liability against an auditor when “the core misconduct alleged is in fact a misstatement”); *In re Nat’l Century Fin. Enters., Inc., Inv. Litig.*, No. 2:03-MD-1565, 2006 WL 469468, at *21 (S.D. Ohio Feb. 27, 2006) (scheme liability is inappropriate when the allegations “merely repeat[] the allegations made in support of Plaintiffs’ misrepresentation and omission claim”); *In re Recoton Corp. Sec. Litig.*, 358 F. Supp. 2d 1130, 1138 n.4 (M.D. Fla. 2005) (refusing to analyze scheme liability claims that were based on alleged misrepresentations and omissions); *JHW Greentree Capital, L.P. v. Whittier Trust Co.*, No. 05 Civ.2985 HB, 2005 WL 3008452, at *7 n.11 (S.D.N.Y. Nov. 10, 2005) (stating that plaintiffs did not sufficiently allege scheme liability since they did not plead any allegations against the defendant personally, “apart from her alleged misrepresentations and omissions”); *In re Rent-Way Sec. Litig.*, 209 F. Supp. 2d 493, 504 (W.D. Pa. 2002) (arguing that since the complaint is based on misstatements, the plaintiffs could only rely on the misstatements and not on any scheme); *In re Redback Networks, Inc. Sec. Litig.*, No. C03-5642 JF (HRL), 2006 WL 1805579, at *5 (N.D. Cal. Mar. 20, 2006) (“[D]espite the fact that Plaintiffs attempt to characterize their second claim as a ‘manipulative act’ claim rather than a ‘misstatements and omissions’ claim, the Court will treat claim two as duplicative of [misstatements and omissions] claim . . .”).

181. See, e.g., *Simpson v. AOL Time Warner Inc.*, 452 F.3d 1040, 1049 (9th Cir. 2006) (“Defendants argue that imposing liability for participation in an overall scheme to defraud would impose liability for conduct other than the making of a material misstatement or omission and would conflict with *Central Bank*. We disagree.”); *In re Parmalat Sec. Litig.*, 376 F. Supp. 2d 472, 492 (S.D.N.Y. 2005) (rejecting the suggestion that scheme liability applies only in cases of market manipulation in a technical sense).

182. See *infra* Part IV.C for a discussion of this approach.

183. See, e.g., *SEC v. Hopper*, No. Civ.A. H-04-1054, 2006 WL 778640 (S.D. Tex. Mar. 24, 2006) (sustaining Rule 10b-5(a) and (c) claims alongside misrepresentation claims against corporate officers who entered into sham transactions inflating corporation’s revenues); *Swack v. Credit Suisse First Boston*, 383 F. Supp. 2d 223, 239 (D. Mass. 2004) (“If [the statements and omissions] were part of a broader fraudulent ‘scheme,’ ‘practice,’ or ‘course of business,’ then they might allege some-

this conclusion on the text of Rule 10b-5(a) and (c).¹⁸⁴ Some courts rely directly on section 10(b), for example, arguing that “manipulative” conduct is not necessarily restricted to market manipulation activities in the narrow sense.¹⁸⁵ This controversy – whether scheme liability has independent significance beyond claims of misrepresentation/omission and market manipulation – is also the central controversy in the pending appeal before the Supreme Court in *Charter Communications*.¹⁸⁶

thing slightly different from a Rule 10b-5(b) claim”); *WM High Yield Fund v. O’Hanlon*, No. Civ.A. 04-3423, 2005 WL 1017811, at *7-8 (E.D. Pa. Apr. 29, 2005) (refusing to dismiss scheme liability claims, even though dismissing misrepresentation claims, based on same facts, against defendants who had not made public statements); *United States v. Bongiorno*, No. 05 Cr. 390(SHS), 2006 WL 1140864, at *7-9 (S.D.N.Y. May 1, 2006) (analyzing claims based on conduct and omission separately). However, the courts sometimes require the plaintiffs to show that there is at least some deceptive *conduct* beyond misrepresentation if scheme liability is to be applicable. *See, e.g., In re Alstom SA Sec. Litig.*, 406 F. Supp. 2d 433, 475 (stating that a defendant can be liable for scheme liability even if it has not made any misrepresentations, but “participated in scheme that encompassed conduct beyond misrepresentation”); *In re Royal Dutch/Shell Transp. Sec. Litig.*, No. 04-374 (JAP), 2006 WL 2355402, at *8 (D.N.J. Aug. 14, 2006) (designed as not for publication) (in order to invoke scheme liability, allegations “must entail a defendant’s undertaking of a deceptive scheme or course of conduct that went beyond misrepresentations”).

184. *See, e.g., Hopper*, 2006 WL 778640, at *11-12.

185. *See In re Global Crossing, Ltd. Sec. Litig.*, 322 F. Supp. 2d 319, 337 (S.D.N.Y. 2004) (arguing that designing of accounting fraud schemes by an outside auditor was manipulative in the meaning of section 10(b)). The courts rejecting the restrictive view of scheme liability do not have a uniform approach to what kind of behavior amounts to actionable scheme. *See infra* Part IV.C.

186. The Supreme Court will answer the question whether *Central Bank* forecloses section 10(b) claims where defendants engaged in transactions with a public corporation only in order to inflate the financial statements of that corporation, but “themselves made no public statements” concerning those transactions. *See Questions Presented, Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, No. 06-43 (U.S. Mar. 26, 2007), available at <http://www.supremecourtus.gov/qp/06-00043qp.pdf>. Interestingly, the defendants in *Charter Communications* who opposed granting of certiorari in the Supreme Court argued that there was no split among the circuit courts, and that the question was well settled. *See Brief in Opposition for Respondent Motorola, Inc., Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, No. 06-43, 2006 WL 3024291, at *5 (U.S. Oct. 20, 2006) (“[T]he Eighth Circuit’s decision was squarely in line with the decisions of [the Supreme Court] and the consistent interpretations of *Central Bank* by Courts of Appeals and District Courts that have considered the issue.”). Defendants in *Simpson* argued to the contrary: “The question presented is a discrete and important issue of federal statutory law that has been the subject of extremely thorough, albeit conflicting, analyses and holdings by the circuit courts and district courts throughout the country.” Petition for a Writ of Certiorari, *Cendant Corp. v. Cal. State Teachers Ret. Sys.*, No. 06-560, 2006 WL 3024299, at *10 (filed U.S. Oct. 19, 2006).

Unsurprisingly, both sides of the controversy appeal to the previous Supreme Court rulings on the extent of Rule 10b-5(a) and (c) claims. For example, the supporters of the restrictive approach cite the following from the *Central Bank* decision: “[W]e again conclude that the statute prohibits only the making of a material misstatement (or omission) or the commission of a manipulative act.”¹⁸⁷ The supporters of the broader approach cite to statements that imply that Rule 10b-5(a) and (c) are not restricted to misstatements and omissions, but can encompass that conduct.¹⁸⁸ They specifically refer to the recent *Zandford* decision, where the Supreme Court held that a broker employed a fraudulent scheme when it basically stole the client’s money.¹⁸⁹ The Supreme Court in *Zandford* stated: “Indeed, each time respondent ‘exercised his power of disposition [of his customers’ securities] for his own benefit,’ that conduct, ‘without more,’ was a fraud.”¹⁹⁰ The supporters of the restrictive view, however, claim that the theory used in *Zandford* was based on a violation of a duty to disclose (i.e. omission) on the part of the broker who had fiduciary duties towards his client, and thus the Rule 10b-5 claim was nothing very novel.¹⁹¹

Some of the cases cited above were decided before *Central Bank*, and in *Central Bank* itself the narrow question presented was the existence of aiding and abetting liability, not the extent of scheme liability.¹⁹² Since *Central Bank* did not address scheme liability or the extent of Rule 10b-5(a) and (c), both sides of the debate rely, at best, on *dicta*. The Court has never faced a case in the post-*Central Bank* environment where the existence of a scheme liability claim absent a misrepresentation, omission or market manipulation would have made a difference in the outcome of the case. Therefore, in order to determine whether these provisions give rise to liability absent a material misrepresentation or omission, the text of the Rule and policy behind it have to be analyzed in more detail.

187. *Cent. Bank*, 511 U.S. at 177. However, right after making the statement, the court cites to *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 473 (1977), where the court held that the “language of § 10(b) gives no indication that Congress meant to prohibit any *conduct* not involving manipulation or deception” (emphasis added).

188. *See Affiliated Ute Citizens v. U.S.*, 406 U.S. 128, 152-53 (1972) (“To be sure, the second subparagraph of the rule specifies the making of an untrue statement of a material fact and the omission to state a material fact. The first and third subparagraphs are not so restricted.”); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 212 (1976) (implying that Rule 10b-5 proscribes “any type of material misstatement or omission, and any course of conduct, that has the effect of defrauding investors” (emphasis added)).

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

190. *Id.* at 821 (emphasis added).

191. *See McLaughlin*, *supra* note 44, at 648-59; Markel & Ballard, *supra* note 8, at 995 n.10.

192. The plaintiffs in *Central Bank* conceded that the defendant was an aider and abettor, and not a primary actor. *See Cent. Bank*, 511 U.S. at 191.

B. Policy of Scheme Liability

The policy arguments relevant to delineating scheme liability claims point in different directions. On one hand, the securities laws help to ensure honest and efficient functioning of the capital markets.¹⁹³ Private securities litigation can be “a most effective weapon” in enforcing securities laws, serving as a supplement to SEC action.¹⁹⁴ Furthermore, the statute “should be construed not technically and restrictively, but flexibly to effectuate its remedial purposes.”¹⁹⁵ As a result of this flexible construction, section 10(b) and Rule 10b-5 are supposed to “prohibit all fraudulent schemes . . . whether the artifices employed involve a garden type variety of fraud, or present a unique form of deception.”¹⁹⁶

On the other hand, the liability should not be excessive. The two main policy reasons for precluding aiding and abetting liability in *Central Bank* were the need for predictability of consequences of business transactions, and the need to prevent unnecessary and unduly burdensome litigation.¹⁹⁷ When the scope of liability is uncertain, then business transactions that could potentially create such liability are costly. For example, using aiding and abetting liability makes the scope of potential liability very unpredictable, since such a claim rests on a vague notion of “substantial assistance” to the primary violator.¹⁹⁸ Unnecessary and burdensome litigation can arise from unclear rules especially because of the nature of securities litigation – the defendants have a lot at stake and face high trial costs and potential extensive liability. Therefore, they would have a strong motivation to settle.¹⁹⁹

The Enron case offers an example of how scheme liability claims produced such a strong motivation to settle. As noted above, the court initially

193. 15 U.S.C. § 78(b) (2000) (stating that one goal of securities regulation is “to insure the maintenance of fair and honest markets in such transactions”).

194. *Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299, 310 (1985).

195. *SEC v. Zandford*, 535 U.S. 813, 819 (2002) (citation omitted).

196. *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 11 n.7 (1971). *See also* *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 151 (1972) (“[Rule 10b-5] proscriptions, by statute and rule, are broad and, by repeated use of the word ‘any,’ are obviously meant to be inclusive.”).

197. *See Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 188-89 (1994).

198. *Id.* at 189 (stating that “rules for determining aiding and abetting liability are unclear,” leading to “decisions made on ad hoc basis, offering little predictability” (quotation marks omitted)).

199. Since SEC has gained the right to institute legal actions against aiders and abettors, *see supra* note 23, businesses cannot very well argue that they do not know whether their behavior is illegal or not – aiding and abetting securities fraud remains illegal. However, giving a private right of action for such an offense is a different matter – vexatious litigation is much more likely when the plaintiffs are class action lawyers than SEC.

refused to dismiss claims against various investment banks for their participation in the Enron accounting scandal.²⁰⁰ However, several years later, the district court itself changed its mind with regard to the extent of scheme liability,²⁰¹ and then the Fifth Circuit Court of Appeals essentially rejected the applicability of scheme liability against most of the banks altogether.²⁰² In the meantime, several investment banks settled out of the case, with the cost in the billions.²⁰³ Even though the banks contested the applicability of scheme liability – certainly a very novel and controversial theory – against them, the pressure to settle was great enough to not wait for an appellate ruling on the issue. In hindsight, the settlement might have been premature from the viewpoint of the banks.²⁰⁴

Unfortunately, since policy considerations behind section 10(b) are conflicting, they provide little help in determining the scope of the scheme liability claims. On the one hand, liability should be broad to give effect to the policy of investor protection. On the other hand, it should be narrow, or at least easily predictable, to avoid unnecessary litigation. The Fifth, Eighth, and Ninth Circuits all advance at least one of the policies behind the Securities Exchange Act.

C. Restrictive View of Scheme Liability

The restrictive view of scheme liability, adopted by the Fifth and Eighth Circuits, follows the policy of preventing unnecessary and burdensome litigation. Indeed, requiring the defendant itself to make a misleading statement,

200. See *supra* notes 43-46 and accompanying text.

201. See *supra* notes 88-96 and accompanying text.

202. See *supra* notes 98-100 and accompanying text. In fact, the Fifth Circuit Court of Appeals stated that the narrow scope of scheme liability would prevent ‘*in terrorem* settlements.’ *Regents of the Univ. of Cal. v. Credit Suisse First Boston (USA), Inc.*, No. 06-20856, 2007 WL 816518, at *14 (5th Cir. Mar. 19, 2007) (quoting *Hundahl v. United Benefit Life Ins. Co.*, 465 F. Supp. 1349, 1363 (N.D. Tex. 1979)).

203. See, e.g., Julie Creswell, *J.P. Morgan Chase to Pay Enron Investors \$2.2 Billion*, N.Y. TIMES, June 15, 2005, at C1; Jennifer Bayot, *Citigroup to Pay \$2 Billion in Enron Lawsuit*, N.Y. TIMES, June 10, 2005, at A1; Jeff Bailey, *CIBC Pays to Settle Enron Case*, N.Y. TIMES, Aug. 3, 2005, C1 (settling the case for \$2.4 billion). Barclays Bank, dismissed from the lawsuit in 2006, never settled its securities fraud case. It later paid \$144 million to settle the claim filed against it in a related bankruptcy case. See *Barclays to Pay \$144 Million to Settle Lawsuit with Enron*, N.Y. TIMES, Nov. 4, 2006, at C4.

204. See, e.g., *Enron Litigation: Laying Down*, ECONOMIST, Mar. 24, 2007, at 33 (stating that considering the Fifth Circuit’s decision, “the banks look to have made an unwise bet”). Just about a week later, the bet looked somewhat better, since the Supreme Court granted certiorari in *Charter Communications*, indicating that the banks’ liability is at least a very contentious issue. See *U.S. Securities Litigation*, FIN. TIMES, Mar. 29, 2007, at 16 (“[D]ecision to settle starts to look a lot better.”).

breach a duty to disclose or commit market manipulation can get rid of many claims brought against accountants, investment banks, attorneys, and other actors. However, if the policy of preventing unnecessary litigation was the only policy goal behind securities laws, the perfect rule would be to eliminate private litigation altogether. Since the laws also strive to prevent securities fraud, restricting litigation cannot in itself dictate the result in interpreting section 10(b).

The restrictive view is clearly not firmly founded on the language of Rule 10b-5. Rule 10b-5(b) covers misrepresentation and omission claims.²⁰⁵ This leaves large parts of Rule 10b-5(a) and (c) without a clear application, since they clearly cover more than simple market manipulation.²⁰⁶ Legal rules should not be interpreted in a way that leaves them with no meaning and application whatsoever.²⁰⁷

One could argue that Rule 10b-5 is broader than the statutory authority for it and that therefore only the text of section 10(b) is controlling.²⁰⁸ Sec-

205. It is prohibited “[t]o 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.” 17 C.F.R. § 240.10b-5(b) (2006). Some failure to disclose claims are based on Rule 10b-5(a) and (c), and not on Rule 10b-5(b), since the latter rule prohibits omissions only when there are previous statements made that need to be corrected. *See Chiarella v. United States*, 445 U.S. 222, 225 n.5 (1980) (“Only Rules 10b-5(a) and (c) are at issue here. . . . The portion of the indictment based on [Rule 10b-5(b)] was dismissed because the petitioner made no statements at all in connection with the purchase of stock.”); *United States v. Bongiorno*, No. 05 Cr. 390(SHS), 2006 WL 1140864, at *7-9 (S.D.N.Y. May 1, 2006) (holding that brokers could be liable under Rule 10b-5(a) and (c) but not under Rule 10b-5(b) for not disclosing that they were improperly trading stocks, since they had made no previous statements that needed to be corrected). However, such failure to disclose cases cannot be the primary targets of Rule 10b-5(a) and (c).

206. According to Rule 10b-5(a) and (c), it is prohibited to “employ any device, scheme, or artifice to defraud” and to “engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.” 17 C.F.R. § 240.10b-5(a), (c). Clearly, those provisions should cover more than market manipulation only. *See also* Brief in Opposition, *Avis Budget Group, Inc. v. Cal. State Teachers’ Ret. Sys.*, No. 06-560, 2007 WL 432471, at *16 (U.S. Feb. 7, 2007) (arguing that each subsection of Rule 10b-5 must have its own independent meaning); Schanbaum, *supra* note 8, at 221-22 (same).

207. *See, e.g., Ratzlaf v. United States*, 510 U.S. 135, 141 (1994) (noting that provisions of statutory enactments should not be constructed so that some other provisions of the same statute would be superfluous).

208. *See Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 173 (2004) (“[A] private plaintiff may not bring a 10b-5 suit against a defendant for acts not prohibited by the text of § 10(b).”); *but see 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)” (citing *United States v. O’Hagan*, 521 U.S. 642 (1997) and *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976))).

tion 10(b) prohibits anyone from “directly or indirectly” using of “any manipulative or deceptive device or contrivance.”²⁰⁹ Again, the use of “any” deceptive device or contrivance is prohibited, not only the use of fraudulent misrepresentations and omissions. By requiring the defendant to make a fraudulent misstatement or omission or to engage in market manipulation,²¹⁰ the statutory text is narrowed to the extent that it is hard to see what meaning some of the words in the statute (“any”, “indirectly”) retain.²¹¹

Despite these textual problems, the restrictive view could be supported by arguments that section 10(b) liability presumes reliance by the plaintiff on the defendant’s fraudulent conduct, and that absent misrepresentation by defendant, there can be no such reliance.²¹² Even if this argument wins,²¹³ the restrictive view cannot solve some types of cases satisfactorily.

Namely, the restrictive view can unduly limit liability where the defendant is closely associated with the issuer, or the defendant is the issuer himself. For example, corporate officers and other employees who prepare corporate statements and mastermind accounting fraud are not necessarily identified with the statements. Yet no court has dismissed claims against such employees.²¹⁴ At the same time, section 10(b) and Rule 10b-5 make no distinction between “insiders” and “outsiders” when discussing the extent of possible liability. Similarly, when an issuer commits fraud by essentially hiring (or just allowing) someone else, such as a security analyst, to make the mis-

209. 15 U.S.C. § 78j(b) (2000).

210. The Eighth Circuit in *Charter Communications* actually does not strictly require that the defendant itself make the misrepresentation, since it is also sufficient for liability if the defendant “affirmatively cause[s]” the fraudulent statement to be made or even omitted. *Stoneridge Inv. Partners, LLS v. Scientific-Atlanta Inc. (In re Charter Communications, Inc., Sec. Litig.)*, 443 F.3d 987, 992 (2006), *cert. granted*, 75 U.S.L.W. 3034 (U.S. Mar. 26, 2007) (No. 06-43). Neither the Eighth Circuit, nor the Fifth Circuit, when following *Charter Communications*, elaborated on when a defendant might affirmatively cause the fraudulent statement to be made.

211. The plaintiffs have emphasized this shortcoming in their briefs. See *Petition for Writ of Certiorari, Regents of the Univ. of Cal. v. Merrill Lynch Pierce Fenner & Smith, Inc.*, No. 06-1341, 2007 WL 1059567, at *20-21 (Apr. 5, 2007).

212. See, e.g., *Brief in Opposition for Respondent Motorola, Inc., Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, No. 06-43, 2006 WL 3024291, at *9 (U.S. Oct. 20, 2006) (stating that “requirement to prove reliance precludes a Rule 10b-5 claim against someone who did not make the statement in question”).

213. The usual response is that plaintiff’s reliance can take place through another part of the fraudulent scheme – the issuer’s misstatements. See *Brief in Opposition, Avis Budget Group, Inc. v. Cal. State Teachers’ Ret. Sys.*, No. 06-560, 2007 WL 432471, at *26 (U.S. Feb. 7, 2007) (“[R]equirement of reliance is satisfied if a misrepresentation was introduced into the securities market as a result of the fraudulent scheme and defendant’s conduct therein.”).

214. See *supra* Part III.F for examples of recent cases. The courts follow different theories in order to maintain such claims. See *id.*

statements,²¹⁵ its liability is based on its engagement in the fraudulent scheme, but not misrepresentation as such.²¹⁶ Finally, the restrictive view does not very well handle cases involving brokers who defraud their clients.²¹⁷ The principal way of holding the broker liable for securities fraud under the restrictive view is by imposing on them a fiduciary duty to disclose, but as indicated in a case above, such duties may not always exist.²¹⁸

The above criticism of the restrictive view applies to the approach of those courts that reject scheme liability in cases where plaintiffs' claims are essentially based on misrepresentations and omissions.²¹⁹ These courts argue that by allowing any fraud case to be analyzed through the scheme liability lens would allow plaintiffs to artfully plead misrepresentation cases as scheme cases, avoiding many issues that *Central Bank* created for them. However, each securities fraud claim should be assessed based on the elements of that particular claim; it is not sufficient to claim that the elements of one claim are rejected, and therefore the second claim must necessarily fail as well.

D. Scheme Liability Beyond Misrepresentation, Omission and Market Manipulation

In the cases where courts reject the restrictive view of scheme liability, the courts, including the Ninth Circuit, follow the policy of effective prevention of securities fraud. The SEC clearly favors a broader approach to scheme liability.²²⁰

215. See *supra* Part III.G for examples of such cases.

216. In fact, the corporation does not make any misstatements at all in such a case – its statements to the analysts are completely accurate. See 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, 729 (1997) ("If a 'bright-line' rule that one entity can never be responsible for another's statements were adopted, puppeteers who manipulate fraudulent schemes from behind the scenes by pulling the strings and making others talk will go unpunished.").

217. See *supra* Part III.D for examples of such cases.

218. See *supra* note 120 and accompanying text for a decision where the court left the existence of fiduciary duties open, but nevertheless imposed scheme liability on a broker.

219. See *supra* note 180 and accompanying text.

220. See Brief of the Securities and Exchange Commission, Amicus Curiae, in Support of Positions that Favor Appellant 16, *Simpson v. Homestore.com, Inc.*, No. 04-55665 (9th Cir. 2004), available at http://www.sec.gov/litigation/briefs/homestore_102104.pdf. The SEC continued to support the broader theory after the Supreme Court decided to address the issue, but the Solicitor General decided not to file an amicus brief, publicly siding with the defendants. See Jane Bryant Quinn, *Little Guy Has Little Recourse*, NEWSWEEK, July 16, 2007, at 45.

The problem with the broader view is that the courts have not proposed a coherent and easily applicable test. The courts often go little beyond a vague statement that there has to be some conduct beyond the misrepresentation by the defendant that is deceptive or fraudulent.²²¹ The most prominent test so far, proposed by the SEC and thereafter adopted with minor modifications by the Ninth Circuit, makes a defendant liable if its conduct within a scheme had the “principal purpose and effect” of fraud.²²²

A reformulation of this test states that a defendant can be liable for scheme liability when its “conduct itself is illegal, serves no business purpose, or creates an impression of a material fact at odds with reality.”²²³ The courts that have rejected the restrictive approach seem to reject scheme liability when it makes “business sense” for the secondary actor (usually the financier or “ordinary” business partner) to engage in practices that lead to securities fraud.²²⁴ Such a test is, however, also broad and does not provide useful guidance for solving scheme liability cases against all groups of defendants discussed above.

For example, it is far from clear what constitutes a legitimate business transaction in the case of investment banks and other financiers. The legitimate business purpose, economic substance, or sham transaction tests devel-

221. See, e.g., *In re Alstom SA Sec. Litig.*, 406 F. Supp. 2d 433, 476 (S.D.N.Y. 2005) (implying that the conduct has to be “in and of itself” fraudulent).

222. *Simpson v. AOL Time Warner Inc.*, 452 F.3d 1040, 1050 (9th Cir. 2006). See also Brief of the Securities and Exchange Commission, Amicus Curiae, in Support of Positions that Favor Appellant, at 16, 18, *Simpson v. Homestore.com, Inc.*, No. 04-55665 (9th Cir. 2004), available at http://www.sec.gov/litigation/briefs/homestore_102104.pdf (proposing the test and arguing that a defendant should not be liable only if it “provides assistance to other participants in a scheme but does not himself engage in a manipulative or deceptive act”). The difference between the two tests is that Ninth Circuit requires that defendant’s own conduct has to be deceptive, not just the transaction in which it was involved. See *Simpson*, 452 F.3d at 1048.

223. *Smith & Goldfarb*, *supra* note 8; see also *Gold & Spinogatti*, *supra* note 8, at 3 (arguing that the Eighth Circuit is “plainly alarmed by the possibility that an ordinary, arm’s-length business transaction could leave the company that engaged in that transaction liable”).

224. See *Simpson*, 452 F.3d at 1050 (“Conduct by the defendant 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.”); *Newby v. Enron Corp. (In re Enron Corp. Sec., Derivative & ERISA Litig.)*, 310 F. Supp. 2d 819, 830 (S.D. Tex. 2004) (liability for “[s]ham business transactions with no legitimate business purpose”). Despite adopting the restrictive view, the Eighth Circuit stated in dicta that it did not want to impose liability in case of “an arm’s length business transaction in goods or services.” *Stoneridge Inv. Partners, LLS v. Scientific-Atlanta Inc. (In re Charter Communications, Inc., Sec. Litig.)*, 443 F.3d 987, 992 (2006), cert. granted, 75 U.S.L.W. 3034 (U.S. Mar. 26, 2007) (No. 06-43).

oped under financial reporting²²⁵ or tax²²⁶ law rules are not very helpful in resolving this question. Such tests are useful in determining whether the issuer has reported its financial position and accounted for tax liability in the correct way. However, false reporting by the issuer is usually presumed in Rule 10b-5 litigation against secondary actors, and thus it is almost always the case that the issuer has allegedly violated some of the financial reporting rules. The tests say nothing about whether the secondary actor, for example by providing financing, has engaged in a transaction that has a fraudulent primary purpose or is inherently fraudulent.

The first Enron decisions illustrate this ambiguity. Initially, the district court considered the banks as having engaged in inherently deceptive transactions when they provided in essence loans that were then accounted for as revenue or equity contributions.²²⁷ However, the court later changed its mind, and for a good reason. The court explained that a bank can justify a transaction as making business sense, even if the corporation accounted for it in a “creative” way, so long as the bank receives a profit (usually, in the way of interest).²²⁸ In fact, the principal way for a bank to engage in a transaction that does not make business sense is when it provides capital at a loss (or for no profit) – something that is highly unlikely to happen in any case. In an economic sense, there are no “sham” transactions from the bank’s point of view since a bank provides money with the hope of receiving it back, with interest. Financing deals are often accounted for in complex ways, through special purpose entities or other schemes, and they are rarely illegal for the simple fact that they are complex. What seems fraudulent or a sham to the third party is just a way of structuring the transaction for the bank in the most risk-free way.²²⁹ Setting up special purpose entities – the central part of the Enron scheme – is the quintessential element of structured finance transac-

225. See generally, e.g., Donald J. Weidner, *Synthetic Leases: Structured Finance, Financial Accounting and Tax Ownership*, 25 J. CORP. L. 445 (2000) (providing an overview of financial accounting rules, including the economic substance doctrine, to synthetic leases).

226. See generally, e.g., David P. Hariton, *Sorting Out the Tangle of Economic Substance*, 52 TAX LAW. 235 (1999) (providing an overview of the economic substance doctrine).

227. See, e.g., *Newby v. Enron Corp. (In re Enron Corp. Sec., Derivative & “ERISA” Litig.)*, 310 F. Supp. 2d 819, 829-30 (S.D. Tex. 2004) (a bank engaged in an actionable sham transaction when it “purchased” property that Enron promised to repurchase with a higher price later).

228. See, e.g., *Newby v. Enron Corp. (In re Enron Corp. Sec., Derivative & “ERISA” Litig.)*, 439 F. Supp. 2d 692, 721 (S.D. Tex. 2006) (“what remains when the bluster is stripped away are financings and investments” (quoting *In re Parmalat Sec. Litig.*, 376 F. Supp. 2d 472, 505 (S.D.N.Y. 2005))).

229. See, e.g., *In re Parmalat Sec. Litig.*, 376 F. Supp. 2d 472, 505 (S.D.N.Y. 2005) (stating that “a bank’s use of special purpose corporate entities in connection with financing and other investment arrangements is neither unusual nor deceptive in and of itself”).

tions.²³⁰ Also, one cannot blame the banks for receiving benefits from the transaction in unusual ways, e.g. in unrelated or even related consulting fees.²³¹ The ways of earning profits from investments are varied, and sometimes providing capital at below cost for business development purposes is a legitimate way of developing additional business.

The business purpose test is also not easily applied when advisers (lawyers, investment banks and accountants in their consulting capacity) are involved. Advice is “in itself” fraudulent probably only when it is false, i.e. the advisor knows that the advice given is not very helpful but proceeds nevertheless. Securities class action plaintiffs do not usually claim that lawyers, accountants, or investment banks somehow misled the defendants. The companies usually know quite well what they were doing when they followed the advice they received. In an ordinary securities fraud case, advisers give exactly the type of advice that the company has wished to receive. Thus, giving advice serves a perfectly legitimate business purpose for the advisor – receiving fees for giving the advice. It is hard to imagine when such advice becomes inherently fraudulent against third parties.

To conclude, the “principal purpose and effect” and “inherently fraudulent conduct” tests can be applicable in some circumstances (e.g. transactions between ordinary business partners), but are not suited to solve other types of cases. It simply does not provide an easily applicable test for assessing whether scheme liability should be imposed in a particular case or not.

E. A Test for Scheme Liability?

Currently, the conflicting decisions in district and circuit courts have amplified the uncertainty in the scheme liability field – no investment bank, auditor, or attorney can be sure whether their advice in complex financial transactions could be later used against them in securities litigation. Similarly, business partners may not know whether their profitable (even though unconventional) transaction might turn into a costly securities action. Surely, a coherent and easily applicable test for analyzing scheme liability claims would create more predictability. However, as the previous discussion has

230. See, e.g., Steven L. Swarcz, *Securitization Post-Enron*, 25 CARDOZO L. REV. 1539 (2004) (describing the issues with securitization transactions in the post-Enron legal environment).

231. Such an argument was made in a case where KPMG, an accounting firm, was involved in a transaction allowing the issuer, a software manufacturer, to misstate its revenues. See Answering Brief of Defendants-Appellees at *34, *Bearingpoint, Inc. & KPMG LLP, Loran Group v. Moores (In re Peregrine Sys., Inc., Sec. Litig.)*, No. 06-55197, 2006 WL 3522394 (9th Cir. Aug. 28, 2006). KPMG’s role in the transaction was to temporarily purchase software so that the manufacturer would be able to report revenue from sales immediately, even though the sales to end users were not completed. *Id.* In turn, KPMG’s allegedly legitimate business purpose was to secure lucrative service contracts connected to the same transactions. *Id.* at *35.

shown, it is almost impossible to devise such a coherent test for all situations and for all defendants. There might well be situations when the defendant should not be held liable absent a misrepresentation or omission. There might well be situations when the conduct itself can be fraudulent so that imposing scheme liability is justified. However, it is not possible to create one easily applicable test for all scheme liability claims.

The impossibility of such a test is an unavoidable consequence of the wording of section 10(b): it prohibits the use of “any manipulative or deceptive device or contrivance.”²³² If Congress wanted clear rules with straightforward applications, it would surely amend such a broad and vague statement. Instead, Congress decided to approach the problem of frivolous and vexatious litigation in another way: by adopting the “Private Securities Litigation Reform Act of 1995.”²³³ Instead of restricting fraud claims substantively, the Act imposed heightened pleading standards on plaintiffs.²³⁴ Pleading standards allow defendants to dismiss frivolous claims much more easily and in earlier stages of litigation, thus reducing the threat of vexatious litigation. The Act thus gives defendants some security that they are not hauled to court for legitimate business transactions, while leaving the door open for claims where fraud actually takes place.

The conclusion that one simple rule or test for assessing scheme liability claims is impossible does not mean that clear standards are not needed for particular types of cases. Therefore, the Supreme Court should adopt a uniform approach in order to remove the conflicting decisions applying the “bright line,” “substantial participation” and “creation of misrepresentation” tests.²³⁵ It should also resolve the conflict between the Fifth, Eighth and Ninth Circuits regarding the appropriate standard of scheme liability for business partners, but restrict its ruling specifically to the types of defendants at issue.²³⁶ Appropriate tests for other types of cases should be devised when those types of cases find more treatment before the appellate courts.²³⁷

232. 15 U.S.C. § 78b (2000).

233. Pub. L. No. 104-67, 109 Stat. 737 (1995) (codified in scattered sections of 15 U.S.C.).

234. See Kevin S. Shmelzer, Comment, *The Door Slammed Shut Needs to Be Reopened: Examining the Pleading Requirements Under the Private Securities Litigation Reform Act*, 78 TEMP. L. REV. 405 (2005) (summarizing the case law implementing the new pleading requirements).

235. See *supra* Part II.A.

236. See *supra* Part III.H. The Supreme Court properly framed the question before it narrowly, referring to applicability of scheme liability to business partners only. See Questions Presented, *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, No. 06-43 (U.S. Mar. 26, 2007), available at <http://www.supremecourtus.gov/qp/06-00043qp.pdf>. It is well beyond the scope of this law summary to suggest which test is most appropriate in that particular case.

237. As Part III of this summary shows, almost all cases on scheme liability so far decided come from district courts.

V. CONCLUSION

Recent cases that have analyzed securities fraud cases under Rule 10b-5(a) and (c) have not yet converged around a unified approach. At the same time, it is unlikely that litigation around Rule 10b-5(a) and (c) will cease soon.²³⁸ The recent options backdating scandals will likely stir up even more litigation under the scheme liability provisions.²³⁹ As long as the extent of scheme liability remains unsettled, the important policy goals of *Central Bank* – to provide certainty and avoid vexatious litigation – remain only partly fulfilled. Therefore, either legislative²⁴⁰ or Supreme Court intervention would provide much-needed clarity into securities litigation. However, the adoption of an unnecessarily restrictive test for assessing scheme liability claims could prevent meritorious claims against entities committing fraud to proceed. Also, a broad test covering allegedly all cases of Rule 10b-5(a) and (c) liability is inappropriate. The Supreme Court should, instead, provide guidelines for assessing scheme liability claims by types of claims and defendants one at a time.

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238. In fact, there are various actions pending in district courts where plaintiffs try to rely on, and defendants try to reject, scheme liability. *See, e.g.*, The UBS Defendants' Memorandum in Support of Their Motion to Dismiss Plaintiffs' Amended "Scheme" and Securities Act Theories, *In re Healthsouth Corp. Sec. Litig.*, No. CV-03-BE-1500-S, 2006 WL 2818165 (N.D. Ala. Aug. 21, 2006) (allegations of scheme liability of investment banks for setting up complex investment instruments in a company that misled the public about the company's financial situation); Memorandum of Law in Support of Oliver Peek's Motion to Dismiss the Complaint and to Vacate the Order of Preliminary Injunction, Freeze of Assets and Other Relief, *SEC v. Lohmus Haavel & Viisemann*, No. 05 CV 9259, 2006 WL 2843181 (S.D.N.Y. Aug. 18, 2006) (allegation that scheme liability is appropriate in a case involving an Estonian day trader who employed a "spider program" to collect information from a business news website before it was made officially public, and traded profitably in stock based on this non-public information).

239. *See Nichols & Warren*, *supra* note 8, at 626; Complaint for Violation of Federal Securities Laws, *Vogel v. Jobs*, No. C06-05208 MHP, 2006 WL 2703413 (N.D. Cal., filed Aug. 14, 2006) (alleging scheme liability against Apple and its directors based on underreporting of company expenses due to options backdating).

240. Compare Taylor, *supra* note 26, at 386 ("Congress should expressly re-establish aiding and abetting liability") with Stephen Labaton, *Businesses Seek Protection on Legal Front*, N.Y. TIMES, Oct. 29, 2006, at 1 (describing efforts to legislatively limit litigation possibilities under Rule 10b-5).