

SCHEME LIABILITY: DOES IT HAVE A FUTURE AFTER *STONERIDGE*?

ROBERT A. PRENTICE*

The Supreme Court of the United States's recent decision in *Stoneridge* rewrote the law of reliance in securities-fraud damage actions without settling the question of the viability of "scheme liability" claims under subsection (a) of rule 10b-5. This Paper argues that scheme liability necessarily exists for the simple reason that section 10(b) is a valid statute that undeniably authorizes the SEC to issue rule 10b-5, which, in turn, clearly makes it illegal "[t]o employ any device, scheme or artifice to defraud." Nothing in *Stoneridge* is to the contrary. The Paper then attempts to divine the future scope of that right to sue, arguing for a generous interpretation of scheme liability and analyzing post-*Stoneridge* lower court decisions.

Introduction.....	352
I. Arguments in Favor of Recognizing a Private Right to Sue Asserting "Scheme Liability".....	355
A. A Right to Sue Under Section 10(b) or Rule 10b-5 Indubitably Exists.	356
B. Section 10(b) Is a Broad, Remedial Antifraud Provision.	357
C. Rule 10b-5 Is a Valid Antifraud Provision that Prohibits Schemes to Defraud.....	359
1. Subsections (a) and (c) Are Firmly Grounded in Congressional Actions.....	360
2. Subsections (a) and (c) Are Firmly Anchored in the Language of Section 10(b).....	362
II. Answering Arguments Opposing Recognition of Scheme Liability	363
A. Scheme Liability and the "Arc of History"	363
1. The Right to Sue to Enforce Subsection (a)'s Scheme-Liability Provision Was Well Recognized Before <i>Cort v. Ash</i>	364
2. Are Implied Rights Frozen in Time as of 1975?	366
3. Are Implied Rights Frozen in Time as of 1995?	369
B. The Common Law and Scheme Liability	371
C. No Express Private Right of Action Recognizes Scheme Liability.....	374

* Ed & Molly Smith Centennial Professor of Business Law, McCombs School of Business, University of Texas at Austin.

D.	Does Section 10(b) Prohibit Only False Representations and Omissions?	377
1.	Language of the Statute and Rule.....	378
2.	Supreme Court Holdings.....	381
E.	Lack of Guidance	383
F.	Existence of SEC Authority	386
G.	Ensnaring Commercial Transactions	388
H.	Legislative Action and Inaction	390
III.	Analyzing <i>Stoneridge</i> to Determine What Is Possible.....	393
A.	Some Projections	394
1.	Scheme Liability Lives!.....	394
2.	Collateral Parties Remain (Limitedly) Liable.....	395
B.	Some Questions.....	395
1.	What is the Scope of Primary Liability?.....	395
a.	What to Make of “Make”.....	396
b.	“Directly or Indirectly”	397
c.	Post- <i>Stoneridge</i> Lower-Court Rulings	398
2.	What Does <i>Stoneridge</i> Mean for Reliance?	400
a.	The Attribution Rule.....	400
b.	The <i>Bridge</i> Decision.....	402
c.	The Post- <i>Stoneridge</i> Lower Courts.....	404
C.	Some Applications	404
1.	<i>Stoneridge</i>	404
2.	<i>Central Bank</i>	408
3.	Authors	408
4.	Officers.....	411
5.	Auditors	414
	Conclusion.....	417

INTRODUCTION

The most significant securities antifraud provision in the world, section 10(b) of the Securities Exchange Act of 1934, outlaws commission of securities fraud in violation of any Securities and Exchange Commission (SEC) rule. The most important rule promulgated by the SEC pursuant to section 10(b)'s authorization is rule 10b-5, which in its three subsections prohibits three types of deceit: (1) schemes to defraud, (2) misleading statements or omissions, and (3) fraudulent courses of business.

Before 1994, due to reasonably generous interpretations of subsection (b) of rule 10b-5, plaintiffs neither had to, nor frequently did, assert claims under either the scheme-to-defraud or fraudulent-

course-of-business subsections.¹ Rather, most section 10(b)/rule 10b-5 litigation focused on misrepresentations or omissions.² Because plaintiffs did not often assert claims under subsections (a) or (c), courts were not required to analyze them in any great detail. The courts, including the Supreme Court of the United States, could, and often did, discuss rule 10b-5 as if it contained only subsection (b). However, because of (1) the Supreme Court's 1994 ruling in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*³ that there is no private right to sue for aiding and abetting under section 10(b); and (2) the majority of lower courts' insistence that the remaining scope of primary liability be tightly confined, plaintiffs began aggressively advancing subsections (a) and (c) as bases for liability in litigation arising out of the manifold Enron-era scandals.

The validity of "scheme liability" under subsection (a) of rule 10b-5 was presented for the Supreme Court's evaluation by *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*⁴ The case involved an imaginative scheme to defraud.⁵ Charter Communications delivered cable services through set-top boxes.⁶ In danger of missing quarterly projections, Charter contacted two of its set-top box vendors with which it had written contracts to buy the boxes at established prices.⁷ Charter proposed to pay an extra \$20 per box for the sole purpose of having the vendors "roundtrip" the funds back to Charter in the form of advertising revenue.⁸ The vendors would buy advertising that they neither needed nor wanted at four to five times the going rate, using Charter's own money, so that Charter could claim advertising revenue that it had not earned.⁹ One vendor simply pretended to raise its prices by \$20 per box.¹⁰ The other agreed to amend the existing contract to impose a \$20 per-box penalty for each box that Charter did not buy during a period when Charter had no intention of buying boxes.¹¹ Both

1. See Taavi Annus, Note, *Scheme Liability Under Section 10(b) of the Securities Exchange Act of 1934*, 72 MO. L. REV. 855, 861 (2007) ("Traditionally (and before *Central Bank*), scheme liability has been applied in very limited circumstances involving market manipulation. Because of the availability of aiding and abetting of misrepresentation claim, there was no need to allege scheme liability separately.").

2. *In re Parmalat Sec. Litig.*, 376 F. Supp. 2d 472, 497 (S.D.N.Y. 2005).

3. 511 U.S. 164 (1994).

4. 128 S. Ct. 761 (2008).

5. *Id.* at 761-62.

6. *Id.* at 766.

7. *Id.*

8. *Id.*

9. *Id.*

10. *Id.* at 767.

11. *Id.*

vendors created, backdated, and transmitted documents to provide credibility to the scheme to defraud Charter's investors.¹² The vendors knew that the sole purpose of these sham transactions was to commit securities fraud.¹³ The scheme fooled Charter's outside auditors and enabled it to inflate its operating cash flow by \$17 million in the fourth quarter in order to meet Wall Street analysts' expectations for revenue and cash flow.¹⁴ Investors were thereby defrauded into paying substantially more for Charter's securities than they would have paid had they known the truth.¹⁵

The *Stoneridge* scheme to defraud was quite comparable to one of Enron Corporation's most infamous cheats, wherein Merrill Lynch pretended to buy electricity-generating Nigerian barges from Enron. The sole purpose of the fake transaction was to enable Enron to claim revenue from the transaction and thereby make its quarterly numbers and artificially maintain its inflated stock price. The sale was a fraud because Enron had secretly promised to repurchase the barges from Merrill within six months at a handsome profit to Merrill. In essence, the transaction was a disguised loan. Merrill knowingly engaged in the bogus transaction that generated the documentation, enabling Enron to complete the scheme to defraud its own investors.¹⁶

While the *Stoneridge* majority opinion did not allow plaintiffs to recover, it did not directly or fully address the scheme-liability issue. Rather, the majority's primary reason for disallowing recovery, supplemented by references to the narrow scope of primary liability and considerations of causation, was that plaintiffs did not sufficiently rely upon defendant vendors' actions.¹⁷

The Court further stressed that allowing plaintiffs to recover might cause section 10(b) litigation to entangle all of an issuer's commercial transactions, thereby creating various unpleasant policy results.¹⁸ This emphasis led some to conclude that the majority faction was drawing a line between commercial defendants, such as Charter's vendors, on the

12. *Id.*

13. *Id.*

14. *Id.*

15. *Stoneridge Invest. Partners, LLS v. Scientific-Atlanta, Inc. (In re Charter Commc'ns, Inc. Sec. Litig.)*, 443 F.3d 987, 989-90 (8th Cir. 2006).

16. *See generally* BETHANY MCLEAN & PETER ELKIND, *THE SMARTEST GUYS IN THE ROOM* 206-09 (2003) (describing the Nigerian-barge fraud); Daniel T. Ostas, *When Fraud Pays: Executive Self-Dealing and the Failure of Self-Restraint*, 44 AM. BUS. L.J. 571, 595 (2007) (same).

17. *Stoneridge*, 128 S. Ct. at 766 ("We conclude the implied right of action does not reach the customer/supplier companies because the investors did not rely upon their statements or representations.").

18. *Id.* at 770.

one hand, and actors in the securities industry, such as Merrill Lynch, on the other.¹⁹ However, the Court's subsequent decision to deny certiorari in the Enron case, *Regents of the University of California v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*,²⁰ quickly disabused observers of that notion, and presaged a broad application of *Stoneridge*'s holding, as did the Court's decision in the Homestore case, *Avis Budget Group, Inc. v. California State Teachers' Retirement System*,²¹ where it vacated and remanded the United States Court of Appeals for the Ninth Circuit's recognition of scheme liability.

Some scheme-liability opponents argue, for reasons that *Stoneridge* addressed and reasons that it did not, that there remains no room for scheme liability anywhere in section 10(b) jurisprudence.²² This Paper argues that both scheme liability under rule 10b-5(a) and course-of-business liability under rule 10b-5(c) must be recognized. Part I makes an affirmative case for such recognition. Part II refutes the primary arguments against such recognition.

Parts I and II will demonstrate both that scheme liability should be recognized and that nothing in *Stoneridge* held to the contrary. However, *Stoneridge* clearly signaled that the majority faction of the Supreme Court believes that the section 10(b)/rule 10b-5 private right to sue should be construed very narrowly. Part III attempts to divine what role scheme liability might play in future section 10(b) litigation in the wake of the Supreme Court's hostile and restrictive opinion in *Stoneridge*. The discussion incorporates available lower-court applications of *Stoneridge*.

I. ARGUMENTS IN FAVOR OF RECOGNIZING A PRIVATE RIGHT TO SUE ASSERTING "SCHEME LIABILITY"

This Part makes three simple points. First, a private right to sue to enforce section 10(b) or rule 10b-5 clearly exists. Second, section 10(b) is a broad antifraud provision that clearly authorizes the SEC to issue antifraud rules and punish their violation. Third, rule 10b-5 is a valid

19. See Jonathan C. Dickey et al., *Stoneridge Investment Partners v. Scientific-Atlanta, Inc.: The Supreme Court Rejects "Scheme" Liability*, INSIGHTS, Jan. 2008, at 1, 2 (noting that many had made this argument).

20. 128 S. Ct. 1120 (2008).

21. 128 S. Ct. 1119 (2008), *vacating and remanding Simpson v. AOL Time Warner Inc.*, 452 F.3d 1040 (9th Cir. 2006). Like Charter Communications, Homestore entered into fake transactions with third parties for the purpose of making its financial statements look better than they truly were.

22. See, e.g., Douglas McCollam, *You Can't Sue the Bean Counters*, BUS. WK., Jan. 17, 2008, at 30, 30 (concluding that the Supreme Court has "shot . . . down" scheme liability).

SEC rule that clearly forbids schemes to defraud. From these three premises flows a strong conclusion that defrauded investors have a right to sue for injuries suffered as a result of schemes to defraud (and fraudulent courses of business) in connection with the purchase or sale of securities. Nothing in the language of the *Stoneridge* majority opinion is to the contrary.

*A. A Right to Sue Under Section 10(b) or Rule 10b-5
Indubitably Exists*

Neither Congress, when it enacted section 10(b) in 1934, nor the SEC, when it promulgated rule 10b-5 in 1942, necessarily intended there to be a private right to sue. That said, such a right has been recognized by the lower courts since *Kardon v. National Gypsum Co.*²³ in 1946. The Supreme Court has repeatedly agreed with the thousands of lower-court opinions recognizing the private right to sue,²⁴ including its observation in *Basic Inc. v. Levinson*²⁵ that “[j]udicial interpretation and application, legislative acquiescence, and the passage of time have removed any doubt that a private right of action exists for a violation of § 10(b) and Rule 10b-5, and constitutes an essential tool for enforcement of the 1934 Act’s requirements.”²⁶

More active forms of congressional approval have recently replaced the “legislative acquiescence” to which the *Basic* opinion referred. In the Private Securities Litigation Reform Act of 1995 (PSLRA),²⁷ for example, Congress enacted a proportionate-liability provision that would have been completely pointless if a private right to sue multiple defendants did not exist.²⁸ The PSLRA also established a pleading requirement for private section 10(b) lawsuits that obviously presumed their continued existence.²⁹ The PSLRA expressly empowered the SEC to either limit or expand the right to sue.³⁰

23. 69 F. Supp. 512, 514 (E.D. Pa. 1946).

24. See, e.g., *Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit*, 547 U.S. 71, 79 (2006); *Basic Inc. v. Levinson*, 485 U.S. 224, 230–31 (1988); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 196 (1976); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 730 (1975); *Superintendent of Ins. of N.Y. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 13 n.9 (1971).

25. 485 U.S. 224 (1988).

26. *Id.* at 230–31.

27. Pub. L. No. 104-67, 109 Stat. 737 (1995).

28. See 15 U.S.C. § 78u-4(f) (2006) (providing for proportional liability for defendants who act only recklessly, as would be necessary only if there were multiple defendants).

29. *Id.* § 78u-4(b)(2).

30. The “rule of construction” accompanying the PSLRA states: “Nothing in this Act . . . or the amendments made by this Act shall be deemed to create or ratify

Additionally, the United States House of Representatives report accompanying the PSLRA referred to private securities-fraud litigation as “an indispensable tool” for enforcing the securities laws and remedying investors’ losses.³¹ Finally, when Congress enacted the Sarbanes-Oxley Act of 2002 (SOX),³² it liberalized the section 10(b) statute of limitations in order to facilitate the bringing of such suits.³³

Given all this legislative activity, it is clear that the *Stoneridge* majority was correct in concluding that Congress has “accepted” and “ratified” the private right to sue.³⁴ Its existence truly cannot be gainsaid.

B. Section 10(b) is a Broad, Remedial Antifraud Provision

The Supreme Court has often instructed that statutory interpretation must begin with the language of the statute.³⁵ That makes it surprising that the *Stoneridge* majority opinion essentially ignored section 10(b)’s verbiage, which is “sweeping”³⁶ in its broad remedial terms.³⁷ The statute reads:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of

any implied private right of action, or to prevent the Commission, by rule or regulation, from restricting *or otherwise regulating* private actions under the Securities Exchange Act of 1934.” *Id.* § 78j-1 (emphasis added). Because the SEC could “regulate” the right to sue by expanding it as well as by contracting it, the authority to expand the right to sue is explicit. The most common definition of *regulate* seems to be “[t]o control or direct according to rule, principle, or law.” AMERICAN HERITAGE DICTIONARY OF THE ENGLISH LANGUAGE (4th ed. 2006), *available at* <http://dictionary.reference.com/browse/regulate>.

31. H.R. REP. No. 104-369, at 31 (1995).

32. Pub. L. No. 107-204, 116 Stat. 745 (2002).

33. *See id.* § 804, 116 Stat. at 801 (amending 28 U.S.C. § 1658).

34. *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 128 S. Ct. 761, 773 (2008).

35. *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 164 (1994); *Ardestani v. INS*, 502 U.S. 129, 135 (1991); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 201 (1976) (noting the same point in a section 10(b) case); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 756 (1975) (Powell, J., concurring) (same).

36. *Musick, Peeler & Garrett v. Employers Ins. of Wausau*, 508 U.S. 286, 303 (1993) (Thomas, J., dissenting) (“The sweeping words of § 10(b) and Rule 10b-5 ban manipulation, deception, or fraud in the purchase or sale of securities.”).

37. *See SEC v. Nat’l Sec., Inc.*, 393 U.S. 453, 467 (1969) (noting the “broad anti-fraud purposes” of section 10(b) and rule 10b-5). The breadth of the provision was recognized from the very beginning. *See* John Hanna & Edgar Turlington, *Protection of the Public Under the Securities Exchange Act*, 21 VA. L. REV. 251, 275 (1935) (noting that section 10(b) “is a very broad provision”).

interstate commerce or of the mails or of any facility of any national securities exchange

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.³⁸

The repeated use of the word *any* sends a strong signal as to how wide a net Congress wished to cast. Not just issuers or officers or directors or sellers are governed by the section. Rather, “any person” is potentially liable. The language requires neither privity³⁹ nor a fiduciary relationship⁴⁰ between plaintiffs and defendants. The Supreme Court has noted that section 10(b) imposes liability “on multiple defendants acting in concert,”⁴¹ rendering the defendants “joint[ly] liab[le].”⁴² Even the stingy *Central Bank*⁴³ opinion explicitly held that ancillary parties such as attorneys, auditors, and investment banks may be appropriate defendants.⁴⁴

It is indisputable that Congress believed that it had to enact the Securities Act of 1933 and the Securities Exchange Act of 1934 because state securities laws and the common law of fraud had been inadequate

38. 15 U.S.C. 78j(b).

39. Countless section 10(b) cases have rejected a privity requirement. *See, e.g., Basic Inc. v. Levinson*, 485 U.S. 224, 228 (1988); *Superintendent of Ins. of N.Y. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 9 (1971); *McGann v. Ernst & Young*, 95 F.3d 821, 823 (9th Cir. 1996); *Baretge v. Barnett*, 553 F.2d 290, 290 (2d Cir. 1977); *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228, 239 (2d Cir. 1974).

40. *See infra* note 315.

41. *Musick, Peeler & Garrett*, 508 U.S. at 296.

42. *Id.* at 292.

43. 511 U.S. 164 (1994). To reiterate, *Central Bank* held that there exists no private right to sue a defendant for merely aiding and abetting a violation of section 10(b) or rule 10b-5. *Id.* at 191. By drawing a line between primary and secondary violations and excusing mere secondary violators from liability, the Court reversed a few hundred years of fraud law. *See* Robert A. Prentice, Stoneridge, *Securities Fraud Litigation, and the Supreme Court*, 45 AM. BUS. L.J. 611, 612–13 (2008).

44. 511 U.S. at 191. Congress has, in the intervening years, put its stamp of approval on that notion by addressing contribution in the Private Securities Litigation Reform Act of 1995, *see* 15 U.S.C. § 78u-4(f) (2006), and providing for proportional liability for defendants who act only recklessly, as would be necessary only if there were multiple defendants. *Id.* Joint and several liability is retained for defendants who act with true scienter.

to the task of protecting investors,⁴⁵ which Congress believed was prerequisite to maintaining public confidence in the securities markets.⁴⁶ The purpose of section 10(b) was to expand, not contract, the protections offered by the common law of fraud and state securities statutes.⁴⁷ The latitudinous language of section 10(b) and the broad discretion it grants the SEC to issue antifraud rules cement that conclusion.

It may be telling that the *Stoneridge* majority, while quoting the statute as a matter of course, did not make any effort whatsoever to reason from the statutory language or to base conclusions upon it. Nothing in the language of section 10(b) supports any part of the *Stoneridge* result. The majority opinion could not, and did not, make any claim to the contrary.

C. Rule 10b-5 Is a Valid Antifraud Provision that Prohibits Schemes to Defraud

Like section 10(b), rule 10b-5 is expansively worded:

45. See *Herman & MacLean v. Huddleston*, 459 U.S. 375, 388–89 (1983) (noting that the securities laws were intended “to rectify perceived deficiencies in the available common-law protections by establishing higher standards of conduct in the securities industry”); *Chiarella v. United States*, 445 U.S. 222, 248 (1980) (Blackmun, J., dissenting) (“[The securities laws’] purpose is to ensure the fair and honest functioning of impersonal national securities markets where common-law protections have proved inadequate.”); *Harris v. Am. Inv. Co.*, 523 F.2d 220, 224 (8th Cir. 1975) (stating that rule 10b-5 offers greater protection to plaintiffs than does the common law of fraud); *Resort Car Rental Sys., Inc. v. Chuck Ruwart Chevrolet, Inc.*, 519 F.2d 317, 321 (10th Cir. 1975) (same).

46. Christopher R. Leslie, *Den of Inequity: The Case for Equitable Doctrines in Rule 10b-5 Cases*, 81 CAL. L. REV. 1587, 1613 (1993) (“The overriding purpose of securities regulation is to ensure the smooth operation of securities markets. Broadly speaking, this purpose is accomplished by ensuring full disclosure to investors and by preventing securities fraud and other unfair practices which destroy public confidence in the integrity of the securities markets.”).

47. Note, for example, how in terms of the liability of auditors, Congress replaced the very protective state common-law *Ultramares* view that auditors could not be liable for *negligence* to third parties unless those third parties were named in the engagement letter, with the broad negligence liability of section 11 of the 1933 Act, which makes auditors potentially liable to all investors in a public offering if the auditors cannot prove their due diligence. See 15 U.S.C. § 77k (listing auditors and other experts as statutory defendants in lawsuits where false statements in registration statements injure investors); *Ultramares Corp. v. Touche*, 174 N.E. 441, 444–45 (N.Y. 1931) (espousing the “privity view” of auditors’ third-party liability for negligence). See generally Hanna & Turlington, *supra* note 37, at 279 (“It is certainly safer now for the man who wishes through his savings to obtain a stake in corporate property in this country than it was before the [1934] Act was passed.”).

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

- (a) To employ any device, scheme, or artifice to defraud,
- (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
- (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.⁴⁸

Those actively involved in the enactment of section 10(b) “understood that the [1934] Act conferred open-ended rulemaking authority on the SEC.”⁴⁹ Congress gave the Commission a broad charge so that it could attack frauds that Congress could not foresee in 1934. The Supreme Court has noted that “Congress meant to prohibit the full range of ingenious devices that might be used to manipulate securities prices”;⁵⁰ that “10(b) and Rule 10b-5 prohibit *all* fraudulent schemes in connection with the purchase or sale of securities, whether the artifices employed involve a garden type variety of fraud, or present a unique form of deception”;⁵¹ and that “[n]ovel or atypical methods should not provide immunity from the securities laws.”⁵² Together, section 10(b) and rule 10b-5 constitute broad, “catchall” fraud provisions, although naturally what they catch must be fraud.⁵³

1. SUBSECTIONS (A) AND (C) ARE FIRMLY GROUNDED IN CONGRESSIONAL ACTIONS

The vast majority of section 10(b) cases over the years has involved subsection (b) of rule 10b-5 and its ban on the making of untrue representations (or omissions). However, section 10(b)'s language clearly indicates a congressional intent to regulate fraud in

48. 17 C.F.R. § 240.10b-5 (2008).

49. Steve Thel, *The Original Conception of Section 10(b) of the Securities Exchange Act*, 42 STAN. L. REV. 385, 394 (1990).

50. *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 477 (1977).

51. *Superintendent of Ins. of N.Y. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 10-11 n.7 (1971).

52. *Id.*

53. *Chiarella v. United States*, 445 U.S. 222, 234-35 (1980); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 203 (1976).

broad terms and to give the SEC nearly untrammelled freedom to issue pertinent rules.⁵⁴ Therefore, the legitimacy of subsections (a) and (c) of rule 10b-5, which punish schemes to defraud and fraudulent courses of business, is self-evident.

Not only were subsections (a) and (c) issued pursuant to nearly limitless authority granted to the SEC by section 10(b), but the SEC was prudent enough to firmly ground them in antifraud language that Congress itself had used. Just as section 10(b) is the broadest antifraud provision in the 1934 Act, which is aimed primarily at policing the secondary markets, section 17(a) is the broadest antifraud provision in the 1933 Act, which is aimed primarily at stopping fraud in the primary securities markets.⁵⁵ Section 17(a) forbids both schemes to defraud and fraudulent courses of business, and rule 10b-5 borrows its language almost verbatim.⁵⁶ Just before the SEC promulgated rule 10b-5, Congress again resorted to nearly identical language in framing section 206 of the Investment Adviser's Act of 1940.⁵⁷ Thus, because Congress itself had outlawed both schemes to defraud and fraudulent courses of business in parallel securities-fraud enactments, it is extremely likely that the Congress in 1934 would have approved the SEC's

54. See text accompanying *supra* notes 36-44.

55. The provision reads:

It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly –

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

(2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

15 U.S.C. § 77q(a) (2006).

56. See THOMAS LEE HAZEN, *THE LAW OF SECURITIES REGULATION* 763 (3d ed. 1996) (“Promulgated in 1942, Rule 10b-5 is patterned directly upon section 17(a) of the 1933 Act except that 10b-5 further extends to misstatements and omissions occurring in connection with either a *purchase or sale* of security while the parent section is limited to fraudulent sales and offers to sell.”); LOUIS LOSS, *SECURITIES REGULATION* 810 (1951) (“[Rule 10b-5] merely borrows the language of Section 17(a) . . .”).

57. See 15 U.S.C. § 80b-6. Section 206 of the Investment Advisers Act of 1940 also prohibits investment advisers from “employ[ing] any device, scheme or artifice to defraud any client or prospective client,” or “engag[ing] in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client.” *Id.*

promulgation of subsections (a) and (c) of rule 10b-5. No one has plausibly suggested to the contrary.

2. SUBSECTIONS (A) AND (C) ARE FIRMLY ANCHORED IN THE
LANGUAGE OF SECTION 10(B)

The language of subsections (a) and (c) is also quite consistent with that of section 10(b), more so even than is the language of subsection (b). Section 10(b) authorizes the SEC to prohibit people from “us[ing] or employ[ing] . . . any manipulative or deceptive device or contrivance”⁵⁸ Rule 10b-5(a) outlaws the “employ[ment of] any device, scheme, or artifice to defraud.”⁵⁹ Subsection (c) of rule 10b-5 makes it illegal “[t]o engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.”⁶⁰ The language of the statute (“device or contrivance”) and subsection (a) (“device, scheme, or artifice to defraud”) are particularly similar and complementary. Commonly accepted synonyms for *device* include *contrivance*, *artifice*, and *scheme*.⁶¹

Standard dictionary definitions confirm that rule 10b-5(a)’s language is firmly grounded in the SEC’s mandate in section 10(b). A device is “a scheme to trick or deceive; a stratagem or artifice; as in the laws relating to fraud and cheating.”⁶² An artifice is “[a]n ingenious contrivance or device of some kind, and, when used in a bad sense, it corresponds with trick or fraud.”⁶³ A contrivance is “[s]omething contrived or arranged, often to deceive; a device; a disguise.”⁶⁴ A scheme is “[a] plan or artifice; a plot.”⁶⁵

The bottom line is that the courts cannot simply ignore the existence of subsections (a) and (c). Well-established rules of statutory construction provide that valid rules should not be interpreted in a way

58. 15 U.S.C. 78j(b).

59. 17 C.F.R. § 240.10b-5(a) (2008).

60. *Id.* § 240.10b-5(c).

61. WEBSTER’S NEW WORLD THESAURUS 194 (1985).

62. BLACK’S LAW DICTIONARY 538 (4th ed. 1968).

63. *Id.* at 145.

64. BALLENTINE’S LAW DICTIONARY 266 (3d ed. 1969).

65. *Id.* at 1142. Quoting a 1934 version of *Webster’s International Dictionary*, the Supreme Court itself has noted that *device* means “[t]hat which is devised, or formed by design; a contrivance; an invention; project; scheme; often a scheme to deceive; a stratagem; an artifice.” *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 199 n.20 (1976) (quoting WEBSTER’S INTERNATIONAL DICTIONARY 580 (2d ed. 1934)). A contrivance is “[a] thing contrived or used in contriving; a scheme, plan, or artifice.” *Id.* at 199 n.20 (quoting WEBSTER’S INTERNATIONAL DICTIONARY 713).

2009:351

Scheme Liability

363

that leaves them with no meaning and application whatsoever.⁶⁶ This is particularly true here because the Supreme Court has repeatedly held that section 10(b) should be construed “not technically and restrictively, but flexibly to effectuate its remedial purposes.”⁶⁷

II. ANSWERING ARGUMENTS OPPOSING RECOGNITION OF SCHEME LIABILITY

If section 10(b) is valid (and it is), rule 10b-5 is valid (and it is), and there is a private right to sue under section 10(b) or rule 10b-5 (and there is), then it should be unquestioned that scheme liability (as well as course-of-business liability) must be recognized in private suits filed pursuant to these provisions. However, many courts and commentators have disagreed, presenting a range of arguments for simply ignoring the existence of subsections (a) and (c) of rule 10b-5. This Part addresses those arguments. *Stoneridge* ignored some of these arguments, rejected others, and approved yet others for the purpose of *limiting* the private right to sue in general. However, no language in *Stoneridge* can be read to eliminate scheme (or course-of-business) liability.

A. *Scheme Liability and the “Arc of History”*

Opponents of scheme liability face an immediate question: If there is a right to sue under rule 10b-5’s subsection (b) prohibition of misleading statements and omissions that even they do not dispute, why is there no right to sue for violations of subsections (a) and (c)? Nothing in the language of the statute or the 1934 Act’s legislative history supports such a distinction. No Supreme Court case so holds.⁶⁸ So how can it be settled that a right to sue exists under subsection (b), yet no right to sue exists under (a) and (c)?

A leading and persuasive opponent of scheme liability, Professor Joseph Grundfest, suggests that the answer is the “arc of history.” His essential point is that, although the lower courts and the Supreme Court

66. See *Dole Food Co. v. Patrickson*, 538 U.S. 468, 477 (2003) (stating that statutes should not be construed to render terms superfluous); *United States v. Nordic Village, Inc.*, 503 U.S. 30, 36 (1992) (“[A] statute must, if possible, be construed in such fashion that every word has some operative effect.”); *Ward v. Race Horse*, 163 U.S. 504, 508 (1896) (“[The] cardinal rule of interpretation . . . ordains that such construction be adopted as gives effect to all the language of the statute.”).

67. *SEC v. Zandford*, 535 U.S. 813, 819 (2002) (quoting *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 186 (1963)); *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 151 (1972) (same).

68. The Supreme Court has, in fact, repeatedly recognized the validity of subsection (a)’s scheme-liability language. See *infra* Part II.D.2.

did imply a right to sue under section 10(b) or rule 10b-5, the Supreme Court's 1975 decision in *Cort v. Ash*⁶⁹ changed the standard for implying rights of action, largely ending the practice of judicially creating private rights to sue.⁷⁰ Although this clearly does not mean that the private right to sue under section 10(b) or rule 10b-5 no longer exists, Professor Grundfest suggests that it does mean that all causes of action are essentially frozen in time as of 1975 when *Cort* was decided.

It is true that the Supreme Court "has . . . repeatedly cautioned against extending pre-existing implied rights . . . to new contexts."⁷¹ Recognition of a private right to sue under section 10(b) or rule 10b-5 is improper under *Cort* standards, yet the Supreme Court repeatedly has held that the right stands unquestioned. Therefore, Professor Grundfest's argument goes, those who sue under subsection (b) of rule 10b-5 have "squatter's rights" because they were allowed to sue before *Cort* set forth the modern view on judicial implication. However, those who wish to sue for scheme liability under subsection (a) or for a fraudulent course of business under subsection (c) of rule 10b-5 cannot do so, for that would constitute an impermissible extension of preexisting implied rights.

This argument rests upon two premises: (1) that on June 17, 1975, when *Cort* was decided, the courts recognized only subsection (b) misrepresentations and omissions liability, and did not recognize subsection (a) scheme liability; and (2) that the law of section 10(b) and rule 10b-5 is frozen in time as of that date. Both premises are incorrect.

1. THE RIGHT TO SUE TO ENFORCE SUBSECTION (A)'S SCHEME-LIABILITY PROVISION WAS WELL RECOGNIZED BEFORE *CORT V. ASH*

As the Supreme Court observed in *Blue Chip Stamps v. Manor Drug Stores*⁷² just before *Cort* was decided, by 1975 literally hundreds of lower-court cases had recognized a private right to sue under section 10(b) and rule 10b-5.⁷³ Although the arc-of-history argument assumes to the contrary, large numbers of those cases involved schemes to defraud in violation of subsection (a) of rule 10b-5. Therefore, even

69. 423 U.S. 812 (1975).

70. The most important pre-*Cort* cases recognizing the private right to sue were *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 730 (1975); *Affiliated Ute Citizens*, 406 U.S. at 150-54; and *Superintendent of Ins. of N.Y. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 13 n.9 (1971).

71. Joseph A. Grundfest, *Is There an Express Section 10(b) Private Right of Action? A Response to Professor Prentice* 8 (Stanford Law Sch., Working Paper No. 352, Dec. 2007), available at <http://www.ssrn.com/abstract=1077437>.

72. 421 U.S. 723 (1975).

73. *Id.* at 723, 732.

under an arc-of-history theory, today's victims of schemes to defraud should enjoy the same squatter's right to sue as do plaintiffs suing under subsection (b).

At least as early as 1960, lower courts were explicitly recognizing the rights of plaintiffs to sue for injuries suffered in schemes to defraud that violated rule 10b-5(a).⁷⁴ For example, the courts recognized the private right to sue in fraudulent schemes that involved ordering securities intending not to pay for them.⁷⁵ This was quite reasonable given that such schemes were also considered violations of the scheme-liability provisions of the mail-fraud statute⁷⁶ from which rule 10b-5's scheme-liability language was ultimately derived.⁷⁷ Although defendants in such schemes often characterized the matters as simple contract disputes arising from the commercial world, courts repeatedly held that entering into contracts with no intent to live up to them constituted an actionable scheme to defraud under subsection (a) of rule 10b-5 if the contracts involved the purchase or sale of securities.⁷⁸

Several pre-*Cort* decisions stressed that the elements of common-law fraud need not be proven for a proper section 10(b) action; rather, plaintiffs need establish only a violation of subsection (a), or (b), or (c) of rule 10b-5.⁷⁹ Many courts emphasized that under rule 10b-5, *all fraudulent schemes* in connection with the purchase or sale of securities

74. See, e.g., *Hooper v. Mountain States Sec. Corp.*, 282 F.2d 195, 202 (5th Cir. 1960).

75. See, e.g., *A.T. Brod & Co. v. Perlow*, 375 F.2d 393, 396-97 (2d Cir. 1967).

76. See, e.g., *Durland v. United States*, 161 U.S. 306, 313 (1896); *United States v. Merritt*, No. 98-4386, 2000 WL 148214 (4th Cir. Feb. 11, 2000); *Schauble v. United States*, 40 F.2d 363, 364 (8th Cir. 1930); *Tucker v. United States*, 224 F. 833, 836 (6th Cir. 1915); *Miller v. United States*, 133 F. 337, 342 (8th Cir. 1904); *United States v. Seehausen*, No. 00C4829, 2000 WL 1809993, at *1 (N.D. Ill. Dec. 11, 2000).

77. Rule 10b-5's scheme to defraud language was copied from section 17(a) of the 1933 Act. See *supra* notes 54-55 and accompanying text. Congress derived that language, in turn, from the mail-fraud statute, which is currently codified at 18 U.S.C. § 1341 (2006). The purpose of section 17(a) was to "extend[] to all securities transactions in interstate commerce the protection formerly afforded only where the mails were employed." *Legislation: The Securities Act of 1933*, 33 COLUM. L. REV. 1220, 1243 (1933); see also W.D.S., *Legislation: The Securities Act of 1933*, 20 VA. L. REV. 451, 462 (1934) (noting that section 17(a) is "couched almost verbatim in the language of the mail fraud statute").

78. See, e.g., *Richardson v. MacArthur*, 451 F.2d 35, 40 (10th Cir. 1971).

79. See, e.g., *Clegg v. Conk*, 507 F.2d 1351, 1358 (10th Cir. 1974); *Kerbs v. Fall River Indus., Inc.*, 502 F.2d 731, 739 (10th Cir. 1974); *Rekant v. Desser*, 425 F.2d 872, 880 (5th Cir. 1970); *A.T. Brod & Co.*, 375 F.2d at 397; *Stevens v. Vowell*, 343 F.2d 374, 379 (10th Cir. 1965); *Stoner v. Ford*, 1974 U.S. Dist. LEXIS 11427, at *22 (N.D. Okla. Dec. 24, 1974); *SEC v. Tex. Gulf Sulphur Co.*, 258 F. Supp. 262, 277 (S.D.N.Y. 1966).

were prohibited.⁸⁰ The Supreme Court itself stated in 1964 that “[section] 10(b) and Rule 10b-5 prohibit *all fraudulent schemes* in connection with the purchase or sale of securities, whether the artifices employed involve a garden type variety of fraud, or present a unique form of deception,”⁸¹ and that “[n]ovel or atypical methods should not provide immunity from the securities laws.”⁸²

Thus, the right to sue to remedy damage sustained as a result of a scheme to defraud under rule 10b-5(a) was almost as firmly established when *Cort* was decided in 1975, as was the right to sue to remedy misrepresentations and omissions under 10b-5(b).⁸³ Because the existence of a private right to sue under the latter provision is settled, the private right to sue under the former necessarily exists as well under any squatter’s-rights theory.

2. ARE IMPLIED RIGHTS FROZEN IN TIME AS OF 1975?

Professor Grundfest’s second erroneous assumption is that the arc of history requires that section 10(b) jurisprudence be frozen as of 1975 and never expanded.⁸⁴ The only securities case that Grundfest cited for this proposition, *Virginia Bankshares, Inc. v. Sandberg*,⁸⁵ specifically rejected the frozen-in-time argument, holding that “where a legal structure of private statutory rights has developed without clear indications of congressional intent, the contours of that structure need *not* be frozen absolutely when the result would be demonstrably inequitable to a class of would-be plaintiffs with claims comparable to those previously recognized.”⁸⁶ In so ruling, the Court followed its earlier language in *Blue Chip Stamps*, which also rejected the frozen-in-time argument.⁸⁷

Therefore, even if pre-*Cort* jurisprudence had not consistently recognized fraudulent-scheme victims’ right to sue, it would be patently inequitable not to extend that right to these would-be plaintiffs. Both

80. See, e.g., *Clegg*, 507 F.2d at 1355; *Allen v. H.K. Porter Co.*, 452 F.2d 675, 678 (10th Cir. 1971); *Richardson*, 451 F.2d at 40; *First Am. Corp. v. Foster*, 51 F.R.D. 248, 251 (N.D. Ga. 1970).

81. *Superintendent of Ins. of N.Y. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 11 n.7 (1971) (quoting *A.T. Brod & Co.*, 375 F.2d at 397) (emphasis added).

82. *Id.*

83. See *Burns v. Paddock*, 503 F.2d 18, 22–23 (7th Cir. 1974); *Clegg*, 507 F.2d at 1354, 1358; *Hadsell v. Hoover*, 484 F.2d 123, 126–27 (10th Cir. 1973).

84. See Grundfest, *supra* note 71, at 8–9.

85. 501 U.S. 1083 (1991). The implied right of action at stake in *Sandberg* involved not section 10(b), but section 14(a) of the 1934 Act, as recognized in *J.I. Case Co. v. Borak*, 377 U.S. 426, 430–31 (1964).

86. 501 U.S. at 1104 (emphasis added).

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

Stoneridge and *Enron* involved factual scenarios where *A* knowingly participated in a scheme to defraud by entering into fake transactions with *B* for the purpose of enabling *B* to fool *C*. For example, as noted earlier, in the Enron fraud, Merrill Lynch pocketed a lot of money in return for pretending to buy electricity-generating Nigerian barges from Enron for the sole purpose of allowing Enron to claim revenue from the transactions and thereby make its quarterly numbers and artificially maintain its inflated stock price. Merrill knowingly engaged in the fake transaction that generated the documentation that enabled Enron itself to complete the scheme to defraud its own investors, as Merrill knew it would.⁸⁸ How can it not be inequitable to refuse to extend the right to sue to these victims of a scheme to defraud? There is precious little difference between *A* shooting *C* and *A* handing the gun to *B* knowing that *B* is going to shoot *C*. Even the court that rejected scheme liability in *Enron* admitted that its result “may not coincide . . . with notions of justice and fair play.”⁸⁹

Before the lower courts began interpreting *Central Bank* to narrowly define *primary liability*, no body of fraud law had ever rewarded a scoundrel for being able to perform his skullduggery from the shadows. As Professor Donald Langevoort has noted:

There is little sense . . . in limiting fraud liability to those whose involvement [in fraud] is public and direct The very nature of securities fraud often involves obscuring the source and interests of its authors. People can have a significant influence on how fraudulent disclosure is packaged, and hence how effective it is, without being identified to the victim.⁹⁰

The common law, from which much of section 10(b)'s antifraud structure is derived, allowed *C* to recover from *A* when *A* knowingly participated in *B*'s scheme to defraud,⁹¹ and therefore would have allowed recovery against both Charter's vendors and against Merrill Lynch in *Enron*. Furthermore, persons who did what the defendants did

88. See generally MCLEAN & ELKIND, *supra* note 16, at 206–09 (describing the Nigerian-barge fraud); Ostas, *supra* note 16, at 595 (same).

89. *Regents of Univ. of Cal. v. Credit Suisse First Boston, Inc.*, 482 F.3d 372, 393 (5th Cir. 2007).

90. Donald C. Langevoort, *Words from on High About Rule 10b-5: Chiarella's History, Central Bank's Future*, 20 DEL. J. CORP. L. 865, 889 (1995).

91. See, e.g., *Sanders v. Berry*, 214 S.W. 58, 61 (Ark. 1919); *Cheney v. Powell*, 15 S.E. 750, 751 (Ga. 1892); *Bank of Commerce & Trust Co. v. Schooner*, 160 N.E. 790, 792 (Mass. 1928); *Cross v. Sylvia Silk Co.*, 225 N.Y.S. 552, 553–54 (N.Y. App. Div. 1927); *McElroy v. Harnack*, 63 A. 127, 129 (Pa. 1906).

in *Stoneridge* or in *Enron* would be convicted under the federal mail-fraud statute.⁹² This is relevant because Congress's scheme-to-defraud language, which it originally inserted into the federal mail-fraud statute in the 1800s and then copied into section 17(a) of the 1933 Act and section 206 of the Investment Advisers Act of 1940, provides the basis for the SEC's wording of subsection (a) of rule 10b-5.⁹³

Until *Brennan v. Midwest Life Insurance Co.*⁹⁴ created a false dichotomy between primary and secondary liability in 1966, section 10(b) had also been interpreted to punish actors such as the *Stoneridge* vendors. In *Fry v. Schumaker*,⁹⁵ for example, one defendant planned to fraudulently acquire plaintiff's shares for less than their real value.⁹⁶ Defendant stockbrokers knowingly participated in the scheme by writing a solicitation letter in which they pretended to offer to acquire the shares.⁹⁷ The brokers moved to dismiss the section 10(b)/rule 10b-5 claim on grounds that they made no false statements in the solicitation letter. The court denied the motion, noting:

No matter how innocent the brokers' solicitation letter may have appeared and without regard to whether it contained any fraudulent or misleading statement of fact, if the brokers knew, as averred, that it was part of a *scheme to defraud* an action would lie against them. In fact it would be sufficient if they had merely mailed a letter without knowing its contents or even had merely supplied their stationery, provided they knew that in so doing they were rendering service essential to or participating in a scheme of fraud.⁹⁸

Merrill Lynch's conduct in the Nigerian-barge transaction was considerably more culpable than these brokers' actions, as was the vendors' conduct in the *Stoneridge* case.

92. See, e.g., *United States v. Jones*, 10 F. 469, 470 (S.D.N.Y. 1882).

93. See *infra* notes 196–202 and accompanying text.

94. 259 F. Supp. 673, 681 (N.D. Ind. 1966). *Brennan* created a "secondary" aiding-and-abetting theory for purposes of extending liability to those whose only wrong was failure to warn a victim of fraud when lacking a fiduciary duty to do so. This led to a ruling in *Central Bank* which, at least as construed by *Stoneridge*, displays a spectacular ignorance of the state of the common law of torts in 1934. See Prentice, *supra* note 43, at 611–12. Until 1994, knowing participation in securities fraud always led to liability, whether that liability was designated as primary (as it always was until 1966) or as secondary (as it sometimes was after 1966).

95. 83 F. Supp. 476 (E.D. Pa. 1947).

96. *Id.* at 477.

97. *Id.*

98. *Id.* at 478 (emphasis added).

Neither the common law, nor the federal mail-fraud statute, nor the blue-sky laws, nor section 10(b) jurisprudence for its first sixty years required that a fraudulent actor's name be attached to a false statement or that that actor speak directly to the fraud victim in order to be held responsible, criminally or civilly, for the injury to that victim.⁹⁹ To insert that requirement into section 10(b) jurisprudence is inconsistent with virtually every known body of tort law and provides a roadmap for fraudsters as to how to perpetrate frauds and yet avoid liability by simply staying in the background. Persons who acted as did the defendants in *Stoneridge* and *Enron* have been held liable in a wide variety of contexts.¹⁰⁰ To allow them to escape liability here because they successfully disguised themselves is just the sort of inequitable result that obviously provides exactly the justification that *Blue Chip Stamps* and *Virginia Bankshares* held is predicate for expanding even a purely implied right of action in the post-*Cort* era.

3. ARE IMPLIED RIGHTS FROZEN IN TIME AS OF 1995?

Although both *Blue Chip Stamps* and *Virginia Bankshares* explicitly held that the implied right to sue should not be frozen in time, the *Stoneridge* majority simply ignored both cases and concluded that it was.¹⁰¹ However, unlike Professor Grundfest, the majority faction in *Stoneridge* concluded that it was frozen not as of 1975, but as of 1995,

99. See Prentice, *supra* note 43, at 670.

100. For example, those who pretend to purchase property so that *B* (debtor) may hide his assets from *C* (creditor) have long been held liable in fraudulent conveyance cases. See, e.g., *Chatman v. Lawlor*, 831 A.2d 395, 404 (D.C. Cir. 2003) (affirming a punitive-damage judgment against a transferee who participated in a fraudulent conveyance); *Golden Budha Corp. v. Canadian Land Co. of Am., N.V.*, 931 F.2d 196, 201 (2d Cir. 1991) (holding defendant transferee liable if he “participated or acquiesced in the transferor’s fraudulent design” (quoting 30 N.Y. JUR. 2d *Creditors’ Rights* § 243 (1983) (emphasis added)); *Rogers v. Conaway*, 147 So. 152, 154 (Ala. 1933); *Lewis v. Superior Court*, 37 Cal. Rptr. 2d 63, 69 (Cal. Ct. App. 1994).

Persons who pretend to purchase property and then lease it back to a purported owner may be liable for the rental value of that person’s possession to the person who has rightful ownership, even though they had no contact with the real owner. See *Ideal Sav. & Homestead Ass’n v. Gould*, 124 So. 688, 690 (La. Ct. App. 1929) (“[T]hose concerned in the simulated transaction are responsible solidarily for the loss caused the real owner of the property.”).

Courts have punished creditors who delivered a note to a debtor to enable him to display it to sureties and thereby mislead them to their disadvantage into believing that he has paid the debt. See *Wilson v. Green*, 25 Vt. 450, 456 (1853) (releasing the sureties from their contract).

101. See *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 128 S. Ct. 761, 773 (2008).

when Congress explicitly ratified the private right to sue by enacting the PSLRA and placing various limitations and restrictions upon the right. The majority opinion concluded, “It is appropriate for us to assume that when § 78u-4 was enacted, Congress accepted the § 10(b) private cause of action as then defined but chose to extend it no further.”¹⁰²

This conclusion ignores the fact that in enacting the PSLRA, Congress lauded the section 10(b) private right to sue as an “indispensable tool” for creating confidence in the securities markets.¹⁰³ It ignores the fact that Congress directly authorized the SEC to expand the private right to sue if it deemed it appropriate to do so.¹⁰⁴ It ignores that Congress itself expanded the right to sue by extending the statute of limitations in Sarbanes-Oxley in 2002.¹⁰⁵ In other words, whereas the Supreme Court’s majority faction is committed to freezing the private right to sue, Congress obviously is not.

Assume for a moment that, contrary to all evidence, Congress did wish to freeze the section 10(b) private right to sue as of 1995. At that point in time many, and perhaps most, lower courts were reading *Central Bank* narrowly to impose primary liability upon collateral participants to whom false statements were not attributed, but who had “substantially participated”¹⁰⁶ or were “intricately involved”¹⁰⁷ in fraudulent schemes. Courts were holding third parties liable because of their “involvement,”¹⁰⁸ “central involvement,”¹⁰⁹ or “direct

102. *Id.*

103. H.R. REP. No. 104-369, at 31 (1995) (Conf. Rep.).

104. *See supra* note 30.

105. *See supra* note 33.

106. *In re Software Toolworks, Inc. Sec. Litig.*, 50 F.3d 615, 628 n.3 (9th Cir. 1994) (holding an accounting firm primarily liable for playing a “significant role” in drafting and editing a misleading document); *see also Employers Ins. of Wausau v. Musick, Peeler & Garrett*, 871 F. Supp. 381, 389 (S.D. Cal. 1994) (holding that one who plays a “significant role” in preparation of a false communication is a “primary actor” who can be held primarily liable).

107. *In re ZZZZ Best Sec. Litig.*, 864 F. Supp. 960, 970 (C.D. Cal. 1994) (holding an accounting firm primarily liable for being “intricately involved” in preparation of misleading documents with which it was not identified).

108. *Adam v. Silicon Valley Bancshares*, 884 F. Supp. 1398, 1401 (N.D. Cal. 1995) (describing the accounting firm that “significantly participated in” preparation of a client’s prospectus, interim financial statements, and press releases that were part of an overall scheme to defraud).

109. *Cashman v. Coopers & Lybrand*, 877 F. Supp. 425, 432 (N.D. Ill. 1995) (holding accountants potentially primarily liable because they played a “central role in the drafting and formation of the alleged misstatements” that their client incorporated into its prospectus).

participa[tion]”¹¹⁰ in fraudulent schemes or their “preparation”¹¹¹ of false documents. Therefore, to freeze the right to sue as of 1995 would not at all necessarily absolve defendants such as Charter’s vendors in *Stoneridge* or Merrill Lynch in *Enron*, despite the *Stoneridge* majority’s contrary assumption.

Most importantly for present purposes, the right to sue for injuries sustained as a result of violation of subsection (a) of rule 10b-5 was well established before 1995.¹¹² Therefore, to recognize scheme liability as a general concept is not to expand section 10(b) by one single iota from either its 1975 or its 1995 status.

B. The Common Law and Scheme Liability

The clear language of section 10(b) and rule 10b-5(a) should definitively establish the right to sue to remedy injuries sustained because of schemes to defraud in connection with the purchase or sale of securities. However, the Supreme Court has stated in both *Central Bank* and *Musick, Peeler & Garrett v. Employers Insurance of Wausau*¹¹³ that when the text of section 10(b) does not clearly resolve an issue, resort to historical reconstruction may be required to determine what Congress in 1934 would have intended had an express cause of action been included in section 10(b).¹¹⁴ In making such determinations, the common law is obviously critically relevant.¹¹⁵ The Supreme Court has stressed the relevance of common-law principles in

110. *In re U.S.A. Classic Sec. Litig.*, Fed. Sec. L. Rep. (CCH) ¶ 98,837, at 93,046, 93,048 (S.D.N.Y. Jun. 16, 1995) (holding the issuer, corporate officers, and underwriter all potentially primarily liable as “direct participant[s]” in a fraudulent scheme).

111. *Whirlpool Fin. Corp. v. GN Holdings, Inc.*, 873 F. Supp. 111, 119 (N.D. Ill. 1995) (noting rule 10b-5’s “wide-open language” in holding liable all those who prepared a false memorandum issued in a corporation’s name).

112. *See supra* notes 74–83 and accompanying text.

113. 508 U.S. 286 (1993).

114. *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 178 (1994); *Musick, Peeler & Garrett*, 508 U.S. at 294.

115. *See, e.g., Bastian v. Petren Res. Corp.*, 892 F.2d 680, 683 (7th Cir. 1990) (purporting to interpret rule 10b-5 consonant with common-law fraud principles); *Harris v. Am. Inv. Co.*, 523 F.2d 220, 221 (8th Cir. 1975) (noting that common-law fraud concepts underlie securities laws and provide guidance as to their reach and applications); *Lanza v. Drexel & Co.*, 479 F.2d 1277, 1289–91 (2d Cir. 1973) (similar); *SEC v. Tex. Gulf Sulphur Co.*, 401 F.2d 833, 855 (2d Cir. 1968) (noting section 10(b) should be interpreted as an expansion of the common law in order to effectuate its broad remedial purpose); *Edward J. DeBartolo Corp. v. Coopers & Lybrand*, 928 F. Supp. 557, 562, 566 (W.D. Pa. 1996) (noting that common-law tort principles underlie the federal securities laws, and that they “provide guidance as to their reach and interpretation”).

the interpretation of the antifraud provisions of the securities laws,¹¹⁶ recently emphasizing the significance of “the common-law roots of the securities fraud action” under section 10(b) and rule 10b-5.¹¹⁷

Scheme-liability opponents have claimed that pre-1934 common law rejected scheme liability.¹¹⁸ Even if this were true, it would be difficult to see how it could override the express wording of the statute and the rule, but an equally important point is that it is simply not accurate. Indeed, the “Fraud and Deceit” entry of *American Jurisprudence* in 1939 indicated that in the common law, “[p]ersons . . . become liable as principals by participating in a *fraudulent scheme*.”¹¹⁹ Indeed, scores, if not hundreds, of pre-1934 common-law cases allowed recovery for “schemes to defraud” and “fraudulent schemes.” Most importantly for our purposes, many cases allowed defrauded purchasers of corporate stock to recover for damages sustained due to defendants’ schemes to defraud.¹²⁰ For example, in *Riles v. Coston-Riles Lumber Co.*,¹²¹ Riles procured timber rights and then organized a corporation pursuant to a fraudulent scheme to sell its stock at a greatly inflated price to the detriment of plaintiff investors.¹²² Defendant vendors sold the timber rights to Riles knowing of his fraudulent scheme.¹²³ The court quoted *Corpus Juris* for the proposition that:

116. See, e.g., *Chiarella v. United States*, 445 U.S. 222, 227–29 (1980).

117. *Dura Pharm., Inc. v. Broudo*, 544 U.S. 336, 344 (2005). The Court reemphasized, “Judicially-implied private securities-fraud actions resemble in many (but not all) respects common-law deceit and misrepresentation actions.” *Id.* at 343 (citing *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 744 (1975)).

118. See Grundfest, *supra* note 71, at 9.

119. 23 AM. JUR. *Fraud and Deceit* § 184, at 1008 (1939) (emphasis added).

120. See, e.g., *Myerhoff v. Tinslar*, 175 Ill. App. 29, 37 (1912) (allowing an investor to recover from directors who, despite losses, declared dividends as “a part of the *fraudulent scheme* to delude unwary persons into buying” a corporation’s stock) (emphasis added); *Reinertson v. Struthers*, 207 N.W. 247, 250 (Iowa 1926) (allowing plaintiffs to recover damages caused by defendants’ fraudulent scheme to seek investors and then convert the invested funds); *Powers v. Am. Traffic Signal Corp.*, 209 N.W. 16, 17 (Minn. 1926) (allowing plaintiff to recover for damage caused by defendants’ fraudulent scheme to induce him to buy shares in exchange for bogus promise of employment); *Robinson v. Phegley*, 177 P. 942, 943 (Or. 1919) (allowing plaintiff to recover damages caused by defendant’s fraudulent scheme to induce her to purchase his securities); *White v. Tex. Co.*, 202 P. 826, 827–30 (Utah 1921) (overruling defendants’ demurrers where plaintiff adequately pled scheme to defraud him into selling stock).

121. 95 So. 43 (Ala. 1922).

122. *Id.* at 45.

123. *Id.*

[T]hird persons who participate with promoters in a fraud upon subscribers for stock in a corporation will be jointly and severally liable with the promoters to such subscribers for the fraud as in other cases of joint tort-feasors. Such liability on the part of third persons participating with promoters in a fraud upon the corporation or upon subscribers for its stock exists irrespective of their motives or the degree of their culpability, and although they originally may not have been parties to the *fraudulent scheme* and may not have shared at all in the profits of the fraud.¹²⁴

Under pre-1934 common law, real-estate buyers recovered for fraudulent schemes.¹²⁵ Real-estate sellers recovered for fraudulent schemes.¹²⁶ Purchasers of bank notes recovered for fraudulent schemes.¹²⁷ Debtors who signed promissory notes recovered for fraudulent schemes.¹²⁸ Shareholders of looted corporations recovered for fraudulent schemes.¹²⁹ Bank depositors recovered from their banks for fraudulent schemes.¹³⁰ Defrauded gamblers recovered from banks that knowingly participated in a crooked gang's fraudulent scheme by allowing the bank's facilities to lend "the gang the appearance of respectability that the backing of a banking institution afforded."¹³¹

124. *Id.* at 46 (quoting 14 C.J. *Corporations* § 365 (1919)) (emphasis added).

125. *See, e.g., Hunter v. Sloan*, 190 S.W. 57, 59 (Mo. Ct. App. 1916) (allowing plaintiff to recover damages caused by defendants' fraudulent land scheme).

126. *See, e.g., Zuckerman v. Cochran*, 158 So. 324, 326 (Ala. 1934) (holding that defendant Cochran was potentially liable for participating in a fraudulent scheme, whereby plaintiff bought Cochran's worthless land based on a promise by codefendant Schuster to purchase the land from plaintiff at a profit to plaintiff, but without any intent to fulfill the promise); *Blair v. Guarantee Title Co. of Long Beach*, 284 P. 719, 724 (Cal. Ct. App. 1930) (allowing plaintiff to recover damages for injuries caused by fraudulent real-estate scheme involving real-estate agent, escrow officer and others).

127. *See, e.g., Bank of Avon v. Smith*, 222 N.W. 936, 937 (S.D. 1929) (allowing plaintiffs to recover damages caused by defendants' fraudulent bank-note scheme).

128. *See, e.g., Johle v. Martin*, 291 S.W. 296, 297 (Tex. Civ. App. 1927) (affirming judgment against creditor whose fraudulent scheme induced debtor to sign promissory notes).

129. *See, e.g., Green v. Hedenberg*, 42 N.E. 851, 853 (Ill. 1896) (allowing plaintiff shareholder to recover damages caused by defendants' fraudulent scheme to misappropriate corporate assets).

130. *See, e.g., Singleton v. Harriman*, 272 N.Y.S. 905, 906 (N.Y. Sup. Ct. 1933) (allowing plaintiff to recover damages caused by defendant bank's fraudulent scheme which involved failure to sell her stock as ordered).

131. *Hobbs v. Boatright*, 93 S.W. 934, 938 (Mo. 1906). The plaintiff in this case was taken to the cleaners by the "Buckfoot Gang," which cheated rubes by inducing them to gamble on fixed races. *Id.* at 935. The defendant bank and cashier were held liable not for any representations they made to plaintiff, but for knowingly

In other words, an in-depth examination of the common law strongly supports recognition of scheme liability under rule 10b-5(a). At common law, when, as in *Stoneridge* and *Enron*, *A* knowingly participated in a fake transaction with *B* in order to enable *B* to execute a fraudulent scheme to fool *C*, *C* was routinely allowed to recover from *A*.¹³²

C. No Express Private Right of Action Recognizes Scheme Liability

Scheme-liability opponents have also argued that “[i]t makes no sense to reason that Congress would create an implied private right that reaches ‘scheme liability’ under Section 10(b) when it refused to do so under any express private remedy in the Acts.”¹³³ This argument’s shortcoming is that it is beyond question that a private right to sue exists for violations of section 10(b) and rule 10b-5. The lower courts have so held for sixty-two years. The Supreme Court has agreed for thirty-seven years. Congress has expressly agreed.¹³⁴ That ship has sailed. The right to sue under section 10(b) is now functionally an express cause of action given the *Stoneridge* majority’s accurate observation that Congress has “accepted” and “ratified” the private right to sue.¹³⁵ Since it is indisputable that a private right to sue exists, should not an inquiry regarding the parameters of that right begin with the language of the statute and the rule (the validity of both of which are unchallenged)?¹³⁶

Because scheme-liability opponents cannot draw support from the language of the statute, rule, or common law, they often resort to *Central Bank*, where the Supreme Court noted that “none of the express private causes of action in the [1934] Act imposes aiding and abetting liability, and there is no evidence that Congress intended that liability

participating in the gang’s fraudulent scheme. *Id.* at 939–40. That they did not share in the loot was held irrelevant. *Id.* at 938.

132. See *supra* note 91.

133. Joseph A. Grundfest, *Scheme Liability: A Question for Congress, Not for the Courts* 10 (Stanford Law Sch., Working Paper No. 344, 2007), available at <http://ssrn.com/abstract=1005524>.

134. In *Dura Pharm., Inc. v. Broudo*, the Supreme Court noted that the PSLRA “makes clear Congress’s intent to permit private securities fraud actions for recovery” where the proper elements are established. 544 U.S. 336, 346 (2005).

135. *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 128 S. Ct. 761, 773 (2008).

136. When enacting the PSLRA and Sarbanes-Oxley, Congress expressly approved the existence of a private right to sue under section 10(b) and rule 10b-5. It could have excised the scheme-to-defraud language from rule 10b-5, but chose not to do so either time. See *supra* notes 27–33 and accompanying text.

for the express causes of action.”¹³⁷ From that starting point, it has been argued that the “same logic” compels the conclusion that there can be no scheme liability under section 10(b) or rule 10b-5.¹³⁸

However, this comparison backfires for two reasons. First, the Supreme Court was flagrantly wrong in its essential conclusion in *Central Bank* that Congress’s failure to expressly mention aiding and abetting in section 10(b) indicates that it did not wish to visit liability upon aiders and abettors.¹³⁹ While Congress could, of course, have mentioned aiding and abetting specifically, it would have been much more natural for it not to do so. In 1934, the universal common law of torts imposed primary liability upon all who knowingly participated in an intentional tort such as fraud. The legal encyclopedias of the time, such as *American Jurisprudence*¹⁴⁰ and *Corpus Juris Secundum*,¹⁴¹ made it clear that a person who knowingly aided, aided and abetted, encouraged, advised, counseled, procured, directed, or commanded an intentional tort was held liable as a joint tortfeasor. While Congress might have listed in section 10(b) all these various forms of knowing participation, including aiding and abetting, it would have been much more natural for it not to do so. This was the accepted rule, so spelling it out would have been unnecessary.

In describing the law of torts, all the legal treatises of the time, including Burdick,¹⁴² Cooley,¹⁴³ Chapin,¹⁴⁴ Harper,¹⁴⁵ Jaggard,¹⁴⁶ Kinkead,¹⁴⁷ Pollock,¹⁴⁸ and Prosser¹⁴⁹ echo *Townes on Torts*:

137. *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 184 (1994).

138. Grundfest, *supra* note 133, at 11.

139. 511 U.S. at 177.

140. 23 AM. JUR. *Fraud and Deceit* § 184, at 1007 (1939) (“A person may not be held liable for fraudulent representations not made, authorized, or *participated in* by him.”) (emphasis added). This encyclopedia also notes that “one who, with knowledge of the facts, assists another in the perpetration of a fraud is equally guilty.” *Id.* at 1008–09.

141. 37 C.J.S. *Fraud* § 61, at 346 (1943) (“One who, by fraudulent representations, induces another to act to his damage is liable for the damages suffered, and it is not essential that there should have been privity of contract or personal dealings; but a person cannot be held liable for a fraudulent misrepresentation unless he made it himself or authorized another to make it for him *or in some way participated therein.*”) (emphasis added).

142. FRANCIS M. BURDICK, *THE LAW OF TORTS* § 198, at 243 (4th ed. 1926) (“Persons are joint wrongdoers when their wrongful conduct is the result of co-operation or of a common understanding or design.”).

143. 1 THOMAS M. COOLEY, *A TREATISE ON THE LAW OF TORTS* 244 (3d ed. 1906) (“All who actively *participate* in any manner in the commission of a tort, or who command, direct, advise, encourage, *aid or abet* its commission, are jointly and severally liable therefor.”) (emphasis added).

All persons who act together in the commission of a tort are jointly and severally liable to the injured person for all the directly resulting damage.

Co-operation which leads to this joint and several liability means not only actual *participation* in the commission of the wrong committed, but advising, counseling, *aiding*, *abetting*, and even acquiescing, in such wrong and *guilty participation in any form leads to liability*.¹⁵⁰

Second, and more relevant given *Stoneridge's* compounding of *Central Bank's* error,¹⁵¹ the Supreme Court's argument in *Central Bank* was based on the *absence* of any aiding-and-abetting language in section

144. H. GERALD CHAPIN, HANDBOOK OF THE LAW OF TORTS 230-31 (1917) (noting that joint liability may be visited upon a person who "commands," "directs," "advises," "procures," or acts in concert).

145. FOWLER VINCENT HARPER, TREATISE ON THE LAW OF TORTS § 302, at 676 (1933) (noting that joint liability in tort may be imposed "when two or more persons actually *participate* in the wrongful action in pursuance of a common plan or design. This is called concert of action and makes all liable jointly and severally.") (emphasis added).

146. 1 EDWIN A. JAGGARD, HAND-BOOK OF THE LAW OF TORTS § 67, at 210 (1895) ("[T]wo or more persons may be held liable because of personal *participation*, by consent to, or actual commission of, the wrong complained of; as where several persons execute a conspiracy to assault, steal from, or *defraud* another [J]oint tort feasons are held responsible . . . because of concerted action toward a common end All persons who aid, counsel, direct, or join in committing a tort are joint tort feasons. The liability of a joint tort feason may attach by direct participation.") (emphasis added).

147. 1 EDGAR B. KINKEAD, COMMENTARIES ON THE LAW OF TORTS § 41, at 79 (1903) ("One may become a joint wrongdoer not only by co-operating in, but by encouraging, aiding, advising or assenting to the commission of a wrongful act. All who aid, command, advise, or countenance the commission of a tort by another, or approve it after it is done, if for their benefit, are joint tort-feasons. All procurers, aiders or abettors, all those who, though not privy to the commission of the wrong, afterward assent to it; all who direct or adopt a wrong; those who encourage or excite another in the commission of an act; those who commit a tort by command; . . . those who wrongfully contribute in any manner to a wrong, are liable as joint tort-feasons.")

148. FREDERICK POLLOCK, A TREATISE ON THE LAW OF TORTS 230 (1894) ("[I]t is an established rule in America, that where torts are committed by several persons the action may be brought against all who participate or against any number of them.")

149. WILLIAM L. PROSSER, HANDBOOK OF THE LAW OF TORTS § 109, at 1094 (1941) ("All those who actively participate in a tortious act, by cooperation or request, or who lend aid or encouragement to the wrongdoer, or ratify and adopt his acts done for their benefit, are equally liable with him.")

150. JNO. C. TOWNES, GENERAL PRINCIPLES OF THE LAW OF TORTS 186 (1907) (emphasis added).

151. *Stoneridge* could have corrected *Central Bank's* apparent error simply by limiting it to its facts, which involved merely a failure to warn in a situation where no duty to warn was owed.

10(b) and rule 10b-5. However, there is no such omission regarding scheme liability; that language is clearly present in rule 10b-5, and just as clearly authorized by section 10(b). Section 10(b) outlaws use of any “deceptive device or contrivance” in violation of an SEC rule, and rule 10b-5 expressly outlaws the employment of any device, scheme, or artifice to defraud. Therefore, the *presence* of scheme-liability language in section 10(b) and in rule 10b-5 fatally undermines any analogy to *Central Bank’s* argument that is based on the *absence* of aiding-and-abetting language.

D. Does Section 10(b) Prohibit Only False Representations and Omissions?

Certainly the scope of rule 10b-5 may not exceed the authority granted to the SEC by section 10(b).¹⁵² Many lower courts have read section 10(b) so narrowly as to conclude that there can be no fraud liability under section 10(b) or rule 10b-5 without misrepresentations, omissions, or classic market manipulation.¹⁵³ Scheme-liability opponents have, for example, quoted an isolated phrase from the *Central Bank* opinion where the Court stated that section 10(b) “prohibits only the making of a material misstatement (or omission) or the commission of a manipulative act.”¹⁵⁴ By noting, correctly, that the Supreme Court has repeatedly held that *manipulation* is a term of art referring to wash sales, matched orders, and the like,¹⁵⁵ these opponents

152. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 214 (1976); see also *SEC v. Zandford*, 535 U.S. 813, 816 n.1 (2002) (“The scope of Rule 10b-5 is coextensive with coverage of §10(b).”).

153. Many lower-court cases rejected scheme liability on these and similar grounds. See, e.g., *Stoneridge Inv. Partners, LLS v. Scientific-Atlanta, Inc. (In re Charter Commc’n, Inc.)*, 443 F.3d 987, 992 (8th Cir. 2006); *Filler v. Hanvit Bank*, 156 Fed. Appx. 413, 415–17 (2d Cir. 2005); *Damato v. Hermanson*, 153 F.3d 464, 471–72 (7th Cir. 1998); *Paracor Fin., Inc. v. Gen. Elec. Capital Corp.*, 96 F.3d 1151, 1160 (9th Cir. 1996); *In re Elan Corp. Sec. Litig.*, No. 02 Civ. 865 (RMB)(FM), 2004 U.S. Dist. LEXIS 9913, at *71–77 (S.D.N.Y. May 18, 2004); *In re Lake States Commodities, Inc.*, 936 F. Supp. 1461, 1471–72 (N.D. Ill. 1996).

Other pre-*Stoneridge* cases embraced some version of scheme liability. See, e.g., *Simpson v. AOL Time Warner Inc.*, 452 F.3d 1040, 1049 (9th Cir. 2006); *Steiner v. MedQuist, Inc.*, No. 04-5487 (JBS), 2006 U.S. Dist. LEXIS 71952, at *18–19 (D.N.J. Sept. 29, 2006); *In re Enron*, 236 F.R.D. 313, 316 (S.D. Tex. 2006); *In re Parmalat Sec. Litig.*, 376 F. Supp. 2d 472, 502–03 (S.D.N.Y. 2005); *Quaak v. Dexia, S.A.*, 357 F. Supp. 2d 330, 342 (D. Mass. 2005); *In re Global Crossing, Ltd. Sec. Litig.*, 322 F. Supp. 2d 319, 336–37 (S.D.N.Y. 2004); *In re Lernout & Hauspie Sec. Litig.*, 236 F. Supp. 2d 161, 173 (D. Mass. 2003).

154. 511 U.S. 164, 177 (1994).

155. *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 476–77 (1977); *Hochfelder*, 425 U.S. at 199 n.21.

have argued that there can be no such thing as scheme liability if the wrongdoing alleged does not involve false statements or omissions.¹⁵⁶

In ruling that fraudulent *conduct* is unpunished by section 10(b) unless it fits into the classic notion of market manipulation, courts adopting this view have attempted to wish subsections (a) and (c) right out of existence. However, an examination of relevant factors leads to the inescapable conclusion that subsections (a) and (c) are legitimate exercises of SEC authority, firmly grounded in the language of section 10(b), and that they were meant to, and do, cover deceitful *conduct* even if it does not involve misrepresentations, omissions, or classic market manipulation.

1. LANGUAGE OF THE STATUTE AND RULE

Oral or written misrepresentations are obviously not necessary to perpetrate a fraud.¹⁵⁷ Therefore, speaking publicly and/or making a misrepresentation have never been requirements of common-law fraud.¹⁵⁸ Long ago the Supreme Court noted, “The gist of the [deceit] action is fraudulently producing a false impression upon the mind of the other party; and, if this result is accomplished, it is unimportant whether the means of accomplishing it are words or acts of the defendant.”¹⁵⁹ Nor did other prominent section 10(b) antecedents, such

156. Grundfest, *supra* note 133, at 11.

157. *Sylvester v. Koehler*, 170 A. 811 (N.J. 1934) (“[F]raud may be committed by actions as well as by words.”). See generally Gary J. Aguirre, *The Enron Decision: Closing the Fraud-Free Zone on Errant Gatekeepers?*, 28 DEL. J. CORP. L. 447, 459 (2003) (noting that, if a fake man of the cloth positioned himself outside a church holding a collection box just before the service began and accepted donations with smiles but no comments, he would obviously be committing fraud, even though he did not speak).

158. W. PAGE KEETON ET AL., PROSSER AND KEETON ON TORTS 736 (5th ed. 1984) (“The representation which will serve as a basis for an action of deceit . . . usually consists, of course, of oral or written words; but it is not necessarily so limited. The exhibition of a document, turning back the odometer of an automobile offered for sale, drawing a check without funds, or a wide variety of other conduct calculated to convey a misleading impression under the circumstances of the case, may be sufficient. Merely by entering into some transactions at all, the defendant may reasonably be taken to represent that some things are true—as for example, that a bank which receives deposits is solvent, or that a stock certificate sold is a valid one, and that he has a permit to sell it. It is trite to say in such cases that ‘actions may speak louder than words.’”).

159. See, e.g., *Stewart v. Wyo. Cattle Rancho Co.*, 128 U.S. 383, 388 (1888); see also MELVILLE M. BIGELOW, THE LAW OF FRAUD AND THE PROCEDURE PERTAINING TO THE REDRESS THEREOF 378 (1877) (“[W]here a man has combined and conspired with others to cheat and defraud the plaintiff in the sale of certain property, by fraudulent concealments, and misrepresentations, and the fraud has been perpetrated accordingly, though by some other member or members of the company, he will be

as state blue-sky laws¹⁶⁰ or the mail-fraud statute,¹⁶¹ require misrepresentations or omissions. In 1934, law dictionaries plainly recognized that deceptive conduct could be nonverbal.¹⁶²

Indeed, the text of section 10(b) does not mention misrepresentations or omissions; rather, it speaks of “deceptive device[s] or contrivance[s],” which are identical to or synonymous with the terms used in rule 10b-5(a)—“devices,” “schemes,” and “artifices.”¹⁶³ While it is beyond cavil that section 10(b) punishes fraudulent misrepresentations, its language focuses more on devices and contrivances that do not necessarily involve false misrepresentations, although they may. Consistent with that language, the legislative history

liable, *even where he has not himself made any of the misrepresentations complained of.*”) (emphasis added).

160. New York’s Martin Act, for example, punishes several types of securities offenses that do not require misstatements. *See, e.g., People v. Napolitano*, 724 N.Y.S.2d 702, 705–08 (N.Y. App. Div. 2001) (punishing insider trading); *State v. McLeod*, No. 50942U, 2006 N.Y. Misc. LEXIS 1227 (N.Y. Sup. Ct. 2006) (punishing “spinning”); *see also SEC v. First Jersey Sec., Inc.*, 101 F.3d 1450, 1471–72 (2d Cir. 1996) (punishing excessive markups).

161. The scheme-liability language of section 10(b) was derived from the mail-fraud statute, and the jurisprudence of that statute makes it clear that no misrepresentation is required for conviction. *United States v. Brown*, 5 F. Supp. 81, 89 (S.D.N.Y. 1933) (“[A] fraudulent representation may be effected by conduct, by acts as well as by words . . .”).

Thus, defendants have been convicted in numerous cases where deeds rather than statements were the essence of the offense. *See United States v. Sancho*, 157 F.3d 918, 921 (2d Cir. 1998) (holding the defendant liable in a bribery case); *United States v. Woodward*, 149 F.3d 46, 55 (1st Cir. 1998) (noting that a scheme or artifice to defraud can consist of a public official’s biased decision making for personal gain that deprives taxpayers of honest services); *United States v. Coyle*, 943 F.2d 424, 427 (4th Cir. 1991) (holding the defendant’s manufacturing and distribution of devices to allow customers to receive cable-television programs without paying for them was a “scheme or artifice to defraud”); *United States v. George*, 477 F.2d 508, 513 (7th Cir. 1973) (describing a kickback scheme); *Epstein v. United States*, 174 F.2d 754, 763 (6th Cir. 1949) (indicating that use of the mail to induce corporations to buy goods at excessive prices from firms controlled by the defendants could constitute mail fraud, although evidence did not sustain convictions in this case); *Bradford v. United States*, 129 F.2d 274, 276 (5th Cir. 1942) (bribery); *Shushan v. United States*, 117 F.2d 110, 116 (5th Cir. 1941) (bribery); *United States v. Buckner*, 108 F.2d 921, 927 (2d Cir. 1940) (embezzlement).

162. *See, e.g.,* BLACK’S LAW DICTIONARY 529 (3d ed. 1933) (defining *deception* to include an “intentional misleading by falsehood spoke[n] or acted”) (emphasis added); BOUVIER’S LAW DICTIONARY 276 (1928) (noting, while defining *deceit*, that a “fraudulent misrepresentation or contrivance . . . need not be made in words”).

163. *See* Prentice, *supra* note 43 (citing several dictionaries).

of the 1934 Act *expressly* indicates an intent to stop “deceptive practices.”¹⁶⁴

More recently, in the PSLRA, Congress’s insertion of a system of proportionate liability into section 10(b) jurisprudence again expressly refers to persons who engage in “conduct with actual knowledge of the facts and circumstances that make the *conduct* of that covered person a violation of the securities laws.”¹⁶⁵

Given the definitions of *device* and *contrivance* discussed above, it is impossible to read section 10(b)’s language and then plausibly contend that deceptive actions are not covered. Rule 10b-5’s three subsections are disjunctive, so clearly the fact that a defendant does not make any statement or omission cannot deprive a plaintiff of relief under rule 10b-5(a) and/or (c).¹⁶⁶

Given this background, it is not surprising that section 10(b) jurisprudence has, over the years, firmly recognized liability in the absence of misrepresentations or omissions. Among the fraudulent schemes not involving misrepresentations that have been held to violate section 10(b) and rule 10b-5 are a customer’s ordering stock with no intention of paying for it,¹⁶⁷ brokers’ churning,¹⁶⁸ charging excessive markups,¹⁶⁹ and trading in unsuitable securities.¹⁷⁰

164. The Senate report stated that section 10(b) and other 1934 Act provisions were “aimed at those manipulative and deceptive *practices* which have been demonstrated to fulfill no useful function.” S. REP. NO. 792, at 6 (1934) (emphasis added). The report drew no distinctions between verbal and nonverbal conduct. It also noted that section 10(b) “authorizes the [SEC] by rules and regulations to prohibit or regulate the use of any other manipulative or deceptive *practices* which it finds detrimental to the interests of the investor.” *Id.* at 18 (emphasis added).

In many provisions of the 1933 and 1934 Acts, Congress defined *fraud* as the use of false or misleading statements. See Aguirre, *supra* note 157, at 500. Therefore, it can be argued that when, in section 10(b), Congress added the words “deceptive device or contrivance,” it must have been intending coverage to go beyond misrepresentations or omissions. The Supreme Court has noted that, when Congress intended to limit fraud liability to misstatements or omissions, “it knew how to do so and did so expressly.” *Touche Ross & Co. v. Redington*, 442 U.S. 560, 572 (1979).

165. 15 U.S.C. § 78u-4(f)(10)(A)(ii) (2006) (emphasis added).

166. *Cochran v. Channing Corp.*, 211 F. Supp. 239, 243 (S.D.N.Y. 1962) (“[O]ne who causes a reduction of dividend in order more cheaply to purchase the shares of a corporation is most certainly employing a device to defraud and is engaging in a course of business which operates as a fraud upon the seller of those securities.”).

167. *A.T. Brod & Co. v. Perlow*, 375 F.2d 393, 396–97 (2d Cir. 1967).

168. *Dzenits v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 494 F.2d 168, 171 (10th Cir. 1974); *Marshak v. Blyth Eastman Dillon & Co.*, 413 F. Supp. 377, 379–81 (N.D. Okla. 1975).

169. *In re Underhill Sec. Corp.*, 42 SEC Docket 689, 697 (Aug. 3, 1965).

170. *Cruse v. Equitable Sec. of N.Y., Inc.*, 678 F. Supp. 1023, 1031 (S.D.N.Y. 1987).

2. SUPREME COURT HOLDINGS

In numerous rulings, the Supreme Court has accepted Congress's clear desire that section 10(b) remedy fraudulent conduct as well as fraudulent statements and omissions, thereby accepting both implicitly and explicitly the validity of subsections (a) and (c) of rule 10b-5.

Until *Stoneridge*, the most relevant case in this connection was *SEC v. Zandford*.¹⁷¹ Although the key issue in *Zandford* was the breadth of the "in connection with" requirement of the statute,¹⁷² the Court strongly indicated the validity of scheme and course-of-business liability that would not require that defendants' names be on specific misleading statements, or that misrepresentations be made at all.¹⁷³ The Supreme Court observed that "neither the SEC nor this Court has ever held that there must be a misrepresentation about the value of a particular security in order to run afoul of [section 10(b)]."¹⁷⁴ Thus, the Court held a stock broker liable despite the fact that he had not made misrepresentations or committed market manipulation, holding that "each time respondent 'exercised his power of disposition [of his customer's securities] for his own benefit,' that conduct, 'without more,' was a fraud."¹⁷⁵ The Court plainly stated that defendant's "sales are properly viewed as a 'course of business' that operated as a fraud or deceit on a stockbroker's customer."¹⁷⁶

A clearer approval of scheme and course-of-business liability is hard to imagine. A stronger indication that section 10(b) or rule 10b-5 punishes fraudulent conduct, even if it does not involve misrepresentations, omissions or market manipulation would be difficult to conjure up. Furthermore, the *Zandford* holding was completely consistent with the language and holdings of multiple other Supreme Court cases.

In *United States v. O'Hagan*,¹⁷⁷ the Supreme Court reversed a United States Court of Appeals for the Eighth Circuit opinion that had ruled that "§ 10(b) covers *only* deceptive statements or omissions."¹⁷⁸

171. 535 U.S. 813 (2002).

172. *Id.* at 822 (rejecting a lower-court ruling that defendant could not be liable because he had made no affirmative misrepresentation).

173. See Andrew S. Gold, *Reassessing the Scope of Conduct Prohibited by Section 10(b) and the Elements of Rule 10b-5: Reflections on Securities Fraud and Secondary Actors*, 53 CATH. U. L. REV. 667, 669 (2004).

174. *Zandford*, 535 U.S. at 820.

175. *Id.* at 821 (quoting *United States v. Dunn*, 268 U.S. 121, 131 (1925)) (emphasis added).

176. *Id.*

177. 521 U.S. 642 (1997).

178. *Id.* at 664 (emphasis added).

By reinstating the conviction of a “misappropriator” in an insider-trading case, the Supreme Court held that misappropriation of material, nonpublic information in order to trade qualifies as a “deceptive device or contrivance,”¹⁷⁹ even in the absence of a misrepresentation or omission.

In *Affiliated Ute Citizens of Utah v. United States*,¹⁸⁰ the Court observed that “the second subparagraph of [Rule 10b-5] 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.*”¹⁸¹

In *Ernst & Ernst v. Hochfelder*,¹⁸² the Court stated that rule 10b-5 proscribes “any type of material misstatements or omissions, *and any course of conduct*, that has the effect of defrauding investors.”¹⁸³

In both *Santa Fe Industries, Inc. v. Green*¹⁸⁴ and *Schreiber v. Burlington Northern, Inc.*,¹⁸⁵ the Supreme Court stated that *deception* was a different concept than either *misrepresentation* or *nondisclosure*, indicating there can be fraud without either of them.¹⁸⁶ For example, in *Santa Fe Industries*, the Court stated the obvious: “Rule 10b-5 prohibits, *in addition to nondisclosure and misrepresentation*, any ‘artifice to defraud’ or any act ‘which operates or would operate as a fraud or deceit.’”¹⁸⁷

In *Bankers Life*, the Court noted that section 10(b) provides a cause of action for any plaintiff who “suffer[s] an injury as a result of deceptive *practices* touching its sale [or purchase] of securities.”¹⁸⁸

Even in *Central Bank*, the Supreme Court held that the language of section 10(b) “reaches all persons who engage, even indirectly, in a proscribed *activity*.”¹⁸⁹ The Court clearly noted, “In § 10(b), Congress

179. *Id.* at 653.

180. 406 U.S. 128 (1972).

181. *Id.* at 152–53 (emphasis added).

182. 425 U.S. 185, 212 (1976) (emphasis added).

183. *Id.*

184. 430 U.S. 462, 476 (1977) (“[T]he cases do not support the proposition, adopted by the Court of Appeals below and urged by respondents here, that a breach of fiduciary duty by majority stockholders, without any deception, misrepresentation, or nondisclosure, violates the statute and the Rule.”).

185. 472 U.S. 1, 12–13 (1985) (“[T]he actions of respondents were not manipulative. The amended complaint fails to allege . . . any misrepresentation, nondisclosure, or deception.”).

186. Aguirre, *supra* note 157, at 495–96.

187. 430 U.S. at 470.

188. *Superintendent of Ins. of N.Y. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 12–13 (1971) (emphasis added).

189. *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 176 (1994) (emphasis added).

prohibited manipulative or deceptive *acts* in connection with the purchase or sale of securities.”¹⁹⁰ Indeed, *Central Bank* referred repeatedly to deceptive acts, deceptive practices, and deceptive conduct as all being within the scope of the statute.¹⁹¹

Given all that precedent, it is not surprising that the *Stoneridge* majority had no choice but to give short shrift to the argument that section 10(b) punishes only misrepresentations, omissions, and market manipulation. Without so much as citing any precedent (although it had much from which to choose), the majority opinion observed bluntly, “Conduct itself can be deceptive.”¹⁹² It is cold comfort, perhaps, but the *Stoneridge* majority did get at least one issue right.

E. Lack of Guidance

Opponents of scheme liability have argued that it should not be recognized because to do so would require the courts to determine the scope of such liability “without any guidance from any provision of the Exchange Act or from any relevant legislative history,”¹⁹³ thereby requiring the Court to “legislate from the bench in the most obvious manner.”¹⁹⁴ This is inaccurate, as a little bit of historical reconstruction discloses.¹⁹⁵

The contention that “there is no statutory analogue for ‘scheme liability’”¹⁹⁶ ignores the fact that ample relevant guidance for what Congress must have intended in 1934 may be derived by tracing rule 10b-5’s scheme-to-defraud language back through section 17(a) of the 1933 Act,¹⁹⁷ to New York’s Martin Act,¹⁹⁸ and finally to the mail-fraud

190. *Id.* at 173 (emphasis added).

191. *Id. passim.*

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

193. Grundfest, *supra* note 133, at 3.

194. *Id.*

195. Professor Grundfest has claimed that recognition of scheme liability will “signal an entirely new and unanticipated jurisprudence of statutory construction.” *Id.* at 4. However, the issues presented by scheme liability require only the same analysis of statutory language, legislative history, statutory purpose, and common-law and statutory antecedents that have long been used in resolving similar questions about the scope and application of section 10(b). Grundfest provided no credible reason to conclude that scheme-liability issues are unique in any way.

196. *Id.* at 11.

197. See THOMAS L. HAZEN, *THE LAW OF SECURITIES REGULATION* 763 (3d ed. 1996) (“Promulgated in 1942, Rule 10b-5 is patterned directly upon section 17(a) of the 1933 Act . . .”).

198. *Aaron v. United States*, 446 U.S. 680, 700 n.18 (1980); see also *Legislation: The Securities Act of 1933*, *supra* note 77, at 1243 n.168 (noting that section 17(a) was “[p]atterned after the Martin Act of New York”).

statute,¹⁹⁹ which was originally enacted in 1872. By 1934, there were literally *decades* of court decisions construing the “scheme or artifice to defraud” language that was grafted into section 10(b) and rule 10b-5 from the mail-fraud statute and other provisions that had copied the language.

Originally codified as section 5480 of the Revised Statutes at Large,²⁰⁰ the mail-fraud statute criminalized “any scheme or artifice to defraud”²⁰¹ involving use of the mails. Congress must have had the mail-fraud statute in mind when it drafted section 17(a) of the 1933 Act, section 10(b) of the 1934 Act, and section 206 of the Investment Advisers Act of 1940, because virtually no other state or federal statute then existing (except New York’s Martin Act) used that language.²⁰²

Although the lower courts initially split between strict and generous interpretations of the statute,²⁰³ in 1895 the Supreme Court

199. *Beth Israel Med. Ctr. v. Smith*, 576 F. Supp. 1061, 1066 (S.D.N.Y. 1983) (noting that the Martin Act’s language is derived from the mail-fraud statute); *People v. First Meridian Planning Corp.*, 635 N.Y.S.2d 144, 148 (N.Y. 1995) (same); *People v. Taylor*, 758 N.Y.S.2d 634, 635 (N.Y. App. Div. 2003) (same).

On the off chance that the Martin Act’s scheme-to-defraud language did not come directly from the mail-fraud statute, it must have come from there indirectly, for existing state blue-sky laws had similar language (Minnesota and Virginia) and their statutes were *consciously* patterned after the mail-fraud provision. See ROBERT R. REED & LESTER H. WASHBURN, *BLUE SKY LAWS* at xi (1921). That same language then found its way into the Uniform Sale of Securities Act. HANDBOOK OF THE NATIONAL CONFERENCE OF COMMISSIONERS ON UNIFORM STATE LAWS AND PROCEEDINGS OF THE THIRTY-NINTH ANNUAL CONFERENCE 199 (1929).

200. Act of June 8, 1872, ch. 335, § 301, 17 Stat. 323 (codified as amended at 18 U.S.C. § 1341 (2006)).

201. See *In re Henry*, 123 U.S. 372, 373 (1887) (quoting the statute).

202. A January 13, 2009 LexisNexis search of the “Federal and State Cases, Combined” database, using “scheme w/3 artifice” for the dates 01/01/1800 to 01/01/1921 (the year the Martin Act borrowed that language) derives 190 hits, more than 150 of which relate to the mail-fraud statute; no other statute is prominent.

Parallels between section 10(b) and the mail-fraud statute have long been noted. See, e.g., *United States v. O’Hagan*, 521 U.S. 642, 648 (1997) (noting that both section 10(b) and the mail-fraud statute require deception; neither remedies breach of fiduciary duty); *SEC v. Rocklage*, 470 F.3d 1, 13 (1st Cir. 2006) (same); *United States v. Autuori*, No. 3:96-cr-161(EBB), 1998 U.S. Dist. LEXIS 22782, at *76 n.10 (D. Conn. Aug. 27, 1998) (noting the difficulties of construing the mail-fraud statute and section 10(b) differently in cases involving securities); *Willcutts v. Jefferson Trust & Sav. Bank of Peoria*, No. 84-2006, 1982 U.S. Dist. LEXIS 17639, at *3 (C.D. Ill. Apr. 21, 1982) (noting the similarity of the mail-fraud and securities-fraud statutes in remedying deceptive acts, and punishing acts that also constitute common-law fraud).

The Uniform Sale of Securities Act also contained such language, which had probably been derived from some state blue-sky laws that were modeled on the mail-fraud statute. See *supra* note 199. It had not been adopted by any states at the time the 1934 Act was passed.

203. See Jed S. Rakoff, *The Federal Mail Fraud Statute (Part I)*, 18 DUQUESNE L. REV. 771, 790–801 (1980) (describing the split). The only legislative history for the

embraced a capacious view in *Durland v. United States*,²⁰⁴ emphasizing that the language of the mail-fraud statute referred to “[a]ny scheme or artifice to defraud,”²⁰⁵ and that the law’s purpose was to “protect[] the public against all . . . intentional efforts to despoil.”²⁰⁶ Amendments to the statute in 1889 and 1909 signaled congressional approval of a generous interpretation²⁰⁷ that has been reinforced with numerous broadening amendments over time.²⁰⁸ Thus, well before 1934, the statute was being construed as broadly as it is today,²⁰⁹ which is to say very broadly.²¹⁰ By 1934, the mail-fraud statute’s scheme language had been applied to a broad range of deceits and other wrongs, many of which did not involve misrepresentations or omissions, such as blackmail.²¹¹

One of those cases sported a factual scenario very similar to that in *Stoneridge*, wherein *A* knowingly participated in *B*’s defrauding of *C*. In *United States v. Jones*,²¹² an 1882 case, the defendant sold counterfeit currency to a buyer who knew that it was counterfeit. Both seller and buyer intended that the buyer would pass the counterfeit bills off as genuine to unsuspecting third parties. As in *Stoneridge*, the defendant was to have no contact with the victims of the fraud. The defendant made no misrepresentations to anyone. Nonetheless, because “the necessary result” of the transaction between the defendant and the buyer would be the defrauding of a third person, the defendant was convicted of mail fraud.²¹³

initial version of the mail-fraud statute is a statement by a sponsor indicating a desire for broad antifraud coverage as he spoke of a need “to prevent the frauds . . . by thieves, forgers, and rapsallions generally, for the purpose of deceiving and fleecing the innocent people in the country.” CONG. GLOBE, 41st Cong., 3d Sess. 35 (1870) (statement of Rep. Farnsworth).

204. 161 U.S. 306 (1896).

205. *Id.* at 313 (emphasis added).

206. *Id.* at 314 (holding that the law punished deceits that might not have been considered fraudulent under the common law).

207. Rakoff, *supra* note 203, at 806 (“[B]oth Congress and the Supreme Court ultimately opted for the broad constructionist approach.”); *id.* at 794 (noting that the 1909 amendment undercut any support for a narrow application of the statute).

208. *See id.* at 772 (describing five of the expansions).

209. *Id.* at 822 (noting that the substantive scope of the statute was, by the end of the 1800s, being construed by most courts virtually as broadly as it is today).

210. *Id.* at 771 (noting that the “adaptability” of the statute makes it a prosecutor’s best friend).

211. *See, e.g., United States v. Horman*, 118 F. 780, 781–82 (S.D. Ohio 1901) (finding extortionate scheme actionable under the mail-fraud statute).

212. 10 F. 469 (S.D.N.Y. 1882).

213. *Id.* at 470.

Courts in mail-fraud cases have long recognized that fraud may be committed by deeds and acts, rather than by representations.²¹⁴ Thus, the statute has been construed to punish not only blackmail and counterfeiting, but also bribery²¹⁵ and election fraud.²¹⁶ Because contracts and transactions that can be used for a legitimate purpose may provide the predicate for a mail-fraud conviction, purchasing goods via the mails with no intention of paying for them also violates the statute.²¹⁷

The mail-fraud statute thus provides reliable guidance regarding what Congress and the SEC must have had in mind in 1934 and 1942 when they used the deceptive-device and scheme-to-defraud language of section 10(b) and rule 10b-5.²¹⁸ Had the Supreme Court thought to consult this long-established body of precedent, it might well have reached different conclusions in *Stoneridge*.

F. Existence of SEC Authority

Scheme-liability opponents have also suggested that the issue in *Stoneridge* was “whether the text of Section 10(b) can be interpreted to support additional and potentially crippling financial exposure through implied private rights of action based on a theory of ‘scheme liability’ against persons who are already subject to the [SEC]’s enforcement authority.”²¹⁹ Broadly speaking, this should have been no question at all, of course. The existence of a private right of action for defrauded

214. *United States v. Brown*, 5 F. Supp. 81, 89 (S.D.N.Y. 1933) (“[A] fraudulent representation may be effected by conduct, by acts as well as by words.”); see also *United States v. Sancho*, 157 F.3d 918, 921 (2d Cir. 1998) (holding the defendant liable in a bribery case); *United States v. Woodward*, 149 F.3d 46, 55 (1st Cir. 1998) (noting that a scheme or artifice to defraud can consist of a public official’s biased decision making for personal gain that deprives taxpayers of honest services); *United States v. Coyle*, 943 F.2d 424, 427 (4th Cir. 1991) (holding defendant’s manufacture and distribution of devices to allow customers to receive cable-television programs without paying for them “was a scheme or artifice to defraud”).

215. *United States v. Faser*, 303 F. Supp. 380 (E.D. La. 1969).

216. *United States v. States*, 488 F.2d 761, 765 (8th Cir. 1973).

217. *Durland v. United States*, 161 U.S. 306, 313 (1896); *United States v. Merritt*, 205 F.3d 1335 (4th Cir. 2000); *Schauble v. United States*, 40 F.2d 363, 364 (8th Cir. 1930); *Tucker v. United States*, 224 F. 833, 836 (6th Cir. 1915); *Miller v. United States*, 133 F. 337, 342 (8th Cir. 1904); *United States v. Seehausen*, No. 00C4829, 2000 WL 1809993, at *1 (N.D. Ill. Dec. 11, 2000).

218. Although the Supreme Court did not recognize this fact in *Stoneridge*, nothing in the long-standing jurisprudence of the mail-fraud statute gives any hint that Congress in 1934 could have intended to exclude from coverage deceitful acts of the type engaged in by Enron’s investment banks and Charter Communications’s vendors. The law was clearly to the contrary, as the *Jones* case indicates.

219. Grundfest, *supra* note 133, at 4.

investors under section 10(b) or rule 10b-5 is beyond peradventure, and the existence of SEC enforcement authority should be utterly irrelevant to interpreting the scope of the language of the statute and rule.

As noted earlier, Congress expressly lauded the section 10(b) private right of action when it passed the PSLRA, characterizing it as “an *indispensable tool* with which defrauded investors can recover their losses without having to rely upon government action [that] promote[s] public and global confidence in our capital markets and help[s] deter wrongdoing.”²²⁰ This conclusion reinforced repeated Supreme Court observations that the private right to sue is an “essential supplement” to SEC action.²²¹ If the private right to sue is an essential supplement to SEC action, the existence of SEC authority cannot be argued to mitigate against the existence of scheme liability.

In *Central Bank*, the Court held that policy considerations were essentially irrelevant to an interpretation of the scope of section 10(b).²²² Shockingly, the *Stoneridge* majority threw off this self-imposed restraint when it cited the existence of SEC authority as a reason to construe section 10(b) narrowly.²²³ However, neither the *Stoneridge* majority nor any other scheme-liability opponent has been so temerarious as to argue that the presence of SEC authority to punish violations of subsection (b) of rule 10b-5 means that investors cannot sue at all to remedy injuries they have sustained because of such violations. No plausible rationale has been suggested for distinguishing between subsection (b) and subsections (a) and (c) in this regard. Therefore, while section 10(b) will likely be construed narrowly in the future, cases based upon subsections (a) and (c) of rule 10b-5 will have to be accorded the same general license as cases brought pursuant to subsection (b).

220. H.R. REP. No. 104-369, at 31 (1995) (Conf. Rep.) (emphasis added).

221. *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499, 2504 (2007); *Dura Pharm., Inc. v. Broudo*, 544 U.S. 336, 345 (2005); *Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299, 310 (1985); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 730 (1975); *J.I. Case Co. v. Borak*, 377 U.S. 426, 432 (1964).

222. *See Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 188 (1994) (“Policy considerations cannot override our interpretation of the text and structure of the Act, except to the extent that they may help to show that adherence to the text and structure would lead to a result ‘so bizarre’ that Congress could not have intended it.”).

223. The Court also cited various supposed adverse impacts of recognizing a private right to sue which constituted not only pure policy considerations, but were characterized in a completely one-sided manner. *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 128 S. Ct. 761, 770–73 (2008).

G. Ensnaring Commercial Transactions

Perhaps the most important argument made by lower courts rejecting application of subsections (a) and (c) to the Nigerian-barge transaction and the round-tripping scams is captured in this disingenuous statement by the United States Court of Appeals for the Eighth Circuit in the *Stoneridge* case:

To impose liability for securities fraud on one party to an arm's length business transaction in goods or services other than securities because that party knew or should have known that the other party would use the transaction to mislead investors in its stock would introduce potentially far-reaching duties and uncertainties for those engaged in day-to-day business dealings. Decisions of this magnitude should be made by Congress.²²⁴

The decision to modify the term *business transactions* by use of the adjective *arm's length* is an interesting one. The term connotes a legitimate, hard-bargained transaction of the type that, in a free-enterprise economy, typically allocates goods and services in an efficient manner. However, other, more accurate adjectives to describe these transactions include *bogus*, *sham*, *fraudulent*, and *deceptive*. Therefore, Congress already settled this issue in 1934 when it enacted, in sweeping terms, an antifraud provision that gave the SEC very broad authority to prohibit and punish transactions of this very type.

That a transaction is facially legitimate is irrelevant if it is being used to commit a fraud, as courts have long observed.²²⁵ The Supreme Court itself has noted that Congress, in passing the 1934 Act, stated that because fraudulent practices “‘constantly vary and where practices legitimate for some purposes may be turned to illegitimate and fraudulent means, broad discretionary powers’ in the regulatory agency ‘have been found practically essential.’”²²⁶ It was precisely because facially legitimate transactions can be put to fraudulent purposes, as happened in *Enron* and *Charter Communications*, that Congress had sufficient foresight to give the SEC broad authority in rule 10b-5.

224. *Stoneridge Invest. Partners, LLS v. Scientific-Atlanta, Inc. (In re Charter Commc'ns, Inc. Sec. Litig.)*, 443 F.3d 987, 992–93 (8th Cir. 2006).

225. *SEC v. Durgarian*, 477 F. Supp. 2d 342, 352 (D. Mass. 2007) (holding that “as of” trades and accounting adjustments made by a mutual fund were not, of themselves, illegal, but violated section 10(b) and rule 10b-5(a) when executed for a deceptive purpose).

226. *Superintendent of Ins. of N.Y. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 12 (1971) (quoting H.R. REP. NO. 73-1383, at 7 (1934)).

Honest firms engaged in true arm's-length transactions have little to fear from the cases that refuse to read subsections (a) and (c) totally off the pages of the Code of Federal Regulations. Recognizing the meaning of these subsections does not introduce "potentially far-reaching duties." It simply informs companies that they should not engage in sham transactions that have as their entire purpose to defraud investors, even if those investors happen to be buying another company's stock. These rulings introduce no "uncertainties" that are not typical of every tort-liability rule. All impositions of liability occur in settings where not all future applications can be precisely foreseen. Every tort defendant in every tort case in history has wanted to argue that applying the rule to his or her unique set of facts would create far-reaching duties and uncertainties.

The Supreme Court explicitly rejected this type of argument in *The Wharf (Holdings) Ltd. v. United International Holdings, Inc.*²²⁷ Plaintiff buyer sued defendant seller on grounds that the seller had sold a security in the form of an option while never intending to honor the option. Defendant argued that to allow the suit would convert every breach of contract involving a security into a section 10(b) or rule 10b-5 claim. The Supreme Court flatly rejected that argument, noting that defendants need not worry about a legitimate transaction being converted into a lawsuit for fraud because plaintiffs cannot recover without establishing the defendant's scienter.²²⁸ The Court also rejected a similar argument in *Zandford*.²²⁹

Any worry that section 10(b) litigation will ensnare all of an issuer's commercial transactions simply ignores both the scienter requirement and the in-connection-with requirement, which has as its primary purpose ensuring that regular commercial transactions unconnected to securities fraud will not be so ensnared.²³⁰

Enactment of section 11 of the 1933 Act led to predictions that "grass would grow on Wall Street" due to its potential for *in terrorem* liability.²³¹ Section 11 imposes strict liability upon issuers and

227. 532 U.S. 588 (2001).

228. *Id.* at 596-97.

229. *SEC v. Zandford*, 525 U.S. 813, 823 (2002).

230. The primary purpose of the in-connection-with requirement is to ensure that not every common-law fraud that just happens to involve securities is brought within the scope of the statute. *Id.* at 820.

231. DAVID L. RATNER, *SECURITIES REGULATION IN A NUTSHELL* § 11 (8th ed. 2005). See generally JOEL SELIGMAN, *THE TRANSFORMATION OF WALL STREET* 79 (rev. ed., N.E. Univ. Press 1995) (1982) (detailing lobbying efforts by business to overturn or soften the legislation). Wall Street firms made the same hysterical "[g]rass will grow" claims when the SEC forced the New York Stock Exchange to unfix commissions. See Andrew Klein, *Celebrating Thirty Years of Market Regulation: Panel Discussion*, 9 *FORDHAM J. CORP. & FIN. L.* 301, 311 (2004).

negligence-based liability upon other defendants,²³² yet this predicted disaster went unrealized.²³³ Wall Street was still paved and making record profits before it suffered the massive, self-inflicted wound of the sub-prime-mortgage scandal.²³⁴

For all these reasons, it is disheartening that the *Stoneridge* majority accepted the notion that section 10(b) litigation should be narrowly channeled in order to avoid applying securities laws to “the realm of ordinary business operations.”²³⁵ However, nowhere in *Stoneridge* did the Court suggest that scheme liability should not be recognized. The holding was simply that it must be narrowly channeled like other forms of section 10(b) or rule 10b-5 liability.

H. Legislative Action and Inaction

Scheme-liability opponents have argued against recognition of scheme liability on the basis of several congressional actions and inactions. Most importantly, it has been pointed out that in 1995 when it enacted the PSLRA, Congress failed to reinstate the aiding-and-abetting cause of action for private lawsuits that *Central Bank* had eliminated.²³⁶ Of course, Congress also failed to narrow the scope of primary liability, eliminate the scheme-liability language from rule 10b-5, or otherwise amend section 10(b) or rule 10b-5. Given all the things that Congress did *not* do, its legislative silence is, of course, a “poor beacon to follow in discerning the proper statutory route.”²³⁷ Legislative inaction is a “weak reed” upon which to base any conclusions about legislative intent.²³⁸ As the Supreme Court has noted, “Congressional inaction frequently betokens unawareness,

232. See Joseph A. Grundfest, *Disimplying Private Rights of Action Under the Federal Securities Laws: The Commission's Authority*, 107 HARV. L. REV. 961, 1004 (1994) (noting the strict liability nature of section 11 for issuers).

233. The first major lawsuit under section 11 was not brought until thirty years after enactment of the statute. See *Escott v. BarChris Constr. Co.*, 283 F. Supp. 643, 652 (S.D.N.Y. 1968).

234. David Wighton, *Merrill Has Its 'Most Successful Year,'* FIN. TIMES (London), Jan. 19, 2007, at 24 (noting that Merrill Lynch “joined Wall Street rivals by reporting record earnings” for 2006).

235. *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 128 S. Ct. 761, 770 (2008).

236. See Grundfest, *supra* note 71, at 5–6.

237. *Zuber v. Allen*, 396 U.S. 168, 185 (1969).

238. *Hahn v. Or. Physicians' Serv.*, 508 F. Supp. 970, 976 (D. Or. 1981) (“Legislative inaction is a weak reed upon which to lean in determining legislative intent.”); see also *Unified Sch. Dist. No. 501 v. Baker*, 6 P.3d 848, 853 (Kan. 2000) (noting that legislative intent should be observed with a “gimlet eye,” for it “is not necessarily indicative of legislative intent”).

preoccupation, or paralysis.”²³⁹ In other words, “a failure to pass legislation is so equivocal as to be meaningless.”²⁴⁰

It is true that the Congress that enacted the PSLRA in 1995 was concerned with frivolous litigation. But it is also true that the Congress that passed Sarbanes-Oxley in 2002 was most concerned with inadequate investor protection, so it lengthened the statute of limitations for the section 10(b) and rule 10b-5 causes of action.²⁴¹ In any event, the key question should be, as the Court has pointed out more than once, what would a Congress in 1934 that wished to create a section 10(b) right to sue have intended?²⁴² This is especially true because neither the PLSRA, SOX, nor any other congressional action taken since 1934 has purported to directly address the validity of scheme liability.

It is claimed that the text of section 20(e) deals a fatal blow to scheme liability because it grants the SEC authority to take action against persons who “knowingly provide substantial assistance to another person in violation of a provision of this title.”²⁴³ The argument is that *any* person who satisfies *any* definition of scheme liability is “by definition providing substantial assistance to another person in violation of the Act,” making them an aider and abettor who, the Supreme Court held in *Central Bank*, cannot be sued by private parties for damages.²⁴⁴ However, this cannot be what *Central Bank* meant. A Supreme Court decision cannot simply obliterate the clear language of a valid agency rule issued pursuant to a broad congressional grant of authority.

Moreover, it is not true that any person satisfying any plausible definition of scheme liability is by definition providing substantial assistance to another person in violation of the 1934 Act. For example, a *single person* working alone can perpetrate a fraudulent scheme.²⁴⁵ In

239. *Zuber*, 396 U.S. at 185 n.21; see also HENRY M. HART, JR. & ALBERT M. SACKS, *THE LEGAL PROCESS: BASIC PROBLEMS IN THE MAKING AND APPLICATION OF LAW* 1359 (1994) (listing many reasons why congressional silence is inscrutable); WILLIAM D. POPKIN, *MATERIALS ON LEGISLATION: POLITICAL LANGUAGE AND THE POLITICAL PROCESS* 540–41 (2d ed. 1997) (similar).

240. *Sorenson v. Jarvis*, 119 Wis. 2d 627, 635, 350 N.W.2d 108, 112 (1984).

241. See Corporate and Criminal Fraud Accountability Act of 2002, Pub. L. No. 107-204, § 804, 116 Stat. 800, 801 (amending 28 U.S.C. § 1658 (2000)).

242. See *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 173 (1994); *Musick, Peeler & Garrett v. Employers Ins. of Wausau*, 508 U.S. 286, 294 (1993).

243. Grundfest, *supra* note 133, at 10 (quoting 15 U.S.C. § 78t(e)).

244. *Id.*

245. One (or more) person(s) may devise and carry out a scheme to defraud. *Isaacs v. United States*, 301 F.2d 706, 725 (8th Cir. 1962); *Reuben v. United States*, 86 F.2d 464, 469 (7th Cir. 1936); *Belden v. United States*, 223 F. 726, 730 (9th Cir. 1915).

such a situation, no one is providing or receiving substantial assistance in committing a fraud. No plausible interpretation of *Central Bank* or *Stoneridge* could eliminate scheme liability in that setting.

Furthermore, this argument would automatically exonerate *all* primary violators under section 10(b) even under the lower courts' restrictive definitions. Under this logic, because all primary violators in any situation where there is more than one defendant automatically provide substantial assistance to the other defendants, then all primary violators are aiders and abettors and no private actions can be brought against them. In other words, there can no longer be *any* private suits under section 10(b) or rule 10b-5, even for misrepresentation or manipulation, if more than one actor was involved in the fraud. It is inconceivable that Congress intended that result.

Ultimately, it must be reemphasized that in enacting the PSLRA and SOX, Congress did not purport to invalidate (or even to address) scheme liability. Scheme-liability opponents are not so bold as to argue that section 10(b) or rule 10b-5 are invalid. The language of section 10(b) clearly authorizes the SEC to issue rules such as section 10b-5 and the SEC has used that authority to create scheme liability. Rather, opponents cite a statutory change in which Congress did not even address scheme liability to conclude that the clear language of section 10(b) and rule 10b-5 has been overruled without being touched. This is not persuasive.

What Congress *did* do in section 20(e) was broadly define whom the SEC could punish as aiders and abettors. Congress deemed this necessary because after *Central Bank* it was unclear whether the Court's decision to eliminate a separate aiding-and-abetting cause of action, rendered in the context of a private suit for damages, extended to SEC actions.²⁴⁶ Congress enacted section 20(e) to ensure that it did not. It is clear that Congress enacted section 20(e) to *strengthen* investor protection, not to weaken it. In enacting section 20(e), Congress "emphatically repudiate[ed]" any potential extension of *Central Bank* to SEC aiding-and-abetting actions.²⁴⁷ It is simply not persuasive to take a proinvestor legislative action like section 20(e) and attempt to interpret it in a way that harms investors, such as by

246. *Central Bank*, 511 U.S. at 195; see Hillary A. Sale, *Banks: The Forgotten(?) Partners in Fraud*, 73 U. CIN. L. REV. 139, 158 (2004) ("[*Central Bank*] did not make clear whether the Court was eliminating the [aiding-and-abetting] cause of action for the SEC or just for private plaintiffs.").

247. *SEC v. Fehn*, 97 F.3d 1276, 1287 (9th Cir. 1996) ("Congress responded rapidly and resoundingly to the Supreme Court's elimination of private actions against aiders and abettors of securities law violations . . . [by] flatly barr[ing] the judicial extension of *Central Bank* to impede SEC enforcement actions . . .").

2009:351

Scheme Liability

393

eliminating scheme liability, especially because section 20(e) does not directly address that issue.

Congress, of course, can invalidate an agency's rules any time it wishes to do so,²⁴⁸ and it often does.²⁴⁹ But only clear Congressional action justifies overruling an agency's regulation,²⁵⁰ and no Congress since 1934 has even addressed scheme liability, let alone clearly overruled it. Never has Congress suggested that the language of rule 10b-5 is invalid or unacceptable. As noted earlier, the language of rule 10b-5 was taken directly from two Congressional provisions, so its presumptive validity is formidable.

Despite the many weaknesses in this argument, the *Stoneridge* majority embraced it,²⁵¹ again not for the purpose of eliminating scheme liability, but for narrowly channeling all forms of section 10(b) and rule 10b-5 litigation. As before, nothing in this argument justifies treating subsections (a) and (c) of rule 10b-5 in a different manner than subsection (b).

III. ANALYZING *STONERIDGE* TO DETERMINE WHAT IS POSSIBLE

By refusing to limit *Central Bank* to its facts, the *Stoneridge* majority revised approximately four hundred years of fraud law by creating (or, perhaps, reaffirming *Central Bank's* creation of) an artificial dichotomy between primary and secondary liability. The majority opinion *may* also have rewritten a couple of hundred years' worth of fraud jurisprudence regarding the reliance element by arguably holding that those who knowingly and actively participate in a fraud may avoid liability by simply staying in the shadows. Given that a majority faction of the Court is willing to completely rewrite basic concepts of fraud jurisprudence without any grounding in the language, legislative history, or policy underpinnings of section 10(b), it is difficult to project what might come next other than that the future likely bodes ill for investors. Nonetheless, this Part offers some tentative suggestions about the future course of section 10(b)

248. Cindy G. Buys & William Isasi, *An "Authoritative" Statement of Administrative Action: A Useful Political Invention or a Violation of the Separation of Powers Doctrine?*, 7 N.Y.U. J. LEGIS. & PUB. POL'Y 73, 92 (2003).

249. See Sidney A. Shapiro, *Scientific Issues and the Function of Hearing Procedures: Evaluating the FDA's Public Board of Inquiry*, 1986 DUKE L.J. 288, 307 (giving an example of Congress invalidating an FDA regulation).

250. See, e.g., *Lepe-Guitron v. INS*, 16 F.3d 1021, 1024 (9th Cir. 1994); *Castillo-Felix v. INS*, 601 F.2d 459, 465 n.16 (9th Cir. 1979); *Baur v. Mathews*, 578 F.2d 228, 233 (9th Cir. 1978).

251. *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 128 S. Ct. 761, 771-72 (2008).

jurisprudence. In so doing, it takes note of post-*Stoneridge* lower-court rulings decided before mid-October 2008.

A. Some Projections

1. SCHEME LIABILITY LIVES!

For all the reasons stated in Parts I and II of this Paper, scheme liability under subsection (a) of rule 10b-5 and course-of-business liability under subsection (c) remain valid bases for liability. Congress authorized the SEC to issue antifraud rules. The SEC did so. Nothing in *Stoneridge* challenged the validity of the grant of authority, or of its exercise. Although the Court did not unambiguously resolve the question of the validity of scheme liability, the majority opinion rejected the most direct assault upon that cause of action by recognizing the obvious fact that actions can be fraudulent.²⁵² That simple conclusion swept away most of scheme-liability opponents' most vigorous objections. Furthermore, no language anywhere in the majority opinion suggested that subsections (a) and (c) of rule 10b-5 are not every bit as valid as subsection (b). Nothing in the language or legislative history of section 10(b) justifies allowing suit under subsection (b), but not under (a) and (c), and the *Stoneridge* majority did not pretend that there is. In other words, there is no reason to conclude from the *Stoneridge* decision that litigation under subsections (a) and (c) of rule 10b-5 will not be treated the same as litigation under subsection (b), although that treatment will be oppugnant and stinting.

The lower courts agree. No post-*Stoneridge* lower court has held that scheme liability was abolished by the Supreme Court. Rather, several such courts have recognized scheme liability's continued existence by struggling with demarking its post-*Stoneridge* parameters,²⁵³ as does most of the rest of this Paper.

It seems clear that when the defendant is a primary actor upon whose actions plaintiffs relied, there will continue to be scheme liability in the post-*Stoneridge* era. As an example, if *A* contracts to buy *B*'s securities, but never intends to pay for them, *A* will be liable for scheming to defraud *B*. *A* is not only actively involved in the scheme, *A* is the sole wrongdoer. Clearly *A* is primarily liable. *B* has dealt

252. *Id.* at 769.

253. *See, e.g., SEC v. Simpson Capital Mgmt., Inc.*, No. 07 Civ. 6072 (JGK), 2008 U.S. Dist. LEXIS 67054, at *29 (S.D.N.Y. Sept. 3, 2008); *In re Able Labs. Sec. Litig.*, No. 05-2681 (JAG), 2008 U.S. Dist. LEXIS 23538, at *67 (D.N.J. Mar. 24, 2008); *In re DVI Inc. Sec. Litig.*, 249 F.R.D. 196, 217-18 (E.D. Pa. 2008); *In re Nat'l Century Fin. Enters., Inc. Fin. Inv. Litig.*, 553 F. Supp. 2d 902, 908-10 (S.D. Ohio 2008); *Burnett v. Rowzee*, 561 F. Supp. 2d 1120 (C.D. Cal. 2008).

2009:351

Scheme Liability

395

directly with *A*, so the reliance element is met as well. Such a scheme to defraud creates criminal scheme liability under the mail-fraud statute,²⁵⁴ and has traditionally created liability under section 10(b).²⁵⁵ It should continue to do so, and probably will. For example, the court in *Burnett v. Rowzee*²⁵⁶ held that a “pitch man” in a Ponzi scheme was liable when he acted deceptively and had “direct contact” with the plaintiff investors.²⁵⁷

But what about collateral parties?

2. COLLATERAL PARTIES REMAIN (LIMITEDLY) LIABLE

Nothing in *Stoneridge* altered *Central Bank*'s observation that third parties such as lawyers, accountants, and banks remain potentially liable under section 10(b).²⁵⁸ At the same time, nothing in *Stoneridge* amended *Central Bank*'s condition for this liability, which is that the defendants must themselves “employ[] a manipulative device [or, presumably, scheme] or make[] a material misstatement (or omission) on which a purchaser or seller of securities relies.”²⁵⁹

B. Some Questions

1. WHAT IS THE SCOPE OF PRIMARY LIABILITY?

Rather than limit *Central Bank* to its facts, the *Stoneridge* majority embraced *Central Bank*'s baseless creation of a false distinction between primary and secondary liability in which secondary wrongdoers are exonerated from liability.²⁶⁰ After *Stoneridge*, a defendant will be liable only if the plaintiff establishes “(1) a material misrepresentation or omission *by the defendant*; (2) scienter; (3) a connection between the misrepresentation or omission and the purchase

254. See *supra* text accompanying note 92.

255. See *supra* notes 94–98 and accompanying text.

256. 561 F. Supp. 2d 1120.

257. *Burnett*, 561 F. Supp. 2d at 1123, 1128, 1130 (holding that an alleged “pitch man” in a Ponzi scheme was potentially liable for engaging in misleading transactions (paying handsome returns to earlier investors out of the funds supplied by later investors in order to induce those earlier investors to put more money into a second scheme) with plaintiff investors).

258. See *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 191 (1994).

259. *Id.*

260. *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 128 S. Ct. 761, 771 (2008).

or sale of a security; (4) reliance upon the misrepresentation or omission; (5) economic loss; and (6) loss causation.”²⁶¹

Regarding the first element, what does “by the defendant” mean? A verb seems to be missing. Is it *created* by the defendant? *Authored* by the defendant? *Published* by the defendant? *Ordered* by the defendant? *Caused* by the defendant? The usual term, and the one contained in subsection (b) of rule 10b-5, is “made” by the defendant. What must a plaintiff prove to establish that a misrepresentation or omission was *made* by the defendant?²⁶²

a. What to make of “make”

Assume that *A* conceives of a fraudulent scheme that turns on issuance of a false statement. *A* summarizes the essence of the statement for *B*, who carefully drafts the false statement for publication. *C* has authority over both *A* and *B* and, after hearing their arguments for committing the fraud and carefully reading the false statement, orders its issuance in *D*'s name. Neither *A*, nor *B*, nor *C* have their names on the false statement as it is published, but under any common sense definition, *A*, *B*, and *C* have all made this statement.

A made the statement in that he conceived and created its essence. Among common definitions of *make* are to “frame or formulate in the mind” and to “create.”²⁶³

B made the statement in that he drafted its wording. Among the common definitions of the verb *make* are “to prepare,” “to cause to exist,” to “compose,” and “to bring into being.”²⁶⁴

C made the statement by ordering its publication. Other common definitions of *make* include “to cause to happen” and “to carry out.”²⁶⁵

From roughly 1613²⁶⁶ until today at common law, and from 1934 to 1994 in section 10(b) jurisprudence, aiding or aiding and abetting fraud justified imposition of liability upon joint tortfeasors, as did acting in concert, encouraging, commanding, countenancing, advising, counseling, directing, joining in, procuring, approving, and other forms of knowing participation.²⁶⁷ It is one thing to read *Central Bank* and *Stoneridge* as saying that encouraging, acting in concert, approving,

261. *Id.* at 768 (emphasis added).

262. Or that a deceitful scheme was “employed” by the defendant or a course of business operating as a fraud was “engaged in” by the defendant?

263. WEBSTER'S NEW COLLEGIATE DICTIONARY 694 (1973).

264. *Id.*

265. *Id.*; see also *United States v. Giles*, 300 U.S. 41, 48 (1937) (defining *make* to mean “to cause to exist, appear or occur”).

266. *Heydon's Case*, 77 Eng. Rep. 1150 (1613).

267. Prentice, *supra* note 43, at 622–43.

joining in, and aiding and abetting are no longer sufficient to constitute primary liability.²⁶⁸ But, it is quite another matter to interpret *Central Bank* and *Stoneridge* as saying that making a false statement or omission by creating them, authoring them, or ordering their publication does not constitute an act of primary liability. Nothing in the facts of either case justifies that conclusion, for neither case involved a defendant hiding in the shadows while making a statement seen by investors.

When speaking of schemes to defraud, the verb used in rule 10b-5(a) is *employ*. Among the most common definitions of *employ* is “to make use of.”²⁶⁹ Because a fraudster can put a scheme to defraud to use without being identified with it (indeed, avoiding such a known connection would typically be preferred by the fraudster), there would seem to be no reason why *to employ* would require that defendants be identified with the fraudulent actions at the time they are undertaken.

b. “Directly or indirectly”

In the preceding hypothetical, all three parties made a false statement if any reasonable meaning of the word is applied. Any narrower view constitutes an indefensibly crabbed interpretation of the statute and rule,²⁷⁰ especially because it ignores the simple fact that both section 10(b) and rule 10b-5 punish those who employ devices or make misrepresentations “directly or indirectly.” The obvious way to commit fraud directly is to issue a statement in one’s own name: “If [as both statute and rule demand] others are to be liable for indirectly committing fraud, then liability must extend beyond the speakers themselves.”²⁷¹

268. Although it is inconsistent with four hundred years of previous fraud jurisprudence, many lower courts held post-*Central Bank* that substantial participation in the form of reviewing and approving documents that contain false statements, *In re Kendall Square Research Corp. Sec. Litig.*, 868 F. Supp. 26, 28 (D. Mass. 1994), or in advising and guiding clients in the making of false statements, *Vosgerichian v. Commodore Int’l*, 862 F. Supp. 1371, 1378 (E.D. Pa. 1994), were not actionable because the defendant did not *make* the material misrepresentation or omission.

269. WEBSTER’S NEW COLLEGIATE DICTIONARY 373 (1973).

270. When a fraudster forges a check or another document, is he not the *maker* of the instrument in any common-sense usage of the term, even though his name is not on the instrument when it is issued?

271. 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, 731 (1997).

The Supreme Court held in *Central Bank* that the “or indirectly” language does not mean secondary aiding-and-abetting liability.²⁷² However, the language must mean something, and the most obvious meaning is that defendants can violate section 10(b) and rule 10b-5 without directly speaking themselves.²⁷³ A common and reasonable definition of *indirectly* is “in [a] roundabout or subtle manner.”²⁷⁴ In the hypothetical example, *A*, *B*, and *C* have all spoken in a roundabout way.

The Supreme Court in *Central Bank* stated that aiding-and-abetting liability was not covered by section 10(b) because it “extends *beyond* persons who engage, even indirectly, in a proscribed activity.”²⁷⁵ That necessarily means that primary liability extends to those who do “engage, *even indirectly*, in a proscribed activity.” Nothing in *Stoneridge* necessarily changed that obvious conclusion, although one cannot be confident that the Court, given its obvious antipathy for private rights to sue, would not take that next step if it had the opportunity. However, it is true that in one passage, the *Stoneridge* opinion referred to reliance upon the defendants’ “*own* deceptive conduct,”²⁷⁶ which could be interpreted as indicating a requirement that the defendant deceive directly, notwithstanding the wording of the statute.

c. Post-Stoneridge lower-court rulings

Stoneridge clearly failed to settle the lower-court controversy regarding where to draw the line between primary and secondary liability now that *Central Bank* (at least according to *Stoneridge*’s interpretation of it) requires such a line to be drawn. Some lower courts have taken a relatively pro-plaintiff view that is reasonably consistent with the law upon which section 10(b) was based by extending primary liability to defendants who “participate in” or are “intricately involved in” a fraud.²⁷⁷ Other courts have taken a much more conservative approach, requiring that defendants’ names be on the false statement for them to be primarily liable (the “attribution rule”).²⁷⁸

272. *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 176 (1994).

273. Prentice, *supra* note 271, at 732.

274. WEBSTER’S INTERNATIONAL DICTIONARY 1267.

275. *Central Bank*, 511 U.S. at 176 (emphasis added).

276. *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 128 S. Ct. 761, 770 (2008).

277. See *supra* text accompanying notes 106–11.

278. See *infra* text accompanying note 286.

Despite *Stoneridge's* rather conservative tone, courts that previously took the more liberal view continue to hold that defendants may still be primarily liable if they substantially participate in a fraud.²⁷⁹ Thus, several cases seem to indicate that corporate officers can be liable when they play important roles in the issuance of corporate misrepresentations, even though their names are not on the documents.²⁸⁰ There have even been hints that establishing primary liability should be easier under subsections (a) and (c) of rule 10b-5 than under subsection (b) because they contain broader language.²⁸¹

However, most courts draw a distinction between corporate officers and collateral parties such as outside counsel,²⁸² even though there is no principled reason to do so. And some courts have dismissed officers who did not sign false statements, even though they were substantially involved in issuing them.²⁸³ However, as noted earlier, even collateral parties have occasionally been held liable though they stayed in the shadows where they were actively involved in a fraud.²⁸⁴

279. See, e.g., *In re Int'l Rectifier Corp. Sec. Litig.*, No. CV 07 02544 JFW (VBKx), 2008 U.S. Dist. LEXIS 44872, at *33 (C.D. Cal. May 23, 2008) (implying that plaintiffs' complaint failed in part because of a lack of allegations regarding how defendants "substantially participated or were intricately involved" in the misleading statements).

280. See, e.g., *In re Dura Pharm., Inc. Sec. Litig.*, 548 F. Supp. 2d 1126, 1141 (S.D. Cal. 2008) (implying that adequately pled details about an officer's "involvement and participation" in drafting a faulty press release would be sufficient to create potential liability); *In re Able Labs. Sec. Litig.*, No. 05-2681 (JAG), 2008 U.S. Dist. LEXIS 23538, at *51-52 (D.N.J. Mar. 24, 2008) (holding the fact that misleading press releases were prepared under an officer's direction or approved by him was sufficient to establish primary liability due to his direct or indirect participation, and distinguishing *Stoneridge* where defendants were third parties); *In re Nat'l Century Fin. Enters., Inc. Fin. Inv. Litig.*, 553 F. Supp. 2d 902, 908, 909-10 (S.D. Ohio 2008) (implying that officers may be held liable for communications not containing their names if they have "authored, reviewed, approved, assisted with, or given direction to" the misleading release or filings).

281. See *SEC v. Simpson Capital Mgmt., Inc.*, No. 07 Civ. 6072 (JGK), 2008 U.S. Dist. LEXIS 67054 at *29 (S.D.N.Y. Sept. 3, 2008) (noting the broader language of subsection (a) and (c), the former using the word *employ*, which means "to make use of," and the latter using the word *engage*, for which *participate* is a synonym).

282. See, e.g., *In re DVI Inc. Sec. Litig.*, 249 F.R.D. 196, 217 (E.D. Pa. 2008) (rejecting the significant-participation test for primary liability and exonerating a law firm alleged to have played a "unique role in initiating and masterminding certain aspects of the overall scheme" because its role was not disclosed to the public).

283. See, e.g., *Katz v. Image Innovations Holdings, Inc.*, 542 F. Supp. 2d 269, 272-73 (S.D.N.Y. 2008) (dismissing a complaint against nonsigners of false financial statements, particularly because the complaint did not explain how their actions were relied upon by investors).

284. *Burket v. Hyman Lippitt, P.C.*, 560 F. Supp. 2d 571, 578, 584 (E.D. Mich. 2008) (holding an attorney potentially primarily liable for reviewing a misleading brochure).

2. WHAT DOES *STONERIDGE* MEAN FOR RELIANCE?

The elements of a section 10(b) private cause of action as formulated in *Stoneridge* require that there be “reliance upon the *misrepresentation or omission*” (made) by the defendant. The opinion’s language does not call for reliance upon defendant’s identity, but upon defendant’s misrepresentation or omission. Because the required reliance is upon the misrepresentation or omission, an argument can certainly be made that a defendant who hides in the shadows but creates, authors, publishes (in another’s name), orders the publication of or otherwise “makes” a misrepresentation or omission will be liable. That person can still be a primary wrongdoer whose misrepresentation or omission is relied upon by the plaintiff.

a. The attribution rule

Ultimately, the scope of post-*Stoneridge* section 10(b) liability in private damage actions will largely be determined by how strongly the courts embrace the attribution rule. The *Stoneridge* majority opinion did not hold that the defendant vendors had not made false statements or employed schemes to defraud. Rather, in the Court’s opinion, the vendors were not liable “because the investors did not rely upon their statements or representations.”²⁸⁵ Again, note that the Court did not mention reliance upon the defendants’ *identities*, but upon their false *statements or representations*. This raises the critical question of whether a defendant can be liable for a false statement or omission that he has *made*, even though his name is not upon it at the time it is issued.

In the wake of *Central Bank*, the majority of lower courts ultimately adopted a constricted view of the scope of primary liability. The central argument for this approach was simply stated by the United States Court of Appeals for the Second Circuit:

[I]f *Central Bank* is to have any real meaning, a defendant must actually *make* a false or misleading statement in order to be held liable under Section 10(b). Anything short of such conduct is merely aiding and abetting, and no matter how substantial that aid may be, it is not enough to trigger liability under Section 10(b).²⁸⁶

285. *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 128 S. Ct. 761, 766 (2008).

286. *Shapiro v. Cantor*, 123 F.3d 717, 720 (2d Cir. 1997) (quoting *In re MTC Elec. Techs. Shareholders Litig.*, 898 F. Supp. 974, 987 (E.D.N.Y. 1995)) (emphasis added).

Obviously, this conclusion is logically false. *Central Bank* could have several “real meanings” short of this one, which is the most extreme of a range of plausible interpretations of *Central Bank*.²⁸⁷ Nonetheless, many courts and commentators concluded that the only way to satisfy this bright-line test is to prove not only that the defendant made a false statement, but that the statement had the defendant’s name on it when it issued so that investors were relying upon the defendant’s identity.²⁸⁸

In this view, defrauded investors cannot recover from a defendant who has created, authored, and ordered the publication of the false statement that misled them if the defendant’s name was not upon the false statement when it was published. Somehow the investors have failed to adequately rely upon *the defendant*, even though the language of *Stoneridge* seems to require only reliance upon *the misrepresentation or omission*. Under this aggressive interpretation of the attribution rule, the only acceptable meaning of *make* is “to publish in one’s own name.” Under this view, when a fraudster tells plaintiffs to “pay no attention to that man behind the curtain,”²⁸⁹ they must obey.

Fortunately, neither *Central Bank* nor *Stoneridge* adopted this view, for the question was not raised in either case. *Central Bank* involved a defendant who made no false statements or actionable omissions. The defendant simply failed to speak out in a situation where it had no duty to do so.²⁹⁰ And although the *Stoneridge* defendants’ false documents provided credibility for Charter’s fraud, they were not viewed directly by (and their existence was unknown to) plaintiff investors.²⁹¹

It is certainly possible that in the future, given the Supreme Court majority faction’s aversion to private securities litigation, the Court will adopt the view that the only way to make a false statement is to issue it in one’s own name, and that the only way for plaintiffs to establish reliance is to see a document with the defendant’s name upon it. However, the facts of *Stoneridge* and *Central Bank* do not require such

287. See generally Robert A. Prentice, *Scheme Liability, Federal Securities Fraud, and John Wayne’s i-Pod* 34–36 (McCombs Sch. of Business Research Paper Series, No. IROM-02-07, 2007), available at ssrn.com/abstract=1014658 (illustrating this point graphically).

288. See Aegis J. Frumento, *Misrepresentations of Secondary Actors in the Sale of Securities: Does In re Enron Square with Central Bank?*, 59 BUS. LAW. 975, 995–97 (2004) (arguing that only the person who issues a statement can be viewed as its maker, for merely creating a false statement does no damage unless it is published).

289. THE WIZARD OF OZ (Metro-Goldwyn-Mayer 1939).

290. See Prentice, *supra* note 43, at 647.

291. See *supra* text accompanying notes 5–15.

conclusions, and the reasoning of the two opinions does not justify them.

b. The Bridge decision

Mention should be made of *Bridge v. Phoenix Bond & Indemnity Co.*,²⁹² decided by the Supreme Court a few months after it issued the *Stoneridge* opinion. Plaintiffs claimed that in tax-lien sales sponsored by Cook County, Illinois, defendants had engaged in a scheme to defraud them.²⁹³ Plaintiffs sued under the Racketeer Influenced and Corrupt Organizations Act's racketeering-enterprise provision,²⁹⁴ alleging that the defendant's predicate act was a violation of the mail-fraud statute.²⁹⁵ This is relevant to scheme liability because, as noted earlier,²⁹⁶ the scheme-to-defraud language of subsection (a) of rule 10b-5 is derived rather directly from similar language in the mail-fraud statute.

The *Bridge* defendants' scheme to defraud had involved using straw parties to submit bids in order to evade official limits on the number of purchases by one bidder. The scheme allowed defendants to purchase more than their share of the bids to the detriment of plaintiffs and other competing bidders. Defendants claimed that they could not be liable to plaintiffs because the false statements they made through the mails were made to the auction officials, not to plaintiffs. Therefore, defendants argued, plaintiffs could establish neither reliance nor proximate cause, as required by common-law fraud.

The Court pointed out that mail fraud, not common-law fraud, is the relevant predicate act under RICO,²⁹⁷ and that reliance is a "specialized condition"²⁹⁸ that grew up in common-law fraud and "simply has no place in a remedial scheme keyed to the commission of mail fraud, a statutory offense that is distinct from common-law fraud

292. 128 S. Ct. 2131 (2008).

293. *Id.* at 2135-36.

294. 18 U.S.C. § 1964(c) (2006). This provision grants a private right of action to "[a]ny person injured in his business or property by reason of a violation [of 1962(c)]," *id.*, which makes it "unlawful for any person employed by or associated with" an enterprise "to conduct or participate . . . in the conduct of such enterprise's affairs through a pattern of racketeering activity." *Id.* § 1962(c).

295. *Id.* § 1341. RICO's section 1962(c), of course, requires that the defendant committed a pattern of "racketeering activity." Prohibited acts of racketeering are listed in the statute and include violations of the mail-fraud statute. *See id.* § 1961(1)(B).

296. *See supra* note 77 and accompanying text.

297. *Bridge*, 128 S. Ct. at 2140.

298. *Id.* at 2142 (quoting *Anza v. Ideal Steel Supply Corp.*, 547 U.S. 451, 477 (2006)).

and that does not require proof of reliance.”²⁹⁹ The Court went on to point out that “there is no general common-law principle holding that a fraudulent misrepresentation can cause legal injury only to those who rely on it.”³⁰⁰ The Court cited several cases where plaintiffs recovered for common-law fraud even though it was a third party, and not the plaintiff, who relied on the defendant’s misrepresentation.³⁰¹

If proof of direct reliance by the plaintiff is not an element of the mail-fraud statute, then it should not be an element of a rule 10b-5(a) scheme-to-defraud claim, given that this provision is derived directly from the mail-fraud statute. As noted earlier in this Paper, in mail-fraud cases involving fraudulent schemes such as that at issue in *Stoneridge*, defendants were held liable even though they had hidden in the shadows and defrauded plaintiffs by engaging in fake transactions with third parties with whom plaintiffs had dealt.³⁰² To the extent that *Stoneridge* is inconsistent with *Bridge*’s holding, *Stoneridge* arguably should be reconsidered.³⁰³

Consider the recent decision in *In re Nature’s Sunshine Products Securities Litigation*,³⁰⁴ where the court held that a CEO who misled auditors in a management letter to his firm’s external auditor was not liable because the investors did not rely upon his false statements.³⁰⁵ The court did not mention *Bridge* or pay attention to the requirements of scheme liability. However, one may argue that the case is factually very similar to *Bridge*—the defendant lied to one party (the outside auditor) as part of a scheme to defraud another party (investors). The auditor relied upon the fraud and because the mail-fraud statute’s scheme-to-defraud provision does not require that the victims of a fraud rely directly upon the defendant’s fraudulent acts, scheme-to-defraud liability could have been imposed.

299. *Id.* at 2143. The Court cited *Stoneridge* for the proposition that section 10(b) also does not incorporate common-law notions of fraud. *Id.* at 2140–41.

300. *Id.* at 2143.

301. *Id.* at 2143 n.7.

302. *See, e.g., United States v. Jones*, 10 F. 469, 470 (S.D.N.Y. 1882) (holding defendant guilty where he sold counterfeit money to a buyer who knew that the money was counterfeit and where the “necessary result” of the transaction between defendant seller and the buyer would be the defrauding of unknowing third parties to whom the buyer would pass the counterfeit money).

303. The mail-fraud statute punishes *A* when he lies to *B* in order to injure *C*, and *Bridge* allows *C* to recover from *A* under RICO. Similarly, the mail-fraud statute punishes *A* when he enters into a fraudulent transaction with *B* in order to defraud *C*. *Stoneridge* should have allowed *C* to sue *A* under rule 10b-5(a), given that the scheme-to-defraud language of that provision comes rather directly from the mail-fraud statute.

304. No. 2:06 CV 267 (TS), 2008 U.S. Dist. LEXIS 73031 (D. Utah Sept. 23, 2008).

305. *Id.* at *12–13.

c. The post-Stoneridge lower courts

As noted earlier, the lower courts have, for no doctrinally sound reason, drawn a line between corporate insiders and others. They have tended to hold that collateral parties who remain in the shadows will not be liable to injured investors, even if they foresaw *or even intended* that their actions would help others mislead those investors.³⁰⁶ However, some cases imply that if investors are informed of the collateral parties' false actions, then liability could follow.³⁰⁷ There seems to be no requirement that the disclosure regarding the collateral parties' role need be made by the collateral party itself. On the other hand, *In re Parmalat Securities Litigation*³⁰⁸ indicates that the disclosure must be specifically about the defendants' own deceptive conduct.

C. Some Applications

Given this background discussion, consider some potential applications of *Stoneridge* to various fact patterns, including its own.

1. *STONERIDGE*

Stoneridge held that, although defendant vendors may well have acted deceitfully in drafting, transmitting, and backdating various documents, they could not be held liable because they hid behind a veil. Ultimately, it was Charter itself that issued false communications to plaintiff investors. Therefore, the majority concluded, the reliance element of a section 10(b)/rule 10b-5 cause of action was not satisfied because "the investors cannot be said to have relied upon any of respondents' deceptive acts in the decision to purchase or sell

306. See, e.g., *Pugh v. Tribune Co.*, 521 F.3d 686, 697 (7th Cir. 2008) (describing that the defendant certified fake circulation figures that boosted advertising revenue and, indirectly, stock prices, but did not communicate directly with investors); *TCS Capital Mgmt., LLC v. APAX Partners, L.P.*, No. 06 CV 134447 (CM), 2008 U.S. Dist. LEXIS 19854, at *70-71 (S.D.N.Y. Mar. 7, 2008) (describing that the defendant allegedly pretended to sell its interest in the company for lower than fair price in exchange for a secret quid pro quo in order to enable the buyer to fool another seller (plaintiff) into selling too cheaply, but did not communicate directly with the plaintiff); see also *In re Nat'l Century Fin. Enters., Inc. Fin. Inv. Litig.*, 553 F. Supp. 2d 902, 909-10 (S.D. Ohio 2008) (noting that to be liable under subsections (a) and (c) of rule 10b-5, a defendant must have engaged in conduct that was itself deceptive, and not merely engaged in nondeceptive conduct that supports a deceptive scheme).

307. *Pugh*, 521 F.3d at 697.

308. 570 F. Supp. 2d 521, 526 (S.D.N.Y. 2008) (observing that only one moving defendant was referred to in the issuer's filings, and that was in relation to "a transaction that was not in itself deceptive").

securities.”³⁰⁹ If the inconsistent *Bridge* decision does not induce courts to alter their views of *Stoneridge*, consider the following possibilities:

Permutation #1: The Supreme Court admitted in *Stoneridge* that defendant vendors had acted “in concert” with Charter in commission of this securities-fraud scheme.³¹⁰ What if that concert had involved the vendors issuing press releases that announced the fake transactions? Clearly, they would have made a false statement in furtherance of a fraudulent scheme. And because Charter was a public company, the fraud-on-the-market theory would apply even under the *Stoneridge* majority’s unwelcoming view of private rights to sue. Therefore, the reliance requirement would be met and liability should naturally follow. The Second Circuit recently observed that *Stoneridge* made no distinction between insiders and third parties regarding application of the fraud-on-the-market test.³¹¹

Permutation #2: A closer question would arise if Charter (rather than the vendors) had issued a press release that specifically announced the fake contracts with the vendors. Instead of just seeing financial statements inflated by \$17 million of bogus revenue, investors in the efficient markets would see and be misled by references to specific contracts involving the vendors that they would not know to be bogus. Reliance upon both the false statements and the vendors’ identities would be present, for the collateral parties are no longer obscured from view as they were in *Stoneridge*. They have been brought into the bright sunlight by Charter’s press release. The reliance element that the majority thought was missing in the *Stoneridge* facts, when it noted that the vendors’ “deceptive acts were not communicated to the public,”³¹² is now present. Would that be sufficient for liability?

It should be.³¹³ But it is certainly possible that the Court would hold in such a case that the vendors have no liability for Charter’s false statements because they did not make them. If the Court did take that point of view, then scheme liability becomes a viable alternative theory. The vendors did not make the false statements, but they knowingly and voluntarily employed the scheme to defraud that was publicized in the

309. *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 128 S. Ct. 761, 774 (2008).

310. *Id.* at 774.

311. *Millowitz v. Citigroup Global Markets, Inc. (In re Salomon Analyst Metromedia Litig.)*, 544 F.3d 474, 481–82 (2nd Cir. 2008) (applying the fraud-on-the-market presumption to a claim against securities analysts).

312. 128 S. Ct. at 769.

313. Note that in discussing reliance, the *Stoneridge* Court observed that plaintiffs were attempting “to impose liability on respondents even absent a public statement.” *Id.* at 770. It did not say a public statement “by the defendant or a public statement with the defendant’s name on it.”

statement. Certainly courts have often drawn a distinction between active and passive wrongdoing. For example, they have been reluctant to impose liability upon innocent parties for the sole reason that they failed to blow the whistle upon others' wrongdoing.³¹⁴ But there is a strong common-law and section 10(b) obligation not to defraud others, even if they are strangers.³¹⁵ Therefore, parties who have knowingly

314. Most lower courts refused to create any free-floating duty to blow the whistle by gatekeepers such as attorneys, auditors, or investment banks in section 10(b) cases. *See, e.g., DiLeo v. Ernst & Young*, 901 F.2d 624, 629 (7th Cir. 1990) (noting that auditors have no "duty to search and sing"); *Latigo Ventures v. Laventhol & Horwath*, 876 F.2d 1322 (7th Cir. 1989) (similar). However, a few courts did. *See, e.g., Roberts v. Peat, Marwick, Mitchell & Co.*, 857 F.2d 646, 653 (9th Cir. 1988) ("Investors can reasonably be expected to assume that an accounting firm would not consent to the use of its name on reports and offering memoranda it knew were fraudulent."); *Rudolph v. Arthur Andersen & Co.*, 800 F.2d 1040, 1045 (11th Cir. 1986) (similar). Furthermore, in the PSLRA, Congress imposed such a duty upon auditors of public companies in limited circumstances. *See* 15 U.S.C. § 78j-1 (2006).

315. The common law makes it clear that fraud typically requires no fiduciary relationship between plaintiff and defendant. *See Agric. Ins. Co. v. Superior Court*, 70 Cal. App. 4th 385, 402 (1999) ("The element of intent makes the fraud actionable regardless of any contractual or fiduciary duty one party might owe the other."); *Lacher v. Superior Court*, 230 Cal. App. 3d 1038, 1046 (1991) (same); *Colo. Mortgage Co. v. Wilson*, 263 P. 406, 407 (Colo. 1928) (noting that courts discountenance the idea that, where a fiduciary relationship is not involved, one may "filch property from another"); *see also* Constantine N. Katsoris, *Accountants' Third Party Liability—How Far Do We Go?*, 36 *FORDHAM L. REV.* 191, 205 (1967) ("There is a general duty to third persons not to misrepresent willfully."). Neither the mail-fraud statute, *see United States v. Allen*, 554 F.2d 398, 410 (10th Cir. 1977); *Williams v. United States*, 368 F.2d 972 (10th Cir. 1966), nor any other body of fraud law in existence in 1934, required a fiduciary duty as a prerequisite to fraud.

The express wording of section 10(b) makes it clear that "any person" who violates rule 10b-5 is a proper defendant. Certainly officers, investment banks, auditors, lawyers, and all sorts of other persons who did not owe fiduciary duties to investors have often been held liable for misrepresentations (and omissions) as well as manipulation under section 10(b) or rule 10b-5. *See* Zachary T. Knepper, *Future-Priced Convertible Securities and the Outlook for "Death Spiral" Securities-Fraud Litigation*, 26 *WHITTIER L. REV.* 359, 398-99 (2004) (noting that there is no limit to the scope of proper defendants under section 10(b) or rule 10b-5).

Just about the only body of fraud law that is dependent upon the existence of a fiduciary duty has evolved from the Supreme Court's somewhat odd reasoning in insider-trading cases. *See, e.g., United States v. O'Hagan*, 521 U.S. 642, 655 (1997); *Chiarella v. United States*, 445 U.S. 222, 232-35 (1980). It has led to some questionable results. *See, e.g., SEC v. Dorozhko*, No. 07 Civ. 9606 (NRB), 2008 U.S. Dist. LEXIS 1730 (S.D.N.Y. Jan. 8, 2008) (holding that a computer hacker who stole material, nonpublic information for the entire purpose of trading on it was not liable for insider trading). Several authors have criticized this approach to insider-trading law. *See* Kathleen Coles, *The Dilemma of the Remote Tippee*, 41 *GONZAGA L. REV.* 181, 221 (2006); Donna M. Nagy, *Reframing the Misappropriation Theory of Insider Trading Liability: A Post-O'Hagan Suggestion*, 59 *OHIO ST. L.J.* 1223, 1249-57 (1998); Robert A. Prentice, *The Internet and Its Challenges for the Future of Insider Trading Regulation*, 12 *HARV. J.L. & TECH.* 263, 296-307 (1999).

2009:351

Scheme Liability

407

entered into fraudulent transactions with *B* as part of a fraudulent scheme with the purpose of defrauding *C* should be liable when *C* relies upon their actions, even if those actions were publicized not by themselves, but by *B*. In this scenario, the vendors were active wrongdoers, even if they were not the agents of their own exposure to the plaintiffs. Martin Luther's message had the same impact whether he personally nailed his ninety-five theses to the church door or had a friend do the nailing for him. The recent ruling in *In re Bristol Myers Squibb Securities Litigation*³¹⁶ would support this outcome, although it features an important distinction in that the defendant was a corporate officer.

Permutation #3: An even closer question would be whether liability would follow in a situation where *A* did not know its role had been publicized. In other words, what if Charter's vendors knowingly entered into fake transactions with Charter for the sole purpose of fooling Charter's investors, but expected to stay obscured in the shadows? Although they expected Charter to communicate fake financial results to investors, not only did they not expect to be named in a Charter press release, but they also did not know about it until after the fact.

Liability should still attach. There is still reliance upon both the defendant vendors' actions and identities. That particular deficiency from the actual facts of *Stoneridge* has been remedied. There is still a scheme to defraud in which defendants were active and voluntary participants. The fact that defendants did not know that they would be "outed" should not undermine either a conclusion that their actions and identities have been relied upon, or a conclusion that they employed a scheme to defraud in which Charter's communications played a critical role. The vendors would be in a similar position to the driver of the getaway car in a bank robbery who expected to remain unknown, but was "ratted out" by the actual gunman who was arrested after entering the bank. A court that made the defendant's knowledge of the publicity a requirement of recovery would truly be going the extra mile to absolve wrongdoers of liability.

Permutation #4: What if investors did not see the vendors' bogus contracts, but Charter showed them to securities analysts who, based upon their existence, recommended Charter's stock to investors? Again the vendors were active participants in a fraudulent scheme (primary liability). Investors relied upon the analysts' recommendations which,

316. No. 07 Civ. 5867 (PAC), 2008 U.S. Dist. LEXIS 63567, at *57-58 (S.D.N.Y. Aug. 20, 2008) (holding a corporate officer who did not make statements himself potentially liable for his role in a fraud which was disclosed in corporate filings).

in turn, were based upon a reading of the contracts (reliance). Under the fraud-on-the-market theory, this should be sufficient to establish reliance, so liability should follow.

2. *CENTRAL BANK*

Consider the facts in *Central Bank*, where a building authority issued bonds to finance public improvements at a planned development. Defendant Central Bank served as indenture trustee. The bonds were secured by landowner assessment liens and the bond covenants required that the land be worth at least 160 percent of the bonds' outstanding principal and interest. The covenants required the developer to give Central Bank an annual report containing evidence that the 160-percent test was met. The developer did so for 1988, but Central Bank later received tentative evidence that the report might be unduly optimistic. An in-house appraiser recommended an independent review of the 1988 report by an outside appraiser. At the request of the developer, Central Bank delayed the independent review by six months and the authority defaulted before the review was completed.³¹⁷

Central Bank did not enter into any fake transactions. It did not issue any false statements. It only failed to warn investors in a situation where both the trial court and the United States Court of Appeals for the Tenth Circuit held that it owed no fiduciary duty to do so.³¹⁸ Not even the common law would visit fraud liability upon Central Bank given these facts. *Stoneridge* confirmed that result.

3. AUTHORS

In an earlier article, the author suggested a hypothetical situation wherein a crooked lawyer serving, let us say, as outside counsel, conceived of the idea for a fraudulent press release, wrote the release in its entirety, persuaded the client to issue it in the client's name (without mentioning the attorney, of course), showed the release widely to unsuspecting potential investors, and, finally, pocketed some of the proceeds of the scam.³¹⁹ The author suggested that when someone is so involved in a fraudulent communication as to reasonably be considered its author or coauthor, that party should not escape liability by hiding in

317. *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 167-68 (1994).

318. *First Interstate Bank of Denver, N.A. v. Pring*, 969 F.2d 891, 899 (10th Cir. 1992).

319. Prentice, *supra* note 271, at 728-29.

the shadows.³²⁰ The district court in *Enron* adopted a version of this rule, holding that when professionals such as attorneys and accountants “take the affirmative step of speaking out, whether individually or as essentially an author or co-author in a statement or report, *whether identified or not*, about their client’s financial condition,” they may be held primarily liable to those third parties they expect will rely upon the false statements.³²¹

Post-*Stoneridge*, a strong argument can be made for liability in this setting. There is clearly a difference between engaging in a fake transaction with *B*, knowing that *B* is going to incorporate that transaction into a communication with investors on the one hand and, on the other hand, being the “ideator,” author, or driving force behind the communication itself.

One cannot say that the defendant vendors made a communication to plaintiff investors in *Stoneridge*, although they culpably participated in Charter’s scheme to defraud. However, using any reasonable definition (indeed, all the reasonable definitions) of the word *make*, the lawyer in this hypothetical has made a misrepresentation by creating, authoring, and causing it to be published. Although the attorney has stayed behind the scenes, there has been reliance upon the false statement that he made, which is all that *Stoneridge*’s formulation of the elements of a section 10(b) violation requires. *Stoneridge* stressed that the defendant vendors “had no role in preparing or disseminating Charter’s financial statements.”³²² In this hypothetical, the defendant played a major role in preparation and dissemination. Neither *Stoneridge* nor any other Supreme Court case has ever required that there be reliance upon a defendant’s identity. The problem in *Stoneridge*, according to the majority opinion, was only that the investors did not know about the vendors’ transactions and the false communications that they made (to Charter) at the time of their investment decisions.³²³

Clearly these predictions are speculative. Nothing in either *Central Bank* or *Stoneridge* requires a different result. However, the tone of both cases is so unsympathetic to the private right to sue, it could not surprise anyone if the majority of the Court were to hold that only an author whose name is on a false statement at issuance can be liable. As

320. *Id.* at 776.

321. *Newby v. Enron Corp. (In re Enron Corp. Sec., Derivatives & ERISA Litig.)*, 235 F. Supp. 2d 549, 610 (S.D. Tex. 2002) (emphasis added).

322. *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 128 S. Ct. 761, 767 (2008).

323. *Id.* at 766 (holding that defendants were not liable because “the investors did not rely upon *their statements or representations*”) (emphasis added).

noted earlier, it could reach that result either by holding (1) that one does not make a false statement unless his name is on it, or (2) that reliance upon a defendant's identity (not just his statements or omissions) is necessary.

At least one lower court has taken this prodefendant view. In *DVI Inc. Securities Litigation*,³²⁴ the court held that allegations regarding a law firm's "unique role in initiating and masterminding certain aspects of the overall [fraudulent] scheme" was insufficient to impose liability where the law firm stayed in the shadows.³²⁵ On the other hand, in *Burket v. Hyman Lippitt, P.C.*,³²⁶ the court held a lawyer potentially liable to nonclients because he had allegedly "played a role" (perhaps by reviewing drafts) in the preparation of a misleading brochure.³²⁷ Reliance was supplied by the *Affiliated Ute* presumption³²⁸ available in nondisclosure cases.³²⁹ The *Burket* court relied upon a 1998 holding that individuals who are "primary participants" in an alleged deception have a duty to disclose if they have "direct contacts" with the plaintiffs.³³⁰ The direct contacts came from the role the lawyer played in reviewing the deceptive documents. *Burket* is indisputably more consonant with all the common-law and statutory predecessors to section 10(b) than is *DVI*, while *DVI* may be more consistent with the

324. 249 F.R.D. 196 (E.D. Pa. 2008).

325. *Id.* at 217. As in *Stoneridge*, the court held plaintiffs could not rest reliance upon the fraud-on-the-market theory because defendant's actions had not become public; plaintiffs could not rest reliance upon the *Affiliated Ute* presumption in cases of nondisclosure either, since this was primarily an active disclosure case. *Id.* at 217-18.

326. 560 F. Supp. 2d 571 (E.D. Mich. 2008).

327. *Id.* at 591. The attorney also allegedly drafted a misleading subscription agreement, *id.* at 577, although both that act and the reviewing of the brochure were individually held sufficient to impose liability. *Id.* at 591.

328. *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 153-54 (1972) (holding that reliance may be presumed in an omission case, though not in a case of active misrepresentation).

329. *Id.*

330. *Burket*, 560 F. Supp. 2d at 583 (quoting *Rubin v. Schottenstein, Zox & Dunn*, 143 F.3d 263, 267 (6th Cir. 1998)); see also *Rubin*, 143 F.3d at 267 ("Although under Rule 10b-5(b) . . . 'only those individuals who had an affirmative obligation to reveal what was allegedly omitted can be held liable as primary participants in the alleged deception[, a] duty to disclose naturally devolve[s] on those who h[ave] direct contacts with 'the other side.'" (quoting *SEC v. Coffey*, 493 F.2d 1304, 1315 (6th Cir. 1974))); *SEC v. Washington County Util. Dist.*, 676 F.2d 218, 223 (6th Cir. 1982) ("A person undertaking to furnish information which is misleading because of a failure to disclose a material fact is a primary participant."); *Coffey*, 493 F.2d at 1315 n.24 ("Direct contacts may take many forms. An accountant or lawyer, for instance, who prepares a dishonest statement is a primary participant in a violation even though someone else may conduct the personal negotiations with a securities purchaser.").

2009:351

Scheme Liability

411

tone of *Stoneridge*. A juxtaposition of these cases makes it clear that some critical issues remain unresolved in the post-*Stoneridge* era.

4. OFFICERS

Permutation #1: Change the facts slightly from the previous hypothetical and make the instigator, author, and profiteer in the scheme the CEO of the issuer. Obviously, one may plausibly argue that the CEO made the false statements (using any reasonable definition of the verb *to make*) and that investors relied upon the false statements. Liability should follow, although most of the reservations expressed in the previous section regarding the crooked attorney apply here. In a future case the Court could decide that investors cannot rely upon the misrepresentations, omissions and/or actions of a party they never knew played a role in the false communication.

The troubling thing about such a result is that it makes it so easy for fraudsters to escape civil liability, and this is particularly disturbing regarding top officers who, studies indicate, are actively involved in most corporate-fraud schemes.³³¹ Should they, by dint of being careful to ensure that false statements are communicated only in the company's name, really be allowed to shield themselves completely from securities-fraud damage litigation?

Again, the question arises: how far will the Supreme Court majority go with the attribution rule? Presumably the Court would not refuse to impose liability upon a fraudster who cleverly induced an innocent party to issue a false representation in the latter's name, but upon what grounds would the Court distinguish between the *Stoneridge* facts and these? Presumably the Court would not wish to absolve a principal from responsibility for a statement issued on its behalf in its agent's name.³³² At least there is a separate legal rationale (agency law) for this distinction.

But what about absolving top officers of liability when they knowingly participate in the creation of a false document that they arrange to have issued in their firm's name rather than their own? Even the post-*Central Bank* lower courts that, before *Stoneridge*, took the narrowest view of primary liability tended to impose liability in those

331. Marshall A. Geiger & Porcher L. Taylor III, *CEO and CFO Certifications of Financial Information*, 17 ACCT. HORIZONS 357, 358 (2003) (citing studies indicating that CEOs and CFOs are involved in 80 percent of corporate frauds).

332. See generally Robert A. Prentice, *Conceiving the Inconceivable and Judicially Implementing the Preposterous: The Premature Demise of Respondent Superior Liability Under Section 10(b)*, 58 OHIO ST. L.J. 1325 (1997) (discussing why respondent superior liability under section 10(b) should survive *Central Bank*).

cases.³³³ They did so by various routes, however.³³⁴ For example, some courts simply departed slightly from the bright-line attribution rule when a particular officer was “primarily responsible” for an issuer’s communications.³³⁵ Others held officers liable for communications issued in their employer’s name under a “group publication” theory,³³⁶ although this appears to be a minority view.³³⁷ Yet others have resorted to section 20(a)’s³³⁸ “controlling person” provision.³³⁹

All of these routes are plausible approaches for the Supreme Court to avoid allowing the moving parties behind frauds to escape liability, especially when they are corporate officers. They all could provide grounds for holding that an actor who plays the driving role in a fraudulent scheme is no mere aider and abettor. However, no one should be surprised if the Court were to decide that all these approaches are inconsistent with its expressed views on reliance. In *Stoneridge*, there were certainly grounds to conclude that the defendant vendors were primary actors rather than mere aiders and abettors because they had drafted, transmitted, and backdated documents. Despite this, the *Stoneridge* majority absolved them of liability on reliance grounds.

On the other hand, the documents that the defendant vendors made were not viewed by investors. *Stoneridge* contained frequent vague references to proximity that seem substantially less applicable if the focus is upon makers of particular false communications that are

333. See, e.g., *Hollin v. Scholastic Corp. (In re Scholastic Corp. Sec. Litig.)*, 252 F.3d 63, 75–76 (2d Cir. 2001) (holding that a vice president who was involved in drafting, producing, and/or disseminating false statements was liable even though they were not attributed to him); *In re Vivendi Universal, S.A. Sec. Litig.*, 381 F. Supp. 2d 158, 170 (S.D.N.Y. 2003) (refusing to dismiss a rule 10b-5 claim against a CFO even though public statements were not attributed to him).

334. See *Annus*, *supra* note 1, at 859 n.29 (noting that even the narrow, bright-line test tends to hold corporate officers liable for drafting, producing, and reviewing documents that go out under the corporate name, even though their names are not on the documents and the reasoning behind imposing liability is inconsistent with the rationale for the bright-line test).

Also, some courts, in a slightly relaxed version of the bright-line test, allow the attribution to be indirect, such as where investors know that a secondary actor, such as an auditor, must be behind the statements. Under this view, the auditors must actually make the statement, but their names need not be on them at the time of publication. *Id.* at 859–60.

335. See, e.g., *Hollin*, 252 F.3d at 76.

336. See, e.g., *In re Qwest Commc’n Int’l, Inc. Sec. Litig.*, 387 F. Supp. 2d 1130, 1144–45 (D. Colo. 2005).

337. See, e.g., *In re Capstead Mortgage Corp. Sec. Litig.*, 258 F. Supp. 2d 533, 561 (N.D. Tex. 2003).

338. 15 U.S.C. § 78t(a) (2006).

339. See, e.g., *Maher v. Durango Metals, Inc.*, 144 F.3d 1302, 1305 (10th Cir. 1998).

2009:351

Scheme Liability

413

viewed by investors or officers who are the primary instigating parties behind a firm's fraudulent schemes.³⁴⁰ In other words, the *Stoneridge* defendants were further removed from the false statements than the typical nonissuer defendants such as officers, auditors, lawyers, and investment banks. Furthermore, the *Stoneridge* Court stressed, "The conduct of a secondary actor must satisfy each of the elements or preconditions for liability."³⁴¹ It is at least possible that a top corporate officer would not be viewed as a secondary actor, and therefore could be held liable for a false statement he instigated even if his name were not on it. In other words, the Court might adopt the attribution rule for collateral defendants, but not for defendants who are corporate insiders.

In post-*Stoneridge* lower-court litigation, most courts seem to be continuing the pre-*Stoneridge* practice of distinguishing between collateral parties and corporate insiders, and generally holding the latter liable if they played a major role in the fraud even if their names were not on the false publications and their identities were not necessarily known to investors.³⁴²

Permutation #2: Assume for a moment that Apple Inc. is in breach of a loan covenant and needs \$100 million in assets to make up the difference. Steve Jobs, being a wealthy fellow, takes \$100 million in bonds that he personally owns and transfers them to Apple so that Apple can display them to lenders as its own. Apple secretly promises to return the bonds to Jobs as soon as the default danger has passed. Later, lenders learn of the fraud and throw Apple into bankruptcy. Investors who bought Apple shares while its financial statements misrepresented the bonds as owned by Apple might well sue Jobs under a scheme-liability theory.

Jobs should be liable. He was the instigator of the scheme and therefore primarily liable. Investors relied upon the fact that the bonds were owned by Apple, even though the financial statements were issued in Apple's name, not in Jobs's name. Primary wrongdoing plus reliance should lead to liability.

Permutation #3: Consider one more scenario. Imagine that Apple issues in its own name, and only in its own name, a very important and very fraudulent press release. Let us assume, again just for purposes of discussion, that Steve Jobs was the moving force behind the entire

340. See, e.g., *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 128 S. Ct. 761, 770 (2008) (noting that an important inquiry is "whether respondents' acts were immediate or remote to the injury").

341. *Id.* at 769.

342. See, e.g., *In re Dura Pharm., Inc. Sec. Litig.*, 548 F. Supp. 2d 1126, 1142 (S.D. Cal. 2008); *In re Able Labs. Sec. Litig.*, No. 05-2681 (JAG), 2008 U.S. Dist. LEXIS 23538, at *51-52 (D.N.J. Mar. 24, 2008); *In re Nat'l Century Fin. Enters., Inc. Fin. Inv. Litig.*, 553 F. Supp. 2d 902, 909-10 (S.D. Ohio 2008).

fraudulent scheme. Although Jobs's name is not on the false statement, is it not likely that the investing public would reasonably believe that no important press release would come from Apple without his approval? Is it not true that investors are relying upon his integrity when they form opinions about the accuracy of Apple's press release? Under those circumstances, would the Supreme Court go so far as to shield Jobs from liability in the face of conclusive evidence of his primary role in the fraud? Would it really hold that one can *never* be liable for a false statement if his name is not on it at the time it is published? An analogous scenario is discussed in the next Section.

5. AUDITORS

In the first several months after *Stoneridge*, there have been virtually no reported cases citing *Stoneridge* that involve auditor defendants. This may be indicative of how protective *Stoneridge* is of auditors and other collateral defendants. Still, sooner or later the issue of auditor liability will arise. Consider the following possibilities.

Permutation #1: Assume that an auditor knowingly certifies the materially inaccurate financial statements of a public company. There seems little doubt that an auditor is potentially liable under section 10(b) and rule 10b-5. The auditor is "speaking" so that it is no mere aider and abettor, and the markets generally rely upon financial statements that are widely distributed. Even if the statements are accurate when issued, the auditors have an obligation to correct them if they learn of errors and know that investors are still relying on the inaccurate statements.³⁴³ *Stoneridge* should not affect this liability of gatekeepers.

Permutation #2: Consider the facts in *Lattanzio v. Deloitte & Touche LLP*,³⁴⁴ in which plaintiffs alleged that (1) there were major errors in Warnaco Group, Inc.'s financial statements that were attached to its Form 10-Q; (2) auditor Deloitte knew of the errors; (3) Deloitte said nothing to correct the statements; and (4) although the statements were not audited, the public knew that by law, Deloitte was required to review them.³⁴⁵

It is certainly possible to argue that a primary purpose of the legal requirement that an outside auditor review unaudited financial

343. *Overton v. Todman & Co.*, 478 F.3d 479, 487–88 (2d Cir. 2007).

344. 476 F.3d 147 (2d Cir. 2007).

345. *Id.* at 154–55. Regulations provide that "[p]rior to filing, interim financial statements included in quarterly reports on Form 10-Q . . . must be reviewed by an independent public accountant using professional standards and procedures for conducting such reviews as established by generally accepted auditing standards." 17 C.F.R. § 210.10-01(d) (2008).

2009:351

Scheme Liability

415

statements appearing in Form 10-Qs would be defeated if the auditor simply ignored the fact that the statements are materially false. Therefore, one might well conclude that Deloitte made a material omission that was obviously relied upon by investors. Even more significant, the investors did not just rely upon an omission made by Deloitte, they knew Deloitte's identity and the role Deloitte played in the process. Some courts have refused to dismiss section 10(b) claims against an auditor where it was "appropriate to infer that . . . investors reasonably attributed the statements" to the auditor, even though his or her name was not on the statements.³⁴⁶

However, *Lattanzio* held that the fact that the market accurately understood that Deloitte was required to review the statements was insufficient to create liability. The court essentially conceded that investors had relied upon both the false statements and Deloitte's role in reviewing them, but concluded that Deloitte's actions were mere aiding and abetting:

Public understanding that an accountant is at work behind the scenes does not create an exception to the requirement that an actionable misstatement be made by the accountant Unless the public's understanding is based on the accountant's articulated statement, the source for that understanding—whether it be a regulation, an accounting practice, or something else—does not matter.³⁴⁷

This is plausible, but it is also reasonable to argue that Deloitte was a primary actor because it made an omission in breach of a legal duty to speak. A court following *Burket* might well hold that the auditor's role in the Form 10-Q caused it to have direct contact with the investing public, giving rise to a duty to disclose.³⁴⁸ A primary violation plus an *Affiliated Ute* presumption of reliance should equal liability.

Permutation #3: Consider for a moment the proper result if plaintiffs managed to prove an unlikely scenario—that an auditor was the moving party behind the false statements in a Form 10-Q. For example, assume that an auditor realizes that its client is about to report unfavorable numbers that may throw it into bankruptcy, endangering

346. *In re Lernout & Hauspie Sec. Litig.*, 230 F. Supp. 2d 152, 166–67 (D. Mass. 2002); see also *In re Livent, Inc. Noteholders Sec. Litig.*, 174 F. Supp. 2d 144, 154–55 (S.D.N.Y. 2001) (refusing to dismiss claims against a broker who allegedly helped in "structuring and keeping secret the misrepresented" relationship between the underwriter and the issuer).

347. 476 F.3d at 155.

348. See *Burket v. Hyman Lippitt, P.C.*, 560 F. Supp. 2d 571, 583 (E.D. Mich. 2008).

the auditor's fee. The auditor creates a fictitious set of transactions (say, versions of the Nigerian-barge deal, but with a nonexistent buyer), and convinces the issuer's CFO to include them in the unaudited financial reports that will be contained in the Form 10-Q. The auditor is a primary actor in the fraud. The public relies upon the auditor to review the statements and relies upon the inaccurate statements as published.

On these facts, the auditor seems to be a primary wrongdoer. How can the instigator and prime mover behind a fraud be a mere aider and abettor? Furthermore, the investing public is relying upon statements that the auditor made in the sense of creating, authoring, and causing to be published. Liability should follow. However, while exonerating defendant vendors, the *Stoneridge* majority argued (with little logical basis)³⁴⁹ that it was Charter "that misled its auditor and filed fraudulent financial statements; nothing [the vendors] did made it necessary or inevitable for Charter to record the transactions as it did."³⁵⁰ When a

349. These "A helps B defraud C" scams are proliferating, indicating that the Court should perhaps not be so cavalier in excusing them. *See, e.g.*, Brook Masters & Saskia Scholtes, *Payback Time: As Subprime Bites, U.S. Investigators Look for Culprits*, FIN. TIMES (London), Aug. 9, 2007, at 11 ("At the height of the US subprime lending boom, taking out a mortgage could not have been easier. Low credit score and history of bankruptcy? No problem. Income too low to qualify for a mortgage? Inflate what you earn on a 'stated income' loan. Nervous that your lender might check up on your 'stated income'? Visit www.verifyemployment.net. For a \$55 fee, the operators of this small California company will help you get a loan by employing you as an 'independent contractor.' They provide paystips as 'proof' of income"); Janet Morrissey, *What's Behind Those Offers to Raise Credit Scores*, N.Y. TIMES, Jan. 19, 2008, at C6 ("[A] San Diego Company, TradeLine Solutions, claims it can improve a borrower's credit score by adding someone else's top-notch credit history to the borrower's history For a \$1,399 fee, TradeLine adds the borrower's name to a stranger's recently paid-off loan just before the account is closed. The account, with its perfect payment history, is then added to the borrower's credit record in 30 to 45 days."); *see also* Angela K. Brown, *The Jury Duty Summons that Wasn't*, LAW.COM, Oct. 25, 2007, <http://www.law.com/jsp/article.jsp?id=1193216623966> ("Feeling like playing hooky, but nervous about getting caught? The Excused Absence Network has got your back. For about \$25, students and employees can buy excuse notes that appear to come from doctors or hospitals. Other options include a fake jury summons or an authentic-looking funeral service program complete with comforting poems and a list of pallbearers.").

The *Stoneridge* majority would say that it was not "necessary or inevitable" that the mortgagee who paid the \$55 for the fake paystip, or the student who paid \$25 for the fake jury summons, or the borrower who paid \$1,399 to improve his credit rating would actually use those documents to mislead third parties. However, this is not especially convincing.

350. *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 128 S. Ct. 761, 770 (2008). Given that the entire purpose of the transaction was to enable Charter to fool its investors, it was, indeed, necessary or inevitable that the fraud would occur unless Charter changed its mind for some unforeseen reason.

2009:351

Scheme Liability

417

defendant has created a fraudulent scheme, authored a false statement, or ordered publication of a false statement, it is much more difficult to argue that it is not “necessary or inevitable” that the fraud will occur. Therefore, *Stoneridge*’s rationale does not in any way require the excessively prodefendant result of *Lattanzio*.

Before *Stoneridge*, several courts interpreting *Central Bank* found primary liability when defendants were “primary architect[s,]”³⁵¹ “mastermind[s,]”³⁵² or inventors³⁵³ of schemes to defraud. This result makes much more sense than the attribution rule when drawing a distinction between primary and secondary liability. It seems utterly indefensible to conclude that the primary mover behind a fraud is only an aider and abettor if he is able to stay behind the curtains while acting as the puppeteer controlling the fraud. The attribution rule provides that only Mortimer Snerd can be liable for his misrepresentations, while a more sensible approach suggests that liability should be visited upon Edgar Bergen.³⁵⁴

Nonetheless, it is certainly possible that the current Supreme Court majority would hew closely to the attribution rule and hold that the auditor was not a primary actor because the false statements were not attributed to it when they were issued. It might also hold that the reliance element is not met because the investors, while they relied upon the auditor generally to review the statements, did not know of the auditor’s particular role in the scam at the time they invested. This would be an extremely unfortunate result, but still a possible one given the current membership of the Court.

CONCLUSION

Reports of the demise of scheme liability have been greatly exaggerated. Section 10(b) is a valid statute that punishes fraud in violation of SEC rules. The SEC used its authority under section 10(b) to issue rule 10b-5 which, in subsection (a), prohibits schemes to defraud. The validity of both the statute and the rule are unquestioned. Even the most vigorous opponents of scheme liability admit that there exists a private right to sue for violations of rule 10b-5(b)’s prohibition of misleading statements and omissions, and any hope they had for

351. *Quaak v. Dexia, S.A.*, 357 F. Supp. 2d 330, 342 (D. Mass. 2005).

352. *In re Global Crossing, Ltd. Sec. Litig.*, 322 F. Supp. 2d 319, 336–37 (S.D.N.Y. 2004).

353. *In re Lernout & Hauspie Sec. Litig.*, 236 F. Supp. 2d 161, 173 (D. Mass. 2003).

354. Edgar Bergen was perhaps the world’s most famous ventriloquist. Mortimer Snerd and Charlie McCarthy were his favorite dummies. See GERALD NACHMAN, RAISED ON RADIO 133–38 (1998).

distinguishing between subsection (b) and subsection (a) was dismissed out of hand by the Supreme Court when it held, simply and obviously, that “[c]onduct itself can be deceptive.”³⁵⁵ There is no basis in the language, policy, or legislative history of section 10(b) to distinguish among the three subsections of rule 10b-5. If there is a right to sue for violations of subsection (b), there is necessarily a right to sue under subsections (a) and (c). Not one word in the *Stoneridge* decision is to the contrary. Lower courts seemingly agree. None has held that *Stoneridge* eliminated scheme liability or course-of-business liability; several have seemingly affirmed their existence by struggling to establish their proper parameters.

While *Stoneridge* clearly, though not expressly, preserved scheme liability, the majority’s tone sent an obvious message: the majority faction is hostile to private rights to sue. One obvious signal is the Court’s decision not to confine *Central Bank* to its facts, and thereby reverse nearly four hundred years of fraud jurisprudence that had held liable all who knowingly participated in a fraud. Another obvious sign was the majority’s decision to ignore its own statement in *Central Bank* that policy concerns are questions for Congress, not the Court, and to voice policy concerns about private litigation that could have been written by Enron’s lobbyists.

The Court’s hostile tone may impact two other key issues that *Stoneridge* left unresolved. First, where do we draw the line between actionable primary liability and inactionable (except by the SEC) secondary liability in section 10(b) and rule 10b-5 cases? In the wake of *Stoneridge*, the lower courts are as split on the issue as they were before. Some courts take a narrow, prodefendant view that in its strictest form holds that if a defendant’s name is not on a false statement or openly associated with a fraudulent scheme, the most the defendant can be is an aider and abettor. Other courts take a broader, more plaintiff view that one who substantially participates in or is intricately involved in a fraud may be a primary wrongdoer. The latter view is more consistent with every body of fraud law upon which section 10(b) could conceivably have been based as well as all section 10(b) jurisprudence from 1934 to 1994. The former view is more consistent with the tone of *Central Bank* and *Stoneridge*.

The second key issue relates to proper application of the reliance requirement. Reliance obviously can be established by direct contact between a plaintiff investor and a defendant, which often happens in securities-fraud cases.³⁵⁶ It can also be established by the fraud-on-the-

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

356. *See, e.g., Burnett v. Rowzee*, 561 F. Supp. 2d 1120, 1126–28 (C.D. Cal. 2008).

2009:351

Scheme Liability

419

market theory when frauds deceive investors in shares traded in public markets, but a key question will be whether courts embrace the attribution rule and require that investors rely upon a defendant's identity or only upon a false representation or fraudulent scheme for which the defendant is responsible. Nearly every body of fraud law in the western legal tradition prevents fraudsters from escaping liability by hiding in the shadows when they are up to their elbows in a fraud, but the attribution requirement, which some courts appear to be applying (at least when the fraudsters are collateral parties rather than corporate officers), creates a jarringly dissonant exception that rewards stealth and guile.

A third method of establishing reliance is via the *Affiliated Ute* presumption in situations where the investors' main complaint is about a failure to disclose rather than an affirmative misrepresentation. The viability of this route for plaintiffs in the future will depend on whether the courts follow the conservative *DVI* reasoning (which allowed a law firm to be a prime mover in a fraud but escape liability)³⁵⁷ or the more proinvestor *Burket* case (which embraced the *Affiliated Ute* reliance presumption when a collateral party was significantly involved in preparation of a document directly communicated to investors).³⁵⁸ Again, the former view allows fraudsters to escape liability by disguising themselves at the time of the transaction. The latter view can attach liability to these fraudsters if their role in the fraudulent statements or schemes is later uncovered.

If most lower courts embrace the prodefendant view of these two issues, several hundred years of fraud jurisprudence will be turned on its head. But the policy preferences of the current majority of the Supreme Court will likely be served.

357. *In re DVI Inc. Sec. Litig.*, 249 F.R.D. 196, 216–17 (E.D. Pa. 2008).

358. *See Burket v. Hyman Lippitt, P.C.*, 560 F. Supp. 2d 571, 587 (E.D. Mich. 2008).