

## SECURITIES LAW

# 10b-5 'Scheme' Liability

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IN SECURITIES FRAUD class actions, billions of dollars can be at stake depending on the answer to the unsettled question of to what extent a defendant who has not made a misstatement or omission may be liable for participating in a "scheme" to defraud under subsections (a) or (c) of Rule 10b-5, 17 C.F.R. 240. Rule 10b-5 was promulgated by the U.S. Securities and Exchange Commission (SEC) pursuant to § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b). Plaintiffs have invoked the scheme theory in lawsuits arising from major corporate scandals in recent years such as Enron Corp. and Global Crossing—plus many cases that have garnered fewer headlines.

The costs of settling cases in which district courts have denied motions to dismiss such theories can be massive. Financial-institution defendants in securities class actions stemming from the collapse of Enron have already paid nearly \$7 billion in settlements. Yet there is no consensus on what exactly it means to participate in (as opposed to aiding and abetting) a fraudulent "scheme" under § 10(b), or even whether such a theory of liability is valid. Courts have articulated conflicting standards, none of which offers reliable guidance as to what kinds of conduct may give rise to liability.

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### 'Central Bank' allowed for secondary-actor liability

The confusion is part of the aftermath of the U.S. Supreme Court's holding in *Central Bank of Denver N.A. v. First Interstate Bank of Denver N.A.*, 511 U.S. 164 (1994), that civil liability under § 10(b) must be premised upon a primary violation of § 10(b) and Rule 10b-5, not on the mere aiding and abetting of another person's fraud. Citing *Santa Fe Indus. Inc. v. Green*, 430 U.S. 462, 471-74 (1977), the court wrote: "[W]e...conclude that the statute prohibits only the making of a material misstatement (or omission) or the commission of a manipulative act." 511 U.S. at 177. The Supreme Court also stated that "[t]he absence of § 10(b) aiding and abetting liability does not mean that secondary actors in the securities markets are always free from liability." Rather, "[a]ny person or entity, including a lawyer, accountant, or bank, who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator under Rule 10b-5, assuming all of the requirements for primary liability...are met." Id. at 191.

Since issuers of securities are sometimes in financial straits when class actions arise, plaintiffs' lawyers like to be able to reach the deep pockets of "secondary actors." In an effort to avoid *Central Bank's* elimination of aiding and abetting claims, plaintiffs in recent years have turned to "scheme" liability, to expand the range of potential defendants.

Some courts, like the 8th U.S. Circuit Court of Appeals in *In re Charter Communications Inc. Securities Litigation*, 443 F.3d 987 (8th Cir. 2006), have rejected "scheme" liability as contrary to the language of § 10(b). The *Charter* plaintiffs invoked the language in subsections (a) and (c) of Rule 10b-5 to support their argument that equipment vendors, who entered into sham transactions knowing that the other party would account for them improperly to inflate revenues, did not merely aid and abet the issuer's fraud but rather could be held liable themselves as primary violators.

In affirming the dismissal of the § 10(b) claims against the vendors, the 8th Circuit observed that § 10(b) prohibits only conduct that is "manipulative or deceptive." Id. The 8th Circuit distilled the Supreme Court precedents into three "governing principles": "a private plaintiff 'may not bring a 10b-5 suit against a defendant for acts not prohibited by the text of § 10(b), including claims under Rule 10b-5'; conduct 'is not 'deceptive,' within the meaning of § 10(b), absent some misstatement or a failure to disclose by one who has a duty to disclose'; and conduct is not 'manipulative' under § 10(b) unless it satisfies 'the limited

contextual meaning ascribed in *Santa Fe*" (illegal trading practices such as wash sales, matched orders or rigged prices that artificially affect market activity). *Id.* at 991-92.

The 8th Circuit concluded that "any defendant who does not make or affirmatively cause to be made a fraudulent misstatement or omission, or who does not directly engage in manipulative securities trading practices, is at most guilty of aiding and abetting and cannot be held liable under § 10(b) or any subpart of Rule 10b-5." *Id.*

Judge Simeon Lake of the U.S. District Court for the Southern District of Texas similarly rejected an effort by plaintiffs to assert scheme liability claims against a bank that allegedly "structured, funded and executed two major series of transactions to hide off Dynegy's balance sheet hundreds of millions of dollars in debt, and artificially inflate Dynegy's reported net income and cash flows." *In re Dynegy Inc. Securities Litigation*, 339 F. Supp. 2d 804, 913-16 (S.D. Texas 2004). "Under *Central Bank* the aid that Citigroup provided Dynegy is not actionable under § 10(b)," Lake wrote, "and plaintiffs cannot invoke subsections (a) and (c) of Rule 10b-5 to circumvent *Central Bank's* limitations on liability for a secondary actor's involvement in the preparation of false and misleading statements." *Id.* at 915.

Another judge in the same district, Judge Melinda Harmon, has reached a different conclusion. In litigation arising out of the collapse of Enron, Harmon embraced scheme liability in a series of opinions that highlight the difficulty, for those courts that accept scheme liability theory, of drawing a clear line between primary participation in a fraudulent scheme and mere aiding and abetting.

Harmon largely adopted a test proposed by the SEC, which focuses on whether the conduct alleged had the principal purpose and effect of deceiving investors: "[I]f a third party enters into a legitimate transaction with a corporation where it knows that the corporation will overstate revenue generated by that transaction, the third party is merely aiding and abetting; in contrast, if the third party and the corporation engage in a transaction whose principal purpose and effect is to create a false appearance of revenues, intended to deceive investors in that corporation's

stock the third party may be a primary violator." *In re Enron Corp. Securities, Derivative and ERISA Litigation*, 2006 U.S. Dist. Lexis 43146, at \*168 (S.D. Texas June 5, 2006).

Harmon acknowledged, however, that "[t]his Court and others have continued to struggle to define parameters for [scheme] liability." *Id.* at \*155. "A major difficulty in the wake of *Central Bank*," Harmon observed, "is defining clearly what conduct constitutes aiding and abetting and what would qualify as a primary violation of § 10(b)." *Id.* at \*168. Indeed, her earlier opinions in the same case appeared to follow a different standard. See 235 F. Supp. 2d 549, 577-94 (S.D. Texas 2002); 310 F. Supp. 2d 819, 829-30 (S.D. Texas 2004). She candidly observed that the case law had developed in the intervening years.

■ **There is still no consensus on what exactly it means to participate in a fraudulent "scheme" (as opposed to aiding and abetting).** ■

■ **9th Circuit modified the basic test promoted by SEC** ■

Later in the same month, the 9th Circuit published *Simpson v. AOL Time Warner Inc.*, 452 F.3d 1040 (9th Cir. 2006), in which it recognized scheme liability, but adopted a different test. The 9th Circuit agreed with the basic test promoted by the SEC: "We agree with the SEC that engaging in a transaction, the principal purpose and effect of which is to create the false appearance of fact, constitutes a 'deceptive act.'" *Id.* at 1048. The 9th Circuit cautioned, however, that "[t]o the extent that the SEC's proposed test purports to include aiding and

abetting or coconspirator liability, we are constrained to reject it." *Id.* at 1043.

Based on these concerns, the 9th Circuit modified the SEC's proposed test: "We hold that to be liable as a primary violator of § 10(b) for participation in a 'scheme to defraud,' the defendant must have engaged in conduct that had the principal purpose and effect of creating a false appearance of fact in furtherance of the scheme. It is not enough that a transaction in which a defendant was involved had a deceptive purpose and effect; the defendant's own conduct contributing to the transaction or overall scheme must have had a deceptive purpose and effect." *Id.* at 1048.

With regard to the complaint in *Simpson*, the 9th Circuit found the allegations inadequate because the third parties were not alleged to have "actually engaged in a deceptive act." *Id.* at 1052. They "helped Homestore to organize and create the triangular transactions" that "were necessary to allow Homestore to overstate its revenues," and they "assisted Homestore in misrepresenting the revenues from these transactions," but they did not "create...sham business entities or engage...in deceptive conduct as part of illegitimate transactions." *Id.*

Still other courts have adopted different formulations. See, e.g., *In re Lernout & Hauspie Securities Litigation*, 236 F. Supp. 2d 161, 173 (D. Mass. 2003); *In re Parmalat Sec. Litig.*, 376 F. Supp. 2d 472, 502-03 (S.D.N.Y. 2005).

The difficulty for legal advisers, and for regular participants in the financial markets, is not only that there are different standards for assessing whether particular conduct could be viewed as giving rise to scheme liability under § 10(b), but also that it is by no means clear how any one of the various formulations is to be applied in practice to particular fact patterns. Seventy years after the provision's enactment, business parties do not know exactly what conduct will be deemed prohibited, and could thus incur millions, or billions, of dollars of liability. ■

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