SECONDARY-ACTOR LIABILITY IN A POST-*STONERIDGE* WORLD: YES, A SUCCESSFUL SUIT AGAINST SECONDARY ACTORS IS STILL POSSIBLE

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I. INTRODUCTION

The corporate scandals of the past decade have forced plaintiffs, courts, and scholars alike to grapple with the scope of secondary-actor liability in securities fraud cases.[1] When does liability under our nation's securities laws extend to lawyers, accountants, and investment bankers who draft the documents, develop the procedures, and structure the transactions that facilitate acts of securities fraud by major corporations? Does liability extend to such actors at all? In response to lingering questions, the Supreme Court of the United States granted a writ of certiorari to hear *Stoneridge Investment Partners, L.L.C. v. Scientific-Atlanta, Inc.* ("*Stoneridge*").[2] Widely viewed as the most important securities case of recent memory, many hoped *Stoneridge* would resolve the uncertainty surrounding secondary-actor liability.[3]

In *Stoneridge*, the Court found that a vendor who had enabled one of its customers to defraud its investors could not be held liable under § 10(b) of the Securities Exchange Act of 1934 ("Exchange

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[1] For the purposes of this Comment, primary actors include the issuers of securities, and secondary actors generally include those who provide services to primary actors, such as lawyers, accountants, investment bankers and other vendors. *See* Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164, 191 (1994). "The use of the term 'secondary actor' relates only to the party's role in the transaction, not secondary or imputed liability." Rodney D. Chrisman, Stoneridge v. Scientific-Atlanta*: Do Section 10(b) and Rule 10b-5 Require a Misstatement or Omission?*, 26 QUINNIPIAC L. REV. 839, 896 (2008).

[2] 128 S. Ct. 761 (2008).

[3] *See* Chrisman, *supra* note 1, at 839–40 (discussing the views of several commentators after the Supreme Court granted certiorari).

Act").[4] The most important question raised by the case was whether a secondary actor must make a material, public misstatement to be found liable in a private cause of action under § 10(b) and Rule 10b-5.[5] More specifically, the Court focused on whether a material, public misstatement is a prerequisite to finding that an investor relied[6] on a secondary actor's deceptive acts in cases where the secondary actor does not owe a duty of disclosure to the investor.[7] The Court posited that such a public misstatement is not required for a plaintiff to attach liability but concluded that the defendants' actions were still "too remote" from the investors' losses for the plaintiffs to demonstrate reliance.[8] But it is unclear when the causal connection between an investor's losses and a secondary actor's deceptive acts would be sufficient to allow a court to impute reliance and attach liability to the secondary actor.[9]

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[4] *Stoneridge*, 128 S. Ct. at 766. The Securities Exchange Act of 1934 (Exchange Act) created the Securities and Exchange Commission (SEC) and authorized it to promulgate rules governing several issues related to securities transactions on secondary markets, including securities fraud, insider trading, shareholder voting via proxy solicitations, tender offers, and periodic disclosures by publicly held corporations. BUSINESS ASSOCIATIONS: CASES AND MATERIALS ON AGENCY, PARTNERSHIPS, AND CORPORATIONS 404–05 (William A. Klein, J. Mark Ramseyer & Stephen M. Bainbridge eds., 7th ed. 2009). Section 10(b), in particular, authorizes the SEC to promulgate rules prohibiting fraudulent activities with respect to the purchase or sale of securities. 15 U.S.C. § 78j (2006); *see* discussion *infra* Part II.A.

[5] *See Stoneridge*, 128 S. Ct. at 769. With respect to the sale or purchase of securities, Rule 10b-5, which was promulgated by the SEC pursuant to § 10(b) of the Exchange Act, broadly prohibits engaging in deceptive and manipulative activities, making untrue statements of material fact, and omitting material facts that would render statements made not misleading. 17 C.F.R. § 240.10b-5 (2010); *see* discussion *infra* Part II.A.

[6] Reliance is a key requirement of securities-fraud actions under Rule 10b-5, providing the requisite causal connection between a defendant's violation of the rule and a plaintiff's losses. Basic Inc. v. Levinson, 485 U.S. 224, 243 (1988). Due to the reality that most securities transactions do not take place in face-to-face encounters, securities law dispenses with the requirement of positive poof of reliance on a defendant's deception. *Id.* at 243–44. The semi-strong form of the efficient-capital-markets hypothesis posits that the market price of a security reflects all publicly available information. RICHARD A. BREALEY, STEWART C. MYERS & FRANKLIN ALLEN, PRINCIPLES OF CORPORATE FINANCE 359 (9th ed. 2008). Therefore, because investors rely on the integrity of a security's market price, reliance is presumed when misstatements are made in an impersonal and well-developed marketplace. *Basic*, 485 U.S. at 247.

[7] Stoneridge Inv. Partners, L.L.C. v. Scientific-Atlanta, Inc, 128 S. Ct. 761, 769 (2008).

[8] *Id.* See *Basic*, 485 U.S. at 247, for a discussion about proving reliance in a well-developed securities market where the fraud-on-the-market presumption is applicable.

[9] *See Stoneridge*, 128 S. Ct. at 770; *The Supreme Court, 2007 Term—Leading Cases*, 122 HARV. L. REV. 485, 490–92 (2008).

By not providing a clear framework for determining the existence of such a causal connection, *Stoneridge* has left an unsettled landscape for shareholders wishing to pursue actions against secondary actors.[10] As one commentator noted, Justice Kennedy and the majority were more concerned with whether their ruling would expand the scope of liability under § 10(b) than about proposing a workable standard for the reliance requirement.[11] Consequently, *Stoneridge* neither closed the door on liability for secondary actors nor established when a secondary actor can be found liable for committing deceptive acts within the ambit of § 10(b) and Rule 10b-5. This result, of course, is confusing and discouraging for injured shareholders who want to seek restitution against secondary actors for their losses.[12]

To resolve the open questions that remain, this Comment proposes a new standard pursuant to which a plaintiff is entitled to a presumption of reliance when a secondary actor undertakes intentional actions aimed at causing the issuance of a misleading statement. Part II of this Comment discusses the evolution of the scope of liability under § 10(b) from the passing of the Exchange Act through the Supreme Court's *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*[13] ("*Central Bank*") decision in 1994. Part III discusses the post-*Central Bank* circuit split over the scope of secondary-actor liability. Part IV analyzes the *Stoneridge* decision in detail and argues that the scope of liability for secondary actors remains undefined because the Court did not establish a framework for presuming reliance in secondary actor cases. Part V explains why existing tests for imputing reliance and attaching liability to secondary actors are unworkable in light of *Stoneridge*. Part VI proposes a test for imputing reliance in the secondary-actor context. Part VII evaluates arguments for judicial recognition of the proposed test. Finally, Part VIII evaluates arguments against the proposed test.

[10] *The Supreme Court, 2007 Term—Leading Cases*, *supra* note 9, at 492.

[11] Chrisman, *supra* note 1, at 878.

[12] Seth S. Gomm, *See No Evil, Hear No Evil, Speak No Evil:* Stoneridge Investment Partners, L.L.C. v. Scientific-Atlanta, Inc. *and the Supreme Court's Attempt to Determine the Issue of Scheme Liability*, 61 ARK. L. REV. 453, 454–55 (2009).

[13] 511 U.S. 164 (1994).

II. THE HISTORY OF THE SCOPE OF LIABILITY FOR SECURITIES FRAUD FROM THE SECURITIES EXCHANGE ACT OF 1934 THROUGH *CENTRAL BANK*

A. *The Securities Exchange Act of 1934*

The intensely speculative and highly leveraged securities trading of the 1920s and the stock market crash of 1929 prompted calls for increased regulation of the securities markets and more rigorous protections for investors.[14] As part of a comprehensive effort to establish a regulatory scheme for the banking and securities industries,[15] President Franklin D. Roosevelt signed the Exchange Act of 1934 into law. Section 10(b) of the Exchange Act affords individual investors broad rights and protections:

> 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 . . . [t]o use or employ, in connection with the purchase or sale of any security . . . 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.[16]

Pursuant to § 10(b), the Securities and Exchange Commission (SEC) promulgated Rule 10b-5, which makes it unlawful

> (a) to employ any device, scheme, or artifice to defraud; (b) to make any untrue statement of material fact or to omit to state a material fact necessary in order to make the statements made, in 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.[17]

The Exchange Act and Rule 10b-5 do not offer an enumerated list of violations. Thus, it appears that Congress left to the courts the role of establishing parameters for the scope of liability.[18] The committee reports of the House and Senate shed little light on who

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[14] H.R. REP. NO. 73-1383 (1934), *reprinted in* 5 LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934 item 18, at 2–5 (J.S. Ellenberger & Ellen P. Mahar, eds., 1973).

[15] *Id.*

[16] 15 U.S.C. § 78j(b) (2006).

[17] 17 C.F.R. § 240.10b-5 (2010).

[18] Ernst & Ernst v. Hochfelder, 425 U.S. 185, 204 (1976) ("The legislative reports do not address the scope of § 10(b) or its catchall function directly.").

should be liable for violations of Rule 10b-5, except to say that liability would not attach without proof of scienter.[19] With reference to § 10(b), the Senate Report merely stated that "'[i]n addition to the discretionary and elastic powers conferred on the administrative authority, effective regulation must include several clear statutory provisions reinforced by penal and civil sanctions, aimed at those manipulative and deceptive practices which have been demonstrated to fulfill no useful function.'"[20] The Court has concluded that "[t]he [Senate] Report therefore reveals with respect to the specified practices, an overall congressional intent to prevent 'manipulative and deceptive practices which . . . fulfill no useful function' and to create private actions for damages stemming from 'illicit practices,' where the defendant has not acted in good faith."[21] The Court further noted that its conclusions about the Senate Report were consistent with the House Report on the Exchange Act.[22] Presumably, Congress did not contemplate the issues of secondary and primary liability with which the courts must grapple today.

In the decades following the Great Depression, however, the courts would begin to define the extent to which private investors could hold violators of Rule 10b-5 accountable. The Supreme Court held in *Superintendent of Insurance of New York v. Banker's Life & Casualty Co.*[23] that Manhattan Casualty Company could hold its controlling shareholder and his collaborators liable under Rule 10b-5 for executing a scheme to purchase the corporation using the corporation's own money.[24] The Court thereby recognized an implied private right of action against violators of Rule 10b-5.[25] The Court stated that "the fact that the fraud was perpetrated by an officer of Manhattan and his outside collaborators is irrelevant to our problem" and citied § 10(b), which states that "any person" can be held liable for engaging in deceptive acts in connection with the sale of a security.[26]

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[19] *Id.*
[20] *Id.* at 204–05 (quoting S. REP. NO. 73-792, at 6 (1934)).
[21] *Id.* at 206 (citing H.R. REP. NO. 73-1383, at 10–11, 20–21 (1934)).
[22] *Id.*
[23] 404 U.S. 6 (1971).
[24] *Id.* at 7–9.
[25] *Id.* at 13 n.9.
[26] *Id.* at 10.

B. A Broad Scope of Liability Emerges in the Courts: Liability for Those Who Merely Aid and Abet Violations of Rule 10b-5

Courts broadly interpreted the implied private right of action to include suits against those who aid and abet violations of Rule 10b-5. In *Brennan v. Midwestern United Life Insurance Co.*,[27] the plaintiffs sued defendant Midwestern for aiding and abetting their stockbroker, Dobich Securities, in its fraudulent activities.[28] Dobich failed to deliver to plaintiffs their stock in Midwestern and used their stock purchase money as working capital for speculation.[29] Plaintiffs who inquired about the status of their stock certificates with Midwestern received letters from Midwestern advising them to notify Dobich Securities of their concerns before reporting the missing stock certificates to the Indiana Securities Commission.[30] Midwestern did this even though it was aware of Dobich's violations of securities laws.[31] Effectively, this letter ensured that there would be a delay in notifying the Indiana Securities Commission of Dobich's actions.[32] The U.S. District Court for the Northern District of Indiana held that Midwestern could be found liable under § 10(b) as an aider and abettor.[33] The court reasoned that even though congressional amendments to codify aider-and-abettor liability under § 10(b) had never become law, aider-and-abettor liability could still be found by applying tort principals to the broad and remedial purpose of the Exchange Act.[34] On appeal, the Seventh Circuit affirmed the district court's ruling and found aider-and-abettor liability cognizable under § 10(b).[35]

The line of cases establishing a broad scope of liability under § 10(b) gave rise to a three-prong test for aider-and-abettor liability.[36] The first prong of the aider-and-abettor liability test required a plaintiff to show a securities violation by the primary party (the issuer of

[27] 259 F. Supp. 673 (N.D. Ind. 1966) (*Brennan I*), *overruled by* Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164 (1994).

[28] *Id.* at 675.

[29] *Id.*

[30] Brennan v. Midwestern Life Ins. Co., 417 F.2d 147, 152–53 (7th Cir. 1969) (*Brennan II*), *overruled by Cent. Bank*, 511 U.S. 164.

[31] *Id.* at 151.

[32] *Id.*

[33] *Brennan I*, 259 F. Supp. at 676–81.

[34] *Id.*

[35] *Brennan II*, 417 F.2d at 154 ("It is our view that the district court was correct in concluding that Midwestern's acquiescence through silence in the fraudulent conduct of Dobich combined with its affirmative acts was a form of aiding and abetting cognizable under Section 10(b) and Rule 10b-5.").

[36] *See* IIT v. Cornfield, 619 F.2d 909, 922 (2d Cir. 1980).

the securities).[37] The second prong required a plaintiff to show that the aider and abettor had knowledge of the securities violation of the primary violator; this satisfied the scienter requirement of securities fraud.[38] The third prong required a plaintiff to show that the aider and abettor contributed substantial assistance to the achievement of the violation.[39] This test for aiding and abetting liability reveals that in the decades following the passage of the Exchange Act, the courts broadly defined the scope of liability under § 10(b) to include liability for aiding and abetting primary violators of Rule 10b-5. A broad scope of liability, however, would not remain in force for long.

C. *Narrowing the Scope of Liability Under § 10(b) of the Securities Exchange Act of 1934:* Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.

The Supreme Court's decision in *Central Bank* presented a paradigm shift in the judiciary's approach to defining the scope of liability under § 10(b) by eliminating aider-and-abettor liability and narrowing the scope of liability for secondary actors.[40] *Central Bank* concerned the sale of bonds by the Colorado Springs Stetson Hills Public Building Authority for which Central Bank served as an indenture trustee.[41] Under the terms of the indenture agreement, the bonds had to be secured by landowner assessment liens, and the land subject to the liens had to be worth 160% of the bonds' outstanding

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[37] *Id.*

[38] *Id.* at 922–23. The Second Circuit held that recklessness satisfied the scienter requirement where the aider and abettor owed a fiduciary duty to the defrauded party. Rolf v. Blyth, Eastman Dillon & Co., Inc. 570 F.2d 38, 44 (2d Cir. 1978). Where the aider and abettor owed no fiduciary duty to the defrauded party, however, the Second Circuit held that the scienter requirement was more stringent and the assistance rendered had to be both substantial and knowing. Edwards & Hanly v. Wells Fargo Sec. Clearance Corp., 602 F.2d 478, 484 (2d Cir. 1979).

[39] *IIT*, 619 F.2d at 922. With respect to this third prong, certain courts refused to impose liability when the substantial assistance consisted of inaction except where a duty to disclose existed. *Id.* at 925–26; Wessel v. Buhler, 437 F.2d 279, 283 (9th Cir. 1971). Other courts took the view that inaction alone could constitute substantial assistance even without an independent duty to disclose, provided that there was a conscious intention to forward the violation. *IIT*, 619 F.2d at 927; *Edwards & Hanly*, 602 F.2d at 484–85; Rochez Bros., Inc. v. Rhoades, 527 F.2d 880, 889 (3d Cir. 1975).

[40] Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164, 191 (1994).

[41] *Id.* at 167. An indenture trustee is a "third party administrator" of a debt contract. THOMAS LEE HAZEN, THE LAW OF SECURITIES REGULATION § 19.1, at 668–69 (6th ed. 2009). The trustee is usually a bank that acts as the agent of the public bond holders. *Id.*

principal and interest.[42] After receiving an appraisal in 1988 that stated that land values had gone almost unchanged from 1986 to 1988, the senior underwriter for the bonds expressed concern to Central Bank that the bank was using an outdated appraisal and that the 160% test was not being met because property values were declining in the Colorado Springs area.[43] Central Bank's in-house appraiser concluded that the 1988 appraisal was too optimistic and that an independent appraiser should be hired to examine the appraisal.[44] Central Bank decided to delay the outside review of the appraisal until the end of the year.[45] Before the outside appraisal was completed, however, the building authority defaulted on the bonds.[46]

After the default on the bonds, First Interstate Bank of Denver and Jack K. Naber sued the bonding authority, the underwriters, and Central Bank, among others, for violations of Rule 10b-5, alleging that Central Bank was secondarily liable for misrepresentation of the value of the bond collateral.[47] The U.S. District Court for the District of Colorado granted summary judgment in favor of Central Bank.[48] The Tenth Circuit reversed, reciting the requirements for a Rule 10b-5 aiding-and-abetting claim.[49] The Tenth Circuit found that Central Bank could be held liable as an aider and abettor on the basis of the facts presented.[50] Specifically, the court opined that "a reasonable trier of fact could conclude that Central Bank had rendered substantial assistance by delaying the independent review of the appraisal" and that there was at least a genuine issue of material fact regarding whether Central Bank was reckless as to a primary violation of Rule 10b-5.[51]

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[42] *Cent. Bank*, 511 U.S. at 167.
[43] *Id.*
[44] *Id.* at 167–68.
[45] *Id.* at 168.
[46] *Id.*
[47] *Id.*
[48] *Cent. Bank*, 511 U.S. at 168.
[49] *Id.* (citing First Interstate Bank of Denver, N.A. v. Pring, 969 F.2d 891, 898–903 (10th Cir. 1992), *rev'd sub nom.* Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164 (1994)). The Tenth Circuit set forth the following requirements for an aiding and abetting claim: "(1) a primary violation of § 10(b); (2) recklessness by the aider and abettor as to the existence of the primary violation; and (3) substantial assistance given to the primary violator by the aider and abettor." *Id.*
[50] *Id.* at 168–69.
[51] *Id.* at 169.

In what has proven to be a watershed decision,[52] the Supreme Court reversed the Tenth Circuit and, basing its decision on several grounds, eliminated the implied private right of action against aiders and abettors.[53] First, the Court held that § 10(b) does not include an express private right of action against aiders and abettors and that Congress had failed to make aiding and abetting grounds for liability in amendments to the Exchange Act.[54] The Court also noted that while bills adding aider-and-abettor liability were introduced in Congress in 1957, 1959, and 1960, all of these bills failed.[55] Second, the Court found that aider-and-abettor liability was untenable because a critical element for recovery was missing from the aider-and-abettor liability framework: reliance.[56] The Court concluded that aider-and-abettor liability allowed plaintiffs to hold defendants liable for aiding and abetting without showing that they relied on the defendant's actions in making their investment decisions.[57] Third, the Court posited that imposing aider-and-abettor liability meant attaching liability to parties who do not commit violations of Rule 10b-5.[58] While § 10(b) states that "[i]t shall be unlawful for any person directly or indirectly" to commit fraud,[59] the Court's principal objection to aider-and-abettor liability was that it "reaches persons who do not engage in the proscribed activities at all, but who give a degree of aid to those who do."[60] Justice Kennedy, writing for the majority, thus reasoned that because liability extends only to those who commit deliberately manipulative or deceptive actions and not to the negligent conduct of the type identified in this case, aiders and abettors, like Central Bank, should not be held liable.[61]

But to read *Central Bank* as closing the door on secondary liability altogether would be a mistake.[62] While mere aiding and abetting cannot be the basis for liability in a private right of action, this "does

[52] *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, 667 (2004) (discussing how *Central Bank* constituted a "major upheaval in securities law").

[53] *Cent. Bank*, 511 U.S. at 191.

[54] *Id.* at 186.

[55] *Id.* at 186–87.

[56] *Id.* at 180.

[57] *Id.*

[58] *Id.* at 176.

[59] 15 U.S.C. § 78j (2006).

[60] *Cent. Bank*, 511 U.S. at 176.

[61] *Id.* at 177.

[62] *Id.* at 191.

not mean that secondary actors in the securities markets are always free from liability under the securities Acts."[63] In fact, "[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" can be held liable as if he were a primary violator under Rule 10b-5, provided that he satisfies all of the elements of primary liability.[64] The Court said that it could not hold Central Bank liable because it "did not commit a manipulative or deceptive act within the meaning of § 10(b)."[65] Thus, if Central Bank, as a secondary actor, had committed a deceptive or manipulative act, it could have been held liable under the statute if it had met the requirements of a primary violation of Rule 10b-5. Courts should apply the same logic to other secondary actors as well: a violation of Rule 10b-5 by a secondary actor should be grounds for liability in a private cause of action provided that the secondary actor satisfies all of the necessary elements of a securities fraud claim.[66]

III. CIRCUIT SPLIT OVER SECONDARY-ACTOR LIABILITY POST-*CENTRAL BANK*: A BRIGHT-LINE RULE VS. SCHEME LIABILITY

In the years following the *Central Bank* decision, courts, grappling with the issue of attaching liability to secondary actors in private causes of action, developed divergent approaches to dealing with very similar instances of deceptive conduct by secondary actors.[67] Some courts opted for a substantial-participation test, which attaches liability to secondary actors who are substantially involved in the production of misstatements made by primary violators of Rule 10b-5.[68] Out

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[63] *Id.*

[64] *Id.*

[65] *Id.*

[66] The basic elements of a securities fraud claim are:

(1) *a material misrepresentation (or omission)*;
(2) *scienter*, i.e., a wrongful state of mind;
(3) *a connection with the purchase or sale of a security*;
(4) *reliance*, often referred to in cases involving public securities markets (fraud-on-the-market cases) as "transaction causation";
(5) *economic loss*; and
(6) "*loss causation*," i.e., a causal connection between the material misrepresentation and the loss.

Dura Pharm., Inc. v. Broudo, 544 U.S. 336, 341–42 (2005) (citations omitted).

[67] *See* Eric Berry, Note, Stoneridge *and the Short-Lived Experiment of Scheme Liability*, 4 N.Y.U. J.L. & BUS. 355, 363 (2007) ("The boundary between primary and secondary violators remain[ed] a matter of dispute between different circuits.").

[68] Chrisman, *supra* note 1, at 860; *see also, e.g.*, Howard v. Everex Sys., Inc., 228 F.3d 1057, 1061–63 (9th Cir. 2000) (holding that substantial involvement in the preparation of fraudulent statements is grounds for liability and that signing consti-

of the substantial-participation test grew the concept of scheme liability articulated by the Ninth Circuit in *Simpson v. AOL Time Warner Inc.*[69] Under this test, a secondary actor is held liable for purposefully committing deceptive acts, such as drafting misleading SEC filings, as part of a scheme to defraud investors.[70] Other courts opted for a more stringent, bright-line rule, which requires plaintiffs to attribute a particular public, material misrepresentation to the secondary actor before attaching liability to that secondary actor under § 10(b) (i.e., the public statement must identify the secondary actor for liability to attach).[71] At the same time, the SEC offered the creator standard as a compromise between the bright-line rule, on the one hand, and the substantial participation and scheme liability approaches on the other.[72] Under the creator standard, a secondary actor is liable if he can be characterized as an author of the misleading statement, as opposed to a mere participant in its drafting.[73] Judicial acceptance of the creator standard, however, appears to be limited compared to the judicial acceptance of the other tests for secondary-actor liability.[74]

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tutes substantial involvement); *In re* Global Crossing, Ltd. Sec. Litig., 322 F. Supp. 2d 319, 333 (S.D.N.Y. 2004) (holding that where the secondary actor's participation in the preparation of a misstatement is substantial enough, the secondary actor will be treated as having made the statement, and the investors may be deemed to have relied on the misstatement even though the statement is not publicly attributed to the secondary actor); *In re* ZZZZ Best Sec. Litig., 864 F. Supp. 960, 972 (C.D. Cal. 1994) (holding that any participant in a course of business or scheme involving the preparation of misstatements can be held liable under § 10(b) and Rule 10b-5).

[69] 452 F.3d 1040 (9th Cir. 2006), *vacated*, 128 S. Ct. 1119 (2008).

[70] For a detailed discussion of the origins and growth of the scheme liability concept, see Nicholas Fortune Schanbaum, Note, *Scheme Liability: Rule 10b-5(a) and Secondary Actor Liability After* Central Bank, 26 REV. LITIG. 183, 205–34 (2008).

[71] *See, e.g.*, Lattanzio v. Deloitte & Touche L.L.P., 476 F.3d 147, 155 (2d Cir. 2007) (declining to adopt the substantial-participation test and holding that the misstatement must be publicly attributed to the actor for liability to attach); Regents of Univ. of Cal. v. Credit Suisse First Boston (USA), Inc., 482 F.3d 372, 389–90 (5th Cir. 2007) (holding that secondary actors' participation in transactions, regardless of their purpose or effect, does not give rise to liability absent a public misstatement by the secondary actor); Ziemba v. Cascade Int'l, Inc., 256 F.3d 1194, 1206 (11th Cir. 2001) (holding that the misstatement must be attributable to the secondary actor for liability to attach); Wright v. Ernst & Young L.L.P., 152 F.3d 169, 175 (2d Cir. 1998) (holding that the misstatement must be attributable to the secondary actor at the time of dissemination for liability to attach).

[72] Elizabeth Cosenza, *Rethinking Attorney Liability Under Rule 10b-5 in Light of the Supreme Court's Decisions in* Tellabs *and* Stoneridge, 16 GEO. MASON L. REV. 1, 22 (2008) ("The SEC's creator standard attempted to forge a compromise between the bright line standard's limited attribution rule and the specter of unlimited liability arguably inherent in the application of the substantial participation standard.").

[73] *Id.* at 23–24.

[74] The Third Circuit in *Klein v. Boyd*, No. 97-1143, 97-1261, 1998 WL 55245 (3d Cir. 1998), adopted the SEC's creator standard, but its decision was later vacated by

Thus, the Ninth Circuit's scheme-liability concept, the substantial-participation test, and the bright-line rule dominated pre-*Stoneridge* jurisprudence.

A. *Scheme Liability:* Simpson v. AOL Time Warner Inc.

Under the scheme-liability framework enunciated in *Simpson*, secondary actors who engage in deceptive acts can be liable if they participate in a scheme to defraud investors, which results in misrepresentations being made to investors.[75] *Simpson*, like so many other cases, involved fraudulent transactions designed to inflate revenues.[76] Defendant Homestore.com would identify a third-party corporation that was thinly capitalized and in need of revenues to facilitate an initial public offering of its stock.[77] Homestore.com would then agree to purchase either shares in that company for inflated values or services or products that Homestore.com did not need.[78] The third party would then agree to purchase advertising from AOL for nearly the entire amount Homestore.com was paying it.[79] The money thus flowed from the third party to AOL, which took a commission and then shared the sham advertising revenues with Homestore.com.[80]

The Ninth Circuit considered the question of whether the secondary-actor defendants had committed a primary violation by facilitating Homestore.com's fraud, but it ultimately decided that they had not.[81] In considering this question, however, the court outlined a framework for finding secondary actors liable as primary actors.[82] The court first reviewed the basic elements of a securities fraud claim found in *Dura Pharmaceuticals, Inc. v. Broudo*.[83] The court then proceeded to outline the requirements for scheme liability within the

the court's decision to grant an en banc rehearing. Schanbaum, *supra* note 70, at 202–03. Nonetheless, the test would later be adopted in a Northern District of Georgia decision in *Carley Capital Group v. Deloitte & Touche, L.L.P.*, 27 F. Supp. 2d 1324, 1334 (N.D. Ga. 1998), and by the Southern District of Texas in *In re Enron Corp. Sec., Derivative & ERISA Litig.*, 235 F. Supp. 2d 549, 590–91 (S.D. Tex. 2002). *Id.* at 203–04.

[75] Simpson v. AOL Time Warner Inc., 452 F.3d 1040, 1043 (9th Cir. 2006), *vacated*, 128 S. Ct. 1119 (2008).

[76] *Id.*

[77] *Id.* (quoting *In re* Homestore.com, Inc. Sec. Litig., 252 F. Supp. 2d 1018, 1023 (C.D. Cal. 2003)).

[78] *Id.*

[79] *Id.*

[80] *Id.* at 1044.

[81] *Simpson*, 452 F.3d at 1046.

[82] *Id.* at 1046–50.

[83] 544 U.S. 336 (2005); *see supra* note 66.

purview of § 10(b).[84] Two of these requirements are particularly germane to the argument: secondary actors must engage in conduct with the principal purpose and effect of creating a material misrepresentation as to the value of securities, and the investor must demonstrate reliance on the secondary actor's acts.

The first requirement for scheme liability is that "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."[85] The court distinguished the "principal purpose" prong of scheme liability from the requirement of scienter.[86] Scienter requires strong "evidence of deliberately reckless or conscious misconduct"; it goes to the defendant's state of mind.[87] On the other hand, the "principal purpose and effect test" looks to the nature of the defendant's conduct and asks whether it was sufficiently deceptive for liability.[88] In particular, the court looks to whether the defendant's conduct involved an illegitimate transaction that may form the basis of a primary violation of Rule 10b-5.[89] In this case, the court held that AOL Time Warner and the other defendants ultimately could not be held liable because their conduct was not sufficiently deceptive within the meaning of the Exchange Act, as the dealings in which they had engaged were, on their face, legitimate business transactions.[90]

The second requirement for scheme liability is that the plaintiff-investor must show reliance on the deceptive act of the secondary party.[91] Where the defendant has no duty to disclose information to investors, courts will presume reliance on a defendant's misstatements if the misstatements are disseminated into an "efficient market."[92] The fraud-on-the-market theory of reliance "'applies to all three clauses of Rule 10b-5: (1) scheme to defraud, (2) misrepresen-

[84] *Simpson*, 452 F.3d at 1046.
[85] *Id.* at 1048.
[86] *Id.* at 1048 n.5.
[87] *Id.*
[88] *Id.*
[89] *Id.*
[90] *Simpson*, 452 F.3d at 1052–55.
[91] *Id.* at 1051.
[92] *Id.* "Indeed, nearly every court that has considered the proposition has concluded that where materially misleading statements have been disseminated into an impersonal, well-developed market for securities, the reliance of individual plaintiffs on the integrity of the market price may be presumed." Basic Inc. v. Levinson, 485 U.S. 224, 247 (1988).

tation or omission, and (3) fraudulent course of business.'"[93] Therefore, the court held that reliance will be presumed where a misrepresentation "necessarily resulted from the scheme and the defendant's conduct" and "was disseminated into an efficient market and was reflected in the market price."[94] The Ninth Circuit found that a plaintiff could show reliance on the deceptive acts of a secondary actor even though no public misrepresentations are directly attributable to that secondary actor.[95]

B. The Bright-Line Rule: Regents of the University of California v. Credit Suisse First Boston (USA), Inc.[96]

In contrast to the Ninth Circuit holding in *Simpson*, the Fifth Circuit held in *Regents of the University of California v. Credit Suisse First Boston (USA), Inc.* ("*Credit Suisse*") that a secondary actor must actually make a public, material representation to be found liable under § 10(b).[97] Much like *Simpson*, *Credit Suisse* involved partnerships and transactions engineered specifically for the purpose of inflating revenue and taking liabilities off the books.[98] In this case, Enron enlisted Credit Suisse, Merrill Lynch, and other investment banks in what has become known as the "Nigerian Barges Transaction."[99] Enron wanted to liquidate its interest in electricity-generating barges off the coast of Nigeria in late 1999 so that it could increase its revenue for the quarter and meet Wall Street expectations.[100] Enron solicited Merrill Lynch to enter into a transaction pursuant to which Merrill Lynch would purchase the barges and Enron would pay Merrill a premium and repurchase the barges within the following six months.[101] Merrill purchased the barges, and Enron bought them back at a premium a few months later.[102] Enron then recorded the transaction, not as a

[93] *Simpson*, 452 F.3d at 1051 (quoting 4 ALAN R. BROMBERG & LEWIS D. LOWENFELS, BROMBERG & LOWENFELS ON SECURITIES FRAUD & COMMODITIES FRAUD § 7:469 (2d ed. 2006)).

[94] *Id.* at 1052.

[95] *Id.*

[96] 482 F.3d 372 (5th Cir. 2007).

[97] *Compare Simpson*, 452 F.3d at 1049 (articulating the rule that a public misstatement need not be attributed to the secondary actor to impose liability), *with Credit Suisse*, 482 F.3d at 385–86 (articulating the rule that absent a duty to disclose, a public misstatement must be attributed to a secondary actor to impose liability).

[98] *Credit Suisse*, 482 F.3d at 377.

[99] *Id.*

[100] *Id.*

[101] *Id.*

[102] *Id.*

loan, as would have been proper, but as a sale in order to boost its 1999 year end revenues.[103] The plaintiffs alleged that the banks knew that the purpose of these transactions was to raise revenue figures, which would in turn increase the rate of executive compensation.[104]

The court in *Credit Suisse* noted that the U.S. District Court of the Southern District of Texas held that "rule 10b-5(a)'s prohibition of 'any scheme . . . to defraud' gives rise to joint and several liability for defendants who commit individual acts of deception in furtherance of such a scheme" on the theory that the banks had a duty not to engage in a fraudulent scheme.[105] The Fifth Circuit reversed the district court decision and held that the plaintiffs failed to plead reliance regarding the defendant's deceptive acts.[106] The court reasoned that neither the presumption of reliance based on a duty to disclose nor the presumption of reliance based on the theory of fraud-on-the-market applied to the facts of the case.[107] First, the investment banks' actions were not deceptive within the meaning of § 10(b) because the banks had no affirmative duty to disclose to Enron's investors.[108] Second, the court argued that the district court's finding of reliance based on a theory of fraud-on-the-market was wrong because "[t]o qualify for the [fraud-on-the-market] presumption [of reliance] . . . a plaintiff must not only indicate that a market is efficient, but also must allege that the defendant made public and material misrepresentations; i.e., the type of fraud on which an efficient market may be presumed to rely."[109] Because the defendant banks in *Credit Suisse* only participated in the transactions and did not make deceptive public misstatements on which the investors could have relied, they could not be held liable under § 10(b).[110]

This Comment is particularly concerned with the court's holding with respect to fraud-on-the-market reliance because the Fifth Circuit rejected the concept of reliance articulated by the Ninth Circuit in *Simpson*.[111] Instead, the Fifth Circuit adopted the Eighth Circuit's reasoning in *In re Charter Communications, Inc., Securities Litiga-*

[103] *Id.*
[104] *Credit Suisse*, 482 F.3d at 377.
[105] *Id.* at 378.
[106] *Id.* at 385.
[107] *Id.*
[108] *Id.* at 386.
[109] *Id.* at 385–86.
[110] *Credit Suisse*, 482 F.3d at 388–90.
[111] *See supra* note 94 and accompanying text.

tion[112] in which the court held that a public misstatement by a secondary actor is necessary for finding that secondary actor liable.[113] The Ninth Circuit and the Fifth Circuit applied different rules to very similar fact patterns.[114] Thus, in examining *Stoneridge*, the question is whether the Supreme Court actually resolved the disagreement among the circuits over attaching liability to secondary actors in cases where the secondary actors have no affirmative duty to disclose their deception. This Comment takes the position that the Supreme Court's decision in *Stoneridge* has not resolved the disagreement; in fact, it has only further muddied the waters.

IV. *STONERIDGE INVESTMENT PARTNERS, L.L.C. V. SCIENTIFIC-ATLANTA, INC.* AND SECONDARY-ACTOR LIABILITY

A. *The Facts and the History*

Stoneridge involved a class-action lawsuit brought by shareholders against Charter Communications and two of its equipment suppliers, Scientific-Atlanta and Motorola, alleging that they had participated in transactions which inflated revenue and cash flow statements.[115] In late 2000, despite other efforts to manipulate its financial results—including the delayed reporting of terminated customers, improper capitalization of costs, and manipulation of billing cut-off dates to inflate its revenues—Charter's revenue was still fifteen- to twenty-million dollars below Wall Street estimates for revenue and cash flow.[116] To help make up the revenue shortfall, Charter decided to modify its existing contractual arrangements with Scientific-Atlanta and Motorola which both sold Charter the digital cable converter boxes used by its cable subscribers.[117] Charter arranged to overpay Scientific-Atlanta and Motorola twenty dollars for each converter box it purchased through the end of the year with the understanding that

[112] 443 F.3d 987 (8th Cir. 2006).

[113] *Id.* at 992 ("Any defendant who does not make or affirmatively cause to be made a fraudulent statement or omission, or who does not directly engage in manipulative securities trading practices, is at most guilty of aiding and abetting and cannot be held liable under § 10(b) or any subpart of Rule 10b-5.").

[114] *Compare supra* note 94 and accompanying text, *with supra* note 109 and accompanying text.

[115] Stoneridge Inv. Partners, L.L.C. v. Scientific-Atlanta, Inc., 128 S. Ct. 761, 766 (2008).

[116] *Id.*

[117] *Id.*

they would return the overpayment by purchasing advertisements from Charter.[118]

To mislead its accountant into certifying the revenue figures, including the fake advertising revenue, Charter requested that Scientific-Atlanta send documents stating that Scientific-Atlanta had increased production costs for the converter boxes by twenty dollars per box, a request with which Scientific-Atlanta complied.[119] Charter also agreed in a written contract to purchase a specific number of set-top boxes from Motorola with the expectation that it would not take delivery of all the boxes and with the express provision that it would pay Motorola liquidated damages of twenty dollars per unit.[120] Scientific-Atlanta and Motorola then signed contracts with Charter to purchase advertising from Charter at a price higher than fair value, which represented a return to Charter of the twenty dollar overpayment it made for each set-top box.[121] Charter backdated the advertising agreements to give the impression that they were negotiated separately from the agreements to overpay for the converter boxes and therefore, represented two separate transactions, which was necessary to allow Charter to record the advertising payments as revenue on its financial statements.[122] Notably, however, Scientific-Atlanta and Motorola played no role in preparing or disseminating Charter's misleading financial statements, and their own financial statements booked the transactions as a wash in accordance with generally accepted accounting principles.[123]

The U.S. District Court for the Middle District of Florida dismissed the complaint for failure to state a claim upon which relief could be granted, and the Eighth Circuit affirmed the dismissal.[124] The Eighth Circuit reasoned that *Central Bank* provided the courts with three guiding principles. The first is that a private plaintiff "may not bring a 10b-5 suit against a defendant for acts not prohibited by the text of § 10(b)."[125] Secondly, the court held that "[a] device . . . is not 'deceptive,' within the meaning of § 10b, absent some misstate-

[118] *Id.*

[119] *Id.* at 767.

[120] *Id.*

[121] *Stoneridge*, 128 S. Ct. at 767.

[122] *Id.*

[123] *Id.*

[124] *Id.*

[125] *In re* Charter Commc'ns, Inc., Sec. Litig., 443 F.3d 987, 992 (8th Cir. 2006) (quoting Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164, 173 (1994)) (internal quotation marks omitted).

ment or failure to disclose by one who has a duty to disclose."[126] Thirdly, the court ruled that the term "manipulative" in Rule 10b-5 has a limited contextual meaning.[127] Applying these principals to *Stoneridge*, the Eighth Circuit held that neither Scientific-Atlanta nor Motorola could have engaged in a deceptive act because neither made a public misstatement and neither was under a duty to disclose information about Charter's financial health.[128] Therefore, both were merely aiders and abettors and could not be held liable.[129] Because the Eighth Circuit's ruling reflected the split among the circuits over "when, if ever, an injured investor may rely upon § 10(b) to recover from a party that neither makes a public misstatement nor violates a duty to disclose but does participate in a scheme to violate § 10(b)," the Supreme Court granted a writ of certiorari to hear the case.[130]

B. *The Key Issue Identified by the Supreme Court in* Stoneridge*: Reliance*

In reaching its conclusion that the plaintiffs in *Stoneridge* could not attach liability to Scientific-Atlanta and Motorola, the Supreme Court focused on whether the plaintiffs had satisfied the reliance requirement (i.e. whether the investors' reliance on the acts and statements of Scientific-Atlanta and Motorola could be presumed even though neither of them had made public misstatements).[131] The plaintiffs argued that Charter's public issuance of a misleading financial statement was "a natural and expected consequence of respondents' deceptive acts" and that "Charter's auditor would not have been fooled, and the financial statement would have been a more accurate reflection of Charter's financial condition" but for the assistance provided by Scientific-Atlanta and Motorola.[132] Essentially, they argued that reliance can be found if the secondary actor is a "but for" cause of the dissemination of a deceptive misstatement.

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[126] *Id.* (citing Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 474–75 (1977)).

[127] *Id.* (citing *Santa Fe Indus.*, 430 U.S. at 476 (holding that manipulation is a term of art that "refers generally to practices, such as wash sales, matched orders, or rigged prices, that are intended to mislead investors by artificially affecting market activity")).

[128] *Id.*

[129] *Id.*

[130] Stoneridge Inv. Partners, L.L.C. v. Scientific-Atlanta, Inc., 128 S. Ct. 761, 767 (2008). *Compare supra* note 94 and accompanying text, *with supra* note 109 and accompanying text.

[131] *Stoneridge*, 128 S. Ct. at 769.

[132] *Id.* at 770.

The Supreme Court rejected the plaintiffs' argument that they relied on the deceptive acts of Scientific-Atlanta and Motorola.[133] Generally speaking, to find that the investors in Charter stock relied on Scientific-Atlanta and Motorola's deceptive acts, the investors would have had to show "the 'requisite causal connection between a defendant's misrepresentation and a plaintiff's injury.'"[134] The Supreme Court explained that there are two ways to establish the causal connection and demonstrate reliance.[135] First, if a party with a duty to disclose omits a material fact, the investor to whom the duty was owed does not need to provide specific proof of reliance because reliance is presumed in such situations.[136] Second, reliance is presumed under the fraud-on-the-market doctrine when material misstatements become public.[137] Concluding that the defendants had no duty to disclose, the Court focused on the second method of satisfying the reliance requirement: the fraud-on-the-market presumption of reliance.[138]

The Court found that the defendants' deceptive acts, namely taking part in the sham transactions and drafting documents to codify those transactions, and the public statements made by Charter were "too remote" from plaintiffs' losses to satisfy the reliance requirement via a fraud-on-the-market presumption.[139] The majority posited that investors do not rely on the transactions reflected in financial statements and that such a concept of reliance would result in attaching liability to the entire marketplace in which the company issuing securities does business.[140] The Court concluded that "nothing respondents did made it necessary or inevitable for Charter to record the transactions as it did" and, therefore, the plaintiffs did not satisfy the reliance requirement.[141] At the same time, however, the Court explained that its conclusion should not be "read to suggest there must be a specific oral or written statement before there could be lia-

[133] *Id.*
[134] *Id.* at 769 (quoting Basic Inc. v. Levinson, 485 U.S. 224, 243 (1988)).
[135] *Id.*
[136] *Id.* (citing Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128, 153–54 (1972)).
[137] *Stoneridge*, 128 S. Ct. at 769 (citing *Basic,* 485 U.S. at 247).
[138] *Id.*
[139] *Id.*
[140] *Id.*
[141] *Id.* at 770.

bility under § 10(b) or Rule 10b-5," and it explicitly noted that "[c]onduct itself can be deceptive."[142]

C. The Scope of Secondary-Actor Liability Remains Undefined: The Supreme Court Did Not Close the Door on Secondary-Actor Liability

Although it restricted the scope of secondary-actor liability outlined in *Central Bank*, the Supreme Court did not clearly resolve the dispute between the circuits by simply choosing the bright-line rule over the scheme liability concept or one of the other tests. By saying that "specific oral or written [mis]statement[s]" are not necessary for a finding of liability,[143] the Supreme Court essentially refused to uphold a key feature of the of the Fifth Circuit's decision in *Credit Suisse* and the Eighth Circuit's decision in *Charter Communications*.[144] At the same time, however, the Court said that it could not hold a secondary actor liable unless its deceptive acts made a primary actor's statement "necessary or inevitable" (i.e., not "too remote").[145] Implicit in this statement is the conclusion that if Scientific-Atlanta and Motorola's actions in *Stoneridge* had made it "necessary or inevitable for Charter to record the transactions as it did," the reliance requirement would have been satisfied and liability would have attached to their actions.[146] The Court's language thus supports the proposition that secondary-actor/scheme liability still exists in some, albeit a limited, form.[147] As one commentator wrote,

> [t]hus the answer to the question certified for review—whether an injured investor "may rely upon § 10(b) to recover from a par-

[142] *Id.* at 769.

[143] *Stoneridge*, 128 S. Ct. at 769.

[144] *See* Regents of the Univ. of Cal. v. Credit Suisse First Boston (USA), Inc., 482 F.3d 372, 385–86 (5th Cir. 2007); *In re* Charter Commc'ns, Inc., Sec. Litig., 443 F.3d 987, 992 (8th Cir. 2006).

[145] *Stoneridge*, 128 S. Ct. at 770.

[146] *Id.*

[147] *See* DAVID WILTENBERG, SUPREME COURT'S LATEST WORD ON PRIVATE SECURITIES FRAUD CLAIMS: STONERIDGE INVESTMENT PARTNERS, LLC V. SCIENTIFIC ATLANTA, INC. 4–5 (LEXIS 2008), 2008 EMERGING ISSUES 1861 ("But what if, in some alternate *Stoneridge*, information about the deceptive acts actually had been communicated – could such acts be 'deceptive' for § 10(b) purposes and thus the predicate for a primary violation? This was the question the Eighth Circuit had answered in the negative and which the Supreme Court was not compelled to reach. Having noted that the suppliers' 'course of conduct included both oral and written statements, such as the backdated contracts,' the Court could have based its affirmance on the absence of reliance alone. Justice Kennedy nevertheless addressed the question squarely, and squarely rejected as 'erroneous' the view impliedly adopted by the Eighth Circuit, in language destined to be quoted in future cases: 'Conduct itself can be deceptive.'") (citations omitted).

ty that neither makes a public misstatement nor violates a duty to disclose but does participate in a scheme"—appears to be "Yes, provided investors actually or presumptively rely upon the party's conduct."[148]

The statutes and accompanying rules buttress the theory that liability can still be attached to secondary actors who do not issue public misstatements. First, reading the *Stoneridge* decision along with the statutory language found in § 10(b) and Rule 10b-5 provides further evidence in support of the proposition that the Supreme Court could not have intended to make a public misstatement a prerequisite for liability.[149] Only Rule 10b-5(b) makes a misstatement grounds for liability; the other parts of the rule do not.[150] Rule 10b-5(a), together with § 10(b), makes it "unlawful for any person, *directly or indirectly* . . . to employ any device, scheme, or artifice to defraud."[151] Rule 10b-5(c) makes it unlawful "to engage in any act, or course of business which operates or would operate as a fraud or deceit on any person."[152] A simple reading of the statute and the rule demonstrates that a misstatement is not the only basis for liability.[153] As one commentator asked, "Why else, in fact, would there be subsections (a) and (c) if not meant to cover some acts different, and totally apart, from (b)?"[154] He went on to argue that "[s]urely, 'indirectly' means something."[155]

Second, when § 10(b) says "*any person,* directly or indirectly," it implicitly brings secondary actors within the scope of liability.[156] In light of *Central Bank*, which held that secondary-actor liability exists, reading the statute and the accompanying rules otherwise would be erroneous.[157] In *Stoneridge*, Justice Kennedy wrote that misstatements are not necessary for liability and that "[c]onduct itself can be decep-

[148] *Id.* at 5.
[149] *See* 17 C.F.R. § 240.10b-5(a), (c) (2010).
[150] *Id.* § 240.10b-5(a)–(c).
[151] § 240.10b-5(a) (emphasis added); *see also* 15 U.S.C. § 78j (2006).
[152] § 240.10b-5(c).
[153] *See* SEC v. Zandford, 535 U.S. 813, 820 (2002) ("[N]either 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 the act.").
[154] Stuart Sinai, Stoneridge – *Escape From Securities Liability Notwithstanding Active, Intentional, Deceptive Conduct,* 8 J. BUS. & SEC. L. 170, 182 (2008).
[155] *Id.*
[156] *See* 15 U.S.C. § 78j (2006) (emphasis added).
[157] See discussion *supra* Part II.C for an analysis of the *Central Bank* decision.

tive."[158] Therefore, Justice Kennedy's opinion in conjunction with the statute, the accompanying SEC rules, and the existing case law demonstrate that liability should still attach to a secondary actor who perpetrates a fraud by engaging in deceptive acts even if those acts do not include the actual issuance of a misstatement into the public domain.[159] With the door not completely closed on secondary-actor liability, the judiciary and investors alike are left with the following question: when are the deceptive acts of a secondary actor not "too remote" from the losses incurred by the investors to impute reliance and attach liability to that secondary actor?

D. *The Open Question: How Do Post-*Stoneridge *Plaintiffs Satisfy the Reliance Requirement?*

The Court's reasoning in *Stoneridge* indicates that it was concerned that an overly broad concept of reliance would result in liability attaching to a multitude of parties engaged in ordinary business transactions with the securities issuer.[160] The majority clearly does not want courts to cast a wide net, ensnaring legitimate businessmen into a maelstrom of liability when the links between the deceptive conduct and the investors' losses are far too attenuated.[161] If, however, the Court's answer to the question is that liability can be attached only when public misstatements are the necessary and inevitable result of the secondary actor's deceptive acts, the lower courts are left to determine the sets of factual circumstances under which deceptive acts make a public misstatement necessary or inevitable.

In requiring that the public misstatements must be the necessary or inevitable result of the secondary actor's deceptive acts, the Supreme Court has left a finding of reliance difficult to envision. Commentators have noted that "it is difficult to conceive how the test could ever be satisfied short of an actor's either making false statements, failing to make statements it was obliged to make, or engaging in traditionally proscribed market manipulation that is the equivalent

[158] Stoneridge Inv. Partners, L.L.C. v. Scientific-Atlanta, Inc., 128 S. Ct. 761, 769 (2008).

[159] *See* Sinai, *supra* note 154, at 181–82 (citing United States v. O'Hagan, 521 U.S. 642, 651 (1997)).

[160] *See Stoneridge*, 128 S. Ct. at 770 ("Were this concept of reliance to be adopted, the implied cause of action would reach the whole marketplace in which the issuing company does business . . . .").

[161] *See id.*

thereof."[162] Only two days after the Supreme Court issued the *Stoneridge* decision, however, the lead plaintiffs in *Credit Suisse* petitioned the Court for a writ of certiorari in hopes that the Court would clarify the scope of secondary liability in their favor, but the Court denied certiorari.[163]

The *Credit Suisse* petition serves to highlight the unsettled nature of the law with respect to secondary-actor liability. The lead plaintiffs in *Credit Suisse* argued,

> [F]ar from warranting a denial of certiorari, this Court's decision in *Stoneridge* demonstrates critical differences between *Enron* and *Stoneridge*—differences that warrant a *grant* of certiorari to determine § 10(b)'s scope not in the context of ordinary business transactions addressed by *Stoneridge*, but in the context of fraud perpetrated by financial professionals engaged in fraudulent dealings in our securities markets.[164]

In an attempt to contrast the *Stoneridge* investors' lack of reliance on suspicious transactions in the marketplace for goods and services with transactions taking place in the investment sphere, the lead plaintiff's brief further noted that *Stoneridge* does not rule out liability for fraud by financial professionals that is directed at securities markets (e.g., schemes designed to inflate a company's quarterly and year-end revenue figures).[165] The plaintiff argued that the scope of secondary-actor liability in *Stoneridge* should be read to include "an underwriter who knowingly underwrites a fraudulent offering and deliberately disseminates fraudulent offering documents, selling securities to the public."[166] Implicit in the plaintiff's argument in the *Credit Suisse* petition for writ of certiorari is the conclusion that the reliance requirement is satisfied and liability should be found in cases where secondary actors are intimately involved in activities closely related to the issuance and sale of securities. After all, it would seem reasonable to conclude that investors do in fact rely on the integrity of those who play vital roles in drafting financial documents and who do just about everything with respect to the creation of the documents except attach their names to or directly disseminate such documents.[167] In any

[162] EVAN A. DAVIS, MITCHELL A. LOWENTHAL & NANCY I. RUSKIN, DAVIS, LOWENTHAL, & RUSKIN ON STONERIDGE INVESTMENT LLC V. SCIENTIFIC ATLANTA, INC. 5 (LEXIS 2008), 2008 EMERGING ISSUES 1880.

[163] *Id.*

[164] Supplemental Brief of Petitioner-Appellant at 2, Regents of the Univ. of Cal. v. Merrill Lynch Pierce Fenner & Smith, Inc., 128 S. Ct. 1120 (2008) (No. 06-1341).

[165] *Id.*

[166] *Id.* at 3.

[167] *See* discussion *infra* Part VII.

case, the petition for a writ of certiorari in the *Credit Suisse* case was likely only the first in what will amount to a multitude of attempts by plaintiffs' lawyers to get the Supreme Court to clarify the scope of secondary liability and, more specifically, to address the circumstances under which the reliance requirement would be deemed satisfied in secondary actor cases.[168]

V. THE EXISTING TESTS FOR SECONDARY-ACTOR LIABILITY DO NOT ADEQUATELY ADDRESS *STONERIDGE'S* CONCERNS ABOUT RELIANCE

Existing tests for imposing liability on secondary actors are instructive, but they do not provide a framework for satisfying the reliance requirements of *Stoneridge* and therefore do not avail a method of recovery against secondary actors. The major tests for secondary-actor liability—namely, the substantial-participation test, the bright-line rule, and the creator test—are unworkable in light of Justice Kennedy's opinion.[169] A plaintiff satisfying either the substantial-participation test or the creator test will likely fail to impose liability on a secondary actor for lack of a causal link between the secondary actor's deceptive acts and the primary actor's misstatement on which the investing public is presumed to rely.[170] Similarly, the existing concept of scheme liability does not adequately address the Court's concerns about the causal relationship between the secondary actor's involvement in the fraudulent scheme and the public release of a misleading statement.[171] By contrast, the bright-line rule would seemingly nullify secondary-actor liability altogether with its requirement that the plaintiff must attribute a public misstatement to the defendant to impose liability for a violation of Rule 10b-5.[172]

A. The Substantial-Participation Test Does Not Provide a Basis for Imputing Reliance

The substantial-participation test implicates actors who are intricately involved in the preparation of fraudulent documents "even though [their] participation might not lead to the [primary] actor's

[168] JAMES L. STENGEL, STEVEN J. FINK AND KRISTEN R. FOURNIER, STONERIDGE INVESTMENT PARTNERS, LLC V. SCIENTIFIC ATLANTA, INC. 4–5 (LEXIS 2008), 2008 EMERGING ISSUES 1881 ("It seems certain that creative plaintiffs will continue to press one or more variants of the scheme liability theory, using as a springboard the Court's statement that '[c]onduct itself can be deceptive . . . .'").

[169] *See* discussion *supra* Part IV.C.

[170] *See* discussion *infra* Part V.A–B.

[171] *See* discussion *infra* Part V.D.

[172] *See* discussion *infra* Part V.C.

actual making of the statements."[173] As one commentator has noted, the substantial-participation test employs a shifting and highly fact-oriented determination of what constitutes substantial participation; many courts have applied this standard on an ad-hoc basis, which has thus offered little predictive value to those secondary actors who want to be sure that their actions are not causing the perpetration of fraud.[174] *Stoneridge*, however, makes direct causation of the public misstatement a prerequisite for imputing reliance and imposing liability in the secondary actor context.[175] The substantial-participation test is thus untenable in the post-*Stoneridge* environment because it would potentially impose liability on those whose deceptive conduct falls short of directly causing a misstatement to be made public.[176]

B. The SEC's Creator Test Does Not Provide a Basis for Imputing Reliance

The creator test proposed by the SEC is untenable for reasons similar to those which make the substantial-participation test unworkable in the post-*Stoneridge* world. Although the creator standard reflects an attempt by the SEC to craft a compromise "between the bright line standard's limited attribution rule and the specter of unlimited liability arguably inherent in the application of the substantial participation standard," such a test would potentially impose liability on anyone who plays a role in authoring a public misstatement even though that person plays no role in its dissemination.[177] One commentator posited that "when disclosure results from the collaborative efforts of a number of people . . . the SEC's creator standard fails to provide a workable framework for analysis."[178] The publication of a misstatement is not the necessary or inevitable result of its creation. Actors other than the creator of the misstatement, such as the actor who edits the document or the actor who offers feedback on the document, often determine whether the misstatement is published.[179] Imposing liability on the basis of someone's status as the author of

[173] Howard v. Everex Sys., Inc., 228 F.3d 1057, 1061 n.5 (9th Cir. 2000).

[174] Cosenza, *supra* note 72, at 32–33.

[175] *See* Stoneridge Inv. Partners, L.L.C. v. Scientific-Atlanta, Inc., 128 S. Ct. 761, 770 (2008); *see also id.* at 774 (Stevens, J., dissenting) (discussing the majority's "super-causation" view of reliance).

[176] *See* Cosenza, *supra* note 72, at 43–44 (citing *Stoneridge*, 128 S. Ct. at 769) (noting that actions in an indirect chain are too remote for imposing liability under *Stoneridge*).

[177] *Id.* at 22.

[178] *Id.* at 38.

[179] *Id.*

the misstatement would thus be problematic because it would potentially implicate actors who are unhinged from the causal chain and too far removed from the issuance of a misleading statement. The creator test, therefore, runs afoul of the requirement that the secondary actor's deceptive conduct must be causally linked to the dissemination of the misstatement.[180]

C. *The Bright-Line Rule Is Incompatible with* Stoneridge

Despite all of the rejoicing among those in the corporate defense bar who view *Stoneridge* as a big win for securities fraud defendants,[181] the close reading of *Stoneridge* advocated by this Comment reveals that the bright-line rule is incompatible with the decision in *Stoneridge*. *Stoneridge*, which states that it would be erroneous "to suggest that there must be a specific oral or written statement before there could be liability under § 10(b) or Rule 10b-5,"[182] directly conflicts with the language found in cases articulating a bright-line rule like *Wright v. Ernst & Young, L.L.P.*[183] *Wright* held that for the plaintiff to satisfy the reliance requirement and attach liability, a public misstatement must be attributable to the secondary actor.[184] For the Court in *Stoneridge*, the question is not whether there is a public misstatement; that is not necessary for a finding of liability.[185] The crucial question is whether the secondary actor's deceptive acts "have the requisite proximate relation to the investors' harm" to satisfy the reliance requirement.[186] Therefore, in so far as it requires the plaintiff to show that the secondary actor actually issued a public statement

[180] *See Stoneridge*, 128 S. Ct. at 770; *see also id.* at 774 (Stevens, J., dissenting) (discussing the majority's "super-causation" view of reliance).

[181] WILTENBERG, *supra* note 147, at 1 ("The 5-3 decision, authored by Justice Kennedy, has been heralded as closing the door on a wide variety of fraud claims against secondary actors . . . ."); *see* JAMES A. FANTO, JAMES FANTO ON THE "BAD APPLES" PERSPECTIVE ON CORPORATE SCANDALS 4 (LEXIS 2008) 2008 EMERGING ISSUES 1817 ("The *Stoneridge* decision may thus be a Pyrrhic victory for business and financial professionals.").

[182] *Stoneridge*, 128 S. Ct. at 769.

[183] 152 F.3d 169, 175 (2d Cir. 1998).

[184] *Id.* ("'[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)'. . . . [A] secondary actor cannot incur primary liability under the Act for a statement not attributed to that actor at the time of its dissemination. Such a holding would circumvent the reliance requirements of the Act . . . .") (citations omitted).

[185] *Stoneridge*, 128 S. Ct. at 770.

[186] *Id.* at 769.

him or herself, the bright-line rule is too restrictive.[187] Such a requirement does not comport with the pronouncement that "conduct itself can be deceptive" articulated by Justice Kennedy in *Stoneridge*.[188] In fact, such a rule is incompatible with the very existence of secondary-actor liability because secondary actors like lawyers, accountants, and investment bankers do not issue statements directly to the investing public but rather play a behind the scenes role, assisting those who do.

D. *The Concept of Scheme Liability Is Incompatible with* Stoneridge

Unlike the Ninth Circuit in *Simpson*, the Supreme Court in *Stoneridge* held that in cases where a secondary actor has no duty to disclose, reliance cannot be presumed, and thus, liability cannot be found simply because secondary actors purposefully engage in conduct that has the principal effect of creating a false appearance of material fact.[189] In *Stoneridge,* both Scientific-Atlanta and Motorola played a significant role in perpetrating the fraud on Charter investors by actively participating in the sham transactions that made the fraudulent misrepresentation possible.[190] Therefore, the *Stoneridge* defendants would have been found liable under § 10(b) if the Court had employed the scheme-liability concept. The Court, however, determined that the plaintiffs did not rely on the defendants' actions because their actions did not make the misstatement on which the investors relied necessary or inevitable.[191] In the eyes of the Court, a sufficient causal nexus did not exist between Scientific-Atlanta's and Motorola's actions and the release of the misleading cash flow statements.[192] The concept of scheme liability based on a principal purpose and effect test is thus incompatible with what Justice Steven's dissenting opinion calls *Stoneridge*'s "super-causation" standard for reliance.[193] Future plaintiffs, who simply allege that a secondary actor acted with the principal purpose and effect of creating a public miss-

[187] Schanbaum*, supra* note 70, at 198–99.

[188] *Stoneridge*, 128 S. Ct. at 769.

[189] *Compare id.* at 770 (explaining that acting with the principal purpose and effect of creating a false appearance of material fact is insufficient to impose liability), *with* Simpson v. AOL Time Warner Inc., 452 F.3d 1040, 1048 (9th Cir. 2006), *vacated*, 128 S. Ct. 1119 (2008) (explaining that secondary-actor liability can be predicated on conduct that has the principal purpose and effect of creating a false appearance of material fact).

[190] *See* discussion *supra* Part IV.A.

[191] *See* discussion *supra* Part IV.B.

[192] *Stoneridge*, 128 S. Ct. at 770.

[193] *See id.* at 774 (Stevens, J., dissenting).

tatement, will fail to establish the causal nexus necessary for the court to impute reliance.[194]

In the brief period since the Court issued the *Stoneridge* decision, scholars have noted the insufficiency of scheme liability. One commentator has opined that similar to the other existing tests for secondary-actor liability, "scheme liability focuses on the actions and intent of the secondary actor rather than on whether the secondary actor has engaged in conduct upon which a plaintiff could presumptively rely."[195] Even advocates of scheme liability point out that there is but a thin distinction between scheme liability's purpose-and-effect test and the standard scienter requirement of securities fraud.[196] The purpose-and-effect test, its supporters say, is designed to determine whether the secondary actor's conduct was sufficiently deceptive to warrant liability.[197] Thus, while the scheme-liability concept may identify conduct that is sufficiently deceptive within the meaning of Rule 10b-5, it does not identify the causal relationship between the secondary actor's conduct and the primary actor's issuance of a material misstatement. A framework that does not adequately focus on that causal relationship is unlikely to pass muster under *Stoneridge* because it will be viewed as opening the litigation flood gates to actions against secondary actors who are, in the Court's eyes, too remote from the primary violator's conduct. As one article has noted, "it is clear that the Court intended to eliminate scheme liability because the Court was concerned that it would expand the implied cause of action" to secondary actors who merely aid and abet the primary violator in releasing public misstatements.[198] The result is that courts are left without a workable framework for imputing reliance and attaching liability in the secondary actor context.

The goal of this Comment, therefore, is to propose a test that the courts can employ in cases involving secondary actors who engage in deceptive acts within the ambit of § 10(b) and Rule 10b-5 but who do not have a duty to disclose their activities and do not directly make a public misstatement. Such a test for imputing reliance and imposing liability must fit within the narrow parameters outlined by Justice Kennedy in *Stoneridge*, which dictate that reliance on the secondary actor's conduct will only be presumed when the secondary actor's deceptive acts clearly make the primary actor's issuance of a material

[194] *See id.*
[195] Chrisman, *supra* note 1, at 866.
[196] Schanbaum, *supra* note 70, at 230–31.
[197] *Id.*
[198] Chrisman, *supra* note 1, at 879.

misstatement necessary or inevitable.[199] In other words, the defendant-secondary actor's deceptive acts and the public misstatement made by the primary actor must be sufficiently close (or not too remote) to allow the court to impute reliance and attach liability. No longer is the defendant's "but for" causation of the plaintiff investor's losses sufficient to satisfy the reliance requirement.[200] To establish reliance on the defendant's deceptive acts, plaintiffs must now show that the defendant's acts were a proximate cause of their losses.[201] Thus, a proper test will allow the courts to determine whether a direct causal connection exists between the conduct of the defendant-secondary actor and the public's reliance on a misstatement issued by the primary actor. Satisfaction of such a test will enable the complaining investor to invoke the fraud-on-the-market presumption of reliance outlined in *Basic*.[202]

VI. PROPOSED TEST: A TWO-PRONGED CAUSE AND EFFECT TEST

The aim of the proposed test is to provide courts with a framework for identifying factual situations where the defendant-secondary actor's deceptive acts and the primary actor's public misstatement are so closely linked that the secondary actor's actions are akin to releasing a misleading statement on which the public is presumed to rely. In other words, the test will identify those situations where a misleading public statement can appropriately be attributed to the secondary actor even though it is the primary actor who actually issues the misstatement. The test is a two-pronged, cause-and-effect, fact-based test. First, the cause prong focuses on the purposeful conduct of the secondary actor and the extent to which it caused the primary actor to make a material, public misstatement. Second, the test focuses on the effect of the fraud resulting from the secondary actor's conduct and the extent to which the secondary actor accrued a material benefit from the fraud. This Comment argues that plaintiffs can satisfy the causation-intensive reliance requirement of *Stoneridge* by demonstrating that the defendant-secondary actors engaged in intentional conduct calculated to cause the public issuance of a misstatement and by showing that the secondary actor gained a material benefit as a result of his or her active role in the fraud.

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[199] *See Stoneridge*, 128 S. Ct. at 770.

[200] *Id.* at 776 (Stevens, J., dissenting); *see generally* Lentell v. Merrill Lynch & Co. Inc., 396 F.3d 161 (2d Cir. 2005) (discussing "but for" causation); Binder v. Gillespie, 184 F.3d 1059 (9th Cir. 1999) (same).

[201] STENGEL, FINK & FOURNIER, *supra* note 168, at 5.

[202] *See supra* note 6.

A. The Cause: Intentional Steps Above and Beyond Drafting Documents

In the wake of *Stoneridge*, plaintiffs must now do more than show that the fraud was a result of the secondary actor's deceptive conduct. Plaintiffs must demonstrate that the secondary actor's deceptive acts made it necessary or inevitable that the primary violator's public misstatement would be made.[203] Therefore, the cause prong of the test requires the plaintiff to establish a prima facie case of a direct causal connection between the secondary actor's deceptive acts and the primary actor's public misstatement on which the plaintiff investor presumably relied in making his or her investment decisions.

Satisfying the cause prong depends on the extent of the role the conduct played in making the material misstatement a reality. The first prong of the test for establishing reliance is met when a plaintiff alleges that the secondary actor engaged in purposeful conduct that actually caused the primary actor to make a public misstatement affecting the value of securities. The fact that a lawyer, accountant, or some other secondary actor purposefully put pen to paper and drafted a misstatement would be insufficient.[204] The plaintiff must establish that the secondary actor took a series of purposeful steps from the point of drafting the misstatement to its actual release to ensure the achievement of his fraudulent designs. Such a series of critical, affirmative steps above and beyond simply drafting the misstatement could include encouraging the primary actor to release the misstatement, counseling the primary actor on the institutionalization of a process enabling the dissemination of false or misleading statements, otherwise facilitating misstatements, or pressuring the client to make misleading statements.

The idea is not completely theoretical. Secondary actors have often gone beyond "acquiescing" in the demands of their clients. Many instances have occurred where auditors, insurers, and investment bankers have specifically designed structures to facilitate misrepresentation of material facts concerning a company's financial condition and openly marketed them to their clients.[205] Several examples are worth noting. Citigroup developed a plan to sell other companies on Enron-style schemes, which included a presentation on trans-

[203] *See Stoneridge*, 128 S. Ct. at 770.

[204] *See* discussion *supra* Part V.D.

[205] Brief for Arkansas, New Jersey, Rhode Island, and the New York State Common Retirement Fund, et. al. as Amicus Curiae Supporting Petitioners at 5, Stoneridge Investment Partners, L.L.C. v. Scientific-Atlanta, Inc., 128 S. Ct. 761 (2008) (No. 06-43).

actions described as balance-sheet friendly and advertisements promoting the use of a special purpose entity operated by Citigroup to effect such transactions.[206] The scheme advertised would in effect make certain commodities trades appear as though they were independent and unrelated even though they were not.[207] Arthur Andersen, the now defunct accounting firm, developed a white paper that explained how to circumvent certain accounting standards to create fictitious revenue.[208] A.I.G., the insurance giant, paid $10 million to the SEC to settle a charge that it had "played an indispensible part" in a fraud by selling an insurance product "A.I.G. had developed and marketed for the specific purpose of helping issuers to report false financial information to the public."[209]

More recently, Lehman Brothers used misleading accounting and legal maneuvers to disguise its true financial health as the credit crisis of 2008 began to unfold. In fact, shortly before its demise in September 2008, Lehman Brothers used repurchase agreements ("repos")[210] to temporarily move toxic securities off its balance sheet and reduce leverage in an effort to foster the false perception among investors that it had sold such securities and was on a strong financial footing.[211] Notably, Lehman Brothers sought a law firm that would

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[206] *The Role of Financial Institutions in Enron's Collapse: Hearings Before the Permanent Subcomm. of Investigations of the Senate Governmental Affairs Comm.*, 107th Cong. (2002) (statement of Robert L. Roach, Chief Investigator, Permanent Subcomm. on Investigations).

[207] *Id.*

[208] Dennis K. Berman, Julia Angwin & Chip Cummins, *Tricks of the Trade: As Market Bubble Neared End, Bogus Swaps Provided a Lift*, WALL ST. J., Dec. 23, 2002, at A1.

[209] Gretchen Morgenson, *S.E.C. Wants a Monitor to Examine A.I.G.'s Books*, N.Y. TIMES, Nov. 3, 2004, at C1.

[210] A repurchase agreement is one in which a firm transfers an asset to a third party as collateral for a short-term borrowing but agrees to repay the cash and take back the collateral at a certain point in the future. *See* Report of Anton R. Valukas, Examiner, at 732 n.2848, *In re* Lehman Brothers Holdings Inc. (S.D.N.Y. Bankr. March 10, 2010) (08-13555). Lehman Brothers often transferred securities to its European subsidiaries in intracompany "Repo 105" transfers. *See id.* at 786.

[211] *See id.* at 732–39. The examiner reported,

> Lehman regularly increased its use of Repo 105 transactions in the days prior to reporting periods to reduce its publicly reported net leverage and balance sheet. Lehman's periodic reports did not disclose the cash borrowing from the Repo 105 transaction – *i.e.*, although Lehman had in effect borrowed tens of billions of dollars in these transactions, Lehman did not disclose the known obligation to repay the debt. Lehman used the cash from the Repo 105 transaction to pay down other liabilities, thereby reducing both the total liabilities and the total assets reported on its balance sheet and lowering its leverage ratios. . . . Lehman never publicly disclosed its use of Repo 105 transactions, its accounting treatment for these transactions, the considerable escala-

provide an opinion letter stating that these transactions were true sales (i.e., not short-term loan agreements).[212] The legal opinion passing on the repurchase scheme was certainly a critical part of Lehman Brothers' ultimately failed effort to hide from market view its vast stockpile of illiquid securities and the true extent of its indebtedness.[213] The Lehman Brothers debacle thus further illustrates the direct effect that the work of secondary actors, like law firms, have on financial markets.

While the culpability of the aforementioned actors and the specific details of their conduct is not the concern of this Comment, if their actions were intentionally calculated to complete a fraudulent scheme, then such conduct clearly would establish a direct causal connection between the secondary actor's conduct and the release of the statement on which the investors relied.[214]

> tion of its total Repo 105 usage in late 2007 and into 2008, or the material impact these transactions had on the firm's publicly reported net leverage ratio.

Id. at 732–34 (internal footnotes omitted). The assets Lehman Brothers transferred as part of these repurchase transactions included commercial mortgage-backed securities, sub-prime mortgages, and leveraged loans. *Id.* at 738–37. In the second quarter of 2008, Lehman Brothers temporarily removed as much as $50.38 billion in securities from its balance sheet. *Id.* at 742.

[212] *See* Report of Anton R. Valukas, Examiner, *supra* note 210, at 740.

[213] In order to classify the repurchase agreements as true sales for accounting purposes, Lehman Brothers had to book the underlying transactions as true sales at law. *Id.* at 782–83. Generally speaking, repurchase transactions cannot be treated as sales in the United States because U.S. attorneys cannot furnish true sale opinion letters under U.S. law. *Id.* at 784. Therefore, Lehman Brothers engaged Linklaters, a British law firm, to analyze the transactions under English law for one of its European subsidiaries through which it executed these repurchase transactions. *See id.* at 740, 782–86. Notably, Lehman Brothers failed to notify its investors that it recorded the repurchase transactions as true sales on the basis of an English legal opinion, not U.S. law. *See id.* at 987. This Comment does not mean to suggest that the opinion letter provided by Linklaters was improper; it merely raises this issue to point out that the work of secondary actors, like law firms, has a direct effect on financial markets.

[214] Distinguishing a legitimate business arrangement between the secondary and primary actor that happens to facilitate fraud and one that encompasses intentional actions calculated to effectuate fraud will not always be an easy task. Certain actions that constitute purposeful steps to achieve fraudulent designs in some cases may be completely innocent in others. *See* Taavi Annus, Note, *Scheme Liability Under Section 10(b) of the Securities Exchange Act of 1934*, 72 MO. L. REV. 855, 883–90 (2007) (discussing the difficulties associated with distinguishing between illegitimate and legitimate business transactions entered by secondary actors, such as major investment banks). Nevertheless, the scienter requirement of securities fraud actions stands as a bulwark against implicating innocent parties and will necessarily resolve such difficulties. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976) (Scienter is the "intent to deceive, defraud, or manipulate.").

B. The Effect: Defrauded Investors and an Enriched Secondary Actor

The second part of this new test for imputing reliance and imposing liability in secondary actor cases requires a showing that the secondary actor actually received some material benefit as a result of his or her participation in the fraudulent scheme. Post-*Stoneridge*, establishing that the secondary actor was enriched by the fraud he perpetrated is crucial because of the Court's concern that the plaintiffs' injuries were too far removed from the defendants' deceptive acts to enable the court to find some connection between the two.[215] Showing that the defendant-secondary actor was directly enriched by the fraudulent scheme overcomes Justice Kennedy's concern about remoteness, demonstrating how involved the secondary actor was in the public misstatement on which the investor relied and how likely it was that a public misstatement would be made. If a secondary actor has a sizeable financial gain or loss at stake in the fraud, the fraudulent public misstatement can become the "necessary or inevitable" result of the secondary actor's deceptive acts. This is because without such a material misstatement by the primary actor, the secondary actor would not have been able to achieve his or her ends.

Situations in which secondary actors derive a material benefit from the deceptive acts are distinguishable from the *Stoneridge* case. In *Stoneridge*, no facts exist in the record to indicate that Scientific-Atlanta and Motorola derived any material benefit from participating in the sham transactions.[216] Both Scientific-Atlanta and Motorola had existing contractual arrangements with Charter, and no evidence indicated that the contracts were ever contingent upon their participation in the scheme.[217] Notably, however, while direct evidence may not have existed to explain why Scientific-Atlanta and Motorola participated in Charter's scheme, the defendants may have profited nonetheless through a quid pro quo relationship which ensured that Charter would continue to buy the defendants' products, and "that someday Charter [might] return the favor when the scheming com-

[215] *See* Stoneridge Inv. Partners, L.L.C. v. Scientific-Atlanta, Inc., 128 S. Ct. 761, 770 (2008) ("[R]eliance is tied to causation, leading to the inquiry whether respondents' acts were immediate or remote to the injury.").

[216] *See id.* at 766–67. "Charter arranged to overpay respondents $20 for each set top box it purchased until the end of the year, with the understanding that respondents would return the overpayment by purchasing advertising from Charter." *Id.* at 766. "And their [referring to Scientific-Atlanta, Inc. and Motorola, Inc.] own financial statements booked the transactions as a wash, under generally accepted accounting principles." *Id.* at 767.

[217] *See id.* at 761.

panies needed to pad their own books to deceive shareholders."[218] Nevertheless, even if the defendants profited indirectly they would avoid liability under the proposed test because it requires evidence of a direct material benefit. In future cases, plaintiffs seeking recovery under the proposed test would have to show that the secondary actors received a real, tangible benefit for their deceptive acts, such as new business contracts, alteration of existing contracts to include more favorable terms, or satisfaction of loan obligations that otherwise would have become bad debts. By requiring the plaintiffs to show that the secondary actor defendants actually received a benefit from actively promoting the fraud, the test ensures that liability will only be imposed when the fraud is closely connected to a secondary actor's deceptive conduct.

VII. ARGUMENTS SUPPORTING THE ADOPTION OF THE PROPOSED TEST

The overarching rationale supporting this proposed test is, of course, the continued need for secondary-actor liability. The reality is that shareholders of a company and the investing public at large do rely on the actions of secondary actors.[219] Average investors have neither the time nor the resources to research every aspect of every company.[220] The result is public reliance on a company's financial statements, regulatory filings, annual reports, and the opinions of the investment community.[221] These reports, which require the involvement of secondary actors, affect the movement of securities' prices on a daily basis.[222] Secondary actors thus have a crucial impact on securities markets, whether they are lawyers, accountants, investment bankers, or others in the business community. This impact justifies an endeavor to clarify the reliance framework in the post-*Stoneridge* environment and ensure that plaintiffs can recover against culpable secondary actors.

Adopting the test proposed in this Comment will allow courts to impute reliance and attach secondary-actor liability while also ensuring that liability is not imposed on parties that are innocent or only tangentially connected to the fraud. In requiring a plaintiff to show that the defendant-secondary actor took additional steps beyond simply drafting the misstatement released by the primary actor, the

[218] Gomm, *supra* note 12, at 479.
[219] *Id.* at 478.
[220] *Id.*
[221] *Id.*
[222] *Id.*

cause prong of this test goes beyond the tests employed before *Stoneridge*.[223] It allows the courts to identify situations in which the misstatement *should* be attributed to the secondary actor because, except for signing the document and transmitting it to the key financial news networks, the secondary actor took the critical steps necessary to ensure that the misleading statement would be released to the investing public. The test effectively places the culpable secondary actor in the shoes of the primary actor for purposes of presuming reliance under *Stoneridge*, and it provides the courts with a clear strategy for avoiding the inequitable and unfair conclusion that a secondary actor can avoid liability simply because he did not imprint his name on a public document for which he was otherwise responsible. At the same time, however, by focusing on whether the secondary actor actually caused a misrepresentation, the proposed test ensures that the scope of liability is not over-encompassing.

In addition to clarifying the reliance requirement in a balanced fashion, the proposed two-pronged test responds to other policy concerns as well. The proposed test will discourage secondary actors from entering into relationships with primary actors that promote fraud and encourage secondary actors to ferret out such fraudulent activities. Secondary actors such as law firms and auditors perform functions ("*e.g.*, designing transactions, drafting press releases and prospectuses, and producing non-public opinions for issuers and underwriters") that are critical to the ability of companies to execute transactions.[224] Without the honest services of secondary actors like law firms and auditors, managers of publicly traded companies can more easily inflate revenue and engage in other efforts to perpetrate fraud.[225]

The corporate scandals of the past decade have illustrated the failure of professional service providers to block the fraudulent endeavors of corporate management.[226] After all, secondary actors, such as lawyers and accountants, have an incentive to acquiesce in clients' demands to assist with the preparation and dissemination of misstatements: fees.[227] Primary violators can "easily threaten to take their business elsewhere" when a secondary actor expresses an unwilling-

[223] *See* discussion *supra* Part VI.A.

[224] Brief for Council of Institutional Investors et. al. as Amicus Curae Supporting Petitioners at 4, Stoneridge Investment Partners, L.L.C. v. Scientific-Atlanta, Inc., 128 S. Ct. 761 (2007) (No. 06-43).

[225] *Id.* at 5.

[226] *Id.* at 4.

[227] *Id.* at 6.

ness to participate in a fraudulent scheme.[228] Absent the specter of liability, the drive for profit on the part of the secondary actors will encourage the perpetration of fraud on the part of secondary actors. The test proposed in this Comment focuses squarely on the profit motive of the secondary actor.[229] By holding those who extract material gain from fraudulent schemes accountable, the test will thwart secondary actors who are lured by a desire to obtain or retain the business of those bent on engaging in fraud.

VIII. ARGUMENTS AGAINST ADOPTING THE PROPOSED TEST

A principal public policy argument against enacting the proposed test may be that even though the test is designed to impose liability only on the most culpable actors, the adoption of the test will lead to a litigation explosion by attracting potential plaintiffs who previously thought that *Stoneridge* precluded them from filing suits against secondary actors.[230] Some might argue that the proposed test will open the flood gates to litigation because it ensures a measure of liability for deceptive acts even when there is no duty to disclose.[231] Members of the securities industry contend that "[i]f Section 10(b) did not require that duty as a condition to liability in the nondisclosure context, every routine commercial or financial transaction with a public issuer would become a minefield of private securities-fraud liability exposure."[232] Litigation abuse might then become an even more significant problem for the securities industry in situations much like the one the market faced in Fall 2008:

> In the context of securities class actions, a variety of factors combine to ensure that (i) class litigation is routinely brought in the wake of large or precipitous drops in the stock price of a publicly traded company, and (ii) a large portion of filed actions that sur-

[228] *Id.*

[229] *See* discussion *supra* Part VI.B.

[230] *See* Gomm, *supra* note 12, at 454–55 ("This article argues that while *Stoneridge* has further empowered the Securities and Exchange Commission ('SEC') in its mandate to police the securities market, it has also left a discouraging and confusing result for injured shareholders who want to seek private restitution for their losses. The result appears to be that, so long as companies *do not disclose* the public truth behind sham contracts and transactions in which they have participated (thereby causing reliance), the companies probably will not be vulnerable to private actions from shareholders.").

[231] *See generally* Brief for the Securities Industry and Financial Markets Association and Futures Industry Association as Amicus Curiae Supporting Respondents at 13, Stoneridge Investment Partners, L.L.C. v. Scientific-Atlanta, Inc., 128 S. Ct. 761 (2008) (No. 06-43) [hereinafter Brief for the Securities Industry].

[232] *Id.* at 3.

vive motions to dismiss settle before their merits are ever tested before a neutral trier of fact.[233]

Therefore, creating a model by which plaintiffs can show reliance might only serve to encourage plaintiffs to file suits against numerous secondary actors.[234]

Aside from arguing that the test itself is balanced and targeted at only those who have directly caused a fraudulent misrepresentation, this Comment counters that the lack of a clear framework for imputing reliance in the wake of *Stoneridge* will cause an uptick in litigation, and the proposed test is what is needed to reduce meritless claims. While the majority in *Stoneridge* was driven by policy concerns about the scope of liability in securities cases and was motivated by a dislike of the implied right of action under § 10(b), "the opinion raises many more questions than it does answers."[235] The result is that the plaintiffs' bar has already begun crafting new arguments explaining why they are entitled to a presumption of reliance, though with limited success to be sure.[236] Nevertheless, the possibility of litigation proceeding past the initial pleading stage remains in light of *Stoneridge's* fact-specific application of the reliance requirement.[237] In response to the uncertainty *Stoneridge* has engendered, the proposed test posits a clear framework that plaintiffs can use to determine when their claims are actually viable. Such a test will, therefore, limit the lawsuits to those situations where plaintiffs can plead that the named secondary actor defendant caused the fraudulent misrepresentation which resulted in financial injury.

The second principal challenge that the proposed test will face is the argument that it is unnecessary because the SEC has already been tasked with prosecuting secondary actors.[238] The SEC, however, disagrees with this contention and argues that private litigation against secondary actors is necessary to prevent flagrant violations of securities laws because the SEC cannot possibly investigate and impose

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[233] Brief of the Washington Legal Foundation as Amicus Curiae in Support of Respondents at 6–7, Stoneridge Investment Partners, L.L.C. v. Scientific-Atlanta, Inc., 128 S. Ct. 761 (2008) (No. 06-43).

[234] *See* Brief for the Securities Industry, *supra* note 231, at 3.

[235] Chrisman, *supra* note 1, at 918.

[236] *The Supreme Court, 2007 Term—Leading Cases*, *supra* note 9, at 492.

[237] *Id.*

[238] *See* Matthew L. Mustokoff, *Fraud Not on the Market: Rebutting the Presumption of Classwide Reliance Twenty Years After* Basic Inc. v. Levinson, 4 HASTINGS BUS. L.J. 225, 243 (2008).

sanctions on every secondary actor engaging in deceptive acts.[239] The SEC noted in its amicus brief filed in the *Simpson* matter that without private suits against secondary actors, too many securities violations would go unpunished because groups of scheming secondary actors could deliberately plan for one schemer to issue the public misstatement necessary for the successful completion of their fraud.[240] This would essentially allow one schemer to risk liability while allowing each of the other participants to avoid it.[241] The proposed test will ensure that private litigation properly supplements the efforts of the SEC to prosecute secondary actors, some of whom might otherwise elude liability.

IX. CONCLUSION

No one doubts that the scope of liability under § 10(b) of the Securities and Exchange Act of 1934 has narrowed significantly in recent years. What was once a law broadly applied to those guilty of committing deceptive and manipulative acts in connection with the acquisition or disposition of financial instruments is now tightly circumscribed. Regardless of the approach taken, the crucial matter for the courts has been the satisfaction of the age old reliance requirement. The reliance requirement remains a legitimate cause for concern. How can one say, absent some misstatement or some duty to disclose, that an investor buying or selling securities relies on the deceptive conduct of some secondary actor who remains unknown to that investor?

In *Stoneridge*, the Supreme Court provided some guidance but did not answer the question fully. In accordance with Rule 10b-5, Justice Kennedy made clear that a material misstatement is not necessary for a finding of liability. Had he said otherwise, the headlines might have proclaimed that the Court had dead-bolted the door on liability for secondary actors.[242] Instead, in stating that "conduct itself can be deceptive," a position that is in harmony with Rule 10b-5, the Court

[239] *See* Linda Greenhouse, *Supreme Court Limits Lawsuits by Shareholders*, N.Y. TIMES, Jan. 16, 2008, *available at* http://www.nytimes.com/2008/01/16/washington/16bizcourt.html.

[240] Brief for the Securities and Exchange Commission as Amicus Curiae Supporting Appellants at 7, Simpson v. AOL Time Warner Inc., 452 F.3d 1040 (9th Cir. 2006) (No. 04-55665).

[241] *Id.* at 7.

[242] For examples of the news headlines that preceded and proceeded the *Stoneridge* decision, see John Engler, *Washington's Biggest Decision*, WASH. POST, July 2, 2007, at D-3; Greenhouse, *supra* note 239; Marc J. Lane, *High Court Securities Case a Threat to Shaky Capital Markets*, CRAIN'S CHI. BUS., Dec. 10, 2007, at 20.

assured the continued viability of private suits against secondary actors who commit primary violations of Rule 10b-5 other than making a public misstatement.[243] The Court, however, did not fully explain how a plaintiff suing such a secondary actor would be able to show that he or she is entitled to a presumption of reliance on the secondary actor's deceptive acts. What the Court did say was that the causal connection between the plaintiff's losses and the secondary actor's deception was far too attenuated to impute reliance and attach liability. Only when such deception makes a public misstatement by a primary actor "necessary or inevitable" would the reliance requirement be satisfied.[244]

Although it narrowly circumscribes the scope of secondary-actor liability, *Stoneridge* does not prevent investors from attaching liability to secondary actors altogether. The proposed test for presuming reliance in the secondary actor context explains that under circumstances factually distinguishable from *Stoneridge*, plaintiffs will be able to demonstrate that there is a close causal connection between the secondary actor's deceitful conduct and their losses. Under the proposed test, reliance will be established when (1) the secondary actor has taken intentional steps calculated to defraud the plaintiff-investor, and (2) the secondary actor has benefitted materially from the fraudulent ends he successfully achieved in partnership with the primary actor.[245] Judicial recognition of this proposed test will prevent the inequity of allowing critical participants in fraudulent schemes who shrewdly avoid placing their name on some public document to avoid compensating investors for their losses, and it will do so without trapping innocent parties in costly litigation.

[243] *See* Stoneridge Inv. Partners, L.L.C. v. Scientific-Atlanta, Inc. 128 S. Ct. 761, 769 (2008).

[244] *See id.* at 771.

[245] *See supra* Part IV.