WHEN SECONDARY

IS PRIMARY

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SCHEME LIABILITY UNDER RULE 10b-5(a) AND (c)

In *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164, 191 (1994), the Supreme Court ruled that secondary actors such as banks, auditors, and law firms could not be liable under Section 10(b) of the Securities Exchange Act of 1934 or SEC Rule 10b-5 for aiding and abetting securities fraud. In so ruling, however, the Court did not completely absolve secondary actors from liability under the securities laws. *Central Bank* specifically noted that:

> [a]ny person or entity, including a lawyer, accountant, or bank, who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator under 10b-5, assuming *all* of the requirements for primary liability under Rule 10b-5 are met.

Id. Plaintiffs in the post-*Central Bank* era have argued under subsections (a) and (c) of Rule 10b-5 (also known as the "scheme liability" subsections) that secondary actors should be held liable as primary violators. Generally, in 10b-5(a) and (c) cases, plaintiffs allege that secondary actors entered into fraudulent transactions (such as creating worthless invoices, participating in wash transactions with no economic substance, or financing sham entities) with the primary actor(s). The plaintiffs do not allege that the secondary actors made or participated in the making of a material misstatement or omission (*i.e.*, 10b-5(b) type of activity).

Two separate tests have emerged to determine what type of activity constitutes a primary violation of the securities laws in 10b-5(a) and (c) cases. Recently, the Supreme Court granted *certiorari* to hear a case out of the Eighth Circuit, under the caption *Stoneridge Investment Partners LLC v. Scientific-Atlanta, Inc., et. al*. *See Stoneridge Investment Partners LLC v. Scientific-Atlanta*, ___ S. Ct. ___, 2007 WL 879583 (2007) (Chief Justice Roberts and Justice Breyer took no part in the decision). The case below was *In re Charter Communications, Inc. Securities Litigation*, 443 F.3d 987 (8th Cir. 2006). The Court accepted the question presented as:

> Whether this Court's decision in *Central Bank, N.A. v. First Interstate Bank, N.A.*, 511 U.S. 164 (1994), forecloses claims for deceptive conduct under § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and Rule 10b-5(a) and (c), 17 C.F.R. 240.10b-5(a) and (c), where Respondents engaged in transactions with a public corporation with no legitimate business or economic purpose except to inflate artificially the public corporation's financial statements, but where Respondents themselves made no public statements concerning those transactions.

See Supreme Court Docket No. 06-43, http://www.supremecourtus.gov/qp/06-00043qp.pdf (last visited May 17, 2007). The Supreme Court has scheduled the case for the October 2007 term but as of publication had not yet set a date for oral argument. *See* Supreme Court of the United States, Granted & Noted Cases List for Argument–October Term 2007, http://www.supremecourtus.gov/orders/07grantednotedlist.html (last visited May 17, 2007).

This article examines the two tests employed by the federal circuit courts to determine whether a secondary actor is liable as a primary violator and outlines the circuit split, which the Supreme Court has targeted.

SECTION 10(b) AND RULE 10b-5

Section 10(b) of the Exchange Act provides that:

> It shall be unlawful for any person, directly or indirectly . . . [t]o use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C.A. § 78j(b) (West 2006).

Rule 10b-5 states:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5 (2006).

The substantial-participation test and the bright-line test are the two competing tests used by the circuit courts in determining the primary liability of secondary actors in 10b-5(a) and (c) cases.

The substantial-participation test requires secondary actors to substantially participate or be intricately involved in the preparation of fraudulent statements to be liable under Section 10(b) and Rule 10b-5; the bright-line test requires secondary actors to "actually make a false or misleading statement" to be liable. The Fifth, Eighth, and Ninth Circuits have taken 10b-5(a) and (c) cases. The Ninth Circuit applies the substantial-participation test, while the Fifth and Eighth apply the bright-line test. As noted above, the Supreme Court has granted *certiorari* to hear the Eighth Circuit case.

This article examines the two tests employed by the federal circuit courts to determine whether a secondary actor is liable as a primary violator and outlines the circuit split, which the Supreme Court has targeted.

THE SUBSTANTIAL-PARTICIPATION TEST

The substantial-participation test predates *Central Bank* but has been applied post-*Central Bank*. Under the substantial-participation test, secondary actors can be held primarily liable when they substantially participate or are intricately involved in the preparation of fraudulent statements, even though the secondary actor's participation might not lead to the primary actor actually making the statements. *See Howard v. Everex Sys., Inc.*, 228 F.3d 1057, 1061 n.5 (9th Cir. 2000); *see also In re Software Toolworks*, 50 F.3d 615, 628–629 (9th Cir. 1994) (finding accountant to be a primary violator for playing a significant role in drafting and editing two letters to the SEC that contained false information).

In *Simpson v. AOL Time Warner, Inc.*, 452 F.3d 1040, 1046–50 (9th Cir. 2006), a 10b-5(a) and (c) case, the Ninth Circuit distinguished between the application of the substantial-participation test in 10b-5(a) and (c) cases and 10b-5(b) cases. Specifically, secondary actors in 10b-5(a) and (c) cases are not liable for mere participation in a scheme to defraud. *Id.* To be liable as a primary violator of Section 10(b) in (a) and (c) cases, a secondary actor must have engaged in conduct that had the principal purpose and effect of creating a false appearance of fact in the furtherance of a scheme to defraud. *Id.* This "principal purpose and effect" requirement is an attempt by the Ninth Circuit to use the substantial-participation test to capture primary violators of Section 10(b) without overreaching into the prohibited realm of aiding and abetting. The Ninth Circuit "see[s] no justification to limit liability under § 10(b) to only those who draft or edit the statements released to the public." *Simpson*, 452 F.3d at 1049.

THE BRIGHT-LINE TEST

The bright-line test requires that a party must "actually make a false or misleading statement" for a Section 10(b) violation; "anything short is aiding and abetting." *In re Parmalat Sec. Litig.*, 376 F. Supp. 2d 472, 499 (S.D.N.Y. 2005). The Fifth and Eighth Circuits have applied the bright-line test to situations where plaintiffs alleged violations of 10b-5(a) and (c). *See Regents of the Univ. of California v. Credit Suisse First Boston (USA), Inc. et al.*, No. 06-20856, 2007 WL 816518, *___ (5th Cir. March 19, 2007) (noting that a finding of liability under § 10(b) "involves either a misstatement or a failure to disclose by one who has a duty to disclose"); *In re Charter Communications, Inc. Sec. Litig.*, 443 F.3d 987, 992 (8th Cir. 2006), *cert. granted sub nom. Stoneridge Investment Partners LLC v. Scientific-Atlanta*, ___ S. Ct. ___, 2007 WL 879583 (2007) (court in a scheme liability case held that "any defendant who does not make or affirmatively cause to be made a fraudulent misstatement or omission, or who does not directly engage in manipulative securities trading practices, is at most guilty of aiding and abetting and cannot be held liable under § 10(b) or any subpart of Rule 10b-5").

The Eighth Circuit claimed it was adhering to the principles of *Central Bank* in evaluating a scheme liability claim, noting that a device or contrivance is not deceptive absent a misstatement or omission by one who has a duty to disclose. The Eighth Circuit stated that the terms "deceptive" and "manipulative" have narrow meanings and limited suits brought by private plaintiffs to conduct expressly prohibited by the text of Section 10(b). The Fifth Circuit followed the Eighth Circuit's lead, and its holding in *Regents of the Univ. of California* is squarely in accord with that of the Eighth Circuit in *Charter Communications*. In *Regents of the Univ. of California*, plaintiffs alleged that the banks allowed Enron to misstate its financial conditions. The Fifth Circuit found plaintiffs' allegations insufficient, noting that "[p]resuming plaintiffs' allegations to be true, Enron committed fraud by misstating its accounts, but the banks only aided and abetted that fraud by engaging in transactions to make it more plausible; they owed no duty to Enron's shareholders." The Fifth Circuit opted

continued on page 53

continued from page 37

within one tower, while securities/derivative actions may trigger another tower. Additionally, within a tower that applies to securities and shareholder derivative actions, certain layers may respond to both types of actions, while upper layers may limit coverage (so-called "Side A only" insurance, which might respond to derivative but generally not securities claims).

Third, both class and derivative litigation settlements generally require court approval. Counsel should consider whether presenting a global settlement of the various related actions may make it easier to obtain approval. For example, a court may be more inclined to approve a shareholder derivative settlement if the settlement is part of a global settlement in which related claims against the company are resolved and the company's shareholders receive a significant benefit.

Finally, the timing of a civil litigation settlement may be influenced by the existence of governmental investigations. Because an investigation may be the first to reach final conclusion on the merits, counsel should consider the impact of a potentially adverse agency determination or action on the settlement (and/or trial) dynamics in the civil actions. To the extent that an adverse determination would have a significant impact on the civil actions, seeking a settlement sooner rather than later may be in the defendants' best interests. ■

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for a strict interpretation of the language of Section 10(b) over the Ninth Circuit's broad interpretation of the statutory language. This strict-interpretation approach has been criticized, however, for failing to address the realities of today's corporate climate where transactions involve numerous "nonspeaking" entities such as law firms, banks, and accounting firms.

CONCLUSION

Two tests have emerged for determining whether secondary actors can be held primarily liable for violations of Section 10(b) under Rule 10b-5(a) and (c). The bright-line test championed by the Fifth and Eighth Circuits provides greater protection to secondary actors, whereas the substantial-participation test employed by the Ninth Circuit is more lenient. The dispute between the two tests should be resolved when the Supreme Court turns its attention to the *Charter Communications* case in its October 2007 term. ■

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