

COMMENTS

FOR NEVER WAS THERE A STORY OF MORE WOE, THAN THIS OF THE DEFRAUDED PLAINTIFF AND HER INSOLVENT PRIMARY ACTOR: WHY SCHEME LIABILITY SHOULD RUN TO GATEKEEPERS AFTER *STONERIDGE*¹

INTRODUCTION

After Enron Corporation's financial scandals,² institutional investors, the U.S. Securities and Exchange Commission (SEC), and Congress scrutinized federal securities laws designed to protect against the abusive acts of public companies.³ Those laws attempt to deter fraudulent transactions to boost the market participation of investors.⁴ Although the Supreme Court has found an implied private cause of action against perpetrators of corporate fraud,⁵ federal statutes have not defined precisely the scope of remedies available to aggrieved investors.⁶

¹ See WILLIAM SHAKESPEARE, *ROMEO AND JULIET* act 5, sc. 3.

² Editorial, *Not Just Bad Apples; The Welcome Convictions in the Enron Trial Do Not Make Post-Enron Accounting Reform Any Less Necessary*, WASH. POST, May 26, 2006, at A20. Enron overstated its profits by \$591 million from 1997 to 2000. *Id.* Near the time that Enron admitted it falsified its financial statements, Tyco International Ltd., WorldCom Inc., and Adelphia Communications Corp. faced similar scrutiny for committing securities fraud. *Id.* For additional discussion of the impact of Enron's financial scandals, see, for example, Faith Stevelman Kahn, *Bombing Markets, Subverting the Rule of Law: Enron, Financial Fraud, and September 11, 2001*, 76 TUL. L. REV. 1579, 1619 (2002).

³ Robert W. Hamilton, *The Crisis in Corporate Governance: 2002 Style*, 40 HOUS. L. REV. 1, 36 (2003); Phyllis Plitch, *When Market Scandals Erupt, Regulation Can Come in a Flood*, WALL ST. J., Jan. 15, 2003.

⁴ *Dura Pharm., Inc. v. Broudo*, 544 U.S. 336, 345 (2005) (citing *Randall v. Loftsgaarden*, 478 U.S. 647, 664 (1986)).

⁵ See, e.g., *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 196 (1976) (finding that courts had established a private cause of action for violations" of § 10(b) and Rule 10b-5); *Superintendent of Ins. of N.Y. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 13 n.9 (1971) (finding that a private right of action is implied under § 10(b) of the Securities Exchange Act of 1934); see also *Lampf v. Gilbertson*, 501 U.S. 350, 358 (1991) (finding that private claims under Rule 10b-5 and § 10(b) are judicially created).

⁶ See Taavi Annus, Note, *Scheme Liability Under Section 10(b) of the Securities Exchange Act of 1934*, 72 MO. L. REV. 855, 856 (2007) (contending that federal courts interpret the validity of scheme liability "unsystematically" and "inconsistent[ly]"); Gregory A. Markel & Gregory G. Ballard, *The Evolution of "Scheme" Liability Under Section 10(b)*, in 38TH ANNUAL INSTITUTE ON SECURITIES REGULATION 991, 999

State common law and federal law both hold issuing companies liable to their investors for intentionally misleading investors regarding material information.⁷ But, for many investors, litigation is futile against the company, which is the primary actor,⁸ because the allegedly fraudulent company is bankrupt.⁹ For example, “Enron’s bankruptcy, the collapse of its accountants, limited insurance, and government seizure of key insiders’ assets” limited investors to nominal recoveries under federal securities legislation.¹⁰

Because gatekeepers—including accounting firms, investment banks, and law firms—assist the stock issuer in verifying financials and distributing disclosures,¹¹ their participation is often necessary to execute the fraud.¹² Therefore, in the past, when the primary actor is bankrupt, investors have looked to these secondary actors, who engaged in the fraudulent transactions, to recoup losses.¹³ After Enron’s demise, its investors pursued private action

(PLI Corp. L. & Practice, Course Handbook Series No. 9151, 2006), available at WL 1571 PLI/Corp 991 (suggesting that “scheme liability can only be described as confusing”).

⁷ Basic Inc. v. Levinson, 485 U.S. 224, 227–28 (1988) (holding Basic liable for injuring shareholders by selling shares at prices artificially depressed by the corporation’s false denial of engaging in merger negotiations). A material fact exists “if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote.” TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976). Information is “material in the sense that a reasonable investor might have considered [it] important in the making of [a] decision” to purchase or sell the security. Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128, 153–54 (1972).

⁸ This Comment refers to the issuer of the security as the “primary actor” and to all other actors as “secondary actors.”

⁹ See Jennifer H. Arlen & William J. Carney, *Vicarious Liability for Fraud on Securities Markets: Theory and Evidence*, 1992 U. ILL. L. REV. 691, 704 n.67 (providing evidence of the incidence of bankruptcies that frustrate fraud recoveries).

¹⁰ Brief for the Regents of the University of California, Court-Appointed Lead Plaintiff in the Enron Securities Litigation, as Amicus Curiae in Support of Petitioner at 13, Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., 128 S. Ct. 761 (2008) (No. 06-43) [hereinafter Brief for the Regents of the University of California]; see Molly Selvin, *Enron Verdicts To Help Civil Claimants*, L.A. TIMES, May 29, 2006, at C1 (concluding that payouts to investors by Enron will probably be meager compared to their losses).

¹¹ John C. Coffee, Jr., *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 B.U. L. REV. 301, 309 (2004) [hereinafter Coffee, *Gatekeeper Failure and Reform*] (identifying gatekeepers as entities that supply “verification or certification services”).

¹² Anixter v. Home-Stake Prod. Co., 77 F.3d 1215, 1230 (10th Cir. 1996) (finding that the auditor’s certification of the misleading financial statements and opinion letter corroborated the fraud); Kline v. First W. Gov’t Sec., Inc., 24 F.3d 480, 486 (3d Cir. 1994) (finding that a law firm that issued a misleading opinion letter concerning tax consequences of investments furthered the fraud of the primary actor); *In re Global Crossing, Ltd. Sec. Litig.*, 322 F. Supp. 2d 319, 326 (S.D.N.Y. 2004) (finding that the auditor designed the fraudulent accounting schemes needed to inflate the companies’ financials); see Mary M. Caskey, *Lifting the Fog: Finding a Clear Standard of Liability for Secondary Actors Under Rule 10b-5*, 41 VAL. U. L. REV. 403, 417 (2006) (suggesting that rarely can a single entity execute a Rule 10b-5 violation).

¹³ Brief for the Regents of the University of California, *supra* note 10, at 13.

claims to recover damages against the large banks involved in the fraud.¹⁴ Unfortunately for the plaintiffs, the difficulty in raising such claims is that they can only allege a securities fraud violation if the secondary actor's conduct amounts to more than just "aiding and abetting" the primary actor's fraudulent acts.¹⁵

A primary actor can be primarily liable for its material fraudulent actions. For example, when company *X* knowingly releases a fraudulent material statement to the market, *X* can be primarily liable to its investors. For secondary actors, however, the federal circuit courts have split¹⁶ over different theories to determine when its conduct amounts to primary liability for violations of federal securities law.¹⁷ The Tenth Circuit and Eighth Circuit adopted a "bright-line" test,¹⁸ requiring the plaintiff to prove he or she relied on the defendant's deceptive statement.¹⁹ The Ninth Circuit, on the other hand, focused on the text of Rules 10b-5(a) and (c) for its "scheme liability" test.²⁰ This test requires plaintiffs to show that the defendant, or secondary actor, was intricately involved in a fraudulent scheme and undertook "conduct that had the principal purpose and effect" of furthering a fraudulent scheme.²¹

¹⁴ *Id.*

¹⁵ *Cent. Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164, 192 (1994). Secondary liability amounts to aiding and abetting securities law violations, in which no private right of action exists. *Id.*

¹⁶ Based on a theory from the SEC, some federal district courts have devised a third theory—the creation-of-misrepresentation test. *In re Enron Corp. Sec., Derivative & ERISA Litig.*, 235 F. Supp. 2d 549, 585–87 (S.D. Tex. 2002); see *Carley Capital Group v. Deloitte & Touche, L.L.P.*, 27 F. Supp. 2d 1324, 1334 (N.D. Ga. 1998) ("[A] secondary actor can be primarily liable when it, acting alone or with others, creates a misrepresentation even if the misrepresentation is not publicly attributed to it.").

¹⁷ Celia R. Taylor, *Breaking the Bank: Reconsidering Central Bank of Denver After Enron and Sarbanes-Oxley*, 71 MO. L. REV. 367, 373–78 (2006).

¹⁸ *In re Charter Commc'ns, Inc., Sec. Litig.*, 443 F.3d 987 (8th Cir. 2006), *aff'd*, *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 128 S. Ct. 761 (2008).

¹⁹ *Anixter v. Home-Stake Prod. Co.*, 77 F.3d 1215, 1226–27 (10th Cir. 1996).

²⁰ *Simpson v. AOL Time Warner Inc.*, 452 F.3d 1040, 1046 (9th Cir. 2006).

²¹ *Id.* at 1048. Prior to the "principal effect and purpose test," the Ninth Circuit held that an actor that "significantly" participates in a fraudulent transaction is not absolved of guilt under federal securities law. *In re Software Toolworks Inc. Sec. Litig.*, 50 F.3d 615, 628 n.3 (9th Cir. 1994). Reaffirming its prior holding, the Ninth Circuit in *Howard v. Everex Systems, Inc.* held "that substantial participation or intricate involvement in the preparation of fraudulent statements is grounds for primary liability even though the participation might not lead to the actor's actual making of the statements." 228 F.3d 1057, 1061 n.5 (9th Cir. 2000) (emphasis added) (citing *Software Toolworks*, 50 F.3d at 628–29 n.3). Congress superseded the "substantial participation" test by passing the Private Securities Litigation Reform Act (PSLRA), which required heightened pleading standards to establish scienter. 15 U.S.C. § 78u-4(b)(2) (2006); see *In re Vantive Corp. Sec. Litig.*, 283 F.3d 1079, 1097 (9th Cir. 2002).

The Supreme Court attempted to resolve these divergent theories in *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*²² Its opinion established that implied private cause of action does not extend to secondary actors for knowingly participating in the execution of a fraudulent scheme.²³ The Court held that the implied private right does not exist against supplier companies of the primary actor unless the plaintiffs can prove that they relied on the secondary actor's material fraudulent actions, statements, or omissions.²⁴

By denying plaintiffs a private cause of action in this case, the Supreme Court continued its tendency to limit the expansion of securities fraud liability.²⁵ After a trend of liberally interpreting the reach of § 10(b) of the Securities Exchange Act of 1934²⁶ (1934 Act) to protect investors,²⁷ the Supreme Court, began to curb the scope of private action to control “vexatious litigation.”²⁸ The Supreme Court limited investors' class action suits against

²² *Stoneridge*, 128 S. Ct. at 766.

²³ *Id.*

²⁴ *Id.* Unless Congress decides to overrule this decision with legislation, the Supreme Court's decision will serve as precedent for other cases. Although congressional backing for such legislation seems unlikely, Senator Christopher Dodd, Chairman of the Senate Banking Committee, expressed his displeasure with the decision because it “goes beyond . . . common-sense law. Instead of protecting innocent businesses, it would protect wrongdoers from the consequences of their actions. Such a misguided standard will do nothing to strengthen the competitive position of America's businesses and capital markets.” Mark H. Anderson, *Court Restricts 3rd-Party Suits in Stoneridge Case*, DOW JONES NEWSWIRE, Jan. 15, 2008; Carrie Johnson & Robert Barnes, *Court Declines Enron Investors' Appeal*, WASH. POST, Jan. 23, 2008, at D1, <http://www.washingtonpost.com/wp-dyn/content/article/2008/01/22/AR2008012200966.html>.

²⁵ *Touche Ross & Co. v. Redington*, 442 U.S. 560, 578 (1979) (noting that, compared to previous decisions, the Court now “adhere[s] to a stricter standard for the implication of private causes of action”); see E. Thomas Sullivan & Robert B. Thompson, *The Supreme Court and Private Law: The Vanishing Importance of Securities and Antitrust*, 53 EMORY L.J. 1571, 1599 (2004) (providing empirical evidence of the Court's tendency toward interpreting federal securities law restrictively).

²⁶ The relevant portion of § 10(b) of the Act provides:

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

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

Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (2006).

²⁷ *J.I. Case Co. v. Borak*, 377 U.S. 426, 432 (1964); see Sullivan & Thompson, *supra* note 25, at 1599.

²⁸ *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 477 (1977) (reasoning that the Court should not find an implied private cause of action where Congress did not intend there to be one).

secondary actors when it disallowed private action against “aiders and abettors” of securities fraud.²⁹ Now, based on the holding in *Stoneridge*, the Court has also prevented investors from applying scheme liability against certain secondary actors.³⁰

Denying plaintiffs the ability to recover from secondary actors decreases investors’ confidence about the integrity of the market.³¹ This Comment argues that federal courts should limit the holding of *Stoneridge* to apply only to secondary actors not traditionally regarded as gatekeepers or corporate advisors in order to preserve a private right of action for investors against these culpable actors.³²

In *Stoneridge*, which considered whether primary liability exists against business partners, the Court expressed concerns about the remoteness of the secondary actor’s actions to the proscribed fraud.³³ The Court even alluded to a different outcome had the actor been in the “investment sphere” instead of the “realm of ordinary business operations.”³⁴ Therefore, courts should limit the application of this precedent and allow investors to raise private claims against gatekeepers, a specified category of secondary actors existing within the financial markets.

Part I of this Comment briefly discusses the origins and elements of the SEC’s Rule 10b-5 to provide a contextual framework for approaching the Supreme Court’s decision in *Stoneridge* and related cases. Part II analyzes the case law relating to the implied right of private action under § 10(b) of the 1934 Act. This Part contends that the judiciary has leaned toward narrowing the scope of liability afforded to investors to collect damages.

Part III postulates that the best solution is for courts not to apply the *Stoneridge* decision to select gatekeepers. This contention is supported by the majority’s decision in *Stoneridge* and evidence that the courts have already

²⁹ Cent. Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164, 173 (1994).

³⁰ *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 128 S. Ct. 761 (2008).

³¹ Coffee, *Gatekeeper Failure and Reform*, *supra* note 11, at 346. This Comment narrowly defines “gatekeepers” as entities charged with making or verifying statements from their own due diligence and investigation. *Id.* at 308. The market holds these entities to a higher standard of accuracy based on the reputational capital they have accumulated over many years of experience. *Id.*

³² For a complete definition of “gatekeepers,” see Coffee, *Gatekeeper Failure and Reform*, *supra* note 11, at 308–11.

³³ *Stoneridge*, 128 S. Ct. at 769.

³⁴ *Id.* at 770, 774 (discussing the difference between financial companies involved in the securities market and other companies trading for goods and services outside the securities market).

imposed a duty on select entities within the financial markets to disclose material misstatements and culpable acts to investors. Finally, Part IV evaluates the policy considerations of extending liability to gatekeepers under a theory of “scheme liability.” This Part concludes that by limiting the application of the *Stoneridge* decision, the judiciary can better balance the congressional goals of deterring fraud and “frivolous lawsuits.”³⁵ By reducing both fraud and litigation, investors benefit.

I. THE ELEMENTS AND ORIGINS OF § 10(B) AND RULE 10B-5

Section 10(b) and Rule 10b-5 have been essential in protecting the integrity of the securities market in the United States for more than fifty years.³⁶ In 1942, the SEC, under the auspices of § 10(b) of the 1934 Act, adopted Rule 10b-5.³⁷ Congress authorized the SEC to adopt regulations specifying and enforcing the provisions of § 10(b) to reduce corporate fraud and increase participation in the capital markets.³⁸ By giving authority to the SEC, Congress delegated not only its role in reforming securities laws, but also any blame arising from the reforms.³⁹

Although § 10(b) does not restrict a company from any particular act, it does authorize the SEC to define illegal activities.⁴⁰ Rule 10b-5 identifies the

³⁵ Robert G. Bone, *Modeling Frivolous Suits*, 145 U. PA. L. REV. 519, 531 (1997) (defining “frivolous lawsuits” as suits filed by a plaintiff with knowledge that the facts support “little or no chance of the defendant’s objective liability”); Russell P. Marsella, *Who’s Primarily To Blame? The Quest for the Better Test of Section 10(b) Liability*, 6 ROGER WILLIAMS U. L. REV. 421, 445 (2000) (suggesting it is “necessary [for courts] to strike a balance between adequately protecting investors” and making secondary actors “scapegoats” for all market losses).

³⁶ See J. ROBERT BROWN, JR., *THE REGULATION OF CORPORATE DISCLOSURE* § 2.06(1) (3d ed. 2005) (“Without a doubt, Rule 10b-5 is the most significant antifraud provision.” (emphasis omitted)).

³⁷ Rather than reach a consensus on politically charged issues, Congress delegated the task of regulating and enforcing Section 10(b) liability to an agency specifically designed and skilled in understanding the financial market. Joseph A. Grundfest, *Disimplying Private Rights of Action Under the Federal Securities Laws: The Commission’s Authority*, 107 HARV. L. REV. 961, 1018 n.287 (1994); see Caskey, *supra* note 12, at 408 n.39.

³⁸ Annus, *supra* note 6, at 857. Many SEC attorney and staff members eventually leave the agency to work for companies working in and with Wall Street. Because this proximity of the SEC to Wall Street creates an inherent sympathetic bias in the system, many critics and scholars have questioned the effectiveness and loyalty of the SEC. ANNE M. KHADEMIAN, *THE SEC AND CAPITAL MARKETS REGULATION: THE POLITICS OF EXPERTISE* 34–36 (1992); Grundfest, *supra* note 37, at 1018 n.287. A federal agency that deals solely with securities issues is more susceptible to corporate pressures and outside influences than an established regime with diversified concerns. *Id.*

³⁹ Grundfest, *supra* note 37, at 1018.

⁴⁰ *Id.* at 978.

duties and obligations of participants in a securities transaction.⁴¹ The SEC intends Rule 10b-5 to prevent companies from misleading investors.⁴²

In their interpretation of this rule, courts have instituted several procedural and substantive barriers that plaintiffs must satisfy to establish a *prima facie* case.⁴³ To proceed to trial under a Rule 10b-5 claim, a plaintiff must show (1) scienter or a wrongful state of mind,⁴⁴ (2) that reliance on the violator's actions caused the damages,⁴⁵ (3) material misstatements or omissions (where a duty to disclose exists),⁴⁶ (4) economic loss,⁴⁷ (5) loss causation,⁴⁸ and (6) a connection with the purchase or sale of any security.⁴⁹ These elements of proof attempt to restrict the allegations of fraud that get heard in court. As

⁴¹ Annus, *supra* note 6, at 857. The SEC's rule mandates:

It shall be unlawful for any person, directly or indirectly . . .

(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 . . . 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 (2008).

⁴² The SEC adopted Rule 10b-5 to close "a loophole in the protections against fraud . . ." by "prohibiting individuals or companies from buying securities if they engage in fraud in their purchase." *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 766 (1975) (quoting Securities Exchange Act Release No. 3230 (May 21, 1942), 1942 WL 34443).

⁴³ *Dura Pharm., Inc. v. Broudo*, 544 U.S. 336, 341 (2005).

⁴⁴ Although not explicitly required in the text of Rule 10b-5, the Supreme Court held that "in the absence of any allegation of 'scienter' a private cause of action for damages will not exist. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976) (citations omitted). To establish scienter, the plaintiff must prove the defendant intended to "deceive, manipulate, or defraud" the plaintiff. *Id.* Among the federal circuit courts, this intent requirement is satisfied by varying degrees of recklessness. *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499, 2507 n.3 (2007). Additionally, under the PSLRA, plaintiffs must "state with particularity facts giving rise to a strong inference" of scienter. 15 U.S.C. § 78u-4(b)(2) (2006).

⁴⁵ See *infra* text accompanying notes 66–70. A plaintiff is not required to show proof of reliance in regard to a material omission or misstatement because reliance is presumed under the fraud-on-the-market doctrine. *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 153–54 (1972).

⁴⁶ A material fact exists "if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote." *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976).

⁴⁷ *Dura Pharm.*, 544 U.S. at 341 (citing 15 U.S.C. § 78u-4(b)(4) (2000)) (economic loss refers to the plaintiff's actual damages).

⁴⁸ Loss causation refers to a "causal connection between the material misrepresentation and the [actual] loss." *Id.* at 342. Although proving loss causation should not be an overly burdensome act for the plaintiff, the plaintiff must provide more evidence than simply "purchase price inflation." *Id.* at 347. Foregoing additional evidence of loss causation would allow the plaintiff to proceed "with a largely groundless claim . . . representing an *in terrorem* increment of the settlement value." *Id.* (quoting *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 741 (1975)).

⁴⁹ *SEC v. Zandford*, 535 U.S. 813, 813–14 (2002) (holding that nonverbal actions meet the fraudulent acts or devices "in connection with the purchase or sale of a security" requirement).

commentators have noted, because the plaintiff's substantial burden of proof is coupled with conservative, corporate-friendly judges presiding over cases, securities lawsuits are overwhelmingly decided against shareholders before they even reach trial.⁵⁰

II. IDENTIFYING THE BOUNDARIES OF THE IMPLIED RIGHT OF PRIVATE ACTION UNDER SECTION 10(B)

Under § 10(b) and Rule 10b-5, no explicit private right of action exists for aggrieved parties.⁵¹ During a period of liberal interpretation of § 10(b), the Supreme Court, based on the 1946 federal district court decision *Kardon v. National Gypsum Co.*,⁵² held that general principles of law implied that a private right of action exists for claims raised under § 10(b) of the 1934 Act.⁵³ The Court acknowledged a duty to create private remedies to protect investors against fraud.⁵⁴ However, the Court eventually recognized that its attempt to protect investors against fraud had plagued businesses with “strike suits”—suits without merit—that attempt to draw out settlement payments from corporations.⁵⁵ Thus, the Court recognized the need to define the boundaries of this private cause of action.⁵⁶

A. *Broadening the Scope of Private Action: Facilitating the Path to Class Action*

In the 1960s, the Supreme Court defined the scope of private remedies available under securities law to protect investors against the abuses of

⁵⁰ Edward Iwata, *Fewer Lawsuits Charge Securities Fraud*, USA TODAY, Oct. 8, 2007, at 9A.

⁵¹ *Lampf v. Gilbertson*, 501 U.S. 350, 358 (1991).

⁵² 69 F. Supp. 512, 513–14 (E.D. Pa. 1946).

⁵³ *Transamerica Mortgage Advisors, Inc. v. Lewis*, 444 U.S. 11, 18 (1979) (“[T]he failure of Congress expressly to consider a private remedy is not inevitably inconsistent with an intent on its part to make such a remedy available.”); see *Superintendent of Ins. of N.Y. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 13 (1971) (granting Manhattan Casualty Co., represented by New York’s Superintendent of Insurance, a private cause of action under Section 10(b)).

⁵⁴ *J.I. Case v. Borak*, 377 U.S. 426, 431–32 (1964) (finding that securities laws do not expressly provide for a private action but that such a remedy is implied to benefit the investor).

⁵⁵ *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 740 (1975). “Strike suits” consist of complaints that have little or no merit, but still have settlement value as long as a judge does not dismiss the complaint. *Id.* Congress recognized the potential harm from “strike suits,” so it amended the 1934 Act to allow courts to mandate “the payment of costs of such suit, including reasonable attorney’s fees” by the losing party. *Id.* (citations omitted).

⁵⁶ *Id.* at 739. The Supreme Court, to deter frivolous lawsuits, limited the class of plaintiffs with standing to sue for a Rule 10b-5 violation to people who purchased or sold securities in a fraudulent transaction.

corporate fraud.⁵⁷ Congress created securities law to protect investors,⁵⁸ but the government's limited resources could not adequately pursue all wrongdoers.⁵⁹ Therefore, the Court, in *J.I. Case v. Borak*, broadly afforded investors a private right of action for suits "brought to enforce any liability or duty created" by the 1934 Act.⁶⁰ The Court rationalized that because it had a duty to offer *any remedies* necessary to effectuate that purpose of the 1934 Act, it logically followed under general principles of law that Congress intended for the courts to establish a private cause of action to facilitate the legislative campaign against fraud.⁶¹

But, without the ability to raise a class action lawsuit, plaintiffs had little motivation to pursue litigation against fraudulent companies.⁶² Generally, individual recovery in securities litigation is insignificant compared to the protracted length and costs of litigation.⁶³ Before *Basic Inc. v. Levinson*, class certification was almost impossible to achieve because, without a class-wide presumption of reliance, each member of the class had to show individual reliance.⁶⁴ And, "a fraud class action cannot be certified when individual reliance will be an issue."⁶⁵

In recognition of the difficulties in establishing class certification in securities litigation, the Supreme Court in *Basic* augmented the power of

⁵⁷ *J.I. Case*, 377 U.S. at 433.

⁵⁸ *Id.* at 432; see *Tcherepnin v. Knight*, 389 U.S. 332, 335 (1967) (noting that protecting investors was one of the core purpose of the 1934 Act).

⁵⁹ *J.I. Case*, 377 U.S. at 433 (finding that the implied private cause of action provides an essential enforcement mechanism to supplement SEC action).

⁶⁰ *Id.* at 431.

⁶¹ *Id.* The judicial creation of a private cause of action serves as an "effective weapon in the enforcement" of the securities laws and [is] "a necessary supplement to [SEC] action." *Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299, 310 (1985) (quoting *J.I. Case*, 377 U.S. at 432). Further, as noted by the Court in *Tellabs Inc. v. Makor Issues & Rights, Ltd.*, "meritorious private actions to enforce federal antifraud securities laws are an essential supplement to criminal prosecutions and civil enforcement actions brought, respectively, by the [DOJ] and the [SEC]." 127 S. Ct. 2499, 2504 (2007).

⁶² John D. Finnerty & Gautam Goswami, *Determinants of the Settlement Amount in Securities Fraud Class Action Litigation*, 2 HASTINGS BUS. L.J. 453, 466 (2006).

⁶³ Richard A. Epstein, *Class Actions: Aggregation, Amplification, and Distortion*, 2003 U. CHI. LEGAL F. 475, 502.

⁶⁴ *Basic Inc. v. Levinson*, 485 U.S. 224, 242 (1988); see *Regents of the Univ. of Cal. v. Credit Suisse First Boston (USA), Inc.*, 482 F.3d 372, 384 (5th Cir. 2007); Note, *Recent Cases: "Tort Law—Indirect Reliance—New Jersey Supreme Court Rejects Fraud-on-the-Market Theory—Kaufman v. i-Stat Corp.*, 754 A.2d 1188 (N.J. 2000), 114 HARV. L. REV. 2550, 2550 (2001).

⁶⁵ *Castano v. Am. Tobacco Co.*, 84 F.3d 734, 745 (5th Cir. 1996); see also *Johnston v. HBO Film Mgmt., Inc.*, 265 F.3d 178, 186 (3d Cir. 2001) (discussing that class certification issues in a fraud class action are "based on individual misrepresentations").

private action by facilitating class action lawsuits.⁶⁶ Under the “fraud on the market” theory, accepted by the Court in *Basic*, plaintiffs can obtain class certification without providing proof of individual reliance for any material misstatements because the courts can presume reliance in such cases.⁶⁷ The fraud-on-the-market theory maintains that in an efficient capital market a security’s price reflects all of its publicly available information.⁶⁸ By trading on the market, the court can presume investors relied on all information disclosed regarding the security, including any materially misleading statements.⁶⁹ Consequently, to establish the element of reliance for a Rule 10b-5 action, plaintiffs only need to show that they purchased or sold securities on the market after the defendant made the misstatement, but before the public uncovered the fraud.⁷⁰ This relaxed standard of class reliance has helped pave the way for investors to use class action suits as a remedy against fraud.⁷¹

B. Pulling Back the Boundary of Private Action: Curbing the Rise of “Vexatious” Lawsuits

Twelve years after the *J.I. Case* decision, the Court diverged from its liberal interpretation of the remedies afforded under § 10(b).⁷² Shifting from its holding in *J.I. Case*, the Court acknowledged it would no longer place “considerable emphasis upon the desirability of implying private rights of action in order to provide remedies thought to effectuate the purposes of a given statute.”⁷³ Instead, the Court in *Cort v. Ash* implemented a four-part test to determine whether the right existed.⁷⁴ The four prongs consisted of whether: (1) the plaintiff is a member of the class for whose benefit the statute

⁶⁶ Epstein, *supra* note 63, at 502; Larry E. Ribstein, Dabit, *Preemption, and Choice of Law*, 2006 CATO SUP. CT. REV. 141, 143; *see Basic*, 485 U.S. at 242 (finding that a showing of individual reliance is not a prerequisite to class certification under the fraud-on-the-market theory).

⁶⁷ *Basic*, 485 U.S. at 243; *see Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 153–54 (1972) (holding that reliance is not a prerequisite to recovery if a material fact is omitted).

⁶⁸ *Basic*, 485 U.S. at 241–47.

⁶⁹ *Id.* at 246–47.

⁷⁰ *Id.* at 244–47. The defendants may rebut reliance by proving that the market was aware of the misleading statements and therefore the stock price was not distorted. *Id.* at 248.

⁷¹ Ribstein, *supra* note 66, at 143.

⁷² To move away from its previous broad interpretation of the implied private cause of action, the Supreme Court, in *Piper v. Chris-Craft Industries, Inc.*, rejected the broad holding of *J.I. Case*. 430 U.S. 1 (1977). Instead of asserting that an implied right existed for all securities law violations under the 1934 Act, the Court retracted the scope of its earlier decisions and found that this implied right existed under § 10(b). *Superintendent of Ins. of N.Y. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 13 (1971).

⁷³ *Transamerica Mortgage Advisors, Inc. v. Lewis*, 444 U.S. 11, 15 (1979).

⁷⁴ 422 U.S. 66, 78 (1975).

was created; (2) any indication exists of a legislative intent, explicit or implicit, to create or deny such a remedy; (3) implying such a remedy is consistent with the overall purpose of the Act; and (4) the cause of action is one generally left to state law to regulate.⁷⁵ Within four years of this decision, the Court narrowed the test further in *Touche Ross & Co. v. Redington*, which instructed lower courts to focus on the text of the “statute, its legislative history, and its purpose” to identify a private cause of action.⁷⁶

Over the years, the Court has also used policy arguments to decide whether to expand the scope of available private remedies.⁷⁷ The Court had previously provided that it must look to congressional intent and not interject its own policy preferences to interpret the extent of the implied right.⁷⁸ But with the rise of lawsuits, the Court began to weigh in the interests of businesses to stop the flow of “vexatious litigation.”⁷⁹ Many ambitious attorneys file abusive actions or “vexatious litigation” to intimidate companies into settlement.⁸⁰ For these corporate defendants, the risk of an unpredictable jury often outweighs the costs of settlement, even when the case lacks substance.⁸¹ Ultimately, as attorneys file actions at the announcement of market losses, regardless of the merits of the case, the companies and their investors are forced to pay the *in terrorem* settlements.⁸²

In *Blue Chip Stamps v. Manor Drug Stores*, the plaintiff class attempted to sue the corporation under § 10(b) for disseminating material information that contained an exaggeratedly dismal outlook of the company.⁸³ The complaint

⁷⁵ *Id.*

⁷⁶ 442 U.S. 560, 575–76 (1979).

⁷⁷ *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 737 (1975) (finding it “proper” to consider policy arguments when other factors do not offer conclusive guidance).

⁷⁸ *Piper v. Chris-Craft Indus., Inc.*, 430 U.S. 1, 26 (1976) (quoting *Scripps-Howard Radio v. FCC*, 316 U.S. 4, 11 (1942)).

⁷⁹ *Blue Chip Stamps*, 421 U.S. at 740. By focusing solely on the vexatiousness of litigation, the Court entangled itself in pro-business speculative policy considerations. *Id.* at 769–70 (Blackmun, J., dissenting).

⁸⁰ *Id.* at 740 (majority opinion) (concluding that “even a complaint . . . [with] very little chance of success at trial has a settlement value to the plaintiff” if it is not dismissed at summary judgment); see Robert G. Bone & David S. Evans, *Class Certification and the Substantive Merits*, 51 DUKE L.J. 1251, 1295 (2002) (noting that a class action “magnifies” the recovery, and so class action attorneys are more likely to file frivolous lawsuits because of the substantial fees received from such action).

⁸¹ Epstein, *supra* note 63, at 502.

⁸² *Id.*; see Janet Cooper Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 STAN. L. REV. 497, 513 (1991) (providing evidence to “suggest that suits alleging securities violations were filed whenever the stock price declined sufficiently following the IPO to support an award of attorneys’ fees that would make it worthwhile to bring a case”).

⁸³ *Blue Chip Stamps*, 421 U.S. at 726.

alleged that by using misleading statements to dissuade the plaintiffs from purchasing company stock at a special discounted offer, the company benefited by offering the stock to the public market at a higher price.⁸⁴

In making its decision, the Court favored businesses' interests over the interest of protecting investors.⁸⁵ The Court provided two reasons for why it would rather protect businesses from liability than protect investors from the risk of unremedied fraud.⁸⁶ First, expanding civil liability unduly would create incentives for lawyers to raise baseless claims at the cost of innocent investors who would end up paying for the judgments.⁸⁷ An increase in frivolous claims backlogs the legal system and "frustrates" the business operations of the defendant.⁸⁸ Second, by allowing such litigation, the Court would open the door to unlimited litigation and liability risks that Congress did not intend.⁸⁹ A plaintiff, without any ties to the corporation, could easily allege that he was entitled to recovery for a materially misleading statement that discouraged him from obtaining stock. Congress did not intend to create a private cause of action for lost opportunities resulting from misleading statements.⁹⁰

Because of the high costs and lengthy duration of litigation, scholars and businesspeople have even suggested that the SEC use its power to create rules to eliminate the private right of action.⁹¹ Although the Court has not completely removed a plaintiff's right to private action through cases such as *Central Bank* and *Stoneridge*, discussed in Part III, the Court recognized the burden of litigation on businesses and narrowed the pool of potential defendants greatly.⁹² Now, any argument proposing to broaden the scope of a private cause of action under § 10(b) of the 1934 Act, in addition to analyzing

⁸⁴ *Id.* at 726–27.

⁸⁵ *Id.* at 762 (Blackmun, J., dissenting) (“[T]he Court exhibits a preternatural solicitousness for corporate well-being and a seeming callousness toward the investing public quite out of keeping . . . with [its] own traditions.”).

⁸⁶ *Id.* at 760.

⁸⁷ *Id.* at 739–40 (majority opinion). Because the defendant company is owned by investors, who bear the costs of these lawsuits, securities litigation is a zero-sum or negative-sum game when factoring in legal fees.

⁸⁸ *Id.* at 740.

⁸⁹ *Id.* at 761.

⁹⁰ Plaintiffs had to have been either “purchasers” or “sellers” of securities under the 1934 Act to find a Rule 10b-5 violation. *Id.* at 754.

⁹¹ Grundfest, *supra* note 37, at 961 (discussing the power of the SEC to eliminate the implied private right of action). Because the SEC has the authority to collect damages on behalf of wronged shareholders, critics find private action redundant. Barbara Black, *Stoneridge Investment Partners v. Scientific-Atlanta (8th Cir. 2006): What Makes It the Most Important Securities Case in a Decade?* 15 (U. of Cin. Pub. Law Research Paper, No. 07-21, 2007), <http://ssrn.com/abstract=1020102>.

⁹² *See infra* Part III.

the text of the statute and congressional intent, must also consider the competing goals of deterring fraud and decreasing the risk of pernicious lawsuits filed to collect against the “innocent investors” of the defendant companies.⁹³

III. DOES PRIMARY LIABILITY EXIST FOR ANY SECONDARY ACTORS AFTER *STONERIDGE*?

While § 10(b) expressly asserts that “[i]t shall be unlawful for any person,” to engage in securities fraud,⁹⁴ the Supreme Court has determined that Congress did not intend to reach all actors involved in securities fraud through this statute.⁹⁵ Accordingly, in *Central Bank*, the Court held that some aiders and abettors of § 10(b) violators are not within the legal jurisdiction of the statute.⁹⁶

Nevertheless, the Court left the door ajar for plaintiffs to raise claims against secondary actors by asserting that secondary actors “are [not] always free from liability under the securities Acts.”⁹⁷ By granting certiorari in *Stoneridge*, critics and scholars hoped that the Court would outline a test for when plaintiffs could raise securities fraud claims against secondary actors.⁹⁸ Unfortunately, while the Court addressed a type of action that does *not* constitute primary liability for secondary actors, the Court failed to explain what action or conduct *would* create primary liability in secondary actors.⁹⁹ Because confusion still exists as to the requisite conduct for establishing primary liability against secondary actors, section A examines the Court’s

⁹³ *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 739 (1975) (stating that “‘innocent investors’” will have to pay “‘for the benefit of speculators and their lawyers’” (quoting *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 867 (1968))); see Michael J. Kaufman, *The Uniform Rule of Liability Under the Federal Securities Laws: The Judicial Creation of a Comprehensive Scheme of Investor Insurance*, 63 TEMP. L. REV. 61, 61 (1990) (suggesting that civil liability in securities legislation reflects the competing goals of deterrence and limiting “*in terrorum*” settlements); Marsella, *supra* note 35, at 445.

⁹⁴ 15 U.S.C. § 78j (2006).

⁹⁵ *Blue Chip Stamps*, 421 U.S. at 733; see *Cent. Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164, 184 (1994) (finding that although aiding-and-abetting liability is firmly rooted in tort liability, securities law does not extend such liability to private causes of action).

⁹⁶ *Cent. Bank*, 511 U.S. at 191.

⁹⁷ *Id.*

⁹⁸ Thomas O. Gorman, *Who Does the Catch-All Antifraud Provision Catch?* *Central Bank, Stoneridge, and Scheme Liability in the Supreme Court*, in SECURITIES LITIGATION & ENFORCEMENT INSTITUTE 2007, at 189, 198 (PLI Corp. L. & Practice Course Handbook Series No. 11072, 2007), available at WL 1620 PLI/Corp 189.

⁹⁹ *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 128 S. Ct. 761 (2008).

faulty analysis in *Central Bank* that led to this ambiguity and then section B addresses when courts can use scheme liability after *Stoneridge* to hold secondary actors liable.

A. Central Bank: An End to Aiding-and-Abetting Liability

In *Central Bank*, the Supreme Court overturned holdings of every federal appellate court¹⁰⁰ by not extending the implied right of private action against aiders and abettors of Rule 10b-5 violations.¹⁰¹ In that case, a municipal agency issued public improvement revenue bonds, secured with property liens and restrictive covenants, to finance residential and commercial development.¹⁰² When the municipal agency attempted to issue new bonds, the bank, serving as the indenture trustee, suspected that the developer had breached its covenant under its debenture.¹⁰³ Yet the bank failed to take immediate action and just sat idle.¹⁰⁴ Eventually, the investors in the deal faced unrecoverable losses because the developer defaulted on the bonds.¹⁰⁵ Aiding and abetting a securities fraud amounts to secondary liability. By claiming that the bank's failure to act was reckless conduct that aided and abetted the securities fraud, the investors attempted to make Central Bank, a secondary actor, secondarily liable under § 10(b).¹⁰⁶

Though the Court purportedly based its decision on a strict textual interpretation of § 10(b),¹⁰⁷ the majority crafted its opinion to shield businesses from “decisions . . . offering little predictive value” to parties seeking fair and

¹⁰⁰ *Cent. Bank*, 511 U.S. at 169 (“[F]ederal courts have allowed private aiding and abetting actions under §10(b).”); see *Cleary v. Perfectune, Inc.*, 700 F.2d 774, 777 (1st Cir. 1983); *Harmsen v. Smith*, 693 F.2d 932, 943 (9th Cir. 1982) (establishing aiding and abetting as legitimate grounds for raising implied private cause of action if defendant provides “substantial assistance in the wrong”); *Kerbs v. Fall River Indus., Inc.*, 502 F.2d 731, 740 (10th Cir. 1974); *Brennan v. Midwestern United Life Ins.*, 259 F. Supp. 673, 680–81 (N.D. Ind. 1966), *aff’d*, 417 F.2d 147 (7th Cir. 1969).

¹⁰¹ *Cent. Bank*, 511 U.S. at 173.

¹⁰² *Id.* at 164. The bond covenants required that the land be worth at least 160% of the bonds’ outstanding principal and interest and that the developer provide an annual report to the indenture trustee to that effect. *Id.* at 167.

¹⁰³ *Id.* *Central Bank* received expert advice that suggested it conduct an independent review by an outside appraiser, but the bank never obtained such a review. *Id.*

¹⁰⁴ *Id.*

¹⁰⁵ *Id.*

¹⁰⁶ *Id.* at 164, 167.

¹⁰⁷ *Id.* at 194–95 (Stevens, J., dissenting) (“[T]he Court *sua sponte* directed the parties to address a question on [the liability of aiders and abettors under Section 10(b) and Rule 10b-5] which even the petitioner justifiably thought the law was settled, and reaches out to overturn a most considerable body of precedent.”).

reasonable settlements.¹⁰⁸ Instead of providing a concrete justification for its holding, the Court speculates on the “ripple effect” that would accrue from holding aiders and abettors accountable for their actions.¹⁰⁹ The following section discusses the faulty textual and historical analysis the Court used to reach its decision.

Even though the Court reached the correct decision in the case, it used an erroneous textual analysis because it left choice words of the statute devoid of effect or purpose.¹¹⁰ The SEC and the investors raising the claim against Central Bank argued that, based on the text of § 10(b), the bank should be held liable because its “indirect” actions contributed to the fraud.¹¹¹ Moreover, they argued that Congress intended to find “*any person*” potentially liable if his or her actions indirectly furthered the proscribed fraudulent activities.¹¹² However, Justice Kennedy, writing for the majority, refused to interpret the phrase “directly or indirectly” to mean that § 10(b) violations included secondary liability.¹¹³ The Court feared that such an interpretation might expand liability beyond people “who . . . engage in the proscribed activities . . . [to parties who simply] give a degree of aid.”¹¹⁴ To prevent expansion of liability, the Court found that questions of primary versus secondary liability are separate and distinct from the question whether the actions were direct or indirect.¹¹⁵ This interpretation of “or indirectly” leaves the words without meaning in the statute, which is an incorrect statutory construction.¹¹⁶

Instead of leaving the term “indirectly” without meaning, the Court should have placed more emphasis on the language of Congress, which suggests that

¹⁰⁸ *Id.* at 188 (majority opinion) (citation omitted) (internal quotation marks omitted); see also Joel Seligman, *The Implications of Central Bank*, 49 BUS. LAW. 1429, 1442 (1994) (finding the Court’s analysis was based on policy rather than the text it purports to follow).

¹⁰⁹ *Cent. Bank*, 511 U.S. at 189 (finding that holding secondary actors liable might prevent them from providing services to newer and smaller business with more potential for business failure)

¹¹⁰ Scott Siamas, *Primary Securities Fraud Liability for Secondary Actors: Revisiting Central Bank of Denver in the Wake of Enron, WorldCom, and Arthur Andersen*, 37 U.C. DAVIS L. REV. 895, 911 (2004).

¹¹¹ *Cent. Bank*, 511 U.S. at 176.

¹¹² 15 U.S.C. § 78j (2006) (emphasis added) (“It shall be unlawful for any person, directly or indirectly . . . [t]o use or employ . . . any manipulative or deceptive device . . .”).

¹¹³ *Cent. Bank*, 511 U.S. at 176 (deciding that respondent’s arguments failed to show that the § 10(b) language of “directly and indirectly” allows aiding-and-abetting liability).

¹¹⁴ *Id.*

¹¹⁵ *Id.*; see *In re Lernout & Hauspie Sec. Litig.*, 236 F. Supp. 2d 161, 171 (D. Mass. 2003).

¹¹⁶ Robert A. Prentice, *Conceiving the Inconceivable and Judicially Implementing the Preposterous: The Premature Demise of Respondeat Superior Liability Under Section 10(b)*, 58 OHIO ST. L.J. 1325, 1353–54 (1997).

“any person” whose indirect actions further the fraud can be liable under § 10(b).¹¹⁷ The Court even supports this assertion because it suggests that secondary actors still can be found liable under § 10(b) as primary violators.¹¹⁸

The Court’s explanation indicates that it would rather exclude aiders and abettors of fraud from the reach of liability than extend the implied private cause of action against innocent defendants.¹¹⁹ The Court should not have eliminated wholesale the private cause of action against aiders and abettors of securities laws. If a natural restriction must exist to limit the coverage of § 10(b),¹²⁰ the Court should have explained the level of culpable conduct that would create a private cause of action against secondary actors who aided and abetted under § 10(b).¹²¹ Here, the Court could have employed a test similar to the Ninth Circuit’s scheme liability test, which requires the secondary actor to engage in a deceptive scheme with “the principal purpose and effect of creating a false appearance of fact in furtherance of the scheme.”¹²² With this rationale, the Court would have clarified the law, while still finding the defendant Bank not liable because it did not employ a deceptive device or scheme to further the fraud.¹²³

Next, the Supreme Court in *Central Bank* also found that Congress has not created a general “civil aiding and abetting tort liability statute.”¹²⁴ Rather, Congress has taken a “statute-by-statute approach” in determining whether it wants to incorporate aiding-and-abetting liability.¹²⁵ Even if aiding and abetting liability were grounded in tort liability, the Court would not presume that Congress created a similar liability in securities legislation.¹²⁶ Thus, the Court concluded that if “Congress intended to impose aiding and abetting

¹¹⁷ 15 U.S.C. § 78j (2006); see Robert A. Prentice, *Scheme Liability, Federal Securities Fraud, and John Wayne’s I-Pod* 11 (McCombs Sch. of Bus. Research Paper Series No. IROM-02-07, 2007), <http://ssrn.com/abstract=1014658> (finding Congress used the word “any” to “send[] a strong signal as to how wide a net Congress wished to cast”).

¹¹⁸ *Cent. Bank*, 511 U.S. at 199 n.10.

¹¹⁹ *Id.* at 176 (“The problem . . . is that aiding and abetting liability extends beyond persons who engage, even indirectly, in a proscribed activity . . .”).

¹²⁰ *Marine Bank v. Weaver*, 455 U.S. 551, 556 (1982); *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 479–80 (1977).

¹²¹ *Cent. Bank*, 511 U.S. at 173. The Court “refuse[s] to allow 10b-5 challenges to conduct not prohibited by the text of the statute.” *Id.*

¹²² *Simpson v. AOL Time Warner*, 452 F.3d 1040, 1048 (9th Cir. 2006).

¹²³ *Cent. Bank*, 511 U.S. at 191 (finding *Central Bank* not liable because it did not execute a manipulative or deceptive act).

¹²⁴ *Id.* at 165.

¹²⁵ *Id.*

¹²⁶ *Id.* at 184.

liability . . . it would have used the words ‘aid’ and ‘abet’ in the statutory text. But it did not.”¹²⁷ However, this conclusion has two faulty premises. First, this statement is hard to reconcile with the judicially created implied private cause of action created under § 10(b).¹²⁸ Congress did not use any words to create an express cause of action; nonetheless, the Court had established this implied right under § 10(b) based on the tenants of common law.¹²⁹ Second, this conclusion falsely assumes that when Congress drafted the 1934 Act it found it necessary or natural to include a specific provision addressing the liability of aiders and abettors.¹³⁰ In 1934, the common law sanctioned all those who intentionally engaged in the fraud—even aiders and abettors—as joint tortfeasors.¹³¹ Thus, Congress had no natural reason to incorporate “aiding and abetting” language into the text of § 10(b).¹³²

Finally, though the majority touts statutory language and congressional intent to arrive at its decision in *Central Bank*, the Court derives its decision from its underlying hostility toward securities fraud claims.¹³³ Justice Stevens, in his dissent, finds that the majority discards “a long history of aider and abettor liability under § 10(b) and Rule 10b-5” without proper deliberation or support.¹³⁴ The Court did not interpret § 10(b) on a case-by-case basis because

¹²⁷ *Id.* at 177 (citing *Pinter v. Dahl*, 486 U.S. 622, 650 (1988)) (suggesting that Congress can easily extend liability if it chooses to do so). Shortly after *Central Bank*, Congress passed an amendment to the 1934 Act to allow the SEC to bring claims against “aiders and abettors” of fraudulent transactions. 15 U.S.C. § 78t(f) (2006). Yet, it did not provide explicitly for a private cause of action. *Id.*

¹²⁸ *Brennan v. Midwestern United Life Ins.*, 259 F. Supp. 673, 680 (N.D. Ind. 1966).

¹²⁹ *Id.*

¹³⁰ Prentice, *supra* note 117, at 29. Professor Robert Prentice suggests that the Supreme Court committed an anachronistic mistake in *Central Bank* by concluding that because Congress did not include the words “aid and abet” it intended not to include them. *Id.* He proposes that at the time of drafting § 10(b), no distinction had been made between primary and secondary actors because liability was thought to extend to all those who participate in the fraudulent acts. *Id.*

¹³¹ *Id.*

¹³² *Id.*

¹³³ Kahn, *supra* note 2, at 1619 (finding evidence of a pro-defendant Court in Rule 10b-5 matters); Jeffrey W. Stempel, *Class Actions and Limited Vision: Opportunities for Improvement Through a More Functional Approach to Class Treatment of Disputes*, 83 WASH. U. L.Q. 1127, 1134, 1184 (2005) (suggesting that the Supreme Court’s decision in *Dura Pharmaceuticals, Inc. v. Broudo* displayed “hostility” for investor’s securities fraud claims). See generally *Pinter v. Dahl*, 486 U.S. 622, 653 (1998) (“The ultimate question is one of congressional intent, not one of whether this Court thinks it can improve upon the statutory scheme that Congress enacted into law.” (quoting *Touche Ross & Co. v. Redington*, 422 U.S. 560, 578 (1979))).

¹³⁴ *Cent. Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164, 192 (1994) (Stevens, J., dissenting) (providing evidence that “all 11 [federal] Courts of Appeals” and “hundreds of judicial and administrative proceedings” have adopted a private cause of action against aiders and abettors under § 10(b) and Rule 10b-5).

the Court wanted “flexibly to effectuate” its remedial purposes.¹³⁵ The Court did not want to create a multi-factored test because a “highly fact-oriented” analysis is inappropriate for “liability imposed on the conduct of business transactions.”¹³⁶ To provide businesses with predictability and prevent protracted litigation,¹³⁷ the Court opted to interpret § 10(b) “technically and restrictively.”¹³⁸ As a result, the Court systematically eliminated all aiding-and-abetting liability for securities fraud.¹³⁹

Moreover, the Court’s holding in *Central Bank* fostered further confusion by keeping the door open for plaintiffs to raise claims against secondary actors even though it eliminated private action against aiders and abettors of § 10(b) violators. A correct textual analysis would not have eliminated a private cause of action against aiders and abettors, but would have identified the factors to determine liability of a secondary actor. Although using these Court-identified factors in *Central Bank* would not have led to a finding of liability for the secondary actors, this type of interpretation would have removed the confusion created in the aftermath of the decision. However, because it is unlikely that the Court will overrule this decision in the near future, plaintiffs must attempt to invoke the theory of scheme liability adopted by the Ninth Circuit to determine if the secondary actor’s conduct is sufficient for primary liability. The next section discusses the differences between secondary liability and scheme liability, and ultimately postulates, still keeping in line with the Court’s decision in *Stoneridge*, that courts limit the application of the scheme liability test to gatekeepers.

B. Discerning the Difference Between Secondary Liability and Scheme Liability

Because of the Supreme Court’s decision a decade ago in *Central Bank* and a split among the federal circuits,¹⁴⁰ ambiguity persists regarding the scope of

¹³⁵ *Id.* at 198 (quoting *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 151 (1972)).

¹³⁶ *Id.* at 188 (majority opinion) (quoting *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 755 (1975)).

¹³⁷ *Id.* at 188–89.

¹³⁸ *See id.* at 198 (Stevens, J., dissenting) (“The language of both § 10(b) and Rule 10b-5 encompasses ‘any person’ who violates the Commission’s antifraud rules, whether ‘directly or indirectly’; we have read this ‘broad language’ not ‘technically and restrictively, but flexibly to effectuate its remedial purposes.’” (quoting *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 151 (1972))).

¹³⁹ *Id.* at 191 (majority opinion).

¹⁴⁰ *Id.* at 170. *Compare* *Regents of the Univ. of Cal. v. Credit Suisse First Boston (USA), Inc.*, 482 F.3d 372, 386–87 (5th Cir. 2007) (adopting a bright-line test to establish secondary liability), *with* *Simpson v. AOL*

activities that can form the basis of civil and criminal liability for actors who actively participated in an issuer's fraud under § 10(b) and Rule 10b-5.¹⁴¹ The Supreme Court attempted to fix the uncertainty in this area by granting certiorari in *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*¹⁴² However, its holding did not expressly overrule the Ninth Circuit's "scheme liability" test—under the Court's interpretation of § 10(b), the plaintiff class cannot recover from a secondary actor engaged in fraudulent schemes *unless* that party violates a duty to disclose or the plaintiff class can show reliance on the fraudulent conduct or statements.¹⁴³ Thus, the Court in *Stoneridge* implicitly provided that investors could rely on a scheme to commit fraud by secondary actors participating in the financial markets.¹⁴⁴ The following subsection suggests that, after the *Stoneridge* decision, plaintiffs can still invoke the "scheme liability test" against the gatekeepers of primary actors.

I. Simpson v. AOL: Establishing the Reach of Liability for Secondary Actors

In *Simpson v. AOL Time Warner Inc.*, the plaintiff class alleged a Rule 10b-5 violation against AOL Time Warner (AOL) for agreeing to "cook" Homestore's financial books by engaging in "triangular transactions."¹⁴⁵ Homestore was the primary actor and AOL was the secondary actor in this scheme. The triangular transaction at issue consisted of Homestore's purchase of stock or unneeded goods and services from start-up companies in search of capital.¹⁴⁶ In exchange, these start-ups would return the invested money by purchasing advertising from AOL.¹⁴⁷ To complete the triangle, AOL would return the "advertising fees" to Homestore after keeping a cut for commission.¹⁴⁸ As a result, Homestore, by purchasing its own revenue and

Time Warner Inc., 452 F.3d 1040, 1042 (9th Cir. 2006) (establishing the scheme liability test to find secondary liability).

¹⁴¹ Ambiguity arises because the Supreme Court has kept the door to liability slightly ajar for secondary actors "who [employ] a manipulative device or [make] a material misstatement (or omission) on which a purchaser or seller of securities relies." *Cent. Bank*, 511 U.S. at 191.

¹⁴² 128 S. Ct. 761 (2008).

¹⁴³ *Id.*

¹⁴⁴ *See id.* at 769 ("Reliance by the plaintiff upon the defendant's deceptive acts is an essential element of the § 10(b) private cause of action.").

¹⁴⁵ *Simpson*, 452 F.3d at 1042.

¹⁴⁶ *Id.* at 1043.

¹⁴⁷ *Id.*

¹⁴⁸ *Id.* at 1043–44.

capitalizing the expenses from that transaction, reported a bloated profit in its financial statements.¹⁴⁹

The Ninth Circuit found that under § 10(b) and Rule 10b-5, a private action for securities fraud “must allege and prove all of the elements for primary liability”; however, prior to that analysis, the court must determine whether the accused were primary violators.¹⁵⁰ The court held that primary liability could be imposed in a private suit if the defendant “engaged in conduct that had the *principal purpose and effect* of creating a false appearance of fact in furtherance of the scheme. It is not enough that a transaction in which the defendant was involved had a deceptive purpose and effect”;¹⁵¹ to be liable for a scheme to defraud, “each defendant [must have] committed a manipulative or deceptive act in furtherance of the scheme.”¹⁵² Distinct from the Tenth Circuit’s bright-line test,¹⁵³ the Ninth Circuit found that § 10(b) does not require that the defendant made a material misrepresentation or omission to engage in market manipulation, but only that the defendant employed deceptive conduct “in the furtherance of a scheme to defraud.”¹⁵⁴

Unlike the defendant in *Central Bank* who passively ignored its ability to demand a reappraisal,¹⁵⁵ to find a defendant liable under the Ninth Circuit’s test, the plaintiff must prove that the defendant committed an egregious affirmative act that was devoid of any legitimate business purpose and furthered the deception.¹⁵⁶ This standard for primary liability sets a high bar for plaintiffs who attempt to seek damages from secondary actors, thereby lowering the risk of frivolous or weak cases passing muster.

Conduct that has any legitimate business purpose should not be included in this category of liability even if the defendant had knowledge of the primary

¹⁴⁹ *Id.*

¹⁵⁰ *Id.* at 1047 (citing *Dura Pharm., Inc. v. Broudo*, 544 U.S. 336, 341–42 (2005)).

¹⁵¹ *Id.* at 1048 (emphasis added).

¹⁵² *Id.* (emphasis added and omitted) (quoting *Cooper v. Pickett*, 137 F.3d 616, 624 (9th Cir. 1997)).

¹⁵³ *Anixter v. Home-Stake Prod. Co.*, 77 F.3d 1215, 1226–27 (10th Cir. 1996).

¹⁵⁴ *Simpson*, 452 F.3d at 1050.

¹⁵⁵ *See Cent. Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164, 168–69 (1994) (describing the court of appeals’s finding that Central Bank’s awareness of the inadequacies of the 1988 appraisal constituted an “extreme departure from the standards of ordinary care”).

¹⁵⁶ *Simpson*, 452 F.3d at 1049 (citing *Quaak v. Dexia*, 357 F. Supp. 2d 330, 342 (D. Mass. 2005)); *In re Global Crossing, Ltd. Sec. Litig.*, 322 F. Supp. 2d 319, 336–37 (S.D.N.Y. 2004); *In re Lernout & Hauspie Sec. Litig.*, 236 F. Supp. 2d 161, 173 (D. Mass. 2003) (citing cases in which finding primary liability under § 10(b) required the defendant to be the mastermind or architect of the deception).

actor's culpable intentions.¹⁵⁷ The Ninth Circuit's test effectively rules out as defendants most supplier companies in roles similar to Scientific-Atlanta and Motorola in the *Stoneridge* case, or AOL in the *Simpson* case, because their relationships with the primary violators had substance beyond just manipulating the market.¹⁵⁸ For example, in *Stoneridge*, Charter Communications (Charter), the primary actor, arranged to purchase set-top boxes from Scientific-Atlanta and Motorola, its business partners.¹⁵⁹ In the agreement, Charter overpaid the business partners \$20 for each set-top box in return for the business partners' purchase of advertising from Charter that was equivalent to the inflated payments.¹⁶⁰ Even though the defendants, Motorola and Scientific-Atlanta, acted fraudulently to boost Charter's revenues, their conduct did not amount to primary liability because the underlying transaction to buy set-top boxes had a legitimate business purpose.¹⁶¹ Additionally, in *Simpson*, the start-up ventures purchased actual advertisements from AOL, thereby forming a legitimate business transaction as the basis of AOL's conduct.¹⁶²

A secondary actor, who only purports to engage in a legitimate transaction of services or goods, but actually does not execute a trade, is not safe from liability because no other explanation exists for the actor's conduct other than to participate in a scheme to defraud the primary actor's investors.¹⁶³ In contrast to the situation where a legitimate purpose underlies the fraudulent scheme, a court in this situation can find that an investor relied on the secondary actor's scheme to defraud because the only intended effect of such a

¹⁵⁷ *Simpson*, 452 F.3d at 1050 (citing *In re Charter Commc'ns, Inc., Sec. Litig.*, 443 F.3d 987, 992 (8th Cir. 2007)).

¹⁵⁸ *See id.* (“[W]hen determining whether a defendant is a ‘primary violator,’ the conduct of each defendant, while evaluated in its context, must be viewed alone for whether it had the purpose and effect of creating a false appearance of fact in the furtherance of an overall scheme to defraud.”).

¹⁵⁹ *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 128 S. Ct. 761, 766 (2008).

¹⁶⁰ *Id.*

¹⁶¹ *See id.* at 774 (noting that the arrangement evolved out of the ordinary course of business in the Vendors' role as suppliers, taking place in the marketplace for goods and services); *see also Simpson*, 452 F.3d at 1050 (“Participation in a legitimate transaction . . . would not allow for a primary violation even if the defendant knew or intended that another party would manipulate the transaction to effectuate a fraud.” (citation omitted)).

¹⁶² *Simpson*, 452 F.3d at 1053.

¹⁶³ *See, e.g., id.* at 1050 (noting that liability may still be found for the secondary actor if “a defendant's conduct or role in an illegitimate transaction has the principal purpose and effect of creating a false appearance of fact in furtherance of the scheme to defraud”); *see also id.* at 1049 (citing *Quaak v. Dexia*, 357 F. Supp. 2d 330, 342 (D. Mass. 2005)).

scheme is to misrepresent the revenue.¹⁶⁴ This rationale is supported by the Supreme Court's explanation in its previous decisions. The majority's finding in *Central Bank* demonstrates that the Court did not require the plaintiff to know the "identity,"¹⁶⁵ of the defendant, but only to rely on its "statements or actions."¹⁶⁶ For example, investors can rely on the acts of banks that set up shell entities for the sole purpose of misrepresenting a partner company's financial statements even if the bank does not itself disclose its fraudulent acts on the market.¹⁶⁷ The Court in *Basic* went even as far as holding that investors do not actually need to be aware of the fraud as long as the information is public or on the market.¹⁶⁸ Thus, a court can find that the investors relied on the secondary actor's actions through introduction of misleading statements by the primary actor. When no goods or services are exchanged, and the plaintiff establishes all other elements of Rule 10b-5, the secondary actors should be found liable.

By adopting the Ninth Circuit's "scheme liability test," courts would resolve the concerns raised by the Supreme Court's decision in *Central Bank*. First, this test removes the ambiguity raised by *Central Bank* for finding primary liability against secondary actors.¹⁶⁹ The scheme liability theory provides a test to distinguish actions that only aid and abet from actions that amount to primary liability for secondary actors.¹⁷⁰ Second, because the Ninth Circuit's analysis excludes from liability any deals with a legitimate business purpose,¹⁷¹ this test sets up safeguards against liability for an "arm's length transaction" and concurrently provides protection for investors against secondary actors whose acts only intended to defraud innocent investors.¹⁷²

¹⁶⁴ *Id.* at 1051 ("[A] scheme to misrepresent the publicly reported revenue of a company may coincide with the purchase or sale of securities because the scheme will not be complete until the fraudulent information is introduced in the securities market.").

¹⁶⁵ See Prentice, *Scheme Liability*, *supra* note 117, at 38 ("Thus, *Central Bank* sensibly requires not that the plaintiffs rely upon the defendant's *identity* It requires only that plaintiffs rely upon the defendant's *statements or actions*.").

¹⁶⁶ *Id.*; see also *Cent. Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164, 180 (1994) (noting that a showing must be made that the plaintiff relied upon the statements or actions of the defendant for a finding of liability).

¹⁶⁷ See, e.g., *Simpson*, 452 F.3d at 1050 (citing *In re Enron Corp. Sec., Derivative & ERISA Litig.*, 235 F. Supp. 2d 549, 580 (S.D. Tex. 2002)).

¹⁶⁸ See *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 128 S. Ct. 761, 776 (2008) (Stevens, J., dissenting) (citing *Basic Inc. v. Levinson*, 485 U.S. 224, 248 (1988)).

¹⁶⁹ See *supra* text accompanying note 141.

¹⁷⁰ *Simpson*, 452 F.3d at 1050 (establishing a "test that examines the purpose and effect of a defendant's conduct" to determine primary liability).

¹⁷¹ *Id.*

¹⁷² *In re Charter Commc'ns, Inc., Sec. Litig.*, 443 F.3d 987, 989 (8th Cir. 2006).

Finally, though the Supreme Court's decision in *Stoneridge*, as discussed below, likely narrowed the application of the "scheme liability test" to only gatekeepers, this Comment argues that the Court did not expressly overrule the Ninth Circuit's test.

2. *Scheme Liability Survives Stoneridge*

In *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, described as one of the most important securities law cases of the decade,¹⁷³ the plaintiffs were shareholders of Charter, a large national cable television provider.¹⁷⁴ The plaintiffs maintained that Charter initiated a "pervasive and continuous fraudulent scheme intended to boost artificially the Company's reported financial results" primarily by exercising purported transactions with equipment vendors, Scientific-Atlanta and Motorola (collectively the "Vendors").¹⁷⁵ As a result, the plaintiffs sued Charter and the Vendors under § 10b and Rule 10b-5.¹⁷⁶

Charter regularly delivered and sold cable service through set-top cable boxes it purchased from third parties, including the Vendors.¹⁷⁷ In a transaction between Charter and the Vendors, Charter arranged to pay them an additional \$20 per set-top cable box over the normal price of the set-top boxes in exchange for the Vendors' returning the inflated payment to Charter in the form of "advertising fees."¹⁷⁸ Charter actualized the fraud by recognizing the \$20 "advertising fee" as immediate revenue in its publicly distributed financial statements and capitalizing the entire cost of the set-top boxes including the additional \$20 it paid.¹⁷⁹ By spreading the expense of the equipment over its expected life, and immediately recognizing the revenue,¹⁸⁰ Charter overstated its gross revenues by \$17 million.¹⁸¹

¹⁷³ Black, *supra* note 91, at 1.

¹⁷⁴ *Stoneridge*, 128 S. Ct. at 761.

¹⁷⁵ *In re Charter*, 443 F.3d at 989.

¹⁷⁶ *Id.*

¹⁷⁷ *Id.*

¹⁷⁸ *Stoneridge*, 128 S. Ct. at 766–67.

¹⁷⁹ *Id.*

¹⁸⁰ For example, if Charter's expected useful life of the set-top boxes was five years, by dividing the additional \$20 in expense over this period, Charter would have reported only \$4 in expenses. By only reporting \$4 in expense and reporting \$20 immediately in revenue from the "advertising fees" it could artificially boost its profit by \$16 for every set-top box it bought.

¹⁸¹ *Stoneridge*, 128 S. Ct. at 767.

To mislead Charter's auditor, Arthur Andersen & Co., the Vendors needed to create the impression that the contracts for the set-top boxes and advertising services were two distinct deals.¹⁸² Scientific-Atlanta sent Charter a document falsely announcing a price increase due to an increase in production costs.¹⁸³ Motorola, with the expectation that Charter would have to pay liquidated damages, stipulated in its contract that Charter would buy a pre-set number of set-top boxes; however, if Charter failed to purchase the entire amount, Charter would pay \$20 in liquidated fees for each set-top box it did not purchase.¹⁸⁴ The Vendors drafted and signed backdated documents to cover up the connection between the increased prices for set-top boxes and the purchase of advertising fees.¹⁸⁵

The plaintiffs alleged that the defendants, Scientific-Atlanta and Motorola, designed and executed this sham transaction to allow Charter to meet the revenue and operating cash flow numbers projected for it by Wall Street analysts.¹⁸⁶ Even though the plaintiffs did not claim that the Vendors distributed Charter's deceptive financial statements and press releases,¹⁸⁷ they did claim that the Vendors knew that Charter intended to account for the "advertising fees" as revenue. Accordingly, plaintiffs claimed that Vendors knew that Charter's analysts would rely on its inflated revenues and on its misleading operating cash flow numbers to make positive stock recommendations to the public.¹⁸⁸

The Supreme Court found no violation of § 10(b), on the premise that the allegations did not show that Vendors "made *misstatements relied upon* by the public or that they violated a duty to disclose."¹⁸⁹ The Court rejected the interpretation of the Eighth Circuit's bright-line test that requires a deceptive oral or written statement to exist to find liability.¹⁹⁰ The Court has held that "[n]either the SEC nor [the Supreme] Court has ever held that there must be a

¹⁸² *Id.*

¹⁸³ *Id.*

¹⁸⁴ *Id.*

¹⁸⁵ *Id.*

¹⁸⁶ *Id.* at 766–67.

¹⁸⁷ *Id.* at 767. The Vendors abided by the Generally Accepted Accounting Principles (GAAP) in recording this transaction as a wash in its own financial statements. *Id.*

¹⁸⁸ *Id.*

¹⁸⁹ *Id.* (emphasis added). No facts suggest that the Vendors helped Charter prepare or disclose its financial statements to the public.

¹⁹⁰ *See id.* at 769 (noting that it is an erroneous interpretation of prior case law to suggest that there must be specific oral or written statements made before liability under Section 10(b) or Rule 10b-5 can be found).

misrepresentation about a particular security's value in order to run afoul of [Rule 10(b)]"¹⁹¹ because "[c]onduct itself can be deceptive."¹⁹²

But even with the sham oral and written contracts and statements made by and between Charter and the Vendors, the Court found that the Vendors could not be held liable.¹⁹³ These deceptive devices were not actionable because the public could not have relied on these documents in their decision to purchase or sell securities¹⁹⁴ or, more specifically, the alleged fraudulent acts were not proximately related to the investors' harm.¹⁹⁵ To presume reliance, a court must establish that the actor owed a duty to the investors to disclose the fraud or a court must adopt the fraud-on-the-market theory.¹⁹⁶

First, a court can presume reliance if the facts omitted are material and if the actor owes a duty to the affected investors.¹⁹⁷ The Supreme Court, in *Affiliated Ute Citizens of Utah v. United States*, explicitly rejected reliance as a prerequisite for finding a violation of Rule 10b-5 if the "facts withheld [were] material in the sense that a reasonable investor might have considered them important in the making of [the] decision."¹⁹⁸ Here, the Court correctly asserted that it could not find a presumption of reliance because the Vendors owed no duty to Charter's investors.¹⁹⁹ However, if the facts of this case had involved gatekeepers, whose actions had no legitimate business purpose, the conclusion might have been different. Depending on the situation, gatekeepers may owe a duty to investors.²⁰⁰ In *Woodward v. Metro Bank*, the Fifth Circuit found that "where the law imposes special obligations, as for accountants,

¹⁹¹ *SEC v. Zandford*, 535 U.S. 813, 814 (2002). Justice Stevens's analysis in *SEC v. Zandford* captured this idea. *Id.* In *Zandford*, a broker in charge of a trust's discretionary accounts had the authority to buy and sell stocks, but he exceeded that authority by selling the stocks and keeping the proceeds for himself. *Id.* at 813. Although the broker did not make a material misstatement about the stocks in issue, his deceptive actions of selling the stock were "in connection with the purchase or sale" of a security. *Id.* at 813-14. Thus, the *Zandford* Court found that even non-expressive actions came within the scope of activities that can form the basis of liability under a Rule 10b-5 claim. *Id.*

¹⁹² *Stoneridge*, 128 S. Ct. at 769..

¹⁹³ *Id.*

¹⁹⁴ *Id.* (agreeing with the court of appeals's determination that "any deceptive statement or act [the Vendors] made was not actionable because it did not have the requisite proximate relation to the investors' harm").

¹⁹⁵ *Id.*

¹⁹⁶ *Id.*; see *supra* text accompanying notes 66-70.

¹⁹⁷ *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 153-54 (1972).

¹⁹⁸ *Id.*

¹⁹⁹ *Stoneridge*, 128 S. Ct. at 769.

²⁰⁰ See *Woodward v. Metro Bank of Dallas*, 522 F.2d 84, 97 n.28 (5th Cir. 1975) (cited in *Ziembra v. Cascade, Int'l, Inc.*, 256 F.3d 1194, 1206 (11th Cir. 2001)).

brokers, or other experts,” a duty to disclose fraud may exist.²⁰¹ A duty to disclose exists especially when the fraud is known and no additional due diligence or investigation is required for the gatekeeper to uncover it on the part of the actor.²⁰²

Second, the Court did not believe the fraud-on-the-market theory applied in *Stoneridge*.²⁰³ The Court dismissed as too attenuated the notion that investors relied on the inflated revenues documented in Charter’s financial statements, which Charter could not have forged without the Vendors actively supplying false documents and creating contracts backdated by one month to deceive the auditors.²⁰⁴ Without this presumption of reliance as adopted in *Basic Inc. v. Levinson*, each individual plaintiff in the class would have to assert individual reliance.²⁰⁵

The Court’s dismissal of the existence of any reliance is appropriate based on the Ninth Circuit’s scheme liability test.²⁰⁶ The plaintiffs attempted to argue that their reliance on Charter’s financial statements satisfied the reliance element of the cause of action because the deceptive financial information was created in part by the conduct of the Vendors.²⁰⁷ Nevertheless, because the underlying purpose of the transaction for the Vendors was to sell set-top boxes, investors could not have relied on the Vendors’ deceptive acts from Charter’s release of its faulty financial statements.²⁰⁸ The Court correctly remarked that if it applied the scheme liability test in this context, liability “would reach the whole marketplace in which the issuing company does business,” including “areas already governed by functioning and effective state-law guarantees.”²⁰⁹ But, because under the scheme liability test a secondary actor’s conduct must be devoid of any legitimate business practice,²¹⁰ the test would not reach the

²⁰¹ *Id.* The Court also noted that knowledge was key to determining the duty to disclose. *Id.*; see Rudolph v. Arthur Andersen & Co., 800 F.2d 1040, 1043 (11th Cir. 1986) (“A defendant who *intentionally* did not reveal what he *knew* to be fraud might more reasonably be expected to speak out . . .”).

²⁰² *Id.*; see United States v. Simon, 425 F.2d 796, 806 (2d Cir. 1969) (“[I]t simply cannot be true that an accountant is under no duty to disclose what he knows when he had reason to believe that, to a material extent, a corporation is being operated not to carry out its business in the interest of all the stockholders . . .”).

²⁰³ *Stoneridge*, 128 S. Ct. at 776.

²⁰⁴ *Id.*

²⁰⁵ *Castano v. Am. Tobacco Co.*, 84 F.3d 734, 745 (5th Cir. 1996) (“[A] fraud class action cannot be certified when individual reliance will be an issue.”).

²⁰⁶ See generally *Simpson v. AOL Time Warner*, 452 F.3d 1040 (9th Cir. 2006).

²⁰⁷ *Stoneridge*, 128 S. Ct. at 770.

²⁰⁸ *Id.*

²⁰⁹ *Id.* at 770–71.

²¹⁰ See *supra* text accompanying note 159.

entire marketplace because supplier companies, such as the Vendors, will typically have a valid underlying business purpose to conduct the fraudulent transaction and therefore will be safe from private action.²¹¹

Even after the Supreme Court's decision in *Stoneridge*, uncertainty exists as to when and which secondary actors can be found liable.²¹² Although the Court rejected finding a business partner liable for the fraud underlying its ordinary business transactions, the Court's decision leaves the door open for using the Ninth Circuit's test for gatekeeper liability.²¹³ The backbone of the Court's rationale in *Stoneridge* rests on the remoteness of the Vendors' relationship to Charter.²¹⁴ The Court found the investors' reliance on the Vendors' backdated contracts to be too attenuated because this relationship was outside "the realm of financing business" but within the world of "ordinary business operations."²¹⁵ Gatekeepers, such as accountants, lawyers, or underwriters, unlike the Vendors in *Stoneridge*, are typically not remote to the fraud because they are assisting the primary actor in the verification and certification of its financial statements.²¹⁶ Further, even if the gatekeeper does not issue the fraudulent statement, investors can rely on its fraudulent acts because, as several courts have suggested, it likely has a duty to disclose the fraud to investors if it is aware of its existence.²¹⁷ Even without a duty to disclose, courts presume reliance because the interaction between gatekeepers and the primary actor typically encompasses not an exchange of goods, but an exchange of financial and legal services, which if provided with an eye to fraud, likely have no other legitimate business purpose.²¹⁸ This explanation leaves open the possibility that courts can find entities within the "investment

²¹¹ *Stoneridge*, 128 S. Ct. at 766.

²¹² See *id.* at 773–74 (discussing the potential situations where a secondary actor can be found liable); see Posting of Larry Ribstein to Ideoblog, <http://busmovie.typepad.com/ideoblog/2008/01/the-future-of-s.html> (Jan. 17, 2008, 15:27 EST) (positing that advisors in securities transaction might have a fate different than that of the secondary actors in *Stoneridge* as the Court didn't establish a complete bar to liability based on deceptive acts); Posting of Eric H. Zagrans to Sixth Circuit Blog, <http://www.sixthcircuitblog.com/2008/01/scheme-liabilit.html> (Jan. 17, 2008, 23:15 EST) (suggesting that scheme liability theory survives, but barely).

²¹³ *Stoneridge*, 128 S. Ct. at 761.

²¹⁴ See *id.* at 769. ("Petitioner, as a result, cannot show reliance upon any of [Vendors'] actions except in an indirect chain that we find too remote to find liability.").

²¹⁵ *Id.* at 770.

²¹⁶ See Coffee, *Gatekeeper Failure and Reform*, *supra* note 11, at 308–10 (noting the high reputational risk and small payoff gatekeepers have for any involvement in misconduct).

²¹⁷ See *supra* text accompanying notes 200–02.

²¹⁸ See also *Simpson v. AOL Time Warner*, 452 F.3d 1040, 1048 (9th Cir. 2006) (describing findings of liability for violations of § 10(b) to be the result of the defendant's own conduct contributing to a transaction with an overall deceptive purpose or effect).

sphere” liable for similar conduct because their connection with the primary actor is not as remote as suppliers or customers.²¹⁹

IV. POLICY REASONS TO EXTEND SCHEME LIABILITY TO GATEKEEPERS

Because Congress did not explicitly provide individuals a private right of action under § 10(b) of the 1934 Act, to imply such a right, courts must conclude that Congress intended for such a right to exist.²²⁰ The Supreme Court has outlined several factors to determine congressional intent, including public policy considerations.²²¹ To find an implied private right of action against secondary actors for primary liability under § 10(b), the courts look to Congress’s policy goals of deterring corporate fraud and decreasing frivolous lawsuits as one factor to guide its decision.²²²

A. *Can Liability Make the Investor Whole?*

Opponents of expanding the private cause of action to incorporate scheme liability also claim that the only beneficiaries of increased liability are litigators that raise *in terrorem* settlement actions against corporations. Because securities regulations are based on a largely outdated view that an investor’s private action will make him or her whole, judicial opinions should discourage broadening liability.²²³ Litigation arguably creates higher losses for the reasonable investor.²²⁴ Securities law is designed to protect investors who are

²¹⁹ *Stoneridge*, 128 S. Ct. at 774.

²²⁰ *Id.* at 772; *Alexander v. Sandoval*, 532 U.S. 275, 286–87 (2001); *Touche Ross & Co. v. Redington*, 442 U.S. 560, 568 (1979); *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 477 (1977).

²²¹ *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 737 (1975).

²²² *Id.*; see also William B. Snyder, Jr., *The Securities Act of 1933 After SLUSA: Federal Class Actions Belong in Federal Court*, 85 N.C. L. REV. 669, 698 (2007) (discussing statutory interpretation of SLUSA in light of Congress’s goals of “protecting defendants by decreasing vexatious strike suits,” protecting investors, protecting market integrity, and advancing an efficient capital market).

²²³ See generally Richard A. Booth, *Taking Certification Seriously—Why There Is No Such Thing as an Adequate Representative in a Securities Fraud Class Action* 22–23 (Villanova Sch. of Law Pub. Law & Legal Theory Working Paper Group No. 2008–07, 2008), <http://ssrn.com/abstract=1026768> [hereinafter Booth, *Taking Certification Seriously*] (noting that to discourage the broadening of liability, “courts should decline to certify securities fraud actions as class actions” because of the “conflicting interests of class members”).

²²⁴ See Richard A. Booth, *In Stoneridge, the Supreme Court Should Focus on Who Really Gains*, LEGAL TIMES, Oct. 9, 2007, <http://www.law.com/jsp/PubArticle.jsp?id=900005492990> [hereinafter Booth, *Who Really Gains*] (describing the losses investors suffer due to successful fraud suits because of the decline in their stock value and the payment of damages by the company).

reasonable.²²⁵ Reasonable investors diversify their portfolios.²²⁶ In the current American capital markets system, most investors diversify their financial portfolio to hedge against the unsystematic risks affecting different industries.²²⁷ Diversified investors should not favor litigation by other investors because the net effect of litigation is a loss to their portfolio.²²⁸ For example, the gains investors face when they are class action plaintiffs wash out when faced with the times they are not eligible to become a part of a class action against a company in which they hold stock.²²⁹ Therefore, to protect the reasonable investor who is diversified, securities law, to abide by its purpose, should curtail the scope of liability for both primary and secondary actors.

Furthermore, imposing liability on secondary actors when the primary corporation is judgment proof does not serve the goal of just compensation because the wealth transfer that occurs arises from one victim getting compensated at the expense of innocent creditors.²³⁰ Professor Richard Booth claims that litigation involving securities fraud is unrewarding unless it surrounds insider trading, which allows violators to “extract stockholder wealth from the market.”²³¹ Even most institutional investors realize that securities fraud litigation is a deadweight loss.²³² For example, evidence suggests that institutional investors forgo approximately \$1.05 billion in potential securities class action settlements because the compensation is “trivial” compared to the time and resources expended.²³³ In the end, as they realize, “only the lawyers win.”²³⁴

²²⁵ See Richard A. Booth, *The End of the Securities Fraud Class Action as We Know It*, 4 BERKELEY BUS. L.J. 1, 10–12 (2007) [hereinafter Booth, *End of Securities Fraud Class Action*] (discussing that reasonable investors diversify their portfolios).

²²⁶ *Id.* at 11.

²²⁷ Booth, *Taking Certification Seriously*, *supra* note 223, at 22.

²²⁸ Booth, *End of the Securities Fraud Class Action*, *supra* note 225, at 11.

²²⁹ *Id.* at 11 n.23.

²³⁰ See Arlen & Carney, *supra* note 9, at 719 (describing how imposing liability on secondary actors “simply replaces one group of innocent victims with another”).

²³¹ Booth, *Who Really Gains*, *supra* note 224.

²³² This view neglects the deterrence purpose of securities legislation. Imposing liability against corporations violating securities laws benefits investors because it deters companies from engaging in fraudulent transactions. See *infra* Part IV.B.

²³³ A.C. Pritchard, *Who Cares?*, 80 WASH. U. L.Q. 883, 883–84 (2002), *cited in* John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation*, 106 COLUM. L. REV. 1534, 1547 (2006) [hereinafter Coffee, *Deterrence and Its Implementation*].

²³⁴ Booth, *Who Really Gains*, *supra* note 224.

B. *Detering Fraud with Gatekeeper Liability*

However, the true goal of securities legislation is not to make the investor whole, but to protect investors by deterring fraud.²³⁵ Fraud impacts not only individual shareholders who lose their investments, but the entire marketplace.²³⁶ As Professor Coffee has identified, an epidemic of corporate fraud is the trigger for a series of events that chills and contracts the economy.²³⁷ Investors wary of financial scandals and economic loss demand higher payouts for the assumed risk of entering the market.²³⁸ As capital costs rise, businesses across the industry have less money for growth opportunities, which can lead to layoffs and economic stagnation.²³⁹ During the scandals in 2000–2001, companies like Enron and WorldCom compelled competitors to emulate its fraudulent practices to remain in the industry.²⁴⁰ Although this scenario is an extreme example, fraud still can wreak havoc on the economy by lowering investor confidence.²⁴¹ Thus, increased liability is a mechanism to deter fraud and regulate corporate governance, which are essential for the vitality and success of the securities market.

Because the value of a gatekeeper is in its reputational capital, gatekeepers have no incentive to risk their reputations by assisting one client in fraud.²⁴² A company that hires a reputable gatekeeper sends a positive signal to the market because the gatekeeper pledges its credibility to the veracity of the company's financial and legal standing.²⁴³ Scholars have stressed that the role and position of gatekeepers enable them to monitor and detect corporate fraud.²⁴⁴ But as a hired hand, gatekeepers also have a strong incentive to keep their

²³⁵ Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (2006).

²³⁶ See, e.g., Coffee, *Deterrence and Its Implementation*, *supra* note 233, at 1565 (describing the cumulative losses faced by not only investors but citizens throughout society as a result of fraud).

²³⁷ *Id.*

²³⁸ *Id.*

²³⁹ *Id.*

²⁴⁰ *Id.* at 1565–66.

²⁴¹ *Id.* at 1565.

²⁴² See John C. Coffee, Jr., *Understanding Enron: "It's About the Gatekeepers, Stupid,"* 57 BUS. LAW. 1403, 1405 (2002) [hereinafter Coffee, *Understanding Enron*] ("In theory, such reputational capital [for gatekeepers] would not be sacrificed for a single client and a modest fee.")

²⁴³ See Coffee, *Gatekeeper Failure and Reform*, *supra* note 11, at 308–10 ("[T]he market recognizes that the gatekeeper has a lesser incentive to deceive than does its client and thus regards the gatekeeper's assurance or evaluation as more credible.")

²⁴⁴ *Id.*; see Assaf Hamdani, *Gatekeeper Liability*, 77 S. CAL. L. REV. 53, 86–87 (2003) (concluding that the attractiveness of market entry for potential wrongdoers would diminish if the threat of liability forced gatekeepers to install adequate checks to detect and report misconduct).

clients satisfied.²⁴⁵ When the risk of liability diminishes for gatekeepers, the benefits of gatekeeper acquiescence increase.²⁴⁶ Increasing the risk of legal exposure to liability preserves the gatekeepers' role as a watchdog.²⁴⁷ Thus, for gatekeepers to become an effective force in deterring fraud, its expected loss from liability must be higher than its expected loss from losing a large client.²⁴⁸

Courts should allow a private cause of action against gatekeepers under the scheme liability theory. If the laws had adequately deterred gatekeepers from engaging in fraud, it might have prevented the fraudulent transactions that plagued the economy from 2000–2001.²⁴⁹ By instituting a private cause of action against gatekeepers under the scheme liability test, the courts would activate an effective mechanism to deter fraud.²⁵⁰

Critics argue that too much deterrence can decrease the number of existing and potential public companies.²⁵¹ With an increase in the risk of liability, gatekeepers will charge even higher prices for the same services.²⁵² Thus, new entities that attempt to enter the public market might reconsider because they

²⁴⁵ Hamdani, *supra* note 244, at 86–87.

²⁴⁶ Coffee, *Understanding Enron*, *supra* note 242, at 1409.

²⁴⁷ *See id.* at 1419 (noting that without increasing risk of legal exposure, and as the benefits of acquiescence of client demands increase, gatekeeper failure could increase correspondingly as well).

²⁴⁸ *See, e.g.,* Coffee, *Gatekeeper Failure and Reform*, *supra* note 11, at 339 (finding that liability for audit committee members will increase in the future as a result of the Sarbanes–Oxley Act). When these audit firms face an increased risk of liability, it forces them to refocus their internal practices and adopt controls to minimize the risk. *Id.*

²⁴⁹ *See* Coffee, *Understanding Enron*, *supra* note 242, at 1419 (describing how gatekeeper failure increased during the 1990s as the risk of auditor liability declined).

²⁵⁰ *See generally id.*

²⁵¹ *See* William J. Carney, *The Costs of Being Public After Sarbanes-Oxley: The Irony of “Going Private,”* 55 EMORY L.J. 141, 143 (2006) (suggesting evidence that rising costs, associated with legal compliance, are forcing some companies to go private); Hamdani, *supra* note 244, at 114–15 (noting that an increase in gatekeeper liability may encourage existing public companies to delist, discourage new companies from going public, or possibly discourage public companies from engaging in other transactions); E. Norman Veasey et al., *Federalism vs. Federalization: Preserving the Division of Responsibility in Corporation Law, in WHAT ALL BUSINESS LAWYERS & LITIGATORS MUST KNOW ABOUT DELAWARE LAW DEVELOPMENTS 2006*, at 221, 231 (PLI Corp. L. & Practice, Course Handbook Series No. 8423, 2006), *available at* WL 1543 PLI/Corp 221 (stating that compliance costs can lead public companies to delist or go private and lead private companies to forgo an opportunity to go public).

²⁵² Hamdani, *supra* note 244, at 114–15; Noam Sher, *Negligence Versus Strict Liability: The Case of Underwriter Liability in IPO's*, 4 DEPAUL BUS. & COM. L.J. 451, 462 (2006); Tamara Loomis, *Costs of Compliance Soar After Sarbanes-Oxley*, LAW.COM, May 5, 2003, <http://www.law.com/jsp/article.jsp?id=900005535244> (reporting that after the Sarbanes–Oxley Act, the costs to stay public have almost doubled and the “increase in audit costs is due largely to heightened sensitivity to liability concerns”).

cannot afford the higher fees for gatekeepers' services.²⁵³ A fee increase could also result in smaller public companies delisting from the public market because it is not cost effective for them to remain public.²⁵⁴

C. *Curbing Vexatious Litigation*

Finally, although securities legislation aims to deter fraud, it also must look to serve the competing interest of protecting businesses against vexatious litigation.²⁵⁵ Corporations are plagued with an overabundance of frivolous lawsuits.²⁵⁶ Organizations have found that the litigation process is geared toward creating inflated settlements regardless of the merits of the case.²⁵⁷ As stated in *Hundahl v. United Benefit Life Insurance Co.*, "even an unmeritorious claim, because of the time its defense would consume, the extensive discovery to which the corporate defendant would be subject, and the difficulty of disposing of most such cases before trial would force [defendants with deep-pockets] to settle early *in terrorem* settlements."²⁵⁸ Moreover, the risk and uncertainty associated with jury trials create incentives for corporations to settle even the most unsubstantiated cases.²⁵⁹ Lawyers that force settlement actions have overreached the protection afforded to investors to institute undeserving, costly litigation.²⁶⁰ Settlement of weak cases leads to undercompensating actual victims of securities violations, while the private enforcement mechanism becomes an inefficient insurance system to protect against market losses.²⁶¹

In response to the overabundance of frivolous securities litigation, in 1995, Congress enacted the Private Securities Litigation Reform Act (PSLRA), requiring the plaintiff to "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind," or

²⁵³ Hamdani, *supra* note 244, at 114–15.

²⁵⁴ *Id.*

²⁵⁵ See, e.g., *Blue Chips Stamps v. Manor Drug Stores*, 412 U.S. 723, 740–42 (1975).

²⁵⁶ See, e.g., *Grundfest*, *supra* note 37, at 973 (noting arguments that the "entire litigation process is a magnet for strike suits that force inflated settlements at sums divorced from the merits of the underlying claims").

²⁵⁷ *Id.*

²⁵⁸ *Hundahl v. United Benefit Life Ins. Co.*, 465 F. Supp. 1349, 1363 (N.D. Tex. 1979); *Grundfest*, *supra* note 37, at 973.

²⁵⁹ See *Grundfest*, *supra* note 37, at 970 (private class actions involve "lower-quality" actions that plaintiffs file to generate huge payoffs from "defendants unwilling to bear the risks and costs of a trial on the merits"); *supra* text accompanying note 80.

²⁶⁰ *Grundfest*, *supra* note 37, at 970.

²⁶¹ Alexander, *supra* note 82, at 501.

scienter.²⁶² Because of the heightened standard of scienter, the PSLRA undermines the overdeterrence argument against extending primary liability to gatekeepers.²⁶³ The inference of scienter does not even need to be the “most plausible” explanation, but a reasonable person must regard the inference of scienter at least as “cogent and compelling” as the non-culpable explanations for the defendant’s conduct.²⁶⁴ Vagueness, ambiguities, or omissions in the complaint, stemming from the lack of dates and details, may negate a strong inference of scienter.²⁶⁵ Though commentators still find the exact standard of scienter ambiguous, the Court’s decision in *Tellabs, Inc. v. Makor Issues & Rights, Ltd.* raised the pleading requirements.²⁶⁶ Proponents of expanded liability should find that the heightened pleading standard coupled with the ability, under the PSLRA, to stay “all discovery and other proceedings . . . during the pendency of any motion to dismiss,”²⁶⁷ essentially diminishes the plaintiff’s ability to bring forth an unsubstantiated claim.²⁶⁸

In response to the stringent requirements of the PSLRA, many plaintiffs began raising suits in states with plaintiff-friendly antifraud statutes and common law claims. However, Congress passed the Securities Litigation Uniform Standards Act (SLUSA) to curtail the scope of class actions brought under state and federal antifraud securities statutes in state courts.²⁶⁹ The

²⁶² 15 U.S.C. § 78u-4(b)(2) (2006).

²⁶³ Amanda M. Rose, *Reforming Securities Litigation Reform: Restructuring the Relationship Between Public and Private Enforcement of Rule 10b-5*, 108 COLUM. L. REV. 1301, 1303 (2008).

²⁶⁴ See *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499, 2510 (2007) (“Congress required plaintiffs to plead with particularity facts that give rise to a ‘strong’—i.e., a powerful or cogent—inference.”).

²⁶⁵ See *id.* at 2511 (noting that omissions and ambiguities, such as a lack of precise dates, can count against an inference of scienter).

²⁶⁶ Richard H. Zelichov, *Tellabs: The Debate over Competing Inferences Will Continue*, in SECURITIES LITIGATION & ENFORCEMENT INSTITUTE 2007, at 499, 510 (PLI Corp. L. & Practice, Course Handbook Series No. 11072, 2007), available at WL 1620 PLI/Corp 499 (nothing that the holding in *Tellabs* raised the scienter standard above the standard applied in the Seventh Circuit’s appellate review of *Tellabs*).

²⁶⁷ 15 U.S.C. § 78u-4(b)(3)(B).

²⁶⁸ In his concurrence, Justice Alito found that the majority’s interpretation of the PSLRA does not distinguish it from the normal pleading standard and “unlikely to make any practical difference.” *Tellabs*, 127 S. Ct. at 2516 (Alito, J., concurring). The interpretation should at least make the inference of scienter “more likely than not.” *Id.*

²⁶⁹ Joseph F. Morrissey, *Catching the Culprits: Is Sarbanes-Oxley Enough?*, 2003 COLUM. BUS. L. REV. 801, 804. Under the SLUSA, no “covered” class action can be raised in any state or federal court when it is based on a state’s statutory or common law that allows for an allegation of a “misrepresentation or omission of a material fact in connection with the purchase or sale of a covered security” or a use of “any manipulative or deceptive device or contrivance in connection with the purchase or sale of a covered security.” 15 U.S.C. § 78bb(f)(1). When more than fifty people seek restitution or damages, the lawsuit, broadly defined, is a “covered class action.” *Id.* § 78bb(f)(5)(B). Further, “a ‘covered security’ is one traded nationally and listed on a regulated national exchange.” *Merrill Lynch v. Dabit*, 547 U.S. 71, 83 (2006).

Supreme Court, to limit the plaintiff class that can recover against defendants, interpreted the SLUSA to preempt state law class action claims brought by holders of securities, purchasers of securities, and sellers of securities.²⁷⁰ As Cornerstone Research and Stanford Law School's Securities Class Action Clearinghouse has noted, the combined effect of the PSLRA and SLUSA has dropped the number of federal shareholder lawsuits to its lowest in a decade.²⁷¹

Finally, even Professor Grundfest, a former SEC commissioner and staunch opponent of scheme liability, contradicts his point on the overabundance of private Rule 10b-5 actions by admitting that claims have decreased due to the deterrent effects of Rule 10b-5.²⁷² Although the compensatory aspect of the rule does not provide significant, if any, benefits to the average diversified investor, the rule does meet its intended goal—deterring unethical or fraudulent actions.²⁷³ As Professor Grundfest admits, “Executives have gotten the message that it’s more dangerous to cheat, so there’s less cheating.”²⁷⁴

By extending the private cause of action to gatekeepers under the scheme liability theory, securities laws would further deter fraudulent activity. Because the successful execution of fraud would likely require the corroboration of gatekeepers, deterring gatekeepers will aid in the reduction of corporate fraud.²⁷⁵ Furthermore, because gatekeepers must act with the primary purpose and effect of furthering the fraud, extending the cause of action to actions against gatekeepers will restrict culpability to only those secondary actors who knowingly took part in the fraud.²⁷⁶ Thus, the courts, by deterring gatekeepers from engaging in fraud, would better shield investors against corporate fraud without sacrificing Congress’s concurrent goal of protecting businesses from frivolous securities litigation.

²⁷⁰ See *Dabit*, 547 U.S. at 84. The *Birnbaum* rule, discussed in *Dabit*, limited the plaintiff class in a private cause of action under § 10(b) and Rule 10b-5 to only “actual purchasers and sellers of securities” and not persons contemplating whether to make a purchase or sale. See *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 730 (1975) (citing *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461, 463 (2d. Cir. 1952)).

²⁷¹ *Iwata*, *supra* note 50 (finding that aggrieved shareholders only filed 116 suits in 2006 compared to a record 240 lawsuits filed in 1998); see Morrissey, *Catching Culprits*, *supra* note 269, at 804–05 (noting how the PSLRA and SLUSA have made it more difficult for plaintiffs to bring suits under their provisions).

²⁷² See *Iwata*, *supra* note 50 (discussing the reasons for the recent decrease in the number of private claims against companies for violations of Rule 10b-5).

²⁷³ *Id.*

²⁷⁴ *Id.*

²⁷⁵ See *supra* text accompanying note 12.

²⁷⁶ See *Simpson v. AOL Time Warner Inc.*, 452 F.3d 1040, 1046 (9th Cir. 2006) (liability as a primary violation under Section 10(b) arises when the defendant engages in conduct that has the principal purpose or effect of creating a false appearance of fact in furtherance of the scheme—the defendant’s own conduct must be a contributing factor in the fraud).

CONCLUSION

Securities legislation exists primarily to protect investors against corporate fraud and boost investor confidence regarding the integrity of capital markets. Without investor confidence, the cost of capital would increase because investors who continued to invest would demand higher returns for their assumption of greater risk of fraud and malfeasance. Therefore, securities legislation also protects honest companies in preserving their value in the market for raising capital.

To effectuate this deterrence goal of securities law, courts have established a private cause of action to supplement government causes of action. Although the Supreme Court has affirmatively established the scope of conduct that amounts to liability for primary actors, the Court has not effectively explained the level of conduct required for secondary actors to be found primarily liable. The Court has failed to adopt definitively either the scheme liability test or the bright-line test. The Supreme Court in *Stoneridge* created an ambiguous middle ground by only explaining the type of activity that would *not* amount to liability for a secondary actor.

If lower courts interpret *Stoneridge* to overrule scheme liability it would still be unclear when investors could raise actions against secondary actors—severely restricting the ability of securities legislation to protect investors against fraud. Conversely, a decision eliminating the application of scheme liability in all contexts would place undue stress on other enforcement agencies in their prosecution of secondary actors, who undeniably would be able to slip through liability and private recovery.

Therefore, as a compromise, this Comment proposes that lower courts should limit *Stoneridge*'s applicability to transactions between supplier companies or companies outside the domain of traditional gatekeeper entities. This reading respects *Stoneridge*'s focus on the Court's inability to presume investor reliance on the actions of supplier companies because those actions were too remote to the fraud. Unlike business vendors, some courts have found that gatekeepers have a duty to disclose any known fraud to investors because no legitimate business purpose exists when they knowingly take steps to further the fraud. When gatekeepers omit known fraud, courts can presume investor reliance. Thus, adopting the Ninth Circuit's scheme liability theory offers a consistent and predictable model for determining liability against secondary actors.

Adopting scheme liability theory within the constraints of the *Stoneridge* decision imposes natural restrictions that prevent liability from expanding throughout the entire marketplace. This theory prevents lawyers and plaintiffs from raising vexatious litigation in two ways. First, under the language of scheme liability, only secondary actors that engage in transactions without any legitimate business maintain the risk of liability. Second, the language from the *Stoneridge* decision further restricts the applicability of scheme liability to only parties within “the realm of financing business.”²⁷⁷

Finally, by restrictively expanding the pool of potential defendants to reach gatekeepers, courts would deter fraud. The SEC posits that by deterring gatekeepers, the agency would deter all “one hundred people” the gatekeepers assist.²⁷⁸ Moreover, gatekeepers such as investment bankers, accountants, and lawyers are critical to the integrity of the securities markets. This narrow increase in the scope of liability available to aggrieved investors would help deter these types of gatekeepers from participating in corporate fraud. Through this deterrence, courts would protect investors from deceptive practices, while still boosting the integrity of the U.S. capital markets system to protect honest companies

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²⁷⁷ *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 128 S. Ct. 761, 770 (2008).

²⁷⁸ Carol J. Loomis, *The SEC Turns the Screw on ‘Gatekeepers,’* FORTUNE, Apr. 18, 2005, at 17–18 (“If you can get the one person who helps 100 people do something, you’ve stopped 100 things, not just one.” (quoting Linda Thomsen, then-deputy director of the SEC’s enforcement division)).

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