Scheme Supreme

Will the Supreme Court Absolve the "Secondary Actors" Who Are the Real Culprits in Recent Corporate Scandals?

By Gary M. Brown[*]

The Supreme Court recently heard oral argument in the case of *Stoneridge Investment Partners LLC v. Scientific Atlanta, Inc., et al.* The case will be the latest of numerous Supreme Court decisions that have given substance to the nature and extent of liability under Section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5 promulgated thereunder. The facts in *Stoneridge*, as well as those of other companion cases awaiting action by the Court (*e.g., Enron*), have been the subject of numerous *Wall Street Journal* editorials over the past two years. The most recent, *A Class Action Scheme*, referred to *Stoneridge* as the "business case of the year." That's cliché and, like much of the discussion of the theoretical underpinnings of the case over the last two years, understates the importance of the case. *Stoneridge* will be the most significant securities case in a generation – a venerable *Brown v. Board of Education* of securities law – further refining the question of who can be sued and who cannot under Rule 10b-5.

Should the *Stoneridge* plaintiffs prevail and "scheme" liability be expressly recognized (to the extent that it already wasn't in the Supreme Court's 2002

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Zandford decision), future litigation will be required to determine the scope of the cause of action and the extent to which settled 10b-5 principles will carry over. This happens frequently – litigation has been required since 1947, when a federal court first recognized an implied cause of action under Rule 10b-5, to refine the scope of 10b-5. It should not be viewed, however, as some have described it, a "breathtaking new legal standard" (as the *Wall Street Journal* did in a June 10 editorial, *Supreme Liability*) or an attempt to "allow the tort equivalent of guilt-by association" (as in the *Journal*'s August 23 editorial, *Guilt by Contact*). It also should not "open the flood gates to the next class-action bonanza (as described in the *Journal*'s October 6 editorial, *A Class-Action Scheme*).

Before discussing the merits, however, let's first put all this in some context. Consider the following findings of a U.S. Senate Committee report:

- Americans have become suspicious of banking and business practices that, in the public view, have undermined the prosperity of the past decade.
- Congressional investigations have exposed cases of double-dealing in the securities business. Self-dealing and outright fraud (not the least of which involved a gigantic, rapidly growing energy operation) have become associated with erosion of the stock market.
- Senate hearings have revealed financial irregularities of large New York banks, their executives, affiliated securities companies, and Wall Street investment bankers and securities analysts.

- Leading Wall Street investment banks are under fire for their lending and investing practices, including transactions designed to allow companies to misstate their financial results. Private side deals and tax avoidance have evoked much criticism of executives and their corporate activities in banking and commerce.

These findings, which sound like they could be the headlines of the early 21st century, actually are the findings of a 1932 Senate Committee investigating the causes of the 1929 stock market crash. The type of activities outlined above spurred Congress, with the encouragement and full support of President Franklin Roosevelt, to pass the U.S. federal securities laws, including the Securities Act of 1933 and the Securities Exchange Act of 1934. Those two laws today still form the backbone of the federal securities regulatory scheme.

Congress passed the '34 Act to, among other goals, "prevent inequitable and unfair practices" in and to "insure the maintenance of fair and honest [securities] markets." One of the most important sections of the '34 Act is §10(b), which provides generally that it is "unlawful . . . [t]o use or employ any manipulative or deceptive device or contrivance" *in contravention of such rules and regulations as the Commission may prescribe* . . .." Section 10(b) is a residual provision that follows the more specific prohibitions against market manipulation in sections 9 and 10 of the '34 Act. Its purpose – as one of the drafters said of a somewhat broader earlier version – "Thou shalt not devise any other cunning devices."

Section 10(b) is not self-effecting – that is, it took action of the SEC to give the section any meaning. It is one of those sections of the federal securities laws in which the SEC, as regulator, is given a "blank slate" on which to write. And write they did.

To give §10(b) meaning, the SEC promulgated Rule 10b-5. In three distinct subsections, Rule 10b-5 prohibits three distinct activities:

- Employing devices, schemes or artifices to defraud (subsection (a));
- Making untrue statements of material fact or failing to disclose material facts necessary to render the statements made not misleading (subsection (b)); and
- Engaging in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person (subsection (c)).

The SEC and the U.S. Department of Justice are given express authority to bring lawsuits for violations of the federal securities laws, including section 10 of the '34 Act and Rule 10b-5. Despite a number of private rights of action that exist under the federal securities laws, Congress did not provide an express right for private parties to bring suit for violations of section 10(b) (and therefore, Rule 10b-5). In 1947, however, a federal district court implied such a right. Rule 10b-5 litigation thereafter grew and, when the question whether the cause of action exists eventually was squarely posed to the Supreme Court in 1971, it was brushed aside in a footnote: "It is now established that a private right of action is implied under §10(b)."

As a practical matter, Rule 10b-5 has been applied in three situations: (1) material misstatements or omissions in corporate documents (*e.g.*, prospectuses, periodic reports, proxy statements and press releases); (2) "insider trading" (*i.e.*, trading while in possession of material undisclosed information); and (3) manipulation. The basic elements of proof required to establish a 10b-5 violation in each area overlap. Additionally, in 1983, the Supreme Court ruled that an implied 10b-5 cause of action could be pursued concurrently with other express remedies under both the '33 Act and '34 Act.

Over the years, numerous Supreme Court cases established the principal elements of a 10b-5 cause of action: the "purchaser/seller requirement" (*Blue Chip Stamps*); the requirement of "deception" (*Santa Fe Industries*); the requirement of "scienter" (*Ernst*); and the requirement of causation (*Dura Pharmaceuticals*). Another series of Supreme Court cases (*Chiarella, Dirks, Carpenter* and *O'Hagen*) established the various theories of insider trading – e.g., "classic," "tipper-tippee" and "misappropriation." After the Supreme Court held in *Basic* and *Affiliated Ute* that reliance was not required to be proven in cases alleging material omissions, the modern securities class action case was born – and it has flourished.

For a time, it appeared that nothing could curb the expansion of 10b-5 actions. Courts freely allowed cases against primary violators of 10b-5 as well as those who aided and abetted violations, such as accountants and lawyers. Then, in the mid-90's two things occurred. Congress passed the Private Securities Litigation

Reform Act and the Supreme Court, in *Central Bank*, held there was no liability for "aiding and abetting" in a private civil action under 10b-5.

Now – back to *Stoneridge.* The "question" that is before the Supreme Court in *Stoneridge* is:

> Whether this Court's decision in [Central Bank] forecloses claims for deceptive conduct under . . . Rule 10b-5(a) and (c) . . . where Respondents engaged in transactions with a public corporation with no legitimate business or economic purpose except to inflate artificially the public corporation's financial statements, but where Respondents themselves made no public statements concerning those transactions.

To understand why the answer should be "no," you have to read both Rule 10b-5 and *Central Bank*. When you do, you'll see that the answer is, in the words of a 60's group – "easy as '(a)' '(b)', '(c)'."

First – note the three distinct activities prohibited by Rule 10b-5's three distinct subsections. Next – note that the question in *Central Bank* was whether private 10b-5 liability extends "to those who *do not engage in the manipulative or deceptive practice* but who aid and abet the violation." (emphasis added). The Supreme Court answered that question "no" and for a good and sensible reason. Remember – Congress did not create an express cause of action for private persons to sue for violations of Rule 10b-5 – that was implied by the courts. Accordingly, it is difficult for one to argue that Congress intended to create a private remedy for "aiding and abetting" the violation of a provision for which Congress provided no express remedy.

Central Bank did not foreclose the issues presented in *Stoneridge*. Material misstatements or omissions were at issue in *Central Bank* – those are covered by subsection (b) of Rule 10b-5. In order to actually engage in the deceptive conduct (become a "primary violator"), a secondary actor would have to actually make a material misstatement or, in the case of an alleged omission, have a duty to speak. That's rarely the case and why, in *Central Bank,* the plaintiffs conceded that Central Bank, as an indenture trustee, did not engage in deceptive conduct. Accordingly, the case was properly dismissed.

Stoneridge, however, does not involve subsection (b) – the question posed relates to subsections (a) (schemes and devices) and (c) (frauds and deceits). *Central Bank*, however, does not discuss subsections (a) or (c) – it was unnecessary because it was conceded that Central Bank did not commit a manipulative or deceptive act. So – while *Central Bank did* foreclose aiding and abetting liability, the case did *not* address what constitutes a "device," scheme," "fraud" or "deceit" that would make one not an "aider and abetter," but a *primary violator* of the securities laws. Indeed, *Central Bank* closed with the following warning:

> "The absence of §10(b) aiding and abetting liability does not mean that secondary actors in the securities markets are always free from liability under the securities Acts. Any person, including a lawyer, accountant, or bank, who employs a manipulative device or makes a material misstatement (or omission) . . . may be liable as a primary violator . . . ."

Despite this warning, secondary actors, such as bankers and lawyers, apparently failed to recognize its significance and breathed a collective sigh of relief when *Central Bank* was decided. One can't ignore what followed – *Central Bank* was decided at the beginning of the period of "irrational exuberance" in the stock market. During this period, banks and lawyers were heavily engaged in creating new financial "products" that were "sold" to clients. No doubt, with the specter of aiding and abetting liability erased by *Central Bank*, many financial engineers were emboldened to push the envelope – and they did. Many financial structures were created that were touted as "balance sheet friendly" and "cash flow friendly" and described as utilizing "black box accounting."

"Black box," indeed: one transaction that was revealed in Congressional investigations into Enron was the subject of an April 20, 2005 *Wall Street Journal* editorial, *Enron Overstretch*, in which the writer argued for leniency, if not outright absolution, for Dan Bayly and several other Merrill Lynch executives convicted (subsequently overturned) for their roles in the now infamous "Nigerian barge deal." That transaction, in which Merrill Lynch willingly participated in its zeal to reap millions of dollars in investment banking fees from Enron, involved the "not so true" sale of six Nigerian power barges from Enron to Merrill Lynch. This phony sale allowed Enron, at the end of 1999, to book millions of dollars in phony revenue and profit. Although the numbers were relatively small, the transaction allowed Enron, at a critical point in time, to meet Wall Street earnings expectations and present to the investing public a robust financial picture. This picture, in turn, formed the basis for Enron's investment grade credit rating, without which its business model would have failed; *i.e.,* the fraud would not have been perpetuated. It remains unclear whether Bayly and the other Merrill Lynch executives will be retried – it also remains unclear why they were charged with "failure to deliver honest services" (a theory rejected by the appellate court) rather with simply with aiding and abetting securities fraud (criminal aiding and abetting is not affected by *Central Bank*).

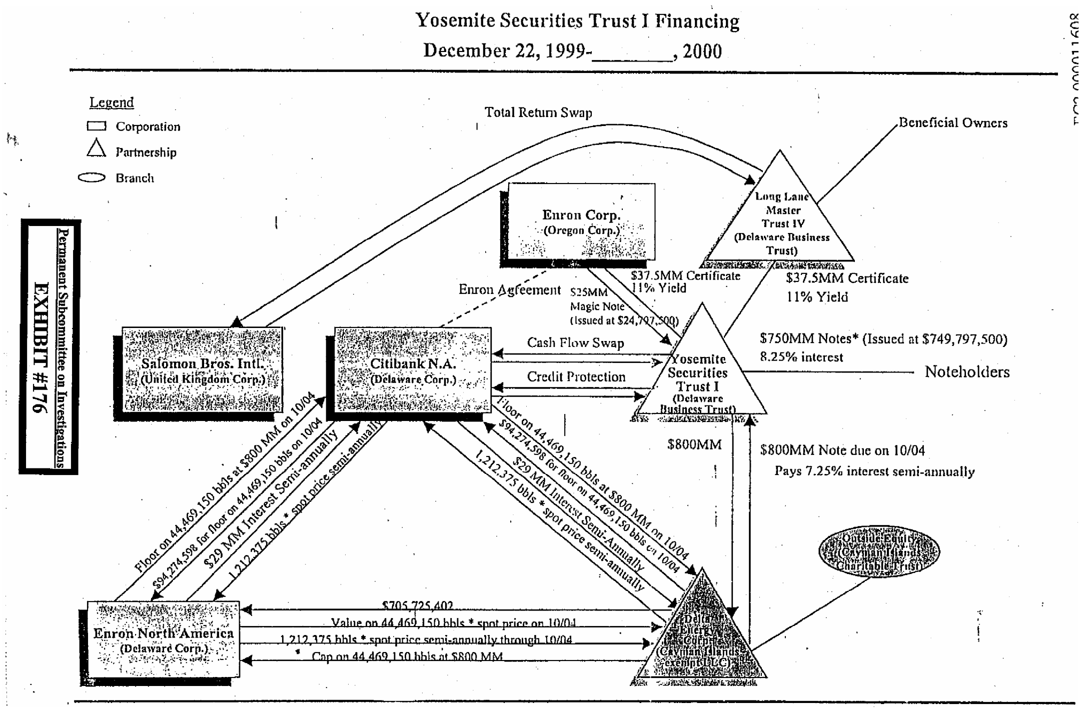
Another *Wall Street Journal* editorial (an April 25 piece entitled, *Enron Perspective*) commenting on the Nigerian barge case is all the more puzzling. There Judge Werlein is praised for the "admirable outcome" in which he initially sentenced Mr. Bayly to 30 months in prison and fined him $840,000 for his role in the Nigerian Barge deal. Judge Werlein labeled Mr. Bayly's conduct "benign" while the *Journal* argued that he was the "victim" of prosecutorial hindsight that makes a "crime" what previously was an "innovative business transaction." I seem to recall Watergate initially being referred to as a "third rate burglary."

Merrill Lynch was not alone in its active participation in Enron's financial manipulations. Other investment banks structured and executed transactions that accomplished the same thing. These companies paid hundreds of millions of dollars in fines and penalties to the SEC ($80 million by Merrill Lynch alone as a result of the Nigerian barge deal) and over $7 billion to settle charges that they were primary violators in the Enron class action securities litigation. Several other investment banks chose to litigate and were rewarded when the Fifth Circuit overturned the class action certification ruling that their conduct did not rise to the level of primary violators – that case is now the back-up case to *Stoneridge*.

When asked whether a prospectus selling securities that were used to fund some of the phony transactions should have disclosed an additional $7 billion in Enron structured finance of which the underwriter was aware, the potentially misleading way the underlying "loan" was represented on Enron's books and the fact that the proceeds were being used to pay down the bank debt of the underwriter's commercial banking affiliate, Senate investigators were told that they "didn't understand." "You see, we were selling Enron investment grade securities and our analysis was that after factoring that in, these securities were still investment grade." Translation – "You don't have to tell investors the truth as long as you think it's a good deal." Sorry – but it's basic securities law that on the day you sell the securities, it's either fraud or not fraud – just because it works out in six months doesn't mean that a fraud wasn't committed.

An e-mail from one of the investment banks that structured one transaction for Enron – "Enron loves these deals as they are able to hide funded debt from their equity analysts because they (at the very least) book it as deferred rev[enue] or (better yet) bury it in their trading liabilities." This e-mail referred to a series of transactions in which what were actually loans to Enron were disguised as "energy trades." This allowed Enron to carry them on its books as "trading liabilities" rather than debt (akin to treating long term debt as accounts payable) and present them in the cash flow statement as cash generated by operations (*i.e.*, earned) rather than cash generated by financing (*i.e.* borrowed). Now – I ask you – Which is the healthier company – the one that *earned* $1 million or the company that *borrowed* $1million? One can quickly see that these financial machinations allowed Enron to present a more robust financial picture to and thereby defraud investors.

The following is a diagram of one of the loans that was so utilized by Enron:



Consider a handwritten note on a fax cover sheet memorializing comments during a Merrill Lynch conference call discussing the Nigerian barge deal in which Mr. Bayly participated – "risk to Merrill Lynch – aid abet Enron income statement manipulation."

Or in a response to a question from Senator Carl Levin asking whether it is the bank's responsibility not to participate in a deception, "Well Senator, I suppose it depends on how you define deception." I can think of many descriptions for the actions I've described above; somehow, "benign" doesn't come to mind.

The bankers and lawyers made no public misrepresentations (that's subsection (b) of Rule 10b-5); however they created and marketed these new financial structures to companies *with the express purpose of creating misleading public disclosures.* Were these bankers and lawyers engaged in a manipulative or deceptive act? Were these bankers and lawyers engaged in an unlawful "scheme"? Or are these bankers and lawyers being sued "simply because [they] did business with someone else who broke the law"?

You be the judge, but this makes me think of another famous Supreme Court quote – "I can't define pornography, but I know it when I see it." The same can be said when determining the difference between a legitimate business transaction and an unlawful "scheme." The sham transactions that powered Enron's meteoric rise *were* unlawful "schemes" – and should be recognized as such. Do we really want to absolve from liability the people who formulate and execute these schemes and are paid millions for doing so?

I think the answer is "no" – that is why the answer to the question presented in *Stoneridge* should be "no." In commenting on *Stoneridge,* Commissioner Paul Atkins (in a *Wall Street Journal* editorial on October 9, 2007, entitled *Just Say No to the Trial Lawyers*) states that the "issue is whether corporations can be held liable under private class-action lawsuits for alleged crimes committed by business partners." Unfortunately Commissioner Atkins' commentary glosses over the real issue presented in *Stoneridge* by pointing to the "trial lawyers" and in doing so, he joins other pundits who have referred to a "bad" result in *Stoneridge* as the next class-action "bonanza," or have stated that the issue of secondary actor liability was "examined before" and "ostensibly put [to] an end" by *Central Bank*.

Indeed, the example that Commissioner Atkins uses – a newspaper that runs a paid ad that raves about a penny stock fraud – strains credulity. This gross oversimplification and overstatement is a resort to the tactic that some pundits have already adopted – warning that companies will be sued "simply because [they] did business with someone else who broke the law." Next, it will be the service station that sold gas to the person that delivered the false prospectuses. Or, for that matter, Federal Express—for delivering them. Or the internet service provider for delivering the electronic copies. That's overlooking some key elements of a 10b-5 securities fraud claim (such as scienter, reliance, and causation), but never mind that – it makes for better headlines.

It is a gross overstatement that a "bad outcome in *Stoneridge* represents a "clear and present danger to American business and investors." (So said the *Wall Street Journal* in an August 23 editorial, *Guilt by Contact*.) The Supreme Court has, in accordance with the mandate of the Private Securities Litigation Reform Act, moved recently in the *Tellabs* decision to put teeth in the heightened pleading requirements. Grumbling by the business community notwithstanding, Sarbanes-Oxley is working. Restatements are down; securities litigation actually is on the wane – and recognizing "scheme" liability will not revitalize it.

There is a difference between doing business with someone who breaks the law and someone who is actively involved essentially as a co-conspirator in breaking the law. There is a difference between a legitimate business transaction and a scheme designed to defraud the investing public. For years, the tax laws require that transactions have a legitimate business purpose in order to receive tax benefits. Is that so hard? Can one test for securities law purposes be whether there is a legitimate business transaction in which the third party is not engaged in a manipulate or deceptive act? If they're not, the transaction is not a "scheme."

Will there be litigation? Yes. But private civil litigation is an important part of the underpinnings of the federal securities laws. That is why Congress created several express private remedies in the securities laws. Legitimate lawsuits serve a purpose – litigation was necessary to realize the ruling in *Brown v. Board of Education*. No one seriously suggests that the case should not have been the way that it was simply because it would spawn litigation. Likewise with 10b-5 litigation, the genie is out of the bottle – unless Congress wants to take away the right of action that has been implied by the courts, it's with us to stay.

Although some, perhaps even Commissioner Atkins, would suggest otherwise, this is not a contest between the business community and the "tort bar" (as the *Journal* described it in *Supremes 2, Tort Bar 0*). This is a fundamental question under the federal securities law system and it is imperative that the Supreme Court gets it right – whether or not it is popular with the business community. Indeed, it is ironic, in a June 16, 2006 editorial entitled *Bankers Ethics*, the *Journal* noted of the billions paid by investment banks to settle their Enron liability that the "interesting question is what lesson the bank's executives have learned from this episode," and added, "[w]e'd like to think that one lesson from this unhappy saga is that transactions designed to hide the truth from investors aren't worth doing, no matter what the fees. The only ones who profit in the end are the lawyers."

Without the specter of liability, I am afraid that lesson will soon be forgotten and, therefore, will go unheeded. The history of corporate fraud shows the troubles that fading memories can cause us – the '29 stock market crash, Watergate, the S & L scandal, Enron. We've been there before; let's try not to go there again.

The beauty of the U.S. federal securities laws is that they were largely written during the early 1930's by brilliant practitioners who anticipated many of the ways that persons could attempt to circumvent the laws' prohibitions and commit frauds. They knew, however, that they could not anticipate all potential frauds. That is why in many situations, such as section 10(b), virtually total authority has been given the SEC. Go to the SEC's website, www.sec.gov, click on "What we do" and you will find a reference to the SEC's Office of Investor Education and Advocacy, which, according to the site, "assists the Commission in ensuring that in all of the agency's activities, the SEC is truly 'the Investor's Advocate.'"

Commissioner Atkins has chosen to depart from the SEC's official position and urge the Supreme Court to reject "scheme" liability. In my judgment, that's not being the "investors' advocate." And it's not the Supreme Court's job to make policy. Congress passed section 10(b) and gave the regulator, the SEC, essentially "carte blanche" authority to make policy. The SEC did so and it thinks there is "scheme" liability. Perhaps the Supremes should listen to them; after all, they *are* the investors' advocate – and right now, it seems as if investors are in need of one.