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Scheme Liability:
A Question for Congress,
Not for the Courts

Joseph A. Grundfest*

* William A. Franke Professor of Law and Business, Co-Director, Rock Center on Corporate Governance, Stanford University; Commissioner, United States Securities and Exchange Commission, (1985 – 1990). This article reflects the approach that I have been taking for several years in teaching the issues raised by the "scheme liability" argument presented in *Stoneridge*. Respondents in *Stoneridge* have retained me to provide counsel in connection with that matter. The views I have expressed to Respondents and reflected in this article have not changed as a consequence of that retention. I disclose the retention for whatever relevance any reader may wish to ascribe to that fact.

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Abstract

Any person who knowingly provides substantial assistance, whether through participation in a scheme or by any other means, to another who violates the federal securities laws also violates the federal securities laws. The Securities and Exchange Commission can sue these "aiders and abettors" and force them to make payments for the benefit of shareholders harmed by the fraud. They can also be criminally prosecuted by the Department of Justice. But are they additionally liable in private civil actions filed under Section 10(b) of the Exchange Act?

The United States Supreme Court will, in *Stoneridge*, decide whether the implied private right of action under Section 10(b) supports claims of "scheme liability" against counterparties who properly account for transactions, make no public statements regarding those transactions, and do not transact in any securities affected by the fraud. Established Supreme Court doctrine and clear statutory text preclude the imposition of such "scheme liability in a private action. Whether the scope of the implied private right should be expanded to encompass "scheme liability" is a question properly put to Congress not to the Courts.

Stoneridge is therefore important for reasons that transcend the narrow question of "scheme liability." Petitioners can prevail only if the Supreme Court repudiates its own precedent, jettisons its well-established technique for interpreting Section 10(b), ignores clearly relevant statutory text, and disregards two Congressional decisions not to expand the private right under Section 10(b) to encompass "scheme liability." The court will, in other words, have to establish an entirely new jurisprudence of statutory construction. This new jurisprudence will inevitably re-open a plethora of doctrinal issues regarding the interpretation of the federal securities laws that are today clearly resolved. Where this new and unanticipated jurisprudence would lead—other than to more litigation over the contours of the implied private right of action—is impossible to predict. *Stoneridge* is truly one of the "most important securities cases" to come before the court "in many years" because, if Petitioners prevail, far more than "scheme liability" is at stake for the future evolution of our nation's securities markets.

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Stoneridge[1] has quite properly been described as "one of the most important securities cases to be heard by [the Supreme] Court in many years."[2] The case is important to many because large sums of money, including large contingent attorneys' fee awards, hinge on the outcome. Indeed, if Petitioners succeed in persuading the Court that "scheme liability" is a cognizable form of primary liability that can be attacked in an implied private right of action under Section 10(b) of the Exchange Act then the number of deep pockets that can be pursued as defendants in these actions is likely to increase exponentially. So too is the potential liability of a broad array of commercial and financial counterparties who do not transact in the securities that would allegedly be affected by the primary fraud giving rise to "scheme liability." It also follows that there would likely be an increase in the incidence of filings alleging "scheme liability" violations of Section 10(b).

More fundamentally, however, in order for Petitioners to prevail in *Stoneridge*, the Supreme Court would have to repudiate its own precedent, jettison its well-established technique for interpreting the scope of the implied private right of action under Section 10(b), ignore clearly relevant statutory text, and disregard the fact that Congress has twice expressly refused to amend the securities laws to provide for the very private right of action that Petitioners in *Stoneridge* ask the Court to create. The court would also have to define the scope of primary liability created by "scheme liability" without any guidance from any provision of the Exchange Act or from any relevant legislative history. The Court would therefore have to legislate from the bench in the most obvious manner.

Principle is therefore also at issue in *Stoneridge*, and it is entirely fair to say that this lawsuit is not all about the money. Indeed, in order for Petitioners to prevail,

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[1] *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, 443 F.3d 987 (8th Cir. 2006), cert. granted, 75 U.S.L.W. 3511 (U.S. Mar. 26, 2007) (No. 06-43

[2] Br. for William H. Donaldson, et al. 2.

the Court will have to signal an entirely new and unanticipated jurisprudence of statutory construction that will inevitably re-open a plethora of doctrinal issues regarding the interpretation of the federal securities laws that are today clearly resolved. This new jurisprudence - - whatever form it might take - - will constitute an open invitation for plaintiffs to re-litigate the contours of the implied private right under Section 10(b), and could spill over to the interpretation of other implied private rights as well. *Stoneridge* may therefore be one of "the most important securities cases to be heard by [the Supreme] Court" for many reasons that have nothing to do with scheme liability and everything to do with the integrity of the interpretive jurisprudence that the Court has constructed around Section 10(b) and other implied private rights of action.

This article focuses on the doctrinal questions presented by *Stoneridge* and, without taking a stand on the question of whether, as a policy matter, the implied private right of action under Section 10(b) should be expanded to encompass scheme liability, argues that this question is properly presented to Congress and not to the Supreme Court.

I. *Stoneridge* and Scheme Liability: An Introduction to the Controversy.

The question pending before the United States Supreme Court in *Stoneridge* is whether the text of Section 10(b) can be interpreted to support additional and potentially crippling financial exposure through implied private rights of action based on a theory of "scheme liability" against persons who are already subject to the Commission's enforcement authority.

More precisely, the question pending in *Stoneridge* is whether and when a person who participates in a transaction with a publicly traded counterparty that misrepresents the transaction to its own shareholders can be held liable to the counterparty's shareholders in a private class action even though: (1) the person engaging in the transaction never speaks publicly about the transaction and never misrepresents the transaction either in its own books and records, or to a third party; (2) the person engaging in the transaction owes no disclosure or fiduciary duty to the counterparty or to the counterparty's shareholders; and (3) the counterparty's shareholders are never in a position to rely on any statement made by the person engaged in the transaction.[3]

[3] "Scheme liability" proponents and courts that have approved of the scheme liability theory have adopted a broad range of definitions of the term, many of which are materially inconsistent. Compare Br. of the SEC at 18, *Simpson* v. *AOL Time Warner*, No. 04-55665 (9th Cir. Oct. 22, 2004) (defendant must "engag[e] in a transaction whose principal purpose and effect is to create a false appearance of revenues") with *Simpson* v. *AOL Time Warner*, 452 F.3d 1040, 1048 (9th Cir. 2006), petition for cert. filed (Oct. 19, 2006) (No. 06-560) ("defendant must have engaged in conduct that had the principal purpose and effect of creating a false appearance of fact in furtherance of the scheme"; rejecting SEC's suggestion that it is sufficient "that a *transaction* in which a defendant was involved had a deceptive purpose and effect") (emphasis in original); *In re Parmalat Secs. Litig.*, 376 F. Supp. 2d 472, 502-04 (S.D.N.Y. 2005) (defendant must "directly or indirectly used or employed any device or contrivance with the capacity or tendency to deceive"; rejecting *Lernout's* requirement of "substantial participation" as inconsistent with Section 10(b)'s text); and *In re Lernout & Hauspie Secs. Litig.*, 236 F. Supp. 2d 161, 173 (D. Mass. 2003)

Plaintiffs have suggested that persons who engage in such transactions are not merely secondarily liable as aiders and abettors. Instead, the "scheme liability" theory suggests that participation in such transactions can give rise to primary liability.

This seemingly fine semantic distinction between primary and secondary liability is essential to the debate because the Supreme Court in *Central Bank* v. *First Interstate Bank*, 511 U.S. 164 (1994), ruled that there is no liability under Section 10(b) for conduct that amounts to aiding and abetting, i.e., there is no secondary liability under Section 10(b). Although Congress acted quickly after *Central Bank* to grant the Commission authority to proceed against aiders and abettors, Congress consciously made the decision not to extend the same authority to private party litigants. Therefore, unless plaintiffs can persuade the Court that "scheme liability" is a form of primary liability, and not just a new name for conduct that has traditionally been characterized as aiding and abetting behavior, plaintiffs will not be able to proceed with private party lawsuits against defendants whose only participation in the alleged fraud arises under a "scheme liability" theory.

"Scheme liability" has been expressly rejected by the Eighth Circuit in *Stoneridge*, and by the Fifth Circuit.[4] "Scheme liability" is also inconsistent with established precedent in the Second, Sixth, Tenth, and Eleventh Circuits.[5] At the appellate level, only the Ninth Circuit, the Circuit most frequently reversed by the Supreme Court,[6] and the same Circuit that was unanimously reversed in *Dura Pharms.* v. *Broudo*, 544 U.S. 336 (2005), has recognized the existence of "scheme liability" as a form of primary liability.[7]

The law on this point is, in my view, remarkably clear. Neither the text of Section 10(b) nor the structure of the Exchange Act support the inference that "scheme liability" is a form of primary liability. The Supreme Court in *Central Bank* failed to find primary liability on facts far more egregious than those at issue in *Stoneridge*, and in *Santa Fe Indus.* v. *Green*, 430 U.S. 462 (1977), the Court explained that Section 10(b) requires a breach of duty of a form that is inconsistent with the existence of "scheme liability."

Further, when Congress in 1995 granted the Commission statutory authority to proceed against secondary violators, it expressly rejected the suggestion that private

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(defendant must "substantially participate[] in a manipulative or deceptive scheme by directly or indirectly employing manipulative or deceptive device … intended to mislead investors").

[4] *In re Charter Comm'ns, Inc.*, 443 F.3d 987, 989 (8th Cir. 2006); *Regents of the Univ. of Cal.* v. *Credit Suisse First Boston (USA), Inc.*, 482 F.3d 372 (5th Cir. 2007), petition for cert. filed (Apr. 5, 2007) (No. 06-1341).

[5] *Fidel* v. *Farley*, 392 F.3d 220, 235 (6th Cir. 2004); *Ziemba* v. *Cascade Int'l*, 256 F.3d 1194, 1213 (11th Cir. 2001); *Wright* v. *Ernst & Young*, 152 F.3d 169, 175 (2d Cir. 1998); *Anixter* v. *Home-Stake Prod.*, 77 F.3d 1215, 1226 (10th Cir. 1996).

[6] *E.g.*, *The Supreme Court, 2005 Term—The Statistics*, 120 HARV. L. REV. 372, 381 (2006) (the Ninth Circuit was reversed or vacated in fifteen out of eighteen cases in the Supreme Court during the 2005 term, accounting for almost 25% of all cases reversed that term).

[7] *Simpson*, 452 F.3d at 1048.

parties should have the same right.[8] Even more telling is the fact that Congress proceeded to define aiding and abetting liability in a manner that clearly encompasses "scheme liability,"[9] and thereby precludes the argument that "scheme liability" is anything other than a form of secondary liability that can be pursued only by the Commission. Congress then again rejected pleas to expand the scope of private liability to encompass aiding and abetting violations as part of the Sarbanes Oxley Act of 2002.[10] Congress has thus twice expressly rejected the invitation to expand the scope of private liability to encompass behavior traditionally denominated as secondary liability.

Thus, the United States Securities and Exchange Commission has express statutory authority to pursue any and all persons who aid and abet violations of the federal securities laws.[11] It also has express authority to force these secondary violators to make "Fair Funds" payments to be distributed "for the benefit of the victims of such violation[s]."[12]

The Commission has not been idle in asserting this authority. The Commission has instituted numerous enforcement proceedings, including many against secondary violators,[13] and has collected more than $8 billion on behalf of investors pursuant to its Fair Funds recovery authority.[14] Secondary violators of the federal securities laws are therefore already exposed to the full range of the Commission's enforcement authority as well as substantial monetary liability.

To the extent that a decision rejecting "scheme liability" raises public policy concerns, these concerns are properly addressed by the legislative branch. Congressional hearings can consider the extent to which scheme liability creates financial exposure wildly disproportionate to the wrong committed by a secondary violator—a level of exposure that has been described by the Second Circuit in a related context as "Draconian."[15] Hearings can also consider the appropriate interaction between the

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[8] S. Rep. 104-98, at 48 (1995) (authorizing "private aiding and abetting liability actions under Section 10(b) would be contrary to [the PSLRA's] goal of reducing meritless securities litigation").

[9] 15 U.S.C. § 78t(e) ("any person that knowingly provides substantial assistance to another person in violation of a provision of this title … shall be deemed to be in violation of such provision to the same extent as the person to whom such assistance is provided").

[10] *E.g.*, H.R. Rep. No. 107-414, at 54 (2002); 148 Cong. Rec. S6584 (daily ed. July 10, 2002).

[11] 15 U.S.C. § 78t(e).

[12] *Id.* § 7246(a).

[13] For example, in one case, the Commission filed suits against dozens of individual defendants under an aiding and abetting theory. SEC News Digest, Issue 2007-13, Jan. 22, 2007, available at http://www.sec.gov/news/digest/2007/dig012207.txt.

[14] SEC 2006 PERFORMANCE AND ACCOUNTABILITY REPORT 23. Chairman Cox, who has made prompt compensation of investors through the Fair Funds process a Commission priority, recently announced the creation of an office in the Commission devoted to this function. Testimony Concerning Fiscal 2008 Appropriations Request Before the Subcommittee on Financial Services of the Senate Appropriations Committee (May 16, 2007), available at http://sec.gov/news/testimony/2007/ts051607cc.htm.

[15] *Elkind* v. *Liggett & Myers, Inc.*, 635 F.2d 156, 170 (2d Cir. 1980).

Commission's current enforcement authority and the additional costs and benefits of allowing supplemental litigation by private party plaintiffs. Congress will be able to deliberate on the extent to which scheme liability will, in the international arena, impose an implied tax on the conduct of businesses with counterparties subject to private party litigation under Section 10(b) liability and provide an incentive for issuers to avoid registration in U.S. trading markets. Hearings will also allow policymakers to consider the creation of a safe harbor for derivative and other complex market transactions that satisfy regulatory standards.[16] In addition, hearings will allow Congress to address the central question of how scheme liability is to be defined, an epistemic challenge that, in light of conflicting definitions by the lower courts, cannot be resolved on the face of the statute as it currently stands.[17] Thus, proponents of "scheme liability" are concerned that affirmance of the Eighth Circuit's opinion raises public policy questions that warrant further consideration, the appropriate response is to address the concern to Congress. [18]

II. The Evolution of the "Scheme Liability" Debate

In order best to understand the contours of the "scheme liability" debate, it is helpful to understand its evolution. Prior to the Supreme Court's decision in *Central Bank*, every Court of Appeals that had addressed the question had ruled that aiders and abettors could be held liable under Section 10(b) both by private party litigants and by the Commission.[19] Because little hinged on the distinction between primary and secondary liability, the case law paid scant attention to the dividing line between primary and secondary liability. Far greater attention was lavished instead on the definition of conduct that rested at the outer limits of secondary liability. After all, that was the definition that then described the functional limits of the reach of the law for both private parties and for the Commission.

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[16] *Interagency Statement on Sound Practices Concerning Elevated Risk Complex Structured Finance Activities*, 72 Fed. Reg. 1372 (Jan. 7, 2007). The Supreme Court in *Central Bank* shared a similar observation when it suggested that "[e]xtending the 10b-5 cause of action to aiders and abettors no doubt makes the civil remedy more far reaching, but it does not follow that the objectives of the statute are better served. Secondary liability for aiders and abettors exacts costs that may disserve the goals of fair dealing and efficiency in the securities markets." 511 U.S. at 188. Precisely the same observation can be made regarding plaintiffs' suggestion that the doctrine of primary liability be interpreted to include "scheme liability."

[17] The Supreme Court in *Central Bank* shared a similar observation when it suggested that "[e]xtending the 10b-5 cause of action to aiders and abettors no doubt makes the civil remedy more far reaching, but it does not follow that the objectives of the statute are better served. Secondary liability for aiders and abettors exacts costs that may disserve the goals of fair dealing and efficiency in the securities markets." 511 U.S. at 188. Precisely the same observation can be made regarding plaintiffs' suggestion that the doctrine of primary liability be interpreted to include "scheme liability."

[18] Here too, the Supreme Court's decision in *Central Bank* alludes to precisely the same observation: "We hasten to add that competing policy arguments in favor of aiding and abetting liability can also be advanced. The point here, however, is that it is far from clear that Congress in 1934 would have decided that the statutory purposes would be furthered by the imposition of private aider and abettor liability." *Id.* at 189-90.

[19] *Central Bank*, 511 U.S. at 192 (Stevens, J., dissenting).

In *Central Bank*, the Supreme Court ruled that neither the text of Section 10(b) nor the text of the statute could support the implication of secondary liability under Section 10(b). The Court's logic reached both private party actions and Commission enforcement proceedings. The Commission therefore voluntarily dismissed pending actions that asserted secondary liability claims.

The Commission then successfully lobbied Congress to reinstate the Commission's authority to pursue aiders and abettors. The result was Section 20(e) of the Exchange Act which is captioned "Prosecutions of Persons Who Aid and Abet Violations" and extends Commission enforcement authority to "any person that knowingly provides substantial assistance another person in violation of this title."[20] Congress rejected pleas to extend the same coverage to private rights of action.[21]

Because Congress reinstated the Commission's enforcement authority over aiding and abetting liability, the battle line in the lower courts shifted to a debate over the dividing line between primary and secondary liability in private party litigation. If conduct was deemed "primary" it could then be attacked in private party litigation. If it was deemed "secondary" only the Commission could file a civil action. "Scheme liability" then emerged as the dominant mechanism by which private party plaintiffs sought to expand the scope of primary liability in order to reach conduct that is, for the reasons described below, clearly secondary in nature.

III. The Facts of *Central Bank* Preclude Scheme Liability

Central Bank of Denver ("Central Bank") served as indenture trustee for bond issues subject to a covenant that certain real estate "be worth at least 160% of the bonds' outstanding principal and interest."[22] The bank was "aware of serious concerns about the adequacy of the security … and the accuracy of the [pre-existing] appraisal."[23] Indeed, a letter from a senior underwriter of the bond suggested that the issuer may have given the bank "'false or misleading certifications of compliance' with the bond covenants."[24] The letter further warned that the prior appraisal, which was then more than 16 months old "should be suspect and not relied on without further independent check" in light of declining real estate market values at the time.[25] Central Bank's own in-house appraiser "expressed concern about the age of comparable sales used and the methodology used," and suggested there be an independent review of the appraisal because the 160% valuation test appeared to be violated.[26]

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[20] 15 U.S.C. § 78t(e).
[21] S. Rep. 104-98, at 48.
[22] 511 U.S. at 167.
[23] *First Interstate Bank of Denver, N.A.,* v. *Pring*, 969 F.2d 891, 894 (10th Cir. 1992), *rev'd sub nom. Central Bank*, 511 U.S. 164.
[24] *Ibid.* (citation omitted).
[25] *Id.* at 894 n.5.
[26] *Id.* at 894.

Despite these warnings, Central Bank agreed with the issuers' request to delay any further independent appraisal by at least six months.[27] The issuer then proceeded to default on a new issuance of bonds that plaintiffs allege would never have come to market had the bank, as indenture trustee and in conformance with its fiduciary obligation, not aided and abetted the issuer's fraud by deferring its obligation to conduct an independent appraisal.

By any definition of "scheme liability" the bank would, on these facts, have been held primarily liable because it had participated in a scheme in the form of a sham transaction (here the breach of the fiduciary duty to assure that the valuation test was satisfied) with clear knowledge of how its actions would be used by its counterparty to defraud investors. Indeed, there is no plausible alternative explanation for the bank's conduct other that a decision to breach a fiduciary duty in a manner that would trigger "scheme liability" under any of the term's myriad definitions. The Bank thus knowingly provided substantial assistance to another person who violated the provisions of the Exchange Act, and even breached a fiduciary duty in the course of providing that assistance. Because of this breach of fiduciary duty, the bank's participation in the fraud was far stronger than is alleged in any of the lower court cases discussing "scheme liability"—indeed, in each of these lower court decisions the counterparties owed no fiduciary duties to the issuer or to the issuer's shareholders.

Respondents conceded and the Court agreed that on the facts as alleged "Central Bank did not commit a manipulative or deceptive act within the meaning of §10(b)."[28] Instead, Central Bank would have to be found "secondarily liable under § 10(b) for its conduct in aiding and abetting the fraud."[29] However, because the Court concluded that secondary liability did not exist under Section 10(b), Central Bank could not be held liable as a secondary violator and its conduct did not satisfy the standard for primary liability. The Supreme Court therefore ruled that the District Court's grant of summary judgment to Central Bank was proper and reversed the judgment of the Court of Appeals.[30]

Central Bank's conduct satisfies every court's test for "scheme liability." If "scheme liability" survives *Central Bank* as a viable definition of primary liability then the Supreme Court could not have affirmed the entry of summary judgement in favor of Central Bank. Put another way, in order to support the existence of "scheme liability" as a form of primary liability one would have to argue that *Central Bank* was wrongly decided because the decision to grant summary judgment in favor of the Bank cannot be

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[27] *Id.* at 895; *Central Bank*, 511 U.S. at 168.
[28] *Central Bank*, 511 U.S. at 191.
[29] *Ibid.* (internal quotation and citation omitted).
[30] *Id.* at 191-92. If Central Bank's conduct could have been described as primary, then plaintiffs would have alleged as much and the Court could have remanded with instructions that the courts below reconsider the case in a manner consistent with the Court's decision. The fact that the Court affirmed the dismissal of the complaint without the suggestion of a remand thus buttresses the conclusion that Central Bank's conduct was perceived by plaintiffs and the Court alike as being clearly secondary, and not primary.

reconciled with the observation that Central Bank's conduct satisfies the test for scheme liability.

IV. The Language of Section 20(e) Precludes "Scheme Liability"

The text of Section 20(e) deals yet another fatal blow to the idea that private party plaintiffs can pursue a "scheme liability" theory. Section 20(e) is captioned "Prosecution of Persons Who Aid and Abet Violations." It grants to the Commission enforcement authority against persons who "knowingly provide substantial assistance to another person in violation of a provision of this title."[31]

However, any person who satisfies any definition of scheme liability is by definition providing "substantial assistance to another person in violation of" the Act.[32] That person is then an aider and abettor as that term has been defined by Congress. Inasmuch as the Supreme Court has clearly held that private parties cannot pursue aiding and abetting claims under Section 10(b) and inasmuch as Congress has clearly defined aiding and abetting liability to include "scheme liability," it follows ineluctably that private party plaintiffs cannot proceed on theories of "scheme liability."

If the clear implications of the text are not enough, consider the fact that Congress could in 1995 when it added Section 20(e) to the statute have responded to the Supreme Court's *Central Bank* decision by granting to private parties precisely the same enforcement rights that it granted to the Commission. Congress obviously did not do so. Consider also the fact that as part of the Sarbanes Oxley Act of 2002, Congress had a second opportunity to extend private rights of action to cover "scheme liability" but again declined the invitation.[33] Adopting a "scheme liability" is therefore directly contrary to a clear Congressional decision that has been twice expressed.

V. No Express Private Right of Action Recognizes Scheme Liability

But even if one misreads *Central Bank*, and even if one ignores the plain text and statutory history of Section 20(e), and even if one fails to recognize Congress's repeated decision not to expand the notion of implied private liability to cover "scheme liability," the "scheme liability" theory is doomed by the observation that there is no express private right of action under any of the federal securities laws that creates liability for a party who can be reached only on that theory. It makes no sense to reason that Congress would create an implied private right that reaches "scheme liability" under Section 10(b) when it refused to do so under any express private remedy in the Acts.

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[31] 15 U.S.C. § 78t(e).

[32] More formally, there is no definition of "scheme liability" that is not also covered by the definition of aiding and abetting liability in Section 20(e). "Scheme liability" is therefore merely a proper subset of a category of behavior that Congress has already defined as secondary. Congress has therefore precluded the possibility that private parties can assert that "scheme liability" is a form of primary liability.

[33] See *supra* note 12.

Thus, just as the Court observed in *Central Bank* that "none of the express private causes of action in the Act imposes aiding and abetting liability, and there is no evidence that Congress intended that liability for the express causes of action,"[34] there is also no evidence that Congress in any express private right of action intended to create exposure to any defendant for scheme liability. Therefore, the same logic that compelled the Court in *Central Bank* to conclude that the structure of the statute would not permit the implication of aiding and abetting liability also compels the conclusion that the Court cannot imply private liability for participation in a transaction that can be reached only on a theory of "scheme liability."

VI. *Santa Fe* and *Ernst & Ernst*

Central Bank is not the only Supreme Court decision incompatible with "scheme liability." Section 10(b) "prohibits only the making of a material misstatement (or omission) or the commission of a manipulative act."[35] The term "manipulative" cannot be read to encompass "scheme liability" because, as the Court has ruled," "[m]anipulation is virtually a term of art when used in connection with the securities markets."[36] "The term refers generally to practices, such as wash sales, matched orders, or rigged prices, that are intended to mislead investors by artificially affecting market activity."[37]

It follows that a party who engages in a transaction with a counterparty who then proceeds to misrepresent the transaction has not himself made a material misstatement (or omission) or committed a manipulative act. Therefore, "scheme liability," by its very definition, falls outside the category of conduct that can be reached pursuant to Section 10(b), and can be reached only as a subspecies of the form of aiding and abetting liability as to which Congress has delegated exclusive enforcement authority to the Commission.

VII. Conflicting Definitions of "Scheme Liability"

As previously observed, even the proponents of "scheme liability" cannot agree on a consistent definition of the concept. They have instead suggested multiple materially inconsistent competing definitions.[38]

Why would that be? The answer is simple.

There is no statutory analogue for "scheme liability." There is also no precedent for such liability in any decision of any court prior to the plaintiff bar's recent invention

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[34] 511 U.S. at 184.

[35] *Id.* at 177; *Santa Fe*, 430 U.S. at 473 ("The language of §10(b) gives no indication that Congress meant to prohibit any conduct not involving manipulation or deception"); *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 214 (1976) ("When a statute speaks so specifically in terms of manipulation and deception … , we are quite unwilling to extend the scope of the statute").

[36] *Hochfelder*, 425 U.S. at 199.

[37] *Santa Fe*, 430 U.S. at 476; see also 15 U.S.C. 78i (prohibiting specific manipulative practices); *Hochfelder*, 425 U.S. at 199; *Piper* v. *Chris-Craft Indus., Inc.*, 430 U.S. 1, 43 (1977).

[38] See *supra* note 5.

of the concept. The concept is instead a semantic subterfuge designed to recast conduct that is clearly secondary, and that clearly fits the statutory definition of aiding and abetting behavior, as a species of primary violation. Put another way, proponents of the theory have invented it without any legislative or judicial guidance as to what the theory does or does not encompass. The theory's proponents therefore cannot even get their stories straight as to what the theory does or does not cover as a form of primary liability. "Scheme liability" is thus a transparently instrumental device designed to achieve an outcome preferred by a class of litigants without any reference to or respect for precedent, statutory language, or legislative intent. Viewed from this perspective, it is hardly a surprise that the theory's staunchest proponents cannot agree as to the theory's definition: they are all just making it up in an effort to support their desired outcome.

VIII. The Section 10(b) Private Right of Action is Implied and Should Therefore be Narrowly Construed

The courts created the private cause of action for violations of Rule 10b-5. Although the Supreme Court recognized in 1983 that the existence of this implied cause of action was "simply beyond peradventure,"[39] the Court has also repeatedly recognized, both before and since 1983, that "there is no indication that Congress, or the Commission, when adopting Rule 10b-5, contemplated such a remedy."[40] Indeed, if the Court's current view about finding implied private causes of action in federal statutes had been in place when the issue was first decided, it seems highly unlikely that the Court would have "confirmed with virtually no discussion . . . that such a cause of action did exist."[41]

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[39] *Herman & MacLean* v. *Huddleston*, 459 U.S. 375, 380 (1983).

[40] *Hochfelder*, 425 U.S. at 196 (footnotes omitted); *see Lampf, Pleva, Lipkind, Prupis & Petigrow* v. *Gilbertson*, 501 U.S. 350, 359 (1991) ("[W]e have made no pretense that it was Congress' design to provide the remedy afforded."). For an analysis of the history of the Section 10(b) implied right of action, *see* Grundfest, *Disimplying Private Rights of Action Under the Federal Securities Laws: The Commission's Authority*, 107 Harv. L. Rev. 963, 985-998 (1994).

[41] *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, 730 (1975) (citing *Superintendent of Ins.* v. *Bankers Life & Cas. Co.*, 404 U.S. 6, 13 n.9 (1971); *Affiliated Ute Citizens* v. *United States*, 406 U.S. 128, 150-154 (1972)). As Justice Scalia noted in *Holmes* v. *Securities Investor Prot. Corp.*, 503 U.S. 258 (1992), "[T]he contours of a Rule 10b-5 action" were "'implied' (*i.e.*, created) by the Court itself—a practice we have since happily abandoned . . . ." *Id*. at 289 (Scalia, J., concurring in judgment) (citing *Touche Ross & Co.* v. *Redington*, 442 U.S. 560, 568-571, 575-576 (1979)). *See generally* Ruder, *Civil Liability Under Rule 10b-5: Judicial Revision of Legislative Intent?*, 57 Nw. U. L. Rev. 627 (1963).

Since the 1970s, the Court has repeatedly cautioned "that private parties may employ . . . an implied private right of action only if they demonstrate an 'unambiguously conferred right.'" *Pharmaceutical Research & Mfrs. of Am.* v. *Walsh*, 538 U.S. 644, 683 (2003) (Thomas, J., concurring in judgment) (quoting *Gonzaga Univ.* v. *Doe*, 536 U.S. 273, 283 (2002)); *see Alexander* v. *Sandoval*, 532 U.S. 275, 286-287 (2001) (stating that without congressional "intent to create not just a private right but also a private remedy . . . a cause of action does not exist and courts may not create one, no matter how desirable that might be as a policy matter, or how compatible with the statute"); *Virginia Bankshares, Inc.* v. *Sandberg*, 501 U.S. 1083, 1102 (1991) ("[A]ny private right of action for violating a federal statute must ultimately rest on congressional intent to provide a private remedy." (citing *Touche Ross & Co.*, 442 U.S. at 575)); *California* v.

The fact that the Rule 10b-5 cause of action is "of judicial creation,"[42] has meant that the courts have had the responsibility for defining its elements.[43] The Supreme Court has recognized that the fact that the cause of action was judicially created, by a process the Court would not now endorse, provides a reason for choosing narrow rather than broad readings of the right.[44]

Sound principles of statutory construction therefore call for the courts not to interpret implied rights of action in an expansive manner, particularly when the Court has observed that the implied right is itself of questionable pedigree under prevailing Court doctrine. The implied nature of the Section 10(b) cause of action is therefore yet another independent rationale for rejecting the "scheme liability" theory in any or all of its incarnations.

IX. The Magnitude of Potential Liability

The damages claims in securities class actions typically are very large – often in the billions of dollars.[45] In this case, for example, the total market capitalization loss upon disclosure of a criminal investigation into Charter's practices was $7 billion. Although recoverable damages in these cases inevitably are lower than the market capitalization loss, and depend upon the complex calculations of each side's experts, that figure is a good indicator of the order of magnitude of the claim.

The transactions between Charter and the defendants in this case, by contrast, involved a total of $17 million. Should those relatively small transactions subject the investors in these two companies to the economic burden of the total damages claim asserted by the plaintiff class?

Sierra Club, 451 U.S. 287, 297 (1981) ("The federal judiciary will not engraft a remedy on a statute, no matter how salutary, that Congress did not intend to provide."); *Touche Ross & Co.*, 442 U.S. at 575 ("The central inquiry [is] whether Congress intended to create, either expressly or by implication, a private cause of action.").

[42] *Lampf*, 501 U.S. at 358.

[43] *Musick, Peeler & Garrett* v. *Employers Ins. of Wausau*, 508 U.S. 286, 292 (1993) ("The federal courts have . . . exercised the principal responsibility for the continuing elaboration of the scope of the 10b-5 right and the definition of the duties it imposes.").

[44] *See Blue Chip Stamps*, 421 U.S. at 748-749 ("We are dealing with a private cause of action which has been judicially found to exist, and which will have to be judicially delimited one way or another unless and until Congress addresses the question."); *cf. Gebser* v. *Lago Vista Indep. Sch. Dist.*, 524 U.S. 274, 284 (1998) (Scalia, J., concurring in judgment) ("Because the private right of action under Title IX is judicially implied, we have a measure of latitude to shape a sensible remedial scheme . . . .").

[45] The series of reports produced by Cornerstone on securities class action filings and settlements document the magnitude of these claims. *E.g.*, Cornerstone Research, *Securities Class Action Case Filings, 2006: A Year in Review* (2007); Cornerstone Research, *Securities Class Action Settlements: 2006 Review and Analysis* (2007). These reports are available at http://securities.stanford.edu/.

This disproportionality is not at all unique. In virtually every case involving a "scheme liability" claim, the defendant's damages exposure is orders of magnitude greater than the size of the transaction alleged to give rise to the defendant's liability. And the theory has no stopping point: a transaction involving only $1 million or $100,000 could, if it was alleged to flunk the "principal purpose and effect" test, produce a complaint seeking to impose primary liability for billions of dollars.

If the Court were to authorize such a regime, it inevitably would alter the willingness of businesses to enter into transactions with public companies. The additional risk would be priced into those transactions and produce higher cost, burdening consumers and investors; start-up companies (where the risk of a securities class action is greater) might face even greater costs, and fewer companies willing to enter into business arrangements; and innovation – especially in the financial services area – would be stifled for fear that new types of transactions would be labeled as "deceptive" and subject a financial institution to huge liabilities.

X. Liability in Derivative Markets and Complex Transactions

The implications of "scheme liability" for the derivatives markets are particularly profound. Derivatives markets transactions commonly raise complex accounting, taxation, and reporting issues. Transactions that seem entirely legal to one impartial fact-finder may seem problematic to another fact-finder considering precisely the same facts.

To illustrate this point, compare and contrast the British High Court's decision in *Mahonia Limited* v. *JP Morgan Chase Bank, West LB AG*, 2004 WL 1808816 (Q.B.D. (Comm. Ct.) Aug. 3, 2004) with the Commission's enforcement action in *SEC* v. *J.P. Morgan Chase & Co.*, No. H-03-28-77 (S.D. Tex.). Both documents consider identical transactions.

The Commission's enforcement action, which was settled, alleges that a series of complex derivative transactions called "prepays" "had no business purpose aside from masking the fact that, in substance, they were loans" and not swap contracts, and should therefore have been accounted for as loans. Compl. ¶ 1. The swap counterparty was therefore alleged to have been liable as an aider and abettor.

In stark contrast, the British High Court, having considered precisely the same transaction, and having taken evidence from the former Chief Accountant of the United State Securities and Exchange Commission, and having considered the complaint and settlement in the SEC enforcement proceeding, concluded (at ¶ 136) that the "accounting for the prepays was not in breach of US GAAP [and] that its accounting for these transactions did not constitute a breach of US securities law." The British High Court further concluded that "[e]ven if there had been a breach of US GAAP," the Court "would not have found that there was any aiding and abetting by Chase because of the absence of either actual knowledge or constructive knowledge that there had been

wrongful accounting in respect of prior prepays or that there would be wrongful accounting in respect of future transactions." *Id.* ¶ 240.

Evidently, objective observers of good faith can have differing views regarding the proper accounting for a derivative market transaction. We are able to discern this fact, as a practical matter, only because the question was litigated in the High Court in the context of the validity of a surety agreement that generated finite, determinable exposure without significant credit or bankruptcy risk to the litigants. The case was, in other words, one that could rationally be litigated through to a verdict rather than one that would have to be settled because of the extreme financial exposure that would result in the event of a verdict adverse to the defendant.

Given the realities of the United States' litigation system, defendants who are unable to gain a dismissal by the point of summary judgment often face irresistible pressure to settle litigation well before trial. This pressure arises even if the defendants believe that they have valid defenses and that they are highly likely to prevail if allowed to pursue the matter to conclusion. However, given the complexities of the modern derivatives market, there exists a pervasive and material probability that plaintiffs will, simply because of the market's complexity, be able to persuade courts to allow them to proceed with class action fraud claims, even though there is, in the High Court's opinion, substantial cause for concern that the transaction involved is neither a primary or secondary violation.

The "scheme liability" theory therefore raises a particular problem for the large and growing derivatives market in which it can be trivially easy for a plaintiff to allege that the accounting for a complex derivative transaction was incorrect, If "scheme liability" is allowed to stand, particularly without transactional safe harbor provisions of the sort that could be created only by Congress, the implications for the derivatives markets, and their continued residence in U.S. markets subject to U.S. prosecution, would be profound - - and not positive.