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SECURITIES LITIGATION & REGULATION

Scheme No More

Recent Enron ruling curtails secondary actor liability under Rule 10b-5(a) & (c).

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SINCE THE SUPREME COURT decided *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994), innovative plaintiffs' lawyers have attempted to get around the Court's holding that there is no private right of action for aiding and abetting a violation of §10(b) of the Securities Act of 1933, 15 U.S.C. §78j, and Rule 10b-5 by alleging violations of subsections (a) and (c) of Rule 10b-5.[1] Although such efforts were rejected by a number of courts, they were accepted (at least initially) by others, leading to considerable uncertainty about the scope of potential private liability for so-called "secondary actors," those alleged to have aided and abetted securities fraud committed by others.[2]

A significant district court decision, however, indicates that the tide has now turned against imposing broad—and amorphous—potential liability against secondary actors under Rule 10b-5(a) and (c). In *In re Enron Securities, Derivative & ERISA Litigation*, 439 F. Supp. 2d 692 (S.D. Tex. 2006) ("*Enron IV*"), Judge Melinda Harmon—one of the most prominent adopters of the "scheme" liability theory advanced to reach secondary actors—openly repudiated the theory underlying her initial decision in *Enron I* and dismissed purported Rule 10b-5(a) and (c) claims against a secondary actor for its alleged participation in allegedly fraudulent transactions.[3]

Along with decisions from the Eighth and Ninth Circuits affirming lower court dismissals of Rule 10b-5(a) and (c) claims against secondary actors, *Enron IV* eliminates much of the uncertainty concerning secondary actors' potential liability under §10(b) and Rule 10b-5.[4]

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Liability After 'Central Bank'

Central Bank held that "there is no private aiding and abetting liability under §10(b)[.]"

While noting that any person "who employs a manipulative device or makes a misstatement (or omission) on which a purchaser or seller of securities relies may be held liable as a primary violator[,]" the Court emphasized that such liability exists only where "all of the requirements for primary liability under Rule 10b-5 are met."[5]

The issue for the Court was "not whether imposing private civil liability on aiders and abettors is good policy but whether aiding and abetting is covered by the statute."[6] The Court explained that a "private plaintiff may not bring a [Rule] 10b-5 suit against a defendant for acts not prohibited by the text of §10(b)."[7] Instead, §10(b) "prohibits only the *making* of a material misstatement (or omission) or the *commission* of a manipulative act.…The proscription does not include giving aid to a person who commits a manipulative or deceptive act."[8]

Following *Central Bank*, the vast majority of circuits adopted a "bright line" test under which a defendant must actually make a misstatement (or omission) or commit a deceptive act to be liable under §10(b).[9] The Ninth Circuit, however, permits Rule 10b-5 liability against a secondary actor who is allegedly a "substantial participant" in another party's fraud.[10] The Ninth Circuit's approach has been repeatedly criticized as contrary to the holding and rationale of *Central Bank*.[11] As the Second Circuit has explained in the context of a misstatement case:

> If *Central Bank* is to have any real meaning, a defendant must actually make a false or misleading statement in order to be held liable under Section 10(b). Anything short of such conduct is merely aiding and abetting, and no matter how substantial that aid may be, it is not enough to trigger liability under Section 10(b).[12]

The scope of secondary actor liability for misstatements or omissions was thus relatively clear; in contrast, the case law concerning liability under Rule 10b-5(a) and (c) for allegedly fraudulent schemes or deceptive acts was slower to develop.

One of only a handful of cases to address private liability under Rule 10b-5(a) and (c),

Enron I threatened to reimpose aiding and abetting liability against banks, accountants, law firms and other secondary actors doing business with those that are alleged to have committed securities fraud.

In *Enron I*, Judge Harmon recognized that the Ninth Circuit's "substantial participation" test "may fail to differentiate between primary liability and aiding and abetting[.]"[13] Apparently believing that the "bright line" test was too stringent, however, Judge Harmon stated that Rule 10b-5(a) and (c) permitted liability against those who, "acting alone or with others, create[] a misrepresentation on which the investor-plaintiffs relied[.]"[14]

Although this statement was arguably dicta, Judge Harmon permitted §10(b) claims against numerous banks that did business with Enron as well as a law firm and an outside auditor.[15] For example, *Enron I* held that Barclays PLC (Barclays) was potentially liable under §10(b) because it allegedly "participated in [Enron's] fraudulent course of conduct and business" by, inter alia, "participating in loans to Enron of over $3 billion during the class period," and "help[ing] Enron structure and finance some of the illicit SPEs and partnerships controlled by Enron and used to falsify its financial reports."[16] The difference between those who "create" a misrepresentation and those who "substantially participate" in another party's misrepresentation was unexplained.

Enron I has been resoundingly criticized by both practitioners and academics on a variety of grounds.[17]

At least one commentator has argued forcefully that the "creator test" articulated by Judge Harmon "presents the very same dangers that the Enron court attributed to the substantial-participation test.…The creator test is virtually indistinguishable from—and thus subject to the same criticisms that apply to—the substantial participation test."[18]

Judge Harmon nevertheless had continued to apply the reasoning of *Enron I*, stating that a defendant's allegedly "substantial, active role in major fraudulent transactions" are sufficient for private liability under Rule 10b-5(a) and (c) and denying Merrill Lynch's motion to dismiss regarding certain power swaps and the well-known Nigerian barge transaction.[19] Judge Harmon's decision in *Enron IV*, however, marked a clear break from these earlier decisions.

The 'Enron IV' Ruling

In *Enron IV*, Judge Harmon reexamined claims under Rule10b-5(a) and (c) against a bank counterparty, Barclays, that executed numerous transactions with Enron, which Enron allegedly used to misstate its financial condition.

Barclays was alleged to have funded and help create certain "illicit" entities, such as Chewco, and other "strawmen" to permit Enron to obtain off balance-sheet treatment for various SPEs, thereby concealing debt, wrongfully recognizing income and accelerating the recognition of future revenues. Barclays was also alleged to have participated in certain prepay deals and metals transactions that allegedly allowed Enron to hide debt and improperly report income and cash flow from operations.

Judge Harmon found that all of these allegations amounted to alleged "aiding and abetting and do not constitute primary violations of §10(b) and Rule 10b-5(a) and (c) as a matter of law."[20]

For example, Judge Harmon concluded that the fraud with respect to Chewco "occurred not in funding an entity that did not qualify as an SPE for nonconsolidation on Enron's balance sheet; it occurred in the improper accounting by Enron and others that did not consolidate."

Although Barclays allegedly understood that Enron would use Chewco, inter alia, "to circumvent the legal requirements under GAAP" in order to conceal debt and "thereby mislead investors in Enron securities[,]" it "was Enron, its accountants, officers, etc., not Barclays, that purportedly 'used or employed' this deceptive device and created the false appearance of a financially strong Enron[.]" Thus, the "allegations at most portray Barclays as a culpable aider and abettor."[21]

Likewise, with respect to the pre-pay deals, the court concluded that "alleging that what were 'loans' from Barclays were classified as cash flow from operations by Enron does not state an actionable claim against Barclays…the inaccurate accounting of cash flow, debt, etc. that deceived investors is alleged[] to have been done by Enron, its officers, and accountants[,]" not by Barclays.

Similarly, "the metals transactions were… deceptive devices used *by Enron* to improperly account for the amounts it received as cash flow from operations and to mask what was actually a debt obligation; the sales themselves were not shams."[22] Because any deception in the transactions arose from how they were "used by Enron[,]" the allegations fell short of a primary violation by Barclays.[23]

In reaching these conclusions Judge Harmon relied heavily on Judge Lewis Kaplan's thorough and scholarly analysis of the scope of Rule 10b-5(a) and (c) liability in *In re Parmalat Securities Litigation*, 376 F. Supp. 2d 845 (S.D.N.Y. 2005) (*Parmalat*).[24] Indeed, Judge Harmon expressly repudiated her original decision in *Enron I*, concluding that "Judge Kaplan's approach [in *Parmalat*] is the better reasoned."[25]

Adopting reasoning from *Parmalat*, Judge Harmon explained:

> These arrangements therefore were not inventions, projects, or schemes with the tendency to deceive. Any deceptiveness resulted from the manner in which Parmalat or its auditors described the transactions on Parmalat's balance sheets and elsewhere. In entering into these transactions the banks therefore did not use or employ a deceptive device or contrivance. At worst the banks designed and entered into the transactions knowing or even intending that Parmalat or its auditors would misrepresent the nature of the arrangements. That is, they substantially assisted fraud with culpable knowledge—in other words they aided and abetted it. Under *Central Bank*, of course, that is not a basis for private civil liability.[26]

Accordingly, because the transactions involving Barclays were economically substantive transactions and the fraud arose only from Enron's misrepresentations about the substance of the transactions in its financial statements, Judge Harmon dismissed the claims against Barclays.[27]

Enron IV's otherwise surprising repudiation of the reasoning behind *Enron I* and *Enron II* was, in retrospect, foreshadowed by an unpublished decision a little more than a month earlier, *In re Enron Corp. Securities, Derivatives & ERISA Litigation*, 2006 U.S. Dist. LEXIS 43146, at *387

& n.158 (S.D. Tex. June 5, 2006) (*Enron III*).

At the end of a lengthy opinion concerning class certification, Judge Harmon considered a motion by Deutsche Bank for reconsideration of its theretofore denied motion to dismiss. *Enron III* granted Deutsche Bank's motion for reconsideration and dismissed the §10(b) claim against it. Specifically, after citing *Parmalat* with approval, Judge Harmon held that allegations that the bank structured transactions for Enron "at most" stated a claim for aiding and abetting absent allegations that Deutsche Bank's structures were themselves "inherently deceptive[.]"[28]

Thus, *Enron IV* follows on the heels of *Enron III* by explicitly adopting Judge Kaplan's approach in *Parmalat*, repudiating the reasoning underlying *Enron I* and *Enron II*, and expressly reversing the conclusions regarding Barclays reached in *Enron I*. While portions of *Enron I*—such as those dismissing §10(b) claims against Lehman Brothers, Bank of America and Kirkland & Ellis—remain good law, the remaining portions of the decision concerning §10(b) claims apparently have been abrogated by *Enron IV*.

Conclusion

Enron IV adopts a standard for primary liability under Rule 10b-5(a) and (c) that properly distinguishes between secondary actors that allegedly engage in inherently deceptive conduct or transactions from those who engage in economically substantive transactions that are allegedly deceptive, if at all, because of how another party discloses those transactions.

Thus, *Enron IV* marks another step in the emergence of a widely accepted standard for secondary actors under Rule 10b-5(a) and (c). In addition to providing useful guidance to banks, law firms and other secondary actors regarding the potential scope of private liability under §10(b), such a standard is consistent with the language of the Securities Exchange Act of 1934 enacted by Congress.[29]

As Judge Kaplan explained in *Parmalat*, the statutory terms "device" and "contrivance" both contain an element of deception.[30] Section 10(b) makes it unlawful for any person to "use or employ" any "deceptive device or contrivance[.]"[31] The terms "use" and "employ" both mean "to make use of."[32] Thus, both *Parmalat* and *Enron IV* properly focus on whether a secondary actor itself makes use of an allegedly deceptive device or contrivance.

Accordingly, the question is whether the secondary actor's own conduct in a transaction is itself inherently deceptive (and is thus within the scope of private liability under the statute) or whether it is deceptive only because of another party's failure to properly disclose the transaction (and is thus mere aiding and abetting not subject to a private right of action). In the former scenario, the secondary actor can be said to "use or employ" the allegedly deceptive device or contrivance. In the latter, scenario, it is the other party that "uses or employs" the allegedly deceptive device or contrivance to mislead investors.

While decisions by two Courts of Appeals contain potentially important differences regarding the scope of primary liability for secondary actors under §10(b),[33] even the Ninth Circuit's arguably more lenient standard is consistent with the approach taken by Judge Kaplan in *Parmalat* and, more recently, by Judge Harmon in *Enron IV*.

As a practical matter, Judge Harmon's adoption of this standard in *Enron IV* means that those engaging in economically substantive transactions will face reduced legal uncertainty and decreased risk of being subject to potentially devastating private liability for other parties' alleged failures to properly disclose the substance of those transactions.

1. Rule 10b-5 provides that it: "shall be unlawful for any person for any person, directly or indirectly…(a) To employ any device, scheme or artifice to defraud, (b) To make any untrue statement [or omission] of material fact…, or (c) To engage in any act, practice, or course of conduct 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.

2. Compare, e.g., *In re Enron Corp. Sec., Derivative & ERISA Litig.*, 235 F. Supp. 2d 549, 569, 588-92 (S.D. Tex. 2002) (*Enron I*) with, e.g., *In re Dynegy, Inc. Sec. Litig.*, 339 F. Supp. 2d 804, 916 (S.D. Tex. 2004); *In re Charter Comm'ns, Inc. Sec. Litig.*, No. 02 Civ. 1186, 2004 WL 3826761, *5-8 (E.D. Mo. Oct. 12, 2004).

3. See 439 F. Supp. 2d at 724.

4. *Simpson v. AOL Time Warner Inc.*, 452 F.3d 1040 (9th Cir. 2006); *In re Charter Comm'ns, Inc. Sec. Litig.*, 443 F.3d 987 (8th Cir. 2006).

5. *Central Bank*, 511 U.S. at 191.

6. Id. at 177.

7. Id. at 172.

8. Id. at 177 (emphasis added).

9. See *In re Charter Comm'ns, Inc. Sec. Litig.*, 443 F.3d 987, 992 (8th Cir. 2006); *Fidel v. Farley*, 392 F.3d 220, 235 (6th Cir. 2004); *Ziemba v. Cascade Int'l, Inc.*, 256 F.3d 1194, 1205-06 (11th Cir. 2001); *Wright v. Ernst & Young LLP*, 152 F.3d 169, 175 (2d Cir. 1998); *Anixter v. Home-Stake Prod. Co.*, 77 F.3d 1215, 1225-26 (10th Cir. 1996).

10. See, e.g., *In re Software Toolworks Inc. Sec. Litig.*, 50 F.3d 615, 628 n.3 (9th Cir. 1994) (as amended March 13, 1995).

11. See, e.g., *Anixter*, 77 F.3d at 1226 n.10; *Ziemba*, 256 F.3d at 1205.

12. *Shapiro v. Cantor*, 123 F.3d 717, 720 (2d Cir. 1997).

13. *Enron I*, 235 F. Supp. 2d at 585.

14. *Enron I*, 235 F. Supp. 2d at 588; see also id. at 591.

15. Each of the defendants in *Enron I* against which claims were allowed to proceed was alleged to have made materially false statements, upon which investors allegedly relied, which Judge Harmon at least arguably could have permitted under Rule 10b-5(b), without reaching the scope of liability under subsections (a) or (c). See, e.g., *Enron I* at 644-45 (discussing allegations regarding CSFB).

16. See id. at 652-53.

17. See, e.g., Robert J. Haft, "Due Diligence —Periodic Reports and Securities Offerings" §8:22 (2003).

18. James Benedict & Christopher Joralemon, "Primary Liability of Secondary Actors in Securities Fraud Cases," 36 Rev. Sec. & Commodities Reg. 205, 210 & n. 36 (2003)

19. *In re Enron Corp. Sec., Derivative & ERISA Litig.*, 310 F. Supp. 2d 819, 829-30 (S.D. Tex. 2004) (*Enron II*).

20. See *Enron IV*, 439 F. Supp. 2d at 724; see also id. at 696, 721-23.

21. Id. at 721. The court concluded in the alternative that allegations based on Chewco were also time-barred. See id.

22. Id. at 722-23 (emphasis added).

23. See id. at 722-24. In *Enron I*, the identical allegations concerning the same transactions were held to state a claim under §10(b). 235 F. Supp. 2d at 652-53.

24. Judge Kaplan's *Parmalat* decision has been widely cited and has received praise from one prominent securities law scholar as one of the best decisions in the Southern District of New York in the past year. See John C. Coffee Jr., "The Envelope Please: Best Southern District Rulings," N.Y.L.J. July 20, 2006. Interestingly, the other decision honored was also written by Judge Kaplan. See id.

25. *Enron IV*, 439 F. Supp. 2d at 718 n.32.

26. Id. at 719 (quoting *Parmalat*, 376 F. Supp. 2d at 505).

27. Id. at 722, 724.

28. *Enron III*, 2006 U.S. Dist. LEXIS 43146, at *383, 387.

29. *Central Bank*'s prohibition against private liability for aiding and abetting does not eliminate liability for such conduct. Instead, the SEC may bring enforcement actions against alleged aiders and abettors See 17 U.S.C. §78t(e).

30. See *Parmalat*, 376 F. Supp. 2d at 502 & n.151 (citing Webster's New International Dictionary, 580, 679 (2d ed. 1934)).

31. 15 U.S.C. §78j.

32. The meanings of "employ" include "to make use of," "to apply" and "use." Webster's New International Dictionary, 839 (2d ed. 1934). The meanings of "use" include "to make use of, esp. habitually or customarily; to follow as a regular custom; to practice or make a practice of," and "to put into operation; to cause to function." Id. at 2806.

33. The Eighth Circuit's standard for potential secondary actor liability under Rule 10b-5(a) and (c) is apparently more restrictive than the standard adopted by the Ninth Circuit. Compare *In re Charter Comm'ns, Inc. Sec. Litig.*, 443 F.3d at 992 with *Simpson*, 452 F.3d at 1048.