Legal Times

WEEK OF MAY 28, 2007 • VOL. XXX, NO. 22

ALM

Bankers for Crooks

Those who work hand-in-hand with schemers like Enron should not escape liability.

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Are Enron's banks liable to Enron's shareholders? Two attorneys who represented an Enron bank that settled with class-action plaintiffs posed that question in *Legal Times* last month ("Don't Blame the Culprit's Bank," April 30, Page 31). Gregory Markel and Gregory Ballard argued that banks should not be held responsible for the "misdeeds of their clients."

Of course, by assuming that only the Enron banks' clients—and not the banks themselves—engaged in "misdeeds," Markel and Ballard assume the truth of the very thing being questioned. Beyond that misstep, however, our colleagues in the bar rightly acknowledge that wide divisions exist over just what sort of "scheme" of misconduct should lead to liability under the nation's securities fraud laws.

Those divisions may soon be erased. The Supreme Court has granted certiorari in *Stoneridge Investment v. Scientific Atlanta Inc*. from the U.S. Court of Appeals for the 8th Circuit. The specific questions before the Court are (1) whether a third party who participates in fraudulent conduct—but does not make any false statements to investors and is under no legal obligation to make public disclosures—can be held liable for fraud under federal securities law and, (2) if so, under what circumstances?

These seemingly narrow issues carry broad implications. Banks are almost never required to make any statements to investors about the companies they work with, and there are only a few situations where securities law imposes disclosure requirements on banks. If the Supreme Court decides that a statement to investors or a legal duty to shareholders is a prerequisite to any legal responsibility for participating in a scheme to defraud, banks basically will be immunized against liability for securities fraud.

At a minimum, such blanket immunity seems at odds with common sense and the core purposes of federal securities law. Yet in *Regents of the University of California v. Credit Suisse First Boston Inc.,* the 5th Circuit reached just such a result. In March of this year, it blocked the case against the Enron banks at the class-certification stage.

The court acknowledged overwhelming evidence that the banks devised and participated in contrived financial structures and deceitful transactions that were created to mislead the outside world about Enron's balance sheet by hiding Enron's debt and generating fake revenue. Nevertheless, the court concluded that because the banks did not make any false statements and had no disclosure obligations, they could not be held liable for investors' losses. In doing so, the court rejected what has become known as "scheme liability."

The Securities and Exchange Commission seemingly had a different liability model in mind when it enacted Rule 10b-5 to effectuate the federal securities anti-fraud statute, Section 10(b) of the Securities Exchange Act of 1934.

On its face, Rule 10b-5 makes participation in a scheme unlawful by making it illegal for "any person" to:

(a) employ *any* device, *scheme,* or artifice to defraud,

(b) . . . make any untrue statement of a material fact or . . . omit to state a material fact . . . *or*

(c) . . . engage in any act, practice, or course of business that operates . . . as a fraud or deceit.

Note the parts we've emphasized. The plain language of the rule clearly reaches "any scheme" to defraud or "any act" that operates as a fraud.

PRIMARY VS. SECONDARY

Although scheme liability is far from a novel legal development, the use of scheme theory to hold investment banks liable under Section 10(b) is a relatively recent happening.

Before 1994, injured investors alleged that complicit banks were subject to liability as "aiders and abettors." But in *Central Bank of Denver N.A. v. First Interstate Bank of Denver N.A.* (1994), the Supreme Court struck down liability for so-called "secondary" violations of Section 10(b). Accordingly, third parties who merely aid and abet "primary" violations of the statute are not liable.

In *Central Bank,* the Supreme Court expressly stopped short of per se immunity for secondary actors such as banks and other third parties. According to the Court, the absence of Section 10(b) aiding and abetting liability does not mean that secondary actors always escape. Instead, the Court warned, "Any person or entity, 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 under Rule 10b-5 . . . assuming all of the requirements for primary liability under Rule 10b-5 are met."

After *Central Bank,* investors used scheme theory to hold banks liable in a limited number of cases where banks had knowingly played a substantial role in a corporate fraud. *Central Bank* thus gave rise to an important distinction between aiding and abetting fraud (secondary liability, which is not actionable for private plaintiffs) and directly participating in a scheme to defraud (primary liability, which is actionable for private plaintiffs).

The decision, however, did not draw a clear line between the two kinds of liability. It did not define or explain in detail what conduct by third parties and other nonprimary actors should result in liability as a primary violator. Nor did the Court analyze or comment on Rule 10b-5(a) and (c).

The SEC, as amicus in the 9th Circuit case *Simpson v. AOL Time Warner Inc*. (2006), explained that "deceptive acts under Section 10(b) include conduct beyond the making of false statements or misleading omissions, for facts effectively can be misrepresented by action as well as words."

The 9th Circuit agreed, holding in *Simpson* that "engaging in a transaction, the principal purpose and effect of which is to create the false appearance of fact, constitutes a 'deceptive act.' " The language used by both the SEC and the 9th Circuit to draw the contours of scheme liability appeared to track Rule 10b-5(a) and (c) closely.

In the suit against the Enron banks, U.S. District Judge Melinda Harmon of the Southern District of Texas followed the SEC's lead. She allowed secondary actors' liability for engaging in Enron's scheme to defraud, based on the nature of the disputed transaction. (For example, Merrill Lynch "bought" Enron's interest in a power plant floating on a barge off the coast of Nigeria on the eve of Enron's 1999 year-end solely to create the appearance of earnings for Enron—but in a side agreement, Enron agreed to unwind the transaction in six months by buying the barge back from Merrill at a large loss to the company and a huge profit to Merrill Lynch.)

Harmon differentiated between situations where a third party enters into a legitimate transaction with a corporation even "where it knows that the corporation will overstate revenue generated by that transaction" and those where "the third party and the corporation engage in a transaction whose principal purpose and effect is to create a false appearance of revenues, intended to deceive investors." Although the former situation amounts to mere aiding and abetting, "inherently deceptive" transactions in the latter category are primary violations and create liability under Section 10(b).

In a 2-1 decision in an interlocutory appeal of class certification, the 5th Circuit reversed. It held that without any false statements, "[t]he banks' participation in the transactions, regardless of the purpose or effect of those transactions, did not give rise to primary liability under §10(b)."

The 5th Circuit admittedly opted for a "limited interpretation" of Section 10 and a "[s]trict construction" of Section 10(b). Under its reasoning, holding third-party banks liable for a scheme to defraud under Rule 10b-5(a) and (c) would inappropriately broaden Section 10(b).

In reaching this result, the 5th Circuit agreed with the 8th Circuit's similar conclusion in *Stoneridge* and expressly rejected the positions of the SEC and the 9th Circuit.

REMEDIAL PURPOSES

The 5th and 8th Circuits' restrictive view of Section 10(b) and the relationship between Section 10(b) and Rule 10b-5 are not only beyond the aiding-and-abetting limitation announced in *Central Bank* but also are at odds with subsequent Supreme Court interpretation of the relationship between the statute and the rule.

In *SEC v. Zandford* (2002), the Supreme Court reiterated that Section 10(b) is to be applied in a "flexible" manner to effectuate its "remedial purposes." Contrary to the 5th Circuit's suggestion in the Enron banks case, the Court expressly stated that "[t]he scope of Rule 10b-5 is coextensive with the coverage of §10(b)."

In *Zandford*, the Court approved the SEC's allegation that the defendant had "carr[ied] out his fraudulent scheme without making an affirmative misrepresentation." The Supreme Court observed that "neither the SEC nor this Court has ever held that there must be a misrepresentation about the value of a particular security" for liability to attach.

PREDICTABILITY

The 5th and 8th Circuit decisions reflect those courts' conclusion that the line between primary and secondary liability under Section 10(b) for third parties is simply too hard to draw and that the difficulty presents an unacceptable lack of certainty for market actors such as banks. The 5th Circuit admitted this explicitly, justifying its decision based on the need for "certainty and predictability" for "good-faith professionals who are attempting to avoid liability."

But investment banks are not the only ones in the marketplace who deserve predictability and certainty. Investors also should be entitled to certainty concerning the integrity of the nation's capital markets and to predictability in their ability to seek damages for affirmative deceptive acts or contrived conduct intended to defraud them.

Unfortunately, the bright-line rule adopted in the Enron banks case and in *Stoneridge* provides certainty and predictability to bad-faith professionals. That reality was not lost on 5th Circuit Judge James Dennis, who dissented from the majority view of scheme liability. He argued that the rule the court adopted "immunizes a broad array of undeniably fraudulent conduct from civil liability under Section 10(b), effectively giving secondary actors license to scheme with impunity, so long as they keep quiet."

The 5th and 8th Circuits' restrictive application of Section 10(b) and Rule 10b-5 seems less an effort to draw a line between primary and secondary violations and more an attempt to protect third-party actors from liability, regardless of how intentional and egregious their misconduct.

We agree with Markel and Ballard that "[f]airness and efficient economy demand a clearer description of the standard of conduct that third parties, and particularly financial institutions, must meet." But we strongly disagree with any rule that places conduct like that engaged in by the Enron banks above the law and outside the reach of Enron's investors and employees, as well as the retirees who lost billions as a direct result of the banks' conduct.

At bottom, Section 10(b) and Rule 10b-5 have long proscribed any scheme or artifice to defraud, as well as any conduct that operates as a fraud on investors.

Enron's banks worked hand-in-hand with Enron to design and implement sham transactions with the sole purpose of hiding debt and generating fake revenue. If that's not participating in a scheme to defraud, what else can we call it?

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