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THE FIFTH CIRCUIT RULES ON THIRD-PARTY LIABILITY FOR SECURITIES FRAUD; UNDERSCORES CIRCUIT SPLIT; SUPREME COURT TO REVIEW

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The United States Fifth Circuit Court of Appeals recently issued an opinion concerning the liability of financial services companies and other vendors for their clients' alleged securities fraud. The case, *Regents of the University of California v. Credit Suisse First Boston (USA), Inc.,* was an effort by shareholders of Enron Corporation to hold certain of Enron's banks (Credit Suisse First Boston, Merrill Lynch & Co., Inc., and Barclays Bank PLC) liable for securities fraud, under Rule 10b-5, for knowingly engaging in transactions with Enron that enabled it to misstate its financial condition. With Enron's assets long since depleted, the plaintiffs sought to recoup their alleged losses from the company's third-party vendors. Under the Supreme Court's ruling in *Central Bank*[1], Section 10(b) of the Securities Exchange Act of 1934 does not give rise to liability for merely "aiding and abetting" a fraud. In *Regents*, however, the plaintiffs had alleged that the banks were primarily liable for their own deception. The lower court certified the case as a class action, ruling that, among other things, participation in a transaction designed to create a false impression of revenues can constitute a "deceptive act" under Rule 10b-5(c).

The Fifth Circuit rejected the lower court's broad interpretation of a "deceptive act." "An act cannot be deceptive within the meaning of § 10(b) where the actor has no duty to disclose," held the Court. *Enron's* banks owed no duty of disclosure to its shareholders, nor had they undertaken to make any statements that were made misleading by the omission of the circular nature of the transactions. Rather, the plaintiffs had alleged only that the banks aided Enron's deception, albeit knowingly, which does not give rise to primary liability under § 10. Enron was the party that misstated its accounts, and the court reasoned that the banks "only aided

[1] *Central Bank, N.A. v. First Interstate Bank, N.A.*, 511 U.S. 164 (1994).

and abetted that fraud by engaging in transactions to make it more plausible; they owed no duty to Enron's shareholders." Pleading that the banks acted through a "scheme" or "act," as opposed to a misrepresentation, does not allow the plaintiffs to escape the requirement that the scheme, act, or misrepresentation be deceptive.

In short, the Fifth Circuit held that the lower court's interpretation of a "deceptive act" conflicted with *Central Bank*. As the court recognized, however, *Central Bank* left the line between primary and secondary liability under Section 10 somewhat blurry. The court burrowed into the Supreme Court decisions underlying *Central Bank* and concluded that, taken as a whole, they represent the Supreme Court's determination that Congress intended § 10(b) to apply only to "deception" and "manipulation." "Manipulation," according to the court's interpretation of Supreme Court and other precedent, requires activity directly within the market for a particular security, which artificially affects the price or gives a false impression of market activity. "Deception," according to the similar precedent, "involves breach of some duty of candid disclosure."

Enron's banks' alleged actions did not constitute "manipulation," and, because the banks owed no duty of disclosure to the plaintiffs, they did not constitute "deceptive acts." As such, the banks' alleged actions did not constitute "misrepresentations" as required for the application of the classwide fraud-on-the-market presumption of reliance under *Basic v. Levinson*.[2] Because the banks had no duty of disclosure, the plaintiffs also were not entitled to the classwide presumption of reliance on an omission under *Affiliated Ute*.[3] Without a classwide presumption of reliance, the plaintiffs must prove individual reliance, and class certification was improper.

CIRCUIT SPLIT AND SUPREME COURT REVIEW

The Fifth Circuit's decision adds to a split among the federal courts of appeal on the extent of primary liability under Section 10. The Eighth Circuit, in *Charter Communications*[4], also held that the Supreme Court's decisions on the issue collectively mean that "deceptive" conduct requires a misstatement or a breach of a duty to disclose. The Ninth Circuit, however, in *Simpson v. AOL Time Warner Inc.*[5], held that conduct that creates a false appearance in deceptive transactions as part of a scheme to defraud is "deceptive" conduct under Section 10. The Ninth Circuit also held that plaintiffs may be presumed to have relied on such a scheme if a misrepresentation enabled by the defendants' participation is disseminated into the marketplace. The Securities and Exchange Commission advocated this broader interpretation in an amicus curiae brief submitted to the Ninth Circuit.

[2] *Basic, Inc. v. Levinson,* 485 U.S. 224 (1988).
[3] *Affiliated Ute Citizens v. United States,* 406 U.S. 128 (1972).
[4] *In re Charter Commc'ns, Inc. Sec. Litig.,* 443 F.3d 987 (8th Cir. 2006).
[5] *Simpson v. AOL Time Warner Inc.,* 452 F.3d 1040 (9th Cir. 2006)

It appears that the Supreme Court intends to resolve the circuit split. Late in March 2007, the Supreme Court decided to review the *Charter Communications* case and decide whether private plaintiff may sue outside vendors for engaging in transactions associated with a company's alleged fraudulent accounting. The Court will begin hearing the case in October 2007.

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