
ARTICLE

READING *STONERIDGE* CAREFULLY: A DUTY-BASED APPROACH TO RELIANCE AND THIRD-PARTY LIABILITY UNDER RULE 10B-5

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INTRODUCTION

In *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*,¹ the Supreme Court addressed whether two third-party participants in a fraudulent scheme, engineered by a corporate issuer, faced liability in a private securities lawsuit for harm caused by the issuer's false and misleading corporate disclosures. Though the inquiry would seem to be a matter of determining whether the participants' deceptive, behind-the-scenes conduct constituted a "primary" violation of the anti-fraud prohibition found in SEC Rule 10b-5,² the Court instead answered by interpreting the reliance element of the plaintiffs' cause of action. The Court held that there is no reliance, and hence no liability, when the link between the third party's actions and the resulting misrepresentation by the issuer is too remote or attenuated.³

Conduct, reliance, and proximity, however, are conceptually distinct; by blending them together, Justice Kennedy's opinion makes something of a doctrinal mishmash. The dish is tasty enough to those who dislike strong securities class actions, with abundant probusiness dicta adding ample spice.⁴ But the recipe has few serious academic defenders, even among those who like its outcome,⁵ and has been the object of disgust for those who do not.⁶ The standard account is that

¹ 552 U.S. 148 (2008). The decision was five to three: Justice Stevens wrote a lengthy dissent, joined by Justices Ginsburg and Souter, and Justice Breyer did not take part in the decision.

² 17 C.F.R. § 240.10b-5 (2009) (declaring it unlawful to use "any facility of any national securities exchange" to commit fraud).

³ See *Stoneridge*, 552 U.S. at 159 ("Petitioner, as a result, cannot show reliance upon any of respondents' actions except in an indirect chain that we find too remote for liability.").

⁴ See, e.g., *id.* at 164 ("Overseas firms with no other exposure to our securities laws could be deterred from doing business here."); see also *infra* note 172.

⁵ See A.C. Pritchard, *Stoneridge Investment Partners v. Scientific-Atlanta: The Political Economy of Securities Class Action Reform*, 2007-08 CATO SUP. CT. REV. 217, 233-34 (defending *Stoneridge* as an attempt to limit the private right of action under Rule 10b-5). For a somewhat more sympathetic view, see Richard A. Booth, *The Future of Securities Litigation*, 4 J. BUS. & TECH. L. 129, 135 (2009), which suggests that although the case could have been decided another way, it invited a thorough reconsideration of the role of causation in Rule 10b-5 litigation.

⁶ See, e.g., Franklin A. Gevurtz, *Law Upside Down: A Critical Essay on Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, 103 NW. U. L. REV. 448, 450-51 (2009) (describing the decision as one based on policy considerations rather than sound doctrine); Mark Klock, *What Will It Take to Label Participation in a Deceptive Scheme to Defraud Buyers of Securities a Violation of Section 10(b)? The Disastrous Result and Reasoning of Stoneridge*, 58 U. KAN. L. REV. 309, 309 (2010) (characterizing *Stoneridge* as "insulating culpable parties from private action liability when they did not directly participate in the sale of securities"); Robert A. Prentice, *Scheme Liability: Does It Have a*

the Court was, yet again, showing its reflexive antipathy toward private securities class actions, throwing whatever was at hand into the pot in order to achieve a business-friendly result. As we shall see, most lower courts have read *Stoneridge* as doing little more than truncating third-party liability via an especially strict reliance requirement.

My sense is that both courts and commentators have paid too much attention to the dicta and too little to the holding. Though I, too, would have decided the case differently, the substance of the academic criticism and the unimaginative way lower courts have read and applied the Court's teachings are too simple. In *Stoneridge*, as in the two other most recent Supreme Court decisions addressing securities class actions, *Tellabs*⁷ and *Dura Pharmaceuticals*,⁸ the Court articulated a more moderate test than it might have, even though all three held for the defendants. Pure antipathy toward securities class action plaintiffs presumably would have led to more extreme holdings, which suggests that something different is going on.

In this Article, I offer a novel reading of *Stoneridge*.⁹ There is a respectable idea at work in the opinion, which we can refine. The Court's

Future After Stoneridge?, 2009 WIS. L. REV. 351, 393 (criticizing the majority for revising hundreds of years of fraud history "without any grounding in the language, legislative history, or policy" underlying section 10(b) of the 1934 Securities Exchange Act); Stuart Sinai, *Stoneridge—Escape from Securities Liability Notwithstanding Active, Intentional, Deceptive Conduct*, 8 J. BUS. & SEC. L. 170, 180 (2008) (describing the *Stoneridge* decision as "clearly wrong").

⁷ See *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 324 (2007) (holding that a complaint will survive dismissal under the Private Securities Litigation Reform Act of 1995 (PSLRA) "only if a reasonable person would deem the inference of scienter cogent and at least as compelling as any opposing inference one could draw from the facts alleged"). Justice Ginsburg's majority opinion in *Tellabs* provoked critical concurrences by Justices Scalia, Thomas, and Alito because of its moderation, but Justice Kennedy voted with the majority. For a discussion of *Tellabs*'s implications, see James D. Cox, Randall Thomas & Lynn Bai, *Do Differences in Pleading Standards Cause Forum Shopping in Securities Class Actions?: Doctrinal and Empirical Analyses*, 2009 WIS. L. REV. 421, 436-38. In particular, the article noted, "*Tellabs*'s salience within securities litigation will come from its call for courts to focus on *all* aspects of the complaint, its requirement that inferences are to be drawn both for and against the plaintiff, and its enunciation of a somewhat malleable meaning for *strong*." *Id.* at 437.

⁸ See *Dura Pharm., Inc. v. Broudo*, 544 U.S. 336, 346-47 (2005) (requiring securities complaints charging fraud under the Securities Exchange Act of 1934 to plead loss causation by alleging an inflated price caused by the securities violation *and* a subsequent price decrease caused by the exposure of the truth in the market).

⁹ My reading bears some similarity to one Ronald Colombo puts forward, though he ties the proper test for third-party liability to "principles of cooperation" derived from moral philosophy and theology. See Ronald J. Colombo, *Cooperation with Securities Fraud*, 61 ALA. L. REV. 61, 91-92 (2009) (using philosophical principles to determine the moral blameworthiness of acts undertaken by one who cooperates with wrongdoers).

choice of reliance as the crucial element indicates the Court's comfort with having different liability outcomes in Rule 10b-5 cases depending on whether the action is an SEC enforcement or criminal prosecution (where reliance is not required) or private litigation (where it is).¹⁰ Why might such a distinction make sense? One possible answer comes by considering the extraordinary nature of the liability in private fraud-on-the-market cases, which is based on the aggregate claims of all those who bought or sold from the time of the alleged primary misrepresentations to the date of corrective disclosure. This figure can be staggeringly large, yet disconnected from any meaningful reliance-in-fact requirement. Even if the underlying conduct was wrongful, making a defendant pay such a large amount can seem severely disproportionate. By contrast, in SEC enforcement actions, the monetary penalty varies based on a set of factors specifically tied to the gravity of the wrongdoing.¹¹ In Part I, I expand on this idea and make my main argument: that by emphasizing remoteness and attenuation in the context of private securities litigation, *Stoneridge* reinvigorates the idea of *duty* as a limitation on liability to open-market investors in order to constrain the unique liability risk that defendants face.

In Part II, I explore the risk of disproportion and make two claims. First, fraud-on-the-market liability is an extraordinary remedy because it creates a potential recovery different from, and in excess of, normal conceptions of provable reliance damages. Second, a hard look at the key elements of a Rule 10b-5 action—including scienter—shows that securities fraud bears enough resemblance to negligence in terms of indeterminacy and precaution costs that a duty-based analysis makes sense. Later in Part II, I also consider how Congress has tried to address the disproportionality problem explicitly. Section 21D(f) of the Securities Exchange Act, added as part of the Private Securities Litigation Reform Act of 1995 (PSLRA), purports to impose a proportionate liability regime, drawn from similar reform efforts in tort law

¹⁰ For more on the relationship between public and private securities law enforcement, and a proposal for bringing private litigation even more under the control of the SEC, see Amanda M. Rose, *Reforming Securities Litigation Reform: Restructuring the Relationship Between Public and Private Enforcement of Rule 10b-5*, 108 COLUM. L. REV. 1301 (2008). Rose proposes greater oversight by the SEC to reduce focus on the implied private right and to achieve optimal deterrence. *Id.* at 1305-06.

¹¹ See Securities Exchange Act of 1934 § 21(d)(3), 15 U.S.C. § 78u(d)(3) (2006) (setting tiers of penalties, with maximum amounts, based on the presence of fraud, pecuniary gain, and losses suffered by investors).

at the state level.¹² My argument is that this provision fails to do its job, thereby justifying judicial concern.

Part III puts forth my duty-based reading of what the *Stoneridge* Court was struggling to say with its emphasis on attenuation and remoteness. I explain that this kind of duty is different from the affirmative duty to speak, which is fairly narrow and circumscribed, and instead performs the tort law-like function of identifying a limited category of relational misconduct for which extraordinary fraud-on-the-market liability is deserved. Thinking of *Stoneridge* in this way gives meaning to portions of the opinion that otherwise might seem unintelligible, like the Court's distinction between defendants who inhabit the realm of commerce versus the realm of finance, and shows that there is, in fact, ample room for third-party liability in the right kinds of cases. Part IV explains that this perspective helps resolve the most common third-party liability problems, comparing and critiquing the overly restrictive way in which lower courts have responded to *Stoneridge*. In Part IV, I take a critical look at the "attribution" test for primary liability, which lower courts seem to assume has survived *Stoneridge*. Though that reading may be formally correct, I suggest that a duty-based reading obviates the need for it.

Because I do not expect to resolve the lingering confusion and inconsistency in current doctrine simply by reading *Stoneridge* differently, a further legislative fix is necessary. The cases are just too gerrymandered to operate fairly or effectively. So, in Part V, I suggest a revision of proportionate liability that is fair and workable in light of the analysis herein. With such a regime in place, concerns about excessive liability should diminish considerably, and with that, we can think in terms of expanding third-party liability beyond what the Court permits, including the restoration of aiding-and-abetting liability.

I. *STONERIDGE*: THE SCOPE OF THIRD-PARTY LIABILITY AND THE ROLE OF RELIANCE

In *Stoneridge*, plaintiffs alleged that two large vendors of cable television set-top boxes, Scientific-Atlanta and Motorola, had entered into deceptive transactions with a cable-system operator, Charter Communications, and backdated or falsified documents to disguise the

¹² See Private Securities Litigation Reform Act of 1995 (PSLRA) § 21D(f), 15 U.S.C. § 78u-4(f) (imposing a framework of joint, several, and proportionate liability on persons covered under the Act).

sham.¹³ Plaintiffs argued that by participating in Charter's scheme to inflate revenues with sham transactions, the vendors assumed responsibility for Charter's lies about its financial condition. This claim raised a host of interpretive questions, many of which the parties or the many amici addressed during briefing and argument. Had the two third-party defendants engaged in a deceptive device or contrivance of their own, rather than simply assisting Charter's? If so, was it in connection with the purchase or sale of a security? Did the plaintiffs adequately plead scienter, reliance, and loss causation? Of all these potential issues, the Court rested its holding solely on lack of reliance.¹⁴

In retrospect, this fixation on reliance seems to be a simple and predictable extension of the Court's 1994 holding in *Central Bank of Denver v. First Interstate Bank of Denver*, which radically narrowed the scope of third-party liability by excluding aiding-and-abetting liability as an acceptable claim under Rule 10b-5.¹⁵ The fact that *Stoneridge* reads that way is hardly surprising, given that Justice Kennedy wrote both opinions and worked hard to make them seamless. But any seeming inevitability is hindsight bias at work: in fact, the two cases pose distinct issues and could readily support very different outcomes.

In *Central Bank*, the Court rejected aiding-and-abetting liability for a number of reasons, textual as well as policy-based, including fear of excessive litigation.¹⁶ In dicta, the Court suggested, among other things, that aiding-and-abetting liability would allow defendants to be held "liable without any showing that the plaintiff relied upon the aider and abettor's statements or actions."¹⁷ Later, the Court repeated that a person who employs a manipulative device can be found primarily liable, "assuming *all* of the requirements for primary liability under Rule 10b-5 [including reliance] are met," but emphasized that it was leaving open the question of the scope of primary liability (i.e.,

¹³ *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148, 153-54 (2008). The plaintiffs also sued Charter and its accountants, but they settled that portion of the case, thereafter turning entirely to the two third-party defendants for the remaining damages.

¹⁴ See *id.* at 161 ("[W]e conclude respondents' deceptive acts . . . are too remote to satisfy the requirement of reliance.").

¹⁵ 511 U.S. 164, 191 (1994).

¹⁶ See, e.g., *id.* at 189 (noting the particular "vexatiousness" of Rule 10b-5 litigation).

¹⁷ *Id.* at 180. The Court seems to have been heavily influenced by an article by Daniel R. Fischel, *Secondary Liability Under Section 10(b) of the Securities Act of 1934*, 69 CAL. L. REV. 80 (1981). Fischel argued that Supreme Court jurisprudence limits *all* liability to what is permissible under the relevant statutory language, rather than under common law traditions. *Id.* at 82.

what kind of conduct exceeds mere aiding and abetting so as to fall within the scope of the prohibition).¹⁸

As commentators on *Central Bank* quickly pointed out, this emphasis on reliance was puzzling,¹⁹ and in the cases that followed, plaintiffs took the perfectly sensible position that so long as there was some causal link between the third party's acts or omissions and the misinformation on which investors relied, the reliance element would be satisfied. After all, the reliance requirement had long been seen as demanding just a "but for" causal relationship.²⁰ If this were the case, the crucial question would simply be when a third party bears responsibility for the public misstatement on which reliance is presumed. This inquiry goes entirely to the question of primary liability. Lower courts famously split on this question, with the first case from the Ninth Circuit taking a relatively liberal approach and holding that responsibility follows whenever the third-party defendant substantially participated in the making of the misstatement.²¹ But other courts—notably the Second Circuit—soon staked out a much stricter position, insisting that primary liability arises only where there is some sort of public attribution of responsibility to the third-party defendant for the misstatement.²² This latter view, which seemingly ruled out any liability for be-

¹⁸ *Central Bank*, 511 U.S. at 191.

¹⁹ See Donald C. Langevoort, *Words from on High About Rule 10b-5: Chiarella's History, Central Bank's Future*, 20 DEL. J. CORP. L. 865, 887 (1995) (criticizing *Central Bank's* departure from other cases that recognized aiding-and-abetting liability); see also Jill E. Fisch, *The Scope of Private Securities Litigation: In Search of Liability Standards for Secondary Defendants*, 99 COLUM. L. REV. 1293, 1294 (1999) (criticizing the Court's lack of guidance on what would merit the imposition of primary liability on secondary defendants); Robert A. Prentice, *Locating that "Indistinct" and "Virtually Nonexistent" Line Between Primary and Secondary Liability Under Section 10(b)*, 75 N.C. L. REV. 691, 710-11 (1997) (listing strong criticisms of *Central Bank's* reasoning).

²⁰ Some early decisions thus refer to reliance as transaction causation. See *Schlick v. Penn-Dixie Cement Corp.*, 507 F.2d 374, 380 (2d Cir. 1974) ("[T]o show transaction causation a plaintiff must demonstrate that he relied on the misrepresentation[.] . . .").

²¹ See *In re Software Toolworks Inc. Sec. Litig.*, 50 F.3d 615, 623-24 (9th Cir. 1994) (refusing to hold underwriters liable for misleading statements because they reasonably did not know the statements were untrue).

²² See, e.g., *Wright v. Ernst & Young LLP*, 152 F.3d 169, 175 (2d Cir. 1998) ("[A] secondary actor cannot incur primary liability under the Act for a statement not attributed to that actor at the time of its dissemination."); *Shapiro v. Cantor*, 123 F.3d 717, 720-21 (2d Cir. 1997) (holding that an accounting firm was not liable for failing to disclose material information when it was not under a duty to do so); see also *Ziembra v. Cascade Int'l, Inc.*, 256 F.3d 1194, 1205 (11th Cir. 2001) ("[T]he alleged misstatement or omission . . . must have been publicly attributable to the defendant at the time that the plaintiff's investment decision was made."). The law in the Second Circuit was muddled by a number of cases that suggested some softening, but not abandonment, of the attribution rule. See *In re Scholastic Corp. Sec. Litig.*, 252 F.3d 63, 75-76 (2d Cir.

hind-the-scenes actors, no matter how important their roles, was justified in large part by reference to the reliance dicta in *Central Bank*. That is, these courts could not see how there could ever be reliance on an unknown actor's private words or conduct. But this reference to reliance was simply justification; instead of addressing reliance as a separate element, courts were addressing the larger question of what constitutes deceptive conduct within the meaning of Rule 10b-5.

Because of the growing judicial conservatism on this particular question as more courts followed the Second Circuit's lead, plaintiffs quickly shifted their emphasis away from claims of misrepresentations for which third-party defendants were responsible under Rule 10b-5(b) to broader allegations that the third party's actions were part of a "scheme to defraud," for which they should bear coconspirator-like responsibility under Rules 10b-5(a) and (c).²³ With this strategy, plaintiffs had a notable (but temporary) district court victory in the massive Enron litigation,²⁴ and some favorable language (though not a favorable result) from the Ninth Circuit in *Simpson v. AOL Time Warner*

2001) (holding that a vice president could be liable for his company's misstatements, even when they were not attributable to him, because he was primarily responsible for the company's communications with investors and the drafting of misleading statements); *In re Parmalat Sec. Litig.*, 383 F. Supp. 2d 616, 622 (S.D.N.Y. 2005) (requiring that plaintiffs show what effect the allegedly fraudulent acts had on the market for the securities in question, without requiring plaintiffs to show specific reliance); *In re Global Crossing Ltd. Sec. Litig.*, 322 F. Supp. 2d 319, 333 (S.D.N.Y. 2004) (permitting claims against an auditor primarily responsible for false statements to survive a motion to dismiss after finding that "[a] strict requirement of public attribution would allow those primarily responsible for making false statements to avoid liability by remaining anonymous"). In a subsequent case on the subject, the Second Circuit was again fairly restrictive. In *Lattanzio v. Deloitte & Touche LLP*, 476 F.3d 147, 155 (2d Cir. 2007), the court reasoned that "[p]ublic understanding that an accountant is at work behind the scenes does not create an exception to the requirement that an actionable misstatement be made by the accountant." Underscoring its rigid attribution requirement, the court stated that "[u]nless the public's understanding is based on the accountant's articulated statement, the source for that understanding—whether it be a regulation, an accounting practice, or something else—does not matter." *Id.* (internal citation omitted). The Second Circuit's return to a strict insistence on attribution was made clear most recently in *Pacific Investment Management Co. LLC v. Mayer Brown*, No. 09-1619, 2010 WL 1659230 (2d Cir. Apr. 27, 2010), discussed *infra* in notes 135-36 and accompanying text.

²³ See Prentice, *supra* note 6, at 353 (discussing plaintiffs' shift toward the use of Rules 10b-5(a) and (c) after *Central Bank*).

²⁴ See *In re Enron Corp. Sec., Derivative & "ERISA" Litig.*, 529 F. Supp. 2d 644, 706-07 (S.D. Tex. 2006) (adopting a "scheme"-based approach that allows prosecution for aiding and abetting as a primary violation of section 10(b)).

*Inc.*²⁵ But there were major losses as well. The Fifth Circuit later overturned the district court ruling in the Enron litigation,²⁶ borrowing extensively from the reasoning of the Eighth Circuit in *In re Charter Communications, Inc.*—the *Stoneridge* case.²⁷

I am not inclined to linger over the Court's choice in *Stoneridge* to make reliance the determinative issue in assessing scheme liability, even though, like the dissenters, I find it strange. The standard fraud-on-the-market theory presumes that investors rely on price integrity, not directly on the misinformation itself.²⁸ The "but for" causal connection between defendants' acts and the price distortion was cogent and well pleaded. In essence, plaintiffs were arguing that the third-party defendants directly misled Charter's auditor, which in turn led the auditor to certify Charter's false financials and, thus, the resultant price distortion. Had the auditors not been fooled, plaintiffs said, it is unlikely that Charter's scheme would have succeeded.²⁹ This is a classic claim of indirect reliance, well known in both tort and securities law. By situating its restrictive approach in the element of reliance, the Court conveniently limited its holding to private securities litigation. This arguably leaves the SEC and criminal prosecutors free to make more aggressive claims against third parties.³⁰ The fact that this distinction was strongly urged by the Solicitor General in the government's amicus brief³¹—which the Court followed fairly faithfully in *Stoneridge*—is circumstantial evidence of a motivation to strike only at *private* securities litigation. If so, then the awkwardness of basing this

²⁵ See *Simpson v. AOL Time Warner Inc.*, 452 F.3d 1040, 1043 (9th Cir. 2006) ("[T]he scope of [section] 10(b) includes deceptive conduct in furtherance of a 'scheme to defraud.'").

²⁶ See *Regents of the Univ. of Cal. v. Credit Suisse First Boston (USA), Inc.*, 482 F.3d 372, 389-90 (5th Cir. 2007) (holding that the district court's interpretation of section 10(b) was too broad).

²⁷ See *In re Charter Commc'ns, Inc. Sec. Litig.*, 443 F.3d 987, 992 (8th Cir. 2006) (rejecting broad use of Rules 10b-5(a) and (c) and narrowing the definition of "deceptive"), *aff'd sub nom. Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148 (2008). The case was restyled as *Stoneridge* when the Supreme Court granted certiorari.

²⁸ See *Basic Inc. v. Levinson*, 485 U.S. 224, 241-42 (1988) (explaining that the fraud-on-the-market theory is premised on the idea that market prices adjust to reflect all available information, and thus fraudulent information distorts prices and affects all investors) (citing *Peil v. Speiser*, 806 F.2d 1154, 1160-61 (3d Cir. 1986)).

²⁹ See *Stoneridge*, 552 U.S. at 160 (explaining plaintiffs' arguments).

³⁰ *But see infra* note 143 and accompanying text (describing a post-*Stoneridge* case in which the alleged executive behavior was insufficient to find primary liability).

³¹ See Brief for the United States as Amicus Curiae Supporting Affirmance at 18, *Stoneridge*, 552 U.S. 148 (No. 06-0043) [hereinafter Brief for the United States] (distinguishing the requirements of private actions from criminal prosecutions).

distinction on reliance is relatively harmless: private plaintiffs are probably in no worse position than if the Court had ruled directly on the issue of what constitutes deceptive conduct, while public enforcers (and their investor beneficiaries) are arguably better off.

The Court did not explain its statement that the chain between defendants' acts and plaintiffs' reliance was "too remote,"³² except in making two related points. One, stressed repeatedly, is that Scientific-Atlanta and Motorola were dealing with Charter in "the realm of ordinary business operations" (i.e., that of purchase and supply contracts, advertising, etc.), as opposed to the realm of finance, which touches on the securities markets and hence is of special federal concern.³³ At first glance, this argument seems almost inane. Accounting and financial reports are nothing more than the quantitative expression of the results of business operations, ordinary and extraordinary. As the Court later acknowledges, what Scientific-Atlanta and Motorola allegedly did was proscribed by federal law as criminal and civil aiding and abetting. In fact, managers at both companies were penalized by the SEC for exactly the same kinds of dealings with Adelphia, another cable television issuer caught up in an even larger financial reporting scandal.³⁴ The federal interest here seems especially compelling because the third parties' deception seemed to be directed at Charter's auditors,³⁵ and independent auditors play a central, congressionally mandated role in the federal regime designed to promote corporate transparency and stock price integrity. Here, like an overzealous advocate getting carried away with his argument, Justice Kennedy seems

³² *Stoneridge*, 552 U.S. at 159.

³³ *Id.* at 161; *see also id.* at 166 (noting that Charter's relationship with defendants "took place in the marketplace for goods and services, not in the investment sphere").

³⁴ *See In re Motorola*, Exchange Act Release No. 55,725, [2007 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 87,908, at 84,809 (May 8, 2007) (instituting a cease-and-desist order against Motorola for participating in a "round-trip of cash" with Adelphia and helping Adelphia falsify its earnings); *In re Eidson*, Exchange Act Release No. 54,031, 88 SEC Docket 782 (June 22, 2006) (establishing a cease-and-desist order against Scientific-Atlanta's senior vice president of finance and operations for approving Adelphia's behavior); *In re Haislip*, Exchange Act Release No. 54,030, 88 SEC Docket 779 (June 22, 2006) (imposing a cease-and-desist order against Scientific-Atlanta's principal accounting officer for approving misreporting done by Adelphia).

³⁵ In their complaint, plaintiffs raised the possibility that the auditors were complicit in the fraud; in fact, Arthur Andersen settled early on. One possible interpretation of the facts is that Andersen wanted fabricated documentation simply so it could feign ignorance of the fraud and thereby escape an obligation to blow the whistle. Were this so, the case for primary liability would be much weaker. On appeal, however, all parties assumed that the deceptive conduct was intended to mislead Andersen.

too quick to seize on a federalism argument. But I think more sense can be made of the distinction, and so I will return to it shortly.

The Court's other justification, also puzzling at first glance, is that nothing the secondary defendants did "made it necessary or inevitable for Charter to record the transactions as it did."³⁶ This could be read to narrow the scope of third-party liability to almost nothing, because very few contributory acts ever make a fraud necessary or inevitable.³⁷ The Solicitor General's brief, from which this idea derives, was more nuanced, claiming in essence that the defendants' sham contracts and falsified documents merely set the stage for Charter to more easily dupe its accountants and, consequently, its investors, but that almost all of the active deception was by Charter.³⁸ In this light, the point is more consistent with, and not substantially different from, the Court's repeated emphasis on remoteness and attenuation.

For our purposes, it is crucial to note how open-ended and indeterminate the Court's remoteness standard is, which should not make it particularly restrictive for lower courts. As noted earlier, some courts had developed much stricter approaches to what constitutes deceptive conduct prior to *Stoneridge*—most notably the "bright-line" attribution test³⁹—that the Court could easily have endorsed in the context of the facts before it. Many amicus briefs supporting the defendants, representing nearly all portions of the business community and drafted by the elite of the Supreme Court bar, were not shy about offering stringent standards that would all but eliminate third-party liability.

That the Court did not follow these pleas is well worth pondering, and takes us to the crucial question: should we read *Stoneridge's* conclusion about attenuation simply as *a* reason the reliance claim failed, or is it *the* reason? If the latter, what does this imply about the scope of third-party liability under Rule 10b-5 more generally? The Court's tradition of holdings narrowly tailored to the facts before it favors the former reading. The Solicitor General's office had strongly urged restraint, telling the Court that it was unnecessary to reach any further questions, like the propriety of the attribution test, when third-party

³⁶ *Stoneridge*, 552 U.S. at 161.

³⁷ One example where this might be an apt characterization would be where a participant deceives not only the company's auditors but other senior managers as well, duping them into repeating the lie in the company's filings.

³⁸ See Brief for the United States, *supra* note 31, at 20-21 ("The critical point is that it was Charter's misrepresentation of its cash flow, not respondents' conduct, on which petitioner allegedly relied.").

³⁹ See *infra* Section IV.A (discussing the pre-*Stoneridge* attribution test).

liability is justified⁴⁰—an equivocation that quite possibly was the result of the office’s own private negotiations with the SEC, which had long pushed for a more expansive approach to primary liability in its own enforcement and amicus briefs.

On the other hand, since there were so many available tests, both for reliance as well as for other elements underlying scheme liability, it seems fair to assume that the Court chose deliberately to use remoteness and attenuation as the best way to think about reliance. At one point, the Court posed the inquiry specifically in terms of whether the third party’s acts “were immediate or remote to the injury,”⁴¹ suggesting that it was putting forth a test. So, without suggesting that it is the only plausible reading of the Court’s opinion, I want to make the following assumption and then see what follows from its natural implication: that there may be a significant category of cases where third-party involvement is *not* too remote or attenuated from plaintiff’s reliance. If so, thinking about what kinds of third-party involvement might be immediate rather than remote is necessary, which in turn requires thinking about what differentiating between the two accomplishes. As discussed more fully below, I posit that the Court’s test is a way of limiting third-party liability to those cases in which the defendant fairly deserves the extraordinary form of liability that fraud-on-the-market lawsuits threaten. The more remote from the fraud the defendant’s conduct is, the less likely it is that this potential liability is either fair or efficient; the more immediate it becomes, the more likely that primary liability would be the defendant’s just deserts. The judge can decide this as a matter of law, thereby dismissing defendants early on when appropriate. The Court offers a sliding-scale test aimed at creating rough proportionality between the conduct and the extraordinary risk of liability these lawsuits generate.

Later, I shall explore how such a reading of *Stoneridge* applies to particular factual circumstances that have arisen in recent cases. But first, an important definitional point: it is tempting to see the Court’s actions as substituting proximate cause for but-for causation in the reliance inquiry. However, the standard approach to proximate cause is famously one of foreseeability. The plaintiffs were probably right to argue to the Court that Scientific-Atlanta and Motorola were aware (or at least that a reasonable person in their position would have been

⁴⁰ See Brief for the United States, *supra* note 31, at 22 n.12 (“[M]isstatements made by a secondary actor must be *publicly attributed* to the secondary actor before liability can attach in a private action.”).

⁴¹ *Stoneridge*, 552 U.S. at 160.

aware) that Charter was going to use the sham contracts and falsified documents to produce false accounting results, thereby satisfying a foreseeability standard. The Court responded to this by explicitly rejecting such a standard, stating that “[w]ere this concept of reliance to be adopted, the implied cause of action would reach the whole marketplace in which the issuing company does business; and there is no authority for this rule.”⁴² This refers back to the world-of-commerce/world-of-finance distinction.

If proximate cause does not aptly describe the kind of analysis at work, what does? Two possibilities come closer. One is standing, which addresses whether the victim’s claimed injury would justify a claim against the defendant in question.⁴³ A better way of describing the analysis, however, is in terms of duty. The Court appears to be saying that only certain kinds of actors and conduct ought to be subjected to the extraordinary risk of a fraud-on-the-market lawsuit—i.e., that the enforceable duty of candor owed specifically to all investors in the capital marketplace should be limited and should not attach to “the whole marketplace in which the issuing company does business” unless the actors can fairly be said to owe a cognizable duty to the marketplace.⁴⁴ Here, the Court’s otherwise incoherent articulation of a difference between the realms of business and finance makes more sense: maybe the duty should largely be limited to those who inhabit the realm of finance and hence are on notice of the extraordinary legal risks and responsibilities that the federal securities laws create. The sliding scale of attenuation and remoteness might capture this fairly well. Part III will explain this notion more fully.

However, we first need to examine and clarify more carefully the supposed need for proportionality. In tort-reform debates, claims of disproportionate liability and limited duty can easily mask probusiness protectionism. If the recovery in fraud-on-the-market cases is nothing more than the sum of all the victims’ real damages, we should be more worried about making the injured investors whole than protecting the pocketbooks of third-party actors who engaged in deceptive,

⁴² *Id.* at 160.

⁴³ I am grateful to Gerry Spann for suggesting standing as a possibility. Another possibility is the “in connection with” requirement, *see infra* Section III.A, but this would apply to SEC actions as well.

⁴⁴ *Stoneridge*, 552 U.S. at 160.

illegal misconduct.⁴⁵ Proximate cause and duty are workhorses in tort law, but mostly in the law of negligence. Rule 10b-5 requires a showing of intent and, hence, culpability. The next Part will show why disproportionality is a troublesome problem in private securities litigation that warrants a measured response.

II. THE PROPORTIONALITY PROBLEM

A. Remedial Overbreadth

The standard measure of damages in securities class actions under Rule 10b-5 is the modified out-of-pocket measure.⁴⁶ In essence, this awards to each person who traded during the class period the difference between the transaction price and the hypothetical fair value of the security at the time of the transaction. This measure is meant to be purely compensatory—punitive damages have no place under the Securities Exchange Act.⁴⁷ When there are multiple defendants, the starting point for calculating damages is that each defendant found guilty of fraud is jointly and severally liable for all the losses her deception proximately caused.⁴⁸ We should note, however, that one of the plaintiffs' bar's aims in pursuing scheme liability was to hold each participant in the scheme responsible for all investor damages flowing from the overall fraud, whether or not directly connected to the participant's own deceptions.⁴⁹ If *Stoneridge* had applied such an approach, Motorola and Scientific-Atlanta would have been liable for damages far beyond the effects of their own transactions, which were only a piece of Charter's fraud.

⁴⁵ See James D. Cox, *Just Deserts for Accountants and Attorneys After Bank of Denver*, 38 ARIZ. L. REV. 519, 520 (1996) (examining the current "scope of liability for collateral participants" under section 10(b)).

⁴⁶ See JAMES D. COX, ROBERT W. HILLMAN & DONALD C. LANGEVOORT, *SECURITIES REGULATION: CASES AND MATERIALS* 717 (6th ed. 2009) (stating that, although courts are amenable to using any appropriate measure of damages, the common standard in Rule 10b-5 cases is the tort-based out-of-pocket measure).

⁴⁷ See Securities Exchange Act of 1934 § 28(a), 15 U.S.C. § 78bb(a) (2006) (limiting recovery to "actual damages").

⁴⁸ See Securities Exchange Act of 1934 § 21D(f), 15 U.S.C. § 78u-4(f), which is discussed *infra* in notes 80-82 and accompanying text.

⁴⁹ See *In re Enron Corp. Sec., Derivative, & "ERISA" Litig.*, 529 F. Supp. 2d 644, 722-23 (S.D. Tex. 2006) (determining that a plaintiff can pursue a claim for joint and several liability against defendants who are "primary violators in the scheme, as a whole"). This is not a necessary conclusion, however, and a court could reasonably hold that third-party defendants are responsible only for damages flowing directly from their own deceptions (e.g., by reference to doctrines of loss causation).

The aggregate of such per-trade recoveries can be staggeringly large, usually far in excess of any benefit the defendants hoped to gain from the misrepresentations or concealment. Multibillion-dollar cases are not infrequent, and hundred-million-dollar cases are ordinary. That is not, by itself, problematic if those recoveries closely approximate actual investor injuries. However, my sense is that they do not, and that the prevailing approach overcompensates fairly significantly, albeit for understandable reasons.

The first reason is doctrinal and connects *Stoneridge* back to *Basic Inc. v. Levinson*,⁵⁰ the Court's seminal decision on reliance in open-market fraud litigation. *Basic* insists that reliance is a crucial element of the plaintiff's cause of action, but it creates a presumption of reliance in most cases involving widely traded securities, thereby facilitating class certification.⁵¹ While *Basic* describes this as a rebuttable presumption, it is well recognized that defendants have no practical ability to rebut on an investor-by-investor basis—and make no effort to do so—once the court has determined that the alleged fraud did, in fact, distort the stock price.⁵² That brings us to what we mean by reliance, and here, *Basic* is confusing. If the presumption of reliance is based on the assumption that investors relied by assuming that the prevailing market price was *accurate* (and thus simply free rode on it), large numbers of investors with actively managed portfolios would not qualify and do not deserve compensation. The failure to exclude these from the recovery class implies substantial overcompensation.

⁵⁰ 485 U.S. 224 (1988).

⁵¹ For elaboration on the points made here, see Donald C. Langevoort, *Basic at Twenty: Rethinking Fraud on the Market*, 2009 WIS. L. REV. 151, 158-62 [hereinafter Langevoort, *Basic at Twenty*], which justifies *Basic's* presumption of reliance as an assertion by the Court that investors have a right to rely on stock-price integrity. See also Donald C. Langevoort, *Theories, Assumptions, and Securities Regulation: Market Efficiency Revisited*, 140 U. PA. L. REV. 851, 892-93 (1992) [hereinafter Langevoort, *Theories*] (describing the “practical consequences and . . . conceptual underpinnings of the fraud-on-the-market theory” as applied in *Basic*).

⁵² *Basic* allows rebuttal if the defendants can show that the decision to buy or sell was disconnected from the allegedly fraudulent market price. See 485 U.S. at 248-49 (“Any showing that severs the link between the alleged misrepresentation and either the price received (or paid) by the plaintiff, or his decision to trade at a fair market price, will be sufficient to rebut the presumption of reliance.”). For example, indexed mutual funds and pension funds commonly participate in recoveries even though they purchase and sell automatically, without regard to price, following an algorithm designed simply to keep the portfolio in balance with the index. Nevertheless, it is easy for investors to claim that they relied in some way or another, and an evidentiary hearing for thousands of investors would be extraordinarily costly and probably fruitless.

If the presumption is instead based on the assumption that investors simply considered the prevailing market price to be *honest* (i.e., not the product of fraud), the problem of overbreadth within the class diminishes. But this comes only by abandoning reliance as a meaningful element. Fraud distorts prices with some frequency, and no reasonable investor would ever assume otherwise by relying blindly on price integrity. Efficient markets price the risk of asymmetric information; they do not assume its absence. To the extent that we continue to insist on reliance—an insistence that *Stoneridge* repeats⁵³—overcompensation comes from allowing recovery as a result of the practical impediments that effectively make the presumption conclusive by those who simply would not be able to demonstrate justifiable reliance on the fraud if put to the task.

There is a way out, which Justice Brennan unsuccessfully tried to urge on Justice Blackmun in private correspondence while the latter was writing the *Basic* opinion:⁵⁴ abandon the insistence on reliance altogether (i.e., make the presumption conclusive) and substitute a causation inquiry to find injury, asking simply whether the investor purchased or sold at a distorted price. This would effectively create an entitlement to reliance on price integrity, conferred as a matter of juristic grace. This is not an unreasonable position as a policy matter,⁵⁵ and it is probably the only plausible explanation for how current law actually operates, notwithstanding the Court's repeated insistence otherwise. But note that this move jettisons reliance as it is conventionally understood in the law of fraud, which means that we can no longer say that the damages imposed in fraud-on-the-market cases simply compensate for detrimental reliance.⁵⁶ For many class mem-

⁵³ See 552 U.S. 148, 159 (2008) ("Reliance by the plaintiff upon the defendant's deceptive acts is an essential element of the [section] 10(b) private cause of action.").

⁵⁴ See Langevoort, *Basic at Twenty*, *supra* note 51, at 153 n.9 (describing attempts by Justices Brennan and Blackmun to satisfy their concerns without losing others' votes). Justice Brennan ultimately gave up this effort after noting that their disagreement was probably trivial precisely because defendants had no practical ability to rebut. See *id.* at 162 nn.45 & 47. Adam Pritchard uncovered this correspondence. See Pritchard, *supra* note 5, at 221 n.16 (citing correspondence between the Justices).

⁵⁵ See, e.g., Zohar Goshen & Gideon Parchomovsky, *The Essential Role of Securities Regulation*, 55 DUKE L.J. 711, 766-81 (2006) (arguing for the viability of the fraud-on-the-market presumption). Early law and economics commentary explicitly rejected a role for reliance in fraud-on-the-market cases. See, e.g., Daniel R. Fischel, *Use of Modern Finance Theory in Securities Fraud Cases Involving Actively Traded Securities*, 38 BUS. LAW. 1, 11 (1983) ("The concept of a presumption of reliance . . . is best abandoned.").

⁵⁶ For a thoughtful discussion of what makes reliance an essential element in fraud cases, see John C.P. Goldberg, Anthony J. Sebok & Benjamin C. Zipursky, *The Place of Reliance in Fraud*, 48 ARIZ. L. REV. 1001 (2006). The authors discuss the fraud-on-the-

bers, what is described as injury is merely the deprivation of a judicially created entitlement. Given the de facto substitution of causation for reliance, it is perfectly fair for courts to ask whether liability is proportionate to the nature of the wrong.

A second reason to worry about disproportion has to do with proving injury. Arriving at the aggregate damage amount is an extremely complicated econometric task, on which plaintiffs' and defendants' expert witnesses inevitably disagree. The potential for erroneous computation by a judge or jury is thus considerable, though it is not clear that the mere potential for error necessarily threatens defendants more than plaintiffs. But there is a steadily growing belief among financial economists that markets can both over- and underreact to news (as well as respond to pseudonews),⁵⁷ so that faith in the precision of the measurement process weakens. Congress was concerned enough about this that it addressed the issue in the PSLRA in 1995, but not in a very sophisticated way.⁵⁸ To the extent that the econometric tools have less power than we would like in a noisy marketplace, the risk of biased measurement of damages goes up. True, there can be both under- and overreaction. But because plaintiffs choose which lawsuits to bring based on the amount of damages that might be recoverable, the sample brought to court will naturally favor those where there may have been an overreaction.

A third—and perhaps the most familiar—reason for concern, initially explored in depth by Frank Easterbook and Daniel Fischel, is that

market theory and argue that *Basic* preserves the special role for a reliance requirement because of the rebuttability of the presumption. *Id.* at 1018-19. I suggest that the norm is instead de facto irrebuttability—and hence simple causation—which changes the analysis substantially.

⁵⁷ See, e.g., Alon Brav & J.B. Heaton, *Market Indeterminacy*, 28 J. CORP. L. 517, 533-35 (2003) (arguing that although analysts assume that “smart” investors know how to adjust incorrect pricing when they see it, there is no evidence to explain how investors identify incorrect prices); Frederick C. Dunbar & Dana Heller, *Fraud on the Market Meets Behavioral Finance*, 31 DEL. J. CORP. L. 455, 509-10 (2006) (describing the phenomenon of market overreaction to non-news); Larry E. Ribstein, *Fraud on a Noisy Market*, 10 LEWIS & CLARK L. REV. 137, 139-41 (2006) (analyzing the layered effects of misinformation and heuristic errors on investor behavior); see also Langevoort, *Theories*, *supra* note 51, at 872 (juxtaposing regulators' view of the efficient market with that of investors “overreacting to the most recent or most vivid news”).

⁵⁸ See, e.g., Nathaniel Carden, Comment, *Implications of the Private Securities Litigation Reform Act of 1995 for Judicial Presumptions of Market Efficiency*, 65 U. CHI. L. REV. 879, 894-95 (1998) (describing PSLRA's limit of damages in fraud-on-the-market cases as a means of controlling descriptive efficiency); see also Robert B. Thompson, “Simplicity and Certainty” in the Measure of Recovery Under Rule 10b-5, 51 BUS. LAW. 1177, 1200 (1996) (“[The PSLRA's damages cap] adds confusion when its drafters sought certainty. It adds complexity when they sought simplicity.”).

fraud produces a mix of losses and gains for investors: for every unfortunate buyer there is a lucky seller, and vice versa.⁵⁹ So the *net* harm to investors as a class approaches zero, with the difference being those trades by insiders complicit in the fraud. This difference is usually just a small portion of the aggregate trading. Although compensating for losses while ignoring all gains might not seem particularly troubling in any single case (except with respect to particular plaintiffs who traded actively during the class period and gained more than they lost),⁶⁰ over time the combination of fortuitous trading gains and compensated losses will put many investors in a better position than they would be in a world with no fraud at all. This suggests systematic overcompensation for many institutional and other active plaintiff-investors—at least, over a lifetime of trading.⁶¹ And institutional plaintiffs are the primary beneficiaries of the contemporary class-action system.⁶²

⁵⁹ See Frank H. Easterbrook & Daniel R. Fischel, *Optimal Damages in Securities Cases*, 52 U. CHI. L. REV. 611, 638-39 (1985) (pointing out that when public corporations issue new, falsely priced stock, prior investors sell at a profit while buyers ultimately lose). An important addition to the net-market-effect literature is Paul G. Mahoney, *Precaution Costs and the Law of Fraud in Impersonal Markets*, 78 VA. L. REV. 623 (1992). Mahoney notes that Easterbrook and Fischel fail to address the issue of social cost: if issuers are forced to pay damages that fall below their net gains, there will be deterrence from the fraudulent activity. *Id.* at 629-30.

⁶⁰ For a discussion of cases dealing with this particular issue, see Samuel Francis, Note, *Meet Two-Face: The Dualistic Rule 10b-5 and the Quandary of Offsetting Losses by Gains*, 77 FORDHAM L. REV. 3045 (2009). Francis analyzes the various issues that have arisen before courts when members of the class purchase and sell multiple times throughout the relevant period, and when some class members benefit while others lose. *Id.* at 3061-64.

⁶¹ See ANJAN THAKOR WITH JEFFREY S. NIELSEN & DAVID A. GULLEY, THE ECONOMIC REALITY OF SECURITIES CLASS ACTIONS LITIGATION 14 (2005) (establishing that as many as forty percent of large institutional investors included in the analysis were overcompensated in securities class actions). This overcompensation is the starting point for analyzing a separate problem: the so-called “circularity” in fraud-on-the-market cases. Circularity arises because either the issuer itself or its director-and-officer insurer fund most settlements and judgments, both of which operate as charges, not directly to the corporate actors who engineered the fraud but rather to the issuer and (thus) its shareholders. The result is that compensation has a pocket-shifting character—i.e., it operates as a form of investor insurance—with high transaction costs. There is controversy in the literature about whether this is truly problematic or not. See Alicia Davis Evans, *The Investor Compensation Fund*, 33 J. CORP. L. 223, 283 (2007) (proposing a compensation fund that would achieve “the promise of superior deterrence because its fraud risk-rating mechanism, unlike securities litigation, subjects all corporations to sanction”); Thomas A. Dubbs, *A Scotch Verdict on “Circularity” and Other Issues*, 2009 WIS. L. REV. 455, 457-58 (criticizing believers of the circularity hypothesis, who argue for denying many investors recovery, as engaging in “academic activism” that contradicts congressional intent); cf. Jill E. Fisch, *Confronting the Circularity Problem in Private Securities Litigation*, 2009 WIS. L. REV. 333, 335-36 (contending that compensation is not problematic because it helps enforce mandatory disclosure obligations). By and large,

A fourth and final reason for concern deserves more attention than it has received. Recall that the computation of aggregate damages proceeds by measuring the difference for each trade by reference to the transaction price (which is known) and a hypothetical “fair” price.⁶³ The near universal assumption in the case law is that the fair price is the price at which the securities would have traded had the truth about the issuer been told.⁶⁴ But for many reasons, some of which are discussed more fully below, that may not be the right counterfactual.⁶⁵ If the more likely alternative to a defendant’s misrepresentation would have been to say nothing at all, or to engage in lawful “puffery” rather than tell the truth,⁶⁶ then damages based on the standard assumption overcompensate. For instance, take a case in which, immediately after a misrepresentation, the price per share is \$21 and the plaintiff buys at that

critics of the circularity argument quite correctly point out that many investors will be net losers, even over a lifetime, and thus deserve compensation. But that criticism would not counter the systemic overcompensation argument if the result of the system is that money is paid without regard to whether a person is actually overcompensated—i.e., to undeserving as well as deserving class members.

⁶² See James D. Cox & Randall S. Thomas, *Letting Billions Slip Through Your Fingers: Empirical Evidence and Legal Implications of the Failure of Financial Institutions to Participate in Securities Class Action Settlements*, 58 STAN. L. REV. 411, 412 (2005) (“In 2004, securities fraud class action settlements produced \$5.45 billion in cash to be distributed to defrauded investors. Institutional investors own the lion’s share of the publicly traded equity securities in this country and therefore were entitled to collect most of that money . . .”). The implication of the critique of compensation in securities class actions is not to abandon these actions but rather to focus more clearly on deterrence as the proper way of structuring a remedy. See, e.g., Donald C. Langevoort, *Capping Damages for Open-Market Securities Fraud*, 38 ARIZ. L. REV. 639, 642-43 (1996) (arguing that the current pocket-shifting scheme of compensation should be replaced by an optimal-deterrence-oriented litigation framework); Rose, *supra* note 10, at 1352 (arguing for an oversight approach to eliminate current problems with the compensatory scheme).

⁶³ See *supra* note 46 and accompanying text.

⁶⁴ See, e.g., *Flamm v. Eberstadt*, 814 F.2d 1169, 1179 (7th Cir. 1987) (noting that damages are usually based on what the stock would have been worth “had all the information been disclosed” (citation omitted)); *In re Royal Dutch/Shell Transport Sec. Litig.*, 404 F. Supp. 2d 605, 610 (D.N.J. 2005) (observing that the “true value” of the shares would be based on the value after the fraud has been disclosed to the public).

⁶⁵ See Donald C. Langevoort, *Compared to What? Econometric Evidence and the Counterfactual Difficulty*, 35 J. CORP. L. 183, 185 (2009) (“[W]e simply cannot say that the counterfactual to an alleged misrepresentation is necessarily the revelation of the truth. If there was no duty to disclose and silence was a realistic option, then that actually may be the more likely counterfactual ‘no fraud’ state of the world.”). For a discussion of the counterfactual problem generally, see Frederick C. Dunbar & Arun Sen, *Counterfactual Keys to Causation and Damages in Shareholder Class-Action Lawsuits*, 2009 WIS. L. REV. 199.

⁶⁶ See COX, HILLMAN & LANGEVOORT, *supra* note 46, at 606-09 (critiquing the proposition expressed in *Eisenstadt v. Centel Corp.*, 113 F.3d 738 (7th Cir. 1997), which stated that that vague but positive statements by an issuer are not material to investor behavior).

price. Assume that, had the truth been told, the price would have been \$15, as it is later once the truth is revealed. That suggests a compensable loss of \$6, which is what nearly all courts would award. But now further assume that the defendant had no duty to speak at all,⁶⁷ and could have chosen to say nothing or to speak in optimistic terms too vague to be actionable. Had the defendant taken this course, the price would probably still have been at (or close to) \$21 and the plaintiff would have a right to little or no compensation. If the latter is the more likely counterfactual—i.e., the plaintiff would have suffered almost exactly the same investment loss in the absence of a violation as it did in the presence of the one that occurred—then awarding \$6 per share is significant overcompensation. While choosing the more likely counterfactual between truth telling and lawful concealment is often difficult, simply presuming that the truth would always have been revealed—and mechanically calculating damages based on that presumption—introduces another overcompensatory bias into the law.

The point of the foregoing analysis is not to criticize those courts that have created a nearly irrebutable presumption of reliance, assumed market efficiency, ignored fraud-based gains, or used truth telling as the standard counterfactual. There are good pragmatic reasons for each of those choices. The crucial point, instead, is that as a cumulative result of these and other doctrinal moves, the fraud-on-the-market theory becomes an extraordinary remedy that does far more than just make fraud victims whole. Once we see the remedy as extraordinary, there is ample justification for the courts that created this remedy to worry about whether particular defendants really deserve to face it.

B. *Culpability and Securities Fraud*

Securities fraud can be—and often is—venal and corrupt, even sociopathic. In this Section, however, I want to show that there is also a significant portion of securities fraud to which we might attach much less (perhaps even no) blameworthiness. It is this portion that, when measured against the extraordinary liability regime just discussed, amplifies the concern about disproportion.

⁶⁷ The duty to speak is a fairly circumscribed category, at least beyond those disclosures mandated by the SEC. *See id.* at 685-96 (showing that mere possession of information does not create a duty to disclose, but prohibits the use of “half-truths” when one affirmatively speaks, and noting that some courts uphold a duty to update, while all courts uphold a duty to correct when misinformation is discovered).

Soon after Rule 10b-5 doctrine abandoned the privity requirement in the late 1960s,⁶⁸ thereby creating risks of vast liability from false disclosure and publicity, courts seemed to realize that more restraint in the Rule's application was needed. One of the first moves in this direction—resolving a decade of confusion in the lower courts—was the Supreme Court's holding that liability under Rule 10b-5 required a showing of scienter,⁶⁹ which means that only intentional or subjectively reckless conduct is proscribed. At first glance, this would seem to eliminate much of the reason for doubt. Because Rule 10b-5 reaches only intentional fraud, rational actors have the ability to refrain from activity that would cause harm.⁷⁰ This brings us back to the point, noted earlier, that tort law tends to apply more restrictive rules of reliance and causation for negligence, but not with respect to intentional harms.⁷¹

In two respects, however, this confidence is misplaced. The first—a lively subject in the scholarly literature in the early 1990s—is that some forms of misrepresentation and omission involve mildly tragic choices where the speaker realizes that telling the truth will severely harm some legitimate interest (e.g., the company and its shareholders), while lying will harm a certain class of traders. The common example is the desire to protect a trade secret or a promising merger negotiation.⁷² To be sure, a reasonable response is to choose the less harmful course but be prepared to compensate the traders if lying is the utilitarian choice. But this gives all the more reason to make sure that the compensatory amount is limited to what is absolutely necessary. As the previous Section shows, there are grounds for concern about that.⁷³ For instance, is it necessarily desirable to compensate a trader who would not be able to show actual reliance on the fraud (but who gains the presumption of reliance after *Basic*) in the case of a misrepresentation or omission that can be justified on utilitarian grounds?

⁶⁸ See *infra* text accompanying notes 88-93.

⁶⁹ See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 212-14 (1976) (holding that scienter is a required element of Rule 10b-5 because of the language of section 10(b) and the legislative history behind the Rule's adoption).

⁷⁰ Easterbrook and Fischel discuss this point in their explanation of legal rules that could achieve proper deterrence. See Easterbrook & Fischel, *supra* note 59, at 621-23.

⁷¹ See *supra* text accompanying note 45.

⁷² See, e.g., Ian Ayres, *Back to Basics: Regulating How Corporations Speak to the Market*, 77 VA. L. REV. 945, 949 (1991) (acknowledging that it is sometimes in the shareholders' best interest for "managers to lie to the market"); Jonathan R. Macey & Geoffrey P. Miller, *Good Finance, Bad Economics: An Analysis of the Fraud-on-the-Market Theory*, 42 STAN. L. REV. 1059, 1091 (1990) (arguing that "strategic misrepresentations" should be permitted when made "in furtherance of [a] fiduciary duty to shareholders").

⁷³ See *supra* Section II.A (discussing proportionality problems in Rule 10b-5 liability).

Intentionality is a much more significantly incomplete response with regards to vicarious liability. Especially in the area of third-party liability, almost all claims of responsibility are directed at entities, not individuals: law firms, investment banks, accounting firms, and so on.⁷⁴ The doctrine of corporate scienter, although admittedly fuzzy around the margins, attributes intent or recklessness fairly readily from agent to principal.⁷⁵ As a result, corporate entities, and therefore their shareholders, bear most of the securities-fraud liability, not the individual agents who committed the wrongful acts. In some cases, there may not be any specific agent who acted wrongfully but simply collective “wrongdoing” based on the conduct and knowledge of multiple agents.

In such cases, blameworthiness is muted, and often nonexistent.⁷⁶ Of course, there may be an economics-based argument for vicarious liability to force the internalization of costs and induce optimal precautions, though as Paul Mahoney, Jennifer Arlen, and William Carney showed in two seminal scholarly works appearing at roughly the same time, this argument is complicated and far from compelling.⁷⁷ This issue does not need to be addressed, although the disappearance of blameworthiness from vicarious liability (except in situations where there is an inexcusable monitoring failure at the entity level) should be noted. Thus, the argument can be made, but it is not easy.

There may be other reasons to worry about disproportion—particularly based on the risk of judging in hindsight⁷⁸—but further

⁷⁴ See, e.g., *supra* note 13 and accompanying text (explaining the claims in *Stoneridge*).

⁷⁵ See *Makor Issues & Rights, Ltd. v. Tellabs Inc.*, 513 F.3d 702, 708 (7th Cir. 2008) (“[T]he doctrines of respondeat superior and apparent authority remain applicable to suits for securities fraud.”); *Southland Sec. Corp. v. INSpire Ins. Solutions Inc.*, 365 F.3d 353, 366-67 (5th Cir. 2004) (explaining that a corporation’s scienter can be inferred from the scienter of its agents).

⁷⁶ *But see* Lawrence E. Mitchell, *The “Innocent Shareholder”: An Essay on Compensation and Deterrence in Securities Class-Action Lawsuits*, 2009 WIS. L. REV. 243, 294-95 (concluding that shareholders, particularly long-term, nontrading investors, should take responsibility to be better informed and more active in management oversight). For a discussion of the connection between vicarious liability and scienter in organizational settings, see Donald C. Langevoort, *Organized Illusions: A Behavioral Theory of Why Corporations Mislead Stock Market Investors (and Cause Other Social Harms)*, 146 U. PA. L. REV. 101, 126-30 (1997).

⁷⁷ See Jennifer H. Arlen & William J. Carney, *Vicarious Liability for Fraud on Securities Markets: Theory and Evidence*, 1992 U. ILL. L. REV. 691, 693 (introducing the notion that corporate-liability theories may be incomplete because some agency costs are conventionally ignored); Mahoney, *supra* note 59, at 624-25 (hypothesizing that abandoning fraud-on-the-market theory in favor of requiring “individualized proof of reliance” would produce optimal deterrence).

⁷⁸ See Mitu Gulati, Jeffrey J. Rachlinski & Donald C. Langevoort, *Fraud by Hindsight*, 98 NW. U. L. REV. 773, 773-74 (2004) (discussing hindsight bias in fraud litigation, where past mistakes could later be misinterpreted as intentional fraud). This is espe-

discussion would take us too far afield. If we were sure that the fraud-on-the-market remedy is simply (and efficiently) compensatory, this might not matter much; risk of error is endemic to all litigation. However, if the previous Section is correct, greater caution in assigning liability is warranted.

C. Section 21D(f)

Thus far, we have largely ignored a crucially important aspect of the problem. Disproportion was a driving force behind the PSLRA, and that legislation is a comprehensive response to it, as well as other fears of litigation abuse. Specifically, Congress added section 21D(f) to direct courts to implement a proportionate liability regime.⁷⁹ One would think, then, that concerns about disproportionality should disappear as a result.

Unfortunately, 21D(f) is a mess of a statutory text. It directs the factfinder to determine the percentage of liability that any given defendant deserves measured against the aggregate fault of all persons claimed to have “caused or contributed to the loss”⁸⁰—whether these persons are named as defendants or not, and perhaps without regard to whether they could be held liable at all. Completely undefined is how the factfinder should construct the denominator: precisely who might have caused or contributed? However, the allocation process is not plaintiff-friendly,⁸¹ so this interpretive problem is not part of my analysis.

What takes away much of the protection is the total exclusion from proportionate liability for those who “knowingly” violated the law, defined with respect to Rule 10b-5 as acting with actual knowledge of the falsity of a representation or omission when persons are

cially true with respect to materiality; because lawsuits are only brought after high-magnitude events (usually adverse ones), there is a risk of overestimating the probability of occurrence that is hard to eliminate.

⁷⁹ For a discussion of the legislative history and many of the interpretive problems of the PSLRA, see generally Donald C. Langevoort, *The Reform of Joint and Several Liability Under the Private Securities Litigation Reform Act of 1995: Proportionate Liability, Contribution Rights and Settlement Effects*, 51 BUS. LAW. 1157 (1996). Section 21D(f) has received little judicial attention, presumably because most viable cases are settled prior to a jury decision on liability. *But see In re Enron Corp. Sec., Derivative & “ERISA” Litig.*, 236 F.R.D. 313, 317 (S.D. Tex. 2006) (noting the court’s inability “to find any opinion by a court that has actually tried a case utilizing the [section 21D liability] provisions,” and setting out a plan for its application).

⁸⁰ See PSLRA § 21D(f)(3), 15 U.S.C. § 78u-4(f)(3) (2006).

⁸¹ See Langevoort, *supra* note 79, at 1166-68 (explaining the ways in which courts allocate damages among responsible parties).

likely to reasonably rely on it.⁸² The apparent intent of the legislation was to distinguish between knowledge and recklessness, with only the latter form of scienter warranting protection.

As previously noted,⁸³ this treatment leaves much conduct that we would regard as relatively low- or no-culpability behavior unprotected, especially with respect to vicarious liability. Though the question was not posed in *Stoneridge* because the case was still at the pleadings stage, Scientific-Atlanta and Motorola might well not have been protected because their agents allegedly knew that they were facilitating a fraud and that knowledge could then be attributed to the entity defendants under agency-law principles.⁸⁴

III. TOWARD A NEW CONCEPTION OF DUTY “WITHIN” RELIANCE

As set forth earlier,⁸⁵ the reading that I am giving *Stoneridge* is best described in terms of duty: Scientific-Atlanta and Motorola did not owe a duty of candor to marketplace buyers of Charter’s stock that is enforceable under Rule 10b-5 because their involvement was too remote or attenuated from those purchases for there to be protectable reliance.⁸⁶ To be sure, this form of duty analysis is jarring. In contemporary Rule 10b-5 jurisprudence, duty plays a relatively circumscribed role, limited primarily to addressing when someone commits fraud through silence or inaction—i.e., the affirmative duty to disclose. Prevailing authority provides that persons automatically assume

⁸² PSLRA § 21D(f)(10)(A), 15 U.S.C. § 78u-4(f)(10)(A).

⁸³ See *supra* Section II.A.

⁸⁴ The sales and marketing personnel apparently made the mid-level decision to aid Charter by engaging in the sham transactions: there was no solid evidence that senior executive officers at either Scientific-Atlanta or Motorola had approved the scheme. See Brian A. Ochs, *Has the Securities and Exchange Commission Expanded Corporate Liability?*, 38 SEC. REG. & L. REP. 1549, 1557 (2006) (noting that the SEC did not allege that Scientific-Atlanta’s executives reviewed the transaction documents). Undoubtedly, the motivation was to keep in place a profitable commercial relationship (Charter could have threatened the loss of business if one supplier failed to play along while the other did). All this easily supports attribution of knowledge as a matter of law to the defendant entities. The best evidence of this comes from the SEC’s enforcement action involving Scientific-Atlanta, which focused not on its assistance of Charter but rather its similar sham transactions with Adelphia Communications. The SEC brought (and settled) an action against Scientific-Atlanta’s chief financial officer, but without claiming that he had knowledge. See *In re Haislip*, Exchange Act Release No. 54,030, 88 SEC Docket 779, at 782 (June 22, 2006) (finding that Haislip was a “cause” of Adelphia’s violations); see also Ochs, *supra*, at 1556-57 (discussing the SEC’s action against Scientific-Atlanta).

⁸⁵ See *supra* text accompanying notes 43-44.

⁸⁶ See *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148, 159 (2008) (holding that the indirect chain of reliance is “too remote for liability”).

an enforceable duty to speak truthfully whenever they either choose or are required by law to speak through a medium that is likely to influence investment decisions.⁸⁷ Under my reading, however, duty takes on a completely different role. In this Part, I will explore in some detail the doctrinal move that this interpretation implies.

A. *The Road Not Taken: The “In Connection With” Requirement*

Concern about disproportion in Rule 10b-5 class actions arose as soon as courts abandoned privity as a requirement for liability.⁸⁸ Until then, private securities fraud litigation had arisen mainly in face-to-face dealings, with fraud by a purchaser or seller of securities and with the victims as the counterparties in the transaction. In *SEC v. Texas Gulf Sulphur Co.*, the Second Circuit famously held that one need not be either a purchaser or a seller to violate section 10(b) or Rule 10b-5.⁸⁹ Rather, the statutory and rule requirement that the fraud be “in connection with the purchase or sale of [a] security” was satisfied when the victims were purchasers or sellers.⁹⁰ The violator could be anyone who made a material misrepresentation or omission in a manner “reasonably calculated to influence the investing public,”⁹¹ regardless of who, how, or why it was made. Immediately, investors started filing class actions, claiming that the entire marketplace had been deceived by some kind of false publicity, and these suits soon became known as fraud-on-the-market cases.⁹²

Over time, the “in connection with” test has come to be interpreted fairly consistently as a proximate cause requirement,⁹³ that is,

⁸⁷ See *Deutschman v. Beneficial Corp.*, 841 F.2d 502, 505-06 (3d Cir. 1988) (discussing “misrepresentations” that would serve to “deceive purchaser” of stock as satisfying the duty requirement, without any further proof of privity).

⁸⁸ See David S. Ruder, *Texas Gulf Sulphur—The Second Round: Privity and State of Mind in Rule 10b-5 Purchase and Sale Cases*, 63 NW. U. L. REV. 423, 441 (1969) (positing that with the elimination of privity, “the defendant’s liability may far exceed the profit he made”).

⁸⁹ 401 F.2d 833, 860 (2d Cir. 1968) (en banc).

⁹⁰ *Id.*

⁹¹ *Id.* at 862.

⁹² See, e.g., *Basic Inc. v. Levinson*, 485 U.S. 224, 241-42, 250 (1988) (holding that “[i]t is not inappropriate to apply a presumption of reliance supported by the fraud-on-the-market theory”).

⁹³ See COX, HILLMAN & LANGEVOORT, *supra* note 46, at 661 (explaining that courts typically focus on the “link between defendants’ fraud and purchases or sales of securities by the victims” in their “in connection with” analysis). It is interesting to note that in *Basic*, the dissenters (who but for the happenstance of vacancies and recusals could easily have been the majority) suggested that the right approach might be a rejection of *Texas Gulf Sulphur* and a reinstatement of a privity requirement, thereby destroying

the standard interpretation of “reasonably calculated” is in terms of foreseeability, not the speaker’s motivation. So long as the speaker understands there to be a reasonable likelihood that the lie will influence investors’ decisions (or, after *Basic*, distort the stock price), liability follows. As we have seen, this is how plaintiffs sensibly argued *Stoneridge*: the third-party defendants allegedly knew that the sham transactions and underlying documentation would mislead Charter’s auditors, and in turn, be incorporated into false and misleading financial statements issued by Charter and certified by those accountants. This, the plaintiffs said, amply satisfied the proximate cause/reasonably foreseeable standard, and should therefore also satisfy the test for third-party primary liability. By rejecting this argument—albeit under the guise of the reliance requirement—the Court was restricting the standard proximate cause analysis.⁹⁴ By referring to reliance, however, the Court explicitly left the “in connection with” law untouched, an outcome that the government (particularly the SEC) no doubt wanted.

We should pause to note that many of the advocates on the defendants’ side wanted the Court to do otherwise. One popular argument was to point to language in a number of the Court’s recent opinions suggesting that the “in connection with” language is satisfied only when the fraud and the purchase or sale “coincide,”⁹⁵ which, they said, would not be the case when behind-the-scenes deception occurs prior to the making of the public disclosure. However, the dicta in question suggesting the need for strict coincidence came out of insider-trading case law⁹⁶ and was meant to justify an expansive interpretation of “in connection with” in the special situation where the fraud is not a communicative act but rather a simple breach of fiduciary duty.⁹⁷

the viability of the fraud-on-the-market lawsuit. See Langevoort, *Basic at Twenty*, *supra* note 51, at 163 (noting that Justice White’s dissent “hint[ed] at a rejection of *SEC v. Texas Gulf Sulphur*”).

⁹⁴ See *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148, 166-67 (2008) (holding that investors could not have been “said to have relied upon” the third parties’ actions).

⁹⁵ *E.g.*, Brief of the American Bankers Ass’n et al. as Amici Curiae in Support of Respondents at 9, *Stoneridge*, 552 U.S. 148 (No. 06-0043) (arguing that “in connection with” can only be satisfied when the defendant’s acts, not an abstract “scheme,” coincide with a purchase or sale).

⁹⁶ See *United States v. O’Hagan*, 521 U.S. 642, 651-52 (1997) (describing the “classical” theory of insider trading in relation to Rule 10b-5 violations).

⁹⁷ In *Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit*, the Supreme Court referred to the “coincide” locution in the context of a fraud-on-the-market claim. 547 U.S. 71, 85 (2006). However, a careful reading makes clear that the Court was simply explaining the breadth of the “in connection with” requirement in the many contexts in which it has been applied—hardly suggesting anything in the way of a limitation. See

Only the most formalistic and mindless reading would suggest that the same idea has any usefulness in fraud-on-the-market cases.

On the other hand, the Court could well have substituted its remoteness/attenuation test in place of proximate cause had it wished to speak more expansively; indeed, that approach would have made more sense as a conceptual matter than using the test to address reliance. So we might wonder what the consequence would be of so doing—besides simply making life harder for government enforcement. One pre-*Stoneridge* case, which otherwise is something of a doctrinal anomaly, offers an interesting clue. In *Ontario Public Service Employees Union Pension Trust Fund v. Nortel Networks Corp.*,⁹⁸ the Second Circuit confronted a case in which a class of purchasers sued Nortel for false financial reporting. Notably, the plaintiffs were not purchasers or sellers of Nortel stock; rather, they had bought shares in JDS Uniphase, relying on the falsely positive financial information about Nortel as a signal of JDS Uniphase's good prospects, because it was Nortel's largest supplier of fiber-optic components.⁹⁹

If this was treated as an “in connection with” case, the question would have been whether it was foreseeable that lies about Nortel could or would affect JDS Uniphase. The answer would almost certainly be “yes”—market efficiency works so that news affects not only the issuer's stock price but also the prices of affiliated companies. However, the court dismissed the complaint on the curious ground that purchasers of JDS Uniphase did not have “purchaser-seller” standing to sue Nortel.¹⁰⁰ The reasoning is cryptic—since the plaintiffs were clearly purchasers—but the court seems to suggest that one must be a purchaser or seller of securities *of the company releasing the information*.

That result, however, makes little sense in terms of “in connection with” precedent: there is nothing in Rule 10b-5 law limiting fraud liability to the issuer itself, and other Second Circuit cases plainly recognize that there is no such limitation.¹⁰¹ But note how the result might

SEC v. Pirate Investor LLC, 580 F.3d 233, 244 (4th Cir. 2009) (surveying contemporary “in connection with” approaches). In other insider trading cases, courts have not been insistent on strict temporal coincidence. See *United States v. Falcone*, 257 F.3d 226, 230-31 (2d Cir. 2001) (insisting only on a reasonable nexus between the misappropriation and the trading).

⁹⁸ 369 F.3d 27 (2d Cir. 2004).

⁹⁹ See *id.* at 29 (observing that ten to fifteen percent of JDS Uniphase's revenues came from Nortel).

¹⁰⁰ *Id.* at 32.

¹⁰¹ E.g., *In re Salomon Analyst Metromedia Litig.*, 544 F.3d 474, 481 (2d Cir. 2008) (finding no case that limits fraud liability to the issuer). In fact, the Second Circuit has

more easily be explained using the “duty within reliance”-type analysis found in *Stoneridge*. The court could have said that the link between Nortel’s false financials and trading in JDS Uniphase was just too attenuated. Put another way, an issuer owes the duty of candor to its own purchasers and sellers (or those of merger partners or takeover targets¹⁰²) but not to the investing world at large.

B. *Rediscovering Duty*

Contemporary Rule 10b-5 jurisprudence uses duty mainly to determine when silence is fraudulent—i.e., the duty to speak. But earlier in its development, duty played a more pervasive role. This was especially true in the earliest days of private securities litigation, before the courts had either imposed a scienter requirement or limited the scope of the affirmative disclosure obligation.¹⁰³ Particularly notable here was the so-called “flexible duty” approach, a holistic inquiry that assessed liability based on (1) informational imbalance between the parties; (2) relative access to information; (3) who initiated the transaction; (4) benefit to the defendant; and (5) defendant’s awareness of the reliance on the misinformation.¹⁰⁴ As the law gradually became more refined and restrictive on scienter and duty to disclose, the flexible duty approach was rendered problematic and gradually fell into disuse—though echoes of it can still be found in modern case law.¹⁰⁵

As this doctrinal retrenchment occurred, the specific question of third-party liability for fraud turned into the law of aiding and abet-

explicitly disclaimed any such reading of *Nortel*. See *In re NYSE Specialists Sec. Litig.*, 503 F.3d 89, 102 (2d Cir. 2007) (“In short, the district court incorrectly read *Nortel Networks* to mean that an action under Rule 10b-5 for false statements about a security purchased by the plaintiff lies only against the issuer of the security . . .”).

¹⁰² See *Semerenko v. Cendant Corp.*, 223 F.3d 165, 177 (3d Cir. 2000) (“We emphasize . . . that it is no defense that the alleged misrepresentations were made in the context of a tender offer and proposed merger . . .”).

¹⁰³ See generally Jeffrey D. Bauman, *Rule 10b-5 and the Corporation’s Affirmative Duty to Disclose*, 67 GEO. L.J. 935 (1979) (recognizing the broad scope of the duty to disclose applicable at the time).

¹⁰⁴ See *White v. Abrams*, 495 F.2d 724, 730-31 (9th Cir. 1974) (recognizing that Rule 10b-5 “must be construed liberally and flexibly” to meet Congress’s intentions); see also *Zweig v. Hearst Corp.*, 594 F.2d 1261, 1268 (9th Cir. 1979) (referring to *White v. Abrams*’s “flexible duty standard” and summarizing relevant analysis factors from that opinion).

¹⁰⁵ See *Arthur Young & Co. v. Reves*, 937 F.2d 1310, 1330 n.26 (8th Cir. 1991) (limiting rejection of the “flexible duty” test to the scienter element of Rule 10b-5); see also Donald C. Langevoort & G. Mitu Gulati, *The Muddled Duty to Disclose Under Rule 10b-5*, 57 VAND. L. REV. 1639, 1671-74 (2004) (discussing the confusion surrounding the “flexible duty” approach).

ting, where it thrived until *Central Bank*.¹⁰⁶ At first glance, aiding-and-abetting law was straightforward, asking simply whether the third-party defendant (1) substantially assisted the primary defendant in violating the law and (2) acted with the requisite scienter. However, a closer look shows that duty played a substantial and explicit role in this inquiry.¹⁰⁷ Courts regularly encountered situations in which the alleged assistance was fairly small, sometimes even nonexistent (i.e., a failure simply to blow the whistle on wrongdoing by the primary violator). The resulting doctrine was messy but generally took the position that if there was a duty (flexibly determined) running from the third party to the victims, then the intent standard would be applied broadly—including recklessness—and the required assistance would not have to be all that great. In the absence of duty, by contrast, the test would be more demanding, requiring actual knowledge and greater involvement.¹⁰⁸ Some courts even said that when there was no duty, secondary actors could not be held liable absent a showing of “high conscious intent,” meaning not only actual knowledge, but a specific desire to have the fraud succeed.¹⁰⁹

What was happening here, obviously, was an effort to restrict aiding-and-abetting liability to situations where, in the courts’ view, the behavior warranted fraud-on-the-market liability—precisely what also motivated *Stoneridge* under my reading. In other words, if a duty-based approach to third-party primary liability were to emerge, it would reconnect contemporary doctrine to a body of law that asked similar questions in a broader context twenty years ago. But for its truncation as a result of *Central Bank*, that body of law might well have evolved to make duty analysis central to Rule 10b-5 more generally.

¹⁰⁶ See *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164, 177 (1994) (concluding that section 10(b) does not reach aiding and abetting).

¹⁰⁷ See William H. Kuehnle, *Secondary Liability Under the Federal Securities Laws—Aiding and Abetting, Conspiracy, Controlling Person, and Agency: Common-Law Principles and the Statutory Scheme*, 14 J. CORP. L. 313, 318-19 (1988) (describing secondary liability in terms of duty).

¹⁰⁸ See, e.g., *IIT v. Cornfeld*, 619 F.2d 909, 923 (2d Cir. 1980) (noting that the scienter requirement “scales upward when [the] activity is more remote” (quoting *Woodward v. Metro Bank of Dallas*, 522 F.2d 84, 95 (5th Cir. 1975))); *Woodward*, 522 F.2d at 96 (“This issue [of the extent of involvement required] turns on the nature of the duty owed by the alleged aider and abettor to the other parties to the transaction.”).

¹⁰⁹ See, e.g., *Abell v. Potomac Ins. Co.*, 858 F.2d 1104, 1126-27 (5th Cir. 1988) (finding that the scienter requirement would be met if the “abettor acts from a desire to help the fraud succeed”); *Barker v. Henderson, Franklin, Starnes & Holt*, 797 F.2d 490, 496-97 (7th Cir. 1986) (insisting on a showing that defendant had “thrown in his lot” with the primary wrongdoer).

C. Defining Duty for Purposes of Third-Party Liability

A reinvigorated approach to duty within reliance essentially says that a person does not bear liability to one or more victims in a Rule 10b-5 lawsuit unless that person owes a duty of honesty or candor to those victims. How, then, might that duty arise? A threshold question here is whether fraud-on-the-market cases differ from ones arising in face-to-face settings. Because the approaches to reliance—as well as the liability risks—differ so considerably depending on whether we are talking about fraud that distorts market price (fraud-on-the-market) or fraud that affects a particular investment transaction, the answer would seem to be “yes.” A stricter conception of duty makes sense in the open-market setting for the reasons set forth in Part II, and what follows is meant to address only that context.

Two methods flow in a fairly straightforward manner from the existing case law on duty. One is for the third party to identify itself, or allow itself to be identified, in such a way that would lead a reasonable investor to believe that it was assuming responsibility for the accuracy of the public communication by the primary violator. Words and phrases like “endorsing” or “vouching for” capture this idea.¹¹⁰

A second method is via a fiduciary relationship, or something sufficiently akin thereto. Corporate officers, directors, and other agents involved in the disclosure process are fiduciaries vis-à-vis the issuer and its shareholders, and this relationship has long been recognized to include a duty of candor. This should suffice to create the requisite duty regardless of attribution, and it also becomes a reasonable (if somewhat awkward) basis for extending the fiduciary duty to the issuer as well.¹¹¹ This duty, of course, is owed only to the insiders’ own investors.

Beyond these, I would suggest three other circumstances that also work to create a relational duty. The first is professional status or ex-

¹¹⁰ This is the plaintiff’s use of attribution as a sword, as opposed to defendant’s use of nonattribution as a shield, as occurs in so many of the cases. See *supra* note 22 (describing cases in which plaintiffs were required to show attribution to state their claim).

¹¹¹ See Langevoort & Gulati, *supra* note 105, at 1654-57 (discussing fiduciary duty in Rule 10b-5 jurisprudence, particularly in its relation to state common law concepts); Jennifer O’Hare, *Director Communications and the Uneasy Relationship Between the Fiduciary Duty of Disclosure and the Anti-fraud Provisions of the Federal Securities Laws*, 70 U. CIN. L. REV. 475, 496 (2002) (“[T]he Delaware Supreme Court has also shown a marked respect for the federal securities laws in cases involving the breach of the fiduciary duty of disclosure.”). This is not to suggest that executives’ *duty to speak* is necessarily so expansive; again, that is a different question. See *United States v. Schiff*, Nos. 08-1903, 08-1909, 2010 WL 1338141, at *8-9 (3d Cir. Apr. 7, 2010) (rejecting the fiduciary-based responsibility of an executive to correct misstatements made by another executive).

pertise in the world of finance that makes it reasonable to expect that the person or entity appreciates both the regulatory constraints and the economic harm that flows from misinformation spread into the investment marketplace. This is one (and perhaps the only) way of making sense of *Stoneridge's* distinction between the worlds of commerce and finance: more can reasonably be expected of those in the latter category. There is room here to take account of the unambiguous obligations to the public that licensed securities professionals (broker-dealers, investment advisers, etc.) have under the prevailing regulatory regime. Conversely, we might also consider whether the nature of the third party's professional obligations cut against a broad imposition of duty. Lawyers' duties are problematic, as many courts have recognized, because of the special obligations of zealous advocacy and confidentiality that apply as a matter of professional obligation.¹¹²

The next duty circumstance is creative involvement in the ultimate public deception—participation that is not simply substantial but actually helps to engineer or design that deception, thereby making it more likely to succeed. Schemes to defraud require planning and cleverness to avoid detection and have their desired effect. Offering the brain power for a plan or arrangement merits the imposition of a duty.¹¹³ This concept ties to the idea in *Stoneridge* that the two third-party defendants were largely supernumeraries to Charter's role as producer, director, and writer of the fraud, which points away from duty. Where the third party itself produces, writes, or directs the scheme, the result should be different.

Finally, borrowing from the aiding-and-abetting cases, a sufficiently high form of purpose or desire to deceive investors in the general marketplace—"throwing one's lot in" with the scheme or arrangement—should probably satisfy the duty requirement, though I am not sure that it adds much to the other factors. Here again, the presence of such specific intent to deceive the investing public removes some of the concern about disproportionality.

To be clear, I am not suggesting that someone violates Rule 10b-5 with respect to another's principal violation simply because a duty at-

¹¹² See *Abell*, 858 F.2d at 1133 (stressing the importance of attorney-client privilege in the justice system). Given the complexity of the issue and the fact that it has been debated so extensively elsewhere, I will not delve more deeply into the question of lawyer's liability here. As a general matter, my inclination would be to hold lawyers liable as "immediate" primary participants in fraud-on-the-market cases only when they assume creative control of the fraud or vouch for the accuracy of their clients' disclosures.

¹¹³ See *infra* Section IV.C (explaining liability premised on participation in a greater "scheme" to defraud).

taches. All I am doing here is assessing whether the third party's conduct is too attenuated or remote from the deception for there to be reliance on the part of the investing public, on the assumption that too much attenuation or remoteness makes it unfair to hold the third party liable for extraordinary fraud-on-the-market damages. Without suggesting that these five possibilities are necessarily the only ways of imposing a duty, they do seem particularly well suited to *Stoneridge's* framing of the issue. In the next Part, we will see how these principles might be applied in specific cases.

IV. APPLYING DUTY

As *Stoneridge* rightly suggests, third-party liability involves a continuum of causation, which can roughly be divided into three segments. The first is when the third party assists but does not otherwise engage in a deceptive act. Since *Central Bank*, this does not suffice for liability in a private lawsuit.¹¹⁴ The second is when the third party engages in a deceptive act, but is a step or two removed from the disclosure that is disseminated publicly. This is the *Stoneridge* problem, and there, the Court says that if the deceptive act is too attenuated from the disclosure, there is no reliance on which to base liability.¹¹⁵ The final segment of causation is when the third party is integrally involved in the preparation of the public disclosure.

One would think that the third category should be easy under *Stoneridge*, and I think it is. The Court spoke of "immediate" involvement in the disclosure as the opposite of attenuation,¹¹⁶ and—so far as reliance is concerned—the question should simply be whether the involvement in the disclosure itself was indeed deep enough. Because reliance was the principal ground on which the Court disposed of the claims against Motorola and Scientific-Atlanta, however, we have to ask whether there might be other grounds on which third parties can escape liability even when their involvement is immediate and they acted with scienter. Textually, the two remaining questions would be whether their conduct was itself deceptive, and if so, whether the deception was "in connection with" the purchase or sale of a security.

¹¹⁴ See *supra* note 106 and accompanying text.

¹¹⁵ See *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148, 162 (2008) ("[Section] 10(b) . . . does not reach all commercial transactions that are fraudulent and affect the price of a security in some attenuated way.").

¹¹⁶ See *id.* at 160 (explaining that the inquiry is whether the act is "immediate or remote to the injury").

On the first of these questions—deception—plaintiffs run into the line of authority discussed earlier: in the eyes of at least some courts, there is no liability unless the public lie can somehow reasonably be attributed to the third-party defendant.¹¹⁷ Our first question, then, is whether *Stoneridge* has anything at all to say about this. I think it does, albeit indirectly. Then the question becomes how the duty-based analysis helps as the circumstances begin to move further away from direct involvement in the fraudulent disclosure.

A. Attribution

Prior to *Stoneridge*, courts asked whether, in these situations, it was fair to say that the behind-the-scenes actor “made” a misrepresentation or “engaged” in a fraud, and so on.¹¹⁸ On this issue, many courts adopted the bright-line attribution standard, especially in Rule 10b-5(b) cases, under which third-party liability simply would not follow unless the third party was publicly identified as responsible for the fraudulent disclosure.¹¹⁹ The Second Circuit was particularly demanding.¹²⁰ Elsewhere, some courts softened this requirement by suggesting that attribution can be implicit, such as when investors are aware of the third party’s presence and could reasonably assume that the third party was involved in the particular disclosure.¹²¹ Others—sometimes at the urging of the SEC in its amicus program¹²²—have rejected the need for attribution altogether and employed other tests.¹²³

The most important lingering question is whether the attribution test survives *Stoneridge*. Formally it does, because the standard was typically articulated as a question of conduct (i.e., what does it mean to “make” or “engage”), not one of reliance per se. The Solicitor General’s amicus brief specifically urged the Court not to rule on the attri-

¹¹⁷ See *supra* note 22 and accompanying text.

¹¹⁸ See, e.g., *Ziembra v. Cascade Int’l, Inc.*, 256 F.3d 1194, 1205-06 (11th Cir. 2001) (declining to find primary liability under Section 10(b) when the “[p]laintiffs admit that no misrepresentations attributable to [the defendant] were ever made to [the p]laintiffs”).

¹¹⁹ See *supra* text accompanying note 22.

¹²⁰ E.g., *Wright v. Ernst & Young LLP*, 152 F.3d 169, 175 (2d Cir. 1998) (requiring attribution before a secondary actor can be primarily liable for misstatements).

¹²¹ See *In re Mut. Funds Inv. Litig.*, 566 F.3d 111, 124 (4th Cir. 2009) (permitting attribution when a court could “plausibly infer” that investors would have known about the secondary defendant’s involvement).

¹²² See *infra* note 124 and accompanying text.

¹²³ See e.g., *Simpson v. AOL Time Warner Inc.*, 452 F.3d 1040, 1043 (9th Cir. 2006) (expanding the scope of liability to deceptive conduct in a fraud “scheme”).

bution question for precisely this reason.¹²⁴ Unfortunately, some lower courts have taken this as a reason to treat *Stoneridge* as having little or no relevance to defining deceptive conduct; as a result, they simply apply pre-*Stoneridge* law—most importantly, the bright-line attribution standard—to that question. When they do refer to *Stoneridge*, it is without paying serious attention to what remoteness means.

It is hard to find a useful place for attribution after *Stoneridge*. That test emerged shortly after *Central Bank* and was justified as necessary to give meaning to the insistence on reliance in that decision. In *Stoneridge*, however, the Court amply took care of that problem by promoting reliance as an independent inquiry in third-party liability cases.¹²⁵ As a result, it is no longer necessary to alter the natural and normal meanings of “make” and “employ”—the only important words at issue—to address reliance.

Also instructive is the Court’s brief discussion of whether there had to be a specific oral or written statement by the third party (or silence when there is a duty to disclose), to which the Court answers “no.”¹²⁶ This responded to the Eighth Circuit’s determination that mere conduct—like overpaying for set-top boxes or entering into useless advertising arrangements—cannot be a fraudulent act.¹²⁷ In arguing this issue in the government’s amicus brief, the Solicitor General strongly disagreed with the Eighth Circuit and asserted that the two defendants *had* employed a deceptive device or contrivance within the meaning of section 10(b).¹²⁸ The Court does not go that far, at least explicitly, but it does agree that mere conduct can be fraudulent and that the lower court was therefore wrong on this aspect of its ruling.¹²⁹

This agreement is more significant than it seems. If Scientific-Atlanta and Motorola did in fact employ a deceptive device or contrivance, then the statutory standard for Rule 10b-5 liability is satisfied so

¹²⁴ See Brief for the United States, *supra* note 31, at 22 n.12 (arguing that attribution did not need to be addressed in *Stoneridge* since no public statements had been made to investors).

¹²⁵ See *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148, 159 (2008) (“Reliance by the plaintiff upon the defendant’s deceptive acts is an essential element of the [section] 10(b) private cause of action.”).

¹²⁶ See *id.* at 158 (stating that it “would be erroneous” to conclude that an oral or written statement is required for liability).

¹²⁷ See *In re Charter Commc’ns, Inc. Sec. Litig.*, 443 F.3d 987, 992 (8th Cir. 2006) (requiring that a defendant “make . . . a fraudulent misstatement or omission” to be liable), *aff’d sub nom.*, *Stoneridge*, 552 U.S. 148.

¹²⁸ See Brief for the United States, *supra* note 31, at 8 (arguing the defendants’ alleged conduct was a deceptive device since it allegedly misled Charter’s accountant).

¹²⁹ See *Stoneridge*, 552 U.S. at 158 (observing that “[c]onduct itself can be deceptive”).

long as the deception was in connection with the purchase or sale of a security and made with scienter. “In connection with” has nothing to do with attribution, nor does state of mind. So, if one follows this logic, then there is simply no place left where attribution might be relevant, except as to reliance. And the *Stoneridge* Court showed no interest in making it important there, either. Put another way, in the face of a strict attribution rule, *Stoneridge*’s principle largely becomes useless, because lack of attribution disposes of most cases without triggering any inquiry into remoteness. The only class of cases in which the principle would be relevant are those in which there is attribution, and it is hard to imagine many cases involving attribution that would raise significant remoteness issues. To me, it is far more plausible that the Court wants *its* principle—not something so different and inconsistent—used to resolve these kinds of questions.

To illustrate why an attribution rule makes no sense, consider a case (similar to many cases that have been litigated) in which a company executive deliberately misleads a securities analyst, who then issues an excessively optimistic buy recommendation without quoting or referring to the executive. The courts’ standard and sensible response has been that the executive and, derivatively, the issuer are liable.¹³⁰ But this would not follow if we applied a strict attribution test. The better approach—*Stoneridge*’s roadmap—is to ask whether the executive employed a deceptive device or contrivance and, if so, whether it was nonetheless too remote or attenuated from the recommendation on which investors relied. Surely if the answer is yes to the first question, and no to the second question, such a result fully justifies the courts’ rulings in this area. If the absence of attribution is not a problem here, why should it be a problem anywhere else? In sum, attribution adds nothing of use to the law now that *Stoneridge* has addressed reliance by reference to remoteness and attenuation.

That said, many lower courts have disagreed and assumed that *Stoneridge* gives them no reason to depart from their prior holdings.

¹³⁰ See, e.g., *Cooper v. Pickett*, 137 F.3d 616, 624 (9th Cir. 1997) (declaring that a corporation “cannot escape liability simply because it carried out its alleged fraud through the public statements of third parties” (quoting *Warshaw v. Xoma Corp.*, 74 F.3d 955, 959 (9th Cir. 1996))); *Freeland v. Iridium World Commc’ns, Ltd.*, 545 F. Supp. 2d 59, 74-76 (D.D.C. 2008) (explaining different courts’ perspectives on liability predicated on misleading analysts). On the status of this idea in the Second Circuit, see *In re Van der Moolen Holding N.V. Securities Litigation*, 405 F. Supp. 2d 388, 403 (S.D.N.Y. 2005), in which the court held that misrepresentations in a company’s operations reports could be ascribed to a specific source, even when not explicitly attributed, because the information could only have been obtained from that source.

Why? There is of course the natural psychological tendency—to which judges are as susceptible as anyone—to interpret new information in a way that justifies and maintains consistency with prior perceptions and actions. I suspect Justice Kennedy likely aided this interpretation with his writing style and the harsh dicta he included in the opinion.¹³¹ He made it very easy for readers to think the decision was simply about restricting third-party liability, which may have blinded them to the more moderate and flexible principle on which the decision turns.

A Ninth Circuit case, *In re Peregrine Systems, Inc. Securities Litigation*, nicely illustrates how difficult it is to stay the course, and deserves its status as an opinion “not for publication.”¹³² The Circuit reads *Stoneridge* as requiring public knowledge of the improper behind-the-scenes transaction, not just the fact that the third party and the main wrongdoer were doing business: “[U]nder *Stoneridge*, which concerned similar allegations, these transactions cannot form the basis of [section] 10(b) liability unless a ‘member of the investing public had knowledge . . . of [the business partner’s] deceptive acts’ sufficient to demonstrate ‘reliance upon any of [the business partner’s] actions.’”¹³³

In fact, the quoted sentences in *Stoneridge* read like this, putting in italics all that the Ninth Circuit left out: “*No member of the investing public had knowledge, either actual or presumed, of respondents’ deceptive acts during the relevant times. Petitioner, as a result, cannot show reliance upon any of respondents’ actions except in an indirect chain that we find too remote for liability.*”¹³⁴

The Second Circuit’s strong reaffirmation of a strict attribution standard in *Pacific Investment Management Co. LLC v. Mayer Brown LLP*¹³⁵ at least quotes accurately from *Stoneridge*, but it is no more open-minded in its reasoning. The court takes note of the remoteness language, but simply decides that anything unattributed is thereby remote—hardly a self-evident proposition. It also confronts the argument that the outside counsel’s alleged deception to the company was in the world of investment, not the world of commerce, but finds this point to be of little significance. Beyond that, the opinion is largely a repetition of the policy-based arguments underlying its initial adoption

¹³¹ See, e.g., *supra* note 4.

¹³² 310 F. App’x 149 (9th Cir. 2009).

¹³³ *Id.* at 151 (quoting *Stoneridge*, 552 U.S. at 159).

¹³⁴ *Stoneridge*, 552 U.S. at 159.

¹³⁵ No. 09-1619, 2010 WL 1659230 (2d Cir. Apr. 27, 2010).

of the bright-line test.¹³⁶ The Second Circuit never acknowledges the possibility that the Supreme Court's failure to embrace an attribution requirement, which would have been an easy way of disposing of the plaintiffs' case against Motorola and Scientific-Atlanta, might suggest that the Court favored the different and more nuanced way of addressing reliance set forth in the opinion.

B. *Involvement in the Disclosure Itself*

If the attribution problem is surmounted, it becomes fairly easy—and justifiable—to hold actors liable when they participate “immediately” in the preparation of the fraudulent disclosure, assuming scienter. Many of the factors set forth above work to justify the imposition of a duty. For example, many of the cases arising in this area involve executives below the CEO or CFO level, who are nevertheless responsible for the document's design and drafting. Company managers involved in the disclosure process are fiduciaries, with a distinct duty of candor, and are on notice that they are working in the world of finance, not in ancillary business activity.

One case in this spirit—part of the small handful in which *Stoneridge* has been read to support plaintiffs' claims—is *New York City Employees' Retirement System v. Berry*, which involved claims against the former general counsel at Juniper Networks, Inc., alleging that she falsified corporate documents as part of an options-backdating scheme.¹³⁷ The court determined that she would be primarily liable for the falsifications, even with respect to those SEC filings that she prepared but did not sign.¹³⁸ The court considered her the main cause of the falsifications, given her level of responsibility at Juniper for both

¹³⁶ The court does not follow Justice Kennedy's lead in dicta, arguing that the bright-line approach is good policy because it protects third parties, like lawyers and bankers, from unnecessary litigation and because it is easy to apply. Instead, it states that a strict test “avoids protracted litigation and discovery aimed at learning the identity of each person or entity that had some connection, however tenuous, to the creation of an allegedly false statement.” *Id.* at *10. This is familiar rhetoric, but it ignores the PSLRA's imposition of heightened pleading requirements, which require specific facts in the complaint that give rise to a strong inference of the defendant's scienter before even getting to discovery. See *infra* note 171. Nor does the court consider seriously the policy implications of a rule that invites secondary actors to instigate fraudulent conduct but then avoid liability to investors just by hiding from public view. In sum, the policy-based reasoning is unlikely to be persuasive to anyone not already convinced of the disutility of private securities class actions as a compensatory or deterrence mechanism.

¹³⁷ 616 F. Supp. 2d 987, 990 (N.D. Cal. 2009).

¹³⁸ See *id.* at 995-96 (holding that the plaintiffs sufficiently alleged Berry's substantial participation in the false statements).

compensation and financial reporting; her conduct thus made the falsity both necessary and inevitable.¹³⁹ This, in turn, supplied the necessary proximity and immediacy to distinguish *Stoneridge* factually.

In *Berry*, the general counsel was truly integral to the fraudulent disclosure.¹⁴⁰ Cases become more difficult when the involvement in the disclosure is slightly less central. Merely being proximate to the fraud is probably not enough to create primary liability, even for fiduciaries. Active engagement in the deception is necessary. What seems most relevant is participation in the creative aspect of drafting the disclosure—involvement of the sort that makes the deception more likely to work. This could sometimes happen through editing or commenting, though the most common kind of third-party review probably rarely rises to this level. I have for some time believed that “co-authorship”—one of the other duty examples—captures this idea of creative involvement fairly well.¹⁴¹

A number of cases have arisen based on claims that a company executive was responsible for alleged fraud by supplying misinformation to the disclosure team. Take, for example, a situation in which a vice president of marketing (or another key sales executive) arranges deals with customers that facilitate inappropriate revenue recognition. The arrangements are misrepresented in the preparation of the accounts and hence fool the company’s auditors (and perhaps others) involved in the reporting and disclosure process. A duty-based analysis says that liability is appropriate, especially if the fraud was specifically designed to fool others inside the company (thereby making it more “inevitable” that it would succeed). Especially in the post-Sarbanes-Oxley reporting environment, internal corporate procedures for financial reporting extend widely into the company, so that all key employees should understand that they are an integral part of

¹³⁹ See *id.* at 996 (explaining that Berry’s oversight responsibilities of the option grant process created primary “scheme” liability).

¹⁴⁰ *Id.* at 990 (describing how general counsel helped to falsify financial statements).

¹⁴¹ I suggested this standard shortly after *Central Bank*. See Langevoort, *supra* note 19, at 892 (proposing that “involvement” be based on a broad conception of co-authorship). The SEC has continued to recommend a test that is very similar: the test asks whether the defendant can fairly be said to have “created” the fraud—at least in Rule 10b-5(b) cases. See Brief for Securities Exchange Commission, Amicus Curiae, In Support of the Position of Plaintiffs-Appellants on the Issue Addressed and in Support of Neither Affirmance nor Reversal at 7, *In re Refco, Inc. Sec. Litig.*, 609 F. Supp. 2d 304 (S.D.N.Y. 2009) (No. 09-1619); see also *In re Enron Corp. Sec., Derivative & “ERISA” Litig.*, 529 F. Supp. 2d 644, 772 n.149 (S.D. Tex. 2006) (discussing the SEC’s recommendation in *In re Refco*).

the disclosure process.¹⁴² Surely a distortion of material information by a high-level executive is enough so that the person can fairly be said to have engaged in a fraud, not just assisted with one. At least one post-*Stoneridge* case, however, has disagreed—though largely on the assumption that the attribution test still prevails.¹⁴³

C. Scheme Cases

Stoneridge was decided in the shadow of the much larger Enron litigation, which raised many of the same issues. Because Enron was insolvent, the focus of litigation was against a set of investment banking firms and law firms that allegedly assisted Enron in structuring scores of transactions that operated deceptively and thus enabled Enron to report its financial condition fraudulently. Perhaps the most famous of these transactions was the “Nigerian Barges Transaction” structured by Merrill Lynch, which disguised what was effectively a loan as a purchase and sale.¹⁴⁴ Some of the banks settled with the plaintiffs for more than \$7 billion after the trial court ruled that their actions could constitute a primary violation of the law.¹⁴⁵

In *Regents of the University of California v. Credit Suisse First Boston (USA), Inc.*, the Fifth Circuit reversed, freeing the nonsettling defendants from liability exposure in the Rule 10b-5 portion of the lawsuit.¹⁴⁶ Like *Stoneridge*, this opinion can be read in a number of different ways. Its emphasis on duty is most striking. Language early in the substantive portion of the opinion suggests that liability under Rule 10b-5 can never arise unless the defendant had a duty to disclose.¹⁴⁷ However, it is not clear that the court really meant to say, for instance, that Merrill Lynch itself would have escaped liability had it publicly

¹⁴² See 17 C.F.R. § 240.13a-15 (2009) (requiring an issuer to implement and evaluate a system of internal financial reporting controls).

¹⁴³ See *SEC v. Lucent Techs., Inc.*, 610 F. Supp. 2d 342, 357-58 (D.N.J. 2009) (finding allegations of a “chain of causation” insufficient to hold defendants primarily liable); cf. *SEC v. Wolfson*, 539 F.3d 1249, 1257-62 (10th Cir. 2008) (declining “to impose an attribution element in an SEC enforcement action”).

¹⁴⁴ See *Regents of the Univ. of Cal. v. Credit Suisse First Boston (USA), Inc.*, 482 F.3d 372, 377 (5th Cir. 2007) (describing the sham transactions used to inflate reported revenues).

¹⁴⁵ See *id.* at 379 (explaining the previous settlements would offset any potential damages award in the present action).

¹⁴⁶ See *id.* at 393-94 (holding that neither the class-reliance presumption nor the fraud-on-the-market presumption served to establish defendants’ liability).

¹⁴⁷ See *id.* at 384 (“For us to invoke the *Affiliated Ute* presumption of reliance on an omission, a plaintiff must . . . demonstrate that the defendant owed him a duty of disclosure.” (citing *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972))).

misrepresented its dealings with Enron. Later on, the court turned specifically to the meaning of “deception” in the context of an alleged scheme to defraud and embraced the Eighth Circuit’s reading, which insisted on either a third-party defendant’s actual misstatement or failure to disclose when there was a duty to disclose¹⁴⁸—precisely the approach that the Supreme Court later rejected as unduly restrictive. The bottom line is stated clearly enough, however: “Enron had a duty to its shareholders, but the banks did not The banks’ participation in the transactions, regardless of the purpose or effect of those transactions, did not give rise to primary liability under [section] 10(b).”¹⁴⁹

Immediately after *Stoneridge*, the Supreme Court denied certiorari in the Enron case,¹⁵⁰ which suggests that the Fifth Circuit’s ruling may be consistent with the Court’s decision.¹⁵¹ That, however, is unfortunate. At the very least, the Fifth Circuit was sympathetic to the Eighth Circuit’s approach to what constitutes deception (i.e., the requirement that there must be either an affirmative misstatement or silence in the face of a duty to disclose), which is why duty plays such an important role in the court’s analysis. The Supreme Court squarely rejected this approach, which renders the analysis suspect in its entirety. If we shift to the Supreme Court’s inquiry into remoteness or attenuation, there are striking differences between the two cases. Most notably, the transactions in *Enron* were not normal commercial arrangements, but rather deals with investment bankers—registered broker-dealers—who were deeply involved in the world of finance.¹⁵² Even putting aside the interesting question of how much of the creative design of these deals was the bankers’ work product, the nature of the engagement was plainly a giant step closer to the issuer’s misrepresentation of its financial condition. In terms of the duty test suggested earlier, the banks’ involvement was far from attenuated, having most assuredly—if plaintiffs’ allegations about knowledge were right—thrown in their lot with Enron’s insiders.

¹⁴⁸ See *id.* at 388 (approving the Eighth Circuit’s definition of “deceptive” conduct (internal citation omitted)).

¹⁴⁹ *Id.* at 390.

¹⁵⁰ *Regents of the Univ. of Cal. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 552 U.S. 1170 (2008) (mem.), *denying cert. to* *Regents of the Univ. of Cal. v. Credit Suisse First Boston (USA), Inc.*, 482 F.3d 372 (5th Cir. 2007).

¹⁵¹ See *In re Enron Corp. Sec., Derivative & “ERISA” Litig.*, 610 F. Supp. 2d 600, 640 (S.D. Tex. 2009) (“Because the majority’s particular holding . . . was not granted a writ of certiorari and was not overturned nor even implicitly affected by *Stoneridge*, it is binding on this Court.”).

¹⁵² See *supra* note 144 and accompanying text.

The doctrinal difference, then, is that the Fifth Circuit was thinking of duty solely in its contemporary “duty to disclose” guise, and had found the absence of such a duty to be dispositive of the broader question of whether the banks had engaged in a deceptive act or practice. This analysis confuses two distinct duty questions.¹⁵³ If banks are assumed to have affirmatively engaged in a deceptive communicative act through the way they structured the behind-the-scenes transactions—meaning that these deals were made with the purpose and intent of fooling Enron’s auditors and other gatekeepers—the remaining question becomes whether that behavior was too remote from Enron’s financial reporting to fairly charge the banks with responsibility to injured investors. I doubt it.

A similar lack of insight post-*Stoneridge* can be found in a Seventh Circuit case, *Pugh v. Tribune Co.*¹⁵⁴ The allegation in *Pugh* was that the publisher and certain other insiders of two Spanish-language newspapers engaged in a scheme to inflate the newspapers’ revenues by lying to advertisers about their circulation through an audit intermediary, who was tasked with verifying the data in question.¹⁵⁵ A subsidiary of the Tribune Company, a public company, owned the newspapers,¹⁵⁶ and as a result of the scheme, Tribune’s financial reports were materially misleading.¹⁵⁷ The Seventh Circuit invoked *Stoneridge* to dismiss the action against the alleged mastermind, saying that, even assuming the publisher foresaw and/or intended that the scheme would result in Tribune making misleading financial statements, the “indirect chain to the contents of false public statements [was] too remote to establish primary liability.”¹⁵⁸

Here again, some distinctions seem obvious. Most notably, the supposed mastermind was a senior official of a Tribune subsidiary. He owed a fiduciary duty to the subsidiary, which presumably ran to Tribune and its shareholders. Here, in other words, we have a fairly conventional duty of candor that the court could have invoked had it wished. The fact that this was a parent-subsidiary relationship, rather than a purely intra-corporate one, should make no difference in applying this type of duty.

¹⁵³ See *supra* text accompanying note 86 (comparing an affirmative duty to disclose to duty arising out of reliance).

¹⁵⁴ 521 F.3d 686 (7th Cir. 2008).

¹⁵⁵ See *id.* at 690 (explaining that falsely raising circulation figures permitted the employees to charge advertisers higher rates that, in turn, increased revenues).

¹⁵⁶ *Id.* at 690-92.

¹⁵⁷ *Id.*

¹⁵⁸ *Id.* at 697.

D. Other Uses of Duty

The approach to duty I have developed here could work very effectively to inform the “in connection with” requirement. Instead of a simple foreseeability analysis—which creates a very broad liability threat—a court might say that, absent evidence of a specific intent, such as desire or motivation to deceive investors, liability for fraud-on-the-market requires a duty to the marketplace. That would encompass deception by issuers (and their officers and directors), underwriters, accountants, investment bankers, brokers, and so forth, but not those more remote from the resulting trading. This would actually explain the *Nortel* case, discussed earlier,¹⁵⁹ far better than its own reasoning.

Consider the following scenario from another case.¹⁶⁰ A well-known mutual fund portfolio manager was interviewed in the financial press, and during the conversation, was asked about particular stocks held by the fund; he said that he considered the technology stocks to be very sound investments.¹⁶¹ However, the manager was in fact aware that the fund had begun dumping its technology stocks, but since he had no obligation to disclose, he declined to do so in order to prevent the stock market price from dropping.¹⁶² Assuming that this should be treated as a lie in the first place, is the manager—and derivatively, the fund’s sponsor—liable for a potentially massive sum to all investors who purchased the stocks between the time of the lie and the revelation of the fund’s sales? One can see why this result might seem excessive. Use of an invigorated duty analysis here could absolve the defendants of liability because the manager’s fiduciary and statutory duties ran to the fund’s investors, not to those in the portfolio companies. Moreover, his statement did not seem to be part of a deliberate attempt to manipulate the market for those stocks.¹⁶³

¹⁵⁹ See *supra* notes 98-100 and accompanying text.

¹⁶⁰ *In re Fidelity/Micron Sec. Litig.*, 964 F. Supp. 539 (D. Mass. 1997).

¹⁶¹ *Id.* at 541.

¹⁶² *Id.* at 541-42.

¹⁶³ In *SEC v. Tambone*, 597 F.3d 436, 448-49 (1st Cir. 2010) (en banc), the First Circuit overturned a panel decision, *SEC v. Tambone*, 550 F.3d 106 (1st Cir. 2008), that had adopted a broad, duty-based view that underwriters implicitly “make” a misstatement contained in a disclosure document prepared by a mutual fund adviser. The en banc court said that even if underwriters owe special duties to investors to investigate the securities they offer, that does not automatically turn into a distinct duty to speak. Absent such a duty or some form of endorsement, they cannot be held liable for statements made by another party. *Tambone*, 597 F.3d at 447-48.

V. LEGISLATIVE REFORM

I have put forth a reading of *Stoneridge* at odds with the conventional account. I do not expect that courts will promptly jettison their own contrary readings and adopt my duty-based interpretation. Among other things, there is so much dicta in Justice Kennedy's opinion—about the scourge of strike suits, American capital-market competitiveness, and the like—that courts committed to a more restrictive interpretation can freely pick among the given reasons to stay the conservative course.

If this is true, then only legislation will change the direction of the law, and I favor that. We are in the midst of an economic crisis that has produced a high degree of sensitivity to greed and irresponsibility and a recognition that the complexity of financial engineering can readily conceal risk—systematic as well as firm- or industry-specific—and thereby promote excess. As a political matter today, if we were to ask whether an otherwise complicit financial engineer should be spared liability to investors simply because she is not identified as responsible for the publicly-transmitted falsity, the popular answer would almost surely be “no.” Unsurprisingly then, there have been legislative initiatives to rewrite the standard for secondary liability.¹⁶⁴

This brings us to the challenge of finding the right definition. If I am correct that the unease that has produced much of the restrictiveness of third-party liability doctrine is a legitimate fear of disproportion, then any line that simply divides secondary actors into two groups—those who face full fraud-on-the-market damages and those who face no damages at all—will inevitably be unsatisfying.

The solution would be to address damages first, and then turn to the scope of liability. This approach could be a systematic reform of Rule 10b-5 damages to address the overcompensatory bias discussed earlier—something I would favor in principle—but this would be a daunting and politically sensitive undertaking, with issues going well beyond the scope of this Article. Thus, for now, let us stay focused on the third-party-liability problem.

There are two plausible approaches. One, recently recommended by John Coffee, Jr., is to create liability “caps” for secondary actors.¹⁶⁵

¹⁶⁴ See Malini Manickavasagam, *Ceiling on Damages Urged for Bill to Restore Aiding and Abetting Liability*, 41 Sec. Reg. & L. Rep. (BNA) 1725 (Sept. 21, 2009) (discussing the testimony and hearings on S. 1551, the bill for the “Liability for Aiding and Abetting Securities Violations Act”).

¹⁶⁵ See John C. Coffee, Jr., Adolf A. Berle Professor of Law, Columbia Univ. Law Sch., Testimony Before the Subcommittee on Crime and Drugs of the United States Senate Committee on the Judiciary 10 (Sept. 17, 2009), *available at* <http://www.columbia.edu/~jcc1000/090917testimony.pdf>.

For entities, Coffee recommends that a penalty not exceed the greater of 10% of the defendant's average income over its last three years, 10% of the defendant's net worth, or 10% of the defendant's total market capitalization.¹⁶⁶ For natural persons, Coffee suggests a penalty of \$2 million but in no event more than \$50 million.¹⁶⁷ I am generally quite sympathetic to redefining liability exposure in all Rule 10b-5 cases,¹⁶⁸ and I would not be opposed to this approach. But it does seem that redefining liability for third-party actors is awkward if it is not part of a more general effort to reform private securities litigation. Restricting liability for secondary actors essentially leaves the bulk of the liability on the issuer, and it is far from clear that this is always appropriate. It also takes questions of the *degree* of involvement and culpability out of the liability inquiry; the nonissuer mastermind of the fraud would have the same limited liability as the less culpable participant.

An alternative is to revisit proportionate liability and revise section 21D(f) from scratch. The first question is who should face the full force of those damages, overcompensatory fears notwithstanding. My articulation would build on, rather than reject out of hand, the simplistic "actual knowledge" standard now in the law. I would say that full-scale liability should attach if, but only if, the defendant acted with actual knowledge of the fraud *and* bore primary responsibility for its commission. Primary responsibility arises when the person was a moving force in the design and execution of the deception. The proposal would permit more than one person to have primary responsibility.

For those who violate Rule 10b-5 but do not bear primary responsibility, the factfinder (I would make it the judge¹⁶⁹) should have reviewable discretion to limit damages to defendants' fair share in light of (1) the severity of the injury to investors and (2) the nature and

judiciary.senate.gov/hearings/hearing.cfm?id=4052 (follow hyperlink under "Witness Testimony") (proposing a ceiling for the maximum penalty that may be imposed on secondary participants so that punishments are "sufficiently painful to deter, but not so large as to threaten insolvency").

¹⁶⁶ *Id.*

¹⁶⁷ *Id.*

¹⁶⁸ See Langevoort, *supra* note 62, at 657-62 (considering which caps or alternative measures would be appropriate to achieve deterrence in liability standards).

¹⁶⁹ There is an important constitutional question about how much authority over factual questions, in the name of litigation reform, Congress can take away from the jury and assign to the judge in light of the Seventh Amendment. In *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, the Supreme Court suggested in dicta that the Seventh Amendment does not restrict the ability of Congress to assign a strong gatekeeping role to the trial judge. See 551 U.S. 308, 327 n.8 (2007) (listing cases in which there had been no Seventh Amendment violation).

culpability of defendants' involvement, as compared to the actions of those with primary responsibility. This formulation is deliberately open-ended but not particularly moreso than the current statutory language, and it avoids the silliness of having to apportion fair shares to responsible parties that sum to one hundred percent. The duty factors set forth earlier would be a useful way of assessing relative culpability.¹⁷⁰

More than open-endedness, a concern with this approach is its post hoc application. Most cases never get to trial, and the indeterminacy of fair share could cast a shadow of fear that would undercut the purposes of proportionate liability. I am not sure how much of a problem this is—settlement bargaining today already takes place in the face of considerable factual and legal uncertainty, yet the results nonetheless seem reasonably responsive to the underlying merits¹⁷¹—but if it is problematic, one solution would be to have the trial judge make a preliminary assessment based on the particularized allegations set forth in the pleadings at the same time that the judge rules on whether there is a strong enough inference of liability in the first place.

This might seem frustrating to plaintiffs and their lawyers. But the payoff is that it clears the way to expand the standard for secondary liability with substantially lessened risk of disproportionality. Additionally, though there could be many ways to expand third-party liability, there are no good reasons why Congress should not simply restore aiding-and-abetting liability once a fairer and more proportionate system for assessing damages is in place.

The defense-side objections to such a restoration are predictable, as are the responses. The point to remember is that aiding and abetting is already both a federal crime and a violation of the Securities Exchange Act, with considerable liability consequences. Restoration only adds an additional civil forum for redress, and stronger proportionate liability reduces the risks considerably. To be sure, there is the concern that low-merit litigation will systematically force unfair settlement payouts, to which Justice Kennedy unfortunately once again gave voice.¹⁷² However, given the changes the PSLRA (which courts have construed fairly

¹⁷⁰ See *supra* Section III.C.

¹⁷¹ See, e.g., Marilyn Johnson et al., *Do the Merits Matter More? The Impact of the Private Securities Litigation Reform Act*, 23 J.L. ECON. & ORG. 627, 649 (2006) (concluding from an empirical study of the impact of the PSLRA that there is "some evidence that the merits do matter more, at least in the filing of complaints and the allegations included in those complaints").

¹⁷² See *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148, 163 (2008) ("[The] extensive discovery and the potential for uncertainty and disruption in a lawsuit allow plaintiffs with weak claims to extort settlements from innocent companies.").

conservatively in the almost fifteen years since its enactment¹⁷³) brought to the law, it is hard to believe that low- or no-merit lawsuits *systematically* survive motions to dismiss so as to pose pervasive strike-suit threats.¹⁷⁴ The shift toward institutional lead plaintiffs has also refreshed the litigation environment by diminishing the autonomy of plaintiffs' lawyers.¹⁷⁵ Perhaps additional reforms are warranted. But assuming that Congress is comfortable with whatever system is in place for balancing the risks of excessive and inadequate liability, that same system should be used to address the secondary liability problem.

CONCLUSION

While I hope that lower courts will be more imaginative and careful in their interpretation of *Stoneridge* in future cases, early reader reactions to any authoritative text are hard to dislodge, even if they are careless. I am certainly postmodern enough not to suggest that there is ever a single meaning or intention discoverable in any text, including a Supreme Court opinion. Thus I will concede that the reading I have given to *Stoneridge* here is just one of many possibilities, and that it strikes me as far more plausible than the more familiar ones in circulation likely reflects my own prior beliefs: I have long been troubled by the disproportionality problem, and I am thus inclined to construe Justice Kennedy's ambiguous text in that light. Still, I am convinced that this is the most sensible reading.

My duty-based reading interprets the reliance requirement (i.e., "duty within reliance"), because that is all the Court addressed.¹⁷⁶ However, there is no need to confine it in this way. As we have seen,

¹⁷³ See cases cited *supra* notes 7-8.

¹⁷⁴ There is evidence that the PSLRA has been imprecise in its impact, allowing cases with merit to be thrown out and cases without merit to survive. See Stephen J. Choi, *The Evidence on Securities Class Actions*, 57 VAND. L. REV. 1465, 1476-1507 (2004) (surveying empirical evidence on the PSLRA's effect on both frivolous and meritorious suits); Michael A. Perino, *Did the Private Securities Litigation Reform Act Work?*, 2003 U. ILL. L. REV. 913, 929-42 (detailing evidence showing that the passage of the PSLRA failed to decrease nonmeritorious filings, despite the Act's intentions).

¹⁷⁵ See James D. Cox, Randall S. Thomas & Lynn Bai, *There are Plaintiffs and . . . There are Plaintiffs: An Empirical Analysis of Securities Class Action Settlements*, 61 VAND. L. REV. 355, 356 (2008) (explaining that the lead-plaintiff provision, which replaced the "first to file" rule, prevents plaintiffs' attorneys from making "hair trigger" filings); Elliott J. Weiss, *The Lead Plaintiff Provisions of the PSLRA After a Decade, or "Look What's Happened to My Baby"*, 61 VAND. L. REV. 543, 551-53 (2008) (explaining that institutional lead plaintiffs have come to act as "reasonably diligent litigation monitors," negotiating with plaintiffs' attorneys at arm's length and overseeing the settlement of their claims).

¹⁷⁶ See *supra* text accompanying notes 41-44.

there is no reason why the line between primary liability and aiding and abetting should not be drawn by focusing on the remoteness or attenuation of the third party's involvement in the same way. So, too, does this apply with respect to standing to sue or even the jurisdictional "in connection with" requirement.¹⁷⁷ In fact, a close look at recent case law shows a number of areas in which courts have used remoteness or attenuation to assess liability, suggesting that this really may be a unifying idea in thinking about the scope of Rule 10b-5 more generally.¹⁷⁸

This reading has both the virtue and vice of moderation. Those on the plaintiff/investor side of the long-standing debate over private securities litigation policy will not like it because *Stoneridge* is a useful symbol of judicial intolerance and derision, which they would like to destroy through legislation. The defense/business side considers it a holy victory to be interpreted expansively, according more to its rhetorical vigor than to its specific holding. So far, the latter construction has the upper hand in the lower courts. I have attempted to move this debate toward compromise. As noted, the strike-suit threat as a systematic concern is far overstated, at least since the PSLRA. So is fear of private litigation as a threat to U.S. competitiveness. On the other hand, the claimed damages at stake can be disproportionate both to the aggregate of real investor-reliance injuries and to the severity of the misconduct in question. This excess encourages too many marginal cases and distorts settlement negotiations. The judicious course is to try to preserve appropriate private securities liability, for third parties and otherwise, but also to pull back on the excess.

¹⁷⁷ See *supra* Section III.A (describing the "in connection with" requirement).

¹⁷⁸ See, e.g., *Morrison v. Nat'l Austl. Bank, Ltd.*, 547 F.3d 167, 175-76 (2d Cir. 2008) (noting that, in assessing the extraterritorial scope of Rule 10b-5, the "absence of any allegation that the alleged fraud affected American investors . . . or capital markets" was a significant factor in the court's ability to hear the claim), *cert. granted*, 130 S. Ct. 783 (2009) (mem.); see also Erez Reuveni, *Extraterritoriality as Standing: A Standing Theory of the Extraterritorial Application of the Securities Laws*, 43 U.C. DAVIS L. REV. 1071, 1092-96 (2010) (discussing the decision in *Morrison* and how to evaluate "conduct" in the context of international investments).