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Reading Stoneridge Carefully:
A Duty-Based Approach to Third-Party Liability under Rule 10b-5

Donald C. Langevoort*

In Stoneridge Investment Partners LLC v. Scientific-Atlanta, Inc.,¹ the Supreme Court addressed whether third-party participants in a fraudulent scheme engineered by a corporate issuer face liability in a private securities lawsuit for harm caused by the issuer’s false and misleading corporate disclosures. Though this would seem to be a matter of determining whether their deceptive behind-the-scenes conduct by itself constituted a “primary” violation of the antifraud prohibition found in SEC Rule 10b-5, the Court instead answered by interpreting reliance element of plaintiffs’ cause of action. It says that there is no reliance, and hence no liability, when the link between the third party’s actions and the resulting misrepresentation is too remote or attenuated.

Conduct, reliance and proximity, however, are conceptually distinct; by blending them together the way it does, Justice Kennedy’s opinion makes a doctrinal mishmash. The dish is tasty enough to those who dislike strong securities class actions, with abundant pro-business dicta adding ample spice. But the recipe has had few serious academic defenders even among those who agree with the outcome,² and has been the object of disgust from those who are not.³ The standard account is

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¹  128 S.Ct. 761 (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.


³  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 (2009); Robert Prentice, Scheme Liability: Does It Have a Future After Stoneridge?, 2009 Wisc. L. Rev. 351; 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 Kan. L. Rev. --- (forthcoming,
that the Court was, yet again, showing its reflexive antipathy toward private securities class actions, throwing whatever was at hand into the pot to suit the pro-business result. As we shall see, most lower courts have also read *Stoneridge* as doing little more than truncating third-party liability via a strict reliance requirement.

Though I, too, would have decided the case differently, the substance of the criticism—and the unimaginative way courts have read and applied the Court’s teachings—are too simple. In *Stoneridge*, as in the two other recent Supreme Court decisions addressing securities class actions, *Tellabs* and *Dura Pharmaceuticals*, the Court articulated a more moderate course than it might have, even though all three held for the defendants. Pure antipathy presumably would have led to more extreme outcomes, which suggests that something more is going on.

In this article, I offer a novel reading of *Stoneridge*. There is a genuine idea at work in the opinion, which we can refine. The choice of reliance as the crucial element suggests the Court’s comfort with different liability outcomes in 10b-5 cases depending on whether the action is SEC or criminal enforcement (where reliance is not a required showing) or private litigation (where it is). Why might such a distinction make sense? One possible answer comes by looking at the extraordinary nature of the remedy granted in private fraud-on-the-market cases—the aggregate out of pocket claims of all those who bought or sold from the time of the alleged primary misrepresentations to the date of corrective disclosure, a figure that can be staggering large and disconnected from any meaningful requirement of reliance-in-fact. Especially when the particular defendant is a secondary actor, there can be a sense of severe disproportion, even if the underlying conduct was wrongful. By contrast, in SEC enforcement actions at least, the monetary penalty varies based on a set of factors all specifically based on

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the gravity of the wrongdoing. In Part I, I expand on this idea and make my main argument: that in its emphasis on remoteness and attenuation applied solely in the context of private securities litigation, Stoneridge reinvigorates 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 indeed an extraordinary remedy because it creates a potential recovery different from and in excess of what we would normally think of as provable reliance damages. Second, a hard look at the key elements of a 10b-5 action—including scienter—shows that securities fraud bears enough of a resemblance to negligence in terms of indeterminacy and precaution costs that duty-based analysis makes sense. Later in Part II, we also consider that 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, purports to impose a proportionate liability regime, drawn from similar reform efforts in tort law at the state level. My argument is that this provision fails to do its job, leaving judicial concern well placed.

Part III then puts forth my duty-based reading of what the Court was struggling to say in its emphasis on attenuation and remoteness, and explains that this kind of duty is different from the affirmative duty to speak—which is a fairly narrow and circumscribed duty—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 about Stoneridge this way helps give 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 then shows how this helps resolve the most common third-party liability problems, comparing and critiquing the overly restrictive way lower courts have in fact responded. In this Part, I take a particularly hard look at the “attribution” test for primary liability, which lower courts seem to assume survives Stoneridge. Though that may be right formally, a duty-based reading obviates the need for it.

Because I do not expect to resolve the lingering confusion and inconsistency in the current doctrinal state of the law simply by reading Stoneridge differently, a further legislative fix is needed. The cases are just too gerrymandered to operate fairly or effectively. So, in the 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. Part VI concludes.

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

Stoneridge involved plaintiffs’ allegations that two large vendors of cable TV set-top boxes, Scientific-Atlanta and Motorola, entered into deceptive transactions with cable system operator Charter Communications (and backdated or falsified documents to disguise the sham). By so taking part in Charter’s scheme to inflate its revenues, plaintiffs said, the vendors assumed responsibility for Charter’s lies about its financial condition. This claim raises a host of questions, many of which were addressed by the parties and/or the many amici during briefing and argument. Was the conduct of the two third-party defendants such that they had 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 plaintiffs adequately plead scienter, reliance and loss causation? Out of all these, the Court rested its holding on lack of reliance.

In retrospect, this seems to be a simple and predictable extension of the Court’s 1994 holding in Central Bank of Denver v. First Interstate Bank, which radically narrowed the scope of third-party liability by excluding aiding and abetting liability as an acceptable claim under Rule 10b-5. That Stoneridge reads that way is hardly surprising given that Justice Kennedy wrote both and works hard to make them seamless. But any seeming inevitability is the 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. In dicta, it suggested that, among other things, aiding and abetting liability would allow defendants to “be held liable without any showing that the plaintiff relied upon the aider and abettor’s

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7 Plaintiffs also sued Charter, of course, as well as Charter’s accountants, but settled that portion of the case, thereafter turning entirely to the two third-party defendants for the remaining damages.
8 511 U.S. 164 (1994).
statements or actions. 9 Later, though emphasizing that it was leaving to future cases the scope of primary liability—i.e., what kind of conduct goes beyond mere aiding and abetting so as to fall within the scope of the prohibition—it repeated the need to show that all the elements of a cause of action (i.e., reliance) are met. 10

As commentators on Central Bank quickly pointed out, 11 this emphasis on reliance was puzzling, 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; some early decisions refer to reliance as transaction causation. 12 If so, the crucial question, simply, is when does a third-party bear responsibility for the public misstatement on which reliance is presumed, which goes 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—responsibility follows whenever the third party defendant substantially participated in the making of the misstatement. 13 But other courts—notably in the Second Circuit—soon staked out a more strict position, insisting that primary liability arises only where there is some sort of public attribution of responsibility to the defendant for what was misstated. 14 This latter view, which seemingly ruled out any liability

9 Id. at 180. The Court seems to have been heavily influenced by an article by Daniel Fischel, Secondary Liability Under Section 10(b) of the Securities Exchange Act of 1934, 69 Cal. L. Rev. 80 (1980).
10 Id. at 191 (emphasis in the original).
13 See In re Software Toolworks Inc. Sec. Litig., 50 F.3d 615 (9th Cir. 1994).
14 See Wright v. Ernst & Young LLP, 152 F.3d 169 (2d Cir. 1998); Shapiro v. Cantor, 123 F.3d 717 (2d Cir. 1997); see also Ziemba v. Cascade Int’l Inc., 256 F.3d 1194 (11th Cir. 2001). The law in the Second Circuit was muddied by a number of cases that suggested some softening, albeit no abandonment, of the attribution rule. See In re Scholastic Corp. Sec. Litig., 252 F.3d 63, 75 (2d Cir. 2002); In re Global Crossing Ltd. Sec. Litig., 322 F. Supp.2d 319, 329 (S.D.N.Y. 2004); In re Parmalat Sec. Litig., 383 F. Supp.2d 616, 622 (S.D.N.Y. 2006). In a recent case on the subject, the Second Circuit was again fairly restrictive. Lattanzio v. Deloitte & Touche, 476 F.3d 47, 55 (2d Cir. 2007).
whatsoever for behind-the-scenes actors no matter how important their role, 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 was simply justification: they were addressing what constitutes deceptive conduct within the meaning of Rule 10b-5, not reliance as a separate element.

Because of the growing judicial conservatism on this particular question, plaintiffs quickly shifted their emphasis away from claims of misrepresentations for which third-party defendants were responsible (10b-5(b)) to broader allegations that the third-party’s actions were part of a “scheme to defraud” for which they bear co-conspirator-like responsibility (10b-5(a) and (c)). On this strategy they had a notable—but temporary—district court victory in the massive Enron litigation, and some favorable language (though not a favorable result) out of the Ninth Circuit in *Simpson v. AOL Time Warner*. But there were major losses as well, particularly when the Fifth Circuit overturned the district court ruling in the Enron litigation, as well as in the Eighth Circuit in *In re Charter Communications Inc*, restyled as *Stoneridge* when the Supreme Court granted certiorari.

I am not inclined to linger over the Court’s choice to make reliance the determinative issue in assessing scheme liability, even though, like the dissenters, I find it strange. Standard fraud-on-the-market theory presumes that investors rely on price integrity, not directly on the misinformation itself. 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 to the auditor’s certification of Charter’s false financials and thus the price distortion. Had the auditors not been fooled, it is unlikely that the scheme would have succeeded. That is a classic claim of indirect reliance, well-known in both tort law and securities law. By situating its restrictive approach in the element of reliance, it conveniently limits its holding to private securities litigation. This arguably leaves the SEC and criminal

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15 See Prentice, supra.
17 452 F.3d 1040 (9th Cir. 2006).
18 *Regents of the University of California v. Credit Suisse First Boston*, 482 F.3d 372 (5th Cir. 2007), cert. denied, 128 S.Ct. 1120 (2008).
19 *In re Charter Communications Inc.*, 443 F.3d 987 (8th Cir. 2006).
prosecutors free to make more aggressive claims against third parties.\textsuperscript{20} The fact that this distinction was strongly urged by the Solicitor General in the government’s amicus brief—which the Court follows fairly faithfully in Stoneridge, as it has done in so many securities cases—is circumstantial evidence of a motivation to strike only at private securities litigation. If so, then the awkwardness of basing this on reliance is relatively harmless: private plaintiffs are probably in no worse position than had the Court made its ruling directly on the issue of what constitutes deceptive conduct, while public enforcers (and their investor beneficiaries) are arguably better off.

The Court says little about what it means by too remote, except for 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.\textsuperscript{21} At first glance, this seems almost inane. Accounting and financial reporting are nothing more than the quantitative expression of the results of business operations, ordinary and extraordinary. As the Court quickly acknowledges, what Scientific-Atlanta and Motorola allegedly did was covered under federal law, as both criminal and civil aiding and abetting. In fact, both companies were penalized by the SEC and/or the Justice Department for these kinds of activities. The federal interest here seems particularly compelling because the third parties’ deception seemed to be directed at Charter’s auditors,\textsuperscript{22} 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 to lose touch with reality in search of a federalism angle. But I think we can make more sense of the distinction, and so will come back to it shortly.

The Court’s other justification, also puzzling at first glance, is that nothing the secondary defendants did “made it necessary or

\textsuperscript{20} But see note --- infra.

\textsuperscript{21} 128 S.Ct. at 769-70; see also id at 774.

\textsuperscript{22} In their complaint, plaintiffs raised the possibility that the auditors were complicit in the fraud; in fact, Arthur Andersen settled early on. One way of viewing the facts would be that Andersen indicated that it wanted fabricated documentation simply to provide it with an excuse for not blowing the whistle on the fraud. 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.
inevitable for Charter to record the transactions as it did.”23 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.24 The Solicitor General’s brief, from which this idea derives as well, was more nuanced, claiming in essence that the defendants’ sham contracts and falsified document merely set the stage for Charter to more easily dupe its accountants and, consequently, its investors, but that almost all the creative work of deception was by Charter.25 Taken 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, note how open-ended and indeterminate the Court’s remoteness standard is, which should not make it particularly confining to lower courts. Prior to Stoneridge, some courts had developed much more restrictive approaches to what constitutes deceptive conduct—most notably the “bright-line” attribution test26—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 didn’t follow these pleas is well worth pondering, and takes us to the crucial question. Should we read Stoneridge’s conclusion as to attenuation simply as a reason the reliance claimed 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? Favoring the former reading, of course, is the Court’s tradition of narrow holdings. 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) about when third-party liability is justified27—an equivocation that quite possibility was the result of its own private negotiations with the SEC, which had long pushed an expansive approach to primary liability in its own enforcement and amicus briefs.

23 Id. at 770.
24 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.
25 Brief of the United States, supra, at 20-21
26 See pp. --- infra.
27 Brief of the United States, supra, at 22 n.12.
On the other hand, given that it was offered so many different possible tests, both for reliance and the other elements underlying scheme liability, it seems fair to assume that the Court chose deliberately and actually preferred remoteness and attenuation as the best way to think about reliance. At one point the Court poses the inquiry specifically in terms of whether the third-party’s acts “were immediate or remote to the injury,”\(^{28}\) suggesting that it is putting forth a test. So, without suggesting that it is the only plausible reading, I want to make this assumption and then see what follows from its natural implication: that there may be a significant category of cases where third-party involvement was not too remote or attenuated from plaintiff’s reliance. If so, we should think hard about what kinds of third-party involvement might be immediate rather than remote, which in turn requires thinking about what differentiating between the two accomplishes. As discussed more fully below, my reading is that the Court’s test is a way of limiting third-party liability to those cases where the defendant fairly deserves the extraordinary form of liability that fraud-on-the-market lawsuits threaten. The more remote and farther away 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 comes, the more likely that would be the defendants’ just deserts. The judge can decide this as a matter of law, thereby dismissing defendants early on when appropriate. In other words, 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, we shall return to this reading of *Stoneridge*, and see how it applies to particular fact circumstances that have arisen in recent cases. But first, an important definitional point. It is tempting to see what the Court is doing as substituting proximate cause for but-for causation in the reliance inquiry. But the standard approach to proximate cause is based on foreseeability. Plaintiffs were probably right in arguing to the Court that Scientific-Atlanta and Motorola were aware (or at least a reasonable person in their position would have been aware) that the sham contracts and falsified documents were going to be used by Charter to produce false accounting results, thereby satisfying that standard. The Court’s response to this was an explicit rejection of foreseeability, saying that “were 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.”\(^{29}\)

\(^{28}\) 128 S.Ct. at 770.

\(^{29}\) Id.
If proximate cause does not aptly describe the kind of analysis at work, what does? To me, there are two possibilities that come closer. One is standing, which addresses whether the injury of which the victim complains is such as to justify a claim against the defendant in question. While this might work, I think a better way of describing the analysis is in terms of duty. The Court appears to be saying that only certain kinds of actors and conduct ought be subjected to the extraordinary risk of a fraud-on-the-market lawsuit—i.e., that the duty of candor owed specifically to all the investors in the capital marketplace should be limited and not attach to “the whole marketplace in which the issuing company does business.” Here, the Court’s otherwise incoherent articulation of a difference between the realms of business and finance makes more sense: maybe the duty should be limited to those who inhabit the realm of finance and hence are fairly on notice of the extraordinary legal risks created by the federal securities laws. The sliding scale of attenuation and remoteness could capture this fairly well. Part III will explain more fully.

Before that, however, we first need to examine the supposed need for proportionality more carefully, because it is far from self-evident. In tort reform debates, claims of disproportion and limited duty can easily just mask pro-business 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 much more worried about making the injured investors whole than protecting the pocketbooks of third-party actors who engaged in deceptive, illegal misconduct.31 Proximate cause and duty are workhorses in tort law, but largely only in the law of negligence. Rule 10b-5 requires a showing of intent and, hence, culpability. Notwithstanding all this, the next part shows why disproportionality is a troublesome problem in private securities litigation, worthy of a measured response.

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30 I am grateful to Gerry Spann for suggesting standing as a possibility. Another possibility is the “in connection with” requirement, see pp. --- infra, but this would apply to SEC actions as well. 
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. In essence, this awards to each purchaser or seller 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. 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 proximately caused by their deception. We should note, however, that one of the plaintiff bar’s aims in pursuing scheme liability was to hold each participant in the scheme responsible for investor damages flowing from the overall fraud, whether or not directly connected to the participant’s own deceptions. If such an approach had been applied in Stoneridge, 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.

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

The first point is doctrinal, and connects Stoneridge back to Basic Inc. v. Levinson, the Court’s seminal decision on reliance in open-market fraud litigation. Basic insists that reliance is a crucial element of

33 See In re Enron Corp., Sec. & Deriv. Litig., 529 F. Supp.2d 644, 722-23 (S.D. Tex. 2006). This is not a necessarily conclusion, however, and a court could reasonably hold (by reference to doctrines of loss causation, etc.) that third-party defendants are responsible only for those damages flowing directly from their own deceptions.
plaintiff’s cause of action, but creates a presumption of reliance in most cases involving widely-traded securities, thereby facilitating class certification. 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 once the court has determined that the alleged fraud did in fact distort the stock price. 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 accurate (and thus simply free-rode on it), the fact is that large numbers of active investors would not qualify and do not deserve compensation. The failure to exclude these from the recovery class leads implies substantial overcompensation.

If the presumption is instead based on the assumption that investors simply considered the prevailing market price to be honest (i.e., not be the product of fraud), the risk of overcompensation diminishes. But this comes only by abandoning reliance as a meaningful element. Prices are distorted by fraud 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.

In other words, to the extent that we stay wedded to insistence on reliance—an insistence that Stoneridge repeats—overcompensation comes from allowing recovery as a result of the practical impediments that effectively make the presumption conclusive by those who 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: abandon the insistence on reliance altogether (i.e., make the presumption conclusive) and substitute a causation

35 Basic allows rebuttal if the defendants can show that the decision to buy or sell was disconnected from the prevailing market price. 485 U.S. at 248-49. Needless to say, it is very easy for investors to claim that they did rely in some way or another, and an evidentiary hearing for thousands of investors would be extraordinarily costly and fruitless. As one 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.
36 128 S.Ct. at 769.
37 See Langevoort, Basic at Twenty, supra, at 153 n.9. Justice Brennan ultimately gave up in 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. This correspondence was uncovered by Adam Pritchard. See Pritchard, supra.
inquiry to find injury, asking simply whether the investor purchased or
sold at a distorted price. This effectively creates an entitlement to
reliance on price integrity, conferred as a matter of juristic grace.

This is not an unreasonable position as a policy matter, and may
well be the only plausible explanation for how current law actually
operates, notwithstanding the Court’s repeated insistence otherwise. But
this move does jettison 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. What is described as injury, for many class members, is
really the deprivation of a judicially-created entitlement. In that light,
for courts to ask whether liability is proportionate to the nature of the
wrong is perfectly fair.

Even apart from this, however, there are reasons for concern
about excess. 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 under-react to news (as well
as respond to pseudo-news), 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. To the extent that the econometric tools have less

38 E.g., Zohar Goshen & Gideon Parchomovsky, The Essential Role of Securities
was explicit in rejecting a role for reliance in fraud-on-the-market cases. See Daniel
Fischel, Use of Modern Finance Theory in Securities Fraud Cases Involving Actively

39 For a thoughtful discussion of what makes reliance an essential element in fraud
cases, see John C.P. Goldberg, Anthony Sebok & Benjamin Zipursky, The Place of
Reliance in Fraud, 48 Ariz. L. Rev. 1001 (2006). The authors discuss fraud-on-the-
market and argue that Basic preserves the special role for a reliance requirement
because of the rebuttability of the presumption. I am suggesting that the norm is
instead de facto irrebuttablity—and hence simple causation—which changes the
analysis substantially.

40 E.g., Frederick Dunbar & Dana Heller, Fraud on the Market Meets Behavioral
Finance, 31 Del. J. Corp. L. 455 (2006); Larry Ribstein, Fraud on a Noisy Market, 10
Lewis & Clark L. Rev. 137 (2006); Alon Brav & J.B. Heaton, Market Indeterminacy,
28 J. Corp. L. 517 (2003); see also Langevoort, Theories, supra.

41 E.g., Nathaniel Carden, Comment: The Implications of the Private Securities
Litigation Reform Act of 1995 for Judicial Presumptions of Market Efficiency, 65 U.
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.

Another—and perhaps the most familiar—reason for concern, first explored in depth by Frank Easterbook and Daniel Fischel, is that fraud produces a mix of losses and gains for investors: for every unfortunate buyer there is a lucky seller, and visa versa. So, the net harm to investors as a class approaches zero, with the difference being those trades by insider complicit in the fraud. This difference is usually just a small portion of the aggregate trading. While 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), over time the combination of fortuitous trading gains plus 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. And institutional plaintiffs are the primary beneficiaries of the contemporary class actions system.


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 Ford. L. Rev. 3045 (2009).

See Anjan Thakor et al., The Economic Reality of Securities Class Actions (2005). This is the starting point for analyzing a separate problem, so-called “circularity” in fraud-on-the-market cases. Circularity arises because most settlements and judgments are funded by either the issuer itself or its director and officer insurer, 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., operates as a form of investor insurance—with high transaction costs. There is controversy in the literature about this is truly problematic or not. See Alicia Davis Evans, The Investor Compensation Fund, 33 J. Corp. L. 223 (2007); Jill E. Fisch, Confronting the Circularity Problem in Private Securities Litigation, 2009 Wis. L. Rev. 333; Thomas A. Dubbs, A Scotch Verdict on “Circularity” and Other Issues, 2009 Wis. L. Rev. 455. By and large, critics of the circularity argument point out, quite correctly, that many investors will be net losers,
A 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. The near universal assumption in the case law is that the fair price is the price the securities would have traded at had the truth about the issuer been told. But for many reasons, some of which are discussed more fully below, that may not be the right counterfactual.46 If the more likely alternative to defendant’s misrepresentation would have been to say nothing at all, or engage in lawful “puffery” rather than tell the truth,47 then damages based on the standard assumption overcompensate. For instance, take a case where as immediately after a misrepresentation, the price per share is $21, and plaintiff buys at that price. Assume that had the truth been told instead, the price would have dropped to $15, as it does later on when the truth is revealed. That suggests a compensable loss of $6, which is what most all courts would award. But now further assume that defendant had no duty to speak at all,48 and could have chosen to say nothing or to speak in optimistic terms too vague to be actionable. Had it taken this course, the price would probably still have been at (or close to) $21 and plaintiff would have no right to any compensation. If the latter is the more likely counterfactual——i.e., our 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 I concede even over a lifetime, and thus deserve compensation. But that would not counter the systemic overcompensation argument if the result of the system is money paid without regard to whether a person is in that category, i.e., to undeserving as well as deserving class members.

45 See James D. Cox & Randall 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 (2006). 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. E.g., Donald C. Langevoort, Capping Damages for Open Market Securities Fraud, 38 Ariz. L. Rev. 639 (1996); Rose, supra.


47 See COX ET AL, supra, at 606-09.

48 The duty to speak is a fairly circumscribed category, at least beyond those disclosures mandated by the SEC. See COX ET AL., supra, at 685-96.
that choosing the more likely counterfactual as between truth-telling and lawful concealment is often very hard, simply presuming that the truth would always have been revealed, and automatically calculating damages mechanically based on that presumption, introduces another overcompensatory bias into the law.

The point of the foregoing is not to criticize the choices that courts have made to create a nearly irrebuttable presumption of reliance, ignore fraud-based gains, or use truth-telling as the standard counterfactual. There are good pragmatic reasons for each of them. The crucial point, instead, is that as a result of these and other doctrinal moves, the fraud-on-the-market 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 fear of disproportion.

Soon after Rule 10b-5 doctrine abandoned privity in the late 1960’s,\(^{49}\) thereby creating the vast liability sums at risk 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 that liability under 10b-5 required a showing of scienter,\(^{50}\) which today means that only intentional or subjectively reckless conduct is proscribed. At first glance, this would seem to eliminate much of our reason for concern. For instance, in their early dissection of fraud-on-the-market damages, Easterbrook and Fischel pushed aside concerns about overcompensation based on net social harm by noting that because Rule 10b-5 reaches only intentional fraud, rational actors have the ability to refrain from activity that would cause harm, and so we should not be overly worried about the severe liability consequences if they choose

\(^{49}\) See SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968)(en banc), cert. denied, 394 U.S. 976 (1969); see TAN --- infra.

\(^{50}\) Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976).
otherwise. 51 This brings us back to the point noted earlier, that tort law tends to apply more restrictive rules of reliance and causation only for negligence, not with respect to intentional harms.

In two respects, however, this confidence is misplaced. The first, a lively subject in the scholarly literature in the early 1990’s, is that some forms of misrepresentation and omission involve mildly tragic choices—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 promising merger negotiation. 52 To be sure, a reasonable response is to say 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 want to make sure that the compensatory amount is limited to what is absolutely necessary. As the previous section shows, we have grounds for concern about that. 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 practically irrefutable presumption of reliance after Basic) in the case of a misrepresentation or omission that can be justified on utilitarian grounds?

But the much more significant respect in which intentionality is an incomplete response is vicarious liability. Especially in the third-party liability area, almost all claims of responsibility are directed at entities, not individuals: law firms, investment banks, accounting firms, etc. And the doctrine of corporate scienter, though very fuzzy around the margins, attributes intent or recklessness fairly readily from agent to principal. 53 What this means—also extensively explored in the academic literature—is that most securities fraud liability is borne by corporate entities, and therefore by its shareholders, not the individual agents who committed the wrongful acts. In some cases, there may not be any specific agent who acted wrongfully, but simply “wrongdoing” by collective attribution from the conduct and knowledge of multiple agents.

51 Easterbrook & Fischel, supra, at 622-25.
53 See Southland Sec. Corp. v. INSpire Ins. Solutions, Inc., 365 F.3d 353, 366 (5th Cir. 2004); Makor Issues & Rights Ltd. v. Tellabs Inc., 313 F.3d 702 (7th Cir. 2008).
Here, blameworthiness is muted, often non-existent. Of course, there may be an economics-based argument for vicarious liability in terms of forcing the internalization of costs and inducing optimal precautions, though as Paul Mahoney, Jennifer Arlen and William Carney showed in two seminal scholarly works appearing at roughly the same time, the argument is complicated and far from compelling. We need not go there, however, but just note the disappearance of blameworthiness from vicarious liability except in those cases where there is an inexcusable monitoring failure at the entity level. The argument can be made, but it is not easy.

There may be other reasons as well to worry about disproportion—particularly based on the risk of judging in hindsight—but further discussion would take us too far afield and the issues have been addressed thoroughly enough elsewhere. Were we sure that the fraud-on-the-market remedy is simply (and efficiently) compensatory, this might not matter much; risk of error is endemic in all litigation. But if the previous section is right, greater caution in assigning liability is warranted.


56 Stoneridge gives us a useful example. The decision to aid Charter by engaging in the sham transactions was apparently made at the mid-level by sales and marketing people: there was no solid evidence of approval of the scheme by senior executive officers at either Scientific-Atlanta or Motorola. The motivation was no doubt to keep in place a profitable commercial relationship (Charter could have threatened the loss of business if one supplier of business 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 similar sham transactions entered into with Adelphia Communications. An action was brought (and settled) against the chief financial officer, but without claiming knowledge on his behalf. See In re Haislip, Exch. Act Rel. No. 54030 (June 22, 2006), discussed in Brian A. Ochs, Has the Securities and Exchange Commission Expanded Corporate Liability?, 38 Sec. Reg. & L. Rep. (BNA) 1549 (Sept. 18, 2006).

57 See G. Mitu Gulati et al., Fraud by Hindsight, 98 Nw. U. L. Rev. 773 (2004). This is especially true with respect to materiality; because lawsuits are only brought after high-magnitude events (usually adverse ones) occur, there is a risk of overestimating the probability of occurrence that is hard to eliminate.
C. Section 21D(f)

Thus far, we have largely ignored something crucially important. 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 the law, specifically directing courts to implement a proportionate liability regime. 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 fact-finder to determine the percentage of liability any given defendant deserves measured against the aggregate fault of all persons—whether named as defendants or not, and perhaps without regard to whether they could be held liable at all—claimed to have “caused or contributed to the loss.” Completely undefined is how the fact-finder should construct the denominator: precisely who might have caused or contributed? But the hints from the legislative history are fairly defendant-friendly, and so this interpretive problem is not part of our story.

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

As noted in the previous section, this leaves much that we would regard as relatively low or no-culpability behavior unprotected, especially with respect to vicarious liability. While the question was not yet posed in Stoneridge because it at the pleadings stage, one would assume that neither Scientific-Atlanta nor Motorola would likely receive protection, because their agents allegedly knew that they were facilitating a fraud, and that knowledge would be attributed to the entity defendants under agency law principles.

58 For a discussion of the legislative history and many of the interpretive problems, see 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 very little judicial attention, presumably because most all viable cases are settled prior to a jury decision on liability. But see In re Enron Corp. Sec., Deriv. & ERISA Litig., 236 F.R.D. 313 (S.D. Tex. 2006).

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

As set forth earlier, the reading that we are giving *Stoneridge* is best described in terms of duty: the Court says that 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 their to be protectable reliance. This form of duty analysis is jarring, to be sure. In contemporary 10b-5 jurisprudence, duty plays a relatively circumscribed role, largely addressing when someone commits fraud through silence or inaction, i.e., the affirmative duty to disclose. Prevailing authority is that persons automatically assume 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.60 Under our reading, however, duty takes on a completely different role. In this section, we will explore in some detail the doctrinal move that this implies.

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

Concern about disproportion in 10b-5 class actions arose as soon as courts abandoned privity as a requirement for liability.61 Until then, private securities fraud litigation had arisen mainly in face-to-face dealings: fraud by a purchaser or seller of securities, with the victims being the counterparties in a face-to-face transaction. In *SEC v. Texas Gulf Sulphur*,62 the Second Circuit famously held that one need not be a purchaser or seller to violate Section 10(b) or Rule 10b-5. 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. The violator could be anyone who made a material misrepresentation or omission in a manner “reasonably calculated” to influence the investing public, regardless or who, how or why. Immediately, class actions started being filed claiming that the entire marketplace had been deceived by some kind of false publicity, which soon became known as fraud-on-the-market cases.

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Over time, the “in connection with” test has come to be interpreted fairly consistently as a proximate cause requirement.\(^{63}\) That is to say, the standard interpretation of “reasonably calculated” is in terms of foreseeability, not the speaker’s motivation. So long as the speaker understands the reasonable likelihood that the lie will likely influence investors decisions (or after Basic Inc. v. Levinson, 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 attested to by those accountants. This, they said, amply satisfied the proximate cause/reasonably foreseeable standard, and should thus 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. By doing so by reference to reliance, however, it explicitly left “in connection with” law untouched, an outcome that 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,”\(^{64}\) which would not be the case when behind-the-scenes deception occurs prior to the making of the public disclosure. But the dicta in question comes out of insider trading case law,\(^{65}\) 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

\(^{63}\) See JAMES D. COX ET AL. supra, at 661. It is interesting to note that in Basic v. Levinson, 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 reinstatement of a privity requirement, thereby destroying the viability of the fraud-on-the-market lawsuit. See Langevoort, Basic at Twenty, supra, at 163.

\(^{64}\) E.g., Amicus Brief of the American Bankers Ass’n et al., at 7.

\(^{65}\) United States v. O’Hagan, 521 U.S. 642, 651 (1997). In Merrill Lynch Pierce Fenner v. Dabit, 547 U.S. 71, 86 (2006), the Supreme Court referred to the “coincide” locution in the context of a fraud-on-the-market claim. 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 is applied—hardly in a way that suggests anything in the way of limitation.
duty. 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 would have made more sense as a conceptual matter than using it 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, at least, which otherwise is something of a doctrinal anomaly, offers an interesting clue. In Ontario Public Services Employees Union Pension Trust Fund v. Nortel Networks Corp., 66 the Second Circuit confronted a case where a class of purchasers sued Nortel for false financial reporting. But plaintiffs were not purchasers or seller of Nortel stock. Rather, they had bought shares in JDS Uniphase, presumptively relying on the falsely positive financial information about Nortel to signal JDS Uniphase’s good prospects as well, because it was Nortel’s largest supplier of fiber optic components.

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—the finance literature has ample studies confirming that market efficiency works so that news affects not only the issuer’s stock price but the prices of companies indirectly affected. But the court dismissed the complaint on the curious ground that purchasers of JDS Uniphase did not have “purchaser-seller” standing to sue Nortel. The reasoning is cryptic, but the court seems to suggest that one must be a purchaser or seller of securities of the company releasing the information.

That, however, makes little sense: there is nothing in 10b-5 law limiting fraud liability to the issuer itself, and other Second Circuit case law plainly recognizes that it does not. 67 But note how that result might more easily be explained using the duty-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, the duty of candor is owed by an issuer to its own

66 369 F.3d 27 (2d Cir. 2004), cert. denied, 125 S.Ct. 919 (2005).
67 E.g., In re Salomon Analysts Metromedia Litig., 544 F.3d 474 (2d Cir. 2008). In fact, the Second Circuit backed off any such reading of Nortel. See In re NYSE Specialists Securities Litigation, 503 F.3d 89, 102 (2d Cir. 2007)(Sotomayor, J.) (“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, or that only statements about a security issuer are actionable”).
purchasers and sellers (or those of merger partners or takeover targets\textsuperscript{68}) but not to the investing world at large.

\textbf{B. Rediscovering Duty}

As noted above, contemporary 10b-5 jurisprudence uses duty mainly just to determine when silence is fraudulent. 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.\textsuperscript{69} Particularly notable here was the so-called “flexible duty” approach, a holistic inquiry that assessed liability based on (1) the informational imbalance between the parties; (2) relative access to information; (3) who initiated the transaction; (4) the benefit to the defendant; and (5) defendant’s awareness of the reliance on the misinformation.\textsuperscript{70} 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.\textsuperscript{71}

As this doctrinal retrenchment occurred, the specific question of third-party liability for fraud turned into the law of aiding and abetting, where it thrived until \textit{Central Bank}. 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. But a closer look shows duty playing a substantial and explicit role in this inquiry.\textsuperscript{72} Courts regularly encountered situations where the alleged assistance was fairly small, sometime even non-existent, i.e., a failure simply to blow the whistle on wrongdoing by the primary violator. The resulting doctrine was messy, but largely took the position that if there was a duty (flexibly determined) running from the third-party to the victims, then

\textsuperscript{68} See Semerenko v. Cendant Corp., 216 F.3d 315 (3d Cir. 2000)(bidder responsible for effects of misrepresentations about its financial condition on target company stock)
\textsuperscript{70} See White v. Abrams, 495 F.2d 724, 730 (9\textsuperscript{th} Cir. 1974); Zweig v. Heast, 594 F.2d 1261, 1266 (9\textsuperscript{th} Cir. 1979).
\textsuperscript{71} See Arthur Young & Co. v. Reves, 937 F.2d 1310 (8\textsuperscript{th} Cir. 1991); see generally Langevoort & Gulati, supra, at 1671-74.
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, the test would be more demanding: actual knowledge, and greater involvement. 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.

What was going on 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 motivates Stoneridge under my reading. In other words, were a duty-based approach to third party primary liability emerge, it would reconnect contemporary doctrine to a body of law that was asking similar questions in a broader context twenty years ago. But for the 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.

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 lawsuit brought pursuant to Rule 10b-5 unless that person owes a duty of honesty or candor to the 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 approach 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 that context specifically.

Two methods follow 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. We can easily use words and phrases like “endorsing” or “vouching for” to capture this

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73 E.g., IIT v. Cornfeld, 619 F.2d 909, 923 (2d Cir. 1980); Woodward v. Metro Bank of Dallas, 522 F.2d 84, 96 (5th Cir. 1975).
74 See, e.g., Barker v. Henderson Franklin Starnes & Holt, 797 F.2d 490, 495 (7th Cir. 1986); Abell v. Potomac Ins. Co., 858 F.2d 1104, 1125-26 (5th Cir. 1988).
idea. (This is plaintiff’s use of attribution as a sword, as opposed to defendant’s use of non-attribution as a shield, as in so many of the cases).

A second method is via a fiduciary relationship, or something sufficient akin thereto. Corporate officers, directors and other agents involved in the disclosure process are fiduciaries vis-à-vis the issuer and its shareholders, which has long been recognized to include a duty of candor. This should suffice to create the requisite duty regardless of attribution, and also becomes a reasonable (if somewhat awkward) basis for extending the fiduciary duty to the issuer as well.\footnote{See Langevoort & Gulati, supra, at 1654-64; Jennifer O’Hare, Director Communications and the Uneasy Relationship Between the Fiduciary Duty of Disclosure and the Antifraud Provisions of the Federal Securities Laws, 70 U. Cinn. L. Rev. 475, 496 (2002).}

Beyond these, I would suggest three other circumstances that also work to create a relational duty. The first of these is professional status or expertise in the world of finance that makes it reasonable to expect that the person or entity appreciates both the regulatory constraints and economic harm flowing 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. There is room here to take account of the unambiguous public-regarding obligations 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. Lawyer’s 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.\footnote{See Abell v. Potomac Ins. Co., 858 F.2d 1104 (5th Cir. 1988). 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 lawyer’s liability question 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.}

The next is creative involvement in the ultimate public deception—participation that is not simply substantial but actually helps engineer or design that deception, thereby making it more likely to succeed. Schemes to defraud take planning and cleverness in order to avoid detection and have their desired effect. Offering the brain-power
to a plan or arrangement merits the imposition of a duty. This ties to the idea in Stoneridge that the two third party defendants were largely supernumeraries to Charter’s role as producer, director and principal actor in the fraud, which points away from duty.

Finally, borrowing from the aiding and abetting cases, a high enough form of purpose or desire to deceive investors in the general marketplace—“throwing one’s lot in” with scheme or arrangement—should probably satisfy the duty requirement, though I am not sure that it adds all that 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 attaches. All we are 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 these five possibilities are the only ways of imposing a duty, they do seem particularly well-suited to that way of seeing the issue as framed by Stoneridge. In the next Section, we will see how they might be applied in specific cases.

IV. APPLYING DUTY

As Stoneridge rightly suggests, third party liability involves a continuum of causation, which can (very roughly) be divided into three segments. The first is where the third party assists but does not otherwise engage in a deceptive act at all. Since Central Bank, this does not suffice for liability in a private lawsuit. The second is where the third party does engage in a deceptive act but this is a step or two removed from the disclosure that is disseminated publicly. This is the Stoneridge problem, and the Court says that if the deceptive act is too attenuated from the disclosure, there is no reliance on which liability can be based. The third is where 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, and—so far

77 See pp. --- infra.
as reliance is concerned—the question should simply be whether the involvement in the disclosure itself was indeed deep enough. However, because reliance was the principal grounds on which the Court disposed of the claims against Motorola and Scientific-Atlanta, 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.

On the first of these—deception—plaintiffs run into the line of authority discussed earlier: in the eyes of some courts, at least, there is no liability unless the public lie can somehow reasonably be attributed to the third party defendant. Our first question, then, is whether Stoneridge has anything to say about this at all. I think so, albeit indirectly. Then we shall turn to how the duty-based analysis helps as we begin to move further away in the continuum 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, etc. On this, many courts adopted the bright-line attribution standard, especially in 10b-5(b) cases, by which third-party liability simply would not follow unless the third-party was publicly identified as responsible for the fraudulent disclosure. The Second Circuit has been particularly demanding. Elsewhere, some courts have softened this by suggesting that attribution can be implicit, as when investors are aware of the third party’s presence and could reasonably assume that it was involved in the particular disclosure. Others—sometimes at the urging of the SEC in its amicus program—have rejected the need for attribution altogether and employed other tests.

The most important lingering question is whether the attribution test survives Stoneridge. Formally it does, because the attribution standard was typically articulated as a conduct question (what does it mean to make or engage), not one of reliance per se. In the Solicitor General’s amicus brief, the Court was specifically urged not to rule on the attribution question for precisely this reason. Unfortunately, many lower courts have taken this as a reason to treat Stoneridge as having little or no relevance to defining deceptive conduct so that they simply
apply pre-*Stoneridge* law—most importantly, the bright-line attribution standard—to that question. Or when they do refer to *Stoneridge*, it is without paying any serious attention to what remoteness means. A good example is *In re Refco*, where Judge Lynch briefly notes the remoteness language but then takes the fact that the third party, a law firm, acted entirely behind the scenes as reason enough to preclude primary responsibility, regardless of how significant or culpable a role it played in assisting the fraud. That the law firm’s involvement was far from the world of ordinary business—the alleged deception came out of the firm’s role in doing due diligence for leveraged buy-out transaction, something squarely in the world of finance—was ignored entirely.

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 has amply taken care of that by promoting reliance to an independent inquiry in third-party liability cases. 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 attend to reliance.

Also instructive is the implication arising out of 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. That 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. In arguing this issue in the government’s amicus brief, the Solicitor General’s office strongly disagreed with the Eighth Circuit and argued that the two defendants had employed a deceptive device or contrivance within the meaning of Section 10(b). The Court does go that far, at least

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78 2009 WL 724378 (S.D.N.Y., March 17, 2009). In a footnote, Judge Lynch indicated that he was not necessarily pleased with the outcome as a matter of policy, suggesting that the issue was “ripe for legislative re-examination.” Id. at *40 n.15. In a related case, Judge Lynch held similarly even though the same law firm had communicated client-supplied misinformation directly to these particular plaintiffs, on grounds that the lawyers had not endorsed or adopted those representations. Thomas H. Lee Equity Fund LP, v. Mayer Brown Rowe & Maw, 2009 WL 762512 (S.D.N.Y., March 23, 2009). The SEC has filed an amicus brief in the Refco litigation arguing that Judge Lynch interpreted the case law too narrowly. See SEC Amicus Brief in Pacific Management LLC v. Mayer Brown LLP et al. (August 2009), available at [http://www.scribd.com/doc/18588471/Pacific-Mgmnt-LLC-v-Mayer-Brown-LLP-8709-Amicus-Brief](http://www.scribd.com/doc/18588471/Pacific-Mgmnt-LLC-v-Mayer-Brown-LLP-8709-Amicus-Brief).
explicitly, but does agree that mere conduct can be fraudulent, and that the lower court was therefore wrong.

This is more significant than it seems because if what Scientific-Atlanta and Motorola did was in fact employ a deceptive device or contrivance, then the statutory standard for 10b-5 liability has been satisfied so long as the deception was in connection with the purchase or sale of a security, and made with scienter. “In connection with” with has nothing to do with attribution, nor does state of mind. So, if we follow 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 remotesness. The only class of cases in which the principle would be relevant would be those where 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—many of which have been brought—where a company executive deliberately misleads a securities analyst, so that the analyst 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.  

But this would not follow if we apply 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 that was nonetheless too remote or attenuated from the recommendation on which investors relied. Surely the answer is yes to the first, and no to the second, fully justifying the courts’ rulings in this area. And if the absence of attribution is not a problem here, why should it be anywhere? 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. Why? There is of course the natural psychological tendency—to which

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79 See Cooper v. Pickett, 137 F.3d 616, 624 (9th Cir. 1997); Freeland v. Iridium World Communications Ltd., 545 F. Supp.2d 59, 75-76 (D.D.C. 2008). On the status of this idea in the Second Circuit, see In re Van Der Moolen Holding Sec. Litig., 405 F. Supp.2d 388, 403 (S.D.N.Y. 2005).
judges are no doubt 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 aided this by his writing style and the harsh dicta he put in the opinion. 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 much more moderate and flexible principle on which the decision turns.

The work that it takes to stay the course can nicely be illustrated by a Ninth Circuit case, *In re Peregrine Systems Inc. Securities Litigation*,80 which deserves its status as “not for publication.” It 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, quoting the Court as follows:

Under *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.” *Stoneridge*, 128 S.Ct. at 769.

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, 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.

In the paragraphs that follow, the remoteness is what the Supreme Court repeatedly stresses. Only by editing that out and completely rewriting the Court’s language does the Ninth Circuit’s conclusion seem plausible. Editing out is indeed what the lower courts have done.

**B. Involvement in the Disclosure Itself**

Once we get over the attribution problem, it becomes fairly easy—and justifiable—to hold actors liable when they participate “immediately” in the preparation of the fraudulent disclosure, assuming scienter, even if they are not identified as responsible for the fraud. 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

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80 310 Fed. Appx. 149, 2009 WL 186165 (9th Cir. 2009).
executives below the CEO or CFO level, but who are responsible for its design and drafting. Company managers involved in the disclosure process are fiduciaries, with a distinct duty of candor, and well on notice that they are working in the world of finance, not ancillary business activity.

One case in this spirit—one of the handful where Stoneridge has been read to support plaintiffs claims—is New York City Employees Retirement System v. Berry, involving claims against the former general counsel at Juniper Networks Inc., that she falsified corporate documents as part of a options backdating scheme. 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. The court considered her the main cause of the falsifications, given her level of responsibility at Juniper for both compensation and financial reporting—thus her conduct made the falsity both necessary and inevitable. 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. Cases start getting harder when the involvement in the disclosure is a little less central. To me, 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 to when the executive crosses the line is taking part in the creative aspect of drafting the disclosure—involvement of the sort that makes the deception more likely to work. This could sometimes come 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 our other duty examples—captures this idea of creative involvement fairly well.

A number of cases have arisen claiming that a company executive was responsible for the fraud by supplying misinformation to the disclosure team. Take, for example, a situation where a vice-president for marketing or other key sales executive arranges deals with customers that facilitate inappropriate revenue recognition. The

82 I suggested this standard shortly after Central Bank, see Langevoort, Words from on High, supra, at 892. The SEC has continued to recommend a test that is very similar—asking whether the defendant can fairly be said to have “created” the fraud—at least in 10b-5(b) cases. See Amicus Brief in Pacific Management LLC v. Mayer Brown LLC, supra, at 7; SEC Amicus Brief, discussed in In re Enron Corp., Sec., Deriv. & ERISA Litig., 235 F. Supp.2d 549 (S.D. Texas 2002).
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—and are usually asked to acknowledge in writing—that they are an integral part of the disclosure process. 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 one. At least one post-\textit{Stoneridge} case, however, has disagreed—though largely on the assumption that the attribution test still prevails.\textsuperscript{83}

C. Scheme Cases

\textit{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 were the Nigerian barge transactions structured by Merrill Lynch, which disguised what was effectively a loan as a purchase and sale. Some of the banks settled with the plaintiffs for more than $7 billion, after the trial court ruled that what they had done could constitute a primary violation of the law.

Much later, in \textit{Trustees of the University of California v. Credit Suisse},\textsuperscript{84} the Fifth Circuit reversed, freeing the non-settling defendants from liability exposure in the 10b-5 portion of the lawsuit. Like \textit{Stoneridge}, the opinion can be read in a number of different ways. What is most striking about it is its emphasis on duty. 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, though it is not clear the court really meant to say, for instance, that had Merrill Lynch itself publicly misrepresented its dealings with Enron, it would


\textsuperscript{84} 482 F.3d 372 (5th Cir. 2007).
have faced no liability. Later on, the court turns specifically to the meaning of “deception” in the context of an alleged scheme to defraud and embraces the Eighth Circuit’s reading that insisted on either an actual misstatement by the third-party defendant or a duty to disclose on the part of the third-party—precisely the approach later rejected by the Supreme Court 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 purposes or effect of those transactions, did not give rise to primary liability under Section 10(b).”

Immediately after Stoneridge, the Supreme Court denied certiorari in the Enron case, which suggests that the Fifth Circuit’s ruling is consistent with the Court’s decision. 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., that 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 that, which renders the analysis suspect in its entirety. And 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 deals with investment bankers—registered broker-dealers—whose involvement was deeply inside the world of finance. 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 I’ve suggested, 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.

The doctrinal difference, then, is that the Fifth Circuit was thinking of duty solely in its contemporary “duty to disclose” guise, and finding the absence of such a duty dispositive of the broader question of whether the banks had engaged in a deceptive act or practice. As noted earlier, this mixes up two distinct duty questions. If we assume that the banks affirmatively engaged in a deceptive communicative act in the way they structured the behind-the-scenes transactions—i.e., that these deals had the purpose and intent of fooling Enron’s auditors and other

gatekeepers—the remaining question becomes whether that 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.*86 The allegation there 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 (through an audit intermediary whose job it was to verify the data in question) about their circulation. The papers were owned by a subsidiary of the Tribune Co., a public company. As a result of the scheme, Tribune’s financial reports were materially misleading. The court invoked Stoneridge to dismiss the action against the alleged mastermind, saying that even assuming he foresaw and/or intended that the scheme would result in misleading financial statements by Tribune, the “indirect chain to the contents of false public statements is too remote to establish secondary liability.”87

Here again, some distinctions seem obvious. Most notably, the supposed mastermind was a senior official of the Tribune subsidiary. He owed a fiduciary duty to the subsidiary that ran, presumably, 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 purely intra-corporate one makes no difference in applying this kind of duty.

**D. Other Uses of Duty**

The approach to duty we have developed could work very nicely as a way of informing the “in connection with” requirement. Instead of a simple foreseeability analysis—which does create a very broad liability threat—a court might say that absent evidence of a specific intent (i.e., 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, etc., but not those more remote from the resulting trading. This would actually explain the Nortel case, discussed earlier, far better than its own reasoning.

Consider the following, another actual case. A well-known mutual fund portfolio manager was interviewed in the financial press, and in the course of the conversation was asked about particular stocks

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86 521 F.3d 686 (7th Cir. 2008).
87 Id. at 697.
held by the fund. He said that he considered them very sound investments for the fund; privately, however, he was aware that the fund is starting to dump these holdings, but does not want to cause the market price to drop by disclosing such plans (which he has no obligation to reveal). Assuming that this should be treated as a lie in the first place, is he—and derivatively, the fund’s sponsor—liable to all investors who buy those stocks between the time of the lie and the revelation of the fund’s sales, which could be a massive sum. One can see why this result might seem excessive. An invigorated duty analysis might absolve defendants of liability because the portfolio manager’s fiduciary and statutory duties run to the fund’s investors, not those in the portfolio companies, and this does not seem to be part of a deliberate attempt to manipulate the market for those stocks.

But duty can also be used offensively, as it was in the one post-
Stoneridge case that seems to resist its simplistic reading. In SEC v. Tambone,88 a panel of the First Circuit—over an impassioned dissent—determined that persons associated with a mutual fund underwriter committed a primary violation of Rule 10b-5, as well as Section 17(a) of the Securities Act, by distributing a prospectus to members of the investing public that they knew was false and misleading, even though it had been prepared by others. Rejecting the defense that this was nothing more than aiding and abetting, the court found that the public-regarding duties and expectations created by law with respect to underwriter involvement in the sale and distribution of securities was enough to justify a determining that the defendants breached an implied representation that they had reviewed and accept the accuracy of selling documents. In essence, the court finessed the Central Bank/Stoneridge problem by finding a duty to disclose. Tambone was later vacated in anticipation of rehearing en banc.

V. LEGISLATIVE REFORM

I have put forth a reading of Stoneridge at odds with the conventional account, without expecting that courts will promptly jettison their own contrary readings and fall into line behind this duty-based interpretation. Among other things, there is too much wild-eyed dicta in Justice Kennedy’s opinion—about strike suits, American capital market competitiveness and the like—that courts committed to a more restrictive interpretation can pick from to stay the course.

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88 550 F.3d 106 (1st Cir. 2008).
If so, then only legislation will change the direction of the law, and I favor that. We are in the midst of an economic crisis, which 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 simply pose the question about whether an otherwise complicit financial engineer should avoid liability to investors simply because he or she is not identified as responsible for the publicly-transmitted falsity, the answer would almost surely be no.

Congress could, of course, address this by revising the standard for secondary liability, but that brings us to the question 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 in a private lawsuit—will inevitably be unsatisfying.

The solution, it would seem, would be to address damages first, and then turn to scope of liability. This could be systematic reform of 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. For now, let us stay focused on the third-party liability problem.

The first step is to revise Section 21D(f) from scratch. Assuming that we have chosen to stay with the current approach to measuring damages, 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 bears primary responsibility for its commission. Primary responsibility arises when the person was a moving force in the design and execution of the deception. There could be more than one person with primary responsibility.

For those who violate Rule 10b-5 but do not bear primary responsibility, the fact finder (I would make it the judge) should have the reviewable discretion to limit damages to defendants’ fair share in light of the nature and culpability of its involvement as compared to the actions of those with primary responsibility, and the severity of the
injury to investors. This is deliberately open-ended, but not particularly more than the current statutory language, and avoids the silliness of having to apportion fair shares to responsible parties that sum to 100%.

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 that is—settlement bargaining today takes place in the face of considerable factual and legal uncertainty, but the results nonetheless seem reasonably responsive to the underlying merits—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 it 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 the way is now cleared for an expansion of the standard for secondary liability. While there could be any number of articulations, I cannot think of any good reason 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 brings down the risks considerably. To be sure, there is the complaint that low-merit litigation will systematically force unfair settlement payouts, to which Justice Kennedy unfortunately once again gave voice.89 However, given the changes brought to the law by the PSLRA—construed fairly conservatively by the courts in the almost fifteen years since—it is hard to believe that low- or no-merit lawsuits systematically survive motions to dismiss so as to be pervasive strike suit threats.90 The shift toward institutional lead plaintiffs has also freshened the litigation

89 128 S.Ct. at 772, saying that “extensive discovery and the potential for uncertainty and disruption in a lawsuit allow plaintiffs with weak claims to extort settlements from innocent companies.”
90 There is evidence that the PSLRA has been imprecise in its impact but with good cases thrown out as well as bad cases let through. For good summaries of the evidence, see Stephen Choi, The Evidence on Securities Class Actions, 57 Vand. L. Rev. 1465 (2004); Michael Perino, Did the Private Securities Litigation Reform Act Work?, 2003 U. Ill. L. Rev. 913.
environment by diminishing the autonomy of plaintiffs’ lawyers.\textsuperscript{91} 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 put to use to address the secondary liability problem.

VI. CONCLUSION

I am postmodern enough not to suggest that there ever is a single meaning or intention discoverable in any text, including a Supreme Court opinion. Thus I will concede that the reading I have given Stoneridge here is just one of many possibilities, and the fact 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 thus am anxious to construe Justice Kennedy’s ambiguous text in that light. Still, I am convinced that this is a better reading than any other.

My 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. The defense/business side considers it a holy victory, to be interpreted expansively according more to its rhetorical vigor than its specific holding. So far, their construal has the upper hand in the lower courts. What I have tried to do is move this debate toward compromise. As just 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, as I hope I have shown. This excess encourages too many marginal cases, and distorts settlement negotiations. The moderate course is to try to preserve appropriate private securities liability, for third parties and otherwise, but also pull back on the excess.

While I would 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. To this end, I have proposed a legislative solution with respect to third-party liability that is fairly straight-forward, in which expanded scope of liability is balanced by a more proportionate measure of damages. But we are probably at a point where the fraud-on-the-market case law is sufficiently incoherent that more comprehensive statutory reform of private securities litigation than the one change I have suggested is appropriate. Were Congress to do that with care and balance, it would be all to the better.