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Ninth Circuit Establishes Pleading Requirements for Alleging Scheme Liability Under §10(b) and Rule 10b-5(a) of the Securities Exchange Act of 1934

On June 30, 2006, the United States Court of Appeals for the Ninth Circuit decided *T. Jeffrey Simpson v. AOL Time Warner Inc.*,¹ affirming the decision of the United States District Court for the Central District of California dismissing, pursuant to Federal Rule of Civil Procedure 12b(6), claims brought pursuant to §10(b) of the Securities Exchange Act of 1934² and Rule 10b-5³ promulgated thereunder, against AOL Time Warner Inc., Cendant Corporation, and L90. The Ninth Circuit addressed in detail the issue of “scheme liability”⁴ and affirmed dismissal of plaintiffs’ complaint for failure sufficiently (and separately) to allege with particularity primary liability as to each defendant. On remand, plaintiffs may seek leave to amend their complaint if that can be done consistent with the Court of Appeals’ opinion.

I. BACKGROUND

Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 impliedly create a private cause of action for fraud in connection with the purchase or sale of securities. In the developing years of 10(b)/10b-5 case law, debate raged as to the scope of liability in respect of third parties other than the issuer and those making false or misleading statements. Aiding and abetting was an in vogue allegation. On April 19, 1994, the Supreme Court decided *Central Bank, N.A. v. First Interstate Bank,*

¹ No. 04-55665 (9th Cir. June 30, 2006).

² 15 U.S.C §78j(b).

³ 17 CFR §240.10b-5.

⁴ Rule 10b-5(a), which describes a type of conduct prohibited by §10(b), makes it unlawful for any person “to employ any device, scheme, or artifice to defraud.” Rule 10b-5(b) and (c) address false or misleading statements and acts, practices and courses of business which operate or would operate as a fraud or deceit.

N.A.⁵, holding that there is no cause of action for aiding and abetting a §10(b) violation. The court observed, however, that third-parties could be held liable as primary violators under §10(b) if all elements of the statute are satisfied. “Any person or entity, including a lawyer, accountant, or bank, who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator under 10b-5, assuming *all* of the requirements for primary liability of Rule 10b-5 are met.” The Supreme Court offered no additional guidance to help determine when a third-party’s actions are properly classified as mere aiding and abetting and when they rise to the level of a primary violation.

Courts addressing this issue post-*Central Bank* have continued to acknowledge the validity of scheme liability⁶, but have disagreed as to the scope of its application. The Eighth Circuit has affirmed a district court holding that, in the wake of *Central Bank*, actions brought under §10b and Rule 10b-5 are limited to claims that the defendant made fraudulent misstatements or omissions, failed to disclose a material fact and had a duty to disclose, or directly engaged in manipulative securities trading practices.⁷ In contrast, in *Enron* the District Court for the Southern Division of Texas recently decided on a less categorical approach, discussing several factors that should be weighed in determining whether an act amounts to a primary violation: Did the deceptive act included a transaction whose principal purpose and effect is to create a false appearance? Did the actor employ a manipulative or deceptive device?⁸ Under the District Court’s analysis, a broad range of activities may still trigger a scheme liability violation under Rule 10b-5. The issue of scheme liability is one that is percolating in the courts.

II. FACTS AND PROCEDURAL HISTORY

Homestore.com created an online real estate website in 1996. Between 1996 and 2001 Homestore repeatedly engaged in a variety of “triangular transactions” in order to meet its revenue expectations. “In such transactions, Homestore paid a company, the company returned part of the money to Homestore by way of a different transaction, and Homestore recorded these returned funds as revenue.”⁹ Plaintiff alleged that AOL facilitated the round-trip transactions by selling advertising on Homestore’s website to Third Party Vendors and, after withholding commissions, passing the payments back to Homestore. L90 was accused of entering into triangular transactions with Homestore through the model set up by AOL. Cendant was alleged to have accepted an inflated payment for its website in return for

⁵ 511 U.S. 164 (1994).

⁶ *SEC v. Hopper*, No. Civ. H-0401054, 2006 WL 778640, 11 (S.D. Tex. Mar. 24, 2006); *In re Global Crossing Ltd. Sec. Litig.*, 322 F. Supp. 2d 319, 336-37 (S.D.N.Y. 2004).

⁷ *In re Charter Communications, Inc. Sec. Litig.*, 443 F.3d 987, 992 (8th Cir. Apr. 11, 2006).

⁸ *In Re Enron Corporation Securities Derivative & ERISA Litigation.*, No. H-0103624 (S. D. Tex. June 5, 2006) (order denying class certification).

⁹ *T. Jeffrey Simpson v. AOL Time Warner Inc.*, No. 04-55665 (9th Cir. June 30, 2006).

promising to funnel money back to Homestore through a corporate entity created expressly for that purpose.

Plaintiff asserted 10b-5 claims against Homestore, AOL, Cendant, and L90, alleging that “multiple actors engaged in a scheme to commit securities fraud by overstating the reported revenues of an Internet company, Homestore.com”.¹⁰ The district court granted a prediscovery motion to dismiss the claims against AOL, Cendant, and L90, relying on *Central Bank*. The Ninth Circuit concluded that Plaintiff failed to allege a valid claim for primary liability and upheld the district court’s dismissal.

III. RATIONALE OF THE COURT

Adopting the reasoning of several trial courts¹¹ and the SEC’s *amicus curiae* brief, the Ninth Circuit applied a “principal purpose and effect” test to determine whether a defendant’s conduct amounts to the use or employment of a deceptive device thereby rising to the level of a primary violation of §10(b). “If a defendant’s conduct or role in an illegitimate transaction has the principal purpose and effect of creating a false appearance of fact in the furtherance of a scheme to defraud, then the defendant is using or employing a deceptive device within the meaning of §10(b).”¹² If the principal purpose and effect of the act is to serve a legitimate business interest, the defendant is not a primary violator of §10(b); they are at most aiding and abetting a securities fraud. To state a 10b-5 claim against a third-party to an alleged fraudulent scheme, a plaintiff must allege, with particularity, that “the deceptive nature of the transaction or scheme was [] an intended result, at least in part, of the defendant’s own conduct.”¹³

The distinction between purpose and intent is emphasized in the decision, “[the] principal purpose prong is related to but different than the element of scienter. . . . While the scienter element ensures a culpable state of mind . . . the ‘principal purpose’ prong examines instead whether the challenged conduct of the defendant had a principal purpose, and not just an accidental effect, of creating a false appearance as part of a deceptive transaction or fraudulent scheme.”¹⁴ This distinction between purpose and intent means that “[p]articipation in a legitimate transaction, which does not have a deceptive purpose

¹⁰ *Id.* at 7238.

¹¹ *Quaak v. Dexia S.A.*, 357 F. Supp. 2d 330, 342 (D. Mass. 2005); *In re Global Crossing Ltd. Sec. Litig.*, 322 F. Supp. 2d 319, 336-37 (S.D.N.Y. 2004); *In re Lernout & Hauspie Sec. Litig.*, 236 F. Supp. 2d 161, 173 (D. Mass. 2003).

¹² *T. Jeffrey Simpson v. AOL Time Warner Inc.*, No. 04-55665 (9th Cir. June 30, 2006).

¹³ *Id.* at 7249.

¹⁴ *Id.* at 7250, fn.5.

or effect, would not allow for a primary violation even if the defendant knew or intended that another party would manipulate the transaction to effectuate a fraud.”¹⁵

The test relies on the purpose and effect of the defendant’s conduct as a “means to assess whether the defendant has used or employed a deceptive device in order to ensure that the defendant’s conduct is sufficiently deceptive to justify imposing primary liability. Thus when determining whether a defendant is a ‘primary violator’ the conduct of each defendant, while evaluated in its context, must be viewed alone for whether it had the purpose and effect of creating a false appearance of fact in the furtherance of an overall scheme to defraud.”¹⁶

Examining the alleged actions of each defendant independently, the court concluded that none of the third-party defendants’ alleged actions had the principal purpose and effect of creating a false appearance of fact in furtherance of a scheme to defraud. The principal purpose and effect of AOL’s actions was to profit from selling advertising space. “The transactions involving AOL did not create a false appearance until they were viewed in conjunction with Homestore’s actions before and after the transaction.”¹⁷ The principal purpose and effect of L90’s actions was to buy advertising space on Homestore.com through AOL. The principal purpose and effect of Cendant’s actions was to sell their real estate website for a profit. Since none of these Defendants engaged in conduct that had the principal purpose and effect of creating a false appearance in furtherance of a scheme to defraud, the Court of Appeals concluded that none of them could be liable as primary violators of §10(b).

IV. SIGNIFICANCE OF DECISION

T. Jeffrey Simpson v. AOL Time Warner Inc. holds that allegations of scheme liability must be plead with specificity for each individual person or entity named as a defendant in a 10b-5 action. The decision sheds light on an area of considerable dispute in the post-*Central Bank* era, namely the reach of scheme liability to third-party participants in an alleged securities fraud.

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or e-mail Charles A. Gilman at

15 *Id.* at 7252.

16 *Id.* at 7253. The specificity required by the Court of Appeals finds support in the pleading requirements imposed on securities fraud complaints by the Private Securities Litigation Reform Act and Federal Rule of Civil Procedure 9(b). The Court of Appeals did not address the tension between its requirement that specificity be on a defendant-by-defendant basis and the sometimes employed notion of “group pleading” and whether group pleading survives in the Ninth Circuit.

17 *Id.* at 7258.

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