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Focus

9th Circuit Clarifies Liability Standards in Securities Fraud

By Thomas C. Klein

In 2005, the total value of all federal securities class settlements, excluding those for Enron, WorldCom and Cendant, was estimated by PricewaterhouseCoopers to be \$7.6 billion. Including Enron, WorldCom and Cendant, the number ballooned to \$17.9 billion. Many of these settlements involved contributions by the alleged wrongdoers' service providers, principally accounting firms and investment bankers. In a securities class action in the Enron matter, Enron's former law firm, Vinson & Elkins, is defending itself against allegations that it was so intertwined with Enron's securities disclosures that the law firm itself is liable for securities fraud.

Federal securities law liability for service providers was limited by the United States Supreme Court ruling in *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164 (1994), and was restricted further in July by the 9th U.S. Circuit Court of Appeals in *Simpson v. AOL Time Warner*, 2006 DJDAR 8652 (June 30, 2006).

In *Central Bank*, the Supreme Court held that there is no civil cause of action for aiding and abetting a securities law violation under the general antifraud statute, Section 10(b) of the Securities Exchange Act of 1934 and the corresponding SEC regulation, Rule 10b-5.

Central Bank was a striking decision because it opposed 30 years of lower-court decisions upholding aider and abettor liability for federal securities fraud violations under Section 10(b) and Rule 10b-5. Although *Central Bank* did not affect aiding and abetting claims for criminal securities violations or state claims, and Congress later restored the SEC's ability to pursue aiding and abetting claims in the SEC's civil enforcement proceedings, securities industry service providers nev-

ertheless were heartened by the *Central Bank* decision. It seemed to insulate securities industry professionals from the securities fraud class-action liability of their clients.

It was these class actions that were the source of the greatest potential monetary damages. Accordingly, the risk for accountants, lawyers, investment bankers and others providing services to public-company clients appeared to be lessened by the *Central Bank* decision.

Central Bank required a court adjudicating a securities class action to determine the primary violation of the securities law and the parties responsible. Any party that would have been deemed "secondarily" liable under the aiding and abetting doctrine prevailing pre-*Central Bank* - that is, having just provided assistance to the primary violator - could not be held liable post-*Central Bank*.

The difficulty that courts soon confronted after *Central Bank* was determining who was a primary violator and thus liable and who merely aided and abetted without liability.

In *Simpson*, the 9th Circuit clarified the boundaries of primary liability. The case involved allegations of securities fraud under Rule 10b-5 against 28 defendants who were alleged to be involved in a "scheme to defraud" shareholders.

One group of defendants - AOL Time Warner, Cendant, and L90 and the employees of each who were involved in the transactions - were third parties who had business relations with Homestore.com, a public Internet company. These business partners were alleged to have engaged in transactions that fabricated revenue for Homestore. Because the Internet companies of the late 1990s usually posted net losses rather than net income as they attempted to build market share, the securities analysts

used revenues as an indicator of the growth of the business and of future earnings potential.

Until 2001, Homestore consistently matched or exceeded revenue growth estimates. To do so, it engaged in barter, round-trip, and triangular transactions involving the business partner defendants, the true nature of which it did not disclose in its public filings.

Homestore's relationship with AOL began a few years before the triangular transactions at issue in the *Simpson* case. Homestore paid AOL to become the exclusive online real estate listing company on AOL, and AOL became a reseller of Homestore advertising for a commission. The allegations against AOL were premised on "triangular transactions" whereby Homestore would contract with a third party for a product or service it did not need, provided that the third party would contract with AOL to advertise on Homestore's site. AOL would then give this advertising money to Homestore after deducting AOL's commission on the sale. AOL's employees were alleged to have developed this third-party transaction scheme jointly with Homestore. The allegations against defendant L90 were similar to those made against AOL.

The allegations against Cendant arose out of Homestore's purchase from Cendant of Move.com for \$750 million of Homestore stock. The plaintiff alleged that this transaction was contingent on a promise by Cendant to recycle part of the payment for Move.com back to Homestore by buying Homestore services. Cendant did indeed set up a subsidiary, funded it with \$95 million and, through this subsidiary, agreed to purchase services from Homestore. The plaintiff did not allege that Cendant tried to conceal this arrangement.

The U.S. District Court for the Central District of California dismissed the com-

plaint against these business partner defendants, holding that alleging a “scheme to defraud” cannot operate as an end run around Central Bank. Thus, the court held that, to find a participant in a “scheme to defraud” liable, it must be pleaded and proved that the defendant participant itself was a primary violator of the securities laws. The court said it was Homestore’s improper reporting of revenue that was the primary violation, not the participation in the transactions by the business partner defendants.

The court added that, in allegations of a “scheme to defraud,” it was necessary for the plaintiff to demonstrate that each defendant committed its own fraudulent act, not merely that it was part of a scheme in which others committed the frauds.

Noninsider defendants, the court said, have been held liable as primary violators of the securities laws only when those noninsiders had a special relationship with the corporation, such as being the corporation’s accountant, attorney, or bank, and the noninsiders substantially and directly participated in the false and misleading public statements.

Because these defendants did not have any special relationship with Homestore or its shareholders, their participation in the transactions that Homestore reported improperly would not support primary liability under *Central Bank*.

On appeal, the 9th Circuit clarified that

Central Bank permits secondary actors to be held liable as primary violators when all elements for securities fraud are satisfied by such defendant’s conduct, whether or not such parties have a special relationship with the corporation. Thus, even though one may be a secondary actor, one still may be liable if the elements of securities fraud can be made out.

The 9th Circuit noted that, since *Central Bank*, it has held that, in allegations of a “scheme to defraud,” each defendant must have committed a manipulative or deceptive act in furtherance of the scheme. In *Simpson*, it added to that requirement by holding that, “to be liable as a primary violator ... in a ‘scheme to defraud,’ the defendant must have engaged in conduct that had the principal purpose and effect of creating a false appearance of fact in furtherance of the scheme. It is not enough that a transaction in which a defendant was involved had a deceptive purpose and effect; the defendant’s own conduct contributing to the transaction or overall scheme must have had a deceptive purpose and effect.”

The court thus made it clear that liability could attach to noninsiders and others without a special relationship to the corporation; however, the court detailed the more-stringent requirements for pleading and proving primary liability under a “scheme to defraud” theory. This standard

makes it difficult for plaintiffs to allege and prove primary 10b-5 liability against parties in regular business transactions with legitimate purposes, even if the defendant knows that the other party would manipulate the transaction to effect a fraud.

Because the conduct of each defendant must be evaluated for whether it had the principal purpose of effecting a fraud, the focus of future litigation in this area may turn on the meaning of the words “principal purpose.”

Under this standard, the 9th Circuit upheld the District Court’s dismissal (which allowed the plaintiffs leave to amend) and determined that AOL and L90 cannot be held liable for participating in legitimate business transactions that became deceptive only when distorted by Homestore. Even when L90 certified certain revenue, because that certification was never ultimately used, it could not create a false appearance of fact. Similarly, it was Homestore’s misreporting of the income from the Cendant transactions that created the false appearance.

Accordingly, mere involvement and participation will not suffice to hold third-party defendants liable in 10b-5 securities class actions in the 9th Circuit.

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