THE ENRON DECISION: CLOSING THE FRAUD-FREE ZONE ON ERRANT GATEKEEPERS?

BY GARY J. AGUIRRE*

ABSTRACT

Enron's investment banks, accountants, and lawyers now face billions in potential liability for allegedly helping Enron construct an $80 billion house of cards. Arthur Andersen, with its $9 billion in annual revenues, simply vanished after it was caught and convicted for shredding Enron records. Why were these gatekeepers, either giant financial institutions or the most sophisticated lawyers and accountants, confident the securities fraud laws would not apply to them?

Supreme Court decisions from 1974 through 1995 provide an answer. In 1974, the Supreme Court abruptly reversed a forty-year trend of federal decisions construing the securities acts consistently with the intent of the Congress that wrote them. Over the next twenty-one years, following its own policy star, the Court dismantled the antifraud provisions enacted by the 73rd Congress after the 1929 crash to protect investors. One key decision, Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., *eliminated liability for aiding and abetting a violation of Section 10(b). In doing so, it defined a zone of conduct beyond the reach of the federal securities acts, a fraud-free zone, where gatekeepers could earn lucrative fees helping public companies cheat their investors.*

Unfortunately for these gatekeepers, the security of their sanctuary has been placed at risk by the class action against them in the Southern District of Texas. Worse yet, Judge Melinda Harmon, to whom the case was assigned, has closed down the fraud-free zone—at least for now. Her decision, In re Enron Corporation Securities, Derivative & ERISA Litigation, *denying the gatekeepers' motions to dismiss, takes a detour around* Central Bank. *But will the detour hold up on appeal? Not likely, but another legal theory may.*

---

*Formerly a partner in Aguirre & Eckmann, he now has an office in San Diego. Aguirre received his LLM (Securities Regulation-International Law) with distinction from Georgetown University Law Center in October 2003. This article won second place in the Association of Securities and Exchange Commission Alumni (ASECA) Annual Securities Law Writing Competition in January 2004. Aguirre thanks Professor Mark Kreitman of Georgetown University Law Center for his insightful feedback on the original concept and first draft and his encouragement to seek publication of this article.

TABLE OF CONTENTS

Page

I. INTRODUCTION 449
II. ENRON'S FRAUD MADE SIMPLE 453
III. BIRTH OF THE FRAUD-FREE ZONE: JUDICIAL ACTIVISM GONE WRONG 460
A. *Supreme Court Decisions Through* Affiliated Ute: *Implementing the Will of Congress* 460
B. *Early Supreme Court Decisions: Barclays Would Be Liable for its Alleged Role in the Enron Fraud* 463
C. Blue Chip Stamps: *A New Court on a New Mission* . 464
D. *Supreme Court Decisions after* Affiliated Ute: *Is There a Rationale? No, There Are Two* 470
E. *Sculpting the Court's Decisions to Reveal the Policy Within* 472
F. *Fraud-Free Zone, Phase I: Getting* "Blue-Chip-Stamped" 474
G. *Fraud-Free Zone, Phase II: Opening for Business* . . 483
H. *Has the Supreme Court Pulled Back from* Blue Chip Stamps? 487
IV. *IN RE ENRON*: A BOLD BUT FLAWED EFFORT TO CLOSE THE FRAUD-FREE ZONE 488
V. CAN THE FRAUD-FREE ZONE BE CLOSED? YES, IF SECTION 10(B) APPLIES TO CONDUCT 492
A. *One Possibility for Closing the Fraud-Free Zone: Conduct as Fraud* 492
B. *Textual Interpretation: Section 10(b) Applies to Conduct* 498
C. *Contextual Interpretation: Section 10(b) Applies to Conduct* 499
D. *Intent of the 73rd Congress: Section 10(b) Applies to Conduct* 500
E. *Replacing the Failed "Policy Considerations" of* Blue Chip Stamps 505
VI. CONCLUSION 508

I. INTRODUCTION

Some twenty-seven months ago, the nation was blind-sided by a harsh truth: the capital structure of its seventh largest corporation—Enron—was a myth. Investors lost nearly $80 billion,[1] but they were not the only victims. Rank and file Enron employees, prohibited from tapping retirement accounts, watched sixty percent of their assets vanish, a $1.3 billion loss.[2] There were, however, a few winners: Enron's top management siphoned off at least $1.8 billion from bonuses and insider sales.[3]

As the dust settled, shock gave way to a disturbing question: Where were the gatekeepers? Why did Enron's investment bankers, accountants, and lawyers fail to detect a fraud of this magnitude and scope and act to curb it?[4] The answer has surfaced as fingerprints taken from the corpus of the fraud were matched with those of Enron's investment bankers,[5]

---

[1]Joseph Weber et al., *Arthur Andersen: How Bad Will It Get?* BUS. WK., Dec . 24, 2001, at 30.

[2]148 CONG. REC. E18 (Jan. 24, 2002) (statement of Rep. Waters); Jeffrey N. Gordon, *What Enron Means for the Management and Control of the Modern Business Corporation: Some Initial Reflections,* 69 U. CHI. L. REV. 1233, 1248 (Summer 2002); Jonathan D. Glater, *Plaintiffs Ask: Just How Deep Are the Pockets at Andersen?* N.Y. TIMES, Jan. 24, 2002, at C1.

[3]Enron insiders received $1.1 billion for stock sold from 1999 through mid-2001. Leslie Wayne, *Before Debacle, Enron Insiders Cashed in $1.1 Billion in Shares*, N.Y. TIMES, Jan. 13, 2002, at A1. Additionally, Enron paid its senior managers $681 million in bonuses through December 2, 2001. Kathryn Kranhold & Mitchell Pacelle, *Enron Paid Top Managers $681 Million, Even as Stock Slid*, WALL ST. J., June 17, 2002 at B1.

[4]*See* John C. Coffee, Jr., *Understanding Enron: "It's about the Gatekeepers, Stupid*," 57 BUS. LAW. 1403, 1405 (2002) ("Properly understood, Enron is a demonstration of gatekeeper failure, and the question it most sharply poses is how this failure should be rectified.").

[5]*See, e.g.*, Third Interim Report of Neal Batson, Court-Appointed Examiner, Appendix D (Role of Citigroup and its Affiliates), U.S. Bankr. Court, S.D.N.Y., *In re Enron*, No. 01-16034 (Bankr. S.D.N.Y. June 28, 2003), at 148, *available at* http://www.enron.com/corp/por/pdfs/examiner3/appendixD.pdf ("The evidence reviewed by the Examiner, and the reasonable inferences that may be drawn from that evidence, are sufficient for a fact-finder to conclude that Citigroup aided and abetted certain Enron officers in breaching their fiduciary duties."); Floyd Norris, *Bankrupt Thinking: How the Banks Aided Enron's Deception* N.Y. TIMES, Aug. 1, 2003, at C1.

> Mr. Batson's voluminous report [addressing the banks' role in Enron's fraud] makes it clear that the banks were not "looking the other way" as Enron misled investors. They were instead dreaming up and selling financial products to allow Enron to mislead. Some of those products appeared to squirm within accounting rules, but even then the banks found themselves engaging in practices that they knew should invalidate the accounting.

Id.

accountants,[6] and lawyers.[7] These gatekeepers were not merely asleep at the switch; rather, each allegedly played a key role in the fraud itself.[8] Senator Levin summed up the evidence taken by the Investigations Subcommittee on the investment banks' creative role in Enron's fraud: "As disturbing as Enron's own misconduct is[,] the growing evidence [shows] that leading U.S. financial institutions not only took part in Enron's deceptive practices, but at times designed, advanced, and profited from them."[9]

The gatekeepers' conduct is puzzling. They knew Congress enacted tough antifraud laws after the market collapse of 1929. They had lawyers or were lawyers themselves, steeped in the intricacies of the securities laws, who monitored the law's pulse—new court decisions, legislative bills, and SEC administrative actions. Why would they risk billions of dollars in civil liability to help Enron construct a house of cards? The class action against them offers a simplistic answer: the gatekeepers knowingly broke the rules to pocket hundreds of millions of dollars in fees.[10]

---

[6]Final Report of Neal Batson, Court-Appointed Examiner, Appendix B (Role of Andersen), U.S. Bankr. Court, S.D.N.Y., *In re* Enron, No. 01-16034 (Bankr. S.D.N.Y. Nov. 4, 2003), at 2, *available at* http://www.enron.com/corp/por/pdfs/examinerfinal/NBFinalAppendixB1.pdf.

> The evidence suggests that, on multiple occasions, Andersen accountants had actual knowledge of the wrongful conduct giving rise to breaches of fiduciary duty by Enron officers with respect to those transactions, and gave substantial assistance to those officers by: (i) approving accounting that made Enron's financial statements materially misleading; and (ii) not communicating to the Audit Committee in accordance with applicable standards.

Id.

[7]*See* John C. Coffee, Jr., *Symposium: Regulating the Lawyer: Past Efforts and Future Possibilities: The Attorney as Gatekeeper: An Agenda for the SEC*, 103 COLUM. L. REV. 1293, 1301 (2003) ("In their statements in the Congressional Record, the Senate co-sponsors of section 307 [of the Sarbanes-Oxley Act] clearly expressed their view that attorneys were at least as implicated as auditors and investment bankers in the financial and accounting irregularities that produced the collapses of Enron . . . .").

[8]*See supra* notes 5-7 and *infra* text accompanying notes 24-62.

[9]*Oversight of Investment Banks' Response to the Lessons of Enron—Vol. 1: Hearing Before the Permanent Subcomm. on Investigations, Senate Comm. on Government Affairs,* 107th Cong. (2002) (statement of Carl Levin, Subcomm. Chair), *available at* http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=107_senate_hearings&docid=f:83485.wais [hereinafter *Hearings on the Lessons of Enron*].

[10]*Regents of the University California v. Lay*, First Amended Consolidated Complaint ¶¶ 17, 25-26, 70, *available at* http://www.enronfraud.com/pdf/MASTER1stAmd.pdf [hereinafter *Enron Class Action Complaint*]. The lawsuit, filed as a class action, was consolidated pursuant to 28 U.S.C.S. § 1407 (1988), with other litigation in *In re Enron Corporation Securities, Derivative & ERISA Litigation*, pending before the United States District Court for the Southern District of Texas, Judge Melinda Harmon presiding. In December 2002, with a few exceptions, Judge Harmon denied the motions to dismiss brought by Enron's investment banks, attorneys, accountants under Rule 12(b)(6) of the Federal Rules of Civil Procedure. *In re* Enron Corp. Sec.,

This answer makes little sense; it assumes the gatekeepers acted irrationally. Take Arthur Andersen (Andersen) for example. It foresaw $100 million in annual fees from Enron.[11] Yet, that sum is inconsequential when compared to its $9.34 billion in revenues for 2001.[12] Andersen knew those revenues could cease and its potential liabilities would be billions more if its role in the Enron fraud should come to light. Why would a company generating more than $9 billion in annual revenues gamble all for a $100 million fee?

Logic dictates that Andersen did not see the risk.[13] The same seems equally true for Enron's investment bankers and attorneys. Two theories could explain why. First, the gatekeepers may not have known Enron was a house of cards and therefore acted innocently in helping Enron consummate its fraud. Alternatively, the gatekeepers may have known the truth about Enron, but believed they violated no law by providing what they saw as investment banking, legal, and accounting services to Enron.[14]

Derivative & ERISA Litig. (*In re Enron*), 235 F. Supp. 2d 549, 708 (S.D. Tex. 2002). The court stated its review of allegations in the original class action complaint would be guided by the following well-established principle: "The district court should consider all allegations in favor of the plaintiff and accept as true all well-pleaded facts in the complaint." *Id.* at 564 n.3. Accordingly, those same allegations in the amended complaint will likewise be accepted as fact in this article.

[11] *In re Enron*, 235 F. Supp. 2d at 673.

[12] Coffee, *supra* note 4, at 1406.

[13] After Enron's collapse, Arthur Andersen engaged in the wholesale destruction of Enron-related documents and e-mails. *See* Stephan Landsman, *Symposium: III. The Jury in Practice: Death of an Accountant: The Jury Convicts Arthur Andersen of Obstruction of Justice*, 78 CHI.-KENT L. REV. 1203, 1216 (2003). It was later indicted and convicted, as a company, for obstruction of justice based on allegations that it had destroyed Enron-related documents. *Id.* at 1208, 1218. It seems improbable that Andersen would have generated these documents and e-mails knowing that it was creating the proof of a securities fraud case against itself.

[14] One commentator pointed out that Vison & Elkins, Enron's outside attorneys, are asserting both defenses. Lisa H. Nicholson, *A Hobson's Choice for Securities Lawyers in the Post-Enron Environment*, 16 GEO. J. LEGAL ETHICS 91, 98 (2002) ("So far, Vinson & Elkins has offered a 'we're-just-lawyers-what-do-we-do?' defense, coupled with the pleea that, whatever it did know, it was duty-bound to keep secret."). On the other hand, J.P. Morgan Chase publicly stated it did not believe it was doing anything wrong when it helped Enron doctor its books. It agreed, however, to hold itself to a "higher standard" in its settlement with the SEC. On July 29, 2003, *The New York Times* reported:

> Enron lied to investors about its financial condition, but it could not have done so without active help from its friendly bankers. And that help constituted fraud.
>
> That was the conclusion reached by the Securities and Exchange Commission and the Manhattan district attorney as they disclosed settlements yesterday with two of the nation's largest financial institutions, J.P. Morgan Chase and Citigroup.
>
> "If you know," said Stephen Cutler, the S.E.C.'s enforcement director, that "you are helping a company mislead its investors, then you are in violation of securities laws."
>
> That is not the way financial institutions have seen it in the past. "Our view

Assuming arguendo the latter, why would these gatekeepers, with their sophisticated securities lawyers on speed dial, believe the securities fraud laws would not apply to them?

Supreme Court decisions from 1974 through 1995 may provide an answer. In 1974, the Supreme Court abruptly reversed a forty-year trend of federal decisions liberally construing the antifraud provisions to protect investors.[15] One key decision, *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.,* eliminated liability for aiding and abetting a violation of Section 10(b).[16] In doing so, it defined a zone of conduct beyond the reach of the antifraud provisions. The Second Circuit made the zone even safer; it delineated its boundary with a bright line.[17] From the safety of this well-marked zone, investment banks, accountants, and lawyers could earn large fees helping public companies cheat their investors, so long as they did not take credit for authoring the lie.[18] In the shadows of this lucrative zone, a fraud-free zone, Citibank, J.P. Morgan, Arthur Andersen, and others allegedly nurtured Enron's conversion from a quasi-viable company to a full-blown Ponzi scheme.[19]

Unfortunately for Enron's gatekeepers, the security of their sanctuary has been placed at risk by the class action against them in the Southern

---

> historically," wrote Marc J. Shapiro, vice chairman of J.P. Morgan Chase in a letter to Robert M. Morgenthau, the Manhattan district attorney, "was that our clients and their accountants were responsible for the clients' proper accounting and disclosure of the transactions." Now, he said, his bank will "hold ourselves to a higher standard."

Floyd Norris, *A Warning Shot to Banks on Role in Others' Fraud*, N.Y. TIMES, July 29, 2003, at C1.

[15]Scherk v. Alberto-Culver Co., 417 U.S. 506 (1974).

[16]Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164 (1994). Although this decision only involved aiding and abetting a violation of Section 10(b), its reasoning applies equally to the other antifraud provisions. Congress, however, reinstated the SEC's power to prosecute civil actions for aiding and abetting violations of the 1934 Act. *See* Securities Exchange Act of 1934, 15 U.S.C.A. § 78t(e) (West 2003).

[17]Wright v. Ernst & Young LLP, 152 F.3d 169, 175 (2d Cir. 1998).

[18]The "bright line" test is one of three tests that the courts have applied in deciding whether a secondary actor is liable as a "primary violator" under Section 10(b). *See* Securities Exchange Act of 1934, 15 U.S.C.A. § 78j(b) (West 1997). Under the "bright line" test, "the misrepresentation must be attributed to that specific actor at the time of public dissemination." *See Wright*, 152 F.3d at 175. The "substantial participation" test treats the secondary actor as a primary violator if there is "substantial participation or intricate involvement" by the actor in the preparation of fraudulent statements "even though that participation might not lead to the actor's actual making of the statements." Howard v. Everex Sys., Inc., 228 F.3d 1057, 1061 n.5 (9th Cir. 2000). A third test, proposed by the SEC and adopted by *In re Enron*, treats a secondary actor as a primary violator if the actor makes a material misrepresentation passed along to investors, even though the actor's identity is not made known to investors. *In re Enron*, 235 F. Supp. 2d at 588-90.

[19]*In re Enron*, 235 F. Supp. 2d at 617.

District of Texas.[20] Worse yet, Judge Melinda Harmon, to whom the case was assigned, has closed down the fraud-free zone—at least for now. Her reported decision, *In re Enron Corporation Securities, Derivative & ERISA Litigation*, denying the gatekeepers' motions to dismiss, takes a detour around *Central Bank*.[21] But will the detour hold up on appeal? Not likely, but another legal theory may.[22]

II. ENRON'S FRAUD MADE SIMPLE

In principle, Enron's fraud was simple. Enron engaged in phony transactions with phony affiliates, which it treated as real, to improve its financial statements.[23] The financial statements were doctored in two ways. First, Enron booked sales and earnings from transactions with its phony affiliates, effectively booking sales and earnings for doing business with itself.[24] Second, Enron used phony deals to move debt off its books onto its affiliates' books.[25] For their part, Enron's investment banks, attorneys and accountants, allegedly created the phony affiliates and, using word and deed, disguised them to appear as independent entities.[26]

Many of Enron's sham affiliates were special purpose entities (SPEs).[27] The first sham SPE, the prototype for later ones, began life as a legitimate SPE.[28] It was a $500 million partnership called "JEDI" between

---

[20]*See Enron Class Action Complaint*, *supra* note 10.

[21]*See In re Enron*, 235 F. Supp. 2d at 581-94.

[22]*See infra* Section V.

[23]*See infra* text accompanying notes 24-62.

[24]*Enron Class Action Complaint*, *supra* note 10, ¶ 11; *In re Enron*, 235 F. Supp. 2d at 616.

[25]*Enron Class Action Complaint*, *supra* note 10, ¶¶ 9, 11; *In re Enron*, 235 F. Supp. 2d at 616.

[26]*Enron Class Action Complaint*, *supra* note 10, ¶ 11; *In re Enron*, 235 F. Supp. 2d at 613-17.

[27]*In re Enron*, 235 F. Supp. 2d at 614-17; William C. Powers, Jr., *Report of Investigation by the Special Investigative Committee of the Board of Directors of Enron Corp.* 5, 36-40 (Feb. 1, 2002) (on file with the Delaware Journal of Corporate Law), *available at* www.chron.com/content/news/photos/02/03/03/enron-powersreport.pdf. *In re Enron* provides the following background information on the Special investigation committee and its report:

> [I]n October, 2001, Enron's board of directors created a special investigative committee, composed of a number of individuals who had been involved in some way in either creating the partnerships at issue or reviewing the transactions, but headed by outsider William C. Powers, Jr., dean of the University of Texas School of Law. The committee performed a review and issued a 217-page report (the "Powers' report"), drafted by a former enforcement director of the SEC, William McLucas, partner in Wilmer, Cutler & Pickering, in February, 2002 . . . .

In re Enron, 235 F. Supp. 2d at 660 n.94.

[28]*Enron Class Action Complaint*, *supra* note 10, ¶ 9; *In re Enron*, 235 F. Supp. 2d at 614.

Enron and the California Public Employees' Retirement System (CalPERS).[29] Since JEDI qualified as a separate entity under generally accepted accounting principles (GAAP),[30] its operations were not consolidated into Enron's financial statements. Hence, JEDI's debt did not show up on Enron's balance sheet.[31] However, Enron's income statement was improved by its share of JEDI's profits.[32]

All went smoothly for Enron, JEDI, and CalPERS until November of 1997, when CalPERS decided to sell its interest in JEDI.[33] Unfortunately, there were no legitimate bidders.[34] Enron could not buy out CalPERS without a calamity: JEDI's operations would be consolidated into Enron's financial statements. This meant Enron would lose forty percent of its 1997 earnings.[35] Additionally, its balance sheet would be hammered twice: debt would be increased by $711 million and shareholders' equity trimmed by $313 million.[36] The combined effect would predictably disappoint investors, causing the stock to plummet.

Enron, its attorneys, Vinson & Elkins (V&E), and one of Enron's investment banks, Barclays Bank (Barclays), allegedly hatched a last-minute plan to preserve JEDI's appearance, but not its reality, as an entity separate from Enron.[37] They created a new SPE, a sham called "Chewco"[38] to buy out CalPERS' interest in JEDI.[39] To be treated as a legitimate SPE under GAAP, and thus a separate entity from Enron, Chewco would have to satisfy two requirements. First, it could not be controlled directly or

---

[29]Powers, *supra* note 27, at 6.

[30]GAAP is an acronym for Generally Accepted Accounting Principles, a body of accounting standards recognized over time by the financial community. DONALD E. KIESO ET AL., INTERMEDIATE ACCOUNTING (11th ed. 2004).

[31]Powers, *supra* note 27, at 6; *In re Enron*, 235 F. Supp. 2d at 614.

[32]Powers, *supra* note 27, at 6; *In re Enron*, 235 F. Supp. 2d at 614.

[33]Powers, *supra* note 27, at 6; *Enron Class Action Complaint*, *supra* note 10, ¶ 9; *In re Enron*, 235 F. Supp. 2d at 614.

[34]*Enron Class Action Complaint*, *supra* note 10, ¶ 10; *In re Enron*, 235 F. Supp. 2d at 614.

[35]*Enron Class Action Complaint*, *supra* note 10, ¶ 9; *In re Enron*, 235 F. Supp. 2d at 614.

[36]*Enron Class Action Complaint*, *supra* note 10, ¶ 61; *In re Enron*, 235 F. Supp. 2d at 614 (consolidating JEDI with Enron would add JEDI's $700 million debt to Enron's balance sheets).

[37]*Enron Class Action Complaint*, *supra* note 10, ¶ 10; *In re Enron*, 235 F. Supp. 2d at 614-15. Kirkland & Ellis (K&E), counsel for Chewco, also allegedly participated in the Chewco-JEDI transaction. Judge Harmon, however, dismissed the only claim against K&E (for allegedly violating Section 10(b)), observing, "Lead Plaintiff has not alleged that Kirkland & Ellis exceeded activities [that] would be protected by an attorney[-]client relationship . . . ." *Id.* at 706.

[38]*Enron Class Action Complaint*, *supra* note 10, ¶ 10; *In re Enron*, 235 F. Supp. 2d at 614-15.

[39]*Enron Class Action Complaint*, *supra* note 10, ¶ 10; *In re Enron*, 235 F. Supp. 2d at 614-15.

indirectly by Enron. Second, an equity investor, also independent of Enron, must put at risk at least three percent of the SPE's capital.[40]

Chewco met neither requirement. It was "owned" by a business partner of an Enron employee.[41] Both the Enron employee and his partner were paid handsomely for taking instructions from Enron's chief financial officer.[42] Additionally, only Enron's assets were put at risk when Chewco bought out CalPERS' interest in JEDI. Barclays loaned Chewco $240 million to make the purchase, but the repayment of the loan was guaranteed by Enron.[43] Likewise, the three percent equity investment in Chewco was a mirage. Barclays loaned Chewco $11.4 million to make the equity investment, but secretly took back $6.58 million from JEDI as a deposit securing the repayment of the loan.[44] Consequently, the equity-capital actually at risk was slightly more than one percent. In short, Chewco was in reality Enron wearing a mustache. The Chewco-JEDI fiction was the "template" for countless other SPEs and phony partnerships, which Enron likewise used to doctor its financial statements.[45]

The use of SPEs, such as Chewco, caused Enron's financial statements to grossly overstate earnings and understate debt from 1997

---

[40]Powers, *supra* note 27, at 5; *Enron Class Action Complaint*, *supra* note 10, ¶ 21; *In re Enron*, 235 F. Supp. 2d at 614 n.48.

[41]*In re Enron*, 235 F. Supp. 2d at 614.

> According to the consolidated complaint at275, pursuant to advice from Vinson & Elkins, Michael Kopper(an Enron employee who worked for Andrew Fastow) was made manager of Chewco because he was not a senior officer of Enron and therefore his role in Chewco would not have to be disclosed. Vinson & Elkins prepared the legal documentation for JEDI and Chewco. On December 12, 1997 Kopper transferred his ownership interest in Chewco to his domestic partner, William Dodson, in a sham transaction effected solely to make it appear that Kopper, and through him, Enron, had no formal interest in Chewco.

Id. See Powers, *supra* note 27, at 1-2, 6-7, 48; Enron Class Action Complaint, *supra* note 10, ¶¶ 10, 438.

[42]Powers, *supra* note 27, at 54 ("From December 1997 through December 2000, Kopper (through the Chewco general partner) was paid approximately $2 million in 'fees' relating to Chewco."). "Kopper had invested $125,000 in Chewco in 1997. The repurchase resulted in Kopper's (and a friend to whom he had transferred part of his interest) receiving more than $10 million from Enron." *Id.* at 8; *Enron Class Action Complaint, supra* note 10, ¶¶ 67, 435-436, 828.

[43]Powers, *supra* note 27, at 49; *Enron Class Action Complaint*, *supra* note 10, ¶ 10; *In re Enron*, 235 F. Supp. 2d at 615.

[44]Powers, *supra* note 27, at 50; *Enron Class Action Complaint*, *supra* note 10, ¶ 10; *In re Enron*, 235 F. Supp. 2d at 615.

[45]*Enron Class Action Complaint*, *supra* note 10, ¶¶ 21-24, 659, 662, 728, & 801. "Chewco became a template for subsequent entities that Enron continued to establish in increasing numbers and size, all secretly controlled by Enron, which Enron and its banks would use to generate enormous phony profits and conceal massive debt." *In re Enron*, 235 F. Supp. 2d at 616.

through 2000.[46] Those rosy financial statements in turn caused analysts to rate Enron stock a perpetual "buy."[47] This house of cards collapsed when Enron restated its earnings and debt in October and November 2001 for its fiscal years 1997 through 2000.[48] Debt was increased by $2.585 billion, while earnings were decreased by $1.048 billion.[49] Investor confidence vanished, causing the stock to plummet. Enron filed bankruptcy less than a month later.[50]

Aside from Enron itself, three gatekeepers allegedly share credit for Chewco's role in cooking Enron's books: V&E, Andersen, and Barclays.[51] Allegedly, V&E formed Chewco, falsified loan documents so Chewco appeared independent from Enron,[52] structured Chewco's phony deals, issued "bogus 'true sale' opinions" on those deals, and drafted the misleading disclosures covering these scams used in Enron's SEC filings.[53] But V&E's participation went beyond Chewco. In Judge Harmon's words, V&E "'effected the very' deceptive devices and contrivances that were the heart of the alleged Ponzi scheme."[54]

Like V&E, Andersen allegedly violated Section 10(b) by its conduct and its words. It participated in structuring phony Enron transactions and SPEs,[55] including Chewco.[56] Andersen also falsely represented in 10Ks, annual reports, and registration statements,[57] among other facts, that "Enron's financial statements were in accordance with GAAP" and Andersen's audits "were performed in accordance with Generally Accepted Auditing Standards ('GAAS')."[58]

The third active participant in the Chewco-JEDI fraud was Barclays. Unlike V&E and Andersen, however, Barclays made no statements to

---

[46]*Enron Class Action Complaint*, *supra* note 10, ¶¶ 61, 126, 164-65; *In re Enron*, 235 F. Supp. 2d at 632.

[47]*Enron Class Action Complaint*, *supra* note 10, ¶¶ 14, 56, 125, 127-28, 130-31, 150, 152-54, 156-63, 166-86, 190-210, 225-70, 272-76, 281-87, 290-381. One securities analyst, Credit Suisse First Boston, issued a report rating Enron as a "strong buy" in August 2001. *In re Enron*, 235 F. Supp. 2d at 634.

[48]Powers, *supra* note 27, at 2; *Enron Class Action Complaint*, *supra* note 10, ¶ 3; *In re Enron*, 235 F. Supp. 2d at 636.

[49]Powers, *supra* note 27, at 2-3; *Enron Class Action Complaint*, *supra* note 10, ¶ 61; *In re Enron*, 235 F. Supp. 2d at 626, 636.

[50]*In re Enron*, 235 F. Supp. 2d at 637.

[51]*See infra* text accompanying notes 52-62.

[52]Powers, *supra* note 27, at 24-26; *Enron Class Action Complaint*, *supra* note 10, ¶¶ 22, 800-810; *In re Enron*, 235 F. Supp. 2d at 614-17, 658.

[53]*In re Enron*, 235 F. Supp. 2d at 660-61.

[54]*Id.* at 704.

[55]*Id.* at 674.

[56]*Id.* at 681-82; *Enron Class Action Complaint*, *supra* note 10, ¶ 946.

[57]Powers, *supra* note 27, at 24-25; *In re Enron*, 235 F. Supp. 2d at 674.

[58]*In re Enron*, 235 F. Supp. 2d at 674.

public investors,[59] the classic basis for a Section 10(b) claim.[60] Instead, *In re Enron* applied a novel theory in denying Barclays's motion to dismiss: Barclays violated Section 10(b) by its deceptive conduct alone.[61] On this point, *In re Enron* held:

> Lead Plaintiff's allegations about Barclays' direct involvement in the formation and funding of JEDI/Chewco in 1997 are sufficient by the very nature of the transactions to state a claim under § 10(b) and Rule 10b-5. According to the complaint *Barclays, along with Lay . . . formed Chewco*, which Enron and *Barclays controlled*, as a sham independent entity to buy a purported independent, outsider's interest in JEDI.[62]

The specific allegations of Barclays's role in forming, funding, and controlling a sham SPE (Chewco) distinguish the Section 10(b) claim against Barclays from those against Bank of America, Deutsche Bank, and Lehman, which were all dismissed.[63] No other defendant was kept in the case solely on the basis of this theory.[64] Therefore, the allegations against Barclays are the purest statement, at least in Judge Harmon's view, of how deceptive conduct may violate Section 10(b).[65]

In re Enron is the first case to broadly hold deceptive conduct in the purchase or sale of a security violates Section 10(b).[66] Previously, the courts recognized only three narrow theories in which conduct by itself—without the classic misrepresentation or nondisclosure—constituted a violation of Section 10(b). One theory permits recovery under the

---

[59] *See id.* at 703.

[60] *See* THOMAS LEE HAZEN, THE LAW OF SECURITIES REGULATION 596 (West Group 4th ed. 2002).

[61] *In re Enron*, 235 F. Supp. 2d at 652, 703. In this article, the phrase "deceptive conduct" means deception in the form of acts, i.e., without a misrepresentation or nondisclosure. Likewise, "deceptive words" means deception in the form of a misrepresentation or nondisclosure.

[62] *Id.* at 703 (emphasis added).

[63] *See id.* at 703-04.

[64] All other gatekeeper-defendants, whose motions to dismiss the Section 10(b) claims were denied, allegedly made misstatements or failed to disclose material facts, in addition to their deceptive conduct. *Id.* at 645, 647, 649-51, 688, 695, 697, 704, & 706. The court overruled the motions of CIBC, Citigroup, J.P. Morgan, Credit Suisse, and Merrill Lynch relying in part on the allegation that no Chinese wall existed at these investment banks and thus each was liable for misleading statements made by their analysts in research reports. *Id.* at 688.

[65] *See In re Enron*, 235 F. Supp. 2d at 703-04, 708.

[66] *In re* Enron Corp. Sec., Derivative & ERISA Litig., 235 F. Supp. 2d 549 (S.D. Tex. 2002).

"manipulative . . . device or contrivance" prohibition of Section 10(b)[67] when the wrongdoer misleads "investors by artificially affecting market activity," for example, by using "wash sales" to run up the stock price.[68] Under controlling Supreme Court decisions, however, this theory cannot be extended to Barclays's conduct.[69] The lower federal courts have also imposed Section 10(b) liability—without a nondisclosure or misrepresentation—on broker-dealers for churning their clients' accounts[70] and for implied representations under the "shingle theory."[71] Neither theory applies to Barclays's conduct, since it was not acting as a broker-dealer for Enron investors.[72]

In re Enron, therefore, extends the reach of Section 10(b)'s prohibition on deceptive conduct far beyond its prior boundaries. It would no longer be limited to a single class of wrongdoers (broker-dealers) for cheating a single class of victims (their customers). Indeed, *In re Enron* extended Barclays's potential liability to injured investors with whom it had

---

[67]Securities Exchange Act of 1934, 15 U.S.C.A. § 78j(b) (West 2003).

[68]The Supreme Court has repeatedly described manipulation as a "term of art" whose scope is limited to "practices, such as wash sales, matched orders, or rigged prices, that are intended to mislead investors by artificially affecting market activity." Schreiber v. Burlington N. Inc., 472 U.S. 1, 6 (1985); Santa Fe Indus., Inc., v. Green, 430 U.S. 462, 476 (1977); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 199 (1976); *Schreiber* further circumscribed manipulation by holding that it requires "misrepresentation or nondisclosure." *Schreiber*, 472 U.S. at 12.

[69]Judge Harmon did not rely on the "manipulative . . . devices or contrivances" language of Section 10(b) in denying the gatekeepers' motions to dismiss. *See In re Enron*, 235 F. Supp. 2d at 695-708. Her decision explains: Section 10(b) "prohibits only the making of a material misstatement (or omission) or the commission of a manipulative or deceptive act. Because 'manipulation' is essentially a limited term of art, the focus in most securities violations is on deception or misrepresentation." *Id.* at 568 n.9. *See generally* HAZEN, *supra* note 60, at 561-64 (discussing "concept of manipulation is a narrow one").

[70]*See, e.g.*, Nesbit v. McNeil, 896 F.2d 380, 382 (9th Cir. 1990). HAZEN, *supra* note 60, at 846.

[71]HAZEN, *supra* note 60, at 831; MARC I. STEINBERG, SECURITIES REGULATION 658-59 (Matthew Bender 3d ed. 1998).

[72]Barclays provided commercial lending and underwriting services to Enron. *In re Enron*, 235 F. Supp. 2d at 703. The underwriting services, however, included no alleged public offering in the United States. It acted as a "placement agent or reseller" in February 2001 private placement of Enron notes. *Enron Class Action Complaint*, *supra* note 10, ¶ 48; *In re Enron,* 235 F. Supp. 2d at 652 n.88. It also underwrote an offering by Yosemite Securities Co. of Enron linked obligations that were listed on the Luxembourg stock exchange. *Enron Class Action Complaint*, *supra* note 10, ¶ 641.12; *In* re *Enron,* 235 F. Supp. 2d at 652 n.88. No holder of either security has asserted a claim against Barclays in the Enron class action. *Enron Class Action Complaint*, *supra* note 10, ¶¶ 62-65. Despite identical allegations that Deutsche Bank and Bank of America participated in 2001 private placement, *id.* ¶¶ 48-49, their motions to dismiss were both granted. *In re Enron*, 235 F. Supp. 2d at 708. Further, in denying Barclays's motion, the court made no reference to Barclays's involvement in the Luxembourg offering. *Id.* at 703. Hence, Barclays's participation in these two offerings was not the basis for the denial of its motion to dismiss. Rather, the court denied Barclays's Rule 12(b)6 motion based on its alleged use of Chewco to doctor Enron's financial statements. *Id.*

no prior contact or relationship.[73] Likewise, *In re Enron* upheld claims against V&E, Andersen, Citigroup, and other investment banks based in part on their alleged deceptive conduct.[74] With its holding, especially in relation to Barclays, *In re Enron* would elevate deceptive conduct to parity with deceptive words as a basis for liability under Section 10(b).[75]

This concept—conduct as fraud— is more easily grasped in a simpler setting. To that end, consider a fake man of the cloth who positions himself outside a church holding a collection box just before the service begins. He wears a cassock identical to the one worn by the minister who preaches from the pulpit. He does not utter a word. He smiles and nods graciously as the faithful fill the box with bills. Is his conduct less fraudulent because no word is spoken? Barclays allegedly used Chewco in much the same way as the fake clergyman used the cassock, collection box, and smile. Both cover the truth with a false veneer.

---

[73]The court summarized the allegations of Barclays's conduct that violated Section 10(b) as follows:

> Lead Plaintiff's allegations about Barclays' direct involvement in the formation and funding of JEDI/Chewco in 1997 are sufficient by the very nature of the transactions to state a claim under § 10(b) and Rule 10b-5. According to the complaint Barclays, along with Lay, Skilling and Fastow, formed Chewco, which Enron and Barclays controlled, as a sham independent entity to buy a purported independent, outsider's interest in JEDI. Barclays purportedly loaned Chewco $240 million and money to the two strawmen, Little River and Big River, to provide the $11.4 million for the [three percent] equity investment in Chewco. In addition, giving rise to a strong inference of scienter that it knew the transactions were non-arm's length and fraudulent, it demanded that Enron provide a secret guarantee that it would be repaid and that Chewco would establish a $6.6 million cash reserve deposit paid to Barclays to insure against risk of loss. Barclays lent an additional $ 500 million to JEDI in 1998. Its subsequent loans and lending commitments of over $4 billion and the $1.9 billion [it] raised by underwriting and selling Enron securities give rise to a strong inference of Barclay's intent to keep the Ponzi scheme in operation.

In re Enron, 235 F. Supp. 2d at 703.

[74]Liability under Section 10(b) for misleading words requires no prior relationship or direct contact between wrongdoer and victim. HAZEN, *supra* note 60, at 574-77; *see* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 745 (1975).

[75]*In re Enron*, 235 F. Supp. 2d at 695-707.

III. BIRTH OF THE FRAUD-FREE ZONE: JUDICIAL ACTIVISM GONE WRONG

A. *Supreme Court Decisions Through* Affiliated Ute: *Implementing the Will of Congress*

Securities fraud was a major cause of the 1929 crash and the resulting economic crisis—at least in the view of the 73rd Congress. The Senate Report on the 1933 Securities Act (1933 Act) explained, in words that ring as true today, how the act was needed to restore investor confidence by curtailing fraud in the purchase of securities:

> The purpose of this bill is to protect the investing public. . . . The aim is to prevent further exploitation of the public by the sale of unsound, fraudulent, and worthless securities through misrepresentation; to place adequate and true information before the investor; . . . to restore the confidence of the prospective investor in his ability to select sound securities; to bring into productive channels of industry and development capital which has grown timid to the point of hoarding; and to aid in providing employment and restoring buying and consuming power.[76]

The Securities Exchange Act of 1934 (1934 Act) and the 1933 Act included multiple antifraud provisions.[77] Of these, several appear by their text to prohibit Barclays's alleged conduct in using Chewco to cause false entries in Enron's books. Section 17(a)(1) of the 1933 Act, for example, declares unlawful the use "of any device, scheme, or artifice to defraud."[78] Likewise, the texts of Section 17(a)(3) and Section 10(b) make deceptive conduct unlawful, even if the defendant acted without scienter.[79] Finally,

---

[76]S. REP. NO. 73-47, at 1 (1933).

[77]These Sections are §§ 11, 12(2) (now 12(a)(2)), and 17(a) of the 1933 Act, 15 U.S.C.A. § 77k, l (West 2003) and 15 U.S.C.A. § 77a (West 2003); and §§ 9, 10(b), and 18 of the 1934 Act, 15 U.S.C.A. § 78i, 78j(b) (West 2003), and 15 U.S.C.A. § 78r (West 2003). As originally enacted, Section 14 of the 1934 Act did not contain antifraud provisions.

[78]15 U.S.C.A. § 77q(a)(1) (West 2003).

[79]Section 17(a) of the 1933 Act makes it unlawful for any person in the sale of any securities:

> 1. to employ any device, scheme, or artifice to defraud, or
> 2. to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which

Section 18(a) of the 1934 Act expressly provides a private civil remedy. Unique among express remedies, it reached beyond words to Barclays's alleged conduct as a "cause" of misleading statements in Enron SEC filings.[80]

Presented with this case at any time before 1972, the Supreme Court would likely have decided Barclays was liable for its alleged role in using Chewco to cook Enron's books. This seems evident from both the holdings and reasoning in the Court's fourteen decisions interpreting the 1933 and 1934 Acts through 1972.[81]

Significantly, twelve of the fourteen appeals were unquestionably decided in favor of investors. *SEC v. Joiner Corp.*,[82] *SEC v. Howey Co.*,[83]

> they were made, not misleading; or
>
> 3. to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

Id. § 77q(a)(3).

Section 10(b) makes it unlawful "[t]o use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors." The 1934 Act § 10(b) presently found at 15 U.S.C.A. § 78j(b) (West 2003).

Rule 10b-5 provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> a) To employ any device, scheme, or artifice to defraud,
>
> b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
>
> in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5 (West 2003).

[80]Section 18(a) reads:

> Any person who shall make or cause to be made any statement in any application, report, or document filed pursuant to this title or any rule or regulation thereunder, which statement was at the time and in the light of the circumstances under which it was made false or misleading with respect to any material fact, shall be liable to any person (not knowing that such statement was false or misleading) who, in reliance upon such statement, shall have purchased or sold a security at a price which was affected by such statement, for damages caused by such reliance, unless the person sued shall prove that he acted in good faith and had no knowledge that such statement was false or misleading. A person seeking to enforce such liability may sue at law or in equity in any court of competent jurisdiction.

The 1934 Act § 18(a), presently found at 15 U.S.C.A. § 78r(a) (West 2003).

[81]*See infra* text accompanying notes 82-109.

[82]320 U.S. 344 (1943).

[83]328 U.S. 293 (1946).

and *Tcherepnin v. Knight*[84] broadened the definition of "securities," extending the act to more investment schemes and thus the antifraud protections to more investors. *SEC v. Ralston Purina Co.*[85] expanded the meaning of "public offering," thereby subjecting more issuers to the disclosure requirements of Section 5 of the 1933 Act. *Wilko v. Swan*[86] held investors did not waive their right to sue broker-dealers under the 1933 Act by signing an agreement containing a mandatory arbitration provision. *A.C. Frost & Co. v. Coeur D'Alene Mines Corp.*[87] refused to allow an issuer to assert the 1933 Act as a defense *against* an investor. *Deckert v. Independence Shares Corp.*[88] allowed an investor to seek equitable relief under the 1933 Act, though the Act did not explicitly provide for these remedies. *J.I. Case Co. v. Borak*[89] first recognized an implied civil remedy for a violation of the antifraud provisions. *Mills v. Electric Auto-Lite Co.*,[90] *Superintendent of Insurance of New York v. Bankers Life & Casualty Co.*,[91] *Affiliated Ute Citizens of Utah v. United States*,[92] and *SEC v. Capital Gains Research Bureau, Inc.*[93] all liberally construed the antifraud provisions to protect investors. Only the narrow holdings in *Blau v. Lehman*[94] and *Reliance Electric Co. v. Emerson Electric Co.*,[95] dealing with the prohibition of Section 16(a) of the 1934 Act on swing sales, marginally limited investor protections, if at all.[96] Indeed, in *Reliance Electric Co.*, the

---

[84]389 U.S. 332 (1967).
[85]346 U.S. 119 (1953).
[86]346 U.S. 427 (1953).
[87]312 U.S. 38 (1941).
[88]311 U.S. 282 (1940).
[89]377 U.S. 426 (1964).
[90]396 U.S. 375 (1970).
[91]404 U.S. 6 (1971).
[92]406 U.S. 128 (1972).
[93]375 U.S. 180 (1963).
[94]368 U.S. 403, 411 (1962).
[95]404 U.S. 418, 424-25 (1972).

[96]Unlike its later decisions circumscribing investor's antifraud remedies (*see infra* Sections III.F-G), the Court carefully ascertained and then applied Congress's intent in reaching its holding in both cases. In *Blau*, the Court declined to extend Section 16(a) liability for "short swing profits" to parties beyond those designated in the statute, because "the very broadening of the categories of persons on whom these liabilities are imposed by the language of § 16 (b) was considered and rejected by Congress when it passed the Act." *Blau*, 368 U.S. at 411. Similarly, in *Reliance Electric Co.*, the Court reasoned: "But a construction of the term 'at the time of . . . sale' that treats two sales as one upon proof of a pre-existing intent by the seller is scarcely in harmony with the congressional design of predicating liability upon an 'objective measure of proof.'" *Reliance Elec. Co.*, 404 U.S. at 424-25 (quoting Smolowe v. Delendo Corp., 136 F.2d 231, 235 (2d Cir. 1943)).

Court opined its holding protected the interests of the outside investor,[97] "the poor little fellow [who] does not know what he is getting into."[98]

B. *Early Supreme Court Decisions: Barclays Would Be Liable for its Alleged Role in the Enron Fraud*

The Supreme Court's pre-1974 rulings shaped the antifraud provisions in two specific ways that validated investors' rights to recover against Barclays for its alleged misadventures with Chewco and JEDI.[99] First, in *J.I. Case Co. v. Borak*,[100] the Court implied a private remedy from an antifraud provision, though its text did not provide for one. *Borak* found an implied cause of action for damages existed under Section 14(a) in favor of stockholders for a deceptive proxy statement.[101] The Court reasoned:

> It is for the federal courts "to adjust their remedies so as to grant the necessary relief" where federally secured rights are invaded. "And it is also well settled that where legal rights have been invaded, and a federal statute provides for a general right to sue for such invasion, federal courts may use any available remedy to make good the wrong done."[102]

Borak's inclusive rationale also dictated the existence of an implied cause of action under Section 17(a).[103] Indeed, the private remedy under Section 17(a) was "taken for granted" until 1975.[104]

Second, the Supreme Court tacitly approved the extension of liability to those who *aided and abetted* violations of Section 10(b).[105] The first and leading case to impose liability for aiding and abetting a violation of an antifraud statute was *Brennan v. Midwestern United Life Insurance Co.*[106] The district court reasoned, "In the absence of a clear legislative expression

---

[97] *Reliance Elec. Co.*, 404 U.S. at 437.

[98] *Id.* at 428 n.2 (quoting from testimony of Thomas Corcoran, Hearings on H.R. 7852 and H.R. 8720 before the House Committee on Interstate and Foreign Commerce, 73d Cong. 85 (1934)).

[99] *See supra* text accompanying notes 37-46, 59-62.

[100] 377 U.S. 426 (1964).

[101] *Id.* at 433.

[102] *Id.* (quoting Bell v. Hood, 327 U.S. 678, 684 (1946)).

[103] *See* HAZEN, *supra* note 60, at 682. *See supra* text accompanying notes 78-79 (analyzing Barclays's conduct under Section 17(a)).

[104] HAZEN, *supra* note 60, at 682 n.15; 6 LOUIS LOSS, SECURITIES REGULATION 3913 (2d ed. 1969 Supp.).

[105] *See infra* text accompanying notes 106-10.

[106] 259 F. Supp. 673 (N.D. Ind. 1966), *aff'd*, 417 F.2d 147 (7th Cir. 1969), *cert. denied*, 397 U.S. 989 (1970).

to the contrary, [Section 10(b)] must be flexibly applied so as to implement its policies and purposes."[107] For nearly three decades, the circuit courts consistently held liability extended to those who aided and abetted violations of Section 10(b).[108] The Supreme Court either declined to grant certiorari to review those decisions or, where it did grant certiorari, left aiding and abetting liability intact.[109] That pattern continued until 1995 when the Rehnquist majority, applying *Blue Chip Stamps*, axed aiding and abetting liability as a basis for violating Section 10(b).[110]

C. Blue Chip Stamps: *A New Court on a New Mission*

Affiliated Ute ended an era in 1972.[111] That decision would be last of its kind—interpreting the antifraud statutes to reach conduct of those cheating investors—for the next thirty years.[112] The Supreme Court would not issue another decision favorable for investors, defining the scope of wrongful conduct under the antifraud provisions, until *SEC v. Zandford*[113] in July 2002.

After *Affiliated Ute*, and before its next decision, the Supreme Court should have warned investors to wear seatbelts. The Court's 180 degree swing was swift and without warning. In its next decision involving the antifraud provisions, for example, the Court would overrule a twenty-year precedent favorable to defrauded investors.[114] Worse yet, the rate at which the Court would decide cases interpreting securities legislation would more

---

[107] *See id.* at 680-81.

[108] "Like the Court of Appeals in this case, other federal courts have allowed private aiding and abetting actions under § 10(b) . . . . Since 1966, numerous courts have taken the same position." Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164, 169 (1994) (citing Cleary v. Perfectune, Inc., 700 F.2d 774, 777 (1st Cir. 1983); Kerbs v. Fall River Indus., Inc., 502 F.2d 731, 740 (10th Cir. 1974)).

[109] *Brennan*, 259 F. Supp. at 673; Stead v. SEC, 444 F.2d 713 (10th Cir. 1971), *cert. denied*, 404 U.S. 1059 (1972); Buttrey v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 410 F.2d 135, 144 (7th Cir.), *cert. denied*, 396 U.S. 838 (1969). The Supreme Court reserved the issue in *Herman & MacLean v. Huddleston*, 459 U.S. 375, 379 n.5 (1983), and *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 191-92 n.7 (1976).

[110] *Cent. Bank*, 511 U.S. at 188-89.

[111] Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128 (1972).

[112] *See infra* text accompanying notes 116-275.

[113] 535 U.S. 813 (2002). This does not include *United States v. O'Hagan,* 521 U.S. 642 (1997), establishing the misappropriation theory of insider trading, because no investor-plaintiff has been able to allege a cause of action on this theory. *See infra* notes 269-70.

[114] Scherk v. Alberto-Culver Co., 417 U.S. 506 (1974).

than quadruple: from an average of one every thirty-five months (through 1972) to one every eight months (since 1973).[115]

In 1975, the Supreme Court first articulated the "policy considerations" that would supersede all others in its interpretation of key provisions of the antifraud statutes.[116] Sometimes those policies were stated explicitly.[117] Other times, when neither precedent nor statutory text could explain the Court's decision, they were implicitly at work.[118] Before analyzing those policies and the opinions they spawned, the elephant in the room must be recognized and addressed: what caused the Court's dramatic reversal of direction in the blink of an eye?

That cause was not external to the Court. Congress had enacted no new legislation. No chorus of prominent legal scholars was protesting that the Supreme Court had misread the intent of the 73rd Congress. To the contrary, the cause was a predictable and recurring event in the Court's history. Its membership had changed. Justices Rehnquist and Powell had replaced Justices Black and Harlan in 1972.[119] This change tipped the scales against investors. Justices Rehnquist and Powell would vote as a bloc in a series of 6-3 and 5-4 decisions that reshaped the antifraud provisions over the following twenty years, favorably for those who committed fraud and unfavorably for those who were victimized by it. That voting block would be strengthened as other aging justices retired over the following sixteen years.[120]

Justice Rehnquist articulated the new "policy considerations" in his first opinion interpreting securities legislation, *Blue Chip Stamps v. Manor Drug Stores*, following his appointment to the Court in 1972.[121] The case

---

[115]From 1934 through 1972, the Court issued fourteen decisions interpreting the securities law as it affected public investors, on average, one new decision every thirty-five months. *See* cases cited *supra* notes 81-98. From 1973 through the present, it issued 46 decisions, on average, one case every eight months. These counts do not include decisions that uniquely involve issues related to the SEC or its powers, e.g., *Jones v. SEC*, 298 U.S. 1 (1936).

[116]Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975).

[117]*See infra* text accompanying notes 121, 131, 225-27, 233, 235-42.

[118]*See infra* text accompanying notes 186-223, 226-30, 235-42.

[119]Both Justices Powell and Rehnquist took their oath as Supreme Court Justices in January 1972 (*available at* http:/www.supremecourtus.gov/about/members.pdf), but neither participated in a decision interpreting the antifraud provisions until 1973 in *Kern County Land Co. v. Occidental Petroleum Corp.,* 411 U.S. 582 (1973). *See* Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128, 131 (1972) ("Powell and Rehnquist, JJ., took no part in the consideration or decision of the case.").

[120]Justice Stevens replaced Justice Douglas in 1975; Justice O'Connor replaced Justice Stewart in 1981; Justice Scalia replaced Justice Burger in 1986; Justice Kennedy replaced Justice Powell in 1988; Justice Souter replaced Justice Brennan in 1990; Justice Thomas replaced Justice Marshall in 1991, *available at* http:/www.supremecourtus.gov/about/members.pdf.

[121]*Blue Chip Stamps*, 421 U.S. at 737.

was an unlikely candidate to be the bearer of the Court's new policies. The issue was whether an exception should be carved out from the purchaser-seller requirement of Section 10(b) for a plaintiff who had relied on a misleading prospectus in deciding to forgo its right to purchase stock pursuant to a consent decree.[122] The majority decided the plaintiff lacked standing on policy grounds remote from any language in either the statute or the rule. This is puzzling. Neither Section 10(b) nor Rule 10b-5 is ambiguous on this issue. The texts of both are explicit: no violation without a "purchase or sale" of a security.[123] Hence, Justice Rehnquist's opinion violated one of his oft stated rules of statutory construction: "When we find the terms of a statute unambiguous, judicial inquiry is complete except in rare and exceptional circumstances."[124] Why then would Justice Rehnquist, a believer in the letter of the law, apply "policy considerations" to interpret the only unambiguous element, the purchase or sale requirement,[125] of Section 10(b)? A skeptic might offer: an uncontroversial decision interpreting unambiguous text would be the ideal messenger to deliver a controversial change of policy. Who would care?

Writing for a majority of six in *Blue Chip Stamps*, Justice Rehnquist expressed deep concern about the proliferation of vexatious litigation in Section 10(b) cases. Such lawsuits in his opinion raised two concerns:

> The first of these concerns is that in the field of federal securities laws governing disclosure of information even a complaint which by objective standards may have very little chance of success at trial has a settlement value to the plaintiff out of any proportion to its prospect of success at trial so long as he may prevent the suit from being resolved against him by dismissal or summary judgment. The very pendency of the lawsuit may frustrate or delay normal business activity of the defendant which is totally unrelated to the lawsuit . . . .
>
> The second ground for fear of vexatious litigation is based on the concern that, given the generalized contours of liability,

---

[122]*Id.* at 727.

[123]*See supra* note 79 and accompanying text.

[124]Demarest v. Manspeaker, 498 U.S. 184, 190 (1991) (opinion by Judge Rehnquist). Justice Rehnquist also stated the rule this way: "We begin with the familiar canon of statutory construction that the starting point for interpreting a statute is the language of the statute itself. Absent a clearly expressed legislative intention to the contrary, that language must ordinarily be regarded as conclusive." Consumer Product Safety Comm'n v. GTE Sylvania, Inc., 447 U.S. 102,108, (1980); Griffin v. Oceanic Contractors, Inc., 458 U.S. 564, 570 (1982).

[125]*See infra* note 153.

> the abolition of the *Birnbaum* rule would throw open to the trier of fact many rather hazy issues of historical fact the proof of which depended almost entirely on oral testimony.[126]

In a sentence, the Rehnquist majority used *Blue Chip Stamps* to declare war, in its view, on flimsy lawsuits that were stifling business activity brought by litigants seeking to extort a settlement. By contrast, Justice Blackmun, writing for the dissent, saw the Rehnquist opinion as "a preternatural solicitousness for corporate well-being and a seeming callousness toward the investing public quite out of keeping . . . with our own traditions and the intent of the securities laws."[127] Although stung by the sharp dissent,[128] the Rehnquist majority took a bold and extraordinary step for any court: it substituted its own policy star—to stamp out strike suits—for the one expressed by Congress—to protect the investor from fraudulent schemes. Further, it did so needlessly to support an interpretation of a statute that was unambiguous on its face. There is only one explanation: the majority of the Supreme Court was on its own mission.

The new policy expressed in *Blue Chip Stamps* was spun out of thin air. The majority cited no public or private studies justifying its war on vexatious lawsuits.[129] There was no survey of Section 10(b) filings, their success rates in comparison with other cases, or their impact on corporate America.[130] Like magic, Justice Rehnquist found the guiding policy hidden in an obscure sentence in Section 11(e) of the 1933 Act, allowing the trial court to require either party to post an undertaking for the payment of costs.[131] This sentence and a similar one in Section 18 of the 1934 Act[132] are the only provisions in the entire statutory scheme that offer public companies protection from their investors. Yet, it was from this unlikely source that Justice Rehnquist found the policy star that would guide the Court in reshaping the antifraud provisions over the next twenty years. Justice Rehnquist offered this rationale in *Blue Chip Stamps*:

---

[126]*Blue Chip Stamps*, 421 U.S. at 740-43. *Birnbaum* in the quote above refers to *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461 (2d Cir. 1952), which also held a violation of Section 10(b) requires a purchase or sale of a security.

[127]*See Blue Chip Stamps*, 421 U.S. at 762 (Blackman, J., dissenting).

[128]*See id.* at 760.

[129]*See* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975).

[130]*See id.*

[131]*See id.* at 740-41.

[132]In relevant part, Section 18 of the 1934 Act states: "In any such suit the court may, in its discretion, require an undertaking for the payment of the costs of such suit, and assess reasonable costs, including reasonable attorneys fees, against either party litigant." 15 U.S.C.A. § 78(r) (West 2003).

> Congress itself recognized the potential for nuisance or "strike" suits in this type of litigation, and in Title II of the 1934 Act amended § 11 of the 1933 Act to provide that: "In any suit under this or any other section of this title the court may, in its discretion, require an undertaking for the payment of the costs of such suit, including reasonable attorney's fees . . . ."[133]
>
> Senator Fletcher, Chairman of the Senate Banking and Finance Committee, in introducing Title II of the 1934 Act on the floor of the Senate, stated in explaining the amendment to § 11 (e): "This amendment is the most important of all." Among its purposes was to provide "a defense against blackmail suits."[134]
>
> Where Congress in those Sections of the 1933 Act which expressly conferred a private cause of action for damages, adopted a provision uniformly regarded as designed to deter "strike" or nuisance actions, . . . that fact alone justifies our consideration of such potential in determining the limits of the class of plaintiffs who may sue in an action wholly implied from the language of the 1934 Act.[135]

In sum, the majority decided it ought to use *Blue Chip Stamps* to deter vexatious lawsuits under Section 10(b), an implied private remedy, because Congress did the same with the express private remedy it created in Section 11. In *Blue Chip Stamps*, however, the Court did not deter meritless lawsuits in the same way Congress had chosen in Section 11. With Section 11(e), Congress gave victims of strike suits the right to recover their costs and attorney fees. With *Blue Chip Stamps*, the Supreme Court trimmed the reach of the substantive law. In later cases, as discussed below, the Court repeatedly sought to stamp out vexatious lawsuits by circumscribing the reach of the antifraud provisions. This is like shooting the patient to stop the virus.

Stated as a syllogism, Justice Rehnquist's reasoning reduces to:

---

[133] *See Blue Chip Stamps*, 421 U.S. at 740 (quoting Securities Act of 1933, 15 U.S.C.A. § 77k(e) (West 1997)).

[134] *See id.* at 740-41 (quoting 78 CONG. REC. 8669 (1934)).

[135] *See id.* at 741.

1. Vexatious lawsuits under Section 10(b) are damaging corporate America;
2. Congress's cure for vexatious suits is to make the plaintiff pay the defendant's costs;
3. Therefore, the reach of Section 10(b) must be restricted by judicial fiat.

Each component of this syllogism is flawed.

First, *Blue Chip Stamps* cites no support for its primary premise: vexatious lawsuits under Section 10(b) are crippling corporate America.[136] It cited only two law review articles to support this point.[137] One dealt with the impact of civil litigation, including Section 10(b), on public offerings.[138] Its only hard conclusion: "There is as yet no evidence that increased liability risks have chilled the writing of new issues, and this may indicate that underwriters are not as risk adverse as they are commonly thought to be."[139] The second article was written by a former SEC Commissioner who discussed SEC enforcement proceedings.[140] He never mentioned private lawsuits, vexatious or otherwise.[141] Since the major premise is unsupported by fact, the syllogism fails.

Likewise, the minor premise (Congress's cure for vexatious lawsuits is to make the plaintiff pay costs) has flaws. Pointing to Section 11(e), Justice Rehnquist claims the 73rd Congress acted to protect business from strike suits.[142] This is only half true. Section 11(e) protects both parties to a lawsuit: it applies when *either* the suit or the defense was without merit.[143] Likewise, the quote attributed to Senator Fletcher only states half what he said.[144] His complete sentence showed equal concern defendants would litigate in bad faith. He told the Senate that 11(e) provided "a defense against blackmail suits as well *as a defense against purely contentious litigation on the part of the defendant*."[145]

---

[136]*See* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975).

[137]*See id.* at 740 (citing James C. Sargent, *The SEC and the Individual Investor: Restoring His Confidence in the Market*, 60 VA. L. REV. 553, 562-72 (1974); Michael P. Dooley, *The Effects of Civil Liability on Investment Banking and the New Issues Market*, 58 VA. L. REV. 776, 822-43 (1972)).

[138]*See* Dooley, *supra* note137.

[139]*Id.* at 841 n.265.

[140]Sargent, *supra* note 137, at 553.

[141]Sargent, *supra* note 137.

[142]*See supra* notes 131-35 and accompanying text.

[143]*See* Securities Act of 1933, 15 U.S.C.A. § 77k(e) (West 1997).

[144]78 CONG. REC. 8669 (1934).

[145]*Id.* (emphasis added).

The most obvious flaw, however, with the syllogism is its conclusion. Even if the major premise (vexatious 10(b) suits injuring business) and the minor premise (cure is to make plaintiff pay costs) are presumed true, the conclusion (the reach of 10(b) must be restricted) would be a *non sequitur*. Instead, the logic dictates this conclusion: plaintiffs who bring vexatious lawsuits under Section 10(b) ought to pay the defendants' costs. Thus, in *Blue Chip Stamps*, the court should have implied a remedy allowing the victimized defendant to recover costs, just as the Court implied a "statute of limitations" and a right to contribution in 10(b) actions.[146]

D. *Supreme Court Decisions after* Affiliated Ute: *Is There a Rationale? No, There Are Two*

As developed above, the Supreme Court chose *Blue Chip Stamps* to announce its new "policy considerations," largely whipped up out of thin air. Over the next twenty years, the Court would substitute its own policy, to stamp out strike suits, for Congress's policy, to protect investors. One commentator, searching for a theme in the Court's application of *Blue Chip Stamps* in subsequent cases, offered this insight: the "common theme [of the cases] seemed to be that plaintiffs always lost."[147]

The Court, however, did not apply its new policy considerations to every case involving the interpretation of the antifraud provisions. It was applied to a narrow but critical band of issues: was the defendant's *conduct* within the reach of the antifraud provisions? If the case raised that issue, it got the *Blue Chip Stamps* treatment.[148] If the case raised a different issue, for example, whether the plaintiff relied on a misstatement, the Court behaved like an appellate court; it searched for and then applied the expressed will of Congress.[149]

The Rehnquist majority never acknowledged its two-tier approach in exactly these words, but it came close. After twenty years of decisions interpreting the antifraud provisions, the Rehnquist majority admitted in *Central Bank* that it was applying two standards. The Court explained, "In our cases addressing § 10(b) and Rule 10b-5, we have confronted two main

---

[146]Musick, Peeler, & Garrett v. Employers Ins. of Wausau, 508 U.S. 286, 297 (1993) (holding defendants in a 10b-5 action have a right to contribution); Lampf v. Gilbertson, 501 U.S. 350, 362-64 (1991) (holding that suits brought pursuant to § 10b and rule 10b-5 "must be commenced within one year after the discovery of facts constituting a violation and within three years after such violation").

[147]ROBERT CHARLES CLARK, CORPORATE LAW § 8.10.1, at 316 (1986).

[148]*See infra* Sections III.F.-G.

[149]*See infra* Section III.E.

issues. First, we have determined *the scope of conduct* prohibited by § 10(b) . . . ."[150] Regarding these cases, the Court continued, "[T]he text of the statute controls our decision."[151] This comment is meaningless. The text of Section 10(b) is ambiguous[152] at best in stating, much less defining, the elements required for its violation, with the exception of "purchase or sale."[153] Accordingly, when the Court confronted what it called a "scope of conduct" issue, whether Section 10(b) reached the wrongdoer's act, it pulled *Blue Chip Stamps* off the shelf and then applied its own "policy considerations."

The Court also described a second standard that it applied when the issue on appeal did *not* involve the defendant's conduct:

> Second, in cases where the defendant has committed a violation of § 10(b), we have decided questions about the elements of the 10b-5 private liability scheme: for example, whether there is a right to contribution . . . . Th[is] latter issue, determining the elements of the 10b-5 private liability scheme, has posed difficulty because Congress did not create a private § 10(b) cause of action and had no occasion to provide guidance about the elements of a private liability scheme. We thus have had "to infer how the 1934 Congress would have addressed the issue[s] had the 10b-5 action been included as an express provision in the 1934 Act."[154]

To sum up, the Court applied its own "policy considerations," aimed at curbing strike suits, when the issue on review involved the reach of the antifraud provisions to the alleged wrongdoer's conduct. On all other issues, the Court found and applied Congress's intent in resolving ambiguities and filling gaps in securities legislation. The Court's applications of these two divergent, if not conflicting, approaches to interpreting securities legislation are analyzed separately below.

---

[150] *Cent. Bank,* 511 U.S. at 172 (emphasis added).

[151] *Id.* at 172-73.

[152] SEC v. Zandford, 535 U.S. 819, 819 (2002) ("This interpretation of the ambiguous text of § 10(b) . . . is entitled to deference . . . .").

[153] Compare the vague language of Section 10(b) (*see supra* text accompanying note 79) with the specific elements established by case law for its violation, including scienter, reliance, and materiality. HAZEN, *supra* note 60, at 574-77.

[154] *Cent. Bank,* 511 U.S. at 172-73.

E. *Sculpting the Court's Decisions to Reveal the Policy Within*

Michelangelo believed he only had to remove the outer layer from the block of stone to reveal the sculpture that lived inside. Using this process on Supreme Court securities decisions also reveals the sculpture inside. The uncut block of stone includes all securities cases after 1973. Our chisel removes layer by layer those cases where the Court *did not* apply *Blue Chip Stamps*. When finished, the process reveals the sculpture inside: cases brought by private investors seeking to bring the *conduct* of a wrongdoer within the scope of the antifraud provisions. How the chips and sculpture were treated by the Supreme Court are the subject of this subsection (chips) and the next subsection (sculpture).

The chisel first chips away cases involving issues unique to the SEC: whether notice must be given to targets of SEC investigations,[155] the burden of proof on review for SEC administrative proceedings,[156] and the maximum period the SEC may suspend trading.[157] In each case, the Court shelved *Blue Chip Stamps*'s "policy considerations" stamping out strike suits, because the SEC does not bring them. Instead, it dutifully ascertained Congress's intent from the Congressional Record and other sources and then applied it in deciding each case.[158]

The chisel next chips away cases involving the verboten issue—whether the antifraud provisions reach a wrongdoer's conduct. Why the verboten issue? With absolute consistency, from 1974 until 2002, the Court declined to extend the reach of Section 10(b) to a wrongdoer's conduct where a private investor had been damaged.[159] The Court, however, embraced this issue—whether the antifraud provisions reach the wrongdoer's specific conduct—when its decision could not serve as a precedent for investors. That was the outcome in *United States v. Naftalin*,[160] where the Court extended Section 17(a) to protect defrauded brokers, who were not investors. The Court frequently cited the Congressional Record to establish legislative intent, much the same way it had done during the thirty-eight years following the statute's enactment.[161] The decision does not violate the *Blue Chip Stamps*' policy of stamping out strike suits; broker-dealers, like the SEC, do not bring strike suits against themselves or their corporate clients. For the same reason, the Court again

---

[155] *See* SEC v. Jerry T. O'Brien, Inc., 467 U.S. 735, 741-42 (1984).
[156] Steadman v. SEC, 450 U.S. 91 (1981).
[157] SEC v. Sloan , 436 U.S. 103 (1978).
[158] *See O'Brien*, 467 U.S. at 746-47; *Steadman*, 450 U.S. at 100; *Sloan* , 436 U.S. at 119.
[159] *See infra* Sections III.F.-G.
[160] 441 U.S. 768 (1979).
[161] *See id.*

shelved *Blue Chip Stamps* when it applied Section 16(b) of the 1934 Act to swing sales in two cases.[162] These decisions could not promote strike suits, and indeed have not, since the recovery must go to the corporation, not to the plaintiff-shareholder.

The chisel next chips away decisions where the Court decided whether a particular investment was a "security." These decisions are double-edged; liberally construing "security" to include an investment incidentally extends the reach of the antifraud provisions. From the Court's perspective, this could encourage strike suits. On the other hand, narrowly defining "security" limits the reach of the entire 1933 and 1934 Acts, including the registration requirements for public offerings (1933 Act), the periodic filing requirements (1934 Act), and the SEC's jurisdiction. Faced with this Hobson's choice—extending the reach of the antifraud provisions or narrowing the application of both acts—the Court chose the former.[163] It interpreted "security" consistently with the purpose of both acts, rather than narrowly to stamp out strike suits.[164] Hence, the Court found it prudent to decide five appeals without regard to the "policy considerations" stated in *Blue Chip Stamps*.[165] Indeed, the Court liberally construed "security" in two decisions, *Landreth Timber Co. v. Landreth*[166] and *Reves v. Ernst & Young*,[167] thereby extending the reach of both acts, including their antifraud provisions.[168]

The chisel finally chips away cases with a hodgepodge of central issues, all of which the Court decided without the aid of *Blue Chip Stamps*. The Court held: a defendant in a 10(b) action may seek contribution;[169] Section 11 of the 1933 Act and Section 10(b) are not mutually exclusive remedies;[170] the burden of proof for an investor is preponderance of the

---

[162]Gollust v. Mendell, 501 U.S. 115 (1991); Kern County Land Co. v. Occidental Petroleum Corp., 411 U.S. 582 (1973). Again in *Gollust*, the Court applied legislative intent to decide for the plaintiff. *Gollust*, 501 U.S. at 121-28.

[163]*See infra* text accompanying notes 165-67.

[164]*See id.*

[165]Reves v. Ernst & Young, 494 U.S. 56 (1990); Landreth Timber Co. v. Landreth, 471 U.S. 681 (1985); Marine Bank v. Weaver, 455 U.S. 551 (1982); International Bhd. of Teamsters v. Daniel, 439 U.S. 551 (1979); United Housing Found., Inc. v. Forman, 421 U.S. 837 (1975).

[166]471 U.S. 681, 688-96 (1985) (holding that the sale of corporate stock is the sale of a "security").

[167]494 U.S. 56, 73 (1990) (concluding that demand notes issued by a co-op are a "security").

[168]See *infra* text accompanying notes 270-72 for discussion of *Wharf (Holdings) Ltd. v. United International Holdings, Inc.*, 532 U.S. 588 (2001), where the Court held an oral agreement granting an option was a "security."

[169]Musick, Peeler & Garrett v. Employers Ins. of Wausau, 508 U.S. 286, 297 (1993).

[170]Herman & MacLean v. Huddleston, 459 U.S. 375, 387 (1983).

evidence;[171] reliance may be proved by the fraud-on-the-market theory;[172] the *in pari delicto* doctrine may not impede enforcement of the antifraud provisions;[173] Section 10(b) has the same limitations period as the express civil remedies;[174] and, finally, an investor's damages are not offset by tax benefits.[175] Remarkably, with the exception of the statute of limitations, all holdings favored investors. What rationale was at work? The Court later explained: in deciding cases that *did not involve the defendant's conduct*, it sought to ascertain "how the 1934 Congress would have addressed the issue[s]."[176] This was the Court's way of saying *Blue Chip Stamps* did not dictate the result.

To sum up, the Court shelved its own pet "policy considerations" and dutifully applied Congress's intent in deciding cases where the central issue involved only the SEC, non-investor-claims, the burden of proof, exclusivity of remedies, reliance, damages, or defenses. These cases are all the chips. Only the sculpture remains: *cases brought by a private investor contending the defendant's conduct comes within the scope of the antifraud provisions*. As discussed next, all these cases got *Blue-Chip-Stamped.*

F. *Fraud-Free Zone, Phase I: Getting* "Blue-Chip-Stamped"

Although *Central Bank* cut the ribbon to open the fraud-free zone, it does not deserve full credit or blame for the zone's creation.[177] By the time the Court decided *Central Bank* in 1994, *Blue Chip Stamps* had whittled away the antifraud provisions for twenty years.[178] Section 10(b) was the last warrior standing but not the warrior it was twenty years earlier. When *Central Bank* crippled the reach of Section 10(b) to third party participants in securities fraud, gatekeepers were given the green light to enter the fraud-free zone. It was open for business.

Section 10(b) stood alone in 1994, because the Court had eliminated or incapacitated its fellow warriors one-by-one. One giant to fall was Section 17(a) of the 1933 Act. That section did not expressly provide for civil liability, but its three prongs had been the basis for implied private

---

[171] *Id.* at 390.
[172] Basic Inc. v. Levinson, 485 U.S. 224, 247 (1988).
[173] Bateman Eichler, Hill Richards, Inc. v. Berner, 472 U.S. 299, 318-19 (1985).
[174] Lampf v. Gilbertson, 501 U.S. 350, 362 (1991).
[175] Randall v. Loftsgaarden, 478 U.S. 647, 660 (1986).
[176] *Cent. Bank*, 511 U.S. at 173.
[177] *See id.*
[178] *See infra* text accompanying notes 179-247.

remedies for thirty years.[179] The Southern District of New York first implied a civil remedy under Section 17(a) in 1949.[180] With the Supreme Court's *Borak* decision in 1964, it blessed the legal principle upon which liability rested.[181] Liability under Section 17(a) was then "taken for granted."[182]

The legal principles supporting civil liability under Section 17(a) fell out of favor with the Court's 5-4 decision in *Transamerica Mortgage Advisors, Inc. v. Lewis*.[183] The thin majority put aside its unanimous holding in *Borak* with this terse comment:

> While some opinions of the Court have placed considerable emphasis upon the desirability of implying private rights of action in order to provide remedies thought to effectuate the purposes of a given statute, e.g., *J.I. Case Co. v. Borak*, . . . what must ultimately be determined is whether Congress intended to create the private remedy asserted, as our recent decisions have made clear.[184]

In *Transamerica*, the Court held no implied cause of action existed for a violation of Section 206 of the Investment Advisers Act of 1940.[185] Section 206 is similar in content and form to Section 17(a). Hence, *Transamerica* undercut *Borak* and implied no civil liability existed under Section 17(a).[186] *Landry v. All America Assurance Co.* sounded the death knell for Section 17(a) in the Fifth Circuit, where the class action against Enron's

---

[179]Osborne v. Mallory, 86 F. Supp. 869, 879 (S.D.N.Y. 1949) *See infra* text accompanying notes 180-83

[180]The court reasoned:

> Even though there is no specific section of the 1933 Act creating liability under [Section] 17 other than the language of [Section] 17 itself, or in the 1934 Act in relation to [Section] 10(b) of that Act other than the language of [Section] 10(b) itself, nevertheless it has been held that a civil liability is implied and a remedy is available under the Acts for violations of their provisions, and that an action may be brought in the appropriate courts to enforce that liability.

Osborne, 86 F. Supp. at 879.

[181]*See* J.I. Case Co. v. Borak, 377 U.S. 426 (1964).

[182]HAZEN, *supra* note 60, at 682 (quoting LOSS, *supra* note 104, at 3913).

[183]444 U.S. 11 (1979).

[184]*See id.* at 15-16.

[185]*See id.* at 24.

[186]Section 206 makes it unlawful for any investment adviser "to employ any device, scheme or artifice to defraud . . . [or] to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client." *Id.* at 16 (quoting 15 U.S.C. §§ 80(b) to 80b-6(1)(2)).

gatekeepers is now pending.[187] Likewise, relying on *Transamerica*, other circuits courts "have denied the existence of a private remedy under [S]ection 17(a)."[188] *Transamerica* therefore resulted in the elimination of Section 17(a)'s three theories of civil liability against Enron's gatekeepers.

A side-by-side comparison of *Transamerica* with *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Curran*,[189] reveals the silent hand of *Blue Chip Stamps* at work. In both cases, the Court considered whether Congress had intended to create a private cause of action, despite its failure to expressly provide for one.[190] As noted in the dissent in *Curran*, the key operative language in both statutes was similar.[191] Contrary to the holding in *Transamerica*, the 5-4 majority in *Curran* held private causes of action existed under the Commodities Exchange Act for fraud or market manipulation.[192] The majority, after considering the Congressional Record, concluded that Congress had intended to create a private remedy,[193] while the dissent concluded exactly the opposite.[194]

These conflicting interpretations of similar statutory language by the majority and dissent in the 5-4 *Transamerica* decision (finding no implied civil action) and 5-4 *Curran* decision (finding an implied civil action) reveal more about the judicial politics of the Court than the intent of Congress. Some other factor was at work. One unstated dynamic might account for the seemingly contradictory results. *Blue Chip Stamps* was concerned with strike suits, especially in the form of class actions.[195] There are only three reported decisions of class actions brought under the Commodities Exchange Act and none were ever certified.[196] Hence,

---

[187] Landry v. All America Assurance Co., 688 F.2d 381 (5th Cir. 1982); *In re* Enron Corp. Sec., Derivative & ERISA Litig., 235 F. Supp. 2d 549 (S.D. Tex. 2002).

[188] HAZEN, *supra* note 60, at 683. In *Touche Ross & Co. v. Redington*, 442 U.S. 560 (1979), the Court concluded on similar grounds that no private cause of action existed under Section 17(a) of the 1934 Act.

[189] 456 U.S. 353 (1982).

[190] *See* Transamerica Mortgage Advisors, Inc. v. Lewis, 444 U.S. 11 (1979); Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Curran, 456 U.S. 353 (1982).

[191] Justice Powell wrote: "Sections 4a and 4b [of the Commodity Exchange Act of 1936] are similar to § 206 of the Investment Advisers Act of 1940. . . . We have held explicitly that the language of § 206 does not create an implied damages action." *Merrill Lynch*, 456 U.S. at 397 (citing *Transamerica*, 444 U.S. at 16 n.6, 24).

[192] *See id.* at 394-95.

[193] *Id.*

[194] *Id.* at 408.

[195] Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 758 (1975).

[196] Class action never certified by district court, *Lopez v. Dean Witter Reynolds, Inc.*, 805 F.2d 880, 882 n.3 (9th Cir. 1986); denial of class action motions, *Cohen v. Dean Witter Reynolds, Inc.*, No. 79 Civ. 212, 1986 U.S. Dist. LEXIS 27433, at *5 (E.D.N.Y. Mar. 31, 1986); and *Molis v. P.G. Commodities Assoc., Inc.*, No. 77 Civ. 1002, 1978 U.S. Dist. LEXIS 19739 (S.D.N.Y. Feb. 3, 1978).

finding an implied private cause of action under the Commodities Exchange Act does not violate *Blue Chip Stamps*' "policy considerations."

The Supreme Court played no favorites as it dismantled the antifraud protections. The express remedies enacted by the 73rd Congress got the same treatment as the implied ones. Section 12(a)(2)[197] of the 1933 Act expressly imposed civil liability on the seller of securities for a misleading "prospectus or oral statement."[198] Section 2(a)(10)[199] of the same Act broadly defined "prospectus" to include any written communication.[200] Hence, on its face, Section 12(a)(2) would apply to the sale of ten million shares in a public offering or the sale of 100 shares in the secondary market years later.

The Rehnquist majority trimmed and then severed the reach of Section 12(a)(2). First, the Court tightly defined "seller" in *Pinter v. Dahl*,[201] thereby narrowing the class of wrongdoers liable under Section 12(a)(2). *Pinter* was followed by *Gustafson v. Alloyd Co.*,[202] a decision that uniformly left legal scholars and securities practitioners scratching their heads in disbelief.[203] In this 5-4 decision, the Court ignored the explicit and broad statutory definition of "prospectus" in Section 2(a)(10), preferring its own narrower one.[204] According to the Court, "prospectus" in the context of Section 12(a)(2) meant only written statements used in public offerings.[205] This eliminated private placements and secondary market sales from the reach of Section 12(a)(2).[206] Turning its back on the investor, the Court yet again restricted the reach of an antifraud provision to the wrongdoer's conduct. *Gustafson* also gave securities practitioners and scholars this anomaly to think about: "prospectus" has the broad statutory definition in deciding civil liability under Section 12(a) for failure

---

[197] Securities Act of 1933, 15 U.S.C.A. § 77*l* (West 1997).

[198] *See id.* § 77*l*(2).

[199] *Id.* § 77b(a)(10).

[200] *Id.*

[201] 486 U.S. 622, 650 (1988).

[202] 513 U.S. 561 (1995).

[203] "This holding was contrary to the understanding of almost all securities law practitioners and scholarly commentators over the years." ROBERT J. HAFT, LIABILITY OF ATTORNEYS AND ACCOUNTANTS FOR SECURITIES TRANSACTIONS § 2:5 (Thomson West 2002-2003 ed.). "A number of questions survive the Court's rather strained reading [in *Gustafson*] of the 1933 Act." HAZEN, *supra* note 60, at 377.

[204] *Gustafson*, 513 U.S. at 576, 584.

[205] *Id.*

[206] *See id.*

to register securities,[207] but a very narrow one in deciding civil liability for securities fraud under the same section.[208]

In another 5-4 decision in 1974, *Scherk v. Alberto-Culver Co.*,[209] the Court held arbitration clauses were enforceable in agreements between broker-dealers and their customers.[210] Since these agreements commonly contain arbitration provisions, investors lost their right to sue broker-dealers in federal district courts for violations of the antifraud provisions.[211] *Scherk* impliedly overruled a precedent the Court set twenty-one years earlier in *Wilko v. Swan*.[212] *Wilko* held arbitration clauses were unenforceable under Section 14 of the 1933 Act, which voided any "stipulation" waiving compliance with any provision of the 1933 Act.[213] *Wilko* reasoned the arbitration process would in practice allow the substantive provisions of the Act to be ignored:

> This case requires subjective findings on the purpose and knowledge of an alleged violator of the Act. They must be not only determined but applied by the arbitrators without judicial instruction on the law. As their award may be made without explanation of their reasons and without a complete record of their proceedings, the arbitrators' conception of the legal meaning of such statutory requirements as "burden of proof," "reasonable care" or "material fact" . . . cannot be examined. Power to vacate an award is limited.[214]

These concerns were just as real when *Scherk* was decided in 1974. *Scherk* stretched to distinguish *Wilko* with this weak rationale: "crucial differences [existed] between the agreement involved in *Wilko* and the one signed by the parties [in *Scherk*]."[215] Showing less pretext, the Court continued to narrow *Wilko*,[216] before flatly overruling it in 1989.[217]

---

[207]Section 12(a)(1) of the 1933 Act subjects any person who violates Section 5 to strict liability. *See* HAZEN, *supra* note 60, at 344. Section 5 uses the broad statutory definition of Section 2(a)(10). *Id.* at 100.

[208]*Gustafson*, 513 U.S. at 576.

[209]417 U.S. 506 (1974).

[210]*Id.* at 519-20.

[211]*See id.* at 515-20.

[212]346 U.S. 427, 438 (1953).

[213]*See id.* at 434-38.

[214]*See id.* at 435-36.

[215]*Scherk*, 417 U.S. at 515.

[216]*See* Shearson/American Express Inc. v. McMahon, 482 U.S. 220 (1987) (stating arbitration provision in *Wilko* was "unenforceable only because arbitration was judged inadequate to enforce the statutory rights created by § 12(2)").

[217]Rodriguez de Quijas v. Shearson/American Express, Inc., 490 U.S. 477, 484 (1989).

The Supreme Court also allowed the lower courts to emasculate another key antifraud provision. Section 18 of the 1934 Act paints fraudulent conduct with a wider brush than any other civil liability section in either the 1933 or 1934 Act: it imposes liability on those who *cause* a misleading statement in any document filed with the SEC under the 1934 Act or its regulations, for example, 10Ks and 10Qs.[218] Put differently, it reaches conduct. Its key language reads:

> Any person who shall make or *cause to be made* any statement in any . . . document filed pursuant to this . . . title [with the SEC], which statement was . . . false or misleading with respect to any material fact, shall be liable to any person . . . who, in reliance upon such statement, shall have purchased or sold a security . . . .[219]

The lower courts rendered Section 18 toothless by holding its reliance requirement could only be satisfied if the investor actually "eyeballs" the SEC filing, e.g., literally reads the 10K.[220] The Supreme Court has consistently denied certiorari in cases raising Section 18 issues.[221] If the reliance element of Section 18 could be established by the "fraud-on-the-market theory," as it may be with Section 10(b),[222] Section 18 would literally apply to Barclays's alleged use of Chewco to doctor Enron's books.

Finally, the Court narrowed the elements and tightened the proof for establishing a violation of Section 10(b), the culprit most responsible for strike suits in the view of the Rehnquist majority. *Ernst & Ernst v. Hochfelder* held claims under Section 10(b) and Rule 10b-5 require scienter.[223] The majority employed a unique principle of statutory construction: it inferred the element of scienter from Congress's *silence*. The rationale was stated with this convoluted sentence: "There is no indication, however, that § 10(b) was intended to proscribe conduct not

---

[218]*See* Securities Exchange Act of 1934, § 18a Commerce and Trade, Liability for Misleading Statements, 15 U.S.C.A. § 78r(a) (West 2003).

[219]*See id.* (emphasis added).

[220]Ross v. A.H. Robins Co., 607 F.2d 545 (2d Cir. 1979); Heit v. Weitzen, 402 F.2d 909, 916 (2d Cir. 1968); Berman v. Richford Indus., Inc., 26 Fed. R. Serv. 2d 10, 16 (S.D.N.Y. 1978) ("Section 18(a) has been construed as requiring direct or 'eyeball' reliance, which means that plaintiff must aver that he personally reviewed and was induced to act upon specific misrepresentations contained in documents filed with the SEC . . . .").

[221]Ross v. A.H. Robins Co., 607 F.2d 545 (2d Cir. 1979), *cert. denied*, 446 U.S. 1946 (1980); Heit v. Weitzen, 402 F.2d 909 (2d Cir. 1968), *cert. denied*, 395 U.S. 903 (1969).

[222]*See* Basic Inc. v. Levinson, 485 U.S. 224 (1988).

[223]Ernst & Ernst v. Hochfelder, 425 U.S. 185, 202 (1976).

involving scienter."[224] Thus, the element of scienter was added to Section 10(b) and Rule 10b-5 by judicial fiat. The dissent linked the holding back to *Blue Chip Stamps*:

> Once again—see *Blue Chip Stamps v. Manor Drug Store* . . . the Court interprets § 10(b) of the Securities Exchange Act of 1934 . . . and the Securities and Exchange Commission's Rule 10b-5 . . . restrictively and narrowly and thereby stultifies recovery for the victim. This time the Court does so by confining the statute and the Rule to situations where the defendant has "scienter," that is, the "intent to deceive, manipulate, or defraud."[225]

Only four years later in *Aaron v. SEC,* the Court concluded subsections 17(a)(2) and 17(a)(3), nearly identical to subsections 10b-5(b) and 10b-5(c), only required proof of negligence in SEC civil actions.[226] Although the Court offered its own rationale why it interpreted similar language[227] to have opposite meanings in *Hochfelder* and *Aaron*,[228] these conflicting decisions also suggest *Blue Chip Stamps* was silently at work. Lowering the mental element from scienter to negligence for the SEC to establish a violation of Section 17(a) does not encourage strike suits because the SEC does not bring them.

Two other decisions made it tougher to prove an actionable misrepresentation or disclosure under all the antifraud provisions, including Section 10(b). *TSC Industries, Inc., v. Northway, Inc.* raised the bar for proving when a fact is "material."[229] Under the former standard, the fact was "material" if a reasonable investor "might" consider it important to the decision.[230] Under the new standard, the fact must have a "substantial likelihood" of having the same effect.[231] Similarly, *Virginia Bankshares, Inc. v. Sandberg* tightened the proof for establishing a misstatement of

---

[224]*See id.*

[225]*See id.* at 215-16.

[226]Aaron v. SEC, 446 U.S. 680 (1980).

[227]*See supra* note 79. Rule 10b-5(b) and (c) are almost identical to subsections 17(a)(2) and 17(a)(3). The primary difference between the texts of the rule and the section is that Rule 10b-5 protects both buyers and sellers, while Section 17(a) only protects buyers.

[228]In *Aaron*, the Court observed, "The language of § 17(a) strongly suggests that Congress contemplated a scienter requirement under § 17(a)(1), but not under § 17(a)(2) or § 17(a)(3)." *Id.* at 685-86. On the other hand, the Court explained the scope of Rule 10b-5 was limited by the text of Section 10(b), which it interpreted to require scienter. *See id.* at 690-91.

[229]TSC Indus., Inc., v. Northway, Inc., 426 U.S. 438, 448-49 (1976).

[230]*See id.* at 449.

[231]*See id.*

intention or opinion.[232] The Court went beyond the substantive law to prescribe the evidence the trial court could consider on this issue. Misstatements of intentions or opinions may be established by "matters of corporate record subject to documentation, to be supported or attacked by evidence of historical fact outside a plaintiff's control."[233] Limiting the nature of the evidence to prove fraud, according to the Court, was once again necessary to prevent "just the sort of strike suits and attrition by discovery that *Blue Chip Stamps* sought to discourage."[234]

With a one-two punch, the Court all but eliminated "manipulative" conduct as an independent basis for violating Section 10(b) and 14(e) of the 1934 Acts. *Santa Fe Industries, Inc. v. Green* implied "manipulative" conduct must also be deceptive to violate Section 10(b)'s prohibition on "manipulative or deceptive" conduct.[235] *Schreiber v. Burlington Northern, Inc.* took *Santa Fe* one step further: it expressly held a "manipulative" act must also be "deceptive" to violate Section 14(e).[236] Both cases interpreted "manipulative" in the phrase "manipulative *or* deceptive" as if it read "manipulative *and* deceptive."[237]

In *Santa Fe*, the majority stockholder bought out the minority's holdings pursuant to Delaware's short-form merger statute.[238] The minority sued under Section 10(b), alleging the majority had breached a fiduciary duty by setting the cash-out price too low, but failed to allege any deception. The Court held the breach of a fiduciary duty, in the absence of deception, did not violate *either* prong of Section 10(b)'s prohibition on

---

[232] Virginia Bankshares, Inc. v. Sandberg, 501 U.S. 1083, 1092 (1991).

[233] *See id.*

[234] *See id.* at 1096.

[235] 430 U.S. 462, 475 (1977).

[236] 472 U.S. 1 (1985).

[237] *See* HAZEN, *supra* note 60, at 564 (The Court in *Schreiber* "ignored the plain meaning of the statute and its use of a disjunctive 'or.'").

[238] *Santa Fe*, 430 U.S. at 465-66.

> [Section] 253 of the Delaware Corporation Law [DEL. CODE ANN. tit. 8, § 253 (2002)], known as the "short-form merger" statute . . . permits a parent corporation owning at least 90% of the stock of a subsidiary to merge with that subsidiary, upon approval by the parent's board of directors, and to make payment in cash for the shares of the minority stockholders. The statute does not require the consent of, or advance notice to, the minority stockholders. However, notice of the merger must be given within 10 days after its effective date, and any stockholder who is dissatisfied with the terms of the merger may petition the Delaware Court of Chancery for a decree ordering the surviving corporation to pay him the fair value of his shares, as determined by a court-appointed appraiser subject to review by the court. DEL. CODE ANN. [t]it. 8, §§ 253, 262 (1975 ed. [&] 1976 Supp.).

Id.

"manipulative or deceptive" conduct.[239] Once again, the Court saw its decision as another battle in the war against its old foe, the strike suit.[240]

Schreiber interpreted "manipulative" in the context of Section 14(e) of the 1934 Act, which prohibits the use of any "fraudulent, deceptive, or manipulative acts or practices, in connection with any tender offer."[241] It held the use of two successive tender offers that allegedly manipulated the price of the target's stock on the market was not "manipulative" within the meaning of Section 14(e) in the absence of any deception.[242] Again, the Court made little effort to ascertain whether Congress also intended the term "manipulative" to require deception.

Santa Fe's and *Schreiber*'s holdings that "manipulative" conduct must also be "deceptive" seem odd, since the texts of Section 10(b) and 14(e) explicitly prohibit deceptive "or" manipulative conduct. Why would 10(b) or 14(e) need to prohibit deceptive conduct twice, once expressly as enacted by the Congress and again by interpretation of the Court? In any case, by redefining "manipulative" to mean "deceptive," the Court injected a redundancy into each section. For example, after *Schreiber*, Section 14(e) should be read to prohibit any "fraudulent, deceptive, or deceptive (formerly manipulative) acts or practices." Further, by creating this redundancy, the Court violated one of its own cardinal principles of statutory construction: an interpretation of a statute that results in redundant language is disfavored.[243]

Finally, the Court *Blue-Chip-Stamped* the government in *Chiarella v. United States*[244] and *Dirks v. SEC*.[245] In both cases, the government sought to extend the reach of Section 10(b) to those trading on non-public

---

[239]*Id.* at 474-80.

[240]*Id.* at 478-79. The Court expressed concern: "The reasoning behind a holding that the complaint in this case alleged fraud under Rule 10b-5 could not be easily contained." This in turn would pose "a 'danger of vexatious litigation which could result from a widely expanded class of plaintiffs under Rule 10b-5,' . . . ." *Id.* (quoting Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 740 (1975)).

[241]Securities Exchange Act of 1934, 15 U.S.C.A. § 78n(e) (West 1997).

[242]*Schreiber* stated its holding: "[W]e hold that the actions of respondents were not manipulative. The amended complaint fails to allege that the cancellation of the first tender offer was accompanied by any misrepresentation, nondisclosure, or deception." *Schreiber*, 472 U.S. at 12-13.

[243]SUTHERLAND STAT. CONSTRUCTION § 45.12, at 61 (5th ed. 1992). The Court applied this principle in *Gustafson v. Alloyd Co.*, 513 U.S. 561, 574-75 (1995), when it narrowly interpreted the term "communication" in Section 2(10) of the 1933 Act. The Court declared: "If 'communication' included every written communication, *it would render 'notice, circular, advertisement, (and) letter' redundant*, since each of these are forms of written communication as well)." *Id.* (emphasis added).

[244]445 U.S. 222 (1980).

[245]463 U.S. 646 (1983).

information by broadening the duty to disclose, which would have likewise broadened the duty to disclose of defendants in private civil litigation.[246] Ruling for the government in these cases would have opened a seam in the new business-friendly antifraud provisions, through which packs of plaintiffs' attorneys could pour. Later, *Chiarella* would serve as a crossbeam in *Central Bank*'s construction of the fraud-free zone.

In sum, the Supreme Court narrowed the reach of the antifraud provisions in the above cases. It eliminated the implied causes of action under each prong of Section 17(a). It restricted the reach of Section 12(a)(2) to sellers as a warm up and then denied its application to secondary markets and private placements. It left investors with no judicially enforceable remedies against broker-dealers. The lower courts' "eyeball" reliance, which the Supreme Court allowed to stand, rendered Section 18 toothless. Applying *Blue Chip Stamps* to Section 10(b), the Court raised the bar for proving three of its elements and even limited the evidence admissible to prove a violation. Not even the government was immune when the decision could be cited as a precedent by lawyers for defrauded investors. The Court, however, would still have to *Blue Chip Stamp* aiding and abetting liability before the world would be safe from strike suits.

G. *Fraud-Free Zone, Phase II: Opening for Business*

Central Bank was a major setback for investors. It eliminated liability for aiding and abetting a violation of Section 10(b), which further restricted the reach of Section 10(b) to those using deceptive words or deceptive conduct to cheat investors.[247] Once again the Court pruned back the antifraud provisions to stop the growth of that same pesky rascal, the strike suit. The Court explained:

> "[L]itigation under Rule 10b-5 presents a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general." *Blue Chip Stamps* . . . . Litigation under 10b-5 thus requires secondary actors to expend large sums even for pretrial defense and the negotiation of settlements . . . .

---

[246] *See Dirks*, 463 U.S. at 660-64; *Chiarella*, 445 U.S. at 226.

[247] Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164 (1994).

> This uncertainty and excessive litigation can have ripple effects. For example, newer and smaller companies may find it difficult to obtain advice from professionals. A professional may fear that a newer or smaller company may not survive and that business failure would generate securities litigation against the professional, among others. In addition, the increased costs incurred by professionals because of the litigation and settlement costs under 10b-5 may be passed on to their client companies, and in turn incurred by the company's investors, the intended beneficiaries of the statute.[248]

What did *Central Bank* mean for errant gatekeepers? It was a license issued under the seal of the Supreme Court to commit fraud up to the point of its final execution. Lawyers, accountants, and investment bankers could conceive the fraud. Like architects, they could take the concept to the drafting table to design the details.[249] Again like architects, they could guide their clients step-by-step through execution of the fraud.[250] If the fraud were successful, they could market their creation to others.[251] The license came, however, with one key limitation: they could not directly execute the fraud on the investor. If they took this last step, they might be treated as a "primary violator."[252]

The Supreme Court warned gatekeepers what might happen if they stepped outside the zone:

> The absence of § 10(b) aiding and abetting liability does not mean that secondary actors in the securities markets are always free from liability under the securities Acts. Any

---

[248] *Id.* at 189.

[249] Senator Levin concluded the evidence before his subcommittee established that J.P. Morgan Chase had designed one of the deceptive devices, known as slapshot, used by Enron: "Finally, the Slapshot transaction, another highly disturbing example of a major U.S. financial institution's helping Enron engage in a deception transaction. It is particularly disturbing because Chase, the financial institution involved here, itself designed the deceptive transaction. That was even more than aiding and abetting." *Hearings on the Lessons of Enron*, *supra* note 9.

[250] "Substantial evidence showed that the financial institutions involved in the deals knew exactly what was going on. They structured the transactions, signed the paperwork, and supplied the funds, knowing that Enron was using the deal to report the company was in better financial condition that it really was." *See id.*

[251] "In the case of Citigroup and Chase, the banks not only assisted Enron, *they developed the deceptive prepays as a financial product and sold it to other companies as so-called 'balance sheet friendly financing*,' earning millions of fees for themselves in the process." *See id.* (emphasis added).

[252] *Cent. Bank*, 511 U.S. at 191.

> 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 under Rule 10b-5 are met.[253]

For the gatekeepers, the warning temporarily created a troubling ambiguity: how is a secondary actor to be distinguished from a primary violator?[254] The Second Circuit resolved this ambiguity in *Wright v. Ernst & Young LLP*, making the zone a far safer place to work.[255] It delineated the zone's boundary with a bright line.[256] Under *Wright*, an actor does not become a primary violator merely by making a misstatement upon which an investor relies.[257] The actor must be identified as the author of the lie in the communication to the investor.[258] Hence, after *Wright*, gatekeepers could go one step further in perpetrating fraud in the Second Circuit, the location of the nation's financial capital. They could tell the lie so long as they refrained from identifying themselves as its author.

Two other risks exist for gatekeepers operating from the fraud-free zone: Section 11 of the 1933 Act and the SEC. The Section 11 risk is easily contained if one simple rule is followed during a public offering: do not serve as a corporate director, underwriter, certifying expert, or signer of the registration statement.[259] A few gatekeepers got sloppy with Enron registration statements and may pay dearly for it.[260]

The last risk was the SEC. Congress reinstated the SEC's power to prosecute civil actions against those who aid and abet violations of the 1934 Act, which *Central Bank* had taken away.[261] Hence, the SEC may enter the fraud-free zone to check whether attorneys, accountants, and broker-dealers are behaving themselves and issue citations if they are not. Gatekeepers had reason to discount this risk. Only one proceeding, a class

---

[253] *See id.*

[254] HAZEN, *supra* note 60, at 691.

[255] *See* Wright v. Ernst & Young LLP, 152 F.3d 169 (2d Cir. 1998).

[256] *Id.* at 175.

[257] *Id.*

[258] *Id.*

[259] *See* Securities Act of 1933, 15 U.S.C.A. § 77k(a) (West 1997).

[260] Section 11 claims were expressly upheld against only four relatively minor players in the Enron fraud. *In re* Enron Corp. Sec., Derivative & ERISA Litig., 235 F. Supp. 2d 549, 707-08 (S.D. Tex. 2002). Whether the Section 11 claim was upheld against Andersen is unclear: Andersen is not listed among the defendants against whom Section 11 claims were upheld. *Id.* On the other hand, its Rule 12(b)6 motion was denied in its entirety. *Id.* at 708.

[261] 15 U.S.C.A. § 78t(e) (West 2003).

action, had ever been brought against any entity for using an SPE to cook the books before Chewco; the claims against the only gatekeeper—an auditing firm—were dismissed during the pleadings stage.[262] The SEC never brought an injunctive or administrative proceeding on this theory before the Enron collapse.[263]

One group, however, knew the SEC was not a risk—banks. Their conception, planning, and execution of the Enron fraud were beyond the reach of the SEC and banking regulators. Senator Levin explained this gap and his solution:

> There is a regulatory gap now. The Securities and Exchange Commission does not generally regulate banks, and bank regulators don't regulate accounting practices or ensure accurate financial statements. Two steps need to be taken which, together, could close this gap.
>
> First, the SEC should issue a policy which states clearly that the SEC will take enforcement action against financial institutions which aid or abet a client's dishonest accounting by selling deceptive structured finance or tax products or by knowingly or recklessly participating in deceptive structured transactions.
>
> Second, the bank regulators, including the Federal Reserve that oversees our financial holding companies, need to state that violation of that SEC policy that I just described would constitute an unsafe and unsound banking practice, thereby enabling bank examiners to take regulatory action during bank examinations.[264]

To summarize, the antifraud provisions created little risk for Barclays on the eve of its alleged misadventure with Chewco. More than

---

[262]*In re* Wellcare Mgmt. Group, Inc. Sec. Litig., 964 F. Supp. 632 (N.D.N.Y.1997).

[263]The first case where the SEC may have contended SPEs were used to cook the books was *HSBC Holdings*, plc, Notice of Application, 76 SEC DOCKET 11, Investment Co. Act of 1940, Release Nos. IC-25318 & 812-12726 (Dec. 17, 2001), but the facts were not stated in sufficient detail to be sure. The SEC did contend the use of SPEs violated Sections 10(b) of the 1934 Act and 17(a) of the 1933 Act in *In re PNC Financial Services Group, Inc.,* 78 SEC DOCKET 1, Securities Act of 1933, Release No. 8112 (July 18, 2002), Securities Exchange Act of 1934, Release No. 46225 (July 18, 2002) and *In re Dynegy, Inc.*, 78 SEC DOCKET 11, Securities Act of 1933 Release No. 8134 (Sept. 24, 2002), Securities Exchange Act of 1934 Release No. 46537 (Sept. 24, 2002).

[264]*Hearings on the Lessons of Enron*, *supra* note 9.

twenty years of Supreme Court decisions had undone the work of the 73rd Congress. *Central Bank* created a fraud-free zone, safe from private civil suits. A regulatory gap prevented the SEC from entering the zone. So long as Barclays did not identify itself as the author of any lie, it could, with *apparent* immunity, conceive, plan, and help execute a fraud on Enron investors.

H. *Has the Supreme Court Pulled Back from* Blue Chip Stamps*?*

In 1995, Congress enacted the Private Securities Litigation Reform Act (PSLRA) to curb what it saw as abusive practices in private securities litigation, particularly in class actions.[265] The legislation tightened pleading requirements for stating securities fraud claims and included an automatic stay of discovery until pleadings issues were resolved.[266] Accordingly, the PSLRA should have obviated the need, from the Court's perspective, for any further steps to implement its war on strike suits.

Indeed, three decisions since the adoption of the PSLRA may signal the Court's pullback from *Blue Chip Stamps*. In the first, *United States v. O'Hagan*,[267] the Court recognized the "misappropriation theory" as a "complement" to the classic theory of insider trading.[268] The decision creates a new source for a duty under Section 10(b).[269] However, *investors* have yet been unable to state a claim under the new theory in any reported decision.[270]

The second decision, *Wharf (Holdings) Ltd. v. United International Holdings, Inc.*, is more important for its reasoning than its holding. The Court decided "security" included an oral option.[271] The Court rejected defendant Wharf's argument that enforcement of oral options would violate

---

[265]*See* 1933 Act § 27 (15 U.S.C.A. § 77z-1(a)); 1934 Act § 21D (15 U.S.C.A. § 78u-4).

[266]*See* 1933 Act § 27 (15 U.S.C.A. § 77z-1(a)); 1934 Act § 21D (15 U.S.C.A. § 78u-4). The PLSRA, of course, made it more difficult for Enron investors to recover under the antifraud provisions because of its pleading requirements and discovery stay. It does not appear, however, to have been a major obstacle in the *Class Action* against the gatekeepers, since the plaintiffs overcame the Rule 12 (b)(6) motions brought by most gatekeeper-defendants. *In re* Enron Corp. Sec., Derivative & ERISA Litig., 235 F. Supp. 2d 549, 708 (S.D. Tex. 2002).

[267]521 U.S. 642 (1997).

[268]*Id.* at 652.

[269]*See id.*

[270]No private claim based on the misappropriation theory has advanced beyond the pleadings stage. *See, e.g.*, TFM Investment Group v. Bauer, No. 99-840, 1999 U.S. Dist. Lexis 15821, at *7-*8 (E.D. Pa. Sept. 29, 1999) ("Thus, on its face, this case does not seem to fall within this theory because defendant does not owe a duty to plaintiff since plaintiff was not the source of this non-public, material information. In other words, defendant did not 'misappropriate' any non-public information from the plaintiff.").

[271]Wharf (Holdings) Ltd. v. United Int'l Holdings, Inc., 532 U.S. 588 (2001).

the policy of *Blue Chip Stamps* "to protect defendants against law suits that 'turn largely on what oral version of a series of occurrences the jury may decide to credit.'"[272] Defendant Wharf's reliance on *Blue Chip Stamps* appears well-founded, since a lawsuit based on a "security" arising out of the spoken word was just the flimsy type of suit that *Blue Chip Stamps* was supposed to stamp out.[273] Hence, the Court's rejection of this argument implies a pullback from *Blue Chip Stamps*.

SEC v. Zandford is the clearest signal of a pullback. The Court found a violation of Section 10(b) where an errant broker failed to disclose he was selling his client's securities to pocket the proceeds.[274] The Court liberally construed the phrase "in connection with" to bring the broker's conduct within the scope of Section 10(b).[275] As discussed next, however, *In re Enron* mistakenly reads *Zandford* to hold Section 10(b) prohibits deceptive conduct without deceptive words.

IV. *IN RE ENRON*: A BOLD BUT FLAWED EFFORT TO CLOSE THE FRAUD-FREE ZONE

The gatekeepers sued in the Enron class action fall into three groups.[276] One group never left the safety of the fraud-free zone; these gatekeepers made *no statements* to investors. Barclays is the only gatekeeper from this group still in the suit. *Central Bank's* holding, rejecting liability for aiding and abetting a Section 10(b) violation, appears to protect this group.[277]

A second group of gatekeepers identified themselves as co-authors of the lie in misleading statements distributed to investors. For example, by placing its audit stamp on Enron's financial statements filed with the SEC and distributed to investors,[278] Andersen joined this group. It voluntarily stepped outside the fraud-free zone. Not even the Second

---

[272] *See id.* at 594 (quoting Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 742 (1975)).

[273] The enforcement of an "oral option" violates at least the spirit if not the letter of *Virginia Bankshares*, 501 U.S. at 1092.

[274] SEC v. Zandford, 535 U.S. 813, 825 (2002). It could also be argued the Supreme Court in *Zandford* merely affirmed its earlier decision in *Superintendent of Ins. v. Bankers Life & Casualty Co.*, 404 U.S. 6 (1971).

[275] SEC v. Zandford, 535 U.S. 813, 825 (2002).

[276] *In re* Enron Corp. Sec., Derivative & ERISA Litig., 235 F. Supp. 2d 549 (S.D. Tex. 2002).

[277] Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164, 191 (1994).

[278] *See supra* text accompanying notes 57-58.

Circuit's "bright line" interpretation of *Central Bank* can rescue Andersen.[279]

The third group of gatekeepers made misleading statements passed along to investors; however, these gatekeepers were not so foolish to identify themselves in the documents as the authors of the lie. This group operates within the fraud-free zone under the Second Circuit interpretation of *Central Bank*, but not so under the SEC's interpretation.[280]

In denying the gatekeepers' motions to dismiss, *In re Enron* articulated two legal theories to overcome *Central Bank*.[281] The first addressed an issue that *Central Bank* left open. *Central Bank* observed secondary actors might become liable as "primary violators" under Section 10(b), but failed to articulate a rule under what circumstances that liability would arise.[282] *In re Enron*, adopting the SEC position, held a secondary actor becomes a primary violator when the actor authors the misstatement statement communicated to the investor, even though the statement does not identify the actor as such.[283] This holding closes the fraud-free zone for all those whose misstatements were passed along to investors, i.e., two of the three groups described above. However, this prong of *In re Enron* did not reach Barclays's use of Chewco, since those allegations were not based on misrepresentations to investors.[284] Barclays was still safely within the fraud-free zone.

The second prong of the decision was aimed at the gatekeepers whose deceptive conduct allegedly violated Section 10(b), such as Barclays.[285] Although a novel theory, it is elegantly simple and rests on legal granite. *Central Bank* held the defendant bank in that case was not liable for aiding and abetting the preparation of a misleading appraisal.[286] Hence, the fraud at the core of *Central Bank* consisted of misleading *words*. Deceiving with misleading words, however, is not the only way to literally violate Section 10(b) and Rule 10b-5. The text of both the statute and the rule expressly include fraud committed by means *other than deceptive words*.[287] On this point, *In re Enron* reads:

---

[279]*See* Wright v. Ernst & Young LLP, 152 F.3d 169, 175 (2d Cir. 1998) (applying the "bright line" test).

[280]*See id.* The SEC's position on *Central Bank* was discussed at some length in *In re Enron,* 235 F. Supp. 2d at 588-90.

[281]*In re Enron,* 235 F. Supp. 2d at 583-90.

[282]*Cent. Bank*, 511 U.S. at 191.

[283]*In re Enron,* 235 F. Supp. 2d at 587-90. The Second Circuit held the defendant must be identified as the author of any misstatement to be a primary violator. *Wright*, 152 F.3d at 175.

[284]*See supra* notes 72-73.

[285]*See In re Enron,* 235 F. Supp. 2d at 577.

[286]*Cent. Bank*, 511 U.S. at 191.

[287]*In re Enron,* 235 F. Supp. 2d at 577.

> Securities fraud actions under § 10(b) and Rule 10b-5 are not merely limited to the making of an untrue statement of material fact or omission to state a material fact. Section 10(b) prohibits "any manipulative or deceptive contrivance," which, as indicated above, the Supreme Court, relying on *Webster's International Dictionary*, includes "a scheme to deceive" or "scheme, plan or artifice."[288]

Hence, even if the wrongdoer made no misstatement to investors, as Barclays had not, it could still be liable if its *conduct* was deceptive. Under this theory, for example, Barclays's alleged use of Chewco would amount to the use of a "deceptive device or contrivance" in violation of Section 10(b).[289] *Central Bank* would not protect Barclays because liability was not based on the theory that it aided and abetted Enron. Rather, Barclays acted as primary violator, but its violation was in the form of alleged acts rather than words. To this point, *In re Enron*'s reasoning is sound; it did not stay that way.

Unfortunately for investors, the decision uniformly misstates the holdings of the cases it cites as authority for its textual interpretation of Section 10(b). *In re Enron* misreads *Zandford* to hold Section 10(b) may be violated by deceptive conduct without the classic misrepresentation or omission. On this point, the court reasoned:

> In *Zandford*, a unanimous Supreme Court opinion, *leaving aside the misrepresentation and omission language since it was not relevant to the case*, the high court focused on § 10(b)'s alternative basis for liability, "unlawful for any person . . . [t]o use or employ, in connection with the purchase or sale of any security . . ., any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [SEC] may prescribe" and Rule 10b-5's ban on the use, "in connection with the purchase or sale of any security," of "any device *scheme*, or artifice to defraud" or any

---

[288] *See id.*

[289] The Enron court summarized the pertinent allegations of this conduct:

> Lead Plaintiff has alleged a scheme or course of business in which the various participant Defendants concealed a pattern of creating unlawful SPEs and utilizing fraudulent transactions with these entities as contrivances or deceptive devices to defraud investors into continuing to pour investment money into Enron securities to keep afloat the Ponzi scheme and thereby enrich themselves in a variety of ways.

See id. at 578 n.15.

> other "act, practice, or *course of business*" that "operates . . . as a fraud or deceit."[290]

Again later, *In re Enron* states *Zandford* "made crystal clear that a misrepresentation need not be involved and that a suit could be based on Rule 10b-5(a) or (c)."[291]

In re Enron's reliance on *Zandford* is misplaced. *Zandford* involved the fiduciary duty of a broker-dealer to his customer in a discretionary account.[292] Zandford was pocketing the proceeds from the sales of securities in his customer's account, but not disclosing the thefts to his customer.[293] Significantly, the taking of the funds was not the violation. Rather, the Supreme Court explained each sale was "deceptive because it was neither authorized by*, nor disclosed to*, the Woods."[294]

Similarly, *In re Enron*'s reliance on *Affiliated Ute*, *Superintendent of Insurance*, *Santa Fe*, *Central Bank*, and *O'Hagan* was misplaced for the same reason.[295] From these cases, *In re Enron* distills the following principle:

> While subsection (b) of Rule 10b-5 provides a cause of action based on the "making of an untrue statement of a material fact and the omission to state a material fact," subsections (a) and (c) "are not so restricted" and allow suit against defendants who, with scienter, participated in "a 'course of business' or a 'device, scheme or artifice' that operated as a fraud" on sellers or purchasers of stock *even if these defendants did not make a materially false or misleading statement or omission*.[296]

None of the holdings go that far. To the contrary, in each case, the Court predicated liability on a misrepresentation or a nondisclosure. *Affiliated Ute* ("they possessed the affirmative duty . . . to disclose " the existence of a second market for the securities);[297] *Superintendent of Insurance* ("Manhattan's Board . . . was allegedly deceived into authorizing

---

[290]*Id.* at 578 (emphasis added) (alterations in original).

[291]*See In re Enron*, 235 F. Supp. 2d at 585.

[292]SEC v. Zandford, 535 U.S. 813, 815 (2002).

[293]*Id.*

[294]*Id.* at 821 (emphasis added).

[295]Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128, 153 (1972); Superintendent of Ins. v. Bankers Life & Casualty Co., 404 U.S. 6, 8 n.1 (1971); Santa Fe Indus., Inc., v. Green, 430 U.S. 462, 474 (1977); Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164, 166 (1994); United States v. O'Hagan, 521 U.S. 642, 660 (1997).

[296]*In re Enron*, 235 F. Supp. 2d at 577 (emphasis added).

[297]*Affiliated Ute*, 406 U.S. at 153.

this sale by the misrepresentation that the proceeds would be exchanged for a certificate of deposit of equal value");[298] *Santa Fe* (no liability because "there was no 'omission' or 'misstatement' in the information statement");[299] *O'Hagan* ("failure to disclose his personal trading . . . made his conduct 'deceptive'");[300] and *Central Bank* (misleading appraisal).[301] Hence, the reasoning of *In re Enron* is flawed.

V. CAN THE FRAUD-FREE ZONE BE CLOSED? YES, IF SECTION 10(B) APPLIES TO CONDUCT

A. *One Possibility for Closing the Fraud-Free Zone: Conduct as Fraud*

At least for now, *In re Enron* closed the fraud-free zone. The case became the first reported decision to interpret Section 10(b) to impose liability on an actor who had no contact with the injured investor, solely on the basis of deceptive conduct.[302] This means Barclays, despite its disciplined silence, may be liable to investors though it never uttered a word to them. The decision, however, is based on the faulty premise that the Supreme Court had already decided deceptive conduct—in the absence of a misrepresentation or omission—may violate Section 10(b). The Court has never decided the issue, at least not in a way that supports *In re Enron*.

Indeed, many commentators interpret *Santa Fe*[303] and *Schreiber*[304] to have reached the opposite holding: a violation of Section 10(b) cannot be established without a misrepresentation or nondisclosure.[305] But their

---

[298]*Superintendent of Ins.*, 404 U.S. at 8 n.1.

[299]*Santa Fe*, 430 U.S. at 474.

[300]*O'Hagan*, 521 U.S. at 660.

[301]*Cent. Bank*, 511 U.S. at 166.

[302]*In re* Enron Corp. Sec., Derivative & ERISA Litig., 235 F. Supp. 2d 549 (S.D. Tex. 2002). The courts, however, have held certain schemes to manipulate prices on the open market to be in violation of Section 10(b). *See* HAZEN, *supra* note 60, at 561-62. Nevertheless, this limited theory cannot be extended by Enron's investors to impose liability on Barclays for its alleged use of Chewco. *See infra* text accompanying note 313.

[303]Santa Fe Indus., Inc., v. Green, 430 U.S. 462 (1977).

[304]Schreiber v. Burlington N. Inc., 472 U.S. 1 (1985).

[305]*See* HAZEN, *supra* note 60, at 564 ("The impact of the Supreme Court's decision in *Schreiber v. Burlington Northern, Inc.* could likely be carried over to Section10(b). The court in *Schreiber* held that '[w]ithout misrepresentation or non-disclosure, § 14(e) has not been violated.'") (quoting *Schreiber*, 471 U.S. at 12); James D. Redwood, *Toward a More Enlightened Securities Jurisprudence in the Supreme Court? Don't Bank on it Anytime Soon*, 32 HOUS. L. REV. 3, 19 (1995) ("The Court [in *Santa Fe*, 30 U.S. at 476] has infomed the securities bar that 'deceptive' in section 10(b) means a misrepresentation or omission to state a material fact . . . ."); Margaret V. Sachs, *The Relevance of Tort Law Doctrine to Rule 10b-5: Should Careless Plaintiffs be Denied Recovery*, 71 CORNELL L. REV. 96, 142 (1985).

views are part of a larger issue: Is there any legal theory under Section 10(b) for holding Barclays liable which is not barred by a holding of the Supreme Court?

One theory might be based on Barclays's nondisclosure of its secret transactions with Enron and JEDI that rendered Chewco a sham.[306] Since nondisclosure may violate Section 10(b),[307] would not Barclays's failure to disclose these facts constitute such a violation? The omitted facts were "material"; for 1997 alone, the disclosure of these facts would have cut Enron's earnings by forty percent, increased its debt by $711 million, and trimmed shareholders' equity by $313 million.[308] There is, however, a fly in the ointment—*duty*. *Chiarella* requires one, but Barclays has none.[309]

No recognized theory obligated Barclays to disclose the secret transactions. First, a duty may arise where the actor is a fiduciary.[310] However, Barclays did nothing to become a fiduciary of Enron's investors. Additionally, even if no duty to speak exists, an actor must speak the full truth if he or she breaks silence—half truths violate Section 10(b).[311] Barclays kept silent. Finally, a duty to speak may arise under SEC regulations, such as Regulation S-K. No SEC regulation required Barclays to speak.[312] Accordingly, Barclays cannot be held liable under Section 10(b) for its failure to disclose a material fact.

What about the theory that Barclays's alleged role in forming, funding, and controlling Chewco violated Section 10(b)'s prohibition against using a *manipulative* device or contrivance? This theory collides with the express bar in *Hochfelder* and *Santa Fe* where the Court held "manipulate" is a "term of art" limited to specific schemes that artificially

---

[306] *See supra* Section II.

[307] *Affiliated Ute* held an omission may serve as the basis for liability under Section 10(b):

> Under the circumstances of this case, involving primarily a failure to disclose, positive proof of reliance is not a prerequisite to recovery. All that is necessary is that the facts withheld be material in the sense that a reasonable investor might have considered them important in the making of this decision.

Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128, 153-54 (1972).

[308] *Enron Class Action Complaint*, *supra* note 10, ¶ 61.

[309] "When an allegation of fraud is based upon nondisclosure, there can be no fraud absent a duty to speak." Chiarella v. United States, 445 U.S. 222, 235 (1980).

[310] *See id.* at 229.

[311] "This statement, then, could be construed to be a half-truth which could be shown to be a § 10(b) violation. Therefore, the court will not dismiss this portion of the claim." Endo v. Albertine, 812 F. Supp. 1479, 1486 (N.D. Ill. 1993).

[312] *See supra* text accompanying note 263.

affect securities prices on the open market, e.g., "wash sales," or "matched orders."[313]

If Section 10(b) cannot get the job done, why not call upon Rule 10b-5 to pick up the slack? Perhaps Barclays's conduct violated one or more of the three prongs of Rule 10b-5, although outside the scope of Section 10(b). This theory risks a rebuke from the Supreme Court based on *Hochfelder*, which held Rule 10b-5 cannot be interpreted broader than the language of Section 10(b).[314]

Consequently, this process of elimination leaves only one contender for holding Barclays accountable: Did Barclays use Chewco as a deceptive device or contrivance in violation of Section 10(b)? This issue turns on the Court's holding in *Santa Fe* and possibly *Schreiber*. Do these cases mean, as commentators suggest,[315] that Section 10(b) can only be violated by deception in the form of misrepresentation or nondisclosure? If so, Section 10(b) does not apply to deceptive conduct, such as Barclays's alleged use of Chewco.[316] For Barclays, this means the denial of its motion to dismiss was error.[317] For investors, it means the fraud-free zone is permanent unless the Supreme Court reverses *Santa Fe*[318] and *Schreiber*[319] or unless Congress acts. Neither appears likely.

The commentators have seized on dicta, ambiguous dicta at that, in *Santa Fe* and *Schreiber* to buttress their theory that Section 10(b) requires the deception to be in the form of a misrepresentation or nondisclosure.[320] In both *Santa Fe* and *Schreiber,* minority shareholders claimed the buyout of their holdings by the majority violated the 1934 Act. The *Santa Fe* plaintiffs alleged the majority conducted a Delaware short-form merger in violation of Section 10(b), while the *Schreiber* plaintiff alleged the majority's tender offers violated Section 14(e).[321] No claim was made in

---

[313]Santa Fe Indus., Inc., v. Green, 430 U.S. 462, 476 (1977); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 205 (1976); *In re* Enron Corp. Sec., Derivative & ERISA Litig., 235 F. Supp. 2d 549, 569 n.10 (S.D. Tex. 2002).

[314]Thus, despite the broad view of the Rule [10b-5] advanced by the Commission in this case, its scope cannot exceed the power granted the Commission by Congress under § 10(b). *Hochfelder*, 425 U.S. at 214.

[315]HAZEN, *supra* note 60, at 564, 678; Redwood, *supra* note 305, at 19 n.52; Sachs, *supra* note 305, at 142.

[316]*In re Enron*, 235 F. Supp. 2d at 703.

[317]*Id.* at 708.

[318]Santa Fe Indus., Inc., v. Green, 430 U.S. 462 (1977).

[319]Schreiber v. Burlington N. Inc., 472 U.S. 1 (1985).

[320]*See supra* note 315.

[321]*Schreiber*'s holding, as opposed to its dicta, comes into sharper focus in the context of the conflict it resolved among the circuit courts over the meaning of "'manipulation" in Section 14(e). The Court described the conflict: "The Court of Appeals for the Sixth Circuit has held that manipulation does not always require an element of misrepresentation or nondisclosure. The

either case that the majority had used *any* form of deception.[322] Accordingly, the issue before the Court in both cases may be stated: Does a violation of Section 10(b) (*Santa Fe*) or Section 14(e) (*Schreiber*) require deception? To the extent the Court decided *that* issue, its decision was a holding. To the extent it sought to distinguish which species of deception violates Section 10(b) or 14(e), an issue the litigants had not raised, it was parsing an issue that was not before it. The Court's conclusions, therefore, on this issue would be dicta and have no precedential value.[323]

Santa Fe, however, does not even offer dicta to support the theory that Section 10(b) prohibits only verbal deception. A "deceptive device or contrivance," according to *Santa Fe*, not only includes misrepresentations and nondisclosures, but also includes other forms of deception which the Court left undefined. The following statement comes closest to being the holding of *Santa Fe*: "[T]he cases do not support the proposition, adopted by the Court of Appeals below and urged by respondents here, that a breach of fiduciary duty by majority stockholders, without any *deception, misrepresentation, or nondisclosure,* violates the statute and the Rule."[324] The use of "deception" in the above phrase must mean something more than misrepresentation or nondisclosure unless the Court's choice of words was

---

Court of Appeals for the Second and Eighth Circuits have applied an analysis consistent with the one we apply today." *Schreiber*, 472 U.S. at 5 n.3 (citations omitted).

In *Mobil Corp. v. Marathon Oil Co*., 669 F.2d 366, 377 (6th Cir 1981), the district court denied Mobil's application for injunctive relief to prevent a rival from closing its tender offer. In reversing, the Sixth Circuit found the acceptance of the rival tender offer to be manipulation in violation of Section 14(e), even if all facts were disclosed to shareholders. The Court reasoned:

> The artificial ceiling on the price of their shares at $125 is manipulation to which they must submit whether it is disclosed to them or not. . . . In short, to find compliance with section 14(e) solely by the full disclosure of a manipulative device as a fait accompli would be to read the "manipulative acts and practices" language completely out of the Williams Act.

Id.

Hazen describes the holding in *Marathon Oil*: "[T]he Sixth Circuit held that 'manipulative' conduct under Section 14(e) could extend beyond deception to include interference with the tender offer market." HAZEN, supra note 60, at 536.

[322]In *Santa Fe*, the Court accepted the district court's conclusion "that the 'complaint fail[ed] to allege an omission, misstatement or fraudulent course of conduct that would have impeded a shareholder's judgment of the value of the offer.'" *Santa Fe*, 430 U.S. at 469. In *Schreiber*, the Court stated: "The amended complaint fails to allege that the cancellation of the first tender offer [the basis of the 14(e) claim] was accompanied by any misrepresentation, nondisclosure, or deception." *Schreiber,* 472 U.S. at 12-13.

[323]Local 144 Nursing Home Pension Fund v. Demisay, 508 US. 581, 592 n.5 (1993) ("It was, if anything, those dicta themselves—uninvited, unargued, and unnecessary to the Court's holdings—which insulted that virtue; and we would add injury to insult by according them precedential effect."); Colgrove v. Battin, 413 U.S. 149, 158 (1973) ("We cannot, therefore, accord the unsupported dicta of these earlier decisions the authority of decided precedents.").

[324]*Santa Fe*, 430 U.S. at 476 (emphasis added).

redundant. That flaw should not be presumed. Since deception includes more than the use of deceptive words, it must also include the use of deceptive conduct. In any case, at a minimum, *Santa Fe* does not bar the application of Section 10(b) to deceptive conduct.

At first glance, *Schreiber*[325] does not even seem relevant to the issue whether Section 10(b) reaches deceptive conduct. How could *Schreiber*'s interpretation of "manipulative" in Section l4(e) have any baring on the meaning of a different term ("deceptive") in the context of a different provision (Section 10(b))? The connective theory has four steps. Step 1: *Schreiber* held "manipulative" conduct does not violate Section 14(e) unless it is also deceptive. Step 2: *Schreiber* also required the deception to be in the form of a misrepresentation or nondisclosure. Step 3: Section 10(b) should apply to the same type of deception as Section 14(e).[326] Step 4: Hence, Section 10(b) only prohibits deception in the form of a misrepresentation or nondisclosure.

The flaw in the above theory is at Step 2. As discussed above, any discussion in *Schreiber* that Section 14(e) only prohibits certain types of deception would have been a dictum, since that issue was not before the Court. But the flaw in Step 2 has a second facet. *Schreiber* does not merely offer one dictum on this issue; it offers four. The Court makes four conflicting statements in *Schreiber*—all dicta—of the type of deception required to establish "manipulative" acts or practices. Two suggest the deception may include conduct: the other two suggest the opposite. The Court stated twice that "manipulation" requires a misrepresentation to violate Section 10(b)[327] and three times that "manipulation" requires either a misrepresentation *or* nondisclosure to violate Section 14(e).[328] In yet a

---

[325]Schreiber v. Burlington N. Inc., 472 U.S. 1 (1985).

[326]Dennis S. Karjala, *Federalism, Full Disclosure, and the National Markets in the Interpretation of Federal Securities Law,* 80 NW. U.L. REV. 1473, 1505 (1986).

> For example, section 14(e) requires that there actually be a tender offer before anything can be considered manipulative, so "shark repellant" techniques like "poison pills" might fall outside its grasp. Moreover, given the general level of complexity, one can understand a judicial desire to adopt a hands-off approach until Congress or the SEC has provided more precise standards.

Id.

[327]*Schreiber*, 472 U.S. at 4 ("The District Court relied on the fact that in cases involving alleged violations of § 10(b) of the Securities Exchange Act, 15 U.S.C. § 78j(b), this Court has required misrepresentation for there to be a 'manipulative' violation of the section."). "But Congress used the phrase 'manipulative or deceptive' in § 10(b) as well, and we have interpreted 'manipulative' in that context to require misrepresentation." *Schreiber*, 472 U.S. at 7-8.

[328]*Schreiber*, 472 U.S. at 8. "Our conclusion that 'manipulative' acts under § 14(e) require misrepresentation or nondisclosure is buttressed by the purpose and legislative history of the provision." *Id.* "We hold that the term 'manipulative' as used in § 14(e) requires misrepresentation or nondisclosure. It connotes 'conduct designed to deceive or defraud investors

third version, which implies deception includes nonverbal acts, the Court stated its holding: "[W]e hold that the actions of respondents were not manipulative. The amended complaint fails to allege . . . *any misrepresentation, nondisclosure, or deception*."[329] The Court also blessed a fourth meaning of "manipulative" which also includes deceptive acts. The Court decided the meaning it had given "manipulative" was "consistent with the use of the term at common law."[330] The Court then explained how "manipulation" at common law could be satisfied by deception in the form of words or acts:

> [T]he seminal English case of *Scott v. Brown, Doering, McNab & Co.*, which broke new ground in recognizing that manipulation could occur without the dissemination of false statements, nonetheless placed emphasis on the presence of deception. As Lord Lopes stated in that case, "*I can see no substantial distinction between false rumours and false and fictitious acts.*" [The court in] *United States v. Brown* [stated:] "[Even] a speculator is entitled not to have any present fact involving the subject matter of his speculative purchase or the price thereof *misrepresented by word or act*."[331]

Under this fourth version, as well as the third, Section 10(b) would apply to deceptive conduct and thus reach Barclays's alleged use of Chewco. Two other dicta in *Schreiber*, however, support the opposite view. The only conclusion that can be drawn from *Schreiber* is the folly of citing the Court's dicta as law.

In sum, it is a leap, unsupported by the law or logic, to take the holdings in *Santa Fe* and *Schreiber*—that a violation of Section 10(b) requires deception—to the conclusion that the deception must be in the form of an omission or a misrepresentation.[332] Further, the Court's language indicates it has not taken that leap. Accordingly, *Schreiber* and *Santa Fe* have left the door ajar for the theory that deceptive conduct, without a misrepresentation or omission, violates Section 10(b).

---

by controlling or artificially affecting the price of securities.' Without misrepresentation or nondisclosure, § 14(e) has not been violated." *Id.* at 12 (citation omitted).

[329] *Id.* at 12-13 (emphasis added).

[330] *Id.* at 7.

[331] *Id.* at 7 n.4 (citations omitted; emphasis added) (quoting Scott v. Brown, Doering, McNab & Co., [1892] 2 Q.B. 724, 730 (C.A.); United States v. Brown, 5 F. Supp. 81, 85 (S.D.N.Y. 1933)).

[332] *See Schreiber*, 472 U.S. at 7, 12-13; *Santa Fe*, 430 U.S. at 476.

That opening may widen if recent Supreme Court decisions truly signal a pullback from the "policy considerations" announced in *Blue Chip Stamps*.[333] As discussed above, in order to deter strike suits, the Court restricted the reach of the antifraud provisions in a series of decisions that began in 1974.[334] The enforcement of those "policy considerations" was obviated, if ever needed, by Congress's adoption in 1995 of PSLRA, which also had the goal of eliminating specious suits for securities fraud.[335] Indeed, the Court's later decisions in *Wharf*, *O'Hagan*, and *Zandford* suggest it may be pulling back from its disciplined application of *Blue Chip Stamps*.[336]

This implies a more benign environment for the Court to consider closing the fraud-free zone. Further, the magnitude and scope of the Enron fraud demonstrate the Court has gone too far in weakening the antifraud provisions to protect Wall Street and corporate America from strike suits. But a benign environment is not enough. A viable legal theory must require the Court to close the zone. That theory must accept as givens the Court's decisions that created the zone, *Blue Chip Stamps* and its progeny, which now, as precedents, obstruct its closing. The legal theory presented next endeavors to satisfy those criteria. It has four complementary but independent strands. The theory begins where *In re Enron* did, but takes a different path at the fork where that case went wrong.

B. *Textual Interpretation: Section 10(b) Applies to Conduct*

The Supreme Court claims to use the most basic rule of statutory construction for deciding whether a wrongdoer's conduct falls within the scope of Section 10(b). In the Court's words, "[T]he statutory text controls the definition of conduct covered by § 10(b)."[337] So, accepting the Court's mandate, what is the literal meaning of the key language in Section 10(b)? The Court has already adopted definitions for two of the three key words in the operative phrase: "deceptive device or contrivance." Using *Webster's International Dictionary*, *Hochfelder* defined "device" to mean

---

[333]Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 737 (1975).

[334]*See supra* Sections III.F.-G.

[335]Securities Exchange Act of 1934, § 21D, 15 U.S.C.A. § 78u-4 (West 1997).

[336]Wharf (Holdings) Ltd. v. United Int'l Holdings, Inc., 532 U.S. 588 (2001); United States v. O'Hagan, 521 U.S. 642 (1997); SEC v. Zandford, 535 U.S. 813 (2002). *See supra* Section III.H.

[337]Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164, 175 (1994); *see also* SUTHERLAND, *supra* note 243, § 47.01 (stating that "[t]he starting point in statutory construction is to read and examine the text of the act and draw inferences concerning the meaning from its composition and structure").

"[t]hat which is devised, or formed by design; a contrivance; an invention; project; scheme; often, a scheme to deceive; a stratagem; an artifice."[338] Again using the same dictionary, the Court defined "contrivance" to mean "in pertinent part . . . '[a] thing contrived or used in contriving; a scheme, plan, or artifice.' [and] [i]n turn, 'contrive' in pertinent part [to mean] '[t]o devise; to plan; to plot . . . [t]o fabricate . . . design; invent . . . to scheme.'"[339] To complete the definitions, the same dictionary defines "deceptive" to mean "tending or having power to deceive."[340] Hence, using the Court's definitions and its choice of dictionaries, a deceptive device or contrivance covers a broad spectrum of conduct, including: an invention, stratagem, or thing fabricated tending to deceive. Thus, a "deceptive device or contrivance" literally includes both the scam artist's use of the cassock and collection box, as well as Barclays's alleged use of Chewco to doctor Enron's books.

C. *Contextual Interpretation: Section 10(b) Applies to Conduct*

Another key principle of statutory construction requires each section of a legislative scheme, such as the 1933 and 1934 Acts,[341] to be construed with the other sections to produce a "harmonious whole."[342] The Supreme Court applied a variant of this principle in *Touche Ross,* when it refused to imply a private remedy under Section 17(a) of the 1934 Act.[343] Preliminarily, the Court observed Congress had created express remedies in Sections 18(a) and 9(e).[344] From that threshold, in refusing to imply a remedy, the Court reasoned: "Obviously, then, when Congress wished to provide a private damages remedy, it knew how to do so and did so expressly."[345]

This principle equally applies in ascertaining the meaning of "deceptive device or contrivance." If Congress intended this phrase to include only fraud committed by misleading statements or omissions, two nagging questions seek an answer: (1) Why did it depart from the two

---

[338]Ernst & Ernst v. Hochfelder, 425 U.S. 185, 199 n.20 (1976) (quoting WEBSTER'S INTERNATIONAL DICTIONARY (2d ed. 1934)).

[339]*Id.* (quoting WEBSTER'S INTERNATIONAL DICTIONARY, *supra* note 338).

[340]WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY 585 (1993).

[341]The Court in *Blue Chip Stamps* treated the 1933 and 1934 Acts as a single legislative scheme. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 740-41 (1975). The Court inferred Congress's intent from its enactment of Section 11(e) of the 1933 Act and presumed the same congressional intent in interpreting Section 10(b) of the 1934 Act. *See id.*

[342]SUTHERLAND, *supra* note 243, § 46.05.

[343]Touche Ross & Co. v. Redington, 442 U.S. 560, 572 (1979).

[344]*Id.*

[345]*Id.*

formulas it used in five other antifraud provisions, and (2) why did it employ such obtuse language in Section 10(b) to say the same thing? Sections 11, 12(a)(2), and 17(a)(2) of the 1933 Act explicitly define fraud as the use of a misrepresentation or omission.[346] Sections 9(a)(4) and 18(a) of the 1934 Act define fraud as the use of false or misleading statements.[347] Hence, using the language "deceptive device or contrivance" to mean the same makes no sense. The principles of statutory construction require a more harmonious interpretation of this statutory scheme.[348] The rule of construction from *Touche Ross* is easily adapted to the issue here: when Congress intended to define fraud committed by a misstatement or omission, "it knew how to do so and did so expressly."[349] Therefore, in using the language "deceptive device or contrivance," Congress must have intended to define a different type of fraud, one that went beyond misleading or omitted words. That leaves deceptive conduct.

D. *Intent of the 73rd Congress: Section 10(b) Applies to Conduct*

By way of background, two identical bills that became the 1934 Act were introduced in the House and Senate during February 1934.[350] Section 9(c) of these bills, which became Section 10(b), did not contain the language "manipulative or deceptive device or contrivance."[351] The original language of Section 9(c) broadly prohibited the use of "any device or contrivance in a way or manner which the Commission may by its rules and regulations find detrimental to the public interest or to the proper protection of investors."[352] Section 9(c) would pass through three iterations on its way to becoming Section 10(b). As discussed below, Congress added the limiting language "manipulative and deceptive" to Section 9(c) so its grant of power to the SEC would not exceed constitutional constraints.

The concern over Section 9(c) was part of the larger concern about the constitutionality of the entire 1934 Act. The 73rd Congress foresaw the risk that the courts might strike down the 1934 Act as an unlawful delegation of legislative authority. This concern was apparent in the report

---

[346]*See* Securities Act of 1933, § 11, 15 U.S.C.A. § 77k (West 1997); § 12(a)(2), 15 U.S.C.A. § 77*l*(a)(2) (West 2003); § 17(a)(2), 15 U.S.C.A. § 77q(a)(2) (West 2003).

[347]*See* Securities Exchange Act of 1934, § 9(a)(4), 15 U.S.C.A. § 78i(a)(4) (West 2003); § 18(a), 15 U.S.C.A. § 78(a) (West 1997).

[348]*See* SUTHERLAND, *supra* note 243, § 46.05.

[349]*Touche Ross*, 442 U.S. at 572.

[350]S. 2693, 73d Cong. (1934); H.R. 7852, 73d Cong. (1934).

[351]S. 2693, 73d Cong. § 9(c) (1934); H.R. 7852, 73d Cong. § 9(c) (1934).

[352]S. 2693, 73d Cong. § 9(c) (1934); H.R. 7852, 73d Cong. § 9(c) (1934).

of the House Interstate and Foreign Commerce Committee (House Committee), which offered a lengthy justification for the broad delegation of legislative power, at that time to the Federal Reserve Board and the Federal Trade Commission.[353] The Report stated the grant of legislative power to regulatory agencies went to the limit the Committee thought the Constitution would permit. The Committee wrote, "The constitutional significance of the wide delegation of powers . . . has been considered with particular care . . . . *The bill legislates specifically, just as far as the Committee feels it can.*"[354]

These concerns were well-founded. At the time the 73rd Congress was holding hearings on the 1934 Act, the National Industrial Recovery Act—enacted a year earlier—was under constitutional attack as an unlawful delegation of legislative authority.[355] The following year, the Supreme Court would strike down two separate provisions of the National Industrial Recovery Act on this exact constitutional ground.[356]

In regard to Section 9(c), the criticism of the bill from the securities industry was unanimous, uniform, and high-pitched. For example, the president of the Associated Stock Exchanges testified before the Senate Banking and Currency Committee (Senate Committee):

> This subsection [9(c)] is so vague and inadequate for the purpose evidently intended to be accomplished that it should be stricken out in its entirety. To allow it to remain leaves in the hands of the commission a weapon with which that body

---

[353]Committee on Interstate and Foreign Commerce, Securities Exchange Bill of 1934, H.R. Rep. No. 73-1383, at 6-7 (1934), *reprinted in* 1 FEDERAL SECURITIES LAWS: LEGISLATIVE HISTORY 1933-1982, at 794, 799-800 (1983). The House Report reads in pertinent part:

> The constitutional significance of the wide delegation of powers to the Federal Reserve Board and to the Federal Trade Commission, which would administer the act, has been considered with particular care—and the delegation made only with the indication of such maximum standards for discretion as, in the considered judgment of the Committee, the technical character of the problems to be dealt with would permit. The bill legislates specifically, just as far as the Committee feels it can. . . . In a field where practices constantly vary and where practices legitimate for some purposes may be turned to illegitimate and fraudulent means, broad discretionary powers in the administrative agency have been found practically essential, despite the desire of the Committee to limit the discretion of the administrative agencies so far as compatible with workable legislation.

Id. at 799-800.

[354]*Id.* (emphasis added).

[355]Amazon Petroleum Corp. v. Railroad Comm'n of Tex., 5 F. Supp. 639, 640 (E.D. Tex. 1934).

[356]A.L.A. Schechter Poultry Corp. v. United States, 295 U.S. 495, 539-42 (1935); Panama Ref. Co. v. Ryan, 293 U.S. 388, 431-33 (1935).

> might determine upon anything as being detrimental to the public interest or to the proper protection of investors.[357]

In a similar vein, the president of the New York Exchange testified before the Senate Committee:

> The final subsection [9(c)] giving the Federal Trade Commission [later changed to the SEC] unlimited power to make unlawful any device or contrivance which it may determine is detrimental to the public interest, is a surprising delegation of power, particularly as any violation of the rules or regulations of the Commission would be a criminal act which might result in heavy fines and imprisonment.[358]

Given the tone of this criticism, both the Senate and the House bills were amended to add the qualifying term "manipulative."[359] The criticism did not abate. After the amendment, the attorney for the New York Stock Exchange testified before the Senate Committee:

> We suggest that section 9 be omitted entirely . . . . As to subsection (c), which seemed to be a general grant of power to the Commission to define as a crime any practice which they thought was manipulative, it seemed to us to be an altogether too broad grant of power to any administrative body. It is a criminal provision there, which the Federal Trade Commission might, by rule or regulation, interpret in common practice, and suddenly announce that it was a violation of that, subjecting the violator to 10 years in jail. It seemed to us to be going a little far, and we suggest its omission *in toto*.[360]

---

[357]Stock Exchange Practices: Hearings on S. Res. 84 (72nd Cong.) and S. Res. 56 and S. Res 97 (73d Cong.) Before the Senate Banking and Currency Committee, 73d Cong. 6988 (1934) (statement of Eugene E. Thompson, President, Associated Stock Exchanges, Washington, D.C.).

[358]*Id.* at 6634 (statement of Richard Whitney, President, New York Stock Exchange); *see also id.* at 6910 (statement of Frank R. Hope, President, Association of Stock Exchange Firms, New York City): "The last subdivision of this section [9] giving them [FTC] control over devices and contrivances might be construed to mean almost anything."

[359]*See* H.R. 8720, 73d Cong. § 9 (c) (1934); *see* S. 3420, 73d Cong. § 10(b) (1934).

[360]Stock Exchange Practices: Hearings on S. Res. 84 (72nd Cong.) and S. Res. 56 and S. Res 97 (73d Cong.) Before the Senate Banking and Currency Committee, 73d Cong. 7561-7562 (1934) (statement of Roland L. Redmond, Attorney for New York Stock Exchange) (emphasis added)

Apparently out of constitutional concerns, the House Committee withdrew Section 9(c) in its entirety from the bill,[361] and the full House passed the bill without 9(c).[362]

The Senate Committee continued to work on the language of 9(c). A proposed amendment was submitted by a spokesperson for the Roosevelt Administration, Assistant Secretary of Commerce, John C. Dickinson (Dickinson).[363] He suggested "deceptive" be substituted for "manipulative" in the phrase "manipulative device or contrivance," the language in the bill then under consideration by the Senate Committee.[364] Dickinson believed the change was necessary because, in his judgment, "manipulative" was so vague a standard that Section 9(c) was unconstitutional. His suggestion to revise Section 9(c) read:

> Section 9c gives to the Commission power to forbid the use of any "manipulative" device or contrivance which the Commission may find detrimental to the public interest. The word "manipulative" is extremely vague and in my opinion supplies no adequate standard for the Commission to act upon. Some word or words should be used which more specifically indicates [sic] the nature of the evil designed to be rectified. I suggest that the word "deceptive" be substituted for "manipulative" in line 3 on Page 27 and also in the heading of Section 9 in line 10 of Page 26. *It would not be in my opinion for Constitutional purposes a sufficiently clear standard to outlaw any device which the Commission may find "detrimental to the public interest."*[365]

---

[361]Steve Thel, *The Original Conception of Section 10(b) of the Securities Exchange Act,* 42 STAN. L. REV. 385, 455 n.325 (1990).

[362]H.R. 9323, 73d Cong. § 9 (1934).

[363]Thel, *supra* note 361, at 417; John Dickinson, *Report to Secretary of Commerce of Committee on Stock Exchange Regulation*, *reprinted in* 5 LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934, at 3 (compiled by J.S. Ellenberger & Ellen P. Mahar, 1973). Dickinson had previously chaired a distinguished committee for the Department of Commerce that studied the need for an exchange act. His committee's report was sent to President Roosevelt, who in turn forwarded it to the Senate. "Senate Committee" refers to the Senate Banking and Currency Committee. Thel, *supra* note 361, at 417-18.

[364]*See* Thel, *supra* note 361, at 453 nn.312-16. This article establishes Dickinson was the source of the amendment to H.R. 8720 that added the term "deceptive." *See id.*

[365]Memorandum, *Suggested Amendments to H.R. 8720 Submitted by John Dickinson, Assistant Secretary of Commerce* (Mar. 30, 1934) (on file with the Harvard Law School Library, James McCauley Landis Papers, box 1, file 7) (emphasis added).

The Senate Committee,[366] and later Congress itself, did half what Dickinson asked. It added "deceptive" but did not delete "manipulative," which resulted in the phrase "manipulative or deceptive device or contrivance" in the final text of Section 10(b).[367]

Accordingly, the legislative history of Section 10(b) warrants the most liberal interpretation of the term "deceptive" in the phrase "manipulative or deceptive device or contrivance." Congress's intent may be stated: "deceptive" was added to the text of Section 10(b) so that section would not be an unlawful delegation of Congressional power. Therefore, in applying congress's will, the court should not define "deception" so broadly that it renders Section 10(b) unconstitutional. Short of that, the term should be interpreted consistently with Congress's intent to delegate the broadest authority to the SEC to promulgate rules, such as Rule 10b-5, to deter and punish securities fraud.

The congressional testimony of Thomas G. Corcoran (Corcoran), "a spokesman for the drafters,"[368] also supports the application of Section 10(b) to deceptive conduct. The Supreme Court has recognized Corcoran's testimony as the "most relevant exposition of the provision that was to become § 10(b)."[369] In February 1934, Corcoran testified before the House Committee to the scope and purpose of Section 9(c) of the original bill that would later become Section 10(b): "Thou shalt not devise any *other* cunning devices."[370] He continued, "Of course subsection (c) is a *catch-all* clause to prevent manipulative devices. . . . The Commission should have the authority to deal with *new* manipulative devices."[371] Since Corcoran testified before the word "deceptive" was added to the text of Section 9(c), the final version would be more aptly characterized as "a catch-all clause" designed to deal "with *new* manipulative or deceptive devices."[372]

Corcoran's use of the terms "other cunning devices" and "catch-all" clarifies Section 10(b)'s place in the statutory arsenal. Section 10(b) was intended to reach future variants of the fraudulent and manipulative practices specifically prohibited by the 1934 Act. Accordingly, the reach of Section 10(b) is tied to the reach of the other provisions in the Act that prohibit manipulative or deceptive practices. If the latter apply to manipulative and deceptive *conduct* as well as misleading *words*, Section

---

[366] *See* Thel, *supra* note 361, at 453 nn.312-16.

[367] *See* H.R. 9323, 73d Cong. § 10(b) (1934).

[368] *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 202 (1976).

[369] *See id.*

[370] Stock Exchange Regulation Hearings on H.R. 7852 and H.R. 8720 before the House Committee on Interstate and Foreign Commerce, 73d Cong. 115 (1934) (emphasis added).

[371] *Id.* (emphasis added).

[372] *See id.*

10(b) must do the same or fail in its role as a "catch-all." In this light, Section 18 of the 1934 Act applies to deceptive conduct as well as misleading words, reaching acts that cause misleading statements to be included in SEC filings. Likewise, Section 9 applies to both conduct and misleading words.[373] Therefore, for Section 10(b) to fulfill its role as a "catch-all," it must also apply to deceptive conduct as well as deceptive words.

E. *Replacing the Failed "Policy Considerations" of* Blue Chip Stamps

The fraud-free zone exists because the Rehnquist majority overlooked one inherent quality of fraud: its ever-changing form. As fraud changes form, it moves beyond the reach of statutes and regulations too tightly drafted or too strictly interpreted. In the context of Enron, as classic accounting fraud morphs into Chewco, it steps beyond the reach of the antifraud provisions too tightly drawn by the Rehnquist majority.

Four decades ago, before the Rehnquist majority, the Supreme Court had a better grasp of this inherent quality of securities fraud: the ability to change its form. In *SEC v. Capital Gains*, the Court recognized, "'general and flexible' antifraud provisions . . . have long been considered necessary to control 'the versatile inventions of fraud-doers.'"[374] It quoted from an eighteenth century English judge who could be describing Barclays's alleged use of Chewco:

> Fraud is infinite, and were a Court of Equity once to lay down rules, how far they would go, and no farther, in extending their relief against it, or to define strictly the species or evidence of it, the jurisdiction would be cramped, and perpetually eluded by new schemes which the fertility of man's invention would contrive.[375]

Capital Gains relied on a chain of authority that linked this principle back to the jurisprudence of ancient Rome. *Capital Gains* borrowed the

---

[373]Of the nine types of practices prohibited by subsection 9(a) and (b), only subsection 9(a)(4) is limited to misleading words. The other eight categories prohibit different types of conduct. *See* Securities Exchange Act of 1934, 15 U.S.C.A. § 78i (West 1997).

[374]SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 199 (1963) (quoting Stonemets v. Head, 154 S.W. 108, 114 (Mo. 1913)).

[375]*Capital Gains*, 375 U.S. at 193 n.41 (quoting Letter from Lord Hardwicke to Lord Kames (June 30, 1759), *printed in* J. PARKES, HISTORY OF THE COURT OF CHANCERY 508 (1828), *quoted in* E. SNELL, PRINCIPLES OF EQUITY 496 (25th ed. 1960)).

phrase "versatile inventions of fraud-doers" from the Missouri Supreme Court, which explained in *Stonemets v. Head* why fraud must be defined flexibly: "Fraud being infinite and taking on protean form at will, were courts to cramp themselves by defining it with a hard and fast definition, their jurisdiction would be cunningly circumvented at once by new schemes beyond the definition."[376] *Stonemets* cited an earlier decision of the same court, *Howard v. Scott*,[377] which suggested, in colorful prose, why fraud must be *undefined*.[378] *Howard* borrowed this notion from an early nineteenth century treatise.[379] That treatise traced the principle—a flexible law to adapt to the changing form of fraud—back to its origin in ancient Rome.[380] Over time Roman jurists, from Cicero to Labeo, had a hand in refining the definition of fraud.[381] Its last and "true" iteration, from more than 2,000 years ago, seems to blend Rule 10b-5 and Section 10(b). Under

---

[376]*Stonemets*, 154 S.W. at 114. The court noted the far-reaching potential of fraud when it stated:

> Fraud is kaleidoscopic, infinite. Fraud being infinite and taking on protean form at will, were courts to cramp themselves by defining it with a hard and fast definition, their jurisdiction would be cunningly circumvented at once by new schemes beyond the definition. Messieurs, the fraud-feasors, would like nothing half so well as for courts to say they would go thus far, and no further in its pursuit. Accordingly definitions of fraud are of set purpose left general and flexible, and thereto courts match their astuteness against the versatile inventions of fraud-doers.

Id. (citations omitted)

[377]*Id.*

[378]The *Howard* court explained "fraud" was left undefined by wisest of jurists:

> *What is fraud?* No statute and no judge has been so daring and unwise as to define it by hard and fast rules. That pre-eminent jurist who "perfected English equity into a symmetrical science," who is deemed by no less an authority than Lord Campbell "the most consummate judge who ever sat in the court of chancery," Lord Chancellor Hardwicke, he who as the lad, Phillip Yorke, was designed by his pious Presbyterian mother for some "*honester trade*" than the profession of an attorney (she longing to "see his head wag in the pulpit") who gave his "days and nights to the volumes of Addison" in acquiring a luminous and chaste style, and at the bar with unremitting toil and pains, superadded to a happy temperament and facile and receptive mind, informed and grounded himself in all essentials to wisdom, learning and virtue on the woolsack, so that his administration on that judgment seat is "fondly looked back upon as the golden age of equity," laid down the precept, never since departed from, *that fraud should be left undefined.*

Howard v. Scott, 125 S.W. 1158, 1165 (Mo. 1910) (emphasis added).

[379]*See id.*; *see* 1 JOSEPH STORY, LL.D, COMMENTARIES ON EQUITY JURISPRUDENCE AS ADMINISTERED IN ENGLAND AND AMERICA 185 (12th ed. 1877). The case cites the 13th edition, which was unavailable.

[380]STORY, *supra* note 379, at 185.

[381]*See id.*

Roman law, fraud was defined "to be any cunning deception, or artifice, used to circumvent, cheat, or deceive another."[382]

The economic and financial collapse that began in 1929 taught the 73rd Congress why the Romans defined fraud so liberally. In explaining the need for the delegation of broad rule-making authority to the SEC, the House Report on the 1934 Act explained:

> In a field where practices constantly vary and where practices legitimate for some purposes may be turned to illegitimate and fraudulent means, broad discretionary powers in the administrative agency have been found practically essential, despite the desire of the Committee to limit the discretion of the administrative agencies so far as compatible with workable legislation.[383]

In a similar vein, the Senate report also spoke to the need for flexibility in the antifraud provisions:

> The [C]ommittee has repeatedly heard testimony illustrating the evasions, suppressions, distortions, exaggerations, and outright misrepresentations practiced by corporations with intent to cloak their operations and to present to the investing public a false or misleading appearance as to financial condition . . . . Many other instances of "window-dressing" were observed, where inexcusable methods were employed to inflate assets, obscure liabilities, and conceal deficits.[384]

What Congress, Corcoran, the Missouri Supreme Court, Lord Chancellor Hardwicke, and Cicero all grasped, and the Rehnquist majority forgot, is the ingenuity of those who commit fraud. Congress saw a spectrum of wrongdoing, ever-changing, comprised of deception at one end, manipulation at the other, and the two overlapping somewhere in the middle. To the extent the Constitution would permit, it delegated the authority to the SEC to adapt the law to these dynamics.

The Rehnquist majority, on the other hand, saw manipulation and deception as two narrow and static bands on the conduct spectrum. For twenty-one years, it conformed the antifraud provisions to this vision.

---

[382]In its original Latin: "Dolum malum esse omnem calliditatem, fallaciam, machinationem ad circumveniendum, fallendum, decipiendum alterum, adhibitam." *See id.*

[383]H.R. No. 73-1383, at 6-7 (1934).

[384]S. Rep. No. 73-792, at 11 (1934).

When the majority was done, the law wore shackles. Attorneys, accountants, and investment banks were licensed to help their clients commit fraud.

Corporate scandals, the recent market collapse, and the Sarbanes-Oxley Act certify the "policy considerations" of *Blue Chip Stamps* a failure. Enron may be the vehicle for the Court to substitute the policy that guided the 73rd Congress—to protect the investor—for the "policy considerations" of *Blue Chip Stamps*—to protect the S&P 500. It is time for the Court to reconsider Justice Blackmun's dissent in *Blue Chip Stamps*: "[T]he Court exhibits a preternatural solicitousness for corporate well-being and a seeming callousness toward the investing public quite out of keeping, it seems to me, with our own traditions and the intent of the securities laws."[385]

VI. CONCLUSION

The Supreme Court has created a haven for expertise and money ready to help others commit fraud. Attorneys and accountants, some of the best, are the expertise. Financial institutions, some of the largest, are the money. These two elements need only a generous risk taker, someone willing to commit fraud for profit. The candidate must be risk-tolerant because fraud is risky business and generous because the services of money and expertise do not come cheap. Such risk takers have never been scarce. Hence, so long as the fraud-free zone is open, fraud is inevitable. When the largest financial institutions and some of the most sophisticated lawyers and accountants help conceive and execute the fraud, as they allegedly did with Enron,[386] its magnitude may be breathtaking.

The 73rd Congress never contemplated the SEC would alone enforce the antifraud provisions. It also armed a militia to help with the task. Both the 1933 and 1934 Acts contain express provisions allowing injured investors to bring civil actions to recover their losses. The courts implied other civil remedies. Those lawsuits curb the greed of money, expertise and risk takers in two ways. First, by bringing the business practices of the enterprise (money-expertise-risk taker) into the sunshine, investor lawsuits raise the risk of enforcement proceedings by the SEC or criminal charges by federal or state prosecutors. Second, and more directly, they make the enterprise less profitable to the extent that investors recover their losses.[387]

---

[385] Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 762 (1975) (Blackmun, J., dissenting).

[386] *See supra* Section II.

[387] *See* Dooley, *supra* note 137, at 836.

Before *Blue Chip Stamps* and its progeny "fixed" the antifraud provisions, it was commonly accepted that private lawsuits deterred securities fraud. Ironically, this point is forcefully made by one of the authorities cited by the Supreme Court in *Blue Chip Stamps* in support of its new "policy considerations."[388] Applying a "cost-benefit analysis," the author explains how private lawsuits under Section 10(b), before *Blue Chip Stamps*, caused issuers and underwriters to improve the accuracy of information disclosed to the public:

> If the costs of inadequate information are imputed to issuers and underwriters, they will be induced to improve the quality of information they supply in prospectuses, up to the point at which the benefit to be derived from reducing the risk of liability by the inclusion or verification of one more item of information is equal to the cost of including or verifying that information. If the marginal cost of improving the information is less than the marginal benefit from avoiding the corresponding risk of liability, the issuers and underwriters will improve the information; and vice versa.[389]

A corollary to the author's reasoning may be stated: if the liability cost for inaccurate information is not imputed to issuers and underwriters, they will not incur the cost to make the prospectus factually accurate.

The 1933 and 1934 Acts seemed to be working well enough over their first forty years. The markets took their bumps, but they were caused by, not the cause of, economic events. The collapse of the financial markets in 2000 was its own doing, the burst of a bubble that began to form in 1995. One year before that bubble began to inflate, *Central Bank* declared the fraud-free zone open for business. Attorneys, accountants, and banks could help public companies cheat their investors and not worry about pesky lawsuits, so long as they stayed within the brightly lit boundaries of the fraud-free zone. The SEC, which had never investigated a Chewco-style fraud, posed little risk for Enron's accountants and attorneys, and no risk for its banks, thanks to a gap in the regulatory system.[390]

No one knew better than Ferdinand Pecora (Pecora) what would happen if money and expertise broke free from the constraints of the 1933 and 1934 Acts. Pecora was chief counsel for the Senate Committee that

---

[388] *Blue Chip Stamps*, 421 U.S. at 740 (citing Dooley, *supra* note 137, at 836).
[389] *See* Dooley, *supra* note 137, at 836.
[390] *See supra* text accompanying note 264.

drafted the 1933 and 1934 Acts, including the key operative language of Section 10(b).[391] His detailed cross-examination of powerful bankers, brokers, and industrialists before the Senate Committee revealed the very ills the 1933 and 1934 Acts were designed to cure.[392] Those hearings eventually were named after him, the Pecora Hearings.[393] Reflecting years later, Pecora warned in his opening words in *Wall Street under Oath*:

> Under the surface of the governmental regulation of the securities market, the same forces that produced the riotous speculative excesses of the "wild bull market" of 1929 still give evidences of their existence and influence. Though repressed for the present, it cannot be doubted that, given a suitable opportunity, they would spring back into pernicious activity.
>
> Frequently we are told that this regulation has been throttling the country's prosperity. Bitterly hostile was Wall Street to the enactment of the regulatory legislation. It now

---

[391] Pecora served as chief counsel to the Senate Committee on Banking and Currency from January 1933 to July 1934, the period during which the 1933 and 1934 Acts passed through the Committee and were enacted by the Congress. *See* FERDINAND PECORA, WALL STREET UNDER OATH: THE *STORY OF OUR MODERN MONEY CHANGERS* 3 (1939), *reprinted by* Augustus M. Kelly (1968).

[392] Cynthia A. Williams, *The Securities and Exchange Commission and Corporate Social Transparency*, 112 HARV. L. REV. 1197, 1224-26 (1999).

> [F]rom January 24, 1933, through May 4, 1934, with full press coverage, Mr. Pecora conducted a painstakingly detailed cross-examination of the country's most respected bankers, brokers, and industrialists, producing evidence of a plethora of problems. In particular, the hearings found evidence of the following: unsound credit practices leading to excess speculation in the markets; manipulative devices used by pools, such as wash sales, matched orders, and short sales, all of which produced a false impression of market activity and/or manipulated or depressed the prices of the securities; unfair or manipulative market activities by insiders and directors; various deceptive and manipulative devices used during the underwriting of securities, including a lack of full disclosure of the underlying facts concerning the companies whose securities were being sold; monopolistic practices by investment banks; and unfair practices, such as the use of "preferred lists" for distributing securities."

Id.

[393] Adam Clymer, *The Nation: Hearing One Tree; Never Have So Many Missed the Forest*, N.Y. TIMES, Feb. 10, 2002, § 4, at 6 ("The most striking past investigations of business were the "money trust" probe in 1912 and 1913 . . . and the stock market investigation of 1932 to 1934 (unique among Congressional probes because it is not named after a chairman, but after its chief counsel, Ferdinand Pecora."); Williams, *supra* note 392, at 1123-24 ("These hearings, referred to as the Pecora hearings after Ferdinand Pecora, the chief counsel hired shortly after Roosevelt's election, produced extensive evidence of market manipulation by corporate officers and investment bankers.").

> looks forward to the day when it shall, as it hopes, reassume the reigns of its former power. . . .
>
> The public, however, is sometimes forgetful. As its memory of the unhappy market collapse of 1929 becomes blurred, it may lend at least one ear to the persuasive voices of The Street subtly pleading for a return to the "good old times."[394]

Pecora got it right with one caveat: The Supreme Court, not the public, would warm to the message that the antifraud provisions were "throttling the country's prosperity." When the Court dismantled those laws, as Pecora predicted, the "same forces that produced the riotous speculative excesses of the 'wild bull market' of 1929 . . . [sprang] back into pernicious activity."[395]

---

[394] PECORA, *supra* note 391, at ix-x.
[395] *Id.* at ix.