Section 10(b) Has Hatched a New Theory of Liability, But Will It Fly?

By Gary J. Aguirre

Gary J. Aguirre is formerly a partner in the San Diego firm of Aguirre & Eckmann. According to California Lawyer, he pioneered construction defect litigation in California. He received his LLM (Securities Regulation-International Law) with distinction from Georgetown University Law Center in October 2003. He has an office in San Diego.

I. INTRODUCTION

Evolution continues. Seven decades after its enactment, Section 10(b) of the Securities Act of 1934 (1934 Act) has hatched a new theory of liability. It happened in an unlikely place, south Texas, under unlikely circumstances, an $80 billion fraud by the nation's seventh largest corporation. Still, the investor class action arising out of Enron's fraud, *In re Enron Corporate Securities, Derivative & ERISA Litigation (In re Enron),* has found a new theory of securities fraud lurking in the text of Section 10(b).[1] Although *In re Enron* applies this new theory to some exotic forms of fraud, e.g., using disguised copper futures to cook Enron's books, it is elegantly simple in principle. It extends liability beyond deceptive words to deceptive conduct.

The features of the fledgling theory come into sharper focus when profiled against its sister theory, liability under Section 10(b) for deceptive *words.* The older sister is at work when a claim under Section 10(b) alleges, for example, an earnings release or annual report failed to disclose or misrepresented material facts. In contrast, the fledgling theory is not based on words, whether stated (misrepresentations) or unstated (nondisclosures). It recognizes that conduct can be just as deceptive as words. A simple example illustrates how conduct can be as deceptive as words: imagine a fake man of the cloth positions himself on the steps of 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. The fake does not utter a word. Instead, he smiles and nods graciously as the faithful stuff the box with bills. Is his conduct less deceptive because no words are spoken? By his conduct, rather than his words, he puts a false veneer on the truth. *In re Enron* treats this type of conduct as securities fraud when it involves the purchase or sale of a security.

Attorneys, accountants, and investment bankers allegedly used both deceptive words and deceptive conduct in making Enron's fraud their own.[2] The accountants and, to a lesser extent, the attorneys face liability to the entire class for their deceptive words: alleged nondisclosures or misrepresentations in annual reports, SEC filings or financial statements widely and periodically distributed to investors.[3] The extent of the investment bankers' liability for deceptive words is on shakier ground.[4] Not surprisingly, *In re Enron* emphasized the investment bankers' deceptive conduct in denying their motions to dismiss.[5] One of them in particular, Barclays Bank (Barclays), was kept in the Enron class action solely on this theory.[6] The facts alleged against Barclays, therefore, provide the clearest picture of the fledgling theory. Accordingly, this article shall focus on Barclays's liability for its alleged role in the Enron fraud.

The new theory reaches a type of conduct otherwise immune from the antifraud provisions. That immunity was granted over time by the Supreme Court as it dismantled some antifraud provisions and severely restricted others enacted by the 73rd Congress after the 1929 crash. Congress designed those statues to protect investors from future securities scams, especially by investment bankers.[7] One decision, *Central Bank v. First Interstate Bank,*[8] eliminated liability for aiding and abetting a violation of the antifraud provisions. In doing so, it defined a zone of conduct beyond the reach of the federal securities laws where investment bankers could earn lucrative fees helping public companies cheat investors. In the shadows of this lucrative zone, a fraud-free zone, Barclays, Citigroup, and J.P. Morgan, among others, allegedly nurtured Enron's conversion from a quasi-viable company to a full-blown Ponzi scheme.[9]

Unfortunately for Enron's investment bankers, the security of their sanctuary has been placed at risk by the investor class action against them. Worse yet, *In re Enron* has closed down the fraud-free zone – at least for now. It denied the investment banks' motions to dismiss by taking a detour around *Central Bank*. But will *In Re Enron* hold up on appeal?[10] Not likely in its current form, but with some changes, it may. The fledgling theory is best understood in the context of the compelling facts that necessitated its birth: the $80 billion Enron fraud. A simplified version of that fraud follows next.

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. The financial statements were doctored in two ways. First, Enron booked sales and earnings from transactions with its phony affiliates, effectively booking sales and

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earnings for doing business with itself. Second, Enron moved debt off its books onto its affiliates' books. For their part, Enron's investment bankers helped create the phony affiliates and, using word and deed, disguised them to appear to be independent entities.[11]

Many of Enron's sham affiliates were special purpose entities (SPEs).[12] The first sham SPE, the prototype for later ones, began life as a legitimate SPE. It was a $500 million partnership called "JEDI" between Enron and the California Public Employees' Retirement System (CalPERS).[13] Since JEDI qualified as a separate entity under generally accepted accounting principles (GAAP),[14] its operations were not consolidated into Enron's financial statements. Hence, JEDI's debt did not show up on Enron's balance sheet. However, Enron's income statement was improved by its share of JEDI's profits.[15]

All went smoothly for Enron, JEDI, and CalPERS until November of 1997, when CalPERS decided to sell its interest in JEDI.[16] Unfortunately, there were no legitimate bidders.[17] 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.[18] Additionally, its balance sheet would be hammered twice: debt would be increased by $711 million and shareholders' equity trimmed by $313 million.[19] The combined effect would predictably disappoint investors, causing the stock to plummet.

Enron, its attorneys and accountants, and Barclays allegedly hatched a last minute plan to preserve JEDI's appearance, but not its reality, as an entity separate from Enron. They created a new SPE, a sham called "Chewco," to buy out CalPERS' interest in JEDI. To be a separate entity from Enron under GAAP, Chewco would have to satisfy two requirements. First, it could not be controlled directly or indirectly by Enron. Second, an equity investor, also independent of Enron, must put at risk at least three percent of Chewco's capital.[20]

Chewco met neither requirement. It was "owned" by a business partner of an Enron employee.[21] Both the Enron employee and his partner were handsomely paid for taking instructions from Enron's chief financial officer.[22] Additionally, only Enron's assets were put at risk when Chewco bought out CalPERS' interest in JEDI. 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.[23] 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 prototype for countless other SPE and phony partnerships, which Enron likewise used to doctor its financial statements.[24]

The use of SPEs, such as Chewco, caused Enron's financial statements to grossly overstate earnings and understate debt from 1997 through 2000.[25] Those rosy financial statements in turn caused analysts to rate Enron stock a perpetual "buy."[26] This house of cards collapsed when Enron restated its earnings and debt for its fiscal years 1997 through 2000 in October and November 2001.[27] Debt was increased by $2.585 billion, while earnings were decreased by $1.048 billion.[28] Investor confidence vanished, causing the stock to plummet. Enron filed bankruptcy less than a month later.[29]

III. AN MRI OF THE NEW THEORY: THE ALLEGATIONS AGAINST BARCLAYS

Barclays's role in the Enron fraud is unique. It made no statements to public investors. Instead, *In re Enron* applied a novel theory in denying Barclays's motion to dismiss: Barclays violated Section 10(b) by its *deceptive conduct.* The court 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 10(b)-5."[30] No other defendant was kept in the case solely on this theory. Therefore, the allegations against Barclays are the purest statement, at least in the court's view, how deceptive conduct may violate Section 10(b).

In re Enron significantly extended the reach of Section 10(b) to deceptive conduct. Previously, the courts recognized only three narrow theories when Section 10(b) applied to deceptive conduct. One prohibits the use of "manipulative conduct" to mislead "investors by artificially affecting market activity," e.g., using "matched orders" to run up the stock price.[31] Supreme Court decisions bar the extension of this narrow theory to Barclays' alleged conduct.[32] The lower federal courts have also imposed Section 10(b) liability on broker-dealers for churning their clients' accounts[33] and for implied representations under the "shingle theory."[34] Neither theory applies to Barclays's conduct, since it was not acting as a broker-dealer for Enron investors.

In re Enron, therefore, extends Section 10(b)'s prohibition on deceptive conduct into new territory. 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* would extend Barclays's liability under Section 10(b) to injured investors with whom it had no prior contact or relationship.[35] In this sense, the decision raises deceptive conduct to parity with deceptive words as a basis for liability under Section 10(b).[36] But is *In re Enron* merely a fluke? Put differently, will the fledgling fly again or will its wings be trimmed by an appellate court? The answer begins with an analysis of the Supreme Court holdings that created the fraud-free zone.

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

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

In 1975, the Supreme Court announced the "policy considerations" that would thereafter dictate its interpretation of the antifraud provisions. In Justice Rehnquist's first opinion interpreting securities legislation, *Blue Chip Stamps v. Manor Drug Stores*, he expressed deep concern Section 10(b) could be used to proliferate vexatious litigation. Such lawsuits in his opinion raised two concerns:

> [I]n the field of federal securities laws … even a complaint which ... 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

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> 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, 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.[37]

In a sentence, the Rehnquist majority used *Blue Chip Stamps* to declare war, in its view, on flimsy lawsuits that could stifle business activity brought by litigants seeking to extort a settlement. In carrying out its war, the Court would rewrite the antifraud provisions enacted by the 73rd Congress 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."[38]

B. The Fraud-Free Zone, Phase I: Getting "Blue-Chip-Stamped"

Central Bank does not deserve full credit or blame for creating the fraud-free zone. It merely laid the last brick. When the Court decided *Central Bank* in 1994, it had whittled away at the antifraud provisions for almost two decades. The effect of that whittling can be measured by using the Enron fraud as a benchmark. The measuring process is simple: how would the antifraud provisions, before and after the whittling, apply to the Enron fraud? Since the focus is on Barclays's alleged conduct, the comparison below only involves the antifraud provisions that expressly reach deceptive conduct: Section 17(a) of the Securities Act of 1933 (1933 Act) and Sections 10 (including Rule 10b-5) and 18 of the 1934 Act.

The text of Section 17(a) has three antifraud prongs. Subsections 17(a)(1) and 17(a)(3), prohibiting deceptive conduct, literally apply to Barclays's alleged use of Chewco. Before the Rehnquist majority, the Court consistently interpreted the antifraud provisions to protect investors.[39] 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.'"[40] It is, therefore, unlikely the pre-Rehnquist Court would have bent the language of Section 17(a) to deprive investors of its explicit application to deceptive conduct. Unfortunately, however, Section 17(a) cannot help Enron investors. Thirty years after the lower courts first recognized civil liability under 17(a),[41] the Court's 5-4 decision in *Transamerica Mortgage Advisors, Inc. v. Lewis* undercut the legal premise upon which that liability rested.[42]

The Supreme Court also allowed the lower courts to emasculate Section 18 of the 1934 Act. Section 18 imposes liability on anyone who shall "cause" a misleading statement in an SEC filing, e.g., a 10K. Its text, therefore, literally applies to Barclays's alleged use of Chewco to cook Enron's books. Its pre-Rehnquist reach was further extended by aiding and abetting liability.[43] The lower courts rendered Section 18 toothless by holding its reliance requirement could only be satisfied if the investor "eyeballs" the SEC filing, e.g., literally reads the 10K,[44] a uniquely high standard for establishing reliance under the antifraud provisions.[45] The Supreme Court has consistently denied certiorari in cases raising Section 18 issues.[46]

That leaves Section 10(b), the culprit most responsible for strike suits in the eyes of the Rehnquist majority. In case after case, the Court narrowed the reach of Section 10(b) to deceptive conduct. Conversely, it created a wider and wider zone of deception immune from the antifraud provisions. *Blue Chip Stamps* held Section 10(b) did not prohibit fraud involving securities in the absence of a purchase or sale.[47] *Ernst & Ernst v. Hochfelder* held the wrongdoer must act with scienter, rather than negligence, to violate Section 10(b). *Santa Fe Industries, Inc. v. Green* decided "manipulative" is a "term of art" that really means "deceptive."[48] Although Section 10(b) literally prohibits "manipulative or deceptive" devices, after *Santa Fe* redefined "manipulative," it should now be read to prohibit "deceptive or deceptive" devices. *TSC Industries, Inc., v. Northway, Inc.* raised the bar for proving when a misrepresentation is "material."[49] *Virginia Bankshares, Inc. v. Sandberg* tightened the proof for establishing a misstatement of intention or belief.[50]

Finally, the Court *Blue-Chip-Stamp*ed the government in *Chiarella v. United States*[51] and *Dirks v. SEC*.[52] In both cases, the government sought to extend the reach of Section 10(b) to those trading on nonpublic information by broadening the duty to disclose, which likewise would have broadened the duty to disclose of defendants in private civil litigation.[53] Ruling for the government in these cases, especially *Chiarella*, would have opened a breach in the fraud-free zone through which packs of plaintiffs' attorneys would pour. Later, *Chiarella* would be a crossbeam in the fraud-free zone.

In sum, the Court nearly annihilated the antifraud provisions reaching deceptive conduct. It eliminated one (Section 17(a)), allowed the lower courts to neutralize a second (Section 18(a)), and put the third (Section 10(b)) on life support.[54] Yet, the Court's war on strike suits was not over. Section 10(b) could still do mischief to those who "aided and abetted" securities fraud. The Court would have to *Blue-Chip-Stamp* Section 10(b) one more time before the world would be safe from strike suits.

C. Fraud-Free Zone, Phase II: Opening For Business

Central Bank eliminated liability for aiding and abetting a violation of Section 10(b), a major blow to investors.[55] But what did it mean for investment bankers? It was a license issued under the seal of the Supreme Court to commit fraud up to the point of its final execution. Investment bankers could conceive the fraud, work out its details, and guide their clients step by step through its execution.[56] If it worked, they could market it to others. According to one Senate investigation, the investment bankers' role in the Enron fraud followed this exact pattern.[57]

But the license came with one limitation: the licensee could not execute the fraud directly on the investor. If any "secondary actor" took this last step, the Supreme Court warned of the consequence:

> Any person or entity, including a lawyer, accountant, or bank, who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator under 10b-5, assuming *all* of

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the requirements for primary liability under Rule 10b-5 are met.[58]

For the investment bankers, the warning created a troubling ambiguity: how is a secondary actor distinguished from a primary violator? The Second Circuit resolved this ambiguity in *Wright v. Ernst & Young LLP*,[59] making the zone a far safer place to work. It delineated the zone's boundary with a bright line. Under *Wright*, an actor does not become a primary violator merely by making a misstatement upon which an investor relies. The actor must be identified as the author of the lie in the communications to the investor. Hence, after *Wright*, investment bankers could go one step further in perpetrating fraud in the in the Second Circuit, the location of the nation's financial capital. They could tell the lie so long as they did not identify themselves as its author.

To summarize, the antifraud provisions created little risk for Barclays on the eve of its misadventure with Chewco. More than twenty-two 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. So long as Barclays did not identify itself as the author of the lie, it could conceive, plan, and execute the fraud.

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

In denying the investment bankers' motions to dismiss, *In re Enron* articulated two legal theories to overcome *Central Bank*. The first addressed an issue left open by *Central Bank*: at what point do secondary actors become liable as "primary violators"? Adopting the SEC position, *In re Enron* held a secondary actor becomes a primary violator when the actor authors the misstatement communicated to the investor, even though the statement does not identify the actor as such.[60] This holding closes the fraud-free zone for all those whose misstatements were passed along to investors. However, this prong did not reach Barclays's use of Chewco, since those activities involved no misstatements by Barclays to investors. Barclays was still safely within the fraud-free zone.

In re Enron's second prong was aimed at defendants whose deceptive conduct allegedly violated Section 10(b), such as Barclays. Although a novel theory, it is elegantly simple and rests on legal granite. *Central Bank* held a secondary actor was not liable for aiding and abetting the preparation of a misleading appraisal.[61] Hence, the fraud at the core of *Central Bank* was misleading *words*. Deceiving with misleading words, however, is not the only way to *literally* violate Section 10(b). Its text also expressly prohibits *deceptive conduct.*[62] On this point, *In re Enron* noted, "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 ... includes 'a scheme to deceive' or 'scheme, plan or artifice.'" Hence, even if the wrongdoer made no misstatement to investors, as Barclays had not, it could still be liable if its *conduct* was deceptive. *Central Bank* would not protect Barclays because liability was not based on the theory it aided and abetted Enron. To this point, *In re Enron*'s reasoning is sound; it did not stay that way.

Unfortunately, the decision uniformly misstates the holdings of the cases it cites as authority for its textual analysis of Section 10(b). *In re Enron* reads *SEC v. Zandford* to hold Section 10(b) prohibits deceptive conduct.[63] That was not the holding. *Zandford* involved the fiduciary duty of a broker-dealer to a customer who opened a discretionary account. Zandford pocketed the proceeds from the sales of securities in his customer's account, but the theft of the funds was not the violation. Rather, each sale was "deceptive" because it was neither authorized by*, nor disclosed to*, the Woods."[64] This holding broke no new ground. *Affiliated Ute Citizens of Utah v. United States*, more than 30 years earlier, also held a fiduciary could violate Section 10(b) by failing to disclose a material fact.[65]

In the same vein, *In re Enron* cites *Affiliated Ute*, *Superintendent of Insurance v. Bankers Life & Casualty Co.*,[66] *Santa Fe*, *Central Bank*, and *United States v. O'Hagan*[67] as support for its theory that Section 10(b) prohibits deceptive conduct.[68] None of the holdings go so far. To the contrary, in each case, liability was predicated on a misrepresentation or nondisclosure. *Affiliated Ute* ("they possessed the affirmative duty ... to disclose" the existence of a second market);[69] *Superintendent of Insurance* ("Manhattan's Board ... was allegedly deceived … by the misrepresentation that the proceeds would be exchanged for a certificate of deposit of equal value");[70] *Santa Fe* (no deception because the district court found "there was no 'omission' or 'misstatement' in the information statement.");[71] *O'Hagan* (O'Hagan's "failure to disclose his personal trading ... made his conduct 'deceptive'");[72] and *Central Bank* (misleading appraisal).[73] Hence, *In re Enron's* legal analysis is flawed.

VI. IS THERE AN ALTERNATIVE LEGAL ANALYSIS TO SALVAGE *IN RE ENRON*?

A. Does *Santa Fe* Limit Section 10(b) to Deceptive Words?

In re Enron took the easy way out in holding Section 10(b) prohibits deceptive conduct: "The Supreme Court made me do it." In fact, the Court has never decided the issue, at least not in a way that supports *In re Enron*. Most commentators interpret *Santa Fe* to hold exactly the opposite. i.e., Section 10(b) only prohibits deception in the form of a misstatement or nondisclosure.[74] If they are right, *In re Enron* is fatally flawed. Curiously, *In re Enron* does not help itself on this issue: it interprets *Santa Fe*, to limit Section 10(b)'s application to deceptive words,[75] but later states *Zanford* applied Section 10(b) to deceptive conduct.[76] This means either *Zandford* overruled *Santa Fe*, which it did not, or both *In re Enron* and the commentators misread *Santa Fe*, which they did.

The issue in *Santa Fe* was whether *any* deception was required to violate Section 10(b). Neither deceptive words nor deceptive conduct had been alleged. The Court merely held deception was required, but did not specify the exclusive form. 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."[77] The Court's use of "deception" in the above phrase must mean

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something more than deceptive words (stated or unstated) or the phrase is redundant. That flaw should not be presumed. Deception must include, therefore, something in addition to deceptive words. That leaves deceptive conduct. Hence, *Santa Fe* has left the door ajar for the theory that deceptive conduct may violate Section 10(b).

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

Wharf (Holdings) Ltd. v. United International Holdings, Inc., may have thrown the door open. It did the unimaginable: held an oral option was a "security."[78] Justifiably outraged, Wharf reminded the Court how *Blue Chip Stamps* was supposed "to protect defendants against law suits that 'turn largely on what oral version [of the facts] the jury may decide to credit.'"[79] Why did *Blue Chip Stamps* fail to shield Wharf from the evils of oral evidence? The answer lies in the last sentence of the decision, where the Court, dismissing Wharf's concerns, recognized the Private Securities Litigation Reform Act of 1995 (PSLRA) "establishes stricter pleading requirements in private securities fraud actions…." Accordingly, *Wharf* implies the Court has pulled back from *Blue Chip Stamps* because Congress has taken charge of the war on specious lawsuits for securities fraud.[80]

Wharf bodes well for the life expectancy of the new theory, Section 10(b)'s application to deceptive conduct. However, since *In re Enron* is flawed, the fledgling must still search for a legal premise to justify its existence. Four promising candidates present themselves below. Each offers a different but complementary argument (textual, contextual, legislative intent and policy) why Section 10(b) prohibits deceptive conduct.

(1) A Textual Interpretation: Section 10(b) Applies to Deceptive Conduct

The Supreme Court has nearly adopted a definition of Section 10(b) that would prohibit deceptive conduct. The key language of Section 10(b), placed at issue by *In re Enron*, prohibits the use of any "deceptive device or contrivance." Using Webster's International Dictionary (2d ed., 1934), *Hochfelder* defined two of the terms: 1) "device" to mean "[t]hat which is devised, formed by design; a contrivance; an invention; project; scheme; often a scheme to deceive; a stratagem; an artifice," and 2) "contrivance" to mean a "thing contrived or used in contriving; a scheme, plan or artifice" and "contrive" to mean to "devise; to plan; to plot ... [t]o fabricate ... design; invent ... to scheme.'" The same dictionary defines "deceptive" to mean "tending or having power to deceive." Hence, using the Court's definitions and choice of dictionaries, a "deceptive device or contrivance" covers a wide spectrum of conduct, including: an invention, stratagem, or thing fabricated tending to deceive. That definition 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. Further, this definition should be adopted by the Court, because, in its words, "the statutory text controls the definition of conduct covered by 10(b)."[81]

(2) Contextual Interpretation: Section 10(b) Applies to Deceptive Conduct

A key principle of statutory construction requires each section of a legislative scheme to be construed with the other sections to produce a "harmonious whole."[82] The Supreme Court applied a variant of this principle in *Touche Ross & Co. v. Redington*,[83] when it refused to imply a private remedy under Section 17(a) of the 1934 Act. Preliminarily, the Court observed Congress had created express remedies in Sections 18(a) and 9(e). 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."

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 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. Sections 9(a)(4) and 18(a) of the 1934 Act define fraud as the use of false or misleading statements. Therefore, 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. The rule of construction from *Touche Ross* is easily adapted for use interpreting Section 10(b): when Congress intended to define fraud committed by a misstatement or omission, "it knew how to do so and did so expressly." Hence, in using the language "deceptive device or contrivance," Congress must have intended to define a different type of fraud, one that goes beyond misleading or omitted words. That leaves deceptive conduct.

(3) Intent of the 73rd Congress: Section 10(b) Applies to Deceptive Conduct

The congressional testimony of Thomas G. Corcoran (Corcoran), "a spokesman for the drafters,"[84] 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)."[85] In February 1934, Corcoran testified before a House committee as 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." 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." (Emphasis added.) 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."[86]

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

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

(4) 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.

Before the Rehnquist majority, the Supreme Court had a better grasp why securities fraud should not be too narrowly defined. In *Capital Gains*, the Court 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.[87]

Capital Gains relied on a chain of authority that linked this principle back to the jurisprudence of ancient Rome. *Capital Gains* cited *Stonemets v. Head* in which the Missouri Supreme Court explained 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."[88] *Stonemets* cited an earlier decision of the same court, *Howard v. Scott*,[89] which borrowed this principle from an early nineteenth century treatise.[90] That treatise traced the principle – a flexible law to adapt to the changing form of fraud – back to its origin in ancient Rome.[91] Over time, Roman jurists from Cicero to Labeo had a hand in refining the definition of fraud.[92] Its "true" iteration, from more than 2,000 years ago, seems to blend Rule 10b-5 and Section 10(b). Under Roman law, fraud was defined "to be any cunning deception, or artifice, used to circumvent, cheat or deceive another."[93]

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 the workable legislation.[94]

What Congress, Corcoran, the Missouri Supreme Court, Cicero and younger Supreme Courts 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.

The Rehnquist majority, on the other hand, saw manipulation and deception as two narrow and static bands on the conduct spectrum. For twenty-two years, it conformed the antifraud provisions to this vision. When the majority was done, the law wore shackles. Attorneys, accountants, and investment bankers 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."[95] ■

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1 235 F.Supp.2d 549 (SD Tex 2002).

2 *Id*. at 695-708.

3 *Id*. at 704-707.

4 For example, J.P Morgan's misrepresentations to the *entire* plaintiff class occurred when its analysts rated Enron a "buy" although they allegedly knew, since no "screening" was in place, that Enron was a Ponzi scheme. *Id.* 639-642. As the dismissal of the 10(b) claim against Lehman demonstrates, this theory by itself failed to state a claim. *Id*. 653-654, 703.

5 *Id*. at 695-704.

6 *Id*. at 703.

7 Ferdinand Pecora, WALL STREET UNDER OATH; THE STORY OF OUR MODERN MONEY CHANGERS (A. M. Kelley, 1968) (1939).

8 511 U.S. 164 (1994).

9 *In re Enron*, 235 F.Supp.2d at 617.

10 *Id*.

11 *Id.* at 613-17.

12 *Id.* 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), available at http://www.chron.com/content/news/photos/02/02/03/enron-powersreport.pdf (Power's Report). *In re Enron*, 235 F.Supp. at 660 n.94., provides the following background on the Power's 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 … in February, 2002 ....

13 Powers, *supra* note 11, at 6; *In re Enron*, 235 F.Supp.2d at 614.

14 GAAP is an acronym for Generally Accepted Accounting Principles.

15 Powers, *supra* note 11, at 6; *In re Enron*, 235 F.Supp.2d at 614.

16 Powers, *supra* note 11, at 6; *In re Enron*, 235 F.Supp.2d at 614.

17 Powers, *supra* note 11, at 7; *In re Enron*, 235 F.Supp.2d at 614.

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

[19] *Id.* at 614.

[20] Powers, *supra* note 11, at 5; In *re Enron*, 235 F.Supp.2d at 614 n.48.

[21] Powers, *supra* note 11, at 1-2, 6-7, 48; *In re Enron*, 235 F.Supp.2d at 615.

[22] Powers, *supra* note 11, at 8, 54.

[23] *Id.* at 49-50; *In re Enron*, 235 F.Supp.2d at 615.

[24] *In re Enron*, 235 F.Supp.2d at 616. ("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.")

[25] *Id.* at 632.

[26] *Id.* at 634.

[27] Powers, *supra* note 11, at 2; *In re Enron*, 235 F.Supp.2d at 637.

[28] Powers, *supra* note 11, at 2-3; *In re Enron*, 235 F.Supp.2d at 626, 636

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

[30] *Id.* at 703.

[31] *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 199 (1976).

[32] *Id.; Santa Fe Indus., Inc., v. Green*, 430 U.S. 462; *In re Enron*, 235 F.Supp.2d at 569 n9.

[33] *Nesbit v. McNeil*, 896 F.2d 380, 382 (9th Cir. 1990).

[34] Marc I. Steinberg, Securities Regulation 658-59 (3d ed. 1998).

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

[36] See Thomas Lee Hazen, The Law of Securities Regulation 574 (West Group 4th ed. 2002). *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 745 (1975) (No privity required for verbal deception).

[37] *Blue Chip Stamps*, 421 U.S. 723, at 740-43.

[38] Robert Charles Clark, Corporate Law § 8.10.1, at 316 (1986).

[39] *Mills v. Electric Auto-Lite Co*., 396 U.S. 375 (1970); *Superintendent of Insurance of New York v. Bankers Life & Casualty Co*., 404 U.S. 6 (1971); *Affiliated Ute Citizens of Utah v. United Sta*tes, 406 U.S. 128 (1972); and *SEC v. Capital Gains Research Bureau, Inc*. 375 U.S. 180 (1963).

[40] 375 U.S. at 199 (1963) (quoting *Stonemets v. Head*, 154 S.W. 108, 114 (Mo. 1913)).

[41] *Osborne v. Mallory,* 86 F. Supp. 869 (SDNY 1949).

[42] 444 U.S. 11 (1979); *Landry v. All America Assurance Co.*, 688 F.2d 381, 388 (5th Cir. 1982).

[43] *In re Caesars Palace Sec. Litigation*, 360 F.Supp. 366, 386 (SDNY 1973)

[44] *Berman v. Richford Indus., Inc*., 26 Fed. R. Serv. 2d 10, 16 (S.D.N.Y. 1978)

[45] See, e.g., *Basic Inc. v. Levinson*, 485 U.S. 224, 247 (1988) (reliance for Section 10(b) established "fraud on the market theory.").

[46] *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).

[47] *Blue Chip Stamps*, 421 U.S. at 754-755.

[48] 430 U.S. 462 (1977); Hazen, *supra*, note 36, at 596.

[49] 426 U.S. 438, 448-49 (1976).

[50] 501 U.S. 1083, 1096 (1991).

[51] 445 U.S. 222 (1980).

[52] 463 U.S. 646 (1983).

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

[54] Incidentally, the Court played no favorites. It whittled the antifraud provisions prohibiting *deceptive words* with equal vigor; see, e.g., *Gustafson v. Alloyd Co., 513 U.S. 561(1995),* eliminating the application of Section 12 (a)(2) of the 1934 Act to secondary markets and private placements.

[55] 511 U.S. 164.

[56] *In re Enron* at 695-704.

[57] Senator Levin summed up the evidence taken by the Investigations Subcommittee on the investment bankers' 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.... In the case of Citigroup and Chase, the banks not only assisted Enron, they developed the deceptive prepays (loans disguised as energy trades) 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...." *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).

[58] *Central Bank,* 511 U.S. at 189.

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

[60] *In re Enron,* 235 F. Supp. 2d at 587-90.

[61] *Central Bank*, 511 U.S. at 191.

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

[63] *SEC v. Zanford*, 535 U.S. 813 (2002).

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

[65] 406 U.S. at 153.

[66] 404 U.S. 6 (1971).

[67] 521 U.S. 642 (1997).

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

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

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

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

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

[73] *Central Bank*, 511 U.S. at 166.

[74] See, 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,* 430 U.S. 462 at 476] has informed 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 to Rule 10b-5: Should Careless Plaintiffs Be Denied Recovery?* 71 Cornell L. Rev. 96, 142 (1985).

[75] *In Re Enron,* 235 F.Supp.2d 569.

[76] *Id.* at 578.

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

[78] 532 U.S. 588 (2001).

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

[80] Bhavik R. Patel, *Securities Regulation - Fraud - Rule 10b-5 No Longer Scares the Judiciary, but May Scare Corporate Defendants: The United States Supreme Court Switches Directions*, 25 U. Ark. Little Rock L. Rev. 191, 207 (2002).

[81] *Central Bank*, 511 U.S. at 175.

[82] Norman J. Singer, Sutherland Statutory Construction § 46.05. (5th ed. 1992).

[83] 442 U.S. 560, 572 (1979).

[84] *Hochfelder*, 425 U.S. at 202.

[85] See *id.*

[86] 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).

[87] *Capital Gains*, 375 U.S. 180, at 199 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)).

[88] 154 S.W. 108, 114 (Mo. 1913).

[89] 125 S.W. 1158, 1165 (Mo. 1910).

[90] *Id.*; 1 Joseph Story, LL.D, Commentaries on Equity Jurisprudence as Administered in England and America 185 (12th ed. 1877).

[91] Story, *supra*, note 84, at 185.

[92] See *id.*

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

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

[95] *Blue Chip Stamps*, 421 U.S. at 762 (Blackmun, J., dissenting).

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