Revisiting Affiliated Ute: High Court Needs A Reboot

By **Gary Aguirre**

Law360, New York (May 17, 2017, 4:26 PM EDT) -- *Last month marked 45 years since the U.S. Supreme Court's ruling in Affiliated Ute Citizens of Utah v. United States, which established a rebuttable presumption of reliance for securities fraud claims based on omissions of material fact. This* ***Expert Analysis special series*** *will explore the decision's progeny in the Supreme Court and various circuits.*

The U.S. Supreme Court ended an era in 1972 with its decision in Affiliated Ute Citizens of Utah v. United States.[1] It would be the last decision for three decades[2] to treat deceptive conduct alone — with no deceptive words — as a violation of the anti-fraud provisions of the securities acts.

The distinction between deceptive conduct and deceptive words is simple in principle. Assume a fake man of the cloth positions himself outside a church just before the service begins. He wears a cassock identical to the one worn by the minister who preaches from the pulpit. Holding a collection box, he smiles and nods graciously as the faithful fill it with bills, but he utters no words. Is his conduct less fraudulent because it is wordless?

Affiliated Ute protected investors in three ways. First, it held that conduct alone — with no words uttered between buyer and seller — could create civil liability under Section 10(b) of the Exchange Act and Rule 10b-5 if the conduct operated to conceal a material fact. Abstracting this principle and applying it to the fake minister, his deceptive conduct created a duty to disclose the material fact his scheme concealed: he is not part of the ministry.

Second, Affiliated Ute also held "positive proof of reliance is not a prerequisite to recovery"[3] under Section 10(b) or Rule 10b-5 when the deceptive scheme creates a duty to disclose. In the hypothetical, the faithful need not prove they relied on the undisclosed fact.

Third, Affiliated Ute articulated this guideline for the courts to apply in construing the anti-fraud allegations of the securities acts: "Congress intended securities legislation enacted for the purpose of avoiding frauds to be construed 'not technically and restrictively, but flexibly to effectuate its remedial purposes.'"[4]

This guideline — construing the securities acts to deter frauds — was anchored in the congressional investigation led by Ferdinand Pecora into the causes of the 1929 Wall Street Crash and the Great Depression. The Pecora investigation revealed that Wall Street had engaged in a wide spectrum of corrupt conduct.[5] That spectrum was ever changing in form, with deception at one end, manipulation at the other, and the two overlapping somewhere in the middle.[6]

Congress included multiple provisions in the Securities Act of 1933 and the Securities Exchange Act of 1934 to curb the types of deception and manipulation in the securities

markets uncovered by the Pecora investigation in 1933 and 1934.[7] To the extent the Constitution permitted, Congress also delegated the authority to the U.S. Securities and Exchange Commission in Section 10(b) of the Exchange Act to adapt the law to the ever-changing forms of market deception and manipulation.[8] For almost 40 years, the Supreme Court applied Congress' vision of the anti-fraud provisions — to protect investors — as it did in Affiliated Ute. [9]

The Supreme Court would abruptly abandon the guidance articulated in Affiliate Ute — to protect the investing public from fraud — in 1975. A three-justice "majority" would use Blue Chip Stamps v. Manor Drug Stores[10] to create a new policy star for construing the reach of the securities acts to deceptive and manipulative conduct. The author of the opinion, then a recent Nixon appointee, Justice William Rehnquist, would hang the new star in his first securities opinion, Blue Chip Stamps. Reduced to its essence, the new policy came to this: The federal courts should construe the securities laws to stomp out flimsy lawsuits brought by greedy plaintiffs seeking to extort nuisance settlements. Left unchecked, in Justice Rehnquist's view, these strike suits would cripple the nation's economy.[11]

Justice Rehnquist's ideology-driven opinion in Blue Chip Stamps at first got a cool reception from six justices. The three concurring justices objected to using a policy ground to reinterpret an unambiguous term in Section 10(b): the requirement of a purchase or sale.[12] In the dissent by three justices, Justice Harry Blackmun, the author of Affiliated Ute, cast Justice Rehnquist's policy — deterring nuisance suits — 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."[13]

Justice Rehnquist's concern that nuisance suits would cripple the economy would have been unsettling to Ferdinand Pecora, but not unexpected. In Wall Street under oath, Pecora warned:

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 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."[14]

With Blue Chip Stamps, Justice Rehnquist invited Wall Street to revisit the "good old times."

Blue Chip Stamps: A New Court on a New Mission

Blue Chip Stamps was an unlikely vehicle for Justice Rehnquist to hang a new policy star. The issue was whether to carve out an exception to the purchaser-seller requirement of Section 10(b). The three-justice "majority" decided the plaintiff lacked standing on policy grounds remote from any language in the statute or rule. This is puzzling. The texts of Section 10(b) and Rule 10b-5 are explicit: a violation requires a "purchase or sale" of a security. 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."[15]

Like magic, Justice Rehnquist found the guiding policy hidden in an obscure phrase in Section 11(e) of the 1933 Act, allowing the trial court to require either party to post a bond

for the payment of costs.[16] This sentence and a similar one in Section 18 of the 1934 Act[17] 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 anti-fraud provisions from 1975 through the present.

Although stung by a sharp dissent,[18] the Rehnquist trio took a bold step for any court: it substituted its own policy star — to stamp out strike suits — for the one expressed by Congress — to protect the investing public from deceptive and manipulative schemes. Further, it did so needlessly to support an interpretation of a statute that was unambiguous on its face. 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?

Getting Blue Chip Stamped

Justice Rehnquist described the case law construing Rule 10b-5 in Blue Chip Stamps as "a judicial oak which has grown from little more than a legislative acorn."[19] Using Blue Chip Stamps, the Supreme Court would saw down that giant oak branch by branch over four decades.[20] From 1975 to the present, the Supreme Court would rework the anti-fraud provisions to conform to Justice Rehnquist's narrow ideology. In doing so, it proved Pecora prescient. The court's decisions — ever weakening the anti-fraud provisions — would eventually create a zone where Wall Street — hedge funds, investment banks, their attorneys and accountants — could profitably engage in fraudulent conduct with little or no risk of civil liability for damages.

Central Bank of Denver NA v. First Interstate Bank of Denver NA[21] sawed off the biggest branch in 1994 — liability for aiding and abetting a violation of Section 10(b). In doing so, Central Bank explicitly relied on Blue Chip Stamps' policy to stamp out nuisance suits: "litigation under Rule 10b-5 presents a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general."[22] Somehow, in the Supreme Court's calculus, nuisance lawsuits posed a greater risk to the economy than the risk an unregulated Wall Street would destabilize the capital markets.

Central Bank cut the ribbon opening the fraud-free zone: The Street — investment banks, their law firms, their hired physicists and accountants — could fully design and construct the deceptive or manipulative scheme. They could license or sell their product to the ultimate retailer, the one who would perpetrate the manipulative or deceptive scheme on the investing public. To stay within the sanctuary of the fraud-free zone, Wall Street had only one rule to obey: do not utter a word to the investor. Communicating with the investor could invoke Rule 10b-5(b), liability for a misrepresentation or a half-truth.

Affiliated Ute: A Fly in the Central Bank Ointment

But there was still one risk to the fraud-free zone: liability under Affiliated Ute for a deceptive or manipulative scheme that operates to conceal a material fact. What difference would it make that Central Bank and Blue Chimp Stamps had sawed off the aiding and abetting branch if it grew back as scheme liability?

In re Enron became the first reported decision to interpret Section 10(b) to impose liability on an actor — in particular Barclays — who had no contact with the injured investor, solely on the basis of deceptive conduct.[23] This meant Barclays, despite its disciplined silence, faced liability to investors though it never uttered a word to them.[24]

Affiliated Ute would collide with Blue Chip Stamps over scheme liability in Stoneridge Investment Partners v. Scientific-Atlanta Inc. Amici briefs for the securities industry again fired up the Blue Chip Stamps chainsaw with arguments like this one: "Today, 32 years after Blue Chip Stamps, and thirteen years after the Court's analogously reasoned decision in Central Bank ... [Petitioner] and its amici present the same types of arguments — and commit the same fallacies — that Blue Chips Stamps exploded."[25] Deeply flawed as it is, Justice Rehnquist's "majority opinion" in Blue Chip Stamps has been elevated to iconic status. And once again, the Supreme Court embraced Blue Chip Stamps in Stoneridge by sounding the death knoll for scheme liability.[26]

From Here, Where?

The Blue Chip Stamps chainsaw has reduced the giant oak — Rule 10b-5 — to a stump with one withered branch, the narrow scope of liability under Rule 10b-5(b). Central bank and Stoneridge have defined a zone of conduct beyond the reach of the federal securities acts, a fraud-free zone, where the Street may conceive, design and construct deceptive and manipulative fraudulent schemes without risk of civil liability. The Street only risks liability — under Rule 10b-5(b) — if it communicates false statements or half-truths directly to investors.

Pecora warned the public might warm to the message that the anti-fraud provisions were "throttling the country's prosperity." When the Supreme 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."[27]

The Supreme Court needs to move beyond its obsession that nuisance suits may harm the economy. The cost for this protection is too high: the 2008 financial crisis delivered a $22 trillion hit to the U.S. economy, according to the U.S. Government Accountability Office.[28] A report by the Senate Subcommittee on Investigations blamed Wall Street fraud for that hit,[29] just as the Pecora investigation blamed Wall Street fraud for the 1929 Crash and the Great Depression.[30] And there is a logical point for the Supreme Court to begin: retrace its steps back to its last decision, Affiliated Ute, before it adopted the false star and sloppy analysis of Blue Chip Stamps.

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

[2] SEC v. Zandford. 535 U.S. 813 (2002).

[3] Affiliated Ute, 406 U.S. at 153.

[4] Id., at 151.

[5] Report of the Senate Committee on Banking and Currency Pursuant to Senate Resolution 84 1934 (hereafter "Pecora Report"), available at https://www.senate.gov/artandhistory/history/common/investigations/pdf/Pecora_FinalReport.pdf.

[6] Id.

[7] Sections 11, 12(2) (now 12(a)(2)), and 17(a) of the 1933 Act and 9, 10(b), and 18 of the 1934 Act.

[8] Aguirre, G. J. (2003) The Enron Decision: Closing the Fraud-Free Zone on Errant Gatekeepers? Delaware Journal of Corporate Law, 28, 506-507.

[9]SEC v. Ralston Purina Co., 346 U.S. 119 (1953) expanded the meaning of "public offering" and thus the reach of the Securities Act's protections. SEC v. Howey Co., 328 U.S. 293 (1946), SEC v. Joiner Corp., 320 U.S. 344 (1943) and Tcherepnin v. Knight, 346 U.S. 119 (1953) all broadened the definition of a "security" and thus extended the reach of the four securities acts. Wilko v. Swan, 346 U.S. 427 (1953) held investors did not waive the right to sue broker-dealers by signing a mandatory arbitration agreement. Deckert v. Independence Shares Corp., 311 U.S. 282 (1940) held an investor could obtain equitable relief under the Securities Act, though the act did not expressly provide this remedy. J.I. Case Co. v. Borak, 377 U.S. 426 (1964) and Mills v. Electric Auto-Lite Co., 396 U.S. 375 (1970) held an investor had an implied civil remedy under Section 14(a) of the Exchange Act for a misleading statement in a proxy statement. Superintendent of Insurance of New York v. Bankers Life & Casualty Co., 404 U.S. 6 (1971) held that a private civil action could be brought under Section 10(b) and Rule 10b-5.

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

[11] Id., at 741.

[12] Id., at 755-756.

[13] Id., at 762.

[14] Ferdinand Pecora, Wall Street Under Oath: The Story of Our Modern Money Changers 3 (1939), reprinted by Augustus M. Kelly (1968), at ix-x.

[15] Demarest v. Manspeaker, 498 U.S. 184, 190 (1991) (opinion by Judge Rehnquist).

[16] Blue Chip Stamps, 421 U.S. at 723

[17] 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."

[18] Blue Chip Stamps, 421 U.S. at 760.

[19] Id., at 737.

[20] Ernst & Ernst v. Hochfelder, 425 U.S. 185, 202 (1976) (Section 10(b) and Rule 10b-5 require scienter); TSC Indus. Inc. v. Northway Inc., 426 U.S. 438, 448-49 (1976) (raised

the bar for proving a fact is "material."); Virginia Bankshares Inc. v. Sandberg, 501 U.S. 1083, 1092 (1991). (tightened the proof for establishing a misstatement of intention or opinion.); Santa Fe Industries Inc. v. Green 430 U.S. 462, 475 (1977) (implied "manipulative" conduct alone did not violate Section 10(b)'s prohibition on "manipulative or deceptive" conduct); Schreiber v. Burlington N. Inc., 472 U.S. 1 (1985) (held a "manipulative" act must also be "deceptive" to violate Section 14(e)); Scherk v. Alberto-Culver Co., 417 U.S. 506 (1974)(arbitration clauses were enforceable in agreements between broker-dealers and their customers).

[21] Cent. Bank of Denver NA v. First Interstate Bank of Denver NA, 511 U.S. 164 (1994).

[22] Id. at 189.

[23] In re Enron Corp. Sec., Derivative & ERISA Litig., 235 F. Supp. 2d 549, 569 n.10, 708 (S.D. Tex. 2002).]

[24] In the author's 2003 article (supra, n. 8), he suggested that the district court's decision in In re Enron stretched the Supreme Court decisions upon which it relied beyond their holdings. In Stoneridge Inv. Partners LLC v. Scientific-Atlanta Inc., 552 U.S. 148, 159-160 (U.S. 2008), the Supreme Court disapproved of In re Enron’s scheme liability theory.

[25] Stoneridge Inv. Partners v. Scientific-Atlanta, Inc., 2006 U.S. Briefs 43, 2-3 (U.S. Aug. 15, 2007).

[26] Stoneridge, 552 U.S. at 166-167. See: Lampkin v. UBS Painewebber Inc. (In re Enron Corp. Sec., Derivative & "ERISA" Litig.), 2017 U.S. Dist. LEXIS 28458 at n. 4 (S.D. Tex. Feb. 28, 2017); Hammer v. Reetz, 2017 U.S. Dist. LEXIS 28306 at 18 (S.D.N.Y. Feb. 24, 2017)

[27] Pecora, supra n. 15, at ix.

[28] U.S. General Accounting Office (GAO) Financial Regulatory Reform: Financial Crisis Losses and Potential Impacts of the Dodd-Frank Act, GAO-13-180 (Washington, D.C.: Jan. 2013); available at http://www.gao.gov/assets/660/651322.pdf.

[29] U.S. Senate, Permanent Subcommittee on Investigations, Wall Street and the Financial Crisis: Anatomy of a Financial Collapse: Majority and Minority Staff Report 7-11, 318-625 (April 13, 2011), available at http://www.hsgac.senate.gov//imo/media/doc/Financial_Crisis/FinancialCrisisReport.pdf?attempt=2.

[30] Supra, n. 5.
