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RECENT TRENDS IN LITIGATION

Expanded Primary Liability Under Section 10(b)

In *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994), the United States Supreme Court held that that § 10(b) of the Securities and Exchange Act of 1934 does not allow recovery for aiding and abetting liability, but cautioned that secondary actors were not always free from liability under § 10(b) because they may still be liable as a primary violator. The Court in *Central Bank* did not, however, fully define under what circumstances a secondary actor may be liable as a primary violator under §10(b). On June 30, 2006, the United States Court of Appeals for the Ninth Circuit in *Simpson v. AOL Time Warner, Inc., et al.*, 452 F.3d 1040 (9th Cir. 2006) addressed the issue and appears to have expanded the scope of primary liability under §10(b) by holding that primary liability is not limited to defendants who personally made a public misstatement or violated a duty to disclose, but includes deceptive conduct in furtherance of a “scheme to defraud” when all elements of §10(b) are otherwise satisfied.

The plaintiffs in *Simpson* were shareholders in a company that in 1996 launched the real estate website Homestore.com (now Move.com). When news broke in 2001 that the company was under investigation for fraud and its stock price dropped, shareholders lost more than \$100 million in market value. Defendants in the case, including AOL, Cendant Corp. and L90, allegedly engaged in fraudulent “triangle transactions,” whereby Homestore would enter into sham transactions with third parties in which Homestore would purchase revenue for itself and record the revenue in violation of SEC rules. For example, Homestore would buy products that it didn't need from a third party, with the understanding that the third party would then use the proceeds from that sale to buy advertising space on Homestore’s website through AOL. AOL would then “share” the revenue with Homestore, enabling Homestore to report higher earnings.

Plaintiffs’ complaint alleged that the defendants were primary violators under §10(b) because they engaged in a “scheme to defraud.” In response, defendants argued that the Supreme Court in *Central Bank* had limited primary liability under § 10(b) to defendants who personally made a public misstatement, violated a duty to disclose or engaged in manipulative trading activity, but had not extended such liability to those engaged in a broader scheme to defraud. On appeal, the Ninth Circuit held that if a defendant engages in conduct that had the principal purpose and effect of creating a false appearance of fact in furtherance of a scheme to defraud, that conduct is sufficient to render the defendant

liable as a primary violator. If the defendant's actions were not themselves deceptive but merely facilitated or assisted a fraudulent scheme, then the defendant would not have primary liability.

The Ninth Circuit's decision in *Simpson* is significant because under its reasoning, there is no requirement to limit liability only to those who, for example, issue a false or misleading statement. To the contrary, under *Simpson* if a defendant's conduct is itself manipulative or deceptive, §10(b) may be satisfied.

The Ninth Circuit's decision also creates an apparent split in the United States Circuit Courts for determining primary liability under §10(b). The *Simpson* holding is at odds with the Eighth Circuit's holding in *Stoneridge Investment Partners LLC v. Scientific-Atlanta, Inc. and Motorola, Inc.*, 443 F.3d 987 (8th Cir. 2006). In that case, the Eighth Circuit held that the Supreme Court's decision in *Central Bank* precludes recovery against a defendant unless he actually issued a misstatement.

If you have questions about this decision and its potential impact, please feel free to contact Elizabeth Pitrof or Scott Wallace at Kerns, Pitrof, Frost & Pearlman, LLC.