

**COUNTERING THE *STONERIDGE* CRITICS: THE PRUDENCE OF
MAINTAINING THE STATUS QUO FOR LAWYER
LIABILITY UNDER RULE 10B-5**

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I. INTRODUCTION

On January 15, 2008, the United States Supreme Court handed a major victory to accounting firms and investment banks. In *Stoneridge Investment Partners v. Scientific-Atlanta, Inc.*,¹ the Court prevented shareholders from suing third parties involved in their company's fraud.² As business groups eagerly applauded the decision,³ the reaction from critics was swift and harsh. A flurry of news articles and commentaries decried *Stoneridge* as another in a long line of anti-investor, probusiness Supreme Court decisions.⁴ Senator Christopher Dodd, an author of the Private Securities Litigation Reform Act of 1995,⁵ denounced *Stoneridge* for producing a misguided standard that would "protect wrongdoers from the consequences of their actions."⁶ Kathleen Flynn Peterson, President of the American Association for Justice (formerly known as the Association of Trial Lawyers of America), expressed her disappointment that *Stoneridge* prevents investors from

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¹ *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 128 S. Ct. 761 (2008).

² *Id.* at 766.

³ See Linda Greenhouse, *Supreme Court Limits Lawsuits by Shareholders*, N.Y. TIMES, Jan. 16, 2008, at C1 (explaining the *Stoneridge* decision was a significant victory for investment banks, accountants, and vendors).

⁴ See, e.g., Tony Mauro, *High Court's 'Stoneridge' Ruling a Win for Business Defendants*, LEGAL TIMES, Jan. 16, 2008, <http://www.law.com/jsp/article.jsp?id=1200391525612>; Jeffrey Rosen, *Supreme Court Inc.*, N.Y. TIMES MAG., Mar. 16, 2008, <http://www.nytimes.com/2008/03/16/magazine/16supreme-t.html>.

⁵ Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (codified as amended in scattered sections of 15 U.S.C.).

⁶ Chris Dodd United States Senator for Connecticut, *Dodd Reacts to Supreme Court Ruling in Stoneridge Case*, Jan. 15, 2008, <http://dodd.senate.gov/index.php?q=node/4197>.

suing all-knowing participants in a fraud case.⁷ The critics' focus also turned to corporate lawyers, who some believe are the shadowy hand facilitating corporate fraud.⁸ This criticism contends the Court granted broad immunity to corporate lawyers, shielding them from liability at the expense of suffering shareholders.⁹

This widespread criticism is unfounded and inaccurate. *Stoneridge* does not necessarily shield from liability third party participants who engage in corporate fraud. Despite the claims by Senator Dodd and others that *Stoneridge* protects wrongdoers, corporate lawyers operate within a system of robust checks on their legal and ethical duties. Lawyers are subject to civil and criminal penalties from the Securities and Exchange Commission (SEC) and the Department of Justice (DOJ), sanctions from state bar associations, common law fraud claims, tort liability, and despite *Stoneridge*, they remain vulnerable to a private action brought by an issuer's shareholders under SEC Rule 10b-5.¹⁰

This Article seeks to rebut this growing criticism by demonstrating that *Stoneridge* properly maintained the status quo on attorney liability. This Article also demonstrates that the Supreme Court reached an efficient outcome in its holding. Part II of this Article describes the majority and dissent of the *Stoneridge* decision and demonstrates that *Stoneridge* did little to alter the legal landscape governing a corporate counsel's liability to a corporation's shareholders. Part III explains why the chorus of criticism is largely unfounded, and Part IV illustrates how the Court arrived at an efficient outcome.

⁷ Posting of Tony Mauro to The BLT: The Blog of Legal Times, <http://legaltimes.typepad.com/blt/2008/01/reaction-to-sto.html> (Jan. 15, 2008, 03:22 PM).

⁸ See Susan P. Koniak, *Corporate Fraud: See, Lawyers*, 26 HARV. J.L. & PUB. POL'Y 195, 195 (2003).

⁹ See Mauro, *supra* note 4 (noting that third parties such as law firms and bankers may be shielded from litigation for their role in corporate fraud).

¹⁰ 17 C.F.R. § 240.10b-5 (2009) ("It shall be unlawful for any person . . . by the use of any means or instrumentality of interstate commerce . . . to engage in any act . . . which operates or would operate as a fraud or deceit upon any person . . .").

II. THE *STONERIDGE* DECISION

A. *The Majority Opinion*

In *Stoneridge*, the Court decided the scope of the implied private right of action available to injured shareholders under SEC Rule 10b-5.¹¹ The Court concluded the right of action did not reach third party defendants in this case.¹² In 2000 Charter Communications, Inc. (Charter), a cable operator, realized that it would miss its projected operating cash flow by fifteen to twenty million dollars.¹³ To compensate, Charter altered its contractual relationships with two suppliers: Motorola, Inc. (Motorola) and Scientific-Atlanta, Inc. (Scientific-Atlanta), both of whom supplied Charter with the cable converter boxes that Charter sold to customers.¹⁴ Charter arranged to overpay twenty dollars for each box, with the understanding the overpayment would be returned in the form of advertisement purchases from Charter.¹⁵ This agreement allowed Charter to record the advertising purchases as revenue, while simultaneously capitalizing its purchases of the cable converter boxes¹⁶—all in violation of Generally Accepted Accounting Principles (GAAP).¹⁷ The sham transactions, which had no economic substance, allowed Charter to fool its auditors into approving materially misleading financial statements.¹⁸ Charter filed these financial statements with the SEC and reported them to the public.¹⁹

Neither Motorola nor Scientific-Atlanta played any role in preparing or disseminating Charter's financial statements, and both companies properly recorded the transactions in their own books according to GAAP.²⁰ Charter shareholders sued not only Charter and some of its executives, but they also sued Motorola and Scientific-Atlanta on the

¹¹ *Stoneridge*, 128 S. Ct. at 766.

¹² *Id.*

¹³ *Id.*

¹⁴ *Id.*

¹⁵ *Id.*

¹⁶ *Id.*

¹⁷ See Federal Accounting Standards Advisory Board, Generally Accepted Accounting Principles, <http://www.fasab.gov/accepted.html> (last visited Dec. 20, 2009).

¹⁸ *Stoneridge*, 128 S. Ct. at 766.

¹⁹ *Id.* at 767.

²⁰ *Id.*

basis that they knowingly entered the transaction in order to permit Charter to achieve a desired accounting outcome.²¹ Motorola and Scientific-Atlanta moved to dismiss.²² The district court granted the motion²³ and the Eighth Circuit Court of Appeals affirmed.²⁴ The Supreme Court also affirmed, but did so upon different reasoning.²⁵

The *Stoneridge* Court held that the plaintiffs could not establish the reliance element necessary for a private 10b-5 action because the acts by Motorola and Scientific-Atlanta were not disclosed to the public.²⁶ The Court noted that reliance can be presumed in only two situations: (1) “if there is an omission of a material fact by one with a duty to disclose,” or (2) “under the fraud-on-the-market doctrine.”²⁷ Neither situation was present.²⁸ Thus, the plaintiffs had to prove actual reliance, but could not do so except in an indirect chain of causation that the Court found too remote for liability.²⁹ “It was Charter, not [the defendants], that misled its auditor and filed fraudulent financial statements; nothing [the defendants] did made it necessary or inevitable for Charter to record the transactions as it did.”³⁰

The decision turned on the reliance issue, but the Court also cited a number of additional considerations against extending liability. The plaintiff’s theory, the majority opined, would be an unfounded interpretation of Congress’s response to the Court’s precedent in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*³¹ *Central Bank* explicitly held that implied 10b-5 liability did not extend to aiders

²¹ *Stoneridge Inv. Partners LLC v. Scientific-Atlanta, Inc (In re Charter Commc’ns, Inc.)*, No. MDL 1506 4:02-CV-1186-CAS, 2004 WL 3826761, at *1 (E.D. Mo. Oct. 12, 2004).

²² *Id.*

²³ *Id.*

²⁴ *Stoneridge Inv. Partners, LLS v. Scientific-Atlanta, Inc. (In re Charter Commc’ns, Inc.)*, 443 F.3d 987, 989 (8th Cir. 2006).

²⁵ *See Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 128 S. Ct. 761, 769 (2008).

²⁶ *Id.*

²⁷ *Id.*

²⁸ *Id.*

²⁹ *Id.*

³⁰ *Id.* at 770.

³¹ *Id.* (citing *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 184 (1994)).

and abettors,³² and when Congress responded in the following year with the Private Securities Litigation Reform Act of 1995, it did not revive aiding and abetting claims for private 10b-5 suits.³³ Thus, the Court was wary of reinstating a cause of action that Congress deliberately left omitted.

Additionally, the Court addressed the issue of scheme liability, an argument proffered by the plaintiffs that caused a split at the circuit court level.³⁴ Scheme liability seeks to hold liable third parties who engage in a scheme to defraud,³⁵ even if their conduct falls short of actual public statements. Most Rule 10b-5 claims arise under the Rule 10b-5(2) prohibition against making any “untrue statement of a material fact,”³⁶ but scheme liability would hold defendants liable if they engaged in a scheme to defraud under Rule 10b-5(1). The difference is nuanced, but significant. By alleging that defendants are part of a scheme, plaintiffs can recast aiders and abettors as primary violators, and thus avoid *Central Bank*.³⁷ The Supreme Court addressed the issue of scheme liability, but did not expressly reject it.³⁸ Instead, the Court reverted to a discussion regarding the reliance issue, which determined much of the decision.³⁹ Nevertheless, the Court seemed to reject the

³² *Cent. Bank*, 511 U.S. at 184.

³³ *Stoneridge*, 128 S. Ct. at 771 (explaining that aiding and abetting liability is limited to actions brought by the SEC, and not available to private parties).

³⁴ *Id.* at 770; see also *Newby v. Enron Corp.* (*In re Enron Corp. Sec., Derivative & “ERISA” Litig.*), 439 F. Supp. 2d 692, 723 (S.D. Tex. 2006) (addressing the issue of scheme liability in the Enron case). Compare *Simpson v. AOL Time Warner Inc.*, 452 F.3d 1040, 1043 (9th Cir. 2006) (holding the scope of section 10(b) includes deceptive acts in furtherance of a scheme to defraud when all other requirements are met), with *Regents of the Univ. of Cal. v. Credit Suisse First Boston (USA), Inc.*, 482 F.3d 372, 392 (5th Cir. 2007) (holding that aiding and abetting should not be considered deceptive acts under section 10(b), which should be strictly construed).

³⁵ 17 C.F.R. § 240.10b-5(a) (2009) (“It shall be unlawful for any person . . . (a) [t]o employ any device, scheme, or artifice to defraud . . .”).

³⁶ *Id.* § 240.10b-5(b).

³⁷ See STUART R. COHN, *SECURITIES COUNSELING FOR SMALL AND EMERGING COMPANIES* § 21:3 (vol. 2, 2008) (noting that recently, plaintiffs have focused on the scheme language to bring third parties into court in the absence of any public statements).

³⁸ See *Stoneridge*, 128 S. Ct. at 770 (finding scheme liability insufficient to answer the question of whether the petitioner could or could not establish reliance).

³⁹ *Id.* at 770.

general premise that merely being part of a scheme is sufficient for primary liability under Rule 10b-5.⁴⁰ Reliance, the Court implied, was the key factor.⁴¹ Moreover, the Court cautioned against allowing federal power to be used to invite litigation in areas already governed by “functioning and effective state-law guarantees.”⁴² The Court also showed concern that a new class of defendants would be subject to extensive discovery, along with the potential for uncertainty and disruption by plaintiffs with weak claims extorting settlements from innocent companies.⁴³ The Court further noted that secondary actors, such as Motorola and Scientific-Atlanta, remain subject to the strong deterrents of civil and criminal penalties.⁴⁴

B. *The Dissent*

The dissent believed all of the requisite Rule 10b-5 requirements were met, including the element of reliance.⁴⁵ The dissent argued that *Stoneridge* and *Central Bank* were distinguishable because the defendants here committed a primary violation of Rule 10b-5, which Charter’s investors relied upon in deciding whether to invest in Charter.⁴⁶ The dissent argued that both Motorola and Scientific-Atlanta violated Rule 10b-5 because their involvement in sham transactions was a deceptive device prohibited under the statute.⁴⁷ In contrast, the defendant in *Central Bank* “did not engage in any deceptive act and, therefore, did not *itself* violate section 10(b).”⁴⁸ The dissent also disagreed with the ma-

⁴⁰ See *id.* (concluding defendants’ deceptive acts were too remote to fulfill the reliance requirement because they were not disclosed to the investing public).

⁴¹ *Id.* (“[R]eliance is tied to causation, leading to the inquiry whether respondents’ acts were immediate or remote to the injury.”); see Sixth Circuit Blog, <http://www.sixthcircuitblog.com/2008/01/scheme-liabilit.html> (Jan. 17, 2008, 11:15 PM) (contending that scheme liability is still alive, though substantially limited).

⁴² *Stoneridge*, 128 S. Ct. at 770-71.

⁴³ *Id.* at 772 (citing *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 740-41 (1975)).

⁴⁴ *Id.* at 773-74 (noting both parties agreed that criminal penalties are a strong deterrent).

⁴⁵ *Id.* at 774-76 (Stevens, J., dissenting).

⁴⁶ *Id.* at 774 (stating that investors relied on Charter’s revenue statements, and thus relied on defendants’ fraud, which is enough to satisfy the requirements of section 10(b)).

⁴⁷ *Id.*

⁴⁸ *Id.* at 775.

majority's application of the fraud-on-the-market doctrine.⁴⁹ The dissent argued that it should have applied here because the Court had not previously held that the investors must be aware of the specific deceptive act in order to demonstrate reliance.⁵⁰ In this case, according to the dissent, the sham transactions had the same effect on the stock price, and under *Basic Inc. v. Levinson*'s application of the fraud-on-the-market doctrine, the complaint should not be dismissed merely because the plaintiffs were not subjectively aware of the deception at the time of their purchase.⁵¹

**C. Stoneridge Does Not Provide Lawyers with Much, if Any,
Additional Protection from Private 10b-5 Lawsuits
Brought by an Issuer's Shareholders**

Criticism of *Stoneridge* centers on the insulation from liability the decision ostensibly provided.⁵² To the contrary, *Stoneridge* did not provide much greater protection for lawyers than what the law previously afforded; it merely maintained the status quo regarding lawyer liability. *Central Bank* held that lawyers could be liable as primary violators of Rule 10b-5, but not as aiders and abettors of an issuer's violation.⁵³ *Stoneridge* retains this possibility.

Generally, lawyers are not liable for an issuer's securities law violations. For example, section 11 of the Securities Act of 1933 specifically enumerates who may be liable for materially false registration statements.⁵⁴ Despite most registration statements being prepared largely, if not entirely, by an issuer's lawyers, section 11 generally excludes lawyers from its list of possible defendants.⁵⁵ Lawyers may be liable under section 11 for only the *expertised* portion of the registration

⁴⁹ *See id.* at 776 (alleging the court misapplied the fraud-on-the-market presumption with respect to causation).

⁵⁰ *Id.*

⁵¹ *Id.* (citing *Basic Inc. v. Levinson*, 485 U.S. 224, 247 (1988) (finding any public material misrepresentations may be sufficient for 10(b) actions)).

⁵² *See, e.g.*, Dodd, *supra* note 6; Mauro, *supra* note 4.

⁵³ *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 176-77 (1994).

⁵⁴ Securities Act of 1933, 15 U.S.C. § 77k(a) (2009).

⁵⁵ *See id.*; *see also* *Herman & MacLean v. Huddleston*, 459 U.S. 375, 386 n.22 (1983) (noting that lawyers not acting as experts are not proper defendants under section 11).

statement,⁵⁶ which is generally limited to narrow legal concerns such as the issuer's standing as a corporation or the validity of the securities issued.⁵⁷ Under Rule 10b-5, however, anyone—including attorneys—may be liable as a primary violator.⁵⁸

Very few Rule 10b-5 claims against attorneys or law firms reach a decision on the merits, and even fewer have found attorneys liable.⁵⁹ Some cases, though, demonstrate the possibility.⁶⁰ *Stoneridge* did little to abate this potential liability.

While the chances are remote, *Stoneridge* does not preclude corporate lawyers from being primary Rule 10b-5 violators. In *Stoneridge*, neither Motorola nor Scientific-Atlanta did anything that made it necessary or inevitable for Charter to file fraudulent financial statements;⁶¹ therefore, the plaintiffs could show reliance only in an indirect chain that the Court held too remote for liability.⁶² However, most corporate lawyers oftentimes maintain a closer nexus to the fraud. A lawyer is more directly involved with an issuer's public statements than both Motorola and Scientific-Atlanta were with Charter's statements.

⁵⁶ *Escott v. BarChris Constr. Corp.*, 283 F. Supp. 643, 683 (S.D.N.Y. 1968). An entire registration statement is not *expertised* because an attorney prepared it. *See id.* Lawyers are not considered to be experts under section 11. Only those portions an expert made are subject to section 11. *See id.*

⁵⁷ 15 U.S.C. § 77k(b)(3)(C); *see COHN, supra* note 37, at § 21:3 (“Section 11 does apply to tax or other opinions of counsel contained in a registration statement, where counsel consented to be named as an expert with regard to such matters.”).

⁵⁸ 17 C.F.R. § 240.10b-5(a) (2009).

⁵⁹ *COHN, supra* note 37, at 21-29.

⁶⁰ *Id.* at 21-24, 25 (citing *Klein v. Boyd*, No. 95-5410, 1996 WL 675554, *22, *27 (E.D. Pa. Nov. 19, 1996), *vacated on grant of reh'g en banc*, Nos. 97-1143, 97-1261, 1998 WL 55245 (3d Cir. Feb. 12, 1998)) (holding that lawyers commit a primary violation “if they have a significant role in drafting a fraudulent private offering document,” and were reckless or knew of included material misstatements). However, the decision settled without reaching the merits. *Id.* at 21-25; *see also SEC v. Frank*, 388 F.2d 486, 489 (2d Cir. 1968) (citations omitted) (noting a lawyer cannot escape liability for fraud “by closing his eyes to what he saw and could readily understand”); *Andreo v. Friedlander, Gaines, Cohen, Rosenthal & Rosenberg*, 660 F. Supp. 1362, 1366 (D. Conn. 1987) (finding allegations sufficient for a claim of aiding and abetting against an attorney who recklessly drafted documents).

⁶¹ *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 128 S. Ct. 761, 770 (2008).

⁶² *Id.* at 769.

For example, consider the outside lawyers who assisted in structuring special purpose entities (SPEs) used to deceive Enron investors as to the true value of their company.⁶³ Enron shareholders sued the investment banks that helped Enron devise the fraudulent SPEs based on a theory of liability similar to that presented in *Stoneridge*.⁶⁴ The *Stoneridge* Court seemingly left open the possibility that plaintiffs in cases like *In re Enron Corp. Securities, Derivative & "ERISA" Litigation v. Enron Corp.* may prevail because the Court did not explicitly address the issue of what conduct would establish a sufficient causal connection to prove reliance.⁶⁵ Instead, the Court vaguely stated that the defendants in *Stoneridge* did nothing to make it *necessary or inevitable* for Charter to mislead its investors.⁶⁶ This phrase is the closest the Court came to actually articulating a standard. Otherwise, the Court merely concluded the defendants' acts were simply too remote to satisfy reliance.⁶⁷

Under the *necessary or inevitable* standard, a court could conceivably find liability in conduct emulating that of Enron's lawyers. The lawyers and investment bankers hired by Enron had a much closer causal connection to the fraud than did the defendants in *Stoneridge* because they created the actual documents the issuer used to mislead its investors.⁶⁸ The *Stoneridge* Court placed great weight on the fact that the defendants "had no role in preparing or disseminating Charter's financial statements."⁶⁹ In the *Enron* case, though, the lawyers and in-

⁶³ See *Newby v. Enron Corp. (In re Enron Corp. Sec., Derivative & "ERISA" Litig.)*, 439 F. Supp. 2d 692, 696-97 (S.D. Tex. 2006). The plaintiffs alleged that Barclays received various fees for helping Enron structure illicit SPEs, which Enron used to falsify its financial results. See *id.* at 696-98.

⁶⁴ *Id.* at 723 (using the theory of reliance in finding secondary actors as primary violators because they aided and abetted the fraudulent activity).

⁶⁵ See *Stoneridge*, 128 S. Ct. at 770 (noting the Court would "not evaluate the 'in connection with' requirement of [section] 10(b)"); see also Ideoblog: The Future of Scheme Liability, <http://busmovie.typepad.com/ideoblog/2008/01/the-future-of-s.html> (Jan. 27, 2008, 03:27 PM). Ribstein signed the amicus brief filed in *Stoneridge* on behalf of former SEC commissioners.

⁶⁶ *Stoneridge*, 128 S. Ct. at 770.

⁶⁷ *Id.* at 769.

⁶⁸ *Enron Corp.*, 439 F. Supp. 2d at 698-99 (discussing the roles and knowledge of Vinson & Elkins, Enron's law firm, and Barclays Capital, Enron's investment bankers).

⁶⁹ *Stoneridge*, 128 S. Ct. at 767.

vestment bankers did prepare and disseminate the fraudulent documents. Thus, a court may have valid grounds to distinguish *Stoneridge* if plaintiffs could show they actually relied on documents prepared and disseminated to them by the lawyers or investment bankers.

Interestingly, the Supreme Court denied certiorari to the plaintiff's appeal in the *Enron* case,⁷⁰ leaving the reliance issue unanswered. The denial of certiorari is unfortunate because the *Enron* facts provided a much stronger case for the Court to define who can be considered a primary violator under Rule 10b-5. Some scholars argue, nonetheless, that the certiorari denial effectively precludes outside counsel from being considered primary violators because the denial came just days after *Stoneridge*, which should be interpreted as an exclamation mark to that decision.⁷¹ This viewpoint has practical merit in that lawyers were rarely found to be primary violators of Rule 10b-5 even before *Stoneridge*. Any case that makes it even more difficult may have the effect of bringing those chances from slim to none.⁷² On a theoretical level however, *Stoneridge* did not significantly change anything. If a lawyer willfully drafts fraudulent documents intended for distribution to investors, a court may find the conduct to be a primary violation of Rule 10b-5 and still be consistent with *Stoneridge*. In sum, *Stoneridge* does not provide the broad safety net for lawyers that many critics claim.

⁷⁰ *Regents of the Univ. of Cal. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 128 S. Ct. 1120 (2008).

⁷¹ See, e.g., Posting of Lyle Denniston to SCOTUSblog, <http://www.scotusblog.com/wp/court-bars-new-look-at-enron-case/> (Jan. 22, 2008, 10:04 AM); Posting of James Oliphant to The Swamp, http://www.swamppolitics.com/news/politics/blog/2008/01/printer-supreme_court_wont_hear_enron.html (Jan. 22, 2008, 11:22 AM).

⁷² See COHN, *supra* note 37, at 21-22 (explaining that, in general, lawyers do not owe primary duties under 10b-5 to non-clients, as they are not obligated to disclose information to prospective investors).

III. THE CRITICS ARE WRONG—ADDITIONAL LIABILITY ON CORPORATE LAWYERS IS UNNECESSARY AND COUNTERPRODUCTIVE

A. *Existing Legal and Ethical Enforcement Measures Are Already Sufficient*

Despite the continued threat of private Rule 10b-5 actions, corporate lawyers still face the myriad of other mechanisms enforcing their legal and ethical duties. As the *Stoneridge* Court highlighted, secondary actors may still be subject to stiff criminal and civil penalties, sued by shareholders under state common law fraud, and subject to state regulators seeking restitution and other penalties.⁷³ Together, the SEC and DOJ have broad enforcement power to impose large civil and criminal penalties on primary securities law violators⁷⁴ and those who aid and abet them.⁷⁵

These governmental agencies perform these tasks vigorously. In 2007 the SEC initiated 776 investigations, 262 civil actions, and 394 administrative proceedings involving financial fraud, abusive backdating of stock options, insider trading, violations by broker-dealers, and fraud related to mutual funds.⁷⁶ Since 2003 the SEC has won approximately \$13.8 billion in disgorgement and penalties against securities law violators.⁷⁷ Even prior to *Stoneridge*, the SEC exercised its authority to pursue Motorola and Scientific-Atlanta for aiding and abetting securities law violations.⁷⁸ The SEC recovered \$20 million in disgorgement from Scientific-Atlanta for entering transactions with a third party that were almost identical to the transactions entered with Charter,⁷⁹ and

⁷³ *Stoneridge*, 128 S. Ct. at 773; *see, e.g.*, DEL. CODE ANN. tit. 6, § 7325(b) (2009).

⁷⁴ *See, e.g.*, 15 U.S.C. § 78u-1 (2009).

⁷⁵ *See, e.g.*, 18 U.S.C. § 2 (2009).

⁷⁶ U.S. SEC. & EXCH. COMM'N, 2007 PERFORMANCE AND ACCOUNTABILITY REPORT 25, available at <http://sec.gov/about/secpar/secpar2007.pdf>.

⁷⁷ *Id.*

⁷⁸ Brief of the Securities Industry and Financial Markets Ass'n and Futures Industry Ass'n as Amici Curiae in Support of Respondents at 26-27, *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 128 S. Ct. 761 (2008) (No. 06-43), 2007 WL 2363256 [hereinafter Brief of the Securities Industry] (citing *Scientific-Atlanta, Inc., SEC Litig. Release No. 19735* (Jun. 22, 2006), available at www.sec.gov/litigation/litreleases/2006/lr19735.htm).

⁷⁹ *Id.* at 27.

recovered \$25 million in civil penalties from Motorola for the same conduct.⁸⁰

The DOJ pursues securities fraud violations with equal ardor. As of mid-2007 the DOJ's Corporate Fraud Task Force obtained 1236 corporate fraud convictions since its inception in 2002.⁸¹ Apart from the legal ramifications of a securities law conviction, the reputational and professional injury can be equally as damaging. After just one obstruction of justice conviction, which the Supreme Court later reversed, Arthur Andersen LLP shut down and terminated most of its 28,000 United States and 85,000 worldwide employees.⁸² To avoid a similar result, KPMG agreed to pay a \$456 million penalty to avoid criminal convictions relating to its tax shelter practice.⁸³ No one considering aiding and abetting a securities law violation can ignore these examples. In a case with facts similar to *Stoneridge*, AOL Time Warner Inc. agreed to pay \$210 million in restitution and penalties for aiding and abetting charges stemming from sham transactions the counterparty, PurchasePro, used to inflate its reported revenue.⁸⁴ In fact, four Charter officers faced fourteen counts of mail fraud, wire fraud, conspiracy to commit those crimes, and aiding and abetting those crimes.⁸⁵ The of-

⁸⁰ *Id.* (citing *In re Motorola, Inc.*, SEC Exchange Act Release No. 55725 at 7 (May 8, 2007), available at <http://www.sec.gov/litigation/admin/2007/34-55725.pdf>).

⁸¹ Brief of the Washington Legal Foundation as Amicus Curiae in Support of Respondents at 15-16, *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 128 S. Ct. 761 (2008) (No. 06-43), 2007 WL 2363255 [hereinafter Brief of the Washington Legal Foundation] (citing U.S. DEP'T OF JUSTICE, FACT SHEET: PRESIDENT'S CORPORATE FRAUD TASK FORCE MARKS FIVE YEARS OF ENSURING CORPORATE INTEGRITY (2007), available at http://www.usdoj.gov/opa/pr/2007/July/07_odag_507.html).

⁸² Brief of the Securities Industry, *supra* note 78, at 22-23 (citing Jonathan D. Glater, *Last Task at Andersen: Turning Out the Lights*, N.Y. TIMES, Aug. 30, 2002, at C3); see also *Arthur Andersen LLP v. United States*, 544 U.S. 696, 708 (2005) (reversing Arthur Andersen's obstruction of justice conviction on a technicality).

⁸³ Brief of the Securities Industry, *supra* note 78, at 24 (citing David Reilly, *Narrow Escape: How a Chastened KPMG Got by Tax-Shelter Crisis—Boss of Just Three Days Admitted Firm's Sins, Fought to Keep Clients*, WALL ST. J., Feb. 15, 2007, at A1).

⁸⁴ *Id.* (citing Press Release, U.S. Dep't of Justice, *America Online Charged with Aiding and Abetting Securities Fraud; Prosecution Deferred for Two Years* (Dec. 15, 2004), available at http://www.usdoj.gov/opa/pr/2004/December/04_crm_790.htm).

⁸⁵ *Id.* at 24-25 (citing 18 U.S.C. § 1341 (2007)).

ficers pled guilty and collectively faced twenty-six months of prison time and \$775,000 in personal fines.⁸⁶

A federal investigation may focus on corporate attorneys to the same extent as it focuses on primary executives. In December 2007 federal prosecutors indicted Joseph Collins, a corporate lawyer, for fraud in connection with legal work performed for a client, Refco Inc.⁸⁷ Collins, a partner from Mayer Brown LLP, a prominent law firm, documented “round trip loans between related entities and outside investors that Refco completed to shift bad debt off its books.”⁸⁸ The SEC also filed a civil complaint against Collins for aiding and abetting Refco’s securities fraud.⁸⁹ While federal authorities do not commonly charge a lawyer in connection with a client’s wrongdoing, the Refco case should serve as a stark reminder to corporate counsel that their actions are well within the purview of SEC and DOJ enforcement.

Securities lawyers must also abide by specific SEC rules enforcing their ethical obligations. Section 307 of the Sarbanes-Oxley Act instructs the SEC to promulgate rules prescribing the required steps securities lawyers must take if they discover that their clients are violating federal or state securities laws.⁹⁰ These rules apply not only to lawyers who represent an issuer of securities and who practice before the SEC, but even lawyers who merely offer advice about a document that will be filed with the SEC.⁹¹ This includes almost any corporate transactional attorney. These new rules subject securities lawyers to discipline by the SEC, including civil penalties and the loss of privilege to appear or practice before the agency.⁹²

⁸⁶ *Id.* (citing *United States v. Barford*, No. 4:03 CR 434 CEJ, 2004 WL 5645086 (E.D. Mo. Apr. 23, 2005)).

⁸⁷ Posting of Nathan Koppel to The Wall Street Journal Law Blog, <http://blogs.wsj.com/law/2007/12/18/mayer-brown-lawyer-indicted-in-connection-with-refco/> (Dec. 18, 2007, 01:24 EST).

⁸⁸ *Id.*

⁸⁹ *Id.*; see also Complaint, SEC v. Collins, *filed*, No. 07CV-11343 (S.D.N.Y. Dec. 18, 2007), available at <http://sec.gov/litigation/complaints/2007/comp20402.pdf>.32.

⁹⁰ Sarbanes-Oxley Act of 2002 § 307, 15 U.S.C. § 7245 (2009).

⁹¹ 17 C.F.R. § 205.6(a)-(b) (2009).

⁹² *Id.* § 205.6.

These additional remedies demonstrate that much of the negative criticism surrounding *Stoneridge* is largely without merit. Despite the lamenting by critics such as Senator Dodd, *Stoneridge* does not provide immunity to participants of corporate fraud. Instead, *Stoneridge* leaves the enforcement of corporate lawyers' ethical and legal obligations to mechanisms more appropriate than private 10b-5 lawsuits. These enforcement devices remain in full force to sanction lawyers for aiding and abetting client fraud. The SEC and DOJ have proven their willingness to pursue lawyers, and any and all state remedies remain readily available.

B. The Dissent Would Have Subjected Corporate Lawyers to Unnecessary and Unfounded Lawsuits

As a normative matter, the *Stoneridge* Court properly held that secondary actors, such as corporate lawyers, may not be held liable in a private 10b-5 suit if the investors did not rely more directly on their statements or actions.⁹³ If the *Stoneridge* Court found for the plaintiffs, then corporate lawyers would certainly become the latest target in shareholder class action lawsuits. If the Supreme Court found that investors relied on third party vendors because the issuer's stock price reflected those transactions (an argument proffered by the plaintiffs),⁹⁴ then lower courts would likely find the reliance element satisfied when lawyers are directly involved in advising companies that commit securities fraud. The nexus between the lawyer and the issuer in that situation is even closer than the nexus between Charter's fraud and the *Stoneridge* defendant. Fortunately for corporate lawyers, the Court held otherwise.⁹⁵ As the amicus curiae brief filed by the Attorneys' Liability Assurance Society, Inc. correctly argues, lawyers would have been dragged into shareholder class actions and be forced to defend themselves at substantial expense for simply carrying out their role as a client advisor.⁹⁶ The *Stoneridge* Court agreed that the practical consequences of expanding liability in this context provided another

⁹³ See *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 128 S. Ct. 761, 769 (2008).

⁹⁴ *Id.* at 770.

⁹⁵ See *id.* at 773-74.

⁹⁶ See Brief for Attorneys' Liability Assurance Society, Inc. as Amicus Curiae in Support of Respondents at 26, *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta*,

reason to find for the defendants.⁹⁷ The Court feared that the settlement extortion caused by plaintiffs with weak claims would spread to a new class of defendants, in this case attorneys, investment bankers, and accountants.⁹⁸ The Supreme Court in 2007 noted the threat of expensive discovery pushes defendants to settle anemic claims.⁹⁹ This recognized problem would only have been exacerbated had the *Stoneridge* dissent been the majority.

Fortunately, the Court's opinion heeded its own caution in *Central Bank* and other precedent to avoid nebulous standards in an "area that demands certainty and predictability."¹⁰⁰ The Court's earlier cases warned against decisions that have little predictive value to advisors in the securities field and would serve only to deter counselors from offering securities advice.¹⁰¹ Specifically, the Court has expressed concern that newer and smaller companies would have difficulty obtaining securities advice because professionals may fear that new and small companies have a greater chance of failing, and thus an increased chance of being sued by investors.¹⁰² *Stoneridge* correctly adhered to its precedent and properly resisted the urge to return to a pre-*Central Bank* standard of liability that left lawyers confused and vulnerable to settlement extortion by creative complaint drafting.¹⁰³

Furthermore, increased litigation costs would increase malpractice insurance premiums, which would chill any lawyer's willingness to

Inc., 128 S. Ct. 761 (2008) (No. 06-43), 2007 WL 2363261 [hereinafter Brief for Attorneys' Liability Assurance Society].

⁹⁷ *Stoneridge*, 128 S. Ct. at 772.

⁹⁸ *Id.* (citing *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 733 (1975)); see also *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 313-14 (2007).

⁹⁹ See *Bell Atl. Corp. v. Twombly*, 550 U.S. 544, 559 (2007).

¹⁰⁰ *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 188 (1994) ("[T]he rules for determining aiding and abetting liability are unclear, in 'an area that demands certainty and predictability.'" (quoting *Pinter v. Dahl*, 486 U.S. 622, 652 (1988)); see also *Blue Chip Stamps*, 421 U.S. at 755 (finding that "such a shifting and highly fact-oriented disposition of the issue of who may bring a damages claim for violation of Rule 10b-5" is not "a satisfactory basis for a rule of liability imposed on the conduct of business transactions").

¹⁰¹ *Cent. Bank*, 511 U.S. at 189 (citing *Va. Bankshares, Inc. v. Sandberg*, 501 U.S. 1083, 1106 (1991)).

¹⁰² *Id.*

¹⁰³ See Brief for Attorneys' Liability Assurance Society, *supra* note 96, at 19-20.

act as a securities counselor. The crisis in the medical field elucidates the severity of allowing baseless litigation to proceed.¹⁰⁴ In a 2003 report, the United States Department of Health and Human Services concluded that the “excesses of the litigation system raise the cost of health care for everyone, threaten Americans’ access to care, and impede efforts to improve the quality of care.”¹⁰⁵ Many doctors, hospitals, and nursing homes faced real difficulty in obtaining malpractice insurance because the premiums increased so dramatically in the last several years.¹⁰⁶ The result is that more patients struggle to obtain access to doctors and other forms of health care because health professionals do not want to be subject to personal liability.¹⁰⁷ Had *Stoneridge* been decided in favor of the plaintiffs, securities lawyers would suddenly face the same threat to their livelihood that doctors now face—unaffordable insurance premiums stemming from increased litigation. The end result would be fewer securities lawyers, which in turn could result in poorer legal advice to companies. Ironically, those companies most in need of first-rate advice, which are those facing a more imminent threat of litigation, would be the least likely to get it.

C. Had the Plaintiffs Prevailed, Stoneridge Would Have Detrimentially Altered the Lawyer-Client Relationship

Some may argue, perhaps with merit, that the world of corporate transactional lawyering fosters a Wild Wild West, anything-goes mentality because sanctions and lawsuits are so few and far between.¹⁰⁸ Critics argue that the alternative enforcement mechanisms discussed above are seldom used, and therefore private 10b-5 suits should be allowed to proceed against anyone participating in the fraud.¹⁰⁹ This

¹⁰⁴ See OFFICE OF THE ASSISTANT SEC’Y FOR PLANNING & EVALUATION, U.S. DEP’T OF HEALTH AND HUMAN SERVS., ADDRESSING THE NEW HEALTH CARE CRISIS: REFORMING THE MEDICAL LITIGATION SYSTEM TO IMPROVE THE QUALITY OF HEALTH CARE (2003), available at <http://aspe.hhs.gov/daltcp/reports/medliab.htm#sectionI>.

¹⁰⁵ *Id.* at 2.

¹⁰⁶ See *id.* at 3-4.

¹⁰⁷ *Id.* at 2-3.

¹⁰⁸ See Koniak, *supra* note 8 at 195-96 (“Lawyers can [roam in a law-free zone] with virtually no risk. There is no real prospect of criminal prosecutions, SEC enforcement actions or discipline, or state bar sanctions.”).

¹⁰⁹ See generally Brief for Petitioner at 19-20, *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 128 S. Ct. 761 (2008) (No. 06-43), 2007 WL 1701941.

viewpoint contends that naming lawyers as defendants in shareholder class actions would deter lawyers from providing advice clients could use to engage in legally dubious activity.¹¹⁰

Lawyers would certainly alter their behavior, but coercing them to do so in this manner ignores a lawyer's proper role in relation to corporate clients. The role of the lawyer is to "exercise independent professional judgment and render candid advice" to the client.¹¹¹ Part of that candid advice requires the lawyer to provide options to the client, especially to clients in the corporate world who are capable of making sophisticated decisions and calculations of risk—including legal risk.¹¹² For example, most companies hire corporate tax attorneys to construct a plan that minimizes tax payments. Seldom would a sophisticated tax attorney for a large corporation provide just one option and assert "This is the best we can do," and leave it at that. Instead, multiple tax attorneys generally confer with other corporate planning specialists and devise a menu of options, each with its own risks—legal, financial, and otherwise. Some of those options may pass IRS legal scrutiny one hundred percent of the time, but some may pass only eighty or ninety percent of the time. These options simply have different levels of legal risk, and the client has a right to be aware of its options. More importantly, the client makes the final decision.¹¹³ The client decides how much legal risk it is willing to assume. That should not be the lawyer's role.

Of course, a lawyer should not present options with a ninety-nine percent likelihood of incurring liability. Offering such advice could subject a lawyer to criminal sanctions. As an example, Raymond Ruble, a former tax partner at a prominent law firm, faced criminal liability for offering legally dubious tax shelters to clients.¹¹⁴ But lawyers must have some level of flexibility to provide a range of options to a client that the lawyer reasonably believes is legal. The world of tax and

¹¹⁰ See *id.* at 35-36 (stating immunity from liability would serve as an incentive for lawyers or business partners to provide false documents for customers or clients).

¹¹¹ MODEL RULES OF PROF'L CONDUCT R. 2.1 (2009).

¹¹² See *id.*

¹¹³ MODEL RULES OF PROF'L CONDUCT R. 1.2(a) (2009).

¹¹⁴ Lynnley Browning, *Guilty Plea Seen Aiding Tax Shelter Prosecution*, N.Y. TIMES, Sept. 11, 2007, at C1.

securities law is complex and uncertain. For instance, a corporate lawyer may never be certain whether a client must disclose a legal proceeding that may or may not be considered material.¹¹⁵ If lawyers suddenly faced additional liability from private 10b-5 suits from a client's shareholders, corporate lawyers would begin to shift their focus from representing the client's interest to protecting their own.¹¹⁶ The lawyer deciding on the materiality of a client's legal proceeding would conclude that disclosure is necessary—not because the client's interest requires it, but rather, because the lawyer's self-interest demands it.¹¹⁷ Lawyers would become overcautious from their own fear of being named a defendant when the client's shareholders bring a lawsuit.¹¹⁸ The end result would be less-informed decision making by the client.

Had *Stoneridge* gone the other way, corporate lawyers would now assume an additional burden to examine not only its own corporate client, but also the companies with which the client deals in the ordinary course of its business. Motorola dealt routinely as a supplier to Charter, and under the plaintiffs' argument, the lawyers for Motorola should have delved not just into the business affairs of Charter, but also into the work of Charter's own accountants and lawyers.¹¹⁹ Given the egregious conduct engaged in by these two companies, that requirement does not seem overly burdensome and unreasonable. But consider a typical law-abiding corporate client that steers clear from fraudulent activity. A corporation would suddenly call upon its lawyers to determine whether a counterparty—i.e., a customer or supplier of that company—intends to or could conceivably use the transaction to mislead its own investors.¹²⁰ The client's lawyers would have to scrutinize the counterparty

¹¹⁵ See generally Brief for Attorneys' Liability Assurance Society, *supra* note 96, at 17-18 ("Securities lawyers regularly deal with complex issues and are often called upon to assess and advise clients based on factual information that is incomplete or in flux Since disclosures are often complex, it will always be possible, with hindsight, to allege that important information was omitted").

¹¹⁶ See *id.* at 22.

¹¹⁷ *Id.* at 25.

¹¹⁸ *Id.*

¹¹⁹ Brief for Richard I. Beattie, Kenneth J. Bialkin, Arthur Fleischer, Jr., Joseph H. Flom, Ira M. Millstein, Jack H. Nusbaum and E. Norman Veasey as Amici Curiae Supporting Respondents at 29, *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 128 S. Ct. 761 (2008) (No. 06-43), 2007 WL 2363253.

¹²⁰ *Id.*

and the work of its advisors to ensure its own client is not incidentally part of some scheme to defraud the counterparty's investors.¹²¹ Transactional lawyers have neither the expertise nor the ability to independently assess whether the counterparty's accounting treatment is in accordance with GAAP and other applicable regulations.¹²² The role of the corporate client's lawyer is not, nor should it be, to join a counterparty's disclosure deliberations in order to protect the client from litigation exposure for a decision neither the client nor the lawyer had any ability to control. No lawyer would be willing to assume that risk.

D. The Stoneridge Shareholders Were Inadvertently Seeking to Harm Their Own Interests

Even if regulation of lawyers in the context of advising companies is too lax, using *Stoneridge* to solve the issue would have been a Pyrrhic victory. Enforcement of lawyers would become stricter, but the shareholders would ultimately realize costs greater than any benefits. A client would have a diminished ability to decide corporate strategy because potential liability would deter lawyers from providing all available options. Had the *Stoneridge* dissent carried the day, the shareholders of companies would be the enforcers of these more stringent standards by bringing private 10b-5 suits against corporate lawyers. But those same shareholders would own shares in a company that would be ill advised on all available wealth-maximizing options. The fear of liability would chill lawyers' willingness to offer thorough corporate planning and tax advice. In the end, potential value would go unrealized. Those same shareholders ultimately stand to lose the most.

IV. THE *STONERIDGE* DECISION PRODUCED AN EFFICIENT OUTCOME

A. The Stoneridge Decision Was Appropriate Under a Cost-Benefit Analysis

Even if a lawyer knowingly gave advice that was part of a scheme to defraud shareholders, the marginal benefit gained from bring-

¹²¹ *Id.* at 29-30.

¹²² *Id.* at 29.

ing a private 10b-5 suit would not exceed the overall marginal costs. One marginal benefit would be additional compensation for shareholders harmed by fraud, but even that would be de minimis relative to typical shareholder losses. Unless the shareholders could show that an entire law firm should be liable, the plaintiffs would likely recover only from the individual lawyers who participated in the fraud, or their insurance providers, because most major law firms have limited liability.¹²³ Another benefit may be additional deterrence from engaging in this type of activity, but evidence demonstrates that securities class actions seldom yield such deterrence. John Coffee, a law professor and director of Columbia Law School's Center on Corporate Governance, demonstrated that while securities class actions impose enormous penalties, they achieve little compensation and only limited deterrence.¹²⁴ Professor Coffee highlighted the distinction between who actually gets sued and who actually bears the costs in these securities class action suits.¹²⁵ Shareholders typically name most inside directors and officers as defendants,¹²⁶ but they rarely contribute to the settlement. Instead, the corporate defendant and insurer usually pay the total settlement amount.¹²⁷ One study from the mid-1990s shows that in cases in which shareholders named officers and directors as defendants, liability insurers paid an average of 68.2% of the settlement, and the defendant corporation paid 31.4%.¹²⁸ Thus, individual defendants paid less than 0.4% of the settlement.¹²⁹ There are exceptions to this generalization, but those tend to be under special facts where no deep-pocketed corporation is available to bail out the individuals.¹³⁰ Of the 1754 federal securities class action settlements between 1991 and 2004, one study identified

¹²³ See Sung Hui Kim, *Gatekeepers Inside Out*, 21 GEO. J. LEGAL ETHICS 411, 433 (2008) (noting most large United States firms have reorganized as limited liability partnerships).

¹²⁴ John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and its Implementation*, 106 COLUM. L. REV. 1534, 1535-36 (2006).

¹²⁵ *Id.* at 1549-50.

¹²⁶ *Id.* at 1549; PRICE WATERHOUSE COOPERS LLP, 2008 SECURITIES LITIGATION STUDY 15 (2009), available at <http://10b5.pwc.com/pdf/NY-09-0894%20securities%20lit%20study%20final.pdf>.

¹²⁷ Coffee, *supra* note 124, at 1550.

¹²⁸ *Id.* (citing FREDERICK C. DUNBAR ET AL., NERA, RECENT TRENDS III: WHAT EXPLAINS SETTLEMENTS IN SHAREHOLDER CLASS ACTIONS? 9 (1995)).

¹²⁹ *Id.*; DUNBAR, *supra* note 128, at 9.

¹³⁰ Coffee, *supra* note 124, at 1551.

only thirteen in which outside directors made out-of-pocket payments.¹³¹ Even if one expects directors' and officers' insurance premiums to rise to the appropriate level based on an individual's liability risk, the shareholders bear that increased cost anyway.¹³² Thus, individual directors and officers can largely escape personal liability to shareholders, eviscerating the claim that securities class actions deter insiders from corporate wrongdoing based on monetary disincentives.¹³³ Similarly, most corporate law firms have different forms of insurance and limited liability which protect individual lawyers from being personally liable.¹³⁴ Therefore, allowing private 10b-5 suits against attorneys would provide little additional deterrence against corporate fraud above and beyond the deterrence already provided by the other enforcement mechanisms outlined above.

Additionally, the costs to the shareholders would exceed any benefits. Evidence shows that at least \$24.7 billion in shareholder wealth has been lost due to securities litigation.¹³⁵ Even the mere filing of a securities lawsuit has been shown to decrease the equity value of the defendant corporation.¹³⁶ Litigation against secondary participants declined significantly after the Court's *Central Bank* decision in 1994 and the passing of the Private Securities Litigation Reform Act in 1995.¹³⁷ Had *Stoneridge* gone the other way, the floodgates would once again be opened, and loss to shareholder wealth would be greatly exacerbated. The other cost to shareholders would come in the form of the unrealized potential value stemming from the hindered exchange of legal advice. In the end, the loss to the company would far outweigh any additional monetary or deterrence benefits.

¹³¹ *Id.* (citing Bernard Black et al., *Outside Director Liability*, 58 STAN. L. REV. 1055, 1063-64, 1068 (2006)).

¹³² *Id.* at 1553.

¹³³ *Id.* at 1548, 1550-51.

¹³⁴ *See id.* at 1550-51.

¹³⁵ Brief of the Washington Legal Foundation, *supra* note 81, at 14 (citing ANJAN V. THAKOR, THE UNINTENDED CONSEQUENCES OF SECURITIES LITIGATION 14 (2005), available at http://www.heartland.org/custom/semmod_policybot/pdf/18330.pdf).

¹³⁶ *Id.*; *see* THAKOR, *supra* note 135, at 4-5.

¹³⁷ Coffee, *supra* note 124, at 1550.

B. The Stoneridge Decision Produced a Pareto Efficient Outcome

1. Pareto Efficiency and the Coase Theorem

The above cost-benefit analysis concludes that *Stoneridge* produced a more efficient outcome for shareholders if efficiency is defined as the point at which the benefits most exceed the costs.¹³⁸ However, efficiency can be defined in many other ways. Under other efficiency analyses, though, the *Stoneridge* holding still proves to be the most efficient outcome. For example, Pareto efficiency is a popular way to examine whether an outcome is efficient, and using the Pareto analysis would yield the same result.¹³⁹ “Pareto superiority is the principle that one allocation of resources is superior to another if at least one person is better off under the first allocation than under the second and no one is worse off.”¹⁴⁰ Put otherwise, a Pareto efficient position is reached when one party cannot be made better without making another party worse.¹⁴¹

The Coase Theorem provides a useful mechanism to determine whether *Stoneridge* reached a Pareto efficient outcome. The Coase Theorem proffers that in a world absent transactions costs,¹⁴² the parties will always bargain their way to an economically efficient outcome, regardless of the legal rule.¹⁴³ Thus, if we assume efficiency is defined here as Pareto efficiency, then the Coase Theorem suggests the parties under the *Stoneridge* facts would have bargained an outcome where one party’s position cannot be improved upon without detrimentally affecting another’s. However, bargaining by the parties is practically impos-

¹³⁸ For a thorough explanation as to why efficiency is desirable, see Richard A. Posner, *The Ethical and Political Basis of the Efficiency Norm in Common Law Adjudication*, 8 HOFSTRA L. REV. 487 (1980).

¹³⁹ See *id.* at 488.

¹⁴⁰ *Id.*

¹⁴¹ *Id.*

¹⁴² Scholars debate the exact definition of a transaction cost, but it generally refers to measurable costs of entering into a transaction. Daniel A. Farber, *Parody Lost/ Pragmatism Regained: The Ironic History of the Coase Theorem*, 83 VA. L. REV. 397, 405 (1997). A transaction cost could include perfect information, or even a party truly knowing what it wants. Some law and economics professors argue that one of the most important transaction costs is the “limited power of human decision makers.” STEPHEN M. BAINBRIDGE, CORPORATION LAW AND ECONOMICS §1.4 (2002).

¹⁴³ Farber, *supra* note 142, at 404-05 (citing R.H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1, 15 (1960)).

sible in this context. Therefore, the corollary to the Coase Theorem provides a more practical approach in determining the Pareto efficient outcome. The corollary inquires into what the bargaining parties would have wanted had they been able to freely negotiate without transaction costs. This question yields the Pareto efficient outcome by approximating what the parties would have bargained for.

To answer that question, the hypothetical bargaining parties must first be identified. Obviously, third party vendors such as Motorola and Scientific-Atlanta would be on one side of the table, and an issuer's shareholders would be on the other. But should anyone else, such as the primary issuer or even the third party's shareholders, be considered a party to this contract? The answer is uncertain because every constituency could conceivably be considered a valid party. Because the implications of the *Stoneridge* decision could be so far reaching, affecting the economy as a whole, every constituent involved could reasonably be considered a party. To narrow the focus, however, assume that one party represents all third party law firms involved in advising corporate clients and the other party represents the shareholders of the primary issuer.

2. Striking the Perfect Bargain

Several methods could be employed to determine what the two parties would bargain for. For one, an empirical survey could ask the parties what they would want, but this would yield poor results. The third party law firms would say they want no liability, and the shareholders would say they want the ability to sue everybody involved in the scheme. Not only would those answers be unhelpful, they do not accurately reflect what the parties truly want—a weakness some economists consider a transaction cost. Transaction costs “refer to measurable costs of entering into transactions,” which some academics believe could even include one party truly knowing what they want.¹⁴⁴ Professor Stephen Bainbridge, a vanguard in law and economics philosophy, aptly noted that one of the most important transaction costs is the “limited power of human decision makers,” which results in bounded ration-

¹⁴⁴ See Farber, *supra* note 142, at 405.

ality.¹⁴⁵ Because of this bounded rationality transaction cost in the empirical study, the study is useless in determining what the parties would have bargained for in the absence of transaction costs.

The transaction cost inherent in the empirical study is that neither party truly knows what it wants. Shareholders may think they want the ability to sue third parties, but in truth what they ultimately seek is to maximize their own wealth. They would mistakenly believe that having the ability to sue third parties will provide a means to that end. As the discussion above illustrates, the ability to sue third parties would ultimately have a deleterious effect on their own stock price. Investment bankers would shy away from conducting business with issuers, and lawyers would be too guarded in their advice to offer the proper range of choices that would enable the company to maximize its own value.¹⁴⁶ At the same time, lawyers and other third parties do not necessarily want to be free from all legal and ethical enforcement. Such an anarchic system would endanger their very livelihood. Poor or unethical advice to companies could lead them to take even greater legal and financial risks than companies already do, which could lead to increased legal action against them. The rise in legal action would yield more bankruptcies, and in the end, less jobs for corporate lawyers. Outside lawyers largely contributed to the Enron collapse,¹⁴⁷ thus it would not be surprising if those same lawyers lost the large bill-paying clients they once had.

Therefore, to determine what the parties would have wanted, the best approach is simply to ask what a reasonable person in their situation would want. A reasonable shareholder most likely is interested primarily in wealth maximization. Of course, some shareholders invest based upon other goals—such as social concerns for proper labor prac-

¹⁴⁵ See BAINBRIDGE, *supra* note 142. However, there is no consensus among law and economic scholars as to whether bounded rationality should be considered a transaction cost.

¹⁴⁶ See *supra* Part III.C-D and accompanying text.

¹⁴⁷ Dan Ackman, *Enron's Lawyers: Eyes Wide Shut?*, FORBES.COM, Jan. 28, 2002, <http://www.forbes.com/2002/01/28/0128veenron.html>; John C. Roper, *Vinson & Elkins Settles With Enron for \$30 Million*, CHRON.COM, June 2, 2006, <http://www.chron.com/disp/story.mpl/special/enron/3921779.html>.

tices or environmental protection.¹⁴⁸ However, socially responsible investing makes up only a small fraction of the aggregate investment market.¹⁴⁹ Most investments are made for the purpose of maximizing a financial return. To achieve those ends in this context, shareholders do not want the ability to sue lawyers, but rather, they want fraudulent behavior to stop because it lowers their economic return.

For lawyers and other third parties, the ultimate goal, to a large extent, is also wealth maximization. Lawyers are in the business of providing a service to clients, for which they expect to be paid. There are differences, however, between an anonymous shareholder investing in a diversified portfolio with many different assets and a lawyer whose career is practicing corporate law. The lawyer may have other goals, such as the prestige that comes along with representing certain clients or the satisfaction derived from cultivating a fruitful career. Regardless of the goal, the avenue to achieving that goal is the same—the lawyer needs clients. Without clients to pay the bills, lawyers would not be able to sustain a practice and would achieve none of their ultimate goals.

Thus, in the *Stoneridge* context, lawyers want the freedom and flexibility to practice their livelihood in a manner that allows them to offer legal advice without excessive liability or placing too great a strain on their ability to act as corporate counsel. Lawyers do not want to be free from all regulation because that could lead to bankrupt clients. Instead, they want an appropriate level of regulation that balances their ability to practice law with the continued sustainability of clients.

¹⁴⁸ See John M. Conley & Cynthia A. Williams, *Engage, Embed, and Embellish: Theory Versus Practice in the Corporate Social Responsibility Movement*, 31 J. CORP. L. 1, 21 (2006); Jason M. Loring & C. Keith Taylor, *Shareholder Activism: Directorial Responses to Investors' Attempts to Change the Corporate Governance Landscape*, 41 WAKE FOREST L. REV. 321, 321 (2006).

¹⁴⁹ Even under the most generous accounting reported by the Social Investment Forum, only eleven percent of the total assets under management in the United States are involved in socially responsible investing. The rest, presumably, are driven entirely by maximizing financial returns. Press Release, Social Investment Forum, Report: Socially Responsible Investing Assets In U.S. Surged 18 Percent From 2005 To 2007, Outpacing Broader Managed Assets (Mar. 5, 2008), <http://www.socialinvest.org/news/releases/pressrelease.cfm?id=108>.

Therefore, the appropriate bargain struck between the two parties is a result that stops fraud, allows companies to operate in a manner that maximizes wealth, and allows lawyers and other third parties to work with corporate clients without excessive regulation. The *Stoneridge* decision reached that result. The Court relegated enforcement of third parties to the SEC, DOJ, state regulators, and other forms of common law redress.¹⁵⁰ The current available enforcement mechanisms have the ability to stop fraud, thus the shareholders achieved one of their bargaining objectives. The restriction on private 10b-5 suits against third parties retains the status quo, which prevents unnecessary and overly burdensome lawyer regulation. The current level of third party liability allows lawyers to retain flexibility in providing their corporate clients with options, and also provides companies a necessary degree of flexibility to maximize shareholder wealth. That flexibility grants both the third party lawyers and the shareholders their ultimate bargaining goals.

V. CONCLUSION

Whether or not one believes the way in which lawyers advise their clients needs to change, litigation by shareholders is not the optimal solution. The costs are great and the benefits minimal. The best solution is to strengthen the enforcement mechanisms already in place. The recent example of Joseph Collins, the corporate lawyer indicted for aiding and abetting Refco's fraud, is an encouraging sign that the federal authorities are cracking down on the dubious casualness that defines many lawyer-executive relationships.¹⁵¹ But prosecution of lawyers is rare, and it is noteworthy that not one outside lawyer or law firm involved in the Enron collapse was charged. However, the SEC's post-*Enron* rules governing corporate lawyers' conduct provide additional regulation proscribing corporate lawyers' malfeasance.¹⁵² To be effective, these regulations need to be enforced. Thus, greater enforcement of clear, precise laws is the only plausible solution here. Adding another layer of liability governed by a murky standard would do nothing but bring more harm than good. The *Stoneridge* Court made a con-

¹⁵⁰ See *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 128 S. Ct. 761, 773 (2008).

¹⁵¹ See *supra* notes 87-89.

¹⁵² 17 C.F.R. § 240.10b-5 (2009).

certed effort to highlight the SEC's recent enforcement activity to demonstrate that proper deterrence of lawyers' participation in fraud rests with the federal authorities. The Court seemed to be encouraging the agency to bolster enforcement efforts. The SEC would be foolhardy to ignore the Supreme Court's call of duty.