Fordham Law Review

Volume 76 | Issue 1 Article 10

2007

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Recommended Citation

Mark S. Pincus, *Circuit Split or a Matter of Semantics? The Supreme Court's Upcoming Decision on Rule 10b-5 "Scheme Liability" and Its Implications for Tax Shelter Fraud Litigation*, 76 Fordham L. Rev. 423 (2007).
Available at: https://ir.lawnet.fordham.edu/flr/vol76/iss1/10

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Cover Page Footnote

J.D. Candidate, Fordham University School of Law, 2008; A.B., Cornell University, 2005. I would like to thank Blair Fensterstock, Maureen McGuirl, and Professor Jill Fisch for their guidance during the Note-writing process.

This article is available in Fordham Law Review: https://ir.lawnet.fordham.edu/flr/vol76/iss1/10

CIRCUIT SPLIT OR A MATTER OF SEMANTICS? THE SUPREME COURT'S UPCOMING DECISION ON RULE 10b-5 "SCHEME LIABILITY" AND ITS IMPLICATIONS FOR TAX SHELTER FRAUD LITIGATION

*Mark S. Pincus**

After Internal Revenue Service investigations exposed widespread fraud among tax shelter promoters, angry investors sued for securities fraud under Securities and Exchange Commission Rule 10b-5, which provides a cause of action against "primary violators" of the Rule but not against mere "aiders and abettors." This controversial distinction is further complicated by the recent introduction of "scheme liability" lawsuits under two previously obscure provisions of Rule 10b-5. This Note examines the circuit split over the "primary violator"/"aider and abettor" distinction in scheme liability claims, arguing that the circuits' conflicting concepts of scheme liability actually cover similar conduct, and that tax shelter promoters likely will be considered primary violators under either concept.

INTRODUCTION

During the economic boom of the mid- to late 1990s, tax shelters became a popular investment option for wealthy individuals.[1] Designed, marketed, and implemented by groups of elite accountants, lawyers, bankers, and financial advisors,[2] these tax shelters were promoted as legal methods for reducing one's tax liability.[3] By the close of the decade, tax shelters had grown into a lucrative and profitable industry, garnering millions of dollars in fees for the professionals involved.[4]

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* J.D. Candidate, Fordham University School of Law, 2008; A.B., Cornell University, 2005. I would like to thank Blair Fensterstock, Maureen McGuirl, and Professor Jill Fisch for their guidance during the Note-writing process.

1. Tanina Rostain, *Sheltering Lawyers: The Organized Tax Bar and the Tax Shelter Industry*, 23 Yale J. on Reg. 77, 78 (2006).

2. *See* Comm. on Homeland Sec. & Gov't Affairs, The Role of Professional Firms in the U.S. Tax Shelter Industry, S. Rep. No. 109-54, at 9 (2005); *see also infra* notes 65–69 and accompanying text.

3. *See infra* notes 82–83 and accompanying text.

4. *See* S. Rep. No. 109-54, at 9.

In the early 2000s, however, the federal government increased its scrutiny of the tax shelter industry.[5] Investigations by the Internal Revenue Service (IRS)[6] and the United States Senate[7] revealed that many of these tax shelters were elaborate fraudulent schemes, built on greed, deception, and gross violations of professional ethics.[8] During these investigations, the IRS audited many tax shelter investors, invalidating the tax savings the investors had declared from their participation in the shelters.[9] The investors, who had already paid high fees to set up and implement the shelters, now owed back taxes, interest on back taxes, and penalties to the IRS.[10]

Investors soon began filing lawsuits alleging that the tax shelters were fraudulent enterprises under the Racketeer Influenced and Corrupt Organizations Act (RICO).[11] According to the investors' lawsuits, each professional involved in the design, marketing, and implementation of the tax shelters had committed fraudulent acts in furtherance of an overarching fraudulent scheme.[12] The courts, however, almost categorically dismissed the investors' RICO claims, citing a 1995 act of Congress that bars plaintiffs from basing RICO claims on conduct actionable as securities fraud under section 10(b) of the Securities Exchange Act of 1934 and its companion, Securities and Exchange Commission (SEC) Rule 10b-5.[13]

There remains some doubt as to which parties involved in a fraudulent scheme may be held liable for securities fraud under Rule 10b-5. In the 1994 case of *Central Bank of Denver v. First Interstate Bank of Denver*,[14] the Supreme Court recognized a private cause of action against "primary violators" of Rule 10b-5, but not against those who merely aid and abet such Rule 10b-5 violations.[15] Since *Central Bank*, the courts have disagreed about how to distinguish primary violators from "aiders and abettors" under Rule 10b-5.[16]

Although Rule 10b-5 has three provisions,[17] early interpretations of *Central Bank* tended to focus exclusively on Rule 10b-5(b)'s prohibition of

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5. *See infra* notes 97–100 and accompanying text.
6. *See* Joel V. Williamson et al., *Litigating Transfer Pricing Cases and Tax-Advantaged Transactions*, 688 PLI/Tax 951, 1057 (2005); *see also infra* notes 97–100.
7. *See generally* S. Rep. No. 109-54.
8. *See infra* notes 105–34 and accompanying text.
9. *See infra* notes 99–106 and accompanying text.
10. *See infra* notes 105–06 and accompanying text.
11. 18 U.S.C. §§ 1961–68 (2000); *see infra* note 135 and accompanying text.
12. *See infra* notes 107–10 and accompanying text.
13. *See infra* Part I.B.
14. 511 U.S. 164 (1994).
15. *Id.* at 177; *see infra* notes 196–202 and accompanying text.
16. *See infra* Parts I.C.2, II.A–B.
17. Rule 10b-5(a) prohibits "any device, scheme, or artifice to defraud"; Rule 10b-5(b) prohibits material misstatements or omissions; and Rule 10b-5(c) prohibits "any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person." SEC Rule 10b-5, 17 C.F.R. § 240.10b-5 (2006).

material misstatements and omissions.[18] The 2002 case of *In re Enron Corp. Securities, Derivative & ERISA Litigation*,[19] however, sparked new interest in the little-used Rules 10b-5(a) and 10b-5(c).[20]

Since *Enron*, securities fraud plaintiffs have begun filing separate claims under Rules 10b-5(a) and 10b-5(c), which scholars collectively have referred to as "scheme liability" claims.[21] This emerging theory of scheme liability, which has been called the "new battleground in securities fraud litigation,"[22] raises new questions about the scope of primary liability under Rule 10b-5. Circuit courts addressing the issue have adopted two opposing views on how to distinguish between primary violations and mere "aiding and abetting" under Rules 10b-5(a) and (c).[23] The U.S. Courts of Appeals for the Fifth and Eighth Circuits have adopted a narrow view of scheme liability,[24] while the U.S. Court of Appeals for the Ninth Circuit has adopted a broad view.[25] In March 2007, the U.S. Supreme Court granted certiorari on the Eighth Circuit's decision, which will be argued as *Stoneridge Investment Partners v. Scientific-Atlanta, Inc.*,[26] during the Court's October 2007 Term.[27] The *Stoneridge* case is likely to resolve the circuit split,[28] which may have implications for tax shelter plaintiffs seeking to bring claims under Rules 10b-5(a) and (c).

Part I of this Note discusses the history of tax shelters and litigation arising from them, as well as the evolution of Rule 10b-5 jurisprudence since *Central Bank.* Part II of this Note examines the circuit split as to the dividing line between primary and "aiding and abetting" liability under Rules 10b-5(a) and (c). Part III of this Note argues that, despite differences in language, both views employ similar concepts of primary liability, and tax shelter promoters are likely to be held as primary violators under either view. Part III discusses how to reconcile scheme liability claims under 10b-5(a) and (c) with the more traditional "misrepresentation or omission" liability under Rule 10b-5(b).

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18. *See infra* Part I.C.2.

19. 235 F. Supp. 2d 549, 589 n.31 (S.D. Tex. 2002).

20. *See* Nicholas Fortune Schanbaum, Note, *Scheme Liability: Rule 10b-5(a) and Secondary Actor Liability After* Central Bank, 26 Rev. Litig. 183, 207 (2007).

21. *See generally* Gregory A. Markel & Gregory G. Ballard, *The Evolution of "Scheme" Liability Under Section 10(b)*, 1571 PLI/Corp 991 (2006); Matthew L. Mustokoff, *"Scheme" Liability Under Rule 10b-5: The New Battleground in Securities Fraud Litigation*, Fed. Law., June 2006, at 20.

22. Mustokoff, *supra* note 21, at 20.

23. *See infra* Part II.

24. *See infra* Part II.A.

25. *See infra* Part II.B.

26. 127 S. Ct. 1873 (2007).

27. A list of cases to be argued during the October 2007 term appears on the U.S. Supreme Court's website at http://www.supremecourtus.gov/orders/07grantednotedlist.pdf.

28. Sarah S. Gold & Richard L. Spinogatti, *§ 10(b) Secondary Actor Liability: High Court to Resolve*, N.Y.L.J., Apr. 11, 2007, at 3.

I. TAX SHELTERS, RICO, AND SECURITIES FRAUD

Part I discusses the history of tax shelter litigation and the evolution of securities fraud jurisprudence since the Supreme Court decided *Central Bank* in 1994. Part I.A charts the rise of the tax shelter industry in the 1990s, outlines the methods that tax shelter promoters used to market the shelters, and discusses the lawsuits filed by investors after IRS and Senate investigations revealed that many tax shelters were fraudulent schemes. Part I.B shows why plaintiffs' RICO claims failed in tax shelter cases, leaving Rule 10b-5 securities fraud claims as a tax shelter plaintiff's primary federal remedy. Part I.C discusses the Supreme Court's holding in *Central Bank* that only primary violators may be held liable under Rule 10b-5 and the lower federal courts' subsequent disagreement about the meaning of this holding.

A. *Tax Shelters: A History and Background*

Stated most simply, a tax shelter is an investment that capitalizes on loopholes or ambiguities in the tax code,[29] allowing investors to reduce the amount of income tax they owe to the government.[30] Because tax shelters deprive the government of potential tax revenue,[31] their position within the American legal landscape is precarious. Although taxpayers may lawfully structure their affairs to minimize their income tax liability,[32] outright abuse of the tax code is prohibited.[33] As tax shelters appear in a variety of forms, no single standard exists to determine whether a specific tax shelter is legitimate or abusive.[34] Instead, the courts must look to a series of statutes, judicial doctrines, and IRS publications for guidance.[35]

Generally, a legitimate investment involves the investment of money to generate income.[36] The law does not permit investments created for the sole or primary purpose of avoiding taxes.[37] Rather, a legitimate

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29. *See* Rostain, *supra* note 1, at 78.

30. *See* Comm. on Homeland Sec. & Gov't Affairs, The Role of Professional Firms in the U.S. Tax Shelter Industry, S. Rep. No. 109-54, at 1 (2005).

31. Rostain, *supra* note 1, at 78 (noting that tax shelters "have cost the federal government tens of billions in lost tax revenue dollars").

32. Judge Learned Hand famously wrote that "[a]ny one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes." Helvering v. Gregory, 69 F.2d 809, 810 (2d Cir. 1934).

33. *See* S. Rep. No. 109-54, at 1.

34. The diversity of tax shelter investments makes it difficult to determine whether a tax shelter is abusive beyond the "I know it when I see it" approach used by Justice Potter Stewart to define obscenity in Jacobellis v. Ohio, 378 U.S. 184, 197 (1964) (Stewart, J., concurring). *See* James S. Eustice, *Abusive Corporate Tax Shelters: Old "Brine" in New Bottles*, 55 Tax L. Rev. 135, 154 (2002).

35. S. Rep. No. 109-54, at 1.

36. *See* Internal Revenue Service, Frequently Asked Tax Questions and Answers: Other (Alternative Minimum Tax, Estates, Trusts, Tax Shelters, State Tax Inquiries), http://www.irs.gov/faqs/faq16.html (last visited Aug. 20, 2007).

37. *Id; see also* S. Rep. No. 109-54, at 1.

investment must exist for a "commercial or industrial purpose[ ]" other than avoiding taxation[38] and must be "likely to produce economic benefits aside from a tax deduction."[39] An easy example of a legitimate investment is stock in General Motors, which exists for the "commercial or industrial purpose" of manufacturing automobiles and is likely to appreciate in value and pay dividends if the company earns profit.

Legitimate tax shelters, which have potential to generate income and offer tax savings in proportion to the amount risked by the investor, often involve tax benefits "clearly sanctioned by the tax laws" and "enacted expressly as incentives for particular activities."[40] If a tax shelter, however, has little or no potential to generate income and offers tax savings that are disproportionately greater than the amount of money risked by the investor, the IRS likely will deem it abusive.[41]

Once the IRS has detected an abusive tax shelter, it often will challenge the shelter's validity in court and take administrative action to prevent the shelter's further use. The IRS also maintains a list of tax shelters it has deemed to be potentially abusive.[42] Taxpayers who participate in these "listed transactions" may be subject to audit and held liable for back taxes, interest on the back taxes, and IRS penalties for participating in an illegal tax shelter.[43]

1. The Rise of an Industry: Tax Shelters Become a Lucrative Business in the 1990s

Tax shelters are not a new phenomenon. Since the creation of the federal income tax in 1913, taxpayers have sought ways to capitalize on loopholes and ambiguities in federal tax law.[44] Tax shelter investments date back to at least the 1930s.[45] During the 1970s and early 1980s, financial advisors with knowledge of the tax code grew wealthy by creating custom-designed investment strategies for high-income and middle-income individuals

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38. Comm'r v. Transp. Trading & Terminal Corp., 176 F.2d 570, 572 (2d Cir. 1949). This concept is commonly known as the "business purpose" doctrine. S. Rep. No. 109-54, at 4.

39. Bail Bonds by Marvin Nelson, Inc. v. Comm'r, 820 F.2d 1543, 1549 (9th Cir. 1987). This concept is commonly known as the "economic substance" doctrine. S. Rep. No. 109-54, at 4.

40. Michael J. Graetz & Deborah H. Schenck, Federal Income Taxation: Principles and Policies 387 (4th ed. 2001). Some examples of legally sanctioned tax shelters are real estate investments and investments in oil exploration ventures. *See id.*

41. *See* Rostain, *supra* note 1, at 84; *see also* Internal Revenue Service, *supra* note 36.

42. The most current version lists thirty abusive tax shelters. *See generally* I.R.S. Notice 2004-67, 2004-2 C.B. 600.

43. S. Rep. No. 109-54, at 1.

44. Sheldon D. Pollack & Jay A. Soled, *Tax Professionals Behaving Badly*, 105 Tax Notes 201, 201 (2004).

45. *See* Donald L. Korb, *Shelters, Schemes and Abusive Transactions: Why Today's Thoughtful U.S. Tax Advisors Should Tell Their Clients to "Just Say No,"* 707 PLI/Tax 9, 15–16 (2006).

seeking to reduce their taxes.[46] In 1986, however, Congress reformed the tax code, closing many loopholes and eliminating most of the tax shelters that existed at the time.[47]

Favorable economic and regulatory conditions in the mid- to late 1990s provided a fertile climate for the resurgence of tax shelters. In the prospering economy, many individuals and corporations realized large capital gains from sales of stock or real estate, facing high tax bills as a result.[48] Also at that time, there was only a slight chance that "the IRS would detect that a highly complex financial transaction [was] a tax shelter."[49] During the 1990s, the understaffed IRS lacked adequate resources for enforcement, sharply decreasing the chance that taxpayers would be audited.[50] In addition, taxpayers were not required to disclose tax shelter participation on their tax returns, further diminishing the chance of detection.[51]

Even in the event of an audit, the IRS's former penalty structure posed little threat to tax shelter investors.[52] The tax code has long provided that tax shelter participants who act in "good faith" and with "reasonable cause" are not subject to penalties.[53] In the 1990s, a tax shelter investor could satisfy this standard merely by showing good faith reliance on an independent tax attorney's heavily researched written opinion[54] concluding that the shelter's tax treatments would "more likely than not"[55] withstand an IRS challenge in court.[56]

Against this opportune backdrop, tax experts developed a new generation of tax shelters. Taking advantage of ambiguities in the tax code, experts

46. *Id.* at 16. For more details on the substance of the shelters used in the 1970s and 1980s, see *id.* at 16–20.

47. *Id.* at 22.

48. *See, e.g.*, Stechler v. Sidley, Austin Brown & Wood, L.L.P., 382 F. Supp. 2d 580, 584 (S.D.N.Y. 2005) (plaintiff realized "large capital gains from the sale of certain stock holdings"); Seippel v. Jenkens & Gilchrist, P.C., 341 F. Supp. 2d 363, 369 (S.D.N.Y. 2004) (plaintiff "sold his stock and realized a large gain").

49. Rostain, *supra* note 1, at 87.

50. *Id.* In the late 1990s, the typical time frame between the filing of a corporate tax return and an IRS audit was five years. *Id.*

51. *Id.* at 87–88. In 2004, Congress amended the Internal Revenue Code to impose penalties for failure to report tax shelter participation. The new provision appears in 26 U.S.C. § 6707A (2004).

52. In 2004 and 2005, Congress amended the Internal Revenue Code, greatly increasing penalties for participation in an abusive tax shelter. The new penalty provisions appear in 26 U.S.C. § 6662A (2005).

53. This requirement is unchanged from 1990s-era versions of the Internal Revenue Code. The statutory language currently appears in 26 U.S.C. § 6664(c)(1) (2006).

54. Marvin A. Chirelstein & Lawrence A. Zelenak, *Tax Shelters and the Search for a Silver Bullet*, 105 Colum. L. Rev. 1939, 1941 (2005).

55. "More likely than not" is generally interpreted to mean that the tax shelter has at least a fifty-one-percent chance of holding up in court. *See id.* Some tax attorneys also issue "should" level opinion letters, which represent a higher level of confidence than "more likely than not" opinions. *See id.* at 1941 n.5.

56. Rostain, *supra* note 1, at 87.

discovered ways to generate large artificial capital losses[57] through a series of "complex, orchestrated [securities] transactions."[58] Investors in entities that performed these transactions could declare these losses on their tax returns, offsetting their capital gains for the year and reducing their taxable income.[59]

These new tax shelters possessed unprecedented potential for growth into a lucrative and profitable industry. Unlike the custom-designed tax shelters of the 1970s and 1980s, which were based on individualized tax advice,[60] the new shelters were prefabricated strategies that could be replicated for multiple clients.[61] Bearing closer resemblance to a generic product than individualized tax advice, the new tax shelters lent themselves well to mass marketing.[62] Also, successful implementation of these tax shelters required the cooperation of skilled professionals,[63] all of whom could charge the investor high fees for their services.[64]

Sensing the potential for financial gain, groups of major players in the fields of accounting,[65] law,[66] banking,[67] and financial advice[68] quickly

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57. Artificial capital losses are "noneconomic losses . . . which are available as deductions under present tax laws." Austin v. Loftsgaarden, 675 F.2d 168, 183 (8th Cir. 1982) (internal citations omitted). In essence, tax law allows the taxpayer to declare a loss on his tax return, even though the taxpayer did not actually experience an economic loss.

58. Comm. on Homeland Sec. & Gov't Affairs, The Role of Professional Firms in the U.S. Tax Shelter Industry, S. Rep. No. 109-54, at 9 (2005). A substantive understanding of the methods used by these tax shelters to generate losses is not necessary for this Note. The IRS has provided further details on the substance of these tax shelters, enumerating the current "listed transactions" and providing cross-references to specific IRS notices with detailed descriptions of these tax shelters. *See* I.R.S. Notice 2004-67, 2004-2 C.B. 600. To date, most published tax shelter cases have involved the "COBRA" tax shelter allegedly developed and marketed by Ernst & Young, Jenkens & Gilchrist, Brown & Wood, and Deutsche Bank. For a description of this shelter, see Seippel v. Jenkens & Gilchrist, P.C., 341 F. Supp. 2d 363, 367 n.4 (S.D.N.Y. 2004).

59. *See Seippel*, 341 F. Supp. 2d at 370 (stating that the plaintiff's tax returns used the shelter's losses to "offset and reduce [plaintiffs'] tax liability").

60. *See* Korb, *supra* note 45, at 23 ("Rather than providing tax planning advice to individual clients based on their particular circumstances, these transactions were developed in a way that made them easy to replicate and promote to a variety of clients and non-clients alike.").

61. *See* S. Rep. No. 109-54, at 9 ("[T]he industry focus has expanded to developing a steady supply of generic 'tax products' that can be aggressively marketed to multiple clients.").

62. *Id.*

63. *Id.* at 5 ("These tax shelters required close collaboration between accounting firms, law firms, investment advisory firms, and banks.").

64. *See id.* at 70.

65. The accounting firms included KPMG and Ernst & Young. *See id.* at 6.

66. The law firms included Brown & Wood (later Sidley Austin Brown & Wood). *See id.* at 11. Jenkens & Gilchrist also was actively involved in the tax shelter business. *See* Seippel v. Jenkens & Gilchrist, P.C., 341 F. Supp. 2d 363, 369 (S.D.N.Y. 2004).

67. The investment banks included Deutsche Bank and UBS. *See* S. Rep. No. 109-54, at 11.

68. The financial advisors included Presidio Advisory Services and Quadra Advisors. *See id.*

moved to the forefront of the developing industry.[69] Through the cooperative efforts of these professionals, the tax shelter industry rapidly grew into an efficient and profitable business focused on creating, implementing, and mass marketing generic tax products.[70] Although individual professionals had varying roles in tax shelter enterprises, this Note collectively refers to all parties involved in the design, marketing, and/or implementation of tax shelters as "promoters."

2. The Hustle: Marketing and Implementing Tax Shelters

Once a group of promoters had designed a shelter and devised its methods for generating artificial capital losses, the marketing and implementation of the tax shelter generally followed a common pattern. Whereas earlier tax shelters depended on "persons who initiate[d] contact with a tax advisor,"[71] the new tax shelter promoters affirmatively sought out investors.[72] In the drive for potential participants, tax shelter promoters actively targeted their own clients[73] and networked to obtain referrals from among other professionals' wealthy client bases.[74] The most aggressive tax shelter promoters even resorted to contacting potential investors through unsolicited telephone calls.[75]

Among the key targets of tax shelter marketing were wealthy individuals[76] facing high tax liabilities from large recent capital gains.[77] These individuals often were introduced to tax shelters by promoters with whom they had an existing fiduciary relationship.[78] Such fiduciary promoters capitalized on the knowledge that the individuals planned to realize,[79] or had already realized, large capital gains.[80] The promoters then

69. *See* Rostain, *supra* note 1, at 78 ("Elite professionals played a prominent role in the emergence of this market. Large accounting firms, investment banks, and corporate law firms all became involved, designing and marketing hundreds of highly lucrative shelters.").

70. *See* S. Rep. No. 109-54, at 9.

71. *Id.*

72. *See* Pollack & Soled, *supra* note 44, at 204.

73. *Id.*

74. *Id.*

75. S. Rep. No. 109-54, at 34. These unsolicited phone calls often are referred to as "cold calls." *Id.*

76. *See, e.g.*, King v. Deutsche Bank AG, No. CV 04-1029-HU, 2005 WL 611954, at *2 (D. Or. Mar. 6, 2005) (stating that "defendants allegedly recruited the other defendants to assist them in locating wealthy clients"). Tax shelter promoters also targeted corporations for participation in tax shelters. *See* S. Rep. No. 109-54, at 1. This Note, however, focuses on tax shelters promoted to individuals and the resulting lawsuits.

77. Pollack & Soled, *supra* note 44, at 204.

78. *See, e.g.*, Heller v. Deutsche Bank AG, No. Civ.A. 04-CV-3571, 2005 WL 525401, at *6 (E.D. Pa. Mar. 3, 2005) (indicating that plaintiffs' "longtime accountants" introduced them to the tax shelter); Seippel v. Jenkens & Gilchrist, P.C., 341 F. Supp. 2d 363, 368 (S.D.N.Y. 2004) (indicating that plaintiff was introduced to the tax shelter by his accountant).

79. *See supra* note 78 and accompanying text.

80. *See King*, 2005 WL 611954, at *20.

informed their clients about the tax shelters and set up meetings and telephone conferences with other promoters.[81]

Potential tax shelter investors generally were subject to similar sales proposals. Through a series of meetings, multiple promoters assured the potential investors that the tax shelter was a legitimate investment[82] and that its tax benefits were likely to hold up in court if challenged by the IRS.[83] These promoters promised independent opinion letters from experienced large-firm tax attorneys certifying the legality of the tax shelter.[84] The promoters assured the potential investor that, in the event of an audit, the opinion letters provided sufficient protection against IRS-imposed penalties.[85] Convinced by elite professionals that the tax shelters were legal investments, many wealthy individuals chose to participate.[86] Participation made economic sense, as the investors' tax liabilities often dwarfed the fees and costs associated with implementing a tax shelter.[87]

Once the investor agreed to participate, the promoters would begin implementing the shelter. Although their precise methods for generating losses varied, most of these tax shelters were structured in a similar manner. First, the investor would invest in a series of corporate, partnership, and/or limited liability entities, which had been set up by the promoters.[88] Then, a promoter (usually an investment banker or a financial advisor)[89] would engage in a series of complex, orchestrated securities

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81. *See, e.g.*, *Heller*, 2005 WL 525401, at *6 (indicating that accountant-promoter set up meetings between plaintiff and other lawyer-promoters and banker-promoters); Stechler v. Sidley, Austin Brown & Wood, L.L.P., 382 F. Supp. 2d 580, 584 (S.D.N.Y. 2005) (indicating that plaintiff's "long-term accountant" set up meetings with financial advisor-promoter to "discuss tax shelters").

82. "Legitimate" implies that the investment had a reasonable ability to generate profits. *See supra* notes 39–40 and accompanying text; *see, e.g.*, *Seippel*, 341 F. Supp. 2d at 367 (noting that promoters represented investment as "legitimate").

83. *See Stechler*, 382 F. Supp. 2d at 583 (stating that promoters assured plaintiff that the tax shelter strategy "would more than likely pass IRS scrutiny if [plaintiff] were ever audited").

84. *See, e.g.*, *id.* at 584 (noting that promoter promised letter from Brown & Wood); *Seippel*, 341 F. Supp. 2d at 369 (noting that promoter promised letters from Brown & Wood and Jenkens & Gilchrist).

85. *See id.*

86. *See generally* Heller v. Deutsche Bank AG, No. Civ.A. 04-CV-3571, 2005 WL 525401 (E.D. Pa. Mar. 3, 2005); King v. Deutsche Bank AG, No. CV 04-1029-HU, 2005 WL 611954 (D. Or. Mar. 8, 2005); *Stechler*, 382 F. Supp. 2d 580; Blythe v. Deutsche Bank AG, 399 F. Supp. 2d 274 (S.D.N.Y. 2005); RA Investments I, LLC v. Deutsche Bank AG, No. Civ.A.3:04-CV-1565-G, 2005 WL 1356446 (N.D. Tex. June 6, 2005); Swartz v. KPMG, LLC, 401 F. Supp. 2d 1146 (W.D. Wash. 2004); Jacoboni v. KPMG LLP, 314 F. Supp. 2d 1172 (M.D. Fla. 2004); *Seippel*, 341 F. Supp. 2d 363; Loftin v. KPMG LLP, No. 02-81166-CIV, 2003 WL 22225621 (S.D. Fla. Sept. 10, 2003).

87. *See* Rostain, *supra* note 1, at 86.

88. *See, e.g.*, *RA Investments*, 2005 WL 1356446, at *1 (partnerships and corporations); *Seippel*, 341 F. Supp. 2d at 369 (partnerships, corporations, and limited liability companies).

89. *See, e.g.*, *Stechler*, 382 F. Supp. 2d at 584 (indicating that DGI, a financial advisor, conducted the transactions); *Swartz*, 401 F. Supp. 2d at 1149 (indicating that Presidio, a financial advisor, conducted the transactions); *Seippel*, 341 F. Supp. 2d at 369 (indicating that Deutsche Bank, an investment banker, conducted the transactions).

transactions on behalf of the entities.[90] These transactions, which often involved foreign or tax-exempt parties,[91] generated large artificial capital losses.[92] Generally, the opinion letters were delivered a few months after the transactions were conducted.[93] An accountant-promoter would then prepare the investor's tax returns, using the artificial losses generated by the tax shelter to offset the investor's capital gains.[94]

In addition to the money invested in the shelter, tax shelter investors paid large fees to promoters for setting up the necessary business entities, conducting the transactions necessary to generate the artificial capital losses, and preparing tax returns reflecting losses generated by the tax shelter.[95] The investors also paid fees to the attorneys for the opinion letters certifying the tax shelter's legality.[96]

3. The Backlash: Angry Investors File Suit Against Tax Shelter Promoters After IRS Audits

By 2000, the federal government had begun to scrutinize the new crop of tax shelters, strongly increasing its enforcement efforts against abusive tax shelter arrangements. The IRS formed the Office of Tax Shelter Analysis (OTSA) to monitor tax shelter activity[97] and began publishing lists of potentially abusive transactions.[98] The IRS also increased the number of taxpayer audits[99] and investigations of tax shelter promoters.[100] As revealed through IRS investigations and a Senate probe of major promoters,[101] the tax shelter industry's transgressions stretched beyond mere abuse of the tax code.[102] During the industry's rapid transformation into big business, promoters often disregarded professional ethics and

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90. *See* Comm. on Homeland Sec. & Gov't Affairs, The Role of Professional Firms in the U.S. Tax Shelter Industry, S. Rep. No. 109-54, at 10 (2005).

91. *See* Korb, *supra* note 45, at 23.

92. *See, e.g.*, *Seippel*, 341 F. Supp. 2d at 369 (noting that the tax shelter generated $12 million in artificial losses for plaintiff).

93. *See, e.g.*, *id.* at 369–70; Loftin v. KPMG LLP, No. 02-81166-CIV, 2003 WL 22225621, at *2 (S.D. Fla. Sept. 10, 2003).

94. *See, e.g.*, *Stechler*, 382 F. Supp. 2d at 585–86.

95. *Id.* at 584–86.

96. *See, e.g.*, *Seippel*, 341 F. Supp. 2d at 370.

97. Williamson, *supra* note 6, at 1056.

98. *See* I.R.S. Notice 2000-44, 2000-2 C.B. 255. The most recent abusive transaction list appears as I.R.S. Notice 2004-67, 2004-2 C.B. 600.

99. Williamson, *supra* note 6, at 1060.

100. *Id.* at 1057.

101. Beginning in October 2002, the U.S. Senate Permanent Subcommittee on Investigations of the Committee on Governmental Affairs began an investigation into the development, marketing, and implementation of tax shelters. The Subcommittee, which probed such major tax shelter promoters as KPMG, Ernst & Young, Sidley Austin Brown & Wood, and Deutsche Bank, conducted hearings in November 2003 and published a formal report of its findings in February 2005. *See* Comm. on Homeland Sec. & Gov't Affairs, The Role of Professional Firms in the U.S. Tax Shelter Industry, S. Rep. No. 109-54, at 1–2 (2005).

102. *See infra* notes 104–34 and accompanying text.

breached their fiduciary duties by committing fraud against their own clients.[103]

The most unfortunate casualties of the government's crackdown on abusive tax shelters were the investors. Relying on misinformation, tax shelter investors participated in abusive tax shelters believing they had found a legal way to save money.[104] After the IRS invalidated the shelters' tax benefits, investors found themselves in a worse financial position than if they had never gotten involved. In addition to the high fees they had paid to tax shelter promoters,[105] investors owed the government back taxes, interest on back taxes, and IRS-imposed penalties.[106]

As the IRS intensified its scrutiny of tax shelters, an increasing number of investors filed suit,[107] alleging that the tax shelters were well-orchestrated fraudulent schemes.[108] In these lawsuits, plaintiff-investors allege that the promoters had worked together to design, market, and implement tax shelter investments with knowledge that the IRS likely would declare the shelters abusive and disregard their tax benefits.[109] According to plaintiff-investors, each tax shelter promoter played an assigned role in advancing the tax shelter scheme through fraudulent misstatements, omissions, and acts.[110]

The lawsuits allege that tax shelter promoters fraudulently misrepresented the shelters as legitimate investments with reasonable potential to generate profits[111] and tax benefits likely to withstand an IRS challenge.[112] According to plaintiffs, some promoters even continued marketing tax shelters similar to those that had already been listed by the IRS as potentially abusive.[113] The most aggressive promoters allegedly even represented the investments as "no-lose"[114] or "conservative."[115]

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103. *See id.*

104. *See supra* note 86 and accompanying text.

105. *See, e.g.*, RA Investments I, LLC v. Deutsche Bank AG, No. Civ.A.3:04-CV-1565-G, 2005 WL 1356446, at *3 (N.D. Tex. June 6, 2005) (noting that plaintiffs "paid substantial amounts of money in fees to the defendants").

106. *See id.*

107. *See* Williamson, *supra* note 6, at 1060.

108. *See, e.g.*, *RA Investments*, 2005 WL 1356446, at *3 (indicating that plaintiffs allege that tax shelter "constituted a scheme to defraud them").

109. *See, e.g.*, Seippel v. Jenkens & Gilchrist, P.C., 341 F. Supp. 2d 363, 368 (S.D.N.Y. 2004) (noting that plaintiffs alleged that "defendants either knew or should have known from the outset that the [tax shelter] would not pass muster with the IRS").

110. *See id.* at 367 (indicating that plaintiffs alleged that defendants "entered into an alliance to operate, market, and promote these tax shelters").

111. *See, e.g.*, *RA Investments*, 2005 WL 1356446, at *3 (noting that defendants concealed that the investment underlying the tax shelter scheme "had no reasonable possibility of a profit").

112. *See, e.g.*, Stechler v. Sidley, Austin Brown & Wood, L.L.P., 382 F. Supp. 2d 580, 583 (S.D.N.Y. 2005) (noting that defendant assured that the tax shelter "would more than likely pass IRS scrutiny," a representation that defendants allegedly "knew or should have known was false").

113. *See, e.g.*, King v. Deutsche Bank AG, No. CV 04-1029-HU, 2005 WL 611954, at *3 (D. Or. Mar. 6, 2005) ("[D]efendants continued to promote the [tax shelter] strategy after

The lawsuits further claim that tax shelter promoters misrepresented the roles of the lawyers.[116] In their sales proposals, promoters purportedly represented that plaintiffs would receive independent attorneys' opinion letters certifying the shelters' legality, which would protect plaintiffs from IRS penalties in the event of an audit.[117] Plaintiffs assert that, in truth, the attorneys who issued opinions were also promoters who helped design the shelters.[118] As the IRS generally disregards opinion letters furnished by interested parties, these legal opinions likely provided no protection to investors.[119] Some tax shelter promoters even forbade investors from seeking review from outside lawyers or accountants, asserting that the tax shelters were "proprietary" and therefore confidential.[120]

The lawsuits also allege that promoters committed fraudulent acts while implementing the shelters. According to plaintiffs, lawyer-promoters issued legal opinions knowing that their lack of independence likely rendered the opinions invalid[121] and the underlying shelters were unlikely to withstand an IRS challenge.[122] Moreover, the lawsuits claim that the accountants, bankers, and financial advisors set up corporate, partnership, and limited liability entities expressly for use in an abusive tax shelter scheme and conducted transactions that were expressly intended to generate artificial losses for use in the scheme.[123] Additionally, plaintiffs allege that the accountants knowingly prepared tax returns reflecting losses generated by a potentially abusive tax shelter.[124]

Notice 2000-44 was issued, even though at least [one of the] defendants had internally concluded that the Notice raised serious concerns.").

114. Jacoboni v. KPMG LLP, 314 F. Supp. 2d 1172, 1174 (M.D. Fla. 2004).

115. *Seippel*, 341 F. Supp. 2d at 369.

116. *See infra* notes 117–20.

117. *Seippel*, 341 F. Supp. 2d at 369 (stating that the promoter allegedly represented that the opinion letter "would serve as a protection against the imposition of tax penalties").

118. *See, e.g.*, *RA Investments*, 2005 WL 1356446, at *3 (noting that law firm provided allegedly independent legal advice, but failed to disclose that it devised the tax shelter strategy).

119. The law abates penalties for tax shelter participants who rely on legal opinions under the "assumption that the lawyer will engage in disinterested and diligent efforts to ascertain her client's legal obligations." Rostain, *supra* note 1, at 93. A "tax opinion letter provided by a person with a financial stake in the tax product being analyzed has traditionally been accorded much less deference than an opinion letter supplied by a disinterested expert." Comm. on Homeland Sec. & Gov't Affairs, The Role of Professional Firms in the U.S. Tax Shelter Industry, S. Rep. No. 109-54, at 47 (2005).

120. *Seippel*, 341 F. Supp. 2d at 368.

121. *See id.* (discussing plaintiffs' allegations that the lawyer-promoters knew that their "undisclosed role in marketing and promoting the shelters both compromised their objectivity and 'presented a risk that the [tax authorities] would and could claim that the opinion letters . . . would not shield them from the assessment of penalties'").

122. *See id.* (discussing plaintiffs' allegations that "defendants either knew or should have known from the outset that the [tax shelter] would not pass muster with the IRS").

123. *See, e.g.*, Stechler v. Sidley, Austin Brown & Wood, L.L.P., 382 F. Supp. 2d 580, 584–85 (S.D.N.Y. 2005).

124. *See, e.g.*, *id.* at 585–86.

Furthermore, promoters allegedly charged excessive fees for their services, often in violation of their professional ethics.[125] According to plaintiffs, lawyer-promoters charged excessive fees for "canned"[126] legal opinions that required little effort to produce.[127] Once an attorney had drafted an opinion letter for a specific tax shelter, the original letter was used as a template.[128] Opinion letters for subsequent investors usually were identical to the template except for the client's name and contained no new facts or analysis.[129] Often, the attorney did not even consult with the client before drafting the opinion letter.[130] This practice likely runs afoul of the American Bar Association's Rules of Professional Conduct, which cite "the time and labor required, the novelty and difficulty of the questions involved, and the skill requisite to perform the legal service properly" as relevant factors in deciding how much to charge for legal services.[131] Accountant-promoters often enacted contingency fee arrangements that were "fixed at a percentage of a client's anticipated tax savings,"[132] a practice contrary to the American Institute of Certified Public Accountants' Code of Professional Ethics[133] and heavily limited by a number of state and federal regulations.[134]

B. *The Failure of RICO Claims in Tax Shelter Lawsuits*

In addition to state law claims for fraud, malpractice, and breach of fiduciary duty, plaintiffs initially alleged that the promoters had operated a fraudulent enterprise in violation of RICO.[135] RICO, enacted by Congress in 1970 to combat organized crime,[136] allows private plaintiffs injured by a

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125. *See* Code of Prof'l Ethics R. 302(2) (Am. Inst. of Certified Pub. Accountants 2006) (providing that an accountant shall not "[p]repare an original or amended tax return or claim for a tax refund for a contingent fee for any client"); Model Rules of Prof'l Conduct R. 1.5 (2002) ("A lawyer shall not make an agreement for, charge, or collect an unreasonable fee.").

126. *Seippel*, 341 F. Supp. 2d at 367.

127. *See id.*

128. Comm. on Homeland Sec. & Gov't Affairs, The Role of Professional Firms in the U.S. Tax Shelter Industry, S. Rep. No. 109-54, at 106 (2005).

129. *Id.*

130. *Id.*

131. Model Rules of Prof'l Conduct R. 1.5 (2002).

132. Rostain, *supra* note 1, at 90.

133. Code of Prof'l Ethics R. 302(2) (Am. Inst. of Certified Pub. Accountants 2006).

134. *See* Comm. on Homeland Sec. & Gov't Affairs, The Role of Professional Firms in the U.S. Tax Shelter Industry, S. Rep. No. 109-54, at 71 (2005) ("Many states prohibit accounting firms from charging contingent fees due to the improper incentives they create, and a number of SEC, IRS, state, and AICPA rules allow their use in only limited circumstances.").

135. *See infra* Part I.B.1–4. The Racketeer Influenced and Corrupt Organizations Act (RICO) appears at 18 U.S.C. §§ 1961–68 (2000).

136. *See* Daniel Z. Herbst, Note, *Injunctive Relief and Civil RICO: After* Scheidler v. National Organization for Women, Inc., *RICO's Scope and Remedies Require Reevaluation*, 53 Cath. U. L. Rev. 1125, 1130 (2004).

"pattern of racketeering activity"[137] to file civil suits in federal court.[138] To demonstrate a "pattern," a plaintiff must show at least two predicate acts of racketeering activity within a ten-year period.[139] Tax shelter investors generally predicated their RICO claims on mail and wire fraud,[140] alleging that the promoters advanced the fraudulent scheme by communicating fraudulent statements and conducting fraudulent transactions through telephone calls, e-mails, and letters.[141]

Civil RICO actions are especially attractive causes of action for plaintiffs, since RICO entitles successful plaintiffs to treble damages and attorney's fees.[142] In 1995, Congress became concerned that plaintiffs injured by securities fraud were proceeding under RICO to take advantage of its generous damage provisions.[143] Convinced that the law of securities fraud provided adequate protection for plaintiffs and that exposing a securities fraud defendant to treble damages was unfair,[144] Congress passed section 107 of the Private Securities Litigation Reform Act of 1995 (PSLRA).[145] Congress intended this section to remove securities fraud as a predicate act for RICO and to prevent plaintiffs from pleading "other specified offenses, such as mail or wire fraud, as predicate acts under civil RICO if such offenses are based on conduct that would have been actionable as securities fraud."[146] Section 107 amended RICO to provide that "no person may rely upon any conduct that would have been actionable as fraud in the purchase or sale of securities to establish a violation of [RICO]."[147]

The Securities Act of 1933[148] and the Securities Exchange Act of 1934[149] (the Acts) enumerate a list of instruments that are considered "securities" under federal law.[150] The definition encompasses most investment

137. 18 U.S.C. § 1962(a). Black's Law Dictionary defines "racketeering" as "[a] pattern of illegal activity (such as bribery, extortion, fraud, and murder) carried out as part of an enterprise (such as a crime syndicate) that is owned or controlled by those engaged in the illegal activity." Black's Law Dictionary 1286–87 (8th ed. 2004). For a list of violations considered "racketeering" under RICO, see 18 U.S.C. § 1961. The list includes mail fraud, wire fraud, and bank fraud. *Id.*

138. 18 U.S.C. § 1964(c).

139. 18 U.S.C. § 1961(5).

140. *See, e.g.*, Jacoboni v. KPMG LLP, 314 F. Supp. 2d 1172, 1175–76 (M.D. Fla. 2004).

141. *See id.* at 1176.

142. 18 U.S.C. § 1964(c).

143. Todd A. Noteboom & Michael A.G. Korengold, *Nunc Pro Tunc: The Application of the Private Securities Litigation Reform Act of 1995 to Pending Civil RICO Claims Based on Securities Fraud*, 23 Wm. Mitchell L. Rev. 565, 572–73 (1997).

144. H.R. Rep. No. 104-369, at 47 (1995) (Conf. Rep.).

145. Pub. L. No. 104-67, § 107, 109 Stat. 737 (1995) (codified at 18 U.S.C. § 1964(c)).

146. H.R. Rep. No. 104-369, at 47.

147. 18 U.S.C. § 1964(c).

148. *See* 15 U.S.C. § 77b(a)(1) (2006).

149. *See* 15 U.S.C. § 78c(a)(10) (2006).

150. The Supreme Court has held that the definitions of "security" under both acts are "virtually identical." Tcherepnin v. Knight, 389 U.S. 332, 335–36 (1967).

instruments, including stocks, bonds, and options.[151] Under the PSLRA bar, a plaintiff may not plead fraud committed "in [connection] with the purchase or sale of securities" as a predicate offense to a RICO claim.[152]

As the Supreme Court most recently reiterated in *SEC v. Zandford*,[153] the securities laws are meant to be "construed 'not technically and restrictively, but flexibly to effectuate [their] remedial purposes.'"[154] Therefore, the courts generally have interpreted the phrase "in connection with the purchase or sale of securities" broadly.[155] Since *Zandford*, the courts have dismissed RICO claims in any tax shelter case where the tax shelter had some relationship to the sale of securities during its existence.[156]

Courts have held tax shelter fraud to be "in connection with the purchase or sale of securities" when the tax shelters generated artificial losses through securities transactions,[157] when plaintiffs sought to shelter capital gains realized from the sale of securities,[158] and when tax shelter plans required plaintiffs to purchase security interests in entities that performed the artificial loss-generating transactions on plaintiffs' behalf.[159] Courts also have rejected arguments that a plaintiff's RICO claim should be preserved because the promoter's primary objective was "phony tax advice" rather than the sale of securities.[160] Furthermore, courts have rejected the argument that each individual act in furtherance of a tax shelter scheme should be assessed separately under the PLSRA bar.[161]

1. RICO Claims Dismissed Because the Tax Shelter Generated Losses Through the Sale of Securities

Courts have found that an alleged fraudulent tax shelter scheme was "in connection with" the sale of securities in cases where the tax shelter generated losses through the sale of securities. In *Stechler v. Sidley, Austin, Brown & Wood, L.L.P.*,[162] the U.S. District Court for the Southern District of New York held that the alleged fraud was "in connection with" the sale of securities because one of the assets that plaintiff bought and sold to generate artificial losses was common stock, which is listed as a "security" under the Acts.[163] Although plaintiff argued that his RICO claims should

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151. *See* 15 U.S.C. §§ 77b(a)(1), 78c(a)(10).
152. 18 U.S.C. § 1964(c).
153. 535 U.S. 813 (2002).
154. *Id.* at 819 (quoting Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128, 151 (1972)).
155. *See id.*
156. *See infra* Part I.B.1–4.
157. *See infra* Part I.B.1.
158. *See infra* Part I.B.2.
159. *See infra* Part I.B.3.
160. *See infra* Part I.B.4.
161. *See infra* Part I.B.4.
162. 382 F. Supp. 2d 580 (S.D.N.Y. 2005).
163. *Id.* at 598; *see also* RA Investments I, LLC v. Deutsche Bank AG, No. Civ.A. 3:04-CV-1565-G, 2005 WL 1356446, at *8 (N.D. Tex. June 6, 2005) (dismissing plaintiff's RICO

be preserved because the tax shelter could have generated artificial losses with assets other than stock, the *Stechler* court rejected plaintiff's argument, holding that "[a]ll that matters is that the alleged fraud which is actually . . . before the Court *did* involve securities."[164]

2. RICO Claims Dismissed Because Plaintiffs Sought to Shelter Capital Gains Realized from the Sale of Securities

Even if the tax shelters did not generate losses from the sale of securities, a number of courts have found an alleged fraudulent tax shelter scheme to be "in connection with" the sale of securities when the capital gains that plaintiff sought to shelter were realized from the sale of securities. In *Seippel v. Jenkens & Gilchrist, P.C.*,[165] plaintiff's accountant knew that plaintiff was about to leave his job, exercise his stock options, and sell the resulting stock.[166] The accountant proposed a tax shelter that used currency option exchanges to generate artificial capital losses, which plaintiff invested in once he sold stock in his company.[167] In opposing plaintiff's RICO claims, defendants did not raise the issue of whether the currency options were securities.[168] However, defendants argued that the alleged tax shelter fraud was "in connection with" the sale of securities because "there would have been no gain for the [tax shelter] to offset" if plaintiff had not sold stock in his company.[169] In dismissing plaintiff's RICO claim, the court held that plaintiff's sale of his company stock was "integrally related to the fraudulent scheme," since defendants "took advantage of their knowledge of [plaintiff's] planned securities transaction to induce him" to participate in the tax shelter.[170] In *King v. Deutsche Bank AG*,[171] plaintiff attempted to distinguish *Seippel*, arguing that the holding in *Seippel* did not apply to him because the defendants in his case did not approach him about the tax shelter until after he sold his stock.[172] The *King* court rejected plaintiff's argument, holding that in both *Seippel* and *King* "the objective was to avoid paying taxes on gains realized from the sale of stock" and therefore that "[t]he date on which the gains accrued is immaterial."[173]

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claim after determining that the option contracts plaintiffs sold to generate losses for a tax shelter scheme were securities).

164. *Stechler*, 382 F. Supp. 2d at 598.

165. 341 F. Supp. 2d 363 (S.D.N.Y. 2004).

166. *Id.* at 368–69.

167. *Id.* at 369.

168. *See id.* at 372.

169. *Id.* at 373.

170. *Id.* at 374.

171. No. CV-04-1029-HU, 2005 WL 611954 (D. Or. Mar. 8, 2005).

172. *Id.* at *20.

173. *Id.*

3. RICO Claims Dismissed Because the Tax Shelter Required Plaintiff to Purchase Security Interests in Entities That Performed the Loss-Generating Transactions on Plaintiff's Behalf

Recent cases also suggest that courts may find an alleged fraudulent tax shelter scheme to be "in connection with" the sale of securities when plaintiff's involvement in a tax shelter required the purchase of security interests in entities that performed loss-generating transactions on plaintiff's behalf. In *Heller v. Deutsche Bank AG*,[174] defendants argued that the alleged fraud was "in connection with" the sale of securities because the tax shelter required plaintiffs to "form and purchase shares in S corporations in order to participate."[175] Although the court denied defendant's motion to dismiss because a question of fact existed as to whether the shares were truly stock, the court held that defendants were "free to re-argue this point via motion for summary judgment."[176] This implies that the RICO claims would be dismissed if the S corporation shares were truly considered stock, which is a security.[177]

4. Failed Arguments Attempted to Circumvent the PSLRA Bar and Establish RICO Liability in Tax Shelter Cases

Tax shelter plaintiffs have put forth a number of unsuccessful arguments while attempting to circumvent the PSLRA bar. When an alleged tax shelter scheme has involved the sale of securities, courts have dismissed plaintiffs' RICO claims against all defendants, regardless of a defendant's alleged motivations for inducing plaintiff to participate. In *Loftin v. KPMG LLP*,[178] plaintiff argued that his RICO claim against his lawyers should be preserved because the lawyers' "primary objective" in the tax shelter was "not the sale of securities, but the sale of 'phony tax advice.'"[179] The court rejected plaintiff's argument, holding that the tax shelter transactions "consisted of the purchase and sale of securities," and, therefore, the "phony tax advice" given by the lawyers was "in connection with" the sale of securities.[180]

When considering whether an alleged tax shelter scheme is "in connection with" the sale of securities, courts commonly have looked at the entire scheme rather than each individual act within the scheme. Generally, the courts have dismissed RICO claims when at least one act within the

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174. No. Civ.A. 04-CV-3571, 2005 WL 525401 (E.D. Pa. Mar. 3, 2005).

175. *Id.* at *4.

176. *Id.*

177. *See id; see also* Blythe v. Deutsche Bank AG, 399 F. Supp. 2d 274, 281 (S.D.N.Y. 2005) ("[A]s in *Heller*, the complaint here does not provide enough information to determine whether the S corporation 'stocks' at issue constitute 'securities' . . . . Once the record is more fully developed, [defendant] may renew this argument on summary judgment.").

178. No. 02-81166-CIV, 2003 WL 22225621 (S.D. Fla. Sept. 10, 2003).

179. *Id.* at *6.

180. *Id.*

scheme was directly related to the sale of securities, even if other acts were not. In *Jacoboni v. KPMG LLP*,[181] plaintiff filed a RICO claim against his accountant, alleging eight different acts of mail and wire fraud in the promotion of tax shelter strategies.[182] In his report and recommendation, the magistrate judge dismissed the RICO claims as to the fraudulent representations that clearly involved securities, including the phone conversations where the accountant induced plaintiff to participate in the tax shelter and the wire transfers that the accountant used to complete the stock transactions.[183] However, the magistrate judge preserved plaintiff's claims as to acts that did not involve securities, such as the accountant's engagement letter, which improperly tried to insulate the accountant from liability, and the accountant's mailing of a misleading tax return for plaintiff, holding that the "remaining predicate acts . . . have no readily apparent connection to securities transactions."[184] The district judge overruled the magistrate judge's findings and dismissed plaintiff's entire RICO claim, holding that since plaintiff "contend[ed] the wrongful acts were committed as part of a single fraudulent scheme, all of the acts must be considered together for securities fraud purposes."[185]

C. *The Great Securities Fraud Controversy: Distinguishing Primary Violators from "Aiders and Abettors" in Rule 10b-5 Lawsuits*

The overwhelming failure of RICO claims in tax shelter cases leaves securities fraud as the primary means for investors to establish liability against tax shelter promoters under federal law. The private cause of action[186] for securities fraud is rooted in section 10(b) of the Securities Exchange Act of 1934, which makes it unlawful for "any person, directly or indirectly" to "use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance" that contravenes SEC rules and regulations.[187]

SEC Rule 10b-5, which accompanies section 10(b), provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange; (a) To employ any device, scheme, or artifice to defraud; (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which

181. 314 F. Supp. 2d 1172 (M.D. Fla. 2004).

182. *Id.* at 1176–77.

183. *Id.* at 1177.

184. *Id.*

185. *Id.* at 1179.

186. Although the language of section 10(b) does not expressly create a private cause of action, the Supreme Court has implied one. *See* Superintendent of Ins. of N.Y. v. Bankers Life & Cas. Co., 404 U.S. 6, 13 n.9 (1971) (holding that "[i]t is now established that a private right of action is implied under § 10(b)").

187. Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j(b) (2000).

> they were made, not misleading; or (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.[188]

However, plaintiffs seeking to establish Rule 10b-5 liability against all parties involved in promoting fraudulent tax shelters face an additional obstacle. Since the Supreme Court decided *Central Bank of Denver v. First Interstate Bank of Denver*[189] in 1994, the courts no longer recognize "aiding and abetting securities fraud" as a valid cause of action under Rule 10b-5.[190] As a result, only defendants deemed "primary violators" of Rule 10b-5 are held liable, while those deemed mere "aiders and abettors" of the 10b-5 violation escape liability.[191] Since *Central Bank*, courts often have disagreed over where to place the dividing line between primary violations of Rule 10b-5 and mere "aiding and abetting."[192] In tax shelter schemes, where promoters had varying roles in the marketing and implementation of the shelter, *Central Bank* and its progeny are important to consider.

1. *Central Bank*: No Cause of Action for Aiding and Abetting Securities Fraud

Before the Supreme Court decided *Central Bank*, almost every federal circuit allowed 10b-5 suits against both primary violators and "aiders and abettors."[193] In fact, liability for aiding and abetting 10b-5 violations had become so firmly ingrained in securities fraud jurisprudence that neither party in *Central Bank* challenged its legitimacy.[194] Instead, the Court sua sponte directed the parties to address whether section 10(b) permitted private 10b-5 suits against aiders and abettors.[195]

With Justice Anthony Kennedy writing for a slim 5–4 majority, the *Central Bank* Court eliminated aider and abettor liability in securities fraud cases.[196] Holding that a "private plaintiff may not bring a 10b-5 suit against a defendant for acts not prohibited by the text of § 10(b),"[197] the Court noted that the language of section 10(b) prohibited "the making of a material misstatement (or omission) or the commission of a manipulative act,"[198] but made no mention of aiding and abetting such conduct.[199]

188. SEC Rule 10b-5, 17 C.F.R. § 240.10b-5 (2006).

189. 511 U.S. 164 (1994).

190. *Id.* at 191.

191. *See infra* Part I.C.1.

192. *See infra* Part I.C.2.

193. *Central Bank*, 511 U.S. at 192 (Stevens, J., dissenting). At the time, eleven circuits allowed private plaintiffs to sue parties who aided and abetted other parties' Rule 10b-5 violations. *Id.* Although the D.C. Circuit had not considered whether private plaintiffs could sue aiders and abettors, it allowed the SEC to bring actions against them. *See id.* at 192 n.1.

194. *Id.* at 194.

195. *Id.* at 194–95.

196. *Id.* at 191 (majority opinion).

197. *Id.* at 173.

198. *Id.* at 177 (citing Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 473 (1977)).

Asserting that Congress would have mentioned "aiding and abetting" in the statutory language if it intended to impose such liability,[200] the Court held that "the text of the 1934 Act does not itself reach those who aid and abet a § 10(b) violation."[201] Since the text of section 10(b) did not cover aiding and abetting, the *Central Bank* Court held that "a private plaintiff may not maintain an aiding and abetting suit under § 10(b)."[202]

The Court, however, held that "[t]he absence of § 10(b) aiding and abetting liability does not mean that secondary actors . . . are always free from liability under the securities Acts."[203] Rather, "[a]ny person or entity, including a lawyer, accountant, or bank, who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies" may be "liable as a primary violator under 10b-5, assuming *all* of the requirements for primary liability under Rule 10b-5 are met."[204]

In ruling that private plaintiffs may not maintain Rule 10b-5 suits against aiders and abettors, the *Central Bank* Court sparked great controversy over a previously non-controversial issue.[205] The *Central Bank* case transformed the distinction between a "primary violator" and a mere "aider and abettor" from a largely academic exercise into a significant factor in determining Rule 10b-5 liability. *Central Bank*, however, failed to provide meaningful insight into how the distinction between "primary violation" and "aiding and abetting" should be made. Since 1994, the lower federal courts have grappled with *Central Bank*'s ambiguous language, often reaching disagreement about its implications for 10b-5 liability.

2. Liability for Misrepresentations and Omissions Under Rule 10b-5(b)

Although Rule 10b-5 has three provisions,[206] earlier cases attempting to clarify *Central Bank*'s "primary violator"/"aider and abettor" dichotomy focused solely on claims for misrepresentations and omissions under Rule

199. *Id.* The Court rejected the argument that the "directly or indirectly" language in section 10(b) imposes aiding and abetting liability. *Id.* at 176 ("[A]iding and abetting liability extends beyond persons who engage, even indirectly, in a proscribed activity; aiding and abetting liability reaches persons who do not engage in the proscribed activities at all, but who give a degree of aid to those who do.").

200. *Id.* at 176–77 (holding that "Congress knew how to impose aiding and abetting liability when it chose to do so" and if "Congress intended to impose aiding and abetting liability, we presume it would have used the words 'aid' and 'abet' in the statutory text. But it did not.").

201. *Id.* at 177.

202. *Id.* at 191.

203. *Id.* at 191. In this sense, a "secondary actor" is someone who does not purchase or sell the actual securities. One's status as a "secondary actor" in the securities market is a separate consideration from whether that person is a "primary violator" or "aider and abettor" under section 10(b).

204. *Id.*

205. *See* Schanbaum, *supra* note 20, at 190.

206. *See* SEC Rule 10b-5, 17 C.F.R. § 240.10b-5 (2006).

10b-5(b). In these cases, investors filed suit under 10b-5, claiming that a company fraudulently misrepresented its financial situation through misleading financial statements.[207] The courts then decided whether certain parties that helped the corporation prepare the fraudulent financial statements could be held liable as primary violators under Rule 10b-5.[208] From these lawsuits emerged three conflicting standards for distinguishing between "primary violators" and mere "aiders and abettors" of Rule 10b-5(b) violations. These three standards have become known as the "bright-line" test,[209] the "substantial participation" test,[210] and the "creator" test.[211]

a. *The Bright-Line Test*

The Second, Tenth, and Eleventh Circuits have adopted the bright-line test for differentiating between "primary violators" and "aiders and abettors" in Rule 10b-5 lawsuits.[212] To be held as a primary violator under the bright-line test, a defendant must personally make a fraudulent misstatement or omission,[213] and the misstatement or omission must be attributed to the defendant at the time the plaintiff's investment decision was made.[214] The defendant, however, need not "directly communicate misrepresentations to plaintiffs for primary liability to attach."[215] Rather, it is enough that the defendant "knew or should have known" that the statement would reach potential investors.[216]

Under the bright-line test, lending "'significant' or 'substantial' assistance to the representations of others" is not enough to impose primary liability on a defendant.[217] The Second Circuit expressed the essence of the bright-line test in holding that, "[i]f *Central Bank* is to have any real meaning, a defendant must actually make a false or misleading statement in

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207. *See, e.g.*, Howard v. Everex Sys., Inc., 228 F.3d 1057, 1059 (9th Cir. 2000); Wright v. Ernst & Young LLP, 152 F.3d 169, 171 (2d Cir. 1998); Shapiro v. Cantor, 123 F.3d 717, 718 (2d Cir. 1997); Anixter v. Home-Stake Prod. Co., 77 F.3d 1215, 1219 (10th Cir. 1996); *In re* Software Toolworks Inc., 50 F.3d 615, 620 (9th Cir. 1994).

208. *See supra* note 207 and accompanying text.

209. Robert A. Prentice, *Locating That "Indistinct" and "Virtually Nonexistent" Line Between Primary and Secondary Liability Under Section 10(b)*, 75 N.C. L. Rev. 691, 728 (1997).

210. Celia R. Taylor, *Breaking the Bank: Reconsidering* Central Bank of Denver *After Enron and Sarbanes-Oxley*, 71 Mo. L. Rev. 367, 375 (2006).

211. Kimberly Brame, Comment, *Beyond Misrepresentations: Defining Primary and Secondary Liability Under Subsections (a) and (c) of Rule 10b-5*, 67 La. L. Rev. 935, 940 (2007). The "creator" test is also known as the "co-author" test. *See* Schanbaum, *supra* note 20, at 202.

212. *See* Ziemba v. Cascade Int'l, Inc., 256 F.3d 1194, 1205 (11th Cir. 2001); *Shapiro*, 123 F.3d at 720; *Anixter*, 77 F.3d at 1225–27.

213. *See Anixter*, 77 F.3d at 1226.

214. *Ziemba*, 256 F.3d at 1205 (citing Wright v. Ernst & Young LLP, 152 F.3d 169, 175 (2d Cir. 1998).

215. *Anixter*, 77 F.3d at 1226.

216. *Id.*

217. *Id.* at 1227.

order to be held liable under Section 10(b)."[218] The Second Circuit further held that "[a]nything short of such conduct . . . is merely aiding and abetting, and no matter how substantial that aid may be, it is not enough to trigger liability under Section 10(b)."[219] Unless the statement is made in the defendant's name, the bright-line test will treat the defendant as no more than an aider and abettor.[220]

The major criticism of the bright-line test is its "potential to allow egregious wrongdoing to go unpunished and serious fraud-inflicted injuries to go uncompensated."[221] Under the bright-line test, a lawyer or accountant who participated heavily in the drafting of a company's fraudulent financial statement with knowledge of the fraud, but did not attach his or her name to the document, would be considered an "aider and abettor" and escape liability in a Rule 10b-5 suit filed by an investor who relied on the statement. Such a rule encourages background actors to conceal their identities from investors.[222] Because the Supreme Court has stated that the securities laws should be construed "not technically and restrictively, but flexibly to effectuate its remedial purposes,"[223] the rigidity of the bright-line test seems almost counterintuitive to the remedial spirit of the securities laws.

b. *The Substantial Participation Test*

The Ninth Circuit has adopted the substantial participation test for differentiating between primary violators and "aiders and abettors" in Rule 10b-5 lawsuits.[224] In addition to holding defendants liable for making self-attributed fraudulent misstatements or omissions, the substantial participation test imposes liability on defendants who "substantial[ly] participat[ed]" or were "intricate[ly] involve[d]" in the misrepresentations or omissions attributed to another actor.[225] Under the substantial participation test, a background actor may be held liable as a primary violator for substantially participating in the misstatements or omissions of

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218. Shapiro v. Cantor, 123 F.3d 717, 720 (2d Cir. 1997) (quoting *In re* MTC Elec. Techs. S'holders Litig., 898 F. Supp. 974, 987 (E.D.N.Y. 1995)).

219. *Id.* (quoting *MTC*, 898 F. Supp. at 987).

220. *See* Prentice, *supra* note 209, at 728–29.

221. *Id.* at 727–28.

222. *In re* Enron Corp. Sec., Derivative & ERISA Litig., 235 F. Supp. 2d 549, 587 (S.D. Tex. 2002).

223. Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128, 151 (1972) (internal quotation marks omitted).

224. Howard v. Everex Sys., Inc., 228 F.3d 1057 (9th Cir. 2000); *In re* Software Toolworks Inc., 50 F.3d 615 (9th Cir. 1994).

225. *Howard*, 228 F.3d at 1061 n.5; *see also Software Toolworks*, 50 F.3d at 628 n.3 (holding an accountant to be a primary violator for "play[ing] a significant role in drafting and editing" a software company's letter to the SEC containing fraudulent financial data, even though the accountant's name did not appear on the letter).

another, even if the defendant did not communicate the misrepresentation to the investor or associate his name with the misstatements or omissions.[226]

The substantial participation test has been criticized for being overly broad[227] and potentially imposing primary liability on conduct that pre-*Central Bank* courts would have considered "aiding and abetting."[228] As one critic has asserted, "This standard seems directly at odds with *Central Bank*" as "it employs the pre-*Central Bank* vernacular of aiding and abetting liability."[229] "Before *Central Bank*," argues the critic, "a defendant could be liable for aiding and abetting a violation of § 10(b) . . . by lending 'substantial assistance' to the primary violator with knowledge of the fraud."[230] The Ninth Circuit's test, he concludes, "seems to be a return to this pre-*Central Bank* rationale."[231]

The substantial participation test is also criticized for its vagueness.[232] Under the ambiguous standard of "substantial participation" there is "no threshold amount of involvement or participation necessary before imposing primary liability upon secondary actors."[233] Courts applying the substantial participation test have imposed primary liability on conduct ranging from mere "review and discussion" of materials containing alleged misstatements[234] to "knowingly certifying false and misleading financial statements" for a client.[235] Under the substantial participation test, even "secondary actors playing only a minor role" may be "subject to the same consequences as primary violators . . . responsible for actually making the fraudulent misstatement or omission."[236]

c. *The Creator Test*

In the 2002 case of *In re Enron Corp. Securities, Derivative & ERISA Litigation*, which resulted from one of the largest and most sensational corporate scandals in American history, the distinction between primary and "aiding and abetting" liability under Rule 10b-5(b) became a contested issue.[237] In *Enron,* the Southern District of Texas took issue with both the

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226. Taylor, *supra* note 210, at 375.

227. *See* Mary M. Wynne, Comment, *Primary Liability Amongst Secondary Actors: Why the Second Circuit's "Bright Line" Standard Should Prevail*, 44 St. Louis U. L.J. 1607, 1625 (2000).

228. Mustokoff, *supra* note 21, at 20.

229. *Id.* at 21.

230. *Id.*

231. *Id.*

232. *See* Wynne, *supra* note 227, at 1625.

233. *Id.*

234. *Id.* at 1625–26 (citing *In re* Software Toolworks Inc., 50 F.3d 615, 628 n.3 (9th Cir. 1994)).

235. *Id.* at 1626 (citing Cooper v. Pickett, 137 F.3d 616, 629 (9th Cir. 1997)).

236. *Id.* at 1624.

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

bright-line and substantial participation tests, choosing to implement its own test instead.[238]

The *Enron* court criticized the bright-line test's requirement that the misstatement be publicly attributed to the actor, holding it to be an improper reading of section 10(b) and *Central Bank*.[239] As section 10(b) makes it unlawful for any person to "directly or indirectly" employ a deceptive device in connection with the purchase or sale of securities,[240] the *Enron* court reasoned that "a person who creates a misrepresentation but takes care not to be identified publicly with it, 'indirectly' uses or employs a deceptive device or contrivance and should be liable under § 10(b)."[241] Thus, the *Enron* court declined to apply the bright-line test, holding that it would provide a "safe harbor from liability for everyone except those identified with the misrepresentations by name" and "would place a premium on concealment and subterfuge rather than on compliance with the federal securities laws."[242]

The *Enron* court also criticized the substantial participation test as vague and overbroad.[243] Stating that "such an expansive test . . . may fail to differentiate between primary liability and aiding and abetting,"[244] the *Enron* court rejected the substantial participation test, calling for "a clearer definition and a narrowing of the kind of conduct and circumstances required to constitute 'substantial participation.'"[245]

Drawing from the SEC's brief in *Klein v. Boyd*, a case that settled prior to review by the Third Circuit en banc, the *Enron* court proposed its own test for determining primary liability in 10b-5 suits.[246] This test, the creator test,[247] provides that "when a person, acting alone or with others, creates a misrepresentation [on which the investor-plaintiffs relied], the person can be liable as a primary violator . . . if . . . he acts with the requisite scienter."[248] Similar to the substantial participation test, a defendant's name need not be associated with the misrepresentation for that defendant to be held as a primary violator.[249] The creator test, however, attempts to define more clearly the threshold at which participation in a statement

238. *Id.* at 583–86.

239. *Id.* at 586.

240. Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j(b) (1997).

241. *Enron*, 235 F. Supp. 2d at 587 (internal quotation marks omitted). It logically follows that a person who creates a misrepresentation that is attributed to him or her would have employed the deceptive device directly.

242. *Id.* at 587.

243. *Id.* at 585.

244. *Id.*

245. *Id.*

246. *See id.* at 586 n.24. There is no published Third Circuit decision available for *Klein*, as the court vacated its opinion after granting a rehearing en banc, and the parties settled prior to the rehearing. *See id.*; *see also* Klein v. Boyd, Nos. 97-1143, 97-1261, 1998 WL 55245 (3d Cir. Mar. 9, 1998).

247. *See* Mustokoff, *supra* note 21, at 21.

248. *Enron*, 235 F. Supp. 2d at 692 (internal quotation marks omitted).

249. *Id.* at 586 n.24.

becomes substantial enough to warrant primary liability. A primary violator under the creator test must have "played such a substantial role in the creation of the statement that [he or she] could fairly be said to be the 'author' or 'co-author' of the statement."[250] Under this standard, parties only are responsible for the individual misstatements in which they participated, rather than the entire document. Primary liability can attach for knowingly writing misrepresentations in a document to be given to investors, "even if the idea from those representations came from someone else."[251] However, a party who "prepares a truthful and complete portion of a document would not be liable as a primary violator for misrepresentations in other portions of the document."[252] Even if that person knew about the other misrepresentations, "he or she would not have created those misrepresentations" and therefore could not be held as a primary violator.[253]

3. Scheme Liability Under Rules 10b-5(a) and 10b-5(c)

The *Enron* decision also took issue with the post-*Central Bank* cases' exclusive focus on misstatements and omissions. Drawing attention to the little-used Rules 10b-5(a) and 10b-5(c), the *Enron* court reiterated the Supreme Court's holding in *Affiliated Ute Citizens of Utah v. United States*[254] that, "[w]hile subsection (b) of Rule 10b-5 provides a cause of action based on [misstatements and omissions of material facts], subsections (a) and (c) are not so restricted."[255] Denying that Rules 10b-5(a) and (c) were "impliedly struck down in *Central Bank* merely because [*Central Bank*] addressed only subsection (b) misrepresentation and omission,"[256] the *Enron* court interpreted Rule 10b-5 as authorizing three distinct causes of action: "scheme" liability under 10b-5(a), "misrepresentation or omission" liability under 10b-5(b), and "course of business" liability under 10b-5(c).[257]

The scope of conduct actionable under Rules 10b-5(a) and (c), however, remains unclear. The language of section 10(b) prohibits "any manipulative or deceptive device or contrivance."[258] Historically, the Supreme Court has held that the term "[m]anipulation" is "virtually a term of art when used in connection with securities markets,"[259] referring to practices "intended to

250. *Id.*
251. *Id.* at 588.
252. *Id.*
253. *Id.*
254. 406 U.S. 128 (1972).
255. *Enron*, 235 F. Supp. 2d at 577 (quoting *Affiliated Ute Citizens*, 406 U.S. at 152–53) (internal quotation marks omitted).
256. *Id.* at 589 n.31.
257. *Id.*
258. Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j(b) (1997).
259. Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 476 (1977) (quoting Ernst & Ernst v. Hochfelder, 425 U.S. 185, 199 (1976)).

mislead investors by artificially affecting market activity,"[260] such as wash sales,[261] matched orders,[262] or rigged prices.[263] Additionally, the Court has interpreted "deception" as "the making of a material misrepresentation or the nondisclosure of material information in violation of a duty to disclose."[264] However, the Supreme Court also has held that section 10(b) prohibits "*all* fraudulent schemes in connection with the purchase or sale of securities, whether the artifices employed involve a garden type variety of fraud, or present a unique form of deception."[265] Thus, the Court held, section 10(b) should be "construed 'not technically and restrictively, but flexibly to effectuate its remedial purposes.'"[266] The Court's recent repetition of this language in the 2002 case of *SEC v. Zandford*[267] suggests that this expansive view of the securities laws still remains in force.[268]

The lack of post-*Central Bank* case law on 10b-5(a) and (c) liability also leaves the dividing line between primary violations and mere "aiding and abetting" in question. The *Enron* case shed little light on the standard for primary liability under Rules 10b-5(a) and (c). Applying a similar standard for both subsections, *Enron* merely held that, "where a group of Defendants allegedly participated in the scheme to defraud the public and enrich themselves in connection with the purchase and sale of securities," any defendant with the requisite scienter who "actively employed a significant material device, contrivance, scheme, or artifice to defraud" would be primarily liable under Rule 10b-5(a), and any defendant who "actively engaged in a significant, material act, practice, or course of business that operated as a fraud or deceit upon any person in connection with the purchase or sale of any security" would be primarily liable under Rule 10b-5(c).[269]

II. THE SPLIT OVER SCHEME LIABILITY

After the *Enron* decision, securities fraud plaintiffs began filing claims alleging "schemes to defraud" under Rules 10b-5(a) and (c) in addition to

260. *Id.*

261. *Id.* A wash sale is a "transaction involving no change in beneficial ownership." *Enron*, 235 F. Supp. 2d at 568 n.8 (citing *Ernst*, 425 U.S. at 205 n.25).

262. *Santa Fe*, 430 U.S. at 476. Matched orders are "orders for the purchase/sale of a security that are entered with the knowledge that orders of substantially the same size, at substantially the same time and price, have been or will be entered by the same or different persons for the sale/purchase of such security." *Enron*, 235 F. Supp. 2d at 568 n.8.

263. *Enron*, 235 F. Supp. 2d at 568 n.8; *Santa Fe*, 430 U.S. at 476.

264. *Enron*, 235 F. Supp. 2d at 568 n.9 (citing *Santa Fe*, 430 U.S. at 470).

265. Superintendent of Ins. of N.Y. v. Bankers Life & Cas. Co., 404 U.S. 6, 11 n.7 (1971). The Court further held, "We do not think it sound to dismiss a complaint merely because the alleged scheme does not involve the type of fraud that is usually associated with the sale or purchase of securities . . . . Novel or atypical methods should not provide immunity from the securities laws." *Id.* (internal quotation marks omitted).

266. Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128, 151 (1972).

267. 535 U.S. 813 (2002).

268. *Id.* at 819.

269. *Enron*, 235 F. Supp. 2d at 693.

the more traditional claims alleging "misrepresentations or omissions" under Rule 10b-5(b).[270] Although the *Enron* court appeared to treat claims for "scheme" liability under Rule 10b-5(a) as separate causes of action from claims for "course of business" liability under Rule 10b-5(c),[271] subsequent courts and scholars have placed both rules under the awning of "scheme liability"[272] and assessed both 10b-5(a) and 10b-5(c) claims under a single standard.[273]

As scheme liability claims have proliferated, controversy has arisen over the proper way to reconcile Rule 10b-5(a) and (c) liability with *Central Bank*. As a result, the distinction between primary violators and "aiders and abettors" under Rules 10b-5(a) and (c) has become a contested issue, leading one commentator to refer to scheme liability as the "new battleground in securities fraud litigation."[274] Whereas the earlier 10b-5(b) cases examined the extent of primary liability for those who participate in another party's fraudulent statement,[275] the new 10b-5(a) and (c) cases generally examine whether primary liability extends to those who participate in a business transaction with knowledge that the other party will use the transaction to misrepresent its financial situation to investors.[276]

Two opposing views have emerged as to the standard for primary liability under Rules 10b-5(a) and (c).[277] The narrow view, embraced by the Eighth Circuit in *In re Charter Communications, Inc., Securities Litigation*[278] and the Fifth Circuit in *Regents of the University of California v. Credit Suisse First Boston (USA), Inc.*,[279] holds that primary liability under Rule 10b-5 extends only to parties who make material misstatements,

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270. *See In re* Mutual Funds Inv. Litig., 384 F. Supp. 2d 845, 853 (D. Md. 2005) (pleading an "omissions case" against certain defendants under Rule 10b-5(b) and a "fraudulent scheme case" against all defendants under Rule 10b-5(a) and (c)); *In re* Global Crossing, Ltd. Sec. Litig., 322 F. Supp. 2d 319, 328 (S.D.N.Y. 2004) ("Plaintiffs here bring their claims not only under Rule 10b-5(b), but also under the more general provisions of Rule 10b-5(a) and (c).").

271. *See Enron*, 235 F. Supp. 2d at 589 n.31; *see also supra* note 257 and accompanying text.

272. *See* Steiner v. MedQuist Inc., No. 04-5487 (JBS), 2006 WL 2827740, at *20–21 (D.N.J. 2006) (referring to "Rule 10b-5(a) and (c) Scheme Liability"); Mustokoff, *supra* note 21, at 20 ("[P]laintiffs are relying progressively more on the 'scheme' liability prongs of Rule 10b-5: subsections (a) and (c).").

273. *See In re* Charter Commc'ns, Inc. Sec. Litig., 443 F.3d 987, 991–92 (8th Cir. 2006) *cert. granted sub nom.* Stoneridge Inv. Partners v. Scientific-Atlanta, Inc., 127 S. Ct. 1873 (2007) (declining to differentiate between Rule 10b-5(a) and Rule 10b-5(c) claims); Simpson v. AOL Time Warner, Inc., 452 F.3d 1040, 1046–48 (9th Cir. 2006) (referring generally to a "scheme to defraud" without differentiating between 10b-5(a) and 10b-5(c)). In this Note, the terms "scheme liability" and "scheme to defraud" refer to claims under both Rules 10b-5(a) and 10b-5(c).

274. Mustokoff, *supra* note 21, at 20.

275. *See supra* Part II.

276. *See generally* Regents of the Univ. of Cal. v. Credit Suisse First Boston (USA), Inc., 482 F.3d 372 (5th Cir. 2007); *Charter Commc'ns*, 443 F.3d 987; *Simpson*, 452 F.3d 1040.

277. *See infra* notes 278–82 and accompanying text.

278. *Charter Commc'ns*, 443 F.3d at 997.

279. *Regents*, 482 F.3d at 387.

make material omissions with a duty to disclose, or participate in the limited range of "manipulative" trading practices defined in *Santa Fe Industries, Inc. v. Green*.[280] The broad view, favored by the Ninth Circuit in *Simpson v. AOL Time Warner Inc.*,[281] holds that defendants who act with the purpose and effect of creating a false appearance of fact are primarily liable, even if those actions do not constitute a misstatement, omission, or manipulative trading practice as defined in *Santa Fe*.[282]

In March 2007, the Supreme Court granted certiorari in the *Charter Communications* case, which will be argued as *Stoneridge Investment Partners v. Scientific-Atlanta, Inc.*[283] In the *Stoneridge* case, which will be argued in the October 2007 Term,[284] the Supreme Court is likely to adopt one of these two views regarding the scope of scheme liability,[285] which could have implications in future tax shelter litigation. Part II.A of this Note discusses the narrow approach to scheme liability favored by the Fifth and Eighth Circuits, while Part II.B of this Note discusses the broad approach favored by the Ninth Circuit.

A. Charter Communications, Regents, *and the Narrow View of Scheme Liability*

The narrow view of scheme liability holds that primary liability under 10b-5(a) and (c) only extends to those who make misstatements of material fact, omissions when they have a duty to disclose, or engage in one of the manipulative trading practices discussed in *Santa Fe*.[286]

The Eighth Circuit case of *Charter Communications* involved a cable company accused of defrauding its investors by falsely inflating the revenue reported on its financial statements.[287] According to plaintiff investors, the cable company entered into a scheme with two equipment vendors in which the cable company agreed to pay an extra twenty dollars for each cable box, and the vendors agreed to pay the extra money back to the cable company as "advertising fees."[288] This arrangement allegedly allowed the cable company to substantially overstate its revenue and cash flow, making the

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280. 430 U.S. 462, 476 (1977). These practices include wash sales, matched orders, and rigged prices. For a definition of these enumerated practices, see *supra* notes 261–63 and accompanying text.

281. 452 F.3d at 1048.

282. *See infra* Part II.B and accompanying text.

283. 127 S. Ct. 1873 (2007).

284. A list of cases to be argued during the October 2007 term appears on the U.S. Supreme Court's website at http://www.supremecourtus.gov/orders/07grantednotedlist.pdf.

285. *See* Gold & Spinogatti, *supra* note 28, at 3.

286. The narrow view has also been adopted by the U.S. District Court for the District of Columbia in the case of *In re* Federal National Mortgage Association Securities. Civ. Action No. 04-1639(RJL), 2007 WL 1378464, at *5 n.3 (D.D.C. May 8, 2007) ("This Court finds that the more restrictive interpretation . . . adopted by the Fifth and Eighth Circuits . . . is in better keeping with the Supreme Court's ruling in *Central Bank*.").

287. *In re* Charter Commc'ns, Inc. Sec. Litig., 443 F.3d 987, 989 (8th Cir. 2006).

288. *Id.*

company appear stronger and more profitable to its investors and Wall Street analysts.[289] Although plaintiffs did not allege that the vendors made or participated in any false statements about the cable company's financial health,[290] they argued that the vendors' knowing participation in sham transactions aimed at falsifying the cable company's financial statements rendered them primarily liable for participation in a scheme to defraud.[291]

Plaintiffs argued that Rules 10b-5(a) and (c) were "broadly worded" and "[did] not require proof of a fraudulent misrepresentation or failure to disclose."[292] The Eighth Circuit, however, rejected plaintiffs' theory of scheme liability, holding that such an expansive view of those rules did not comport with an accurate reading of section 10(b) or *Central Bank*.[293]

According to the Eighth Circuit, *Central Bank*'s holding that a private plaintiff "'may not bring a 10b-5 suit against a defendant for acts not prohibited by the text of § 10(b)' included claims under Rule 10b-5(a) and (c), as well as Rule 10b-5(b)."[294] Examining the language of section 10(b), which prohibits "any manipulative or deceptive device or contrivance,"[295] the court looked to *Santa Fe*,[296] where the Supreme Court defined "manipulative" as a term of art encompassing certain trading practices and "deceptive" as a misstatement of fact or a failure to disclose by one with a duty to disclose.[297] Therefore, held the Eighth Circuit, "any defendant who does not make or affirmatively cause to be made a fraudulent misstatement or omission" or "who does not directly engage in manipulative securities trading practices, is at most guilty of aiding and abetting and cannot be held liable under § 10(b) or Rule 10b-5."[298]

As the vendors did not make any misstatements to investors, had no duty to disclose information to the cable company's investors, and had no role in approving the financial statements issued by the cable company, the *Charter Communications* court refused to hold the vendors liable as primary violators under any section of Rule 10b-5.[299] The court further opined that "to impose liability for securities fraud on one party to an arm's length business transaction in goods or services other than securities because that party knew or should have known that the other party would use the transaction to mislead investors" would "introduce potentially far-

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289. *Id.* at 990.
290. *Id.*
291. *Id.* at 991.
292. *Id.*
293. *Id.* at 992.
294. *Id.* (quoting Central Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164, 173 (1994) (internal citations omitted)).
295. Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j(b) (1997).
296. 430 U.S. 462 (1977).
297. *Charter Commc'ns*, 443 F.3d at 992; *see supra* notes 259–64.
298. *Charter Commc'ns*, 443 F.3d at 992.
299. *Id.* Neither the plaintiffs nor the court made any mention of "manipulative" trading practices.

reaching duties and uncertainties for those engaged in day-to-day business dealings."[300]

The Fifth Circuit case of *Regents* involved a similar scheme in which Enron arranged to sell certain of its assets to banks on the promise that it would buy the assets back at a premium six months later.[301] Enron then used these arrangements to inflate the revenue listed on its year-end financial statements.[302] Similar to *Charter Communications*, plaintiffs did not allege that the banks made any misstatements to shareholders, but argued that the banks should be held as primary violators for participation in a fraudulent scheme.[303] Adopting the Eighth Circuit's view that "deceptive" conduct covers only fraudulent misstatements and omissions,[304] the Fifth Circuit refused to hold the banks liable as primary violators.[305] According to the Fifth Circuit, the banks had no duty to disclose information to Enron's shareholders, and therefore the "transactions in which the banks engaged" amounted at most to aiding and abetting "Enron's deceit by making its misrepresentations more plausible."[306]

B. Simpson *and the Broad View of Scheme Liability*

The broad view of scheme liability holds that defendants who act with the purpose and effect of creating a false appearance of fact are primarily liable under Rule 10b-5, even if those actions do not constitute a misstatement, omission, or manipulative trading practice as defined in *Santa Fe*.[307]

Simpson, a Ninth Circuit case, also involved a company accused of inflating its revenues through sham transactions with third parties.[308] In these transactions, an Internet company allegedly bought assets from various vendors at inflated prices.[309] According to plaintiffs, the vendors then contracted with America Online for advertising on the Internet company's web site, and America Online would return the money to the Internet company through its own separate advertising agreement.[310] The

300. *Id.* at 992–93.
301. Regents of the Univ. of Cal. v. Credit Suisse First Boston (USA), Inc., 482 F.3d 372, 377 (5th Cir. 2007).
302. *Id.*
303. *Id.*
304. *Id.* at 388.
305. *Id.* at 390.
306. *Id.*
307. The broad view also has been adopted by the U.S. District Court for the District of New Jersey in Steiner v. MedQuist, Inc., Civil No. 04-5487 (JBS), 2006 WL 2827740, at *21 (D.N.J. Sept. 29, 2006) ("The Court here finds [the reasoning of the Ninth Circuit] persuasive.").
308. 452 F.3d 1040, 1042 (9th Cir. 2006).
309. *Id.* at 1044.
310. *Id.*

Internet company then declared the returned money as revenue.[311] Similar to *Charter Communications* and *Regents*, the *Simpson* court assessed whether the vendors who participated in the transactions with the Internet company were liable as primary violators under "scheme to defraud" claims.[312]

Formulating its view on scheme liability, the Ninth Circuit referenced the Supreme Court's holding in *Zandford*[313] that section 10(b) "should be construed not technically and restrictively, but flexibly to effectuate its remedial purposes."[314] Focusing on section 10(b)'s prohibition of "any manipulative or deceptive device or contrivance," the Ninth Circuit broadly defined "deception" as "engaging in a transaction, the principal purpose and effect of which is to create a false appearance of fact."[315]

According to the Ninth Circuit, a primary violator in a scheme to defraud "must have engaged in conduct that had the *principal purpose and effect* of creating a *false appearance* in furtherance of the scheme."[316] Under this view of scheme liability, scienter alone does not turn a defendant into a primary violator.[317] Even if a defendant acts with intent to deceive, the defendant is a mere aider and abettor of the scheme to defraud unless he performs an action that actually creates a false appearance.[318] As the *Simpson* court held, "It is not enough that a *transaction* in which a defendant was involved had a deceptive purpose and effect; the defendant's *own conduct* contributing to the transaction or overall scheme must have had a deceptive purpose and effect."[319]

The Ninth Circuit dismissed the plaintiffs' claims, holding that the plaintiffs failed to allege that either America Online or the vendors had created a false appearance in furtherance of the scheme. According to the Ninth Circuit, "illegitimate transactions in furtherance of a scheme to misrepresent revenues" create a false appearance and are chargeable as primary violations, while actions that merely "facilitate[] or assist[] the fraudulent misreporting of legitimate transactions" do not themselves create a false appearance and therefore only constitute "aiding and abetting."[320] As the complaint failed to allege that the transactions were illegitimate or

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311. *Id.*

312. *Id.* at 1046.

313. 535 U.S. 813 (2002) (favoring an expansive view of the securities laws).

314. *Simpson*, 452 F.3d at 1049 (quoting *Zandford*, 535 U.S. at 819) (internal quotation marks omitted).

315. *Id.* at 1048. The *Simpson* court does not elaborate on the definition of "manipulative." This Note assumes that the *Simpson* court accepts the Supreme Court's definition of "manipulative" as expressed in *Santa Fe*.

316. *Id.*

317. *See id.* at 1048 n.5.

318. *Id.* ("A defendant may intend to deceive the public by substantially assisting another's misconduct as part of a scheme to defraud, but fail to perform personally any action that created a false appearance as part of this scheme.").

319. *Id.* at 1048.

320. *Id.* at 1052.

that "actual advertisements were not purchased and sold" by the vendors, the court held that plaintiffs had not alleged primary violations against America Online or the vendors.[321] According to the court, a false appearance was not created until the Internet company chose to misrepresent the transactions in its financial statements.[322]

The court also set a few guidelines for determining whether a defendant's conduct has "a principal purpose and effect of creating a false appearance of fact."[323] According to the court, "[c]onduct by the defendant that does not have a principal legitimate business purpose"[324] may qualify, while "[c]onduct that is consistent with the defendants' normal course of business" typically would not.[325] Also, "[p]articipation in a legitimate transaction, which does not have a deceptive purpose or effect" would not be considered a primary violation, "even if the defendant knew or intended that another party would manipulate the transaction to effectuate a fraud."[326]

III. FILING TAX SHELTER CASES ALLEGING SCHEME LIABILITY UNDER RULES 10B-5(A) AND 10B-5(C)

Part III discusses the impact of the recent scheme liability decisions on tax shelter litigation and contemplates how to reconcile scheme liability under Rules 10b-5(a) and (c) with traditional "misstatement or omission" liability under Rule 10b-5(b). Part III.A argues that, despite their difference in language, the standards for primary liability set forth under both the narrow view of *Charter Communications/Regents* and the broad view of *Simpson* likely cover the same range of conduct. Part III.B of this Note then discusses how tax shelter schemes differ markedly from schemes discussed in previous 10b-5(a) and (c) lawsuits. Part III.C argues that under

321. *Id.* at 1053.

322. *See id.*

323. *Id.* at 1049.

324. *Id.* at 1050. The court gives as an example "the invention of sham corporate entities to misrepresent the flow of income." *Id.* (citing *In re* Enron Corp. Sec., Derivative & ERISA Litig., 310 F. Supp. 2d 819, 830 (S.D. Tex. 2004) ("Sham business transactions with no legitimate business purpose that are actually guaranteed 'loans' employed to inflate Enron['s] financial image are not above-board business practices.")).

325. *Simpson*, 452 F.3d at 1050 (citing *Enron*, 235 F. Supp. 2d at 580) ("Conclusory allegations that are consistent with the normal activity of such a business entity, standing alone, . . . are insufficient to state a claim of primary liability under *Central Bank*.") (internal quotation marks omitted)).

326. *Id.* (The *Simpson* court recognizes that the *Charter Communications* court refused to "impose primary liability 'on a business that entered into an arm's length non-securities transaction with an entity that then used the transaction to publish false and misleading statements to its investors and analysts.'") (citing *In re* Charter Commc'ns, Inc. Sec. Litig., 443 F.3d 987, 992 (8th Cir. 2006)). The *Simpson* court also cited *In re Parmalat Securities Litigation*, 376 F. Supp. 2d 472, 505 (S.D.N.Y. 2005) ("At worst, the banks designed and entered into the transactions knowing or even intending that Parmalat or its auditors would misrepresent the nature of the arrangements. That is, they substantially assisted fraud with culpable knowledge—in other words, they aided and abetted it.").

both views of scheme liability, all tax shelter promoters are likely to be held as primary violators. Part III.D suggests that defendants held as primary violators under a theory of scheme liability should be held as primary violators for all misstatements or omissions made in furtherance of the scheme, even if they would not have been held as primary violators for each individual misstatement.

A. *Circuit Split or a Matter of Semantics?*

The scholarship and case law following *Charter Communications/Regents* and *Simpson* has framed these two views as a circuit split over which conduct is actionable in scheme liability claims brought under Rules 10b-5(a) and (c).[327] Both views certainly employed opposite language while interpreting section 10(b)'s prohibition of "manipulative or deceptive device[s] or contrivance[s]."[328] Despite this difference in language, it appears that both views may cover the same range of conduct.

Charter Communications and *Regents* employed restrictive language in their approach to scheme liability.[329] Invoking *Central Bank*'s holding as a "categorical declaration that a private plaintiff 'may not bring a 10b-5 suit against a defendant for acts not prohibited by the text of § 10(b),'"[330] both the *Charter Communications* and *Regents* courts restricted "deceptive" conduct to material misstatements and omissions by those with a duty to disclose, and restricted "manipulative" conduct to the limited number of transactions discussed in *Santa Fe*.[331] According to this view, any defendant whose conduct does not fit into one of these categories "is at most guilty of aiding and abetting" and "cannot be held liable under § 10(b) or Rule 10b-5."[332]

Conversely, *Simpson* employed expansive language in its approach to scheme liability.[333] Although *Simpson* did not challenge the narrow view's

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327. Regents of the Univ. of Cal. v. Credit Suisse First Boston (USA), Inc., 482 F.3d 372, 386 (5th Cir. 2007) ("[T]he Eighth and Ninth Circuits have split with respect to the scope of primary liability for secondary actors."); *In re* Fed. Nat'l Mortgage Ass'n Sec., Civ. Action No. 04-1639(RJL), 2007 WL 1378464, at *5 n.3 (D.D.C. May 8, 2007) (considering the Ninth Circuit's standard "more liberal" than the Eighth Circuit's standard); Markel & Ballard, *supra* note 21, at 994 ("The Ninth Circuit's decision [in *Simpson*] is at variance with the opinion of the U.S. Court of Appeals for the Eighth Circuit [in *Charter Communications*].").

328. SEC Rule 10b-5(a), 17 C.F.R. § 240.10b-5(a) (2007). *Compare supra* Part II.A (discussing the narrow language employed by *Charter Communications* and *Regents*), *with supra* Part II.B (discussing the broad language employed by *Simpson*).

329. *See supra* Part II.A.

330. *See supra* note 294 and accompanying text; *see also* Central Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164, 173 (1994).

331. *See also supra* note 297 and accompanying text.

332. *See supra* note 298 and accompanying text; *see also In re* Charter Commc'ns Sec. Litig., 443 F.3d 987, 992 (8th Cir. 2006).

333. *See supra* Part II.B.

definition of "manipulative,"[334] the *Simpson* court seemed to take a broader approach to the term "deceptive."[335] Invoking the holding of *SEC v. Zandford* that section 10(b) "should be construed not technically and restrictively, but flexibly to effectuate its remedial purposes,"[336] the court held that deceptive conduct encompasses "engaging in a transaction, the principal purpose and effect of which is to create the false appearance of fact."[337]

Under closer observation, however, it appears that this "split" simply may be a matter of semantics.[338] Gregory A. Markel and Gregory G. Ballard, two New York securities litigators, believe that the *Simpson* test covers "active participation in a fraudulent scheme by someone who does not make a misstatement or omission, or engage in a manipulative securities trade."[339] The courts, however, have yet to provide an example of a "deceptive" act that does not involve a misrepresentation or omission, but still would impose primary liability on the actor.

Although *Simpson* may use more expansive language than *Charter Communications*, the conduct prohibited by the *Simpson* standard is actually quite similar. According to *Simpson*, "It is not enough that a *transaction* in which a defendant was involved had a deceptive purpose and effect; the defendant's *own conduct* contributing to the transaction or overall scheme must have had a deceptive purpose and effect."[340] Under *Simpson*, a primary violator must affirmatively act in furtherance of the scheme with the purpose of deceiving the plaintiff.[341] Aside from the "manipulative" acts discussed in *Santa Fe*,[342] however, it appears that any act whose "principal purpose and effect" is to "create a false appearance of fact"[343] can be classified as either a material misstatement or omission. Obviously, a securities fraud defendant who intentionally transmits false information to the plaintiff has acted with the "principal purpose and effect" of "creat[ing] a false appearance of fact."[344]

The inquiry then must turn to the extent of liability for nonspeaking actors. *Simpson* made clear that a defendant who participates in a transaction and merely is aware that the transaction eventually will be used

334. *See supra* note 315 and accompanying text.

335. Markel & Ballard, *supra* note 21, at 1002 (considering *Simpson*'s holding a "broader view").

336. SEC v. Zandford, 535 U.S. 813, 819 (2002) (internal quotation marks omitted); *see also supra* note 314 and accompanying text.

337. Simpson v. AOL Time Warner Inc., 452 F.3d 1040, 1048 (9th Cir. 2006); *see supra* note 323 and accompanying text.

338. *See supra* Part II.A–B.

339. Markel & Ballard, *supra* note 21, at 993.

340. *Simpson*, 452 F.3d at 1049.

341. *See supra* Part II.B.

342. *See supra* notes 298, 304 and accompanying text; *see also Simpson*, 452 F.3d at 1049.

343. *See supra* note 323 and accompanying text.

344. *See Simpson*, 452 F.3d at 1049.

for a deceptive purpose is considered an "aider and abettor," and therefore would not be liable under 10b-5(a) or (c).[345] This holding appears to be in accord with the holdings in *Charter Communications* and *Regents* that primary liability does not attach without a misstatement of fact or a failure to disclose by one who has a duty to disclose.[346] Without the duty to disclose the true facts to the plaintiff, such as the duty created by a fiduciary relationship,[347] a party's silence would not subject the party to primary liability in 10b-5(a) and (c) lawsuits under either view of scheme liability.

B. *Tax Shelters: A Different Type of Scheme*

To date, the only published cases addressing scheme liability under Rules 10b-5(a) and (c) have dealt with alleged schemes to defraud investors through the publication of misleading company financial statements.[348] In these cases, plaintiff-investors generally alleged that a company entered into sham transactions with third parties and then used these transactions to falsely inflate their reported revenue on public financial statements.[349] Although the plaintiffs in these cases levied claims against multiple actors, these plaintiffs generally alleged that they were injured by a single fraud in furtherance of the scheme: namely, the inflation of the company's stock price through the issuance of misleading financial statements.[350] In these cases, plaintiffs did not dispute that the company's underlying business was legitimate,[351] nor did they dispute that the stock they bought had the potential to generate profit.[352] Additionally, plaintiffs in these cases did not allege that the fraudulent scheme caused any losses beyond the money they invested in the company.[353]

The tax shelter cases present a markedly different type of scheme than any alleged in previous scheme liability cases. In the tax shelter cases, plaintiffs were injured through a succession of separate frauds in furtherance of the overall scheme.[354] Tax shelter promoters lured investors into tax shelters with false representations about the legality of the shelters' tax benefits[355] and the independence of the legal opinions that sanctioned those benefits.[356] The promoters also misrepresented the tax shelter's potential to generate profit, causing investors to place money in the tax shelter with virtually no chance of earning a return on their investment.[357]

345. *See supra* note 326 and accompanying text.
346. *See supra* note 298 and accompanying text.
347. *See infra* Part III.C.
348. *See supra* Part II.A–B.
349. *See supra* Part II.A–B.
350. *See supra* Part II.A–B.
351. *See supra* Part II.A–B.
352. *See supra* Part II.A–B.
353. *See supra* Part II.A–B.
354. *See supra* Part I.A.3.
355. *See supra* note 111 and accompanying text.
356. *See supra* notes 116–17 and accompanying text.
357. *See supra* note 112 and accompanying text.

Also, lawyer-promoters charged plaintiffs excessive fees for opinion letters, knowing that the letters' lack of independence rendered them ineffective in protecting plaintiffs from IRS penalties.[358] Additionally, the nonlawyer promoters charged plaintiffs excessive fees to conduct illegitimate loss-generating transactions, knowing that the IRS likely would never allow plaintiffs to use the losses to reduce their taxes.[359] Furthermore, accountant-promoters charged plaintiffs excessive fees to prepare tax returns reflecting tax treatments the accountants knew were likely to be invalidated by the IRS.[360] Finally, the combined representations and acts of all promoters induced plaintiffs to file these returns, costing plaintiffs back taxes, interest on back taxes, and penalties once the IRS discovered plaintiffs had participated in an abusive tax shelter.[361]

The role of professionals in tax shelter cases also differs markedly from the role contemplated in both *Central Bank* and previous cases addressing the extent of primary liability under Rule 10b-5.[362] In these prior cases, professionals only appeared in their role as "gatekeeper"[363] for the corporation issuing the fraudulent financial statements.[364] In most of these cases, investors sued the corporation's accountants and lawyers for preparing and approving the corporation's fraudulent financial statements in furtherance of a scheme to defraud.[365] In tax shelter cases, professionals were jointly responsible for creating the scheme, and then took an active role in promoting the scheme to investors.[366] Even those promoters not directly involved in the sales proposal were responsible for its content.[367] The lawyer-promoters, whose true role in the scheme was not disclosed to investors, allowed their names to be associated with the shelter, as their legal opinions were essential to the shelter's marketability.[368] Once investors agreed to participate in the tax shelter, professionals also provided their services, creating fiduciary relationships with investors.[369]

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358. *See supra* notes 121–22 and accompanying text.
359. *See supra* note 123 and accompanying text.
360. *See supra* note 124 and accompanying text.
361. *See supra* note 105 and accompanying text.
362. *See supra* Part I.C.1–2.
363. A "gatekeeper" is an outside professional (often an auditor or attorney) that advises a corporation on the permissibility of its actions. A common function of a gatekeeper is to "assess[] or vouch[] for the corporate client's own statements about itself or a specific transaction." John C. Coffee, Jr., *What Caused Enron? A Capsule Social and Economic History of the 1990s*, 89 Cornell L. Rev. 269, 280 (2004).
364. *See supra* Part I.C.2.a–c.
365. *See supra* Part I.C.2.a–c.
366. *See supra* notes 108–10 and accompanying text.
367. *See supra* notes 104–34 and accompanying text.
368. *See supra* notes 117–20 and accompanying text.
369. *See supra* notes 121–24 and accompanying text.

C. *Tax Shelter Promoters Are Likely to Be Held as Primary Violators Under Both Views of Scheme Liability*

Under both the *Simpson* and *Charter Communications/Regents* tests, tax shelter promoters are likely to be held as primary violators under Rules 10b-5(a) and (c). As the original RICO lawsuits did not allege any of the "manipulative" transactions discussed in *Santa Fe*, a court's inquiry likely will focus on whether tax shelter promoters engaged in conduct considered "deceptive" under section 10(b).

As discussed above, it is doubtful whether primary scheme liability under *Charter Communications* and *Regents* differs materially from primary scheme liability under *Simpson*.[370] Even assuming a material distinction exists between the narrow and broad views' definitions of the term "deceptive,"[371] such a distinction is largely irrelevant as to tax shelter promoters.[372] In tax shelter cases, each successive fraud perpetrated by promoters in furtherance of the tax shelter scheme would be covered under the "more restrictive" *Charter Communications/Regents* test, since each could be classified as either a misstatement of material fact or an omission by someone with a duty to disclose.[373]

Tax shelter promoters made a series of affirmative misstatements to induce investors to invest money in the shelter and declare the shelter's tax benefits on their tax returns.[374] The nonspeaking promoters had collaborated with the speaking promoters in creating the misstatements used in the sales pitch.[375] Although one could argue that subsequent professional services performed by the promoters could be considered "acts" rather than statements or omissions, it is important to remember that these professionals were in fiduciary relationships with investors[376] and some also were bound by written codes of professional ethics.[377] As both professionals and fiduciaries, the promoters had duties of loyalty to their clients' best interests and professional duties not to charge excessive fees.[378] In these tax shelters, lawyers concealed that their opinion letters were not independent,[379] accountants concealed that the tax returns they prepared contained tax treatments unlikely to withstand IRS scrutiny,[380] and bankers/financial advisors concealed that the transactions they conducted lacked economic substance and produced artificial losses that likely could

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370. *See supra* Part III.A.

371. *Compare supra* Part II.A (discussing *Charter Communications* and *Regents*, which use broad terms to define "deceptive"), *with supra* Part II.B (discussing *Simpson*, which uses narrow terms to define "deceptive").

372. *See infra* notes 373–94 and accompanying text.

373. *See supra* note 298 and accompanying text.

374. *See supra* notes 111–20 and accompanying text.

375. *See supra* notes 109–10 and accompanying text.

376. *See supra* Part I.A.3.

377. *See supra* note 125 and accompanying text.

378. *See supra* note 125 and accompanying text.

379. *See supra* notes 121–22 and accompanying text.

380. *See supra* note 124 and accompanying text.

not be used to offset capital gains.[381] Instead of acting in their investor-clients' best interests and informing the investors that they had entered a fraudulent scheme, these professionals chose to profit, accepting high fees from the investor-clients for their services.[382]

Under the *Simpson* test, tax shelter promoters also likely would be held liable as primary violators under the theory of scheme liability.[383] The "principal purpose and effect"[384] of all of the aforementioned misstatements and omissions was to create the false appearance that the tax shelter was a legitimate enterprise.[385] The promoters committed each successive fraudulent act in furtherance of an overarching plan to market and implement the tax shelter and thus defraud the investor out of his money.[386] None of the transactions relating to the tax shelters had any "principal legitimate business purpose,"[387] nor were the transactions consistent with any professional's "normal course of business."[388] A lawyer's normal course of business does not involve charging excessive fees for fraudulent legal opinions, nor does an accountant's, financial advisor's, or investment banker's normal course of business involve charging excessive fees to perform transactions lacking economic substance. Moreover, an accountant's normal course of business does not involve preparing tax returns claiming tax benefits the accountant knows to be abusive, nor does any professional's normal course of business involve promoting and implementing fraudulent tax shelter schemes for profit.

Reported tax shelter cases mention little about the parties from whom the promoters acquired the financial instruments that were later used to effectuate the tax shelter.[389] Plaintiffs did not file claims against these parties in any reported lawsuit, nor do the facts suggest any impropriety in the methods by which promoters acquired the instruments.[390] It is likely that these parties are the "aiders and abettors" who *Charter Communications*, *Regents*, and *Simpson* intended to exempt from liability under Rules 10b-5(a) and (c).[391] Under the broad view's reasoning, these parties made no misstatements to investors, and, even if they knew the promoters would use the instruments for a tax shelter, they had no relationship with investors that would impose a duty to disclose such information.[392] Through *Simpson*'s lens, the third party's simple

381. *See supra* note 123 and accompanying text.
382. *See supra* notes 125–34 and accompanying text.
383. *See supra* Part II.B.
384. *See supra* note 316 and accompanying text.
385. *See supra* Part I.A.3.
386. *See supra* Part I.A.3.
387. *See supra* note 324 and accompanying text; *see also* Simpson v. AOL Time Warner Inc., 452 F.3d 1040, 1050 (9th Cir. 2006).
388. *See supra* note 325 and accompanying text; *see also Simpson*, 452 F.3d at 1050.
389. *See supra* note 86 and accompanying text.
390. *See supra* note 86 and accompanying text.
391. *See supra* Part II.A–B.
392. *See supra* Part II.B.

knowledge that the instruments would later be used for a deceptive purpose would not be enough to impose primary liability.[393] Even if the promoters entered the transactions with a deceptive purpose, no evidence indicates that the parties who sold the instruments to the promoters did so with the purpose of furthering the tax shelter scheme or for any other deceptive purpose.[394]

D. *Reconciling Scheme Liability with Traditional "Misstatement or Omission" Liability*

Charter Communications, *Regents*, and *Simpson* do not indicate how the courts will reconcile claims for scheme liability under Rules 10b-5(a) and (c) with the more traditional "misrepresentation or omission liability" of Rule 10b-5(b). If one assumes that the parameters of scheme liability under both *Simpson* and *Charter* are functionally equal,[395] then one could argue that the only difference between scheme liability and traditional 10b-5(b) liability is that scheme liability covers the "manipulative" trading practices in *Santa Fe* in addition to the misstatements or omissions covered under both theories. As tax shelter cases generally do not allege conduct commonly viewed as "manipulative" by the federal courts,[396] one could also argue that the standard of primary liability would be the same, regardless of whether plaintiffs brought scheme liability claims under 10b-5(a) or (c) or misrepresentation/omission claims under 10b-5(b).

The term "scheme," however, connotes more than just a series of independent misrepresentations or omissions. Although the federal courts never have defined "scheme" as used in Rule 10b-5(a), the Oxford English Dictionary defines "scheme" as "a plan of action devised in order to attain some end."[397] Under this definition, the tax shelters discussed in this Note were fraudulent "schemes" in the true sense of the term. Tax shelter promoters engaged in a premeditated plan of action to market and implement fraudulent tax shelters, devised to achieve their desired end of earning profit. Each promoter was instrumental in designing this plan of action and played a predetermined role in its implementation.

A true scheme, such as the tax shelters discussed in this Note, represents a whole greater than the sum of its constituent parts. The illusion of legitimacy created through the concerted efforts of tax shelter promoters hinged on a series of interdependent misstatements and omissions. Unless promoters properly executed each successive misstatement or omission, the tax shelter plan as a whole was doomed to fail.

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393. *See supra* Part II.A.
394. *See supra* note 389 and accompanying text.
395. *See supra* Part III.A.
396. *See supra* note 389 and accompanying text.
397. Oxford English Dictionary 616 (2d ed. 1989).

Rule 10b-5(b)'s prohibition of material misstatements and omissions[398] seems to apply to single, independent misstatements and omissions, while Rule 10b-5(a)'s prohibition of schemes to defraud seems to apply to premeditated and concerted efforts to perpetrate an overarching fraud through multiple misrepresentations and omissions.[399] Under the narrow conception of 10b-5(b) "misstatement or omission" liability articulated by the Second Circuit's bright-line test,[400] a primary violator's name must be associated with the fraudulent statement at the time it is disseminated.[401] Establishing primary liability under Rule 10b-5(b) against all promoters for the entire operation could be problematic if certain parties' names were not associated with certain specific misstatements. Scheme liability under Rule 10b-5(a) or (c) should differ from Rule 10b-5(b) liability in this critical respect. A party held primarily liable under Rules 10b-5(a) or (c) for furthering a fraudulent scheme should be liable for all misstatements or omissions committed in furtherance of that scheme, regardless of whether the party would be held as a primary violator for each individual misrepresentation or omission. When a party has played enough of an integral role in planning and orchestrating a fraudulent scheme to be held as a primary violator under 10b-5(a) or (c), he should be held as a "creator" of every misstatement, similar to the concept articulated in the *Enron* case.[402] This standard would ensure that each party would be held liable for the wrongful conduct of others who commit fraud in furtherance of the scheme.

In previous scheme liability cases, which dealt with fraudulent financial statements issued on behalf of a corporation, this concept was not much of an issue. In both of these cases, the court found that only one party, the corporation itself, was a primary violator.[403] Although multiple individuals within the corporation may have been responsible for creating or disseminating the fraudulent financial statements, all statements were issued in the name of the corporation, and thus could be imputed to the corporation.[404]

In tax shelter cases, however, the promoters were not acting as agents of a corporation to which all of their conduct could be imputed.[405] Rather, the tax shelter scheme itself, which did not take the form of an identifiable entity, was their "principal." In determining scheme liability for tax shelter promoters under Rule 10b-5(a) and (c), the promoters' relationship should be viewed similarly to a general partnership. By entering into an arrangement to promote, market, and implement a tax shelter, each promoter's actions on behalf of the overall scheme should be considered

398. *See* SEC Rule 10b-5(b), 17 C.F.R. § 240.10b-5(b) (2007).
399. *See* SEC Rule 10b-5(a), 17 C.F.R. § 240.10b-5(a).
400. *See supra* Part I.C.2.b.
401. *See supra* Part I.C.2.b.
402. *See supra* Part I.C.3.
403. *See supra* Part II.A–B.
404. *See supra* Part II.A–B.
405. *See supra* note 389 and accompanying text.

binding on all other promoters when determining Rule 10b-5(a) and (c) liability. When one promoter makes a misstatement during a sales pitch to an investor, he speaks on behalf of all of the other promoters, even if the investor is unaware of an individual promoter's involvement in the statement. A lawyer who co-plans a tax shelter scheme is equally responsible for misstatements made during the sales pitch by other promoters, even though his true role is concealed to create an illusion of legitimacy in his opinion letters. Under 10b-5(a) and (c), each promoter also should be liable for his co-promoters' actions in furtherance of the scheme. When a banker-promoter performs the orchestrated transactions on behalf of the tax shelter scheme, all other promoters should be held responsible for the consequences, even if they did not take part in the transactions themselves.

CONCLUSION

Regardless of which standard the Supreme Court chooses to adopt in the upcoming *Stoneridge* case, tax shelter promoters are likely to be considered primary violators. However, litigating tax shelter fraud cases may be easier for plaintiffs under Rules 10b-5(a) and (c) than under 10b-5(b). Rather than having to prove that each promoter is responsible for each misstatement made in furtherance of the scheme, plaintiffs can simply demonstrate the existence of a premeditated scheme and prove that each promoter acted in furtherance of that scheme.

Notes & Observations