

A Securities Law Update

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Supreme Court Rejects “Scheme Liability” in Section 10(b) Securities Cases

In a widely-anticipated decision, the Supreme Court yesterday refused to expand the implied private right of action for securities fraud under Section 10(b) to include investor claims for so-called “scheme” liability against those who advise or do business with securities issuers. In *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, No. 06-43 (U.S. January 15, 2008), the Court held that Section 10(b) does not permit investors to recover from a “secondary” party that allegedly participates in a fraudulent scheme with an issuer, unless that party violates a duty to disclose in doing so, or the investors relied on that party’s public misstatements or acts.

In other words, defrauded investors cannot use Section 10(b) to sue business advisors or firms who did not directly mislead the investors, but who nevertheless worked with issuers that did. The Court’s decision in *Stoneridge* thus curbs the threat of vastly-expanded potential securities law liability, not just for the issuer’s investment bankers, lawyers, accountants, and other advisors, but also for any firm that is or was a vendor, customer or business partner of the issuer.

The plaintiff investors alleged in *Stoneridge* that the issuer, Charter Communications, a cable TV company, arranged to overpay two of its cable-box suppliers, who in turn agreed to purchase advertising from Charter at above-market prices or pay liquidated damages in the amount of the overpayments. These arrangements allegedly allowed Charter to mislead its accountants, overstate its revenues and thus inflate its stock price. Plaintiffs also alleged that the suppliers deliberately “backdated” documents and knew Charter would use the “sham” transactions to issue false financial statements upon which research analysts and investors would rely.

The District Court dismissed the investors’ complaint. The Eighth Circuit Court of Appeals affirmed, noting that the suppliers had, at most, allegedly aided and abetted Charter’s financial misstatements, and that the Supreme Court had ruled there is no private right of action for aiding and abetting a Section 10(b) violation in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 191 (1994). The Supreme Court affirmed, but on different grounds.

In *Stoneridge*, the Supreme Court began by restating the traditional elements of Section 10(b) liability, including the plaintiff’s reliance on a material misrepresentation or omission by the defendant in purchasing or selling a security. Because the investors had not relied on any acts or statements of Charter’s suppliers, the suppliers could not be liable under Section 10(b). In the

Court's view, the reliance element is "essential" because it "ensures" that the "requisite causal connection" exists between a defendant's misstatement or misconduct and a plaintiff's injury.

Departing from the Eighth Circuit's more restrictive view of Section 10(b), the Supreme Court observed that not just public misstatements, but "[c]onduct itself can be deceptive" and provide the basis for liability. Although investor reliance may be presumed if a defendant omits a material fact in spite of an underlying duty to disclose it or a defendant's misstatement or misconduct is made public, neither presumption applied in *Stoneridge* — Charter's suppliers had no such duty, and their deceptive acts had not been communicated to the public. Thus, the supplier's acts were "too remote to satisfy the requirement of reliance."

After all, "[i]t was Charter, not [its suppliers], that misled its auditors and filed fraudulent financial statements; nothing [the suppliers] did made it necessary or inevitable for Charter to record the transactions as it did."

The Court noted that there was no authority for the plaintiffs' scheme liability theory, which would vastly expand Section 10(b) liability "beyond the securities markets — the realm of financing business — to purchase and supply contracts — the realm of ordinary business operations." In the Court's view, scheme liability "would reach the whole market-place in which the issuing company does business," including "areas already governed by functioning and effective state-law guarantees."

As further support for its decision, the Court warned that the "extensive discovery and the potential for uncertainty and disruption in a [securities] lawsuit allow plaintiffs with weak claims to extort settlements from innocent companies," and that adopting "scheme" liability "would expose a new class of defendants to these risks," potentially "raising the cost of doing business," deterring overseas firms from doing business here, and "shift[ing] securities offerings away from domestic capital markets." Moreover, plaintiffs' theory would effectively "revive" aiding and abetting liability under Section 10(b) and overrule the Court's holding in *Central Bank* thirteen years earlier, which Congress had left undisturbed when it subsequently enacted the Private Securities Litigation Reform Act ("PSLRA").

The Court stressed that secondary parties who engaged in deceptive conduct with issuers will not go scot-free, because Congress had directed in the PSLRA that such aiders and abettors be prosecuted by the SEC, which had collected more than \$10 billion in disgorgement and penalties from them since 2002. In addition to the deterrence of SEC enforcement, some states permit their regulators to sue aiders and abettors, the federal securities laws "provide an express private rights of action against accountants and underwriters in certain circumstances," and the implied private right of action under Section 10(b) "continues to cover secondary actors who commit primary violations."

In reaching its 5-3 decision, the Court sided with the Department of Justice, rejecting the position advocated by the SEC, which had sided with the plaintiff investors and resolved a split over scheme liability in the Courts of Appeals. The *Stoneridge* holding implicitly rejected the more expansive liability standard adopted by the Ninth Circuit in *Simpson v. AOL Time Warner Inc.*,

452 F.3d 1040 (9th Cir. 2006), that “the defendant must have engaged in conduct that had the principal purpose and effect of creating a false appearance of fact in furtherance of the scheme.”

Stoneridge’s effect on the other Circuit Court case cited by the Supreme Court, the investor suit against three investment banks that engaged in alleged sham transactions with Enron, *Regents of the Univ. of California v. Credit Suisse First Boston (USA), Inc.*, 482 F.3d 372 (5th Cir. 2007), in which a petition for certiorari to the Supreme Court is pending, remains to be seen. Other investment banks and other firms that did business with Enron have paid more than \$7.2 billion to settle securities suits. However, the alleged deceptive acts of the remaining defendants in *Credit Suisse* are arguably less remote for investor “reliance” purposes than the suppliers’ misconduct alleged in *Stoneridge*.

In the final analysis, securities plaintiffs will find it more difficult to reach secondary actors such as an issuer’s suppliers and customers — or perhaps its investment banks — under Section 10(b) without scheme liability in their arsenal. *Stoneridge* should, therefore, serve to reassure those who advise or do business with publicly-traded companies that they now face a reduced risk of “strike suits” by counsel for disappointed investors of those companies.

Nevertheless, the Supreme Court did reject the Eighth Circuit’s much more restrictive interpretation of Section 10(b) liability in *Stoneridge* that “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 Sec. 10(b) or any subpart Rule 10b-5.” As a result, while the *Stoneridge* decision is not the “Ruling of the Century” or the “Securities Law *Roe v. Wade*” some had hoped for, it is the latest in a series of Supreme Court rulings hostile to securities plaintiffs that are clearly pro-business, but also pro-enforcement, through SEC actions, not class actions.

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