The Supreme Court Rejects Liability of Customers, Suppliers and Other Secondary Actors in Private Securities Fraud Litigation

Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc. (In re Charter Communications)

By Anissa Seymour and Yuval Rogson

Summary

On January 15, 2008, the United States Supreme Court issued its decision in *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*,[1] a case that was closely monitored by the securities litigation bar because of the impact it would have on the exposure of customers, suppliers and other secondary actors to liability in private federal securities fraud litigation. At issue in *Stoneridge* was "scheme liability"—shareholder plaintiffs' theory that secondary actors who engage in deceptive transactions that enable publicly held companies to commit securities fraud may be liable under Rule 10b-5. By a 5 to 3 majority, the Supreme Court in *Stoneridge* rejected scheme liability, holding plaintiffs could not show that the shareholders relied upon any of the secondary actors' actions "except in an indirect chain that [is] too remote for liability."[2]

In *Stoneridge*, shareholder plaintiffs brought a securities fraud action against cable company Charter Communications ("Charter"), and its suppliers of set-top cable boxes, Scientific-Atlanta and Motorola (the "Vendors").[3] Plaintiffs alleged that when Charter realized it was unlikely to meet its projected revenue and operating cash-flow numbers, it enlisted the Vendors' help to enter into transactions that would enable Charter to make it appear as if it had met its projections.[4] Specifically, plaintiffs alleged that Charter would overpay the Vendors for the set-top boxes with the understanding the Vendors would return the overpayment by buying advertising from Charter.[5] Charter then recognized the advertising fees as revenue, even though the fees were merely a refund.[6] So that Charter's auditors would not unearth the arrangements, "the companies drafted documents to make it appear the transactions were unrelated and conducted in the ordinary course of business."[7] The Court's ruling meant that neither Scientific-Atlanta nor Motorola could be held liable for any of Charter's deceptive acts, regardless of their participation in them.

However, the Court noted that its ruling did not foreclose all options against culpable secondary actors because:

- secondary actors can be liable for aiding and abetting fraud in an action brought by the Securities and Exchange Commission;[8]
- secondary actors may be liable for aiding and abetting fraud in an action brought under certain state laws;[9]
- secondary actors are subject to criminal penalties;[10]
- the securities statutes provide an express private right of action against accountants and underwriters under certain circumstances;[11] and
- secondary actors who commit primary violations may be held liable.[12]

The decision in *Stoneridge* has already had an immediate impact on pending cases. The Supreme Court denied *certiorari* in *Regents of University of California v. Merrill Lynch Pierce Fenner & Smith, Inc. (In re Enron)*,[13] declining to address the Enron shareholders' argument that *Stoneridge* does not extend to secondary actors who are financial professionals. By doing so, the Supreme Court has allowed the Fifth Circuit's decision to reject claims of scheme liability made against such financial professionals to remain the law. By contrast, the Supreme Court vacated the Ninth Circuit's decision to permit certain scheme liability claims and remanded the case with instructions to the Ninth Circuit to reconsider its holding in light of *Stoneridge*. In *In re Parmalat Securities Litigation*,[14] where the district court had earlier denied motions to dismiss securities fraud claims based on scheme liability, the district court has asked the parties to brief the effect of *Stoneridge* on the issue of summary judgment.

The Genesis of "Scheme Liability"

The Supreme Court eliminated aiding and abetting liability for federal securities fraud in *Central Bank of Denver N.A. v. First Interstate Bank of Denver, N.A.*[15] The following year, as part of the Private Securities Litigation Reform Act of 1995 (PSLRA),[16] Congress provided the SEC with statutory authority to prosecute aiders and abettors of violations of the securities laws.[17] It declined to provide similar statutory authority to private litigants.

Since *Central Bank*, the plaintiffs' bar has struggled to find a way to broaden the scope of Rule 10b-5 to reach secondary actors. Through the theory of scheme liability, plaintiffs attempted to sidestep the decision in *Central*

Bank by recasting secondary actors as primary violators of the rule. Under the theory of scheme liability, secondary actors who knowingly facilitate securities fraud by engaging in deceptive transactions with the primary actor do not merely aid and abet a violation of Rule 10b-5, but actually commit an independent violation of the statute, taking them outside the ruling of *Central Bank*.

Courts wrestled with the concept of scheme liability and ultimately reached different conclusions. Courts in the Second and Ninth Circuit recognized scheme liability as possibly falling outside of *Central Bank*. The Fifth and Eighth Circuits rejected scheme liability as merely a compelling subspecies of aiding and abetting liability foreclosed by *Central Bank*.

In *Parmalat*, for example, the Court considered allegations of scheme liability brought against several banking defendants.[18] The plaintiffs alleged that the banking defendants participated in a scheme to improperly enhance Parmalat's earnings by engaging in deceptive transactions such as double-counting receivables and disguising loans as equity transactions.[19] The Court saw no distinction between the actions of Parmalat and those of the banking defendants:

> The transactions in which the defendants engaged were by nature deceptive. They depended on a fiction, namely that the invoices had value. It is impossible to separate the deceptive nature of the transactions from the deception actually practiced upon Parmalat's investors.[20]

As a result, the Court determined that the banking defendants could be held liable for a primary violation of Rule 10b-5: "[W]here, as alleged here, a financial institution enters into deceptive transactions as part of a scheme in violation of Rule 10b-5(a) and (c) that causes foreseeable losses in the securities markets, that institution is subject to private liability under Section 10(b) and Rule 10b-5."[21] Accordingly, the Court recognized scheme liability as unaffected by the holding of *Central Bank* and denied several of the banking defendants' motions to dismiss.[22]

Similarly, in *Simpson v. AOL Time Warner, Inc.*,[23] the Ninth Circuit considered allegations of scheme liability against several defendants accused of participating in sham transactions that allowed Homestore.com to inflate its revenue and deceive its investors.[24] The Ninth Circuit held that the defendants who engaged in these transactions could be held liable for a primary violation of Rule 10b-5:

> If the Defendants' conduct, as alleged in the [complaint], had the purpose and effect of creating a false appearance from illegitimate transactions in furtherance of a scheme to misrepresent revenues, then Plaintiff has alleged a primary violation of § 10(b).[25]

The Court then dismissed the complaint because it found that the allegations against the defendants did not meet this standard.[26]

However, both the Fifth Circuit and the Eighth Circuit rejected similar claims of scheme liability. When the Eighth Circuit considered *In re Charter Communications, Inc., Securities Litigation*,[27] it held that the "district court properly dismissed the claims against the Vendors as nothing more than claims, barred by *Central Bank*, that the[y] knowingly aided and abetted the Charter defendants in deceiving the investor plaintiffs."[28] The court agreed with the district court that the Vendors:

> did not issue any misstatement relied upon by the investing public, nor were they under a duty to Charter investors and analysts to disclose information useful in evaluating Charter's true financial condition. None of the alleged financial misrepresentations by Charter was made by or even with the approval of the Vendors.[29]

Similarly, in *Regents of the University of California v. Credit Suisse First Boston (USA), Inc.*,[30] the Fifth Circuit considered allegations of scheme liability brought against banks associated with Enron Corporation prior to its collapse.[31] The plaintiffs had alleged the banks "entered into partnerships and transactions that allowed Enron [] to take liabilities off its books temporarily and to book revenue from the transactions when it was actually incurring debt."[32] The district court had certified a class against these bank defendants based on the fraud-on-the-market presumption of reliance.[33] Inherent in the district court's certification was a finding that the bank defendants had committed a deceptive act in violation of Section 10(b).[34] The Fifth Circuit reversed the district court:

> The district court's conception of "deceptive act" liability is inconsistent with the Supreme Court's decision that § 10 does not give rise to aiding and abetting liability. An act cannot be deceptive within the meaning of § 10(b) where the actor has no duty to disclose. Presuming plaintiffs' allegations to be true, Enron committed fraud by misstating its accounts, but the banks only aided and abetted that fraud by engaging in transactions that make it more plausible; they owed no duty to Enron's shareholders.[35]

The Court further held that the bank defendants did not engage in market "manipulation" because they "did not act directly in the market for Enron securities."[36]

Parmalat and *Simpson*, on the one hand, and *Charter* and *Regents*, on the other hand, demonstrate the judicial divide regarding scheme liability that gave rise to the Supreme Court granting *certiorari* in *Stoneridge*.

The Supreme Court's Decision in *Stoneridge*

In its decision in *Stoneridge*, the Supreme Court set out to resolve the uncertainty regarding scheme liability.[37] The Court recounted the plaintiffs' allegations in Charter against the Vendors and noted that the Vendors had allegedly engaged in transactions with Charter that had "no economic substance" and "enable[d] Charter to fool its auditor into approving a financial statement showing it met projected revenue and operating cash-flow numbers."[38] The Court further noted, however, that the Vendors "had no role in preparing or disseminating Charter's financial statements."[39]

The Court began by reiterating that *Central Bank* eliminated aiding and abetting liability for private actions under Section 10(b) and Rule 10b-5.[40] Thus, to state a claim against the Vendors, the petitioner's allegations would have to "satisfy each of the elements or preconditions for [primary] liability[.]"[41]

The Court held that the petitioner's allegations failed to meet the element of reliance necessary to state a Rule 10b-5 claim against the Vendors.[42] The Court reasoned that the Vendors "had no duty to disclose; and their deceptive acts were not communicated to the public."[43] As a result, "[n]o member of the investing public had knowledge, either actual or presumed, of respondents' deceptive acts during the relevant times."[44] Thus, the Court held that the petitioner "cannot show reliance upon any of respondents' actions except in an indirect chain we find too remote for liability."[45]

The discussion of what actions were "immediate" and "remote" to the injury informed the holding of the Court. The Court determined that "[i]t was Charter, not respondents, that misled its auditor and filed fraudulent financial statements; nothing respondents did made it necessary or inevitable for Charter to record the transactions as it did."[46] Accordingly, the Court distinguished Charter's more immediate act of recording and releasing its fraudulent financial statements from the Vendors' more remote act of engaging in sham transactions with Charter that enabled Charter to ultimately misstate its financials. This distinction was sufficient to break the chain of liability under Rule 10b-5. In reasoning this way, the Court struck down any permissive view of scheme liability.

Several additional factors led the Court to its decision. The Court determined that allowing scheme liability to function as an exception to *Central Bank* would ignore the will of Congress.[47] In response to *Central Bank*, Congress amended the securities laws to authorize the SEC to bring actions against aiders and abettors of securities fraud. Congress did not provide such authority to private litigants. Thus, the Court held that if it adopted scheme liability "it would revive in substance the implied cause of action against all aiders and abettors except those who committed no deceptive act in the process of facilitating the fraud[,]" which "would undermine Congress' determination that this class of defendants should be pursued by the SEC and not by private litigants."[48] It also noted the power of the SEC to pursue secondary actors in an enforcement action.[49]

The Court also expressed concern that allowing scheme liability would unduly expand the implied private right of action under Rule 10b-5. Under the petitioner's theory, Section 10(b) would be made to apply "beyond the securities markets—the realm of financing business—to purchase and supply contracts—the realm of ordinary business operations."[50] "Were this concept of reliance to be adopted, the implied cause of action would reach the whole marketplace in which the issuing company does business[.]"[51]

The Court noted the risks attendant to such an increase in exposure to securities claims. "[E]xtensive discovery and the potential for uncertainty and disruption in a lawsuit allow plaintiffs with weak claims to extort settlements from innocent companies."[52] The "[a]doption of petitioner's approach would expose a new class of defendants to these risks" and therefore "raise the cost of being a publicly trading company. . . ."[53] This, in turn, may discourage foreign investment in "domestic capital markets" and adversely affect the economy.[54] In light of these concerns, the Court expressly held that the implied private right of action under § 10(b) "should not be extended beyond its present boundaries" without direction from Congress.[55] Accordingly, the Supreme Court affirmed the dismissal of the petitioner's securities fraud claims against the Vendors.[56]

Conclusion

The Court in *Stoneridge* refused to recognize scheme liability as a work-around or an exception to the rule in *Central Bank* eliminating aiding and abetting liability. In addition, the Court expressly refused to extend the implied private right of action under Rule 10b-5 past its current boundaries. In reaching these conclusions, the Court provided predictability and clarity while balancing the interests of investors, businesses, and the economy.

Endnotes

1. 128 S. Ct. 761 (2008).
2. *Id.* at 769.
3. *Id.* at 766.
4. *Id.*
5. *Id.*

6. *Id.*
7. *Id.* at 767.
8. *Id.* at 771, 773 (citing 15 U.S.C. § 78t(e)).
9. *Id.* at 773 (citing, *e.g.*, Del. Code Ann., Tit. 6, § 7325).
10. *Id.* (citing 15 U.S.C. § 78ff).
11. *Id.* (citing 15 U.S.C. § 78k).
12. *Id.* (citing *Central Bank of Denver N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 191 (1994)).
13. 128 S. Ct. 1120 (2008).
14. 376 F. Supp. 2d 472 (S.D.N.Y. 2005).
15. 511 U.S. 164 (1994).
16. Pub. L. No. 104-67, 109 Stat. 737 (1995) (codified as amended in scattered sections of 15 U.S.C. (1994)).
17. 15 U.S.C. § 78t(e).
18. *Parmalat*, 376 F. Supp. 2d at 481–90.
19. *See id.*
20. *Id.* at 504.
21. *Id.* at 510.
22. *Id.*
23. 452 F.3d 1040 (9th Cir. 2006).
24. *Id.* at 1043.
25. *Id*
26. *Id.* at 1052-55.
27. 443 F. 3d 987 (8th Cir. 2006).
28. *Id.* at 992.
29. *Id.*
30. 482 F. 3d 372 (5th Cir. 2007).
31. *See id.* at 377.
32. *Regents*, 482 F. 3d at 377.
33. *Id.* at 378.
34. *Id.*
35. *Id.* at 386.
36. *Id.* at 392.
37. *Stoneridge*, 128 S. Ct. at 767–68.
38. *Id.* at 766.
39. *Id.* at 767.
40. *Id.* at 768–69.
41. *Id.* at 769.
42. *Id.*
43. *Id.*
44. *Id.*
45. *Id.*
46. *Id.* at 770.
47. See *id.* at 771.
48. *Id.*
49. *Id.* at 770–71.
50. *Id.* at 770.
51. *Id.*
52. *Id.* at 772.
53. *Id.*
54. *Id.*
55. *Id.* at 773.
56. *Id.* at 774.

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