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Stoneridge Investment Partners v. Scientific-Atlanta, Inc.: The Supreme Court Rejects "Scheme" Liability

In its recent decision in Stoneridge, *the Supreme Court ruled in favor of defendants on the scope of primary liability under the key anti-fraud provision of the federal securities laws. Nevertheless, it is expected that the plaintiffs' bar will argue for an expansive reading of the Court's definition of "deceptive conduct."*

by Jonathan C. Dickey, Mark A. Perry, and Julian W. Poon

On January 15, 2008, the Supreme Court issued its decision in *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*,[1] resolving a critical issue concerning the scope of primary liability under the key anti-fraud provision of the federal securities laws. In an opinion authored by Justice Kennedy (joined by Chief Justice Roberts and Justices Scalia, Thomas, and Alito), the Court reaffirmed its decision in *Central Bank of Denver, N. A. v. First Interstate Bank of Denver, N. A.*[2] (*Central Bank*), that liability under Section 10(b) of the Securities Exchange Act of 1934 (Exchange Act) does "not extend to aiders and abettors," and held that, to be actionable, "[t]he conduct of a secondary actor must" *itself* "satisfy each of the elements or preconditions for liability" under Section 10(b) and Rule 10b-5. To most observers, the Supreme Court's decision in *Stoneridge* sounds the death knell for claims invoking so-called scheme liability under Section 10(b), and makes clear that any further expansion of remedies in private securities class actions is a matter for Congress, not the courts.

Background

A summary of the key facts in the case is important to an understanding of the Court's decision. Defendants Scientific-Atlanta and Motorola were equipment vendors to Charter Communications, the issuer of publicly-traded securities purchased by plaintiff class members. Charter was one of the nation's largest cable television operators. The two vendors both sold set-top boxes to Charter, which Charter resold to its customers.

In 2000, Charter negotiated with the two vendors to undertake the transactions at issue in the case. Charter, for its part, would purchase set-top boxes for $20 more per box than normal, allegedly on condition that the two equipment vendors would, for their part, agree to purchase advertising services from Charter for equal amounts. In effect, the two transactions constituted a "wash" transaction that, according to plaintiffs, should have been

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accounted for under GAAP as no gain to Charter. Instead, Charter recorded the advertising monies as revenues, and capitalized the cost of the purchased set-top boxes, thus improving its operating cash flows. The net effect was that Charter recognized a total of over $17 million in allegedly fictitious revenues.

As pointed out in the Supreme Court opinion, the equipment vendors had no role in preparing or disseminating Charter's financial statements to the investing public. As for their own financial statements, both equipment vendors properly accounted for the transactions as a "wash." Before entering into the transactions, however, Charter allegedly discussed the proposed transactions with its outside auditor, and was advised that in order to recognize revenue, the two sets of payment obligations needed to be unrelated to each other, negotiated at least one month apart, and made at fair market value. In order to accomplish this, Charter asked one of the vendors to notify Charter that it was raising prices on the set top boxes it already had agreed to purchase, and to cite higher manufacturing costs as the reason for the price increase. Although the vendor was alleged to know that this purported explanation was false, it sent the requested notice.

The Eighth Circuit Decision

The Eighth Circuit affirmed the district court's dismissal of the complaint. In its opinion, the Eighth Circuit noted that plaintiffs had in fact alleged that the equipment vendors had "entered into these sham transactions knowing that Charter intended to account for them improperly, and that analysts would rely on the inflated revenues and operating cash flow in making stock recommendations." *In re Charter Communications, Inc. Securities Litigation*,[3] the Court of Appeals found, however, that the vendors "did not issue any misstatement *relied upon by the investing public*, nor were they under any duty to Charter investors and analysts to disclose information useful in evaluating Charter's true financial condition."[4] Similarly, the Court found that "none of the alleged misrepresentations by Charter was made by or even with the approval of the Vendors."[5] The Court of Appeals characterized the relationship between Charter and its vendors as an "arms-length business transaction in goods and services other than securities."[6] Finding that no case had yet been decided that extended the reach of Section 10(b) to such a transaction, the Court concluded that "decisions of this magnitude should be left to Congress."[7]

In reaching its decision, the Court of Appeals analyzed prior controlling Supreme Court precedent, including *Central Bank*, and noted three principles that animated these past decisions. First, a private suit under Rule 10b-5 could not exceed the limits of liability arising under the text of the enabling statute, Section 10(b). Second, a device or contrivance is not "deceptive" under Section 10(b) *unless it is accompanied by a misstatement or failure to disclose by one who has a duty to disclose*. Third, the term "manipulative" as used in Section 10(b) is limited to the meaning ascribed to it in the Supreme Court's decision in *Santa Fe Industries, Inc. v. Green*,[8] namely, transactions in the securities marketplace that cause the market price of a security to not accurately reflect its true value.

Significant controversy has swirled around the Court of Appeals decision, as manifested by the numerous *amicus* briefs submitted to the Supreme Court that interpreted the decision to be strictly based on the question of whether a "deceptive act" must involve a material misstatement or omission by a party with a duty to speak, or rather whether it was based on the element of reliance. Most notably, the Solicitor General's Office submitted an amicus brief in which it pointedly argued that the Eighth Circuit erred to the extent it held that Section 10(b) "reaches only misstatements, omissions, made while under a duty to disclose, or manipulative trading practices." At oral argument before the Supreme Court, the Solicitor General repeated that position, and urged the Court to find that the conduct of the vendors was "deceptive" within the meaning of the statute. At the same time, however, the Solicitor General argued that the decision should be affirmed on the grounds that plaintiffs had failed to plead reliance (after a fairly public dispute with the SEC over whether to file an *amicus* brief at all, and contrary to the views of several SEC Commissioners, who reportedly wanted the SEC file a brief in support of plaintiffs).

The Court of Appeals' fleeting discussion of reliance in its opinion raised questions over whether the Court of Appeals decision has adequately considered—much less based its decision on—the issue of reliance. In its Supreme Court *amicus* brief, the Solicitor General sided with defendants, arguing that "although the court of appeals erred by concluding that petitioner had failed to satisfy Section 10(b)'s deception requirement, it nevertheless correctly upheld the district court's dismissal of petitioner's complaint, because petitioner did not sufficiently plead reliance on respondents' deceptive conduct." As the Solicitor General's brief noted, "petitioner does not contend that it (or the investing public) was even aware of the transactions that respondents executed with Charter." It thus described the vendors as having engaged in "undisclosed deceptive conduct," which therefore was not actionable.

The reliance issue came before the Supreme Court on a less than full record. As noted in the Solicitor General's brief, the district court apparently had accepted defendants' contention that the complaint simply had not alleged reliance, and defendants had renewed that argument on appeal. Noting, "while the Court of Appeals did not address the reliance issue in detail," the Solicitor General nevertheless observed that the appellate court "appears to have endorsed the district court's resolution of that issue." In fact, the Court of Appeals decision did not clearly hold that reliance was not sufficiently pled.

The Supreme Court Decision

The Supreme Court affirmed the Eighth Circuit's decision, and upheld the dismissal of the underlying complaint because petitioner failed to adequately allege "[r]eliance . . . upon the [respondents'] deceptive acts," which "is an essential element of the §10(b) private cause of action." Specifically, the Court "conclude[d] [that] the implied right of action does not reach the customer/supplier companies *because the investors did not rely upon their statements or representations* " (emphasis added).

The Court explained that in previous decisions, it had "found a rebuttable presumption of reliance in two different circumstances"—when "there is an omission of a material fact by one with a duty to disclose," and "under the fraud-on-the-market doctrine, . . . when the statements at issue become public"—neither of which applied in the case before it. As to the first test, the Court flatly stated that "[r]espondents had no duty to disclose."

As to the second test, the Court found that the vendors' allegedly deceptive acts "were not communicated to the public. No member of the investing public had knowledge, either actual or presumed, of respondents' deceptive acts during the relevant times. Petitioner, as a result, cannot show reliance on any of respondents' actions except in an indirect chain that we find too remote for liability." The Court elaborated that "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; and there is no authority for this rule." Rather, the Court reasoned, defendants' alleged deceptive acts must be sufficiently close or "immediate" to the plaintiffs' alleged injury in order for plaintiffs to have reasonably relied on those alleged deceptive acts. The Court observed that because "[i]t was Charter, not respondents, that misled its auditor and filed fraudulent financial statements," therefore "respondents' deceptive acts, *which were not disclosed to the investing public*, are too remote to satisfy the requirement of reliance" (emphasis added). Because "Charter was free to do as it chose in preparing its books, conferring with its auditor, and preparing and then issuing its financial statements," the investors could not be said to have relied upon any of the allegedly deceptive acts by these respondents in the decision to purchase or sell securities. Therefore, the Court concluded, "the requisite reliance cannot be shown," and respondents thus "have no liability to petitioner under the implied right of action."

Less helpful to defendants was the Court's analysis of the "deceptive conduct" issue, with respect to which the Court effectively rejected the Court of Appeals decision. Observing that the Eighth Circuit had seemingly stated that only misstatements or omissions by one with a duty to disclose were actionable, the Court said that "if this conclusion were read to suggest there must be a specific oral or written statement before there could be liability under Section 10(b) or Rule

10b-5, it would be erroneous."[9] In language that is significantly broad, the Court stated that "[c]onduct itself can be deceptive," and "in this case, moreover, respondents' course of conduct included both oral and written statements, such as the backdated contracts agreed to by Charter and respondents."

The Court's Policy Rationale

The Court's decision in *Stoneridge* is significant because of its rejection of theories of reliance that rest on chains of inference so attenuated as to extend "the private cause of action under § 10(b) . . . beyond the securities markets." The Court grounded its decision on its traditional reluctance to extend this private cause of action into "areas already governed by functioning and effective state-law guarantees." In particular, the Court referred to the securities markets as "the realm of financing business," while the transactions involved in the *Stoneridge* case—purchase and supply contracts—related to the "realm of ordinary business operations" that are governed by state law. Recognizing a private right of action for conduct in this realm would "invite litigation beyond the immediate sphere of securities litigation and in areas already governed by functioning and effective state-law guarantees."

The Court also relied on Congress' amendment of the securities laws, in the wake of *Central Bank*, "after the Court [had] moved away from a broad willingness to imply private rights of action," and its prior directives "to provide for limited coverage of aiders and abettors" only "in certain cases but not others." Specifically, the Court found that Section 20(e) of the Exchange Act,[10] which was enacted as part of the Private Securities Litigation Reform Act of 1995, granted the SEC, but not private plaintiffs, the right to pursue claims against a person who "knowingly provides substantial assistance to another person in violation of a provision of this Act," codifying the rule in *Central Bank* that no private right of action exists for mere "aiding and abetting." The Court's language on this point was direct and unequivocal: "were we to adopt [petitioner's] construction of § 10(b)," the Court reasoned, "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," thereby "undermin[ing] Congress'[s] determination that this class of defendants should be pursued by the SEC and not by private litigants." The Court strongly reaffirmed its recent jurisprudence recognizing that "[t]he § 10(b) private cause of action is a judicial construct that Congress did not enact in the text of the relevant statutes" and declining to broadly construe that implied cause of action. "Though it remains the law, the §10(b) private right should not be extended beyond its present boundaries," as "[t]he decision to extend the cause of action is for Congress, not for [the Court]."

The Court also underscored the adverse "practical consequences of" petitioner's contended-for "expansion" of Section 10(b)'s private cause of action, including:

1. The increased risk that "innocent companies" would have to pay "extort[ionate] settlements" in order to avoid the cost, uncertainty, and disruption that even "weak claims" under Section 10(b) cause;
2. The deterrent effect on "[o]verseas firms with no other exposure to our securities laws," and
3. The resultant "shift [of] securities offerings away from domestic capital markets."

Finally, the Court underscored that "[s]econdary actors are subject to criminal penalties… and civil enforcement by the SEC," that "[t]he enforcement power is not toothless," and that "some state securities laws permit state authorities to seek fines and restitution from aiders and abettors." Accordingly, the Court found that investors would not be left without an effective remedy to redress any perceived wrongful conduct by secondary actors, such as the equipment suppliers to Charter.

Implications of the Court's Decision

The "spin" already has begun on what the Supreme Court's decision augurs for future private securities litigation. *The Wall Street Journal* recently wrote that the Court's decision "extends Wall Street's winning streak on securities cases," and "dims the hopes for shareholders in big accounting frauds, such as Enron Corporation."

The plaintiffs' bar already is marshaling its arguments for why the *Stoneridge* decision is not fatal to their claims against secondary actors in a number of pending cases. One argument they appear to be advancing is based on the Court's distinction between the "realm of financing business" and the "realm of ordinary business operations." Indeed, in connection with the cert. petition to the Supreme Court in the *Enron* litigation, denied on January 22, 2008,[11] in which plaintiffs sought review of the Fifth Circuit decision denying class certification, plaintiffs' counsel contended that, under *Stoneridge,* the conduct of the secondary actors they are suing in *Enron* falls within the "realm of financing business," in that the allegedly improper off-balance-sheet transactions were carried out with the help of "financial professionals." Therefore, they contended, the claims still are actionable. Although that argument failed for the time being in *Enron,* no doubt that argument will be advanced again in the district court, and in other pending and future cases. As one of the plaintiffs' lawyers in *Enron* has publicly proclaimed, "the fight continues to hold the banks accountable for orchestrating the fraud.[12]"

Further evidence of the Supreme Court's views on how its ruling should affect other cases comes from the Court's recent remand of the decision in *Simpson v. AOL Time-Warner,* in which the Ninth Circuit had formulated a more liberal standard of primary liability under Section 10(b), in connection with class action claims against various secondary actors involved with Homestore.com. On January 22, the Court granted the cert. petition in that case, and swiftly remanded it to the Ninth Circuit to reconsider its ruling in light of *Stoneridge.* Notably, no similar remand occurred in the *Enron* case, suggesting perhaps that the Justices believe that the *Simpson* ruling simply cannot stand.

Another major issue that may arise in future cases is how the trial courts will apply the Court's definition of "deceptive conduct" to non-speaking defendants who otherwise had no duty to disclose. The statement by the Court, for example, that the "backdated contracts" to which the vendors were parties in *Stoneridge* constitute potentially actionable "oral and written statements" raises questions over how the plaintiffs' bar will apply this concept of "deceptive conduct" in future cases, particularly against counter-parties to contracts. For example, under current disclosure rules, issuers are required to disclose information about material contracts in their SEC filings. If counter-parties to contracts are thus disclosed to the investing public, can investors now allege that they relied upon the conduct of those counter-parties?

A further political question will be how the SEC's Enforcement Division responds to the Court's ruling.

Given the Court's strong endorsement of the authority of the SEC to pursue wrongdoing by secondary actors, a further political question will be how the SEC's Enforcement Division responds to the Court's ruling, and whether it will interpret the decision as expanding its authority to pursue enforcement actions against a wider range of secondary actors. Members of the financial press and other commentators already are speculating that the 2008 presidential election may have an impact as well, if a Democrat wins the White House and a new SEC Chairman is nominated.

Finally, the impact of *Stoneridge* on "gatekeepers" such as audit firms, lawyers and financial advisors is yet to be determined, but the Court's statement that "conduct itself can be deceptive"—shorn of any misstatement or omission by one with a duty to disclose—is not helpful in that regard. Although audit firms already can be sued for primary liability under Section 10(b) in connection with audited financial statements, the plaintiffs' bar may attempt to apply the Court's observation that "conduct itself can be deceptive" to other forms of conduct by audit firms or other gatekeepers.

For now, the defense bar applauds the result, and takes comfort in the strong policy statements issued by the Court in its opinion. As the old adage goes, however, "the devil is in the details." The next year will tell us whether trial courts will endorse a narrow reading of *Stoneridge,* or whether the plaintiffs' bar will suc-

cessfully argue for an expansive reading of the Court's definition of "deceptive conduct" in future cases.

NOTES

1. *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. __ (2008).
2. *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U. S. 164, 191 (1994).
3. *In re Charter Communications, Inc. Sec. Litig.*, 443 F.3d 987, 990 (8th Cir. 2006).
4. *Id*. at 992 (emphasis added).
5. *Id.*
6. *Id.*
7. *Id*. at 993.
8. *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462 (1977).
9. *Stoneridge Inv*., 552 U.S. _____.
10. 15 U.S.C. § 78t(e).
11. *Regents of University of California v. Credit Suisse First Boston (USA) Inc*., U.S. 06-1341 (February 22, 2008).
12. "Stoneridge Precedent Sinks Cert Bid for Enron Case," *Securities Law 360* (Jan. 22, 2008) (remarks of Dan Newman, Coughlin Stoia Geller Rudman & Robbins LLP).

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