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The Supreme Court Rejects Scheme Liability Under §10(b) and Rule 10b-5

On January 15, 2008, the U.S. Supreme Court issued a 5-3 decision in *Stoneridge Investment Partners, LLC* v. *Scientific-Atlanta, Inc.*, delineating the parameters of the private right of action implied in §10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5.[1] The Court declined to impose liability thereunder on secondary actors who have not themselves issued misleading financial statements to the investing public. The Court reasoned that a recognition of "scheme liability" — a theory plaintiffs' lawyers have advanced to assert 10b-5 claims against secondary actors such as accountants, underwriters and lawyers — would subject secondary actors to liability without the requisite showing that investors relied upon those actors' statements or actions. The *Stoneridge* decision, authored by Justice Kennedy, resolved what had been a circuit split on the issue of scheme liability.[2]

I. The Facts of the Case

Stoneridge was a class-action suit by investors, alleging that Charter Communications, Inc. ("Charter"), a cable television provider, engaged in various fraudulent practices and issued misleading financial statements in order to meet revenue expectations. The investor plaintiffs also sued two of Charter's equipment suppliers, Scientific-Atlanta, Inc. and Motorola, Inc., alleging a scheme in which Charter purchased digital cable converter (set top) boxes from the two suppliers, agreeing to overpay them by $20 per set top box, in exchange for their returning the overpayment to Charter in the form of advertising fees. Plaintiffs alleged that these were sham transactions intended to inflate Charter's revenue and operating cash flow in order to meet analyst expectations and that Charter deceived investors by including inflated numbers in its financial statements filed with the Securities and Exchange Commission ("SEC") and reported to the public. Although the two suppliers did not participate in Charter's accounting for its transactions with them or in the preparation or dissemination of Charter's financial statements, plaintiffs sued the suppliers under a theory of scheme liability, claiming that they knew of or recklessly disregarded Charter's intention to utilize the transactions to inflate revenue and knew that Charter's fraudulent finan-

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[1] No. 06-43, slip. op. (U.S. Jan. 15, 2008). Justice Breyer took no part in the consideration or decision of the case.

[2] *Compare Simpson* v. *AOL Time Warner Inc.*, 452 F.3d 1040 (9th Cir. 2006) (recognizing scheme liability) *with Stoneridge Investment Partners, LLC* v. *Scientific-Atlanta, Inc.*, 443 F.3d 987 (8th Cir. 2006) *and Regents of the University of California* v. *Credit Suisse First Boston (USA), Inc.*, 482 F.3d 372 (5th Cir. 2007) (rejecting scheme liability).

cial statements would be relied upon by investors. Plaintiffs' contention was that the suppliers' participation in the scheme made them primarily liable under §10(b) for Charter's misstatements.

II. The Court's Rationale

A. The Opinion of the Court (Kennedy, J.)

The Court relied on its decision in *Central Bank of Denver, N.A.* v. *First Interstate Bank of Denver, N.A.*,[3] in which the Court held that there is no §10(b) liability for aiders and abettors, in part because a decision to the contrary would impose liability upon the defendant without the requisite showing that the plaintiff relied upon the aider and abettor's statements or actions. The Court reasoned that the suppliers' acts in *Stoneridge* do not give rise to liability under §10(b) because they were not relied upon by investors.[4] The Court reiterated that a plaintiff's reliance upon the defendant's acts is an indispensable element of a §10(b) cause of action, since it ensures that there exists the "causal connection between a defendant's misrepresentation and a plaintiff's injury" necessary for imposing liability.[5]

The Court explained that there are two circumstances in which a rebuttable presumption of reliance may be found. First, if an entity which owes a duty to disclose makes an omission of material fact, the investors to whom the duty was owed are presumed to have relied upon the omission. Second, the fraud-on-the-market doctrine provides a presumption of reliance when the statements at issue are made public. Because public information is reflected in the stock price, investors who buy or sell stock at the market price are presumed to have relied upon the statement. However, the Court continued, neither of these presumptions applies to the current case, because the suppliers did not owe investors a duty to disclose, nor were their deceptive acts communicated to the public.[6]

The Court declined to credit the investors' position that the suppliers' participation in the scheme enabled Charter to fool its auditor and issue misleading financial statements, and that ultimately, "in an efficient market investors rely not only upon the public statements relating to a security but also upon the transactions those statements reflect."[7] The Court reasoned: "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."[8] The Court concluded that the suppliers' "deceptive acts, which were not disclosed to the investing public, [were] too remote to satisfy the requirement of reliance"; nothing that the suppliers did made it "necessary or inevitable" for Charter to mislead its auditor and issue fraudulent financial statements.[9]

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[3] 511 U.S. 164 (1994).

[4] Slip. op. at 7.

[5] *Id*. at 8.

[6] *Id*.

[7] *Id*. at 9.

[8] *Id*.

[9] *Id*. at 10.

The Court buttressed its opinion by observing that extending the implied private cause of action under §10(b) to secondary actors would risk federal power being used to encourage litigation beyond the realm of immediate securities litigation and into areas already covered by effective state-law guarantees.[10] Additionally, the Court recalled that Congress specifically rejected pleas for the creation of an aiding and abetting cause of action following the *Central Bank* decision and instead empowered the SEC (but not private parties) to bring actions against aiders and abettors in §104 of the Private Securities Litigation Reform Act (PSLRA).[11] Accepting plaintiffs' scheme liability theory seeking to impose primary liability on aiders and abettors, said the Court, "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" and "would undermine Congress' determination that this class of defendants should be pursued by the SEC and not by private litigants."[12]

Noting that "there is an implied cause of action only if the underlying statute can be interpreted to disclose the intent to create one," the Court was unwilling to take it upon itself to expand the §10(b) private cause of action.[13] The Court stated: "The decision to extend the cause of action is for Congress, not for us."[14]

The "practical consequences" of expanding the §10(b) cause of action provided the Court another reason to reject scheme liability. Permitting plaintiffs to sue secondary actors for securities fraud would expose a new class of defendants to the extensive discovery and uncertainty that often allow plaintiffs with meritless claims to extort settlements from innocent companies. Contracting parties would likely feel compelled to protect against these risks, thus raising the cost of doing business, and foreign companies may be deterred from conducting business in the United States. Consequently, explained the Court, the cost of being a publicly traded company in the United States is likely to rise, and securities offerings may well be shifted away from domestic capital markets.[15]

Finally, the Court emphasized that its decision does not mean that securities violations committed by secondary actors will go unpunished. Not only are secondary actors subject to criminal penalties and civil enforcement by the SEC, but some state securities laws allow state authorities to seek fines and restitution from aiders and abettors. In addition, accountants and underwriters are subject to an express private right of action under the securities statutes in certain circumstances, and the §10(b) implied private cause of action continues to be available against "secondary actors who commit primary violations."[16]

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10 *Id.*

11 *Id*. at 11.

12 *Id*. at 11-12.

13 *Id*. at 13-14.

14 *Id*. at 14.

15 *Id*. at 12-13.

16 *Id*. at 15.

B. The Dissenting Opinion (Stevens, J.)

The dissent, authored by Justice Stevens, viewed the case differently. Assuming for purposes of analysis that Charter could not have inflated its revenues without the knowing actions of the suppliers, the dissent reasoned that investors who relied on Charter's financial statements also relied on the suppliers' fraud, deeming this sufficient to satisfy the reliance requirement of §10(b). Noting that the suppliers knew their actions would constitute the basis for misleading statements on which investors would rely, the dissent concluded that the suppliers "proximately caused Charter's misstatement of income."[17] The dissent also highlighted the distinction between this case and *Central Bank*, in which the bank did not actually engage in any deceptive act in violation of §10(b). The dissent adopted the position that liability attaches "when the company doing business with the issuing company has *itself* violated §10(b)."[18]

III. The Significance of the Court's Decision

The Court's decision in *Stoneridge* makes clear that, absent satisfaction of all of the elements for primary liability, there is no liability under §10(b) and Rule 10b-5 for secondary actors. One portion of the decision likely to give rise to future litigation is the Court's recognition that there need not be a specific oral or written statement before there could be liability under §10(b) or Rule 10b-5 because conduct can be deceptive as well.[19]

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Charles A. Gilman at (212) 701-3403 or cgilman@cahill.com; Jon Mark at (212) 701-3100 or jmark@cahill.com; or John Schuster at (212) 701-3323 or jschuster@cahill.com; or Yafit Cohn at (212) 701-3089 or ycohn@cahill.com.

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17 *Id*. at 6 (Stevens, J., dissenting).

18 *Id*.

19 *Id*. at 7.