

January 16, 2008

U.S. Supreme Court Limits Secondary Actors' Liability for Securities Fraud Under Section 10(b) and Rule 10b-5

As widely reported, on January 15, 2008, the U.S. Supreme Court decided *Stoneridge Investment Partners LLC v. Scientific-Atlanta, Inc.*, No. 06-43. The Court's opinion, written by Justice Anthony M. Kennedy for a five-justice majority, affirmed dismissal of the investors' claim against the secondary actors, rejected the concept of "scheme liability," held that there is no implied right of action under Section 10(b) or Rule 10b-5 against persons or entities who did not themselves make public statements upon which investors relied upon in connection with the purchase or sale of a security, and reaffirmed that there is no implied right of action under Section 10(b) and Rule 10b-5 for aiding and abetting a Section 10(b) violation. As discussed below, while the ruling clearly is good news for accountants, lawyers, broker-dealers, and other professionals who render services in connection with securities, it is less than clear how the Court's reasoning may be applied to different allegations more tailored to investor reliance on the secondary actor.

The alleged fraud in *Stoneridge* was that in order to meet its quarterly earnings projections, Charter Communications, a cable television company, made an agreement with defendants Scientific-Atlanta and Motorola to overpay \$20 per unit for digital cable converter boxes that Charter provided to its customers, with the understanding that Scientific-Atlanta and Motorola would return the overpayment by purchasing advertising from Charter. Although the transactions were an economic wash, they enabled Charter to file financial statements with the SEC showing that it had met its revenue and operating cash flow projections. To prevent Charter's auditors from discovering their scheme, each of the companies fabricated documents to make it appear as if the transactions were unrelated and conducted in the ordinary course of business. Scientific-Atlanta and Motorola played no role in preparing or disseminating Charter's financial statements, but they were nonetheless sued for violating Section 10(b) and Rule 10b-5.

The district court granted Scientific-Atlanta and Motorola's motion to dismiss, and the Eighth Circuit affirmed, holding that plaintiffs had failed to allege that Scientific-Atlanta and Motorola had made misstatements relied upon by the public or that they had violated a duty to disclose, and thus there was no violation of Section 10(b). The Supreme Court affirmed the Eighth Circuit's ruling, albeit on arguably different reasoning.

Reiterating first the Court's holding in *Central Bank of Denver N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 191 (1994), that the "Section 10(b) implied right of action does not extend to aiders and abettors," the Court considered whether plaintiffs' allegations concerning Scientific-Atlanta and Motorola's conduct satisfied "each of the elements or preconditions for liability." Referring to the Eighth Circuit's conclusion that plaintiffs had not alleged that Scientific-Atlanta or Motorola had "engaged in a deceptive act within the reach of the § 10(b) right of action," the Court stated, "If this conclusion were read to suggest there must be a specific oral or written statement before there could be liability under § 10(b) or Rule 10b-5, it would be erroneous. Conduct itself can be deceptive, as respondents concede." The Court noted in particular that Scientific-Atlanta's and Motorola's alleged course of conduct had included false and misleading oral and written statements and other deceptive acts.

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The Court focused, therefore, not on whether these companies had committed deceptive acts – allegedly, they had – but on whether their deceptive statements or acts took place in the “investment sphere” and therefore had “the requisite proximate relation to the investors’ harm.” The issue as thus framed by the Court turned on an analysis of the remoteness of the investors’ reliance, rather than on a bright-line test that secondary actors who did not make a public statement in connection with a security are not liable under Section 10(b).

The Court rejected plaintiffs’ argument that they should benefit from a rebuttable presumption of reliance, stating that Scientific-Atlanta and Motorola had no duty to disclose, and that “[n]o member of the investing public, had knowledge, either actual or presumed, of respondents’ deceptive acts during the relevant times.” Plaintiffs also invoked the concept of “scheme liability,” arguing that Scientific-Atlanta and Motorola had engaged in deceptive conduct with the purpose and effect of furthering a scheme to misrepresent Charter’s financial position; that their conduct had the natural and foreseeable consequence of false and misleading financial statements being released to the public; and that but for these companies’ deceptive acts, Charter’s financial statements would have more accurately reflected its true financial position. The Court rejected the “scheme liability” theory, finding that the companies’ deceptive acts, which were not disclosed to the investing public, were “too remote to satisfy the requirement of reliance.” The Court continued: “It 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.”

The Court’s reasoning suggests that deceptive acts and even false and misleading statements by secondary actors that take place “in the marketplace for goods and services, not in the investment sphere,” cannot support a private right of action under Section 10(b) or Rule 10b-5. Even when such a fraudulent scheme is committed for the purpose of allowing an issuer of securities to misrepresent its financial position, the Court views the issuer as bearing ultimate responsibility for preparing its books and records, conferring with its auditor, and preparing and issuing its financial statements. Under this view, investors would be deemed to have relied upon the issuer’s conduct and statements, and not upon secondary actors’ deceptive acts supporting the issuer’s misrepresentations, in deciding to purchase or sell securities. Absent such reliance, the secondary actors have no liability to investors under Section 10(b) or Rule 10b-5.

It remains to be seen how lower courts, faced with different allegations, will apply the Court’s focus on the remoteness of the defendants’ acts to the plaintiffs’ injuries in the context of reliance. *Stoneridge* makes it more difficult, but arguably not impossible, for plaintiffs to plead securities violations against secondary actors who did not make misrepresentations directly to the investing public in connection with a security. For example, it is unclear how a court might respond to an investor’s argument that he or she read and relied upon a financial statement disclosure about a specific transaction that was later discovered to be the product of fraudulent collusion between the issuer and secondary actors. An investor might argue that such allegations present a less remote theory of reliance than in *Stoneridge*; a defendant might argue that such disclosures remain the responsibility of the issuer and not the secondary actors and thus still cannot support secondary actor liability. The Court’s reliance analysis in *Stoneridge*, notwithstanding its clearly stated reluctance to extend Section 10(b) liability to aiders and abettors, may continue to provide opportunities for investors seeking additional avenues of civil recovery.

