

U.S. Supreme Court Rejects Securities-Fraud Liability for Secondary Actors Absent Reliance

January 16, 2008

On January 15, 2008, the United States Supreme Court issued its eagerly awaited decision in *Stoneridge Investment Partners v. Scientific-Atlanta, Inc.*, which raised the question whether and to what extent secondary actors who allegedly participate in a scheme to misstate another company's financials, but who do not themselves make any misrepresentations, can be held liable in damages to private plaintiffs under § 10(b) of the Securities Exchange Act of 1934 and the SEC's Rule 10b-5. The Court held that § 10(b)'s implied private right of action does not extend to secondary actors who neither make alleged misstatements nor engage in deceptive conduct on which investors rely. While the Court's decision does not directly address whether so-called "scheme" liability could ever support a § 10(b) claim against secondary actors, it rejects private plaintiffs' use of scheme liability against secondary actors in the absence of either reliance on those actors' allegedly deceptive conduct or the secondary actors' independent duty to speak.

Background

In 2002, purchasers of securities issued by Charter Communications, Inc. ("Charter") filed a securities-fraud class action against Charter, its independent auditor, and two of Charter's suppliers (and later customers), Scientific-Atlanta, Inc. and Motorola, Inc. (the "supplier-defendants"). Plaintiffs alleged that Charter – a cable operator – had engaged in a variety of fraudulent practices to meet market expectations for cable-subscriber growth and operating cash flow. When Charter realized that it would not meet the market's estimates, it purportedly altered its existing arrangements with the supplier-defendants to boost revenues.

According to the complaint, Charter arranged to overpay the supplier-defendants for digital cable converter boxes that Charter was buying to furnish to its own customers. In exchange for this overpayment, the supplier-defendants purportedly agreed to purchase advertising from Charter, thereby "returning" the overpayment. These allegedly interrelated transactions lacked economic substance, but allowed Charter to record the advertising purchases as revenue and to capitalize the purchase of the converter boxes. The supplier-defendants allegedly knew about the purported fraud and signed backdated documents so that Charter's purchase of the converter boxes would appear to have been negotiated separately from the subsequent advertising agreements.

The district court dismissed the plaintiffs' claims against the supplier-defendants, and the U.S. Court of Appeals for the Eighth Circuit affirmed, holding that the allegations did not

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show that the supplier-defendants had made any misstatement or had engaged in any market manipulation; nor had the supplier-defendants violated any independent duty to disclose the alleged fraud. The Supreme Court granted certiorari and affirmed.

The Supreme Court's Decision

The Supreme Court began its analysis with its 1994 decision in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, which had held that § 10(b) liability does not extend to mere aiders and abettors, as opposed to primary violators. The Court observed that, one year after *Central Bank*, Congress had revived aiding/abetting liability in SEC enforcement proceedings, but had not extended it to private actions. Accordingly, the Court confirmed in *Stoneridge* that § 10(b)'s "implied private right of action does not extend to aiders and abettors" and that "[t]he conduct of a secondary actor must satisfy each of the elements or preconditions for liability" under § 10(b).

Turning to the elements of primary § 10(b) liability, the Court rejected the notion that § 10(b) always requires "a specific oral or written statement." Instead, the Court held that, in some situations, "[c]onduct itself can be deceptive." But the Court stressed that, even if a plaintiff can establish some type of deceptive conduct, the plaintiff also must prove he or she *relied* on that conduct, because reliance is "an essential element of the private § 10(b) cause of action." The Charter investors' claims against the supplier-defendants foundered on the reliance requirement.

The Supreme Court recognized that reliance sometimes can be presumed in a securities-fraud case if "there is an omission of a material fact by one with a duty to disclose" or if a statement "become[s] public" and is incorporated "in the market price of [a] security" trading in an efficient market. But neither of these presumptions applied to the supplier-defendants, because (i) they themselves "had no duty to disclose" their alleged conduct involving the converter boxes and advertising purchases, and (ii) "their deceptive acts were not communicated to the public." There was no allegation that the investing public "had knowledge, either actual or presumed, of [the supplier-defendants'] deceptive acts during the relevant times."

The plaintiffs attempted to sidestep this deficiency in their complaint by arguing that the efficient-market theory permits investors to rely "not only upon the public statements relating to a security but also upon the transactions those statements reflect." In other words, plaintiffs contended that, even if the market did not know about or fully understand the impact that the alleged transactions between Charter and the supplier-defendants had on Charter's financial statements, investors nevertheless could be presumed to have relied on the transactions insofar as they were reflected in those financial statements (*i.e.*, the alleged fraud that allowed Charter to generate economically substanceless revenues).

The Supreme Court rejected this argument, holding that, “[w]ere 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.” Instead, the Court concluded that the supplier-defendants’ allegedly “deceptive acts, which were not disclosed to the investing public, are too remote to satisfy the requirement of reliance. It was Charter, not [the supplier-defendants], that misled its auditor and filed fraudulent financial statements; nothing [the supplier-defendants] did made it necessary or inevitable for Charter to record the transactions as it did.”

Justices Stevens, Souter, and Ginsburg dissented from the majority’s opinion. Justice Breyer did not participate.

The World After *Stoneridge*

Stoneridge could focus attention on several important issues in the future.

First, the decision might encourage courts and litigants to address what types of conduct can give rise to a § 10(b) claim. *Stoneridge* makes clear that an oral or written statement is not always required and that, at least in some circumstances, “[c]onduct itself can be deceptive.” But, as *Stoneridge* illustrates, not all allegedly deceptive conduct can lead to liability.

Second, *Stoneridge* could refocus attention on a Circuit split that has developed in the wake of *Central Bank*. Some courts (such as the Second Circuit) have adopted a “bright-line rule” and have held that *Central Bank*’s proscription of aiding and abetting liability means that § 10(b) liability can lie against only those persons to whom an allegedly false statement was *publicly attributed*. Other courts (such as the Ninth Circuit) have adopted a “substantial participation” test and have allowed § 10(b) claims to proceed against secondary actors who *substantially participated* in a speaker’s alleged misstatement, even if the misstatement was not publicly attributed to the secondary actor. As noted above, *Stoneridge* holds that § 10(b) does not necessarily require a misstatement (or omission) at all; the statute can apply to deceptive conduct in some circumstances. Courts now will need to decide whether that holding affects the debate about the “bright-line rule” versus the “substantial participation” test for secondary actors.

Third, *Stoneridge* might enter into the ongoing discussion about § 10(b)’s separate loss-causation requirement, which the Supreme Court recently examined in its 2005 decision in *Dura Pharmaceuticals, Inc. v. Broudo*. Post-*Dura* cases have considered whether a plaintiff can prove that an alleged fraud actually *caused* a loss if the purported fraud was never revealed to the public. Future cases might consider whether *Stoneridge*’s emphasis on the need for public disclosure and reliance (at least as to secondary actors) has any bearing on loss-causation issues.

Fourth, *Stoneridge* might raise questions about how closely any allegedly deceptive acts must be related to an issuer's securities (as opposed to broader aspects of the issuer's business operations). In holding that plaintiffs' allegations about the converter boxes and advertising purchases were too remotely related to Charter's financial statements, the Court cited yet another element of a § 10(b) claim: that a deceptive act must have been committed "in connection with the purchase or sale of any security." The Court took care to distinguish this "in connection with" requirement from the separate causation requirement, but it noted that "the emphasis on a purchase or sale of securities does provide some insight into the deceptive acts that concerned the enacting Congress." The Court ultimately concluded that, "[t]hough § 10(b) is not limited to preserving the integrity of the securities markets, . . . it does not reach all commercial transactions that are fraudulent and affect the price of a security in some attenuated way." Future litigation might flesh out where the dividing line lies. (The dissent focuses largely on this third issue, asserting that the majority's opinion creates a number of conceptual difficulties. Other cases could arise in which a secondary actor's participation in the issuer's affairs might not be considered excessively remote.)

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