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Client Alert

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Supreme Court Limits Private Securities Fraud Lawsuits Against Secondary Actors

In an important securities decision this week, the Supreme Court rejected an effort to expand the ability of private parties to sue, under section 10(b) of the Securities Exchange Act of 1934, secondary actors, including third party vendors, suppliers, and customers, who knowingly or recklessly engage in "deceptive acts" that assist a public company's securities fraud. In a five to three decision, the Court held that, where a secondary actor has no independent duty to disclose information to the investing public, and where the investing public does not act in reliance on that party's deceptive conduct, the secondary actor is not liable in a private section 10(b) action for its participation in a public company's scheme to defraud its investors. *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.,* ---S.Ct. ---, 2008 WL 123801 (January 15, 2008).

Factual Background

In *Stoneridge*, Stoneridge Investment Partners, an investor in cable television provider Charter Communications, brought a section 10(b) action on behalf of itself and a putative class of investors against two of Charter's vendors, Motorola, Inc. and Scientific-Atlanta, Inc. ("Vendors"), that supplied cable boxes at an inflated price and then paid an amount equivalent to the inflated portion of the price to Charter for advertising. The complaint alleged that the Vendors participated in these sham transactions in furtherance of Charter's scheme to manipulate its financial statements to cover losses; in their own financial statements, the Vendors booked the transactions as wash transactions in accordance with GAAP. Stoneridge argued that the Vendors' knowing or reckless participation in Charter's scheme constituted an independent violation of section 10(b), separate and apart from Charter's violation.[1] The District Court dismissed Stoneridge's complaint on the basis that it merely alleged a claim for aiding and abetting Charter's fraud, a cause of action not available to private plaintiffs under the Supreme Court precedent of *Central Bank N.A. v. First Interstate Bank, N.A.*[2] The Eighth Circuit affirmed on the basis that the Vendors had not committed any deceptive acts within the meaning of section 10(b), defining deceptive acts as including only misstatements, omissions and manipulative trading practices. The U.S. Supreme Court granted *certiorari* to consider whether a private suit for violations of section 10(b) could lie against the Vendors.

The Supreme Court's Decision

Justice Kennedy, writing for the majority, which included Justices Roberts, Alito, Scalia and Thomas, rejected Stoneridge's attempts to impose liability on the Vendors under section 10(b) for their role in Charter's fraud, affirming the Eighth Circuit's decision. As a general matter, the Court found that the private right of action implied in section 10(b) "does not reach the customer/supplier companies because the investors did not rely upon their statements or representations." 2008 WL 123801 at *2.

Reaffirming the Court's prior holding in *Central Bank* that section 10(b) does not extend to aiders and abettors, Justice Kennedy began with the central principle that the conduct of secondary actors must satisfy every element of a section 10(b) violation for liability. In light of section 10(b)'s limited reach, the Court considered whether the Vendors' conduct could be found to be a primary violation: that is, whether the Vendors engaged in a "deceptive" act as defined by section 10(b), and whether Stoneridge relied on that act

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[1] Stoneridge settled the claims it had asserted against Charter Communications.

[2] 511 U.S. 164 (1994).

in making its investment decisions. Finding that deceptive acts include conduct as well as oral and written statements (a definition unanimously adopted by the Court[3]), Justice Kennedy determined that the Vendors' actions were deceptive acts under section 10(b) and that, to the extent the Eighth Circuit had held otherwise, it had erred. *Id.* at *6. Despite finding that the Vendors had committed deceptive acts, however, the Court concluded that reliance by the public on those deceptive acts, an essential element of a section 10(b) private cause of action, could not be demonstrated where, as here, they were unknown to the investing public at the time of the securities transactions at issue. Thus, the Vendors' "deceptive acts, which were not disclosed to the investing public, are too remote to satisfy the requirement of reliance". *Id.* at *7.

The Court rejected the application of so-called "scheme liability" in which the acts of primary violators are attributed to a secondary actor. This theory has been accepted by several courts, most notably by the Ninth Circuit. *See Simpson v. AOL Time Warner, Inc.,* 452 F. 3d 1040 (9th Cir. 2006). Noting that Stoneridge sought to impose liability on Vendors even absent a public statement, the Court dismissed the scheme liability argument on the basis that it failed to address that Stoneridge had not in fact relied upon the Vendors' own deceptive conduct. "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 upon any of respondents' actions except in an indirect chain that we find too remote for liability." 2008 WL 123801 at *6. The Court also rejected Stoneridge's argument that investors rely not only upon the public statements relating to a security but also on the transactions those statements reflect, as a position without legal authority and potentially harmful to the financial markets. "Were this concept of reliance to be adopted," the Court wrote, "the implied cause of action would reach the whole marketplace in which the issuing company does business." *Id.* at *7.

The Court also addressed the policy reasons for its decision, warning against an expansion of section 10(b) liability beyond the securities markets and the realm of financing business operations, to the "ordinary business operations" of purchase and supply contracts, areas already effectively governed by state law. *Id.* A whole new class of defendants would be exposed to the risks of uncertain and disruptive litigation, the likely effect of which would be to increase the cost of doing business in the United States. Quoting briefs submitted by the Organization for International Investment and NASDAQ Stock Market, Inc., the Court observed, "[o]verseas firms with no other exposure to our securities laws could be deterred from doing business here. . . . This, in turn, may raise the cost of being a publicly traded company under our law and shift securities offerings away from domestic capital markets." *Id.* at *9.

In rejecting the requested expansion of section 10(b), the Court observed that its conclusion "is consistent with the narrow dimensions we must give to a right of action Congress did not authorize when it first enacted the statute [a reference to the judicially created nature of the right] and did not expand when it revisited the law" (a reference to Congress' rejection of a private right of action against aiders and abettors in the PSLRA). The Court noted that other remedies for the Vendors' deceptive conduct exist, including the SEC's enforcement authority over secondary actors, criminal penalties and state court actions.

The Dissent

Writing for the dissent, which Justices Souter and Ginsburg joined, Justice Stevens called the underlying theme of the majority's analysis a "mistaken hostility towards the section 10(b) private cause of action." And, in the wake of several recent high-profile cases restricting the rights of private litigants to recover under section 10(b), Justice Kennedy registered his dissent "from the Court's continuing campaign to render the private cause of action under section 10(b) toothless." *Id.* at *16.

Justice Stevens found that the vendors had themselves violated section 10(b) through their deceptive acts and, on that basis, distinguished the case from *Central Bank,* where "Central Bank engaged in no deceptive conduct whatsoever – in other words. . .it was at most an aider and abettor. . . .", for which no private right of action exists. By contrast here the Vendors themselves engaged in deceptive acts in violation of section 10(b) and proximately caused Charter's misstatement, allegedly knowingly or recklessly disregarding that their deceptive acts would be the basis for financial statements that would influence the market price of the stock. The dissent took issue with the majority's view of reliance, finding it to be "unduly stringent and unmoored from authority." Never before has the Court held that "investors must be aware of the specific deceptive act which violates section 10(b) to demonstrate reliance," Justice Stevens observed. *Id.* at *13. Thus, Justice Kennedy believed the Vendors were liable to shareholders when Charter, their partner in these deceptive acts, transmitted false information to the market.

Justice Stevens also responded to the majority's policy argument that permitting the requested expansion of section 10(b) liability would likely have a disruptive effect on the country's financial markets. Quoting a brief filed by several former SEC Commissioners, Justice Stevens opined that

[3] *Id.* at *12.

liability for those who violate section 10(b) "will not harm American competitiveness; in fact, investor faith in the safety and integrity of our markets *is* their strength. The fact that our markets are the safest in the world has helped make them the strongest in the world." *Id.* at *15. Justice Stevens further dismissed the majority's concern that a broadening of section 10(b) liability would have a chilling effect on the marketplace in general, responding that the "sham transactions" at issue in the case were "unquestionably isolated departures from the ordinary course of business in the American marketplace." Thus, it does not "invade the province of 'ordinary' business transactions," to place liability on "[a] corporation engaging in a business transaction with a partner who transmits false information to the market. . . where the corporation *itself* violates 10(b)." *Id.* at *14.

The Future

Viewed from the perspective of the policy bases set out by the Court for its ruling, including its explicit warning that the section 10(b) private right of action should not be expanded, *Stoneridge* closes the door to many of the creative theories of investors and their counsel to hold secondary actors liable in section 10(b) shareholder actions. The *Stoneridge* decision will come as a welcome relief to companies in the capital markets and those who fear their business transactions with public companies could place them at risk of meritless litigation from aggrieved investors in search of a deep pocket. However, while substantially narrowing any remaining avenues available to pursue secondary actors in private section 10(b) actions, when viewed from the perspective of the Court's analysis of section 10(b), the decision did leave open for another day the determination of several issues.

While the majority acknowledged a conflict among the circuits as to when, if ever, an injured investor may rely upon section 10(b) to recover from a party that participates in a scheme to violate section 10(b) but neither makes a public misstatement nor violates a duty to disclose, *Stoneridge* does not answer the question. In that regard, the case was decided on its facts. The Court did not rule out the possibility of imposing liability in a case where a secondary actor's deceptive acts were known to the investing public, even if those acts became known as a result of statements by the primary violator, in this case Charter. Plaintiffs may assert in future cases that there are at least factual issues whether a secondary actor's deceptive acts were, in fact, known to investors. Nor did the Court entirely foreclose the possibility of employing "scheme liability" to state a private section 10(b) cause of action in an appropriate case, such as if Charter had explicitly announced its allegedly sham advertising contracts with the Vendors. Finally, the Court did not delineate the boundaries between "financing business"—to which the securities laws appropriately apply—and "ordinary business transactions"—which the Court indicated were beyond their realm, or suggest exactly how that distinction should be applied in future decisions. The Court's decision, expected momentarily, on the pending petition for *certiorari* in the Enron case (*Regents of University of California v. Credit Suisse First Boston (USA), Inc.*) may be the first light shed on this issue since it more directly concerns "financing business" which *Stoneridge* did not. In any event, all these and other issues remain for another day in court.

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