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SECURITIES LAW

‘Stoneridge’ alters legal landscape

In limiting scope of primary liability, justices shield secondary actors.

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ON JAN. 15, THE U.S. Supreme Court decided what was heralded as one of the most important securities fraud cases to reach the court in decades. In *Stoneridge Inv. Partners LLC v. Scientific-Atlanta Inc.*, 128 S. Ct. 761 (2008), the court upheld the dismissal of a fraud claim under § 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 against two customers/suppliers that were alleged to have engaged in a “scheme” with an issuer of securities to defraud investors. The case has widespread implications for third parties that engage in business relationships with issuers, including customers, suppliers, investment banks and financial services and accounting firms, and it signals a pro-business trend of the Roberts court. See also *Tellabs Inc. v. Makor Issues & Rights Ltd.*, 127 S. Ct. 2499 (2007).

To put the case in context, consider the legal landscape in the years leading to the Supreme Court’s decision. In 1994, the Supreme Court in *Central Bank of Denver N.A. v. First Interstate Bank of Denver N.A.*, 511 U. S. 164 (1994), held that there is no private right of action for aiding and abetting a violation of § 10(b) and Rule 10b-5. At the time, the *Central Bank* decision was hailed as a victory for investment banks, underwriters and

other entities in business relationships with issuers alleged to have made misstatements or otherwise failed to disclose material information in violation of the federal securities law. While *Central Bank* provided some comfort to such third parties, the Supreme Court’s decision left open the possibility that a third party could be liable as a primary violator for engaging in a “scheme” with an issuer to violate § 10(b). *Stoneridge* closes this loophole.

The facts of the *Stoneridge* case bear repeating. As alleged, Charter Communications, a Rocky Mountains cable TV company, engaged in a scheme with two of its set top box suppliers—Motorola Inc. and Scientific-Atlanta Inc.—to misstate its financial statements through a series of “wash” transactions lacking in economic substance. As part of the alleged scheme, the suppliers falsely increased the price of the set top boxes by \$20. Upon receipt of Charter’s payment of an additional \$20 per set top box, the suppliers turned around and used the additional revenue to pay Charter for advertising. Neither company had advertised with Charter before. The “scheme” allowed Charter to treat the “extra” \$20 it was being charged by the suppliers as a capital expense that could be amortized over time, and the advertising dollars it received from the suppliers as ordinary income. Charter was thus able to produce financials that satisfied analyst expectations. Along the way, the parties allegedly created false documentation that hid the “wash” transactions from Charter’s auditors.

Upon discovery of the alleged scheme, Charter, Motorola and Scientific-Atlanta were sued for securities fraud. The issue that went to the Supreme Court concerned the potential liability of Motorola and Scientific-Atlanta,

which, by the way, did account for the wash transactions appropriately on their own books. The question was: Did these two companies have potential liability to Charter’s shareholders under subsections (a) and (c) of Rule 10b-5 because their acts were in furtherance of a “scheme” or constituted a fraudulent “act” or “practice”?

The Supreme Court held that, even when a third party participates in a scheme in violation of § 10(b), an injured investor cannot rely on § 10(b) to recover from a party that neither makes a public misstatement nor violates a duty to disclose under § 10(b). The court reached this conclusion by focusing on the element of reliance. Most other legal analysts and most defendants facing similar claims have argued that the words “manipulative” and “deceptive” in § 10(b) are very limited terms of art, and thus they make a tacit or express argument that parts (a) and (c) of Rule 10b-5 are beyond the scope of the Securities and Exchange Commission (SEC)’s rule-making authority. That analysis might work for the word “manipulative,” which under prior Supreme Court case law has a very circumscribed meaning, but not so for “deceptive,” which the court in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), said had its ordinary, broad meaning from common usage.

Reliance is a different matter, and the only required element of Rule 10b-5 that provides any hope of producing consistent results from the courts. In the ordinary course, investors will not be able to say that they relied upon third parties that participated in facilitating someone else’s fraud in the way that Motorola and Scientific-Atlanta were alleged to have acted in the *Stoneridge* case. These contracting third parties have no duty to speak to the public

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about their transactions with a securities issuer, and in the ordinary course, investors often will not even know of their existence, much less of the existence of the transactions themselves.

This is exactly how the court reached its result in *Stoneridge*, in which it held that Motorola and Scientific-Atlanta “had no duty to disclose” their arrangements with Charter to the public, and their “deceptive acts” were not communicated to the public, and therefore the plaintiffs “cannot show reliance upon any of [the defendants’] actions except in an indirect chain that we find too remote for liability.” *Id.* at 769. In so holding, the court rejected the plaintiffs’ claim that they relied upon not just the public statements of Charter and the two set top box manufacturers, but also upon the integrity of the transactions they engaged in, which, the plaintiffs alleged, naturally and as a direct consequence of their scheme found their way into Charter’s financial statements, which were disclosed to the public. This was essentially the approach the 9th Circuit took in *Simpson v. AOL Time Warner Inc.*, 452 F.3d 1040 (2006).

Court held plaintiffs failed to show reliance on third parties.

The reasoning is not illogical, and indeed, *Stoneridge* was a 5-3 decision, with Justice Stephen G. Breyer recusing himself, so it was a close vote. Nonetheless the court rejected this argument largely on policy grounds. After reiterating that a private right of action for aiding and abetting liability under § 10(b) does not exist, the court determined that the only way for the conduct of a secondary actor such as Motorola and Scientific-Atlanta to be actionable would be for the plaintiffs to satisfy all of the elements for primary liability. The court stated that “[r]eliance by the plaintiff upon the defendant’s deceptive acts is an essential element of the § 10(b) private cause of action. It ensures that, for liability to arise, the ‘requisite

causal connection between a defendant’s misrepresentation and a plaintiff’s injury’ exists as a predicate for liability.” *Id.* Dismissal thus was based on the fact that the plaintiff could not show reliance.

Court also refused to recognize ‘scheme liability’ claim.

The court similarly refused to use “scheme liability” as a means to create a basis for liability absent a public statement or duty to disclose on the part of the secondary actor. The premise of the court’s refusal was rooted in its finding that the private right of action under § 10(b) is implied by the courts and has not been codified in the Securities Exchange Act. Thus, adopting the petitioners’ theory of “scheme liability,” the court found, would expand the reach of the federal securities law to ordinary business operations and would risk that “the federal power would be used to invite litigation beyond the immediate sphere of securities litigation and in areas already governed by [state law].” *Id.* at 771.

In this regard, the court pointed to Congress’ response to *Central Bank* when it had the opportunity to include a private remedy for aiding and abetting liability, but did not. Instead, in enacting the Private Securities Litigation Reform Act of 1995, Congress authorized only the SEC to enforce aiding and abetting liability, which countenanced against expanding the implied, private right of action against third parties. It also concluded that if this theory were adopted, § 10(b)’s implied cause of action “would reach the whole marketplace in which [public companies] do[] business,” including “overseas firms” that might be deterred from doing business here. *Id.* at 770. The court also focused on the fact that exposing a greater number of companies to potential 10b-5 liability would raise the costs of doing business, as contracting parties would seek ways to protect

themselves from a whole new category of potential liability.

A real-world appreciation of the significance of the *Stoneridge* decision is evident upon examination of the litigation against the banks and other advisers arising in the aftermath of fall of Enron. It was clear from the beginning that the massive fraud at Enron would bankrupt the company and that investors would never be able to cover their losses from Enron or its insurers alone. That left the investment banks that assisted Enron in structuring its off-balance sheet transactions as potential deep pockets, and indeed, to date, the plaintiff class has recovered more than \$7 billion from settling banks out of the \$40 billion the class claims as losses.

The holding in *Stoneridge* indicates that all or most of that \$7 billion probably did not have to be paid, because the banks, even if they acted with full knowledge that they were engaged in a scheme with Enron, had no liability to the investing public under the anti-fraud provisions of the federal securities laws. Note that while the settling banks in Enron paid approximately \$7 billion, there remained a number of banks that declined to settle, and that would have faced massive exposure had *Stoneridge* been decided differently. By rejecting the “scheme liability” theory, the Supreme Court has profoundly changed the risks faced by professionals such as investment bankers, accountants and lawyers, as well as ordinary contracting parties that advise or conduct business with issuers of securities.

While *Stoneridge* does not close third-party liability completely, a secondary actor can be held liable for securities fraud today only if the plaintiff can allege and prove all of the elements for establishing primary liability. As a practical matter, because most secondary actors do not make public statements regarding transactions with issuers, and do not have a duty to disclose such transactions, satisfying the primary liability standards will prove to be very difficult. **NLJ**

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