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CLIENT ALERT

SUPREME COURT REJECTS "SCHEME LIABILITY" FOR SECONDARY ACTORS ON RELIANCE GROUNDS

On January 15, 2008, the U.S. Supreme Court issued its much-anticipated decision in *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc., et al.*, in which the Court largely rejected the theory of "scheme liability" against third parties (known as "secondary actors"). The ruling was 5 to 3, with Justice Breyer not participating.

The *Stoneridge* decision has significant implications for the business community. A finding in favor of scheme liability for the deceptive acts of third parties would have greatly extended the reach of the securities laws and empowered plaintiffs to target the practices of all firms who conduct business with publicly traded companies. The Court's decision will make it much more difficult for future plaintiffs to plead creative "scheme liability" theories against deep-pocket third-party defendants who were only tangentially involved in the alleged violations.

In *Stoneridge*, plaintiffs alleged that Charter Communications, Inc., a cable operator, engaged in fraudulent transactions with its equipment vendors to inflate revenues and cash flow to meet Wall Street's expectations. These transactions allegedly included arrangements with Scientific-Atlanta, Inc. and Motorola, Inc. under which Charter agreed to overpay these vendors for cable boxes in return for the vendors' purchases of advertising from Charter in excess of fair value. Charter then improperly recorded the advertising purchases as revenue and capitalized its purchases of cable boxes by creating the fiction that the transactions were unrelated.

To accomplish this scheme, the companies allegedly falsified documents for the cable-box transactions. Scientific-Atlanta falsely increased the price of its cable boxes, and Motorola entered purchase-commitment contracts with Charter that provided liquidated damages for unpurchased cable boxes even though Charter was not expected to meet its purchase commitments. The parties then backdated these documents so it appeared that they were negotiated a month before the advertising arrangements. This documentation allowed Charter to falsely separate the cable-box and advertising arrangements and, in doing so, mislead its auditor and falsely report the transactions in its financial statements.

Despite this allegedly knowing or reckless conduct, Scientific-Atlanta and Motorola were not alleged to have made any misrepresentations to Charter's shareholders or to have participated in drafting Charter's alleged misrepresentations. To meet the reliance requirement of Section

10(b), plaintiffs nonetheless argued that investors not only rely upon the public *statements* related to a security, they also rely on the underlying *transactions* that are the subject of those statements.

The Supreme Court rejected this argument, reasoning that such an "implied cause of action would reach the whole marketplace in which the issuing company does business; and there is no authority for this rule." The Court held that Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 do not confer a private cause of action against a third party that participates in a fraudulent scheme unless plaintiffs can show reliance: the "requisite causal connection between a defendant's misrepresentation and a plaintiff's injury." In *Stoneridge*, the Court found that the plaintiffs could not show that they relied upon the third parties' actions because they did not have knowledge of the third parties' allegedly deceptive conduct, and the rebuttable presumptions of reliance—a duty to disclose or actual disclosure of the deceptive acts—did not apply. In the words of Justice Kennedy's majority opinion, "[n]o member of the investing public had knowledge, either actual or presumed, of [Scientific-Atlanta's and Motorola's] deceptive acts . . . [and plaintiffs] cannot show reliance upon any of [their] actions except in an indirect chain that we find too remote for liability."

The *Stoneridge* ruling follows the course charted by the Court's seminal ruling in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, which held that Section 10(b) only applies to parties which engage in manipulative or deceptive practices that are relied upon by investors, not merely parties who "aid and abet" a violation. In *Stoneridge*, it was Charter, not Scientific-Atlanta or Motorola, that misled its auditor and filed fraudulent financial statements, and the third parties' conduct did not make it necessary or inevitable that Charter would falsely report the transactions.

The Court cited several grounds supporting its decision. It noted that extending a private cause of action in this case would expand the reach of Section 10(b) beyond the securities markets and into the realm of ordinary business operations, which are largely governed by state law. The Court also reasoned that Section 10(b) should not be interpreted to provide a private cause of action against the entire marketplace in which an issuing company operates. The Court further noted that creating an implied cause of action in these circumstances would be contrary to Congress' response to *Central Bank* in Section 104 of the Private Securities Litigation Reform Act, which provides that aiders and abettors can be pursued only by the SEC, not private litigants. Finally, the Court noted several practical consequences supporting its ruling, such as the potential for plaintiffs with weak claims to extort settlements from innocent companies, and the possible implications for overseas firms with no other exposure to the U.S. securities laws, which could deter them from doing business here, raise the costs of being a publicly traded company under U.S. law, and shift securities offerings away from domestic capital markets.

In dissent, Justice Stevens condemned this result and criticized the majority's reliance on *Central Bank*. Notably, the justices who dissented in *Stoneridge*—Stevens, Souter and Ginsburg—also dissented in *Central Bank*. Justice Stevens distinguished *Central Bank* as limited to the issue of potential liability for aiding and abetting when the third party is *not* alleged to have committed any deceptive acts. In *Stoneridge*, by contrast, Justice Stevens found that falsifying and back-dating documents to disguise the connection between the Charter transactions "plainly describe 'deceptive devices' under any standard reading of the phrase." Justice Stevens also reasoned that the Court's protection of Scientific-Atlanta and Motorola had established an unprecedented new burden for pleading causation—a "kind of super-causation"—to establish reliance for securities fraud. Finally, he criticized the Court's reluctance to find judicially created private rights of action under Section 10(b), and suggested that when the Securities Exchange Act of 1934 was enacted, it was understood that courts would create such remedies in the common-law tradition to ensure that "every wrong shall have a remedy."

The *Stoneridge* opinion is significant because the Court protected Scientific-Atlanta and Motorola from liability even though they were alleged to have knowingly or recklessly falsified documents to enable a publicly traded business partner to issue fraudulent financial statements. This victory for defendants, however, is not as sweeping as it could have been. The Court's opinion departs from still broader holdings of the 8th and 5th Circuits, which ruled that third parties may be held liable only for misstatements, omissions by one who has a duty to disclose, and manipulative securities trading practices. In contrast, *Stoneridge* does not foreclose the possibility that non-speaking third parties could be liable for a broader range of conduct on which the plaintiffs relied. But the Court's ruling makes it doubtful that liability could attach absent actual disclosure of the deceptive acts, as the *Stoneridge* plaintiffs were unable to recover from Scientific-Atlanta and Motorola even though their allegedly deceptive conduct specifically enabled Charter to issue fraudulent financial statements.

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