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NEWSLETTER

U.S. Supreme Court Curbs Securities Lawsuits Against Secondary Actors

January 15, 2008

On January 15, 2008, the United States Supreme Court held that investors suing business partners of an issuer must plead and ultimately prove actual reliance to state a claim under Section 10(b) of the Securities Exchange Act of 1934, rejecting so-called "scheme liability." *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc., et al.*, – U.S. –, No. 06-43 (Jan. 15, 2008). In a 5-3 decision authored by Justice Kennedy, the Court held that the secondary actors' alleged conduct in *Stoneridge* was not actionable because the investors could not have relied on the secondary actors' allegedly deceptive conduct because it was not disclosed to the market.

The secondary actors in *Stoneridge*, Scientific Atlanta, Inc. and Motorola, Inc., engaged in alleged wash barter transactions with Charter Communications, Inc., in which Charter purchased set top cable boxes from the vendor at a $20 per box premium above the actual price. In return, the suppliers agreed to return the overpayment by purchasing advertising from Charter. While the suppliers accounted for the transactions as a wash, Charter recognized revenue from the advertising fees and capitalized the expenses associated with the cable box purchases, thereby inflating its cash flows and revenue and allowing Charter to meet its financial projections. Charter and the suppliers also assertedly prepared false documentation that hid the correlation between the cable box purchases and the advertising deals from Charter's auditor in order to obtain the desired favorable accounting treatment. The cable box suppliers had no role in preparing or disseminating Charter's financial statements and otherwise made no public disclosures regarding the wash transactions.

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The district court granted the suppliers' motion to dismiss for failure to state a claim. The United States Court of Appeals for the Eighth Circuit held that the suppliers, which made no public statements, could not be held primarily liable under Section 10(b). The Eighth Circuit opined that a "deceptive device" under Section 10(b) means only oral or written misrepresentations or omissions when the defendant had a duty to disclose the withheld information. Accordingly, it determined that because they made no public statements, the suppliers had only aided and abetted Charter's misrepresentations. Since there is no private right of action for aiding and abetting a Section 10(b) violation, the Eighth Circuit affirmed the suppliers' dismissal. *In re Charter Commc'ns Inc. Sec. Litig.*, 443 F.3d 987 (8th Cir. 2006).

The Supreme Court affirmed, but on arguably different grounds. At the outset, the Court observed that the Eighth Circuit's decision could be interpreted as making an oral or written representation a prerequisite to liability under Section 10(b). According to the Court, such a reading would be "erroneous" because conduct can be deceptive, and, in any event, the suppliers in *Stoneridge* had made oral and written statements (*i.e.*, falsifying the contracts). The Court therefore concluded the correct interpretation of the Eighth Circuit's decision was that the suppliers' allegedly deceptive acts were not actionable because they did not have "the requisite proximate relation to the investors' harm."

In reviewing that holding, the Court first found that the investors could not avail themselves of rebuttable presumptions of reliance under either *Affiliated Ute Citizens of Utah v. U.S.*, 406 U.S. 128 (1972), or *Basic Inc. v. Levison*, 485 U.S. 224 (1988), because the suppliers owed no duty to disclose the substance of the transactions, and their purportedly fraudulent conduct was not communicated to the market. Accordingly, the Court found that the investors had to plead and prove actual reliance.

Turning to the investors' reliance allegations, the Court then determined that the causal connection predicated upon scheme liability espoused by the investors was too attenuated to support liability. According to the investors, the suppliers were liable because they engaged in a deceptive act with "the purpose and effect of creating a false appearance of material fact to further a scheme to misrepresent Charter's revenue." The investors contended that because the misstated financials upon which they had relied were a natural and foreseeable result of the scheme and the suppliers' deceptive acts, the causal connection necessary to trigger the fraud-on-the-market presumption existed. The Court squarely rejected this argument, reasoning 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." Moreover, according to the Court, Charter—not the suppliers—misled its auditor and the investing public. According to the Court, "nothing [the suppliers] did made it necessary or inevitable for Charter to record the transactions as it did." The Court also expressed concerns about the impact of the investors' expansive view of reliance, which could result in a risk of litigation outside of the "immediate sphere of securities litigation" in "areas already governed by functioning and effective state-law guarantees." In the Court's view, it would also expose a new class of defendants to the risks and costs of strike suits (*i.e.*, "weak claims" used to "extort settlements from innocent companies").

The Court also focused on the history of Section 10(b) claims in rejecting scheme liability. The Court found that the investors' view of reliance would run afoul of Congress's decision not to create a private right of action for aiding and abetting a Section 10(b) violation. Rather, Congress had given the authority to pursue aiders and abettors to the Securities & Exchange Commission. According to the Court, the investor's proposed scheme liability would "revive" an implied right of action against all aiders and abettors other than those who did not engage in a deceptive act. Moreover, the Court indicated that its prior jurisprudence counseled against the expansion of the implied right of action under Section 10(b) that would necessarily result under the investors' view of reliance.

Finally, the Court observed that substantial deterrents to fraudulent conduct by aiders and abettors currently exist in the form of criminal and civil penalties by the SEC. In addition, secondary actors are not "immune from private suit." For example, the Court noted that Section 11 of the Securities Act of 1933 provides an express private right of action against accountants and underwriters involved in certain securities offerings. The Court also specifically observed that "the implied right of action in Section 10(b) continues to cover secondary actors who commit primary violations."

Key Effects

- The Court's decision resolved a split among circuits and should make it more difficult for plaintiffs to plead (and ultimately prove) securities violations against secondary actors that did not make any misrepresentations. By requiring plaintiffs to plead actual reliance at the motion to dismiss stage, this decision creates a higher bar than pleading the prerequisites to the fraud-on-the-market presumption.
- The Court did not foreclose all private suits against secondary actors under Section 10(b), noting that secondary actors could still be held primarily liable if all the elements of such a claim are met, including actual reliance. In concluding that the investors did not establish the requisite reliance, the Court stressed that "nothing [the suppliers] did made it necessary or inevitable for Charter to record the transactions as it did." Plaintiffs may seize on this passage to distinguish future cases from *Stoneridge* by arguing that the causal connection in a future case is less attenuated than that in *Stoneridge*.
- The Court will likely remand the highly-publicized Enron case to the Fifth Circuit and the Homestore case to the Ninth Circuit—both of which are subjects of pending Petitions for a Writ of Certiorari—for determination based on the *Stoneridge* ruling. *See Regents of the Univ. of California v. Credit Suisse First Boston (USA), Inc.*, 482 F.3d 372 (5th Cir. 2007); *Simpson v. AOL Time Warner Inc.*, 452 F.3d 1040 (9th Cir. 2006). Accordingly, the remand briefing in those two cases will likely provide the first substantial applications of the Court's ruling.