SIMPSON THACHER



REPORT FROM WASHINGTON

The Supreme Court Rejects "Scheme" Liability For Secondary Actors In The Absence Of Actual Reliance On The Deceptive Conduct Or A Separate Duty To Speak

January 15, 2008

TO VIEW THE SUPREME COURT'S DECISION IN *STONERIDGE INVESTMENT PARTNERS, LLC V. SCIENTIFIC-ATLANTA, INC.*, – S.CT. –, NO. 06-43, 2008 WL 123801 (2008), PLEASE CLICK HERE.

Earlier today, the Supreme Court affirmed 5-3 the Eighth Circuit's decision in *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, -- S.Ct. --, No. 06-43, 2008 WL 123801 (2008). The Court held that secondary actors are not liable under Section 10(b) of the Securities Exchange Act and Rule 10b-5 where plaintiffs cannot prove reliance. The Court held that reliance was lacking where the secondary actors did not have a duty to disclose and their alleged deceptive acts were not communicated to the public. Through its opinion, the Court dealt a firm blow to private plaintiffs suing secondary actors for violations of the securities laws on the basis of "scheme" liability at a time when courts have been faced with an increasing number of such cases. As demonstrated by comments at oral argument and the opinion of the Court, a majority of the justices are concerned with expanding the implied Rule 10b-5 right of action in light of the potential costs that would be borne by the financial community as a result of lawsuits.

Simpson Thacher filed an *amicus* brief on behalf of the National Association of Manufacturers in support of affirming the Eighth Circuit's decision, arguing that actors should not be exposed to Section 10(b) liability merely by engaging in commercial transactions with an issuer of securities that might later be claimed to have somehow aided an alleged securities law violation. In addition, firm partner Richard I. Beattie was a signatory to a separate amicus brief in support of the Eighth Circuit's decision that was filed on behalf of leading transactional lawyers.

BACKGROUND

The *Stoneridge* appeal arose from an Eighth Circuit case captioned *In re Charter Communications, Inc., Securities Litigation*,

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CHIEF JUSTICE ROBERTS
(at Oral Argument)

443 F.3d 987 (8th Cir. 2006). Plaintiff represented a putative class of purchasers of the stock of Charter Communications, Inc. ("Charter") between November 8, 1999 and August 16, 2002. Plaintiff alleged that Charter, which was one of the nation's largest providers of cable television, engaged in a "pervasive and continuous fraudulent scheme intended to artificially boost the Company's reported financial results." The allegations related to Charter's alleged practice of: (1) delaying the disconnection of customers failing to pay their bills; (2) improperly capitalizing labor costs; and (3) entering into sham transactions that improperly inflated operating revenues and cash flow.

Among the defendants alleged to have participated in the scheme were two of Charter's equipment vendors – Scientific-Atlanta, Inc. and Motorola, Inc. (the "Vendors"). Specifically, Plaintiff alleged that Charter agreed to pay the Vendors an additional $20 for each cable set-top box purchased in exchange for the Vendors' returning the additional payments to Charter as advertising fees. Plaintiff claimed that Charter's operating cash flow was inflated by $17 million in the fourth quarter of 2000 in order to meet Wall Street analysts' expectations because Charter improperly capitalized the increased equipment costs and treated the advertising fees as revenue.

The district court granted the Vendors' motion to dismiss on the grounds that the Supreme Court's decision in *Central Bank of Denver, N. A. v. First Interstate Bank of Denver*, N. A., 511 U.S. 164 (1994), holding that there is no Rule 10b-5 private right of action for aiding and abetting a Rule 10b-5 violation precluded Plaintiff's claims, which the court characterized as nothing more than claims for aiding and abetting violations of Section 10(b) and Rule 10b-5. The district court emphasized the lack of any statements, omissions, or actions by the Vendors relied upon by Plaintiff, and indicated that it could "find no precedent for the conclusion that business partners, such as [the Vendors], made false and misleading statements by virtue of engaging in a business enterprise with a company such as Charter, the entity purported to have made the statements at issue."

The Eighth Circuit panel affirmed. The unanimous panel stated: "[A]ny defendant who does not make or affirmatively cause to be made a fraudulent misstatement or omission, or who does not directly engage in manipulative securities trading practices, is at most guilty of aiding and abetting and cannot be held liable under § 10(b) or any subpart of Rule 10b-5." The Eighth Circuit focused on the following three elements of the *Central Bank* holding:

"(1) The Court's categorical declaration that a private plaintiff 'may not bring a 10b-5 suit against a defendant for acts not prohibited by the text of § 10(b)' ....

(2) A device or contrivance is not 'deceptive,' within the meaning of § 10(b), absent some misstatement or a failure to disclose by one who has a duty to disclose.

(3) The term 'manipulative' in § 10(b) has the limited contextual meaning ascribed in [*Santa Fe Industries, Inc. v. Green*, 430 U.S. 462, 97 S. Ct. 1292, 51 L. Ed.2d 480 (1977)]," such that it "is a 'term

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JUSTICE KENNEDY
(at Oral Argument)

of art' and refers to illegal trading practices such as 'wash sales, matched orders, or rigged prices, that are intended to mislead investors by artificially affecting market activity.'"

Furthermore, the Eighth Circuit panel noted: "To impose liability for securities fraud on one party to an arm's length business transaction in goods or services other than securities because that party knew or should have known that the other party would use the transaction to mislead investors in its stock would introduce potentially far-reaching duties and uncertainties for those engaged in day-to-day business dealings. Decisions of this magnitude should be made by Congress."

Before the Supreme Court on October 9, 2007, Plaintiff/Petitioner argued that the Vendors' conduct of creating false advertising revenue for Charter fell squarely within the text of Rule 10b-5's prohibition against "any deceptive device by any person, directly or indirectly, in connection with the purchase or sale of a security." Justice Scalia challenged Petitioner early, asking why the Court could not "sensibly limit it so that, for example, schemes can be attacked by the SEC, but schemes do not form the basis for private attorney general's actions," after which Chief Justice Roberts stated: "My suggestion is that we should get out of the business of expanding [the implied right of action under the securities laws] because Congress has taken over and is legislating in the area . . . ." Members of the Court also expressed concern with Petitioner's argument that actors engaging in a deceptive act in furtherance of a scheme to violate the securities laws should be liable as a primary violator, with Justice Kennedy noting that: "I see no limitation to [Petitioner's] proposal for liability."

After the Vendors/Respondents argued that Petitioner was attempting to remove the requisite element of reliance from the private right of action for a violation of Section 10(b) and Rule 10b-5, Justice Ginsburg pressed Respondents as to whether or not a "middle category" existed between primary liability and aiding and abetting, and seemed to suggest that perhaps there should be one when actors knowingly and silently engage in sham transactions without any economic substance that result in securities violations. Justices Kennedy and Souter first questioned whether principal liability and aiding and abetting can overlap, and then pressed Respondents on the limits of when secondary actors may be held liable. Respondents conceded that actors other than the company may be primary violators, but only when they make a statement upon which the market relies, *e.g.*, accountants may be primary violators when "they issued opinions that were circulated to investors, that were attributed to them and which were authorized by them . . . ."

THE DECISION

In the opinion of the Court, delivered by Justice Kennedy and joined by Chief Justice Roberts and Justices Scalia, Thomas, and Alito, the Supreme Court affirmed the Eighth Circuit's decision that Respondents

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were not liable under Section 10(b) of the Securities Exchange Act and Rule 10b-5 promulgated thereunder. Noting that Respondents had no role in preparing or disseminating Charter's financial statements, and that their own financial statements booked the transactions as a wash, the Majority concluded that the Rule 10b-5 "implied right of action does not reach the customer/supplier companies because the investors did not rely upon their statements or representations."

After noting that "[r]eliance by the plaintiff upon the defendant's deceptive acts is an essential element of the §10(b) private cause of action," the Court analyzed whether Petitioner satisfied this element. The Court first rejected the rebuttable presumption of reliance, as Respondents neither had a duty to disclose nor were their deceptive acts communicated to the public. The Majority then dismissed Petitioner's implicit contention that, in an efficient market, investors rely not only on the public statements relating to a security, but also on the transactions underlying those statements. The Court stated: "Were [Petitioner's] 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."

Noting that "Petitioner's view of primary liability makes any aider and abettor liable under § 10(b) if he or she committed a deceptive act in the process of providing assistance," the Majority appeared concerned that finding in favor of Petitioner would revive the implied cause action against many aiders and abettors. The Majority viewed Congress' response to *Central Bank*—passing Section 104 of the Private Securities Litigation Reform Act, in which Congress provided the Securities and Exchange Commission ("SEC"), and not private parties, with the authority to prosecute aiders and abettors—as its intention to allow only the SEC to pursue claims for aiding and abetting. The Court also stated that: "Adoption of petitioner's approach would expose a new class of defendants to [the] risks" associated with securities actions.

Although it found that Respondents' acts were too remote to establish reliance, the Majority was careful to point out that the Eighth Circuit's decision should not be "read to suggest there must be a specific oral or written statement before there could be liability under § 10(b) or Rule 10b-5 . . . ." Rather, the Court interpreted the Eighth Circuit's decision to stand for the proposition that: "any deceptive statement or act respondents made was not actionable because it did not have the requisite proximate relation to the investors' harm." Additionally, the Court did not specifically address whether "scheme" liability could ever establish primary liability.

In his dissent, joined by Justices Souter and Ginsburg, Justice Stevens criticized a number of aspects of the Majority's opinion. First, Justice Stevens stated that *Stoneridge* is "critically different" from *Central Bank* because the bank in that prior case did not itself engage in any deceptive act. Furthermore, the Eighth Circuit did not ground its

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decision on the absence of reliance, and so Justice Stevens believed the "fairest course" would have been to remand the case for the Court of Appeals to determine whether Petitioner adequately alleged reliance. Because the Majority based its opinion on reliance, Justice Stevens also stated: "This Court has not held that investors must be aware of the specific deceptive act which violates §10(b) to demonstrate reliance." In fact, the fraud-on-the-market presumption allows investors to recover when they cannot demonstrate specific reliance. Finally, Justice Stevens criticized the Majority for addressing the fraud-on-the-market presumption prior to the causation required. He suggested that Petitioner alleged not only transaction causation, but also proximate causation because Respondents' actions "had the foreseeable effect of causing Petitioner to engage in the relevant securities transactions."

Justice Breyer took no part in the consideration or decision of the case.

IMPLICATIONS

Although it does not address whether "scheme" liability ever supports a violation of Section 10(b), the Court's decision in *Stoneridge* rejects private plaintiffs' use of "scheme" liability against secondary actors in the absence of actual reliance on the deceptive conduct or a separate duty to speak.

It is now clear that the SEC alone may bring claims for aiding and abetting violations under Section 10(b). While the Majority already noted that the civil penalties that may be imposed by the SEC are not "toothless," having collected over $10 billion in disgorgement and penalties since September 30, 2002, the SEC may shift its enforcement priorities and/or resources to prosecute aiding and abetting claims. Additionally, given the fact that the Majority did not rule out scheme liability altogether, and the fact that the SEC need not establish reliance in its enforcement actions, the SEC may still be able to assert claims for primary violations against secondary actors on the basis of scheme liability.

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