

Client Alert

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The US Supreme Court's Decision in *Stoneridge* and its Implications

"The Court handed a victory to many secondary actors in reaffirming *Central Bank* and emphasizing that §10(b) liability does not extend to those who transact business with public companies, but make no statements to investors and undertake no duty to disclose material information to them."

In the January 15, 2008 decision in *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, the US Supreme Court restricted investors' ability to recover damages against secondary actors whose conduct played no "immediate" role in the investors' decision to trade in the company's securities. In a much anticipated decision, the Court held that the implied right of action in §10(b) of the Securities Exchange Act of 1934 "does not reach the customer/supplier companies because the investors did not rely upon their statements or representations."¹ The full implications of the opinion remain to be seen, but what is clear is that the Court essentially has cut-off most private actions for securities fraud under §10(b) against secondary actors who do business with an issuer accused of fraud but make no statements or representations to investors, nor owe any duty to speak to them.

Background

Stoneridge was a class-action suit by investors of Charter Communications (Charter). The Supreme Court granted *certiorari* to resolve a split among the circuits regarding "when, if ever, an injured investor may rely upon §10(b) to recover from a party that neither makes a public misstatement nor violates a duty to disclose but does participate in a scheme to violate §10(b)."²

The Court accepted as facts the following: Charter, a cable operator, "engaged in a variety of fraudulent practices so its quarterly reports would meet Wall Street expectations for cable subscriber growth and operating cash flow."³ The practices included misclassifying its customer base, delaying the reporting of terminated customers, improperly capitalizing certain costs, and manipulating billing cutoff dates to inflate revenues. Charter nonetheless was faced with operating cash flow shortfalls, and decided to alter its arrangements with Scientific-Atlanta and Motorola (Defendants) in an effort to stop the bleeding.

Defendants supplied Charter with digital cable converters that Charter in turn provided to its customers. "Charter [then] arranged to overpay [Defendants] \$20 for each set top box it purchased until the end of the year, with the understanding that [Defendants] would return the overpayment by purchasing advertising from Charter. The transactions . . . had no economic substance; but, because Charter would then record the advertising purchases as revenue and capitalize its purchase of the set top boxes, in violation of generally accepted accounting principles, the transactions would enable Charter to fool its auditor into approving a financial statement showing it met projected revenue and operating cash flow numbers."⁴

Charter's auditor, Defendants and Charter concocted documentation and contractual arrangements to hide the link between Charter's increased payments for the boxes and the advertising purchases. The converter box arrangements were backdated to make it appear as though they were negotiated before the advertising arrangements, a point with some impact on Charter's accounting for the transactions. To complete the fraudulent scheme, Charter recorded the advertising payments as revenue, thereby inflating its cash flow by approximately \$17 million.

Defendants had no role in preparing or disseminating the financial statements containing these inflated numbers. Nevertheless, Plaintiff claimed that Defendants "knew or were in reckless disregard of Charter's intention to use the transactions to inflate its revenues and knew the resulting financial statements issued by Charter would be relied upon by research analysts and investors."⁵

The Eighth Circuit's Decision

The Eighth Circuit concluded that Plaintiff failed to show Defendants engaged in any deceptive acts within the scope of the implied right of action under §10(b). It held that the allegations in the Complaint did not show that the public relied on misstatements by the Defendants, or that Defendants otherwise were in violation of a duty to disclose the facts concerning the converter box transactions. At most, Defendants aided and abetted Charter's fraud—a private cause of action precluded by *Central Bank*. Because Plaintiff failed to allege adequately that Defendants engaged in a deceptive act, and could not cure the deficiency by repleading, the Court of Appeals affirmed the district court's dismissal for failure to state a claim upon which relief may be granted.

The Court's Analysis and Holding

The Court began its analysis by reaffirming the importance of *Central Bank*,⁶ in which it held that private §10(b) liability does not extend to aiders and abettors because, among other things, plaintiffs do not rely upon those who merely provide assistance to the "primary" violator. In *Stoneridge*, the Court likewise focused primarily on the issue of reliance. Writing for the majority, Justice Kennedy (the author of *Central Bank*) emphasized *Central Bank's* concern that if private causes of action for aiding and abetting were implied under §10(b), a "defendant could be liable without any showing that the plaintiff relied upon the aider and abettor's statements or actions."⁷

Reliance, the Court reiterated, "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."⁸ Moreover, because Defendants had no duty to disclose, and their acts were not communicated to the public, *Stoneridge* could not show any reliance on their actions except in an indirect chain which the Court found too "remote."

The Court then turned to Plaintiff's theory of "scheme liability," *i.e.*, that investors rely "not only upon the public statements relating to a security but also upon the transactions those statements reflect." Were the Court to accept this theory, it would create an implied cause of action that would "reach the entire marketplace in which the company did business"—for which, the Court held, there was no authority. The Court observed that even though *Central Bank* led to calls for Congress to create an express cause of action for aiding and abetting, Congress rejected that idea and instead explicitly vested the SEC with jurisdiction to prosecute aiders and abettors. Thus, the Court

refused Plaintiff's proposed construction of §10(b), because "it would revive in substance the implied cause of action against all aiders and abettors except those who committed no deceptive act in the process of facilitating the fraud; and ... undermine Congress' determination that this class of defendants should be pursued by the SEC and not by private litigants."⁹

The Court opined that "judicial creation of a private cause of action cautions against its expansion."¹⁰ Because the decision to extend a cause of action lies with Congress, the Court refused to extend the scope of §10(b) beyond its present boundaries. In so reasoning, the Court emphasized that restraint was appropriate in light of the Private Securities Litigation Reform Act (PSLRA), which requires private plaintiffs to meet "heightened pleading requirements" and demonstrate loss causation in any action arising under the Securities Exchange Act; in enacting the PSLRA (15 U.S.C. § 78u-4, *et seq.*), "Congress accepted the §10(b) private of cause as then defined but chose to extend it no further."

Stoneridge presented the Court with an opportunity to resolve broader questions concerning the outer bounds of conduct that could constitute "decepti[on]" under §10(b)—which would have implications not only for private actions, but also SEC enforcement actions or criminal prosecutions, which do not require a showing of reliance. However, the opinion provides little guidance in this area, and instead focuses the analysis on private actions by investors. The Court did touch on these issues, but avoided clarity. For example, the Court noted that the Eighth Circuit had concluded "that only misstatements, omissions by one who has a duty to disclose, and manipulative trading practices . . . are deceptive," but said it would be erroneous to suggest that "there must be a specific oral or written statement before there could be liability under §10(b) or Rule 10b-5." The

Court emphasized that "[c]onduct itself can be deceptive," pointing out that Defendants' "course of conduct included both oral and written statements, such as the backdated contracts," and describing Defendants' conduct—in passing—as "deceptive acts."¹¹

Although these passages might be read to suggest an expansive interpretation of "deceptive," the Court also later points out that "§10(b) provides that the deceptive act must be 'in connection with the purchase or sale of any security'" and that "the emphasis on a purchase or sale of securities does provide some insight into the deceptive acts that concerned the enacting Congress."¹² This suggests that for conduct to be deceptive (in any §10(b) case for primary liability, not just a private action), there must be a tight nexus between the defendant's conduct or statements and the purchase or sale of a security—a strong shield for most secondary actors that merely do business with public companies.

The Dissent

Justice Stevens, joined by Justices Souter and Ginsburg, dissented.¹³ In the dissent's view, investors "relied on Charter's revenue statements in deciding whether to invest in Charter and in doing so relied on [Defendant's] fraud, which was itself a 'deceptive device' prohibited by §10(b) of the Securities Exchange Act of 1934." In other words, Charter would not have been able to inflate its revenues *but for* the knowing participation of Scientific-Atlanta and Motorola. In the view of the dissent, the vendors in *Stoneridge* were not mere aiders and abettors—unlike the bank in *Central Bank*—because the Complaint alleged that they knowingly produced falsified documents and signed contracts they knew to be backdated in order to disguise the connection between the increased costs and the purchase of advertising. The dissenters cited *Basic Inc. v. Levinson*, 485 US 224 (1988), for

the proposition “that reliance provides the requisite causal connection between a defendant’s misrepresentation and a plaintiff’s injury,” and reasoned that the fraud-on-the-market theory was “surely a sufficient response to the argument that a complaint alleging that deceptive acts which had a material effect on the price of a listed stock should be dismissed because the plaintiffs were not subjectively aware of the deception at the time of the securities’ purchase or sale.” Coupled with what the dissenters viewed as a relatively low hurdle to plead causation in a private cause of action under §10(b), the fraud-on-the-market presumption should have been enough for the Plaintiff in *Stoneridge* to plead reliance and survive dismissal.

The Implications of *Stoneridge*

It is, of course, too early to assess the full implications of *Stoneridge*. However, in reaffirming *Central Bank* and emphasizing Congress’ decision in the PSLRA not to extend private §10(b) claims to aiders and abettors, the Court handed a victory to many secondary actors, potentially including banks, auditors, lawyers and advisors who transact business with public companies but make no statements to investors and undertake no duty to disclose material information to them. The Court effectively shielded such actors from costly and harmful private claims, holding that if those who merely engage in transactions with a company are subject to private liability under §10(b), “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.”¹⁴ This is an important result, given that shareholder class action filings in 2007 were again on the rise, and the average settlement to resolve a shareholder class action hit a new high.¹⁵

The Court did reiterate that the SEC and the Department of Justice retain

the power to bring civil enforcement and criminal actions, respectively, against such actors in appropriate cases for aiding and abetting securities fraud. And, as the Court pointed out, these enforcement powers are far from “toothless.”¹⁶

Significantly, the Court also rejected “scheme liability,” a relatively recent theory advanced by the plaintiffs’ securities bar which had met mixed success until now. Private plaintiffs no longer can evade *Central Bank* by alleging that they relied not only upon a company’s financial statements, but also upon the company’s underlying transactions with those who “engaged in conduct with the purpose and effect of creating a false appearance of material fact to further a scheme” to defraud.¹⁷ The Court flatly rejected this theory.¹⁸ Unless the conduct has a link that is “immediate,” not “remote,” to the alleged harm, it is not subject to private §10(b) liability.¹⁹

Endnotes

- ¹ *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, No. 06-43, slip op. at 1 (Jan. 15, 2008) (Slip Opinion).
- ² *Id.* at 4-5.
- ³ *Id.* at 2.
- ⁴ *Id.* at 2-3.
- ⁵ Slip Opinion at 4.
- ⁶ *Central Bank of Denver, N. A. v. First Interstate Bank of Denver, N. A.*, 511 U.S. 164 (1994).
- ⁷ Slip Opinion at 6 (*quoting Central Bank*, 511 U.S. at 180).
- ⁸ *Id.* at 8.
- ⁹ *Id.* at 11-12.
- ¹⁰ *Id.* at 14.
- ¹¹ *Id.* at 7-8.
- ¹² *Id.* at 9 (*quoting* 15 U.S.C. § 78j(b)).
- ¹³ Justice Breyer recused himself.
- ¹⁴ *Id.* at 9.
- ¹⁵ Stephanie Plancich, Ph.D., Brian Saxton, and Svetlana Starykh, *Recent Trends in Shareholder Class Actions: Filings Return to 2005 Levels as Subprime Cases Take Off; Average Settlements Hit New High* (New York: NERA Economic Consulting, 2007), 1-2.

¹⁶ Slip Opinion at 15.

¹⁸ Slip Opinion at 9-11.

¹⁷ The securities bar will be testing the consequences of the Court's refusal to extend private §10(b) claims to "remote" participants in a fraud, including, potentially, whether this result has implications on the theory of "collective scienter."

¹⁹ *Id.* at 8-9.

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