



The Stoneridge Decision: Supreme Court Confirms Limits on the Section 10(b) Private Right of Action

In *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc., et al.*, No. 06-43 (Jan. 15, 2008), the United States Supreme Court confirmed that the implied private right of action for securities fraud under Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934 does not extend to “secondary actors” or “aiders and abettors” (i.e., parties who have some role in fraudulent conduct but do not themselves make a misrepresentation or engage in deceptive conduct that is disclosed to the investing public). The ruling expressly upheld the 1994 decision in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994), in which the Supreme Court held that a claim by shareholders under Section 10(b) may not impose liability on aiders and abettors because 10(b) makes no mention of aiding and abetting liability.

While the decision does not meaningfully impact securities claims against D&Os who are alleged to have directly violated the federal securities laws by making material misstatements or engaging in other deceptive conduct upon which investors rely, the decision provides significant benefit to other types of defendants (e.g. bankers, accountants, lawyers, etc.) and their insurers.

A. Facts and Lower Court Rulings

Plaintiffs were stockholders of Charter Communications, Inc., a cable television operator that allegedly engaged in fraudulent practices in order to report inflated financial results. When these improprieties were revealed, Charter’s share price dropped precipitously. Charter stockholders sued Charter and certain of its D&Os for directly violating the securities laws by making misrepresentations regarding the company’s financial results, and that litigation settled in 2004. In a separate action — the *Stoneridge* lawsuit — Charter stockholders sued Scientific-Atlanta and Motorola, companies which supplied Charter with digital cable converter units (“set top boxes”) that Charter provided to its cable television subscribers. Plaintiffs alleged that Charter agreed to overpay the defendants \$20 for each set top box that Charter purchased, with the understanding that defendants would return the overpayment by purchasing advertising from Charter. Allegedly, the transactions had no economic substance but allowed Charter to issue inflated financial statements showing it had met its projected revenue and operating cash flow targets.

Plaintiffs alleged that defendants knowingly entered into these sham transactions with Charter, and that Charter could not have inflated its financial results without defendants’

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fraudulent conduct. Plaintiffs contended that investors who relied on Charter's false financial statements effectively also relied on defendants' fraudulent conduct. According to plaintiffs, defendants were knowing and important participants in Charter's fraudulent scheme and therefore were liable under Section 10(b)/ Rule 10b-5. However, defendants did not make any misrepresentations to Charter stockholders, and their participation in the fraudulent transactions was not revealed to the public.

Thus, the District Court dismissed the case, holding that the plaintiffs' "scheme liability" theory was essentially a claim for aiding and abetting and therefore was barred by *Central Bank of Denver*. The Eighth Circuit Court of Appeals affirmed, concluding that "any defendant who does not make or affirmatively cause to be made a fraudulent misstatement or omission...is at most guilty of aiding and abetting and cannot be held liable under Section 10(b)..."

B. The Supreme Court's Opinion

The Supreme Court affirmed the dismissal of the claims against defendants in a 5-3 decision, holding that the implied private right of action for securities fraud under Section 10(b) does not extend to third parties who neither made alleged misstatements nor engaged in deceptive conduct on which investors relied. In reaching its decision, the Supreme Court made the following important points.

First, the Court confirmed its holding in *Central Bank of Denver* that the Section 10(b) implied private right of action does not extend to aiders and abettors. The Court noted that the *Central Bank of Denver* decision prompted calls for Congress to create an express private right of action for aiding and abetting. However, Congress rejected those calls, and instead amended the federal securities laws to allow the Securities and Exchange Commission — but not private plaintiffs — to assert Section 10(b) claims against aiders and abettors. Accordingly, the Court commented that it must give "narrow dimensions" to "a private right of action Congress did not authorize when it first enacted the statute and did not expand when it revisited the law."

Second, the Court observed that plaintiffs had failed to demonstrate reliance by Charter stockholders on any of defendants' allegedly deceptive acts. The Court explained that reliance is an essential element of a Section 10(b) action because it is "the requisite causal connection between a defendant's misrepresentation and a plaintiff's injury." Although recognizing that a plaintiff is entitled to a presumption of reliance in cases where there is an omission by one with a duty to disclose, or where the alleged deceptive conduct becomes public, the Court concluded that neither of these circumstances were present in this case: defendants did not owe any duty to Charter stockholders, and defendants' deceptive acts were not communicated to the public. Because the Charter investors could only show reliance on the defendants' conduct through an indirect chain, the Court concluded any possible reliance was too remote to serve as a basis of liability.

Third, the Court expressly rejected "scheme liability," a theory that would extend Section 10(b) liability to those who do not themselves make material misstatements, but instead engage in conduct with the purpose and effect of creating false appearances that furthers a scheme to misrepresent. The Court held that such deceptive acts — when not disclosed to the public — are too remote to satisfy the requirement of reliance. The Court also commented that such a theory would circumvent Congress's decision after *Central Bank of Denver* to allow the SEC, but not private litigants, to pursue Section 10(b) aiding and abetting claims. In addition, the Court expressed concern about the harms that would result from allowing scheme liability litigation. Among other things, the Court observed that a scheme liability cause of action would "invite litigation beyond the

immediate sphere of securities litigation and in areas already governed by functioning and effective state-law guarantees,” could “raise the cost of being a publicly traded company,” and could “shift securities offerings away from domestic capital markets.”

Fourth, to the disappointment of many potential defendants, the Court rejected the Eighth Circuit’s suggestion that only specific oral or written statements can give rise to liability under Section 10(b), stating, “conduct itself can be deceptive.” In essence, the Court focused on whether investors could show they relied upon the defendants’ deceptive acts rather than the form or nature of the defendants’ deceptive conduct.

C. Impact

In most respects, *Stoneridge* does not make new law. Rather, it affirms the Supreme Court’s 1994 holding in *Central Bank of Denver* that the Section 10(b) implied private right of action for securities fraud does not extend to secondary actors. Nonetheless, like all Supreme Court decisions, *Stoneridge* will impact future cases as both plaintiffs and defendants seek to use the decision to their advantage, and the lower courts add their judicial gloss. Some of the more likely consequences of the decision include:

- The decision should have little, if any, direct impact on claims against D&Os since those claims typically allege that the defendant D&Os were directly involved in the misrepresentations or omissions to investors, and that the investors directly relied upon the deceptive conduct of those defendant D&Os.
- To the extent the decision reduces or eliminates the liability exposure of other third party defendants in securities class actions, there may be greater pressure on the defendant D&Os and the defendant company to pay more in settlement of the claims since there will be fewer “deep pockets” to fund the settlement.
- Banks, underwriters, attorneys, accountants, and other professionals that transact business with or perform services for a public company (and their E&O insurers) are the primary beneficiaries of the decision since their liability is greatly reduced in many instances.
- However, to some extent those third party defendants now have greater liability exposure in certain circumstances. Prior to *Stoneridge*, lower courts frequently ruled that a third party defendant was an aider and abetter (and therefore not liable) as long as the third party had no meaningful participation in making misstatements to investors. Under *Stoneridge*, it appears that a third party who had no meaningful participation in making misstatements can be liable if the third party participated in some related deceptive conduct, provided investors relied on that deceptive conduct. In applying *Stoneridge* to other cases, one of the main issues that will be debated is what must investors rely on in order to establish liability? Must investors merely know about the subject transaction or event; must investors know about the defendants’ role or participation in the subject transaction or event; or must investors know about the defendants’ specific deceptive acts in the transaction or event?
- Because secondary actors can more easily be found liable under Section 11 of the Securities Act of 1933, which was not addressed in *Stoneridge*, third party defendants will still be target defendants in Section 11 securities litigation relating to a securities offering.

The material in this outline is not intended to provide legal advice as to any of the subjects mentioned but is presented for general information only. Readers should consult knowledgeable legal counsel as to any legal questions they may have.