

Milbank

January 16, 2008

Litigation

BEIJING FRANKFURT HONG KONG LONDON LOS ANGELES MUNICH NEW YORK SINGAPORE TOKYO WASHINGTON, DC

SUPREME COURT IN STONERIDGE LIMITS PRIVATE SECURITIES FRAUD CLAIMS AGAINST SECONDARY ACTORS

By C. Neil Gray

In a much anticipated securities law decision, the Supreme Court yesterday decided *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., et al.*, No. 06-43, and preserved strict limits on private securities fraud claims against secondary actors under Section 10(b) of the Securities Exchange Act of 1934. In a 5-3 decision,¹ the Court affirmed a decision of the United States Court of Appeals for the Eighth Circuit and held that the implied right of action for fraud under Section 10(b) does not permit claims by investors who did not rely on a defendant's statements or acts in connection with their purchase or sale of a

security.

The Court rejected the plaintiff's concept of "scheme liability" — that even absent a public statement, the defendants had engaged in conduct with the purpose and effect of furthering a scheme to make misrepresentations to investors — as a viable basis for pleading claims under Section 10(b). As the Court explained, "[w]ere this concept of reliance [scheme liability] 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." *Id.* at 9.

Stoneridge is not likely to be the death knell for private

securities litigations that many commentators predicted. But it continues more than a decade of jurisprudence from the Supreme Court, beginning with *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.* 511 U.S. 164 (1994),² strictly limiting the reach of the federal securities laws for private litigants and making clear the Court's position that any decision to extend the reach of Section 10(b) must come from Congress.

Facts of *Stoneridge*

The facts alleged by the plaintiff in *Stoneridge* are straightforward. *Stoneridge* was brought on behalf of a class of investors in the common stock of

For further information about this Client Alert, please contact any of the following attorneys:

David R. Gelfand,
Practice Leader and
Partner, Litigation Group
(212) 530-5520
dgelfand@milbank.com

Doug Henkin,
Partner, Litigation Group
(212) 530-5393
dhenkin@milbank.com

C. Neil Gray,
Associate, Litigation Group
(212) 530-5127
cngray@milbank.com

You may also contact any member of Milbank's Litigation Group. Contact information can be found on Milbank's website at: http://www.milbank.com/en/PracticeAreas/LitigationArbitration_alpha.htm

¹ Justice Breyer took no part in the consideration or decision of the case. Justice Kennedy wrote the Court's opinion.

² See also *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499 (2007); *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*, 547 U.S. 71 (2006); *Dura Pharm., Inc. v. Broudo*, 544 U.S. 336 (2005); *United States v. O'Hagan*, 521 U.S. 642 (1997).

www.milbank.com

Charter Communications, Inc. (“Charter”), a cable operator. The complaint alleged that in late 2000, Charter realized it would miss Wall Street expectations for operating cash flow. To remedy the shortfall, Charter entered into a scheme with defendants Scientific-Atlanta, Inc. and Motorola, Inc., two equipment suppliers who supplied Charter with set-top cable boxes for use by Charter’s customers. Under the scheme, Charter agreed to overpay defendants by \$20 for each set-top box it purchased for the remainder of 2000 with the understanding that Scientific-Atlanta and Motorola would return the \$20 overpayment by purchasing advertising from Charter. Charter recorded the advertising purchases as revenue and capitalized its purchase of the set-top boxes — thus artificially inflating revenue with transactions that had “no economic substance.” Investors thereby relied on Charter’s “false” financial statements.

The Decisions of the Lower Courts

Scientific-Atlanta and Motorola moved to dismiss the federal securities fraud claims for failure to state a cause of action. The District Court granted the motion and the Eighth Circuit affirmed, holding that Scientific-Atlanta and Motorola had neither violated a duty to disclose nor made misstatements relied upon by the public. The Supreme Court granted certiorari to resolve a conflict among the Courts of Appeal as to “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).” *Stoneridge*, at 4-5 (citing *Simpson v. AOL Time Warner Inc.*, 452 F. 3d 1040 (9th Cir. 2006) and *Regents of Univ. of Cal. v. Credit Suisse First Boston (USA), Inc.*, 482 F. 3d 372 (5th Cir. 2007)).

The Supreme Court’s Analysis

The Court first reviewed the development of the implied private right of action under Section 10(b).³ Under the Court’s jurisprudence, to prevail on a claim under Section 10(b) a plaintiff must prove (1) a material misrepresentation or omission by the defendant; (2) scienter; (3) a connection between the misrepresentation or omission and the purchase or sale of a security; (4) reliance upon the misrepresentation or omission; (5) economic loss; and (6) loss causation. *Stoneridge*, at 6. The Court reiterated its holding in *Central Bank* that the implied right of action is delimited by the text of the statute, in which there is no mention of aiding and abetting liability. The Court found that Congress accepted that boundary when it enacted the Private Securities Litigation Reform Act of 1995 (“PSLRA”) and gave only the Securities and Exchange Commission (“SEC”) the power to pursue aiding and abetting claims. The Court thus concluded that “[t]he conduct of a secondary actor must satisfy each of the elements or preconditions for liability” under Section 10(b).

Having determined that the plaintiff had to allege all the elements of a Section 10(b)

claim with respect to Scientific-Atlanta and Motorola, the Court focused on reliance. The Court held that neither of two rebuttable presumptions of reliance applied — plaintiff was not entitled to a presumption of reliance because Scientific-Atlanta and Motorola had no duty to disclose with respect to investors in Charter stock and the fraud-on-the-market doctrine did not apply because “no member of the investing public had knowledge, either actual or presumed, of respondents’ deceptive acts during the relevant times.” *Stoneridge*, at 8. The requirement that a claim against a secondary actor be based on a communication of the secondary actor’s allegedly improper conduct to the investing public is one of the key principles of the Court’s decision.

The Court then considered and rejected the argument that “scheme liability” is actionable under Section 10(b). The plaintiff argued that under “scheme liability,” Scientific-Atlanta and Motorola should be liable under Section 10(b) because the “financial statement Charter released to the public was a natural and expected consequence of respondents’ deceptive acts” and that “in an efficient market investors rely not only upon the public statements relating to a security but also upon the transactions those statements reflect.”

First, the Court concluded that Scientific-Atlanta and Motorola’s allegedly deceptive acts were “too remote to satisfy the requirement of reliance,” and in any event the public was not

³ *Stoneridge*, at 5-6 (citing *Superintendent of Ins. of N.Y. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 13, n.9 (1971)).

aware of those acts at any relevant time. The Court then held that the plaintiff's theory would expand liability under Section 10(b) beyond what Congress intended by allowing claims against the entire marketplace in which an issuing company operates, perhaps even anyone with whom the issuer does business. Finally, the Court stated that Congress' decision to empower only the SEC to pursue aiding and abetting claims — despite having had the opportunity to grant that power to others — meant that Congress intended to exclude private plaintiffs from pursuing such claims. The Court thus rejected plaintiff's "scheme liability" theory.

In reaching its conclusions, the Court recognized that expanding the scope of Section 10(b) as plaintiff suggested would have serious practical consequences, including expanding the class of defendants who might be coerced to settle with plaintiffs rather than face "extensive discovery and the potential for uncertainty and disruption," increased costs of doing business resulting from the need to protect against these threats, the risk that overseas firms might be deterred from doing business in the United States, and the risk that securities offerings might shift away from domestic capital markets.

Justice Stevens wrote a dissenting opinion,⁴ seeking to distinguish *Stoneridge* from *Central Bank* on the ground that the defendant in *Central Bank* did not engage in any deceptive acts. The dissent argued that in *Stoneridge* the defendants' acts "had the foreseeable effect

of causing the petitioner to engage in relevant securities transactions" and therefore fell within the scope of the implied right of action under Section 10(b). The dissent argued that the Court's interpretation of reliance is "unduly stringent," "cuts back further on Congress' intended remedy," and reflects the Court's "continuing campaign to render the private cause of action under §10(b) toothless."

Conclusion

Although it further clarifies the guidelines for the federal courts, *Stoneridge* may not entirely eliminate plaintiffs' attempts to bring secondary liability claims under Section 10(b). By focusing on reliance and the concept that the alleged bad acts were not communicated to investors, and specifically leaving open the concept that secondary actors may be liable under Section 10(b) for primary violations, it is possible that *Stoneridge* will cause plaintiffs' lawyers to re-examine what they might previously have called "scheme liability" claims to try to find ways to allege that allegedly improper acts were communicated to and relied on by investors as a way to evade the large-scale elimination of secondary liability claims that some commentators predicted. For example, it remains to be seen what effect the *Stoneridge* decision will have on *Regents of the Univ. of Cal. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, No. 06-1341, which is pending in the Supreme Court. A decision in that case is expected soon and may further illuminate the

ultimate impact of *Stoneridge*. *Stoneridge* also clarified that liability under Section 10(b) or Rule 10b-5 does not require specific oral or written statements relied upon by investors and that "conduct" itself can be deceptive and provide a basis for liability. *Stoneridge*, at 7.

To maximize the protection provided by *Stoneridge*, parties engaged in transactions with issuers may wish to consider seeking representations, warranties, or agreements that nothing they exchange will be used in securities filings or communicated to investors without express written permission. Whether such an agreement would ultimately be enforceable as a way of avoiding primary Section 10(b) liability is unclear, but in light of the Court's recent decision in *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499 (2007), such an expression of the parties' intent could be very useful in fighting claims on the basis of failure to plead scienter and might also be used to attack a plaintiff's reliance allegations.

* * * *

This Client Alert is a source of general information for clients and friends of Milbank, Tweed, Hadley & McCloy LLP. Its content should not be construed as legal advice, and readers should not act upon the information in this Client Alert without consulting counsel. Copyright 2008, Milbank, Tweed, Hadley & McCloy LLP. All rights reserved.

⁴ Justice Souter and Justice Ginsburg joined the dissenting opinion.

For further information about this client alert, please visit our website at www.milbank.com or contact one of the Litigation partners listed below.

New York

Wayne M. Aaron	212-530-5284	waaron@milbank.com
Thomas A. Arena	212-530-5328	tarena@milbank.com
Parker H. Bagley	212-530-5343	pbagley@milbank.com
Sander Bak	212-530-5125	sbak@milbank.com
Jeffrey Barist	212-530-5115	jbarist@milbank.com
James N. Benedict, <i>Chair</i>	212-530-5696	jbenedict@milbank.com
George S. Canellos	212-530-5174	gcanellos@milbank.com
James G. Cavoli	212-530-5172	jcavoli@milbank.com
Christopher E. Chalsen	212-530-5380	cchalsen@milbank.com
Scott A. Edelman	212-530-5149	sedelman@milbank.com
David R. Gelfand, <i>Practice Group Leader</i>	212-530-5520	dgelfand@milbank.com
John M. Griem, Jr.	212-530-5429	jgriem@milbank.com
Douglas W. Henkin	212-530-5393	dhenkin@milbank.com
Michael L. Hirschfeld	212-530-5832	mhirschfeld@milbank.com
Lawrence T. Kass	212-530-5178	lkass@milbank.com
Sean M. Murphy	212-530-5688	smurphy@milbank.com
Michael M. Murray	212-530-5424	mmurray@milbank.com
Stacey J. Rappaport	212-530-5347	srappaport@milbank.com
Richard Sharp	212-530-5209	rsharp@milbank.com
Alan J. Stone	212-530-5285	astone@milbank.com
Errol B. Taylor	212-530-5545	etaylor@milbank.com
Andrew E. Tomback	212-530-5971	atomback@milbank.com
Fredrick M. Zullo	212-530-5533	fzullo@milbank.com

Washington, DC

David S. Cohen	202-835-7517	dcohen2@milbank.com
Robert J. Koch	202-835-7520	rkoch@milbank.com
Andrew M. Leblanc	202-835-7574	aleblanc@milbank.com
Michael D. Nolan	202-835-7524	mnolan@milbank.com
William E. Wallace, III	202-835-7511	wwallace@milbank.com

Los Angeles

Linda Dakin-Grimm	213-892-4404	ldakin-grimm@milbank.com
Gregory Evans	213-892-4488	gevans@milbank.com
Jerry L. Marks	213-892-4550	jmarks@milbank.com
Daniel Perry	213-892-4546	dperry@milbank.com
Mark Scarsi	213-892-4580	mscarsi@milbank.com

London

David Perkins	44-20-7615-3003	dperkins@milbank.com
---------------	-----------------	--

Offices Worldwide

Beijing Frankfurt Hong Kong London Los Angeles Munich New York Singapore Tokyo Washington, DC