COMMENTARY

Stoneridge Limits Private Securities Fraud Claims Against Secondary Actors

By C. Neil Gray, Esq.


The court affirmed 5-3 a U.S. Court of Appeals for the 8th Circuit decision 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 securities.

The court rejected the plaintiff's “scheme liability” concept (that even absent a public statement, the defendants 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). 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 likely will not be the death knell for private securities litigation as many commentators are predicting. But it continues more than a decade of Supreme Court jurisprudence, 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 the plaintiff in Stoneridge alleged are straightforward. The case was brought on behalf of a class of investors in the common stock of cable operator Charter Communications Inc. The complaint alleged that in late 2000, the company realized it would miss Wall Street expectations for operating cash flow. To remedy the shortfall, it conspired with defendants Scientific-Atlanta Inc. and Motorola Inc., two equipment companies that supplied Charter with set-top cable boxes.

Under the alleged scheme, Charter agreed to overpay the co-conspirators by $20 for each set-top box Charger purchased for the remainder of 2000 on the agreement that each would return the $20 overpayment by buying advertising from Charter. Charter then 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 Lower Court Decisions

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 8th Circuit affirmed, holding that the defendants did not violate any duty to disclose and made no misstatements the public had relied on.
The Supreme Court granted certiorari to resolve a conflict among the appeals courts as to “when, if ever, an injured investor may rely upon Section 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 Section 10(b).” *Stoneridge*, at 4-5 (citing *Simpson v. AOL Time Warner Inc.*, 452 F.3d 1040 (9th Cir. 2006), and *Regents of the 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). 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 on the misrepresentation or omission (5) economic loss and (6) loss causation. *Stoneridge*, at 6.

The high court reiterated its holding in *Central Bank* that the implied right of action is constrained by the text of the statute, in which there is no mention of aiding and abetting liability. The court said Congress accepted that boundary when it enacted the Private Securities Litigation Reform Act of 1995 and gave only the Securities and Exchange Commission the power to pursue aiding-and-abetting claims.

The high 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 must allege all the elements of a Section 10(b) claim with respect to Scientific-Atlanta and Motorola, the court focused on reliance. It held that neither of two rebuttable presumptions of reliance applied: The 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 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 held 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 “[i]n an efficient market, investors rely not only upon the public statements relating to a security but also upon the transactions those statements reflect.”

The court concluded that Scientific-Atlanta and Motorola’s allegedly deceptive acts were “too remote to satisfy the requirement of reliance.” It then held that the plaintiff’s theory would expand liability under Section 10(b) beyond what Congress intended to allow claims against the entire marketplace in which an issuing company operates, perhaps even to anyone with whom the issuer does business.

Finally, the court said Congress’ decision to empower only the SEC to pursue aiding-and-abetting claims meant it intended to exclude private plaintiffs from pursuing such claims.

The court thus rejected plaintiff’s scheme liability theory.

In reaching its conclusions, the Supreme Court recognized that expanding the scope of Section 10(b) as the plaintiff suggested would have serious practical consequences, including expanding the class of defendants that might be forced to settle with plaintiffs rather than face “extensive discovery and the potential for uncertainty and disruption” of litigation and the increased cost of doing business as a result of the need to protect against such threats. The high court also noted the risks that overseas firms might be deterred from doing business in the United States and that securities offerings might shift away from domestic capital markets.

**The Dissent**

Justice John Paul Stevens’ dissent distinguished *Stoneridge* from *Central Bank* on the ground that the defendant in *Central Bank* did not engage in any deceptive acts. He said the *Stoneridge* 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 Section 10(b) toothless.”

**The Stoneridge Conclusion**

Although *Stoneridge* further clarifies the guidelines for the federal courts, it may not entirely eliminate plaintiffs’
attempts to bring secondary liability claims under Section 10(b). Stoneridge focuses on reliance and the concept that the allegedly wrongful acts were not communicated to investors. It specifically leaves 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” to find ways to assert that allegedly improper acts were communicated against and relied on by investors, and thus evade the large-scale elimination of secondary liability claims that some commentators predicted.

Stoneridge also clarified that liability under Section 10(b) or Rule 10b-5 does not require that investors rely upon specific oral or written statements and that “conduct” itself can be deceptive and provide a basis for liability.

Stoneridge, at 7.

Related Cases

The Supreme Court’s treatment of two other cases promptly following Stoneridge suggests that Stoneridge’s long-term effect may take time to be fully understood.

On Jan. 22 in Regents of the University of California v. Merrill Lynch, Pierce, Fenner & Smith Inc., No. 06-1341, cert. denied (U.S. 2008), the high court declined to review a U.S. Court of Appeals for the 5th Circuit decision reversing and remanding the grant of class certification for a $40 billion lawsuit against investment banks that did business with Enron. The 5th Circuit declined to address potential alternative bases for the action to continue and remanded the case for “further proceedings as appropriate.” Attorneys for the plaintiff responded to the high court’s refusal to review the decision by saying they would seek to revive the suit in the District Court.

That same day, in Avis Budget Group Inc. v. California State Teachers’ Retirement System, a class-action lawsuit concerning more than $190 million in accounting errors at Homestore.com, the Supreme Court simultaneously granted certiorari, vacated the judgment of the U.S. Court of Appeals for the 9th Circuit and remanded for reconsideration in light of Stoneridge.

It is unclear whether the high court intended these actions to signal a broad or narrow application of Stoneridge. In Avis, for example, the 9th Circuit affirmed the dismissal but remanded to allow the plaintiffs to replead their claims. Had the Supreme Court simply denied certiorari, it would have allowed the 9th Circuit’s decision allowing repleading to stand, but the result of reconsideration could be that the claims as pleaded are sufficient under Stoneridge, that repleading would be pointless or that the plaintiffs should be permitted to try to replead.

To maximize the protections provided by Stoneridge, parties engaged in transactions with issuers may wish to consider seeking representations, warranties or agreements signifying that nothing they exchange will be used in securities filings or communicated to investors without express written permission. Whether such an agreement ultimately would be enforceable as a way to avoid primary Section 10(b) liability is unclear but such an expression of the parties’ intent could be useful in fighting claims based on failure to plead scienter and might also be used to attack any allegations of reliance.

Notes

1 Justice Stephen Breyer abstained from considering or deciding the case. Justice Anthony Kennedy wrote the majority opinion.


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)).

4 Justice David Souter and Justice Ruth Bader Ginsburg joined the dissenting opinion.

C. Neil Gray is an associate in the Litigation Practice Group at Milbank, Tweed, Hadley & McCloy LLP in New York.