SECONDARY LIABILITY, SCHEME LIABILITY, AND THE RELIANCE FACTOR: THE SUPREME COURT'S RULING IN *STONERIDGE INVESTMENT PARTNERS, LLC v. SCIENTIFIC-ATLANTA, INC.*

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I. INTRODUCTION

The scope of liability under Section 10(b) of the Securities and Exchange Act of 1934[1] ("Act") is a hazy area of jurisprudence for those in academics and in the business world alike. Until recently, the Supreme Court's decision in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver* largely governed the area.[2] Accountants, lawyers, underwriters, and others often faced liability under Section 10(b), until the Supreme Court held in *Central Bank* that the Securities Act did not reach those who aided or abetted a Section 10(b) violation.[3] After *Central Bank*, liability attaches only to "primary participants" in investor defrauding schemes, though

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1. *See* 15 U.S.C. § 78j ("It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange--(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, or any securities-based swap agreement (as defined in section 206B of the Gramm-Leach-Bliley Act [15 USCS § 78c note]), any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.").

2. Central Bank of Denver, N.A. v. First Interstate Bank of Denver, 511 U.S. 164 (1994).

3. *See* JAMES D. COX, ROBERT W. HILLMAN & DONALD C. LANGEVOORT, SECURITIES REGULATION: CASES AND MATERIALS 760 (5th ed. 2006) (noting that aiding and abetting a client's conduct was itself a violation under Section 10(b) and Rule 10b-5 for three decades).

different definitions of this term have since emerged between the circuits.[4]

Thirteen years after *Central Bank*, both the definition and the scope of liability for "primary participants" reached the Court for clarification. Yet, when the Supreme Court decided *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*,[1] it effectively declined either to resolve the circuit split regarding who qualifies as a primary participant or to narrow the scope of Section 10(b) liability. The Court, instead, simply held that the vendors who had aided a communications company in its fraudulent public statements could not be held liable because the investors did not rely upon the defendants' statements or representations. Thus, although *Stoneridge* is still an unequivocally pro-business decision, the concept of scheme liability was not rejected outright, no doubt to the chagrin of many in the business world.

II. LEGAL BACKGROUND

In *Central Bank of Denver, N.A. v. First Interstate Bank of Denver*, the Court granted review of a Tenth Circuit decision allowing private aiding and abetting actions under Section 10(b).[5] Plaintiff First Interstate purchased bonds issued by the local authority. Central Bank was the indenture trustee for the bonds and was thus contractually obligated to ensure compliance with the bonds' covenants.[6] After the appraisal for the bond offering was found to be dated, Central Bank delayed independent review of the appraisals and the local authority defaulted on the bonds prior to any review by Central Bank.[7]

Noting that the express liability provisions of the Securities and Exchange Act do not proscribe aiding and abetting and that a private Section 10(b) claim is an implied cause of action, the Court determined that Congress could not have intended to proscribe such activity in a private Section 10(b) claim.[8] Accordingly, "only the making of a material misstatement (or omission) or the commission

4. *See id.* at 764–70 (discussing the differing approaches taken by the varying circuits as well as the SEC's position).
5. *Central Bank*, 511 U.S. at 164.
6. *Id.* at 167.
7. *Id.* at 167–68.
8. *See id.* at 179–80.

of a manipulative act" is prohibited by the statute.[9] Finally, the Court noted that allowing an action for aiding and abetting under Section 10(b) would have circumvented the judicially-created reliance requirement because there was no showing that the plaintiff had relied on Central Bank's statements or actions.[10]

Subsequent to *Central Bank*, two different approaches emerged for determining whether a secondary actor can be held primarily liable under Section 10(b). The stricter approach, opposed by the Securities and Exchange Commission ("SEC"), is referred to as the "bright-line" test and mandates that "a defendant must actually make a false or misleading statement in order to be held liable under Section 10(b)."[11] The Second Circuit reiterated this approach in *Wright v. Ernst & Young, LLP*, when it held that "the misrepresentation must be attributed to that specific actor [making the misrepresentation] at the time of public dissemination, that is, in advance of the investment decision."[12]

Most courts, however, use the "substantial participation" test, which focuses on the degree of involvement the defendant had in the making of the misleading statement. For example, the Ninth Circuit has held that accountants and underwriters who both had a significant role in drafting, reviewing, and editing misleading financial reports and deliberately concealed the truth could be held liable as primary participants.[13] Similarly, the Sixth Circuit held that "while an attorney representing the seller in a securities transaction may not always be under an independent duty to volunteer information about the financial condition of his client, he assumes a duty to provide complete and nonmisleading information with respect to subjects on which he undertakes to speak."[14]

In the wake of the *Central Bank* decision, Congress passed the Private Securities Litigation Reform Act of 1995 ("PSLRA"), Pub. L. No. 104-67, 109 Stat. 743, which added Section 20(e) to the Exchange

9. *Id.* at 177 (citing Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 473 (1977)).

10. *Id.* at 180.

11. Shapiro v. Cantor, 123 F.3d 717, 720 (2d Cir. 1997) (quoting *In re* MTC Elec. Techs. S'holders Litig., 898 F. Supp 974, 987 (E.D.N.Y. 1995)).

12. Wright v. Ernst & Young, LLP, 152 F.3d 169, 175 (2d Cir. 1998), *cert. denied,* 525 U.S. 1104 (1999).

13. *In re* Software Toolworks Inc. v. Painewebber Inc., 50 F.3d 615, 627, 629 (9th Cir. 1994).

14. Rubin v. Schottenstein, Zox & Dunn, 143 F.3d 263, 268 (6th Cir. 1998).

Act[15] and affirmed the right of the SEC to prosecute aiders and abettors.[16] Private actors were not extended this right, in accordance with the general themes of the PSLRA to curb abusive actions, frivolous suits, and huge settlements.[17]

The Court could have reviewed the Eighth Circuit's decision to resolve the circuits' split regarding the proper test for finding a secondary actor liable under Section 10(b). But instead, the Court seemingly ignores much of this backdrop in its decision in *Stoneridge*, though it does mention the intentions of Congress with the PSLRA and the Act's relevance for secondary actors.[18]

III. FACTUAL AND PROCEDURAL HISTORY

The plaintiffs in *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, were stockholders of Charter Communications, Inc. ("Charter") who had purchased Charter shares on the open market. This purchase led to the subsequent securities fraud class action against: Charter; ten Charter executives; Charter's independent auditor, Arthur Andersen, LLP; and two equipment vendors, Scientific-Atlanta, Inc. and Motorola, Inc. (collectively, the "Vendors").[19]

The plaintiffs alleged that Charter inflated its stock price by entering into sham transactions with the Vendors, which Charter used as the basis for misleading financial statements.[20] Specifically, the Vendors' arrangement with Charter "improperly inflated Charter's reported operating revenues and cash flow."[21] According to the plaintiffs, the Vendors knew upon entering into these sham transactions that Charter would account for them improperly, leading

15. *See* 15 USCS § 78t(e) ("Prosecution of persons who aid and abet violations. For purposes of any action brought by the Commission under paragraph (1) or (3) of section 21(d) [15 USCS § 78u(d)(1) or (3)], any person that knowingly provides substantial assistance to another person in violation of a provision of this title [15 USCS §§ 78a et seq.], or of any rule or regulation issued under this title [15 USCS §§ 78a et seq.], shall be deemed to be in violation of such provision to the same extent as the person to whom such assistance is provided.").

16. Codified as amended at 15 U.S.C. § 78t (1995).

17. Thomas O. Gorman, *Vendors May Face Higher Risk When Doing Business With Public Companies:* 'Stoneridge' *and Scheme Liability*, CORP. COUNS. WKLY., Oct. 17, 2007, at 320.

18. Stoneridge, 128 S. Ct. at 772–73.

19. *In re* Charter Commc'ns, Inc., 443 F.3d 987, 989 (8th Cir. 2006), *aff'd sub nom.* Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., 128 S. Ct. 761 (2008).

20. *In re Charter*, 443 F.3d at 989.

21. *Id.*

analysts to recommend the stock based on the inflated revenues.[22] Importantly, the plaintiffs did not allege that the Vendors were involved in the preparation or dissemination of the fraudulent financial statements and press releases on which analysts and investors subsequently relied.[23]

Based on *Central Bank of Denver, N.A. v. First Interstate Bank of Denver*,[24] the district court granted defendant-Vendors' motion to dismiss the plaintiffs' Securities Exchange Act of 1934 Section 10(b) claims and denied the plaintiffs' motions for reconsideration and for leave to amend their complaint.[25] The court held that there was no basis for the plaintiffs' "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."[26]

The Eighth Circuit affirmed, holding that the plaintiffs' focus on Charter's deception in publishing fraudulent financial reports and press releases failed to allege that either Motorola or Scientific-Atlanta "engaged in any such deceptive act."[27] Thus, the claims against the Vendors had been properly dismissed "as nothing more than claims barred by *Central Bank* that the Vendors knowingly aided and abetted the Charter defendants in deceiving the investor plaintiffs."[28]

IV. HOLDING

The Supreme Court affirmed the Eighth Circuit's decision in *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, but did not adopt its reasoning. Instead, the Court held that because Charter investors did not rely on the Vendors' statements or representations, the Section 10(b) private right of action does not reach the Vendors.[29] The Court rejected the Eighth Circuit's notion that Section 10b-5[30]

22. *Id.* at 990.
23. *Id.*
24. Central Bank of Denver, N.A. v. First Interstate Bank of Denver, 511 U.S. 164 (1994).
25. *In re Charter*, 443 F.3d at 989, 991.
26. *In re Charter Commc'ns, Inc.*, No. 1506, 2004 U.S. Dist. LEXIS 29647, at *21 (E.D. Mo. Oct. 12, 2004).
27. *In re Charter*, 443 F.3d at 992.
28. *Id.*
29. Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., 128 S. Ct. 761, 774 (2008).
30. *See* 15 U.S.C.A. § 78j (West 2000) ("Employment of manipulative and deceptive devices. It shall be unlawful for any person, directly or indirectly, by the use of any means or

required a "specific oral or written statement but did not extend to deceptive acts and practices."[31]

Writing for the Court, Justice Kennedy specified that conduct, rather than just public misstatements, can be deceptive. Indeed, the Vendors' conduct in the form of oral and written misstatements, including the backdated contracts that permitted Charter's improper accounting, was deceptive and thus proscribed by Section 10(b).[32] The Court softened its blow, however, by claiming that the holding in the lower court could also be interpreted as stating only that respondents' conduct, though deceitful, was not actionable due to its lack of "*requisite proximate relation* to the investors' harm."[33] This opened the door for the Court to examine the reliance issue on which it had apparently hoped to focus instead of the exact threshold for liability.[34]

Since the Court's decision in *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988), the plaintiff's reliance upon the defendant's deceptive acts has been considered an "essential element of the Section 10(b) private cause of action."[35] The Court stated that "a rebuttable presumption of reliance" exists in either of two circumstances: (1) where one with a duty to disclose omits a material fact;[36] or (2) under the fraud on the market doctrine.[37] Because here the Vendors had no duty to disclose information and because their acts were not communicated to the public, neither presumption applied. The Court found that the investors were unaware of the sham transactions of the Vendors that

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instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange, (a) To employ any device, scheme, or artifice to defraud, (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.").

31. *Stoneridge*, 128 S. Ct. at 769.

32. *Id.*

33. *Id.* (emphasis added).

34. Notably, Chief Justice Roberts and Justice Ginsburg commented at oral argument that the reliance issue was not squarely before the Court. *See* Transcript of Oral Argument at 55–57, Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., 128 S. Ct. 761 (2008) (No. 06-43).

35. *Stoneridge*, 128 S. Ct. at 769.

36. *Id*.

37. *See, e.g.*, Peil v. Speiser, 806 F.2d 1154, 1160–61 (3d Cir. 1986) ("The fraud on the market theory is based on the hypothesis that, in an open and developed securities market, the price of a company's stock is determined by the available material information regarding the company and its business. . . . Misleading statements will therefore defraud purchasers of stock even if the purchasers do not directly rely on the misstatements.").

were then used to prepare the statements made to the public, so investors cannot impute reliance on these transactions to the Vendors.[38]

In conclusion, the Court warned of the policy implications of extending the implied cause of action under Section 10(b) to the practices in question, which would "invite litigation beyond the immediate sphere of securities litigation and in areas already governed by functioning and effective state-law guarantees."[39] Additionally, were the Court to adopt the investors' construction of Section 10(b), it would revive the cause of action against aiders and abettors authorized only to the SEC by the PSLRA.[40] Finally, the Court noted that a decision to extend the private cause of action rested with Congress.[41]

V. ANALYSIS

In the months prior to and following *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*'s oral arguments, many believed it to "be the most important securities law decision in years."[42] Others noted its potential to be the business "decision of the century."[43] Specifically, "[a] ruling by the Court adopting the position of either party would dramatically reshape Section 10(b) liability and could change the way business is conducted."[44]

A decision in favor of the plaintiffs and their open-ended scheme liability theory would have permitted the *Enron Litigation*,[45] *Simpson v. AOL Time Warner, Inc.*,[46] and future class actions to proceed, "potentially imposing securities fraud liability and damage awards on a host of companies, banks, investment banks, and other unsuspecting

38. *Stoneridge*, 128 S. Ct. at 770.
39. *Id.* at 771.
40. *Id.*
41. *Id.* at 772–73.
42. Gorman, *supra* note 17, at 320.
43. Posting of Thomas O. Gorman to SEC Actions, http://www.secactions.com/?p=293 (Jan. 16, 2008, 2:18PM EST).
44. Gorman, *supra* note 17, at 318.
45. Regents of the Univ. of Cal. v. Credit Suisse First Boston (USA), Inc., 482 F.3d 372 (5th Cir. 2007) (the "Enron Litigation"), *cert denied.*, 128 S. Ct. 1120 (2008).
46. Simpson v. AOL Time Warner, Inc., 452 F.3d 1040 (9th Cir. 2006), *cert. granted sub nom.* Avis Budget Group, Inc. v. Calif. State Teachers' Retirement System, 128 S. Ct. 1119 (2008), *and remanded.*

business partners of public companies."[47] Such an imposition was a common concern in the majority opinion,[48] as it would have forced public companies and their securities lawyers to agonize over the minute details of every transaction prior to a closing. This agony would be in addition to the costliness of preventing liability through due diligence, in addition to the unfortunate possibility that foreign companies would refrain from doing business in the United States under such stringent legal standards.[49] Finally, a decision extending liability to secondary actors would have directly conflicted with the Court's continuing efforts to "circumscribe the implied cause of action," consistent with its efforts under the PSLRA."[50]

Conversely, the Court's actual decision can be viewed as contrary to the principles underlying the PSLRA, which are meant to provide a remedy for those who actually suffer a loss in the securities realm. For example, in many instances the secondary actors could be seen as providing the deepest pockets for an injured shareholder, given the primary actor's financial distress. The Court, however, apparently believes that this problem can be addressed by the SEC because the Court's decision reiterates the agency's ability to bring fraud claims based on aiding and abetting liability.[51] The beauty of deciding *Stoneridge* solely on the element of reliance is that the SEC is not inhibited because it does not have to prove reliance.[52]

Although the decision can certainly be read as pro-business, *Stoneridge* is not the "decision of the century" as some had anticipated.[53] The decision was a narrow holding that merely elaborated on the SEC's ability to bring actions against secondary actors but that declined to narrow the scope of Section 10(b) liability. Had the Court upheld the Eighth Circuit's reasoning, class actions against issuers and others would have been demonstrably more difficult given the limited reach of the private right of action under Section 10(b).

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47. Gorman, *supra* note 17, at 318.
48. Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., 128 S. Ct. 761, 771–73 (2008).
49. *Id.* at 772.
50. Gorman, *supra* note 17, at 319.
51. *See Stoneridge*, 128 S. Ct. at 772–73 (2008) (clarifying that the preclusion of a private claim does not preclude an SEC action).
52. Gorman, *supra* note 43.
53. *Id.*

A holding affirming the Eighth Circuit's judgment and reasoning, however, would have been somewhat consistent with the Court's most recent securities fraud decision, *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, in which the Court interpreted the PSLRA to mandate pleading a strong inference of scienter.[54] The *Tellabs* decision demonstrated the Court's proclivity to interpret the implied cause of action under Section 10(b) narrowly, while the Court's decision in *Stoneridge* does so in a somewhat less predictable manner.

The dissent noted that, given the isolated nature of the transactions in question, perhaps a decision in favor of the plaintiffs would not inhibit business in the manner feared.[55] Specifically, "[a] corporation engaging in a business transaction with a partner who transmits false information to the market is only liable where the corporation *itself* violates Section 10(b). Such a rule does not invade the province of 'ordinary' business transactions."[56] The dissent emphasized that when a party has so clearly violated a law designed to protect a group of people, the victims should have their remedy in court—even if the court must fashion the remedy via an implied cause of action.[57]

The court implicitly reaffirmed its *Stoneridge* decision by denying certiorari in the *Regents of the University. of California. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.* (the *Enron Litigation*) and *Avis Budget Group, Inc. v. Cal. State Teachers' Retirement System* (the *Simpson* class actions) class actions mere days later.[58] The disposition of these cases is instructive given each case's similarities and differences from the fact pattern and decision-making in the lower courts compared to *Stoneridge*.[59]

In the *Enron Litigation*, the Fifth Circuit held that the investment bank defendants, who allegedly structured sham transactions knowing Enron would use them in "misstating its accounts" and thus defraud

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54. Tellabs, Inc. v. Makor Issues & Rights, Ltd., 127 S. Ct. 2499 (2007).

55. *Stoneridge*, 128 S. Ct. at 777 (Stevens, J., dissenting).

56. *Id.*

57. *See id.* at 779–82 (noting that the purpose of the Act is to protect investors from exactly the sort of deceptive conduct involved here).

58. Regents of the Univ. of Cal. v. Merrill Lynch, Pierce, Fenner & Smith, Inc. (mem), 128 S. Ct. 1120 (2008) (denying certiorari); Avis Budget Group, Inc. v. Cal. State Teachers' Retirement System (the *Simpson* class actions) (mem.), 128 S. Ct. 1119 (2008) (denying certiorari).

59. Gorman, *supra* note 43.

its shareholders, did not violate Section 10(b).[60] The court based its holding on the Supreme Court's precedent in *Central Bank* that Section 10(b) "does not give rise to aiding and abetting liability."[61] This holding is startlingly similar to the decision of the Eighth Circuit in *Stoneridge*; however, on the reliance issue, the Fifth Circuit reached a similar conclusion as the Supreme Court in *Stoneridge*—that the plaintiffs had not alleged that the defendants had made "public and material misrepresentations."[62] The Supreme Court's denial of certiorari is significant because it leaves standing both a ruling on the deceptive act, narrower than that reached in *Stoneridge*, and a win for the defendants on the same reliance grounds as in *Stoneridge*.[63]

In *Simpson*, the Ninth Circuit concluded that the scheme liability alleged by the plaintiffs combined with a fraud on the market presumption was a sufficient Section 10(b) cause of action.[64] Given the lower court's careful examination of reliance and the fraud on the market theory, it is not surprising that the Court granted certiorari and then remanded the case.[65] Additionally, the Supreme Court did not specifically reject the Ninth Circuit's scheme liability because it disregarded that issue and instead focused on the reliance element.

VI. CONCLUSION

Given the *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, decision and the succinct rulings that followed, secondary liability under Section 10(b) remains a hazy area of securities law. Because the Supreme Court did not specifically renounce the concept of scheme liability when it remanded the *Enron Litigation*, did not affirm it when it granted certiorari in *Simpson*, and alluded that participation in a scheme to defraud may well reach the threshold of deception in *Stoneridge*, plaintiffs may continue to bring claims under the theory.

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60. Regents of the Univ. of Cal. v. Credit Suisse First Boston (USA) (the *Enron Litigations*), Inc., 482 F.3d 372, 386 (5th Cir. 2007).

61. *Id.*

62. *Id.* at 385–86.

63. Gorman, *supra* note 43.

64. Simpson v. AOL Time Warner Inc., 452 F.3d 1040, 1051 (9th Cir. 2006).

65. *See* Gorman, *supra* note 43 (The Simpson class action was remanded for further consideration in light of *Stoneridge*).

Meanwhile, the circuit split regarding the bright-line and substantial participation tests is as pronounced as it was prior to the Court's undertaking of *Stoneridge*. What remains, then, is the critical factor of whether a secondary actor's deception is actually disclosed to investors sufficient for them to show reliance. Issuers, their lawyers, and their business partners should therefore be increasingly wary of certain transactions' disclosures in their SEC filings and other public statements in order to avoid meeting the reliance requirements adopted in *Stoneridge*.