



Securities Enforcement and Litigation Update — Supreme Court Addresses “Scheme Liability” – Reins in Investor Suits

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The Securities and Futures Regulation Group

SCHIFF HARDIN LLP

Atlanta
One Atlantic Center, Suite 2300
1201 West Peachtree Street
Atlanta, Georgia 30309

New York
900 Third Avenue
New York, NY 10022

Boston
225 Franklin Street, Suite 2600
Boston, MA 02110

San Francisco
One Market
Spear Street Tower
Thirty-Second Floor
San Francisco, CA 94105

Chicago
6600 Sears Tower
233 South Wacker Drive
Chicago, IL 60606-6473

Washington
1666 K Street NW, Suite 300
Washington, DC 20006

Lake Forest
One Westminster Place
Lake Forest, IL 60045-1885

www.schiffhardin.com

The Supreme Court issued its much anticipated decision in *Stoneridge Investment Partners LLP v. Scientific-Atlanta, Inc.* on January 15, limiting the scope of investor suits under Rule 10b-5. In addressing the exposure to private damage claims of those who facilitated deception by others, the Court, in an opinion by Justice Kennedy writing for himself and four other justices, held that private liability for damages is limited to those on whom investors directly rely, while at the same time emphasizing the continuing exposure of aiders and abettors to enforcement proceedings initiated by the Securities and Exchange Commission (“SEC”) and criminal prosecution.

The Issues before the Court

In *Stoneridge* the plaintiff, seeking to represent a class, alleged that several vendors to (also customers of) Charter Communications, Inc. (“Charter”) had engaged in transactions with Charter that facilitated Charter’s issuance of financial statements that materially overstated Charter’s earnings, allowing Charter to meet Wall Street estimates of its earnings and cash flow. Plaintiff alleged that the two vendors (for simplicity referred to here as the defendants) worked with Charter in drafting deceptive documentation of bogus transactions between the vendors and Charter. Neither of the defendants made any false statement to the public; their own financial statements correctly reflected the true substance of their transactions with Charter. The question before the Court was whether these vendors were liable under Rule 10b-5 to those who purchased Charter stock. As stated by the Court, the question was “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).”

The Majority Opinion

After describing the development of the implied private cause of action under Rule 10b-5, the Supreme Court decision in *Central Bank*, which held that Rule 10b-5 does not reach aiding and abetting, and Congress’ decision, in the Private Securities Litigation Reform Act to grant power to the SEC to pursue aiding and abetting without providing for private damage actions for such conduct, the Court turned its focus to the essential elements of deception and reliance in a private action under Rule 10b-5. The Court noted that “[c]onduct itself can be deceptive,” though in this case the alleged deception was in both oral and written statements that allegedly fooled Charter’s accounting firm. Because the defendants “had no duty to disclose” and “their deceptive acts were not communicated to the public,” however, the Court held that plaintiff “cannot show reliance

upon any of [defendants’] actions except in an indirect chain that we find too remote for liability.” Thus, while there was no question that plaintiff had alleged deception by the defendants, the Achilles heel in the claim was that this deception was not practiced directly on the investing public, or in any event was too remote from the actionable deception reflected in Charter’s financial statements.

In the words of the majority opinion, allowing the claim here would effectively “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 we would undermine Congress’ determination that this class of defendants should be pursued by the SEC and not by private litigants.” As the Court stated in concluding its opinion, “Unconventional as the arrangement was, it took place in the marketplace for goods and services, not in the investment sphere. . . . In these circumstances, the investors cannot be said to have relied upon any of [defendants’] deceptive acts in the decision to purchase or sell securities”

The Court rejected the broad “scheme liability” theory advanced by the plaintiff, observing:

In effect [plaintiff] contends 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. Were this concept of reliance 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.

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. . . Were the implied cause of action to be extended to the practices described here, however, there would be a risk that the federal power would be used to invite litigation beyond the immediate sphere of securities litigation and in areas already governed by functioning and effective state-law guarantees.

After addressing issues of statutory construction and legislative intent, the Court relied on policy concerns if the theory of liability advanced by the plaintiff were accepted, citing *amici* briefs, including NASDAQ’s:

Overseas firms with no other exposure to our securities laws could be deterred from doing business here. . . . This, in turn, may raise the cost of being a publicly traded company under our law

and shift securities offerings away from domestic capital markets.

The majority concluded by emphasizing that secondary actors remain subject to criminal penalties under the Securities Exchange Act and to civil enforcement by the SEC, a power that is “not toothless.”

The Dissenting Opinion

Justice Stevens, joined by Justices Souter and Ginsburg, dissented. (Justice Breyer did not participate in the case.) The dissent distinguished the facts here from those in *Central Bank*, where the alleged aider and abettor had not engaged in any deception. On the policy issue considered by the majority, the dissent observed that liability under Section 10(b) in these circumstances would not harm American competitiveness but instead would underscore the strength of the domestic markets, quoting from an *amicus* brief filed by several former SEC Commissioners. The dissent concluded with a ringing endorsement of the implied cause of action for investors under Rule 10b-5, in contrast to what it characterized as the majority’s “mistaken hostility towards the § 10(b) private cause of action.”

The Lessons of *Stoneridge*

Defendants’ victory was generally anticipated by the securities litigation bar, especially after the oral argument in the case and the Court’s decision last June in *Tellabs, Inc. v. Makor Issues & Rights, Ltd.* that reflected a somewhat defendant-oriented approach to the heightened pleading standard for *scienter* in the Private Securities Litigation Reform Act.

The most significant aspect of the ruling is that deception, even deliberate deception, by so-called secondary actors that facilitates the conduct of a primary actor that deceives investors is not actionable where that deception by the secondary actors did not directly deceive investors. This obviously raises serious questions about the private damage liability of investment bankers, lawyers, accountants and other advisers who assist a client in structuring a transaction or creating documents, especially in the “investment sphere,” that in the end deceive investors. This Court is not inclined to extend the implied cause of action for damages under Rule 10b-5 beyond its current parameters.

While the outcome may have been expected, some aspects of the Court’s reasoning should temper the interpretation of this as a pro-defendant ruling. The concept of “remoteness” relied on by the Court may lead

plaintiffs to attempt to craft pleadings that seek to tie the secondary actor’s deception more closely to the alleged deception of the public. The degree of closeness that is required remains to be explored – reminiscent of the almost theological debate that emerged after *Central Bank* over how to define a “primary” violation of Rule 10b-5. The concept of the “primary” violation survives, however, as the Court reiterated that the implied cause of action “continues to cover secondary actors who commit primary violations.” The Court also reiterated the rebuttable presumptions of reliance in certain cases of omissions and in fraud-on-the-market cases notwithstanding that those principles were not directly before the Court and there has been increasing academic criticism of and judicial narrowing of the latter presumption.

Perhaps more important, at the urging of the Solicitor General in an *amicus* brief the Court made clear – and the dissent agreed – that deceptive conduct reached by Rule 10b-5 goes beyond omissions (such as when there is a duty to speak), half-truths and misrepresentations. Non-verbal conduct may be deceptive within the meaning of Rule 10b-5. While some courts have narrowly construed “manipulation” that violates Rule 10b-5, the concept of nonverbal “deception” may energize not only SEC enforcement efforts but also claims by private litigants based on such alleged deception. This underscores the potential breadth of Rule 10b-5, especially in terms of conduct in the markets as distinguished from claims of faulty disclosure.

The majority took pains to emphasize that secondary actors remain vulnerable to civil or criminal enforcement actions. Nothing in *Stoneridge* – unlike the narrow construction placed on Rule 10b-5 in *Central Bank* – creates an impediment to enforcement actions by the SEC, especially given the repeated references to the SEC’s power to pursue aiding and abetting. The majority stated that “if business operations are used, as alleged here, to affect securities markets, the SEC enforcement power *may* reach the culpable actors,” though at the same time Rule 10b-5 “does not reach all commercial transactions that are fraudulent and affect the price of a security in some attenuated way.” (Emphasis added)

The majority and dissent directly joined issue on the implications of the impact of the private liability regime on the U.S. securities markets and the country’s competitive position in the global economy, not an issue that has not been at the heart of Supreme Court securities law opinions (which have generally been grounded instead in statutory interpretation).

For Further Information

If you have questions concerning this update, contact any member of our Securities and Futures Regulation Group:

Atlanta

Ethan H. Cohen	ecohen@schiffhardin.com	t 404.437.7033
Wendy B. Hart	whart@schiffhardin.com	t 404.437.7019
Michael K. Wolensky	mwolensky@schiffhardin.com	t 404.437.7030

Chicago

Paul E. Dengel	pdengel@schiffhardin.com	t 312.258.5614
Paul E. Greenwalt III	pgreenwalt@schiffhardin.com	t 312.258.5702
Stacie R. Hartman	shartman@schiffhardin.com	t 312.258.5607
Allan Horwich	ahorwich@schiffhardin.com	t 312.258.5618
Michael L. Meyer	mmeyer@schiffhardin.com	t 312.258.5713
Carl A. Royal	croyal@schiffhardin.com	t 312.258.5707
Robert B. Wilcox Jr.	rwilcox@schiffhardin.com	t 312.258.5590

Washington, D.C.

Mark M. Attar	mattar@schiffhardin.com	t 202.778.6427
Joseph P. Corcoran	jcorcoran@schiffhardin.com	t 202.778.6432
Andrew M. Klein	aklein@schiffhardin.com	t 202.778.6415
Howard L. Kramer	hkramer@schiffhardin.com	t 202.778.6414
Laura S. Pruitt	lpruitt@schiffhardin.com	t 202.778.6470

San Francisco

Craig Bridwell	cbridwell@schiffhardin.com	t 415.901.8798
John S. Worden	jworden@schiffhardin.com	t 415.901.8764

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