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A legal update from Dechert's White Collar and Securities Litigation Group

Supreme Court Rejects "Scheme Liability" Theory for Extending Implied Rights of Action for Securities Fraud

Summary

In its long-awaited decision in *Stoneridge*,[1] the U.S. Supreme Court firmly rejected extension of the implied civil cause of action for federal securities fraud to secondary parties under the "scheme liability" theory. That theory, applied in controversial cases such as the *Enron* litigation[2], allowed underwriters, professionals, contractors, and other parties to be considered "primary" violators of the federal securities anti-fraud statutes and rules by virtue of conduct that furthered an alleged scheme to defraud investors. The Court's 5-3 ruling, however, affirmed the lower court's determination that such scheme liability was just another form of aiding and abetting liability, which the Court had previously found[3] to be outside the increasingly sharp borders of the civil fraud cause of action implied under Section 10(b) of the Securities Exchange Act of 1934.

Stoneridge provides considerable protection to secondary parties from exposure to the potentially significant damages associated with securities fraud class actions. It also represents the latest in a series of high court decisions that narrows the scope of potential private claims for securities fraud while raising the pleading bar to make out such claims. The Court's decision also reflects an increasing sensitivity to extrajudicial policy concerns regarding the impact on the U.S. economy of litigation that places the domestic markets at a disadvantage in the global economy. Importantly, however, the decision placed no limits on the ability of the SEC to pursue civil and criminal remedies against such parties who aid and abet securities fraud by others and, indeed, the Court's ruling will pressure the SEC to remain active in pursuit of such misconduct.

The Claims at Issue

Investors in a cable television operator, Charter Communications, sued Charter and others in federal court in St. Louis in a proposed class action, alleging that Charter had defrauded them by issuing falsely positive financial statements in 2000 that inflated the price of Charter stock. Among other things, the plaintiffs charged that Charter schemed with two suppliers of television set-top cable boxes to enter into contracts that had no purpose other than to allow Charter to artificially increase its revenues in order to meet the company's earnings projections. Charter allegedly agreed to overpay the two suppliers for the set-top boxes in exchange for their agreement to purchase advertising from Charter.

Charter recognized the advertising revenue immediately, increasing cash flow, but capitalized the hardware overpayments, mitigating their immediate impact on profits. The new set-top box agreements, plaintiffs alleged, were backdated so that they appeared to have been reached prior to the orders for advertising in order to mislead Charter's auditors, Arthur Anderson, into believing the transactions were unrelated.

The two supplier defendants, however, played no role in preparing or distributing Charter's financial statements, and their own financial statements

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1 *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, ___ U.S. ___, 2008 WL 123801 (Jan. 15, 2008).

2 *In re Enron Corp. Securities, Derivative & "ERISA" Litigation*, 439 F.Supp.2d 692, 723 (S.D.Tex. 2006).

3 *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 191 (1995).

correctly reflected the transactions as a wash. Plaintiffs contended, though, that both knew, or recklessly disregarded, that Charter intended to use the transactions to inflate its revenue and that each knew that this would mislead research analysts and investors. They asserted that these facts rendered not only Charter but the two supplier defendants liable to the class under Section 10(b) of the Securities Exchange Act and Rule 10b-5 adopted under it.

Key Holdings

While the Court recognized that the suppliers were involved in deceptive conduct, their deception was not actionable, according to the Court, because investors did not rely on that conduct and the suppliers breached no duty to disclose their improper conduct. Reliance, the Court found, was a critical component of the limited private right of action recognized under Section 10(b), reiterating that reliance provided "the requisite causal connection between a defendant's misrepresentation and a plaintiff's injury."[4]

Plaintiffs had urged a theory of "scheme liability" to supply that connection. They contended that the defendants had engaged in conduct that was intended to and in fact did artificially inflate Charter's revenues as disclosed in its financial statements. Because investors are presumed to rely on such financial disclosures, under the fraud on the market theory approved in *Basic*, the plaintiffs argued, they necessarily relied on the improper conduct that generated such false statements. The Court, however, declined to presume under the efficient market hypothesis that "investors rely not only upon the public statements relating to a security but also upon the transactions those statements reflect." This, the Court said, would extend this judicially-implied cause of action to transactions with "the whole marketplace in which the issuing company does business."

The Court found that the investors had alleged reliance not on any allegedly false statements or deceptive conduct of the suppliers but on the financial statements said to have been artificially inflated as a result of such statements or conduct. The suppliers' deceptive acts, it held, had not been disclosed to the investing public and were "too remote to satisfy the requirement of reliance."

[4] Quoting *Basic Inc. v Levinson*, 485 U.S. 224, 243 (1988).

Implications

First, *Stoneridge* erects a substantial barrier to private securities fraud claims against underwriters, accountants, attorneys, vendors, and others playing a secondary or external role in connection with statements or conduct affecting trading in a security. Unless the market and/or investors were aware of and relied upon statements actually made by such secondary participants (such as an auditor's opinion), or, in the case of fraudulent omissions, such participants had an independent duty to disclose their misconduct, private plaintiffs will not be able to pursue federal claims against such defendants, even if they remain subject to SEC enforcement or even criminal sanctions for their involvement. Since such secondary participants are often named in cases because the potential primary defendants are in weak financial condition or there is limited insurance, *Stoneridge* will also discourage civil claims involving primary violators that lack the financial resources to compensate for alleged investor losses.

Second, the majority opinion displayed considerable displeasure with the precedent it established decades ago in recognizing an implied private right of action under Section 10(b).[5] Bowing to that initial ruling and the many that followed, implicitly affirmed by Congress' passage in 1995 of the Private Securities Litigation Reform Act, the Court nonetheless has now plainly foreclosed future judicial expansion of that implied right's reach.

Third, the Court's reasoning for not extending the implied right of action included policy concerns that permeate recent decisions by the Court that have restricted private claims for securities fraud.[6] *Stoneridge* voiced considerable doubt that the private cause of action was the best mechanism for enforcing compli-

[5] *See Superintendent of Ins. of N.Y. v. Bankers Life & Casualty Co.*, 404 U.S. 6, 13, n.9 (1971).

[6] *E.g.*, *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336, 341-342 (2005) (tightening pleading requirements for loss causation); *Merrill, Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*, 547 U.S. 71 (2006) (broadly interpreting the preemptive effect of Securities Litigation Uniform Standards Act on state law claims); *Credit Suisse Securities (USA) LLC v. Billings*, 127 S.Ct. 2383 (2007) (dismissing antitrust claim relating to IPO offerings on basis that role of SEC as regulator was preeminent) and *Tellabs v. Makor Issues and Rights*, 127 S.Ct. 2499 (2007) (adopting restrictive view of heightened pleading standards for private federal securities fraud claims).

ance with the securities laws because the SEC was better equipped to do so, also reiterating its concern, often noted in recent decisions, "that extensive discovery and the potential for uncertainty and disruption in a lawsuit allow plaintiffs with weak claims to extort settlements from innocent companies." Justice Kennedy, writing for the majority, also noted that expanding the scope of possible defendants could raise the cost of doing business in the United States and shift securities offerings away from our capital markets.

Thus *Stoneridge*, like the Court's recent decisions in *Dura*, *Dabit*, *Credit Suisse*, and *Tellabs*, conveys a clear message to the lower federal courts that they should avoid expansive interpretations of private civil claims for securities fraud and strictly interpret pleadings in such cases. By virtue of the Private Securities Litigation Reform Act and the Supreme Court decisions since its passage, the barriers to success for plaintiffs pressing securities fraud claims have grown higher, their targets narrower, and their recovery more difficult. *Stoneridge* is powerful evidence that this trend remains firmly in place.

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