# Analysis
## Securities Fraud Liability

# Vendors May Face Higher Risk When Doing Business With Public Companies: 'Stoneridge' and Scheme Liability

BY THOMAS O. GORMAN

On Oct. 9, 2007, the Supreme Court heard arguments in a case which many believe will be the most important securities law decision in years. It could decide whether vendors who wish to avoid securities fraud lawsuits can do business with a public company without first having their securities lawyer and forensic accountant investigate how their business partner will book the transaction. While such a prospect may seem far-fetched, it is the question for decision in *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*[1] Although the parties and most commentators expect the Court to resolve this issue, a narrower, but nonetheless important, decision on the scope of future securities damages cases may be the result.

In *Stoneridge*, the legal question is who can be held liable under the catch-all antifraud provision, Section 10(b), the weapon of choice for plaintiffs' lawyers filing securities fraud class actions. The issue keys on the distinction between primary and secondary liability, or primary violators and those called aiders and abettors.

Plaintiffs rely on a theory of "scheme liability," developed initially by the Securities and Exchange Commission, to try to hold liable business partners who engage in transactions booked by their public company's partner in a fraudulent manner. Defendants counter this theory by arguing that scheme liability is outside the statute and contrary to an earlier Supreme Court decision. If *Stoneridge* resolves this issue, it may be a landmark business and securities law decision, redefining who can be named and held liable in securities class actions. Comments by the Justices at oral arguments, coupled with the Court's approach in a recent key securities case, suggest, however, that the decision may be much narrower and give district courts directed discretion to continue developing Section 10(b) liability. Such a decision could permit huge class actions such as *Enron*[2] to continue while giving defendants new arguments with which to seek dismissal.

The fact pattern in *Stoneridge* illustrates the potential ramifications of the Court's decision. The case centers on a deal involving Charter Communications, Inc. ("Charter"), a large cable company, and two of its vendors, Scientific-Atlanta, Inc. ("Scientific-Atlanta") and Motorola, Inc. ("Motorola"). In a three-way barter deal, Charter acquired TV set-top cable boxes in exchange for advertising. As part of the transaction, Charter paid an additional $20 per box. That sum was returned to the company as advertising revenue. Charter capitalized the cost of the boxes, while recognizing the revenue from the advertising, thus deferring expenses while adding to income. The district court and the Eighth Circuit Court of Appeals rejected plaintiffs' claims as outside the scope of Section 10(b).[3] The Supreme Court agreed to review the dismissal of the action as to the third-party vendors.

The *Stoneridge* petitioner-plaintiffs call the barter deal fraudulent. According to the complaint, Charter improperly booked the barter deal thereby falsifying its financial statements which were disseminated to the market and its shareholders—securities fraud. Plaintiffs rely on a scheme liability theory to establish a Section 10(b) violation by the vendors based on the barter deal. Under this theory, a party who participates in a fraud committed by a public company may, under certain circumstances, be held liable when the fraudulent information is given to the securities markets and relied on by investors.[4]

*(continued on page 318)*

[1] S. Ct. No. 06-43. The lower court opinion is available at *In re Charter Commc'n, Inc. Sec. Litig.*, 443 F.3d 987 (8th Cir. 2006).

[2] *Regents of the Univ. of Cal. v. Credit Suisse First Boston (USA), Inc.*, 482 F.3d 372 (5th Cir. 2007), *petition for cert. filed sub nom. Regents of the Univ. of Cal. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 75 U.S.L.W. 3557 (Mar. 5, 2007) (No. 06-1341) ("Enron").

[3] *In re Charter Commc'n, Inc. Sec. Litig.*, 443 F.3d at 992 (holding that the plaintiffs' claims alleging deception against Charter, Scientific-Atlanta Inc., and Motorola under Section 10(b) were properly dismissed because liability could not be imposed on businesses who merely engage in "an arms length non-securities transaction with an entity that then used the transaction to publish false and misleading statements to its investors and analysts").

[4] Brief of Petitioner-Appellee at 33, *Stoneridge Investment Partners, LLC, v. Scientific-Atlanta, Inc.*, No. 06-43 (8th Cir. Jul. 7, 2006).

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*(continued from back page)*

Plaintiffs' theory was previously advanced in a more expansive form by the SEC in an amicus brief filed in *Simpson v. AOL Time Warner, Inc.*,[5] a securities fraud class action based on a barter transaction alleged to have been used by Homestore.com to improperly bolster its earnings. According to the SEC, a third-party vendor is liable "for engaging in a scheme to defraud—[if it] directly or indirectly, engages in a manipulative or deceptive act as part of a scheme" whose purpose and effect is to create a false appearance of revenue.[6] The *Simpson* court adopted a variation of this theory, which was later rejected by the Fifth Circuit Court of Appeals in the *Enron* securities class actions. The high court has not ruled on requests to review *Simpson* and *Enron*.

From the perspective of the respondent-defendants, the barter deal is a business transaction. How Charter booked the transaction and what it told the market is between the company and its shareholders, according to defendants.

Defendants argue that scheme liability is outside the scope of Section 10(b) and contrary to the Court's 1994 decision in *Central Bank*.[7] That decision concluded that aiding and abetting—liability based on rendering substantial assistance to a primary fraudster who violated Section 10(b)—is outside the scope of Section 10(b). Congress essentially resolved the issue here, according to defendants, with the passage of the Private Securities Litigation Reform Act of 1995 ("PSLRA").

In that Act, Congress reformed the pleading and substantive requirements for private securities fraud lawsuits and added Section 20(e) to the Exchange Act. That section gave the SEC the authority to bring fraud lawsuits on an aiding and abetting theory in the wake of *Central Bank*.[8] Congress did not, however, extend the same right to private plaintiffs. According to defendants, this congressional action suggests that the Court should not expand the judicially created remedy under Section 10(b). Defendants also contend that plaintiffs have failed to plead reliance, a key element of a Section 10(b) private damage action.[9]

**'Stoneridge' may be a landmark business and securities law decision, redefining who can be named and held liable in securities class actions.**

In one of the minor melodramas surrounding the case, the Solicitor General denied the SEC's request to file an amicus brief supporting plaintiffs.[10] Presumably, that brief would have argued for scheme liability. The Solicitor filed a brief agreeing with defendants that the cases were properly dismissed, but only for failure to plead reliance. The Solicitor General admitted that there was a misrepresentation within the meaning of Section 10(b). In a footnote,[11] the brief claims that the SEC's scheme liability theory is wrong and contrary to *Central Bank*.

## Comments by the Justices

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. Adoption of plaintiffs' scheme liability theory would permit not only *Stoneridge*, but also *Enron*, *Simpson*, and other class actions to proceed, potentially imposing securities fraud liability and damage awards on a host of companies, banks, investment banks, and other unsuspecting business partners of public companies. Conversely, a ruling for defendants would terminate these class actions and could potentially leave many injured shareholders claiming huge losses without a remedy. Such a decision would also significantly alter the scope of future securities damage actions and the right of shareholders to pursue securities fraud claims.

The Justices are no doubt aware of the stakes in *Stoneridge*. During oral arguments, the positions asserted by the Justices seemed to evolve from support for defendants toward a middle ground. Early in the proceedings, Chief Justice Roberts raised a key point undercutting plaintiffs' argument. In questioning petitioners' counsel, the Chief Justice suggested that adopting scheme liability would expand the scope of Section 10(b) in a manner that is inconsistent with congressional action in the PSLRA: "I mean, we don't get in this business of implying private rights of action any more. And isn't the effort by Congress to legislate a good signal that they have kind of picked up the ball and they are running with it and we shouldn't?" [12]

Later, the Chief Justice returned to this theme: "[M]y suggestion is not that we should go back and say that there is no private right of action. My suggestion is that we should get out of the business of expanding it, because Congress has taken over and is legislating in the area in the way they weren't back when we implied the right of action under 10(b)." [13] The Court's reluctance to expand judicially created causes of action has been a theme in many of its Section 10(b) cases.[14]

Later, the Chief Justice, along with Justices Scalia, Kennedy, and Alito, further undercut plaintiffs' position by suggesting that it is inconsistent with the Court's 1994 decision in *Central Bank*. Justice Alito may have

[5] *Simpson v. AOL Time Warner, Inc.*, 452 F.3d 1040 (9th Cir. 2006).

[6] Brief for the Securities and Exchange Commission as Amici Curiae Supporting Appellants, *Simpson v. AOL Time Warner, Inc.*, 452 F.3d 1040 (9th Cir. 2006) (No. 04-5565).

[7] *Central Bank of Denver, N.A. v. First Interstate Bank of Denver*, 511 U.S. 164 (1994).

[8] 15 U.S.C. § 78t (2006).

[9] *Dura Pharmaceuticals, Inc. v. Broude*, 544 U.S. 336 (2005).

[10] *A Class Action Scheme*, WALL ST. J., Oct. 6, 2007, at A20; Susan Beck, *Solicitor General Sides Against SEC in Major High Court Securities Case*, THE AMERICAN LAWYER, Aug. 16, 2007, *available at* http://www.law.com/jsp/article.jsp?id=1187168525349#; Nicholas Rummel, *In Stoneridge Arguments, Supreme Court Justice Kennedy Plays Typical Role of 'Man In the Middle,' With Secondary Liability Hanging in the Balance*, FINANCIAL WEEK, Oct. 9, 2007, *available at* http://www.financialweek.com/apps/pbcs.dll/artikkel?Avis=CF&dato=20071009&kategori=REGandlopenr=71009009&Ref=AR.

[11] Brief for the United States as Amici Curiae Supporting Respondents, *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, No. 06-43 n.13 (8th Cir. Jul. 7, 2006).

[12] Transcript of Oral Argument at 6, *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, No. 06-43 (S. Ct. argued Oct. 9, 2007) ("Tr.").

[13] Tr. at 7.

[14] *See, e.g., Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 737 (1975) ("When we deal with private actions under Rule 10b-5, we deal with a judicial oak which has grown from little more than a legislative acorn.").



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summarized the view of some members of the Court at this point when he stated: "I see absolutely no difference between your test and the elements of aiding and abetting." [15]

Indeed, Justice Kennedy amplified this sentiment by suggesting that petitioners' scheme liability theory is so broad that it is effectively limitless, scooping up every petty act that could affect share price: "there are any number of kickbacks and mismanagements and petty fraud that go on in the business, and business people know that any publicly held company's shares are going to be affected by its profits, so I see no limitation" to plaintiffs' theory of scheme liability.[16] A bright line and predictable result is a key point in *Central Bank*, and has been a theme of the Court's 10(b) jurisprudence, which periodically references the potential harm caused by frivolous securities fraud damage lawsuits.

As the arguments progressed, however, the approach of the Justices shifted. In response to defendants' claim that they did not make any misstatement to Charter's shareholders, Justice Ginsburg noted that the lack of a statement (or silence) was the key to the fraudulent scheme: "[T]hat's the essence of the scheme. You said that they—they are home free because they didn't themselves make any statement to investors. But they set up Charter to make those statements, to swell its revenues—revenues that it in fact didn't have." [17] In other words, defendants participated in a scheme to defraud.

While defendants tried to focus the Court on their theory that any ruling for plaintiffs would impinge on the role Congress adopted in promulgating the PSLRA—a point raised earlier by the Chief Justice—Justice Ginsburg began a move to middle ground: "[T]hat's if they are aiders and abettors, which is what Congress covered [in Section 20(e) of the Exchange Act]. And I again go back to, is there another category or is everyone—either Charter, the person whose stock is at stake, the company whose stock is at stake and everyone else is an aider?" [18]

Justice Kennedy continued the search for middle ground by asking defense counsel if, under the common law of torts, there was a category between primary violator and aider and abettor.[19] Justice Souter echoed this theme by inquiring if there was "overlap" between the two categories—that is, some kind of common ground which would in fact be a third category.[20] The Court has previously used common law fraud theory to limit the scope of Section 10(b) when defining the elements of a claim for damages.[21]

**Based on the Justices' comments as well as recent Court precedent, however, the decision may be much narrower and give district courts directed discretion to continue developing Section 10(b) liability.**

As the arguments drew to a close, questions from the Justices continued to focus on a search for middle ground. Justice Stevens asked defense counsel whether reliance—a key defense argument—is an element of a private cause of action or of a statutory violation. Defense counsel responded that it is an element of a private action [22]—a response drawn straight out of the Court's decision in *Dura*, decided two years ago.

The Chief Justice, in a comment echoed by Justice Ginsburg, followed up on this point by noting that the question of reliance had not been squarely ruled on by the lower courts. Since the Court frequently declines to decide such issues, these questions suggest the Court may not resolve the reliance issue. The sole remaining issue in that event would be the scope of Section 10(b).

## Analysis and Conclusion

In *Tellabs*,[23] the Court's most recent securities fraud case, an eight-Justice majority held that the PSLRA's twin goals are to permit meritorious private damage actions to proceed and eliminate those which are frivolous. There, Justice Ginsburg, writing for the Court, crafted a standard for pleading a strong inference of scienter under the PSLRA.

The Court remanded the case to the district court for further proceedings consistent with its opinion. The consensus approach of *Tellabs*, based on a focused point, coupled with a vesting of broad discretion in the district court, appears to be the formula that drew together eight votes on a Court which is frequently fractionalized along ideological lines.

The "all or nothing" approach of the *Stoneridge* parties is inconsistent with the focused consensus approach of *Tellabs*. Plaintiffs' "scheme liability" theory may, as the Chief Justice suggested, be viewed as an expansion of Section 10(b) liability at a time when the Court is trying to circumscribe the implied cause of action it created in a manner which is consistent with the PSLRA. Defendants' "business as usual" approach may be viewed as leaving shareholders alleged to have suffered huge losses in well-publicized financial fraud cases such as *Enron* without a remedy, a result that might also be viewed as contrary to the PSLRA.

A decision limited to a construction of Section 10(b), however, with a remand to the lower courts, may create a *Tellabs*-type consensus. Under this approach, the Court could give definition to what constitutes a primary violation of Section 10(b) in a manner consistent with its restrictive view of interpreting the section.[24]

Since the question of reliance deals with an element of a claim, not statutory construction, the Court could leave this issue to another day, as it frequently has done in the past. The case could then be remanded for reconsideration in view of the opinion. This would give the lower courts discretion to continue developing the notion of Section 10(b) liability under instructions from the high court.

A *Tellabs*-style middle ground consensus approach would permit all sides to declare victory—for now. Plaintiffs' case—and those in the wings, such as *Enron*—could go forward. Defendants would have new arguments for dismissal. The lower courts would have new guidance on the question left open by *Central Bank* years ago—who is liable under Section 10(b)?

An important decision? To be sure. The case of the decade—that may have to wait for another day.

[15] Tr. at 17.
[16] Tr. at 18.
[17] Tr. at 35.
[18] Tr. at 35.
[19] Tr. at 41.
[20] Tr. at 42.
[21] *See, e.g., Dura*, 544 U.S. at 344–46.
[22] Tr. at 47.
[23] *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499 (2007).
[24] *See, e.g., Santa Fe Indus., Inc. v. Green*, 430 U.S. 462 (1977).