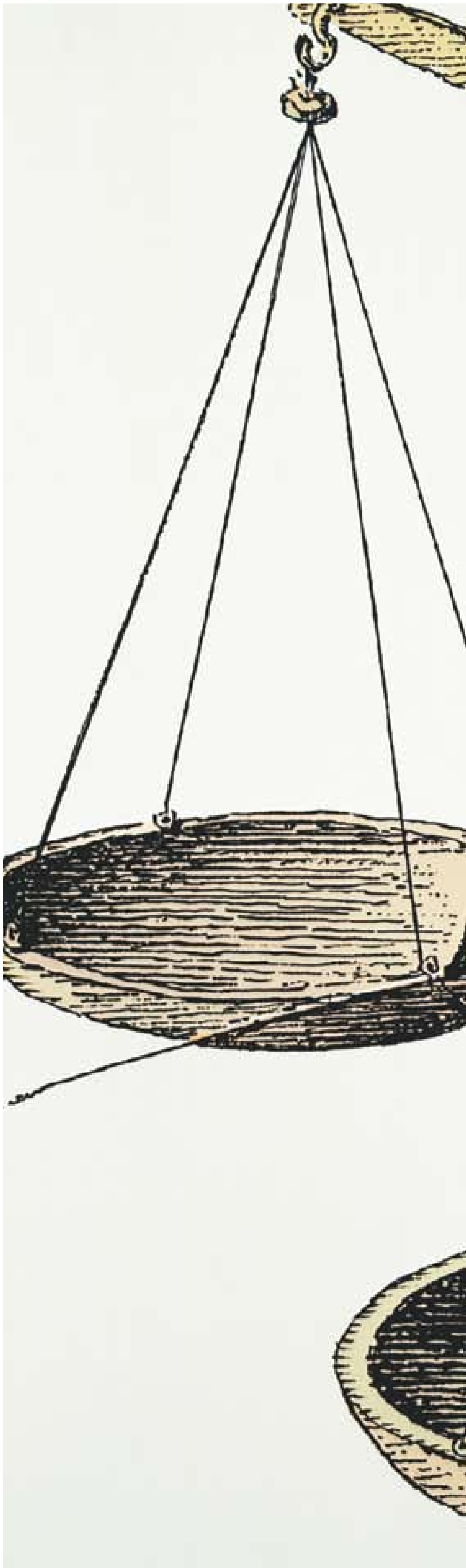
SUPREME COURT DECIDES STONERIDGE CASE

by NICOLE M. ZEISS and MICHAEL W. STOCKER

More than thirteen years after the controversial ruling in *Central Bank, N.A. v. First Interstate Bank, N.A.* eliminated "aiding and abetting" liability for participants in securities fraud, on January 15, 2008 the Supreme Court decided *Stoneridge Investment Partners LLC v. Scientific-Atlanta, Inc.*, No. 06-43, clarifying the exposure of such entities to primary liability claims. While *Stoneridge* has been touted by commentators from the defense bar to be the end of "scheme liability" for actors who do not make public statements, in the 5-3 decision written by Justice Anthony Kennedy (the author of *Central Bank*), the Court held that such misstatements are not the only possible basis of liability—answering an important question left over from *Central Bank*. The decision does illustrate, however, that the Supreme Court's new composition has led to an increasingly pro-business activism and a resulting drift away from shareholder protections.



Central Bank was the first chapter of the Supreme Court's struggle with the issue of liability for non-speaking participants in fraud schemes. In that 1994 decision, a closely divided Supreme Court (5-4) held that a private investor could not sue those "who do not engage in the proscribed activities at all, but 'who give a degree of aid to those who do.'" Nevertheless, the Court left untouched case law holding that third parties could be liable as primary violators, observing:

Any person or entity, including a lawyer, accountant, or bank, who employs a manipulative device…on which a purchaser or seller of securities relies may be a primary violator under 10b-5, assuming all of the requirements for primary liability under Rule 10b-5 are met.

The years following *Central Bank* saw increasing attention paid to "non-speaking" parties to fraud in the wake of massive and complex debacles involving bankers and accountants at companies such as Global Crossing and Enron. In this period, courts struggled to hold these participants liable under the securities laws while avoiding the Supreme Court's admonition against aiding and abetting liability.

This tension came to a head in *Stoneridge*. At issue in that case was whether the plaintiff could hold vendors of Charter Communications liable for their alleged participation in sham business transactions that created the appearance of additional revenue for Charter, even though the vendors did not themselves make direct statements to Charter's investors. In its decision rejecting liability for the vendors, the Eighth Circuit held that the only "non-speaking" conduct prohibited by the Exchange Act was illegal trading practices intended to mislead investors about market activity, such as wash sales and matched orders.

It was apparent during the *Stoneridge* oral argument last fall that the Court saw the case as something of a referendum on the vitality of private causes of action to enforce the securities laws. The Court was divided between Justices such as Ruth Bader Ginsburg who did not want to immunize companies that "made it possible for [the] deception to happen," and those who favored increasing the restrictions on private litigants started by the Private Securities Litigation Reform Act (PSLRA), in the name of opening the United States' securities markets to foreign investment.

At the argument, the government's Deputy Solicitor, General Thomas G. Hungar, suggested a compromise position—that the ultimate test for upholding an investor's claim should turn not on whether a third party made direct statements, but on whether the investor could show "reliance" on the third party's deception.

In the January 15 ruling, the presiding Justices unanimously rejected the Eighth Circuit's unduly narrow holding that fraud liability should be limited to oral and written statements. "If this conclusion were read to suggest there must be a specific-oral or written statement before there could be liability under § 10(b) or Rule 10b-5, it would be erroneous. Conduct itself can be deceptive… ."

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Given that the Eighth Circuit grounded its ruling on this faulty basis alone, the Supreme Court could have ended its decision in *Stoneridge* here and remanded the case for consideration of the other elements of a securities fraud claim, as pointed out by the dissent. The fact that the Court went so much further in its opinion is some indication of the strength of the tensions between the Justices on the issue of private causes of action to enforce the securities laws.

Perhaps adopting the approach advocated by the Solicitor General, the majority opinion went on to consider whether the investors could show that they relied upon the alleged fraudulent acts by Charter's vendors. Unfortunately for the plaintiff, the Court held "that respondents' acts or statements were not relied upon by the investors and that, as a result, liability cannot be imposed…" In language that is sure to be central to any future litigation of this issue, the Court explained:

> **Respondents had no duty to disclose; and their deceptive acts were not communicated to the public. No member of the investing public had knowledge, either actual or presumed, of respondents' deceptive acts during the relevant times. Petitioner, as a result, cannot show reliance upon any of respondents' actions except in an indirect chain that we find too remote for liability.**

Although the vendor-defendants were linked to information in Charter's public financial statements, the Court concluded that the plaintiff "impermissibly" sought to connect the vendors to the primary violators through their actions in the "realm of ordinary business operations" (better patrolled by state law), rather than in the world of finance and securities markets—the proper domain of an Exchange Act claim. For the majority, this tenuous causal connection resurrected the aiding and abetting liability that had been rejected in *Central Bank*. From a policy perspective, upholding the claim would have opened the door to rising "cost[s] of being a publicly traded company under our law and shift[ed] securities offerings away from domestic capital markets."

For the dissent, the majority's requirement of "super-causation" "is unwarranted and without precedent." Referring to the Brief of Former SEC Commissioners as *Amici Curiae*, Justice Stevens reminded the majority that liability for violators of Section 10(b) "' will not harm American competitiveness; in fact, investor faith in the safety and integrity of our markets is their strength. The fact that our markets are the safest in the world has helped make them the strongest in the world.'"

The majority's analysis appears to leave the door open to claims against an issuer's accountants, lawyers, and investment bankers for potentially fraudulent conduct within the "financial sphere," at least where investors were on notice of their involvement with the issuer. However, casting doubt on such a conclusion, days following *Stoneridge*, the Supreme Court refused to hear an appeal that could have restored claims against the "non-speaking" banks Enron used to allegedly structure its sham transactions. Because the actions of these banks appear to fall within the realm of the "finance and securities markets," the Court may be read as implicitly ruling that reliance is an obstacle to liability for non-speaking participants even in these markets.

The next major test will be the Ninth Circuit's reconsideration of its decision that, in part, allowed a "scheme liability" claim against third-party vendors in *Simpson v. Homestore.Com, Inc.*, which was recently remanded by the Supreme Court in light of *Stoneridge*. The appellate court's ruling in that case could solidify that *Stoneridge* has not practically put scheme liability to rest. LS

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