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'Stoneridge': Answered and Unanswered Questions

On Tuesday the U.S. Supreme Court will hear argument in *Stoneridge Investment Partners, LLC v. Scientific Atlanta Inc. and Motorola Inc.*, an appeal from a U.S. Court of Appeals for the Eighth Circuit decision in *In re Charter Communications, Inc.*[1] This is a case of great interest to the securities bar, as it raises the question of how to define the difference between primary and secondary private civil liability under §10(b) of the Securities Exchange Act of 1934[2] and Rule 10b-5.[3] There are, however, other important issues in play, such as the scope of the "reliance," "in connection with," and "loss causation" elements of a private §10(b) claim.[4]

The U.S. Supreme Court received 31 briefs from amici curiae, 15 favoring the petitioner and 16 favoring the respondents. One of the briefs supporting affirmance was filed by the Solicitor General's office, which specifically disagreed with a position previously taken by the Securities and Exchange Commission in *Simpson v. AOL Time Warner Inc.* concerning the "reliance" element for private claims under §10(b).[5] Two former SEC commissioners (including one former chairman) have filed an amicus brief in support of petitioner. Fourteen former SEC commissioners (including three former chairmen) have filed an amicus brief in support of respondents.

The purpose of this article is to explain why the *Stoneridge* case is important, to identify the potential issues on which the case's outcome may turn, and to explain why subsidiary issues involving the elements of a private §10(b) claim may dictate the result, leaving unresolved the larger issue of the outer limits of primary liability in a private §10(b) claim.

Charter Communications

Charter Communications Inc. is one of the country's largest cable television providers. Its customers receive signals through converter boxes that Charter bought from two manufacturers, Scientific-Atlanta and Motorola, (the vendors.) Prior to August 2000, Charter had contracts with the vendors to buy the converter boxes at a fixed price. However, in August 2000, Charter offered to pay the vendors $20 more per converter box in exchange for returning the additional $20 as "advertising fees." This allowed Charter to record all of the $20 in "advertising fees" immediately as income, while amortizing the additional $20 in expense for the cable boxes over the course of several years. This scheme was one of many allegedly used to falsify Charter's financial results.

A private civil complaint alleging violations of §10(b) was filed naming as defendants Charter and certain of its officials, Scientific-Atlanta and Motorola, and Charter's outside auditors, Arthur Andersen LLP. The vendors moved to dismiss the complaint on the pleadings, arguing that the claims were foreclosed by the U.S. Supreme Court's decision in *Central Bank, N.A. v. First Interstate Bank, N.A.*,[6] which held that there is no implied private cause of action for aiding and abetting a violation of §10(b). To avoid the holding in *Central Bank*, the plaintiff articulated a theory which made the vendors "primary violators" of §10(b), along with Charter. The theory was that even though the vendors did not make any false statements to investors and had no fiduciary duty to disclose anything, the vendors' "sham" backdated contracts with Charter constituted "a manipulative or deceptive device or contrivance" as that term is used in §10(b). The district court rejected the plaintiff's argument, and granted the vendors' motion to dismiss.

On April 11, 2006, the Eighth Circuit affirmed the district court, holding that after *Central Bank*, "any defendant who does not make or affirmatively cause to be made a fraudulent statement or omission, or who does not directly engage in manipulative securities trading practices, is at most guilty of aiding and abetting and cannot be held liable under §10(b) or any subpart of Rule 10b-5."[7] The court explained: "To impose liability for securities fraud on one party to an arm's length business transaction in goods or services other than securities because that party knew or should have known that the other party would use the transaction to mislead investors in its stock would introduce potentially far-reaching duties and uncertainties for those engaged in day-to-day business dealings."[8]

Subsequently, the Ninth Circuit took a contrary position in *Simpson v. AOL Time Warner, Inc.*[9] The U.S. Supreme Court then granted certiorari in *Charter Communications*

What Is at Stake?

From the long list of amici who have filed briefs in *Stoneridge*, one can see that many powerful interests believe this to be a case of great significance. Those who support the petitioner's position argue that an affirmance of the Eighth Circuit's decision will undermine a critical purpose behind §10(b), namely, to deter fraudulent conduct which results in harm to investors. Those who argue for affirmance emphasize the need to limit private civil liability under §10(b), lest innocent parties who do business with public companies be sued by aggressive plaintiffs' lawyers, leading to settlements driven more by litigation costs than by the merits. According to published reports, President George W. Bush's chief economic advisor, Allan Hubbard, said that the president conveyed to the solicitor general that he believed that it is important to reduce "unnecessary lawsuits because that's a very big burden to the economy."[10] Hubbard also is reported to have said that the U.S. Treasury, the

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Federal Reserve and the Office of the Comptroller of the Currency sent letters to the solicitor general urging him to support the president's view.[11]

Of course, these public policy considerations are not statutory interpretation. However, the Supreme Court invited this kind of argument in *Central Bank* when it reviewed public policy considerations in order to determine whether the failure to recognize a private claim for aiding and abetting a §10(b) violation would lead to a result "so bizarre" that Congress could not have intended it.[12]

The Court in *Central Bank* wrote that "the rules for determining aiding and abetting liability are unclear," and expressed concern that recognizing aiding and abetting claims under §10(b) might lead to "decisions made on an ad hoc basis, offering little predictive value to those who provide services to participants in the securities business."[13] Noting that there were competing policy arguments for and against allowing for aiding and abetting liability under §10(b), the Court concluded: "[I]t is far from clear that the Congress in 1934 would have decided that the statutory purposes would be furthered by the imposition of private aiding and abettor liability."[14] The Court refused to recognize private claims for aiding and abetting liability under §10(b).

In *Stoneridge*, as in *Central Bank,* there are clearly competing policy arguments for and against affirmance. Therefore, to the extent that the Court finds that the text of §10(b) does not clearly define the parameters of primary versus secondary liability, it may read the scope of §10(b) narrowly, just as it did in *Central Bank,* because of the same concern, the risk of vexatious litigation.[15]

The Issues

• Distinguishing between primary and secondary liability

Towards the conclusion of its opinion in *Central Bank,* the Court wrote: "The absence of §10(b) aiding and abetting liability does not mean that secondary actors in the securities markets are always free from liability under the securities acts. Any person or entity, including a lawyer, accountant or bank, who employs a manipulative device or makes a material misstatement—or omission on which a purchaser or seller relies—may be liable as a primary violator under 10b-5, assuming all of the requirements for primary liability are met…."[16]

The Court did not provide any additional guidance on how to distinguish primary from secondary violators. This left the door ajar for plaintiffs to argue that aiders and abettors might also be primary violators under some circumstances.

However, as the Court pointed out, this small opening depends on plaintiffs' ability to prevail on all of the other elements of a private §10(b) claim. For the reasons explained below, because petitioner in *Stoneridge* has so many other hurdles to overcome in satisfying the other elements of a private §10(b) claim, it appears unlikely that the Court will need to identify specific factors that will enable the lower courts to distinguish between primary and secondary violators of §10(b).

• Defining a "deceptive device or contrivance"

In *Central Bank*, the first part of the Court's analysis looked to the words of the statute to determine if they clearly applied to aiding and abetting liability. Finding no reference to aiding and abetting liability in the statute itself, the Court was unwilling to infer it from the statute.[17] Plaintiff in *Stoneridge*, citing the words "deceptive device or contrivance" in §10(b) alleges that the vendors' backdated contracts with Charter were designed to make "sham" transactions look real, and that they were created for the purpose of misleading Charter's accountants so that Charter could file false financial statements with the SEC.

To the extent that the Court finds that the text of §10(b) does not clearly define the parameters of primary versus secondary liability, it may read the scope of §10(b) narrowly, just as it did in 'Central Bank,' because of the same concern, the risk of exatious litigation.

The Eighth Circuit focused on the word "deceptive," citing language in *Central Bank*, *Chiarella v. United States*,[18] and *United States v. O'Hagan*,[19] to conclude that "deception" under §10(b) is limited to those who make misstatements to the public or a failure to disclose by one who has a duty to disclose.[20] Whether or not the Supreme Court intended to put this limitation on the word "deceptive" in §10(b) will be one of the issues before the Court in *Stoneridge*.

• "In Connection With"

Section 10(b) prohibits the use of a deceptive device and contrivance only "in connection with the purchase and sale of any security." Even if the vendors in *Stoneridge* engaged in a "deceptive device" with Charter, was that deceptive device "in connection with" the purchase and sale of Charter stock?

The leading cases on the meaning of §10(b)'s "in connection with" requirement are *SEC v. Zanford*,[21] and *United States v. O'Hagan*,[22] both of which are failure to disclose cases. In *Zanford,* a broker sold his customer's securities in order to convert the proceeds. The deceptive device in that case, the broker's failure to disclose what he was doing, was held to be "in connection with" the purchase and sale of securities because the non-disclosure "coincided with the [securities] sales themselves."[23] Similarly, a lawyer's use of his client's material non-public information was "in connection" with the purchase and sale of securities in *O'Hagan* because "the securities transaction and the breach of duty…coincide[d]."[24]

The Supreme Court will need to decide how to apply those cases to the *Stoneridge* case, where the allegation is not a failure to disclose, but rather "deceptive" conduct. In *Stoneridge*, unlike in *Zanford* and *O'Hagan*, the defendants had no duty to disclose. Their deceptive device "the allegedly sham contracts" occurred long before Charter Communications filed its false statements with the SEC, and therefore did not "coincide" with the purchase and sale of securities by the plaintiffs.

Citing *Zanford*, the petitioner's brief in *Stoneridge* argues that the "in connection with" requirement was met because the vendors' deceptive conduct caused the purchases to be made at inflated prices.[25] In essence, petitioner argues that because the scheme was not complete until the purchases were made, all of the steps that were performed with scienter during the course of the scheme were "in connection with" plaintiff's purchases. Nothing in *Zanford* or *O'Hagan* suggests that the Supreme Court will find that all such steps along the way "coincide" with the securities transaction.

• The reliance element

Almost as an aside in *Central Bank,* the Court noted: "Were we to allow the aiding and abetting action proposed in this case, the defendant could be liable without any showing that the plaintiff relied upon the aider and abettor's statements or actions."[26] The clear import of that comment is that, for purposes of a private §10(b) claim, a plaintiff cannot be said to "rely" on the conduct of one who did not make a false statement to the plaintiff and had no duty to the plaintiff. This should sound the death knell for the petitioner in *Stoneridge*.

That *Stoneridge* should turn on the issue of reliance is ironic for a number of reasons. First, the reliance issue was mentioned only in passing in *Charter Communications*, and was not the ground on which the Eighth Circuit's decision rested. Yet the solicitor general's office is advocating affirmance based on the argument that petitioner failed to adequately plead reliance.[27] The second irony is that the word "reliance" does not appear in the text of §10(b). It was only determined to be an essential element of a private §10(b) claim by the Supreme Court.[28]

Third, as noted above, the SEC's position on reliance in *Simpson* was contrary to the one now being taken by the solicitor general. The solicitor general's amicus brief in *Stoneridge* acknowledged this difference, adding: "The SEC's [amicus] briefs [in

Simpson], however, were filed without the involvement of the Solicitor General, and the position on reliance that was expressed in those briefs does not reflect the views of the United States."[29]

The SEC's argument in *Simpson*, repeated by petitioner in *Stoneridge*, was that a "prior deceptive act, from which the making of the false statement follows as a natural consequence, can constitute a sufficient step in the causal chain to support a finding of reliance."[30] The petitioner, relying on *Simpson*, also argues that it is entitled to a presumption of reliance, citing *Affiliated Ute Citizens v. United States*[31] and *Basic*. The solicitor general's amicus brief disagrees with that position, and argues: "Words or actions by a secondary actor that facilitate an issuer's misstatement, but are not themselves communicated to investors, simply cannot give rise to reliance (and thus primary liability in a private action). That principle is at the heart of the distinction between primary liability and secondary liability of the kind rejected in *Central Bank*."[32] On this point, the solicitor general is almost certainly correct. If the plaintiffs in *Central Bank* could not have satisfied the reliance element as aiders and abettors, it is hard to see how the petitioner in *Stoneridge* can.

- **Loss causation**

"Loss causation" is the term used to describe the requirement that a plaintiff prove that the defendant's fraudulent conduct "proximately caused the plaintiff's economic loss."[33] Petitioner's brief in *Stoneridge* appears to conflate "loss causation" and "reliance" because it emphasizes that "but for" the vendors' deceptive acts, Charter stock would have traded at a lower price (loss causation) and the false information would not have entered into the efficient securities market (triggering the theory of presumed reliance).[34]

Reliance and loss causation are, of course, different issues. They both have a "but for" quality, as argued by the petitioner. However, one can rely on a statement, and still not suffer an economic loss. For example, if a plaintiff actually or presumptively relied on a false statement, but that statement did not cause the stock to trade at an inflated price, reliance would have been proved, but not loss causation.

Whether the complaint in *Stoneridge* was specific enough to allege loss causation will depend on the facts of that case. However, the Court may decide, as a general proposition, that a plaintiff must separately allege "loss causation" for each alleged bad act. That would undercut the petitioner's case because the complaint in *Stoneridge* alleged multiple false statements by Charter, only some of which related to Charter's "sham" contracts with the vendors.

- **The validity of "scheme liability" theory**

"Scheme liability" is shorthand for the theory that there can be private §10(b) liability in the absence of a false statement to the market, a failure to disclose when there is a duty to disclose, or a manipulative trade. The theory of scheme liability was rejected by the Eighth Circuit in *Charter Communications* and the Fifth Circuit in *Regents of the State of California v. Credit Suisse First Boston (USA), Inc.*[35] In *Simpson*, the Ninth Circuit accepted that theory, relying on Judge Lewis Kaplan's opinion in *In re Parmalat Sec. Litig.*[36] By selectively quoting from various U.S. Supreme Court decisions, the parties in *Stoneridge* and the solicitor general provide competing views on whether §10(b) covers "scheme liability."

Ultimately, those who eagerly await a resolution of the debate on the issue of scheme liability may be disappointed by *Stoneridge*. As noted above, there are any number of other issues on which the case may turn without resolving the scheme liability issue. And the reality is that defining the parameters of scheme liability is as daunting a task as defining the limits of primary versus secondary liability in a private §10(b) action.

Moreover, if the Court decides *Stoneridge* on other grounds, the issue of scheme liability in private civil actions may become academic. In order for that theory to remain viable in private civil §10(b) cases, petitioner in *Stoneridge* must win on all of the other issues, which seems unlikely. And in SEC actions or criminal actions under §10(b), the government does not need to use the concept of scheme liability because, even after *Central Bank*, it may still bring SEC and criminal actions for aiding and abetting §10(b).[37] All of this suggests that if the scheme liability issue is not outcome-determinative in *Stoneridge*, the issue may, as a practical matter, become a non-factor in all future §10(b) cases.

Conclusion

The *Stoneridge* appeal presents the U.S. Supreme Court with an opportunity to clarify many open issues relating to private claims under §10(b). Even if, as expected, the Court rules for the respondents, it will still be interesting to see which issues will determine the outcome. There will be no shortage of amici curiae, and securities lawyers, watching.

1. 443 F.3d 987, (Eighth Circuit 2006) cert. granted sub nom., *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 2007 U.S. LEXIS 3582 (U.S., March 26, 2007).

2. Section 10(b) makes it unlawful, directly or indirectly, "to use or employ, in connection with the purchase or sale of any security…any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [SEC] may prescribe." 15 U.S.C. §78j(b).

3. Rule 10b-5 provides: "It shall be unlawful for any person, directly or indirectly…(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 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." 17 C.F.R. §240.10b-5.

4. The elements of a private Section 10(b) claim were summarized in *Dura Pharmaceuticals Inc. v. Broudo*, 544 U.S. 336, 341-42 (2005): "In cases involving publicly traded securities and purchases or sales in public securities markets, the action's basic elements include: (1) a material misrepresentation (or omission)…; (2) scienter, i.e., a wrongful state of mind…; (3) a connection with the purchase or sale of a security…; (4) reliance, often referred to in cases involving public securities markets (fraud-on-the-market cases) as transaction causation…; (5) economic loss…; and (6) loss causation, i.e., a causal connection between the material misrepresentation and the loss…"

5. 452 F.3d 1040 (9th Cir. 2006), petition for cert. pending, No. 06-560 (filed Oct. 19, 2006). A clear conflict exists between *Charter Communications* and *Simpson* on the question of whether Section 10(b) covers conduct when the defendant does not make a false statement to the public, has no duty to disclose, and does not engage in manipulative trading activity. *Charter* rejected that theory, as did the Fifth Circuit later in *Regents of the State of California v. Credit Suisse First Boston (USA), Inc.*, 482 F.3d 372 (5th Cir. 2007), petition for cert. pending, No. 06-1341 (filed April 5, 2007). The Ninth Circuit's decision in *Simpson* accepted that theory, relying on *In re Parmalat Sec. Litig.*, 376 F. Supp. 2d 472 (S.D.N.Y. 2005).

6. 511 U.S. 164 (1994).

7. *Charter Comm.*, 443 F.3d at 992.

8. Id. at 992-93.

9. 452 F.3d 1040 (9th Cir. 2006).

10. Susan Beck, "Solicitor General Sides Against SEC in Major High Court Securities Case," The American Lawyer, Aug. 16, 2007 (available at www.law.com/jsp/law/LawArticleFriendly.jsp?id=1187168525349).

11. Id.

12. 511 U.S. at 188, quoting *Demarest v. Masnpeaker*, 498 U.S. 184, 191 (1991)

13. Id. (quoting *Pinter v. Dahl*, 486 U.S. 622, 652 (1988)).

14. Id. at 189.

15. Id. at 189.

16 Id. at 191.

17. Id. at 170-78.

18. 445 U.S. 222 (1980).

19. 521 U.S. 642 (1997).

20. 443 F.3d at 992 (A device or contrivance is not "deceptive," within the meaning of §10(b), absent some misstatement or a failure to disclose by one who has a duty to disclose.)

21. 535 U.S. 813 (2002)

22. 521 U.S. 642 (1997).

23. *Zanford*, 535 U.S. at 820-21.

24. *O'Hagan*, 521 U.S. at 656.

25. See Brief for Petitioner at 22.

26. 511 U.S. at 180.

27. "The district court accepted respondents' contention that the complaint failed to allege reliance, noting that petitioner do[es] not assert that *** [it] relied on any statement, omission or action made by either of [respondents]." Pet. App. 41a. Respondents renewed that contention on appeal…. While the court of appeals did not address the reliance issue in detail, it appears to have endorsed the district court's resolution of that issue. See, e.g., Pet. App. 7a (quoting the district court's ruling on reliance); id. at 10a (noting that respondents "did not issue any misstatement relied upon by the investing public). In its brief before this Court, petitioner does not contend that the Court should not address the reliance issue, but instead contends only that reliance was sufficiently pleaded. See Br. 37-40." Brief for the United States as Amicus Curiae Supporting Affirmance, *Stoneridge Investment Parnters, LLC v. Scientific Atlanta, Inc., et al.*, at 18, fn. 9.

28. See *Basic, Inc. v. Levinson*, 485 U.S. 224, 243 (1988), *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 206 (1976).

29. Brief for the United States, supra note 27, at 23-24, fn. 13

30. See Brief of Petitioner in *Stoneridge* at 39 (quoting the SEC's amicus brief in *Simpson* at 22).

31. 406 U.S. 128 (1972).

32. Brief for the United States, supra note 27, at 22.

33. *Dura Pharmaceuticals*, 544 U.S. at 346.

34. See Brief for the United States, supra note 27, at 37-40.

35. 482 F.3d 372 (5th Cir. 2007).

36. 376 F Supp. 2d 472 (S.D.N.Y. 2005).

37. The SEC may bring an aiding and abetting enforcement action under 15 U.S.C. §78t(e). Aiding and abetting a Section 10(b) violation may be prosecuted under 18 U.S.C. §2.