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STONERIDGE RULING SHUTS DOWN CREATIVE SECURITIES FRAUD CLAIMS

by

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In 1994, the U.S. Supreme Court ruled in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994) that Section 10(b) of the Securities Exchange Act of 1934 does not provide a private cause of action for aiding and abetting another party's violation of the federal securities laws. Among the many factors that influenced the Court's decision was the fact that, if such claims were possible, the defendant could be liable without any showing that the plaintiff had relied upon the aider and abettor's statements or actions. *Id.* at 180

At the time of *Central Bank*, it was well-established that a plaintiff must show reliance on the defendant's misstatement or omission in order to recover under Section 10(b). *Id.* The Court in *Central Bank*, therefore, refused to sanction an aiding and abetting cause of action because it would have allowed plaintiffs to circumvent one of the essential elements of a Section 10(b) claim and thereby "disregard the careful limits on [Section 10(b)] recovery mandated by [the Supreme Court's] earlier cases" *Id*. The Court in *Central Bank* made clear that a so-called "secondary actor" defendant, such as "a lawyer, accountant, or bank" that "employs a manipulative device or makes a material misstatement (or omission) *on which a purchaser or seller of securities relies* may be liable as a primary violator under 10b-5," but only if "*all* of the requirements for primary liability under Rule 10b-5 are met." *Id*. at 191 (second emphasis in original).

Fourteen years later, the Supreme Court again re-visited these issues in *Stoneridge Investment Partners v. Scientific-Atlanta, Inc. and Motorola, Inc.*, 128. S. Ct. 761 (2008).[1] The Court issued its opinion on January 15, 2008 and held that two equipment suppliers doing business with Charter Communications could not be liable under Section 10(b) for the purportedly false and misleading statements that Charter made to its shareholders. Like *Central Bank*, the Court again focused on the fact that the critical element of reliance was missing with respect to the supplier defendants and, thus, the claims against them were not viable as a matter of law. *Id*. at 766. The Court rejected plaintiffs' request that it recognize a presumption of reliance to overcome this deficiency, noting that there was no support for such a theory in its prior opinions on reliance. *Id.* at 769. Instead, the Court reiterated the holding from *Central Bank* – namely, that

[1]Justice Kennedy, the author of the majority opinion in *Stoneridge*, also wrote the majority opinion in *Central Bank*.

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all preconditions or elements of a Section 10(b) claim must be satisfied as to each defendant before primary liability may exist. *Id.*

The Supreme Court's continued enforcement of the reliance requirement is important for any potential defendant in a securities case. The *Stoneridge* decision is, however, of particular interest to secondary actor defendants who, in the past, may have been sued in cases involving their customers and clients. The "scheme liability" claims rejected in *Stoneridge* were widely perceived to be an attempted "end run" around *Central Bank* and the Court's directive that Section 10(b) claims must be pled on a defendant by defendant basis. The Supreme Court correctly concluded that the end result should not change simply because claims that were once described as "aiding and abetting" now bear the label of "scheme liability."

The Issues on Appeal in Stoneridge. Investors in Charter stock had filed suit against Charter and certain of its former officers and directors alleging that Charter made false and misleading statements to its investors about its financial condition purportedly in violation of the federal securities laws. *Id* at 766. The plaintiffs sought to add as defendants to the existing case two companies that supplied cable television equipment to Charter. It was, however, undisputed that these suppliers had made no statements to investors about Charter nor did they owe Charter's investors a duty of disclosure. *Id.* at 767. Instead, the claims against the suppliers were based on certain commercial transactions with Charter that Charter had failed to account for properly on its books. The suppliers' accounting for these same transactions was proper and they had no role in the preparation of Charter's financial statements nor any involvement in that company's accounting practices. *Id*. at 766-67.

The lower courts had ruled that plaintiffs' complaint, at the most, attempted to plead that the suppliers had aided and abetted Charter's misstatements and, therefore, those claims were barred by the Court's prior decision in *Central Bank*. *Id.* at 767. Consistent with this analysis, the Supreme Court in *Stoneridge* invoked *Central Bank* and held that these claims were properly dismissed because the Charter investors did not rely on anything the supplier defendants said or did when they decided to purchase Charter securities. *Id*. at 774.

The Court's Analysis Focused on the Reliance Requirement. The *Stoneridge* Court began its analysis by observing that "[r]eliance by the plaintiff upon the defendants' deceptive acts is an essential element of the [Section] 10(b) cause of action." *Id*. at 769. It ensures that "the 'requisite causal connection between a defendant's misrepresentation and a plaintiff's injury' exists as a predicate for liability." *Id.* The Court then acknowledged that it had previously recognized a rebuttable presumption of reliance in two different circumstances.

The first time was in the context of "an omission of a material fact by one with a duty to disclose" and the second time was in conjunction with the "fraud-on-the-market" theory. *Id.* Plaintiffs in *Stoneridge* had argued that they were entitled to invoke the fraud-on-the-market theory, which is described in *Basic Inc. v. Levinson*, 485 U.S. 224 (1988). Under this theory, reliance may be presumed if the company's stock trades in an efficient market and the defendant's statements at issue in the case became public. The theory is premised on the notion that all public information about a company is reflected in its stock price and, thus, when an investor buys or sells in reliance on the market price of a stock, it is presumed that they are relying on those public statements that had the opportunity to influence this price. *Stoneridge*, 128 S. Ct. at 769.

The Supreme Court, however, held that no previously recognized presumption of reliance could possibly apply to the facts on appeal in *Stoneridge*. The suppliers did not owe a disclosure duty to the Charter shareholders and, thus, the omissions-based presumption from *Affiliated Ute Citizens of Utah v.*

United States[2] could not apply. Similarly, *Basic*'s fraud-on-the-market theory was inapplicable because "[the suppliers' allegedly] deceptive acts were not communicated to the public." *Stoneridge*, 128 S. Ct. at at 769. Indeed, "[n]o member of the investing public had knowledge, either actual or presumed, of [the suppliers' purported] deceptive acts during the relevant times." *Id.* Plaintiffs could not, therefore, show reliance, except in an indirect chain that the Court deemed too remote for liability to attach. *Id.*

The Court also specifically rejected the plaintiffs' attempt to rely on a new "purpose and effect" test for reliance. Even though the investors were unaware of the defendants' actions, plaintiffs argued that liability would nevertheless be appropriate so long as the defendants "engaged in conduct with the purpose and effect of creating a false appearance of material fact to further a scheme to misrepresent [a company's] revenue." *Id*. at 770. Plaintiffs claimed that this connection was sufficient for purposes of invoking the fraud-on-the-market theory from *Basic*. Plaintiffs' contention was that "investors rely not only upon the public statements relating to a security but also upon the transactions those statements reflect." *Id.*

Basic, however, by its very terms applied only to claims based on the defendant's allegedly false or misleading public statements. In *Basic*, the Supreme Court was willing to presume reliance "[b]ecause most *publicly available information* is reflected in [the] market price [of a stock and, thus,] an investor's reliance on any *public material misrepresentations* . . . may be presumed for purposes of a Rule 10b-5 action." 485 U.S. at 225 (1988) (emphasis added). Thus, the presumption of reliance in *Basic* applies only (1) where a defendant speaks to investors and (2) those statements were made public. The defendants in *Stoneridge* made no public statements and the conduct of which they were accused was likewise never made public. To apply *Basic* under these facts would have been an unprecedented expansion of that decision and one that conflicts with the fundamental principles that led the Court to adopt the presumption in the first place.

The Supreme Court recognized that there was simply no support for such a reliance theory, which would have extended the cause of action under Section 10(b) to "reach the whole marketplace in which the issuing company does business." *Stoneridge*, 128 S. Ct. at 770. Charter, not the supplier defendants, filed the allegedly false financial statements and the Court concluded that nothing the suppliers did "made it necessary or inevitable for Charter to record the transactions as it did." *Id.* Prior Supreme Court precedent also made clear that the federal securities laws were not intended to "reach all commercial transaction that are [alleged to be] fraudulent and [that] affect the price of a security in some attenuated way" *Id.* at 771.

Concerns over Abusive Litigation Practices and Potential Adverse Consequences to the Financial Markets Also Factored into the Court's Analysis. The Court also considered the practical consequences of embracing plaintiffs' approach to the securities laws. In prior cases interpreting the federal securities laws, the Court had acknowledged the extensive discovery demands that arise in these cases and the potential for uncertainty and disruption that allow plaintiffs with weak claims to extort settlements from innocent companies. *Id.* at 772. The Court observed that adoption of the plaintiffs' approach would expose a new broader class of defendants to these risks, which could in turn increase the cost of doing business to protect against these threats. *Id.* Overseas companies with no other exposure to this country's securities laws might also be deterred from doing business here. *Id*. Further, if broader potential liability made it more costly to be a publicly traded company in this country, securities offerings could shift away from domestic capital markets. *Id.*

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[2]406 U.S. 128 (1972). Moreover, even under the *Affiliated Ute* presumption, the plaintiff must nevertheless still show that he or she relied generally on the defendant or had a relationship of trust and confidence with that defendant. *See, e.g.*, *Cavalier Carpets, Inc. v. Caylor*, 746 F.2d 749, 756 (11th Cir. 1984). *Affiliated Ute* also cannot apply to a "mixed case," *i.e.,* one where the plaintiff alleges injury from both omissions of material fact and affirmative misstatements. *See id.* at 756-57.

Once again, this type of analysis is consistent with *Central Bank*, where the Court similarly looked to policy considerations arising from the uniquely burdensome nature of private securities litigation.[3] There, the Court found that subjecting secondary actors to aiding and abetting liability would extract costs "that may disserve the goals of fair dealing and efficiency in the securities markets." *Central Bank*, 511 U.S. at 188. As was the case with aiding and abetting liability, the plaintiffs' proposed "purpose and effect" test in *Stoneridge* would have injected a great deal of uncertainty and ad hoc decision-making into "an area that demands certainty and predictability." *Id.* The amorphous purpose and effect test would have raised factual disputes in virtually every case, making it difficult for innocent defendants to obtain an early dismissal. "Because of th[is] uncertainty . . . , entities . . . m[ight] find it prudent and necessary, as a business judgment, to abandon substantial defenses and to pay settlements in order to avoid the expense and risk of going to trial." *Id.* at 189.

Conclusion. Given the obvious similarity in the issues presented, it was not surprising that the Court in *Stoneridge* invoked the basic principles of *Central Bank.* *Central Bank* long ago recognized that no person or entity may be liable as a primary violator under Section 10(b) unless all of the requirements for primary liability can be met as to that defendant separately, which necessarily resolved the issues on appeal in *Stoneridge*. 128 S. Ct. 761, 769 (2008). In fact, reliance was only one of the many required elements that were missing as to the supplier defendants. Among other deficiencies, plaintiffs could not establish the mandatory requirement of loss causation as to these defendants consistent with the Court's decision in *Dura Pharmaceuticals, Inc. v. Broudo*.[4] *Stoneridge* demonstrates that creative arguments for expanding liability will not prevail at the expense of long-established safeguards like the reliance requirement that protect defendants from abusive litigation.

[3]The Court observed that "'litigation under Rule 10b-5 presents a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general.'" *Central Bank*, 511 U.S. at 189 (quoting *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 755 (1975).)

[4]544 U.S. 336 (2005). The claims against the supplier defendants were also deficient because these defendants did not "use or employ" a "deceptive device" "in connection with" a securities transaction as required to state a claim for primary liability under Section 10(b).

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