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NEW YORK'S NEW HOME EQUITY THEFT PREVENTION ACT
Alka Bramhandkar and Gwen Seaquist..69

THE *STONERIDGE* DECISION AND SECONDARYACTOR LIABILITY IN SECURITIES FRAUD

by
Eileen P. Kelly*
Alka Bramhandkar**

INTRODUCTION

Securities fraud class action suits increased substantially in the wake of the scandals at Enron, WorldCom, and a host of other corporations. On January 15, 2008, the Supreme Court handed down one of the most important securities fraud cases in decades in *Stoneridge Investment Partners, LLC, v.Scientific-Atlanta, Inc*[1]. The focus of the *Stoneridge* case was secondary actor scheme liability. Secondary actors are parties that engage in business relationships with a company. Such parties could include suppliers, investment banks, financial services, law firms and accounting firms. In *Stoneridge*, the question put before the Supreme Court was whether shareholders could bring a private suit against secondary actors in a securities fraud action. First, the facts of the case will be explained. Next background information on private causes of action is provided Then the decisions of the District Court, Court of Appeals, and Supreme Court will be outlined. Finally, the implications of the Supreme Court's decision will be discussed.

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FACTS OF THE CASE

Charter Communications (Charter) was founded in the year 1993. Its main products were cable television and analog video service. In 1998, Microsoft cofounder Paul Allen purchased the company for $4.5 billion. After acquiring several companies like Greater Media & Helicon Cable, Charter went public in the year 1999 raising $3.2 billion.[2]

Charter's problems began soon after its initial public offering (IPO), which was one of the largest IPOs at that time. It entered into an agreement with Motorola and Scientific Atlanta (Suppliers) to buy cable boxes. As per the terms of the agreement, Charter negotiated a price which was 20% higher than the fair market prices for cable boxes. In return, the suppliers promised to pay back the premium as marketing expenses.[3] How Charter treated this transaction on its books was definitely non-routine and did not conform to the standard accounting principles. Charter recorded the premium "ad revenue" as revenue for the current year registering a significant growth rate in its sales. The added cost of the cable boxes was not shown as an operating expense but appeared as an increase in revenue flowing straight to its net income. Charter chose to spread the extra cost over the next several years leading to a mismatch between the timing of the revenue and the cost of generating that revenue.

The major motivation behind this manipulation was to increase the stock price, which produced large gains for a small group of Charter executives. An objection by the company auditors was addressed by de-linking the cable box purchases from the ad revenue. The suppliers were aware of the accounting fraud but chose to remain quiet. They did not engage in any fraud as far their own books were concerned. In the year 2001, a total of 850,000 boxes were purchased, adding $17 million to Charter's reported revenue.[4]

This simple accounting scheme coupled with incorrect and inflated subscriber count, kept Charter's stock price high through the year 2001. In 2003, however, 4 executives pleaded guilty to securities fraud.

On April 15, 2003, Charter revised several items on its financial statements for the years 2000 & 2001. Items such as option compensation, corporate expense charge, and loss on derivatives were restated with absolutely no change in its income for the year. In terms of the balance sheet, major changes were made in total investment in cable properties on the assets side. On the liabilities side, large adjustments were made in other long term liabilities. For the year 2000, adjustments in revenue and other expenses actually resulted increasing its loss. On the balance sheet, several additional items (accounts receivables, cash equivalents on the assets side and accounts payable on the liabilities side) underwent revisions. The following section discusses the issue of private actions in security fraud suits.

PRIVATE FEDERAL SECURITIES ACTIONS

The majority of private securities fraud claims are filed under Section 10(b) of the Exchange Act and its implementing regulation Rule 10b-5. Section 10(b) of the Securities and Exchange Act of 1934 prohibits "manipulative" or "deceptive" acts. In particular, the section states that it is:

> unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange ... [t]o 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 Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.[5]

The Securities and Exchange Commission (SEC) enacted Rule 10b-5 to enforce Section 10(b). The rule states it is unlawful:

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 the 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.[6]

On its face, the express language of Rule 10b-5 is more expansive than the statutory language contained in Section 10(b) and appears to encompass other types of misconduct.

The statutory language of the Securities Exchange Act does not expressly provide for a private cause of action under Section 10(b). Rather, the private cause of action for securities fraud is a judicial construct in which the Supreme Court found a right of private action implied in the statute and Rule 10b-5. In *Superintendent of Insurance of the State of New York v. Bankers Life and Casualty Company,*[7] the Supreme Court rejected a narrow interpretation of Section 10(b) limited solely to preserving the integrity of the securities markets, instead advocating a more expansive interpretation to effectuate the remedial purposes of the Act. The Court noted that:

> Since there was a "sale" of a security and since fraud was used "in connection with" it, there is redress under 10(b), whatever might be available as a remedy under state law.......We agree that Congress by 10(b) did not seek to regulate transactions which constitute no more than internal corporate mismanagement. But we read 10(b) to mean that Congress meant to bar deceptive devices and contrivances in the purchase or sale of securities whether conducted in the organized markets or face to face."[8]

The Supreme Court has noted that private actions under Section 10(b) are distinct from a common law deceit and misrepresentation claim. On the other hand, the Supreme Court has ruled that Rule 10b-5 cannot be interpreted to impose liability beyond the express statutory language of Section 10(b) which prohibits only "manipulative" or "deceptive" conduct.[9]

Generally speaking, a plaintiff states a private action for securities fraud, if the following are alleged and proved:

(1) a material misrepresentation or omission by the defendant,
(2) scienter, i.e., knowledge of the wrongdoing,
(3) a connection between the misrepresentation or omission and the purchase or sale of a security,
(4) reliance upon the misrepresentation or omission,
(5) economic loss, and

(6) loss causation, i.e. a causal connection between a material misrepresentation and loss.[10]

The implied private right of action for securities fraud clearly covers secondary actors who commit primary violations. The critical question before the courts in the *Stoneridge* case was whether the implied private right of action for security fraud under Section 10(b) extended to aiding and abetting by secondary actors. Should there be liability when the secondary actors did not engage in a securities transaction and did not make or participate in making a material misstatement or omission?

THE DISTRICT COURT ACTION

Stoneridge Investment Partners filed a securities fraud class action under Sec. 10(b) and Rule 10(b)(5) in the United States District Court for the Eastern District of Missouri against Charter, its senior executives, Charter's auditor Arthur Andersen LLP, Scientific Atlanta and Motorola on behalf of investors who had purchased Charter Communications stock.[11] Scientific Atlanta and Motorola were Charter's vendors, and later their customers, who supplied it with digital cable boxes. The plaintiffs contended that two of the secondary actors, Scientific Atlanta and Motorola, schemed with Charter Communications to defraud Charter's investors.

The plaintiffs alleged that Scientific-Atlanta and Motorola were secondary actors who engaged in sham transactions for "advertising" with Charter in order to inflate Charter's operating cash flow and revenues to meet the analyst's expectations. The plaintiffs further contended that Scientific Atlanta and Motorola had clear knowledge that Charter was:

a. fraudulently accounting for their payments as revenues,
b. fraudulently recording the payments Charter was making to them as capital expenses,
c. fraudulently inflating its operating revenue and cash flow,
d. fraudulently deceiving stock analysts who would rely on the inflated revenues and operating cash flow in making stock recommendations, and
e. fraudulently deceiving investors in Charter Communications.

The plaintiffs argued that by entering into these sham transactions with Charter, Scientific- Atlanta and Motorola knowingly or recklessly engaged in a scheme to defraud Charter's investors. More pointedly, they:

a. violated Section 10(b) and Rule 10b-5(b) by making material and misrepresentations to Charter investors, and
b. violated Rule 10b-5(a) and (c) by engaging in a scheme or artifice to defraud and by engaging in an acts which operate as a fraud or deceit upon Charter's investors.

The District Court ruled in favor of the two defendants and dismissed the complaint against them. The Court held that while Motorola and Scientific-Atlanta aided and abetted Charter's fraud, those actions did not violate Section 10(b) and Rule 10b-5. In doing so, the Court relied on the Supreme Court's decision in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*[12] In *Central Bank*, the Supreme Court ruled that Section 10(b) prohibits only "manipulative or deceptive" devices or contrivances. The Supreme Court noted "that the statute prohibits only the making of a material misstatement (or omission) or the commission of a manipulative act...The proscription does not

include giving aid to a person who commits a manipulative or deceptive act."[13] In reviewing the statutory language and legislative history of the Securities Exchange Act of 1934, the Supreme Court concluded that Congress did not intend to impose secondary liability for aiding and abetting.

> Because the text of § 10(b) does not prohibit aiding and abetting, we hold that a private plaintiff may not maintain an aiding and abetting suit under § 10(b). 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 of securities relies may be liable as a primary violator under 10b-5, assuming *all* of the requirements for primary liability under Rule 10b-5 are met.[14]

In the seminal *Central Bank* decision, the Supreme Court held that there was no civil secondary liability under Section 10(b) for aiding and abetting. The Court stated that extending such liability to secondary actors would not serve the objectives of the statute and might in fact impair the efficiency in the securities markets.

The District Court stressed that the plaintiffs' never asserted that Scientific-Atlanta and Motorola ever made fraudulent statements themselves or were involved in the preparation of Charters misleading financial statements.

> Instead, plaintiffs contend that Scientific-Atlanta and Motorola are liable to Charter's investors on the basis that they engaged in a business transaction that Charter purportedly improperly accounted for..... The Court can find no precedent for the conclusion that business partners, such as Motorola and Scientific-Atlanta, made false and misleading statements by virtue of engaging in a business enterprise with a company such as Charter, the entity purported to have made the statement said issue.[15]

The District Court went on to reject the plaintiffs argument that *In re Enron Corp. Sec., Derivative & ERISA Litig.,*[16] was controlling. In the *Enron* case, the plaintiffs argued that the secondary actors, mainly Enron's lawyers, accountants, and underwriters, participated in a Ponzi scheme, which led to fraudulent financial statements. The *Enron* court held several secondary actors liable for securities fraud. The District Court noted that:

> This Court does not find *Enron* on point. To reiterate, *Enron* held that § 10(b) liability may only be imposed for secondary actors who have created a document containing a misrepresentation upon which investors relied. The Amended Complaint does not allege that Scientific-Atlanta or Motorola created or participated in the creation of any of Charter's accounting, financial statements, public filings or public statements, nor does it allege that they directed, or even knew of, Charter's accounting treatment. The plaintiffs also do not allege Scientific-Atlanta and Motorola made public representations about Charter or that any Charter investor relied on anything Scientific-Atlanta and Motorola said. The Court concludes that plaintiffs' claim fails as neither Scientific-Atlanta nor Motorola made a representation to Charter's investors nor participated in the drafting of statements Charter made to its investors.[17]

THE EIGHTH CIRCUIT COURT OF APPEALS DECISION

On Stoneridge's appeal, the Eighth Circuit affirmed the District Court's ruling.[18] The plaintiffs stressed that the lower court had erred, and that they indeed had properly alleged a primary violation of the securities laws. Employing a narrow interpretation of *Central Bank*, the plaintiffs argued that Scientific-Atlanta and Motorola violated Rule 10b-5(a) and (c) by participating in a "scheme or artifice to defraud" and by engaging in a course of business, which operates as a fraud or deceit. The plaintiffs relied heavily on the United States District Court for the Southern District of New York decision, *In re Parmalat Sec. Litig.*[19] In *Parmalat*, the Southern District concluded that Rule 10b-5(a) and (c) read together are broadly worded and therefore don't require the proof of a fraudulent misrepresentation or failure to disclose that Rule 10b-5(b) does.

The Eighth Circuit rejected the plaintiffs interpretation of *Central Bank* and reiterated that a private party may not bring a 10b-5 suit for acts not prohibited under Section 10(b). The Court concluded that the basis of the plaintiffs' claims was deception, and therefore was barred under *Central Bank*. The Court noted the danger of allowing such suits.

> 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.[20]

Scientific-Atlanta and Motorola's engagement in the sham transactions with Charter at best amounted to aiding and abetting since the latter companies had neither made false or misleading statements, nor had they been responsible for the content of Charter's financial statements. Their actions were not relied upon by the public. The Eighth Circuit commented that any expansion of secondary liability would ultimately rest with Congress, for it was their responsibility to change the securities laws. In fact, the Court pointed out that Congress had done the opposite. In Section 104 of the Private Securities Litigation Reform Act of 1995 (PSLRA), Congress directed the SEC to prosecute aiders and abettors but did not create thereby a private cause of action.[21] The PSLRA in fact requires the private plaintiff to "state 'with particularity' facts giving rise to a 'strong inference' that the defendant acted with the scienter required for the primary actor cause of action."[22]

THE SUPREME COURT DECISION

Split in the Circuits

The Supreme Court granted certiorari in large part because of the split in the circuits, particularly by the Eighth Circuit and the Ninth Circuit, over the issue of scheme liability for secondary actors. Scheme liability refers to secondary actors aiding and abetting in a fraudulent scheme that does not involve a misstatement, omission or manipulation in security transactions. The split over this issue was evident even within the Bush administration. The SEC supported the private plaintiffs, while the Treasury Department supported the defendants. Notably, the White House denied the SEC the authority to file an amicus brief, while it directed the Justice Department to argue against allowing shareholders suits.

As noted above, the Eighth Circuit in *Stoneridge* strongly rejected secondary liability for aiding and abetting as outside the scope of the statutory language of Section 10(b). In *Simpson v. AOL Time Warner Inc.*,[23] the Ninth Circuit Court of Appeals essentially endorsed scheme liability making secondary actors liable for participating in a fraudulent scheme for actions other than material misstatement, omission or manipulation. The Supreme Court reasoned that such conduct was "deceptive" within the meaning of Section 10(b) and thereby actionable. But the Court noted that:

> Participation in a fraudulent transaction by itself, however, is insufficient to qualify the defendant as a "primary violator" if the deceptive nature of the transaction or scheme was not an intended result, at least in part, of the defendant's own conduct. We hold that to be liable as a primary violator of § 10(b) for participation in a "scheme to defraud," the defendant must have engaged in conduct that had the principal purpose and effect of creating a false appearance of fact in furtherance of the scheme. It is not enough that a *transaction* in which a defendant was involved had a deceptive purpose and effect; the defendant's *own conduct* contributing to the transaction or overall scheme must have had a deceptive purpose and effect.[24]

It was against this backdrop of controversy, that the Supreme Court granted a writ of certiorari in *Stoneridge*. On January 15, 2008, in a 5-4 decision, the Supreme Court affirmed the Eighth Circuit's decision.[25] The Court reaffirmed its previous position in *Central Bank* that Section 10(b) liability did not extend to secondary actors who aided and abetted a "scheme to defraud."

Reliance on Deceptive Actions

The Supreme Court pointed out that Scientific-Atlanta and Motorola's engagement in sham transactions which inflated Charter's operating revenues and cash flows took place in the marketplace for goods and services rather than in the investment sphere. The Court reasoned that Scientific-Atlanta and Motorola did not have a duty to disclose Charter's or their own alleged deceptive acts. Their actions were never communicated to the public and were too remote in the chain of fraud for investors to have relied on them. Reliance on deceptive acts is a critical element in bringing a private cause of action for securities fraud under Section 10(b). The Supreme Court held that the plaintiffs were unable to meet that burden of proof.[26]

Scheme Liability

The Supreme Court rejected the plaintiff's argument of scheme liability. The Court noted that the plaintiff's position would require potential private liability to be applied to the entire marketplace. The court found this untenable and stressed the need for the federal courts to guard against expansion by judicial interpretation.

> The petitioner invokes the private cause of action under § 10(b) and seeks to apply it beyond the securities markets-the realm of financing business-to purchase and supply contracts-the realm of ordinary business operations. The latter realm is governed, for the most part, by state law. It is true that if business operations are used, as alleged here, to affect securities markets, the SEC enforcement power may reach the culpable actors. It is true as well that a dynamic, free economy presupposes a high degree of integrity in all of its parts, an integrity that must be underwritten by rules

> enforceable in fair, independent, accessible courts. Were the implied cause of action to be extended to the practices described here, however, there would be a risk that the federal power would be used to invite litigation beyond the immediate sphere of securities litigation and in areas already governed by functioning and effective state-law guarantees.[27]

The Supreme Court underscored that the petitioner's position would contravene Congress's specific response to *Central Bank* in Section 104 of the PSLRA. As noted previously, Section 104 expressly authorizes the SEC to bring actions for aiding and abetting, not private parties.

> The determination of who can seek a remedy has significant consequences for the reach of federal power....Concerns with the judicial creation of a private cause of action caution against its expansion. The decision to extend the cause of action is for Congress, not for us.[28]

Other Remedies Available

The Court pointed out in *Stoneridge* that that secondary actors can still be found primarily liable. "All secondary actors, furthermore, are not necessarily immune from private suit. The securities statutes provide an express right of action against accountants and underwriters in certain circumstances and implied right of action in 10(b) continues to cover secondary actors who commit primary violations."[29]

However, the Court noted that other remedies are nonetheless available against secondary actors. Criminal penalties and civil enforcement by the SEC are key enforcement tools. The Court noted that since 2002, the SEC collected over 10 billion in disgorgement and penalties. Enforcement tools also exist at the state level with state securities laws. Furthermore, the Court pointed out that when the secondary actors indeed have primary liability, remedies already exist.

IMPLICATIONS OF THE *STONERIDGE* DECISION

The importance of the *Stoneridge* case for the future of private securities litigation is enormous. The *Stoneridge* decision was clearly a cause for celebration on Wall Street and dismay for stockholders. The New York Times characterized the decision as placing "a towering obstacle in the path of shareholders looking for someone to sue when a stock purchase turned sour."[30]

The *Stoneridge* decision sharply limited the ability of shareholders who are defrauded by a company to sue other parties. This is particularly poignant when the company in question is bankrupt like Enron. Secondary actors, such as investment bankers, vendors, and accountants, breathed a sigh of relief with the Supreme Court's stipulation that shareholders must rely directly on secondary actor's statements for liability to accrue. In order to be held accountable under Section 10(b) in private actions, the secondary actor's actions must satisfy each of the elements under that section for primary liability.[31] As a practical matter, since the majority of secondary actors have little reason to speak to the public about their transactions and have no duty to do so, there is little likelihood that they will. In light of this, satisfying the elements of primary liability will be excruciatingly difficult. The *Stoneridge* decision was a clear loss for those who believed in scheme liability in securities fraud. Clearly, this decision has implications in the ever escalating subprime mortgage litigation.[32]

The implications of the *Stoneridge* decision for the $40 billion class action lawsuit filed by Enron shareholders against the investment banks that advised Enron – Merrill Lynch & Co., Credit Suisse Group, Barclays PLC and Pershing LLC- was almost immediate.[33] One of the more infamous frauds that secondary actors engaged in with Enron was the notorious Nigerian barge deal that Enron and Merrill Lynch entered into. A week after the Supreme Court handed down the *Stoneridge* decision, it denied certiorari in the *Enron* impliedly ruling that the *Stoneridge* decision has sounded the death knell for secondary actor scheme liability.[34] Whether the *Stoneridge* decision will be counterproductive in the long run remains to be seen.

ENDNOTES

[1] *Stoneridge Inv. Partners, LLC, v.Scientific-Atlanta, Inc.*, 128 S. Ct. 761 (2008).
[2] Company History for Charter Communications, Inc. *available at* http://www.fundinguniverse.com/company-histories/Charter-Communications-Inc-Company-History.html.
3 Jess Bravin and Kara Scannell, *Justices Question Liability Of 3rd Parties in Stock Fraud*, WALL STREET JOURNAL, (Eastern edition), Oct. 10, 2007, at A4
[4] John Higgins, *Four Former Charter Executives Indicted*, BROADCASTING & CABLE, July 28, 2003, at 2.
[5] 15 U.S.C. § 78j.
[6] 17 C.F.R. § 240.10b-5.
[7] *Superintendent of Ins. of N.Y. v. Bankers Life and Cas. Co.*, 404 U.S. 6 (1971).
[8] *Id.* at 169.
[9] *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994), *superseded by statute as stated in Stoneridge Inv. Partners, LLC, v.Scientific-Atlanta, Inc.*, 128 S. Ct. 761 (2008).
[10] *Dura Pharms., Inc. v. Broudo*, 544 U.S. 336, 341 –342 (2005) .

[11] *In re Charter Commc'ns, Inc.*,2004 WL 3826761 (E.D. Mo.).
[12] *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994).
[13] *Id.* at 177.
[14] *Id.* at 191.
[15] *In re Charter Commc'ns., Inc.*, 2004 WL 3826761, at *5 –*6 (E.D. Mo. Oct. 12, 2004).
[16] *In re Enron Corp. Secs. Litig.*, 235 F. Supp. 2d 549, 577 (S.D. Tex. 2002).
[17] *In re Charter Commc'ns., Inc.*, 2004 WL 3826761, at *8 (E.D Mo. Oct. 12, 2004).
[18] *In re Charter Commc'ns., Inc..*, 443 F.3d 987(8th Cir. 2006).
[19] *In re Parmalat Sec. Litig.*, 376 F. Supp. 2d 472 (S.D.N.Y. 2005).
[20] *Id.* at 992–93.
[21] *Private Securities Litigation Reform Act of 1995*, Pub. L. No. 104-67, 109 Stat. 737(1995) *codified in* 15 U.S.C. § 78U-4.
[22] Ann Morales Olazabal and Patricia Sanchez Abril, *The Ubiquity of Greed: A Contextual Model for Analysis of Scienter*, 60 FLA. L. REV. 401, 401 (2008).
[23] *Simpson v. AOL Time Warner, Inc.*, 452 F.3d 1040 (9th Cir. 2006).
[24] *Id.* at 1048.
[25] *Stoneridge*, 128 S. Ct. 761 (2008)
[26] *Id.* at 764.
[27] *Id.* at 770–71.
[28] *Id.* at 773.
[29] *Id.* at 773–74.
[30] Linda Greenhouse, *Supreme Court Limits Lawsuits By Shareholders*, N.Y. TIMES, Jan. 16, 2008, *available at* http://www.nytimes.com.
[31] Marcia Coyle, *Stoneridge Still Leaves Questions*, NATIONAL LAW JOURNAL, Vol. 30, No. 19, at 8–9.
[32] Daniel Tyukody and Michael Hefter, *Stoneridge Alters Legal Landscape in Limiting Scope of Primary Liability, Justices Sheild Secondary Actors*, NATIONAL LAW JOURNAL, Vol. 30, No. 27, at S1–S3.
[33] *Regents of the Univ of Cal. v. Merrill Lynch*, 128 S. Ct. 1120 (2008).
[34] Mark Anderson, *Supreme Court Denies Suit Brought By Enron Investors*, WALL STREET JOURNAL, Jan. 22, 2008, *available at* http://www.wsj.com.