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## The Supreme Court Narrows Secondary Actor Liability by Abrogating Scheme Liability: *Stoneridge Investment Partners, LLC v. Scientific-Atlanta*

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# The Supreme Court Narrows Secondary Actor Liability by Abrogating Scheme Liability: *Stoneridge Investment Partners, LLC v. Scientific- Atlanta*

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## I. INTRODUCTION

Following *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*,<sup>1</sup> which eliminated a private cause of action for aider and abettor liability in securities law regulation but did not wholly proscribe liability for secondary actors,<sup>2</sup> the secondary actor landscape of securities law went through a period in which plaintiffs' attorneys attempted to assert claims on innovative theories of indirect liability in order to establish primary liability.<sup>3</sup> In response to these theories, three circuit courts of appeals, in addition to numerous district courts, have issued opinions setting forth various tests for determining how and when to impose primary liability and, specifically, scheme liability.<sup>4</sup> Recently, the

1. 511 U.S. 164 (1994) (*superceded by statute*, Private Securities Litigation Reform Act of 1995 § 20, *as recognized by* SEC v. Pasternak, 561 F. Supp. 2d 459, 501 (D.N.J. 2008)).

2. *Cent. Bank*, 511 U.S. at 177. A secondary actor is a party that assists a business entity in violating the securities laws even though the assisting party does nothing to induce the public dissemination of information pertaining to the violation and does not release such information itself.

3. Nicholas Fortune Schanbaum, *Scheme Liability: Rule 10b-5(a) and Secondary Actor Liability After Central Bank*, 26 REV. OF LITIG. 183, 184 (2007).

4. *See, e.g.*, Howard v. Everex Sys., Inc., 228 F.3d 1057 (9th Cir. 2000) (*superceded by statute*, Private Securities Litigation Reform Act of 1995 § 20, *as recognized by* *In re* Nash Finch Co. Sec. Litig., 323 F. Supp. 2d 956 (D. Minn. 2004); Wright v. Ernst & Young LLP,

Supreme Court of the United States laid to rest many of these new theories in *Stoneridge Investment Partners, LLC v. ScientificAtlanta, Inc.*<sup>5</sup>

In *Stoneridge*, the Supreme Court held that primary liability under Section 10(b) of the Securities Exchange Act of 1934 (“SEA”) does not extend to the conduct of third parties that participate in deceptive business transactions, despite the fact these transactions are intended to—and succeed in—deceiving investors.<sup>6</sup> Thus, *Stoneridge* held that plaintiffs cannot assert a successful cause of action by relying on scheme liability to satisfy the necessary causation and reliance elements.<sup>7</sup> While the *Stoneridge* Court held that a claim under Section 10(b) of the SEA and Rule 10b-5 against parties transacting “business” with an issuer of securities does not result in scheme liability, the Court’s reasoning was based on faulty logic and prevents the securities laws from serving their purpose. In short, the Supreme Court created a blanket exemption, independent of the facts of a particular case, for secondary actors in their dealings with issuers of securities. The Court held that a party must make a public misstatement before the schemer can be held liable under the securities laws.<sup>8</sup> The majority’s reasoning is susceptible to being easily abused with minimal effort on the part of would-be defendants and is, therefore, an inappropriate test to determine liability when considering complex sham business transactions. Rather, the proper method of analysis for extending liability to secondary actors is the “substantial participation test” developed by the Ninth Circuit Court of Appeals.<sup>9</sup> This test examines the facts in each case before the court and places secondary liability on those actors where it is deemed appropriate. Due to the wide variety of factual scenarios and the varying degree in which would-be defendants enter into fraudulent business transactions, a case-by-case analysis is best suited to meet the goals of the securities laws and protect the investing public.

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152 F.3d 169 (2d Cir. 1998); *Anixter v. Home-Stake Prod. Co.*, 77 F.3d 1215 (10th Cir. 1996).

5. 128 S. Ct. 761 (2008).

6. Travis S. Souza, *Freedom to Defraud: Stoneridge, Primary Liability, and the Need to Properly Define Section 10(b)*, 57 DUKE L.J. 1179 (2008).

7. *Stoneridge*, 128 S. Ct. at 774.

8. *Id.* at 769.

9. See Howard, 228 F.3d at 1061 n.5. Specifically, the Ninth Circuit stated that “substantial participation or intricate involvement in the preparation of fraudulent statements is grounds for primary liability even though that participation might not lead to the actor’s actual making of the statements.” *Id.*

Section II of this comment will introduce and discuss aspects of the securities laws relevant to securities transactions in general, but specifically to the Supreme Court's decision in *Stoneridge*. After exploring the laws which provide the foundation for this area of the law, Section III will examine the Court's decision in *Stoneridge*. It will also offer a brief critique of the *Stoneridge* opinion. After considering the current legal analytical approach for reviewing secondary actor liability, the Ninth Circuit's test, which was rejected by the Supreme Court in *Stoneridge*, will be compared to the new law advanced in *Stoneridge*, and the argument will be made that the Supreme Court's decision provides secondary actors with a shield from liability that is too broad and does not look at the facts of the particular case to determine whether the secondary actor's conduct warrants liability. Finally, Part III will argue that the Supreme Court should retreat from *Stoneridge* and adopt the Ninth Circuit's substantial participation test when faced with imposing secondary actor liability in the form of scheme liability in securities law litigation.

## II. BACKGROUND

The federal laws regarding fraudulent securities transactions are found in the Securities Act of 1933 and the Securities Exchange Act of 1934.<sup>10</sup> Congress's intent in enacting the Securities Act of 1933 was "to provide investors with full disclosure of material information concerning public offerings of securities in commerce, to protect investors against fraud and, through the imposition of specified civil liabilities, to promote ethical standards of honesty and fair dealing."<sup>11</sup> Meanwhile, the SEA was drafted "principally to protect investors against manipulation of stock prices through regulation of transactions upon securities exchanges and in over-the-counter markets, and to impose regular reporting requirements on companies whose stock is listed on national securities exchanges."<sup>12</sup> Congress, recognizing the need for flexibility in the regulation of securities, created the Securities Exchange Commission ("the SEC") in the 1934 Act to interpret and enforce the securities laws.<sup>13</sup>

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10. See 15 U.S.C. §§ 77a-77aa (2006) & 15 U.S.C. §§ 78a-78oo (2006).

11. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 195 (1976) (citing H.R. Rep. No. 85, 73d Cong. 1st Sess. 1-5 (1933)).

12. *Ernst & Ernst*, 425 U.S. at 195 (citing S. Rep. No. 792, 73d Cong. 2d Sess. 1-5 (1934)).

13. *Id.*

Section 10(b) of the 1934 Act grants the SEC authority to prohibit deceptive and manipulative conduct related to the purchase or sale of securities.<sup>14</sup> Section 10(b) of the SEA specifically prohibits "the use or employ[ment of] . . . 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."<sup>15</sup> Under its administrative rulemaking authority, the SEC promulgated Rule 10b-5.<sup>16</sup> Rule 10b-5 provides guidance in interpreting the broad framework of conduct barred in Section 10(b). The Rule proscribes three types of actions: (a) "any device, scheme, or artifice to defraud"; (b) making "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"; and (c) "to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person."<sup>17</sup> Of course, any of these actions must be made in connection with the sale or purchase of securities.<sup>18</sup> While the SEC provided these three broad examples of conduct that violate Section 10(b), it did not provide information regarding "the elements of a Rule 10b-5 violation or the level of conduct that would constitute a violation."<sup>19</sup> Federal courts, therefore, had to apply the rule in its skeletal form and flesh out "the ultimate extent of section 10(b) by examining the statute in the context of the Securities Acts as a whole."<sup>20</sup> The courts compared Section 10(b) and the Securities Acts of 1933 and 1934 and determined that there was a reliance requirement implied by the statutes.<sup>21</sup> The Supreme Court has also found an implied requirement that, in order to bring a claim under Section 10(b) and Rule 10b-5, a plaintiff must be a purchaser or seller of securities.<sup>22</sup>

While Congress did not provide for a private cause of action under Section 10(b), courts have implied one.<sup>23</sup> The courts have also

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14. *Id.* (stating that the SEC is "provided with an arsenal of flexible enforcement powers"). *Id.*

15. Securities Exchange Act, Section 10(b), 15 U.S.C. § 78j(b) (2006).

16. 17 C.F.R. § 240.10b-5 (2007).

17. 17 C.F.R. § 240.10b-5(a)-(c).

18. 17 C.F.R. § 240.10b-5.

19. Schanbaum, *supra* note 3, at 187.

20. *Id.* at 187-88.

21. *Id.* at 188.

22. *See, e.g., Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 735-36 (1975).

23. *See, e.g., Blue Chip Stamps*, 421 U.S. at 748-49.

added requirements to a Section 10(b) cause of action that must be satisfied before scheme liability can be imposed because scheme liability is a type of primary liability under Section 10(b).<sup>24</sup> Plaintiffs asserting a private cause of action must demonstrate that the defendant used or employed a “deceptive device or contrivance.”<sup>25</sup> Significantly, there is a threshold element of materiality that requires a substantial likelihood that revealing omitted facts would be deemed by a reasonable investor to significantly change the pool of information available.<sup>26</sup> Also, plaintiffs are required to allege fraud “in connection with a purchase or sale of any security.”<sup>27</sup> In other words, because a transaction in which securities are exchanged must occur, the plaintiff in a Rule 10b-5 cause of action must be either a purchaser or seller of a security.<sup>28</sup>

In addition, plaintiffs are required to prove reliance on the fraud or deception, which provides “the requisite causal connection between a defendant’s misrepresentation and a plaintiff’s injury.”<sup>29</sup> Thus, the plaintiff must show that the defendant’s conduct caused the purchase or sale of securities.<sup>30</sup> While showing reliance may prove challenging for a plaintiff, if the security at issue is traded on an open and developed stock market, a plaintiff does not need to demonstrate specific reliance.<sup>31</sup> Rather, the “fraud-on-the-market” theory provides “that, in an open and developed securities market, the price of a company’s stock is determined by the available material information regarding the company and its business.”<sup>32</sup>

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24. Eric Berry, *Stoneridge and the Short-Lived Experiment of Scheme Liability*, 4 N.Y.U. J. L. & BUS. 355, 357 (2007).

25. Securities Exchange Act, Section 10(b), 15 U.S.C. § 78j (2000).

26. *Basic Inc. v. Levinson*, 485 U.S. 224, 231-32 (1988).

27. Securities Exchange Act, Section 10(b), 15 U.S.C. § 78j(b) (2000).

28. *Id.*

29. *Basic Inc.*, 485 U.S. at 243.

30. *Newton v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 259 F.3d 154, 174 (3d Cir. 2001).

31. Berry, *supra* note 24, at 358-59.

32. *Basic Inc.*, 485 U.S. at 241 (1988) (citing *Peil v. Speiser*, 806 F.2d 1154, 1160-61 (3d Cir. 1986)). Furthermore, “[m]isleading statements will therefore defraud purchasers of stock even if the purchasers do not directly rely on the misstatements . . . . The causal connection between the defendants’ fraud and the plaintiffs’ purchase of stock in such a case is no less significant than in a case of direct reliance on misrepresentations.” *Peil*, 806 F.2d at 1160-61. The *fraud-on-the-market theory* is defined as “the doctrine, that, in a claim under the antifraud provisions of the federal securities laws, a plaintiff may presumptively establish reliance on a misstatement about a security’s value—without proving actual knowledge of the fraudulent statement—if the stock is purchased in an open and developed securities market.” BLACK’S LAW DICTIONARY 549 (8th ed. 2004).

A plaintiff is required to demonstrate that his or her loss was caused by the fraud or deception of the defendant.<sup>33</sup> Thus, a plaintiff cannot rely on "changed economic circumstances, changed investor expectations, new industry-specific or firm-specific facts, conditions, or other events, which taken separately or together account for some or all of that lower price."<sup>34</sup> Finally, scienter<sup>35</sup> must be pled with particularity.<sup>36</sup> The state of mind required for a private cause of action is "intent to deceive, manipulate, or defraud."<sup>37</sup> Thus, the scienter standard bars securities cases that allege mere negligence and not some more culpable form of intent.<sup>38</sup>

A. *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*

In 1994, the Supreme Court of the United States decided a case with significant consequences regarding primary liability for secondary actors: *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*<sup>39</sup> Central Bank of Denver served as the indenture trustee<sup>40</sup> for bonds issued in 1986 and 1988 to finance construction on a residential and commercial development in Colorado Springs, Colorado.<sup>41</sup> The bonds, secured by landowner assessment liens, had covenants which "required that the land subject to the liens be worth at least 160% of the bonds' outstanding principal and interest."<sup>42</sup> The covenants also required the property developer to provide Central Bank with a yearly report demonstrating the 160% test was satisfied.<sup>43</sup> Before the 1988 bonds

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33. *Dura Pharms., Inc. v. Broudo*, 544 U.S. 336, 343 (2005).

34. *Dura Pharms.*, 544 U.S. at 343.

35. *Scienter* is defined as "a mental state consisting in an intent to deceive, manipulate, or defraud." BLACK'S LAW DICTIONARY 1115 (8th ed. 2004).

36. Private Securities Litigation Reform Act of 1995 ("PSLRA"), 15 U.S.C. § 78u-4 (2000). The PSLRA requires that "the complaint shall specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed." *Id.* at § 78u-4(b)(1)(B).

37. *Ernst and Ernst*, 425 U.S. at 185.

38. *Id.*

39. 511 U.S. 164 (1994).

40. *Indenture trustee* is defined as "a trustee named in a trust indenture and charged with holding legal title to the trust property." BLACK'S LAW DICTIONARY 1267 (8th ed. 2004). An *indenture* is "a formal written instrument made by two or more parties with different interests." BLACK'S LAW DICTIONARY 638 (8th ed. 2004).

41. *Cent. Bank*, 511 U.S. at 167.

42. *Id.*

43. *Id.*

were issued, the property developer supplied an updated assessment of the land securing the bonds issued in 1986 and of the land expected to secure the bonds issued in 1988.<sup>44</sup> This assessment contained land values that were virtually unchanged from the prior assessment.<sup>45</sup> After receiving the updated assessment, Central Bank was notified by an underwriter for the 1986 bonds “that property values were declining in Colorado Springs and that Central Bank was operating on an appraisal over 16 months old[.] [T]he underwriter expressed concern that the 160% test was not being met.”<sup>46</sup> At this point, Central Bank’s in-house appraiser recommended obtaining an independent review by an outside appraiser to assess the property values.<sup>47</sup>

However, before the outside appraisal could be conducted, the bond issuer defaulted and First Interstate Bank of Denver, having purchased \$2.1 million worth of the 1988 bonds, filed suit against Central Bank alleging violations of § 10(b) and that Central Bank was “secondarily liable under § 10(b) for its conduct in aiding and abetting the fraud.”<sup>48</sup> The Supreme Court held that “[b]ecause the text of § 10(b) does not prohibit aiding and abetting, . . . a private plaintiff may not maintain an aiding and abetting suit under § 10(b).”<sup>49</sup> The Court reasoned that, while the statute prohibited making a material misstatement, “[t]he proscription does not include giving aid to a person who commits a manipulative or deceptive act.”<sup>50</sup> The Court stated it could not “amend the statute to create liability for acts that are not themselves manipulative or deceptive within the meaning of the statute.”<sup>51</sup> The Court further reasoned that 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.”<sup>52</sup> While the Court noted that multiple parties may be involved in any intricate securities fraud, First Interstate Bank admitted that “Central Bank did not commit a manipulative or deceptive act with the

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44. *Id.*

45. *Id.*

46. *Cent. Bank*, 511 U.S. at 167.

47. *Id.* at 167-68.

48. *Id.* at 168.

49. *Id.* at 191.

50. *Id.* at 177.

51. *Cent. Bank*, 511 U.S. at 177-78.

52. *Id.* at 191.



meaning of § 10(b).<sup>53</sup> Thus, by the plaintiff's own words, Central Bank was not liable as an aider and abettor.<sup>54</sup>

Thus, *Central Bank* represented a significant departure from precedent leading up to the case. *Central Bank* altered the securities litigation rules regarding "secondary actors by flatly stating that the absence of the words 'aiding and abetting,' in either section 10(b) or Rule 10b-5, precludes a section 10(b) aiding and abetting cause of action."<sup>55</sup> Before *Central Bank*, plaintiffs were free to allege violations of the securities laws against parties aiding and abetting securities fraud under Rule 10b-5.<sup>56</sup> Also, some lower federal courts found "an implied private right of action against aiders and abettors."<sup>57</sup> In the wake of *Central Bank*, subsections (a) and (c) fell by the wayside.<sup>58</sup>

Despite the Supreme Court's abrogation of a private cause of action for aider and abettor liability in *Central Bank*, the decision in *Central Bank* left open the possibility that some form of secondary actor liability may still exist.<sup>59</sup> In *Central Bank*, the Supreme Court, in eliminating the possibility of aider and abettor liability, stated that "the statute prohibits only the making of a material misstatement (or omission) or the commission of a manipulative act."<sup>60</sup> The *Central Bank* Court stated that its holding barring aider and abettor liability "does not include giving aid to a person who commits a manipulative or deceptive act."<sup>61</sup> In addition, despite the Supreme Court's clear pronouncement that aider and abettor liability does not exist, the Court did not delineate what

53. *Id.*

54. *Id.*

55. Schanbaum, *supra* note 3, at 189.

56. *Cent. Bank*, 511 U.S. at 193 n.2 (Stevens, J., dissenting).

57. Souza, *supra* note 6, at 1181-82. See, e.g., *Brennan v. Midwestern United Life Ins. Co.*, 259 F. Supp. 673, 681 (N.D. Ind. 1966), *aff'd*, 417 F.2d 147, 155 (7th Cir. 1969) (*abrogated by Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994)).

58. Schanbaum, *supra* note 3, at 189.

59. In its opinion, the Supreme Court stated that:

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.

*Cent. Bank*, 511 U.S. at 191 (emphasis in original). The Court went on to indicate that secondary actors primarily liable for a section 10(b) violation would be exposed to primary liability in a section 10(b) action. *Id.*

60. *Id.* at 177.

61. *Id.* at 177-78.

actions would constitute a “material misstatement” and make a party a primary violator.<sup>62</sup> Thus, the task of interpreting the language of the Supreme Court’s abrogation of aider and abettor liability fell to the lower federal courts. This process of interpretation ultimately focused on determining what actions rose to such a level sufficient to impose primary liability.<sup>63</sup> As a result, competing tests for imposing primary liability developed among the United States Courts of Appeals.

### B. *Three Competing Tests for Secondary Actor Liability and the Abrogation of Scheme Liability*

In light of *Central Bank*’s partial proscription of secondary actor liability,<sup>64</sup> courts faced a difficult challenge in determining the difference between primary and secondary violators. As a result, several competing tests were advanced by plaintiffs in various lower federal courts. Thus, by the time the Supreme Court granted certiorari to hear *Stoneridge*, several different tests for determining scheme liability had emerged among the circuit courts of appeals. Among these tests were the “bright line test” employed by the Second Circuit, the “substantial participation test” employed by the Ninth Circuit, and the “co-author test” which was advanced by the SEC.<sup>65</sup>

The bright line test requires “public attribution of the secondary actor’s fraudulent statement.”<sup>66</sup> Thus, the test requires—as did the Supreme Court in *Central Bank*—that a plaintiff rely on the defendant’s misstatement. The substantial participation test, applied by the Ninth Circuit, focuses on a secondary actor’s fraudulent conduct to determine if liability exists. Thus, under the substantial participation analysis, there is less of a focus on the plain-

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62. *Id.* at 164.

63. Schanbaum, *supra* note 3, at 236-37.

64. Secondary actor liability is liability imposed on a party that assisted a public business entity in violating the securities laws even though the assisting party does nothing to induce the public dissemination of information pertaining to the violation and does not release such information itself.

65. See Andrew S. Gold, *Reassessing the Scope of Conduct Prohibited by Section 10(b) and the Elements of Rule 10b-5: Reflections on Fraud and Secondary Actors*, 53 CATH. U. L. REV. 667, 675-88 (2004).

66. *Shapiro v. Cantor*, 123 F.3d 717, 720 (2d Cir. 1997). In *Shapiro*, the Second Circuit stated that:

If *Central Bank* is to have any real meaning, a defendant must actually make a false or misleading statement in order to be held liable under Section 10(b). Anything short of such conduct is merely aiding and abetting, and no matter how substantial that aid may be, it is not enough to trigger liability under Section 10(b).

*Id.*

tiff's reliance on the defendant's conduct.<sup>67</sup> Finally, the co-author test provides courts with a "compromise between the bright-line and substantial participation tests."<sup>68</sup> The co-author test is more similar to the substantial participation test than the bright line standard in its application.<sup>69</sup>

C. *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*

Stoneridge Investors filed suit "on behalf of purchasers of Charter stock alleging that, by participating in the transactions, Scientific-Atlanta and Motorola violated § 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5."<sup>70</sup> Charter, a cable company, conducted a number of fraudulent business practices so that its quarterly financial reports would satisfy expectations of investors with regard to cable subscriber growth and operating cash flow.<sup>71</sup> The fraudulent business practices included: "misclassification of its customer base; delayed reporting of terminated customers; improper capitalization of costs that should have been shown as expenses; and manipulation of the company's billing cutoff dates to inflate reported revenues."<sup>72</sup> Scientific-Atlanta and Motorola supplied digital cable converter ("set top") boxes to Charter, which were in turn provided to cable subscribers.<sup>73</sup> The fraud occurred when Charter arranged to pay Scientific-Atlanta and Motorola an additional twenty dollars above the usual price for every converter box purchased.<sup>74</sup> In addition, Scientific-Atlanta and Motorola agreed to "return the overpayment[s] by purchasing advertising from Charter."<sup>75</sup>

Stoneridge Investors alleged these transactions had no "economic substance."<sup>76</sup> Despite this lack of true economic value, the transactions benefitted Charter because the advertising purchases were recorded as revenues and capitalized in violation of generally

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67. Schanbaum, *supra* note 3, at 197.

68. *Id.*

69. *Id.*

70. *Stoneridge*, 128 S. Ct. at 766.

71. *Id.*

72. *Id.*

73. *Id.*

74. *Id.*

75. *Stoneridge*, 128 S. Ct. at 766.

76. *Id.*

accepted accounting principles.<sup>77</sup> The transactions would also allow Charter to “fool its auditor into approving a financial statement showing it met projected revenue and operating cash flow numbers.”<sup>78</sup> In order to prevent its auditor from discovering this scheme, Charter drafted documents to obscure that fact that the transactions were related.<sup>79</sup> Charter requested Scientific-Atlanta to provide documents stating that production costs for the converter boxes had increased, which was a lie.<sup>80</sup> Scientific-Atlanta complied with Charter’s request by raising the price of the converter boxes by twenty dollars per unit for the remainder of the year.<sup>81</sup> As for Motorola, Charter agreed to purchase “a specific number of set top boxes and pay liquidated damages of \$20 for each unit it did not take.”<sup>82</sup> Charter and Motorola entered into this contract “with the expectation Charter would fail to purchase all the units and pay Motorola the liquidated damages.”<sup>83</sup> Finally, in order to “return the additional money from the [converter] box sales, Scientific-Atlanta and Motorola signed contracts with Charter to purchase advertising time for a price higher than fair [market] value.”<sup>84</sup> The contracts relating to the converter boxes were backdated “to make it appear that they were negotiated a month before the advertising agreements.”<sup>85</sup>

The public disclosure of the manipulated financial statements occurred when the documents were filed with the SEC.<sup>86</sup> Despite the public dissemination of the financial statements, Scientific-Atlanta and Motorola played no part in the preparation or disbursement of them.<sup>87</sup> Their own financial statements recorded the transactions as a wash in accordance with generally accepted accounting standards.<sup>88</sup> Stoneridge Investors alleged that Scientific-Atlanta and Motorola “knew or were in reckless disregard of Charter’s intention to use the transactions to inflate revenues and

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77. *Id.* Generally accepted accounting principles are defined as “the conventions, rules and procedures that define approved accounting practices at a particular time.” BLACK’S LAW DICTIONARY 567 (8th ed. 2004).

78. *Stoneridge*, 128 S. Ct. at 766.

79. *Id.* at 767.

80. *Id.*

81. *Id.*

82. *Id.*

83. *Stoneridge*, 128 S. Ct. at 767.

84. *Id.*

85. *Id.*

86. *Id.*

87. *Id.*

88. *Stoneridge*, 128 S. Ct. at 767. A wash is defined as “a situation in which two effects offset each other.” BLACK’S LAW DICTIONARY 1322 (8th ed. 2004).

knew the resulting financial statements issued by Charter would be relied upon by research analysts and investors.”<sup>89</sup>

The District Court granted Scientific-Atlanta and Motorola’s motion for failure to state a claim on which relief can be granted.<sup>90</sup> The Court of Appeals for the Eighth Circuit affirmed, stating that, while respondents had aided and abetted Charter in its scheme to misstate financial statements, no private cause of action existed for aiding and abetting a § 10(b) violation.<sup>91</sup> Due to a conflict in the circuits, the Supreme Court granted certiorari.<sup>92</sup>

The plaintiffs in *Stoneridge*, arguing that the Court should not apply the bright line test, claimed that the Court should not restrict Rules 10b-5(a) and 10b-5(c) in the same manner that *Central Bank* restricted Rule 10b-5(b).<sup>93</sup> The Supreme Court did not agree with the plaintiffs’ contention because “reliance . . . is an essential element of the section 10(b) private cause of action.”<sup>94</sup> The reliance requirement “ensures that, for liability to arise, the requisite causal connection between a defendant’s misrepresentation and a plaintiff’s injury exists as a predicate for liability.”<sup>95</sup> Because the public did not have the necessary knowledge, Stoneridge Investors “cannot show reliance upon any of respondents’ actions except in an indirect chain that we find too remote for liability.”<sup>96</sup>

Despite the Court’s refusal to extend liability on an aiding and abetting theory, the plaintiffs argued that liability should be imposed on a scheme liability theory.<sup>97</sup> Stoneridge Investors argued that reliance can be shown because “the financial statement Charter released to the public was a natural and expected consequence of respondents’ deceptive acts; had respondents not assisted Charter, Charter’s auditor would not have been fooled, and the financial statement would have been a more accurate reflection of Charter’s financial condition.”<sup>98</sup> In response to this argument, the Court reiterated that reliance is closely related to causation and that Section 10(b) requires that “the deceptive act must be in con-

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89. *Stoneridge*, 128 S. Ct. at 767.

90. *Id.*

91. *Id.*

92. *Id.*

93. *In re Charter Commc’ns, Inc.*, 443 F.3d 987, 989-90 (8th Cir. 2006), *sub nom.* Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., 128 S. Ct. 761 (2008).

94. *Stoneridge*, 128 S. Ct. at 769.

95. *Id.*

96. *Id.*

97. *Id.* at 770.

98. *Id.*

nection with the purchase or sale of any security.”<sup>99</sup> The Court concluded that respondents’ conduct, deceptive though it may have been, was “too remote to satisfy the requirement of reliance.”<sup>100</sup> Thus, the Court was satisfied that Charter, not Scientific-Atlanta or Motorola, was the party that misled its auditor, filed the fraudulent financial statements, and misled the public.<sup>101</sup>

In light of this reasoning, it is obvious that the Court essentially adopted the Second Circuit’s bright line test which places the greatest emphasis on reliance. The Court further indicated that there are only two exceptions to the reliance requirement.<sup>102</sup> First, “if there is an omission of a material fact by one with a duty to disclose, the investor to whom the duty was owed need not provide specific proof of reliance.”<sup>103</sup> Second, and more importantly, the Court recognized that the fraud-on-the-market theory can supplant the need for a plaintiff to demonstrate reliance.<sup>104</sup> The Court also held that the fraud-on-the-market theory did not apply because “no investor had knowledge of the deceptive acts at the relevant time.”<sup>105</sup> The Supreme Court immediately noted that neither of these exceptions applied in *Stoneridge*.<sup>106</sup>

Interestingly, the plaintiffs argued that the reach of the fraud-on-the-market theory should be extended because in “efficient markets investors rely not only on the public statements relating to a security but also upon the transactions those statements reflect.”<sup>107</sup> Given the Court’s view of reliance, plaintiffs’ argument was rejected because the Court feared that the broader standard of reliance advocated by the plaintiffs would have the capability of reaching the entire marketplace in which the issuing company’s securities are exchanged.<sup>108</sup>

Justice Stevens’s dissent argued that Section 10(b) applies to the defendants’ conduct because it was deceptive under the meaning of the statute.<sup>109</sup> Despite the majority’s willingness to con-

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99. *Stoneridge*, 128 S. Ct. at 770.

100. *Id.*

101. *Id.*

102. *Id.*

103. *Id.* at 769 (citing *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 153-54 (1972)).

104. *Stoneridge*, 128 S. Ct. at 769.

105. *Id.* The Court’s application of the fraud-on-the-market theory does not appear to be a true application of the test. For more on this contention, see Section III.

106. *Id.*

107. *Id.* at 164.

108. *Id.*

109. *Stoneridge*, 128 S. Ct. at 774 (Stevens, J., dissenting).

strue *Stoneridge* as presenting an identical situation as *Central Bank*, Justice Stevens went on to note a key factual distinction between the two cases.<sup>110</sup> Namely, in *Central Bank*, the defendant-bank did not engage in any deceptive conduct; however, the defendants in *Stoneridge* did engage in complex sham business transactions that were deceptive.<sup>111</sup> The dissent also indicated that the majority opinion improperly required the plaintiffs to allege that the defendants “made it necessary or inevitable” for the issuer to record the fraudulent business transactions the way it did.<sup>112</sup> In other words, the majority opinion required the plaintiffs to prove that the parties conspiring with Charter compelled Charter to use the sham business transactions in a fraudulent manner. This level of reliance is a strict requirement that necessitates a type of evidence that will only be possessed by the occasional, fortuitous plaintiff.

Most importantly, Justice Stevens vigorously disagreed with the majority’s reliance standard and asserted that the majority applied the fraud-on-the-market theory incorrectly.<sup>113</sup> Instead of the majority’s stringent standard of reliance, the dissent stated that the more easily satisfied standard of “transaction causation” is the proper standard of reliance to be applied.<sup>114</sup> Transaction causation is “defined as requiring an allegation that but for the deceptive act, the plaintiff would not have entered into the securities transaction.”<sup>115</sup> The dissent went on to note that even if the “but for” transaction causation was not satisfied in the present case, the plaintiff “also alleged that respondents proximately caused Charter’s misstatement of income” and that the “plaintiff ha[d] alleged that respondents knew their deceptive acts would be the

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110. *Id.*

111. *Id.*

112. *Id.* at 776.

113. *Id.* The dissent asserted that:

The Court’s view of the causation required to demonstrate reliance is unwarranted and without precedent. In *Basic Inc.*, we held that the “fraud-on-the-market” theory provides adequate support for a presumption in private securities actions that shareholders (or former shareholders) in publicly traded companies rely on public material misstatements that affect the price of the company’s stock. The holding in *Basic* is surely a sufficient response to the argument that a complaint alleging that deceptive acts which had a material effect on the price of a listed stock should be dismissed because the plaintiffs were not subjectively aware of the deception at the time of the securities’ purchase or sale. This Court has not held that investors must be aware of the specific deceptive act which violates § 10(b) to demonstrate reliance.

*Id.*

114. *Stoneridge*, 128 S. Ct. at 776 (Stevens, J., dissenting).

115. *Id.* See, e.g., *Lentell v. Merrill Lynch & Co.*, 396 F.3d 161, 172 (2d Cir. 2005).

basis for statements that would influence the market price of Charter stock on which shareholders would rely.”<sup>116</sup> Thus, the defendants’ “acts had the foreseeable effect of causing [investors] to engage in the relevant securities transactions.”<sup>117</sup> However, neither “but for” nor proximate causation satisfied the majority’s standard of reliance, which the dissent characterized as “unduly stringent and unmoored from authority.”<sup>118</sup>

### III. ANALYSIS

While it can be argued that some federal court decisions support the Supreme Court’s rejection of scheme liability in *Stoneridge*, the decision is flawed for several reasons. First, *Stoneridge* does not comport with the broad remedial purposes of the securities laws. Second, the majority’s reasoning is misplaced because *Stoneridge* appears to rest on an inaccurate application of the reliance element of a private cause of action. Specifically, the majority opinion misconstrues the fraud-on-the-market theory by applying it in an overly stringent manner, as noted by Justice Stevens. Most importantly, the majority ignores the fact that scheme liability can meet all the requirements of a private cause of action. The *Stoneridge* decision, following the standard of reliance set in *Central Bank*, allows for businesses to easily avoid liability despite culpable behavior. The majority provided weak justification for allowing this large loophole, stating that remedies for scheme liability are available under state law and that abrogating scheme liability would help to ensure the stability of the economy. For these reasons, the holding of *Stoneridge* represents a break from precedent and an overly harsh interpretation of the law. The issue of scheme liability should therefore be reconsidered by the Court. In the alternative, Congress should take steps to restore scheme liability to help ensure an atmosphere of integrity in the securities markets of the United States.

When compared with the overarching purpose of the Securities Act of 1933 and the Securities Exchange Act of 1934, it is clear that the *Stoneridge* decision squarely contradicts the congressional purpose of the securities legislation.<sup>119</sup> The Securities Act

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116. *Stoneridge*, 128 S. Ct. at 776-77.

117. *Id.* at 777.

118. *Id.*

119. See *Ernst & Ernst*, 425 U.S. at 195. See also H.R. REP. NO. 73-85, at 1-5 (1933) (stating that the SEA is “but one step in our broad purpose of protecting investors and depositors.”). The SEA “should be followed by legislation relating to the better supervision



of 1933 "was designed to provide investors with full disclosure of material information concerning public offerings of securities in commerce, to protect investors against fraud and, through the imposition of specified civil liabilities, to promote ethical standards of honesty and fair dealing."<sup>120</sup> The SEA was "intended principally to protect investors against manipulation of stock prices through regulation of transactions upon securities exchanges and in over-the-counter markets."<sup>121</sup> Even though both statutes "contain numerous carefully drawn express civil remedies and criminal penalties, Congress recognized that efficient regulation of securities trading could not be accomplished under a rigid statutory program."<sup>122</sup>

While the majority of the Court noted the existence of other methods of ensuring candid securities transactions and expressed fears of scheme liability reaching the entire marketplace, the Court nevertheless limited the broad remedial nature of the securities acts. The Court's decision foils the basic tenant of the securities laws, which is to protect the investing public from manipulations and frauds whose sole purpose is to enhance stock prices of a corporation to the detriment of investors. By holding that secondary actors—who themselves do not make fraudulent statements—cannot be held liable for assisting a securities issuer in committing a fraud, the Court essentially provided an incentive for companies to assist one another in developing complex fraudulent business transactions. For example, in *Stoneridge*, Scientific-Atlanta and Motorola both knew or should have known that a fraud was afoot. Both companies willingly engaged in the backdating of contracts, which should have raised suspicions about Charter's motives. Instead, both companies ignored these suspicions and fully participated in the fraud devised by Charter. In addition, Scientific-Atlanta even provided documents falsely stating that it was increasing its prices in order to assist Charter in manipulating its accounting records. Such business transactions,

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of the purchase and sale of all property dealt in on exchanges, and by legislation to correct unethical and unsafe practices on the part of officers and directors of banks and other corporations." H.R. REP. NO. 73-85, at 1.

120. *Ernst & Ernst*, 425 U.S. at 195. The Court continued, "The 1934 Act was intended principally to protect investors against manipulation of stock prices through regulation of transactions upon securities exchanges and in over-the-counter markets, and to impose regular reporting requirements on companies whose stock is listed on national securities exchanges." *Id.*

121. *Id.* at 195.

122. *Id.*

among others, should have alerted both Scientific-Atlanta and Motorola that Charter was involving them in a complex fraud that would affect Charter's financial records.

The majority's approach entails only looking to a securities issuer and checking to see if that party engaged in fraudulent business practices to benefit its stock prices. As the examples above demonstrate, fraudulent business schemes are complex, involving multiple steps and multiple parties. By allowing aggrieved parties to only seek relief from the securities issuer, the Court has indicated that companies engaging in similar conduct—or perhaps worse—would be insulated from liability. Without the possibility of reprimand, there is little to prevent companies from engaging in such conduct. Therefore, *Stoneridge* is inconsistent with the congressional purpose of allowing the securities statutes to have a broad remedial power and fails to ensure and maintain the protection of the investing public in securities transactions.

The Court essentially turned a blind eye to the fraud committed by the defendants solely because the fraud was behind the scenes, relative to the securities transactions involved. The majority justified allowing such frauds, in part, by stating that punishing the conduct of Scientific-Atlanta and Motorola may lead to unbridled liability that could reach the entire marketplace.<sup>123</sup> While business dealings in the marketplace may be far-reaching, the plaintiffs in *Stoneridge* were not advocating that every fraud conducted by businesses would result in securities liability. Instead, plaintiffs argued that only those business transactions entered into for the purpose of defrauding investors (such as inflating the sales figures, the net worth of a business, or other quantitative data that is used to analyze the strength of a business for purposes of investment) should be grounds to impose liability under Section 10(b) and Rule 10b-5. The Court's fear is demonstrated by the fact that it adopted a standard that does not even consider the facts of a given case. Rather, the Court blindly denied liability in all situations.

The majority in *Stoneridge* further held that liability should not extend to the defendants because there was no reliance by investors on the sham business transactions entered into by the defendants.<sup>124</sup> The reasoning employed by the majority was that because neither a duty to disclose nor a misstatement existed, the

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123. *Stoneridge*, 128 S. Ct. at 765, 771.

124. *Id.* at 769.

plaintiff could not prove direct reliance on the fraudulent business transactions engaged in by Scientific-Atlanta and Motorola.<sup>125</sup> As discussed previously, the majority felt that the plaintiff was asking the Court to adopt a standard of reliance in which "the implied cause of action would reach the whole marketplace in which the issuing company does business."<sup>126</sup> Thus, the majority concluded that, if a third party's actions do not make the fraudulent statements "necessary or inevitable," potential plaintiffs will not be said to have relied on those actions.<sup>127</sup>

The dissent responded to the majority by referring to the Restatement (Second) of Torts' definition of deceit, specifically fraudulent misrepresentation: "[t]he maker of a fraudulent misrepresentation is subject to liability . . . if the misrepresentation, although not made directly to the other, is made to a third person and the maker intends or has reason to expect that its terms will be repeated or its substance communicated to the other."<sup>128</sup> Because the 10b-5 cause of action is based on the common law doctrine of deceit, the dissent concluded that "the sham transactions described in the complaint in this case had the same effect on Charter's profit and loss statement as a false entry directly on its books that included \$17 million of gross revenues that had not be received."<sup>129</sup> The conduct of Scientific-Atlanta and Motorola, therefore, was clearly deceptive and should have led to liability. Investors clearly relied upon Scientific-Atlanta's and Motorola's conduct because those companies directly allowed Charter to manipulate accounting records—to the tune of \$17 million—by providing false documentation of advertising and converter box revenues, which was used to prepare faulty financial statements directly relied upon by the public.

The requirement that a 10b-5 plaintiff demonstrate reliance is necessary to ensure that the plaintiff's harm is linked closely enough to the defendant's conduct.<sup>130</sup> Thus, the reliance element serves to eliminate those claims in which the defendant's conduct did not cause the plaintiff's harm.<sup>131</sup> The majority stated that, because no public disclosure was made in *Stoneridge*, the plaintiffs

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125. *Id.*

126. *Id.* at 770.

127. *Id.*

128. *Id.* at 777 (Stevens, J., dissenting) (citing RESTATEMENT (SECOND) OF TORTS § 533 (1977)).

129. *Stoneridge*, 128 S. Ct. at 777.

130. *Basic Inc.*, 485 U.S. at 243.

131. *Id.*

did not rely on the sham business transactions taking place behind the scenes.<sup>132</sup> However, the Court should have held that, if undisclosed information would materially affect a reasonable investor's decision to purchase the securities, reliance should be deemed proven, despite nondisclosure, so long as the undisclosed information is sufficiently related to the securities exchanged. Logically, the information relating to the sham business transactions did induce reliance by investors. Once investors learned that Charter had met Wall Street's expectations, they would rely on the information to purchase Charter stock due to its consistent performance. In *Stoneridge*, such a standard of reliance would easily have been satisfied because Scientific-Atlanta and Motorola "[we]re alleged to have known that the outcome of their fraudulent transactions would be communicated to investors."<sup>133</sup>

The majority's interpretation of the reliance standard was also faulty because it created a standard that could rarely be met by plaintiffs seeking redress for alleged securities violations. While it has long been established that reliance is an element of a private cause of action under Section 10(b),<sup>134</sup> it would be only in the rarest of circumstances in which a plaintiff would have knowledge of a defendant's deceptive acts at the time they transpired. Even though the majority discussed the fraud-on-the-market theory, it misconstrued the doctrine. The dissent, while recognizing that the majority appropriately discussed the fraud-on-the-market theory's requirements, made an interesting observation that the fraud-on-the-market theory refers only to causation on the part of the defrauded investors.<sup>135</sup> The doctrine remains silent on "what an individual or corporation must do in order to have 'caused' the misleading information that reached the market."<sup>136</sup> Thus, the dissent stated that the majority approached the causation issue in an inappropriate fashion and, as a result, reached the improper conclusion that the plaintiffs could not demonstrate reliance.<sup>137</sup>

By stating that the fraud-on-the-market theory only applies to a party that actually makes a public statement, the Court failed to realize that "[p]arties should be viewed as making public statements if they are intimately involved in the acts that create those

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132. *Stoneridge*, 128 S. Ct. at 769.

133. *Id.* at 777 (Stevens, J., dissenting).

134. Souza, *supra* note 6, at 1185.

135. *Stoneridge*, 128 S. Ct. at 776 (Stevens, J., dissenting).

136. *Id.*

137. *Id.*

statements.”<sup>138</sup> As a result, when businesses engage in dishonest business transactions that serve as the basis for public misstatements, courts should recognize that the plaintiff has satisfied the reliance element.<sup>139</sup> If such a standard had been applied in *Stoneridge*, the transactions engaged in for the purpose of inflating stock values would surely have led to liability for Scientific-Atlanta and Motorola for the voluntary and knowing roles they played in assisting Charter to structure a complex series of fraudulent business transactions.

The blanket proscription on scheme liability announced in *Stoneridge* is not desirable because the securities laws were intended to be flexible remedial devices designed to address fraud in connection with the sale or purchase of securities. More importantly, *Stoneridge* follows in the footsteps of *Central Bank* by providing a complete defense to culpable conduct because the standard announced in *Central Bank* allows for businesses to avoid liability as long as they did not make a misstatement. Therefore, a business is free to engage in sham transactions which influence revenues and other statistics related to the vitality of a business so long as that business does not make any misstatement. Basically, by remaining silent, the business can engage in unethical and fraudulent behavior without any liability under the securities laws. The Court dismissed this concern by simply stating that such conduct could be addressed by litigation under state law.<sup>140</sup>

In order to allay the Court's concerns, a case-by-case approach to scheme liability that scrutinizes the facts and circumstances of every case should be adopted. By taking the time to examine the specific facts of each case, rather than simply imposing a blanket proscription on scheme liability, scheme liability would only be imposed in situations where the conduct of the defendants rose to a level sufficient to recognize culpability. For example, suppose two companies entered into a contract for the sale of goods that dramatically affected one of the company's stock prices to the benefit of its investors. If, at a later date, an unexpected breach and payment of liquidated damages occurred, liability would not be appropriate because the intent to defraud investors was not the motivation to enter into the contract. However, where a contract is entered into with the intent to breach and pay liquidated damages merely as a method of shifting money from one company to

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138. Souza, *supra* note 6, at 1196.

139. *Id.*

140. *Stoneridge*, 128 S. Ct. at 770.

another or increasing the value of accounting records and stock prices, liability should arise. Obviously a case-by-case approach would ensure that liability is only extended to the intentional conduct of businesses engaging in transactions to manipulate stock prices and other financial information that is relied upon by prospective investors.

A case-by-case approach to securities litigation involving schemes would also benefit the securities markets, the larger economy, and the investors—more than the majority's approach in *Stoneridge*. By examining the specific facts of a case, a court may determine the degree of culpability and, accordingly, whether scheme liability should be imposed. Such an approach is more desirable than the Supreme Court's total bar to scheme liability, which does not consider the severity of any participant's actions in a scheme and may allow truly fraudulent business practices to go unpunished in the securities arena merely because state law causes of action exist to address the situation.

If the courts focused on deterring culpable conduct, the substantial participation test advanced by the Ninth Circuit would be the appropriate standard to apply to scheme liability cases. The substantial participation test developed by the Ninth Circuit provides that parties involved in fraudulent or sham business transactions may be deemed primary violators if their roles in the culpable conduct rise to a sufficient level.<sup>141</sup> This approach requires the court to review the actual conduct of the parties and determine the degree to which they were involved in the transactions and the subsequent issuance of public statements.<sup>142</sup> Therefore, “[a]s a result of its focus on conduct, the substantial participation approach actually deters culpable actors by holding them liable as primary violators.”<sup>143</sup>

#### IV. CONCLUSION

*Stoneridge* represents the most recent addition to the body of case law defining what constitutes a primary violator. While the case is certainly significant in the law of securities regulation, the Supreme Court unfortunately made several errors. Many of the issues with the opinion appear to have been introduced because the Court failed to bear in mind the overarching purpose of the

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141. Souza, *supra* note 6, at 1205.

142. *Id.*

143. *Id.*

securities laws. If the Court considered that the securities laws are designed as remedial statutes that are meant to be flexible to achieve Congress's intent, the Court would have realized that its decision did not comport with this purpose. Given the fact that the language of Section 10(b) and Rule 10b-5 appear to allow primary liability, the purpose of Congress in enacting the statutes should act as the guiding principle courts use in interpreting the facts of a case implicating scheme liability.

In addition, the Supreme Court failed to extend liability to a culpable party in *Stoneridge*. By doing so, the Court has essentially sent a message that businesses may engage in sham business transactions and remain silent to avoid any liability. As a result, the Court's opinion fails to maintain the deterrence effect that many of the securities laws have on the conduct of investors and securities issuers. In order to help serve the underlying purposes of the securities laws, the Supreme Court should reconsider the principles espoused in *Stoneridge*. Perhaps the best hope for addressing the Supreme Court's lackluster performance in *Stoneridge* is that Congress takes swift action to clarify that scheme liability is, in fact, a valid cause of action.

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