Stoneridge Investment Partners: The Supreme Court Rejects ‘Scheme Liability’ Under Section 10(b)

By Susan E. Hurd

On January 15, 2008, the Supreme Court issued its much-anticipated decision in Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc. and Motorola, Inc. In a 5-3 decision, the Court affirmed the prior decision of the Eighth Circuit Court of Appeals, holding that so-called “scheme liability” claims under Section 10(b) of the Securities Exchange Act of 1934 against certain product supplier defendants were properly dismissed with prejudice. The Court explained that the implied right of action previously recognized under Section 10(b) does not reach such defendants because the investors at issue did not rely on any statements or representations made by those defendants in deciding to purchase or sell stock.

This decision is an important one for any potential defendant in a Section 10(b) case, but is of particular interest to so-called “secondary actor” defendants, such as accountants, banks and lawyers, who may have been sued in the past in securities class actions involving their customers or clients. Stoneridge re-affirmed the Court’s prior directive in cases like Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., that every defendant has a right to insist upon a threshold showing by the plaintiff that all of the necessary elements or preconditions of liability under Section 10(b) can be satisfied as to him or her separately. In Stoneridge and Central Bank, the Court chose to focus in particular on the failure to establish the essential element of reliance.

The Court in Stoneridge also recognized, consistent with its prior decisions, that there is significant potential for abuse in the area of private securities litigation, which counseled against subjecting a broader group of potential defendants to these risks. Indeed, Stoneridge

2 Id. at 766.
4 Stoneridge, 128 S. Ct. at 769.
5 See id. at 774; Central Bank, 511 U.S. at 180.
6 Stoneridge, 128 S. Ct. at 772.

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is the most recent in a series of decisions from the Supreme Court where, after acknowledging the existence of these risks, the Court insisted upon full compliance with each element of a Section 10(b) claim as to each defendant in the case.\(^7\) Accordingly, entities that do business with public companies or professionals providing services to such companies should take comfort in *Stoneridge*, which evidences the Court’s rejection of a recent attempt to circumvent the existing safeguards available to defendants under Section 10(b).

**Overview of the Issues on Appeal in Stoneridge.** *Stoneridge* involved Section 10(b) claims brought against two equipment suppliers that did business with Charter Communications, Inc. The suppliers entered into a business transaction with Charter, which Charter failed to account for properly on its books.\(^8\) The suppliers’ accounting for this transaction was proper and they had no role in Charter’s accounting decisions or the preparation of its financial statements.\(^9\) Also, the suppliers made no statements to Charter shareholders nor did they have a duty to speak to those shareholders. Charter alone made the allegedly false and misleading statements that supposedly caused injury to its shareholders.\(^10\)

Nevertheless, investors in Charter stock, who had sued Charter and certain of its former officers and directors under the federal securities laws, sought to add the suppliers as defendants to their pending securities fraud class action.\(^11\) The district court dismissed with prejudice the attempted claims against the supplier defendants.\(^12\) The court held that there could be no violation of Section 10(b) because the supplier defendants made no misstatements that were relied upon by the public nor did they have a duty to speak to the investors at issue.\(^13\) Thus, at the most, the claims against them were for “aiding and abetting” Charter’s misstatement and, therefore, barred by the Supreme Court’s decision in *Central Bank*.\(^14\)

The Eighth Circuit Court of Appeals affirmed the ruling of the lower court.\(^15\) The Eighth Circuit opinion was later adopted by the Fifth Circuit Court of Appeals in an appeal taken from the Enron case.\(^16\) Only the Ninth Circuit came to a different conclusion on whether such “scheme liability” claims were viable under the federal securities laws, but did so largely based on existing Ninth Circuit precedent.\(^17\) Both the Fifth and Ninth Circuit decisions were the subject of separate certiorari petitions that have now been resolved in light of the Court’s decision in *Stoneridge*.\(^18\)

**The Supreme Court’s Analysis of the Reliance Requirement in Stoneridge.** Justice Kennedy, writing for the majority,\(^19\) acknowledged, as a threshold matter, that the express language of Section 10(b) does not provide for a private cause of action for investors, but that such a right has been implied previously by courts from the text of the statute.\(^20\) For this implied right of action, a shareholder plaintiff must be able to plead and prove reliance on the alleged misrepresentation or omission of the defendant, among other mandatory requirements.\(^21\) Indeed, one of the main reasons why the Court rejected private aiding and abetting liability in *Central Bank* was that such claims would “[l]et plaintiffs to circumvent the reliance requirement [and thereby] disregard the careful limits on 10b-5 recovery mandated by [the Supreme Court’s] earlier cases.”\(^22\) Thus, the Court’s decision in *Central Bank*, which Justice Kennedy also authored, made clear that primarily liable may exist under Section 10(b) only if all of the mandatory elements of such a claim are satisfied as to that defendant.\(^23\)

The Supreme Court agreed with the lower courts that the claims in *Stoneridge* were deficient because the investors could not plead reliance on any actions or statements of the supplier defendants.\(^24\) The Court reiterated that reliance is an essential element of Section 10(b) because “[i]t 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.”\(^25\)

\(^7\) See, e.g., Tellabs, Inc. v. Makor Issues & Rights, Ltd., 127 S. Ct. 2499, 2505-06 (2007) (requiring a plaintiff to plead a “strong inference” of scienter or fraudulent intent as to each defendant that is cogent and at least as compelling as any opposing inference of non-fraudulent intent); Dura Pharm., Inc. v. Broudo, 544 U.S. 336, 346 (2005) (holding that, under the loss causation requirement, a plaintiff must plead and prove that the defendant’s misrepresentation proximately caused the plaintiff’s economic loss).

\(^8\) *Stoneridge*, 128 S. Ct. at 766-67.

\(^9\) Id. at 767.

\(^10\) Id.

\(^11\) In re Charter Communications, Inc. Sec. Litig., 443 F.3d 987, 989 (8th Cir. 2006).

\(^12\) Id.

\(^13\) Id. at 991.

\(^14\) Id.

\(^15\) Id. at 992.

\(^16\) Regents of Univ. of Cal. v. Credit Suisse First Boston (USA), Inc., 482 F.3d 372 (5th Cir. 2007).

\(^17\) Simpson v. AOL Time Warner Inc., 452 F.3d 1040 (9th Cir. 2006). The Ninth Circuit, however, suggested that its opinion was not inconsistent with the Charter decision. Id. at 1050.

\(^18\) On January 22, 2008, the Supreme Court denied the petition for certiorari in the Regents case, leaving intact the Fifth Circuit’s prior decision. Regents of Univ. of Cal. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., No. 06-1341, 2008 U.S. LEXIS 1120 (U.S. Jan. 22, 2008). In Regents, the Fifth Circuit had refused to certify a proposed class action against certain banks that had done business with Enron prior to its collapse. The claims against the banks under Section 10(b) were premised on the same type of “scheme liability” theory at issue in Stoneridge. On the same day, the Supreme Court also granted the petition for certiorari regarding the Ninth Circuit’s Simpson decision and vacated that decision. Avis Budget Group, Inc. v. Cal. State Teachers’ Ret. Sys., No. 06-560, 2008 U.S. LEXIS 1170 (U.S. Jan. 22, 2008). That case, which involved a Rule 12(b)(6) motion to dismiss, was then remanded for further consideration in light of Stoneridge.

\(^19\) Justices Roberts, Scalia, Thomas, and Alito joined in the majority opinion. Justices Stevens, Souter, and Ginsberg dissented and Justice Breyer did not participate in the decision.

\(^20\) *Stoneridge*, 128 S. Ct. at 768.

\(^21\) Id.

\(^22\) Id. (quoting Central Bank, 511 U.S. at 180).

\(^23\) Id. at 768-69.

\(^24\) Id. at 769.

\(^25\) Id. (quoting Basic Inc. v. Levinson, 485 U.S. 224, 243 (1988)).
Stoneridge re-affirms that every defendant has a right to insist upon a threshold showing by the plaintiff that all of the necessary elements or preconditions of liability under Section 10(b) can be satisfied as to him or her separately.

In earlier cases, the Court had recognized that a presumption of reliance may exist under two different circumstances, but found that no such presumption could apply under the facts of Stoneridge. The Court had previously recognized a presumption of reliance in the context of an omission made by one with a duty to speak.26 Also, it had held that a presumption could exist in conjunction with the “fraud-on-the-market” theory, which assumes that, when a company’s stock trades in an efficient market, all publicly available information about that company will be reflected in its stock price.27 Neither circumstance had any possible application here because the supplier defendants had no duty to disclose and no alleged actions by them were ever communicated to the public.28 Thus, “[n]o member of the investing public had knowledge, either actual or presumed, of [defendants’ allegedly] deceptive acts during the relevant times.”29

Rather, the Court observed that the plaintiffs could not show reliance except in an indirect chain that was too remote and attenuated for liability to attach.30 In an attempt to invoke the “fraud-on-the-market” theory, the plaintiffs had argued that investors relied not only on public statements regarding a security, but also on the transactions that those statements reflect.31 The Court held that, “[w]here this concept of reliance to be adopted, the implied cause of action would reach the whole marketplace in which the issuing company does business” and there was no authority for such a rule.32

Indeed, plaintiffs’ theory, if adopted, would have had the effect of extending Section 10(b) claims “beyond the securities markets—the realm of financing business—to purchase and supply contracts—the realm of ordinary business operations.” At present, if business operations are used to affect the securities markets, the SEC’s enforcement power is available to reach culpable actors.34 But if a private implied cause of action extended to such operations, the Court concluded that there would be a risk of inviting litigation into areas already effectively governed through these civil enforcement actions by the SEC or through the imposition of criminal penalties.35

Other Factors That Influenced the Court’s Decision-Making. As further support for its conclusions, the Court looked to Congress’ specific response to Central Bank, which was codified in the Private Securities Litigation Reform Act.36 Immediately after Central Bank, Congress was asked to create a private cause of action for aiding and abetting liability, but instead chose to provide only limited coverage for aiders and abettors through suits brought exclusively by the SEC and not by private parties.37 The plaintiffs’ view of primary liability under Section 10(b) simply could not be reconciled with this development. Plaintiffs asked the Court to revive in substance an implied cause of action against aiders and abettors, which would have undermined Congress’ determination that this class of defendants should be pursued only by the SEC.38 The Court determined that it must give weight to Congress’ decision to “restore[] aiding and abetting liability in certain cases but not others.”39

As noted above, the Court also recognized the potential coercive effect of securities litigation being imposed on a new, broader class of defendants and the increased cost of doing business to protect against the threat such litigation poses.40 Further, overseas companies with no other exposure to this country’s securities laws might be deterred from doing business here. And 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.41

What Impact Will Stoneridge Have on Securities Litigation? The Supreme Court made clear in Stoneridge that the Court will not look favorably upon any new, creative theories of liability whose ultimate goal is to expand the reach of the federal securities laws. The Court stated that its rejection of such a theory in Stoneridge was “consistent with the narrow dimensions [that the Court] must give to a right of action Congress did not authorize when it first enacted the statute and did not expand when it revisited the law.”42 Stoneridge, Central Bank, and other recent decisions from the Court also emphasize to the benefit of all defendants the need for plaintiffs to demonstrate at the motion to dismiss stage of the case that they can successfully plead all elements of a Section 10(b) claim separately as to each defendant. Thus, simply because a plaintiff may be able to state a claim under Section 10(b) as to the issuer of the stock does not lessen a plaintiff’s pleading burden as to other individuals or entities merely because they did business with that company.

26 Id. (citing Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128, 154 (1972)).
27 Id. (citing Basic, 485 U.S. at 247).
28 Id.
29 Id.
30 Id. at 769-71.
31 Id. at 770.
32 Id.
33 Id.
34 Id.
35 Id. at 770-71, 773.
36 Id. at 771.
37 Id.
38 Id.
39 Id.; see also id. at 768-69.
40 Id.
41 Id. at 772.
42 Id.
43 Id.
44 Id. at 774.
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The requirement that plaintiffs must plead claims on a defendant-by-defendant basis is not a new one and, indeed, this principle factored heavily into the Court’s rejection of aiding and abetting liability in Central Bank. Nevertheless, the Court’s strict adherence to this rule in Stoneridge has certainly made it more difficult for plaintiffs to bring claims against non-speaking defendants in general and, in particular, against the traditional types of secondary actor defendants mentioned previously—e.g., banks, lawyers, and accountants.

The instances in which these actors speak directly to the market about an issuer are rare and often simply do not exist in a given case. Prior to Stoneridge, the existing case law in the majority of jurisdictions already prevented claims against secondary actor defendants for statements communicated to the market by others. Stoneridge closed the door on an attempted end-run around these cases. Stoneridge also made clear that allegations of “scheme participation” against non-speaking defendants are insufficient to plead a viable claim under the federal securities laws. A scheme theory simply cannot cure critical pleading deficiencies, including but not limited to, the plaintiff’s inability to plead reliance.

45 See, e.g., Ziemba v. Cascade Int’l, Inc., 256 F.3d 1194, 1205-07 (11th Cir. 2001) (holding that, notwithstanding allegations of substantial assistance in the alleged fraud, “no statements attributable to [the defendant] were ever made to [p]laintiffs; therefore [p]laintiffs could not have relied on [the defendant] in making their investment decisions”); Wright v. Ernst & Young LLP, 152 F.3d 169, 175 (2d Cir. 1998) (noting that “[r]eliance only on representations made by others cannot itself form the basis of liability.”) (quoting Anixler v. Home-Stake Prod. Co., 777 F.3d 1215, 1255 (10th Cir. 1996).