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Supreme Court Rejects Scheme Liability in Securities Fraud Litigation

In *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, No. 06-43, the Supreme Court today ruled that private plaintiffs may state securities fraud claims under Section 10(b) of the Securities Exchange Act of 1934 *only* against defendants upon whose representations they relied. Parties who allegedly enabled or participated in a company's fraud on investors, but did not commit acts or make statements upon which investors relied, are not liable under that statute. This ruling rejects the legal theory – known as "scheme liability" – by which the plaintiffs' securities bar had attempted to circumvent earlier actions by both the Supreme Court and Congress eliminating "aiding and abetting liability" in private lawsuits under Section 10(b). It will be enormously consequential with respect to pending and future litigation against major financial market participants such as investment banks, and reflects the Court's most forceful reiteration to date of its intent to prevent judicial expansion of the scope of that statute.

In *Stoneridge*, the defendants had allegedly entered into sham transactions with a public company, Charter Communications, which Charter used to inflate the revenue reported on its financial statements. Neither the transactions nor the defendants' role in them was publicly disclosed, and the financial statements of defendants themselves were unaffected. It was alleged that the defendants knew of or recklessly disregarded Charter's intention to use the transactions to falsify its financial statements.

The Court, in a 5-3 decision, focused on one particular element of the Section 10(b) private cause of action: a plaintiff must prove it relied on the fraudulent statement or conduct. It held that it is not enough that a plaintiff relied on a fraud of which the defendant's actions were a part; the plaintiff must have relied on the statement or conduct *of the defendant being sued.* The Court wrote:

> [W]e conclude [defendants'] deceptive acts, which were not disclosed to the investing public, are too remote to satisfy the requirement of reliance. It was Charter, not [defendants], that misled its auditor and filed fraudulent financial statements; nothing [defendants] did made it necessary or inevitable for Charter to record the transactions as it did.

It therefore held that "the implied right of action [under Section 10(b)] does not reach the customer/supplier companies because the investors did not rely upon their statements or

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representations." In doing so, it rejected "scheme liability" – plaintiffs' theory that would have extended Section 10(b) liability to any party that participates in a scheme to defraud – where the plaintiff "did not in fact rely upon [defendants'] own deceptive conduct."

The Court's ruling effectively limits private liability under Section 10(b) in financial fraud cases to (1) defendants who make false public statements or engage in deceptive conduct publicly attributed to them, (2) defendants who omit material facts that they are under a duty to disclose, and (3) defendants who engage in narrow categories of specifically precluded activity such as market manipulation or insider trading.[1]

This ruling is likely to curb litigation under the federal securities laws against investment banks that entered into transactions with companies such as Enron, which those companies allegedly used to inflate their reported earnings. It may also provide protection for lawyers, accountants and other advisors who, with increasing frequency, have been named as defendants when the companies they served have been sued. The Supreme Court's decision does not, however, limit the ability of the SEC or federal or state prosecutors to pursue these parties.

The Court's language reveals a clear concern about the impact of American securities litigation on the marketplace, and a resulting determination to rein in lower courts that have in some cases been receptive to novel expansions of liability. It warns that Section 10(b) "should not be interpreted to provide a private cause of action against the entire marketplace in which the issuing company operates," and cautions that plaintiffs' theory would expose market participants – including overseas firms considering doing business in the United States – to disruption, extorted settlements, and unjustifiably increased costs. The Court holds that "[t]hough it remains the law, the § 10(b) private right should not be extended beyond its present boundaries." Taken together with its several decisions in recent terms tightening the requirements for private lawsuits under Section 10(b),[2] the Court's ruling in *Stoneridge Investment Partners* is a strong expression that, while private securities litigation under Section 10(b) was a judicial creation, any future expansion should come only from enactments of Congress and not from the creativity of the plaintiffs' bar or the courts.

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1 The language of the decision suggests that claims under Section 10(b) cannot be asserted against affiliates, subsidiaries or employees (other than control persons) of the entity that makes the false statement, although the Court did not expressly address this situation. Thus, it may provide a defense, for example, in cases of company personnel who engaged in stock option backdating but did not sign financial statements that improperly accounted for the options by failing to recognize a compensation charge.

2 *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499 (2007); *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*, 547 U.S. 71 (2006); *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336 (2005).

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This memorandum is not intended to provide legal advice with respect to any particular situation, and no legal or business decision should be based solely on its content. Questions concerning issues addressed in this memorandum should be directed to any member of the following:

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