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A Securities Fraud and Corporate Governance Quarterly

*Fourth Quarter 2007*

# Silence is Golden: *Stoneridge* Decision Deals a Blow to Investors' Scheme Liability Claims

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On January 15, 2008, the Supreme Court issued a significant and, unfortunately, anti-investor decision in *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc., No. 06-43*, about the scope of "scheme liability" claims against third parties for securities fraud under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5. Regrettably, the Supreme Court affirmed — by five to three, with one Justice not participating — the dismissal of investors' claims against defendants who engaged in sham transactions that had the purpose and effect of enabling a company to issue false financial statements. The majority opinion is, we believe, poorly reasoned, contrary to law, and driven by the majority's acceptance of misguided policy arguments from corporate lobbyists who waged an aggressive political campaign to restrict investors' rights. Despite this disappointing, anti-investor result, which is likely to prevent victims of fraud from recovering their losses in many meritorious cases, we believe that the Court's opinion should not prevent investors from vindicating their rights in cases that do not involve scheme liability claims against third parties. *Stoneridge* also might not prevent investors from recovering their losses in some scheme liability cases with facts different from those of *Stoneridge.*

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The Supreme Court majority in *Stoneridge* engaged in illogical, circular reasoning. Investors' right to sue under Rule 10b-5 is an "implied" cause of action, that is, the 1934 Act does not expressly provide for private suits under Section 10(b), but the courts — including the Supreme Court — have recognized for decades that Congress intended to allow investors to bring private actions under this statute. The question in *Stoneridge* was whether that longstanding cause of action applies to third parties who defraud investors. The majority of the Court, however, simply assumed that the cause of action does not apply to those third parties, repeatedly suggesting the investor plaintiffs were trying to "expand" the scope of the law. Thus, the majority's reasoning began from a false premise.

The majority also rested its decision on the theory that the investors, when they decided to buy the issuer's securities, did not "rely" on the third parties' conduct. This theory was not argued by the defendants in the lower courts, was not the basis of the lower courts' rulings, and was not the focus of defendants' brief in the Supreme Court. Rather, this theory was introduced only at the last minute in a brief by the Solicitor General of the United States, who rejected the Securities and Exchange Commission's request that the government file

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a pro-investor brief in *Stoneridge*, and instead filed an anti-investor brief. Thus, the investor plaintiffs were not given a fair opportunity to develop their arguments against this theory. As Justice Stevens' forceful and well reasoned dissent pointed out, the fair and proper course for the Supreme Court would have been to remand the case for the lower courts to reconsider under the majority's new standard. Instead, the majority affirmed the final dismissal of the case without allowing the investors a fair chance to argue their position.

The Supreme Court majority also devoted considerable space in its opinion to parroting arguments by corporate interest groups, who argued that allowing investors to sue fraudsters will somehow harm the American capital markets. But liability for parties that commit securities fraud does not harm American competitiveness; rather, investors' faith in the integrity and safety of U.S. markets is what makes those markets strong.

The impact of the Supreme Court's *Stoneridge* decision will only become known as lower courts interpret and apply it in other cases. The ambiguities, faulty reasoning, and anti-investor rhetoric of the majority opinion may lead lower courts to interpret *Stoneridge* as a broad repudiation of investor rights. Judges who interpret *Stoneridge* broadly may dismiss meritorious cases.

We believe, however, that *Stoneridge*, if properly interpreted by the lower courts, should allow investors to pursue securities fraud claims against third parties that engage in deceptive conduct, as long as information about the defendants' deceptive conduct is publicly disclosed and relied on by investors. The Supreme Court held in *Stoneridge* that "the implied right of action in Section 10(b) continues to cover secondary actors who commit primary violations." Thus, *Stoneridge* affirms that Section 10(b) and Rule 10b-5 impose primary liability on secondary actors who engage in deceptive conduct upon which investors rely. Such claims may be viable against financial market participants such as investment banks, accountants, and lawyers that join an issuer in engaging in deceptive conduct about which public disclosures are made to investors.

The defendants in *Stoneridge* were outside "suppliers" and "customers" of the issuer of the securities in question in that case, and the outside parties "had no role in preparing or disseminating [the issuer's] financial statements." Accordingly, the Court held that "[i]n these circumstances the investors cannot be said to have relied upon any of [the vendors' and customers'] deceptive acts in the decision to purchase or sell securities."

Thus, *Stoneridge* primarily addresses the question whether scheme liability is a viable theory to hold a commercial counterparty liable for knowingly engaging in transactions that enable an issuer to misrepresent its financial statements. The Supreme Court's decision appears to place some weight on the *Stoneridge* defendants' status as suppliers and customers acting "in the marketplace for goods and services, not in the investment sphere." *Stoneridge* also states that the defendants were "remote" from investors in the issuer with which they did business: "[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 [the issuer], not [the issuer's customers and vendors], that misled its auditor and filed fraudulent financial statements; nothing [the customers and vendors] did made it necessary or inevitable for [the issuer] to record the transactions as it did." Thus, *Stoneridge* might not preclude claims against financial market professionals, as opposed to commercial customers and suppliers.

The Supreme Court also held in *Stoneridge* that there need not be "a specific oral or written statement before there could be liability under Section 10(b) or Rule 10b-5." Rather, the Court held that "[c]onduct itself can be deceptive." By acknowledging that non-verbal conduct can give rise to liability under Section 10(b), the Supreme Court rejected earlier rulings by the 8th Circuit and 5th Circuit Courts of Appeals that liability requires either a false statement, or an omission by a defendant who has a duty to speak. This aspect of the Supreme Court's decision might allow securities fraud claims against third parties such as accountants, lawyers, and investment bankers who actively structure sham transactions for an issuer without themselves making false statements to the investing public.

It is also worth noting that *Stoneridge* does not limit in any way the 10b-5 liability of a securities issuer itself, and its officers and directors, when the issuer and its officers and directors make false statements to the investing public. Nor does *Stoneridge* in any way limit investors' right to sue issuers, officers and directors, auditors, and underwriters for materially misleading statements in registration statements and prospectuses for public offerings of securities under the Securities Act of 1933. *Stoneridge* only concerns the scope of 10b-5 liability of parties other than the issuer for securities fraud affecting aftermarket trading.

In sum, we believe that *Stoneridge* was wrongly decided and represents an unfortunate diminution in investors' rights, which will deny investors any recovery in many cases of serious fraud. However, the decision in this case should not prevent investors from vindicating their rights in all cases.

Hopefully, members of Congress will see the exposure innocent, defrauded investors will face in light of this decision and will act quickly to restore their remedies through legislation.

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