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Supreme Court Rejects "Scheme Liability"

The United States Supreme Court today held that third parties (such as customers or suppliers) who transact business with an issuer who publishes fraudulent financial statements that reflect the transactions may not be held liable for damages in a private securities fraud action, even if those third parties knew that the issuer intended to defraud investors. Because the actions of those third parties were "not disclosed to the investing public" and "not relied upon by the investors", the Court ruled that the third parties' conduct was not within the scope of a private action under Section 10(b) or Rule 10b-5.

The case, *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.,* 552 U.S. ___ (2008), was a class action on behalf of investors who lost money after purchasing common stock of Charter Communications. The plaintiffs alleged that respondents had engaged in transactions with Charter with "no economic substance," knowing of or recklessly disregarding "Charter's intention to use the transactions to inflate its revenues" and knowing that the "resulting financial statements … would be relied upon by research analysts and investors." Invoking the so-called "scheme liability" theory that had been accepted by some lower courts, the plaintiffs argued that, but for the respondents' assistance to Charter, investors would not have been misled.

The Court, by a five-to-three majority, rejected plaintiffs' theory of reliance as "too remote." To hold otherwise, the Court reasoned, would apply the Section 10(b) private right of action "beyond the securities markets – the realm of financing business – to purchase and supply contracts – the realm of ordinary business operations" and "invite litigation beyond the immediate sphere of securities litigation and in areas already covered by functioning and effective state-law guarantees." To do so, the Court explained, would be inconsistent with its prior interpretations of Section 10(b) and with the PSLRA's limitation of aiding-and-abetting liability to SEC actions, and would risk "rais[ing] the cost of being a publicly traded company" in the United States and "shift securities offerings away from domestic capital markets."

The Court also pointed out that "[s]econdary actors" may be subject to criminal penalties, SEC enforcement, fines and restitution under state law, certain express rights of action under the securities laws, and even Section 10(b) liability for "primary violations." But they could not be held liable under Section 10(b) when it was Charter who "was free to do as it chose in preparing its books, conferring with its auditor, and preparing and then issuing its financial statements."

Stoneridge is important but not surprising. In prior decisions, the Supreme Court has limited implied rights of action under the securities laws. The *Stoneridge* Court was explicit that although the judicial creation of a § 10(b) private cause of action by the courts – what the majority called "a judicial construct" – "remains the law," the action "should not be extended beyond its present boundaries." *Stoneridge* reflects an emerging jurisprudence that emphasizes public enforcement of the securities laws and limits opportunities for "private attorney-general" suits designed to obtain settlements disproportionate to the merits and potentially inimical to broader public interests.

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