Supreme Court Rejects Scheme Liability Theory under Rule 10b-5

James Hamilton, J.D., LL.M.
CCH Principal Analyst

Introduction

In a significant case for the business and securities professional communities, the U.S. Supreme Court has ruled that secondary non-speaking actors said to have participated with a company in a securities fraud scheme were not liable in a private action under Exchange Act Rule 10b-5. The Court reasoned that the acts of suppliers who allegedly participated in the fraud were too remote to satisfy the antifraud rule's reliance element. Because the company was free to do as it chose in preparing its books, conferring with its auditor, and issuing its financial statements, reasoned the Court, the investors cannot be said to have relied on any of the suppliers' deceptive acts. This was a 5-3 opinion, withthe majority opinion rendered by Justice Kennedy. *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.,* No. 06-43 (Jan. 15, 2008).

Rejecting the concept of scheme liability, the Court said that to accept that investors in an efficient market rely not only on the public statements relating to a security, but also on the transactions those statements reflect, would be an unwarranted extension of the Rule 10b-5 implied cause of action to embrace the whole marketplace in which the issuing company does business. Judicial precedent and congressional intent argue against this broad extension of the Rule 10b-5 private cause of action beyond the securities markets into the realm of ordinary business operations, which are essentially governed by state law.

In addition, the practical consequences of expanding an implied private right of action for securities fraud militate against the acceptance of scheme liability. The extensive discovery and the potential for uncertainty could allow investors with weak claims to extort settlements from innocent companies. It would also expose to such risks a new class of defendants, said the Court, namely overseas firms with no other exposure to U. S. securities laws, thereby deterring them from doing business in the U.S. In turn, this would raise the cost of being a publicly traded company under U. S. law, thereby shifting securities offerings away from domestic capital markets.

Scheme Liability

Scheme liability imposes liability when secondary actors engage in conduct with the purpose and effect of creating a false appearance of material fact to further a scheme to misrepresent the company's revenue. The argument is that the financial statement the company released to the public was a natural and expected consequence of the non-speaking actor's deceptive acts. Had the actors not assisted the company, the theory goes, the company's auditor would not have been fooled, and the financial statement would have been a more accurate reflection of the company's financial condition. That causal link is sufficient to apply a presumption of reliance to the secondary actors.

In effect, scheme liability is based on the premise that in an efficient market investors rely, not only on the public statements relating to a security, but also on the transactions those statements reflect. In rejecting scheme liability, the Court reasoned that, if this concept of reliance was adopted, the Rule 10b-5 implied cause of action would reach the

whole marketplace in which the issuing company does business; and there is no authority for such a broad rule.

The battle over scheme liability is joined when investors argue that, for example, an investment bank or auditor need not have made misleading statements or omissions to be liable for securities fraud since participating with scienter in a sham transaction with no legitimate business or economic purpose should suffice. The countervailing argument is that the actors must make a misleading statement to be held liable under Rule 10b-5; and thus scheme defendants who remain silent and owe no duty of candor to investors are categorically exempt.

Lack of Reliance

In this action, since the suppliers' deceptive acts were not disclosed to the investing public, the Court deemed them too remote to satisfy the requirement of reliance. It was the company, not the suppliers, that misled its auditor and filed fraudulent financial statements. There was nothing the secondary actors did that made it necessary or inevitable for the company to record the transactions as it did.

In this case, the investors alleged losses after purchasing common stock. They sought to impose securities fraud liability on suppliers alleged to have participated in arrangements that the company used to mislead its auditor and issue a misleading financial statement affecting the stock price. Specifically, it was alleged that the suppliers produced documents falsely claiming that costs had risen and signed contracts they knew to be backdated in order to disguise the connection between the increase in costs and the purchase of advertising.

The suppliers had no role in preparing or disseminating the company's financial statements, noted the Court, and their own financial statements booked the transactions as a wash, under GAAP. It was alleged that the suppliers knew or were in reckless disregard of the company's intention to use the transactions to inflate its revenues; and knew the resulting financial statements would be relied on by research analysts and investors. Citing its *Central Bank* ruling, the Court observed that, since the Rule 10b-5 implied private right of action does not extend to aiders and abettors, the conduct of a secondary actor must satisfy each of the elements or preconditions for liability; and reliance is an essential element of Rule 10b-5. The reliance element ensures that liability is conditioned on the requisite causal connection between a misrepresentation and an investor's injury.

The Court has found a rebuttable presumption of reliance in two different circumstances. 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. Second, under the fraud-on-the-market doctrine, reliance is presumed when the statements at issue become public. Neither presumption applies to this case, said the Court, since the suppliers had no duty to disclose and their deceptive acts were not communicated to the public. Because no investor had knowledge of the deceptive acts during the relevant

times, held the Court, no investor could show reliance on any of suppliers' actions except in an indirect chain that was too remote for liability.

On one level, the opinion represents an affirmation of the ruling in *Central Bank of Denver v. First Interstate Bank*, (U.S. Sup. Ct. 1994), 1993-1994 CCH Dec. ¶98,178. In *Central Bank*, the Court determined that Section 10(b) liability did not extend to aiders and abettors. The Court found that the scope of the antifraud statute was delimited by the text, which makes no mention of aiding and abetting liability. The Court doubted the implied private right of action for securities fraud should extend to aiders and abettors when none of the express causes of action in the securities acts included that liability.

The *Stoneridge* Court, itself basing its decision on the lack of investor reliance, noted that, in *Central Bank*, the Court said that allowing the aiding and abetting action would mean that defendants could be liable without any showing that investors relied on the aider and abettor's statements or actions. Allowing investors to circumvent the reliance requirement would disregard the careful limits on 10b-5 recovery mandated by earlier cases.

The Court also noted that *Central Bank* led to calls for Congress to create an express cause of action for aiding and abetting within the Exchange Act. Congress did not follow this course. Instead, in Section 104 of the Private Securities Litigation Reform Act of 1995 (PSLRA), Congress directed prosecution of aiders and abettors by the SEC. The Court construed this to be a conscious decision by a Congress aware of the *Central Bank* ruling not to legislatively expand the scope of Rule 10b-5 to private rights of action by investors against aiders and abettors.

It thus follows that the scheme liability theory places an unsupportable interpretation on Congress' specific response to the *Central Bank* ruling. Aiding and abetting liability is authorized in actions brought by the SEC but not by private parties. The scheme liability view of primary liability makes any aider and abettor liable under the antifraud rule if he or she committed a deceptive act in the process of providing assistance. An adoption of this construction of 10(b), reasoned the Court, would revive in substance the implied cause of action for aiders and abettors laid dormant by *Central Bank.*

Allowing an implied private right of action against all aiders and abettors except those who committed no deceptive act in the process of facilitating the fraud would undermine Congress' determination that this class of defendants should be pursued by the SEC and not by private litigants. This is not a case in which Congress has enacted a regulatory statute and then has accepted, over a long period of time, broad judicial authority to define substantive standards of conduct and liability. And in accord with the nature of the cause of action at issue here, the Court gave weight to Congress' amendment to the Act restoring aiding and abetting liability in SEC enforcement actions but not in private actions, which supports the conclusion that there is no liability.

Importantly, the Court said that conduct itself can be deceptive. But it comes down to whether the deception had the requisite proximate relation to the investors' harm, which is consistent with the Court's determination that the suppliers' acts or

statements were not relied on by the investors and that, as a result, liability cannot be imposed on them.

State Law, Policy Concerns

The Court refused to take the invitation to inject the Rule 10b-5 private cause of action beyond the realm of financing business, which is the securities markets, to the realm of ordinary business operations, which is the purchase and supply contracts. This latter realm is governed, for the most part, by state law. If, as alleged here, business operations are used to affect securities markets, the SEC enforcement power may reach the culpable actors. It is also axiomatic that a dynamic, free economy presupposes a high degree of integrity in all of its parts, an integrity that must be underwritten by rules enforceable in fair, independent, accessible courts.

Were the implied cause of action to be extended to the practices described here, however, there would be a risk that the federal power would be used to invite litigation beyond the immediate sphere of securities litigation and in areas already governed by functioning and effective state law guarantees. Harking back to *Santa Fe Industries v. Green* (U.S. Sup Ct 1977), 1976-1977 CCH Dec. ¶95,914, the Court noted that Congress, in enacting the securities laws, did not intend to provide a broad federal remedy for all fraud. While conceding, as it must, that the antifraud rule is not limited to preserving the integrity of the securities markets, the Court maintained that it does not reach all commercial transactions that are fraudulent and affect the price of a security in some attenuated way.

The Court also found entirely unpersuasive the argument that there could be a finding of reliance if this were a common law action for fraud. Even if the assumption is correct, it is not controlling since Section 10(b) does not incorporate common-law fraud into federal law.

The Court then turned to the practical consequences of an expansion of the implied private right of action against aiders and abettors of fraud, which provide a further reason to reject scheme liability. The Court noted that extensive discovery and the potential for uncertainty and disruption in a lawsuit allow investors with weak claims to extort settlements from innocent companies. Adoption of scheme liability would expose a new class of defendants to these risks. Contracting parties might find it necessary to protect against these threats, raising the costs of doing business. Similarly, overseas firms with no other exposure to U.S. securities laws could be deterred from doing business in the U.S. This, in turn, may raise the cost of being a publicly-traded company and shift securities offerings away from domestic capital markets.

On a broad policy concern, the Court noted that the history of the 10(b) private right and the careful approach the Court has taken before proceeding without congressional direction provide further reasons to find no liability for these non-speaking actors. In this context, the Court found significant the fact that the implied Rule 10b-5 private cause of action is a judicial construct that Congress did not enact in the text of the relevant statutes. The determination of who can seek a remedy has significant

consequences for the reach of federal power. Concerns with the judicial creation of a private cause of action caution against its expansion. Ultimately, the decision to extend the cause of action is for Congress, not for the Court.

This restraint is further appropriate in light of the PSLRA, which imposed heightened pleading requirements and a loss causation requirement on any private action arising from the Exchange Act. Clearly, emphasized the Court, these requirements touch on the implied right of action, which is now a prominent feature of federal securities regulation. It can be correctly assumed that, when the PSLRA was enacted, Congress accepted the 10(b) private cause of action as then defined but chose to extend it no further.

Finally, essentially addressing the dissent's statement that there should be a remedy for every wrong, the Court noted that secondary actors are subject to criminal penalties and civil enforcement by the SEC. The enforcement power is not toothless, the Court felt compelled to note, pointing out that, since September 30, 2002, SEC enforcement actions have collected over $10 billion in disgorgement and penalties, much of it for distribution to injured investors. In addition, some state securities laws permit state authorities to seek fines and restitution from aiders and abettors. Moreover, the Court noted that all secondary actors are not necessarily immune from private suit. The securities statutes provide an express private right of action against accountants and underwriters in certain circumstances, and the implied right of action in 10(b) continues to cover secondary actors who commit primary violations.

Amicus Briefs

The *Stoneridge* case generated intense interest and involved many groups who filed friend-of-the-court briefs, including a number of former SEC chairs and commissioners. Although the opinion was confined to suppliers, it has wide ramifications for other secondary actors such as investment bankers, attorneys, and accountants and auditors. In addition, the ruling has great significance for the broader corporate community.

For example, in an *amicus* brief filed with the Court, the U.S. Chamber of Commerce called scheme liability a label in search of a cause of action. The theory of scheme liability under which non-speaking actors, such as auditors and investment banks, can be held liable for securities fraud is no more than aiding and abetting liability disguised behind a new name, the Chamber asserted. The Chamber further contended that scheme liability would put U.S. companies at a tremendous competitive disadvantage. For instance, issuers of securities would have to price their commercial transactions to reflect the substantial added risk of liability for their counterparties. Moreover, in order to avoid litigation risk, both domestic and foreign companies would have significant incentives to do business with companies listed on foreign exchanges, or with private companies.

The interest in the case was not confined to the U.S. The overseas corporate community was intensely interested in the Court's treatment of scheme liability. In the opinion, the court alluded to a brief filed by an international consortium when it mentioned that application of scheme liability could deter overseas firms from doing business in the U.S.

The consortium of international business organizations had urged the Court to reject scheme liability for non-speaking secondary actors in private securities fraud actions. From the perspective of foreign companies in particular, said the brief, scheme liability is unworkable and would convert foreign companies in overseas transactions with U.S. entities into *de facto* auditors of their U.S-listed counterparty's financial statements. In turn, the imposition of scheme liability would have a material chilling effect on the willingness of foreign companies to engage in general commercial transactions with U.S. public companies.

More broadly, the brief, citing the German press, noted that scheme liability endangers transatlantic economic relations because it could be at odds with the spirit of the April 2007 U.S.-E.U. Economic Summit at which the parties agreed to work towards the harmonization of the regulatory environment for financial markets. For example, the German Securities Trading Act limits liability for misstatements to the issuer and, potentially, its directors and officers. But the Act does not provide for claims against silent third-parties to commercial transactions that the issuer misreports. The brief was filed by, among others, the International Chamber of Commerce and the Confederation of German Industries.

The U.S. Solicitor General had urged the Supreme Court to reject scheme liability for non-speaking secondary actors in private securities fraud actions since such an expansion of liability would upset the delicate balance Congress has crafted. In its brief, the government argued that scheme liability runs counter to the congressional balance between exposure to private actions for aiding and abetting and empowering the SEC alone to pursue secondary claims against non-speaking actors, such as lawyers and accountants. In an argument that the Court seemed to respect, the Solicitor General maintained that non-verbal conduct by secondary actors can constitute deception within the meaning of Rule 10b-5. But in this particular case, although deception could be alleged, the investors did not rely on any conduct by the non-speaking vendor.

The case generated such intense interest that former SEC chairs and commissioners weighed in on both sides of the issue. Former SEC Chairs Harvey Pitt, Rod Hills, and Harold Williams, along with a plethora of former Commissioners, urged the Supreme Court to reject scheme liability for non-speaking secondary actors in private securities fraud actions. The former SEC officials called scheme liability a semantic ploy designed to recast secondary conduct as a primary violation of Rule 10b-5 in order to get around the Court's ruling in the *Central Bank* case that there is no private right of action against secondary actors who aid and abet securities fraud.

The former chairs warned that the approval of scheme liability would inject confusion into Rule 10b-5 actions since not even the proponents of scheme liability can consistently define this amorphous concept. They further contended that scheme liability exposes those engaging in commercial transactions with public companies to disproportionate damages orders of magnitude greater than the size of the transaction alleged to give rise to the liability.

On the other hand, former SEC Chairs William Donaldson and Arthur Levitt urged the Court to hold that non-speaking actors who engage in deceptive acts as part of a scheme to defraud investors may be liable under Rule 10b-5 even if they did not directly issue fraudulent statements. Former SEC Commissioner Harvey Goldschmid also joined them on the brief. Calling the action one of the most important securities cases to be heard by the Supreme Court in many years, the former SEC senior officials said it is critical to the antifraud purposes of the federal securities laws that actors, other than issuers and their officers and directors, who actively engage in deceptive conduct for the purpose and with the effect of creating a false statement of material fact in the disclosure of a public company, continue to be held liable in private securities fraud actions.

About the Author

James Hamilton is a Principal Analyst at Wolters Kluwer Law & Business, a leading provider of corporate and securities information, and a prolific blogger (Jim Hamilton's World of Securities Regulation at http://jimhamiltonblog.blogspot.com/). Hamilton has been tracking, analyzing and explaining securities law and regulation for nearly 30 years as an analyst for CCH. He has written and spoken extensively on federal securities law and has been cited as an authority by a federal court. His analysis of the Sarbanes-Oxley Act, the *Sarbanes-Oxley Manual: A Handbook for the Act and SEC Rules,* is considered a definitive explanation of the Act. His other works include the popular guidebook *Responsibilities of Corporate Officers and Directors under Federal Securities Law,* the *Guide to Internal Controls*, and the monthly newsletter *Hedge Funds and Private Equity: Regulatory and Risk Management Update*. In addition to his many books and articles, Hamilton serves as a leading contributor to the industry-standard publication, the *CCH Federal Securities Law Reporter*. Hamilton received an LL.M. from New York University School of Law.