Primary Securities Fraud Liability: *Stoneridge Investment v. Scientific-Atlanta, Inc.*

name redacted
Legislative Attorney

January 23, 2008

Congressional Research Service
7-....
www.crs.gov
RS22723

Summary

On January 15, 2008, the United States Supreme Court issued its decision in *Stoneridge Investment Partners v. Scientific-Atlanta, Inc.*, which was appealed from a decision by the Court of Appeals for the Eighth Circuit. The case concerned whether secondary actors who make no public statements concerning deceptive transactions engaged in by primary actors may be liable for fraud under the federal securities laws. The Court held that these secondary actors had not violated the major antifraud statute of the federal securities laws.

On January 15, 2008, the United States Supreme Court issued its decision in the case *Stoneridge Investment Partners v. Scientific-Atlanta, Inc.*,[1] a case appealed from a decision by the United States Court of Appeals for the Eighth Circuit.[2] The questions presented to the Supreme Court were whether the Supreme Court's decision in *Central Bank, N.A. v. First Interstate Bank, N.A.*[3] foreclosed claims for deceptive conduct under section 10(b) of the Securities Exchange Act of 1934[4] and Rule 10b-5(a) and (c),[5] where Respondents engaged in transactions with a public corporation with no legitimate business or economic purpose except to inflate artificially the public corporation's financial statements but where Respondents themselves made no public statements concerning those transactions. The Court held that Respondents had not violated the major antifraud statute of the federal securities laws.

In this case plaintiff investors brought a securities fraud class action, alleging that Charter, one of the country's largest cable television providers, engaged in fraud to boost artificially its reported financial results by such actions as deliberately delaying the disconnecting of customers no longer paying their bills, improperly capitalizing labor costs, and entering into sham transactions with two equipment vendors that improperly inflated Charter's reported operating revenues and cash flow. In addition to naming Charter, Charter's executives, and Charter's independent auditor as defendants, plaintiff investors also named the two equipment vendors, Scientific-Atlanta, Inc., and Motorola, Inc. (called the "Vendors" in this case). Plaintiff investors alleged that the Vendors entered into sham transactions with the knowledge that Charter intended to account for them improperly and that analysts would rely on inflated revenues and operating cash flow in making stock recommendations. However, plaintiff investors did not allege that the Vendors prepared or disseminated the fraudulent financial statements and press releases which Charter published to deceive analysts and investors.

Plaintiff investors alleged that the Vendors' actions violated section 10(b) of the Securities Exchange Act of 1934, the general antifraud statute, and Rule 10b-5, implemented by the Securities and Exchange Commission (SEC) to carry out the antifraud statute. Section 10(b) makes it unlawful, directly or indirectly, "[t]o use or employ, in connection with the purchase or sale of any security ... any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [Securities and Exchange Commission] may prescribe." Rule 10b-5 provides:

> It shall be unlawful for any person, directly or indirectly ... (a) [t]o employ any device, scheme, or artifice to defraud, (b) [t]o make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or (c) [t]o engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person in connection with the purchase or sale of any security.

The Eighth Circuit held that plaintiff investors' allegations did not state a section 10(b) securities fraud claim against the Vendors as primary violators. Much of the reasoning of the court relied upon the Supreme Court's decision in *Central Bank of Denver v. First Interstate Bank of Denver*.[6]

---

[1] No. 06-43.

[2] *In Re Charter Communications, Inc., Securities Litigation*, 443 F.3d 987 (8th Cir. 2006).

[3] 511 U.S. 164 (1994).

[4] 15 U.S.C. § 78j(b).

[5] 17 C.F.R. § 240.10b-5(a) and (c).

[6] 511 U.S. 164 (1994).

In *Central Bank* the Supreme Court held that section 10(b) does not allow investors to bring civil suits against those who have aided securities fraud. Instead, according to the Court, section 10(b) may be applied only to those who "use or employ ... any manipulative or deceptive device or contrivance...."

> As in earlier cases considering conduct prohibited by § 10(b), we again conclude that the statute prohibits only the making of a material misstatement (or omission) or the commission of a manipulative act.... The proscription does not include giving aid to a person who commits a manipulative or deceptive act.[7]
>
> Extending the 10b-5 cause of action to aiders and abettors no doubt makes the civil remedy more far-reaching, but it does not follow that the objectives of the statute are better served. Secondary liability for aiders and abettors exacts costs that may disserve the goals of fair dealing and efficiency in the securities markets.[8]

The Eighth Circuit stated in its decision that, because the focus of plaintiffs' section 10(b) and Rule 10b-5 claims was deception by Charter and that neither Motorola nor Scientific-Atlanta was alleged to have engaged in any deceptive act of the type engaged in by Charter, "the district court properly dismissed the claims against the Vendors as nothing more than claims, barred by *Central Bank*, that the Vendors knowingly aided and abetted the Charter defendants in deceiving the investor plaintiffs."[9]

> [W]e are aware of no case imposing § 10(b) or Rule 10b-5 liability on a business that entered into an arm's length non-securities transaction with an entity that then used the transaction to publish false and misleading statements to its investors and analysts. The point is significant. To impose liability for securities fraud on one party to an arm's length business transaction in goods or services other than securities because that party knew or should have known that the other party would use the transaction to mislead investors in its stock would introduce potentially far-reaching duties and uncertainties for those engaged in day-to-day business dealings. Decisions of this magnitude should be made by Congress.[10]

It should be noted that the *Central Bank* case stated that secondary actors are not always free from liability under the securities acts.

> The absence of § 10(b) aiding and abetting liability does not mean that secondary actors in the securities markets are always free from liability under the securities Acts. Any person or entity, including a lawyer, accountant, or bank, who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator under 10b-5 assuming *all* of the requirements for primary liability under Rule 10b-5 are met.[11]

The Supreme Court affirmed the Eighth Circuit decision. The Court stated that *Central Bank* had rejected aiding and abetting liability because aiding and abetting liability is not mentioned in section 10(b). Recognizing aiding and abetting liability, according to the Court, would allow

[7] *Id.* at 177.

[8] *Central Bank* at 188.

[9] *Charter Communications* at 992.

[10] *Id.* at 992-993.

[11] *Central Bank* at 191.

plaintiffs to avoid the 10(b) requirement that they show reliance on the aider or abettor's misstatements or deceptions. In *Stoneridge*,

> Respondents had no duty to disclose; and their deceptive acts were not communicated to the public. No member of the investing public had knowledge, either actual or presumed, of respondents' deceptive acts during the relevant times. Petitioner, as a result, cannot show reliance upon any of respondents' actions except in an indirect chain that we find too remote for liability.[12]

In response to plaintiffs' argument that Charter's released financial statement was to be expected from the secondary parties' deceptive acts and therefore was a kind of "scheme liability" engaged in by the secondary parties, the Court stated that the plaintiffs could not prove that they had relied on the deceptive acts of the secondary parties.

> In effect petitioner contends that in an efficient market investors rely not only upon the public statements relating to a security but also upon the transactions those statements reflect. Were 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 is no authority for this rule.[13]

Further, the Court stated that plaintiffs' argument conflicted with section 104 of the Private Securities Litigation Reform Act,[14] which was a response by Congress to *Central Bank*. This statute provides that aiding and abetting liability is authorized in actions brought by the SEC but not by private parties.

> Were we to adopt this [plaintiffs'] construction of § 10(b), it would revive in substance the implied cause of action against all aiders and abettors except those who committed no deceptive act in the process of facilitating the fraud; and we would undermine Congress' determination that this class of defendants should be pursued by the SEC and not by private litigants.[15]

On January 22, 2008, the Supreme Court declined without comment to hear an appeal by Enron investors suing major banks which had allegedly aided Enron to disguise its financial problems.[16] It is likely that the Court's refusal to grant certiorari in this case is based upon its holding in *Stoneridge*.

Author Contact Information

(name redacted)
Legislative Attorney
[redacted]@crs.loc.gov, 7-....

---

[12] *Stoneridge*, slip op. at 8.

[13] *Stoneridge*, slip op. at 9.

[14] 15 U.S.C. § 78t(e).

[15] *Stoneridge*, slip op. At 11-12.

[16] *Regents of the University of California v. Merrill Lynch*, No. 06-1341.

EveryCRSReport.com

The Congressional Research Service (CRS) is a federal legislative branch agency, housed inside the Library of Congress, charged with providing the United States Congress non-partisan advice on issues that may come before Congress.

EveryCRSReport.com republishes CRS reports that are available to all Congressional staff. The reports are not classified, and Members of Congress routinely make individual reports available to the public.

Prior to our republication, we redacted names, phone numbers and email addresses of analysts who produced the reports. We also added this page to the report. We have not intentionally made any other changes to any report published on EveryCRSReport.com.

CRS reports, as a work of the United States government, are not subject to copyright protection in the United States. Any CRS report may be reproduced and distributed in its entirety without permission from CRS. However, as a CRS report may include copyrighted images or material from a third party, you may need to obtain permission of the copyright holder if you wish to copy or otherwise use copyrighted material.

Information in a CRS report should not be relied upon for purposes other than public understanding of information that has been provided by CRS to members of Congress in connection with CRS' institutional role.

EveryCRSReport.com is not a government website and is not affiliated with CRS. We do not claim copyright on any CRS report we have republished.