# SEVENTH CIRCUIT, IN A CASE OF FIRST IMPRESSION UNDER *STONERIDGE*, HOLDS THAT EMPLOYEE WHO PARTICIPATED IN FRAUDULENT SCHEME BUT DID NOT PERSONALLY PREPARE OR DISSEMINATE FALSE FINANCIAL STATEMENTS IS SHIELDED FROM SECURITIES FRAUD LIABILITY

In *Pugh v. Tribune Company*, Nos. 06-3898 and 06-3909, 2008 WL 867739 (7th Cir. April 2, 2008), the United States Court of Appeals for the Seventh Circuit, applying *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, 128 S. Ct. 761 (2008) in a case of first impression, held that an employee who participated in a fraudulent scheme but did not participate in the preparation or dissemination of false financial statements or press releases was not liable for securities fraud. The Seventh Circuit's holding extends *Stoneridge*, which held that third parties could not be liable for an issuer's securities fraud, to protect not only independent entities that participate in a "scheme" but also employees of an issuer, as long as those employees did not themselves participate in the preparation of a published false statement and the issuer's investors are otherwise unaware of their involvement.

*Pugh* involved allegations that several employees of Newsday, a New York subsidiary of Tribune Company, had participated in a scheme to report falsely inflated circulation numbers for the newspapers *Newsday* and *Hoy*, thereby increasing the amount they were able to charge advertisers and inflating reported revenues. The scheme came to light when, in February 2004, advertisers in *Newsday* and *Hoy* sued Tribune, alleging a variety of fraudulent schemes to inflate reported circulation numbers. The schemes included bogus deliveries and wholesale dumping of newspapers, which were then falsely certified by Newsday employees and reported as paid circulation to the Audit Bureau of Circulation, an independent nonprofit monitoring organization. Internal and government investigations followed. Tribune ultimately recorded a $90 million charge to cover expected refunds to advertisers. Several Newsday and Tribune employees also pled guilty to fraud charges in connection with the scheme. Investors subsequently brought claims against Tribune and several individuals under sections 10(b) and 20(a) of the Securities Exchange Act, seeking to hold these parties responsible for, among other things, losses caused by the disclosure of overstated revenues attributable to the fraudulent circulation scheme. The district court, finding a variety of pleading deficiencies, dismissed each of plaintiffs' claims with prejudice.

The Seventh Circuit affirmed. Noteworthy here is plaintiffs' claim against Louis Sito, a Tribune employee and, in his role as the publisher of *Newsday* and *Hoy*, the alleged "mastermind" of the circulation fraud scheme. Applying *Stoneridge*, the circuit court rejected plaintiffs' theory that Sito — who had since pled guilty to criminal charges for certifying false circulation figures — was liable for securities fraud because it was "foreseeable" that the circulation fraud scheme would result in an overstatement of revenue on Tribune's financial statements. The Seventh Circuit found it dispositive that Sito had not personally participated in the preparation or dissemination of a false statement on which investors could have relied. As the Seventh Circuit noted:

> Sito may have forseen (or even intended) that the advertising scheme would result in improper revenue for *Newsday* or *Hoy*, which would eventually be reflected in Tribune's financial statements. But *Stoneridge* indicates that an indirect chain to the contents of false public statements is too remote to establish primary liability. Without allegations establishing the requisite proximate relation between the *Newsday* and *Hoy* advertiser fraud and the Tribune investors' harm, we cannot uphold the complaint.[1]

The circuit court went on to affirm the dismissal of claims against Tribune on the grounds that Sito's state of mind could not be imputed to the company under *respondeat superior* principles.

The Seventh Circuit's decision in *Pugh v. Tribune Company* suggests that lower courts are inclined to read *Stoneridge* broadly and dismiss claims against any third parties ─ regardless of their affiliation with an issuer ─ who are not alleged to have participated in preparing or disseminating false financial statements or other public statements.

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[1] *Pugh*, 2008 WL 867739, at *7 (7th Cir. April 2, 2008).