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Whither 'Stoneridge v. Scientific-Atlanta'? Early Results

In *Stoneridge Investment Partners LLC v. Scientific-Atlanta Inc.*,[1] the U.S. Supreme Court held that third parties who do nothing more than transact business with an issuer can not be liable to the issuer's investors under §10(b) of the Securities Exchange Act and Rule 10b-5 in the absence of any public statement or other conduct by those third parties on which the investors could have relied.

The Court's holding in *Stoneridge* seemed to put to rest the question of "scheme liability," that is, whether securities fraud liability could be predicated solely on a third party's participation in a fraudulent scheme, a question that a number of lower courts had answered in the affirmative. Since then, lower courts have applied *Stoneridge* broadly with mostly consistent results.

This article reviews some of those decisions and identifies emerging themes.

'Stoneridge v. Scientific-Atlanta'

In *Stoneridge*, Scientific-Atlanta Inc. and Motorola Inc., two vendors of Charter Communications Inc., allegedly participated in a scheme by which Charter deliberately paid an additional $20 for each set top cable box that it purchased. The vendors then paid the money back to Charter, enabling Charter falsely to record the vendors' payments as advertising revenue. The vendors allegedly agreed to help Charter conceal the true nature of the transactions by backdating sales contracts and falsifying documents, all for the purpose of convincing Charter's independent auditor that the transactions were real

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advertising purchases. Eventually, the scheme came to light, leading to criminal and civil fraud investigations and a restatement. The *Stoneridge* plaintiff, a Charter investor, later sued Scientific-Atlanta and Motorola alleging, among other things, that their conduct constituted a "device, scheme or artifice to defraud" in violation of §10(b) and Rule 10b-5(a) and (c).

The district court dismissed the claims against Scientific-Atlanta and Motorola, holding that the vendors—not having made a misstatement or omission on which plaintiff could rely—could be liable only as aiders and abettors, a cause of action rejected by the Supreme Court in *Central Bank of Denver*.[2] The U.S. Court of Appeals for the Eighth Circuit affirmed[3] and the Supreme Court granted plaintiff's certiorari petition.[4]

The issue before the Court was whether third parties could be liable to Charter's investors solely because they participated in a "scheme" to commit securities law violations.

The Supreme Court held that these third parties were not liable to Charter's investors. The Court explained that "[r]eliance by the plaintiff upon the defendant's deceptive acts is an essential element of the §10(b) private cause of action" and held that the third-party vendors "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."[5]

In the wake of this ruling, commentators questioned whether the Court's holding was limited to claims against commercial parties like the vendors in *Stoneridge*.[6] Some support for this interpretation exists in the *Stoneridge* decision, in particular the Court's observation that:

> [u]nconventional as the arrangement [between the vendors and Charter Communications] was, *it took place in the marketplace for goods and services, not in the investment sphere*. Charter was free to do as it chose in preparing its books, conferring with its auditor, and preparing and then issuing its financial statements. *In these circumstances* the investors cannot be said to have relied upon any of respondents' deceptive acts in the decision to purchase or sell securities.[7]

'Scheme Liability' Valid Claim?

The Court's comment suggests an effort to differentiate between the third-party vendors in *Stoneridge*—those who act in the "marketplace for goods and services"—and those who act in the "investment sphere," such as lawyers, accountants, and investment bankers. This, in turn, led some to wonder whether "scheme liability" could still be a valid claim against financial and legal professionals. Almost as soon as the question was asked, it was answered by the Supreme Court itself when, one week after *Stoneridge* came down, the Court denied the certiorari petition of plaintiffs in the

Enron[8] class-action securities litigation, who had argued that *Stoneridge* did not extend to financial professionals accused of facilitating securities fraud.

With the Supreme Court's ruling in *Stoneridge* and its denial of certiorari in the *Enron* class action, the stage has been set for a sweeping rejection of scheme liability in the lower courts. And, as illustrated below, lower courts have so far taken a broad view of *Stoneridge*.

'Pugh v. Tribune Co.'

So far, the most significant lower-court ruling applying *Stoneridge* has been the Seventh Circuit's decision in *Pugh v. Tribune Co.*.[9] *Pugh* involved allegations that several employees of Newsday, a New York subsidiary of Tribune Co., 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 pleaded guilty to fraud charges in connection with the scheme. Investors subsequently brought claims against Tribune and several individuals under §§10(b) and 20(a) of the Securities Exchange Act, seeking to hold them 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 Mr. Sito—who had since pleaded 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 Mr. 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:

> [Mr.] Sito may have foreseen (or even intended) that the advertising scheme would result in improper revenue for Newsday and Hoy, which would eventually be reflected in Tribune's revenues and finally published in its 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.[10]

'Pugh' and 'In re DVI' suggest that lower courts are inclined to read 'Stoneridge' broadly and dismiss claims against third parties, regardless of their affiliation, who are not alleged to have prepared… false financial statements or other public statements.

The Seventh Circuit's holding in *Pugh* extended *Stoneridge* to protect not only commercial entities that participate in a scheme but also employees of an issuer, as long as those employees do not themselves participate in the preparation of a published false statement and the issuer's investors are otherwise unaware of their involvement.

Additional Courts

Other federal courts that have considered *Stoneridge* in securities fraud claims against corporate employees have reached similar conclusions. In *Katz v. Image Innovations Holdings Inc.*,[11] for example, Judge John G. Koeltl of the U.S. District Court for the Southern District of New York dismissed 10b-5 claims against corporate employees that merely alleged that the employees were liable as participants in a fraudulent scheme but noted that "*Stoneridge* does not require dismissal" of claims against defendants "alleged to have signed the allegedly fraudulent financial statements."[12] Similarly, in *In re National Century Financial Enterprises Inc. Financial Investment Litigation*,[13] the district court dismissed claims against employees where "[t]he complaints identify 17 misleading press releases and six misleading SEC filings issued by e-MedSoft, but none of the moving Defendants are alleged to have authored, reviewed, approved, assisted with, or given direction to any of the releases or filings."[14] And in *In re Dura Pharmaceuticals Inc. Securities Litigation*,[15] the district court, following *Stoneridge*, dismissed securities fraud claims against an employee who "did not make any of the statements in the press releases or to analysts."[16]

One question that the cases cited above do not squarely address is whether, under *Stoneridge*, an employee or other corporate insider (which in certain contexts can include third parties such as outside counsel) who participates in preparing an alleged false statement, but who is not identified as a speaker and whose participation is thus unknown to investors, can be liable for securities fraud. On the one hand, a corporate insider who participates in the preparation of an alleged false statement, unlike the third-party vendors in *Stoneridge*, arguably has a duty to disclose the truth to the company's investors. On the other hand, to the extent that the insider's participation in a fraud is unknown to investors, it can be argued that, like the third-party vendors in *Stoneridge*, investors have not relied on the insider's deceptive acts. The cases discussed below look at this question in a little more depth.

'In Re DVI Securities'

In *In Re DVI Inc. Securities Litigation*,[17] the question of whether outside counsel's participation in drafting an allegedly false public statement is sufficient to trigger securities fraud liability in the wake of *Stoneridge* was answered, unequivocally, no. DVI was a medical equipment finance company that financed medical providers by providing credit secured by health care receivables. DVI's business deteriorated and it was ultimately liquidated in bankruptcy proceedings. Eventually, it was determined that the price of DVI's securities had been artificially inflated through a variety of schemes, including concealed cash shortages, double pledged collateral, pledged ineligible collateral, and a refusal to report impaired assets and loans. Plaintiff investors brought

securities fraud claims against the company's officers, directors, and others, including the law firm Clifford Chance, which had acted as DVI's lead corporate counsel. As to Clifford Chance, plaintiffs principally alleged that the law firm, with full knowledge of the truth of DVI's dire condition, had "directed" and "coordinated" the publication of false financial reports. After some initial procedural wrangling, plaintiffs moved to certify the plaintiff class and Clifford Chance opposed the motion, arguing that plaintiffs could not rely on either the fraud-on-the-market presumption or the existence of a duty to disclose to establish reliance on the law firm's alleged deceptive conduct.

The district court agreed. Relying "in large part" on the *Stoneridge* decision, the district court considered Clifford Chance to be analogous to the third-party vendors at issue in *Stoneridge* who made no public statements on which investors relied. Consequently, the *DVI* court held that there could be neither a fraud-on-the-market presumption of reliance nor a duty to disclose as to Clifford Chance because the law firm, like the *Stoneridge* vendors, had made no public statements.[18]

As to the plaintiffs' contention that Clifford Chance had "directed" and "coordinated" false disclosures, the *DVI* court found it dispositive that "the misleading 10-Q was issued solely by DVI and contains no indication that any statement therein is attributable to Clifford Chance" and that "none of [Clifford Chance's] alleged conduct was [publicly] disclosed such that it affected the market for DVI's securities."[19] The district court's opinion did not address whether, separate and apart from the fact that none of the alleged misleading statements had been publicly attributed to Clifford Chance, the law firm could be under an independent duty to disclose the truth to DVI's investors based on its alleged role in drafting the statements.

The district court in *Lopes v. Vieira*[20] reached a different conclusion on analogous, if somewhat atypical, facts. Plaintiffs were, among other things, investors in Valley Gold LLC, whose main asset was to be a cheese manufacturing company that was allegedly created for the sole purpose of assisting its promoter, George Vieira, in a massive fraud. After the scheme unraveled and Mr. Vieira's scheme came to light, plaintiffs sued, among others, the law firm of Downey Brand, which had drafted the offering memorandum for Valley Gold. Plaintiffs essentially alleged that the firm knew that Mr. Vieira was under criminal investigation for a similar scheme while it was drafting the offering memorandum for Valley Gold but failed to disclose this fact to the investors. Downey Brand moved to dismiss the securities fraud claims on the basis that none of the alleged false statements in the offering memorandum were publicly attributed to the firm. Although it acknowledged the *Stoneridge* decision, the district court seemed to distinguish the case on its facts, noting that *Stoneridge* involved a corporation's "vendors and suppliers, who are secondary actors or aiders and abettors" whereas Downey Brand's role as the drafter of the offering memorandum implied the existence of a duty to disclose.[21] In reaching this conclusion, the district court relied heavily on the Ninth Circuit's decision in *In re Software Toolworks Inc. Securities Litigation*,[22] where the appellate court held that an accounting firm could be liable for securities fraud based on false statements contained in two letters submitted by its client to the SEC, even though the accounting firm did not sign or issue the letters, because the firm had "played a significant role in drafting and editing" the letters.[23]

Conclusion

The *Pugh v. Tribune* and *In re DVI Inc. Securities Litigation* decisions suggest 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.

One interesting question not yet resolved by the lower courts is the degree to which a third party's active participation in drafting or preparing false statements that are then communicated to investors gives rise to a duty to disclose and whether the existence of such a duty, under *Stoneridge*, trumps the fact that the false statements were not publicly attributable to the third party. The court in *In re DVI Inc. Securities Litigation* answered this question in the negative but that likely is not the last word on this subject.

1. 128 S.Ct. 761 (2008).
2. See *In re Charter Communications Inc., Sec. Litig.*, No. 4:02-CV-1186 CAS, 2004 WL 3826761, at *5-8 (E.D. Mo. Oct. 12, 2004) (citing *Cent. Bank of Denver v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994)).
3. See *In re Charter Communications Inc., Sec. Litig.*, 443 F.3d 987 (8th Cir. 2006).
4. See Supreme Court of the United States Docket, http://www.supremecourtus.gov/docket/06-43.htm.
5. *Stoneridge*, 128 S. Ct. at 769.
6. See Douglas McCollam, "Stoneridge Ruling Shields Third-Party Advisers," BUSINESSWEEK, Jan. 15, 2008, at http://www.businessweek.com/investor/content/jan2008/pi20080115_844276.htm?chan=top+news_top+news+index_investing; "Is Stoneridge the Death Knell for Scheme Liability?," SECURITIES LAW 360, Jan. 17, 2008, at http://securities.law360.com/secure/ViewArticle.aspx?Id=44442; "Stoneridge: What Does it Mean?" SECURITIES LAW 360, Jan. 16, 2008, at http://securities.law360.com/Secure/ViewArticle.aspx?id=44416.
7. 128 S.Ct. at 774 (emphasis added).
8. See *Regents of the Univ. of Cal. v. Credit Suisse First Boston (USA) Inc.*, 482 F.3d 372 (5th Cir. 2007). Certiorari was denied on Jan. 22, 2008. See Supreme Court of the United States Docket, http://www.supremecourtus. gov/docket/06-1341.htm.
9. 521 F.3d 686 (7th Cir. 2008).
10. *Pugh*, 521 F.3d at 697.
11. 542 F.Supp.2d 269 (S.D.N.Y. 2008).
12. 542. F.Supp.2d 269, 273.
13. No. 2:03-md-1565, 2008 WL 918708 (S.D. Ohio April 2, 2008).
14. *Nat'l Century*, 2008 WL 918708, at *5.
15. No. 99CV0151 JLS (WMc), 2008 WL 483613 (S.D. Cal. Feb. 20, 2008).
16. *Dura Pharm.*, 2008 WL 483613, at *11.
17. No. 2:03-CV-05336-LDD, 2008 WL 1900384 (E.D. Pa. April 29, 2008).
18. *In re DVI*, 2008 WL 1900384, at *21.
19. Id. at *21, n.39.
20. 543. F.Supp.2d 1149 (E.D. Cal. 2008).
21. 543 F.Supp.2d 1149, 1178 (citing *Stoneridge*, 128 S.Ct. 761).
22. 50 F.3d 615 (9th Cir. 1994). The Ninth Circuit in *Software Toolworks* distinguished the Supreme Court's *Central Bank* decision on the grounds that the accounting firm had been involved in an "extensive review" of allegedly false letters prior to their submission to the SEC and had played a significant role in drafting and editing one of the letters, and that two partners at the firm had been identified to the SEC as a source of "further information." The court found these allegations, among others, to be sufficient to "sustain a primary cause of action under §10(b)." *Software Toolworks*, 50 F.3d at 628, n.3.
23. 543 F.Supp.2d 1149, 1176 (citing *Software Toolworks*, 50 F.3d at 628, n.3).

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