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Supreme Court Rejects “Scheme” Liability Under Section 10(b)

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Supreme Court Rejects “Scheme” Liability Under Section 10(b)

In *Stoneridge Investment Partners LLC v. Scientific-Atlanta Inc.*, No. 06-43, 552 U.S. ____ (January 15, 2008), the Supreme Court today ruled that secondary actors cannot be liable to private plaintiffs under the federal securities laws for statements made by others. What the Court said about so-called “scheme” liability should come as welcome news to Wall Street and those suppliers, business partners, accountants, banks, lawyers, and others who conduct business with and work for public companies that are sued by shareholders.

In *Stoneridge*, a case on review from the U.S. Court of Appeals for the Eighth Circuit, the plaintiff investors sued Charter Communications, Inc. for violations of Section 10(b) of the Securities Exchange Act of 1934, the securities regulation most frequently invoked by private litigants. The plaintiffs also sued secondary actors — certain suppliers of Charter, including, among others, Scientific-Atlanta and Motorola. The plaintiffs claimed that the suppliers engaged in a scheme with Charter to defraud Charter’s shareholders. The complaint alleged that Charter entered into unlawful agreements with the suppliers whereby Charter overpaid for “set top” boxes and other hardware. In exchange for this overpayment, the suppliers agreed to purchase advertising from Charter. Charter then recorded the advertising purchases as revenue, artificially inflating the total revenue that Charter reported to the market.

Charter’s shareholders sued Charter’s suppliers even though the suppliers were not alleged to have had any part in the preparation of the financial reports that Charter disseminated to the market. The Eighth Circuit ruled for the suppliers.

The Supreme Court affirmed the Eighth Circuit’s judgment for the suppliers and resolved a Circuit-split in holding that “scheme” claims are not viable. The Court set forth a basic framework for Section 10(b) liability: a person cannot be liable under Section 10(b) unless (1) the person had an affirmative duty to disclose information that they failed to disclose or (2) the person’s deceptive conduct or statement is disseminated to the market. The Court held that the suppliers had no affirmative duty to disclose anything to Charter’s shareholders, and also held that the suppliers’ alleged conduct, although potentially deceptive, was “too attenuated” to give rise to liability because investors did not know about the suppliers’ conduct.

The Court explained that “deceptive acts,” by secondary actors, “which are not disclosed to the investing public, are too remote to satisfy the requirements of reliance,” a key element of a private plaintiff’s Section 10(b) claim. It was Charter, not the suppliers, who “filed fraudulent financial statements,” and nothing that the suppliers did “made it necessary or inevitable for Charter to record the transactions that it did.” The Court concluded that the suppliers could not be liable for securities fraud because “no member of the investing public had knowledge, either actual or presumed, of [the suppliers’] deceptive acts during the relevant times.” As the plaintiffs did not know about the suppliers’ alleged wrongdoing, they could not show that they relied upon it or that the suppliers’ conduct caused their alleged harm.

In deciding not to expand private plaintiffs’ ability to bring suit, the Court explained that Section 10(b) private rights of action were judicially, not legislatively, created. Further, the Court noted that the Private Securities Litigation Reform Act of 1995 specifically bestowed powers on the SEC to prosecute secondary actors for their roles in securities fraud. If Congress had intended a private right of action for scheme liability, the Court reasoned, Congress would have explicitly done so when enacting the Reform Act. Finally, the Court expressed concern that an extension of the scheme liability theory would allow plaintiffs with weak claims to

“extort settlements from innocent companies.”

Stoneridge marks another clear step in the direction of limiting securities fraud claims against secondary actors by limiting the reach of Section 10(b) and its use by private litigants to pull more types of defendants (i.e., deep pockets) into securities litigation. *Stoneridge* does not affect or limit the government’s ability to enforce the federal securities laws against secondary actors.

Justice Kennedy wrote the opinion of the Court and was joined by Chief Justice Roberts and Justices Scalia, Thomas, and Alito. Justice Stevens filed a dissent in which Justices Souter and Ginsburg joined. The dissent contended that liability should be imposed where secondary actors’ deceptive conduct has a foreseeable effect on a company’s stock price. The dissent characterized the Court’s ruling as part of a “continuing campaign to render the private cause of action under § 10(b) toothless.” Justice Breyer did not participate in the case or decision.

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