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Online Feature

May 27, 2008

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# The SEC's Role in Pursuing Secondary Actors Following 'Stoneridge'

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SPECIAL TO LAW.COM

MAY 27, 2008

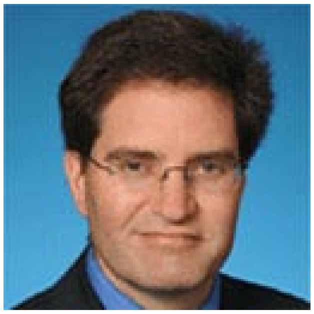
As all securities practitioners are well aware, on Jan. 15, 2008, the United States Supreme Court issued its decision in *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, affirming the 8th U.S. Circuit Court of Appeals and holding that shareholders could not maintain a securities fraud action against third-party suppliers for engaging in sham transactions designed to help a public company inflate its reported revenue.[FOOTNOTE 1]

Although *Stoneridge* may mark the end of private securities claims alleging "scheme liability" against secondary actors under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5, the decision has cast a spotlight back on the Securities and Exchange Commission, which remains authorized to pursue accountants, bankers, attorneys and other secondary actors, such as third-party lenders, as aiders and abettors of primary securities law violators. Public remarks by SEC enforcement officials acknowledge the greater burden on the SEC following Stoneridge to police misconduct by aiders and abettors. The SEC's task will not be without challenge, however, given the unsettled standard across the circuits regarding the degree of scienter required for an SEC aiding and abetting claim.

## BACKGROUND TO 'STONERIDGE'

### *Exchange Act Section 10(b)*

Section 10(b) makes it unlawful "[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 Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors." The SEC implemented Section 10(b) by promulgating Rule 10b-5, which, among other prohibitions, proscribes "any device, scheme, or artifice to defraud." Although Congress did not expressly permit a private cause of action under Section 10(b), the Supreme Court implied one. [FOOTNOTE 2] In a Section 10(b) private cause of action, the plaintiff must prove (1) a material misrepresentation or omission by the defendant; (2) scienter, that is, an intent to defraud; (3) a connection between the misrepresentation and or omission and the purchase or sale of securities; (4) reliance on the misrepresentation or omission; (5) economic loss; and (6) loss causation. [FOOTNOTE 3]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### *The Supreme Court's Holding in 'Central Bank' and the PSLRA*

Over a decade ago, in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, the Supreme Court held that Section 10(b) liability did not extend to aiders and abettors.[FOOTNOTE 4] *Central Bank* led Congress to enact Section 104 of the Private Securities Litigation Reform Act ("PSLRA"), which created an express cause of action for aiding and abetting liability under Section 10(b). The provision, however, authorized only the SEC to pursue such a claim. Private plaintiffs must, therefore, show that an aider or abettor has met each of the preconditions for primary Section 10(b) liability, including reliance.

Over the next decade, litigation involving secondary actors resulted in a split among the circuits. Some courts held that claims against secondary actors were no more than disguised aiding and abetting claims if no specific false and misleading statement by a secondary actor could be alleged, while other courts held that, in the language of Rule 10b-5, participation in a fraudulent "scheme" could form the basis of liability if its purpose was to create a false appearance, whether or not such participation included an actionable false or misleading statement.[FOOTNOTE 5]

## THE LONG-ANTICIPATED 'STONERIDGE' Decision

*Stoneridge* involved Section 10(b) claims brought by shareholders against two of Charter Communications, Inc.'s ("Charter") equipment suppliers.[FOOTNOTE 6] Charter is a cable television operator. The shareholders alleged that the third party suppliers participated in wash transactions with Charter in which Charter arranged to overpay the third party suppliers $20 for each digital cable converter box it purchased with the understanding that the third party suppliers would return the overpayments by purchasing advertising from Charter -- transactions the shareholders alleged had no economic substance.[FOOTNOTE 7] The plaintiffs claimed that Charter then recorded the advertising purchases as revenue and capitalized its purchases of the boxes in violation of Generally Accepted Accounting Principles, which allegedly enabled Charter to meet Wall Street's projected revenue and cash flow expectations.[FOOTNOTE 8] Charter and its third party suppliers also purportedly falsified documents by backdating them to make it appear to Charter's auditors that the two transactions were unrelated.[FOOTNOTE 9]

The shareholders alleged that the suppliers knew or recklessly disregarded Charter's scheme to report revenue from the sham transactions in its financial statements and knew that the financial statements Charter issued would be relied upon by research analysts and investors.[FOOTNOTE 10] The shareholders did not allege that the suppliers had any role in preparing or disseminating Charter's financial statements or that the suppliers' own financial statements failed to properly record the transactions.[FOOTNOTE 11]

Affirming the 8th Circuit's decision, the Supreme Court held that the Section 10(b) claims against the third party suppliers were properly dismissed. The Court focused on the essential element of reliance, which requires that the "requisite causal connection between a defendant's misrepresentations and a plaintiff's injury" must exist.[FOOTNOTE 12]

Before rejecting so-called "scheme liability" against the third-party suppliers, the Supreme Court first declined to apply the two rebuttable presumptions of reliance that can arise in securities fraud actions. First, if there exists a duty to disclose to an investor, the investor need not demonstrate actual reliance.[FOOTNOTE 13] Second, reliance is presumed under the fraud-on-the-market theory, which holds that when a deceptive statement becomes public, the information is reflected in the market price of the securities of the company involved. It can therefore be assumed that an investor relied upon the statement in buying or selling the company's stock at market price. In Stoneridge, however, the third party suppliers had no duty to disclose the sham transactions to Charter's investors, and the deceptive scheme was never communicated to the public.[FOOTNOTE 14]

The Supreme Court next addressed and declined to permit the shareholders to pursue their claims under the "scheme liability" theory. The shareholders alleged that the suppliers "engaged in conduct with the purpose and effect of creating a false appearance of material fact to further a scheme to misrepresent Charter's revenue."[FOOTNOTE 15] The shareholders argued that financial statements Charter released to the public were an inevitable consequence of the suppliers' deceptive acts and had the suppliers not engaged in such conduct, Charter's auditors would not have been misled and Charter's financial statements would have accurately reflected the company's financial condition.[FOOTNOTE 16] The Supreme Court concluded, however, that the deceptive transactions were "too remote to satisfy the requirement of reliance."[FOOTNOTE 17] It was Charter -- not its third party suppliers -- that misled its auditors and shareholders.

The Supreme Court further held that the shareholders' scheme liability theory would essentially eviscerate the PSLRA in which Congress authorized only the SEC to bring claims against aiders and abettors.[FOOTNOTE 18] The Court reasoned that the shareholders' argument for the suppliers' primary liability under Section 10(b) would make any secondary actor liable if he or she committed a deceptive act in the process of providing assistance to the primary violator, improperly resuscitating the implied cause of action against aiders and abettors that *Central Bank* and Congress determined could only be brought by the SEC, not private litigants.[FOOTNOTE 19]

## THE SEC'S HEIGHTENED ROLE AGAINST AIDERS AND ABETTORS

Although it dismissed the shareholders' private securities fraud claims against the alleged aiding and abetting third party equipment suppliers, the *Stoneridge* Court noted that secondary actors are still subject to criminal actions by the Department of Justice, and civil enforcement actions by the SEC.[FOOTNOTE 20] Indeed, the Supreme Court remarked that the SEC's "enforcement power is not toothless,"[FOOTNOTE 21] citing statistics that since September 30, 2002, SEC enforcement actions have raked in over $10 billion in disgorgement funds and monetary penalties.[FOOTNOTE 22] Around the same time, Mark Schonfeld, the SEC's New York Regional Director, remarked that "[t]he inability of the private bar to bring actions" against third parties "could put more of an onus on the SEC to bring those cases."[FOOTNOTE 23]

## THE VARYING AIDING AND ABETTING SCIENTER STANDARD

The scienter or state-of-mind standard the SEC must meet to sustain aiding and abetting claims differs depending on the jurisdiction involved. In administrative actions, the SEC has held that recklessness is sufficient for aiding and abetting liability.[FOOTNOTE 24] The scienter standard has not been interpreted uniformly or clearly in the courts, however, with some courts requiring the SEC to meet a more stringent standard than recklessness.

The 9th and 10th circuits have held that recklessness is enough for SEC aiding and abetting liability.[FOOTNOTE 25] While the D.C. Circuit has held that recklessness may suffice in SEC aiding and abetting actions, a 2004 D.C. Circuit decision suggests that the SEC should be held to a higher standard of "extreme" or "severe" recklessness.[FOOTNOTE 26] Extreme or severe reckless conduct may be found where the alleged aider and abettor encountered "'red flags'" or "'suspicious events creating reasons for doubt that should have alerted him to the improper conduct of the primary violator,'"[FOOTNOTE 27] or "'a danger ... so obvious that the actor must have been aware of'" it.[FOOTNOTE 28]

At least two district courts in the 2nd Circuit have taken it to an even higher level, requiring that the SEC prove "knowing misconduct" for aiding and abetting liability to be imposed. In *SEC v. Cedric Kushner Promotions*,[FOOTNOTE 29] the parties disputed the degree of scienter required for aiding and abetting liability under Section 10(b) and Rule 10b-5 with respect to one defendant who was treasurer, principal financial and accounting officer and a director of the defendant company.[FOOTNOTE 30] The SEC argued that as a director, the alleged aider and abettor owed a fiduciary duty to the company and its shareholders and, therefore, recklessness was sufficient.[FOOTNOTE 31] The court rejected the SEC's argument, holding that "recklessness, even for fiduciaries, is no longer sufficient for the imposition of aiding and abetting liability" and that "knowing misconduct must now be shown." The court relied on language in Section 20(e) of the Exchange Act, the provision authorizing the SEC to pursue enforcement actions for aiding and abetting liability, which imposes such liability only for the "knowing" provision of substantial assistance to a primary violator.[FOOTNOTE 32]

The same standard was found to apply in SEC v. KPMG LLP.[FOOTNOTE 33] Rejecting the SEC's contention that Section 20(e) encompassed recklessness, the district court relied on another PSLRA Exchange Act provision expressly defining the term "knowingly" as requiring actual knowledge.[FOOTNOTE 34] It also reviewed Section 20(e)'s legislative history, and noted that a proposed amendment that would have added recklessness to the SEC's aiding and abetting standard was rejected by the Senate: "The Bryan Amendment was voted down, and the floor debate over the language of the amendment bolsters defendants' contention that Congress intended to allow the SEC to bring aiding and abetting actions only against violators with actual knowledge."[FOOTNOTE 35]

The 7th Circuit has raised the circuit differences in the aiding and abetting scienter standard without deciding the issue.[FOOTNOTE 36]

## CONCLUSION

As the Supreme Court put it in Central Bank, the "rules for determining aiding and abetting liability are unclear, in an 'area that demands certainty and predictability.'"[FOOTNOTE 37] That certainly remains true regarding the scienter element for SEC aiding and abetting claims given the varying scienter standard across jurisdictions. Until greater clarity or uniformity is legislatively or judicially provided, the SEC's burden in sustaining aiding and abetting claims may depend on the forum in which it decides to pursue those claims.

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:::::FOOTNOTES:::::

FN1 128 S. Ct. 761 (U.S. 2008).

FN2 See Superintendent of Ins. of N.Y. v. Bankers Life & Cas. Co., 404 U.S. 6, 13 n. 9 (1971).

FN3 See Dura Pharm., Inc. v. Broudo, 544 U.S. 336, 341-42 (2005).

FN4 511 U.S. 164 (1994).

FN5 See Simpson v. AOL Time Warner Inc., 452 F.3d 1040 (9th Cir. 2006); Regents of Univ. of Cal. v. Credit Suisse First Boston (USA) Inc., 482 F.3d 372 (5th Cir. 2007).

FN6 128 S. Ct.. at 766.

FN7 See id.

FN8 See id.

FN9 See id. at 767.

FN10 See id.

FN11 See id.

FN12 Id. at 769 (citations omitted).

FN13 See id.

FN14 See id.

FN15 Id. at 770.

FN16 See id.

FN17 Id.

FN18 Id. at 771 (citing 15 U.S.C. § 78(t)(e)).

FN19 See id.

FN20 See id. at 773 (citing 15 U.S.C. §§ 78ff and 78t(e)).

FN21 Id. at 773.

FN22 See id. (citing SEC, 2007 Performance and Accountability Report, at 26).

FN23 Stephen Joyce, Stoneridge Case May Put Scrutiny 'Onus' on SEC to Boost Its Enforcement Actions, 6 Corporate Accountability Report, BNA, No. 6, at 132 (2008).

FN24 In the Matter of Flynn, SEC Initial Decision Release No. 316 (August 2, 2006) (citing Sharon M. Graham, 53 S.E.C. 1072, 1080-85 & n.33 (1998)); Russo Sec., Inc. 53 S.E.C. 271, 278-79 & n.16 (1997)).

FN25 See, e.g., Ponce v. SEC, 345 F.3d 733, 737 (9th Cir. 2003); Geman v. SEC, 334 F.3d 1183, 1195 (10th Cir. 2003).

FN26 Howard v. SEC, 376 F.3d 1136, 1143 (D.C. Cir. 2004).

FN27 Id. (citations omitted).

FN28 Id. (quotations omitted).

FN29 417 F. Supp. 2d 326 (S.D.N.Y. 2006).

FN30 Id. at 327.

FN31 Id at 334.

FN32 Id.

FN33 412 F. Supp. 2d 349 (S.D.N.Y. 2006).

FN34 Id. at 382-83 ("[T]he fact that the [sic.] 'knowingly' was defined as actual knowledge in the very same bill that contained Section 20(e) weighs in favor of the defendants' contention that the provision does not encompass recklessness.").

FN35 Id. at 383.

FN36 See Monetta Fin. Services, Inc. v. Bacarella, 390 F.3d 952, 956-57 (7th Cir. 2004) (vacating portion of SEC's order finding aiding and abetting liability because even if a reckless standard applied, the court found it had not been met).

FN37 511 U.S. at 188 (quoting Pinter v. Dahl, 486 U.S. 622, 652 (1988)).