

LAW UPSIDE DOWN: A CRITICAL ESSAY ON *STONERIDGE INVESTMENT PARTNERS, LLC v.* *SCIENTIFIC-ATLANTA, INC.*

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INTRODUCTION

*Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*¹ is one of the most contentious securities law decisions handed down by the United States Supreme Court in recent years.² At issue in the case was the scope of liability created by § 10(b) of the Securities Exchange Act of 1934 and by Rule 10b-5, promulgated pursuant to that section.³ Specifically, the Court considered whether parties beyond the corporation issuing a false financial report could be held liable to private plaintiffs for their fraudulent acts in violation of these provisions.⁴ The defendants in the *Stoneridge* case were (in a somewhat unusual set of facts) third-party vendors of the corporation issuing the false statement,⁵ but everyone understood that the Supreme Court's decision would impact accountants, lawyers, investment bankers, and the like, who have been involved in transactions resulting in fraudulent financial reporting. As a result of the decision's anticipated impact, the Supreme Court was inundated with amicus briefs.⁶ Given the current leaning of the Supreme Court, victory for the defendants in *Stoneridge* was proba-

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¹ 128 S. Ct. 761 (2008) (link).

² See, e.g., Robert A. Prentice, *Stoneridge, Securities Fraud Litigation, and the Supreme Court*, 45 AM. BUS. L.J. 611 (2008) (criticizing the decision) (link); Stuart Sinai, *Stoneridge—Escape from Securities Liability Notwithstanding Active, Intentional, Deceptive Conduct*, 8 J. BUS. & SEC. L. 170 (2008) (same).

³ *Stoneridge*, 128 S. Ct. at 766. See 15 U.S.C. § 78j(b) (2006) (link); 17 C.F.R. § 240.10b-5 (2007) (link).

⁴ *Stoneridge*, 128 S. Ct. at 767, 773–74.

⁵ *Id.* at 766–67.

⁶ See, e.g., Brief of Ohio, Texas, and 30 Other States and Commonwealths as Amici Curiae in Support of Petitioner, *Stoneridge* (No. 06-43), 2007 WL 1957413; Brief of the New York State Teachers' Retirement System, the Retirement Systems of Alabama, the Sacramento County Employees' Retirement System, and the Government of Guam Retirement Fund as Amici Curiae in Support of Petitioner, *Stoneridge* (No. 06-43), 2007 WL 1701935; Brief for Former SEC Commissioners and Officials and Law and Finance Professors as Amici Curiae Supporting Respondents, *Stoneridge* (No. 06-43), 2007 WL 2329638; Brief of the Chamber of Commerce of the United States of America as Amicus Curiae in Support of Respondents, *Stoneridge* (No. 06-43), 2007 WL 2363260. Links to all briefs filed in the case are available at http://www.scotuswiki.com/index.php?title=Stoneridge_v._Scientific-Atlanta (link).

bly predictable. Nevertheless, the decision is worth academic discussion because it illustrates how utterly irrational the law governing private securities fraud actions has become.⁷

I. THE CASE

Before undertaking a policy critique of the *Stoneridge* opinion, it is useful to take a brief look at the facts of the case and the Court's decision.

A. *The Complaint*

Several years ago, a cable operator, Charter Communications, Inc., was having trouble meeting earnings expectations.⁸ According to the plaintiffs in *Stoneridge*, Charter's management decided to make up for its underperformance through a time-honored technique—lying.⁹ More specifically, the plaintiffs alleged that Charter's corporate officers decided to pretend that Charter was taking in more advertising revenue than it actually was.¹⁰ There was just one little problem: Charter, as a public company, is required to have audited financial statements, and auditors are on the lookout for things like imaginary revenue numbers. This concern, in turn, led Charter's management to engage in a more elaborate scheme. Purportedly, Charter's management made an agreement with Scientific-Atlanta and Motorola (two companies from which Charter purchased digital cable converter boxes). The two vendors agreed to place ads with Charter, while Charter's managers agreed to pay inflated prices on the cable boxes Charter ordered from them, so that the advertising purchased by Scientific-Atlanta and Motorola would, in fact, be free.¹¹ In order to hide the swap, and thereby allow Charter to claim revenue from selling the ads, Scientific-Atlanta and Motorola allegedly backdated documents and misrepresented the facts as to the cable box sales.¹²

B. *The Decision*

Given that the plaintiffs alleged that Scientific-Atlanta and Motorola made misrepresentations with knowledge of their falsity, and that such mi-

⁷ Even before *Stoneridge*, commentators with otherwise diverse perspectives had come to question whether the securities fraud class action served much social utility. See, e.g., John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation*, 106 COLUM. L. REV. 1534, 1536–37 (2006) (suggesting that recovery against the corporation serves no purpose) (link); Stephen J. Choi, *The Evidence on Securities Class Actions*, 57 VAND. L. REV. 1465, 1466 (2004) (arguing that securities fraud class actions are often meritless) (link).

⁸ *Stoneridge*, 128 S. Ct. at 766.

⁹ *Id.*

¹⁰ *Id.*

¹¹ *Id.* at 766–67.

¹² *Id.* at 767.

srepresentations would form the basis for false earnings reports issued by Charter,¹³ it would seem easy enough at first glance to find that the defendants' conduct fell within Rule 10b-5's prohibition on fraud and false or misleading statements in connection with the purchase or sale of securities. The case reached the Supreme Court, however, because of the Court's earlier decision in *Central Bank of Denver v. First Interstate Bank of Denver*.¹⁴ In *Central Bank*, the Supreme Court held that persons cannot be held liable in a private action under Rule 10b-5 for aiding and abetting another person's fraud.¹⁵ Scientific-Atlanta and Motorola argued that the allegations against them essentially amounted to aiding and abetting Charter's fraud, thereby bringing *Central Bank* into play.¹⁶ The problem for Scientific-Atlanta and Motorola, however, was that the Supreme Court had placed a seemingly significant caveat on its decision in *Central Bank*. The Court specifically stated that, while there could be no private Rule 10b-5 action based solely on aiding and abetting, parties who themselves engaged in fraudulent conduct upon which investors relied would not simply be aiding and abetting. Hence, such parties could be liable in a private Rule 10b-5 action.¹⁷ It was this seemingly straightforward exception that the plaintiffs sought to invoke in *Stoneridge*.¹⁸

While implicitly recognizing that, unlike the defendant in *Central Bank*, Scientific-Atlanta and Motorola had allegedly engaged in misrepresentation, the majority in *Stoneridge* still found no basis for liability.¹⁹ According to the majority, this was because the plaintiffs had not relied on the vendors' misrepresentations.²⁰ Specifically, since Charter reports only its composite revenue numbers to the public, and not all of the details about—or documents supporting—the transactions that produced the composite numbers, the plaintiffs never would have seen the misrepresentations by Scientific-Atlanta and Motorola.²¹

II. THE CRITIQUE: GETTING BLINDED BY THE CORPORATE FICTION TO REACH AN IRRATIONAL RESULT

A. Doctrinal Missteps

On the simple level of applying precedent, the Court's reasoning is

¹³ *Id.*

¹⁴ 511 U.S. 164 (1994) (link).

¹⁵ *Id.* at 176–80, 191.

¹⁶ Brief for Respondents at 16–38, *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 128 S. Ct. 761 (2008) (No. 06-43) (link).

¹⁷ *Central Bank*, 511 U.S. at 191.

¹⁸ *See Stoneridge*, 128 S. Ct. at 770–71.

¹⁹ *See id.* at 774.

²⁰ *Id.*

²¹ *Id.* at 770.

perplexing. The notion that the plaintiffs had not relied on Scientific-Atlanta's and Motorola's misrepresentations because the plaintiffs had not seen those misrepresentations seems inconsistent with the indirect reliance inherent in the fraud on the market theory adopted by the Supreme Court in *Basic Inc. v. Levinson*.²² The fraud on the market theory is based upon the idea that traders in a market often rely on information they never see. Instead, traders rely on other market actors who, in seeing and acting upon information they receive firsthand, impact the trading price of shares.²³ The majority, in pointing out that the fraud on the market theory would not apply in *Stoneridge* because Scientific-Atlanta's and Motorola's misrepresentations were never directly communicated to the public,²⁴ gave short shrift to this fundamental point.

The reason the majority did so, in substantial part, seems to be its concern that imposing liability upon persons who aid a fraudulent scheme through misrepresentations could significantly limit the reach of *Central Bank*.²⁵ Yet the Court in *Central Bank* explicitly stated that persons who themselves engage in fraud and misrepresentation would remain liable in a private action.²⁶ Nothing in *Central Bank* ever suggested that its conclusion was dependent upon some sort of "fraud hierarchy" under which misrepresentations made in aid of another's misrepresentation are treated differently from "primary" misrepresentations; indeed, this would not have made sense given the context of the court's comment in *Central Bank*.²⁷

B. The Real Policy Behind the *Stoneridge* Decision

The Court's expansion in *Stoneridge* of *Central Bank*'s immunity for secondary parties suggests that neither decision flows from doctrinal logic, but rather from a results-oriented policy determination.²⁸ Put simply, these cases raise the question: Who ought to pay for securities fraud? As is apparent from the Supreme Court's decision to confine liability to the perceived primary wrongdoer, the answer is not so-called secondary offenders. Underlying this determination are two intuitions. The first is that plaintiffs (or their attorneys) bring in peripheral parties in a sort of piggish grasping around for deep pockets. The second is a concern—which also underlies

²² 485 U.S. 224 (1988) (link).

²³ *Id.* at 246–47.

²⁴ *Stoneridge*, 128 S. Ct. at 769–70.

²⁵ *Id.* at 771–72.

²⁶ *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164, 191 (1994).

²⁷ *See id.* (stating that "[i]n any complex securities fraud . . . there are likely to be multiple violators . . .").

²⁸ *See* A.C. Pritchard, *Stoneridge Investment Partners v. Scientific-Atlanta: The Political Economy of Securities Class Action Reform*, 2007–2008 CATO SUP. CT. REV. 217 (explaining the court's underlying policy concerns) (link).

the heightened pleading requirements adopted by Congress in the Private Securities Litigation Reform Act of 1995²⁹—about innocent parties being sued and forced to settle Rule 10b-5 actions. Coupled with this concern is the notion that the more defendants brought into securities fraud lawsuits, the more chance there is of suits against parties who actually did nothing wrong. Yet, as appealing as these intuitions might seem, the question of who should pay for securities fraud calls for a more careful analysis. Specifically, did the court in *Stoneridge* get it right in indentifying who was a real wrongdoer and ought to pay, and who was simply a peripheral player?

Key to the *Stoneridge* majority's approach is the conception that the corporation, Charter, committed the fraud. Doctrinally, characterizing the matter as fraud by Charter allowed the court to conclude that any misrepresentations by Scientific-Atlanta and Motorola were too remote to engender the plaintiffs' reliance.³⁰ From a policy standpoint, characterizing the matter as Charter's fraud framed Charter as the primary wrongdoer upon whom any private action should focus, and reduced the import of any secondary bad acts engaged in by other parties. The fundamental problem with the majority's view, however, is that it rests upon a fiction: Charter, like any corporation, cannot knowingly make false statements—only people can. Hence, in actions for fraud filed pursuant to § 10(b), it is useful to pierce through the corporate fiction to ask some important questions. Who knowingly caused Charter to issue false earnings reports? Who profited from them? And what is the impact of imposing fraud liability solely upon Charter?

C. Whose Fraud Is It?

Investors typically see (if they so choose) the corporation's financial statements. But to focus solely on these statements misunderstands the way in which financial reporting fraud commonly works. The corporation's financial statements reflect the sum totals from innumerable transactions. Only in the most brazen and unsophisticated cases does financial fraud consist of simply altering the numbers on financial statements. Instead, as in *Stoneridge*, it works in the bowels of the business to alter what is reported in various transactions from which the totals in financial statements derive. This is why Congress, in the Sarbanes-Oxley Act, focused attention on assuring the adequacy of corporate internal controls.³¹ Congress recognized (unlike the majority in *Stoneridge*) that investors do not just rely on the accuracy of the sum totals reported in the financial statements; they also indirectly rely on the accuracy of all of the reporting of transactions that produce those totals. In other words, to use a cliché, when it comes to the numbers on a financial statement, it is garbage in, garbage out.

²⁹ 15 U.S.C. § 78u-4(b)(2) (2006) (link).

³⁰ *Stoneridge*, 128 S. Ct. at 766, 769.

³¹ 15 U.S.C. §§ 7241, 7262 (2006) (link to § 7241) (link to § 7262).

According to the plaintiffs' allegations, the false information entered the stream of internal reporting in *Stoneridge* when at least two parties made misrepresentations. There were the Charter managers, who created the misrepresentations in documenting and reporting on the Charter side when they reported advertising revenue from the cable box transactions. In addition, Scientific-Atlanta and Motorola made misrepresentations in documenting and characterizing these transactions via the backdating and falsification of their own documents.³² Hence, the *Stoneridge* majority's focus on this being Charter's fraud pretends that a fictional entity created financial statements, and ignores the parties who actually made the intentional misrepresentations reflected in those statements.

D. Who Should Pay (Or Why Charter Was the Wrong Target in Stoneridge)

To point out that it is people, rather than corporations, who make knowingly false statements is not to imply that we should ignore the fiction and never hold corporations liable for false statements made in the company's name. In fact, the Securities Act of 1933 expressly calls for the issuing corporation, among others, to be liable to buyers in the event of misrepresentation on the SEC registration statement filed prior to public offering.³³ Yet, before automatically assuming that the corporation is the party that should pay for any false statements promulgated in its name, it is useful to examine the actual impact of holding the corporation liable in a case such as *Stoneridge*.

The plaintiffs in the *Stoneridge* case were persons who bought stock in Charter. If Charter pays the plaintiffs, who is paying whom? Assuming Charter is solvent, any recovery from Charter is ultimately at the expense of Charter's shareholders. If the plaintiffs have retained the stock they purchased in Charter, in essence recovery from Charter means that the plaintiffs are simply paying themselves (at least to the extent of the plaintiffs' shareholdings in the company).³⁴ Perhaps, however, plaintiffs have sold the stock they purchased in Charter. If they sold before disclosure of the fraud,

³² To be consistent, it was employees of Scientific-Atlanta and Motorola who made these misrepresentations. It appears, however, that these employees acted in order to obtain some benefit for Scientific-Atlanta and Motorola (free advertising or some other quid pro quo) and thus principles of vicarious liability attribute the employees' acts to their companies.

³³ 15 U.S.C. § 77k (2006) (link).

³⁴ There is also the impact of forcing a distribution from the corporation to the plaintiff shareholders. When fraud involves the issuance of stock or securities by the corporation such that the plaintiffs have paid money either directly or indirectly to the corporation, the remedy of forcing the corporation to return the money produces a real remedy insofar as it unwinds the impact of the wrong. In the more common *Stoneridge* situation—where the fraud involves corporate statements that impact market trading in which the corporation is not involved—it is less clear why the appropriate remedy for false statements should be to force a distribution of money from the corporation to its own shareholders.

then we should substitute plaintiffs.³⁵ If they sold after disclosure of the fraud, then we seemingly start to have a real transfer of wealth between shareholders as a result of recovery against the corporation—in this case, from those who bought the plaintiffs' stock to the plaintiffs. On the other hand, consider how, in a rational market, buyers should respond to this prospective outcome. They should lower the price they are willing to pay following disclosure of securities fraud to offset prospective recovery against the corporation. This means that corporate recovery simply lowers the price at which the plaintiffs are able to sell their stock, and, once again, all that is happening is that plaintiffs are essentially paying for their own recovery.

The instance in which there is a real wealth transfer between shareholders occurs if there are shareholders who bought into the corporation before the fraud and retained their stock until disclosure. Yet, unless these shareholders were in on the fraud, what would be the rationale for having them effectively compensate the plaintiffs? One might claim that they benefited from the fraud if it led to an increase in stock prices. Notice, however, that this benefit only accrues if the shareholder sells his stock during the period in which the fraud inflated the stock price; but, in this case, the selling shareholder no longer suffers the impact of recovery against the corporation. The irony is that the shareholders who benefited from the fraud do not end up having to pay for it, at least insofar as the plaintiffs' remedy is recovery against the corporation.³⁶

So if the aim of imposing securities fraud liability is to discipline those who profited from a knowing misrepresentation, and if the corporation (like Charter) is the wrong target for such liability, who did profit from engaging in fraudulent conduct? One answer, presumably, would be the Charter managers who fudged the numbers.³⁷ Fortunately, lest all sanity has left the field after *Stoneridge*, such managers can be held liable as controlling persons of Charter.³⁸ The other parties who profited from their knowing misrepresentations are Scientific-Atlanta and Motorola. They received free advertising (and, one suspects, some later quid pro quo). Indeed, if they did

³⁵ Since buyers before disclosure of the fraud are purchasing based upon false market information, they should be plaintiffs. Buyers who turned around and sold their shares before the fraud was disclosed have presumably not suffered any harm from the fraud.

³⁶ Since it is possible for a shareholder to sell some stock and retain some stock, to be more precise, the more one benefits, the less one indirectly pays.

³⁷ See, e.g., Donald C. Langevoort, *On Leaving Corporate Executives "Naked, Homeless, and Without Wheels": Corporate Fraud, Equitable Remedies, and the Debate Over Entity Versus Individual Liability*, 42 WAKE FOREST L. REV. 627, 630 (2007) (advocating focusing liability upon the wrongdoing executives) (link).

³⁸ Otherwise, we would have had the bizarre result that managers have escaped liability based upon the argument that it was the corporation's fraud, not theirs. For an example of a fraud case in which corporate officers are held liable for their actions, see *Wool v. Tandem Computers Inc.*, 818 F.2d 1433 (9th Cir. 1987) (applying controlling person liability under Section 20(a) of the Securities Exchange Act) (link).

not get some benefit, one assumes they would not have engaged in misrepresentations that might subject them to government prosecution.

CONCLUSION

One can generalize the forgoing analysis to suggest that the appropriate defendants in a securities fraud action often *should* include the so-called secondary players. Specifically, the accountants, lawyers, investment bankers, and others who engage in misrepresentations giving rise to false or misleading corporate financial statements, and who receive substantial compensation for doing so, should be deemed liable. If so, *Stoneridge* has created a result that, from a policy standpoint, is upside down: the law holds the corporation liable when there is typically no point in doing so, and allows the parties who ought to pay—those who benefited from the fraudulent actions—to escape liability (at least in private suits). In the end, therefore, the *Stoneridge* case has taken an irrational state of law governing securities fraud actions under § 10(b)—with pointless actions against corporations—and made it even worse.