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Interpreting Reliance **Two** Years After 'Stoneridge'

The standards for §10(b), Rule 10b-5 liability continue to evolve.

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A LITTLE OVER two years ago, the U.S. Supreme Court decided *Stoneridge Investment Partners, LLC v. Scientific-Atlanta Inc.*, 552 U.S. 148 (2008). Since then, *Stoneridge*, building upon *Central Bank*,[1] has established the standard for addressing liability for defendants who did not issue the public statements at issue in civil cases brought by private parties under §10(b) of the Securities Exchange Act of 1934 (Exchange Act) and SEC Rule 10b-5. In analyzing such liability, courts have focused on whether the plaintiffs could have relied on the actions of the non-issuer defendant.

This article examines a few of the key cases following *Stoneridge*.

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'Central Bank,' 'Stoneridge:' a Recap

In *Central Bank*, the Supreme Court held that a private plaintiff may not maintain an aiding and abetting action under §10(b).

There, a public building authority defaulted on public improvement bonds secured by landowner assessment liens and the bondholders filed an action against various individuals, including Central Bank, for aiding and abetting the allegedly fraudulent appraisal of the lien in violation of §10(b) and Rule 10b-5. The Court held that §10(b) does not extend to claims of aiding and abetting if brought by private plaintiffs.[2] In particular, the Court held that "[w]ere we to allow the aiding and abetting action proposed in this case, the defendant could be liable without any showing that the plaintiff relied upon the aider and abettor's statements or actions."[3]

Following that decision, the Supreme Court decided *Stoneridge*, in which the plaintiff alleged that Scientific-Atlanta Inc. and Motorola Inc., two customers and supplies of Charter (the issuer), violated §10(b) and Rule 10b-5 by engaging in a fraudulent scheme with Charter that had the effect of improperly inflating Charter's reported operating revenues and cash flow.

Charter reported these allegedly inflated numbers on financial statements filed with the SEC and also to the public. Although Scientific-Atlanta and Motorola had no role in preparing or disseminating Charter's financial statements and were not disclosed to the public as parties to the transactions at issue, plaintiffs alleged that "respondents knew or were in reckless disregard of Charter's intention to use the transactions to inflate its revenues and knew the resulting financial statements issued by Charter would be relied upon by research analysts and investors"[4] and therefore, by participating in the transactions, respondents violated §10(b) and Rule 10b-5.

The Supreme Court held that plaintiff could not pursue the claims against Scientific-Atlanta and Motorola because the plaintiff failed to allege reliance. The Court stated that it recognizes a rebuttable presumption of reliance in two difference circumstances.

First, if there is an omission of a material fact by one with a duty to disclose, and second, under the fraud-on-the-market doctrine, reliance is presumed when the statements at issue become public.[5] The Court held that plaintiff failed to allege reliance given that:

(1) Scientific-Atlanta and Motorola had no duty to disclose information, and

(2) the allegedly deceptive acts, which were not disclosed to the public, were too remote to satisfy the requirement of reliance.

Specifically, the Court held that "[i]t was Charter, not respondents, that misled its auditor and filed fraudulent financial statements; nothing respondents did made it necessary or inevitable for Charter to record

the transactions as it did."[6]

Furthermore, the Court rejected the plaintiff's contention that "in an efficient market investors rely not only upon the public statements relating to a security but also upon the transactions those statements reflect[,]" stating that "[w]ere this concept of reliance adopted, the implied cause of action would reach the whole marketplace in which the issuing company does business; and there is no authority for this rule."[7]

The Interpretive Case Law

Perhaps the most interesting case law that has developed after *Stoneridge* concerns situations where the non-issuer defendant or secondary actor defendant is disclosed to the public as a party to the allegedly deceptive transactions, but had no role in preparing the allegedly false filings. See *In re Peregrine Systems Inc. Securities Litigation*, No. 06-55197, 2009 WL 186165 (9th Cir. Jan. 23, 2009) and *In re Parmalat Securities Litigation*, 570 F.Supp.2d 521 (S.D.N.Y. 2008).

For example, *Parmalat Securities* involved a class action on behalf of investors in Parmalat Finanziaria S.p.A. and its subsidiaries and affiliates (collectively, "Parmalat") against, among others, Parmalat's banks, including Bank of America Corporation, Bank of America, N.A., and Banc of America Securities Limited (collectively "BoA"), Citigroup Inc., Citibank, N.A., and Eureka Securitisation plc (collectively "Citi") and its lawyers, Pavia e Ansaldo (Pavia), for allegedly making representations and structuring transactions that operated to defraud Parmalat's investors in violation of §10(b) and Rule 10b-5.

In particular, the plaintiffs alleged that Citi purchased and securitized allegedly worthless invoices to inflate Parmalat's cash flow from its operations, Citi and BoA structured transactions in which loans to Parmalat were disguised as equity investments, and Pavia allegedly designed and assisted in perpetrating transactions intended to misrepresent Parmalat's financial situation.

Plaintiffs argued the public was made aware of the allegedly deceptive transactions in which each defendant, including the secondary actors, was involved because Parmalat:

(1) issued press releases, prospectuses, and offering memoranda in which it named BoA as the leader of a group of investors involved in one of the allegedly fraudulent deals,

(2) discussed in its financial statements, prospectuses, and private placement memoranda its securitization operations, which were transactions that to some extent involved Citi, and

(3) discussed in prospectuses and press releases an allegedly fraudulent transaction that was structured and implemented by Pavia.

In 2005, prior to the *Stoneridge* decision, Judge Lewis Kaplan dismissed some, but not all, of plaintiffs' §10(b) claims against defendants, notwithstanding the lack of any actionable misrepresentations or omissions by defendants.[8] Following the decision in *Stoneridge*, the defendants filed a motion for summary judgment on the ground that *Stoneridge* foreclosed this theory of liability. Judge Kaplan granted the motion and found that plaintiffs failed to establish the reliance element of their §10(b) claims against BoA, Citi, and Pavia.

'Stoneridge,' building upon 'Central Bank,' has established the standard for addressing **liability** for defendants who **did not issue** the public statements at issue in civil cases brought by private parties under §10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5.

The court found that even though the secondary defendants were specifically mentioned in documents released to the public, plaintiffs failed to demonstrate reliance on such defendants.

Plaintiffs argued that "these disclosures led investors to rely on the deceptive transactions themselves, not merely on financial statements that were impacted by those transactions."[9] The court, however, stressed that under *Stoneridge* investors must show reliance upon a defendant's deceptive conduct and found that "plaintiffs' evidence would establish only that investors relied on Parmalat's deceptive disclosures concerning transactions to which defendants were parties. It would not establish reliance on any [of] defendant's own deceptive conduct except 'in an indirect chain' the type of which the Supreme Court found 'too remote for liability.'"[10]

Therefore, although the public was aware of defendants' involvement in these transactions, the Court found that insufficient to show that plaintiffs relied upon those defendants.

Similarly, *Peregrine Systems*[11] involved an investor in Peregrine Systems Inc. (Peregrine) who brought an action against various individuals and entities, including Peregrine's accountant, KPMG, for allegedly enabling Peregrine to improperly recognize $32.1 million in revenue through a fraudulent scheme. Plaintiff argued that because the partnership between Peregrine and KPMG was referenced in press releases issued to the investing public, plaintiff could establish reliance using the fraud-on-the-market presumption.

The district court dismissed plaintiff's §10(b) claims against KPMG and, on appeal, the Ninth Circuit affirmed. Relying on *Stoneridge*, the court rejected plaintiff's argument that the facts pled established reliance and held that:

> Thus, the press releases did not communicate the KPMG Defendants' allegedly deceptive acts and, therefore, do not trigger a presumption of reliance. See *Stoneridge*, 128 S.Ct. at 769 (holding that the fraud-on-the-market presumption did not apply because business partners' "deceptive *acts* were not communicated to the public" (emphasis added)). As was the case in *Stoneridge*, it was Peregrine, not the KPMG Defendants, "that misled its auditor and filed fraudulent financial statements; nothing [the KPMG Defendants] did made it necessary or inevitable for [Peregrine] to record the transactions as it did." 128 S.Ct. at 770.[12]

Consequently, plaintiffs could not have relied upon the KPMG defendants.

In contrast, the Fourth Circuit, in *In re Mutual Funds Investment Litigation*, 566 F.3d 111 (4th Cir. 2009) found that *Stoneridge* did not preclude liability against the defendants. There, shareholders of an asset management firm, Janus Capital Group Inc. (JCG), filed a class action suit against JCG and its wholly-owned investment advisory subsidiary, Janus Capital Management LLC (JCM), the investment advisor to the Janus mutual funds.

It was alleged that JCG and JCM were responsible for certain misleading statements in the funds' prospectuses that misrepresented that the funds' managers discouraged and actively prevented market timing of the funds,

when in fact plaintiffs alleged that JCG and JCM entered into secret arrangements to allow several hedge funds to engage in market timing transactions in various Janus funds.

Even though each fund was its own company and the prospectuses did not explicitly name JCG and JCM as drafters, plaintiffs argued that the public was aware that JCG and JCM participated in the drafting or approved of the prospectuses issued by the individual funds because JCM and JCG caused the prospectuses to be issued and made the prospectuses available to the investing public through filings with the SEC and dissemination on a joint Janus funds-JCG-JCM Web site, www.janus.com. Furthermore, JCM was responsible for the funds' day-to-day management.

The Fourth Circuit found that plaintiffs pled facts sufficient to support their fraud-on-the-market theory under §10(b) against JCM, but that they failed to plead sufficient facts against JCG.[13] In analyzing the allegations against JCM, the court found that "given the publicly disclosed responsibilities of JCM, [including its day-to-day management of the funds,] interested investors would infer that JCM played a role in preparing or approving the content of the Janus fund prospectuses[,]"[14] even though JCM's role in preparing the prospectuses was not known to the public.

Based on this inference, the court found that the facts pled by plaintiff were sufficient to establish fraud-on-the-market reliance as to JCM. The court stated that "[w]hile *Stoneridge* makes clear that the fraud-on-the-market presumption does not apply to transactions that are not publicly disclosed, the holding in *Stoneridge* has no application to situations in which the allegedly misleading statements are indisputably public and the inquiry is focused solely on whether the investing public would have attributed a particular statement to a particular defendant."[15]

The court found that plaintiff failed to plead an adequate claim for liability against JCG because, although JCG played a role in the dissemination of the fund prospectuses on the Janus Web site, there was no allegation that JCG was involved in the funds' day-to-day operations and the court found it insufficient to show that investors would believe JCG had prepared or approved the prospectuses.

Class Certifications Also Affected

Stoneridge has also influenced case law regarding presumptive reliance at the class certification stage. Although it does not appear that any court has fully confronted the issue of its applicability and *Stoneridge* does not directly address whether the two recognized rebuttable presumptions of reliance negate other means of finding presumptive reliance, courts have utilized *Stoneridge* in determining whether common issues will predominate a class.

In *In re DVI Inc. Securities Litigation*, 249 F.R.D. 196 (E.D. Pa. 2008), litigation arose from DVI's bankruptcy filing in 2003 and class certification followed the dispute which survived a 2005 motion to dismiss. In determining the motion for class certification, the district court found that while class certification was proper with respect to claims against the officers, directors, independent auditors, and the largest shareholder, it was not proper against DVI's corporate counsel, Clifford Chance.

Clifford Chance argued that plaintiffs could not satisfy either theory of presumptive reliance established in *Stoneridge* because corporate counsel did not owe a duty to investors and the investors did not allege any public misstatements. As a result, the court found that, "individual issues of reliance will predominate over common issues of law and fact…"[16]

Another case involving the denial of class certification based on *Stoneridge* is *Desai v. Deutsche Bank*, 573 F.3d 931 (9th Cir. 2009). The court affirmed a district court's decision not to certify a class because the court determined that based on *Stoneridge*, a district court is not obligated to recognize theories of presumptive reliance beyond the two recognized in *Stoneridge*.

In *In re Metropolitan Sec. Litig.*, No. CV-04-25-FVS, 2009 U.S. Dist. LEXIS 123133, (E.D. Wash. Jan. 6, 2009), a district court in denying class certification refused to entertain plaintiff's argument for an expansion of the fraud on the market doctrine that relied on *Cromer Finance Ltd. v. Berger*, 205 F.R.D. 113 (S.D.N.Y. 2001). The court stated that:

> No other federal district court or court of appeals had adopted the *Cromer* rationale prior to *Stoneridge*. In light of the Supreme Court's statements about presumptions, lower federal courts and state courts are even less likely to follow *Cromer* now.[17]

Thus while no court has stated that *Stoneridge* eliminates other means of establishing presumptive reliance, courts are utilizing *Stoneridge* to limit their willingness to entertain theories of presumptive reliance.

Over the past two years *Stoneridge* has had a great impact on securities cases and it will be interesting to see how the post-*Stoneridge* case law develops over the next few years.

1. *Central Bank of Denver, N.A. v. First Interstate Bank of Denver*, N.A., 511 U.S. 164 (1994).

2. The Supreme Court has articulated its preference to limit a court imposed implied private right of action under §10(b). See Id. at 174 (determining that the scope of conduct prohibited is limited by the text of §10(b)); see also *Stoneridge Investment Partners, LLC v. Scientific-Atlanta Inc.*, 552 U.S. 148, 165 (2008) (stating that "[c]oncerns with the judicial creation of a private cause of action caution against its expansion. The decision to extend the cause of action is for Congress, not for us").

3. Id. at 180.

4. *Stoneridge Investment Partners, LLC v. Scientific-Atlanta Inc.*, 552 U.S. 148, 155 (2008).

5. Id. at 159.

6. Id. at 161.

7. Id. at 160.

8. *In re Parmalat Securities Litigation*, 376 F.Supp.2d 472 (S.D.N.Y. 2005).

9. *In re Parmalat Securities Litigation*, 570 F.Supp.2d 521, 525-526 (S.D.N.Y. 2008).

10. Id. at 525 (quoting *Stoneridge Investment Partners, LLC*, 552 U.S. at 159).

11. *In re Peregrine Systems Inc. Securities Litigation* is an unreported case.

12. *In re Peregrine Systems Inc. Securities Litigation*, No. 06-55197, 2009 WL 186165, *2 (9th Cir. Jan. 23, 2009) (quoting *Stoneridge Investment Partners, LLC*, 552 U.S. at 161).

13. The court found that JCG may be liable as a control person under §20(a), the discussion of which is outside the scope of this article.

14. *In re Mutual Funds Investment Litigation*, 566 F.3d 111, 127 (4th Cir. 2009).

15. Id.

16. Id. at 218.

17. *In re Metropolitan Sec. Litig.*, No. CV-04-25-FVS, 2009 U.S. Dist. LEXIS 123133 at *20 (E.D. Wash. Jan. 6, 2009).