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COURT PROTECTS INVESTORS BY BARRING UNWARRANTED SECURITIES FRAUD SUITS

(Stoneridge Investment Partners v. Scientific-Atlanta)

The U.S. Supreme Court issued a decision today that protects investors by imposing restraints on the ability of plaintiffs' attorneys to bring unwarranted securities fraud lawsuits that, although nominally filed for the purpose of protecting investors, actually harm investors by transferring wealth from stockholders to the pockets of lawyers.

The decision was a victory for the Washington Legal Foundation (WLF), which filed a brief in the case, *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, opposing such lawsuits. WLF argued that a company should not be subject to a securities fraud lawsuit based solely on having entered into an arm's-length, non-financial transaction with another company alleged to have engaged in fraud. WLF's brief was written with the *pro bono* assistance of Kenneth Starr, the Dean of Pepperdine University School of Law and a former federal judge, U.S. Solicitor General, and Independent Counsel. Assisting Starr were other attorneys associated with the law firm of Kirkland & Ellis LLP, including Robert R. Gasaway, Ashley C. Parrish, Derek S. Bentsen, and Angela M. Butcher.

The Supreme Court -- agreeing with all but one of the federal appeals courts that have previously addressed the issue -- held that securities law claims are improper unless the plaintiff can demonstrate that, when buying or selling a security, (s)he relied on the defendant's allegedly deceptive practice or conduct. The Court stated that there was no evidence of reliance in this case; the defendants had had no contact with the plaintiffs but were simply merchants who had done business with the company that had issued fraudulent earnings statements. The Court stated that suits filed under the securities law ought to focus on conduct directly related to the purchase and sale of securities and should not be used to justify suits over every-day commercial activity unrelated to stock sales.

"The public should not be fooled by the plaintiffs' bar into thinking that allowing suits of this sort to go forward will somehow help investors," said WLF Chief Counsel Richard Samp after reviewing the Court's decision. "The open-ended liability standards the plaintiffs pressed for would likely prompt more frauds inside the judicial system than the frauds outside the system they claim to be combating. We must not overlook the fact that the investing public ultimately bears the burden of any further increase in potentially abusive litigation enabled by subjective liability standards," Samp said.

The case involved claims brought against two manufacturers of digital set-top boxes used by cable-television subscribers. The companies sold boxes in 2000 to Charter Communications, Inc., a cable-television operator. At Charter's request, the companies submitted invoices that included inaccurate information regarding prices Charter paid for boxes. The manufacturers accurately recorded the transactions on their own books. But Charter issued financial reports that inaccurately recorded the transactions and thereby fraudulently inflated its cash flow. Charter also released other, unrelated fraudulent financial information. When the truth came out, Charter's stock plummeted.

Attorneys purporting to represent Charter shareholders then filed suit not only against Charter and its executives but also against the manufacturers. The lower courts dismissed claims against the manufacturers, noting that (per a 1994 Supreme Court decision) securities law does not permit private suits against those alleged merely to have aided and abetted another company's securities fraud. They rejected the plaintiffs' claim that the manufacturers could be held liable for a *primary* violation of the securities laws, holding that such liability is prohibited in the absence of evidence either that the plaintiff relied on the defendant's deception or that the defendant failed to disclose something that it owed a duty to disclose. The Supreme Court today affirmed those decisions.

In addition to arguing that Congress intended to impose a reliance requirement, WLF's brief argued that securities fraud litigation has not deterred fraud and, in fact, generally works against the best interests of shareholders. Because securities lawsuits that can survive a motion to dismiss are generally settled without regard to the defendants' culpability (because the economics of such suits generally demand settlement), they have minimal deterrent effect and serve simply to transfer wealth from shareholders (who, of course, own the companies being sued) to the plaintiffs' bar. WLF argued that enforcement actions by the SEC (which is empowered to pursue not only primary securities law violators but also aiders and abetters) are much more effective than private actions in deterring fraud and compensating victims of fraud.

WLF is a public interest law and policy center with supporters in all 50 states. It devotes a substantial portion of its resources to promoting tort reform and reining in excessive litigation.

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For further information, contact WLF Chief Counsel Richard Samp, (202) 588-0302. A copy of WLF's brief is posted on its website, www.wlf.org.