Legal Backgrounder

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STONERIDGE v. SCIENTIFIC-ATLANTA: "SCHEME LIABILITY" IN THE HIGH COURT

by

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The eyes and ears of Wall Street will be focused squarely on the United States Supreme Court when the high court convenes in early October to begin its 2007 term. The reason: the Court is set to hear oral arguments on October 9 in what is arguably the most important securities case to reach the Supreme Court in a generation.

The case is *Stoneridge Investment Partners v. Scientific-Atlanta and Motorola*. The issue is whether shareholders of companies that commit securities fraud should be able to sue investment banks, accounting firms, lawyers and other third parties that allegedly participated in the fraud, even if the entities never made fraudulent statements. This concept of expanding liability to third parties is commonly referred to as "scheme liability."

The Supreme Court's decision in *Stoneridge* whether to adopt scheme liability is sure to have far-reaching implications for law firms, investment banks and other third parties that do business with companies that commit fraud. If the high court finds in favor of the plaintiffs and puts its stamp of approval on scheme liability, the scope of securities class-actions will be significantly broadened. And, as discussed more fully below, such expansive liability would mean that law firms, investment banks and other third parties would become prime targets of abusive securities lawsuits simply because of their deep pockets.

The Facts of Stoneridge. Stoneridge Investment Partners brought a class action lawsuit on behalf of all purchasers of the securities of Charter Communications, Inc. ("Charter"). Charter is one of the nation's largest cable television providers. At the time in dispute, Charter delivered cable services through set-top boxes installed on customers' television sets. The Plaintiffs alleged that Charter and two equipment vendors, Scientific-Atlanta and Motorola, entered into sham transactions that improperly inflated Charter's reported operating revenues and cash flow. Specifically, Plaintiffs alleged that Charter agreed to overpay the equipment vendors an additional $20 per cable set-top box in exchange for the equipment vendors returning the additional payments to Charter in the form of advertising fees.

Plaintiffs claimed that these were sham or wash transactions with no economic substance, contrived to inflate Charter's operating cash flow by $17 million in order to meet the revenue and operating cash flow

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expectations of Wall Street analysts. Plaintiffs alleged that the equipment vendors entered into these sham transactions knowing that Charter intended to account for them improperly and that Wall Street analysts would rely on the inflated revenues and operating cash flow in making stock recommendations. Plaintiffs did not allege that the vendors played any role in preparing or disseminating the fraudulent financial statements and press releases through which Charter published its deception to analysts and investors.

A federal district court in Missouri dismissed Plaintiffs' Section 10(b) and Rule 10b-5 claims against the equipment vendors. The district court reasoned that the allegations were no more than aiding and abetting allegations that were precluded by the Supreme Court's 1994 decision in *Central Bank, N.A. v. First Interstate Bank, N.A.*, 511 U.S. 164 (1994). The U.S. Court of Appeals for the Eighth Circuit affirmed the dismissal. The Supreme Court then agreed to hear the case.[1]

The Legal Framework. Section 10(b) of the Securities Exchange Act of 1934 prohibits the use or employment of any manipulative or deceptive device or contrivance in connection with the purchase or sale of a security. Rule 10b-5 of the Securities Exchange Commission implements Section 10(b) by declaring it unlawful:

> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

The scope of liability under Section 10(b) and Rule 10b-5 has been a hot topic for many years. Prior to 1994, plaintiffs sought to impose liability on defendants whose conduct allegedly facilitated a public company's fraud – but whose conduct was not relied on by investors – by accusing them of "aiding and abetting."

In an effort to clarify the scope of liability under Section 10(b) and Rule 10b-5, the Supreme Court held in *Central Bank* that Section 10(b) and Rule 10b-5 do not create liability for aiding and abetting securities fraud. The Supreme Court concluded that Section 10(b) "prohibits only the making of a material misstatement (or omission) or the commission of a manipulative act" and confirmed that plaintiffs "may not bring a 10b-5 suit against a defendant for acts not prohibited by the text of § 10(b)." 511 U.S. at 173, 177. The high court then added a caveat: A "secondary actor" – such as "a lawyer, accountant, or bank" – that "employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator under 10b-5," but only if "*all* of the requirements for primary liability under Rule 10b-5 are met." *Id.* at 191 (emphasis in original).

The Supreme Court in *Central Bank* did not define the term "primary violator." Initially, this was not much of an issue. Courts simply held that Section 10(b) only authorized private suits against secondary actors who made statements relied on by investors. In the typical case, an investment bank, accountant or law firm does not expressly make the statement relied on by investors, but instead is somehow connected to the statement. For example, a law firm might know that a statement made by a company was false and refuse to take any action to prevent the statement from being disseminated. Because the law firm in such a situation did not make the statement in question, courts traditionally refused to impose liability on the law

[1]Interestingly, Chief Justice John Roberts and Justice Stephen Breyer recused themselves from the case. According to mandatory financial disclosure forms, Roberts owned Scientific-Atlanta stock and Breyer owned Cisco stock in 2006. Cisco acquired Scientific-Atlanta in 2006. On September 20, 2007, Chief Justice Roberts announced that he would participate in the Supreme Court's consideration of the case. Roberts did not say why he would rejoin the case.

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firm and other secondary actors in similar positions.

But plaintiffs' lawyers did not give up. Instead, plaintiffs' lawyers became more and more creative, seeking a way to circumvent *Central Bank's* prohibition against aiding and abetting liability. The concept of scheme liability was hatched. Plaintiffs sought to evade *Central Bank* by arguing that law firms, accounting firms and banks could be held liable as primary violators under Rule 10b-5(a) and (c), which are broadly aimed at participation in fraudulent securities schemes.

The Circuit Split. To date, three federal circuit courts – the Fifth, Eighth and Ninth circuits – have addressed whether Rule 10b-5(a) and (c) permit plaintiffs to sue traditional secondary actors under a theory of scheme liability. The Fifth Circuit and Eighth Circuit have refused to approve scheme liability while the Ninth Circuit has approved a form of scheme liability.

The argument in favor of scheme liability is relatively simple. Plaintiffs assert that they can allege a primary violation of the securities laws within the meaning of *Central Bank* because various individuals and entities violated Rule 10b-5(a) and (c) by participating in a "scheme or artifice to defraud" and by engaging in a "course of business which operates…as a fraud or deceit." The argument emphasizes that Rule 10b-5(a) and (c) are broadly worded and, unlike Rule 10b-5(b), do not require proof of fraudulent misrepresentation or failure to disclose.

The Eighth Circuit squarely rejected Plaintiffs' effort to make an end run around *Central Bank*, relying on "three governing principles."

- First, *Central Bank's* "categorical declaration that a private plaintiff 'may not bring a 10b-5 suit against a defendant for acts not prohibited by the text of § 10(b)' included claims under Rule 10b-5(a) and (c), as well as Rule 10b-5(b)." *In re Charter Commc'ns, Inc., Sec. Litig.*, 443 F.3d 987, 992 (8th Cir. 2006)

- Second, "[a] device or contrivance is not 'deceptive,' within the meaning of § 10(b), absent some misstatement or a failure to disclose by one who has a duty to disclose." *Id.*

- Third, "[t]he term 'manipulative' in § 10(b) has the limited contextual meaning ascribed in *Santa Fe Indus. v. Green,* 430 U.S. 462, 476 (1977)," which defined "manipulation" to mean practices "that are intended to mislead investors by artificially affecting market activity." 443 F.3d. at 992.

The Eighth Circuit also held that "[t]o impose liability for securities fraud on one party to an arm's length business transaction in goods or services other than securities because that party knew or should have known that the other party would use the transaction to mislead investors in its stock would introduce potentially far-reaching duties and uncertainties for those engaged in day-to-day business dealings. Decisions of this magnitude should be made by Congress." *Id.* at 993. The Fifth Circuit, in *Regents of the University of California v. Credit Suisse First Boston (USA), Inc.*, 482 F.3d 372 (5th Cir. 2007), joined the Eighth Circuit in declining to extend the scope of primary liability for securities violations to secondary actors.

The Ninth Circuit is the lone circuit to find that third parties can be liable in certain instances in which they do not make the statement at issue. In *Simpson v. AOL Time Warner Inc.*, 452 F.3d 1040, 1048 (9th Cir. 2006), the Ninth Circuit held that secondary parties in fraud schemes can sometimes be held liable if "its conduct has 'the principal purpose and effect of creating a false appearance of fact' in support of a scheme to defraud." The problem with the Ninth Circuit's "purpose and effect" test is that it is subjective and malleable. In *Central Bank*, the Supreme Court noted that the scope of Section 10(b) liability is an issue that "demands certainty and predictability." 511 U.S. at 188. It is hard to fathom how the Ninth Circuit's "purpose and effect" test brings any certainty to this area of the law. Indeed, the term "principal purpose" is not defined and, as a result, there is no clear standard for courts to follow to determine whether certain conduct constitutes aiding and abetting or results in "primary liability."

Friends of the Court Offer Support. The significance of the *Stoneridge* case is best exemplified by the number of "friend of the court" briefs filed by various individuals and entities interested in the outcome of the case. All told, more than 100 separate individuals and entities filed briefs by the August 15, 2007, deadline for *amicus curiae* involvement.

Most notably, the Bush Administration urged the Supreme Court to reject the notion of scheme liability. "Congress' unwillingness to recognize a private right of action for aiding and abetting suggests that this Court should be loath to create the functional equivalent of such a right of action itself," the Bush Administration's brief said. "Such a radical expansion of liability is a task for Congress, not the courts."

Sixteen former Securities and Exchange Commission chairmen, commissioners and officials, submitted an *amicus* brief opposing the concept of scheme liability. The New York Stock Exchange and NASDAQ, American Bankers Association, American Institute of Certified Public Accountants, and the U.S. Chamber of Commerce also filed briefs opposing scheme liability. On the other side, the Regents of the University of California, 32 states and numerous and various state retirement systems filed *amicus curiae* briefs for the Plaintiffs.

Public Policy Concerns. Another factor militating against scheme liability is the potential for such liability to encourage wasteful and meritless litigation.

It is well recognized that private securities fraud actions can be employed abusively to impose substantial costs on companies and individuals who conform to the law. Even weak securities fraud cases may have substantial settlement value because of the huge potential impact an adverse judgment will have on the bottom line. Moreover, the pendency of a securities fraud lawsuit may frustrate or delay normal business activity. Most securities litigation also entails enormous discovery costs regardless of whether it is meritorious.

Scheme liability would greatly expand the categories of targeted defendants, permitting suit against limitless numbers of counter-parties with no direct connection to market activity. A plethora of accounting firms, law firms and investment banks would be prime targets of abusive securities lawsuits because the deeper the pocket, the greater the likelihood that a marginal party will be added as a defendant. There is also concern that amorphous and poorly defined liability rules will likely worsen the competitive position of American markets, discouraging foreign investors from investing in the United States public markets.

Conclusion. The *Stoneridge* case provides the Supreme Court with the unique opportunity to clarify the limits of liability under Section 10(b) and Rule 10b-5. It is the first time since *Central Bank* that the Supreme Court will grapple with the contours of liability for so-called secondary actors. As a result, the business community is closely watching what the Supreme Court will do.

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