SECURITIES LAW360

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Stoneridge: Not The End Of The Road

Friday, Jan 18, 2008 --- The United States Supreme Court on Jan. 15, 2008, issued its highly anticipated decision in Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc., sharply curtailing if not virtually eliminating a popular theory under which banks, auditors, outside advisors and business partners had been charged with securities fraud liability as a result of their business relationships and dealings with public companies that had engaged in securities fraud.

At issue in the case was whether companies that had business dealings with a public company which had engaged in securities fraud could themselves be held liable for such involvement under § 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b–5, where they made no public statements themselves but merely were alleged to have knowingly participated in business arrangements that were intended to assist the public company in issuing misleading financial statements affecting its stock price.

The theory of cases like this — often dubbed "scheme liability" — was that the defendant businesses had engaged not in untrue or misleading statements or omissions in violation of Rule 10b-5(b), or a fraud or deceit in violation of Rule 10b-5(c), but rather simply had participated in a "scheme...to defraud" in violation of Rule 10b-5(a).

While the initial characterization of the Supreme Court's ruling in the press was that it represented a big win "for business," the reality is more nuanced.

The rejection of "scheme liability" obviously helps protect many categories of potential "deep pocket" defendants — such as banks and other financing parties, accountants, lawyers and other professionals — from potential multibillion dollar class-action securities-fraud liabilities based on their dealings with public companies that were engaged in fraud.

Other segments of the business community, however, may not fare so well. For example, pension funds that have suffered securities fraud losses now must find other ways to recover those losses if the primary wrongdoer lacks sufficient assets or insurance, lest they become underfunded.

Similarly, D&O insurers of the primary wrongdoers will find that there are fewer checkbooks at the table (such as those of professional liability insurers) to share the cost when it comes time to negotiate settlements.

Moreover, it still remains to be seen whether the ever-creative securities fraud bar will be able to find ways to recharacterize their cases against secondary actors so as to be able to keep them viable even under the

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strictures laid down in Stoneridge.

Background

The Plaintiffs in Stoneridge brought a securities fraud class action against cable company Charter Communications, Inc. for alleged misstatements in its financial statements designed to inflate its stock price.

In addition to suing Charter, Plaintiffs also sued certain of its third-party vendors, including respondents Scientific-Atlanta, Inc. and Motorola, Inc., claiming they had engaged in certain wash transactions that had no legitimate business or economic purpose except to facilitate Charter's misleading of its auditors so as to gain approval for its misstated financial statements.

Notably, Plaintiffs alleged that Respondents in entering into these wash transactions actually knew the fraudulent purpose that Charter sought to accomplish through them with regard to its financial statements. Respondents, however, had no role in preparing or disseminating Charter's financial statements and had made no public statements concerning them.

The Supreme Court's Decision

After the district court dismissed the case against the Respondents for failure to state a claim and the Eighth Circuit affirmed, the Supreme Court affirmed the dismissal in a 5-3 ruling written by Justice Kennedy.

Justice Kennedy's majority opinion began by pointing to the Court's 1994 holding in Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164, 191 (1994), that the § 10(b) implied private right of action does not extend to aiders and abettors.

Central Bank noted that allowing such liability would enable plaintiffs to recover without showing any reliance by the plaintiffs on the aider and abettor's actions, and that the requirement of reliance was a critical limitation on such claims.

While Congress later responded to Central Bank by authorizing the SEC to bring civil proceedings against such aiders and abettors, it did not include any authorization to restore the right of private 10b-5 plaintiffs to bring suit against such persons.

The Supreme Court then considered whether Respondents' allegedly deceptive acts met the elements for 10b-5 liability. The Court found them lacking.

The Court held that because the Respondents were under no duty to disclose and their deceptive acts were not disclosed to the investing public, the plaintiffs could not show any reliance upon those acts "except in an indirect chain that we find too remote for liability."

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The Court noted, “It 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.”

The Court also noted that Congress had specifically considered undoing the effects of the Central Bank holding, including in regard to private securities fraud litigation, but ultimately decided to grant express authorization only to the SEC to proceed against aiders and abettors.

Given that background of circumscribed Congressional action, the Court said, it would be an unwarranted extension of the private right of action to essentially revive the aiding and abetting liability that Central Bank had struck down beyond the limited degree that Congress had expressly authorized in response.

The Court cited several beneficial policy effects that it said would result from this interpretation of the private right of action.

One was that allowing liability in circumstances like those at bar would open the door to expanding private securities actions into matters “beyond the immediate sphere of securities litigation and in areas already governed by functioning and effective state-law guarantees,” such as the regulation of ordinary business operations like purchase and supply contracts.

Additionally, allowing such liability would “expose a new class of defendants” to the risks that “extensive discovery and the potential for uncertainty and disruption in a lawsuit [would] allow plaintiffs with weak claims to extort settlements from innocent companies,” which the Court said might raise the cost of business and deter foreign firms “with no other exposure to our securities laws” from doing business in the United States.

The Court even expressed a concern that the risks of “scheme liability” could “raise the cost of being a publicly traded company under our law and shift securities offerings away from domestic capital markets.”

The Court stressed that its decision should not be regarded as a “free pass” for secondary actors who engage in deceptive conduct, noting that even though such actors might be beyond the litigation reach of private plaintiffs, they were still subject to criminal penalties and civil enforcement by the SEC.

Justice Stevens filed a dissenting opinion joined by Justice Souter and Justice Ginsberg, asserting that the Court had taken an “unduly stringent” view of the reliance requirement in 10b-5 cases.

He argued that, in contrast to the facts that had given rise to Central Bank, this was a case where the Respondents were actively involved in deceptive conduct themselves.

In his view, “[i]nvestors relied on Charter’s revenue statements in deciding

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whether to invest in Charter and in doing so relied on respondents' fraud, which was itself a 'deceptive device' prohibited by §10(b) of the Securities Exchange Act of 1934."

Conclusion

Stoneridge represents a significant victory for banks, other financing parties, accountants, lawyers and other professionals who have increasingly been targeted by the plaintiff's securities bar as potential deep pockets.

The Court cut off a potentially drastic expansion of the securities laws to reach conduct by such secondary actors that may only be tangentially related to the primary wrongdoer's fraudulent conduct.

Currently, in Enron-related litigation, for example, such as Regents of the University of California v. Credit Suisse First Boston (USA), Inc., 482 F.3d 372 (5th Cir. 2007), pet. for cert. filed, 75 U.S.L.W. 3557 (Apr. 5, 2007) (see C&P March 28, 2007 client alert), private securities plaintiffs are seeking billions of dollars in damages from investment banks who advised Enron on its fraudulent transactions.

The Stoneridge decision poses a very serious roadblock to such claims, at least as they are currently pled.

However, securities fraud plaintiffs may possibly now pursue creative new forms of pleading in an attempt to plead around Stoneridge's holding — such as trying to allege that, in contrast to Stoneridge, the actions of the defendants in their cases did make it "necessary or inevitable for [the public company] to record the transactions as it did."

In sum, while the rules of the game plainly have changed, and perhaps significantly so in favor of many categories of defendants, it may be premature to declare the game over quite yet.

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