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U.S. Supreme Court Curtails Investor Lawsuits: Possible Effects on Subprime Exposure

Breaking Developments Affecting the London Market
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The United States Supreme Court dealt a significant blow to investor lawsuits in a decision issued on January 15, 2008. In *Stoneridge Investment Partners v. Scientific-Atlanta, Inc.* (06-43), the Supreme Court curbed the ability of shareholders to recover damages from “secondary” parties, which could include investment banks, lawyers, accountants, consultants and other parties.

Secondary Liability per *Stoneridge*

Stoneridge involved a class-action suit filed by investors against Charter Communications, Inc., a cable television operator. The *Stoneridge* plaintiffs also named two of Charter’s suppliers, Scientific-Atlanta, Inc. and Motorola, Inc. The investors alleged that Scientific-Atlanta and Motorola were liable for securities fraud under the Securities Exchange Act of 1934 and SEC Rule 10b-5. The complaint alleged that Charter entered into fraudulent agreements with its suppliers to permit Charter to report higher revenues and profitability, thereby misleading investors. The investors claimed that the suppliers’ knowing participation in this scheme to defraud investors swept them into the purview of securities fraud.

Writing for a 5-3 majority, Justice Anthony Kennedy stated that investors could not establish reliance on any deceptive statements made by Charter’s suppliers to establish liability on the suppliers. Scientific-Atlanta and Motorola “had no duty to disclose, and their deceptive acts were not communicated to the public.” As a result, investors “cannot show reliance upon any of the [companies’] actions except in an indirect claim chain that we find too remote for liability.” Justice Kennedy was joined by Chief Justice John Roberts and Justices Antonin Scalia, Clarence Thomas and Samuel Alito.

The Supreme Court previously ruled that the private cause of action implied in §10(b) and Rule 10b-5 does not extend to aiding and abetting a violation. *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 191 (1993). Although Central Bank prompted calls for the creation of liability for aiding and abetting, Congress declined to do so in adopting the Private Securities Litigation Reform Act of 1995, instead directing the SEC to prosecute aiders and abettors.

Stoneridge confirms that a securities fraud plaintiff must satisfy each of the elements or preconditions for §10(b) liability, including reliance upon a material misrepresentation or omission by the defendant. In the context of secondary parties, proof of reliance generally requires some combination of a duty to disclose, public misstatements and/or deceptive acts communicated to the investing public during the relevant times—factors that do not generally exist in the context of secondary parties. Despite allegations of a “scheme” by investor plaintiffs, *Stoneridge* makes clear that actions by secondary parties, which are not disclosed to the investing public, are too remote to satisfy the reliance requirement. Accordingly, the Supreme Court rejected investor attempts to extend securities fraud liability into the realm of ordinary business operations.

What This Means for Subprime Exposure

Like many of the other recent legislative and regulatory developments, the long-term affects of *Stoneridge* are unclear in the context of subprime lending. The *Stoneridge* decision has no bearing on shareholder claims against the primary entity or securities issuer. An issuer of securities, including its directors and officers, may remain exposed to securities fraud claims to the extent that subprime issues affected the issuer’s financial performance, but were not properly disclosed. Thus, recent lawsuits by shareholders against the issuing entities with participation in the subprime markets will remain unaffected by the Supreme Court’s decision.

Nevertheless, the *Stoneridge* decision will make it more difficult for investors to reach beyond the specific entity, fund or investment in which they invested to assert a securities fraud claim against secondary parties. Thus, the decision has the benefit of curbing lawsuits triggering professional indemnity obligations involving accountants, lawyers, investment banks, and others secondary parties. Further, the decision will make it difficult for investors to assert claims against subprime participants where the investors did not invest directly with those entities, instead asserting derivative liability or some “scheme” in furtherance of the alleged securities fraud. This development is good news for many directors, officers, other professionals, and their insurers.

Finally, it should be noted that *Stoneridge* does not necessarily give the secondary parties a free pass. An issuer, which is held liable for securities fraud by investors, could pursue the secondary parties based on common law claims under state law. Further, *Stoneridge* has no bearing upon whether an investor could seek to hold a secondary party liable for securities fraud under a state securities act.

Although helping to refine the landscape for potential subprime issues, the Supreme Court’s ruling in *Stoneridge* leaves many issues to be resolved by future developments.

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