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Supreme Court Grants Review To Consider Whether Shareholders Can Assert "Scheme" Claims Against Secondary Actors

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Supreme Court Grants Review To Consider Whether Shareholders Can Assert "Scheme" Claims Against Secondary Actors

Can shareholders of a company sue that company's vendors, business partners, accountants, banks, or lawyers for participating in a "scheme" to issue materially misleading statements to shareholders? The Fifth and Eighth Circuit Courts of Appeal have said "no," and the Ninth Circuit has said "sometimes." The issue might now be settled relatively soon, because today the United States Supreme Court decided to review a case that should provide guidance on this important question. *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, 549 U.S. ____ (U.S. 06-43 Mar. 26, 2007).

In the decision under review, the Eighth Circuit ruled that a party cannot be liable under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5(a) and (c) promulgated thereunder for engaging in "schemes" to defraud. According to the Eighth Circuit, liability under Section 10(b) is limited to those who (1) "make or affirmatively cause to be made a fraudulent misstatement or omission," or (2) "directly engage in manipulative securities trading practices."

The Eighth Circuit affirmed dismissal of securities fraud claims asserted by shareholders of Charter Communications ("Charter") against two of Charter's vendors, Scientific-Atlanta, Inc. and Motorola, Inc. Charter's shareholders claim that Scientific-Atlanta and Motorola entered into sham transactions while knowing that Charter intended to account for the transactions improperly. Neither Scientific-Atlanta nor Motorola made or affirmatively caused to be made any allegedly misleading statements to Charter's shareholders about those transactions. Nevertheless, Charter's shareholders claim that the two vendors could be liable for participating with Charter in a "scheme" to defraud Charter's shareholders. The vendors allegedly deceived Charter's shareholders because the "sham" transactions artificially inflated Charter's cash flow by about $17 million in one quarter, which thereby inflated revenue forecasts and Charter's stock price.

In rejecting "scheme" liability, the Eighth Circuit relied on the Supreme Court's landmark decision in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 191 (1994). In *Central Bank*, the Court prohibited private claims brought under Section 10(b) and Rule 10b-5 for aiding and abetting. *Central Bank*, however, also observed that the absence of aiding and abetting liability "does not mean that secondary actors in the securities markets are always free from liability."

More than a decade after *Central Bank*, the federal courts are divided on whether "scheme" claims against secondary actors are different from claims for aiding and abetting. Although the Eighth Circuit ruled that "scheme" liability cannot be squared with *Central Bank*'s prohibition on aiding and abetting liability, the Ninth Circuit has ruled that it can under limited circumstances. Last year, the Ninth Circuit held that secondary actors can be liable for participating in a scheme to deceive investors if they engaged in conduct that had the "principal purpose and effect of [creating] a false appearance of revenues" even if they did not make misleading statements. *Simpson v. AOL Time Warner, Inc.*, 452 F.3d 1040, 1048 (9th Cir. 2006). Just last week, however, the Fifth Circuit expressly rejected the Ninth Circuit's standard and joined the Eighth Circuit in rejecting "scheme" liability for secondary actors. *Regents of The University of California v. Credit Suisse First Boston (USA), Inc., et al.*, No. 06-20856 (5th Cir. Mar. 19, 2007).

The Supreme Court likely will hear arguments and issue an opinion in *Stoneridge* during its next term, which begins in October 2007.