manatt

January 17, 2008

SECURITIES LAW UPDATE @MANATT

NEWSLETTER OF THE CAPITAL MARKETS PRACTICE GROUP OF MANATT, PHELPS & PHILLIPS, LLP

In Closely Watched *Stoneridge* Case, U.S. Supreme Court Rejects "Scheme Liability" Theory and Declines to Extend Securities Fraud Liability to Secondary Actors in Context of Private Litigation

Court Upholds Dismissal of Secondary Actors From Private Securities Fraud Action, Holding That Plaintiff Failed to Allege Necessary Element of Reliance

Bruce B. Kelson, Partner, Securities Litigation Practice Group

James J. Vieceli, Partner, Capital Markets Practice Group

On January 15, 2008, the United States Supreme Court issued its much anticipated ruling in the high profile case of *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, No. 06-43, 552 U.S. ____, in which it considered the reach of the implied private right of action under §10(b) of the Securities Exchange Act of 1934. The Court addressed the specific issue of whether the private right of action could be used to impose liability on "secondary actors," such as suppliers and customers, whose alleged nonpublic deceptive acts – in this case, sham business transactions between the secondary actors and the issuer of securities – allowed the issuer to mislead its auditor and issue false financial statements affecting its stock price. In a 5-3 vote, the Court ruled that the suppliers/customers could not be held liable in a private action under a so-called "scheme liability" theory, because

NEWSLETTER EDITORS

Blase P. Dillingham
Partner
bdillingham@manatt.com
310.312.4159

James J. Vieceli
Partner
jvieceli@manatt.com
310.312.4246

Mark J. Kelson
Partner
Chair, Capital Markets Practice Group
mkelson@manatt.com
310.312.4156

OUR PRACTICE

Our Capital Markets Practice Group represents publicly held companies, investment banks and institutional shareholders in connection with public offerings of equity and debt securities. We have particular experience in initial public offerings and offerings of convertible and other hybrid securities. We represent leading national investment banks, as well as maintaining an extensive base of public corporate clients. Our lawyers regularly participate in transactions involving a wide variety of industries, including manufacturing, telecommunications, financial services, media, consumer products and retail. We also advise our clients with respect to corporate governance matters and the design and implementation of comprehensive compliance investors in the issuer's securities did not rely upon the representations or conduct of the secondary actors.

The ruling reaffirms that the §10(b) private right of action does not permit suits against simple "aiders and abettors," and, more importantly, establishes that secondary actors cannot be held liable as "primary violators" in private securities fraud actions where the element of reliance cannot be met. The ruling thus grants broad protection to secondary actors against private suits based merely on their interactions or transactions with other companies that engage in securities fraud – and substantially allays the fears of the business communities that the "scheme liability" theory would expose a new class of defendants to abusive and expensive securities litigation, increase the risks and costs of doing business with U.S. companies, and impair the competitive position of the U.S. capital markets. As the Court emphasized, however, secondary actors that engage in sham transactions still remain subject to potential criminal prosecution as well as civil enforcement actions brought by the SEC.

Background

According to the complaint, executives of Charter Communications, Inc. ("Charter"), a cable operator, realized in late 2000 that they would miss projected operating cash flow numbers by $15 to $20 million. To meet the shortfall, Charter decided to alter existing arrangements with two suppliers of digital cable converter (set top) boxes, Scientific-Atlanta and Motorola, to overpay the suppliers $20 for each set top box it purchased, with the understanding that the suppliers would return the $20 overpayment back to it by purchasing overpriced advertising time. The transactions had no economic substance, but allowed Charter to record the advertising payments as revenue while capitalizing its set top box purchases.

The parties allegedly prepared documents intended to make it appear that the set top box pricing and advertising transactions were unrelated and conducted in the ordinary course of business. At Charter's request, Scientific-Atlanta sent a letter to Charter stating falsely that it was raising its price for set top boxes by $20 to reflect increased production costs. Motorola entered into a revised contract in which Charter agreed to pay a liquidated damages amount of $20 for units that it knew it would not take.

programs.

INFO & RESOURCES

. Subscribe
. Unsubscribe
. Sarbanes-Oxley Act
. Newsletter Disclaimer
. Technical Support
. Manatt.com

Both suppliers simultaneously entered into contracts with Charter to purchase advertising time at above market prices. The set top box agreements were backdated to make it appear that they were negotiated one month prior to the new advertising contracts.

As a result of these arrangements, Charter recorded – and reported to the market – advertising payments that inflated revenue and operating cash flow by approximately $17 million. The suppliers had no role in preparing or disseminating Charter's financial statements, and their own financial statements booked the transactions as a wash in accordance with GAAP.

The plaintiff, Stoneridge Investment Partners, LLC, brought a securities fraud class action against Charter and certain of its executives as well as the two suppliers. Stoneridge later obtained a settlement with Charter and the executives in the amount of $144 million, covering numerous allegations of fraud – but continued the litigation as against the two suppliers based on the allegations noted above. The district court dismissed the case for failure to state a claim, and the Eighth Circuit Court of Appeals affirmed. The Supreme Court granted certiorari in order to resolve a conflict in the Courts of Appeals as to "when, if ever, an injured investor may rely upon §10(b) to recover from a party that neither makes a public misstatement nor violates a duty to disclose but does participate in a scheme to violate §10(b)."

Ruling

The Court's ruling, authored by Justice Kennedy, and joined by Chief Justice Roberts and Justices Scalia, Thomas and Alito, notes first that "aiding and abetting" liability is not available in a private securities fraud action and thus, the conduct of a secondary actor must satisfy each of the elements of liability, including reliance by the plaintiff upon the defendant's misrepresentation or deceptive act. (Addressing certain language in the Court of Appeals opinion, the Court confirmed that "[c]onduct itself can be deceptive" and that §10(b) liability does not require a "specific oral or written statement.") In its central holding, the Court then stated that the plaintiff in this situation cannot show reliance upon any actions of the secondary actors – except in an "indirect chain" that the Court found "too remote for liability." The Court noted that the suppliers had no duty to disclose information, that their deceptive acts were not communicated or disclosed to the investing public, and that "[n]o member of the investing public had knowledge, either actual or presumed, of respondents' deceptive acts during the relevant times." Accordingly, the investors did not rely – and could not have relied – upon the suppliers' sham transactions with Charter. The Court emphasized that "[i]t was Charter, not respondents, that misled its auditor and filed fraudulent financial statements" and that "nothing respondents did made it necessary or inevitable for Charter to record the transactions as it did."

The plaintiff argued that "scheme liability" is appropriate because the suppliers engaged in conduct with the "purpose and effect" of furthering a scheme to misrepresent Charter's revenue, and that in such situations investors rely not only upon an issuer's public statements but also upon the transactions those statements reflect. The Court rejected this theory, stating that if this concept of reliance were adopted, "the implied cause of action would reach the whole marketplace in which the issuing company does business." The Court emphasized again that the suppliers' nonpublic deceptive acts were "too remote to satisfy the element of reliance," and that §10(b) "does not reach all commercial transactions that are fraudulent and affect the price of a security in some attenuated way."

The Court supported its ruling by stating that such an extension of the implied cause of action would invite federal litigation "beyond the immediate sphere of securities litigation" and would also essentially undermine Congress' decision, in the Private Securities Litigation Reform Act of 1995, to authorize the SEC – but not private plaintiffs – to bring "aiding and abetting" claims. The Court also noted the "practical consequences" of such an expansion, as illustrated in amicus curiae briefs, including exposure of a new class of defendants to the risks of extortionate litigation, increased costs of doing business with U.S. companies, and shifting of securities offerings away from the domestic capital markets. The Court further noted its reluctance to find implied rights, and that the "decision to extend the cause of action is for Congress, not for us." In closing, the Court emphasized that secondary actors are subject to criminal penalties and civil enforcement by the SEC, and that the "enforcement power is not toothless."

Justice Stevens, joined by Justices Souter and Ginsburg, dissented from "the Court's continuing campaign to render the private cause of action toothless" and argued that the requirements of §10(b) were amply met because investors "relied on Charter's revenue statements in deciding whether to invest in Charter and in doing so relied on respondents' fraud, which was itself a 'deceptive device' prohibited by §10(b)." (Justice Breyer did not participate in the ruling.)

Conclusions and "Take-Aways"

Stoneridge is the latest in a series of pro-business Supreme Court decisions in the area of securities law and litigation. In *Stoneridge*, the Court held essentially that private securities fraud plaintiffs may proceed only against defendants upon whose statements or conduct the plaintiff has relied, either because the defendant had a duty to disclose material facts that were omitted or because such statements/conduct were made public – and that a private claim may not proceed against a secondary actor based solely on involvement in an issuer's own fraud. In rejecting "scheme liability," the ruling prevents the expansion of primary violator securities liability as to other entities, such as vendors and business partners, who might otherwise become swept up in litigation based on their commercial involvement with a company that is the primary target of securities litigation. The ruling also likely provides increased protection for accountants, lawyers and other advisors who work with companies that become subject to securities litigation. At its foundation, the ruling also indicates the current temperament of the Court with respect to the expansion of implied private rights, as reflected in the suggestion of Chief Justice Roberts during oral argument that the Court should perhaps "get out of the business of expanding" private causes of action under §10(b). However, the protection afforded by this ruling should not be interpreted to reduce the potential for liability in criminal proceedings or SEC enforcement actions. Accordingly, companies should continue to enter into transactions for proper business purposes and to document those transactions accurately and contemporaneously.

back to top

Bruce B. Kelson Mr. Kelson's practice focuses on securities litigation and other complex commercial litigation for U.S. and foreign clients. He represents and advises clients in connection with securities class action and shareholder derivative litigation, internal investigations, SEC and other regulatory proceedings, transaction-related issues and litigation, director and officer liability and corporate governance issues and litigation, antitrust and unfair competition litigation, and other commercial litigation. Mr. Kelson has extensive experience in federal and state courts and arbitral forums in California, New York, Delaware and other states.

James J. Vieceli Mr. Vieceli's practice focuses on corporate and securities matters, including public and private offerings of equity and debt securities, capital markets transactions, mergers and acquisitions and venture capital investments. He also regularly advises clients on their SEC reporting and disclosure obligations and corporate governance requirements.