

January 15 , 2008

Supreme Court & Appellate Practice

Stoneridge Investment Partners v. Scientific-Atlanta, Inc., No. 06-43

In a case argued by Mayer Brown partner Stephen Shapiro and previously described by the Wall Street Journal as “the biggest securities-litigation court clash in a generation,” the Supreme Court today affirmed that third parties who do not themselves mislead investors cannot be held liable for damages under Section 10(b) of the Securities Exchange Act even if their conduct facilitates the fraud of another.

Section 10(b), which prohibits securities fraud, has been found to contain an implied private right of action for damages. In *Central Bank v. First Interstate Bank*, 511 U.S. 164 (1994), the Supreme Court held that Section 10(b) does not create secondary liability for those who “aid and abet” securities fraud and that only primary violators are subject to investor suits for damages. In the subsequently enacted Private Securities Litigation Reform Act, Congress confirmed that the SEC’s enforcement authority extends to aiders and abettors of fraud, but did not similarly include aiders and abettors within the Section 10(b) private cause of action. In response, securities plaintiffs began asserting that defendants who do not themselves make misleading statements to investors but who participate in a “scheme” that facilitated a fraud are primary violators of Section 10(b) rather than aiders and abettors. Every federal circuit to have considered the issue, other than the Ninth, refused to embrace this theory of “scheme liability.” Today, the Supreme Court emphatically endorsed the lower court consensus and rejected the notion of scheme liability under Section 10(b), holding that the third-party defendants have no liability to the investors under that provision “because the investors did not rely upon their statement or representations.”

Stoneridge was filed as a putative class action under Section 10(b) on behalf of shareholders of Charter Communications, a cable television company. The plaintiffs alleged that Charter and its executives engaged in a “multi-prong scheme” to fraudulently inflate revenues. Part of the alleged scheme involved transactions between Charter and two equipment vendors. Under the terms of the relevant agreements, Charter purportedly paid the vendors more for their products than it would otherwise have, and in exchange was paid an identical amount by the vendors for advertising. Charter allegedly misled its auditor about these transactions and used them to overstate its earnings by \$17 million. In their suit, plaintiffs asserted that the vendors were liable as primary violators under Section 10(b) for their role in Charter’s “scheme” to defraud its investors. There was no allegation that the vendors provided information to Charter’s accountants or to any Charter shareholder, that Charter’s shareholders were aware of the transactions with the vendors, or that the vendors had any role in preparing Charter’s financial statements. And the vendors accounted for the transactions properly in their own financial statements. But plaintiffs claimed that Charter’s fraud could not have occurred without the vendors’ conduct, and that the vendors knew or should have known of Charter’s plan to use the transactions to inflate its revenue figures. The district court dismissed the suit against the

vendors, and the Eighth Circuit affirmed. The Supreme Court granted certiorari.

In a 5-3 decision penned by Justice Kennedy, the Supreme Court affirmed (Justice Breyer was recused). The Court first emphasized the rule that, in private Section 10(b) cases, plaintiffs must show that they relied upon the defendant's deceptive acts. Slip op. at 8. It then rejected the investors' attempt to avoid the reliance requirement in cases where the defendant did not directly mislead investors but where its actions facilitated the issuer's fraudulent "scheme." Id. at 8-13. The Court deemed such a connection "too remote to satisfy the requirement of reliance," because "it was Charter, not [the vendors], that misled its auditor and filed fraudulent financial statements" and "nothing [the vendors] did made it necessary or inevitable for Charter to record the transactions as it did." Id. at 10. Accepting the plaintiffs' theory of reliance, the Court said, would "provide a private cause of action against the entire marketplace in which the issuing company operates" and thereby extend Section 10(b) beyond the securities markets into "the realm of ordinary business operations." Id. at 10-11. The Court feared that such a vast expansion would cause the federal securities laws to interfere with the traditional role of state law in governing contracts. Id. at 10. In addition, the Court noted, expansion of liability under Section 10(b) would have significant deleterious consequences for the national economy, by heightening the risk of extortionist suits and otherwise increasing the costs of doing business in America, which could deter foreign firms from doing business here and cause companies to issue securities in foreign rather than domestic capital markets. Id. at 12-13.

Today's ruling is a significant victory for the business community, even though it simply affirms the view shared by the vast majority of courts to rule on the issue of scheme liability. The decision reinforces the holding of Central Bank that secondary parties will not face private liability under Section 10(b) for securities violations by issuing companies, unless those parties themselves misled investors by committing deceptive acts upon which the investors relied. And it makes clear that it is up to the SEC to bring actions against secondary violators, as Congress provided in the Private Securities Litigation Reform Act.

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