Client Advisory

KELLEY DRYE

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THE STONERIDGE DECISION

Reliance Returns To 10b-5 Cases

Introduction

On January 15, 2008, the U.S. Supreme Court handed down its decision in *Stoneridge Investment Partners v. Scientific Atlanta*, the case which has been called the most important securities law case to reach the Court this decade and "the securities lawyer's *Roe v. Wade*.[1]" While the case had both domestic and international corporations concerned about its potential to dramatically expand the scope of 10b-5 claims in order to target third parties doing business with public companies that concern can now be laid to rest.

With this decision, the U.S. Supreme Court determined that third parties such as investment banks, accounting firms, and lawyers, among others, who contract with companies that commit securities fraud are not liable to shareholders of those companies as primary violators of § 10(b) and Rule 10b-5. In a 5-3 decision (Justice Breyer took no part in the consideration or decision of the case), the Supreme Court firmly declared secondary actors free from liability for participating in a principal's fraud against its investors, so long as there is no reliance on the actions of the secondary actor by the investors in making their investment decisions.

Holding

The Court held on a motion to dismiss, that the implied private right of action under Section 10(b) of the Securities Exchange Act of 1934[2] does not apply to plaintiffs who fail to show that investors relied upon the conduct of the defendant in question. The Court assumed, as it must on a motion to dismiss, that the allegations of the complaint were true, and therefore assumed defendants had actually and knowingly entered into backdated contracts and sham transactions with a company that then reported those transactions on its financials in such a way as to misrepresent its financial standing. Despite this actual and knowing conduct by the defendants, the Court held that no liability could be imposed because the defendants had no duty to the investors of another company, nor did they make any public statements about the transactions such that their conduct could be termed 'fraud on the market.'[3]

[1] Ariane de Vogue, *Supreme Court to Examine Scope of Investor Rights*, ABC News, Oct. 9, 2007 (quoting Donald Langevoort, Professor, Georgetown University Law Center).

[2] 15 U.S.C. § 78j(b).

[3] See *Basic Inc. v. Levinson*, 485 U.S. 224 (1988).

Background

Charter Communications, Inc. (Charter), a publicly traded company, is one of the country's largest cable television providers. Charter sells digital service to customers, who receive cable programming through set-top boxes connected to their television sets. Charter contracted with vendors, such as defendants Scientific-Atlanta and Motorola, to purchase these set-top boxes and other equipment which it then provided to its customers. In August 2000, facing a revenue and cash flow deficiency, Charter approached Scientific-Atlanta and Motorola with a plan, the purpose of which was to create the appearance of a growth in Charter's revenues and cash flow – common market indicators of the value of a cable company – in order to maintain the value of its common stock.

As part of Charter's plan, it entered into new contracts with Scientific-Atlanta and Motorola under which it agreed to pay $20 more per set-top box than it had been obligated to pay under its existing contracts. The parties also entered into separate advertising contracts, under which the defendants agreed to purchase advertising from Charter at a price exactly equal to Charter's overpayment on the set-top boxes. Charter accounted for the equipment contracts as expenses and the advertising contracts as revenue, allowing it to overstate its revenue and operating cash flow in financial statements filed with the Securities and Exchange Commission and disseminated to the public. Once these facts were revealed and Charter's financial statements were adjusted to reflect its actual financial position, the market price of its securities suffered a substantial decline.

Case History

Stoneridge Investment Partners, LLC, on behalf of the class of investors who held Charter stock at the time of the alleged scheme, brought a securities fraud class action against Charter, certain of its executives, its independent auditors, and Scientific-Atlanta and Motorola. The lawsuit alleged that the defendants engaged in deceptive acts in violation of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 of the Code of Federal Regulations[4] and were liable for their knowing scheme with Charter to inflate its revenue and cash flow by $17 million and deceive its investors, even if they never actually made any deceptive statements directly to those investors. The investors thus claimed that the defendants were "primary violators," as opposed to "secondary violators" due to their participation in Charter's fraudulent securities scheme.

The other non-vendor defendants settled with the plaintiffs, but Scientific-Atlanta and Motorola moved to dismiss the complaint for failure to state a claim. The District Court for the Eastern District of Missouri granted the motion and found that the defendants were not primary violators of § 10(b) and Rule 10b-5, but rather were mere aiders and abettors of Charter in its own violation of the statute. Thus the court granted the defendants' motion to dismiss the suit against them on the basis that claims against § 10(b) aiders and abettors are barred by the U.S. Supreme Court's holding in Central Bank[5].

[4] 17 CFR § 240.10b-5 (2007).

[5] Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164 (1994).

The Court of Appeals for the Eighth Circuit affirmed, holding that "any defendant who does not make or affirmatively cause to be made a fraudulent misstatement or omission, or who does not directly engage in manipulative securities trading practices, is at most guilty of aiding and abetting and cannot be held liable under § 10(b) or any subpart of Rule 10b-5."[6]

Analysis

The Supreme Court affirmed the decision of the Court of Appeals and reaffirmed its holding in *Central Bank* that no private cause of action exists for a claim of mere aiding and abetting. No express cause of action against aiding and abetting is to be found in the text of the statute or rule, and the Court found that Congress had rejected the creation of any implied cause of action when it passed the Private Securities Litigation Reform Act of 1995 (PSLRA), which provide that only the Securities and Exchange Commission could prosecute such claims.[7] The Court resoundingly rejected the concept of "scheme liability" as being too far-reaching and with the danger of exposing innocent companies to "extortion" from plaintiffs facing a loss in their investment based on the mere fact that that these companies did business with a party that then defrauded its investors.[8] The Court held that liability must rest on causation, where plaintiffs must show that the deceptive acts committed by the third party in aid of the primary actor's fraud were proximately related to the harm suffered by the investors. In other words, the investor must have relied on such deceptive acts. The Court noted that reliance effectively means either the deceptive acts were communicated to the public so that the now public information is reflected in the price of the security (the *Basic* "fraud on the market test") or that defendants must have had a duty to disclose under the securities law but failed to do so. In this case neither Scientific-Atlanta or Motorola had any duty under the securities law to disclose anything to Charter's investors nor did they make any public statements concerning the alleged transactions. The Supreme Court determined that without reliance by investors, there can be no actionable harm against third parties. Since there was no showing that the defendants ever made any deceptive statements to the Charter investors upon which they relied, the defendants could not be liable for their losses.

In the opinion, the Supreme Court draws a distinction between the world of "ordinary business" and that of securities markets, and is conscious of trying to avoid making all fraud subject to a securities claim. Thus the Court notes that the defendants' conduct in question took place in the realm of ordinary business of purchase and supply contracts governed by state law, as opposed to the realm of securities markets governed by the SEC, and then notes that federal involvement should not extend beyond the area of securities litigation absent a showing that ordinary business operations have been used to affect the securities market.[9]

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[6] *In re: Charter Communications, Inc., Securities Litigation*, 443 F.3d 987, 992 (8th Cir. 2006).

[7] 15 U.S.C. § 78t(e).

[8] *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, No. 06-43, slip op. at 13 (U.S. Jan. 15, 2008).

[9] *Id.* at 10.

Conclusion

Stoneridge clarified the limits of liability under § 10(b) and Rule 10b-5 and protects third parties from being held responsible for the fraudulent actions of business associates. Even not-so-innocent third parties will avoid liability so long as they make no statements to the public that affect investment decisions. As important, the Court made its seminal ruling in the context of a motion to dismiss, thus indicating that such claims can and should be dismissed at the earliest states of litigation.

The Court clearly was cognizant of the possible dangers of an expansive reading of Rule 10b-5 in this regard:

> Adoption of petitioner's approach would expose a new class of defendants to these risks [of extortive lawsuits]. As noted in *Central Bank*, contracting parties might find it necessary to protect against these threats, raising the costs of doing business. Overseas firms with no other exposure to our securities laws could be deterred from doing business here. This, in turn may raise the cost of being a publicly traded company under our law and shift securities offerings away from domestic capital markets.

International firms should take comfort from the *Stoneridge* decision. Merely doing business with U.S. parties that turn out to have defrauded their own investors will not expose such firms to liability absent a showing of their making misrepresentations on which the investing public is has relied. Just as important, such firms do not have to fear being embroiled in lengthy and costly class-action litigation before the claim is dismissed. A motion to dismiss should be enough. Bottomline, as long as companies use care to avoid making any direct misrepresentations to the public in connection with such business dealings, they may confidently transact business with public corporations without fear of potential liability for those corporations' violations of securities laws.

For More Information

If you have questions regarding this decision and its implications, please do not hesitate to contact us. Please email or call any of the following members of Kelley Drye & Warren's Litigation Group for further assistance:

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[10] *Id.* at 13.