

January 16, 2008

SUPREME COURT REJECTS “SCHEME LIABILITY” THEORY IN SECURITIES CLASS ACTIONS

Yesterday the Supreme Court issued a ruling in *Stoneridge Investment Partners v. Scientific-Atlanta, Inc.*, one of the most closely-watched securities cases in decades. In a 5-3 decision, the Court squarely rejected efforts to bring securities class actions based on “scheme liability” against secondary actors – such as lawyers, lenders, investment banks, accountants, vendors – that enter into transactions with public companies. Under the “scheme liability” theory, plaintiffs seek to hold secondary actors liable for allegedly participating in a “scheme” to defraud plaintiff shareholders even if the secondary actor did not itself make false statements to the market and the plaintiff shareholders did not rely on the secondary actor’s alleged misconduct. Given the wide range of individuals and entities interacting with publicly-traded companies on a regular basis, the Supreme Court’s decision prevents far-reaching claims of “scheme liability” from introducing inefficiencies and uncertainties into the business world and harming the competitive position of the U.S. securities markets.

In *Stoneridge*, the plaintiff shareholders alleged that Scientific-Atlanta and Motorola, equipment vendors to cable television provider Charter Communications, entered into a scheme with Charter to allow Charter to misrepresent its revenue. The plaintiff shareholders claimed that Charter overpaid the equipment vendors for cable boxes with the understanding that the vendors would use the overpayment to purchase advertising from Charter. The vendors allegedly entered into these sham transactions knowing that Charter would improperly account for them, giving investors the appearance of higher Charter revenues (which later were required to be restated). The shareholders conceded that the equipment vendors had themselves made no false public statements and had no role in disseminating Charter’s false financial statements to the market, but nonetheless claimed the vendors had defrauded them.

The Supreme Court rejected the plaintiff shareholders’ claims, holding that they could not demonstrate reliance, an essential element of a securities fraud claim. The plaintiff shareholders could not be presumed to have relied on the vendors’ conduct because they had no knowledge of the transactions with the vendors at the time they purchased Charter stock, nor did the vendors have any duty to disclose information regarding the transactions to Charter shareholders.

Most importantly, the Supreme Court rejected as “too remote for liability” the plaintiff shareholders’ claim that they had relied on the equipment vendors’ conduct because such conduct had the “purpose and effect of creating a false appearance of material fact to further a scheme to misrepresent Charter’s revenue” and impacted Charter’s financial statements as “a natural and expected consequence of” the vendors’ deceptive conduct. The Court found that the plaintiff shareholders’ arguments – that investors rely not only on a company’s financial statements, but also on the underlying transactions reflected in those financial statements – would extend securities fraud liability to “the whole marketplace in which the issuing company does business; and there is no authority for this rule.” The Court further noted that “nothing [the vendors] did made it necessary or inevitable for Charter to record the transactions as it did.”

In support of its interpretation of the reliance requirement in securities fraud cases, the Court relied heavily on Congress’ response to a 1994 Supreme Court decision, *Central Bank of Denver, N.A. v. First Interstate Bank of Denver*, which had foreclosed securities fraud claims against secondary actors for allegedly aiding and abetting securities fraud by another. In response to *Central Bank*, Congress amended the securities laws to authorize the

SEC to bring actions for aiding and abetting, but did not authorize private parties to bring such actions. The *Stoneridge* majority reasoned that allowing scheme liability would undermine Congress' determination that aiders and abettors should be pursued only by the SEC.

The Court also considered the "practical consequences" of allowing the plaintiff shareholders' scheme liability theory. Extending potential securities fraud liability as the shareholder plaintiffs sought would expose a new class of potentially innocent companies to the risk of extensive discovery being used to extort settlements. The Court also noted that scheme liability could deter overseas companies from doing business in the U.S. and shift securities offerings away from the U.S. capital markets.

While the Court affirmed the dismissal of the plaintiff shareholders' complaint, it did so on different grounds than the Eighth Circuit. The Eighth Circuit had held 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." Without discussion, the Supreme Court acknowledged that "conduct itself can be deceptive," and reiterated that secondary actors may be liable to plaintiff shareholders if the secondary actors' conduct satisfied each element of a securities fraud claim. As for defining the circumstances in which a plaintiff shareholder might successfully show that they relied on the allegedly deceptive conduct of a secondary actor, the *Stoneridge* decision provides little guidance to litigants and lower courts. That issue will likely become the next battleground in the efforts of plaintiff shareholders to bring cases against deep pocket secondary actors who they view as having played a role in their investment losses.

Two other cases presenting scheme liability issues are before the Court. Pending before the Court on petitions for writ of certiorari are the Fifth Circuit's opinion reversing class certification in *Newby et al. v. Enron Corp. et al* and the Ninth Circuit's opinion affirming the dismissal of *In re Homestore.com Securities Litigation*. Both petitions are currently set for consideration at the Court's January 18, 2008 conference.

Haynes and Boone, LLP is Texas litigation counsel for Credit Suisse First Boston (USA), Inc. (n/k/a Credit Suisse (USA), Inc. and Credit Suisse First Boston LLC (n/k/a Credit Suisse Securities (USA) LLC, together with the New York law firm of Cravath Swaine & Moore LLP, in *Newby et al. v. Enron Corp. et al*.

If you have any questions regarding the *Stoneridge* case or other Securities and Shareholder Litigation matters, please call any of the attorneys listed below.

George W. Bramblett
(214) 651-5574

george.bramblett@haynesboone.com

Noel M. Hensley
(214) 651-5631

noel.hensley@haynesboone.com

Odean L. Volker
(713) 547-2036

odean.volker@haynesboone.com

Carrie Huff
(214) 651-5509

carrie.huff@haynesboone.com

Nicholas Even
(214) 651-5045

nick.even@haynesboone.com

Thad Behrens
(214) 651-5668

thad.behrens@haynesboone.com

Dan Gold
(214) 651-5154

daniel.gold@haynesboone.com

Barrett Howell
(214) 651-5843

barrett.howell@haynesboone.com

Matt Chester
(214) 651-5338

matt.chester@haynesboone.com