SIMPSON THACHER

REPORT FROM WASHINGTON

Supreme Court Hears Arguments on Expanding Securities Fraud Liability to Secondary Actors Based on Allegedly Fraudulent, Arm's Length Business Transactions

October 10, 2007

The Supreme Court yesterday heard oral arguments in *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, a case in which the Court is expected to revisit the extent to which secondary actors may be liable in a private action under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5. Although the Supreme Court held in *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164, 114 S. Ct. 1439, 128 L.Ed.2d 119 (1994) that there is no aiding and abetting liability for violations under Section 10(b) and Rule 10b-5, the Court left open the possibility of secondary actor liability: "[a]ny person or entity, including a lawyer, accountant, or bank, who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator under 10b-5 . . . ." In recent years, an increasing number of cases have been brought against secondary actors, including financial institutions, accountants, lawyers, and, in the case of *Stoneridge*, vendors, on the grounds that they participated in a "scheme" to violate the securities laws. Faced with these cases, district and circuit courts around the country have reached different conclusions as to what conduct constitutes a primary violation of the securities laws and is therefore actionable under the securities laws. Of particular note, although not on yesterday's docket, a petition for certiorari involving the issues presented by *Stoneridge* is currently pending in a securities case related to the 2001 collapse of Enron Corp.

Simpson Thacher filed an *amicus* brief on behalf of the National Association of Manufacturers in support of affirming the Eighth Circuit's decision, arguing that actors should not be exposed to Section 10(b) liability merely by engaging in commercial transactions with an issuer of securities because they make no disclosures to purchasing shareholders and owe them no duty. In addition, firm

TO VIEW A TRANSCRIPT OF THE ORAL ARGUMENT BEFORE THE SUPREME COURT OF THE UNITED STATES IN THE STONERIDGE CASE, PLEASE CLICK HERE.

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partner Richard I. Beattie was a signatory to a separate *amicus* brief in support of the Eighth Circuit's decision that was filed on behalf of leading transactional lawyers.

BACKGROUND

The *Stoneridge* appeal arises from an Eighth Circuit case captioned *In re Charter Communications, Inc., Securities Litigation,* 443 F.3d 987 (8th Cir. 2006). Plaintiff represents a putative class of purchasers of Charter Communications, Inc.'s ("Charter") stock between November 8, 1999 and August 16, 2002. Plaintiff alleges that Charter, which was one of the nation's largest providers of cable television, engaged in a "pervasive and continuous fraudulent scheme intended to artificially boost the Company's reported financial results." The allegations relate to Charter's alleged practice of: (1) delaying the disconnection of customers failing to pay their bills; (2) improperly capitalizing labor costs; and (3) entering into sham transactions that improperly inflated operating revenues and cash flow.

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CHIEF JUSTICE ROBERTS

Among the defendants alleged to have participated in the scheme were two of Charter's equipment vendors – Scientific-Atlanta, Inc. and Motorola, Inc. (the "Vendors"). Specifically, plaintiff alleges that Charter agreed to pay the Vendors an additional $20 for each cable set-top box purchased in exchange for the Vendors' returning the additional payments to Charter as advertising fees. Plaintiff claims that Charter's operating cash flow was inflated by $17 million in the fourth quarter of 2000 in order to meet Wall Street analysts' expectations because Charter improperly capitalized the increased equipment costs and treated the advertising fees as revenue.

The district court granted the Vendors' motion to dismiss on the grounds that *Central Bank* precludes plaintiff's claims, which the court characterized as nothing more than claims for aiding and abetting violations of Section 10(b) and Rule 10b-5. The district court emphasized the lack of any statements, omissions, or actions by the Vendors relied upon by plaintiff, and indicated that it could "find no precedent for the conclusion that business partners, such as [the Vendors], made false and misleading statements by virtue of engaging in a business enterprise with a company such as Charter, the entity purported to have made the statements at issue."

The Eighth Circuit panel affirmed. The unanimous panel stated: "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." The Eighth Circuit focused on the following three elements of the *Central Bank* holding:

> "(1) The Court's categorical declaration that a private plaintiff 'may not bring a 10b-5 suit against a defendant for acts not prohibited by the text of § 10(b)' ….
>
> (2) A device or contrivance is not 'deceptive,' within the meaning of § 10(b), absent some misstatement or a failure to disclose by one who has a duty to disclose.
>
> (3) The term 'manipulative' in § 10(b) has the limited contextual meaning ascribed in [*Santa Fe Industries, Inc. v. Green,* 430 U.S. 462, 97 S. Ct. 1292, 51 L. Ed.2d 480 (1977)]," such that it "is a 'term of art' and refers to illegal trading practices such as 'wash sales, matched orders, or rigged prices, that

"I see no limitation to [Petitioner's] proposal for liability."

JUSTICE KENNEDY

are intended to mislead investors by artificially affecting market activity.'"

Furthermore, the Eighth Circuit panel noted: "[t]o impose liability for securities fraud on one party to an arm's length business transaction in goods or services other than securities because that party knew or should have known that the other party would use the transaction to mislead investors in its stock would introduce potentially far-reaching duties and uncertainties for those engaged in day-to-day business dealings. Decisions of this magnitude should be made by Congress."

SUMMARY OF THE ARGUMENT

Before the Supreme Court yesterday, Plaintiff/Petitioner argued that the Vendors' conduct of creating false advertising revenue for Charter fell squarely within the text of Rule 10b-5's prohibition against "any deceptive device by any person, directly or indirectly, in connection with the purchase or sale of a security." The Court generally was critical of this argument. Justice Scalia challenged Petitioner early, asking why the Court could not "sensibly limit it so that, for example, schemes can be attacked by the SEC, but schemes do not form the basis for private attorney general's actions?" Petitioner responded by saying that the Court recently reaffirmed in *Dura Pharmaceuticals, Inc. v. Broudo,* 544 U.S. 336, 125 S. Ct. 1627 (2005), the existence of the private right of action. Chief Justice Roberts replied that he was not advocating for the elimination of the private right of action, but rather: "My suggestion is that we should get out of the business of expanding [the implied right of action under the securities laws] because Congress has taken over and is legislating in the area . . . ."

Members of the Court also expressed concern with Petitioner's argument that actors engaging in a deceptive act in furtherance of a scheme to violate the securities laws should be liable as primary actors. Justice Alito suggested that, even if the Vendors agreed to a scheme with Charter and Charter's accountant Arthur Andersen, such conduct on the part of the Vendors would constitute only aiding and abetting (and not a primary violation). Chief Justice Roberts similarly noted that the alleged fraud on the market is that of Charter's accounting statements, not statements by the Vendors. Justice Scalia expressed skepticism regarding Petitioner's proposal for determining liability, and suggested that it would result in subjecting innocent actors to "trial which causes [any such company's] stock price to tank . . . ." Justice Kennedy stated that: "I see no limitation to [Petitioner's] proposal for liability."

The Vendors/Respondents argued that Petitioner was attempting to remove the requisite element of reliance from the private right of action for a violation of Section 10(b) and Rule 10b-5. Justice Ginsburg asked Respondents whether or not a "middle category" existed between primary liability and aiding and abetting, and seemed to suggest that perhaps there should be one when actors knowingly and silently engage in sham transactions without any economic substance that result in securities violations. Justice Ginsburg recognized that: "If it was communicated to the investors that there had been $20 per set box over the regular price . . . then the whole thing would have failed. So this can work only if the Vendors are silent." Justices Kennedy and Souter questioned whether principal liability and aiding and abetting can overlap. Justices Kennedy and Souter then pressed Respondents on the limits of when secondary actors may be held liable, asking whether there is primary liability when an accountant or attorney prepares statements for a company. Respondents argued that actors other than the company may be primary violators, but only when they make a statement upon which the market relies. For instance, accountants may be primary violators when: "they issued opinions that were circulated to investors, that were attributed to them and which were authorized by them . . . ."

The United States argued that the Court should affirm the Eighth Circuit decision on the ground that Petitioner's position would remove the reliance requirement set forth in *Basic Inc. v. Levinson,* 485 U.S. 224, 108 S. Ct. 978, 99 L. Ed.2d 194 (1988) and *Central Bank*. When asked by Justice Ginsburg whether the Securities and Exchange Commission could award restitution to injured investors, counsel for the United States stated that the Securities and Exchange Commission is authorized to prosecute aiding and abetting violations, and that it may impose fines that ultimately are distributed to investors.

Justice Breyer has recused himself from the *Stoneridge* appeal.

IMPLICATIONS

The Court's decision in *Stoneridge* is highly anticipated. Over the last few years, courts have grappled with the secondary actor issue, reaching different conclusions as to what constitutes a primary violation. Both the Fifth Circuit and the Ninth Circuit have also issued opinions on this issue. *Compare Regents of the University of California v. Credit Suisse First Boston (USA), Inc.*, 482 F.3d 372 (5th Cir. 2007), *with Simpson v. AOL Time Warner, Inc.*, 452 F.3d 1040 (9th Cir. 2006). In an opinion consistent with the Eighth Circuit's *Charter* decision, the Fifth Circuit held in its *Regents* decision that financial institutions that had engaged in transactions with Enron were not subject to primary liability, regardless of the purpose or effect of the transactions, absent a duty to disclose. Conversely, the Ninth Circuit stated in *Simpson* that a secondary actor may be found liable as a primary violator absent a specific duty to disclose. Largely adopting the position set forth in the Securities and Exchange Commission's amicus brief, the Ninth Circuit set forth the following test: "to be liable as a primary violator of § 10(b) for participation in a 'scheme to defraud,' the defendant must have engaged in conduct that had the principal purpose and effect of creating a false appearance of fact in furtherance of the scheme." Petitions for writ of certiorari with respect to these cases are pending.

The Court's decision in *Stoneridge* likely will have a significant impact on the securities litigation landscape. If affirmed, investors' ability to sue secondary actors who do not speak will be curtailed. By contrast, a reversal might strengthen potential securities actions against counterparties to public companies and other secondary actors.

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