FINE TUNING SECURITIES FRAUD: WHAT A FIGHT OVER CABLE BOXES MEANS FOR THE DEFENSE BAR

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Amid a Supreme Court term filled with headline grabbing discussions of Guantanamo Bay and the Second Amendment, you might have missed a securities fraud case the *New York Times* described as "one of the most closely watched business cases in years."[1] In short, the high court refused to extend securities fraud liability in private lawsuits to defendants who only aid and abet securities fraud. An opinion authored by Justice Kennedy,[2] *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*[3] affirmed an Eighth Circuit decision finding that the private cause of action implicitly conferred by Rule 10b-5[4] of the Securities Exchange Act of 1934[5] (the "Exchange Act") does not extend beyond defendants who directly violate the rule themselves. While the case's facts only address liability of suppliers and customers, the Court's reasoning should apply equally to attorneys, accountants, advisors, and others, creating a smaller landscape of liability in such private securities fraud suits and changing the way lawyers approach such cases.

Rule 10b-5

Coming on the heels of the Securities Act of 1933[6] in a Depression-era wave of enhanced regulation, the Exchange Act was enacted to provide investors in secondary securities markets with protections like the right to receive certain information, the prohibition of insider trading, and the like. Paramount among these safeguards is the general § 10(b) prohibition of fraud in securities transactions.[7]

The Securities and Exchange Commission (the "SEC") promulgated Rule 10b-5 pursuant to its authority vested by the Exchange Act to prohibit fraudulent behavior under § 10(b) of the Act. Courts have interpreted Rule 10b-5 to require proof of six elements for a violation: "(1) a material misrepresentation or omission by the defendant; (2) scienter; (3) a connection between the misrepresentation or omission and the purchase or sale of a security; (4) reliance upon the misrepresentation or omission; (5) economic loss; and (6) loss causation."[8]

Alternatively, the so-called fraud-on-the-market theory provides plaintiffs with a shortcut for 10b-5 claims when the security in question is traded on a public market such as the New York Stock Exchange or NASDAQ. According to the fraud-on-the-market doctrine, public securities markets are efficient, meaning that the market value of publicly traded stock takes into account all publicly available information. So, in such markets, every buyer and seller of a particular company's stock has implicitly relied upon all public information in deciding whether to buy or sell and at what price to buy or sell. If misleading information has been made public and such information artificially inflates or deflates the price of the stock, it logically follows that buyers and sellers of the stock relied upon the misleading information in deciding to buy or sell an inaccurately valued stock. For example, if a CEO's falsely optimistic comments in a television interview trigger an uptick in his company's publicly traded stock, an investor who purchased the stock the following day would be deemed to have relied upon that statement in deciding to purchase and at what price to purchase. This reliance occurs regardless of whether the investor was even aware the interview had taken place, because the investor would have relied on the integrity of the market. Therefore, the fraud-on-the-market doctrine allows a court to presume reliance when the fraudulent statement was made publicly.

§ 10(b) and Rule 10b-5 do not explicitly provide for a private cause of action, but courts have agreed that private enforcement against direct violators is implicit in the anti-fraud provisions of each.[9] However, prior to *Stoneridge*, courts disagreed about the ability of a private investor to bring a cause of action against a party that does not directly violate Rule 10b-5 and § 10(b) but aids and abets a violation.

Cable Box Controversy

In *Stoneridge*, the Supreme Court addressed a case in which shareholders of Charter Communications, Inc. sued Scientific-Atlanta, Inc. and Motorola, Inc. Both defendants had supplied set-top cable boxes to Charter for resale to Charter's customers.

At Charter's request, Charter agreed to overpay Scientific-Atlanta by $20 for each set-top box purchased. In exchange, Scientific-Atlanta agreed use the surplus to purchase advertising time at an inflated rate from Charter. Charter figured the increase in advertising revenue would offset the overpayment for cable boxes while improving Charter's revenue projections and, ultimately, artificially inflating the perceived value of their stock. Scientific-Atlanta sent documents that falsely cited increased production costs for the $20 markup. Even though the transaction was an economic wash for Charter, it allowed Charter to post higher revenue numbers.

Also at Charter's request, Motorola entered into a contract with Charter where Charter agreed to purchase more cable boxes than it actually intended to purchase while agreeing to pay $20 in liquidated damages for each cable box it did not purchase under the contract. Like Scientific-Atlanta, Motorola purchased advertising time from Charter for prices exceeding market value.

Both of the cable box sales arrangements were backdated to appear separate from the respective advertising contracts, and Charter intended that both arrangements would be economic washes while inflating revenues. Charter reported approximately $17 million of revenue from the advertising in documents publicly filed with the SEC.

The $17 million inflation of revenue proved to be only one instance in a larger scheme of fraud that led to four Charter executives' pleading guilty to criminal charges and a $144 million civil settlement with Stoneridge and other Charter shareholders.[10] The *Stoneridge* case pitted Stoneridge and other purchasers of Charter stock against Scientific-Atlanta and Motorola, rather than against Charter. The United States District Court for the Eastern District of Missouri dismissed the case against Scientific-Atlanta and Motorola for failure to state a claim on which relief can be granted, and the Eighth Circuit affirmed.[11]

In its interpretation of Rule 10b-5, the Supreme Court found that the material misrepresentation was the false inflation of revenues shown in Charter's financial statements filed with the SEC. Because Scientific-Atlanta and Motorola did not assist Charter with its financial statements or make false statements on their own (their own financial statements complied with Generally Accepted Accounting Principles), the Court found that the plaintiffs did not rely upon material misrepresentations made by either defendant. Because Charter, and not Scientific-Atlanta or Motorola, actually made the material misrepresentation, neither the six-part test nor the fraud-on-the-market theory would allow recovery against Scientific-Atlanta or Motorola. Therefore, at most, the defendants could have aided and abetted Charter's fraud.

Citing *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*,[12] in which the Court found that the text of the Exchange Act did not allow a private cause of action against aiders and abettors, and pointing to intervening congressional actions that ignored the issue despite congressional testimony urging Congress to extend private suits to aiders and abettors, the Court found that no private cause of action against a party that aids and abets fraud exists under § 10(b) or Rule 10b-5. Therefore, for a private cause of action to stand, the plaintiffs must establish that the defendant directly perpetrated fraud either via the six-part test or the fraud-on-the-market doctrine, an insurmountable hurdle for the *Stoneridge* plaintiffs.

Going Forward

Stoneridge definitively establishes that investors cannot prevail in a private securities fraud lawsuit without proving that the defendant

actually engaged in fraud. Therefore, for example, a lawyer who aids and abets securities fraud would likely be immune from a private securities fraud lawsuit unless the lawyer committed fraud himself. This immunity would extend beyond lawyers and suppliers of set-top cable boxes to customers, accountants, advisors, and others. The opposite result would, in Justice Kennedy's words, subject "the whole marketplace in which the issuing company does business" to liability.[13]

Likely the most lasting impact of *Stoneridge* is the inability of shareholders to recover securities fraud damages when the fraudulent party is insolvent. The paradigm of this dilemma is the Enron litigation. Enron defrauded its shareholders and quickly became insolvent. Enron shareholders brought a $40 billion class action suit against Wall Street investment firms with a similar legal theory used by the Charter investors in *Stoneridge*. Within days after the *Stoneridge* decision, the Supreme Court turned away the Enron appeal, "effectively end[ing]" the suit.[14] Based on the precedent established in *Stoneridge*, a defendant that did not actually perpetrate fraud (such as the third party defendants in the Enron litigation) should prevail on a motion to dismiss for failure to state a claim on which relief can be granted.

Although *Stoneridge* limits private civil liability for aiding and abetting, other state and federal remedies exist, including the SEC's authority to bring suits against aiders and abettors. For example, in December 2007, the SEC brought charges against Mayer Brown LLP partner Joseph P. Collins for aiding and abetting a § 10(b) and Rule 10b-5 violation by his client, Refco, Inc. While other penalties may exist outside of Rule 10b-5, *Stoneridge* effectively curbs the expansion of the list of liable parties under the rule.

In "[the Supreme Court's] most important securities fraud case in years" and "a major and ardently sought victory for investment banks, accountants and vendors,"[15] the Court's refined definition of the *prima facie* hurdle in Rule 10b-5 and § 10(b) cases will have a lasting impact on investors, companies, and third parties with whom they transact business—including their lawyers.

(Endnotes)

1 Linda Greenhouse, *Plaintiffs Face Skeptical Court in Key Fraud Case*, N.Y. Times, October 10, 2007, *available at* http://www.nytimes.com/2007/10/10/business/10bizcourt.html?_r=1&scp=2&sq'stoneridge&st=nyt&oref'slogin#.

2 Justice Kennedy was joined by Chief Justice Roberts and Justices Scalia, Thomas, and Alito. Justice Stevens' dissent was joined by Justices Souter and Ginsberg. Justice Breyer recused himself.

3 552 U.S. ___ (2008).

4 17 C.F.R. 240.10b-5 (2007).

5 15 U.S.C. § 78a, *et seq.* (regulating secondary securities trading markets).

6 15 U.S.C. § 77a, *et seq.* (regulating initial issuances of securities).

7 15 U.S.C. § 78j.

8 *Stoneridge*, 552 U.S. at *p. 6 (citing *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336, 341-342 (2005)).

9 *Id.* (citing *Superintendent of Ins. of N.Y. v. Bankers Life & Casualty Co.*, 404 U.S. 6, 13, n. 9 (1971)).

10 Greenhouse, *supra* note 1.

11 *In re Charter Communications, Inc., Securities Litigation*, 443 F. 3d 987 (8th Cir. 2006).

12 511 U.S. 164 (1994).

13 *Stoneridge*, 552 U.S. at *p. 9.

14 Jess Bravin & Mark H. Anderson, *Justices Rebuff Enron Shareholders*, Wall St. J., January 23, 2008, at A2.

15 Greenhouse, *supra* note 1.

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