LITIGATION ARTICLE

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"Scheme Liability" Case

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On October 9, 2007, the Supreme Court heard oral argument in the case of Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc., No. 06-43. This controversial case - which has engendered disputes within the Securities and Exchange Commission and Department of Justice on which side is correct – will define the scope of the antifraud provisions set forth in Section 10(b) of the Securities Exchange Act and SEC Rule 10b-5. Section 10(b) and Rule 10b-5 prohibit any person from using or employing any manipulative or deceptive device, making untrue statements of material facts or misleading someone by omitting material facts in connection with the sale of a security. The basic issue in Stoneridge is whether parties that are actively involved in a fraudulent scheme with a public company to defraud investors can be liable to investors under Section 10(b) when those parties make no representations to investors and thus there is no reliance by the investors on any statement.

In Stoneridge, Motorola and Scientific-Atlanta were vendors of cable boxes to Charter Communications, Inc., a large cable television provider that was a public company. Motorola and Scientific-Atlanta are alleged to have been knowing participants in a scheme that Charter created to inflate Charter's earnings to meet analysts' expectations and mislead investors. Specifically, the lawsuit alleged that Charter agreed to pay Scientific-Atlanta and Motorola an additional $20 per cable box if they returned the payments to Charter as fees for advertising. This transaction was alleged to have no economic substance, and Scientific-Atlanta and Motorola allegedly fabricated paperwork to deceive Charter's accountants on the true nature of the investment. This arrangement produced $17 million of operating cash flow to Charter in the fourth quarter of 2000 because Charter capitalized the higher equipment expenses but recognized the advertising fees as revenue in that quarter. These transactions allowed Charter to meet analysts' expectations for revenue in the fourth quarter of 2000.

When investigations by the Securities and Exchange Commission and the Department of Justice brought these transactions to light, investors sued Motorola and Scientific-Atlanta for their role in the alleged scheme. The legal problem that the investors faced was that an earlier Supreme Court case, Central Bank, N.A. v. First Interstate Bank, N.A., had held that aiders and abettors of a security fraud were not liable to investors under Section 10(b) and Rule 10b-5. To avoid the holding in Central Bank, the investors argued that Motorola and Scientific-Atlanta were primary violators of Section 10(b) because they were knowing and integral participants in a scheme to defraud investors.

Motorola and Scientific-Atlanta moved to dismiss the case on the basis that they made no misrepresentations to investors and had no duty to disclose to investors. They contended that there could be no claim under Section 10(b) and Rule 10b-5 because a critical element of the cause of action -- reliance by investors on a statement by them -- was missing. The district court dismissed the case and held that the holding in Central Bank barred the claims against Motorola and Scientific-Atlanta. The district court agreed that Motorola and Scientific-Atlanta were aiders and abettors that made no representations on which investors had relied. The Eighth Circuit Court of Appeals affirmed that dismissal on the same basis. The Supreme Court agreed to hear the case, and its outcome may very well determine the liability in several high-profile securities fraud cases, including Enron, where investors are pursuing investment banks, banks, attorneys and accountants for their roles that allegedly facilitated massive frauds.

The Stoneridge case has been high-profile and divisive, even within the government. The Securities and Exchange Commission voted 3-2 to ask the government to file a friend of the court brief in support of the investors. The Justice Department, however, ultimately filed a brief that supported Motorola and Scientific-Atlanta and argued that they were not primary violators of the securities laws but were merely aiders and abettors who did not have liability under Section 10(b). The Justice Department argued that the courts should not expand the scope of the securities laws but should leave that task to Congress and noted the potential harm to the economy that greater litigation over securities fraud could bring.

In addition, twenty-nine friend of the court briefs were filed, including briefs by former Securities and Exchange Commissioners, Congressmen Barney Frank and John Conyers and various industry groups on both sides of the issue.

At oral argument before the Supreme Court, Justice Roberts asked the counsel for the investors pointed questions as to whether Congress rather than the courts should be the appropriate entity to expand liability under the federal securities laws. Justice Roberts and Alito also focused in on whether the investors' claims were any different from the aiding and abetting claim that the Supreme Court had rejected in Central Bank.

For the defendant's counsel, Justices Ginsberg and Kennedy inquired whether the vendors' conduct here was beyond mere aiding and abetting because their conduct was an essential part of deceiving investors that was at the heart of the fraudulent scheme. Their questions focused in on whether a middle tier of wrongdoing exists between a mere aider and abettor and a primary violator who makes false statements to investors that would support liability under Section 10(b) and Rule 10b-5.

It is difficult to predict outcomes based in questions from the Supreme Court Justices, but a fair reading is that the investors have a substantial hurdle to overcome in arguing that the courts rather than Congress are the appropriate body to expand liability under Section 10(b) and Rule 10b-5. If the Supreme Court affirms the dismissal of the investors' claims, a likely result is that Congress may take another look at what kind of conduct is sufficient to state a federal securities fraud claim and whether laws are needed to create liability for parties that are knowing participants in a scheme to defraud but make no representations to investors.