

News from our Securities Litigation Group

Supreme Court Rejects “Scheme” Liability Under the Federal Securities Laws

On January 15, 2008, the United States Supreme Court issued a long-awaited decision on the civil liability of secondary actors under the federal securities laws. In *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, the Court ruled 5-3 that investors could not bring a private securities fraud lawsuit under § 10(b) of the Securities Exchange Act of 1934 against two suppliers of a public corporation, because the corporation’s investors did not rely on any statements by those suppliers when making their investment decisions.

Investors in the common stock of cable company Charter Communications, Inc. (“Charter”) filed a class action, alleging they had suffered losses after purchasing Charter stock. The plaintiffs sought to impose liability on two companies that supplied digital converter “set top” boxes to Charter, on the theory that the suppliers had agreed to a scheme that allowed Charter to mislead its auditors and issue false financial statements. The investors claimed that in order to avoid reporting disappointing quarterly revenues to the public, Charter entered into a scheme under which the suppliers would purchase advertising from Charter (which would be accounted for as revenues in the current period) in exchange for Charter overpaying the suppliers in an offsetting amount for set-top boxes (which expenses would be capitalized over several periods). According to plaintiffs, this swap had no economic substance and it was improper for Charter to record the advertising revenue.

The investors claimed that the suppliers should be liable under § 10(b) because they knew or recklessly disregarded Charter’s intention to inflate its revenue, and knew that Charter’s financial statements would be relied upon by the public. The District Court dismissed the investors’ complaint and the Eighth Circuit Court of Appeals affirmed.

Affirming the Eighth Circuit, the Court held that the suppliers could not be liable because they had not made any misstatement on which investors relied, and had no duty under the securities laws to make any statements to Charter’s investors. Writing for the majority, Justice Kennedy wrote, “[w]e conclude the private right of action does not reach the customer/supplier companies because the investors did not rely upon their statements or representations.” The Court explained, “[r]eliance by the plaintiff upon the defendant’s deceptive acts is an essential element of the §10(b) private cause of action.” The Court also noted that the suppliers had no role in preparing or disseminating Charter’s financial statements and that their own financial statements followed generally accepted accounting principles.

The Court also rejected the notion of “scheme liability,” under which the investors sought to base liability on participation in a “scheme” by actors who made no public statement. “Were this concept of reliance to be adopted, the implied cause of action would reach the whole marketplace

in which the issuing company does business,” Justice Kennedy wrote.

Finally, the Court noted that its decision was an affirmation of its 1994 ruling in the *Central Bank* case that had prohibited liability for “aiding and abetting” a securities law violation. Following that decision, the Court

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noted, Congress had not enacted legislation to provide for aider-and-abettor liability in private suits, but had instead passed the Private Securities Litigation Reform Act of 1995, which authorized aiding and abetting liability only in civil enforcement actions brought by the SEC. In the view of the Court's majority, Congress's failure to expand the reach of shareholder actions following *Central Bank* provided further support for its decision in *Stoneridge*.

Justice Kennedy was joined in the majority by Chief Justice John Roberts Jr. and Justices Antonin Scalia, Clarence Thomas and Samuel Alito. Justice John Paul Stevens authored the dissent, which was supported by Justices David Souter and Ruth Bader Ginsburg. Justice Stephen Breyer did not participate in the decision. ■