



LEVETT ROCKWOOD
P.C.

NEWSLETTER
A Courtesy To Our Clients and Friends

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UNITED STATES SUPREME COURT NARROWS SCOPE OF “SCHEME LIABILITY” FOR SECURITIES FRAUD

The U.S. Supreme Court recently decided the closely watched case of *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.* At issue was whether a party who engages in deceptive conduct enabling the issuer of a security to misrepresent its financial condition in public filings is liable in lawsuits by investors under the securities laws for “scheme liability.” The Court said no.

The theory of “scheme liability” was developed in response to *Central Bank of Denver, N.A. v. First Interstate Bank of Denver*, a 1994 decision in which the Supreme Court held that a party who aids and abets an issuer in making a false statement in violation of the securities laws is not liable to investors for their losses. Congress responded by amending the securities laws to make clear that aiders and abettors are subject to Securities and Exchange Commission (“SEC”) enforcement actions and criminal sanctions. The amendments, however, did not address the holding in *Central Bank* with respect to private lawsuits by investors.

Private plaintiffs subsequently tried to get around the *Central Bank* holding by arguing that parties who assist issuers in creating sham transactions to make financial statements misleading are directly liable to investors under the securities laws – essentially treating them as if they had communicated false information to investors themselves. To do this, the plaintiffs relied on subsections (a) and (c) of SEC Rule 10b-5, which make it unlawful to “employ any device, *scheme*, or artifice to defraud” and to “engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.” In *Stoneridge*, the Court resolved a difference of opinion among federal appeals courts and rejected this theory.

The investors who brought the lawsuit in *Stoneridge* owned stock in a cable television company named Charter Communications, Inc. They claimed that Charter entered into an arrangement with two of its suppliers to improperly inflate Charter’s revenue and thus its stock price. The Court ruled that the investors in Charter could not sue the two suppliers despite their allegations that the suppliers knowingly participated in a scheme with Charter to facilitate fraud by (a) entering into a sham transaction with no economic

substance and (b) creating a false paper trail to assist Charter in accounting for the transaction improperly. According to the Court, even though the suppliers may have engaged in deceptive conduct, and even though Charter’s false financial statements were the natural and expected consequence of that conduct, none of the suppliers’ deceptive acts were known to Charter’s investors at the time. Thus, no investor could have relied on the suppliers’ deception. And since reliance is a necessary element of an investor case under the securities laws, the investors’ claims against the suppliers had to be dismissed.

The Court was concerned that extending a private cause of action under the securities laws to the actions described in *Stoneridge* would risk inviting litigation beyond the securities markets into “the realm of ordinary business operations” – an area governed by state law. Doing so, the Court believed, could cause parties who contract with issuers of securities to take actions to protect themselves from the threat of liability, raising the cost of doing business and perhaps even deterring foreign companies with no other exposure to U.S. securities laws from doing business here.

Under *Stoneridge*, parties who enter into transactions with issuers who subsequently account for those transactions in a misleading way are spared civil liability in investor suits. Those same parties, however, are not completely out of the woods. They still may be subject to SEC enforcement actions and criminal prosecution if they have aided or abetted an issuer’s violation of the securities laws. The recent criminal convictions, in Federal District Court in Hartford, of former executives of General Reinsurance Corporation for cooperating with American International Group, Inc. in creating what the government claimed was a sham transaction designed to enable AIG to misrepresent its financial condition, drove this point home with a vengeance. So, even if you are not the issuer of a security, don’t assume that *Stoneridge* allows you to act recklessly.

If you have questions or would like to discuss these issues further, please contact **Frank J. Silvestri**, **Brian E. Spears** or **Janna D. Eastwood** of our office at (203) 222-0885.

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