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SOLICITOR GENERAL, FORMER SEC OFFICIALS, AND LEGAL PRACTITIONERS TAKE POSITIONS IN SUPREME COURT CASE ON SCHEME LIABILITY

In our continuing effort to keep our readers apprised of developments in the much-anticipated U.S. Supreme Court case involving the scope of the so-called "scheme liability" provisions of the 1934 Securities Exchange Act, *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, this article describes amicus submissions recently filed by the Solicitor General, former officials of the SEC, and various private-sector leaders in the field of banking and merger and acquisition transactions. These submissions reflect the high-level interest this case has engendered in the securities and finance industries, as the Court's opinion is expected to have wide-ranging ramifications both for the U.S. financial markets in general and, more specifically, for accountants, law firms, investment advisers, and other third parties with respect to their potential exposure to liability under federal securities laws based on their participating in transactions on behalf of issuers of securities and other entities.

The underlying case involves a claim of securities fraud against respondents Scientific-Atlanta, Inc. and Motorola, Inc., both of which manufacture digital set-top boxes used by cable television subscribers. *See In re Charter Communications, Inc. Sec. Litig.*, 443 F.3d 987, 989 (8th Cir. 2006). The respondents supplied set-top boxes to Charter Communications, Inc. ("Charter"), one of the nation's largest cable television operators. *Id.* at 989-990. In August 2000, Charter allegedly realized that it was unlikely to meet its annual target for operating cash flow, and therefore entered into so-called "wash" transaction with the respondents, whereby Charter paid them additional amounts for the set-top boxes they were supplying, and respondents would in turn use those amounts to "purchase" advertising on Charter's cable channels. *Id.* In effect, these transactions would entitle the respondents to receive the advertising for free. *See* Amicus Brief for the United States at 2, *Stoneridge Investment Partners,*

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LLC v. Scientific-Atlanta, Inc., U.S. Supreme Court (No. 06-43) ("Solicitor General's Amicus"). At the same time, the transactions helped Charter improve its reporting of its operating cash flow. In other words, Charter capitalized the payments to respondents (for the purchase of equipment) while treating the return payments from respondents as revenue (for the purchase of advertising). *Id.* Arthur Andersen had advised Charter that the transactions could be accounted for in this manner as long as the two sets of payments were unrelated to each other; in other words, the contracts had to be negotiated at least one month apart and made at fair market value. *Id.* Accordingly, the respondents each entered into separate contracts with Charter for the price increase in the set-top boxes and for the advertising, and the set-top box contracts were backdated by a month so the contracts would not be considered related to each other. *Id.*

The plaintiffs in the underlying case charged Charter, as well as the two respondents, with violating Section 10(b) of the securities laws, and in particular Rule 10b-5(a) and (c), the so-called "scheme liability" provisions of that rule. As to Scientific-Atlanta and Motorola, the proposed second amended complaint alleges that they knew that Charter intended to use these transactions improperly to inflate its operating cash flow. And the pleadings allege that the backdating of the contracts was indicative of the respondents' scienter and complicity in the alleged scheme to mislead Charter's auditors and thereby to defraud investors. The district court granted the respondents' motion to dismiss on the grounds that the allegations amounted to claims for aiding and abetting liability. Private party claims for aiding and abetting under Section 10(b) has long been barred by the U.S. Supreme Court's decision in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver*, 511 U.S. 164 (1994).

The Eighth Circuit Court of Appeals affirmed, rejecting petitioner's contention that the conduct of the respondents constituted "primary" violations of Section 10(b), as opposed to mere aiding and abetting another's primary violations. *In re Charter*, 443 F.3d at 991-92. The Eighth Circuit held that primary violations under the "deceptive conduct" clause of Rule 10b-5 must involve either a "misstatement or a failure to disclose by one who has a duty to disclose." *Id.* at 992. The court held that "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." *Id.* Since the focus of the underlying claims involved misconduct by Charter, and because neither of the respondents made any misstatements or omissions (in the face of a duty to disclose), the court held that their entering into the challenged transactions amounted to at most aiding and abetting. *Id.* The court relayed that it was "aware of no case imposing § 10(b) or Rule 10b-5 liability on a business that entered into an arm's length non-securities transaction with an entity that then used the transaction to publish false and misleading statements to investors and analysts." *Id.*

It is this holding that is the subject of the pending appeal to the U.S. Supreme Court. And it is the scope of the "scheme liability" provisions of Rule 10b-5 and what exactly amounts to aiding and abetting, as opposed to a primary violation, of those provisions that has engendered the great interest in this case within the financial community.

THE POSITION OF THE UNITED STATES AS ANNOUNCED BY THE SOLICITOR GENERAL

In its recently filed amicus brief, the Solicitor General (on behalf of the United States) weighed into the debate surrounding "scheme liability." In explaining the United States' interest in this matter, the brief notes that in connection with enforcing the federal securities laws "[m]eritorious private actions are an essential supplement to criminal prosecutions and civil enforcement actions brought by the government." Solicitor General's Amicus at 1. But the administration's position on the scope of such private actions is confirmed by its warning that "[a]t the same time, private securities actions can be abused in ways that impose substantial costs on companies that have fully complied with the applicable laws." *Id.* The United States also expressed concern with ensuring that entities in the banking and other industries "providing services to publicly traded companies" are not "subject to inappropriate secondary liability." *Id.* Based on this per-

spective, the United States argued against imposing primary liability on Scientific-Atlanta and Motorola, but for reasons different from those on which the Eighth Circuit relied.

The Solicitor General argued that the Eighth Circuit erred in the test that it applied for "deceptive" or "manipulative" conduct under the "scheme liability" provisions of Rule 10b-5. To the extent the Court held that primary liability under those provisions can only be stated based on misstatements, omissions made while under a duty to disclose, or manipulative trading practices, the Solicitor General argued that such test is too restrictive and does not reach the full extent of prohibited conduct under Section 10(b). *Id.* at 8. It is the position of the United States that Section 10(b) reaches all conduct that is "manipulative" or "deceptive," including nonverbal conduct (which the Court's test presumably would exclude from liability). "Properly understood, a person engages in 'deceptive' conduct for purposes of Section 10(b) when the conduct by its nature is objectively likely to mislead another person, *e.g.*, when it has the effect of conveying a false appearance of material fact to an observer (assuming, of course, that the defendant possessed the requisite mental state in engaging in the conduct)." *Id.* Based on this broader reading of the statute, the United States argued that the conduct engaged in by Scientific-Atlanta and Motorola, *i.e.*, the "wash" transactions in question, could constitute a "deceptive device or contrivance" under the statute. The Solicitor General stated that this would not disturb the prohibition against private claims for aiding and abetting under *Central Bank of Denver*, in that the defendants must themselves engage in the conduct to be held primary violators, and all the other elements of primary liability must still be satisfied. *Id.*

Notwithstanding the United States' critique of the Eighth Circuit test, the Solicitor General argued for an affirmance based on the petitioner's failure to sufficiently plead their reliance on the respondent's deceptive conduct. *Id.* at 9. The petitioner did not even allege that it was aware of the "wash" transactions between respondents and Charter when they decided to purchase Charter stock. At most, they were aware of and relied only on Charter's misstatements in its financial statements as to those transactions. Petitioners did not allege that Scientific- Atlanta or Motorola drafted or otherwise created those misstatements. Indeed, there is no dispute that Charter independently decided to make the misrepresentations in its financial statements. Thus, there was no causal link between the conduct of Scientific-Atlanta or Motorola and the petitioners' decision to purchase Charter stock. The connection between the two actions was too attenuated to satisfy the reliance element of a securities fraud claim. For the same reason, petitioner failed to satisfy the loss causation element as well. *Id.*

Finally, the United States warned against a wholesale expansion of the judicially inferred private right of action under Section 10(b) and Rule 10b-5, which could potentially expose customers, vendors, and other actors "far removed from the market to billions of dollars in liability when issuers of securities make misstatements to the market." *Id.* at 9. The Solicitor General pointed out that it would be particularly inappropriate for courts to allow private liability under circumstances where Congress rejected private rights of action for aiding and abetting, and instead allowed only the SEC to pursue such claims. *Id.*

CERTAIN FORMER SEC OFFICIALS AND FINANCE PROFESSORS ALSO ARGUED FOR AFFIRMANCE

Several former Chairmen of the SEC—Harvey Pitt, Roderick Hills, and Harold Williams—a number of former SEC Commissioners and General Counsel, as well as many distinguished professors of law and finance, many of whom have been involved in drafting portions of the federal securities laws, recently submitted an amicus brief arguing that the Eighth Circuit's decision as to the scope of "scheme liability" and "primary liability" under the securities laws should be affirmed. (*See* Amicus Brief for Former SEC Commissioners and Officials, at 1, *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, U.S. Supreme Court (No. 06-43) ("Former SEC Officials' Amicus"). In essence, they argued that merely "enabling" a public company's commission of an alleged securities fraud is a classic description of "secondary liability," and Congress has expressly decided that only the SEC, and not private individuals, has the authority to bring claims for such liability under the federal securities laws. They contend that there is no basis here to recognize a liability theory that Congress has decided not to make available to private plaintiffs. *Id.* at 5-6.

They also pointed out that policy considerations cannot override the text and structure of the Securities Exchange Act unless petitioners show that adherence to the existing rule would lead to results so bizarre that Congress could not have intended them. *Id.* at 6. There is no such showing here. While investor compensation may be a laudable goal, there is a broad consensus in the academic community that the out-of-pocket measure of damages used in Rule 10b-5 class actions is economically irrational because it bears little relation to the actual net harm suffered by investors. *Id.* at 6-7. Moreover, the SEC can now provide recovery to investors under the "Fair Funds" provision in the Sarbanes-Oxley Act of 2002. *Id.* at 7. The deterrent justification is also dubious as substantial deterrents already exist under the existing enforcement scheme. And pursuing private "scheme liability" would give rise to substantial costs that might exceed its questionable deterrent benefits, meaning the risk of huge potential liability may cause defendants to settle at exorbitant amounts, thereby raising the costs of doing business for companies listed in the U.S. markets. *Id.*

Finally, they argued that Congress, not the courts, is in the best position to assess the propriety of creating a private right of action for aiding and abetting violations of the securities laws. *Id.* at 7-8. If it were to decide to do so, Congress would have to weigh competing policy considerations, including the impact of such an expansion of potential liability on efficiency, competition, and capital formation. It would also have to consider the proper parameters of scheme liability, including whether to provide safe harbors for derivatives or other transactions. The very fact that the legislature could reasonably come down on either side of this issue "demonstrates that the decision is not one for the Judiciary in the first instance." *Id.*

TRANSACTIONAL LAWYERS HAVE ALSO SUBMITTED AN AMICUS BRIEF FAVORING AFFIRMANCE

Experienced transactional lawyers from a variety of prominent law firms, who regularly represent underwriters, private equity firms, and large financial institutions in a wide range of financial transactions including public and private offerings, structured finance, commodities and derivatives transactions, off-balance sheet financings, joint ventures, limited partnerships, and merger and acquisition transactions, filed an amicus brief explaining why they think the Eighth Circuit's decision should be upheld. These lawyers claim an interest in the outcome of the appeal in that it will affect the advice they provide, and have long provided, to their clients as to these numerous complex transactions. (*See* Amicus Brief for Richard I. Beattie, *et al.*, at 1, *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, U.S. Supreme Court (No. 06-43) ("Practitioners' Amicus").

The lawyers reminded the Court that there is a long history of legal decisions (both leading up to *Central Bank of Denver* and afterward) that clearly establishes a rule limiting liability under Section 10(b) to those persons who themselves actually made a material misstatement (or omission in the face of a duty to disclose) or committed a manipulative trading practice. Their brief traces the history and consistent rulings of these precedents. The lawyers also contend that the conspiracy-based theory of "scheme liability" advanced by the petitioner is virtually indistinguishable from the aiding and abetting liability expressly rejected by the Court in *Central Bank of Denver*. *Id.* at 3-28. Adopting their proposed rule would effectively nullify that decision.

In addition, the transactional lawyers contend that the "vague" theory of liability espoused by the petitioners will hinder the ability of lawyers to represent (and provide clear advice to) clients who do business with issuers. *Id.* at 28-30. In other words, they argue against abandoning the bright line rule adopted by the Eighth Circuit (whereby primary liability for third parties must be based on their making misrepresentations, omissions, or engaging in manipulative trading practices) in favor of an undefined and vague standard proposed by petitioners. *Id.* That vague test would expose companies that do business with issuers to Section 10(b) litigation whenever a plaintiff can plausibly allege that the counterparty's conduct had the "purpose and effect" of furthering the issuer's "fraudulent scheme." *Id.* at 29. As the lawyers argued, "[s]uch 'scheme' allegations—always made in hindsight, after something bad has happened at the issuer—may

be too readily made, particularly in a business environment in which transactions are frequently complicated and the applicable accounting principles are continuously evolving and require numerous judgment calls." *Id.* Expanding the existing standard will require transactional lawyers to delve into and examine in detail the business affairs of not only the issuer, but also its outside advisors, accountants, auditors, and attorneys with a view toward preventing their own potential liability under this expansive liability scheme. This will prove unmanageable in business circles and will necessarily impose higher transaction costs on all manner of financing transactions.

CONCLUSION

Overall, these amicus briefs illustrate the great importance the *Stoneridge* decision may have for U.S. securities markets and the private enforcement of federal securities laws. Not only will the Supreme Court likely clarify uncertainty that has arisen surrounding the "scheme liability" provisions of Rule 10b-5 and the "secondary liability" question under *Central Bank of Denver*, its decision could have broad ramifications for companies doing business with U.S. issuers. This in turn will affect the decisions of issuers as to whether or not to list their securities on U.S. exchanges or otherwise potentially expose themselves to U.S. securities laws. For this reason, this case is one of the most closely watched U.S. Supreme Court decisions in recent memory.

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