

Under Scrutiny:

SHB's Government Enforcement & Compliance Monitor

JANUARY 16, 2008



THE *STONERIDGE* DECISION: PRIVATE PLAINTIFF INVESTORS MUST RELY ON DECEPTIVE CONDUCT OF SECONDARY ACTORS

The U.S. Supreme Court yesterday held that the implied private right of action under §10(b) and Rule 10b-5 does not extend to aiders and abettors and that reliance by investors upon a defendant's deceptive acts is a key element of the private cause of action. This ruling significantly limits the potential liability for third-party contractors, vendors, and consultants under §10(b) of the Securities Exchange Act of 1934 and Securities and Exchange Commission (SEC) Rule 10b-5.

In *Stoneridge*, investors in Charter Communications, Inc., filed a class action against Charter and some of its executives, independent auditor, and suppliers. The Court's focus in yesterday's decision was on the liability of the suppliers. The plaintiff class alleged that as part of a fraudulent scheme to meet operating cash flow projections with respect to its advertising revenues, Charter allegedly entered into an agreement with the defendant suppliers under which Charter paid the suppliers inflated prices for cable boxes it purchased to provide the suppliers funds to turn around and use to purchase advertising from Charter. The suppliers also allegedly agreed to backdate the advertising contracts so that the advertising contracts would appear to be unrelated to the contracts increasing the price of the cable boxes. These agreements and activities allowed Charter to fraudulently inflate its advertising revenues to meet its revenue projections in a manner that would be undetected by its auditors. The petitioners in *Stoneridge* alleged that the suppliers violated §10(b) and Rule 10b-5 by participating in the transactions when they knew or recklessly disregarded Charter's intention to use the agreements to

GOVERNMENT ENFORCEMENT & COMPLIANCE

Although the challenges may change, our mission remains the same: Eliminating the legal obstacles to achieving your business objectives.

Our clients face unprecedented enforcement scrutiny and novel legal theories. Today, government enforcement actions can include civil as well as criminal investigations and litigation. They can involve a host of independent actors including federal and state prosecutors, regulators, whistleblowers and their counsel, and class-action attorneys. These cases must be defended under the watchful eye of investors and the public.

Shook, Hardy & Bacon has long been known for its Iron Triangle Theory of Modern Defense, a recognition that effective defense cannot take place solely in the courtroom but must entail anticipating, understanding and responding effectively to the other two important aspects of high-stakes litigation: government and media relations.

Drawing on our experience and the Iron Triangle Defense Theory, our Government Enforcement & Compliance Practice recognizes that successful representation and defense requires effective responses to the multiple independent actors that can affect the progress and outcome of a government-enforcement action.

inflate its revenues, and knew that the resulting financial statements issued by Charter would be relied upon by research analysts and investors.

Resolving a circuit split as to when, if ever, an injured investor may rely upon §10b to recover from a party that neither makes a public misstatement nor violates a duty to disclose but does participate in a scheme to violate §10b, the Court held that the private cause of action does not reach the suppliers because the investors did not rely upon their statements or misrepresentations. In so holding, the Court reiterated that in a §10b private action, a plaintiff must prove 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. There are two circumstances in which there is a rebuttable presumption of reliance. The first exists if there is an omission of a material fact by one with a duty to disclose. The second falls under the fraud-on-the-market doctrine. Neither circumstance was present in *Stoneridge*. Although the suppliers participated in Charter's scheme to alter its financial statement, there was no presumption of reliance because they had no duty to disclose and their allegedly deceptive acts were not directed at or otherwise communicated to the public.

The Court also rejected petitioners' "scheme-liability" argument that the financial statement that Charter released to the public was the natural and expected consequence of suppliers' deceptive acts, and that if they had not assisted Charter, the financial statement would have been more accurate and not fooled Charter's auditor. Again, the Court focused on petitioners' inability to show reliance upon the deceptive acts in finding no "scheme-liability." It also stated that Congress had revised the securities laws to restrict liability in private securities actions for aiders and abettors, while retaining the ability of the SEC to regulate their conduct. The Court also declined to adopt the petitioners' theory that secondary actors (actors other than the issuer) become primary violators subject to a private right of action merely because they aid and abet the scheme to defraud by engaging in underlying conduct

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that facilitates the scheme when that conduct is not affirmatively disclosed to the public – a theory that would eviscerate the Congressional limitations on aider and abettor liability, and would expose suppliers and other contracting parties to liability that would increase the issuer's costs of doing business. This would in turn lead to a shift of securities offerings to foreign markets.

In sum, the private cause of action under §10(b) and Rule 10b-5 does not extend to secondary actors when plaintiffs cannot show reliance by investors upon allegedly deceptive acts. Secondary actors remain subject to criminal penalties and civil enforcement by the SEC, as well as possible state fines and restitution.

SHB's Government Enforcement & Compliance Group represents and advises companies, their boards and management, and individuals in all aspects of §10(b) compliance and liability.

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