



January 19, 2008

**Supreme Court Limits Scope Of Securities Fraud Shareholder Liability
Of Businesses That Enter Into Transactions With Public Companies
But Risk Of Criminal Action Or SEC Enforcement Remains**

The U.S. Supreme Court earlier this week issued its decision in the widely followed *Stoneridge* case, rejecting a broad theory of “scheme liability” for securities fraud that would have exposed many companies that do business with public corporations to shareholder suits.

In *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.* (No. 06-43), 2008 U.S. Lexis 1091 (U.S. 2008), the issue was whether investors in a public company could sue other companies that entered into transactions with the issuer, where those transactions were used to falsify the issuer’s financial statements. The Supreme Court said no, because the investors relied on the financial statements of the issuer company in which they invested, and not on the behind-the-scenes transactions of the other company.

Requiring private plaintiffs to show reliance is not new, but the Court applied the requirement in a way that likely cuts off a broad swath of securities fraud claims targeted at parties other than issuers of securities (and their officers and directors) such as vendors and banks.

The Court’s decision represents the latest step in its curtailment of private actions against non-issuers under section 10(b) of the Securities Exchange Act of 1934. Claims against such “third parties” once were brought as claims for aiding and abetting, but the Court ruled in *Central Bank NA v. First Interstate Bank NA*, 511 U.S. 164 (1994) that there could be no aiding and abetting liability under section 10(b). Plaintiffs’ lawyers then tried to sue these kinds of parties as primary violators, rather than aiders and abettors, on the theory that they were participants in a scheme. The Court’s decision in *Stoneridge* strongly rejects that effort.

Plaintiffs’ lawyers will attempt to limit the effect of the case by contending that it is based on a scenario where the third-party defendants were contract vendors in “the realm of ordinary business operations,” as the Court described the vendors in *Stoneridge*, and that the result might be different where the third parties are investment professionals helping a company structure transactions. However, unless it can be shown that shareholders were aware of the acts of the investment professionals or other third parties, it will likely be difficult even in those cases for plaintiffs to satisfy the reliance element as defined by the Court.

This Client Bulletin is published for the clients and friends of Bryan Cave LLP. Information contained herein is not to be considered as legal advice.
This Client Bulletin may be construed as an advertisement or solicitation. © 2008 Bryan Cave LLP. All Rights Reserved.

Bryan Cave LLP Chicago | Hamburg | Hong Kong | Irvine | Jefferson City | Kansas City | Kuwait | Los Angeles | Milan
New York | Phoenix | Shanghai | St. Louis | Washington, DC | and Bryan Cave, A Multinational Partnership London | www.bryancave.com

While the Court's decision significantly reduces the risk of non-issuer liability to shareholders, those who help an issuer to falsify financial statements can still face criminal prosecution or SEC enforcement action. In fact, *Stoneridge*, decided by a 5-3 vote, highlights the disparity between private civil lawsuits and government enforcement actions in the current legal regime, where claims against third parties under section 10(b) that would be dismissed in a private action end up going to trial in a criminal or SEC action.

Significantly, the Supreme Court in *Stoneridge* decided the case based on the lack of reliance rather than the lack of any misleading statement by the vendor, the rationale used by the appeals court whose result the Supreme Court affirmed. While reliance is an element in a private action under Section 10(b), it is not one in criminal or SEC enforcement actions. The U.S. Solicitor General filed an amicus brief urging the Court to decide the case in this manner, in an apparent effort to avoid any spillover effect on governmental securities fraud actions.

The Court also noted in its opinion that the SEC was not affected by *Central Bank*. That is because after the *Central Bank* decision, Congress expressly authorized the SEC to bring aiding and abetting cases. Further reflecting the Court's emphasis on governmental enforcement of the securities laws, Justice Kennedy's opinion discussed the vigor of government enforcement of the securities laws, including amounts recovered by the SEC to distribute to injured investors.

Indeed, it is clear that the threat of governmental action against third parties who enable an issuer to falsify its financial statements remains real. At the time the Court handed down its decision, a trial was proceeding in Hartford, Connecticut against four former executives of General Re Insurance accused of helping AIG falsify its financial statements. The four (along with a former AIG employee) are on trial for securities fraud, as well as conspiracy, making false statements to the SEC and mail fraud. An SEC complaint is also pending against them. . Two other General Re executives have pleaded guilty in the case and settled SEC charges.

The scenario alleged is similar to that in *Stoneridge*: one company, seeking to generate the appearance of a desired result in its financial statements, enlists another company to conduct a transaction that lacks economic substance, and the employees of the other company knowingly agree to help. In the General Re case, those employees were charged with crimes by a U.S. Attorney, as well as being charged in a SEC enforcement action.

In such cases, the issue for the defense is whether the government can prove sufficient knowledge or intent, typically an issue to be decided at trial. Quoting email correspondence and taped telephone conversations, the indictment alleges that the General Re executives knew that AIG was going to account improperly for the transaction. The defendants have pleaded not guilty, and are vigorously disputing that they knew the transaction was improper.

Of course, while there are fewer legal hurdles for the government in maintaining a securities fraud case, it does bear a heavier burden of proof in a criminal case, beyond a reasonable doubt. Further, criminal indictments of corporations are more rare than indictments of individuals. While the SEC might act more often than criminal prosecutors against both corporations and their employees, it is still unlikely to bring as many cases as the private plaintiffs' bar might have had the Court decided *Stoneridge* the other way. As the law stands after *Stoneridge*, there may be fewer securities fraud cases against parties other than issuer corporations and their officers and directors, but the stakes in those cases will likely be higher for those who are charged.

To discuss this issue further, please speak to your Bryan Cave contact or any of the following members of Bryan Cave's [Securities Enforcement, Compliance and Litigation Client Service Group](#).

New York

Austin Campriello
(212) 541-2065
avcampriello@bryancave.com

James Devita
(212) 541-1241
jdevita@bryancave.com

Eva Jerome
(212) 541-2293
eljerome@bryancave.com

David Kasakove
(212) 541-2096
dpkasakove@bryancave.com

Eric Rieder
(212) 541-2057
erieder@bryancave.com

Dermot Sullivan
(212) 541-2135
djsullivan@bryancave.com

Richard Schulman
(212) 541-1265
rschulman@bryancave.com

Kira Watson
(212) 541-1257
kpwatson@bryancave.com

Daniel Waxman
(212) 541-2040
dpwaxman@bryancave.com

Noah Weissman
(212) 541-2028
nmweissman@bryancave.com

Chicago

Steven R. Smith
(302) 602-5040
srsmith@bryancave.com

Santa Monica

Howard O. Boltz
(310) 576-2233
hoboltz@bryancave.com

Edward Rosenfeld
(310) 576-2104
emrosenfeld@bryancave.com

Washington, D.C.

William Bavinger III
(202) 508-6037
wfbavinger@bryancave.com

Alec Farr
(202) 508-6053
awfarr@bryancave.com

Julie Anne McDonough
(202) 508-6151
jamcdonough@bryancave.com

Therese Pritchard
(202) 508-6252
tdpritchard@bryancave.com

St. Louis

Leo Asaro
(314) 259-2158
ljasaro@bryancave.com

John Michael Clear
(314) 259-2283
jmclear@bryancave.com

Robert Ebert Jr.
(314) 259-2633
rtebert@bryancave.com

Bruce Oetter
(314) 259-2336
bcoetter@bryancave.com

Mary Reichert
(314) 259-2188
mgreichert@bryancave.com

Jeffrey Russell
(314) 259-2725
jsrussell@bryancave.com

Kansas City

Perry Brandt
(816) 374-3206
perry.brandt@bryancave.com