



Background on the Enron and Stoneridge Cases

On October 9, 2007, the U.S. Supreme Court heard oral arguments in the securities fraud class-action lawsuit entitled *Stoneridge Investment Partners v. Scientific-Atlanta, Inc.* Many experts consider it the most important securities case that the Court has heard in decades. The Court's decision, expected early next year, has future implications for the integrity of the country's investment markets, and will have a direct impact on whether the victims of the Enron and other corporate frauds can gain compensation.

SCHEME LIABILITY

"Scheme liability," a legal concept applied in securities fraud cases, holds that any party who knowingly engages in "deceptive conduct" as part of a scheme to defraud investors can be held accountable for fraud under the federal securities laws – even if that party did not make a false or misleading statement directly to the public. The U.S. Securities and Exchange Commission has consistently supported the general principle of scheme liability.

THE ENRON CASE

In the wake of the Enron debacle, defrauded investors filed a lawsuit to recover their losses. Enron documents detailed how several large investment banks engineered sham transactions to keep billions of dollars of debt off Enron's balance sheet and to create the illusion of increasing earnings and operating cash flow. Testimony by bank employees also confirmed the banks' roles in the fraud.

When the illusion of financial strength and profitability that these banks helped create finally collapsed Enron's investors lost as much as \$40 billion.

The class action lawsuit named several large banks as defendants, alleging they knowingly and actively participated in the fraudulent scheme by structuring contrived financial transactions to falsify Enron's financial statements, generating fake profits and hiding billions of dollars in debt.

To date, Enron investors have recovered more than \$7 billion in settlements with financial institutions, including Citigroup, JPMorgan Chase, Lehman Brothers, Bank of America and Canadian Imperial Bank of Commerce.

Claims were still pending against several other institutions in March 2007, when the Fifth Circuit Court of Appeals rejected scheme liability and granted the remaining banks complete immunity from liability for their actions. [*Regents of the University of California et. al. v. Credit Suisse First Boston (USA), Inc. et. al., No. 06-20856, Opinion and Order (5th Cir. Mar. 19, 2007)*].

For more background on the Enron lawsuit: www.universityofcalifornia.edu/news/enron

Fifth Circuit Decision

- Although the Fifth Circuit acknowledged the banks' conduct was "hardly praiseworthy," the court's 2-to-1 ruling rejected scheme liability.
- Based on its interpretation of federal securities laws, the court held that because the banks themselves did not make any "false statements" about their conduct to investors, they could not be held liable even if they knowingly engaged in deceptive conduct as part of the scheme to defraud Enron investors.
- The court's majority acknowledged their ruling "may not coincide...with notions of justice and fair play."
- The Fifth Circuit decision conflicts with a recent Ninth Circuit decision upholding scheme liability and the SEC's position in support of scheme liability.

THE STONERIDGE CASE

- Charter Communications is a cable company which delivers service through set-top boxes installed on customers' TV sets. It purchases those boxes from Scientific-Atlanta and Motorola.
- In 2000, Wall Street analysts projected Charter's fourth-quarter numbers, and the company realized it would fall short of its operating cash flow expectations. To generate the \$17 million in additional cash flow it needed to garner positive reviews, Charter devised a plan in which it would pay Scientific-Atlanta and Motorola \$20 over the normal asking price for each set-top box if they would return the overpayments back to Charter in the form of advertising fees. Scientific-Atlanta and Motorola went along with the plan by falsifying and backdating contracts to reflect the extra \$20 charge. Charter then characterized the overpayments as revenue on their books – creating a misleading picture of its financial health.
- Stoneridge Investment Partners filed a securities-fraud class action on behalf of investors who purchased Charter stock between 1999 and 2002. [*Stoneridge Investment Partners v. Scientific-Atlanta, Inc.*, 443 F.3d 987 (8th Cir. 2006), cert. granted 127 S.Ct. 1873, (U.S. Mar. 26, 2007) (No. 06-43)]
- The plaintiffs alleged that Charter engaged in a "pervasive and continuous fraudulent scheme intended to artificially boost the Company's reported financial results" by entering into sham transactions with Scientific-Atlanta and Motorola that improperly inflated Charter's reported operating revenues and cash flow. The shareholders' complaint also named Scientific-Atlanta and Motorola as defendants alleging they knowingly participated in the fraudulent scheme with Charter.

Lower Court Rulings

- The U.S. District Court for the Eastern District of Missouri dismissed the claims against Scientific-Atlanta and Motorola under Section 10(b) of the Securities Exchange Act of 1934 and the SEC's implementing regulation, Rule 10b-5.
- The Court of Appeals affirmed the District Court's holding, stating that the plaintiffs' allegations did not state a Section 10(b) securities fraud claim against Scientific-Atlanta and Motorola as primary violators simply because they did not make any verbal misstatements to investors.
- The SEC has filed briefs in support of scheme liability in several recent cases, including the Enron case, and it recommended the Solicitor General file a pro-scheme liability brief in favor of the Stoneridge plaintiffs.
- The Solicitor General instead filed a brief in favor of the Stoneridge defendants, although it concluded their conduct constituted "deceptive conduct" under the securities laws even though they did not issue any false statements to the public. However, the Solicitor General argued that they should not be held liable for their deceptive conduct because the plaintiffs did not rely on their deception when making investment decisions.

The Issue before the Supreme Court

The issue that the Supreme Court will consider in the Stoneridge case is the same as that in the Enron case:

Does liability exist for knowingly participating in a scheme to defraud investors under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5(a) and (c) where the actors engaged in contrived financial transactions with a public corporation to distort and falsify its financial statements regardless of whether the actors made a false or misleading statement?

In short, do the securities laws allow shareholders to sue third parties, such as banks, accountants and lawyers, who participate in schemes to defraud – even if they did not directly mislead investors?

Implications of the Supreme Court Decision

FOR ENRON INVESTORS: The Supreme Court's decision in the Stoneridge case will determine if the investors defrauded in the Enron scandal can proceed with their claims and recover their losses from the banks that participated in the worst securities fraud in our nation's history.

FOR THE ECONOMY: If the Supreme Court rejects scheme liability in the Stoneridge case, in the future, banks, accountants, law firms and others who intentionally commit fraud in order to deceive the investing public will be immune from any responsibility to their victims. This consequence will reduce deterrence against fraud and seriously damage the integrity of the U.S. markets.

Applicable Securities Law

Section 10(b) of the Securities Exchange Act of 1934 holds it is unlawful, directly or indirectly, to “use or employ, in connection with the purchase or sale of any security ... any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [SEC] may prescribe” [15 U.S.C. § 78j(b)].

Rule 10b-5, the SEC's implementing regulation for this act, states:

“It shall be unlawful for any person, directly or indirectly...

(a) to employ any device, scheme, or artifice to defraud,

(b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or

(c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person in connection with the purchase or sale of any security.”