The Battle for Stone Ridge

By Stephen J Nelson, The Nelson Law Firm, LLC

Originally Published in *Traders Magazine* on February 21, 2008

http://www.tradersmagazine.com/news/100290-1.html

The universe of remedies for violations of U.S. securities law is presided over by an imperial triumvirate. The SEC rules over the realm of civil enforcements, which runs the gamut from injunctions and banishments (bars) to fines. To the Department of Justice (DOJ) belongs criminal prosecutions for penalties consisting of fines and imprisonment. The plaintiff's bar has the duty of recovering damages for victims of fraud, typically by bringing a class action lawsuit against the persons who caused the harm. The U.S. Supreme Court, in the case of *Stoneridge Investment Partners v. Scientific-Atlanta*, decided last month, has challenged the triumvirate's neat allocation of responsibilities, ushering in a new era of securities law enforcement.

The *Stoneridge* case began as a class action against Charter Communications, Inc. Charter was a cable operator that the Court found had engaged in a number of fraudulent practices in an effort to meet Wall Street expectations for cable subscriber growth and operating cash flow. Among other things, Charter misclassified its customer base; delayed reporting terminated customers; improperly capitalized costs that should have been shown as expenses; and manipulated the company's billing cutoff dates to inflate reported revenues. In late 2000, Charter executives realized that, despite these efforts, the company would miss projected operating cash flow numbers by $15 to $20 million. To help meet the shortfall, Charter decided to enlist two of its suppliers, Scientific-Atlanta and Motorola, in a conspiracy to defraud investors.

Scientific-Atlanta and Motorola supplied Charter with digital cable converters that Charter furnished to its customers. To make the numbers, Charter would agree to overpay Scientific-Atlanta and Motorola $20 per converter, but would never actually have to pay the $20. Instead, Charter would supposedly reimburse them with "advertising," which was never actually delivered. The overpayments were capitalized, while the $20 for advertising was included as revenue. To fool Charter's auditors, Scientific-Atlanta and Motorola created lots of phony documents, including false statements that they had increased production costs for the converters. This trick enabled Charter to inflate its revenue and operating cash flow by approximately $17 million.

As is all too often the case, Charter lacked the resources to fully compensate the victims of its fraudulent conduct. So, the attorneys for the victims naturally thought that Scientific-Atlanta and Motorola should contribute some compensation and brought suit against them pursuant to Rule 10b-5 under the Securities Exchange Act of 1934.

The Supreme Court disagreed and dismissed the plaintiff's case against Scientific-Atlanta and Motorola on the theory that there is no private right of action under Rule 10b-5 for persons who merely "aid and abet" a securities law violation. The Court relied on its 1994 decision in *Central Bank of Denver v. First Interstate Bank of Denver*, which stood for the same principle. The Court waved away a spirited dissent, which argued that the *Central Bank* case was different because Motorola and Scientific-Atlanta had actively participated in the fraud, whereas the *Central Bank* defendants were merely negligent in failing to preventing it. In the view of the majority of the justices, their decision did not leave victims without any opportunity to recover their losses from persons who participated in the fraud because the SEC could sue the aiders and abettors and provide the proceeds to victims.

It is hard to overestimate the profound impact of the Court's ruling.

Class actions generally, and securities class actions in particular, are an answer to a problem of modern technology. With the rise of mass communication, it is possible for a fraudster to steal a large amount of money by defrauding small sums from many people. Traditionally, our common law system would require each of the many victims to bring their own lawsuits for recovery. However, individual lawsuits to recover small sums make no sense economically. So, the class action permits one of the victims to represent all of the other victims and distribute the proceeds to all of them.

While providing an elegant solution to an intractable problem, the fact is that class actions are a most imperfect device with a checkered past. In many cases, the lawyers bringing the case recover most of the proceeds, leaving little if anything to distribute to victims. And, the ultimate judgment in a class action can be so large and threatening that many companies will attempt to settle, although the plaintiff may not have a good case.

So, why not have the SEC bring class action cases, which should at least result in more recovery to the victims, and less to the lawyers?

The answer is that, in the United States, we are reluctant to grant the sort of power implicit in the class action device to a government agency. For one thing, federal agencies, while theoretically independent, are not immune from political influences. The ruling party gets the opportunity to appoint three of the SEC's five commissioners, while the loyal opposition must settle for two. In deciding which cases to bring, it is feared that the ruling party will discourage litigation against its supporters, while punishing supporters of the opposition. The motives of the plaintiffs' bar, by contrast, are purely financial and unaffected by political affiliation.

Some would argue that our fear of governmental power, handed down to us by our country's founders, is misplaced. Maybe so. In any event, we are about to find out whether our fears about governmental power are a nightmare, or a fantasy. The *Stoneridge* case will also provide the SEC's Division of Enforcement with an expanded role and a new job. It will be worth the price of admission to see if the Court finds their work more satisfactory than the performance of the class action plaintiffs' bar.