No. 06-43

In The
Supreme Court of the United States

STONERIDGE INVESTMENT PARTNERS, LLC,

Petitioner,

v.

SCIENTIFIC-ATLANTA, INC. AND MOTOROLA, INC.,

Respondents.

**On Writ Of Certiorari To
The United States Court Of Appeals
For The Eighth Circuit**

BRIEF OF AARP, CONSUMER FEDERATION OF AMERICA, AND U.S. PIRG AS *AMICI CURIAE* IN SUPPORT OF PETITIONER

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INTEREST OF *AMICI CURIAE*[*]

AARP is a non-profit, non-partisan organization with more than 38 million members, dedicated to addressing the needs and interests of Americans aged 50 and older. As the largest membership organization representing the interests of older Americans, AARP has long been concerned about fraudulent practices in the securities industry. Older Americans are frequent targets of fraud because they often have significant assets and look for investment opportunities that will supplement Social Security and other sources of retirement income. As a result, AARP has made the need to combat securities fraud a high priority. It has regularly commented on legislative and regulatory proposals that address investment fraud, filed *amicus* briefs in cases involving the federal securities laws, and opposed legislative efforts to limit the remedies of defrauded investors.

AARP's advocacy and consumer education activities are informed by the many studies it has undertaken over the years to understand investors' knowledge, behaviors, and concerns. *See, e.g.*, *AARP, Investor Perceptions and Preferences Toward Selected Stock Market Conditions and Practices: An AARP Survey of Stock Owners Ages 50 and Older* 21 (March 2004), *available at* http://www.assets.aarp.org/rgcenter/econ/investor.pdf. These studies show that individual investors often lack basic knowledge of how the securities markets operate and are unaware of the important features of their own investments. This problem

[*] No party's counsel wrote this brief (in whole or in part), and no person other than *amici* and their counsel contributed monetarily to this brief 's preparation or submission. The parties' letters consenting to the filing of this brief have been lodged with the Clerk of the Court.

is of particular concern given the entry of many first-time investors into the market and the responsibility for retirement investing that pensioners have had to assume as a result of the shift from defined benefit pension plans (under which employers bear the risk of loss) to defined contribution pension plans (under which plan participants bear the risk of loss). Integrity in the securities markets and the remediation of securities fraud is therefore more important today than ever.

The Consumer Federation of America (CFA) is a nonprofit association of 300 consumer groups, which in turn represent more than 50 million Americans. It advances the consumer interest through research, education, and advocacy. As increasing numbers of Americans have come to rely on the nation's financial markets to fund their retirement and invest their savings, CFA has made enhancing investor protections a top legislative and regulatory priority. CFA's policies in this area are based on a fundamental belief that investors are entitled to a marketplace that provides them with a choice of appropriate investments and service providers, the information necessary to make informed choices, protection against fraud and abuse, and effective remedies when they are defrauded. CFA has for nearly two decades been a leader in efforts to promote investor protection legislation and regulations, and to oppose efforts to weaken those protections, at both the state and federal levels. One of CFA's particular areas of concern has been the ability of investors to seek legal redress for their losses. Toward these ends, CFA has testified before Congress, participated in Securities and Exchange Commission (SEC) roundtables, submitted *amicus* briefs on a range investor-protection issues, and consulted with members of Congress, SEC Commissioners, and state securities regulators.

U.S. PIRG is a national, non-profit advocacy group with over one million members around the country. Its mission is to protect the interests of consumers and ordinary citizens using the tools of investigative research, media reports, grassroots organizing, legislative and public policy advocacy, and litigation. Investor protection has been a long-standing area of concern to U.S. PIRG. It has appeared as an *amicus curiae* in support of investor rights in several of the important securities fraud cases that have come before the Court during recent years.

SUMMARY OF ARGUMENT

The answer the Court gives to the question presented in this case will have significant consequences for victims of major corporate frauds of the sort that brought down Enron, WorldCom, and other companies during the last decade. Recent history shows that investors harmed by these frauds all too often go uncompensated for their losses when the accountants, bankers, lawyers, and others who are not affiliated with the corporate issuer but who actively scheme with the issuer to defraud investors – *amici* call them "outside actors" here for ease of reference – are not held to account for their violations of § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b). Outside actors are often the only culpable defendants with assets sufficient to satisfy a judgment or fund a settlement that secures any real measure of relief for defrauded investors. Of course, the Court should not fashion a § 10(b) jurisprudence around an indiscriminate search for deep pockets. But neither should it lose sight of the consequences that would result if it were to adopt the Court of Appeals' unduly restrictive interpretation of § 10(b).

ARGUMENT

Investors in Major Securities Fraud Cases Will Often Be Denied a Remedy for Their Losses When Outside Actors Are Not Held Liable for Violating § 10(b) of the Exchange Act

This past decade has seen corporate fraud on an unprecedented scale. *See, e.g., In re Enron Corp. Sec., Derivative, & ERISA Litig.*, 235 F. Supp. 2d 549, 565, 593, 687 (S.D. Tex. 2002); John C. Coffee, Jr., *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 B.U. L. Rev. 301, 302 (2004) [hereinafter "*Gatekeeper Failure*"]; Geoffrey P. Miller, *Catastrophic Financial Failures: Enron and More*, 89 Cornell L. Rev. 423, 423-24 (2004); Robert W. Hamilton, *The Crisis in Corporate Governance*, 40 Hous. L. Rev. 1, 1-33 (2003); David Wessel, *What's Wrong – Venal Sins: Why the Bad Guys of the Boardroom Emerged En Masse*, Wall St. J., June 20, 2002, at A-1. The costs of recent frauds to shareholders – many of them individual investors and pension funds – have been enormous. Investor losses in many individual § 10(b) cases have run into the billions of dollars. The Enron fraud alone resulted in claimed damages totaling $40 billion. *See, e.g., Regents of the Univ. of California v. Credit Suisse First Boston (USA), Inc.*, 482 F.3d 372, 379 (5th Cir. 2007).

Few, if any, of the major corporate frauds of the last decade have been perpetrated by corporate securities issuers (including their officers, directors, managers, and other insiders) acting alone. Outside actors have played significant roles in nearly every one – in some instances by making false statements calculated to deceive investors about the issuer's financial condition and in others by participating in deceptive financial transactions calculated to achieve the same result.[1]

If the Exchange Act is to serve as the "indispensable tool with which defrauded investors can recover their losses" that Congress intended, Conference Report on Securities Litigation Reform, H.R. Conf. Rpt. 104-369, at 31, 1995 U.S.C.C.A.N. at 730 (1995); *see Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*, 126 S. Ct. 1503, 1510 (2006), then outside actors must be held accountable

[1] We anticipate that the plaintiffs in the Enron securities fraud case (and perhaps others) will appear as an *amicus curiae* in this case and detail the fraudulent misrepresentations that Enron's banks made to the investing public through their financial transactions with Enron. *See, e.g.*, *In re Enron*: 235 F. Supp. 2d at 637-57, 695-704; Pet. Writ Cert., *Regents of the Univ. of California v. Merrill Lynch Pierce Fenner & Smith, Inc.,* No. 06-1341. Enron, though, is not the only example of a notorious fraud case that arose in large part from the conduct of outside actors. Other examples include the frauds involving *Global Crossing*, *see In re Global Crossing, Ltd. Sec. Litig.*, 322 F. Supp. 2d 319, 335-37 (S.D.N.Y. 2004), and Lincoln Savings & Loan, *see, e.g.*, *In re: Am. Cont'l Corp./Lincoln Sav. and Local Sec. Litig.*, 140 F.R.D. 425, 428 (D. Ariz. 1992).

Amici also anticipate that petitioner and other *amici* will point out that outside actors are hardly blameless for many of recent history's securities frauds. Some distinguished commentators – not all of them sympathetic to the securities plaintiffs' bar – have assigned much of the blame for these frauds to the accountants, bankers, lawyers, and other professionals (called "gatekeepers" by one commentator) on whom the investing public relies to ensure that our markets operate with integrity. *See, e.g.*, Coffee, *Gatekeeper Failure*, *supra*; John C. Coffee, Jr., *Guarding the Gatekeepers*, N.Y. Times, May 13, 2002, at A-2.

when (as alleged in this case) their conduct violates the explicit language of § 10(b) and its companion SEC rule, Rule 10b-5, 17 C.F.R. § 240.10b-5. The victims of several of the most notorious recent frauds have achieved a substantial measure of recovery (though in each case far from all of their losses) only because courts allowed them to proceed against culpable outside actors. *See, e.g.*, *In re WorldCom, Inc. Sec. Litig.*, 388 F. Supp. 2d 319, 322, 325 (S.D.N.Y. 2005); Pet. Writ. Cert., *Regents of the Univ. of Calif. v. Merrill Lynch Pierce Fenner & Smith, Inc.* (No. 06-1341), at ii, 3 (Enron).

As *amici* establish below, none of the other usual sources of recovery in securities fraud cases – i.e., the corporate issuer, the issuer's officers, directors, and other insiders, or the issuer's directors' and officers' (D&O) liability policies – can provide any meaningful relief for the victims of most major frauds.

I. Major Fraud Cases Often Involve Insolvent Stock Issuers from Which Defrauded Investors Cannot Obtain Any Recovery for Their Losses.

Nearly all of recent history's most notorious securities fraud cases – including those involving Enron, Equity Funding, Global Crossing, Lincoln Savings and Loan, Refco, Sunbeam, U.S. Financial, and WorldCom – involved securities issuers that were insolvent by the time (or soon after) the filing of a § 10(b) case. *See, e.g.*, *Hevesi v. Citigroup, Inc.*, 366 F.3d 70, 73 (2d Cir. 2004); Hamilton, *The Crisis in Corporate Governance, supra*, at 20-26. The result for investors defrauded by insolvent issuers is usually the same: The issuer files for bankruptcy, and the automatic stay provision of the bankruptcy code, 11 U.S.C.

§ 362(a), then shields the issuer from suit, leaving the defrauded shareholder with a usually-worthless (prepetition) claim against the insolvent issuer that is not worth pursuing and is seldom pursued.[2] *See, e.g.*, *Hevesi*, 366 F.3d at 74 n.1 (noting that WorldCom's bankruptcy filing "prevent[ed] litigation against WorldCom from going forward").

As a result, only culpable stock issuer's officers and managers, directors, and outside actors remain viable defendants in these cases.[3] *See, e.g.*, *id.*; *see also, e.g.*, *In re Refco Sec. Litig.*, 05 Civ. 8626, 2007 U.S. Dist. LEXIS 31969, at *11 (S.D.N.Y. Apr. 30, 2007); *In re Global Crossing Sec. and ERISA Litig.*, 225 F.R.D. 436, 441 (S.D.N.Y. 2004); *In re: Am. Cont'l Corp./Lincoln Sav. and Loan Sec. Litig.*, 140 F.R.D. at 427; *In re Equity Funding Corp. of Am. Sec. Litig.*, 375 F. Supp. 1378, 1380 (1974). *See generally* Coffee, *Reforming the Securities Class Action*, *supra*, at 1551 n.64 (noting that "insiders and secondary participants [i.e., outside actors] are the only parties that can be sued once bankruptcy has been filed").

[2] Criminal proceedings against individual defendants in civil cases may also result in stays. In the WorldCom securities litigation, for instance, the district court stayed all proceedings against the company's former CEO (Bernard Ebbers) pending the resolution of criminal proceedings against him. *See In re WorldCom Sec. Litig.*, 02 CV 3288, 2005 Dist. LEXIS 1805, at *5 n.1 (S.D.N.Y. Feb. 10, 2005); *see also In re WorldCom, Inc. Sec. & ERISA Litig.*, No. 02 Civ. 3288, 2002 U.S. Dist. LEXIS 23172 (S.D.N.Y. Dec. 5, 2002) (staying litigation against other executives).

[3] Securities class actions are actually seldom filed (against the stock issuer or anyone else) if the stock issuer declares bankruptcy. *See, e.g.*, John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation*, 106 Colum. L. Rev. 1534, 1551 n.64 (2006) [hereinafter "Reforming the Securities Class Action"].

II. Corporate Insiders Seldom Have Sufficient Assets to Compensate Defrauded Investors for Their Losses in Major Fraud Cases.

As for the issuer's officers, directors, managers, and other insiders,[4] their personal assets can usually cover only (at best) a small fraction of investor losses in any sizable fraud. *See, e.g.*, Coffee, *Reforming the Securities Class Action*, *supra*, at 1554-55. The damages in major securities fraud cases can and often do run into the billions of dollars. *See, e.g.*, *Regents of the Univ. of California*, 482 F.3d at 379; *In re Global Crossing*, 225 F.R.D. at 460; *see also* Coffee, *Reforming the Securities Class Action*, *supra*, at 1555 (cataloguing settlement amounts in major securities fraud cases). Few, if any, corporate officers and directors have the kind of assets needed to make their victims whole. *See, e.g.*, *In re Global Crossing*, 225 F.R.D. at 460 (noting that settlement was being funded by individuals "whose assets individually and collectively do not come close to the tens of billions of dollars of liability claimed"). The combined assets of Enron's CEO (Jeffrey Skilling) and board chairman (Kenneth Lay) just after their convictions, for example, represented less than one

[4] While outside directors are often sued, they usually do not face liability or contribute personally to settlements. *See* Bernard Black, Brian Cheffins, & Michael Klausner, *Outside Directors Liability*, 58 Stan. L. Rev. 1055, 1063-64 (2006); Joann S. Lublin, Theo Francis, & Jonathan Weil, *Directors Are Getting the Jitters – Recent Settlements Tapping Executive' Personal Assets Put Boardroom on Edge*, Wall St. J., Jan. 13, 2005, at B-1. A recent study found only 13 securities fraud cases before Enron and WorldCom in which outside directors made out-of-pocket payments to fund a settlement. *See id*. As for Enron's and WorldCom's outside directors, they contributed only $18 million and $13 million out of pocket, respectively, to the Enron and WorldCom settlements. *See* Black, Cheffins, & Klausner, *Outside Directors Liability*, *supra*, at 1057.

percent of the total damages suffered by Enron's defrauded investors. *See, e.g.*, John R. Emshwiller & Gary McWilliams, *What's Left of Lay and Skilling Wealth Is at Risk*, Wall St. J., May 27, 2006, at A-2; *see also, e.g.*, *In re WorldCom*, 2005 Dist. LEXIS 1805, at *5 (noting that the outside directors' $18 million contribution to the settlement in WorldCom represented 20 percent of the directors' total combined assets). It is telling that the largest payout in a securities fraud settlement by a corporate insider (Gary Winnick, the chairman of Global Crossing) was $55 million in a suit involving claimed damages in the billions of dollars. *See, e.g.*, Coffee, *Reforming the Securities Class Action*, *supra*, at 1552.

Even the limited assets of insiders, though, are not always available for recovery by defrauded investors. Sometimes they are seized in connection with, or exhausted on defense costs in, the related criminal proceedings that often accompany civil securities fraud cases. *See, e.g.*, Emshwiller & McWilliams, *What's Left of Lay and Skilling Wealth Is At Risk*, *supra*; John R. Emshwiller, *Enron Trial Highlights Issue of Plea Bargain*, Wall St. J., Oct. 11, 2004, at C-1.

III. D&O Policies Usually Provide No or Inadequate Coverage in Major Fraud Cases.

While D&O policies fund much of the plaintiffs' and class members' recovery in garden-variety fraud cases, *see, e.g.*, Coffee, *Reforming the Securities Class Action*, *supra*, at 1551, they do the victims of major frauds involving insolvent stock issuers little good in most cases. There are four main reasons why:[5]

First, nearly all D&O policies exclude from coverage the kind of fraud that normally gives rise to § 10(b) liability. Once the defendant is found liable for securities fraud, the insurer may decline coverage. *See, e.g.*, Black, Cheffins, & Klausner, *Outside Directors Liability*, *supra*, at 1086; Coffee, *Reforming the Securities Class Action, supra*, at 1574. Matters are only likely to get worse in the future. Insurers have begun to cut back on coverage, *see, e.g.*, Jonathan D. Glater & Joseph B. Treaster, *Insurers Scale Back Corporate Liability Policies*, N.Y. Times, Sept. 7, 2002, at C-1, and some insurers have even refused to issue policies altogether in perceived "high-risk" industries, *see, e.g.*, Hamilton, *The Crisis in Corporate Governance*, *supra*, at 38.

Second, a D&O policy may be impaired. The insurer of an insolvent company embroiled in allegations of fraud will often seek to rescind the company's D&O policy on the claimed ground that the company made misrepresentations (deliberately or negligently) when it purchased the policy. *See, e.g.*, Coffee, *Reforming the Securities Class Action*, *supra*, at 1551, 1556, 1578-79; Michael H. Diamond, *D&O Insurance: Pitfalls in a New World*, Nat'l L. J., Aug. 26-Sept. 2, 2002, at A-22. Oftentimes the misrepresentations that

[5] *Amici* exclude from consideration here fiduciary and other insurance policies that may cover pension plan losses arising from the investment of pension plan assets in the security issuer's stock. Recovery of those losses are not sought in § 10(b) actions but instead in breach-of-fiduciary actions brought under the Employee Retirement Income Security Act (ERISA), 29 U.S.C. § 1001 *et seq.* ERISA suits, of course, benefit only pension plan participants, not stock purchasers generally.

forms the basis of the rescission reside in the very SEC filing that forms the basis of the securities fraud claim. *See, e.g.*, *In re WorldCom, Inc. Sec. Litig.*, 354 F. Supp. 2d 455, 462 (S.D.N.Y. 2005). Disputes over rescission have become common. *See, e.g.*, *id.* at 455, 456-66; *Two Insurers Seek Right to Challenge Claims From Enron Lawsuits*, Wall St. J., Feb. 22, 2002, at B4. Insurers have responded by writing policies that expand their rights of rescission in cases of alleged fraud. *See, e.g.*, Theo Francis, *Directors' Armor: Adelphia Ruling Shows Legal Bills Must Be Covered*, Wall St. J., Mar. 24, 2004, at C-5.

Third, even an unimpaired D&O policy will cover only a modest fraction of the total damages. Losses in major securities fraud cases dwarf coverage limits. *See, e.g.*, Black, Cheffins, & Klausner, *Outside Directors Liability*, *supra*, at 1119, 1125; Coffee, *Reforming the Securities Class Action*, *supra*, at 1555-56, 1577-78. Most large U.S. companies carry D&O policies with coverage limits of between $100 and $200 million, *see, e.g.*, Coffee, *Reforming the Securities Class Action*, *supra*, at 1577-78, and not even the largest corporations can afford to insure against losses on the order of those suffered by the investors of issuers like WorldCom, *see id.* at 1556. (Few insurers even sell policies with coverage exceeding $300 million. *See id.* at 1578.) All of Enron's D&O policies together provided only $350 million in coverage. *See, e.g.*, *Two Insurers Seek Right to Challenge Claims from Enron Lawsuits*, Wall St. J., Feb. 22, 2002, at B-4. WorldCom, whose fraud likewise caused billions of dollars in investors losses, had only $100 million in D&O coverage. *See In re WorldCom,* 354 F. Supp. 2d at 460.

Fourth, defense costs in securities fraud cases often quickly exhaust whatever limited D&O coverage may exist. *See, e.g.*, Black, Cheffins, & Klausner, *Outside Directors Liability*, *supra*, at 1125. Securities fraud cases are complex, protracted, and expensive to defend. The longer a suit's life, the less insurance money there will be to fund a settlement or satisfy a judgment. For example, by the time of the (partial) settlement in the Enron securities fraud case, $150 million of Enron's $350 million (combined) policies had been spent on defense costs, *see, e.g.*, Black, Cheffins, & Klausner, *Outside Directors Liability*, *supra*, at 1125; in the WorldCom securities case, $15 million of a $100 million policy had been spent on defense costs, *id.* at 1119; and in the Global Crossing securities fraud case, to give a last example, $40 million of a $50 million policy had been spent on defense costs. *See Global Crossing*, 225 F.R.D. at 443, 445, 460.

* * *

Several of the lower courts (including the Court of Appeals in this case) that have interpreted § 10(b) to exclude so-called "scheme liability" from its reach have justified their interpretation by indulging dubious policy considerations of one sort or another. *See, e.g.*, *Credit Suisse First Boston*, 482 F.3d at 391-92; *In re Charter Communications, Inc. Sec. Litig.*, 443 F.3d 987, 992-93 (8th Cir. 2006). There are, however, important countervailing policy considerations that support the plain-meaning reading of § 10(b) (and its companion SEC regulation, Rule 10b-5) urged by the petitioner in this case. None of them is more important, to be sure, than the ability of defrauded investors to recover their losses in the sort of major fraud cases addressed in this brief.

CONCLUSION

The Court should reverse the judgment of the Court of Appeals.

Respectfully submitted,

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