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## The Stoneridge Case and the Need to Control Class Actions

By Peter J. Wallison

At a time when policy specialists in Washington and New York are debating the reasons why the United States seems to be losing financial transactions and public company listings to markets abroad, the arrival of the Stoneridge case at the Supreme Court tells us all we need to know. In the comprehensive study published in January by New York mayor Michael Bloomberg and New York Senator Charles Schumer, excessive litigation risk was the principal reason given for the reluctance of foreign companies to enter our public securities markets. In their introductory letter, the two politicians noted that “the legal environments in other nations, including Great Britain, far more effectively discourage frivolous litigation.”

The Stoneridge case not only encapsulates the very idea of frivolous litigation, but its arrival at our highest court shows that the rich incentives offered to plaintiffs lawyers by the U.S. private class action system will keep the danger of expensive litigation vivid in the minds of the foreign companies that are now fearful of entering our securities markets. Compounding the problem, the Securities and Exchange Commission (SEC) has now recommended that the government enter this case on the side of the plaintiffs. If the SEC’s position is upheld, the number of wary foreign companies will expand to include all those doing business with U.S. public companies; it will not even be necessary

to issue shares in the United States in order to incur securities liability.

The case is easily summarized. A cable company purchased set-top cable boxes from two suppliers. As part of the transaction, it overpaid for the boxes, but asked that the vendors return the overpayment as advertising fees. The cable company treated the boxes as capital equipment, depreciable over a period of years, but treated the rebated advertising fees as revenues, thus enhancing its revenues, profits, and cash flow that year. The cable company clearly violated the securities laws by falsifying its financial statements. The most interesting element of the case was that the plaintiff shareholders sued not only the company and its accountants, but also the vendors of the cable boxes, claiming that the vendors participated in securities fraud. There was no allegation that the vendors were actually aware of how the cable company handled the transactions for financial reporting purposes.

The Eighth Circuit Court held that the vendors were not liable, and the Supreme Court took the case on appeal from the plaintiffs. It is never easy to determine why the Court takes particular cases, but in this instance there was an apparent conflict between the circuits. In an earlier case, the Ninth Circuit declared that vendors could be liable in similar circumstances, but found procedural faults with the pleadings and returned the case to the trial court.

It is an old legal saw that hard cases make bad law, but Stoneridge should not be a hard case. The legal principle advanced by the plaintiffs—

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that persons unrelated to the statements that constituted securities fraud could be held liable for the plaintiffs' losses—would be impossible to restrict or cabin in any effective way. Every party that engaged in ordinary commercial transactions with a public company in the United States could later be accused of participating in a securities fraud if the commercial transaction itself could be characterized as fraudulent or deceptive—even if the commercial transaction was not understood by the defendant to be part of a securities fraud.

This is another example of how difficult it is—and will always be—to control securities class actions. Ever since a private securities class action was originally authorized by a federal district court in 1946, both the Supreme Court and Congress have sought to gain some control over these beasts, especially since the SEC can effectively enforce the same rule (SEC Rule 10b-5) under which these suits are brought. First, in the 1970s, the Court clarified that the private right of action under this rule was only available to buyers or sellers of securities, and later that the plaintiff must show that the defendant intended to defraud. When this did not stanch the flow, the Court resumed its pruning effort in the 1990s, shortening the period during which these actions could be brought, and finally declaring that aiders and abettors could not be sued

under Rule 10b-5. In 1995, Congress stepped in, adding restrictive pleading requirements in the Private Securities Litigation Reform Act and, when class action lawyers started using state courts, with the Securities Litigation Uniform Standards Act in 1997.

None of these steps has materially reduced the filing or costs of securities class actions, which, even if they are justified by the facts, result only in the innocent shareholders of a defendant company reimbursing the former shareholders who bought or sold—and, of course, paying the lawyers on both sides. Now, after various vain efforts by the Court and Congress to restrict the scope of Rule 10b-5 and to narrow the procedural window through which these suits must pass, we have the Stoneridge case, advancing yet another theory for why someone, somewhere, should cover the plaintiffs' losses.

Is it any wonder foreign companies want to stay as far as they can from our securities markets and the jurisdiction of our courts?

The Supreme Court should add this case to the line of decisions in which it sought to narrow the scope of private securities class actions, but there is only so much the Court can do to save us from our political timidity. At some point we as a nation must decide that securities class actions have real costs in economic growth, jobs, and the international competitiveness of our capital markets.

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