American Enterprise Institute for Public Policy Research

June 2007

On the Issues

Will the Bush Administration Cave in to Political Pressure from Trial Lawyers?

By Ted Frank

The Supreme Court has agreed to hear a case that could expand the scope of securities litigation. After heavy lobbying by the plaintiffs bar, the press is reporting that the Securities and Exchange Commission (SEC) will ask the solicitor general to intervene on the side of the plaintiffs, who are seeking to reverse an existing Supreme Court precedent. It remains to be seen whether the administration will support the trial bar's attempt to let meritless and extortionate securities litigation spiral out of control.

Treasury secretary Henry Paulson called securities litigation the "Achilles heel for our economy," endangering the global competitiveness of American financial markets. Last January, a report released by Senator Charles Schumer (D-N.Y.) and New York City's Republican mayor Michael Bloomberg concluded that investors were being driven away from American shores because "the highly complex and fragmented nature of our legal system has led to a perception that penalties are arbitrary and unfair."

The proposed solution to the legal mess offered by the so-called Paulson Committee Report was modest enough: "Greater clarity for private litigation." Yet even this small step could suffer a big setback. After heavy lobbying by the plaintiffs bar, the SEC intervened in a pending Supreme Court case, *Stoneridge v. Scientific-Atlanta*, on the side of a gigantic expansion of private litigation.

> How can a business function if it is potentially liable for hundreds of millions of dollars because those whom they trade with misreport a day-to-day transaction?

Stoneridge v. Scientific-Atlanta

The case's facts are straightforward: Charter Communications purchased set-top cable boxes but got back $20 per box in the form of advertising bought by the vendors. Charter executives recorded the outgoing money as a "capital expenditure" (to be depreciated over several years) but the incoming money as revenue recorded within a single year, thus falsely inflating operating cash flow. Three Charter executives went to prison over the shenanigans. Plaintiffs attorneys sued Charter and the executives, of course, but named as codefendants two of the vendors, Motorola and Scientific-Atlanta.

The suit makes little sense. The vendors had no say in how Charter accounted for or reported its transactions. (Indeed, the whole point of Charter's accounting fraud was to disguise the true nature of the transaction from outsiders by burying it in the aggregated financial statements.)

Ted Frank is a resident fellow and director of the Liability Project at AEI. Mr. Frank is a member of the putative plaintiff class in the Stoneridge litigation. Moreover, he was once personally subpoenaed by Scientific-Atlanta in unrelated litigation. A version of this article appeared in the *Wall Street Journal* on May 31, 2007.

Worse is the precedent it represents. How can a business function if it is potentially liable for hundreds of millions of dollars because those whom they trade with misreport a day-to-day transaction? The Supreme Court stopped such private "secondary liability" suits in *Central Bank v. First Interstate Bank*, a 1994 decision that Congress ratified the next year, explicitly rejecting private suits for "aiding and abetting" in the Private Securities Litigation Reform Act (repeating the rejection in the 2002 Sarbanes-Oxley Act.)

A federal court in Missouri dismissed the case against the equipment vendors, and the Eighth Circuit Court of Appeals affirmed that decision: such liability would, the court said, create far-reaching "uncertainties for those engaged in day-to-day business dealings." Nevertheless, the Supreme Court has agreed to hear an appeal.

Why? The Court may—one hopes—be stepping in to reassert itself, since some courts have permitted plaintiffs lawyers to whittle away at Central Bank. In the Enron litigation, for example, a federal court in Houston erroneously certified a class action after plaintiffs alleged investment banks doing business with Enron were "primary violators" of the securities laws—even though these defendants took huge losses when Enron collapsed. With plaintiffs claiming total liability of $40 billion, many banks surrendered when offered a chance to settle for less than a nickel on the dollar. Such a settlement is a better bargain than a 90 percent chance of winning at trial—a basic cost-benefit analysis the plaintiffs bar counts on when bringing baseless litigation. (Plaintiffs with meritorious cases do not settle for pennies on the dollar with a solvent defendant.)

Innocent investors paid $7.3 billion in settlements, about $700 million of which was diverted to attorneys, including Democratic fundraiser and trial lawyer William Lerach. Merrill Lynch, among others, fought the court's ruling and was vindicated when the Fifth Circuit Court of Appeals tossed out the case.

Mr. Lerach has appealed to the Supreme Court, asking that his case be joined with *Stoneridge*. Representative Barney Frank (D-Mass.) will helpfully hold hearings in June to highlight trial-lawyer criticisms of the SEC. Meanwhile, trial lawyers are attacking SEC chairman Christopher Cox for supposedly being insufficiently supportive of investors—by which they mean, of course, the interests of trial lawyers. Credulous journalists are adopting Lerach's line wholesale without noting the actual costs to investors or the American economy. This full-court press seems to have had its desired effect. The *Washington Post* is reporting that the SEC will take the side of plaintiffs attorneys, which means it will be up to others in the Bush administration to hold the line.

Curbing the Expansion of Meritless Securities Litigation

But one can help investors without paying billions to the likes of Mr. Lerach. The SEC, whose budget has tripled in the last decade, has criminal and civil enforcement authority against real "secondary violators," and Sarbanes-Oxley mandated that fines collected by the SEC be returned to defrauded investors instead of to the Treasury. These "fair funds," while suffering from bugs of government bureaucracy, are still fairer and more efficient than the contingency fees of up to 30 percent for trial lawyers—especially when those civil suits are often either meritless extortionate litigation or just piling on parasitically after government authorities have already sussed out the fraud. (In the WorldCom case, the settlement actually cost lead plaintiff New York State Common Retirement Fund money: its portfolio included shares in the defendant banks that paid out more than the fund received, in part because trial lawyers took a cut of hundreds of millions of dollars for transferring money from diversified investors' left-hand pockets to their right-hand pockets.)

Unfortunately, we cannot be certain why the Supreme Court has taken the case or if it will do the right thing. While Chief Justice John Roberts and Justice Stephen Breyer have spoken of the need for judicial modesty, both have recused themselves from the case. The SEC has caved to trial lawyer political pressure. This is all the more reason for the Treasury to stand firm and ask the solicitor general to urge the Supreme Court to keep liability circumscribed—and for Senator Schumer to explain to his Democratic colleagues why that would be a wise choice, before they pressure the Bush administration into making the wrong decision.