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THE PAULSON REPORT RECONSIDERED: How to Fix Securities Litigation by Converting Class Actions into Issuer Actions

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ABSTRACT

This short essay considers the findings and recommendations of the Paulson Report relating to securities fraud class actions under the 1934 Act and Rule 10b-5. While the report exposes numerous problems with securities litigation in the United States, it understates the problems inherent in stock-drop actions. As a result, the report fails to propose an effective fix. As the report recognizes, diversified investors gain nothing from stock-drop actions: Because the corporation pays, holders effectively reimburse buyers and sellers keep their gains. In other words, the system suffers from circularity akin to a game of musical chairs in that stock-drop actions ultimately do no more than transfer wealth among investors. Indeed, diversified investors are net losers to the extent of attorney fees and other costs of litigation. But the report fails to note that issuers who are targets of such actions see their stock drop in price by more than it otherwise would because of the prospect of litigation and a feedback effect: When the issuer pays to settle the case, the payment further reduces the value of the company, which leads to a further decrease in stock price and a further increase in the potential for damages. In the end, a target company faces a higher cost of capital than it would in a world without securities fraud class actions. And in some cases it may face financial ruin. The report also fails to note that diversified investors may suffer genuine financial loss when insiders take advantage of nonpublic information for personal gain or when they damage the reputation of the company by failure to be candid with the market. In such cases, stockholders have a real gripe and should have a remedy. The simple solution is for the courts to deem stock-drop actions under the 1934 Act and Rule 10b-5 to be derivative actions rather than direct (class) actions. It is well settled that it is up to the court to decide whether an action is direct or derivative. The fact that the parties style the action as a direct (class) action rather than as a derivative action does not make it so. By recasting stock-drop actions as derivative actions, the courts could in one stroke eliminate the glaring market inefficiency of circular recovery, lower the cost of capital for issuers, emphasize individual responsibility, induce boards of directors and gatekeepers to become more vigilant, and reduce the need for criminal prosecution.

KEYWORDS: Paulson Committee, securities litigation, enforcement, stock-drop action, diversification, circularity, feedback, cost of capital, class action, derivative action, issuer action, Rule 10b-5

JEL Codes: G10, G20, G30, K22, K41

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Legal scholars have known for years that securities fraud class actions – stock-drop actions – make no economic sense. Finally, the financial world has taken notice. The report of the Committee on Capital Markets Regulation (popularly known as the Paulson Committee) finds that "the public value of securities class action litigation is questionable" because (1) the costs fall on the corporation and thus its stockholders (even though the company gained nothing from the fraud), (2) settlements account for a very small percentage of total investor losses, and (3) the settlement is effectively paid by investors who held shares at the time of the fraud to investors who bought during the fraud period.[1] This litany of problems is really three ways of saying the same thing: securities fraud class actions suffer from circularity.

Regrettably, the report misses the simplest and most powerful point it could have made: In a stock-drop case – as in musical chairs – someone is going to suffer the loss one way or the other. The so-called fraud is nothing more than a delay of the inevitable. The loss suffered by those who buy during the fraud period – the period before the truth comes out – is nothing more than bad luck in buying at the wrong time. Their bad luck is offset – dollar for dollar – by the good luck of investors who happen to sell at the right time. In other words, securities fraud is a zero sum game.

Moreover, the report understates the case against stock-drop actions. Because most investors are diversified, they suffer no net harm from securities fraud. A diversified investor who trades from time to time – for purposes of portfolio balancing, tax planning, and so forth – is equally likely to gain as to lose.[2] It all comes out in the wash. Diversified

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[1] *See Interim Report of the Committee on Capital Markets Regulation* (November 30, 2006) at 78-79 (hereafter Report). A stock-drop action is fundamentally different from an action based on a fraudulent offering by an issuer company. In a fraudulent offering, the company obtains funds under false pretenses and investors may recover under the Securities Act of 1933 (the 1933 Act). In a stock-drop action, buyers of outstanding stock seek to recover losses when the stock declines in price as a result of the disclosure of bad news that allegedly should have been disclosed before the buyers bought. A stock-drop action is typically based on the antifraud provisions of the Securities Exchange Act of 1934 (the 1934 Act) and specifically Rule 10b-5 thereunder. These two types of actions may arise simultaneously if a publicly traded company issues additional stock. In such a case, those who buy the newly issued stock sue under the 1933 Act. And those who buy outstanding stock sue under Rule 10b-5. It is much easier to make out a case under the 1933 Act, but damages are limited to the difference between the offer price and the market price after decline. Under the 1934 Act damages are the difference between purchase price and market price after decline. Thus, an individual who buys newly issued stock in the aftermarket at a price higher than the issue price would really have two claims, one under each act. For the year 2006, only about 12 percent of cases involved fraudulent offerings. *See* Cornerstone Research, *Securities Class Actions Filings, 2006: A Year in Review,* at 20. The focus here is on stock-drop actions under the 1934 Act.

[2] Recent studies indicate that only about one-quarter of trading volume is motivated by stock-picking whereas about three-quarters of trading volume is motivated by other strategies such as portfolio balancing,

investors are effectively insured against securities fraud by virtue of being diversified. Litigation is pointless.[3] Investors in the aggregate are net losers to the extent of attorney fees. The costs of litigation, including both direct expenses and such intangibles as management distraction, are a dead weight loss that reduces investor returns.[4] For a diversified investor, it is the equivalent of paying for two insurance policies against the same risk.[5]

In addition, as the report correctly notes, a diversified investor is likely to be a non-trading holder of many stocks that become the target of securities fraud class actions. In such cases, non-trading holders effectively reimburse buyers because the issuer pays the settlement. Thus, although diversified investors break even as traders, they always lose as

tax planning, arbitrage, and so forth. *See* Utpal Bhattacharya & Neal E. Galpin, *Is Stock Picking Declining Around the World?* AFA 2007 Chicago Meetings Paper (November 2005), http://ssrn.com/abstract=849627; Martijn Cremers & Jianping Mei, *Turning Over Turnover,* Yale ICF Working Paper No. 03-26, AFA 2005 Philadelphia Meetings (November 2004), http://ssrn.com/abstract=452720 (finding that about three-quarters of trading is motivated other than by stock picking). *See also* Martijn Cremers & Antti Petajisto, *How Active is Your Fund Manager? A New Measure that Predicts Performance,* AFA 2007 Chicago Meetings Paper (January 15, 2007), http://ssrn.com/abstract=891719 (finding that more active managers of nonindex funds outperform less active managers); Meir Statman, *et al., Investor Overconfidence and Trading Volume,* AFA 2004 San Diego Meetings (March 2003), http://ssrn.com/abstract=168472. For a treatment of trading frequency from a legal point ov view, see Paul G. Mahoney, *Is There a Cure for "Excessive" Trading?,* 81 Va. L. Rev. 713 (1995). *See also* Lynn A. Stout, *Are Stock Markets Costly Casinos? Disagreement, Market Failure, and Securities Regulation,* 81 Va. L. Rev. 611 (1995); Lynn A. Stout, *Reply: Agreeing to Disagree over Excessive Trading,* 81 Va. L. Rev. 751 (1995). It is possible that the mix of investors varies from one corporation to the next. That is, it is possible that a particular corporation may attract the disproportionate attention of stock pickers. But for most companies, most trading appears to be motivated by other factors.

[3] It is peculiar – and somewhat misleading – that the report notes that settlements account for only a small fraction of investor losses and that it reasons that securities fraud litigation does a poor job of compensating investors. The simple explanation is that only buyers have standing to sue. But if holders also had standing to sue for their losses, the gain from the settlement would be exactly offset by a decrease in the value of the subject stock. For example, in discussing the minimal contribution typically made by individuals, the report states that the twelve outside directors of WorldCom paid about $25 million in damages even though the its potential liabilities were over $70 billion, the market capitalization of WorldCom at its peak. The implicit assumption is that in a fair world investors should be able to recover that amount. But WorldCom was never in fact worth $70 billion. It was bound to decrease in value as the market became more rational and less exuberant and as its creative accounting came to light. But WorldCom was still worth something. It failed in the end not because it was a fraudulent enterprise but because of the prospect of securities fraud litigation.

[4] Plaintiff attorney fees are average about 20 percent of the recovery. Report at 72, 79. Defense attorneys probably command about the same amount. *See* Thomas Baker & Sean Griffith, *Predicting Corporate Governance Risk: Evidence from the Directors' and Officers' Liability Insurance Market,* 74 U. Chicago L. Rev. 487 (2007), http://ssrn.com/abstract=909346

[5] This would be quite apparent – and quite controversial – if the law required sellers to give up their gains to reimburse buyers.

holders.[6] Accordingly, a diversified investor is not merely indifferent to securities fraud litigation. A diversified investor should be positively opposed to the system as it stands.[7]

Feedback and the Cost of Capital

The report fails to recognize altogether that because the company pays, its value – and thus its stock price – falls even more than it would have fallen because of the disclosure of bad news. As a result, buyers claim even more in damages, the settlement grows even larger, and the stock price falls even further. In other words, the prospect of securities fraud litigation gives rise to positive feedback that has the effect of magnifying the decrease in the price of the stock.[8]

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[6] The report notes that the chances are about 10 percent that any given company will become the target of securities litigation in any five year period. Report at 74. This is a roundabout way of saying that there are about 10,000 listed companies and about 200 securities fraud class actions filed each year. In other words, two in every hundred companies are likely to get sued in any given year. But the report fails to connect the dots. If a diversified investor holds 500 different stocks through a mutual fund, ten stocks are likely to be the target of a securities fraud action each year. If the mutual fund has an annual turnover ratio of 40 percent – about the market average – then on the average it will be a buyer in two cases, a seller in two cases, and a holder in six cases. The fund and its investors will break even on the 40 percent of the portfolio that trades during the year, but it will lose on the 60 percent that is held.

[7] As the report points out, any given diversified investor may be on both sides of the recovery. Report at 79. If an investor holds shares in the defendant company and buys more during the fraud period, he may lose as much on the shares he holds as he recovers on the shares he bought. For this insight, the report cites John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and its Implementation,* 106 Colum. L. Rev. 1534 (2006), http://ssrn.com/abstract=893833 (page references herein to SSRN). As I argue elsewhere, holder-buyers who stand to lose more than they gain from a class action would oppose certification of the action if they could vote on the matter. Thus, there is an inherent conflict of interests within the plaintiff class that should preclude class certification. It is no answer that holder-buyers may opt out of the action. If the action proceeds as a class action, they must remain in the plaintiff class to obtain their share of any recovery. In other words, there is a kind of market failure at work here. And it is thus up to the courts to remedy the situation by declining to certify the action as a class action. *See* Richard A. Booth, *Taking Certification Seriously – Why There Is No Such Thing as an Adequate Representative in a Securities Fraud Class Action* (November 2007), http://ssrn.com/abstract=1026768. To be sure, not all stockholders are diversified. Indeed, recent studies indicate that the average individual investor in the US holds just four stocks even though one can eliminate virtually all company-specfic risk by holding about 20 stocks. The report expresses some concern about undiversified investors. Report at 80. But it is well settled that federal securities law protects reasonable investors. A passive investor who fails to diversify assumes more risk than necessary without the prospect of any additional return. That is irrational behavior for an investor. Moreover, most investors are well diversified, because at least three-quarters of all stock is held through various institutional vehicles. Even if one is reluctant to deny a remedy to undiversified investors, presumably the interests of the great majority of investors should trump those of a small minority of investors. This is not to say that an individual undiversified investor might not have a legitimate claim on occasion. For example, an investor who seeks to gain control of a target company is likely to be undiversified. Such investors may sometimes be victims of fraud. But such investors are likely to have claims against an identifiable seller (whether a stockholder or the company itself) and must likely show reasonable reliance on some falsehood propounded by a counterparty.

[8] *See* Richard A. Booth, *The End of the Securities Fraud Class Action as We Know It,* 4 Berkeley Bus. L. J. 1 (2007), http://ssrn.com/abstract=683197. To be sure, in many cases the settlement is paid by insurance. Report at 78 and note 1 (a 1995 study indicates that insurance pays about 68 percent of claims and that defendant companies pay about 31 percent). Moreover, there is reason to think that issuers collude with

Legal scholars noted long ago that the market seems to overreact to bad news and generally blamed it on market inefficiency.[9] But a perfectly efficient market will overreact to bad news – as a result of feedback – if it appears likely that the company will become the target of securities fraud litigation as a result.[10] The extent of the feedback effect depends on the number of shares represented in the plaintiff class:

total decrease in market value = expected decrease / (1 – % of shares damaged)[11]

For example, if the expected decrease in firm value based solely on the revelation of bad news (without feedback) is 10 percent and the plaintiff class – those who bought during the fraud period – represent 40 percent of the shares, the total decrease in the value of the shares will be about 17 percent:

total decrease in market value = .10 / (1 – .40) = .10 / .60 = .166

If the plaintiff class represents 50 percent of the shares, the total decrease in value will be 20 percent – twice the decrease that would be seen if there were no threat of a securities fraud class action. And if the plaintiff class represents 80 percent of the shares, the total decrease in value will be 50 percent – five times what it would have been if there were no threat of a securities fraud class action. In other words, the company will be worth half

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plaintiff lawyers to settle for amounts that will be covered by insurance. *See* Coffee at 43-50. One might argue that feedback is unlikely to be significant because most of the cash for the settlement does not come from the defendant company. But the fact that the settlement is paid by insurance does not eliminate feedback. First, depletion of insurance by the settlement means that the company is exposed to the possibility of other claims that will not be covered by insurance. In other words, one may think of insurance as an off balance sheet asset that supports stock price. Second, insurance is likely to become more expensive for the settling company in the future (as well as for other companies). Thus, the company will have higher insurance expenses in the future, returns will be lower in the future, and stock price will adjust downward accordingly. So feedback sneaks back into the picture one way or the other. On the other hand, feedback will arise only to the extent that the market thinks the company will pay. If it is true that issuers and plaintiff lawyers generally agree to settle for an amount that will covered by insurance, presumably the market will react accordingly. In other words, market price will not necessarily fall by an amount that reflects the full amount of damages that might be awarded, if the market thinks that the case will be settled for some lesser amount.

[9] *See* Janet Cooper Alexander, *The Value of Bad News in Securities Class Actions,* 41 UCLA L. Rev. 1421 (1994); Baruch Lev & Meiring de Villiers, *Stock Price Crashes and 10b-5 Damages: A Legal, Economic, and Policy Analysis,* 47 Stan. L. Rev. 7 (1994). *See also* Werner F. M. De Bondt & Richard Thaler, *Does the Stock Market Overreact?* 40 J. Fin. 793 (1985); Werner F. M. De Bondt & Richard Thaler, *Further Evidence on Investor Overreaction and Stock Market Seasonality,* 42 J. Fin. 557 (1987).

[10] This is not the usual pie-in-the-sky argument that the market knows all. Rather the point is that *even if* the market is perfectly efficient it will overreact to bad news that is likely to give rise to a securities fraud class action in the sense that the market price of the subject stock will fall by more than it should in light of the bad news. In the real world, the market may fall even further as a result of true (inefficient) overreaction.

[11] For a derivation of this formula, see the appendix hereto. *See* Richard A. Booth, *The End of the Securities Fraud Class Action as We Know It,* 4 Berkeley Bus. L. J. 1 (2007), http://ssrn.com/abstract=683197.

what it would have been worth in such a case even though the bad news was that its value had fallen by 10 percent.[12]

Although the report correctly states that holders lose because the company pays, this bland statement hardly captures the situation. Holders see their stock fall in price by more than it should. And perhaps more important, the defendant company sees its market capitalization – its aggregate value – fall by more than it should. Going forward, the company faces a higher cost of capital than it should – if it survives.[13]

The report notes that individual defendants rarely pay any part of the settlement in a securities fraud class action except in cases in which the company is insolvent and has tapped out its insurance.[14] But the report stops short of suggesting that individuals *should* pay more (though it does endorse individual liability where appropriate). This is not too surprising in that the report finds that securities fraud litigation confers no benefits on investors. Rather, the report suggests a series of clarifications in the law defining securities fraud and proposes that corporations and their stockholders should be free to choose alternative dispute resolution methods.[15] Neither of these recommendations

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[12] One of the intractable technical problems with securities fraud class actions is that there is no reliable way to determine the number of damaged shares short of soliciting claim forms from the plaintiff class because many of the damaged shares may have been traded repeatedly during the class period. *See* Robert A. Alessi, *The Emerging Judicial Hostility to the Typical Damages Model Employed by Plaintiffs in Securities Class Action Lawsuits,* 56 Bus. Law. 483 (2001). This has given rise to several different (and statistically dubious) models that purport to estimate the number of damaged shares. For a description of the latest model, see Linda Allen, *Meeting* Daubert *Standards in Calculating Damages for Shareholder Class Action Litigation,* 62 Bus. Law. 955 (2007). Although there is no easy way to determine the number of damaged shares, the market may effectively estimate the number quite efficiently. *See generally* JAMES SUROWIECKI, THE WISDOM OF CROWDS (2004).

[13] About 30 percent of defendant companies end up bankrupt. *See* Laura E. Simmons & Ellen M. Ryan, Cornerstone Research, *Post Reform-Act Securities Settlements, 2005 Review and Analysis,* at 14. In many cases, defendant companies may be on the verge of failure anyway. But most publicly traded companies have a solid core business. For example, Jensen and Murphy estimate that Enron was worth about $30 billion when it failed but not the $70 billion that the market attached to it. *See* Michael C. Jensen & Kevin J. Murphy, *Remuneration: Where We've Been, How We Got to Here, What Are the Problems, and How to Fix Them,* ECGI Working Paper No. 44/2004 at 46. So the question is why did the market price of Enron fall to zero? Feedback seems a likely answer. The same seems likely to be the case with WorldCom. In that case, the class period was more than three years long, suggesting that almost all of the stockholders would be members of the plaintiff class. *See* In re Worldcom, Inc. Securities Litigation, 294 F. Fupp. 2d 392, 2003 US Dist. LEXIS 8245 (SDNY). To be sure, many of the plaintiffs in the WorldCom litigation acquired their shares from WorldCom itself as the company grew by taking over other smaller companies in stock for stock deals. Such plaintiffs had legitimate 1933 Act claims against the company. But the irony remains that in the case of both Enron and WorldCom, the plaintiffs would have been much better off if no securities fraud class action had been filed.

[14] Report at 78-79.

[15] Report at 80-84. Specifically, the report recommends that the SEC and the courts should clarify the meaning of materiality, *scienter,* and reliance. In addition, the SEC should use its powers to prevent duplicative recovery in cases where there is both private litigation and an SEC enforcement action. And plaintiff lawyers should be prohibited from engaging in practices that amount to paying clients to serve as plaintiffs. The report also addresses the overuse of criminal sanctions, the dangers of imposing excessive

addresses the real problem. In essence, the recommendation is that we should be more efficient about handling pointless litigation.[16]

Issuer Recovery

Despite the problems inherent in class actions, there may be a point to *other forms* of securities litigation. The report misses the important possibility that insiders – the CEO and other high ranking officers – may gain from securities fraud. Have we forgotten that Ken Lay, Jeff Skillings, Andy Fastow and other Enron insiders sold more than $800 million in Enron stock as the end drew near? In effect, they misappropriated $800 million from the market.[17] This is not to suggest that insider trading as narrowly defined under federal law is the only way that insiders may do genuine financial harm to outsiders. For example, it is not clear that backdating options constitutes insider trading, but it is quite clear that it reduces returns to other stockholders. Moreover, even in the absence of insider gain, failure to be candid with the market may do harm to the reputation of the company among investors and cause a drop in stock price. But who should recover for such wrongs? In a case of insider trading, it seems clear that the insider should give back the gain. But to whom? How do we figure out who was on the other side of a trade? And

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liability on auditors and outside directors. Report at 84-91. The executive summary emphasizes the need for continued enforcement against individual wrongdoers. Report at xii. But curiously there is almost nothing to that end in the discussion of securities fraud class actions. Rather, the report ultimately and rather cryptically recommends that corporations and their stockholders should be free to choose alternative dispute resolution methods. Report at 109-112. This might be read as something of an endorsement for derivative actions.

[16] One might naturally ask how we ended up with the confused system that we now have. The short answer is that under the 1933 Act investors who buy newly issued stock have an express cause of action against the issuer if there is any material falsehood in the registration statement or the prospectus. But the 1933 Act also provides that the issuer cannot be held liable for any more than the proceeds of the offering. As a result, the courts have ruled that only those investors who buy stock that is part of the offering may recover. If the issuer is already publicly traded – if the offering is one of additional stock – it is likely that other investors will read the offering materials and may rely on falsehoods therein in connection with the purchase of already outstanding stock. The investor would not likely know whether the shares he bought were part of the offering, but the courts nonetheless required plaintiffs to trace their shares back to the offering in order to have standing to sue. In other words, for investors who bought their shares in the aftermarket, it was largely a matter of accident whether one had standing to sue under the 1933 Act. It is thus understandable that the courts would permit other investors to sue under Rule 10b-5 which carries stiffer requirements of pleading and proof anyway. Indeed it became routine for plaintiff lawyers to add a claim under Rule 10b-5 to all 1933 Act claims. *See* Richard A. Booth, *The Missing Link Between Insider Trading and Securities Fraud,* 2 J. Bus. Tech. L. 185 (2007), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=975949. It is not surprising that securities fraud class actions became established in the 1960s at a time when most investors were poorly diversified and heavily focused on company-specific factors. Bhattacharya and Galpin find that in the United States in the 1960s about 60 percent of trading was motivated by stock picking. As noted above, they find that today only about 24 percent of trading is motivated by stock picking. They predict that the level of stock picking will continue to decline and will stabilize at about 11 percent. *See* Utpal Bhattacharya & Neal E. Galpin, *Is Stock Picking Declining Around the World?* AFA 2007 Chicago Meetings Paper (November 2005), http://ssrn.com/abstract=849627.

[17] *See* Robert Prentice, *Review Essay: Enron: A Brief Behavioral Autopsy,* 40 Am. Bus. L.J. 417 (2003).

why should the counterparty recover because just because she happened to buy their stock from one of the culprits rather than someone else?

There is a simple solution: issuer recovery. The corporation should recover the ill-gotten gains of insiders.[18] And if the corporation fails to seek recovery, a stockholder may file a derivative action on behalf of the corporation. If the corporation recovers, the value of the corporation increases dollar for dollar, and the recovery is effectively spread over all the stockholders. There is no problem of circularity. And there is no feedback effect because *the company* recovers. Investors are compensated to the extent of their true loss – the amount that insiders have extracted from the market – and not the amount of losses that would have occurred anyway. Moreover, the remedy is consistent with the fiduciary duty that insiders owe to the corporation.

Issuer recovery is also consistent with the findings and recommendations in the report. Indeed it is somewhat surprising that the report fails to connect the dots and propose a similar solution. For example, the report suggests that enforcement should focus more on individual wrongdoers while at the same time expressing general concern about the overuse of criminal sanctions.[19] In addition, the report suggests that recent revelations of lawyers bribing plaintiffs indicates that in many cases plaintiffs are not otherwise inclined to sue because they have not suffered any real loss (or would lose as much as holders as they gain as members of the plaintiff class).[20] Finally, the report also recommends that the SEC clarify the meaning of *scienter.*[21] Although Congress stiffened pleading standards in 1995 by requiring facts indicating a strong inference of *scienter,* we seem to have lost track of the fact that *scienter* means *intent to defraud* – intent to (mis)appropriate the wealth of another by deception.[22] However reprehensible it is for a

[18] This seems quite obvious in a case of reputational harm. It would hardly make sense to make the corporation pay because it was harmed by one of its agents. Yet that is essentially the system we have with stock-drop actions. It also seems clear that in a case of options backdating, the optionee should give back the ill-gotten options. That remedy addresses the harm to other stockholders – dilution – quite directly. Insider trading has always been a bit confusing on this score because it has not always been clear why insider trading is illegal. But the misappropriation theory seems now to be well settled. *See* United States v. O'Hagan, 521 U.S. 642 (1997). Thus, it seems clear that the issuer can recover for the insider trading of its fiduciaries. *See* Moss v. Morgan Stanley Inc., 719 F. 2d 5, 21 (2d Cir. 1983) (holding that if insider trading is based on a theory of misappropriation of information from the source of the information, the source of the information may have standing to sue but the counterparty to the trade does not). It is telling that the 1934 Act takes a similar position in §16(b) which provides that the issuer may recover insider gain from short swing trading and that where the issuer fails to do so a stockholder may maintain a derivative action to that end. This would seem to be a powerful argument for issuer recovery and against securities fraud class actions under the 1934 Act and Rule 10b-5.

[19] Report at xii.

[20] Report at 82-84. *See* Richard A. Booth, *Why Pay a Fraud Plaintiff to Sue?* washingtonpost.com, June 26, 2006.

[21] Report at 80-82.

[22] Exchange Act §21D. *See* Tellabs, Inc. v. Makor Issues & Rights, Ltd., 127 S. Ct. 2499, 168 L. Ed. 2d 179 (2007). *See also* Basic, Inc. v. Levinson, 485 U.S. 224 (1988) (dissent of Justice White questioning whether there could be fraud where perpetrator does not trade or otherwise gain); In re Time Warner

company to lie to the market in the hope that bad news might be covered up, it is not fraud, and there is no *scienter,* unless someone gains in the bargain.[23]

Issuer recovery would be easy to implement. The courts should simply deem securities fraud class actions to be derivative actions – actions in the name of the corporation by which the corporation recovers.[24] The character of an action is a matter for the discretion of the courts.[25] The fact that the parties style the action as a direct (class) action rather than as a derivative action does not make it so.[26] The real harm from securities fraud (if

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Securities Litigation, 9 F.3d 259, 268 (2d Cir. 1993), *cert. denied*, 511 U.S. 1017 (1994) (dissent of Judge Winter arguing that corporate officers could not have expected alleged fraud to result in gain to the corporation and that accordingly there could be no *scienter*). *See generally* Richard A. Booth, *The Missing Link Between Insider Trading and Securities Fraud,* 2 J. Bus. Tech. L. 185 (2007). available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=975949

[23] Curiously, Professor Coffee seems to assume that securities fraud class actions always involve insider gain. *See* Coffee at 19-20. Not true. In 2006 only 42 of 110 cases (38%) involved allegations of insider trading, while 20 of 110 cases involved options backdating. *See* Cornerstone Research, *Securities Class Actions Filings, 2006: A Year in Review,* at 3, 20. The report also notes that few recent actions have named auditors as defendants – even though about 60 percent of cases appear to be based at least in part on allegations of improper accounting – probably because of the Supreme Court decision in *Central Bank v. First Interstate Bank,* 511 U.S. 164 (1994), foreclosing claims for aiding and abetting. Report at 87. *See also* Coffee at 16; PricewaterhouseCoopers LLP, *2004 Securities Litigation Study,* at 11. Although the point is that the accounting profession remains exposed to litigation, the (unintended) suggestion is that many actions are based on illusory losses. Similarly, the report also suggests that the SEC should provide more guidance about what constitutes materiality and reliance. In both cases, the thrust seems to be to assure that the actions that are litigated are the ones in which there has been genuine economic loss.

[24] As a practical matter, a court could so rule in a motion to certify on the rationale that conflicts within the plaintiff class render an action for individual damages inappropriate for class action treatment under FRCP 23(b)(3). Specifically, the interests of buyers (who want the action to go forward) and buyer-holders (who do not) conflict in a way that cannot be resolved by the formation of subclasses. But both groups would favor a derivative action if there is insider misappropriation. And FRCP 23(b)(2) permits the court to certify an action as a class action if:

> the party opposing the class has acted or refused to act on grounds that apply generally to the class, so that final injunctive relief or corresponding declaratory relief is appropriate respecting the class as a whole.

That is essentially a description of a derivative action or at least the part that involves compelling the corporation to sue the wrongdoers. *See* Richard A. Booth, *Taking Certification Seriously – Why There Is No Such Thing as an Adequate Representative in a Securities Fraud Class Action* (November 2007), http://ssrn.com/abstract=1026768. Interestingly, FRCP 23(b)(2) seems to permit such an action even in the absence of demand on the corporation.

[25] *See* Bangor Punta Operations, Inc. v. Bangor & Aroostook R. Co., 417 U.S. 703 (1974); Tooley v. Donaldson, Lufkin, & Jenrette, Inc., 845 A.2d 1031(Del. 2004).

[26] Legal scholars seem to agree that it is up to the courts to fix the problem. AALS Section on Business Associations, Annual Meeting, New York, January 3, 2008. Although the courts might be reluctant to effect such a change, the SEC could presumably nudge them in right direction by using its broad power to grant exemptions under federal securities law. *See generally* Joseph A. Grundfest, *Disimplying Private Rights of Action Under the Federal Securities Laws: The Commission's Authority,* 107 Harv. L. Rev. 961 (1994). For example, the SEC might exempt issuers from class actions except in cases in which they have

any) comes from the misappropriation of stockholder wealth by insiders. The redistribution of inevitable losses among innocent investors is regrettable, but stockholders can easily protect themselves from that sort of harm through diversification. To be sure, in the absence of insider gain, the action will likely be dismissed.[27] But that is as it should be. No harm, no foul.[28]

What About Deterrence?

Professor Coffee argues that although securities fraud class actions are unlikely to afford significant compensation to investors, they are the most important source of deterrence we have. He recognizes that the threat of a stock-drop action constitutes wildly excessive deterrence aimed at the wrong target. Nevertheless, he argues that eliminating corporate liability would so reduce the incentives to sue that we would lose the deterrent effect of private litigation: "One cannot safely eliminate corporate liability ... without radically reducing the likelihood of private enforcement." [29]

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dealt in their own stock or cases litigated as derivative actions. One might object that it is somehow inappropriate to focus here on the procedural form of the action. In other words, whether one has a cause of action should not depend on the procedural device one chooses to pursue it. The easy answer is that Congress did exactly that in PSLRA and SLUSA by establishing special rules for securities fraud actions that take the form of class actions. Looking back, that seems like an extraordinary thing to do. On the other hand, it indicates that lawmakers somehow intuited the problem of circularity. Moreover, it is quite clear that the courts have considerable discretion in the management of class actions because they affect the rights of absent parties. That is the point of the certification requirement. A derivative action is ultimately a type of class action. It would seem to follow (as the Delaware courts have known for a long time) that the courts have the power to decide what form an action should take. *See* Richard A. Booth, *Taking Certification Seriously – Why There Is No Such Thing as an Adequate Representative in a Securities Fraud Class Action* (November 2007), http://ssrn.com/abstract=1026768. Here too, the SEC could play an important role by intervening in securities fraud class actions at the certification stage.

[27] Technically speaking, the issuer suffers no direct harm from many instances of misappropriation (such as insider trading). Rather the claim is more one of unjust enrichment on the part of insiders. Still it is well established that a corporation may recover in such circumstances. *See* ALI, PRINCIPLES OF CORPORATE GOVERNANCE §5.04.

[28] In addition, a derivative action is subject to procedural complications (such as the demand requirement and the possibility that the corporation may seek *voluntary* dismissal) that may make it less desirable than a direct action. Moreover, the settlement of a derivative action based on misappropriation or other gain to the wrongdoer likely will not be covered by insurance. Thus, although defendant companies could argue on their own initiative that securities fraud class actions should be recast as derivative actions, they are unlikely to do so, because such claims would not be covered by insurance. As I discuss further below, the SEC could help alleviate these problems by intervening in appropriate situations.

[29] *See* Coffee at 41. The courts seem to agree. As Justice Ginsburg recently stated, "This Court has long recognized that meritorious private actions to enforce federal antifraud securities laws are an essential supplement to criminal prosecutions and civil enforcement actions brought, respectively, by the Department of Justice and the Securities and Exchange Commission (SEC)." Tellabs, Inc. v. Makor Issues & Rights, Ltd., 127 S. Ct. 2499, 168 L. Ed. 2d 179 (2007).

This is a peculiar argument. If there is so little at stake that the plaintiff bar will find it uneconomic to sue, so be it.[30] Moreover, if diversified investors are effectively insured – by virtue of being diversified – against the possibility that they may buy at the wrong time, what exactly do we want to deter? The only real worry for a diversified investor is that insiders may take advantage of nonpublic information in some way to misappropriate stockholder wealth from the market. But there is little danger of underdeterrence here. There is plenty of motivation for plaintiff lawyers to file derivative actions. Who would not be motivated by the prospect of a fee equal to (say) one-third of the $800 million misappropriated by the officers of Enron? [31] Besides, one of the major problems with securities fraud class actions is that the potential damages are wildly in excess of what is needed for effective deterrence. With issuer recovery, the amount of any recovery is likely to be quite small in compared to amounts claimed in securities fraud class actions, but it is likely to be significant for an individual defendant.

Legal scholars have suggested a variety of other fixes for the class action mess. Some have suggested a system of civil fines that limit the amount payable by the corporation.[32] The problem with civil fines – as with criminal prosecution – is that they are not particularly scalable. Fines – and criminal prosecution – are pretty much one size fits all. And they fit no one particularly well.

The report suggests that SEC fines be used to compensate investor victims and that private awards be reduced by such amounts.[33] But that fix does not address the feedback problem. The market does not care where the money goes or the route it takes when the company pays. As long as the issuer remains on the hook for investor losses, feedback will magnify the loss.

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[30] Maybe that is why plaintiff lawyers found it necessary to bribe plaintiffs to serve. *See* Richard A. Booth, *Why Pay a Fraud Plaintiff to Sue?* washingtonpost.com, June 26, 2006.

[31] In addition, it is possible that misappropriation or other acts of bad faith by insiders may do harm to the reputation of the business. If so, it may be appropriate for the corporation to recover damages over and above the sums that insiders misappropriate. But because a securities fraud class action also causes a decrease in the market price of the subject company, it is impossible to know how much real damage has been done. In the absence of the threat of a class action, this element of damage would become much easier to measure and where appropriate the corporation could recover. *See* Malone v. Brincat, 722 A.2d 5 (Del. 1998).

[32] Coffee at 37. *See* Donald C. Langevoort, *Capping Damages for Open-Market Securities Fraud,* 38 Ariz. L. Rev. 639 (1996); Janet Cooper Alexander, *Rethinking Damages in Securities Class Actions,* 48 Stan. L. Rev. 1487 (1996).

[33] Report at 82. As the report notes, the SEC has authority under the *Fair Funds for Investors* provision of the Sarbanes Oxley Act to use funds obtained from civil penalties to compensate victims of securities fraud. *Id.* For the year 2004, class action settlements totaled $5.5 billion while SEC monetary sanctions totaled $3.1 billion. Report at 71.

Accordingly, others have suggested that issuers be exempt from liability under Rule 10b-5 in cases in which the issuer itself does not sell stock.[34] To be sure, that fix would leave plaintiffs with nothing but an action against individual wrongdoers. But it does nothing to change the way damages are calculated against the remaining defendants.[35] Moreover, there may be cases in which the issuer gains from securities fraud and should disgorge. For example, if the issuer repurchases shares while sitting on good news, selling stockholders may have a legitimate claim.[36] So to exempt issuers is overbroad.

It is much simpler to clean up the class action mess with issuer recovery than with the other fixes that have been proposed. By definition, issuer recovery exempts the issuer because the issuer is the plaintiff. Thus, there is no need for an issuer exemption.[37] Issuer recovery also limits damages to the amount of insider gain. It is a much more efficient way to limit damages because the limit is automatically scaled to the offense.[38]

The obvious argument against issuer recovery is that no corporation will go after its own and that the corporation will likely do all it can to thwart any derivative action. That is undoubtedly true in a world with securities fraud class actions. It is only natural that a company accused of fraud will circle the wagons.[39] No company would dare initiate an

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[34] Coffee at 63-67. *See* Joseph A. Grundfest, *Disimplying Private Rights of Action Under the Federal Securities Laws: The Commission's Authority,* 107 Harv. L. Rev. 961, 976-99 (1994). For a response, see Joel Seligman, Commentary, *The Merits Do Matter: A Comment on Professor Grundfest's "Disimplying Private Rights of Action Under the Federal Securities Laws: The Commission's Authority,"* 108 Harv. L. Rev. 438, 439 (1994). For Professor Grundfest's response to Professor Seligman, see Joseph A. Grundfest, *Why Disimply?* 108 Harv. L. Rev. 727, 727 (1995).

[35] On the other hand, it should be apparent that it makes no sense to hold other defendants liable for the all the losses suffered by buyers. *See* Fridrich v. Bradford, 542 F.2d 307 (6th Cir. 1976).

[36] *See* Richard A. Booth, *The End of the Securities Fraud Class Action as We Know It,* 4 Berkeley Bus. L. J. 1 (2007), http://ssrn.com/abstract=683197.

[37] If the issuer gains from the sale of overpriced stock, investors remain free to sue under the 1933 Act. If the issuer gains from a repurchase of underpriced stock, sellers (who no longer own their stock) could maintain a direct (class) action against the issuer as the actual buyer. There is no danger of feedback because damages would be limited to the actual gain enjoyed by the corporation. *See* Richard A. Booth, *The End of the Securities Fraud Class Action as We Know It,* 4 Berkeley Bus. L. J. 1 (2007), http://ssrn.com/abstract=683197.

[38] Civil fines and criminal prosecution are blunt instruments. The penalty is more or less all or nothing. In contrast, in a civil action, the plaintiff must plead and prove damages. Thus, with civil liability you know who lost what and who recovers. In addition, a private plaintiff must weigh the costs and benefits of filing a civil action. In other words, civil remedies are both self-executing and self-regulating. (As Gordon Gekko might have said, the need to quantify the stakes clears the mind and focuses the will.) In contrast, neither a regulator nor a prosecutor must prove damages. And neither has much of any reason not to prosecute an offense other than the prospect of losing. On the other hand, simple compensatory damages may be insufficient deterrence. If the only consequence of securities fraud is that one must disgorge ill-gotten gains, there is little reason to give it a go. A similar problem with insider trading is addressed under the Insider Trading & Securities Fraud Enforcement Act by providing for a treble the gain fine in addition to compensatory damages. *See* Exchange Act §20A.

[39] Coffee at 44.

action against its own officers for fear that it would trigger a ruinous class action.[40] Indeed, as the law currently works, it may even be rational to cover up bad news that is likely to give rise to a class action. If the news is bad enough that a class action would likely bankrupt the company, there may be nothing to lose from a cover up. Thus, it is arguable that securities fraud class actions constitute a significant obstacle to effective corporate governance. And that may explain at least in part the recent growth in the criminal prosecution of such controversies.[41]

There is no reason to assume that a corporation will respond in the same way in the absence of the class action threat. In the current environment, one can hardly fault an outside director who concludes that it is contrary to the best interests of the corporation to pursue an action against a CEO. In the absence of the class action threat, however, outside directors would themselves be subject to potential legal action for failure to seek restitution when appropriate, whereas outside directors are practically immune to legal action as things stand.[42]

Nevertheless, the question remains: What is to keep the company honest if it is not liable for misleading the market? In the absence of insider gain, there would seem to be no reason for a company not to lie to the market. There at least two good answers.

First, companies act only through individuals who may be liable for any gain they enjoy or facilitate for others and for any loss they cause by harming the reputation of the company. To be sure, non-trading insiders may often be protected by the business judgment rule because issuer recovery is essentially a matter of state law.[43] But the business judgment rule may not protect a non-trading insider from liability if there is a violation of SEC rules.[44] Moreover, the SEC always has the authority to prosecute a civil enforcement action in any such case and may presumably join a private action where appropriate.

Second, given that equity is the primary form of compensation for most CEOs and other high level officers, insiders should have every incentive to assure that the market is as

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[40] Compare Coffee at 61-62.

[41] *See* Richard A. Booth, *What is a Business Crime?* 3 J. Bus. Tech. L. xxx (2008), http://ssrn.com/abstract=1029667.

[42] Report at 90-91. *See* Joy v. North, 692 F.2d 880 (2d Cir. 1982).

[43] *But see* Exchange Act §16(b).

[44] It is not clear that the business judgment rule affords protection against a clear violation of an SEC rule. Just as speeding constitutes negligence per se if one is involved in an accident even if speeding might otherwise be reasonable, the violation of an express SEC rule relating may constitute unprotected illegal behavior for state law purposes. *See* Richard A. Booth, *The Missing Link Between Insider Trading and Securities Fraud,* 2 J. Bus. Tech. L. 185 (2007), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=975949.

fully informed as it can be. Where equity compensation is the norm, no company can afford to be blacked out of the market. Companies need to issue stock and options and to buy back stock to control for dilution. And officers who exercise options need to sell stock for tax planning and diversification. In other words, insiders themselves have every reason to keep their companies honest.

Obviously, equity compensation did not prevent the most recent spate of frauds. Indeed, some have argued that equity compensation was ultimately to blame.[45] But the incentives would be quite different if issuer recovery were the rule. As things currently stand, the issuer foots the bill and insiders often keep their gains. If insiders are potentially liable to disgorge any gain – fault or no fault – as misappropriation under state law, they should be eager to ensure that the market is fully informed when they cash out. To be sure, one might argue that issuer recovery would cause officers to insist on even more compensation or costly insurance against such claims.[46] But insurance is not generally available if there is personal gain involved.[47] The same goes for indemnification.[48]

To be sure, issuer recovery puts the board of directors in a somewhat peculiar position. In effect, the board becomes an arbiter for the competing claims of officers and stockholders. In some cases, the board must pursue claims against officers, while in other cases, the board may conclude that it is not in the best interest of the corporation to do so. But that is a good thing. Again, for a diversified investor, the only real worry is insider misappropriation. Everything else comes out in the wash. But it is not always clear what constitutes misappropriation. For example, although it seems quite clear that backdating options is usually inappropriate, it is not so clear that granting options at a time when the stock is trading at a low is problematic. Such decisions are judgment calls. The board of directors is well suited to striking the required balance between stockholder expectations and the competing interests of management. Moreover, to view the board of directors as an arbiter is consistent with the proposal in the report that the SEC should explore the possibility of permitting companies to opt out of class actions and into alternative dispute resolution.[49] That seems like an odd idea if one thinks of stockholders and the corporation

[45] *See* Michael C. Jensen & Kevin J. Murphy, *Remuneration: Where We've Been, How We Got to Here, What Are the Problems, and How to Fix Them,* ECGI Working Paper No. 44/2004.

[46] *See* Coffee at 65-67.

[47] *See generally* Coffee at 57-62.

[48] *See* DGCL 145. *See also* MBCA 8.51. A corporation may, however, advance litigation expenses in most circumstances, subject to an agreement on the part of the recipient to repay if she does not prevail.

[49] Report at 109-112. As I have argued elsewhere, it may make more sense to view a corporation as a partnership between stockholders and officers in which the officers effectively work for a piece of the action. *See* Richard A. Booth, *Executive Compensation, Corporate Governance, and the Partner-Manager,* 2004 U. Ill. L. Rev. 269, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=719983. This view is consistent with recent scholarship about team production and may explain away much of the recent controversy about executive compensation. Coincidentally, Jensen and Murphy have argued that the board of directors should be viewed primarily as a management monitor and that the support role of the board be viewed as strictly subordinate to its role as management monitor. *See* Michael C. Jensen & Kevin J.

as adversaries. If that is the model, why should one party to a potential dispute (the corporation) be permitted to dictate terms to the other (the stockholders)? But if one thinks of the typical dispute as one between stockholders and officers about how to share the corporate wealth, it is easy to see how the board of directors might officiate.

Finally, issuer recovery should reduce the need for criminal sanctions by freeing outside directors to do the right thing. The criminalization of controversies that traditionally have been seen as matters of corporate governance and fiduciary duty is due at least in part to the failure of boards of directors to monitor management with any real enthusiasm.[50] But the danger of triggering a securities fraud class action – with the potential for costs far in excess of any benefit to the stockholders – impedes vigorous action by the board of directors. If we eliminate this obstacle to effective monitoring by the board of directors, it may not be necessary to prosecute cases that do not involve a truly criminal enterprise.[51]

In the end, the Paulson Report took an important step in reforming securities fraud litigation by exposing the contradictions and inefficiencies inherent in stock-drop actions. The next step is for the courts (with a little help from the SEC maybe). By recasting stock-drop actions as derivative actions, the courts could in one stroke eliminate the glaring market inefficiency of circular recovery, lower the cost of capital for issuers, emphasize individual responsibility, induce boards of directors and gatekeepers to become more vigilant, and reduce the need for criminal prosecution. What a deal.

Murphy, *Remuneration: Where We've Been, How We Got to Here, What Are the Problems, and How to Fix Them,* ECGI Working Paper No. 44/2004 at 53-56.

[50] *See* Richard A. Booth, *What is a Business Crime?* 3 J. Bus. Tech. L. xxx (2008); http://ssrn.com/abstract=1029667; Larry E. Ribstein, *Perils of Criminalizing Agency Costs,* U. Illinois Law & Economics Research Paper No. LE06-021 (July 2006), http://ssrn.com/abstract=920140.

[51] *See* Report at 84-86. Moreover, confusion about how to measure the loss from securities fraud also infects criminal prosecutions in that sentencing guidelines require the courts to estimate the loss from the fraud. Not surprisingly, prosecutors and the courts have used the same (questionable) theories used to estimate stockholder losses in securities fraud class actions with the result that sentences have been wholly out of proportion with the harm suffered by investors. *See, e.g.,* United States v. Olis, 2006 US Dist. LEXIS 68281 (S.D. Tex.).

APPENDIX

Securities fraud class actions usually arise from the failure of a publicly traded company to disclose material information in a timely fashion. The information may be either good news or bad news. In other words, a securities fraud action may be triggered by news that causes the price of a stock to rise (in which case those who sold during the fraud period suffer harm) or by news that causes the price of a stock to fall (in which case those who bought during the fraud period suffer harm). There are notable examples of both types of fraud. *See, e.g.,* Basic, Inc. v. Levinson, 485 U.S. 224 (1988) (good news); Dura Pharmaceuticals, Inc. v. Broudo, 544 U.S. 336 (2005) (bad news). But bad news fraud is far more common at least in part *because* of the way damages are awarded in securities fraud class actions. Indeed, for the year 2006, there were only two cases out of 118 that involved good news. See Stanford Law School, Securities Class Action Clearinghouse, Securities Class Action Filings (2006).[52] In a bad news case, the fact that the company pays causes the price of the company's stock to fall more than it otherwise would. In contrast, in a good news case, the fact that the company pays has the effect of muting the price increase that otherwise would have obtained. Thus, the formula for calculating the feedback effect differs in the two types of cases.

The pages that follow explain the derivation of formulas for the calculation of total damages in both bad news cases and good news cases, together with a chart showing the results for various class sizes as a percent of shares outstanding (damaged shares or absolute turnover). The last page compares these results graphically.

[52] http://securities.stanford.edu/fmi/xsl/SCACPUDB/recordlist.xsl?-db=SCACPUDB&-lay=Search&FIC_DateFiled_Year=2006&-sortfield.1=FIC_DateFiled&-sortfield.2=LitigationName&-sortorder.1=ascend&-max=25&-find=&-lay.response=ListGral&-encoding=UTF-8&-grammar=fmresultset

DERIVATION OF FORMULAS

BAD NEWS CASE

PRE-DISCLOSURE MARKET VALUE (10M shares)	$100M = 10/share
POST-DISCLOSURE THEORETICAL VALUE	90M = 9/share
DAMAGES TO BUYERS (60% turnover)	6M = .60/share
NET MARKET VALUE POST (tentative)	90M – 6M = 84M = 8.40/share

But if market value post is 84M, then damages should be 16M x .60 = 9.6M.
Now market value post is 90M less 9.6M = 81.4M = 8.14/share.
Process repeats to limit of $15M in total damages to buyers.

DAMAGES TO BUYERS	15M / 600K shares = $2.50/share
NET TO HOLDERS	90M – 15M = 75M = $7.50/share
NET TO BUYERS	$7.50/share plus $2.50/share

GENERAL RULE FOR BAD NEWS CASES:

total decrease in market value = theoretical decrease / (1 - % of shares damaged)

BAD NEWS CASE EXAMPLES

Assume hypothetical pre-damages decrease of $10M:

If 20% of shares are damaged, total award is $2.5M or $1.25/share.

If 40% of shares are damaged, total award is $6.67M or $1.67/share.

If 50% of shares are damaged, total award is $10M or $2.00/share.

If 60% of shares are damaged, total award is $15M or $2.50/share.

If 80% of shares are damaged, total award is $40M or $5.00/share.

If 90% of shares are damaged, total award is $100M or $10.00/share.*

* Note that $100M is more than entire value of company at $9 per share.

GOOD NEWS CASE

PRE-DISCLOSURE MARKET VALUE (10M shares)	$100M = 10/share
POST-DISCLOSURE THEORETICAL VALUE	110M = 11/share
DAMAGES TO SELLERS (60% turnover)	6M = .60/share
NET MARKET VALUE POST (tentative)	110M – 6M = 104M = 10.40/share

But if market value post is 104M, then damages should be 4M x .60 = 2.40M.
Now market value post is 110M less 2.4M = 107.6M = 10.76/share.
Process repeats to limit of 3.75M in total damages to sellers.

DAMAGES TO SELLERS	3.75M / 600K shares = .625/share
NET TO HOLDERS	110M – 3.75M = 106.25M = 10.625/share
GROSS TO SELLERS	10/share + .625/share = 10.625/share

GENERAL RULE FOR GOOD NEWS CASES:

total increase in market value = theoretical increase / (1 + % of shares damaged)

GOOD NEWS CASE EXAMPLES

Assume hypothetical pre-damages increase of $10M:

If 20% of shares are damaged, total award is $1.67M or $.833/share.

If 40% of shares are damaged, total award is $2.86M or $.714/share.

If 50% of shares are damaged, total award is $3.33M or $.667/share.

If 60% of shares are damaged, total award is $3.75M or $.625/share.

If 80% of shares are damaged, total award is $4.44M or $.556/share.

If 100% of shares are damaged, total award is $5.00M or $.500/share.*

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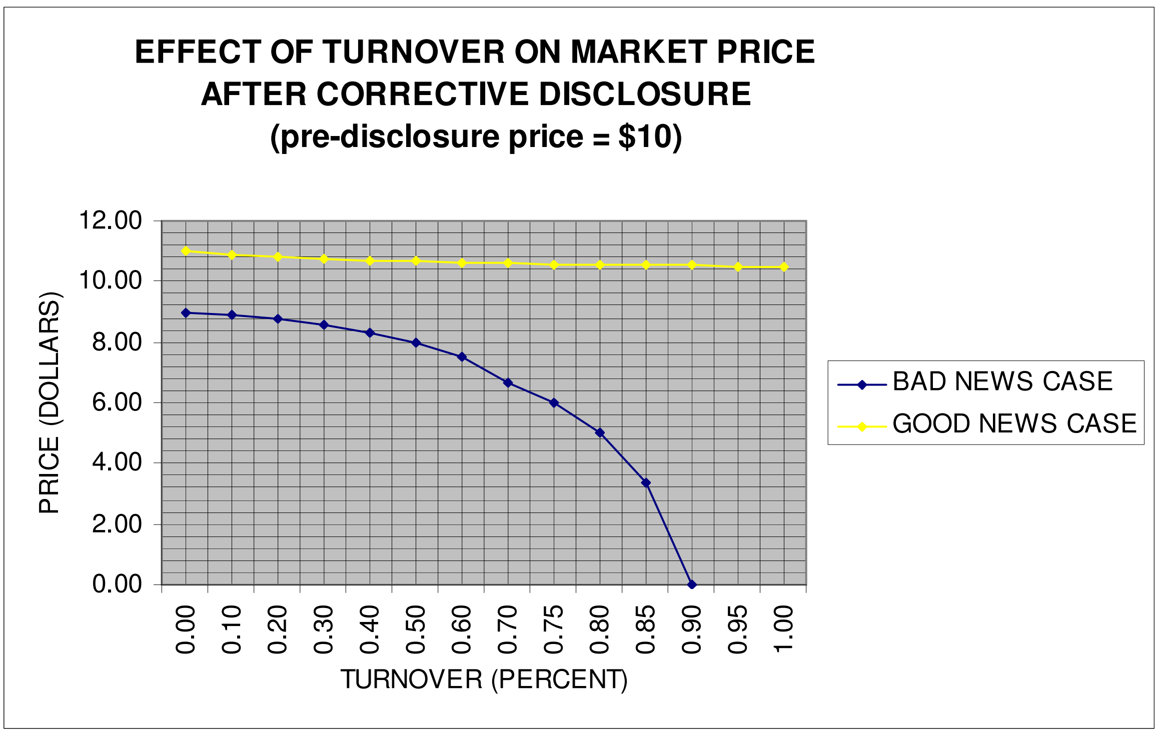
* Note that $5M is exactly half of the hypothetical increase.


EFFECT OF TURNOVER ON MARKET PRICE
AFTER CORRECTIVE DISCLOSURE
(pre-disclosure price = $10)
12.00
10.00
8.00
6.00
4.00
2.00
0.00
PRICE (DOLLARS)
0.00
0.10
0.20
0.30
0.40
0.50
0.60
0.70
0.75
0.80
0.85
0.90
0.95
1.00
TURNOVER (PERCENT)
BAD NEWS CASE
GOOD NEWS CASE