Working Paper Series

Villanova University Charles Widger School of Law *Year* 2009

Direct and Derivative Claims in Securities Fraud Litigation

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DIRECT AND DERIVATIVE CLAIMS IN SECURITIES FRAUD LITIGATION

By Richard A. Booth

ABSTRACT

In the typical securities fraud class action under Rule 10b-5, the plaintiff class consists of buyers who seek damages equal to the difference between the price paid for the stock during the fraud period and the lower price that prevails after corrective disclosure. The argument here is that this claim is really an amalgam of direct and derivative claims and that the derivative claims should result in recovery *by the corporation* for the benefit of all stockholders. There are three types of losses that arise in the typical stock-drop action. First, part of the loss may be attributable to lower expected earnings (fundamental loss). Second, part of the loss may be attributable to an increase in the cost of equity because of increased risk associated with the corporation (capitalization loss). Third, part of the loss may be attributable to the class action itself which if successful will result in a payout by the corporation to settle the litigation (feedback loss). It is not clear that fundamental loss should be actionable since it is a loss that will occur whether or not there is fraud. Capitalization loss may or may not be actionable. If it arises because of harm to the reputation of the corporation as a result of fraud or similar wrongful acts that cause the market to lose trust in the corporation resulting in an increased cost of capital for the corporation, the loss is derivative because it affects the corporation as a whole and affects all stockholders in the same way. On the other hand, the corporation may also suffer a capitalization loss in the absence of any fraud because the market learns new information about firm-specific risk. This loss – like fundamental loss – arises whether or not there is fraud. It should not be actionable. Finally, feedback loss arises only because the corporation pays if the class action is successful. But if the only actionable loss is capitalization loss for which the corporation should recover, there is no justification for a class action, no reason for the corporation to pay, and no feedback loss. In other words, feedback loss goes away if the class action goes away. In short, the only genuine loss in a stock-drop action under Rule 10b-5 is attributable to claims that should be characterized as derivative.

The mystery is why the courts and litigants have failed to characterize such claims as derivative rather than direct. Although there is some doubt whether capitalization loss is actionable as a matter of federal securities law, such claims are clearly actionable under the state law of fiduciary duty, particularly when there is insider misappropriation involved. The fact that such claims are litigated as direct class claims rather than derivative claims is especially puzzling because most stock is held by well-diversified institutional investors that lose from class actions. Such investors are equally likely to sell (gain) as to buy (lose) during the fraud period. Gains and losses net out over time. So the cost of litigation is a deadweight loss that reduces portfolio return. Moreover, because the corporation pays if the action is successful, the net effect is that holders pay buyers. A diversified investor who buys a few shares during the fraud period to add to existing holdings may lose more on its holdings than it gains from any recovery. Thus, diversified investors should be opposed to direct class actions in principle. They should favor derivative actions that seek recovery by the corporation for any loss such as capitalization loss from fraud. But each of the constituencies that might advocate for derivative actions – institutional investors, defendant corporations, and the plaintiff bar – is afflicted by a disabling conflict that discourages reform. An institutional investor cannot afford to opt out of securities fraud class action because by doing so it would effectively pay as a holder without the benefit of an offsetting recovery as a buyer.

Defendant corporations may be reluctant because insurance may not cover claims made in the context of a derivative action. And the plaintiff bar may be disinclined to prosecute derivative actions with much vigor because attorney fees are likely to be significantly greater in a class action. As a result, reform is unlikely unless the courts take the initiative. But this is arguably as it should be. It is well settled that procedure is a matter for the courts. And the characterization of claims as direct or derivative is a judicial function governed by the rules of procedure. Besides, the securities fraud class action is a judicial invention. Thus, the courts have the power and the duty to clean up the mess.

KEYWORDS: stock-drop action, securities fraud class action, Rule 10b-5, damages, settlement, diversified investor, institutional investor, direct action, class action, derivative action, fundamental loss, capitalization loss, feedback loss, earnings surprise, expected return, risk, volatility, cost of capital, trust, reputation, insider trading, misappropriation, disgorgement, fiduciary duty, deterrence, Rule 23, Rule 23.1, market failure, lead plaintiff, opt-out, PSLRA, SLUSA, indemnification, waiver, arbitration.

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

DIRECT AND DERIVATIVE CLAIMS IN SECURITIES FRAUD LITIGATION

By Richard A. Booth

INTRODUCTION

The usual practice in a stock-drop action under Rule 10b-5 is for the plaintiff class to claim per share damages equal to the difference between the price paid for the stock during the fraud period and the lower price that prevails after corrective disclosure. The claim by those who bought the stock during the fraud period seeks individual recovery by class members from the corporation. In other words, the claim made is a direct claim. The argument here is that this claim is really an amalgam of direct and derivative claims and that the derivative claims should result in recovery *by the corporation* from the responsible officers for the benefit of all stockholders – not simply those who bought shares during the fraud period.

There are three types of losses that arise in the typical stock-drop action. First, part of the loss may be attributable to lower expected earnings (fundamental loss). Second, part of the loss may be attributable to an increase in the cost of equity because of increased risk associated with the corporation (capitalization loss). Third, part of the loss may be attributable to the class action itself which (if successful) will result in a payout by the corporation to settle the litigation (feedback loss).

It is not clear that fundamental loss should be actionable since it is a loss that will occur whether or not there is a fraud – a failure of timely disclosure. If there is no fraud, there is no claim. Because the loss will happen – fraud or no fraud – there is no causal connection between the fraud and the loss. Thus, there should be no claim.

Capitalization loss may or may not be actionable. If it arises because of harm to the reputation of the corporation as a result of fraud or similar wrongful acts that cause the market to lose trust in the corporation and that cause an increase in the cost of capital for the corporation, the loss is derivative because it affects the corporation as a whole and affects all stockholders in the same way. On the other hand, the corporation may also suffer a capitalization loss because the market learns new information about the risk inherent in the corporation's business. This loss – like fundamental loss – arises whether or not there is fraud. It should not be actionable.

Finally, feedback loss arises only because the corporation pays if the class action is successful. But if the only actionable loss is capitalization loss for which the corporation should recover, there is no justification for a class action, no reason for the corporation to pay, and no feedback loss. In other words, feedback loss goes away if the class action goes away.

The upshot is that the only genuine loss in a stock-drop action under Rule 10b-5 is attributable to claims that should be characterized as derivative. Although there is some doubt whether capitalization loss is actionable as a matter of federal securities law, such claims are clearly actionable under the state law of fiduciary duty, particularly when there is insider gain involved. And if there is insider gain involved, such claims may also be actionable under federal law or may be tried in federal court as a matter of supplemental jurisdiction. In any event, recovery should go to the corporation.

The question is why the courts have failed to characterize such claims as derivative rather than direct. This is especially puzzling because most stock is held by well-diversified institutions that on the average lose from class actions. Diversified investors are equally likely to sell (gain) as to buy (lose) during the fraud period. Over time gains and losses net out. So the cost of litigation is a deadweight loss that reduces portfolio return. Second, because the corporation pays, the net effect of settlement is that holders pay buyers. A diversified investor who buys a few shares during the fraud period to add to existing holdings may lose more on its holdings than it gains from the settlement. Thus, diversified investors should be opposed to direct class actions in principle. On the other hand, they should favor derivative actions that seek recovery by the corporation for any capitalization loss from fraud.

There are several possible answers to this puzzle. One reason for the survival of direct class actions is a combination of confusion and inertia. A class action is quite appropriate under the 1933 Act where the point is disgorgement by the issuer of funds obtained by fraud. Buyers have a legitimate direct claim in such cases. But claims arising solely under Rule 10b-5 involve already outstanding shares. So the effect of recovery from the corporation is to penalize other stockholders. The Supreme Court has sought to confine Rule 10b-5 actions to the most meritorious cases by limiting standing to those who actually purchase shares (among other ways). But this rule has suggested to some that corporations themselves may lack standing to sue the wrongdoers and hence that derivative actions may be precluded under federal law. In addition, Congress has sought to limit class actions by enacting a series of statutory restrictions, including limits on the ability of holders to sue under state law, although Congress also expressly preserved state law derivative actions. The unintended effect is that direct class actions seem to be well established as a matter of precedent and even statutory law.

Another reason for the survival of direct class actions is the rule that the class member with the largest claim may serve as the representative plaintiff. Although the biggest claim is likely to belong to a well-diversified institutional investor who should oppose direct class actions and favor derivative actions, there will usually be at least one fund that stands to gain more from a class action as a buyer than the same fund will lose as a holder. Moreover, if the class action goes forward, investors who would have preferred a derivative action cannot afford to opt out of the class action, because by doing so they forgo their share of any direct recovery to offset their losses as holders.

Yet another reason for the survival of direct class actions is that directors and officers (D&O) insurance discourages corporations from seeking to recast fraud claims as derivative. A derivative action is ultimately a claim made by the corporation *against* its directors, officers, or agents. D&O insurance generally does not cover such claims. So individual defendants have every incentive to let the corporation pay for insurance and to let the insurance company pay the claim. To be sure, insurance companies could devise more sensible insurance policies, but the existing system may be much more lucrative for insurance companies than a system focused on insuring individual officers against potential liability for derivative harms. Moreover, the cost such insurance is likely to be borne by the officers themselves in the form of reduced compensation.

Finally, although one might expect the plaintiff bar to advocate for derivative actions as a way of competing for legal business, it may be that the fees from successful securities fraud class actions are so large that derivative action lawyers are satisfied with a small share of a very big pot.

In short, it appears that securities fraud class actions survive because of a series of market failures that discourage reform. As a result, reform is unlikely unless the courts take the initiative. But this is arguably as it should be. The characterization of claims as direct or derivative is a judicial function governed by the rules of procedure. And procedure is a matter for the courts. Moreover, the securities fraud class action is a judicial invention. Thus, the courts have the power and the duty to clean up the mess.

This article proceeds as follows: After setting forth a case study that illustrates the various kinds of loss that may arise from securities fraud, I discuss the nature of each type of loss and how one might go about measuring each. Thereafter, I address the law relating to direct and derivative claims, the role of the courts in the management of such representative actions, and how it is that federal law (mistakenly) came to rely on class actions rather than derivative actions to deal with securities fraud claims. I then suggest several forces that may stand in the way of reform and why it is up to the courts to get it right. Finally, I deal with the inevitable argument that securities fraud class actions are a necessary deterrent to securities fraud and show that derivative actions would provide superior deterrence. Thus, I conclude that there is every reason for the courts to recast securities fraud class actions as derivative actions. Indeed, there are no good reasons not to do so. Such a move would be win-win for investors and issuers both.

CASE STUDY: COCA COLA ENTERPRISES

On March 31, 2006, stockholders filed a securities fraud class action against Coca Cola Enterprises, Inc. (CCE) alleging that CCE had misled investors about the corporation's prospects.[1] The class action complaint charged that CCE had engaged in the practice of channel stuffing – forcing customers to take delivery of more product than they could likely sell – in order to boost CCE earnings. According to the complaint, this scheme effectively came to light as a result of a July 29, 2004 press release in which CCE disclosed that it was unlikely to meet earnings expectations. CCE attributed the shortfall to the weather. The price of CCE stock fell from $25.03 to $20.63 – a decline of about 18 percent. In other words, with 469M shares outstanding, the market capitalization of CCE fell from $11.739B to $9.675B for a total one-day loss of $2.064B in stockholder wealth.[2] Accordingly, the class action complaint sought damages of at least $4.40 per share on behalf of those who bought stock between October 15, 2003 and July 29, 2004, a class

[1] CCE should not be confused with the Coca Cola Corporation. I use CCE as the primary example here because it is part of a larger study that I have conducted of securities fraud class actions filed in 2006 and because there is good information about analyst estimates both before and after corrective disclosure. In the study, I gather and analyze information relating to class period, analyst estimates, trading volume, risk level, and other similar factors as they relate to claimed damages. A summary of the data from this study appears in the appendix hereto.

[2] *See* CCE 10Q as of July 2, 2004.

period of 287 days.[3] The complaint also alleged that the individual defendants engaged in insider trading, with three officers selling 7,252,093 shares during the class period.[4]

As a result of this earnings surprise, the consensus estimate for CCE earnings per share (EPS) fell from $1.54 for the current year and $1.69 for the next year to $1.41 for the current year and $1.55 for the next year – a decrease of 8% in both cases. Thus, one would think that the stock should have dropped by 8% to $23.02.[5] The question is why would an 8% decrease in projected EPS result in an 18% decrease in stock price?

One possible (but ultimately circular) explanation is that the market multiplier (P/E) for CCE decreased from about 15.5 before the press release to about 14 after the press release in

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[3] This assumes that the market reacts fully and accurately to the new information immediately on the day of disclosure. Although federal securities law does not contain any express reference to adjusting damages for the movement of market prices, it seems fair to presume that the courts have the discretion to do so and indeed would do so since it is well-established that most stocks tend to follow the market. On July 29, 2004, the S&P500 rose from 1095.42 to 1100.43 or 0.46%. Assuming that CCE tracks the market – has a beta coefficient of 1.00 – CCE should have *increased* in price on July 29, 2004 by 0.46% to $25.15 thus further enhancing damages by $0.12 per share. In addition, as a matter of federal securities law, damages would be based on the average trading price over the next 90 calendar days -- $19.68. So the per share claim in this case would be $5.47 rather than $4.40. Ironically, the 90 day rule was enacted in order to compensate for so-called crash damages on the theory that the market overreacts to bad news. If one adjusts these numbers for market movement, damages are further enhanced. The average closing price for the S&P500 over the next 90 calendar days was 1107.71 – an increase of 1.12%. So CCE should have traded at an average price 1.12% higher than its price before the press release or $25.33. The bottom line is that if one applies the 90-day formula and adjusts for changes in market price, the damages in this case should be the difference between $25.33 and $19.68 or $5.65 per share. Finally, if the truth leaked out earlier, some stockholders might have bigger claims, since CCE traded for as much as $29.34 during the class period (on June 22, 2004). CORNERSTONE (maximum dollar loss).

[4] See Class Action Complaint at ¶¶ 102-109 (Feb. 7, 2006). In this article, I use the term *officer* to denote an individual acting in an executive capacity. Needless to say, many officers are also directors. I use the term director or board of directors herein to refer to individuals acting solely in the capacity of directors. This distinction is important in talking about the role of the board of directors in addressing derivative actions brought on behalf of the corporation. This distinction is important in other contexts as well. For example, I argue elsewhere in connection with executive compensation that the corporation should be seen more as a partnership between inside stockholders (officers) and outside stockholders (ordinary investors) in which the key question is how to share the gains and losses. MMM. Under this model, it is the primary role of the board of directors to mediate disputes between the two constituencies.

[5] The value of a business – and thus of a share of stock in that business – is a direct function of expected return. To be specific, value equals expected return divided by the required rate of return (RROR). For example, if expected return is $2.00 per share and RROR is 10%, stock price should be $2.00 / 0.10 or $20.00. If expected return falls to $1.50 per share, the price should fall to $1.50 / 0.10 or $15.00. In short, stock prices changes by the same percentage as expected return. The usual way to measure return is earnings per share (EPS), but earnings as calculated under GAAP is not necessarily the best measure of return. Indeed, most analysts would probably agree that cash flow is a better measure of return as far as investors are concerned and that the market is thus likely to react to cash flow rather than earnings. *See* RICHARD A. BOOTH, APPRAISAL AND VALUATION IN CORPORATION LAW (Oxford 2009). It may also seem somewhat odd that the market focuses on EPS rather than aggregate earnings. But if earnings were reported primarily in aggregate terms, it would be necessary for investors to determine changes in the number of shares outstanding in order to estimate the return associated with a share of stock and thus to evaluate market price. By reporting EPS, the corporation conveys important information both about performance and dilution that might be difficult for investors to gather on their own. Accordingly, FAS 128A requires that public corporations report EPS and sets forth detailed rules governing its calculation.

recognition of increased risk. In other words, it may be that the market concluded that CCE was riskier than previously thought and that the required rate of return on its equity increased as a result of the new information.[6]

Another explanation is that the change in market price reflected *both* lower expected return *and* the likely payout to the plaintiff class as a result of the class action. In other words, the aggregate market value of a corporation should decrease not only because of lower expected return but also because some amount of stockholder wealth is likely to be paid out to the plaintiff class. Indeed, it is difficult to believe that the market does not react to both of these factors if it appears likely that the news will give rise to a securities fraud class action.[7]

In short, there are at least three different types of loss that may be rolled into one in a stock drop action: (1) the decrease in price from lower expected return, (2) the decrease in price from any increase in perceived risk and concomitant increase in the cost of equity, and (3) the decrease in price from the prospect of payout in connection with a securities fraud class action.

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[6] Conceptually, the earnings multiplier is the reciprocal of the required rate of return (RROR) that the market assigns to the corporation. If the corporation becomes riskier, the market requires a higher rate of return and the multiplier decreases accordingly. The multiplier may also change because of marketwide conditions – because the overall market rate of return changes. Moreover, individual corporations follow the market to varying degrees. Thus, it is important to net out marketwide changes in any effort to measure the change specific to any given corporation. Here, the calculation of P/E is based on the average of projected earnings for 2004 and 2005 and the market price of CCE stock before and after the press release. This is not to say that P/E is the best way to measure the market's assessment of risk or that it is even a good measure (again because earnings are suspect as a measure of return). But in the instant context, P/E can be safely used for purposes of an apples-to-apples comparison. In other words, although P/E may not be a particularly accurate measure of the cost of equity, the comparison of P/E before and after corrective disclosure should afford a reasonably accurate measure of the *change* in the cost of equity.

[7] Although analyst estimates for EPS are usually based on return from operations, in some cases they may reflect anticipated charges in connection with settlement or other non-recurring items. If so, the estimate should be adjusted accordingly in order to afford a clear picture of market multiplier. For example, if the non-recurring item is an expected charge in connection with the settlement of a class action, the anticipated charge (in lump sum) should be added back to the market capitalization of the corporation in order to derive a constructive per share price and multiplier. I discuss how one might estimate this loss further below. One might think that the market would react first to an earnings surprise and then later to news of the class action when and if it is filed. But a significant earnings surprise is almost certain to trigger a securities fraud class action. So there is every reason to think that the market will react to both factors immediately because the size of the claim is more or less defined as of that moment. Indeed in the CCE case, there was no perceptible effect on the market price of CCE stock around the date of the filing of the securities fraud class action. On the other hand, it appears that the market did react to dismissal of the action. The complaint was dismissed on February 7, 2007 with leave to amend. The amended complaint was dismissed with prejudice on October 3, 2007. The market price rose steadily following the initial dismissal of the complaint on February 7, 2007 and final dismissal with prejudice on October 2, 2007, from $20.01 to $24.31 or 21.49%. During the same period, the S&P500 rose from 1450.02 to 1546.63 or 6.66%. Of course, it is also possible that there was an increase in the expected return for CCE during this period.

THE NATURE OF LOSSES FROM SECURITIES FRAUD

In a securities fraud class action under federal law, these losses are all lumped together as a unified direct claim that may be asserted by those who bought during the class period. But when considered separately, each of these claims is quite different in character.

Fundamental Loss

The first claim might be called *fundamental* loss because it is based on the decrease in price that results from the news that return will be lower than previously expected. In the CCE case, the consensus estimate for earnings pre share (EPS) decreased by 8 percent. Thus, one would expect the price of CCE stock to drop from $25.03 to $23.02 or $2.01 per share – fraud or no fraud – based on the new consensus earnings estimate at the same multiplier. It is not clear that fundamental loss is loss at all. Whether disclosure is timely or not, stock price is bound to fall when the truth comes out. That is a risk that investors freely assume (and that they can costlessly hedge away through diversification). Thus, it is not at all clear that fundamental loss is causally connected to the fraud if any.

Capitalization Loss

In the CCE case, fundamental loss accounts only for 8% of the 18% decrease in price. What accounts for the additional 10% decrease in price? Some of the additional decrease may be attributable to an increase in the cost of equity applicable to CCE. The market may have perceived new risks in connection with CCE's business. For example, it may be that the market did not appreciate weather-related risks. Or the market may have concluded that the earnings surprise suggested that consumer taste was more fickle than previously thought. Or it may be that the market decided that information coming from the corporation could not be trusted as much as had been thought. Either way, the harm to stockholders results from the market assigning a higher cost of capital to the corporation.[8] This portion of the claim might be called *capitalization* loss because it results from a change in the earnings multiplier.

Capitalization loss may or may not be the proper stuff of a stockholder claim. If the loss is attributable to added risk resulting from bad behavior by management, stockholders may have a derivative claim because the loss affects all stockholders in the same way.[9] If the loss is attributable to new information that changes the market's perception of risk through no fault of

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[8] Capitalization loss may extend to the cost of all forms of capital. For example, it is conceivable that a corporation may see its bond prices fall as a result of fraud. If so, it is also possible that stock price may fall a bit more because the cost of debt increases.

[9] Presumably, a corporation's reputation for candor may have an effect on its cost of capital. There has been a good deal of recent scholarship about the importance of trust in corporation law. *See* Margaret M. Blair & Lynn A. Stout, *Trust, Trustworthiness, and the Behavioral Foundations of Corporate Law,* 149 U. Pa. L. Rev. 1735 (2001); Edward B. Rock & Michael L. Wachter, *Islands of Conscious Power: Laws, Norms, and the Self-Governing Corporation,* 149 U. Pa. L. Rev. 1619 (2001); Larry Ribstein, *Law v. Trust,* 81 B.U. L. Rev. 553 (2001). *See also* George Akerloff, *The Market for Lemons: Qualitative Uncertainty and the Market Mechanism,* 84 Q. J. ECON. 488 (1970) (discussing generally the effect of untrustworthy information on market prices even though some information may be trustworthy).

management – for example about consumer tastes – the claim is akin to one based on the inevitable loss that goes with an announcement of lower earnings.

Under the current regime – in a world of direct class actions – buyers have a direct claim if they can show that officers misled the market and acted with *scienter*. But if so, there will likely also be a derivative claim for reputational loss.[10]

Feedback Loss

Finally, some of the additional decrease in price is attributable to the class action itself because the corporation must ultimately pay for any settlement. Again, stock price presumably falls by some additional amount because it appears likely that a meritorious securities fraud class action will be filed and that the corporation will pay out some sum in settlement – much as a stock drops in price when it goes ex-dividend. The curious thing about this element of the claim is that it compounds itself through a positive feedback effect. If the corporation must pay the claim, the value of the corporation drops further by the amount of the payout. That has the effect of increasing the amount of the claim and the payout still further.[11] The larger the plaintiff class, the greater the effect of feedback. Feedback loss affects all stockholders in the same way and to the same extent. Thus, it should be seen as derivative. But feedback loss goes away if the class action goes away. So it may not matter how it is characterized.[12]

[10] One implication of the analysis here is that if the market drops only by as much as it should given lower projected earnings – if there is nothing but fundamental loss – there should be no cognizable claim. Nevertheless, as federal law currently stands it is possible to state a claim under such circumstances because fundamental loss is compensable under federal law. On the other hand, it is at least conceivable that the market might in rare cases react positively to the revelation of a fraud – drop less than it should – perhaps because the market thought the company was in even worse shape than it turns out to be. After all, the market sometimes rises when a company announces a loss that less bad than expected. Of course, fraud is presumably different in that it is based on the notion that the news is a genuine surprise, leaving aside cases in which the news might have been dribbled out to cover up the market effect. *See* Dura Pharmaceuticals, Inc. v. Broudo, 544 U. S. 336 (2005). It is also possible that the market does not agree with analyst projections, but it is not clear how one could ever prove it.

[11] Feedback works differently depending on whether the information withheld is good news or bad news. In a bad news case, feedback has the effect of magnifying the decrease in price and thus the claim. In a good news case, feedback has the effect of muting the price increase and thus decreasing the size of the claim. Accordingly, the vast majority of class actions involve bad news. For example, in 2006 only two of 106 class actions involved good news. See Appendix. This skewing is likely compounded by the fact that the market tends to react more to bad news than it does to good news. Fear trumps greed. Thus, most insider trading cases also involve bad news because bad news is more certain to cause a decrease in price (and perhaps because the culprits are likely to be more concerned about preserving what they have rather than getting more).

[12] Feedback is not an issue in claims arising under the 1933 Act. The 1933 Act applies only to the offer and sale of securities by the issuer where the remedy is one of disgorgement – the issuer must pay back the funds that it obtained by fraud. In contrast, in a stock-drop action under Rule 10b-5 involving already outstanding stock, the corporation pays while the sellers keep their (effective) gains. Accordingly, the analysis here applies only to actions under Rule 10b-5. In theory, the extent of feedback can be calculated if one knows the number of damaged shares and the probability of a successful claim. But there is no good way to determine the number of damaged shares short of polling the plaintiff class. That is expensive to do. *See* Richard A. Booth, *The End of the Securities Fraud Class Action as We Know It,* 4 Berkeley Bus. L. J. 1 (2007).

To be sure, virtually all cases settle – usually for whatever amount is available under the corporation's applicable insurance policy. Indeed, there has never been a case in which the defendant corporation paid other than pursuant to a settlement. And there have been very few cases that have been tried. Insurance does not affect the analysis here. First, insurance is arguably part of the value of the corporation. Investors know that they are protected from fraud up to some aggregate amount and are thus presumably willing to pay more for the stock. So when the insurance is depleted, the corporation is worth that much less. Second, the corporation will be required to pay more for insurance in the future, thus reducing future returns and stock price. Third, even though feedback is likely to be mitigated in the real world, one must evaluate legal rules on their own terms. Indeed, the law itself is well settled that the availability of insurance should be ignored for purposes of establishing liability.

MEASURING LOSS

While it is relatively easy to estimate fundamental loss (at least where there are several analysts who follow the stock), it is difficult to distinguish capitalization loss from feedback loss. In the CCE case, the market multiplier (P/E) dropped from about 15.5 to about 14. But that is ambiguous information. It may be the result of increased risk and a higher cost of equity – capitalization loss. Or it may be because of the prospect of payout to the plaintiff class – feedback loss. So the question is how much of the drop in price is attributable to increased cost of equity. Fortunately, there are ways to measure changes in risk and (by implication) changes in the cost of equity. Thus, it is possible to isolate the effect of increased risk (if any) on the value of the corporation following an earnings surprise. Presumably, any remaining decrease is the result of feedback.

Risk is the volatility associated with expected return. The most common way to measure risk – as estimated by the market – is to calculate the beta coefficient for the stock – its tendency to move with the market. The problem with beta for present purposes is that it must be calculated over an extended period of time. In other words, beta is not very good a capturing sudden changes in firm-specific risk. Another good way to measure the market risk of a stock is to look to the spread associated with trading in the stock. The greater the risk, the greater the spread. Changes in spread can be measured over a relatively short period of time. Moreover, spread measures risk *ex ante.* That is, spread indicates the market's assessment of risk looking forward. So if the market perceives additional risk following corrective disclosure, that additional risk should be reflected by an increase in spread.[13]

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[13] Spread is a good way to measure risk because it reflects the judgment of numerous competing market makers about what should be the difference between bid and ask given the volatility of the stock. The problem is that published spreads may be inaccurate for a variety of reasons. And historical data is not readily available. *See* Richard A. Booth, *Using Spread and Net Trading Range to Measure Risk in Suitability Cases.* Fortunately, it is possible to work around this problem using net trading range (NTR) – intraday high minus intraday low minus the absolute change in price from open to close. But however one measures it, spread tells us nothing when considered in isolation. It must be considered comparatively. For example, one might look at changes in spread over time or one might compare the spread of the subject stock to that of other stocks or some benchmark such as the S&P500. The data in the appendix hereto shows monthly average NTR for CCE less monthly average NTR for the S&P500 in order to control for changes in the volatility of the market as a whole. In other words, the chart reflects the difference between the spreads of CCE and the S&P500. One might call this relative NTR or RNTR. Looking to RNTR is consistent with the approach under CAPM in that RNTR is a measure of the additional risk inherent in a specific stock as compared to the benchmark index. Thus, RNTR is similar in concept to beta, but beta is based on historical returns looking backward. Given that

In the case of CCE, average spread over the following 24 months increased by about 5.1% as compared to the spread associated with the S&P500.[14] Thus, one would expect the equity premium for CCE to increase proportionally.[15] The total cost of equity for CCE immediately before the earnings surprise can be estimated by the ratio of expected earnings per share ($1.69) to price per share ($25.03): 6.75%.[16] The risk free rate as measured by the two-year government note at the time was 2.51%.[17] Thus, the equity premium for CCE was 4.24% and should have risen by

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the question here is how to isolate the market's assignment of a higher cost of equity going forward, spread would seem clearly to be the better measure. One subtle danger of measuring risk in this way is that the corporation might announce a repurchase of stock immediately after an earnings surprise to reduce spread and thus reduce damages. But similar tactics are also possible under the PSLRA 90-day look-forward rule. Moreover, if the point of securities fraud class actions is to compensate buyers for their losses, it is not clear that there is anything wrong with a corporation taking steps to limit the damages. Indeed, it may be cheaper for a corporation to repurchase shares via self tender offer at a price equal to the pre-correction price than it is to litigate the securities fraud class action to settlement.

[14] For the month ended June 30, 2004, NTR was 0.0039% for the S&P500 and 0.0082% for CCE for RNTR of 0.0044%. The average difference for the 24 months ended June 30, 2004 was 0.0059%. The average difference for the following 24 months was 0.0062%. To be more precise, RNTR increased over the 12 months immediately following the earnings surprise. But it then decreased somewhat more rapidly such that it was less than the pre-surprise level nine months thereafter. By the time the class action complaint was dismissed, RNTR was less than half what it had been before the earnings surprise in July 2004. *See* Appendix and Chart. In other words, spread changes over time (as does beta). So a stockholder who sells his stock immediately after the earnings surprise may suffer more or less in capitalization loss than a stockholder who sells later. One could focus on the period immediately following the earnings surprise. Or one could measure spread over the three month period following the earnings surprise consistent with the PSLRA approach to calculating damages. Or one could measure spread at the end of that period. There are innumerable possibilities. Then again, by the same logic, one could argue that stockholders suffer no loss at all if the stock recovers within some specified period of time. And indeed, the 90-day rule might have such an effect in extreme cases. *See* Richard A. Booth, *Windfall Awards Under PSLRA,* 59 Bus. Law. 1043 (2004). The obvious response is that if the stock recovers, it would have risen that much more but for the fraud. But ultimately one runs up against the rule that limits recovery to actual damages. For present purposes, I measure spread – or more precisely the change in spread – over the 24 months following the earnings surprise on the theory that the average mutual fund portfolio has an annual turnover of about 50% and thus holds any given stock for about two years. Accordingly, the average increase in spread over the 24 months following an earnings surprise should be a good way to estimate the aggregate capitalization loss over the same period and the average loss suffered by individual investors.

[15] The assumption here is that there is a one-to-one relationship between volatility as measured by spread and the equity premium assigned by the market – the required rate of return (RROR) in excess of the risk-free rate. While it is clear that more risk requires more return, it is not clear that the relationship must be linear or that if it is linear it must have a slope equal to 1.00. On the other hand, CAPM is based on a similar assumption that the equity premium is proportional to beta. For example, if the equity premium for the benchmark portfolio (usually the SP500) is 10% a stock with a beta of 1.10 will have an equity premium of 11% (ignoring any additional small corporation premium). Thus, CAPM also assumes that the relationship is one-to-one. The approach here is to adjust the known equity premium for CCE before the earnings surprise (4.24%) by the percentage change in volatility.

[16] I use the consensus estimate for the coming year rather than the consensus estimate for the current year on the theory that market price reflects long term expectations.

[17] *See* FRB, Selected Interest Rates, July 26, 2004. I use the rate of return on the two-year treasury note because I calculate average spread over a two-year period in turn because that reflects the average holding period. Under CAPM, the usual convention is to calculate beta over five years and to use the rate of return on the treasury long bond strip as the risk-free rate.

5.1% to about 4.46% following the earnings surprise for a total cost of equity of 6.97%. The bottom line is that CCE stock should have traded at $1.55 / .0697 or $22.24. The difference between $22.24 and $20.63 is presumably attributable to feedback loss.[18] The following chart summarizes the components of the claim.

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[18] It is easy to estimate feedback loss if one knows the number of shares represented in the plaintiff class – the number of damaged shares. As I have argued elsewhere, one can calculate the effects of feedback using the formula:

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

See Richard A. Booth, *The End of the Securities Fraud Class Action as We Know It,* 4 Berkeley Bus. L. J. 1 (2007). The problem is that it is difficult to determine the number of damaged shares because it is quite likely that many shares that traded during the class period were traded multiple times. In other words, reported volume during the class period is no measure of the number of damaged shares. The above analysis suggests an elegant solution to this puzzle. Since we know by process of elimination that feedback accounts for $755M of the total decline in value, the number of damaged shares must be 755M / 4.40 or 172M because feedback loss equals the likely payout to members of the plaintiff class (assuming that the market believes that 100% of damaged shares will recover 100% of their losses). Those 172M shares comprise 36.6% of outstanding shares. For the record, total volume during the class period (287 calendar days / 198 trading days) was 277M shares or about 59% of the outstanding 469M shares.

	Per Share ($)	Aggregate ($M)
Before Earnings Surprise [19]	25.03	11739
less FUNDAMENTAL LOSS	(2.07)	(971)
Subtotal	22.96	10768
less CAPITALIZATION LOSS [20]	(0.72)	(338)
Subtotal	22.24	10430
less FEEDBACK LOSS	(1.61)	(755)
After Earnings Surprise [21]	20.63	9675

[19] This figure does not reflect the increase in price that would have been expected in the absence of bad news given that in the CCE case the S&P500 increased on the day of corrective disclosure.

[20] Based on increase in cost of equity from 6.75% to 6.97% (in proportion to change in bid-ask spread relative to SP500).

[21] This is the closing price on the day of corrective disclosure. It does not reflect further decreases suffered during the subsequent 90 days.

Needless to say, one might quibble with these figures. Indeed, because it is highly unlikely that any case will be settled for the full amount of the claim, feedback loss will almost certainly be less than the calculated amount (though one could adjust the size of the number of damaged shares for the likely settlement as a percentage of the maximum claim).[22] There are several responses. First, as illustrated by the CCE case, the earnings surprise alone often does not account for all of the loss. If the loss exceeds the amount that can be explained by fundamental loss and capitalization loss, there must be some feedback loss. And given that feedback loss adds to the otherwise formidable threat that securities fraud class actions pose to defendant corporations, it is important to consider if only because of the possibility that it adds to already excessive deterrence. Second (and to repeat), even if the feedback loss is less dramatic than it would be if the case went to trial and the plaintiffs were awarded 100% of their claim, it seems only fair to evaluate the legal system on its own terms. In other words, it is no answer to say that the existing law makes sense because it is not in fact applied in the real world. The bottom line is that in a successful securities fraud class action, the corporation pays and that reduces the value of the corporation by some amount even if the claim is paid by insurance. Thus, holders lose more than they otherwise would lose in the absence of securities fraud class actions. Finally, the point here is not to litigate the CCE case with evidence that would be admitted in court, but rather to illustrate conceptually the various sources of loss suffered by investors in a typical case of securities fraud whatever might be their measure in the end.

DIRECT CLAIMS AND DERIVATIVE CLAIMS

There are two types of claims that may be asserted in securities fraud actions: direct claims and derivative claims.

A direct claim is a claim by which the plaintiff *stockholders* recover from the wrongdoer because the wrong is one that violates a right or interest that runs directly to the stockholder.[23] Most securities fraud actions involve direct claims by buyers against the corporation to recover for the difference between price paid and price after correction. These claims are almost always pursued by means of a class action. Indeed, the phrase *class action* essentially connotes that the action is a direct action.

A derivative claim is a claim by which the *corporation* recovers for a wrong done to the corporation. For example, a claim in connection with backdating options is quite clearly derivative. The corporation is harmed because it receives too little for the shares (among other possible reasons). The stockholders are harmed derivatively because the bargain sale dilutes the value of other stockholders. In other words, the stockholders suffer harm because the harm to the corporation presumably causes the value of their shares to fall.[24] Needless to say, insiders in control of the corporation are not likely to sue themselves for such wrongs. Thus, a stockholder may file a

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[22] See Bradford Cornell & James Rutten, Market Efficiency, Crashes, and Securities Litigation (Dec. 2005), available at http://ssrn.com/abstract=871106.

[23] *See* ALI, Principles of Corporate Governance §7.01

[24] *See* ALI, Principles of Corporate Governance §7.01

derivative action seeking recovery on behalf of the corporation. The stockholder benefits (together with other stockholders) because when the corporation recovers, the value of its shares presumably increases.

Characterizing Component Claims

In a securities fraud class action, buyers seek to recover for their entire loss. In other words, the measure of damages is the difference between purchase price and price following corrective disclosure.[25] But the various component claims that make up the whole of a class action claim – fundamental loss, capitalization loss, feedback loss – differ in character. Some are arguably direct claims, while others are quite clearly derivative.

Leaving aside the claim for fundamental loss for the moment, the claim for capitalization loss is clearly derivative if it is attributable to mismanagement or fraud or anything else that harms the reputation of the corporation in the eyes of investors. Again, capitalization loss may arise without any wrongdoing. For example, an earnings surprise without any cover-up by insiders may cause the market to assign more risk to the corporation. If a securities fraud class action ensues, presumably it will be dismissed for lack of *scienter*. On the other hand, if there is a cover-up – if there is *scienter* – the market may react both to the new information about risk and to the fact that it was covered up. In other words, capitalization loss may comprise both derivative and non-derivative claims. It is clear that the corporation has a claim against its officers and other agents who cause it reputational harm. It is equally clear that the corporation has no claim against its officers and agents simply because its business turns out to be riskier than previously thought. Moreover, the capitalization loss resulting from harm to the reputation of the corporation affects all stockholders in the same way – by causing an increase in the cost of equity and a decrease in stock price. There is no apparent reason why only buyers should be able to recover for this loss. The loss falls primarily on the corporation that must pay more for capital. Thus, the corporation should recover. But under current practice – in a direct class action – the plaintiff class may recover for both types of capitalization loss.

As for feedback loss, much the same analysis applies. Feedback loss affects all of the stockholders equally. The price of the stock decreases because of the prospect of payout by the defendant corporation. To be sure, the payout goes to the plaintiff class under the current regime. But the fact that some stockholders stand to recover does not change the fact that the price of all of the shares decreases equally as a result of feedback. In short, it seems clear that the claim for feedback loss should be derivative rather than direct even though it is a result of the securities

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[25] In many cases, there is also filed a tag-along derivative action. *See* Laura E. Simons & Ellen M. Ryan, Cornerstone Research, *Securities Class Action Settlements: 2007 Review and Analysis,* at 11 (reporting that about 55% of cases settled in 2007 were accompanied by a derivative action and that derivative actions are often resolved with changes in governance but little or no cash payment). If the derivative action is successful, typically a small portion of the settlement is paid to the plaintiff attorneys in the derivative action as a fee. But little if any of the recovery goes to the corporation. *See, e.g.,* Chambers Development Securities Litigation, 912 F. Supp. 822, 841 (W.D. Pa. 1995) (describing derivative action as mere appendage and discussing proposed settlement in which entire amount to be recovered by the corporation would go to derivative plaintiff counsel or if not approved into class action pot). *But see* In re Zoran Corp. Deriv. Litig., 2008 U.S. Dist. LEXIS 48246 (rejecting settlement because of minimal payment proposed).

fraud class action rather than the fraud itself. At the very least, it seems clear that the corporation has a claim against the individual wrongdoers for this loss.[26]

Since the claims for capitalization loss and feedback loss affect all shares – not only shares bought during the fraud period – it is difficult to see how a court could fail to characterize these claims as derivative. Although the courts implicitly recognize all of these claims as direct – in that they are subsumed within the claims of the buyers who constitute the plaintiff class – these claims are really derivative in nature. If they are actionable, they arise because officers lied to the market, triggering a securities fraud action and causing reputational harm to the corporation. In other words, these claims arise from actions that cause the value of the corporation to fall more than it otherwise would have fallen if new information had been timely disclosed. Thus, it seems clear that these claims are derivative in nature.

Who Should Recover and Who Should Pay?

The foregoing analysis gives rise to a paradox of sorts. If the corporation recovers, its value will increase and its stock price will rise accordingly. Indeed, if the corporation recovers the entire amount of feedback damages and reputational damages, its stock price should revert to what it would have been in the absence of fraud. The only loss that would remain is the fundamental loss and so much of the capitalization loss as results from new non-reputational information about risk. Moreover, if the market knows that the corporation will recover, its stock price will not fall as much in the first place. In short, if the individual wrongdoers are liable to the corporation for feedback damages and reputational damages, there would be no such damages.

So who should pay the claim for fundamental loss? Is this loss direct or derivative? It is arguable that the loss is direct because it affects only those who bought during the fraud period. And clearly, the Supreme Court has recognized (at least by implication) that such claims are direct because it has recognized that stockholders may recover their losses from the corporation.[27] But it is also arguable that fundamental loss is no loss at all. The loss is one that will happen one way or the other – fraud or no fraud. When the truth comes out, stock price will fall. If the loss is inevitable, it is not clear that there is any causal connection between the fraud (so-called) and the loss.[28] So it is not clear that the plaintiffs have a claim. As in musical chairs, the only question is *who* loses.

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[26] Indeed, there will always be a meritorious derivative claim if there is a meritorious direct claim because the direct claim itself visits harm on the corporation when it settles. But there may be a meritorious derivative claim even in the absence of a meritorious direct claim since it is possible to show a breach of fiduciary duty even in the absence of *scienter* as defined under federal law. Similarly, some courts have observed that a corporation might be able to recover from its officers and agents as a result of losses suffered from an improvident settlement of a securities fraud class action. *See* In re Cendant Corporation Securities Litigation, 109 F. Supp. 2d 273 (D.N.J. 2000).

[27] *See* Basic, Inc. v. Levinson, 485 U.S. 224 (1988). Although the explosion in class action litigation can be traced to the Supreme Court's endorsement of the fraud on the market doctrine in *Basic,* that is not the real problem. The real problem is the idea – mistakenly borrowed from the 1933 Act – that the corporation itself rather than individual officers should be liable.

[28] *See* Dura Pharmaceuticals, Inc. v. Broudo, 544 U. S. 336 (2005) (requiring proof of loss). In some cases, it might be arguable that officers misled investors and caused the corporation to become overvalued by the market and that somehow this is different from mere failure to disclose bad news in a timely fashion. But even in such cases, the gains of stockholders who sell high will offset the losses of stockholders who buy high except to the extent that insiders sell

Moreover, it is not clear that it matters much where the loss falls. Most stockholders are well diversified because they hold their shares through institutions that are well diversified. Diversified stockholders suffer no real loss because they gain as often as they lose. Thus, even though a diversified stockholder might sometimes lose, she would be opposed in principle to a rule that permits recovery because she is effectively insured against loss by virtue of being diversified. The cost of litigation is a deadweight loss.[29] In addition, diversified investors are likely to lose more as holders than they gain from any recovery. Because securities fraud class actions give rise to feedback loss, holders lose more than they would otherwise lose because stock price falls farther than it would otherwise fall. And since most investors are more likely to be holders than to be either buyers or sellers in most cases, most investors are likely to be net losers from securities fraud class actions.[30] Finally, since much of the trading by institutional investors is likely to be for purposes of portfolio balancing and thus is likely to involve only a small fraction of their holdings of any individual stock, it is likely that institutional investors lose more from feedback losses than they lose from purchases even when they do trade.[31] Thus, it seems clear that institutional investors – as well as other investors who follow similar strategies – are net losers from securities fraud class actions. If the securities laws are intended to serve (or at least reflect) the interests of investors, presumably the interests of the vast majority of investors should trump the interests of a relatively

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their own shares at prices they know are too high. Still, it is clear that officers may be liable under Rule 10b-5 even if they did not cause the market to become overvalued.

[29] *See* Richard A. Booth, *The End of the Securities Fraud Class Action as We Know It,* 4 Berkeley Bus. L. J. 1 (2007). In Coasean terms, the loss should fall on stockholders because they are best able to bear it through diversification. For a diversified stockholder, there is arguably no loss at all from securities fraud in the absence of insider misappropriation and the capitalization loss that arises from reputational harm. The risk of fundamental loss and non-reputational capitalization loss can be diversified away, whereas capitalization loss that arises from reputational harm cannot be diversified away. It is easy to harm one's reputation. But it is quite difficult to enhance it. To be clear, this argument is based on the idea that securities law should reflect the interests of diversified stockholders rather than undiversified stockholders, because the goal of federal securities law is to serve the interests of real stockholders. FRB data indicate that about 76% of all shares are held through diversified institutions. *See* Richard A. Booth, *The Buzzard Was Their Friend -- Hedge Funds and the Problem of Overvalued Equity,* 10 U. Penn. J. Bus. Emp. L. 879 (2008). It is costless to diversify, in that it costs no more to invest through a mutual fund than to maintain an individual account. So it is arguable that undiversified stockholders assume the risk of fraud. In any event, there is no reason that an individual undiversified stockholder cannot file suit if he is defrauded.

[30] As of 2004 (the year of the CCE fraud), turnover among mutual funds was about 50% per year while marketwide turnover was about 105%. (In the meantime, turnover has increased marketwide, but has remained relatively stable among mutual funds.) *See* ICI, 2005 Investment Corporation Fact Book, at 14; NYSE Facts and Figures, Market Activity, NYSE Group Turnover 2000-2009 *See generally* Richard A. Booth, *The Buzzard Was Their Friend -- Hedge Funds and the Problem of Overvalued Equity,* 10 U. Penn. J. Bus. Emp. L. 879 (2008). Assuming that mutual fund turnover is a good indication of turnover among other institutional investors, and given that about 75% of all stock is held by institutional investors, it can be estimated that institutional investors accounted for 105% x 75% x 50% or about 40% of all trading in 2004. This suggests that institutional investors are likely to be holders about 60% of the time. *See also* Utpal Bhattacharya & Neal E. Galpin, *Is Stock Picking Declining Around the World?* AFA 2007 Chicago Meetings Paper (November 2005), http://ssrn.com/abstract=849627 (finding that about three-quarters of trading is motivated other than by stock picking).

[31] *See* Richard A. Booth, *Taking Certification Seriously – Why There Is No Such Thing as an Adequate Representative in a Securities Fraud Class Action*.

small minority when it is necessary to choose between the two. And it is necessary here to choose. There is no way to keep direct class actions without penalizing holders.[32]

Even if one is reluctant to accept the above reasoning – and the implication that direct class actions should be abolished – it seems clear that if the corporation recovers for capitalization loss, the stockholders will be in exactly the position they would have been in had there been no fraud at all. The only issue is the distribution of losses. But assuming investor diversification, the distribution of losses matters little, and it is difficult to see why buyers should be able to recover anything in a direct action against the corporation. So even if one is not persuaded by the argument from stockholder diversification, it would seem to follow that securities law should decline to recognize the direct claims of buyers and that securities fraud class actions under Rule 10b-5 should be abolished. In other words, securities fraud actions make sense only as derivative actions.[33]

Presumably, a corporation should be able to recover for capitalization loss resulting from reputational factors but not for capitalization loss resulting from non-reputational factors. The problem is that it is difficult to separate these two types of capitalization loss – to quantify how much of the capitalization loss comes from new information about risk and how much comes from reputational harm. Both will show up as a decrease in P/E ratio – an increase in the cost of equity. But it may be possible to identify cases in which it is likely that some capitalization loss resulted from reputational harm by scrutinizing motives.

One way to do so is to ask why the officers of a public corporation would want to mislead the market? There are two possibilities. One possibility is that they might want to sell their own stock first or otherwise secure some sort of financial advantage that depends on keeping stock price artificially high. The other possibility is everything else. For example, the officers may delay disclosing the truth in hopes of keeping a troubled corporation afloat long enough to turn things around. In other words, the officers may have a legitimate business reason for their actions however misguided it may turn out to be. If the motive is insider trading or some other form of misappropriation, the market is likely to punish the stock by bidding down the price more than merely reflects lower expected earnings and higher expected risk. If the motive is a proper business purpose, the market may not further punish the stock at all. In the former case, the true loss arises from the additional decrease in price. In the latter case, there is no real loss. It is simply reality coming home to roost.[34]

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[32] Class actions may make sense in a world of undiversified individual investors. Indeed, class actions evolved in such a world. But the world changed and class actions remained. The future of securities fraud class actions is part of a larger debate about whether securities regulation should be focused on the retail market or the wholesale market.

[33] On the other hand, if we continue to recognize the direct claims of the buyer class, it would seem to follow that the class should recover both for fundamental loss and for so much of the capitalization loss that results from the non-reputational increase in perceived risk – the loss that would occur fraud or no fraud.

[34] *See* Makor Issues & Rights, Ltd. v. Tellabs, Inc., 513 F.3d 702 (7th Cir. 2008). There is one other possibility. It might be argued that corporations sometimes cover up bad news for the benefit of existing stockholders so that they may bail out of their investments. If so, it might make sense to hold the corporation liable to the buyers as in the current scheme of securities fraud class actions. The problem with this argument is that it depends on the notion that existing stockholders are somehow tipped off that it is time to dump their shares while the market like so many mushrooms is kept in the dark and fed bullshit. Moreover, this argument does not explain why we should punish the holders who fail to sell out while we permit the sellers to keep their gains.

Ironically, this is a pretty good description of how the federal courts distinguish meritorious cases from those that should be dismissed. In order to survive a motion to dismiss, the plaintiff must plead specific facts that show *scienter* – intent to defraud.[35] The problem is that if the plaintiff succeeds in doing so, the remedy includes recovery for all forms of capitalization loss and not just the loss that arises from reputational harm. In other words, the remedy does not match the true loss suffered by the plaintiff class. Rather it includes a windfall because if the claim succeeds – indeed if it survives a motion to dismiss – the plaintiff class may recover for all of the loss in value including the loss that would have occurred in the absence of any fraud.[36] Moreover, if the corporation pays, feedback will be reintroduced: If the corporation is liable to pay the claim, its stock price will fall further because of the payout. As a result, diversified stockholders will lose in those cases in which they are holders.[37]

Misappropriation as a Substitute Claim

The ideal solution is to hold individual wrongdoers liable to the corporation for capitalization loss that results from reputational harm rather than to assess liability against the corporation. That is exactly what happens if we characterize the claim as derivative. At first, this may seem like an extreme solution. The individual wrongdoers may not be able to pay such an award.[38] But there is

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[35] The majority rule is that *scienter* does not require intent to gain on the part of the perpetrator. It is enough that the victim's loss is foreseeable. So it is no defense to argue that the perpetrator sought no gain. *See* Makor Issues & Rights, Ltd. v. Tellabs, Inc., 513 F.3d 702 (7th Cir. 2008). On the other hand, if the loss is one that would have occurred anyway – irrespective of the actions of the perpetrator – the claim should fail for lack of loss causation. *See* Dura Pharmaceuticals, Inc. v. Broudo, 544 U. S. 336 (2005). *See also* Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc., 128 S.Ct. 761, 169 L. Ed. 2d 627 (2008) (discussing requirement of proximate cause). One of the basic problems with securities fraud litigation is that there are many losses that do not call for compensation. Sometimes bad things just happen. But the fact of a loss combined with a failure of timely disclosure seems to suggest that there must be wrongdoing. In most other areas of the law, this question of causation is much easier. But with securities fraud, the result, exacerbated by wrong turns in the law, is too much litigation. *See* Richard A. Booth, The Future of Securities Litigation, 4 J. Bus. & Tech. L. 129 (2009).

[36] One might argue that this should be the price of fraud or that the windfall element serves as a form of punitive damages designed to deter fraud because it may be difficult to detect or prosecute. But the cost of this approach is significant in that it likely threatens too many defendants into settlement. Besides it is not at all clear that securities fraud is likely to go undetected or unprosecuted. *See* Frank H. Easterbrook & Daniel R. Fischel, *Optimal Damages in Securities Cases,* 52 U. Chi. L. Rev. 611 (1985).

[37] Curiously, the courts have recognized this rather obvious truth in cases in which individual holders have sought to recover for their losses and have ruled accordingly that such actions are derivative rather than direct. But the courts have not extended the same logic to class actions. *See* Smith v. Waste Management, Inc., 407 F.3d 381 (5th Cir. 2005); Shirvanian v. DeFrates, 161 S.W.3d 102 (Tex.App. 2004). *See also* Cowin v. Bresler*,* 239 U.S. App. D.C. 188, 741 F.2d 410, 414 (D.C. Cir. 1984) ("Requiring derivative enforcement of claims belonging in the first instance to the corporation also prevents an individual shareholder from incurring a benefit at the expense of other shareholders similarly situated.").

[38] On the other hand, even if we were to hold individual wrongdoers liable for the full amount of (direct) buyer claims, they would pay less than the corporation pays, because feedback loss goes away if individual wrongdoers pay. The individual wrongdoers would pay even less if the award were limited to reputational capitalization loss. Assuming that half of the capitalization loss results from reputational factors, the individuals would pay just $169M. That is still a big number. But it is a smaller big number. To be sure, because the loss is one that affects all of the shares, the total

no reason such claims could not be covered by insurance. Moreover, if we measure the claim by capitalization loss from reputational harm, the amount of damages will be much less than it would be if we measure the claim as we now do including fundamental loss, feedback loss, and other forms of capitalization loss.

It is quite clear that the corporation – and the stockholders derivatively – have such a claim under state law. To be specific, under state law fiduciary duty, stockholders have a well-established claim when officers and other agents of the corporation cause harm to the value of the corporation as a result of wrongful acts in connection with the management of the corporation.[39] It is also clear as a matter of state law that the claim is derivative and that stockholders have no direct class claim for losses that result from a mere decrease in value.[40] Still, the problem remains that it is difficult to distinguish the two forms of capitalization loss. Again, the corporation may recover for harm to its reputation, but it cannot recover because its business turns out to be riskier than thought.

There is a rather obvious second-best solution to this problem. The law could hold the wrongdoers liable to the extent of any gain they enjoy as a result of their wrongdoing. Indeed, it is well-settled that corporate officers are liable as a matter of state law to disgorge any ill-gotten gains to the corporation. For example, it is clear that the corporation has a state-law claim against officers and agents who engage in insider trading.[41] And in the CCE case itself, there was a claim for insider trading against several officers.[42]

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recovery for this element of damages will be greater in a derivative action than the portion that affects just the buyers. For a similar argument, see *Perlman v. Feldmann,* 219 F.2d 173 (2d Cir. 1955). *See also* Richard A. Booth, *A Note on Individual Recovery in Derivative Suits,* 16 Pepperdine L. Rev. 1025 (1989).

[39] *See* LaSala v. Bordier et Cie, 519 F.3d 121 (3d Cir. 2008); In re Oracle Corp., 867 A.2d 904 (Del. Ch. 2004), *aff'd*, 872 A.2d 960 (Del. 2005) (table); Metro Comm. Corp. BVI v. Adv. Mobilecomm Techs., Inc., 854 A.2d 121, 168 (Del. Ch. 2004) (Strine, V.C.) (loss in value or economic viability is harm to corporation and only derivatively harm to stockholders); Gotham Partners, L.P. v. Hallwood Realty Partners, L.P., 817 A.2d 160, 173 (Del. 2002). *See also* Malone v. Brincat, 722 A.2d 5 (Del. 1998) (suggesting possibility of derivative claim in such circumstances).

[40] *See* ALI, Principles of Corporate Governance §7.18. *See also* Manzo v. Rite Aid Corp., 2002 Del.Ch.LEXIS 147. *But see* Malone v. Brincat, 722 A.2d 5, 12-13 (Del. 1998) (suggesting that state law should provide a remedy to holders but not to buyers because buyers have a claim under federal law). Delaware and most other states have declined to follow the fraud on the market doctrine, in part because federal law has occupied the field (by statute since SLUSA) and in part because they see it as an encouraging excessive litigation. *Id. See generally* WorldCom Securities Litigation, 336 F.Supp.2d 310 (S.D.N.Y. 2004) (collecting cases). As a result, buyers usually must prove reliance in a direct action in state court. So there is little reason to pursue such claims in state court.

[41] *See* Brophy v. Cities Service Co., 70 A.2d 5 (Del. Ch. 1949); ALI, Principles of Corporate Governance § 5.04. *See also* United States v. O'Hagan, 521 U.S. 642, 654 (1997) (fiduciary who engages in insider trading defrauds principal in connection with the purchase or sale of securities by misappropriating principal's information for personal gain); Moss v. Morgan Stanley, Inc., 719 F.2d 5 (2d Cir. 1983) (counterparty to insider trade has no claim where violation is based on duty that runs to principal whose information was misappropriated). Ironically, there is some doubt about whether state law claims for disgorgement continue to survive in the face of sweeping federal law that arguably occupies the field of insider trading. But there seems to be no question that insider trading constitutes a breach of fiduciary duty and that *consequential* damages may be recovered. *See* In re Oracle Corp., 867 A.2d 904, 928 n.111 (Del. Ch. 2004) ("Notably, the abolition of *Brophy* would not preclude a recovery by the corporation for *actual* harm to itself caused by illicit insider trading by a fiduciary, but the existence and extent of such damage would have to be proven." (emphasis in original)); LaSala v. Bordier et Cie, 519 F.3d 121 (3d Cir. 2008). *See also* Schein v. Chasen, 313 So.2d 739, 746 (Fla. 1975) (holding that corporation may recover only if it suffered harm from insider trading); Freeman v. Decio, 584 F.2d 186, 192 (7th Cir. 1978); In re ORFA Securities Litigation, 654 F.Supp 1449 (D.N.J. 1987). *But see* Diamond v.

The problem with this solution is that it is likely to undercompensate the corporation for its capitalization loss. The gain to insiders is likely to be quite small compared to the capitalization loss suffered across all of the shares. Moreover, mere disgorgement of gain provides little deterrence, while securities fraud class actions clearly overcompensate stockholders and thus provide excessive deterrence. On the other hand, a state law claim for misappropriation may extend to other gains that may not constitute insider trading. For example, an officer who accepts stock options when she has inside information that indicates the stock is underpriced is probably liable to disgorge her gains under state law.[43] But she is not likely to be guilty of insider trading under federal law.[44] In other words, misappropriation under the state law of fiduciary duty comprehends a

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Oreamuno, 24 N.Y. 2d 494, 301 N.Y.S. 2d 78, 248 N.E.2d 910 (1969). *See generally* Douglas Branson, Choosing the Appropriate Default Rule: Insider Trading Under State Law, 45 Ala. L. Rev. 753 (1994).

[42] Coincidentally, the federal courts often look for some sort of personal gain – such as insider trading – in order to establish *scienter. See, e.g.,* Novak v. Kasaks, 216 F.3d 300 (2d Cir. 2000). This is not to say that insider trading necessarily causes any additional decrease in stock price. It is conceivable that the price of a stock may fall a bit more than it otherwise would fall because of additional volume added by insider trading, but the effect would be difficult to quantify. On the other hand, insider trading may contribute to reputational loss. While this loss is more in nature of consequential damages than disgorgement and thus more often associated with a duty of care claim, it is clear that an officer may be liable for such damages that flow from a duty of loyalty claim. In other words, it is possible to state a duty of loyalty claim without reference to insider gain. *See* ALI. Principles of Corporate Governance §5.04; Thrasher v. Thrasher, 27 Cal. App.3d 23, 103 Cal.Rptr. 618 (1972) (discussing duty of officers not to harm corporation). *See also* Robert T. Miller, *Wrongful Omissions by Corporate Directors:* Stone v. Ritter *and Adapting the Process Model of the Delaware Business Judgment Rule,* 10 U. Pa. J. Bus. & Emp. L. 783 (2008) (discussing compensatory damages for duty of loyalty claims). *But see* Baruch Lev & Meiring de Villiers, *Stock Price Crashes and 10b-5 Damages: A Legal, Economic, and Policy Analysis,* 47 Stan. L. Rev. 7 (1994) (arguing that there should be no recovery for consequential damages in connection with securities fraud claims).

[43] *See* Ryan v. Gifford, 918 A.2d 341 (Del. Ch. 2007); Brandin v. Deason, 941 A.2d 1020 (Del. Ch. 2007); Conrad v. Blank, 940 A.2d 28 (Del. Ch. 2007). *See also* Tyson Foods, Inc. Consolidated Shareholder Litigation, 919 A.2d 563 (Del. Ch. 2007), as modified, 2007 Del. Ch. LEXIS 120 (allegations that directors used inside knowledge to enrich employees and avoid restrictions in stockholder-approved plan or concealed terms of grants suffice to raise doubt as to application of the business judgment rule).

[44] The SEC has been remarkably forgiving about these issues. The argument seems to be that because the corporation itself is a party to the trade and is deemed to know any material nonpublic information, there is no insider trading and therefore no abuse. As one commissioner opined: "Boards, in the exercise of their business judgment, should use all the information that they have at hand to make option grant decisions. An insider trading theory falls flat in this context where there is no counterparty who could be harmed by an options grant. The counterparty is the corporation -- and thus the stockholders! They are intended to benefit from the decision.... In the best exercise of their business judgment, directors might very well conclude that options should be granted in advance of good news. What better way to maximize the value that the option recipient attaches to the option?" *Atkins Says Insider Trading Likely Not an Issue in Options Grants,* 38 Sec. Reg. & L. Rep. (BNA) 1214 (July 10, 2006). *See generally* Lee G. Dunst, *Private Civil Litigation: The Other Side of Stock Option Backdating,* 39 BNA Sec. Reg. & L. Rep. 1345 (September 3, 2007). On the other hand, if an officer controls the flow of information and sits idly by while the board of directors grants him options at a time when he knows the corporation is about to strike it rich, the result may be otherwise. *See* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968). To be sure, backdating has triggered numerous SEC enforcement actions. *See Former Apple GC to Pay $ 2.2M to Settle Options Backdating Charges,* 40 BNA Sec. Reg. & L. Rep. 1316 (August 18, 2008); *Corporation, Co-Founder Settle SEC Charges of Backdating, Improperly Reporting Options,* 40 BNA Sec. Reg. & L. Rep. 779 (May 12, 2008); *Broadcom to Pay $ 12M to Settle Options Backdating Charges,* 40 BNA Sec. Reg. & L. Rep. 682 (April 28, 2008); *McGuire, Former UnitedHealth CEO to Pay $ 467M Over Options Backdating,* 39 BNA Sec. Reg. & L. Rep. 1909 (December 10, 2007). *See generally* Rachel McTague, *More Stock-Options Backdating Cases Expected in Near Future, SEC Official Says,* 39 BNA Sec. Reg. & L. Rep. 80

wider array of harms to the corporation.[45] Moreover, it is relatively easy to determine the amount that should be disgorged, whereas it may be quite difficult to determine damages based on capitalization loss.

Still there is no reason not to try to measure the capitalization loss that arises from reputational harm. Although there are few if any such claims that have been fully litigated, the Delaware courts seem well equipped to sort out these claims which are similar to others that are routinely handled in state courts (such as appraisal claims and claims for rescissory damages). But it is important to be clear about the measure of harm to be applied in any given case. It is not clear that gain from insider trading causes any loss to outsiders. So it may be double-dipping for the corporation to recover for both capitalization loss and misappropriation. At the very least, any recovery for insider trading or other insider gain should offset any award for capitalization loss.

THE ROLE OF THE COURTS

The question is why do the courts fail to characterize claims for capitalization loss and feedback loss as derivative rather than direct? The parties may assert that these claims are direct by filing a class action rather than a derivative action. But that does not make it so. It is ultimately up to the discretion of the court to determine the character of the claim. Both class actions and derivative actions are representative actions. They do not belong to the plaintiff in the way that an individual action does. Indeed, caselaw makes it clear that derivative actions belong in the first instance to the corporation.[46]

The survival of class actions is all the more mysterious because the law generally favors derivative actions over direct actions. Although this may sound like a precatory generalization, it follows from the rule that the burden is on the plaintiff to show that he has suffered some sort of injury that is different from injury suffered by all the stockholders as stockholders. In the leading case on the subject, *Tooley v. Donaldson, Lufkin & Jenrette,* the Delaware Supreme Court ruled that the direct injury must be independent of any injury to the corporation. That is, the stockholder must demonstrate that the duty breached was owed to the stockholder and that she can prevail without

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(January 22, 2007); Rachel McTague, *Cox: Agency Aiming to Halt Practice of Backdating Stock Options,* 38 Sec. Reg. & L. Rep. (BNA) 1142 (June 26, 2006). Backdating has also given rise to criminal prosecution. *See* Christopher Brown, *Ex-CFO of Engineered Support Systems Enters Guilty Plea To Backdating Options,* 40 BNA Sec. Reg. & L. Rep. 1243 (August 4, 2008); Tom Gilroy, *BroadCom Co-Founder Samueli Admits Role in Stock Option Backdating Scheme,* 40 BNA Sec. Reg. & L. Rep. 1029 (June 30, 2008); *Brocade CEO Reyes Gets 21 Months Following Verdict on Options Backdating,* 40 BNA Sec. Reg. & L. Rep. 100 (January 21, 2008); John Herzfeld, *Former SafeNet CFO Pleads Guilty to Illegal Stock-Option Backdating,* 39 BNA Sec. Reg. & L. Rep. 1594 (October 15, 2007); Joyce E. Cutler, *N. Calif. Prosecutors Create Task Force on Backdating Stock Options,* 38 BNA Sec. Reg. & L. Rep. 1253 (July 17, 2006). Finally, backdating also leads to tax problems in that the immediate gain is immediately taxable. *See IRS Criminal Unit Joining Task Force to Investigate Backdating of Options,* 38 BNA Sec. Reg. & L. Rep. 1576 (September 18, 2006).

[45] In addition, state courts may presumably consider federal law and SEC rules inasmuch as violation thereof presumably constitutes a breach of fiduciary duty. *See* Richard A. Booth, *The Missing Link Between Insider Trading and Securities Fraud,* 2 J. Bus. Tech. L. 185 (2007). *But see* In re DPL Securities Litigation, 2003 US Dist. LEXIS 27473 (enjoining state court derivative action asserting breach of fiduciary duty based on violations of federal law).

[46] *See* Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981).

showing an injury to the corporation.[47] As the Third Circuit puts it, Delaware law generally does not allow shareholders to assert fiduciary duty claims directly unless the shareholders can show damage distinct from the damage to the corporation.[48]

Legal doctrine aside, a derivative action is a much more efficient way to deal with a claim than a class action. A class action inevitably involves administrative difficulties that arise from dealing with hundreds or thousands of claimants. In contrast, in a derivative action, there is one claim – that of the corporation – and if the corporation recovers all stockholders benefit pro rata.[49]

In short, there are powerful economic reasons that militate in favor of derivative actions and against class actions in any situation in which there is a choice. Thus, if a claim can be pursued in the name of the corporation, the courts generally hold that it should be so pursued if only as a matter of judicial economy. So the question remains why have the courts failed to do so?

Procedure in the Federal Courts

It seems quite clear under the Federal Rules of Civil Procedure (FRCP) that the courts have the power to recast direct actions and derivative actions when it is appropriate. Class actions are governed by FRCP Rule 23, which requires that an action must be certified as class action at an

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[47] *See* Tooley v. Donaldson, Lufkin & Jenrette, 845 A.2d 1031, 1034 (Del. 2004). *See also* Kramer v. Western Pacific Indus., Inc., 546 A.2d 348, 351 (Del. 1988) (stockholder must be injured independently of the corporation to have standing to bring direct action) (emphasis in original). *And see* Daily Income Fund, Inc. v. Fox (1984) 464 US 523(1984) Papilsky v. Berndt, 466 F2d 251 (2d Cir. 1972); Brug v. Enstar Group, Inc., 755 F. Supp. 1247, 1257 (D. Del. 1991) (same). The *Tooley* court also stated that that in determining whether a stockholder's claim is derivative or direct, the issue must turn *solely* on (1) who suffered the alleged harm (the corporation or the suing stockholders, individually) and (2) who would receive the benefit of any recovery or other remedy (the corporation or the stockholders, individually)? Tooley, 845 A.2d at 1033. Regretably, this formulation begs the question. Perhaps a better approach would be to ask who should pay.

[48] *See* LaSala at 130. Moreover, Delaware strictly prohibits individual recovery in derivative actions. *See also* Bangor Punta Operations, Inc. v. Bangor & Aroostook R. Co., 417 U.S. 703 (1974). *But see* Perlman v. Feldmann, 219 F.2d 173 (CA2 1955); ALI, Principles of Corporate Governance §7.16, §7.18.

[49] One possible problem is that stockholders come and go. Thus, some who suffered harm may not recover if they sell their shares. And others who suffered no harm may enjoy a windfall if they buy after a potential claim comes to light. But the choice to buy or sell would seem to be an investment decision like any other. As long as the market is informed of the derivative action, presumably investors can decide whether to buy or sell by adding any pending derivative action into the mix of information. Moreover, diversified investors are likely to be indifferent about guessing wrong. The risk is ultimately like any other corporation-specific risk in that it can be diversified away. A closely related question is how we should conceive of the mythical reasonable investor. Because stockholders come and go, individual identity is largely irrelevant. Only the interest of the body really matters. This argument is similar to one I have made that a corporation has no obligation to consider the peculiar interests of stockholders who slice and dice their shares. *See generally* Richard A. Booth, *Stockholders, Stakeholders, and Bagholders (Or How Investor Diversification Affects Fiduciary Duty),* 53 Bus. Law. 429 (1998) (discussing possible clientele effect in the context of derivative securities and trading strategies). *See, e.g.,* Korenvaes Investments, LP v. Marriott Corp., 1993 Del. Ch. LEXIS 90, 1993 Del. Ch. LEXIS 105. Tax law has grappled with some of the same issues in recent years in applying the continuity of interest doctrine in connection with corporate reorganizations. *See* Howard E. Abrams & Richard L. Doernberg, Federal Corporate Taxation §10.02 (5th ed. 2002).

early practicable time. In other words, the trial court must determine that the action is an appropriate one to be handled as a class action.[50]

Rule 23(b) sets forth three situations in which a class action is appropriate. The rule states that a class action may be maintained if the basic requirements of Rule 23(a) – numerosity, common questions, typicality, and adequate representation – are satisfied and if:

> (1) prosecuting separate actions by or against individual class members would create a risk of: (A) inconsistent or varying adjudications with respect to individual class members that would establish incompatible standards of conduct for the party opposing the class; or (B) adjudications with respect to individual class members that, as a practical matter, would be dispositive of the interests of the other members not parties to the individual adjudications or would substantially impair or impede their ability to protect their interests;
>
> (2) 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; or
>
> (3) the court finds that the questions of law or fact common to class members predominate over any questions affecting only individual members, and that a class action is superior to other available methods for fairly and efficiently adjudicating the controversy. The matters pertinent to these findings include: (A) the class members' interests in individually controlling the prosecution or defense of separate actions; (B) the extent and nature of any litigation concerning the controversy already begun by or against class members; (C) the desirability or undesirability of concentrating the litigation of the claims in the particular forum; and (D) the likely difficulties in managing a class action.

When certified, securities fraud class actions are invariably certified under Rule 23(b)(3). But it is not at all clear why Rule 23(b)(2) would not work just as well. Rule 23(b)(2) seems to describe a derivative action which is essentially an action that seeks to compel the corporation to seek recovery for the benefit of all stockholders. Indeed, derivative actions have been described as two actions rolled into one – a class action seeking to enjoin the corporation to sue the wrongdoer and an action at law in the name of the corporation to recover damages. The Supreme Court itself has stated that a derivative action is one kind of true class action (while actions under Rule 23(b)(3)

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[50] The courts have not always applied the requirements of Rule 23 strictly. But the Second Circuit recently ruled that a trial court must determine that all of the requirements for a class action have been met in order to certify the class. It is not enough for the trial court to find that there has been some showing that the action satisfies the standards set forth in Rule 23. Rather the court must find by a preponderance of the evidence that the action satisfies the requirements of Rule 23. In other words, the court must assess all of the relevant evidence and determine whether each Rule 23 requirement has been met, just as the court would resolve a dispute about any other threshold prerequisite for continuing a lawsuit. In re Initial Public Offering Securities (IPO) Litigation, 471 F.3d 24 (2d Cir. 2006). *See also* Oscar Private Equity Investments v. Allegiance Telecom, Inc., 487 F.3d 261, 2007 U.S. App. LEXIS 11525 (5th Cir. 2007); Regents of the University of California v. Credit Suisse First Boston (USA), Inc., 482 F.3d 372; 2007 U.S. App. LEXIS 6396 (5th Cir. 2007). The Supreme Court has ruled to the same effect in connection with motions to dismiss for lack of scienter. *See* Tellabs, Inc. v. Makor Issues & Rights, Ltd., 2007 US LEXIS 8270.

have been called *spurious* class actions).[51] To be sure, Rule 23.1 separately addresses derivative actions. But the fact that Rule 23.1 also addresses derivative actions simply means that a class action of that type must meet certain additional requirements.[52]

The Evolution of Federal Securities Regulation

So why do class actions survive as the primary vehicle for securities fraud litigation? One reason for the survival of direct class actions is confusion about the goals of securities regulation. Is the goal to compensate investors for their losses or to deter wrongdoing? A class action is quite appropriate under the 1933 Act where disgorgement and compensation are congruent. In such cases, buyers – including those who bought newly issued shares in the aftermarket – have a legitimate direct claim.[53] But claims arising solely under Rule 10b-5 involve already outstanding shares. Typically, the corporation itself has not sold any shares. Yet because the 1933 Act permits investors to recover from the corporation when they buy shares in a fraudulent offering, it seems to follow that investors may recover from the corporation for similar losses when they buy outstanding shares in the open market even though the effect is to penalize other stockholders. If the ultimate point is to deter wrongdoing rather than to compensate investors, it is not at all clear that investors should be able to recover under Rule 10b-5. In any event, it is quite clear that deterrence and compensation are two very different things in the context of a stock-drop action.[54]

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[51] *See* Ross v. Bernhardt, 396 U.S. 531, 541-42 (1970). Moreover, the courts have held that where there is a choice, an action should be certified under Rule 23(b)(2), because there is no right to opt out of such an action which thus has a more certain *res judicata* effect. In addition, the Supreme Court has emphasized that the FRCP should not be applied in such a way as to alter substantive legal rights.

[52] The argument here is about the proper characterization of damages in securities fraud actions arising under Rule 10b-5. As I argue elsewhere, Rule 23(b)(3) actions are also fatally flawed because of unavoidable conflicts within the plaintiff class between diversified and undiversified investors. *See* Richard A. Booth, *Taking Certification Seriously – Why There Is No Such Thing as an Adequate Representative in a Securities Fraud Class Action*.

[53] The 1933 Act strictly limits recovery under §11 to actual losses (although it does provide for rescission under §12). Thus, an investor who buys in the aftermarket and pays more than the offering price for a stock may recover only for the difference between the offering price and the value of the stock. She cannot recover damages under the 1933 Act for any amount paid in excess of the offering price. This is good evidence that Congress was more concerned with deterrence and unjust enrichment of the issuer (disgorgement) than with compensation of the investor. The rather obvious explanation is that Congress sought to avoid creating a system of investor insurance because to do so would relieve investors of the responsibility to inform themselves. This limit on recovery (which is repeated in §18 of the 1934 Act) argues against the type of recovery that has evolved in stock drop actions where the overriding (and misguided) goal appears to be to make the investor whole. Although it is unlikely that Congress considered the ability of investors to protect themselves from such frauds (so-called) through diversification, the policy rationale for avoiding a scheme of investor insurance militates against permitting recovery for risks that investors can cheaply and easily avoid through diversification. Moreover, the current scheme tends to make investors lazy. A contrary rule would enhance deterrence somewhat through increased investor vigilance.

[54] Securities fraud class actions are sometimes likened to imposing vicarious liability on the corporation for the wrongdoing of its officers. This is not an accurate characterization. Rather, securities fraud class actions are actions against the corporation as wrongdoer and not against the corporation as principal in a principal-agent relationship. This gives rise to another subtle problem. Because the corporation is the defendant in a class action, it is the corporation that must have *scienter.* This means that the proof of *scienter* may be pieced together from the knowledge, actions, and motivations of numerous officers. In other words, it is possible to make out a case against the corporation even though there may be no one individual who has the requisite intent to commit fraud. This is not an issue if the

Partly as a result of the laws misguided focus on compensation and the extraordinary incentives thus created for the plaintiff bar, the Supreme Court has sought to confine the scope of Rule 10b-5 actions, and Congress has sought to limit the use of class actions to litigate securities fraud under PSLRA and SLUSA. One unintended effect is that direct class actions seem to be well established as a matter of precedent and statutory law. In other words, it is arguable that the Supreme Court has recognized that buyers have a direct claim for their entire loss and that Congress has effectively ratified the existence and propriety of securities fraud class actions.[55]

To complicate matters further, the Supreme Court has held that only those who buy (or sell) during the fraud period have standing to maintain a private action under Rule 10b-5.[56] So one might argue that a corporation has no standing to sue under federal law, unless the corporation itself was a purchaser or seller. That is not likely to be the case in the typical stock-drop action.[57] But again it is

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defendants are individuals as in a derivative action. *See* Makor Issues & Rights, Ltd. v. Tellabs, Inc., 513 F.3d 702 (7th Cir. 2008). *See also* ALI, Restatement of Agency Third § 5.03.

[55] There are really two parts to this point: (1) that the Supreme Court has recognized an implied cause of action under Rule 10b-5 in such circumstances, and (2) that the action should be direct rather than derivative. As for the first point, it was the courts that implied a cause of action under Rule 10b-5. So the courts (or possibly the SEC) could presumably disimply the action. At least one legal scholar has so argued. *See* Joseph A. Grundfest, *Disimplying Private Rights of Action Under the Federal Securities Laws: The Commission's Authority,*107 Harv. L. Rev. 961 (1994). *See also* Joel Seligman, *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 (1994); Joseph A. Grundfest, *Why Disimply?,* 108 Harv. L. Rev. 727 (1995) (also arguing that the SEC could disimply a right of action against issuers while leaving the implied right of action intact with regard to other categories of defendants). As for the second point, the fact that there is a private action under Rule 10b-5 does not necessarily mean that the action must be a direct action. The character of an action is a matter for the courts. So disimplication is not clearly necessary. The courts could (and should) simply deem securities fraud class actions to be derivative actions. Thus, the proposal here does not depend on anything that can fairly be called judicial activism.

[56] *See* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975). The holding in *Blue Chip Stamps* is a bit peculiar in that the Court does not hold that there is no claim, but only that the claim must be asserted by a buyer (or seller). Thus, the rule is often said to be that only buyers (or sellers) have standing to sue under the implied private right of action under Rule 10b-5. Thus, investors who bought before the fraud period (holders) cannot assert a claim under federal law. It is not clear whether this limitation applies to a derivative action in which the object is recover for the benefit of the corporation, particularly if the corporation itself is not a buyer. But it is clear that holders may have a claim under state law. *See* Malone v. Brincat, 722 A.2d 5 (Del. 1998). On the other hand, if such a claim is based on a failure of disclosure and is asserted as a direct class action, it is preempted under SLUSA. In other words, it must be tried in federal court under federal law, with the result that the case will be dismissed because the plaintiffs have no claim under federal law. *See* Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit, 126 S. Ct. 1503 (2006). In *Dabit,* the Supreme Court ruled that holder claims are covered by SLUSA even though the holder has no claim under purchaser-seller rule of *Blue Chip Stamps.* In other words, *Dabit* holds that the phrase *in connection with the purchase or sale of stock* has a different meaning under the *Blue Chip Stamps* rule than it does in SLUSA. It is also worth noting that Blue Chip Stamps involved an offering of new stock. Presumably, the plaintiffs sued under Rule 10b-5 because it is quite clear that only a buyer may recover under the 1933 Act.

[57] On the other hand, in an age of equity compensation, there is a good chance that the corporation will have bought back some of its own stock. If so, the corporation has standing to sue, and (by analogy to the role of a derivative plaintiff) should be able to maintain the whole of the claim for damages to the corporation either outright or as a matter of supplemental jurisdiction. On the other hand (and by analogy to the role of a lead plaintiff in a class action), the court might limit the corporation to its share of the loss and then set it off against the amount to be paid to the plaintiff class. One common situation in which it is quite clear that the corporation has standing to sue – and where there is little

quite clear that the corporation clearly has a claim under state law for any capitalization loss resulting from reputational harm. And stockholders may prosecute that claim derivatively. To be sure, one could argue that prosecution of the action in the name of the corporation is a thinly veiled attempt to circumvent the strictures of SLUSA. But SLUSA itself contains an express exemption for derivative actions – the so-called Delaware carve-out.

Moreover, it is not at all clear that the rule of *Blue Chip Stamps* applies to a derivative action. As the Supreme Court noted in *Blue Chip Stamps* itself:

> . . . Rule 10b-5 proscribed only fraud "in connection with the purchase or sale" of securities, and since the history of §10(b) revealed no congressional intention to extend a private civil remedy for money damages to other than defrauded purchasers or sellers of securities, *in contrast to the express civil remedy provided by §16(b) of the 1934 Act,* the court concluded that the plaintiff class in a Rule 10b-5 action was limited to actual purchasers and sellers. (emphasis added) [58]

In other words, the fact that Congress provided an explicit disgorgement remedy for short swing trading running to the issuer corporation – even though the issuer is not a party to the trading – strongly suggests that the corporation has standing to maintain a securities fraud action against its own officers. Moreover, §16(b) expressly authorizes enforcement by derivative action.[59]

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confusion about the derivative nature of the action – arises when the claim is based on options backdating. *See* Zoran Corporation Derivative Litigation, 511 F. Supp. 2d 986 (N. D. Cal. 2007). In *Zoran,* the court ruled that the corporation had a valid federal claim because it (implicitly) relied on misrepresentations or omissions by its defendant directors and officers who received backdated options (as to both exercised and unexercised options). In other words, the corporation had standing as a defrauded seller in that it had issued options and shares to prices that were lower than they should have been. The *Zoran* court also ruled that the corporation had valid state law claims for breach of fiduciary duty in connection with the granting and receiving of backdated stock options, insider trading (under state law), unjust enrichment, and corporate waste. It is worth noting that the court subsequently refused to approve a settlement that did not provide for monetary recovery by the corporation. *See* In re Zoran Corporation Derivative Litigation, 2008 U.S. Dist. LEXIS 48246 (N.D. Cal.).

[58] Blue Chip Stamps, at 731, *citing* Birnbaum v. Newport Steel Corp., 193 F. 2d 461, 463-464 (2d Cir. 1952).

[59] One complication is that federal law (as amended in 1988) also provides a direct claim for investors who trade contemporaneously with anyone who trades illegally on inside information. *See* Exchange Act § 20A. It is not at all clear what happens if a corporation sues its officers for disgorgement under state law and contemporaneous traders also sue for damages under §20A. Although one might argue that federal law preempts state law in this connection, the fact remains that federal law still provides for recovery by the corporation in cases of short swing trading under §16(b) of the 1934 Act. To be sure, not all cases of insider trading are also cases of short swing trading (or vice versa). But the potential for conflict is there. The section also preserves other causes of action under the 1934 Act, which presumably includes the rights of buyers (if any) to recover in a securities fraud class action. On the other hand, the act elsewhere preserves state law causes of action, which presumably include the right of the corporation to recover for breaches of fiduciary duty. And it is at least conceivable that a corporation could assert a claim under §20A as the representative of its stockholders. It is noteworthy, that §20A specifically limits recovery by contemporaneous traders to the wrongdoers' gain (or loss avoided). §20A(b)(1). Moreover, §20A provides that the claims of contemporaneous traders are reduced to the extent that the SEC obtains disgorgement from the wrongdoers (although the statute elsewhere directs the SEC to compensate contemporaneous traders out of funds recovered). There is no indication that the liability of wrongdoers is similarly limited and thus no indication that the corporation is barred from seeking compensation for any greater capitalization loss that it might have suffered, although it is possible that a court would net out any disgorgement. Thus, on balance, it does not appear that §20A limits the ability of a corporation to pursue any claim for breach of fiduciary duty. Quite to the contrary, there is reason to think that the courts might deny direct

Finally, there is substantial precedent indicating that the rule of *Blue Chip Stamps* should not apply to an issuer corporation.[60] These cases suggest that a corporation may be able to maintain an action in federal court because trading in the corporation's stock during the fraud period satisfies the requirement under Rule 10b-5 that the fraud be one in connection with the purchase or sale of stock even though the corporation itself did not purchase or sell its own stock. First, one might argue that the corporation has standing to sue because the corporation suffered harm *as a corporation* as a result of a fraud perpetrated on the market by its own officers.[61] Or one might argue that the corporation has standing as a representative of its stockholders who suffered harm as a result of the fraud.[62] Second, in cases in which corporate officers have engaged in insider trading or have otherwise secured some sort of improper benefit through a purchase or sale of stock, the fact that the fraud is carried out by means of trading in stock seems quite enough to suffice.[63]

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recovery under §20A where the corporation has asserted the same claim or a more comprehensive claim against its officers or agents. Incidentally, §20A suggests that Congress favors disgorgement (as under §16(b)), although PSLRA elsewhere seems at least to recognize that stockholders may seek out of pocket losses in securities fraud class actions. *See* Exchange Act §21D(e).

[60] In *Wharf (Holdings) Ltd. v. United Int'l Holdings, Inc.,* 532 U.S. 588, 594-95 (2001), the issue was whether an oral agreement granting an option to the plaintiff could form the basis of a fraud claim. The Court suggested that the Blue Chip rule may not apply if the claim is based on a consummated purchase or sale – rather than a potential purchase or sale – such that parties would be able to testify as to whether the relevant events had occurred and where the amount of the claim is readily ascertainable. (By the same token, the BCS rule might apply – even if it is clear that the plaintiff class consists solely of purchasers – if the number of purchasers is not readily ascertainable.) In *SEC v. Zandford,* 535 U.S. 813 (2002), a stock broker embezzled cash and securities in a customer account. The Fourth Circuit ruled that there was no cause of action under Rule 10b-5 because the sale of securities in the customer account was merely incidental to theft. The Supreme Court reversed, ruling that the fraud was covered by Rule 10b-5 because it was in connection with the purchase or sale of securities in that the securities had been entrusted to the broker for investment purposes. Although the court did not discuss the Blue Chip rule, it seems apparent that it would have ruled that the customer (as opposed to the SEC) would have had a cause of action under Rule 10b-5.

[61] *See, e.g.,* Goldberg v. Meridor, 567 F.2d 209 (2d Cir. 1977).

[62] *See* In re Mutual Funds Investment Litigation, 384 F.Supp.2d 845, 854-55 (D. Md. 2005), involved a class action on behalf of mutual fund investors who claimed that they had been damaged by the late trading and market timing of hedge funds and other investors. The court refused to dismiss the claims of non trading holders of mutual fund shares, suggesting that the buyer-seller rule of *Blue Chip Stamps* might be satisfied by virtue of the fact that the *defendants'* late trades and market-timed activities constituted purchases and sales of securities. *See* In re Alger, Columbia, Janus, MFS, One Group, and Putnam Mutual Fund Litigation, 320 F. Supp. 2d 352, 355 (D. Md. 2004). Incidentally, one of the big issues in the case was whether the action should proceed as a class action or as a derivative action. *See* Richard A. Booth, *Who Should Recover What for Late Trading and Market Timing?* 1 J. Bus. Tech. L. 101 (2006) (arguing for recovery by the fund with allocation of proceeds to individual accounts).

[63] Indeed, that is essentially what the Court held in *Zandford. See also* United States v. O'Hagan, 521 U.S. 642 (1997); Falkowski v. Imation Corp., 309 F.3d 1123 (9th Cir. 2002). Although *Cowin v. Bresler,* 741 F.2d 410 (D.C. Cir. 1984) might appear to be contrary, it arguably supports the thesis here. In *Cowin,* the plaintiff sought to maintain a direct action seeking *inter alia* an injunction under Rule 10b-5 against a controlling stockholder who had engaged in a variety of tactics allegedly constituting self-dealing and mismanagement. The court held that the action should have been a derivative action and that the plaintiff was barred from seeking any relief – including injunctive relief – in the context of a direct action because of the *Blue Chip Stamps* purchaser-seller rule. Although one might argue that the direct-derivative distinction matters little in an action for an injunction, *Cowin* does not touch on the question of the corporation's standing under Rule 10b-5.

A recent Third Circuit case offers some hope that the courts may fix the class action mess without the need for legislation or new SEC rules. In *LaSala v. Bordier et Cie,* the plaintiff was a litigation trust that represented a class of plaintiff purchasers in a class action alleging that officers of the defendant corporation had artificially inflated the price of the corporation's stock during the fraud period.[64] The defendant corporation declared bankruptcy. And under the bankruptcy settlement, the corporation's claims against its own officers – who had allegedly sold their own stock while in possession of material insider information – were assigned to the trust. The district court dismissed these claims on the theory that they were really class claims and were thus preempted under SLUSA. The Third Circuit reversed, holding that a pump-and-dump scheme gives rise to both derivative and direct claims. The purchasers suffer direct harm because they pay too much for their stock. But the corporation also suffers harm: "[B]ecause of the pump-and-dump scheme, [the corporation] lost its economic viability, as reflected in its declining stock price and eventual bankruptcy." [65] The point for present purposes is that the plaintiffs were forced by the circumstance of the corporation's bankruptcy to focus on the derivative claim rather than the usual class claim against the corporation. As a result it becomes clear – rather as one can see the stars during a solar eclipse – that some of the loss suffered by the plaintiffs is in fact derivative rather than direct and apparently may be litigated by the plaintiff class in federal court as a derivative claim.[66] There is no reason to think that the same result would not obtain even if the defendant corporation remained solvent (although the corporation itself would get first crack at the matter). And because the derivative claim affects all of the stockholders in the same way, presumably any court faced with the question would resolve all claims that can be characterized as derivative first and would address direct claims only after resolving derivative claims.

MARKET FAILURE AND THE SURVIVAL OF DIRECT CLASS ACTIONS

The foregoing analysis suggests that there is a good case to be made for litigating stock-drop actions as derivative actions. It is perhaps understandable that the courts have failed to recast such claims as derivative on their own motions. But it is curious that the parties have failed to advocate for derivative actions rather than class actions. Why have institutional investors failed to perceive their own interest? Why have defendant corporations failed to assert control of the derivative claims imbedded within class actions? And why has the plaintiff bar failed to pursue such claims with any vigor? There are several possible explanations all of which boil down to market failure.

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[64] LaSala v. Bordier et Cie, 519 F.3d 121 (3d Cir. 2008).

[65] Id. at 131. *See also* Makor Issues & Rights, Ltd. v. Tellabs, Inc., 513 F.3d 702 (7th Cir. 2008).

[66] The action also contains the remnants of a direct claim on behalf of the plaintiff class. So it may be that the court has only supplemental jurisdiction over the derivative claim.

Institutional Investors

It is not clear why plaintiffs themselves have failed to push for derivative actions rather than class actions. Again, at least three-quarters of all stock is held through well-diversified funds that suffer net harm from class actions. Moreover, under PSLRA the class member with the biggest claim – presumably a well-diversified fund – is entitled to serve as representative plaintiff. So why would such an investor fail to assume control and argue that the action should be recast as a derivative action? [67]

One reason may be the rule itself. Although the biggest claim is likely to belong to a well-diversified fund that should oppose direct class actions and favor derivative actions, there will usually be at least one fund that stands to gain more from any given class action as a buyer than it will lose as a holder. There is likely to be at least one fund that has made a big bet on the subject corporation during the fraud period.[68] For such an investor, it makes sense to file a class action even though the investor will lose more in other class actions over the long haul. Thus, such a fund is likely to seek the role of representative plaintiff. And even if the investor has considered this calculus, the investor may figure that other big investors will sue in other cases. It takes only one investor to file a class action. [69]

What is perhaps more important is that when one investor files a class action, it makes no sense for any other investor to opt out. If the action goes forward, those who would have preferred a

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[67] To the contrary, when such investors assume the mantle of lead plaintiff they often devote significant resources to the prosecution of a class action even though many institutional investors leave money on the table by failing to file a claim. *See* James D. Cox & Randall S. Thomas, *Leaving Money on the Table: Do Institutional Investors Fail to File Claims in Securities Class Actions?* 80 Wash. U. L.Q. 855 (2002). As I suggest below, it may be that some class action plaintiffs – such as state and union pension funds – are politically motivated. Thus it would be interesting to know about the types of funds that seek recovery and whether state and union pension funds file claims more often than for-profit funds.

[68] Whether a buyer-holder loses more as a buyer or a holder depends on the extent of the feedback effect which itself depends on the size of the plaintiff class. The feedback effect increases as the size of the plaintiff class increases. Thus, the loss suffered by holders increases as the size of the plaintiff class increases. Assuming that the plaintiff class consists of 50% of the outstanding shares, the feedback effect causes holder losses to double. Thus, a fund that buys more of the subject stock during the fraud period than it held before the fraud period – a fund that more than doubles its investment – will gain more from a successful class action than it will lose in connection with its holdings from before the class period. In contrast, a fund that increases its holdings by 10% will lose $9 on its holdings for every $2 it recovers from the class action (before attorney fees and litigation expenses). *See* Richard A. Booth, *Taking Certification Seriously – Why There Is No Such Thing as an Adequate Representative in a Securities Fraud Class Action.*

[69] Moreover, an investor who has made a particularly big bet on one stock may be emotionally motivated to seek satisfaction (or revenge) if the investment goes south. This is not necessarily inconsistent with being well diversified. The investor may have chosen to diversify by choosing a particular stock to represent a particular industry. And even though the loss may be offset by gains in other stocks, the investor (or more precisely the investment adviser) may be worried that fund investors will complain about stock picks that turn out to be losers. To be sure, it is not clear that an investment adviser necessarily serves his own interest well be claiming to have been fooled by a portfolio corporation. But the fund may also conclude that it has a fiduciary duty to seek recovery in such circumstances.

derivative action cannot afford to opt out of the class action, because by doing so they forgo their share of any direct recovery to offset their losses as holders.[70]

Yet another answer is that an institutional investor who seeks to be named lead plaintiff may conclude that it is has assumed a fiduciary duty to represent those who favor the class action and that it cannot use its influence to undermine their case even if it stands to lose more as a holder than it may gain from recovery. Indeed, there is some risk of sanction by the courts or even an action for breach of fiduciary duty.[71] Moreover, an institutional investor may conclude that is has a duty to support a class action when filed by others because the institutional investor has a fiduciary duty to its own investors to maximize return. Again, a class member who opposes class actions on principle cannot afford to register his opposition by opting out.[72]

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[70] *See* Richard A. Booth, *Taking Certification Seriously – Why There Is No Such Thing as an Adequate Representative in a Securities Fraud Class Action.* To be sure, big funds have on occasion opted out of class actions to prosecute their own direct actions in an effort to secure bigger settlements or lower attorney fees or both. But this does not change the fact that direct actions are ultimately contrary to the interests of well-diversified investors. So it may also be the lesser of evils to remain in a class action that will minimize the collateral damage to the corporation from feedback. Ironically, the courts often cite the failure of institutional investors to opt out of a class action as a reason to approve settlement. *See, e.g.,* Cendant Securities Litigation, 109 F.Supp.2d 235, 257-58 (D.N.J. 2000), *citing* Girsch v. Jepson, 521 F.2d 153 (3d Cir. 1975) (setting forth factors to be considered in approving class action settlements). Indeed, much of the law relating to judicial approval of class action settlements is ill-suited to securities fraud. In addition to considering the number of opt-outs, the courts also consider the ability of the corporation to pay even though the payment constitutes a redistribution of wealth among its own stockholders from holders to buyers. And the courts expressly ignore the allocation of the burden among settling defendants even in cases in which there is a derivative action pending. *See, e.g.,* In re Cendant Corporation Securities Litigation, 109 F. Supp. 2d 235 (D.N.J. 2000); In re Cendant Corporation Securities Litigation, 109 F. Supp. 2d 273 (D.N.J. 2000) (addressing and largely dismissing objections to settlement by derivative plaintiff); In re Cendant Corporation Litigation, 264 F.3d 286 (3d Cir. 2001) (same). While these factors and approaches may make sense in the context of (say) a product liability claim (where the plaintiff class has no ownership interest in the defendant), it makes no sense in the context of a securities fraud action. On the other hand, *Cendant* involved substantial claims under the 1933 Act (which are quite correctly seen as direct rather than derivative) in tandem with claims under Rule 10b-5. *See* Richard A. Booth, *The End of the Securities Fraud Class Action as We Know It.* Although the *Cendant* court considered the unique aspects of 1933 Act claims, it did not expressly consider the difficulties inherent in Rule 10b-5 claims where there is both a direct and a derivative action pending.

[71] *See, e.g.,* Heckmann v. Ahmanson, 168 Cal. App. 3d 119, 214 Cal. Rptr. 177, 187-88 (1985).

[72] In addition, as noted above much of the harm from the class action itself is done when an action is filed. The market presumably reacts immediately when the action is filed by adjusting stock price not only for fundamental loss but also for capitalization loss and feedback loss (presumably as adjusted for the probability of success). To be sure, the harm that results from the class action itself may ultimately be reversed if the derivative action is successful or because the class action lacks merit (as seems to have happened in the CCE case). But it may be that funds also decline to opt out because they figure that the damage has already been done and that there is nothing to be lost from remaining in a class action. On the other hand, there is no reason that an investor could not prosecute a derivative action and nonetheless decline to opt out of a class action, although there is some possibility that failure to opt out might be cited as somehow rendering the derivative plaintiff an inadequate representative by analogy to the rule one person may not serve simultaneously as a representative plaintiff in a direct action and a derivative action arising out of the same set of events. Moreover, the cost to the investor is likely to be significant, while the gain from success is likely to be small and to redound to the benefit all of the stockholders. Indeed, much of the benefit is likely to take the form of future savings and deterrence in other cases. Ordinarily, this would argue for leaving the matter to SEC enforcement, but the issues here are essentially state law issues.

Finally, it is the lawyers often run the show. And they are not likely to seek out a lead plaintiff who will undermine the class action. Moreover, it may be that politics plays a significant role in the decision of many big investors to prosecute class actions. It is probably no accident that state and union pension plans tend to serve as representative plaintiffs much more often than do for-profit institutional investors. Such investors may be motivated in part by a political agenda or may be able to exact other benefits such as campaign contributions from class counsel. Although it is clearly illegal to pay a plaintiff to sue, there is nothing to prevent a law firm from making campaign contributions to those who ultimately control state pension plans.[73] So it may be no coincidence that state pension plans serve as representative plaintiffs with increasing frequency. Moreover, securities fraud class actions may be seen as an extension of state police powers into areas otherwise occupied by the SEC and DOJ. That is, state authorities may often be motivated to prosecute securities fraud class actions by the desire to appear tough on white collar crime. In any event, it is not common to see for-profit institutional investors as representative plaintiffs in securities fraud class actions.

Defendant Corporations

Defendant corporations could do much to rectify the situation. A defendant corporation may always file a motion to recast a class action as a derivative action. But there are significant barriers to pursuit of this strategy. The primary problem is that a derivative action is a claim made by the corporation against its own officers. Directors and officers (D&O) insurance may not cover such claims. Even though it may provide coverage for other claims against officers that may result in liability to the corporation, D&O insurance never covers claims for misappropriation or fraud.[74] Moreover, it is usually up to the officers of a corporation to direct the defense of the corporation (and themselves) even if the case is covered by insurance (in contrast to the usual arrangement by which the insurance company assumes control).[75] Thus, it is not surprising that corporations do not seek to recast class actions as corporate (derivative) actions against individual defendant officers. Aside from doubts about insurance coverage, individual defendant officers would usually be required to retain their own counsel possibly at their own expense. And the conduct of separate defenses might expose both the corporation and the individual defendants to allegations aimed at each other that might weaken the defense of both. In other words, the separate defense of the individual defendants might increase the chances of an adverse outcome for both the individuals and the corporation.[76]

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[73] In early 2006, it came to light that several plaintiff lawyers had paid (or bribed) investors to serve as representative plaintiffs in numerous securities fraud class actions. Several big name members of the plaintiff bar went to jail as a result. *See* Richard A. Booth, *Why Pay a Fraud Plaintiff to Sue?* washingtonpost.com, June 26, 2006.

[74] *See generally* Interim Report of the Committee on Capital Markets Regulation (November 30, 2006); Thomas Baker & Sean Griffith, *Predicting Corporate Governance Risk: Evidence from the Directors' and Officers' Liability Insurance Market,* 74 U. Chicago L. Rev. 487 (2007); John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and its Implementation,* 106 Colum. L. Rev. 1534 (2006).

[75] One intriguing possibility might be to delegate responsibility for the defense of class actions to the insurance company. Given that derivative actions are likely to involve a smaller payout, an insurance company is likely to see the advantages of a derivative action quickly.

[76] Needless to say, this assumes that the derivative action proceeds in tandem with a direct action in which the corporation is a defendant. The thesis here is that derivative actions are a complete substitute for direct (class) actions

Corporations could deal with many of these issues by negotiating up front for appropriate insurance coverage. Or insurance companies could develop new policies that encourage corporations to try to recast class actions as derivative actions. Indeed, it is surprising that corporations have not sought such coverage. Under such a policy, the corporation – rather than the stockholders – would recover for any capitalization loss from reputational harm. And that would enhance the bottom line. There is no obvious reason why an insurance company would refuse to write such a policy. The insurance company has no reason to care about whom it pays. In addition, as noted above, it seems likely that the payout would be smaller in a derivative action than in securities fraud class actions as currently configured. And such a policy would reduce moral hazard in comparison to the extant scheme. In a direct class action, the corporation typically settles for both itself and any individual wrongdoers. So the individual wrongdoers can be fairly sure that they will be covered even if they engage in some sort of behavior that might constitute an actionable wrong to the corporation because most cases settle without a trial. This alternative form of policy would cover a narrower range of risks relative to securities fraud claims than does the current form of policy. Presumably, insurance companies would prefer to write such policies. Moreover, the insurance company that does so stands to capture much of the market at least until others catch up.[77]

Given the competitive advantage that would likely inure to both insurance companies and insured corporations from crafting such an innovation in insurance coverage, there must be some reason that they have not done so (other than the possibility that no one has yet thought of it). One possible reason is that insurance companies and insured corporations are happy with the existing system. Presumably, it is more lucrative for insurance companies to write policies with higher limits. As for corporate officers, insurance focused on personal coverage might be seen as akin to compensation. One might argue that officers should give up some portion of their compensation as

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which – like the state according to Marx – should soon wither away. But it seems likely – or at least a significant risk – that the courts might permit both actions to proceed. The procedural issues that would likely arise are discussed further below. One possible problem with the scheme proposed here is that there is well-developed body of law as to organizational *scienter*. *See* Makor Issues & Rights, Ltd. v. Tellabs, Inc., 513 F.3d 702 (7th Cir. 2008). So plaintiffs may continue to argue that the corporation itself is somehow culpable and thus should pay for something. On the other hand, the same body of law might argue for some sort of joint liability among various officers. But the more fundamental point here is that there is no compensable harm in the absence of harm to the corporation's reputation. If that harm arises as a result actions that result in some kind of personal gain, presumably those who enjoy the benefit should pay either through damages or disgorgement. But if the harm to the corporation arises as a result of some sort of good faith mistake of judgment – whether individual or collective – presumably it would be covered by insurance and the corporation would recover rather than pay. Indeed, that is implicit in the idea that insurance should be written to cover individuals for liability to the corporation. If we carve out instances of personal gain, there is nothing else for insurance to cover. To be sure, such cases may be quite rare (which suggests that such insurance may be quite cheap). Nevertheless, insurance companies may often choose to settle as they currently do. But the trade-off is much easier to work out if the choice is a simple one between defending individual wrongdoers and settling the case. Under the current regime, the presence of the corporation as a defendant complicates matters and likely inclines insurance companies to settle sooner rather than later.

[77] To be sure, there is no guarantee that the courts can be persuaded to recast direct class actions as derivative actions. So there is no guarantee that a new form of policy would ultimately replace the existing form. But that too could be addressed by contract. For example, an insurance company might write a conventional policy and agree to refund some portion of premiums to the insured corporation that succeeds in recasting a class action as a derivative action. In other words, despite the fact that one cannot presume that a class action will in fact be converted into a derivative action simply because the defendant corporation seeks to do so, it should be relatively easy to draft contractual language that encourages such a strategy with assuming that it will work.

compensation.[78] Under the current system, D&O coverage is largely incidental. Coverage is focused on the corporation itself as the primary target in a securities fraud class action. The fact that such insurance also effectively covers officers for potential liability to the corporation flies under the radar of stockholder activists. In short, the current system permits officers to use other people's money to pay for insurance that covers them personally.

Finally, corporations could adopt various charter provisions that would address the issue. Such a provision might require that class actions be pursued in the first instance as derivative actions or that derivative remedies be exhausted before direct remedies may be pursued. Or the corporation might adopt a provision that absolves itself and its officers from liability under federal securities law for any action taken in good faith and without personal gain (as is now standard fare under state law).[79]

Or the corporation might adopt a provision that requires that all stockholder disputes be submitted to arbitration.

To some extent, these solutions suffer from the same problem described above. A corporation might be reluctant to mandate derivative actions because of doubts about insurance. But the most significant problem with addressing these issues by charter amendment is that federal law and SEC rules prohibit waiver of the provisions of federal securities law.[80] This might well foreclose the possibility of absolution even for good faith violations, although it is arguable that the prohibition against waiver applies only to express causes of action and not to implied causes of action such as under Rule 10b-5. It seems much less likely that rules against waiver would foreclose a provision requiring that such claims be pursued as derivative claims or that they be arbitrated. Indeed, the Supreme Court has so held at least with regard to the arbitration of individual claims.[81]

Plaintiff Lawyers

It is not completely clear why members of the plaintiff bar have failed to advocate for derivative actions. Rather, derivative actions have been relegated to tag along status. To be sure, there is usually much more money at stake in a class action than in a derivative action. The pot (and the

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[78] It is interesting (and amusing) to note that in the EU the fashion is to refer to executive pay as remuneration rather than compensation. After all, the word compensation – as in the phrase compensatory damages – connotes a payment designed to make the recipient whole in some sense. It may be that the use of the word compensation in the US connotes that CEO assume significant business risk when they assume the position.

[79] *See* DGCL 102(b)(7).

[80] Securities Act §14; Exchange Act §29(a).

[81] *See* Shearson / American Express, Inc. v. McMahon, 482 U.S. 220 (1987); Rodriguez deQuijas v. Shearson / American Express, Inc., 109 S. Ct. 1917 (1989) (upholding arbitrability of individual claims under federal securities law). *See also* Volt Information Sources, Inc. v. Trustees of Leland Stanford Junior Univ., 109 S. Ct. 1248 (1989); Green Tree Financial Corp. v. Bazzle, 351 S.C. 244, 569 S.E.2d 349 (2002), vacated, 539 U.S. 444 (2003) (arguably upholding arbitrability of class action claims). *See generally* Interim Report of the Committee on Capital Markets Regulation (November 30, 2006). *But see* Thomas L. Riesenberg, *Arbitration and Corporate Governance: A Reply to Carl Schneider,* 4 Insights 2 (1990).

fee) is bigger if the claim includes both elements. So the attorneys who represent the plaintiff class have no incentive to distinguish between these two elements of damages. Thus, the plaintiff lawyers who have captured the class action business have little reason to argue for derivative actions. But other attorneys will have very different incentives. The plaintiff's attorney in a derivative action has every incentive to maximize the derivative claim even it has the effect of reducing the direct claim more than dollar for dollar. So the interests of class action lawyers does not explain why other plaintiff lawyers have not attempted to wrest away the business by attempting to displace class actions with derivative actions.

One possible answer is the danger of sanctions. Plaintiff lawyers may be reluctant to assert themselves because it is a novel idea that securities fraud should be seen as a derivative claim.[82] Indeed, there is case law indicating that federal judges are seriously confused about and even hostile to derivative actions in this context.[83]

The ultimate answer to this puzzle may be that class action lawyers effectively share the wealth with derivative action lawyers by consenting to more generous fees than would likely be approved by the court if the derivative action were the primary focus of the litigation. In other words, the lawyers who prosecute derivative claims may enjoy larger fees for less work than they would if they were more successful. In many derivative actions that are coupled with class actions, the corporation gains no monetary recovery but nonetheless pays a substantial fee to the derivative plaintiff lawyers ostensibly in consideration of improvements in corporate governance.[84] This is perhaps understandable in a system focused on class actions in which the corporation (or its insurer) pays the award. It makes little sense in such circumstances for the corporation as the primary defendant to gain from the settlement. But when the smoke clears, the substance is that the class lawyers and the derivative lawyers effective collude to share the fees.

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[82] See FRCP Rule 11(b)(2) (claims, defenses, and other legal contentions must be warranted by existing law or by a nonfrivolous argument for extending, modifying, or reversing existing law or for establishing new law); Exchange Act § 21D (c) (requiring court to issue findings as to compliance with FRCP 11(b) by each party and attorney in securities fraud class action).

[83] *See, e.g.,* In re Chambers Development Securities Litigation, 912 F. Supp. 822, 841-843 (W.D. Pa. 1995). In *Chambers,* the court stated that it was difficult to view the derivative action as a true class action in part because no motion had been made to certify it as a class action. Although the court accidentally stumbled onto the subtle truth that a derivative action is a type of class action, the notion that it might need to be certified is so far off the mark that one must wonder about the credentials of the derivative lawyers. Moreover, the court proceeded to analyze the proposed settlement of the derivative action applying the law relating to settlement of class actions as if the plaintiff class would recover and the corporation would pay. It may also be that the federal courts see derivative litigation as a matter for the state courts.

[84] *See, e.g.,* In re Cendant Corporation Securities Litigation, 109 F. Supp. 2d 235 (D.N.J. 2000) (approving settlement of class claims); In re Cendant Corporation Securities Litigation, 109 F. Supp. 2d 273 (D.N.J. 2000) (addressing and largely dismissing objections to settlement by derivative plaintiff); In re Cendant Corporation Litigation, 264 F.3d 286 (3d Cir. 2001) (same); In re Chambers Development Securities Litigation, 912 F. Supp. 822, 841 (W.D. Pa. 1995) (describing derivative action as mere appendage and discussing proposed settlement in which entire amount to be recovered by the corporation would go to derivative plaintiff counsel or if not approved into class action pot). *But see* In re Zoran Corporation Derivative Litigation, *2008 U.S. Dist. LEXIS 48246* (rejecting settlement because of minimal payment proposed).

Practical Considerations

In addition to various forms of market failure, it may be that practical questions of how to manage a derivative action in tandem with a direct class action have flummoxed the courts into inaction. What would happen if a stockholder filed a competing derivative action seeking to recover for capitalization loss and feedback loss in the name of the corporation? How would the prosecution of the (derivative) state law claim affect the direct federal claim? One possibility is that the two actions could proceed independently. Another possibility is that the state law claim could be heard by the federal court as a matter of supplemental jurisdiction.[85] But this does not answer the ultimate question: Which action should take precedence? A class action invariably seeks to recover for the entire amount of the loss suffered by buyers. If the corporation seeks to recover for the same amount on behalf of all stockholders, buyers would effectively recover twice – contrary to federal securities law limiting recovery to actual damages.[86]

The answer is that a derivative action should always trump a direct action. And only claims that remain (if any) should be the subject of direct claims.[87] In other words, any claim that can be resolved by derivative action should be so resolved if only because the derivative action reduces the direct claim while the direct action increases the derivative claim.[88]

To be clear, the argument here is that the two remedies cannot peacefully coexist. Much of what is sought as recovery in a class action – damages for reputational loss – should be the subject of a derivative action. And there should be no recovery *against* the corporation except in the rare case in which the corporation itself has somehow gained from the fraud. Accordingly, the derivative

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[85] *See, e.g.,* In re Zoran Corporation Derivative Litigation, 511 F. Supp. 2d 986 (N. D. Cal. 2007).

[86] *See* Exchange Act § 28. One possible solution to this problem is to permit non-buyer holders to recover individually (so as to avoid double recovery for buyers). But case law generally forbids that solution. Moreover, the need for such a Byzantine rearrangement of remedies suggests that there is a problem with the alignment of parties. *See* Bangor Punta Operations, Inc. v. Bangor & Aroostook R. Co., 417 U.S. 703 (1974) (holding that corporation could not maintain direct action in its own name because after a near total turnover of its stockholders few if any stockholders would have standing to maintain a derivative action based on wrongs committed before vast majority of stockholders owned any stock).

[87] In addition, FRCP 23 requires the federal court to consider other pending litigation and the most appropriate forum for the action. Although one might wonder how a federal court will know that there is a conflict between a federal class action and a state derivative action, one of the parties will always have an incentive to inform the court. On the other hand, PSLRA and SLUSA also contain provisions permitting a federal court to stay state law actions. *See* Cardinal Health, Inc. Securities Litigation, 365 F. Supp. 2d 866 (S.D. Ohio 2005) (enjoining discovery in state court derivative action because of pending federal class action)**;** DPL, Inc. Securities Litigation, 247 F. Supp. 2d 946 (S.D. Ohio 2003) (same). *See also* Newby v. Enron Corporation, 338 F.3d 467 (5th Cir. 2003) (upholding federal injunctions aimed at related state court proceedings); DPL, Inc. Securities Litigation, 2003 US Dist LEXIS 27473 (S.D. Ohio) (enjoining prosecution of state court derivative action based on theory that directors and officers caused or permitted violations of federal securities laws).

[88] *See* ALI, Principles of Corporate Governance § 7.01, Comment (f), Reporter's Note 6 (noting that deciding derivative claim first avoids double recovery).

action should be litigated first or at least seen as the primary controversy rather than the other way round.[89]

WHAT ABOUT DETERRENCE?

The usual response to any proposal to curtail securities fraud class actions is that they are the primary deterrent against fraud. The argument is that corporations – or more precisely their officers – would have little reason not to lie to the market in the absence of the class action threat.[90]

There are numerous responses.

First, it is not clear why we want to deter fraud that in many cases causes no real harm for most stockholders. Again, fundamental loss happens – fraud or no fraud. The same goes for the capitalization loss that arises from non-reputational factors. And feedback loss arises because of the class action remedy itself. The only loss that matters is the capitalization loss that results from reputational factors.

Second, there are serious problems with securities fraud class actions as a deterrent against fraud. Class action claims far exceed the real losses suffered by real stockholders. So securities fraud class actions provide excessive deterrence. Moreover, SEC fines have grown such that in the aggregate they are almost as significant in amount as class action awards. This is not to say that the SEC is necessarily good at focusing enforcement where it matters. But inasmuch as SEC fines are generally in addition to securities fraud class action claims, they exacerbate the problem of excessive deterrence.[91]

Finally, class actions focus deterrence in the wrong place. Individual wrongdoers seldom pay. And insurance almost always pays for both the corporation and any individual defendants.[92]

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[89] Generally speaking the courts have not perceived that there is any inherent conflict between class actions and derivative actions (even though it is well settled that one person may not serve as a representative plaintiff in both a class action and a derivative action). *See generally* ALI, Principles of Corporate Governance § 7.01, Comment (f) and Reporter's Note 6. *But see* Richard A. Booth, *Taking Certification Seriously – Why There Is No Such Thing as an Adequate Representative in a Securities Fraud Class Action* (arguing that there is an inherent conflict between direct and derivative plaintiffs both of whom would want to maximize share of recovery). In other words, the courts have had little difficulty entertaining both types of action simultaneously, though it is typical for the derivative action to be seen as a second-class tag-along dispute to be addressed only after resolving the main event class action. *See, e.g.,* Chambers Development Securities Litigation, 912 F. Supp. 822, 841 (W.D. Pa. 1995) (describing derivative action as mere appendage and discussing proposed settlement in which entire amount to be recovered by the corporation would go to derivative plaintiff counsel or if not approved into class action pot). *But see* In re Zoran Corporation Derivative Litigation, *2008 U.S. Dist. LEXIS 48246* (rejecting settlement because of minimal payment proposed).

[90] *See* John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and its Implementation,* 106 Colum. L. Rev. 1534 (2006); Amanda M. Rose, *Reforming Securities Litigation Reform: Restructuring the Relationship Between Public and Private Enforcement of Rule 10b-5,* 108 Colum. L. Rev. 1301 (2008).

[91] *See* Interim Report of the Committee on Capital Markets Regulation (November 30, 2006) at 78-79.

[92] *See* Interim Report of the Committee on Capital Markets Regulation (November 30, 2006) at 78-79.

Again, a derivative action might well be insufficient deterrence if limited to simple disgorgement of insider gains. Such a remedy suffers from the same problem that goes with simple disgorgement for insider trading: Ignoring legal expenses, there is no incentive not to trade on inside information if the only penalty is that one must give back the gain. Indeed, because of this problem Congress enacted ITSA and ITSFEA to provide for fines of up to three times the gain. But this argument fails to consider the deterrent effect of derivative liability for capitalization loss. That is the true cost of fraud to the corporation. And the claim for capitalization loss from such factors (where it exists) will always be larger than a claim for simple disgorgement. To be sure, it may be difficult to figure out the amount of capitalization loss that results from reputational harm. But that is no reason not to try.

Yet another response to the idea that we should rely on derivative actions for deterrence is that the (nominal) plaintiff corporation may seize control of the action through a special litigation committee (SLC) and seek to have the action dismissed. But this may be a blessing in disguise. Some claims for capitalization loss have merit – where there is reputational harm – while others do not. This is not to suggest that there is a bright-line distinction between meritorious and non-meritorious actions or even to propose a standard by which they can be distinguished. The point is that there are two possibilities and that someone must make the distinction even if it is made case-by-case. That is exactly what happens in the context of a derivative action.

Moreover, it is more efficient to sort out good claims and bad claims in the context of a derivative action than in the context of a class action. In a world of class actions, someone is bound to file suit. And no investor can afford to opt out. In a derivative action, the SLC has a duty to exercise its judgment in the best interests of the corporation and may even find itself in litigation if it fails to do so.[93] Moreover, SLCs are in a good position to mediate between the competing claims of disgruntled investors and the business judgment of a corporation's officers. While a federal court addresses *scienter* more or less in a vacuum, the SLC is focused on the best interest of the corporation. In a class action, it is up to the court to make the decision, usually based on the ill-fitting concept of *scienter* and without regard to the best interests of the corporation because the corporation is the defendant. In other words, in a class action the court is effectively precluded from considering the most fundamental issue – the best interest of the corporation.

Most legal scholars seem to assume that SLCs will invariably seek to dismiss derivative actions – irrespective of the merits – as contrary to the interests of the corporation.[94] This may be a legitimate worry as long as class actions are the primary remedy for securities fraud. In a world of securities fraud class actions, a corporation cannot afford to prosecute a derivative action with any vigor for fear that it will help the class action succeed. So it is not surprising that the corporation circles the wagons. But an SLC decision to seek dismissal is invariably scrutinized by the courts.[95]

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[93] *See* Joy v. North, 692 F.2d 880 (2d Cir. 1982); In re Oracle Corp. Derivative Litigation, 824 A.2d 917, 2003 Del. Ch. LEXIS 55.

[94] *See* ALI, Principles of Corporate Governance § 7.10, Reporter's Note 6-9.

[95] *See* Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981); Aronson v. Lewis, 473 A.2d 805 (Del. 1984); Auerbach v. Bennett, 47 N.Y.2d 619 (1979); ALI, Principles of Corporate Governance §§ 7.07 – 7.08. *See also* Burks v. Lasker, 441 U.S. 471 (1979) (federal courts must apply state law to determine whether directors have the power to terminate

And the courts do not always agree with the SLC.[96] Indeed, SLCs do not always seek to dismiss derivative actions.[97]

Still, in a world without class actions, it might not be as common as it now is for SLCs to seek dismissal. The best interest of the corporation is quite different absent the risk of a potentially ruinous class action claim against the corporation itself. The possibility that the SLC may get it wrong is no reason to scrap the system in favor of a system of class actions in which no one has any incentive to discriminate between good claims and bad claims.[98]

Finally, securities fraud class actions may actually induce management to lie to the market in some circumstances. If bad news is bad enough, it is almost certain to trigger a class action. Because of the feedback effect, the class action itself may bankrupt the corporation. Or bad news may become a self-fulfilling prophecy by inducing a further decline in business fortune.[99] If so there is no reason – other than the possibility of jailtime – not to cover up the bad news in the hope of turning things around and saving the corporation. Moreover, unless the law works perfectly to distinguish between good claims and bad claims, one can imagine a situation in which a CEO wakes up to realize that bad news probably should have been disclosed earlier – if only someone had connected the dots. In theory, a court should dismiss a claim based on negligence or simple bad judgment for lack of *scienter.* But the law relating to *scienter* is so nebulous that one must worry

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derivative litigation); Kamen v. Kemper Financial Services, Inc., 500 U.S. 90 (1991) (federal courts must apply state law regarding necessity of demand); Gall v. Exxon Corp., 418 F. Supp. 508 (S.D.N.Y. 1976) (demand requirement is no mere formality).

[96] *See* Joy v. North, 692 F.2d 880 (2d Cir. 1982); In re Oracle Corp. Derivative Litigation, 824 A.2d 917, 2003 Del. Ch. LEXIS 55.

[97] See American International Group, Inc., Consolidated Derivative Litigation, 2009 Del.Ch.LEXIS 15.

[98] To be sure, this assumes that the board of directors or at least the SLC is genuinely independent. Although there is much talk (and even law) about director independence, most commentators are justifiably skeptical about whether directors are often truly independent because the board of directors is usually seen primarily as an adviser to the CEO. Thus, most legal scholars do not distinguish between directors and officers in terms of the duties they owe to the corporation. They assume a community of interest between directors and officers by which the directors see it as their function to support management to the maximum extent possible. Indeed, my own scholarship sometimes conflates the two into the collective concept of management. But it is also possible to see the board of directors as a monitor or even an arbiter between the interests of stockholders and officers, particularly in a world of equity compensation. *See generally* Richard A. Booth, *Stockholders and Stock Options -- Malfeasance, Manipulation, Misappropriation. Or Not?* Jensen. This view is all the more the appealing given the requirement imposed by the Sarbanes-Oxley Act that a majority of directors be independent. To be sure, this view raises interesting questions. For one, why would anyone want to serve as a member of such a body? On the other hand, one could ask the same question under the more traditional view. For the view of one scholar, see Lynn A. Stout, *In Praise of Procedure: An Economic and Behavioral Defense of Smith v. VanGorkom and the Business Judgment Rule,* 96 Nw. U. L. Rev. 675 (2002) (directors are not necessarily in it for the money). The recent spate of cases alleging backdating of options provides a natural experiment. These cases involved little in the way of buyer claims based on fallen stock price. Interestingly, the corporations involved did not often seek outright dismissal of these claims. To the contrary, there seems to have been a significant tendency to prosecute such actions quite vigorously, albeit to settlement.

[99] *See* Makor Issues & Rights, Ltd. v. Tellabs, Inc., 513 F.3d 702 (7th Cir. 2008); Landon Thomas, *Stung by a Fraud Indictment, A Power Broker Punches Back,* New York Times, Sunday, April 15, 2007 at 1:1 (discussing indictment of David Stockman in connection with failure of Collins & Aikman).

that a court might get it wrong.[100] So it is tempting to cover up the bad news in the hope that it will go away because it is not clear that the cover up really does any harm in the absence of any attempt by insiders to capitalize on it. Thus, while some might dismiss the possibility of excessive deterrence with the notion that it is better to be safe than sorry, the cost of excessive deterrence is more than the waste of resources from excessive efforts to detect and prevent fraud. In the context of securities fraud class actions excessive deterrence may lead to more fraud by inducing cover-up.

In short, it is not at all clear that direct class actions provide more deterrence than derivative actions would provide. But it is quite clear that derivative actions would provide better deterrence.

CONCLUSION

In the typical stock-drop action under Rule 10b-5, the only genuine financial loss is the loss that the corporation suffers in the form of a higher cost of capital as a result of harm to its reputation if it suffers any such loss at all. As a loss suffered by the corporation, such capitalization loss should be the subject of an action by the corporation or a derivative action by which the corporation recovers for the benefit of all of its stockholders. There is no justification for a direct class action. The loss that results from new information about earnings or risk is loss that will occur anyway – fraud or no fraud. Well-diversified stockholders – the vast majority of stockholders – are effectively insured against such loss by virtue of being diversified. They do not need or want the supposed protection afforded by securities fraud class actions that entail deadweight losses in the form of litigation expenses and management distraction. Moreover, the class action itself visits a loss on the defendant corporation because in a direct class action the corporation pays. This feedback loss goes away if class actions are recast as derivative actions.

The question is why do securities fraud class actions survive despite the overwhelming logic in favor of derivative actions? There are several answers that all boil down to market failure. Although institutional investors, defendant corporations, and the plaintiff bar could advocate for class actions to be recast as derivative actions, each suffers from one or more disabling conflicts. Thus, reform is unlikely unless the courts take the initiative. This is arguably as it should be. The characterization of claims as direct or derivative is a judicial function governed by the rules of procedure. And procedure is a matter for the courts. Besides, the securities fraud class action is a judicial invention. So it is no objection that such a reform might be seen as judicial activism. To the contrary, the courts have the power and the duty to clean up the securities fraud class action mess.

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[100] *See* Tellabs, Inc. v. Makor Issues & Rights, Ltd., 2007 US LEXIS 8270.