

THE END OF THE SECURITIES FRAUD CLASS ACTION AS WE KNOW IT

By Richard A. Booth

Abstract

In this article, I argue that securities fraud class actions (SFCAs) should not be treated as class actions but rather should be treated as derivative actions. In addition, I argue that such actions should be dismissed unless it appears that insiders (including the company itself) have enjoyed gains from trading during the fraud period. Both of these conclusions are based on the fundamental argument that (1) securities law seeks to protect the interests of reasonable investors, (2) reasonable investors diversify, and (3) diversified investors are effectively protected against the supposed financial harms of securities fraud by virtue of being diversified, except in cases in which insiders have extracted gains by trading during the fraud period. Only those actions that involve insider trading or the equivalent by directors, officers, or agents of the defendant company (or the company itself) entail genuine financial harm to the plaintiff class, because only those actions involve an extraction of wealth from the public market. Accordingly, only SFCAs that allege insider trading or the equivalent should survive a motion to dismiss.

In addition to the fact that diversified investors suffer no compensable harm in the absence of insider trading or the equivalent – *simple securities fraud* -- SFCAs visit serious collateral damage on defendant companies, ultimately reducing investor return. In an action based on failure to disclose bad news, the prospect of payout will cause stock price to fall by more than it otherwise would -- even in a perfectly efficient market -- and will trigger a positive feedback mechanism that will have the effect of magnifying the potential payout. This feedback effect can be quantified with precision using a simple formula. For example, in a case in which the release of bad news should cause market price to fall by 10 percent, the SFCA feedback effect will result in a price decline of about 20 percent if share turnover has been 50 percent during the fraud period. Thus, by their very nature SFCAs cause additional damage to defendant companies and stockholders. It is easy to fix the feedback problem. If the case does not involve insider extraction of gains, it should be dismissed. If the case does involve insider extraction of gains, it should be litigated in the name of the corporation, and the corporation should recover any gain extracted by insiders. Specifically, treating a securities fraud action as an action by the corporation (whether it is maintained by the corporation itself or derivatively by a representative stockholder) will make stockholders whole and will avoid collateral damage to the issuer corporation.

Finally, the argument here suggests a new rationale for why insider trading should be illegal, namely, that it involves the extraction of wealth from the market and presumptively diversified investors. In turn, this suggests that diversified investors and largely undiversified insiders should be viewed as two different classes of investors with distinct interests. Thus, I also explore the public policy reasons for recognizing such a distinction and some of its other implications.

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By Richard A. Booth*

Introduction

Over the last ten years, nearly 2400 securities fraud class actions (SFCAs) have been filed against publicly traded companies in the United States.¹ These actions have resulted in settlements of about \$27 billion, and attorney fees of about \$7 billion.² More than one in fifty companies is the target of such an action each year.³ Yet for most investors these awards confer no economic benefit. Indeed, for conservative buy-and-hold investors (the majority) they reduce investment returns.

At best, an award from an SFCA is nothing more than an expensive rearrangement of wealth from one pocket to another (minus a cut for the lawyers). Diversified investors are equally likely to sell an overpriced stock as to buy one. For diversified investors, gains and losses wash out. On the other hand, SFCA awards constitute an unjustifiable transfer of wealth from conservative buy-and-hold investors to stock-picking traders. In addition, SFCAs visit serious collateral damage on defendant companies, ultimately reducing returns for conservative buy-and-hold investors. The prospect of payout by the defendant company causes stock price to fall by more than it otherwise would – even in a perfectly efficient market – and triggers a positive feedback mechanism that has the effect of magnifying the potential payout – sometimes with devastating effects. Indeed, about 30 percent of settling companies end up bankrupt.⁴

I argue here that a securities fraud class action should be dismissed for failure to state a claim unless it appears that insiders (including the company itself) have enjoyed

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¹ See Cornerstone Research, *Securities Class Action Case Filings, 2005: A Year in Review*, at 1.

² See Laura E. Simmons & Ellen M. Ryan, Cornerstone Research, *Post Reform-Act Securities Settlements, 2005 Review and Analysis*, at 1; Anjan V. Thakor, *The Economic Reality of Securities Class Action Litigation* (Navigant Consulting, October 26, 2005), Exhibit A (finding plaintiff attorney fees of \$1.7 billion in connection with settlements totaling \$11.9 billion in a sample of 482 class actions). Assuming that this sample is representative of the percentage of settlement awarded as plaintiff attorney fees (approximately 14 percent in the sample), a good estimate of the total plaintiff attorney fees awarded in SFCAs since 1995 is \$3.6 billion (14 percent of \$26 billion). Assuming that defendant firms have been paid roughly the same amount, it seems a fair estimate that SFCAs have generated about \$7 billion in attorney fees over the last ten years. To be sure, defendant firms are paid in all cases, whether or not the plaintiff prevails, but presumably defendant firm fees are a good deal less than plaintiff firm fees in cases in which plaintiffs prevail. Note that plaintiff attorney fees are paid out of the settlement and that accordingly the estimated amount available for investors was \$26 billion less \$3.6 billion or about \$22.4 billion.

³ See Cornerstone Research, *Securities Class Action Case Filings, 2005: A Year in Review*, at 4.

⁴ See Laura E. Simmons & Ellen M. Ryan, Cornerstone Research, *Post Reform-Act Securities Settlements, 2005 Review and Analysis*, at 14

gains from trading during the fraud period. Only those actions that involve insider trading or the equivalent by directors, officers, or agents of the defendant company (or the company itself) entail genuine financial harm to the plaintiff class, because only those actions involve an extraction of wealth from the public market. If the case does not involve insider extraction of gains, it should be dismissed. No harm, no foul. If the case does involve insider extraction of gains, it should be litigated in the name of the corporation, and the corporation should recover any gain extracted by insiders. Specifically, treating a securities fraud action as an action by the corporation (whether it is maintained by the corporation itself or derivatively by a representative stockholder) will make stockholders whole and will avoid the collateral damage to the issuer corporation.

The essential point can be well illustrated by an allegory. Imagine a crowded room in which everyone has \$200 in one-dollar bills in his pocket. Dobby, the mostly invisible house elf of Harry Potter fame, scurries about the room randomly picking a single bill from the pocket of one individual and inserting it immediately into the pocket of another.⁵ How much would one pay to avoid the risk of ending up a dollar short at the end of the day? Not much. Even though a very speedy elf might redistribute hundreds of dollars, it is highly unlikely that any individual will end up much worse off in the end. Indeed, as a statistical matter, the most likely outcome is that one will end up precisely where one starts – with \$200. And it is almost impossible that one would end up more than a couple of dollars short or long. Thus, for an individual to pay even a dollar for elf insurance would likely cost more than the harm. Now suppose that a few folks in the room have two \$100 bills in their pockets. If the elf's practice is to lift a single bill at a time from any one individual, an individual with two \$100 bills would likely be worried enough to buy elf insurance. Although the odds remain even that one will end up even, the risk that one will lose \$100 or even \$200 is much greater. But there is a cheap and easy way to avoid the risk: An individual can protect himself by getting change and holding only singles.

Accordingly, a diversified investor (one who can lose only a dollar from any single fraud) should not be too worried about securities fraud, whereas an undiversified investor (one who can lose half his wealth from a single fraud) will be very worried about it. Indeed, undiversified investors might favor hiring a securities guard (so to speak) with sophisticated elf detection equipment. They might even favor taxing all investors to pay for protection. On the other hand, diversified investors would be opposed to any such tax for the same reason that they would decline to buy elf insurance. They would argue that undiversified investors should simply get change for their big bills and stop worrying.

⁵ This allegory was inspired by a presentation made by Joseph Grundfest at the University of Maryland School of Law several years ago. Easterbrook and Fischel use a similar though slightly less apt example involving Robin Hood. Frank H. Easterbrook & Daniel R. Fischel, *Optimal Damages in Securities Cases*, 52 U. Chicago L. Rev. 611, 622 (1985). Those familiar with Harry Potter books will recognize Dobby as the house elf featured therein.

But suppose that Dobby keeps every second dollar for himself. Even a diversified investor would worry a bit in such circumstances, because a speedy elf might subtract wealth from the aggregate in the room. Although even a diversified investor would favor some form of protection in such circumstances, a diversified investor would only be willing to pay for protection focused on cases in which the elf keeps the money. Protection that extends to mere redistribution among investors would still be seen as a waste of money.

This allegory illustrates a fundamental problem with SFCAs. There is an inherent conflict between diversified and undiversified investors. Although undiversified investors may see a need for SFCAs, diversified investors should be opposed to SFCAs as a deadweight loss except in situations in which an insider has kept some of the money by trading on withheld information.

A second fundamental problem with SFCAs is that the defendant company pays the damages. As a result, the value of the defendant company is reduced by the amount of the payout *in addition* to any decline in the stock price of the company that results from disclosure of new information. Moreover, in a bad news case, this reduction in value itself results in a further decline in stock price and sets up a positive feedback mechanism that can lead to a total decline in price that may be *several times* the decline that would have resulted simply from the disclosure of negative information. For diversified investors, this additional loss is a significant cost over and above the expenses of litigation. These costs confer few benefits. Although they may afford some amount of deterrence, they do nothing to recoup the gains extracted by elfin insiders, but they do significant harm to defendant companies and thus to portfolio returns.

This article proceeds as follows. Part I describes how SFCAs arise, how damages are calculated under current law, and why the current approach leads to several problems. Part II explains portfolio diversification, how it can protect stockholders from the effects of securities fraud in the absence of insider trading or the equivalent (*simple securities fraud*), and why securities law in this area should presume that stockholders are diversified. Part III discusses securities fraud accompanied by insider trading or the equivalent, why diversification cannot fully protect stockholders in such circumstances, and how feedback distorts both awards and the market itself. Part IV shows how treating securities fraud as a claim belonging to the issuer company can solve the problems inherent in SFCAs and why the courts should treat SFCAs as derivative actions. Part V addresses how such a solution might be implemented. Finally, Part VI discusses some of the broader implications of viewing securities fraud essentially as a problem of insider trading.

I. BACKGROUND

SFCAs usually arise from the failure of a publicly traded company to disclose material information in a timely fashion. The information itself may be either good news or bad news. In other words, a securities fraud action may be triggered by news that causes the price of a stock to rise (in which case those who sold during the fraud period

suffer harm) or by news that causes the price of a stock to fall (in which case those who bought during the fraud period suffer harm). There are notable examples of both types of fraud.⁶ But bad news fraud is far more common *because* of the way damages are awarded in securities fraud class actions as I explain in detail below. Thus, the discussion here is based generally on the premise that securities fraud involves the failure to disclose *bad* news in a timely way.

In a bad news case, the plaintiff class consists of all who purchased the stock in question after an actionable misrepresentation or omission and who hold the stock until some time after corrective disclosure.⁷ The standard approach to damages in a bad news case is to award the difference between the price paid by the buyer and the market price after corrective disclosure.⁸

⁶ See, e.g., *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988) (good news); *Time Warner Securities Litigation*, 9 F.3d 259 (2d Cir. 1993) (bad news). There are, of course, many other forms of securities fraud, ranging from those arising in face-to-face dealings to those arising in connection with corporate level mismanagement, but these other actions are seldom amenable to pursuit as class actions. In other words, SFCAs invariably arise as a result of an issuer's failure to disclose material information to the market in a timely fashion.

⁷ Some may quibble with this characterization in that it can be unclear exactly when the truth comes out. See *Broudo v. Dura Pharmaceuticals, Inc.*, 339 F.3d 933 (9th Cir. 2003), *rev'd*, 2005 U.S. LEXIS 3478 (holding that loss causation may be proved by evidence that a stock was overpriced as a result of false statements or omissions at the time of purchase even though the price did not fall with corrective disclosure). See generally Jay W. Eisenhofer, Geoffrey C. Jarvis & James R. Banko, *Securities Fraud, Stock Price Valuation, and Loss Causation: Toward a Corporate Finance-Based Theory of Loss Causation*, 59 Bus. Law. 1419 (2004). Nevertheless, no one seems to deny that the price of the stock must decline for some reason after the plaintiff purchases, and most would likely agree that the decline must somehow be tied to the original failure of disclosure. Thus, for convenience, I will assume here that a prototypical SFCA involves a prolonged failure of disclosure followed by a corrective disclosure by which the whole truth comes out all at once and with no interim leakage. I should note that I do not distinguish here between misrepresentations and omissions. Both are generally actionable, although there are subtle differences in the relevant law. Compare *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128 (1972), with *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988). In practice, most securities fraud class actions arise from some combination of the two. For example, a company might issue a press release or periodic report that is correct at the time of release. The press release then becomes false or misleading as a result of intervening events, but the company then fails to issue another release to correct the lingering false impression. See *In Re Time Warner Securities Litigation*, 9 F.3d 259 (2d Cir. 1993).

⁸ This approach to calculating damages can be traced back to *Green v. Occidental Petroleum Corp.*, 541 F.2d 1335 (9th Cir. 1976), and it is the formulation upon which Congress relied in connection with the Private Securities Litigation Reform Act (PSLRA). See H.R. CONF. REP. NO. 104-369 at 42. Although this is a common description of the measure of damages, and may well be applied in some cases, it is a gross oversimplification. For example, factors other than fraud may have affected market price before corrective disclosure, or the truth may dribble out. See Richard A. Booth, *Windfall Awards Under PSLRA*, 59 Bus. Law. 1043 (2004); Janet Cooper Alexander, *Rethinking Damages in Securities Class Actions*, 48 Stan. L. Rev. 1487, 1490-92 (1996); Michael Y. Scudder, *The Implications of Market-Based Damages Caps in Securities Class Actions*, 92 Nw. U. L. Rev. 435 (1997). Of course, most SFCAs are settled if they are not dismissed. Thus, it is unusual for damages ever to be awarded by a court. Nevertheless, the putative measure of damages will affect settlement negotiations. Moreover, given that the settlement of a class action must be approved by the court, the court itself may well consider the parties' assumptions and estimates as to damages. Accordingly, I use the more neutral word *award* to refer herein to both damages and settlements.

It is well known that there are serious problems with this measure of damages.

First, although it is easy to calculate damages if there is a single plaintiff, the calculation of aggregate damages has proved to be exceedingly difficult in the context of a class action. Many shares may be bought and sold repeatedly during the fraud period. Trading volume during the fraud period is likely to be many times the number of damaged shares. The problem is that there is no way to determine how many *different* shares traded during the fraud period short of sending out claim forms.⁹ This intractable problem has led to serious uncertainty in the context of settlement negotiations. It has also led to the invention of several suspect trading models designed to estimate aggregate damages that have been characterized as junk statistics by some commentators.¹⁰

Second, most investors are diversified and as a result are effectively protected against simple securities fraud -- securities fraud in the absence of insider trading or the equivalent. Simple securities fraud is a zero-sum event. For every buyer-loser there is a seller-winner. Buyers and sellers *in the aggregate* neither gain nor lose.¹¹ A diversified investor is equally likely to be on the winning side of a given trade as on the losing side. A diversified investor who owns 200 to 300 different stocks with a modest turnover of about 60 percent per year (as is the case with a typical mutual fund) is likely to see gains and losses that are roughly equal over the course of a few years. Thus, a diversified

⁹ See Janet Cooper Alexander, *The Value of Bad News in Securities Class Actions*, 41 UCLA L. Rev. 1421, 1427 (1994); Kenneth R. Cone & James E. Laurence, *How Accurate are Estimates of Aggregate Damages in Securities Fraud Cases?* 49 Bus. Law. 505 (1994). For example, suppose that a company has a public float of 10 million shares and annual trading volume of 15 million shares. The fraud period is one year. And the largest single trade during that period is a block trade of 100,000 shares that occurs on the first day of the fraud period. It is theoretically possible that the 100,000 shares could be bought and sold 150 times during the year (in trades of varying sizes), accounting for the entire volume of trading. It is also possible that as many as 10 million different shares were sold during the fraud period. Assuming that damages are (say) \$5 per share, aggregate damages could range from \$500,000 to \$50 million. Unless the context requires otherwise, I use the word *investor* to include all investors -- regardless of whether they buy and hold for long periods or trade often. Although many commentators distinguish between investors and traders, the position I advocate here does not require any such distinction.

¹⁰ Again, one could wait until after trial -- when class members submit claim forms -- to calculate damages. See Janet Cooper Alexander, *Rethinking Damages in Securities Class Actions*, 48 Stan. L. Rev. 1487 (1996); Robert A. Alessi, *The Emerging Judicial Hostility to the Typical Damages Model Employed by Plaintiffs in Securities Class Action Lawsuits*, 56 Bus. Law. 483 (2001). But the vast majority of SFCAs settle before trial. In order to settle, the parties must determine a settlement amount. Moreover, in a class action, the court must approve the settlement and the amount of plaintiff attorney fees, which is typically based on the settlement amount. Thus, a court cannot avoid involving itself in the calculation of damages even if the case does settle. The role of the court is thus somewhat unusual, given that the issue of damages arises in the context of the parties' joint submission of a negotiated settlement agreement in a proceeding that is not clearly governed by the rules of evidence, which makes the use of dubious trading models all the more worrisome.

¹¹ To be sure, all investors lose when bad news is announced and stock price falls. But this is a loss that all would suffer anyway -- fraud or no fraud. Thus, a shareholder who avoids a loss effectively enjoys a gain.

investor is already effectively protected against securities fraud in most cases.¹² To be sure, some investors may not be diversified. But it is irrational for passive investors not to diversify. Through diversification, an investor can avoid significant company-specific risk without any reduction in return and can do so at no cost. Because it is irrational to assume more risk than necessary, it follows that rational investors diversify. On the other hand, even diversified investors in the aggregate may lose if the fraud involves inside transactions by which wealth is transferred out of the public market. If the fraud involves nothing more than the failure to disclose material information in a timely fashion, there is no effect on aggregate stockholder wealth. Gainers equal losers. But if the fraud is accompanied by insider selling before bad news is announced, wealth is transferred out of the public market to the extent of insider gain (or loss avoided). A rational approach to damages should be based on the effect of securities fraud on diversified investors.¹³ It should distinguish between cases in which investors suffer no genuine harm and cases in which the market is harmed by inside transactions.

Third, the company pays the damages.¹⁴ Accordingly, the prospect of the SFCA award itself causes the market price of the stock to fall by an *additional* amount on top of the amount by which it fell as a direct result of the corrective disclosure. That additional decrease in price will cause an increase in damages, which in turn will cause a further decrease in price. In the case of bad news fraud, SFCAs trigger a positive feedback mechanism that magnifies the decrease in market price -- and the potential award to plaintiffs -- sometimes by several multiples of the decrease that would have occurred as a simple result of the disclosure of new information in the absence of the threat of a class action.¹⁵ Feedback will arise even in a perfectly efficient market. To be sure, the market may over-react to bad news and may fall by more than it should. But overreaction is beside the point for present purposes. The point is that *even if the market is working perfectly*, feedback magnifies damages. Feedback is inherent in the class action system. Indeed, the prospect of a significant payout by the issuing company may often cause

¹² See Janet Cooper Alexander, *Rethinking Damages in Securities Class Actions*, 48 Stan. L. Rev. 1487, 1496 -1502 (1996). Investors may be diversified at various levels. Obviously, investors who invest through mutual funds are very well diversified. Studies indicate, however, that an investor who holds at least 20 different stocks can gain almost all of the benefits of diversification.

¹³ One might say that investors are the cheaper cost avoiders for securities fraud. See Frank H. Easterbrook & Daniel R. Fischel, *Optimal Damages in Securities Cases*, 52 U. Chicago L. Rev. 611 (1985).

¹⁴ The award goes to those who bought or sold during the class period at the expense of longer term investors who did not trade during the fraud period. Because SFCA award are paid by defendant companies, the award is paid in effect by the stockholders of the defendant company. See, e.g., Donald C. Langevoort, *Capping Damages for Open-Market Securities Fraud*, 38 Ariz. L. Rev. 639 (1996). Even if a large part of the award is paid by accountants or attorneys or other agents or insurance companies, presumably, these costs are ultimately borne by the company, through higher professional fees and insurance premiums, although such costs may be spread through the market.

¹⁵ Feedback works in the opposite way in a good news case, where the prospect of payout by the defendant company triggers a *negative* feedback mechanism that has the effect of muting the increase in stock price that one would expect on the basis of fundamentals. This explains why bad news cases are far more common than good news cases.

more of the price decline than the fraud itself. As I explain below, the positive feedback mechanism reaches a mathematical limit that depends on the number of shares traded during the class period. The larger the number of shares traded, the greater the potential award. Thus, It is no surprise that plaintiff attorneys favor cases with long class periods.¹⁶

The implications of diversification and feedback taken together are striking. Diversified investors suffer no harm from securities fraud except in those cases in which insider trading subtracts wealth from the market. Even then the transfer is likely to be miniscule. But the feedback effect means that the market price of a defendant company stock in a bad news case will fall by more – sometimes much more – than it should. The net effect is that SFCAs are a *wash* for diversified investors. On the other hand, defendant companies see their stock price fall by more than it should, and they are thus deprived of the capital to which they would have access in a market undistorted by SFCAs. In short, SFCAs do no apparent good for anyone (other than lawyers), but they do considerable harm to defendant companies.

The foregoing problems could be avoided altogether if the courts were to treat securities fraud claims as belonging to the *company* rather than to the stockholders. If the fraud does not involve insider trading, there is no harm to diversified stockholders in the aggregate and no award is necessary. If the fraud does involve insider trading, investors are fully compensated if the company recovers the insider gain. Because the company recovers, such an approach avoids the problem of feedback, and it eliminates the need to determine the number of damaged shares. To be sure, this solution requires the company to sue insiders who may have engaged in improper trading. But if the company fails to sue, stockholders can maintain a derivative action.

The focus here is on securities fraud not involving an offering by the issuer company. Obviously, if the company has sold stock fraudulently, it makes no sense for the company to recover. The appropriate remedy is for the company to give back the money. And that is essentially the remedy under the 1933 Act. But it is also clear that

¹⁶ Commentators have suggested several other possible reasons for the preponderance of bad news cases. First, it seems more likely that management will seek to hide bad news than to hide good news. Moreover, management is likely to be less fearful of the consequences of hiding bad news if the company is on the verge of collapse anyway. See Jennifer Arlen & William Carney, *Vicarious Liability for Fraud on Securities Markets: Theories and Evidence*, 1992 U. Ill. L. Rev. 691. Some commentators have also suggested that the market overreacts to bad news. See Werner F. M. De Bondt & Richard Thaler, *Does the Stock Market Overreact?* 40 J. Fin. 793 (1985); Werner F. M. De Bondt & Richard Thaler, *Further Evidence on Investor Overreaction and Stock Market Seasonality*, 42 J. Fin. 557 (1987). Whether or not that is true, it is clear that the market discounts the value of the subject company not only for the bad news itself but also for the prospective payout. See also Janet Cooper Alexander, *The Value of Bad News in Securities Class Actions*, 41 UCLA L. Rev. 1421 (1994). Although most commentators who have focused on the issue have simply noted the fact that the prospect of SFCA damages causes a stock's price to fall more than it otherwise would on the basis of new (negative) information (what might be called the *fundamental decline*), some commentators have attempted to measure the difference or *crash component* of stock price decline by calculating and netting out the theoretical price to which a stock should decline on the basis of the information disclosed. 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).

under the 1933 Act the total award is limited to the amount of the offering.¹⁷ Accordingly, there is no possibility of feedback in a simple 1933 Act case.¹⁸

II. SIMPLE SECURITIES FRAUD

In a civil action, one must allege and prove compensable harm in order to state a claim and ultimately recover.¹⁹ In the absence of a credible allegation of financial harm to the plaintiff or class proximately caused by securities fraud, presumably the case should be dismissed.²⁰ In most SFCAs, diversified investors as a group suffer no financial harm as a direct result of the fraud. A simple SFCA -- one based on an allegation that agents of the defendant company misled the market and not involving financial gain to the company or its agents (*simple securities fraud*) -- is a zero sum event. For every investor who buys and suffers a loss, there is another investor who sells and effectively enjoys a gain (by avoiding a loss). Gains equal losses among traders. In short, most securities fraud class actions amount to a zero-sum redistribution of wealth.²¹

¹⁷ Securities Act §11(g). See *Hertzberg v. Dignity Partners, Inc.*, 191 F.3d 1076 (9th Cir. 1999) (discussing need to trace shares to offering).

¹⁸ It is common in actions under the 1933 Act for the plaintiff also to include a claim based on Rule 10b-5. A Rule 10b-5 claim is superfluous in connection with an IPO, but in connection with subsequent offerings, a Rule 10b-5 claim has the effect of joining additional class members who bought shares that were already outstanding. In such a case, the feedback created by the Rule 10b-5 claim will have the effect of enhancing claims under the 1933 Act as well. If Rule 10b-5 claims are seen as claims in the name of the company, as I propose here, it seems unlikely that they will be pleaded in connection with claims under the 1933 Act.

¹⁹ See generally FRCP 12(b)(6) (providing for motion to dismiss for failure to state a claim upon which relief can be granted). The requirement of monetary damage in connection with a violation of federal securities law is implicit in the requirement that the plaintiff prove loss causation, as codified by the Private Securities Litigation Reform Act (PSLRA): "in any private action arising under this chapter, the plaintiff shall have the burden of proving that the act or omission of the defendant alleged to violate this title *caused the loss* for which the plaintiff seeks to recover damages." 15 U.S.C. § 78u-4(b)(4) (2000). See *Dura Pharmaceuticals, Inc. v. Broudo*, 125 S. Ct. 1627, 161 L. Ed. 2d 577, 2005 U.S. LEXIS 3478. See also *Suez Equity Investors, L.P. v. Toronto-Dominion Bank*, 250 F.3d 87 (2d Cir. 2001). See generally Jay W. Eisenhofer, Geoffrey C. Jarvis, and James R. Banko, *Securities Fraud, Stock Price Valuation, and Loss Causation: Toward a Corporate Finance-Based Theory of Loss Causation*, 59 Bus. Law. 1419 (2004). Moreover, both the 1933 Act §11(g) and the 1934 Act §28(a) expressly prohibit recovery in excess of actual damages. Cf. *Dirks v. SEC*, 463 U.S. 646 (1983); *United States v. O'Hagan*, 521 U.S. 642 (1997) (both requiring some element of financial gain to support tipper breach of duty in connection with charges of insider trading); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975) (holding that only traders have standing to sue under Rule 10b-5 and thus suggesting that the plaintiff in a Rule 10b-5 action must demonstrate a *realized* monetary loss).

²⁰ In the context of a class action, it is arguable that the representative plaintiff must also allege that the class has suffered financial harm *as a class*. In other words, it is not enough that the individual plaintiff allege that he or she has been harmed. This requirement would also seem to be implicit in the requirements that common questions predominate and that the representative be an adequate representative of class interests. Given that most stock is held in diversified portfolios, it seems clear that an undiversified plaintiff cannot be an adequate class representative. But a diversified plaintiff arguably suffers no loss and cannot serve as a representative either.

²¹ The aggregate value of a company's shares is the same after the disclosure of bad news whether the disclosure is timely or not although the identity of the investors may differ. In other words, there is no

A diversified investor is equally likely to be on the winning side of a trade as on the losing side. To be sure, a diversified investor may still suffer harm from an individual trade. But for a diversified investor with many different portfolio stocks, the harm is likely to be small. More important, gains and losses will net out over time.²² Such investors are fully protected from simple securities fraud through diversification. They need no remedy.²³

Admittedly, an *undiversified* investor may suffer significant harm from securities fraud. An investor who forgoes the benefits of diversification and picks a single stock can lose her entire investment. But it does not follow that an undiversified investor should have a remedy if she *voluntarily* assumes the unnecessary risk that goes with failure to

direct social cost. Non-traders may suffer paper losses. But they would have suffered such losses earlier anyway even in the absence of fraud. In any event, it is well settled that non-traders have no standing to sue. *See Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975).

²² This is particularly true of investors who invest through mutual funds and other institutional vehicles. Such funds typically invest in 200 to 300 different stocks. And 62 percent of all stocks (by dollar amount) are held by institutions. *See* Statistical Abstract of the United States, Table 1173 (2002). The number is probably much higher because individual holdings include holdings by non profit institutions. On the other hand, nonprofits include some pension plans which may be undiversified. As Julian Velasco has pointed out, there may be an intergenerational conflict that affects the analysis. For example, it is likely that a younger investor who follows a rational buy-and-hold strategy and who is therefore a net buyer would suffer disproportionately from bad news fraud (fraud that results in overpricing). Such an investor might not sell as often he buys. Still such an investor will sell with some frequency because of the need periodically to rebalance his portfolio, or, if the account is taxable, in order to net out gainers and losers. The question is whether purchases outweigh sales. Moreover, as the investor ages and becomes a net seller, the bias reverses. But that may not be enough to overcome the time-value of earlier lost returns. The more important question is whether investors gain enough from SFCA's when they are members of a plaintiff class to make up for the losses they suffer when they are non-trading holders of the stock of a target company, especially under a system in which a significant amount of the award goes to the lawyers. In addition, one must consider the added risk from positive feedback in bad news cases. Those who have invested in companies that become targets of SFCA's lose more than they should when they are holders of such stocks, while they are merely made whole (less their share of attorney fees) when they are a member of the plaintiff class in a successful SFCA. As a result, investing is riskier than it needs to be.

²³ *See* Anjan V. Thakor, *The Economic Reality of Securities Class Action Litigation* (Navigant Consulting, October 26, 2005). The Thakor study included 2596 large institutional investors who traded in 476 securities that were the subject of class action settlements between December 22, 1995 and August 25, 2005 and found (based on modest assumptions about the timing of trades during fund reporting periods) that the institutions suffered losses of \$43.8 billion and gains of \$30.7 billion in the affected securities for a net loss of \$13.1 billion before settlement. Interestingly, the institutions' share of settlement proceeds in these cases was \$11.9 billion (less \$1.7 billion in attorney fees) for a net loss before attorney fees of just \$1.2 billion. The Thakor study also found evidence that the pre-settlement losses were attributable to new issues of securities during the fraud period. Specifically, \$1.5 billion in loss was attributable to IPOs and \$10.6 billion in loss was attributable to the half of the non IPO cases involving issuers who were relative net sellers of stock. Just \$1.0 billion in loss was attributable to the half of cases involving companies classified as non-issuers. (It is unclear why the study divided the remaining cases in half rather than according to whether the issuer was in fact a net seller or net buyer during the class period.)

diversify. Again, it is irrational for a passive investor not to diversify. And securities law is protects only reasonable investors.²⁴

A. *The Presumption of Investor Diversification*

Rational investors diversify. Through diversification an investor can eliminate the risk that goes with investing in a single stock without any sacrifice of expected return.²⁵ Studies indicate that one can eliminate more than 99% of company-specific risk with a portfolio of as few as twenty stocks. And with 200 to 300 stocks all company-specific risk is gone.²⁶ The only risk that remains is market risk -- the risk that the market as a whole will rise or fall.

Moreover, investors have no real choice but to diversify. The fact that company-specific risk can be avoided means that the market sets the price of individual securities as if no such risk exists.²⁷ To see why, suppose that market prices did reflect company-specific risk. Portfolio investors would buy up securities -- which would be underpriced from their point of view -- and hold them in portfolios that eliminate company-specific risk. The price of stocks would rise and eliminate any return attributable to company-specific risk. Undiversified investors would then be forced to pay higher prices for individual stocks even though the return remained the same. In other words, an investor who buys a single stock as a stand-alone investment takes more risk than is necessary to achieve the expected return from that single stock. Such behavior in an investor who is able to diversify is irrational by definition, because the fundamental goal of investing is to generate the greatest possible return at the lowest possible risk.

Finally, it is virtually costless to diversify. Although it might at first seem as if only the very wealthy can afford to hold as many as 200 or 300 stocks, complete diversification is available very cheaply through mutual funds for investors with as little as \$1000 to invest.²⁸ In short, it is so cheap and easy for investors to diversify that it is

²⁴ See *TSC v. Northway*, 426 U.S. 438 (1976). Denying a remedy to undiversified investors creates an added incentive to diversify. Thus, it may be more accurate to characterize the effect as eliminating a subsidy for undiversified investors. On the other hand, many courts have permitted action against trustees for losses on imprudent investments even though the losses are more than offset by gains from other investments and even though trust law requires diversification. See Restatement (Second) of Trusts § 213 (1959). See generally Jeffrey N. Gordon, *The Puzzling Persistence of the Constrained Prudent Investor Rule*, 62 N.Y.U. L. Rev. 52 (1987) (criticizing the so-called anti-netting rule).

²⁵ As a result, a diversified investor is risk-neutral. See Easterbrook & Fischel, *supra* note 1, at 29-30. This is not to say that a diversified investor is indifferent to risk. Rather, a diversified investor will prefer that management of any individual company pursue the highest risk-adjusted return even at the risk of the ruin of the company.

²⁶ See JAMES H. LORIE, ET AL., *THE STOCK MARKET: THEORIES AND EVIDENCE* 21-24 (2d ed. 1985).

²⁷ See BURTON G. MALKIEL, *A RANDOM WALK DOWN WALL STREET* 193-209 (4th ed. 1985).

²⁸ See ROBERT W. HAMILTON & RICHARD A. BOOTH, *BUSINESS BASICS FOR LAW STUDENTS* § 15.2 (1998). To be sure, many funds impose sales charges of various sorts. But there are also many that do not. One must also consider the management fees and other charges paid by the fund itself. On the other hand, funds

simply unnecessary for investors to take company-specific risk. There is no downside to diversification.²⁹ Accordingly, a rational investor *must* diversify. By the same token, it is fair to say that it is irrational for an investor who can do so not to diversify.

B. The Implications of Investor Diversification

If federal securities law is intended to protect reasonable investors, then it would seem to follow that investors should be presumed to be diversified.³⁰ Even if one is reluctant to deny a remedy to undiversified investors, it is undeniable that there is a fundamental conflict of interests between diversified and undiversified investors.³¹ The two groups have distinctly different preferences. The law cannot serve both groups. If there is a need to choose, the choice is clear. The law should presume that a reasonable investor is a diversified investor.

A diversified investor is not merely indifferent to SFCAs. Rather, a diversified investor should be positively *opposed* to any effort by other investors to prosecute such actions. For a diversified investor -- who is effectively insured against loss from simple securities fraud -- the costs associated with SFCAs result in a net loss of portfolio return even after adding in the proceeds from awards. It seems clear that the interests of diversified investors should trump the interests of undiversified investors where the two come into conflict.

C. The Limits of Investor Diversification

There are several possible responses to the foregoing arguments. First, one might argue that stockholders diversify in order to eliminate the risk of bad management and that securities fraud is a different sort of risk involving dishonesty rather than honest bad judgment. But there is more than one form of securities fraud. Some nondisclosures are prompted by a legitimate business purpose. For example, a company may want to maintain secrecy during the course of product development in order to avoid competition

are able to command very low commission rates in connection with trades. Thus, in the end it is unlikely that even a wealthy investor can invest more cheaply than through a mutual fund.

²⁹ In addition, diversification (in conjunction with the efficient market) relieves the investor of the need to engage in costly research. As for those investors who choose to invest on their own, an investor who buys 20 round lots of different stocks will typically pay about the same commission or spread in total as an investor who buys 2000 shares of a single stock.

³⁰ One might even say that federal securities law should ignore the interests of undiversified investors just as the definition of materiality ignores the interests of stockholders who merely *might* be interested in the disclosure of a particular item of information. *See* TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438 (1976).

³¹ *See* Janet Cooper Alexander, *Rethinking Damages in Securities Class Actions*, 48 Stan. L. Rev. 1487, 1506 (1996).

and maximize return.³² On the other hand, some nondisclosures are designed to facilitate improper trading by insiders or the company itself before the market is fully informed. Both forms of fraud are equally actionable under federal securities law.³³

The risk of the former – simple securities fraud – is a risk like any other ordinary business risk. Sometimes you win and sometimes you lose, but it all comes out in the wash. Securities fraud merely rearranges existing wealth. Investors can avoid the harms associated with securities fraud through diversification. Hence, there is no reason for a diversified investor to sue as long as all other investors decline to sue. On the other hand, if some investors sue, then all investors must do the same -- a classic market failure. Thus, diversified investors will favor a rule that prohibits legal action in such circumstances, because the cost of the action is a deadweight loss to the system.

The risk of fraud with insider trading is different. Fraud with insider trading constitutes a net loss to investors in the aggregate.³⁴ Gainers do not cancel out losers because insiders extract some of the gain. The public market loses to the extent that insiders have extracted wealth. Diversification provides complete protection only in a simple securities fraud case. In a case of fraud with insider trading, the perpetrators extract some of the gain that would otherwise go to innocent traders. That loss is a loss to the system. In other words, simple securities fraud is a zero sum game. But securities fraud with insider trading is a negative sum game.³⁵ Even diversified investors will

³² See Donald C. Langevoort, *Half-Truths: Protecting Mistaken Inferences by Investors and Others*, 52 *Stan. L. Rev.* 87, 100 (1999).

³³ To be sure, a plaintiff must plead and prove *scienter* in order to recover for securities fraud under Rule 10b-5. But *scienter* involves only some level of knowingness. It does not necessarily involve a *bad* motive. Although I suggest here that cases not involving some form of insider trading should be dismissed, it would accomplish a similar result for the courts to winnow cases according to the motive for non-disclosure. To some extent the courts have done so. See *Time Warner Securities Litigation*, 9 F.3d 259 (2d Cir. 1993). But it appears that the courts have become less inclined to do so following the enactment of the Private Securities Litigation Reform Act (PSLRA) and in particular § 21D thereof. See *Novak v. Kasaks*, 216 F.3d 300, 310 (2d Cir. 2000).

³⁴ This assumes of course that one views the fraudster as an outsider. In most cases, however, the fraudster is also a stockholder. There may be situations in which it is appropriate to allow a fraudster to keep the proceeds. Indeed, Henry Manne has made a career of arguing as much. See, e.g., Henry G. Manne, *Options? Nah. Try Insider Trading.*, *Wall Street Journal*, August 2, 2002 at A8. One possibility is to limit actions to those who could have made or participated in the decision to disclose the information on the theory that they must have delayed disclosure in order to trade. In other words, an insider who is in no position to disclose the information publicly should not be forced to sit idly by and miss an opportunity to trade. Incidentally, it is unclear that there are any situations other than insider trading coupled with power to delay disclosure that would amount to fraud.

³⁵ The distinction is the same as that between the duty of care and the duty of loyalty under corporation law. As I have argued elsewhere, the ultimate justification for the business judgment rule may be that stockholders can diversify away the risk of bad judgment but not the risk of theft. See Richard A. Booth, *Stockholders, Stakeholders, and Bagholders (Or How Investor Diversification Affects Fiduciary Duty)*, 53 *Bus. Law.* 429 (1998). As for bad judgment, some risky business decisions pay off, while others do not. Only the average matters. Assuming that the potential returns from risky business decisions are adequate to justify the risk -- that the decisions are made in good faith -- and that the stockholder is well diversified,

recognize that there is a need for some sort of remedy in such cases. But the SFCA is a singularly bad remedy as I discuss further below.

Second, it might be argued that some stockholders cannot diversify and may need the protections afforded by SFCAs. Three classes of stockholders come to mind: (1) stockholders who own shares in a closely held corporation, (2) large investors who have or seek control over the issuer, and (3) employee stockholders who may be precluded from selling their shares even though a public market exists.

As for stockholders in closely held corporations, it is unclear that federal securities law – which is focused on public offerings and public trading – should apply, although it is well-established that it does.³⁶ Nevertheless, such cases are unproblematic for present purposes, because few if any are likely to give rise to a class action. On the contrary, it is likely that the victim of a fraud will almost always have an action against the buyer or seller on the other side of the trade (including the corporation itself). A state law fiduciary duty claim will also be available in many cases. As for a large investor who has or seeks control over the issuer, any such investor is free to pursue an individual action.³⁷

The one class of potential plaintiffs that is truly troubling is the class of employees who have been induced to invest discretionary funds in an undiversified retirement plan such as appears to have occurred at Enron. As for employee stockholders precluded from trading, they will seldom have a federal cause of action anyway precisely because they cannot trade. Only buyers and sellers may sue. Thus, if an employee

then the winners will make up for the losers. But it is unlikely in a self-dealing case that the corporation will gain from a transaction with a conflicted director or officer. In other words, there is seldom if ever the potential for a big upside to a duty of loyalty problem. Diversification works on the law of averages. If the universe of outcomes is breakeven at best, with possible losses from dishonesty, the average outcome will be a loss. Diversification may cushion the blow, but it cannot eliminate the loss as it does with good faith business decisions where a big return on one long shot makes up for a big loss on another. Thus, one can overcome the business judgment rule by showing that a corporation entered into a no-win transaction. *See Joy v. North*, 692 F.2d 880, 893 (2d Cir. 1982); *Litwin v. Allen*, 25 N.Y.S.2d 667 (N.Y. Co. Sup. Ct. 1940). Arguably, the business judgment rule might not apply in a world in which losses were more common than profits, but that is not the world we have -- at least not among publicly traded companies. It is worth noting that diversification protects an investor both as to the disclosure of new information and as to the underlying event itself. Indeed, securities fraud is arguably *less* worrisome than the risk of bad business judgment from which stockholders in the aggregate lose wealth. This also suggests that investors may not care much about company-specific information as long as it relates to a risk that can be diversified away. *Cf. Wielgos v. Commonwealth Edison Co.*, 892 F.2d 509 (7th Cir. 1989) (discussing significance of company-specific information). But the risk of insider trading or the equivalent, like the risk associated with a duty of loyalty claim, is a risk that cannot be diversified away. Indeed, in most cases, insider trading constitutes a duty of loyalty claim.

³⁶ *See, e.g., Landreth Timber Co. v. Landreth*, 471 U.S. 681 (1985); *Jordan v. Duff & Phelps, Inc.*, 815 F.2d 429 (7th Cir. 1987).

³⁷ Moreover, such an investor tends not to trade with much frequency and would not likely be a member of the plaintiff class. As for those justifiably undiversified investors who do in fact trade, the chances seem quite high that if they have in fact been defrauded, it will have been in a unique face-to-face transaction.

happens to buy or sell during the fraud period, the employee will presumably be included in any class action. Moreover, the fact that the employee was free to trade during the fraud period suggests that the employee was free to diversify. And one could argue that employees have even more reason to diversify because much of their human capital is tied up in the issuer-employer.³⁸ On the other hand, such employees may have a cause of action against those who induced them to forgo diversification.³⁹ But it may be that in many cases employees will be precluded from maintaining an action by ERISA.⁴⁰

If there are other classes of investors who are justifiably undiversified, the burden would seem to rest with the investor to explain why he or she forwent the benefits of diversification, which in turn would introduce individualized issues of proof that would likely preclude certification of the case as a class action. In short, it is not clear that justifiably undiversified investors have much need for the supposed protections afforded by SFCAs.

Third, it may be argued that some investors are rationally undiversified, for example, NYSE specialists, NASDAQ market makers, and day-traders. Moreover, one might argue that these traders are very important to the market because they provide liquidity for other investors. But the fact that specialists and market makers focus on individual stocks does not necessarily imply that they are undiversified. Most market makers make a market in hundreds of stocks. And although specialist firms were

³⁸ Cf. SEC v. Ralston Purina Co., 364 U.S. 119 (1953) (noting that employee-investors are especially in need of accurate information).

³⁹ See generally Richard A. Booth, *The Suitability Rule, Investor Diversification, and Using Spread to Measure Risk*, 54 Bus. Law. 1599 (1999). See Robertson v. Central Jersey Bank & Trust Company, 47 F.3d 1268 (3d Cir. 1995); Ehrlich v. First Nat'l Bank of Princeton, 505 A.2d 220, 233-34 (N.J. Super. Ct. Law Div. 1984).

⁴⁰ Yet another group of undiversified investors may be high level employees or agents or even directors who have been compensated with stock or options. It is unlikely that such investors will ever be so numerous as to need to resort to SFCAs and the circumstances of their sales will almost always preclude class certification. Many Enron employees were involuntarily undiversified, however, as are the employees of many other companies that fund their retirement plans with excessive amounts of company stock. But in most cases, the remedy, if any, is a matter of employment law as governed by ERISA and not of federal securities law. Moreover, it is arguable that plans funded primarily with company stock are more in the nature of profit-sharing plans than investment accounts. Although the employee-beneficiaries may have been misled or misinformed, there is nothing inherently wrong with a profit-sharing plan that ties the fortunes of the employee to those of the employer. I do not mean to suggest that undiversified investors should never have a remedy under federal securities law. Indeed, there are many situations in which they should have protection. An investor who buys a large block of stock with a view to exercising some control over the issuer is rationally undiversified and should have a remedy if defrauded. And a small investor whose broker or adviser fails to diversify the investor's portfolio may well have a claim. See Richard A. Booth, *The Suitability Rule, Investor Diversification, and Using Spread to Measure Risk*, 54 Bus. Law. 1599 (1999). But such claims will seldom if ever give rise to a class action. Thus, my argument here is limited to SFCAs in which there is no privity between plaintiff and defendant and in which reliance is not an issue. See Donald C. Langevoort, *Capping Damages for Open-Market Securities Fraud*, 38 Ariz. L. Rev. 639 (1996); Janet Cooper Alexander, *Rethinking Damages in Securities Class Actions*, 48 Stan. L. Rev. 1487 (1996).

traditionally individually owned and focused on the five or so stocks assigned to each individual specialist, today there are only a handful of specialist firms handling the 2500 or so stocks traded on the NYSE. Clearly, market makers and specialist firms are diversified in the sense that the risk of fraud is spread over many stocks. Moreover, a market maker or specialist can in theory pursue those traders who trade on the basis of inside information. In other words, they do not need the supposed protection afforded by SFCAs.⁴¹ As for day traders, it is not at all clear that they are necessary to the market as a source of liquidity.⁴² Indeed, it appears that there is far less day trading going on today than there was at the height of the market in 2000. Yet the markets remain perfectly liquid. Moreover, to the extent that day traders remain a significant constituency to be considered in framing securities law, it seems clear that they have voluntarily forgone the benefits of diversification in favor of a risky strategy.

Fourth, one might argue that precluding recovery for securities fraud on the grounds that rational shareholders diversify would eliminate an important mechanism by which companies are made to disclose material information to the market and that in the absence of such information the market would become less efficient and investing would become riskier. There are several responses. First, the fact that stockholders lack a remedy does not necessarily mean that *issuers* have no duty to disclose. Stockholder rights and management duties need not be symmetrical.⁴³ The SEC can handle enforcement in egregious cases.⁴⁴ Second, companies may do a better job of disclosure if they are not subject to hair-trigger lawsuits for mistakes.⁴⁵ Presumably, the better a company does at disclosure, the less risky it is to invest in that company, and the higher the price of that company's stock. In other words, the market provides plenty of natural

⁴¹ Ironically, market makers have often been excluded from SFCAs at least for purposes of determining the number of damaged shares, because it is presumed that as in-and-out traders they suffer no harm.

⁴² To the contrary, it has also been suggested that day traders may constitute a menace by creating unduly thin markets at many different price levels. In any event, it seems clear that the vast majority of trading can be traced to portfolio adjustments of various sorts by diversified investors and that relatively little trading is motivated by stock picking. See Paul G. Mahoney, *Is There a Cure for "Excessive" Trading?*, 81 Va. L. Rev. 713 (1995). See also Lynn A. Stout, *Are Stock Markets Costly Casinos? Disagreement, Market Failure, and Securities Regulation*, 81 Va. L. Rev. 611 (1995); Lynn A. Stout, *Reply: Agreeing to Disagree over Excessive Trading*, 81 Va. L. Rev. 751 (1995).

⁴³ See generally Richard A. Booth, *The Suitability Rule, Investor Diversification, and Using Spread to Measure Risk*, 54 Bus. Law. 1599 (1999).

⁴⁴ See Donald C. Langevoort, *Capping Damages for Open-Market Securities Fraud*, 38 Ariz. L. Rev. 639 (1996). See also A.C. Pritchard, *Markets as Monitors: A Proposal to Replace Class Actions with Exchanges as Securities Fraud Enforcers*, 85 Va. L. Rev. 925 (1999).

⁴⁵ In theory, this hypothesis could be tested by comparing the rate of voluntary disclosure before and after the adoption of the PSLRA safe harbor for forward looking disclosure.

incentive to disclose, other things being equal.⁴⁶ SFCAs constitute a wildly excessive penalty for getting it wrong, and thus presumably create a disincentive to disclose.

Fifth (and finally), it seems clear that investors in the aggregate and the market itself are harmed by securities fraud. Surely the fact that investors cannot trust the market to set accurate prices must have some adverse effects. But it is not at all clear how to measure the damage from loss of trust or confidence. One might argue that Enron and WorldCom damaged the market as a whole and not simply their own stockholders. But it is not clear that securities law does or should afford a remedy for such harms. Indeed, the fact that the market rises and falls from the waxing and waning of investor confidence is one of the inherent risks of investing.⁴⁷

In short, there is a fundamental conflict between diversified and undiversified stockholders. A diversified stockholder should be opposed *ex ante* to private actions for damages based on securities fraud unless it can be shown that the perpetrator extracted a gain from the fraud. Even then a diversified stockholder would favor a private action for damages only to the extent that it sought restitution from the perpetrator.⁴⁸ A diversified stockholder is protected against simple securities fraud by being diversified. The cost to the company of defending against the private action is a deadweight loss. In other words, diversified stockholders are not merely indifferent to securities litigation. They should oppose it in principle.⁴⁹

⁴⁶ See Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 Va. L. Rev. 669 (1984). See also John C. Coffee, Jr., *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 Va. L. Rev. 717 (1984).

⁴⁷ It is also arguable that SFCAs do additional harm to the market generally by suggesting that the market is less trustworthy than it really is. If indeed there are many – or even a few – SFCAs that should be dismissed for lack of cognizable financial harm, it stands to reason that many investors will view such actions as evidence that the market is crooked.

⁴⁸ Diversified investors would likely also favor a rule that includes a penalty of some sort, such as treble damages, that would create additional deterrence as well as compensation in order to deal with problems of detection. This is essentially the idea behind the Insider Trading Sanctions Act of 1984 (ITSA) and the Insider Trading and Securities Fraud Enforcement Act of 1988 (ITSFEA) both of which provide for disgorgement of gains and a penalty of three times that amount. See Securities Exchange Act § 21A. This should not be seen as a windfall to investors, but rather as a rough way of making them whole by affording compensation for undetected cases.

⁴⁹ It is ironic that the class action was touted as especially well suited to securities fraud cases. See Official Comment to FRCP 23. Interestingly, it appears that mutual funds and other institutional investors often forgo the opportunity to file claims in successful securities fraud class actions. 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, 855 (2002). Although one might be tempted to argue that this constitutes some kind of evidence that institutional investors have recognized that securities fraud class actions are counterproductive, the fact is that failure to file a claim when others file is irrational (irrespective of whether one favors SFCAs) and amounts to a subsidy running from funds to claimants. On the other hand, it may be that mutual fund investments tend to be concentrated in particular stocks and that failure to file a claim is more common in cases in which most other investors are also mutual funds, suggesting a form of consciously parallel behavior. See Adam C. Pritchard, *Who Cares?* 80 Wash. U. L.Q. 883 (2002) (replying to Cox and Thomas). In any event, there has been a flurry of lawsuits recently against mutual funds that

III. FRAUD WITH INSIDER TRADING

As noted above, diversification affords full protection only from zero-sum simple securities fraud. But some cases of securities fraud are non zero sum. If bad news fraud is accompanied by insider or company sales, there will be a net transfer of wealth from outside investors to insiders or the company. That is, if insiders sell on nonpublic bad news, outsiders who buy will lose. But not *all* of the gains will go to other outside investors who happen to sell. Some of the gains will go to insiders. In other words, outside investors as a class will be net losers as a result of the fraud. Similarly, outside investors may suffer a net loss if the *company* sells shares without disclosing bad news. And, in cases of good news fraud, outside investors will lose if insiders or the company buy stock or if the company grants stock options. To be sure, a diversified investor will be *less* concerned about the costs of fraud than an undiversified investor. But on the average and over time, even diversified investors lose from fraud with insider transactions, because some amount of capital is diverted from the public market to insiders.

A. *The True Measure of Damage*

It does not follow, however, that individual investors who happen to buy or sell during the fraud period should be able to recover the difference between trade price and post disclosure market price. In a market undistorted by the effects of SFCAs, most of the price difference will be attributable to new information about the company, and relatively little of the price difference will be the result of wealth extraction by insiders. In the absence of insider trading, market price will change when new information comes to light. Insider trading makes it change by a bit more or a bit less than it would. But for diversified investors that is the bit that matters. Thus, to permit investors who trade during the fraud period to recover the *full* difference between trade price and post disclosure market price is far too generous, because it compensates them for damage they did not suffer -- that part of the price change that would have occurred at some point anyway when the truth came out. The true measure of the loss to investors in the aggregate is the amount extracted by insiders.⁵⁰ In a perfectly efficient market, market prices will be just a bit lower after such a fraud than they would have been in the absence of the fraud -- whether it is good news fraud or bad news fraud. In other words, the true damage to the market comes from something like dilution. The rather obvious remedy is for the perpetrators to disgorge their gains to the company. In a perfectly efficient market, disgorgement should have the effect of increasing market price by exactly the extra amount by which it fell from the fraud. Thus, a class action is the wrong way to fix the problem. An action by the company or a derivative action would do the job far better.

failed to file claims in SFCAs. See Jonathan D. Glater, *Suits Contend Mutual Funds Fail to Collect in Settlements*, New York Times, January 19, 2005 at C1.

⁵⁰ See Thakor at 16, note 10.

B. Feedback in Bad News Cases

Aside from the fact that the standard approach to damages overcompensates diversified investors, a class action invariably does *more* harm than it does good, because the issuing company pays the award to the plaintiff class, reducing the aggregate value of the issuing company and its stock by the amount of the payment. Because of the feedback effect, that reduction may be several multiples of the loss that would have obtained from corrective disclosure in the absence of feedback.

For example, suppose that Acme Corporation has ten million shares outstanding and that the current market price is \$10 per share. The market capitalization of Acme is thus \$100 million. Acme management learns that a key customer is about to cancel a major contract, which will have the effect of reducing profits by ten percent. Accordingly, the price of Acme stock is expected to fall to \$9 per share. For some reason, management decides to withhold this information from the market for several months. During that period, six million Acme shares are traded. To avoid unnecessary complications, assume that during the fraud period there has been no leak of information or insider trading and that all of the six million shares traded are *different* shares that have been traded just once. When Acme finally discloses the bad news to the public, the price of its stock will fall by ten percent plus some amount that reflects the likelihood that Acme will become the target of an SFCA. Given that 60 percent of Acme shareholders bought during the fraud period and that the loss in value is one dollar per share, one would expect that the damages payable to the buyers will total \$6 million. The problem is that if Acme pays out \$6 million in damages, its aggregate value is further reduced by that amount, which in turn causes the market price to drop further, which in turn increases the per share damages. And so on. In other words, the process repeats itself through a positive feedback mechanism that causes the market price to fall a bit more with each iteration. The proverbial bottom line in this case is that if the market is working perfectly, the price will equilibrate at \$7.50 per share. In other words, what should have been a 10 percent decline in price will have been magnified to become a 25 percent decline in price because of the prospect of SFCA damages.⁵¹

One can calculate the total percentage decrease in market price in a bad news case using the following formula:

$$\text{total decrease in market value} = \text{expected decrease} / (1 - \% \text{ of shares damaged})$$

Note that the formula makes it clear that the greater the percentage of shares damaged (the greater the turnover of *different* shares), the greater the total decrease in market price (and the greater the aggregate damages or settlement value). Indeed, in a case in which all of the shares have turned over, the total decrease in value is theoretically infinite. To be sure, a company cannot decline in value to less than zero. But SFCA damages can wipe out 100 percent of a company's market capitalization even though some stockholders did

⁵¹ For a more detailed derivation of the solution, see the appendix.

not trade. The following chart sets forth the results for Acme at various levels of turnover. A graph of these results follows in Appendix II.

BAD NEWS CASE EXAMPLES

Assume hypothetical pre-damages decrease of \$10M:

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

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

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

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

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

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

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

There are two distinct problems created by the feedback effect of SFCAs. First, it constitutes an excessive penalty against the defendant company. Indeed, in a simple SFCA there is no clear reason to penalize the company at all. The decrease in the value of its stock from the disclosure of the new information is probably penalty enough.⁵² Second, SFCAs invariably result in the transfer of wealth from diversified buy-and-hold investors to undiversified stock-picking traders. Thus, SFCAs encourage irrational investment strategies.⁵³ In the case of bad news fraud, the award goes to some of the current shareholders who bought in at a too high price (thus redistributing wealth within the corporation from older to newer shareholders).⁵⁴

⁵² There are presumably two sources of decrease: (1) the decrease in price that results from the disclosure, and (2) some additional decrease in price that results from a loss of trust. The latter may be significant in that there are many investment opportunities for investors (who can move their money virtually costlessly) and who may easily avoid the defendant company in favor of other more trustworthy companies. Moreover, even a non-stock-picking diversified investor might choose to avoid investing in particular companies and nonetheless remain fully diversified. Thus, the market probably provides adequate deterrence for most disclosure problems.

⁵³ Investors are presumably marginally conscious of the fact that if they get cheated they will always have the prospect of recovery via SFCA. Thus, the current system subsidizes investment strategies that should be discouraged.

⁵⁴ Presumably the plaintiff class will include both undiversified investors and diversified investors who just happened to buy at the wrong time. In the case of good news fraud, the award goes entirely to former shareholders who sold out at too low a price. In both cases, the award will tend to go primarily to active traders rather than to buy and hold investors. To the extent that an award constitutes a mere rearrangement of capital within the market, it may not be too terribly worrisome. One might argue that investors in the aggregate (the market) are no worse off (but for attorney fees and other expenses of litigation). Presumably,

C. *Feedback in Good News Cases*

In a good news case, feedback has the opposite effect. Rather than magnifying the decrease in stock price, feedback in a good news case has the effect of dampening the increase in stock price.

For example, suppose that Binford Corporation has ten million shares outstanding and that the current market price is \$10 per share for a market capitalization of \$100 million. Binford management learns that a new customer is about to sign a major contract, which will have the effect of increasing profits by ten percent. The price of Binford stock is expected to rise to \$11 per share. Again, management decides to withhold this information from the market. During the fraud period, six million different Binford shares are traded. When Binford Corporation finally discloses the good news to the public, the price of its stock will rise by ten percent less some amount that reflects the likelihood that Binford will become the target of an SFCA. Given that 60 percent of Binford shareholders sold during the fraud period and that the increase in value is one dollar per share, one would expect that the damages payable to the sellers will total \$6 million. But if the company pays out \$6 million in damages, its value is reduced by that amount, which in turn causes the market price to drop back from \$11, which in turn decreases the per share damages. The process repeats itself through a *negative* feedback mechanism. The market price falls a bit less with each iteration. If the market is working perfectly, the price will equilibrate at \$10.625 per share. What should have been a ten percent increase in price will have been muted by normal market mechanisms to become a 6.25 percent increase in price because of the prospect of SFCA damages.⁵⁵

the funds will be reinvested. Money -- like matter and energy -- can neither be created nor destroyed. Thus, all awards are ultimately mere rearrangements of wealth. That does not mean, however, that we do not need to get it right. Clearly the argument proves too much. *See generally* Ronald H. Coase, *The Problem of Social Cost*, 3 J. L. & Econ. 1 (1960).

⁵⁵ For a more detailed derivation of the solution, see the appendix.

One can calculate the total percentage increase in market price in a good news case using the following formula:

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

Note that the formula makes it clear that the greater the percentage of shares damaged (that is the greater the turnover of *different* shares), the smaller the total increase in market price (and the smaller the aggregate damages or settlement value). The following chart sets forth the results for Binford at various levels of turnover.

GOOD NEWS CASE EXAMPLES

Assume hypothetical pre-damages increase of \$10M:

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

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

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

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

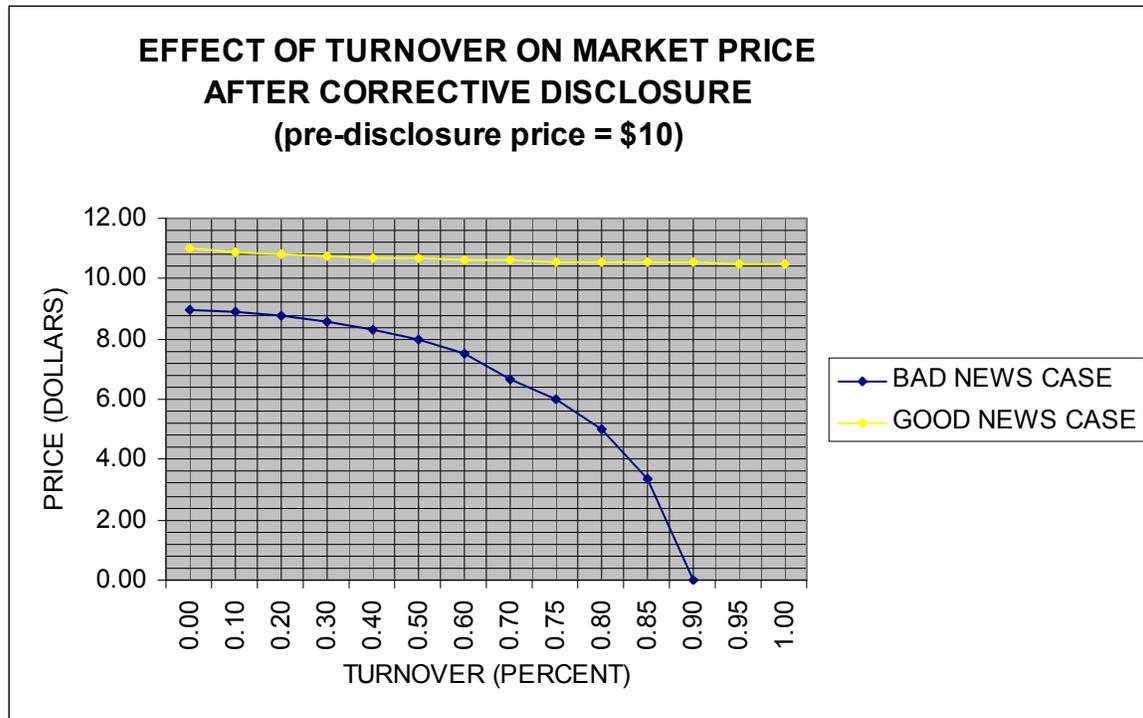
If 80% of shares are damaged, total award is \$4.44M or \$.556/share.

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

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

D. Why Bad News Cases Predominate

Although it probably goes without saying at this point, the difference between a good news case and a bad news case is striking. In the examples – both of which involve a hypothetical ten percent change in stock price – the price rises in the good news case by only 6.25 percent whereas it falls in the bad news case by 25 percent. Moreover, as the number of shares traded increases, the price change becomes ever smaller in the good news case and ever larger in the bad news case. In a good news case, the price change reaches a limit equal to half of the hypothetical percentage decrease. But in a bad news case, there is no downside limit at all. If enough shares trade, the price of the stock will fall to zero. The graph depicts the relationship.



It is thus not at all surprising that bad news cases are far more common than good news cases and that cases with long class periods are more serious than those with short class periods. The system makes it so. But it makes no sense for the system to be skewed in this way. In an efficient market, the chances should be fifty-fifty that the next price move will be up or down. One would think that securities law should see a given price change in either direction as equally important. But as things stand, the law punishes failure to disclose bad news far more severely than failure to disclose good news.⁵⁶

IV. ISSUER RECOVERY AND DERIVATIVE ACTIONS

It is easy to fix the feedback problem. Diversified investors can be made whole by *issuer* recovery of insider gains. Consider a case of bad news fraud accompanied by

⁵⁶ To be sure, investors are said to be risk averse and may thus care more about bad news than good news. And the markets have always been skeptical of short sellers. The stock markets (unlike the commodity markets) impose restrictions on short selling. Thus, there is some precedent for asymmetric regulation. But the rules against short selling are widely criticized as a drag on market efficiency. Moreover, it is unclear that these rules have much impact in a market in which options and futures on stocks are readily available. One feature that may differentiate stocks from other investments, is that stock prices tend to go up over time. Nevertheless, investors generally recognize that there are nearly as many opportunities to make money when prices go down as when they go up. In addition, it is not at all clear that stock investors are in fact risk averse *vis a vis* individual stocks. Indeed, a diversified investor is risk neutral (if not risk preferring) precisely because of diversification. Thus, a diversified investor is has a strong preference for accurate pricing in both directions, and should be opposed to any system that skews access to information or the impact of new information.

insider selling before disclosure. If the company recovers the insider gains, the value of the company is increased by the amount the insider extracted from the market (ignoring attorney fees and other costs of recovery) and diversified investors end up precisely where they would have ended up in a simple fraud case. The feedback effect does not arise, *because the recovery goes to the company*. Thus, securities fraud actions involving insider trading should be litigated in the name of the issuer, either by the issuer directly or by means of a derivative action by a stockholder.

This solution does not require any change in statutory law. Rather, actions alleging simple securities fraud should be dismissed for failure to allege damages.⁵⁷ Actions alleging securities fraud accompanied by insider trading of some variety should be classified as derivative rather than direct.⁵⁸ It is well settled that the question whether an action is derivative or direct is one for the court.⁵⁹ If the real harm from securities fraud is akin to insider trading, then it seems clear that the cause of action belongs to the company.⁶⁰ After all, the offense of insider trading is based first and foremost on the

⁵⁷ It is important to emphasize that the argument for this fix does not necessarily depend on the assumption that all investors *are* diversified. It is enough that most investors are diversified, or indeed that they are able to diversify costlessly. Even in a world of mostly undiversified investors, one might argue that the risk of buying or selling at the wrong moment is one that investors willingly assume. The fact that a stock may fall or rise abruptly when new information comes to light will inevitably fall *somewhere* whether or not the disclosure is timely. Thus the law might deny recovery to undiversified investors on a theory akin to contributory negligence or assumption of risk. Although the due diligence defense under Rule 10b-5 has been narrowed in recent years, it is still recognized. *See Teamsters Local 282 Pension Trust Fund v. Angelos*, 762 F.2d 522 (7th Cir. 1985). I do not mean to suggest here that securities fraud actions in which there is privity between buyer and seller are abusive or should be curtailed. Indeed, an action by a company against an agent who trades on inside information is such an action. Moreover, in such an action the allegation is that the defendant traded with the plaintiff on the basis of material non public information and that the defendant owed a direct duty to the plaintiff not to do so.

⁵⁸ In the alternative, all SFCAs could be classified as derivative rather than direct on the theory that the only actions that may proceed are derivative actions. It would then be up to the subject company to seek dismissal of those cases not involving a duty of loyalty problem such as misappropriation through insider trading. It is conceivable also that the subject company might choose to proceed against individuals who misled the public on the grounds that the corporation has a state law duty of disclosure. *See Malone v. Brincat*, 722 A.2d 5 (Del. 1998).

⁵⁹ *See Tooley v. Donaldson, Lufkin, & Jenrette, Inc.*, 2004 Del. LEXIS 161.

⁶⁰ Both the Second Circuit and the Ninth Circuit have recently reiterated that allegations of *unusual* insider trading may constitute evidence of *scienter*. *Levi v. Corning, Inc.*, 2005 U.S. App. LEXIS 5259 (2d Cir.); *Sparling v. Daou*, 411 F.3d 1006 (9th Cir. 2005). On the other hand, data show that allegations of insider trading are not a reliable predictor that an SFCA will survive a motion to dismiss. *See A.C. Pritchard & Hillary A. Sale, What Counts as Fraud? An Empirical Study of Motions to Dismiss Under the Private Securities Litigation Reform Act*, at 25 (U. Mich. Working Paper #03-011, 2003), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=439503. As Pritchard and Sale point out, insider trading is a noisy signal. In many companies insiders trade quite frequently, because much of their compensation comes in the form of stock options, and when an option is exercised, one must sell at least enough option stock to cover the tax due on the gain. Moreover, because insiders are heavily invested in the stock of their own companies, they need to diversify. Thus, the courts are quite correct to require a showing of *unusual* insider trading in order to satisfy the requirement that *scienter* be pleaded with particularity. Notwithstanding the fact that unusual insider trading may be evidence thereof, *scienter* is not the issue for

misappropriation of information from the company. And even if one grants that insiders also owe a duty to investors not to trade on material non public information, the *primary* duty is one owed to the company.⁶¹

So far, the focus here has been on securities fraud not involving an offering by the issuer company. But some SFCAs involve offerings.⁶² As with securities fraud with insider trading, when a company issues stock without disclosing negative material information about the company's business, the company effectively extracts capital from the market without giving the market the opportunity to determine a fair price. Obviously, if the company has sold stock fraudulently, it makes no sense for the company to recover. The appropriate remedy is disgorgement. That is essentially the remedy mandated by the 1933 Act. But under the 1933 Act the total award is limited to the amount of the offering.⁶³ Accordingly, there is no possibility of feedback in such cases. It is quite appropriate in such a case for aggrieved investors -- whether diversified or not -- to recover from the company itself. As long as recovery is limited to those investors who bought the stock improperly issued by the company, such a remedy has none of the untoward consequences of SFCAs based on Rule 10b-5.⁶⁴

present purposes. Rather the point here is that plaintiff classes do not suffer harm in the absence of insider trading or the equivalent. In other words, the issue here is loss causation.

⁶¹ Most commentators who have tackled the anomalies of damages and settlement in connection with SFCAs have advocated either a statutory limit on awards or a system of fines. *See* Janet Cooper Alexander, *Rethinking Damages in Securities Class Actions*, 48 *Stan. L. Rev.* 1487 (1996); Donald C. Langevoort, *Capping Damages for Open-Market Securities Fraud*, 38 *Ariz. L. Rev.* 639 (1996). Both such solutions would inevitably be somewhat arbitrary. The central reform suggested here -- direct action by aggrieved issuers backed up by the threat of a shareholder derivative action -- has the distinct advantage of affording a remedy that is both precise and adjustable to the harm.

⁶² The Thakor study found that 70 of 482 actions studied involved IPOs. *See* Thakor *supra*.

⁶³ *See* Securities Act §11(g); *Hertzberg v. Dignity Partners, Inc.*, 191 F.3d 1076 (9th Cir. 1999).

⁶⁴ To be sure, it is common in an action in connection with an offering also to include a general claim based on Rule 10b-5. And except in cases in which the offering is an IPO, it is likely that a class action will be filed on behalf of all investors who bought during the fraud period, not just those investors who bought stock in the offering. Thus, the number of allegedly damaged shares may exceed the number of shares offered. In any event, a Rule 10b-5 claim is superfluous with respect to shares sold by the company as part of the offering if the remedy under both is disgorgement and the issuer company is required to disgorge under the 1933 Act anyway. If Rule 10b-5 claims are limited to claims in the name of the company to recover gains from insider trading, such a claim would be out of place in a case involving an offering, unless insiders also engaged in selling previously outstanding shares during the offering. But any such claim would arise under the 1934 Act anyway. Thus, assuming that open market securities fraud actions under Rule 10b-5 are limited to actions in the name of the company, investors remain fully protected by the 1933 Act. The 1934 Act adds nothing to a claim involving an offering. The Supreme Court has suggested on at least two occasions that the reach of the securities laws should be similarly limited. *See* *Gustafson v. Alloyd Co.*, 513 U.S. 561 (1995) (limiting claims under §12 of the 1933 Act to offerings); *Herman & McClean v. Huddleston*, 459 U.S. 375 (1983) (suggesting under the doctrine of nullification that Rule 10b-5 should be applied in connection with an offering only if it affords a remedy in addition to the 1933 Act). Janet Alexander has suggested that one of the reasons that a stock's price may crash in a case involving an offering is that buyers in an offering obtain what she calls a *litigation put* that effectively guarantees that the company will buy back the stock at the offering price if the price falls because of some failure to

Issuer recovery also presents difficulties if the fraud involves the *repurchase* of stock by the issuing company. In cases in which a repurchase has the effect of raising stock price so that insiders can sell at artificially inflated prices, a derivative action against the insiders is a perfectly adequate remedy.⁶⁵ But suppose that a company issues an unduly gloomy press release --depressing its own stock price -- and then proceeds to buy back shares.⁶⁶ It would hardly make sense for the company to recover damages in such a case. Indeed, the company would need to sue itself to do so. Even if there is no insider trading during the fraud period, insiders may increase their proportionate ownership of the company, effectively banking gains for a later day, without ever trading.⁶⁷ And that constitutes an extraction of wealth from the public market.⁶⁸

It may be appropriate to permit SFCAs in this one context. If handled properly, SFCAs relating to fraudulent repurchases need not give rise to a feedback problem because the number of damaged shares and hence aggregate damages can be determined with precision. To be specific, the number of damaged shares is the number of shares repurchased by the company, and the aggregate damage to the public is that number multiplied by the price increase following corrective disclosure (adjusted for dilution).⁶⁹

disclose material information. See Janet Cooper Alexander, *The Value of Bad News in Securities Class Actions*, 41 UCLA L. Rev. 1421, 1427 (1994). In other words, the risk of buying stock in an offering *at the offering price* is more or less eliminated by the statutory remedies afforded by the 1933 Act. When a fraud occurs, the litigation put effectively expires and ceases to protect subsequent investors from any further decline in price. The same is presumably true for all investors when the statute of limitations expires, but there is no evidence that the market declines then. Obviously, the litigation put theory can explain a price crash only in a case involving an offering (and an IPO at that). Even then, the litigation put affords no protection at prices above the offering price even though many investors in the aftermarket pay prices that are well above the offering price. And it affords no explanation in connection with an open market case arising *solely* under the 1934 Act. Given that the focus here is on non-1933 Act cases, the litigation put does not come into play. Nevertheless, I doubt that the litigation put has independent value from the prospect of recovery in a legal action under the 1933 Act once it is filed. In other words, the idea that the litigation put has independent value is a result of double counting.

⁶⁵ Jesse M. Fried, *Insider Signaling and Insider Trading with Repurchase Tender Offers*, 67 U. Chi. L. Rev. 421 (2000).

A similar problem arises if the company grants options at a time when stock price is artificially depressed. See *SEC v. Texas Gulf Sulphur Co.* 401 F. 2d 833, 862 (2d Cir. 1968). Cheap options result in the extraction of value by the recipients just as if they had engaged in insider trading. Charles M. Yablon & Jennifer Hill, *Timing Corporate Disclosures to Maximize Performance-Based Remuneration: A Case of Misaligned Incentives?* 35 Wake Forest L. Rev. 83 (2000). Again, recovery by the company works just fine as a remedy. Moreover, under the Sarbanes Oxley Act insiders must disgorge any gains resulting from the effects of false information on market prices even in the absence of fraud.

⁶⁶ Such cases are presumably rare, because companies have a strong incentive to disclose good news. Moreover, the Thakor study found that on balance institutions enjoyed gains in such cases. See Thakor *supra*.

⁶⁷ See Jesse M. Fried, *Insider Abstention*, 113 Yale L. J. 455 (2003).

⁶⁸ See Securities Exchange Act Rule 10b-18.

⁶⁹ As with a 1933 Act case, the damages are limited to the number of shares repurchased by the company.

Only those stockholders who sold during the fraud period may recover.⁷⁰ To be sure, there are likely to be many more shares traded during the fraud period than the number bought back by the company. Thus, the award to each class member is likely to be quite small.⁷¹

V. IMPLEMENTATION

The practical question for a court is whether a securities fraud action is direct or derivative. The answer depends on whether the harm is primarily to the corporation or to individual stockholders and whether recovery should go to the corporation or individual stockholders.⁷² In light of the analysis herein, it seems clear that a securities fraud action should be seen as derivative in nature. Assuming that reasonable investors diversify, and that federal securities law aims to protect reasonable investors, the only harm that comes from securities fraud is the harm that results from insider misappropriation of gain. To be sure, that is a harm that is suffered collectively by the stockholders, and not by the company itself except in the sense that it affects company reputation. But the harm that the stockholders suffer is harm from a general reduction in stock price (however small it might be in the absence of an SFCA) that they would suffer equally (again in the absence of an SFCA). Harm that affects all stockholders equally by affecting stock price is classically derivative.⁷³ Again, whether an action is direct or derivative is a question for the court. It is in effect a matter of law – albeit procedural law.⁷⁴

⁷⁰ One might argue that fraudulent repurchase constitutes a direct and non *pro rata* harm to those stockholders who sold their shares back to the company on the cheap and accordingly is an appropriate case for a direct action (class action) rather than a derivative action. One might also think of the repurchase as rearrangement of wealth within the corporation akin to a recapitalization.

⁷¹ Members of the plaintiff class will ordinarily recover more under this measure of aggregate damages than they would under the current measure, because feedback in a good news case tends to mute the change in market price upon corrective disclosure.

⁷² In the alternative, some courts have suggested that the answer depends on whether all stockholders have suffered the same harm, or if the harm consists in the differential treatment of stockholders of the same class. By the same token, one might say that where recovery by the corporation results in equal treatment of stockholders, the action should be seen as derivative and not direct.

⁷³ In other words, the argument (for example) that buyers in a bad news case suffer differently from holdover stockholders (and sellers) is based in large part on the threat of SFCAs. In the absence of that threat, all stockholders (other than sellers who do not really count) would suffer the same harm, whereas following recovery from an SFCA buyers are made whole at the expense of holdover stockholders. Thus, the different treatment of stockholders is the *result* of the SFCA. The argument that buyers are different because they bought into a sinking ship when holders would have suffered losses anyway ultimately begs the question.

⁷⁴ As noted above, and whether or not the action is classified as direct or derivative, the court must determine whether the individual plaintiff is an adequate representative of the class or the corporation as the case may be. If rational investors diversify, presumably only a diversified investor can qualify as an adequate representative. Moreover, if the argument herein is correct, a diversified representative should be opposed to litigating any claim that does not involve insider trading or the equivalent, and would prefer to

There are also powerful contextual arguments for the idea that SFCAs should be seen as derivative in nature when there is insider trading involved. Congress has explicitly endorsed recovery by the company – and by derivative action when necessary – in Section 16(b) of the 1934 Act. That section famously creates a bright line rule requiring insiders to disgorge *to the company* any gain from short swing trading. Specifically, Section 16 applies to officers, directors, and ten percent stockholders of 1934 Act registered companies and provides that any profit (or loss avoided) from the purchase and sale or sale and purchase of equity securities may be recovered by the issuing company. Further, Section 16(b) explicitly creates a right of action in the name of the issuer and provides that if the issuer fails to bring suit within 60 days of a demand by a stockholder, the stockholder may recover on behalf of the issuer. Although Section 16 is largely dismissed these days as an outdated notion of what constitutes insider trading (and a trap for the unwary), it is nonetheless a clear statement by Congress that *the issuer* should recover.⁷⁵

In addition, it is arguable that SFCAs enhance damages artificially through feedback (in bad news cases) and that the feedback portion of damages is in excess of actual damages. Thus, it is also arguable that Section 28 of the 1934 Act, which provides that recovery under the act is limited to recovery of actual damages, dictates that SFCAs be recast as derivative.⁷⁶ In other words, given that SFCAs have the effect of magnifying the harm, it follows that investors may only recover amounts misappropriated by insiders if any.⁷⁷

litigate those claims as derivative claims. Thus, it would seem that one way to implement the solution proposed here is to make it part of the review of plaintiff adequacy under FRCP 23 and FRCP 23.1.

⁷⁵ It is curious that up to now this provision has not inclined anyone to argue that SFCAs should be prosecuted by the issuer or derivatively. Of course, the argument would depend on the willingness of issuers to prosecute such actions. Thus, it is perhaps understandable that issuers have chosen to fight rather than switch. But as I have shown here, the SFCA alternative is more odious. It is also arguable that the Sarbanes Oxley Act (with its emphasis on internal controls) expresses a Congressional preference for such an approach.

⁷⁶ Some legal scholars have argued that the price effect of litigation may be regarded as consequential damages that are a proximate result of the fraud. 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). See also Janet Cooper Alexander, *The Value of Bad News in Securities Class Actions*, 41 UCLA L. Rev. 1421 (1994). The implication is that crash damages ought to be cognizable and compensable. To the contrary, my argument here is that such damages are a cost of a *system* that relies on SFCAs. Although one might be tempted to argue that plaintiff attorney fees also contribute to excess price decline, fees are paid out of the award. They reduce the payment per share to class members, but they do not directly increase the payout by the company. On the other hand, generous attorney fees do effectively insure that SFCAs will be filed.

⁷⁷ It is also worth noting that a derivative action is presumably cheaper to prosecute than is a class action, which involves identification of and notice to all class members. Moreover, a derivative action effectively represents all of the stockholders rather than only those who traded during the fraud period, and if the action is successful, the company pays the attorney fees based on the benefit to the company which may arguably exceed the monetary recovery. Thus, there remains a substantial incentive for the plaintiff bar to prosecute such actions.

Admittedly, it is also arguable that Congress has recognized by statute that securities fraud is direct in nature. For example, the Private Securities Litigation Reform Act (PSLRA) and the Securities Litigation Uniform Standards Act (SLUSA) both seem to recognize that a class action is the appropriate procedure for securities fraud by virtue of numerous provisions that address how SFCAs should be conducted. But one might also argue that these acts simply acknowledge that SFCAs exist.⁷⁸ In addition, one might argue that in the Insider Trading & Securities Fraud Enforcement Act (ITSFEA) Congress recognized an individual cause of action for insider trading. But that does not mean that the company has somehow lost its right to enforce fiduciary duties owed to it by its agents.⁷⁹ Indeed, the primary legal theory upon which insider trading is deemed to be an actionable wrong is misappropriation.⁸⁰ Moreover, the courts have held that a stockholder has no right to assert a misappropriation claim directly.⁸¹

⁷⁸ It is ironic that when Congress enacted the Securities Litigation Uniform Standards Act (SLUSA) in response to the migration of SFCAs to state court after PSLRA, a provision known as the Delaware Carve Out (DCO) was included to preserve the traditional jurisdiction of state courts over stockholder derivative actions. The suggestion here is that most SFCAs should in fact be litigated as derivative actions. Thus, under the DCO, such actions may be brought in state court after all even though SLUSA was clearly intended to preempt state law actions based on theories of nondisclosure as opposed to fiduciary duty. Of course, it is also possible to pursue a derivative action in federal court. Indeed, if the action is ultimately based on a Rule 10b-5 claim asserted by the company, it *must* be litigated in federal court. But the strongest claim will often be one based on common law agency principles. Treating SFCAs as derivative actions would also have the salutary effect of eliminating the problem of determining the number of damaged shares represented by the plaintiff class. This problem has proved to be utterly intractable and has given rise to dubious statistical models that purport to estimate total damages in SFCAs. (Indeed, this article started out as a one addressed to that subject.) To be sure, only shareholders who are shareholders at the time of the wrong and who remain shareholders have standing to sue. Thus, it might be argued that no one would have standing (or motivation) to sue in a case of good news fraud. Although such cases are much less common than bad news cases and thus are less worrisome, it quite seems likely that the plaintiff bar will rise to the challenge. After all, holdover shareholders have standing to sue derivatively and can argue that the company should recoup any illicit gains of its agents. Thus, there is no real contemporaneous ownership problem. And again, selling stockholders are ultimately protected by diversification. That is, they will sometimes gain from windfall awards in good news cases. Finally, one should not dismiss the possibility that publicly traded companies might become quite aggressive about policing insider trading if the collateral damage from doing so were not as devastating as it is under the current system. *Cf.* *Carpenter v. United States*, 484 U.S. 19 (1987). On the other hand, there is some chance that the courts might dismiss a derivative action if it appears that too many shares have traded during the fraud period. *See Bangor Punta Operations v. Bangor & Aroostock R.R.*, 417 U.S. 703 (1974). One would hope not in that diversified investors will depend on recovery in as many meritorious cases as possible whether or not they were a stockholder at the time of the fraud.

⁷⁹ Moreover, ITSFEA limits individual recovery for insider trading to the profits of the insiders who traded, net of any other recovery including presumably a recovery by the company. One might even argue that SFCAs are a roundabout way of avoiding this express limitation on recovery. It is worth noting that ITSFEA does not apply to the issuer company which would not be limited to recovery of the insider gains, but might seek compensation for consequential harm.

⁸⁰ *See United States v. O'Hagan*, 521 U.S. 642 (1997). It may also be possible for a company to limit a stockholder's right to sue directly by an appropriate provision in its articles of incorporation.

⁸¹ *See Moss v. Morgan Stanley Inc.*, 719 F.2d 5 (2d Cir. 1983). One might also argue from *Blue Chip Stamps*, that only traders have standing to sue under Rule 10b-5 and that a derivative action effectively

VI. THEORETICAL & POLICY IMPLICATIONS

The analysis of SFCAs herein assumes (1) that insider trading is a bad thing and (2) that inside stockholders and outside stockholders should be seen as two distinct groups with interests that may conflict. Neither of these assertions is non-controversial.

Again, diversified stockholders are indifferent to simple securities fraud but not to fraud with insider trading. It may be a bit too strong to say that the argument *assumes* that insider trading is a bad thing. The argument is simply that diversified public investors suffer no reduction in aggregate wealth from securities fraud unless it is accompanied by insider trading or the equivalent. Accordingly, these are the only cases in which diversified stockholders would favor a remedy.

The assumption that insider trading is a bad thing will not bother most readers. But some legal scholars have argued that insider trading should not be illegal and may even be beneficial.⁸² Moreover, if one thinks of the market as including both insiders and outsiders, then there is no net effect on aggregate stockholder wealth. If so, all SFCAs should be dismissed outright. Thus, only if one thinks of these two groups of stockholders as having somewhat adverse interests is there any basis for SFCAs.⁸³ But if they do have

permits non trading holdover stockholders to gain the benefits of a securities fraud action. It is well settled, however, that Rule 10b-5 will support a derivative action for example where a corporation is harmed by one of its agents through trading in securities. To be sure, in most SFCAs other than those involving stock options, the corporation itself will not have traded in its own stock. But in *O'Hagan* the Supreme Court held that the misappropriation of business information for purposes of insider trading is a sufficient nexus to support a cognizable breach of duty to the corporation under Rule 10b-5. In other words, *O'Hagan* would seem to limit the applicability of *Blue Chip Stamps* where the issuer corporation is the plaintiff in an insider trading case. Moreover, in *Malone v. Brincat*, 722 A.2d 5 (Del. 1998), the Delaware Supreme Court recognized a fiduciary duty of timely disclosure for the benefit of traders and non traders alike, which would seem to support the idea that a non trading stockholder has standing to maintain a derivative action based on Rule 10b-5. And even if it does not support a federal action, it clearly supports a state law derivative action by which stockholders may be made whole. Finally, it is well settled that a principal need not plead or prove loss in order to recover for a breach of fiduciary duty by an agent (as in connection with recovery of secret profits obtained by an agent). See Restatement (Second) of Agency §§ 402 – 404; *Cede & Co. v. Technicolor*, 634 A.2d 345 (Del. 1993). But see *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156 (Del. 1995). Notwithstanding the recent development of state law relating to disclosure, it might be argued that in spirit SLUSA requires all actions based on some claim of non-disclosure, should be litigated in federal court. See *In re Mutual Funds Investment Litigation (Janus Subtrack) (MDL 1586)*, 384 F.Supp.2d 873 (D. Md. 2005). Indeed, one might argue as much from the fact that federal jurisdiction is exclusive under the 1934 Act. In any case, it matters little for present purposes whether the claim would be litigated in federal or state court. All that matters is that it be litigated as a derivative claim.

⁸² See Henry G. Manne, *Options? Nah. Try Insider Trading.*, Wall Street Journal, August 2, 2002 at A8; Richard A. Booth, *Insider Trading, Better Markets*, Wall St. J., June 28, 1991 at A12.

⁸³ It well recognized that various classes of security holders and even stockholders may have interests that conflict with each other. Indeed, most cases involving the rights of preferred stockholders and bondholders are based on such conflicts. Moreover, the courts have recognized that interests may conflict within a class and that a court may consider such conflicts when appropriate. See *Unitrin, Inc. v. American General Corp.*, 651 A.2d 1361 (Del. 1995). On the other hand, the courts have also recognized that the corporation is free within a broad range of action to manipulate finances in favor of the common stockholders.

somewhat adverse interests, it seems to follow that insider trading should be legally cognizable.⁸⁴

The argument that all stockholders -- inside and outside -- should be viewed as one big happy family with congruent interests clearly proves too much. Few if any would question the policy behind the 1933 Act that offerings under false pretenses designed to gain access public capital should be prohibited (even if one has quibbles with the details of how the act works). In other words, although one might argue that a fraudulent stock offering is ultimately nothing more than a rearrangement of wealth among investors, it is a rearrangement that we choose to prohibit.

Moreover, even those scholars who do not see intrinsic harm in insider trading will likely acknowledge that there may be subtle dangers. Insiders may withhold information in order to make time to execute trades. Or the company may even choose to go public in order to create opportunities for insider trading. Thus, it seems that the debate about whether insider trading is in fact harmful relates primarily to those trades that do not involve intentional withholding of information from the market.

One standard argument against the illegality of insider trading is that it seems to be a victimless wrong. Unsuspecting investors who take the other side of a trade based on inside information, presumably would have traded anyway, and would have lost what they lost whether or not an insider had been in the market. Moreover, even if one could identify those particular investors who took the other side of the trade, it is unclear that they should be favored with a recovery when others were in the market at the same time. But if the recovery is distributed among all contemporaneous outside traders (as it is under current law), the amount that would be recovered by each outsider would likely be *de minimis*.

One obvious response is that the insider who is in the market because of inside information adds to the trading volume and thus is responsible for some small increase in volume. (Specialists and market makers will always be there to accommodate these trades.) But that does not avoid the problem of how to distribute the recovery and whether it is worth the candle. To be sure, the deterrent effect may be more important than positive recovery. But deterrence is difficult to measure, particularly if one is concerned with the value of cases in which there is no intentional withholding of material information.

Arguably, the debate about the harm from insider trading would likely be mooted by treating SFCAs as derivative in nature. Simply stated, if insider trading is seen as a claim belonging to the corporation, most of the problems that arise from the private

⁸⁴ Stockholders could in theory waive any claim in connection with insider trading, for example, by means of a provision in the articles of incorporation adopted prior to a public offering. But it does not seem that any company has ever attempted to do so. And it is unclear that a company that did do so would ever be able to sell its stock.

prosecution of such claims magically disappear. Specifically, if the corporation recovers the ill gotten gains of its faithless agents, the value of the corporation and its stock should increase by just enough to compensate for the harm to public investors. Moreover, the recovery would automatically be spread over all the stockholders.⁸⁵

Whether or not one questions the wisdom of deeming insider trading to be illegal, it is quite clear that it is and that the legal foundation for that conclusion is solid.

First, it is clear that directors, officers, major stockholders, and indeed employees owe a fiduciary duty to the corporation. And it is well established that that duty extends to self-dealing, appropriation of opportunities, and competition with the corporation, any one of which may comprehend insider trading.⁸⁶ It is well recognized that insider trading may be a violation of fiduciary duty.⁸⁷

Second, even in the absence of fiduciary duty, it is clear that corporation law presumes that each stockholder of a given class is entitled to equal financial rights unless the articles of incorporation provide otherwise.⁸⁸

Third, it is clear that any compensation paid to insiders must be authorized by the board of directors or an agent to which it has delegated that authority.⁸⁹

Fourth, the use of inside information for profit and without permission may constitute an independent wrong under mail and wire fraud laws.⁹⁰

Fifth, stock exchange rules also prohibit insider trading. Moreover, stock exchange rules now generally require stockholder approval of equity compensation.⁹¹ These rules may be seen as an implicit part of the contract with stockholders or as a warranty as to the package of rights carried by a share of stock.

⁸⁵ Admittedly, in a good news case, those who sold would not share in the recovery. But the forces of diversification would make them whole over time.

⁸⁶ See ALI Principles of Corporate Governance § 5.04.

⁸⁷ See *Diamond v. Oreamuno*, 24 N. Y. 2d 494 (1969); *Brophy v. Cities Service Co.*, 31 Del.Ch. 241 (1949). But see *Schein v. Chasen*, 478 F.2d 817 (2d Cir. 1973), *vacated and remanded sub nom.*, *Lehman Bros. v. Schein*, 416 U.S. 386 (1974), *on certification*, 313 So.2d 739 (Fla.1975); *Freeman v. Decio*, 584 F.2d 186 (7th Cir. 1978).

⁸⁸ See MBCA 6.01. The same goes for the rights of partners as between each other. See UPA § 18; RUPA § 401.

⁸⁹ See ALI Principles of Corporate Governance §5.03.

⁹⁰ See *Carpenter v. United States*, 484 U.S. 19 (1987).

⁹¹ See SEC Assents To Shareholders' Right To Rule On Equity Compensation Plans, 35 Sec. Reg. & L. Rep. (BNA), July 7, 2003 at 1103.

Sixth, Section 16(b) of the Exchange Act provides that the corporation has a right of action against an insider in connection with short swing trading.⁹² By analogy, the corporation should have a similar right in connection with other forms of insider trading.

Although the foregoing arguments suggest that insider trading must be seen as illegal, none quite answers the question whether insider trading is intrinsically wrong. It is not clear that the question has -- or needs -- an answer, because it is quite clear that all investors (both diversified and undiversified) will favor a rule that prohibits the secret reduction of their returns.⁹³ Clearly, a company *may* adopt an internal rule providing that information obtained in the course of business is deemed to be a company asset for business use only. Indeed, it seems likely that in the absence of some sort of waiver, the law would presume as much as it currently stands. Such a rule presumably increases trust in the market and keeps stock prices higher for all than they otherwise would be in the absence of such a rule. In other words, insider trading has social costs that can easily be avoided by imposing a rule that investors might not be able to negotiate on their own. And that is a pretty good rationale for a legal rule.⁹⁴

In addition, it may matter *why* companies go public. Although the conventional view is that companies go public to raise capital in order to grow, there are other reasons that may be even more important. Companies also go public in order to create a liquid market for their stock with continuous pricing. That also permits the use of equity compensation (such as stock options) and permits insiders to gain diversification. The use of equity compensation in turn entails active management of float through repurchases. Under the conventional view, once a company goes public, trading is of little direct moment to the company. Traders may trade all they want, but the company has its money. What the market thinks matters little. Under the expanded view, the company cares very much about the market, because the market is the gateway to liquidity and diversification. Going public is merely a first step in creating a market that permits the company to sell (and buy) stock more or less on demand. To be blunt, insiders need the market so they can bail out at will.

Although many might at first espouse the conventional view that the primary purpose of going public is to raise money, it is clear that insiders continue to care about the market despite the fact that the proceeds of the offering are long since in the bank. And it is not simply because they fear the wrath of the SEC if they fail to serve the stockholders. Thus, it seems quite clear that for a seasoned company with no particular plan to return to the market, there is more to being publicly traded than the occasional stock offering. Indeed, in most years, publicly traded companies buy back more stock than is offered to the public.⁹⁵ The SEC has acknowledged the other functions of being

⁹² 15 USC § 78p(b).

⁹³ This probably explains why compensatory stock options have become so controversial.

⁹⁴ See Ronald H. Coase, *The Problem of Social Cost*, 3 J. L. & Econ. 1 (1960).

⁹⁵ See Federal Reserve Board, Flow of Funds Accounts of the United States 1995-2003, December 9, 2004, Table F213.

publicly traded by adopting a series of rules over the last twenty years designed to facilitate active participation in the market by issuers and insiders.⁹⁶ In short, *going public* and *being public* may be *more* about having the company stock publicly traded than it is about the cash. If so, there is every reason to worry about unauthorized access to the market by insiders. In other words, insider trading may be all about the inherent conflict between diversified and undiversified investors.

Finally, one obvious response to the idea that securities fraud and insider trading should be pursued derivatively is that corporations are likely to seek dismissal of such claims as against the best interests of the corporation, a tactic that is unavailable in connection with a class action. To be sure, corporations have a good deal of control over derivative actions. But many companies may be deterred from pursuing claims against their own agents because of the *in terrorem* effect of SFCAs. In short, the present cure is so much worse than the disease that no sane company would ever pursue such claims on its own. Indeed, it is not too strong to say that the current system of enforcement by SFCAs effectively precludes any effective form of self-policing. Treating securities fraud as a claim belonging to the company would eliminate the devastating collateral consequences of SFCAs which constitute a significant impediment to self policing.

Conclusion

Securities fraud class actions do far more harm than good. Indeed, when one considers the effects of diversification, it does not appear that anyone other than the lawyers gain from private securities litigation. Diversified buyers, sellers, and traders should be indifferent to securities fraud except to the extent that it is accompanied by insider trading. But because both defendant companies and long-term stockholders always pay, they cannot avoid the risk of securities fraud through diversification. In short, private securities litigation creates significant costs but no identifiable benefits. This is not a case in which the cure is worse than the disease. The cure is the disease. The simple solution is to view securities fraud (other than in connection with an offering) as a cause of action belonging to the issuer and accordingly to view a stockholder action as derivative in character. First do no harm.

⁹⁶ See, e.g., Securities Act Rule 415 (shelf registration and continuous offerings); Exchange Act Rule 10b-18 (safe harbor for open market repurchases); Exchange Act Rule 10b5-1 (safe harbor for insider sales pursuant to plan explicitly citing insider diversification as rationale).

APPENDIX

DERIVATION OF FORMULAS

BAD NEWS CASE

PRE-DISCLOSURE MARKET VALUE (10M shares) $\$100M = 10/\text{share}$

POST-DISCLOSURE THEORETICAL VALUE $90M = 9/\text{share}$

DAMAGES TO BUYERS (60% turnover) $6M = .60/\text{share}$

NET MARKET VALUE POST (tentative) $90M - 6M = 84M = 8.40/\text{share}$

But if market value post is 84M, then damages should be $16M \times .60 = 9.6M$.

Now market value post is $90M$ less $9.6M = 80.4M = 8.04/\text{share}$.

Process repeats to limit of $\$15M$ in total damages to buyers.

DAMAGES TO BUYERS $15M / 600K \text{ shares} = \$2.50/\text{share}$

NET TO HOLDERS $90M - 15M = 75M = \$7.50/\text{share}$

NET TO BUYERS $\$7.50/\text{share plus } \$2.50/\text{share}$

GENERAL RULE FOR BAD NEWS CASES:

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

GOOD NEWS CASE

PRE-DISCLOSURE MARKET VALUE (10M shares) $\$100M = 10/\text{share}$

POST-DISCLOSURE THEORETICAL VALUE $110M = 11/\text{share}$

DAMAGES TO SELLERS (60% turnover) $6M = .60/\text{share}$

NET MARKET VALUE POST (tentative) $110M - 6M = 104M = 10.40/\text{share}$

But if market value post is 104M, then damages should be $4M \times .60 = 2.40M$.

Now market value post is $110M$ less $2.4M = 107.6M = 10.76/\text{share}$.

Process repeats to limit of $3.75M$ in total damages to sellers.

DAMAGES TO SELLERS $3.75M / 600K \text{ shares} = .625/\text{share}$

NET TO HOLDERS $110M - 3.75M = 106.25M = 10.625/\text{share}$

GROSS TO SELLERS $10/\text{share} + .625/\text{share} = 10.625/\text{share}$

GENERAL RULE FOR GOOD NEWS CASES:

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