

REASSESSING DAMAGES IN SECURITIES FRAUD CLASS ACTIONS

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INTRODUCTION

Trading publicly listed securities on the open market is markedly different from traditional face-to-face securities transactions.¹ In turn, the modern-day fraud-on-the-market securities class action bears little factual resemblance to its common-law predecessors, deceit and misrepresentation, which provided conventional contract-based remedies for fraud in face-to-face dealings.² And yet, even though securities laws have detailed pleading standards and nuanced requirements for “loss causation,” no coherent doctrinal statement exists for calculating open-market damages in Rule 10b-5 securities fraud class actions.³ Instead, courts endeavored to fashion common-law deceit and misrepresentation remedies to fit open-market fraud.⁴ The result is a relatively ineffective system with a hallmark feature: unpredictable damage awards. This poses a significant fraud deterrence problem from both a practical and a theoretical standpoint.

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¹ The key feature of face-to-face transactions for our purposes is that the securities purchaser buys the securities directly from the corporation or a corporate agent and are thus in privity with the corporation or corporate agent. Consequently, these transactions differ markedly from open-market transactions where investors trade securities with one another through the publicly traded securities market. *See generally* Steven A. Fishman, *Duty to Disclose under Rule 10b-5 in Face-to-Face Transactions*, 12 J. CORP. L. 251, 256-57 (1987).

² *See* Janet Cooper Alexander, *Rethinking Damages in Securities Class Actions*, 48 STAN. L. REV. 1487, 1488 (1996) (“Securities class action litigation today has little in common with suits over the common law torts of fraud and misrepresentation from which the compensatory remedy was derived.”)

³ *See* Frank H. Easterbrook & Daniel R. Fischel, *Optimal Damages in Securities Cases*, 52 U. CHI. L. REV. 611, 611 (1985). This Article’s scope is limited to Rule 10b-5 actions involving secondary market transactions. Numerous securities class actions include claims under sections 11 and 12 of the 1933 Securities Exchange Act and while the damages measure under section 11 is similar to Rule 10b-5 cases, this Article focuses on Rule 10b-5. Unlike section 11 or Rule 10b-5 cases, to plead a case under section 12, plaintiffs do not have to demonstrate that the misrepresentation or omission caused them economic harm. *In re Daou Sys., Inc.*, 411 F.3d 1006, 1029 (9th Cir. 2005); *Casella v. Webb*, 883 F.2d 805, 808-09 (9th Cir. 1989); *Rousseff v. E.F. Hutton Co.*, 867 F.2d 1281, 1282 (11th Cir. 1989).

⁴ Because a corporation acts only through its agents, the corporation is often required to compensate investors for its agents’ acts. The agents themselves may not even be named in the class action and if they are, their portion of the settlement payment will likely come from directors’ and officers’ liability insurance. Lisa M. Fairfax, *Spare the Rod, Spoil the Director? Revitalizing Directors’ Fiduciary Duty Through Legal Liability*, 42 HOUS. L. REV. 393, 412-13 (2005); Alexander, *supra* note 2, at 1498; Jennifer A. Arlen & William J. Carney, *Vicarious Liability for Fraud on Securities Markets: Theory and Evidence*, 1995 U. ILL. L. REV. 691, 699 (1992). John C. Coffee, Jr. argues that to achieve optimal deterrence, agents should bear more of the costs of wrongdoing. John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation* 19 (March 2006) (unpublished manuscript, on file with author), *available at* http://ssrn.com/abstract_id=893833. *But see* Sanjai Bhagat et al., *Managerial Indemnification and Liability Insurance: The Effect on Shareholder Wealth*, 54 J. RISK & INS. 721, 726 (1987). Unless the Department of Justice prosecutes the agents for criminal actions, half or more of their settlement payment will likely come from these insurance policies, which the corporation usually pays for. *See* Alexander, *supra* note 2, at 1498.

Though precise damage calculations generally come at the end of litigation, the legal standard for measuring loss, and thus for calculating damages to remedy that loss, is important at the suit's outset to determine whether plaintiffs experienced a compensable loss for purposes of pleading a viable securities fraud action.⁵ In 2005, the Supreme Court had the opportunity to clarify what constituted a loss in the open market, which could have facilitated earlier dismissal of cases without compensable losses. Instead, dicta in *Dura Pharmaceuticals v. Broudo*⁶ further confused the damage issue by (1) perpetuating the idea that courts can tailor damages from common-law deceit and misrepresentation actions to remedy open-market fraud despite the factual disparities between the two and (2) opening the door to a new form of hypothetical losses where the stock price increases after an opportune disclosure of fraud.⁷ Although *Dura* diminished plaintiffs' ability to sue based on alleged purchase price inflation, its dicta, which indicated that plaintiffs might be able to recover when their share prices did not increase as much as they otherwise would have after the discovery of fraud, muddied the water with regard to what constituted loss.

The Supreme Court's insinuation that a new form of hypothetical losses might be recoverable destabilizes the general notion that plaintiffs are entitled to compensation only for their out-of-pocket losses. Usually, when a corporation discloses a previous unfavorable misrepresentation or omission, its stock price drops. This decline indicates that the investing public considered the information relevant. In *Dura*, the court implied that an investor might recover damages when a stock's price does not *increase* as much as it would have absent the fraud.⁸ In other words, if a corporation bundles adverse and favorable information that causes its stock price to increase, an investor without any net loss might be able to sue. This suggests that

⁵ Although a plaintiff must purchase or sell a security to have standing, she must also have experienced a loss that results in an injury. *Barr v. Matria Healthcare, Inc.*, 324 F. Supp. 2d 1369, 1376 (N.D. Ga. 2004); *see generally* *Miller v. Asenio & Co., Inc.*, 364 F.3d 223, 230 (4th Cir. 2004) ("Requiring plaintiffs to demonstrate the fact of proximately caused damage to establish 10b-5 liability precludes wholly speculative claims and claims by plaintiffs who ultimately profit from, or experience no economic pinch as a result of, the challenged transaction."); *Wolf v. Frank*, 477 F.2d 467, 478 (5th Cir. 1973) (holding that plaintiffs have standing only when they can show an injury of the type Rule 10b-5 is intended to prevent).

⁶ 544 U.S. 336, 343 (2005). Several commentators have discussed the impact of *Dura* in other respects. *See* Larry E. Ribstein, *Fraud on a Noisy Market*, 10 LEWIS & CLARK L. REV. 137, 153 (2006); John C. Coffee, Jr., *Loss Causation After Dura: Something for Everyone*, N.Y.L.J. 5 (May 19, 2005); John C. Coffee, Jr., *Causation By Presumption? Why the Supreme Court Should Reject Phantom Losses and Reverse Broudo*, 60 BUS. L. J. 533 (2005).

⁷ *Dura* indicated that "private securities-fraud actions resemble in many (but not all) respects common-law deceit and misrepresentation actions" and that litigants should examine these common-law roots to determine whether a plaintiff suffered an injury and economic loss. *Dura*, 544 U.S. at 343. The Court also noted, "The same is true in respect to a claim that a share's higher price is lower than it would otherwise have been – a claim we do not consider here." *Id.* As John Coffee observed, "to raise this issue is to suggest that it stands on the same logical footing as price inflation that results in a stock price decline." Coffee, *Loss Causation After Dura: Something for Everyone*, *supra* note 6, at 5. Even before *Dura*, some courts suggested in dicta that stockholders may experience an actionable loss if stock does not appreciate as it would have absent the fraudulent conduct. *Gebhardt v. ConAgra Foods, Inc.*, 335 F.3d 824, 832 (8th Cir. 2003).

⁸ The Court noted that its reasoning in *Dura* could also apply to "a claim that a share's higher price is lower than it would otherwise have been – a claim we do not consider here." *Id.* By mentioning the issue, the Court seemed to suggest that a price increase should be taken as seriously as a traditional stock price decline. *See* Coffee, *Loss Causation After Dura: Something for Everyone*, *supra* note 6, at 5.

plaintiffs might not be limited to damages for traditional out-of-pocket losses.⁹ A number of intrinsic problems could result from compensating investors for more than these losses. To cite but one example, providing investors with a double-recovery, one from the net stock price increase and one from class-action damages, could create a perverse incentive to invest purposefully in companies showing signs of fraud.¹⁰

To illustrate these potential effects, consider the following situation:

“We’ve Found Gold!” claims Corporation in a half-page press release in the New York Times. Corporation’s stock price increases from \$10 a share to \$50 a share. An investor calls her broker and purchases ten shares at \$50 per share. Three-months later, Corporation announces in two-inch, bold, capital letters, *“We’ve Found Platinum!”* Beneath the capitals, small, footnoted text reads *“but not gold.”* The investor’s stock soars to \$200 per share. But she wants to recover for the inflation in her purchase price based upon the gold misrepresentation.¹¹

After *Dura*, assuming that she could meet the other elements of a claim, this investor might be able to maintain a securities class action against Corporation even though she did not suffer out-of-pocket losses.¹² Although some have argued that courts should expand private litigation remedies to deter this type of opportune disclosure,¹³ the better view is that courts should limit recovery to out-of-pocket losses and recognize that private remedies need not be invariably coextensive with enforcement by the Securities Exchange Commission (“SEC”).¹⁴

⁹ Securities fraud cases on the open market have typically involved a decline in the stock price after the disclosure of wrongdoing.

¹⁰ One obvious ex ante indicia of fraud includes accounting restatements. Stephen J. Choi, *The Evidence on Securities Class Actions*, 57 VAND. L. REV. 1465, 1499 (2004).

¹¹ This example is adapted from the Supreme Court’s oral argument in *Dura Pharmaceuticals, Inc. v. Broudo*. Transcript of Oral Argument, *Dura Pharm., Inc. v. Broudo*, 544 U.S. 336, available at 2005 WL 236546, (Jan. 12, 2005). If the gold-platinum scenario sounds too hypothetical, consider a pharmaceutical company that announces higher than expected profits to create a market frenzy and later issues both a revised 10K filing revealing its past financial woes and announces that it received FDA approval for a new cancer-fighting drug.

¹² This scenario is not far-fetched. The oral argument in *Dura Pharmaceuticals, Inc. v. Broudo* contemplates but does not resolve this scenario. Transcript of Oral Argument, *Dura Pharm., Inc. v. Broudo*, 544 U.S. 336, available at 2005 WL 236546, (Jan. 12, 2005). For another example, see *In re Columbia Sec. Litig.*, 155 F.R.D. 466, 483 (S.D.N.Y. 1994) (observing that just because the price did not drop as a result of alleged misrepresentations did not preclude a fraud-on-the-market claim since the misrepresentations might have prevented a price rise that otherwise would have occurred). The court in *Gebhardt v. ConAgra Foods, Inc.* seems to think that plaintiffs should be able to recover in this situation. It observed that “stockholders can be damaged in ways other than seeing their stocks decline.” 335 F.3d at 83. “If a stock does not appreciate as it would have absent the fraudulent conduct, investors have suffered a harm.” *Id.* at 832.

¹³ See, e.g., Merritt B. Fox, *Understanding Dura*, 60 BUS. LAW. 1547, 1558 (2005) (arguing that courts should accept a variety of evidence to demonstrate price inflation and that a price drop is not necessary for recovery).

¹⁴ Although this article is not a defense of the securities class action – particularly when investors have not suffered from out-of-pocket losses – the securities class action has been defended in numerous circumstances. See, e.g., James D. Cox, *Making Securities Fraud Class Actions Virtuous*, 39 ARIZ. L. REV. 497 (1997).

Private class-action litigation is problematic in the gold-platinum hypothetical because investors were already financially advantaged when the price appreciated above the purchase price. Yet permitting corporate agents to escape liability through opportune disclosures¹⁵ impugns the stock market's integrity and could adversely affect the economy. Still, the option is not between private litigation and no enforcement. Even without a private remedy, the SEC, the Department of Justice, and the exchanges themselves can penalize corporate wrongdoing.¹⁶ Thus, limiting the availability of private class actions when investors do not experience an out-of-pocket loss does not mean that fraud would go undeterred or unpunished. Yet without a clear doctrinal statement limiting recovery to out-of-pocket losses, the securities class action is arguably available to recoup the inflation in the purchase price from the misleading gold misrepresentation.

Compensating investors (who are corporate shareholders) when the net stock price increases, injures investors by requiring them to pay significant transaction costs, such as attorneys fees, to transfer wealth from one pocket to another.¹⁷ When investors sue a corporation, its shareholders indirectly bear those costs. Because investors are diversified, they may belong to the shareholder group indirectly paying for the litigation on one day and may be in the class of investors suing a corporation on the next. Thus, in the aggregate, compensating diversified investors when the net stock price increases is a costly means for wealth redistribution.

Part I begins with a brief overview of securities laws to provide a contextual framework for approaching damage awards. Part I then follows *Dura's* directive to examine common-law deceit and misrepresentation actions for guidance on economic loss and damages in modern securities-fraud awards.¹⁸ As a result, this part also reviews courts' criteria for awarding common-law contract and equity-based damages to determine whether the criteria also apply to open-market securities violations.

Part II considers normative theories justifying the private securities class action as an enforcement tool. Even though recovering damages after plaintiffs' experience a net gain is problematic under the current system, perhaps the system should change if recovery further promoted the goals of the securities class action. Yet, after analyzing compensation and deterrence as possible goals, I conclude that compensating plaintiffs for net gains redistributes

¹⁵ Under the federal securities laws, corporations that have a duty to disclose must disclose all material information whether it is positive or negative. This use of "disclosure" in this article implies bad news and that any subsequent class litigation is comprised of purchasers who allege that they bought the security based on a misrepresentation or omission.

¹⁶ Unlike private actions, the SEC need not prove injury or damage to maintain a claim. *S.E.C. v. Rana Research, Inc.*, 8 F.3d 1358, 1363 (9th Cir. 1993); *S.E.C. v. Rind*, 991 F.2d 1486, 1490 (9th Cir. 1993); ALAN R. BROMBERG & LEWIS D. LOWENFELS, *BROMBERG AND LOWENFELS ON SECURITIES FRAUD AND COMMODITIES FRAUD* § 9:1 (2003).

¹⁷ See *infra* pages 23-24 and accompanying footnotes.

¹⁸ Securities fraud damages have long vexed courts. See, e.g., Robert B. Thompson, Symposium, "*Simplicity and Certainty*" in *the Measure of Recovery Under Rule 10b-5*, 51 *BUS. LAW.* 1177, 1179 (1996). Two suggestions in *Dura* could increase unpredictability in awarding damages and thereby decrease deterrence. First, *Dura* hints that plaintiffs might be able to sue when a security's higher trading price is lower than it might have been absent the fraud. Second, *Dura* observes that private securities fraud class actions resemble common-law deceit and misrepresentation actions – which permitted damages apart from out-of-pocket losses.

wealth among diversified shareholders (minus significant transaction costs) and may cause perverse effects on investor education and motivation. Instead, deterrence is the most substantiated rationale for private recovery. Nevertheless, without defining a criterion for awarding damages, the unpredictable nature of remedies in private class actions may decrease deterrence. To foster optimal deterrence, courts need a defined method for calculating open-market damages. Part III proposes that this method limit recovery to out-of-pocket losses and thus compensate only net losers from the fraud. This part also identifies and discusses the practical and theoretical ramifications of restricting recovery to investors who experienced a net out-of-pocket loss.

My inquiry throughout this Article focuses exclusively on open-market damages for securities fraud in class action lawsuits; I do not advocate changing damage measures for face-to-face transactions or for more traditional nonclass suits. This Article takes for granted that the SEC, the Department of Justice, and the exchanges coexist with private litigation to deter fraud, that private class-based litigation can deter fraud with appropriate damage restrictions in place, that it is (sometimes) desirable to enforce Rule 10b-5 against non-issuing corporate defendants, and that courts will continue to use the fraud-on-the-market theory at least for awhile despite numerous academic challenges to the efficient capital markets hypothesis. These assumptions are subject to ongoing debate, but they are beyond the scope of this Article's focus on determining (a) whether the system should compensate investors through private actions when their stock price does not increase as much as it would have absent fraud and (b) whether limiting investors to their out-of-pocket losses in this regard could bolster fraud deterrence.

I. MEASURING DAMAGES FROM OPEN MARKET LOSS

The appropriate method for calculating economic loss and awarding damages for open-market fraud has long proved problematic for courts.¹⁹ In all private securities fraud litigation, class actions or otherwise, damages are an essential prerequisite for maintaining a claim.²⁰ Yet, because securities fraud class-action cases generally settle before courts calculate damages, opinions are scarce.²¹ Accordingly, this section begins with a brief securities laws overview to contextualize the purpose of private remedies.

¹⁹ See Thompson, *supra* note 18, at 1179 (“The measure of recovery in a Rule 10b-5 action always has been confusing. Not coincidentally, it always has been an afterthought in Rule 10b-5 case law. Litigants seeking to establish the existence and the elements of a private cause of action under Rule 10b-5 were content to leave the measure of recovery to be resolved another day.”).

²⁰ 15 U.S.C. § 78u-4(b)(4) (2006); *Dura Pharm., Inc. v. Broudo*, 544 U.S. 336, 342 (2005).

²¹ *Miller v. Asensio & Co., Inc.*, 364 F.3d 223 (4th Cir. 2004) (“The treatises note the ‘relative paucity of decisions’ dealing with damages in Rule 10b-5 cases.”) (quoting THOMAS L. HAZEN, *THE LAW OF SECURITIES REGULATION* § 12.12, at 528 (2002)); 3 ALAN R. BLOOMBERG & LEWIS D. LOWENFELS, *BLOOMBERG & LOWENFELS ON SECURITIES FRAUD & COMMODITIES FRAUD*, § 9.1, at 9.10.14 n. 6 (2003); Daniel P. Lefler et al., *Just How Much Damage Did Those Misrepresentations Actually Cause and To Whom?: Damages Measurement in “Fraud on the Market” Securities Class Actions*, 1505 *PLI/Corp* 285, 289 (2005); Thompson, *supra* note 18, at 1179; Donald C. Langevoort, *Capping Damages for Open-Market Securities Fraud*, 38 *ARIZ. L. REV.* 639, 648 (1996); Bradford Cornell & R. Gregory Morgan, *Using Finance Theory to Measure Damages in Fraud on the Market Cases*, 37 *UCLA L. REV.* 883, 884 (1990).

A. Contextualizing Securities Laws to Provide a Framework to Understand Damage Awards

As early as 1975, the Supreme Court recognized that the securities class action “presents a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general.”²² Consequently, during the 1990s, Congress passed the Private Securities Litigation Reform Act of 1995 (“PSLRA”)²³ to rein in prolific use of the 1933²⁴ and 1934²⁵ Exchange Acts.

In passing the PSLRA, Congress stated that private securities litigation was “an indispensable tool with which defrauded investors can recover their losses.”²⁶ But it also observed that the class action device, as then used in securities litigation, injured “the entire U.S. economy.”²⁷ The Act’s supporters alleged that class-action lawyers filed frivolous complaints²⁸ and targeted deep-pocket defendants,²⁹ which produced blackmail settlements,³⁰ discouraged qualified people from serving on boards of directors, and placed heavy economic burdens on both corporations and the economy as a whole.³¹

As a result of these arguments, Title I of the PSLRA limits recoverable damages and attorneys’ fees, creates a “safe harbor” for forward-looking statements,³² requires sanctions for frivolous litigation,³³ and provides a mechanism to stay discovery pending a judicial review of a motion to dismiss.³⁴ The limit on recoverable damages entitles plaintiffs to receive only the

²² *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975). Certainly not everyone believed that securities class actions caused all of the pernicious effects that the proponents of the PSLRA and SLUSA attributed to them. See, e.g., Joseph A. Grundfest, *Why Disimply?*, 108 HARV. L. REV. 727, 743-44 (1995).

²³ 15 U.S.C. § 77z-1, 78u. The PSLRA has been criticized for making it more difficult to bring class actions in general rather than weeding out the nonmeritorious ones. See, e.g., See A.C. Prichard, *Markets as Monitors: A Proposal to Replace Class Actions with Exchanges as Securities Fraud Enforcers*, 85 VA. L. REV. 925, 960 (1999) (“But the procedural obstacles of the Reform Act do not screen out only frivolous suits: Instead, the Reform Act makes it harder to bring class actions, whatever their individual merit.”).

²⁴ 15 U.S.C. § 77a (2006).

²⁵ 15 U.S.C. § 78a.

²⁶ *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*, 126 S.Ct. 1503, 1509 (2006) (quoting the House Conference Report, 109 Stat. 737).

²⁷ H.R. Rep. No. 104-369, at 31 (1995).

²⁸ See *Novak v. Kasaks*, 216 F.3d 300, 308 (2d Cir. 2000) (“Legislators were apparently motivated in large part by a perceived need to deter strike suits wherein opportunistic private plaintiffs file securities fraud claims of dubious merit in order to extract large settlement recoveries.”).

²⁹ H.R. Rep. No. 104-369, at 31 (1995).

³⁰ For a discussion of the general theory of blackmail in the class action setting, see L. Elizabeth Chamblee, *Unsettling Efficiency: When Non-Class Aggregation of Mass Torts Creates Second-Class Settlements*, 65 LA. L. REV. 157, 222 (2004).

³¹ *Id.*; S. Rep. No. 98, 104th Cong., 1st Sess. 8-10 (1995), reprinted in 1996 U.S.C.C.A.N. 679.

³² “Deterrence is further undermined by the safe harbor that the Reform Act creates for forward-looking statements. The safe harbor immunizes such statements if they were not knowingly false when made, a departure from the ordinary standard of recklessness.” Prichard, *supra* note 23, at 962.

³³ 15 U.S.C. § 78v-4(c) (2006); see also Choi, *supra* note 10, at 1469-74.

³⁴ 15 U.S.C. § 78u-4; see also *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*, 126 S.Ct. 1503, 1511 (2006); *Felton v. Morgan Stanley Dean Witter & Co.*, 2006 WL 1149184, at *3 (S.D.N.Y. May 2, 2006). Some have observed that these reforms crippled the securities class action and undermined its application to, for example, forward looking statements. See, e.g., Cox, *supra* note 14, at 497 (defending the securities class action on both deterrent and compensatory grounds). Others have argued that the PSLRA may chill meritorious actions just as much as it does frivolous actions. See, e.g., Hillary Sale, *Heightened Pleadings and Discovery Stays: An Analysis of the Effect of the PSLRA’s Internal-Information Standard on ’33 and ’34 Act Claims*, 76 WASH. U. L. Q. 537, 537-38

difference between the sale price of the security and the security's mean price over a ninety-day period following disclosure of the information.³⁵ Title I also mandates heightened pleading requirements for §10(b) and Rule 10b-5 claims that require plaintiffs to specify each misleading statement and to provide particular facts showing that the defendant acted with the required state of mind.³⁶ Even though Congress has demonstrated a steadfast commitment to insuring market integrity, most of its reforms have erected barriers to class action recovery.

Stringent pleading requirements are one of the principal barriers to private recovery. Plaintiffs must allege the following elements to state a claim for cases involving publicly traded securities: (1) a material misrepresentation or omission; (2) scienter; (3) a connection with the purchase or sale of a security; (4) reliance; (5) economic loss; (6) loss causation.³⁷ For loss causation and standing purposes, plaintiffs must allege an injury to a legally protected interest and a causal relationship between the injury (the economic loss) and the defendant's conduct.³⁸ Defendant's conduct must, therefore, proximately cause plaintiffs' loss.³⁹

Causation has two components: transactional causation and loss causation.⁴⁰ Because many individuals turn their finances over to investment brokers and might not be aware of a misstatement (or omission), much less have relied on it, plaintiffs may plead transactional

(1998). The problem is that many times the use of discovery is the only way that plaintiffs can find viable facts to plead a strong inference of wrongdoing. See Prichard, *supra* note 23, at 961; Jordan Eth & Michael Dicke, *Insider Stock Sales in Rule 10b-5 Corporate Disclosure Cases: Separating the Innocent From the Suspicious*, 1 STAN. J.L. BUS. & FIN. 97, 105 (1994).

³⁵ 15 U.S.C. § 78u-4 (2)(1), (2). Still, this leaves open the possibility of recovery insinuated by *Dura*, that a plaintiff might recover when the price does not increase as much as it otherwise would have.

³⁶ Dabit, 126 S.Ct. at 1511 (quoting *Dura Pharm., Inc. v. Broudo*, 544 U.S. 336, 345 (2005) (internal citations omitted)). Professors Grundfest and Prichard have commented on the legislative ambiguity of "strong inference" in their 2002 *Stanford Law Review* article. Joseph A. Grundfest & A.C. Prichard, *Statutes with Multiple Personality Disorders: The Value of Ambiguity in Statutory Design and Interpretation*, 54 STAN. L. REV. 627 (2002). The "strong inference" standard first appeared in Senate Bill 240. Private Securities Litigation Reform Act of 1995, S. 240, 104th Cong. § 36(b) (1995).

³⁷ *Dura Pharm., Inc. v. Broudo*, 544 U.S. 336, 342 (2005).

³⁸ With regard to loss causation, "the plaintiff shall have the burden of proving that the act or omission of the defendant alleged to violate this chapter caused the loss for which the plaintiff seeks to recover damages." 15 U.S.C. §78u-4(b)(4) (2006); see also *Barr v. Matria Healthcare, Inc.*, 324 F. Supp. 2d 1369, 1376 (N.D. Ga. 2004); *Gaines v. Guidant Corp.*, 2004 WL 2538374, *18 (S.D. Ind. Nov. 8, 2004) (quoting *Lee v. City of Chicago*, 330 F.3d 456, 468 (7th Cir. 2003); *Packer v. Yampol*, 630 F. Supp. 1237, 1240 (S.D.N.Y. 1986); see also *Lujan v. Defenders of Wildlife*, 504 U.S. 555, 561 (1992); *Pasley v. Freeman*, 3 T.R. 5:1, 100 Eng. Rep. 450, 457 (1789) (if "no injury is occasioned by the lie, it is not actionable: but if it be attended with a damage it then becomes the subject of an action."). In securities fraud litigation under Rule 10b-5, the PSLRA includes an "additional" requirement that the plaintiff prove that the defendant's act or omission "caused the loss for which the plaintiff seeks to recover damages." 15 U.S.C. § 78u-4(b)(4).

³⁹ *Theoharous v. Fong*, 256 F.3d 1219, 1224 (11th Cir. 2001). Section 10(b) of the Securities Exchange Act of 1934 forbids (1) the "use or employ[ment]" of any "deceptive device," (2) "in connection with the purchase or sale of any security," and (3) "in contravention of" Securities and Exchange Commission "rules and regulations." 15 U.S.C. § 78j(b). *Binder v. Gillespie*, 184 F.3d 1059, 1063 (9th Cir. 1999); *Friedlander v. Troutman, Sanders, Lockerman & Ashmore*, 788 F.2d 1500, 1503 n. 3 (11th Cir.1986) (quoting *Diamond v. Lamotte*, 709 F.2d 1419, 1422-23 (11th Cir. 1983)) (citations omitted); see also *Ross v. Bank South, N.A.*, 885 F.2d 723, 728 (11th Cir. 1989) (en banc); *In re Healthsouth Corp. Sec. Litig.*, 213 F.R.D. 447, 458 (N.D. Ala. 2003).

⁴⁰ *Robbins v. Koger Props., Inc.* 116 F.3d 1441, 1448 (11th Cir. 1997); see, e.g., *Emergent Capital Inv. Mgmt. v. Stonepath Group, Inc.*, 343 F.3d 189 (2d Cir. 2003).

causation by alleging “fraud-on-the-market” if the market is “efficient.”⁴¹ The fraud-on-the-market theory establishes a rebuttable presumption that investors rely on material representations made to the public in determining whether to buy or sell a particular security.⁴² Thus, the theory satisfies both reliance and transaction causation.⁴³ To satisfy the second causation component, loss causation, the plaintiff must establish that the defendant “caused the loss for which the plaintiff seeks to recover damages.”⁴⁴ And yet, even though they are interrelated, there is a distinction between loss causation, economic loss, and damages. As measured by the out-of-pocket rule, damages compensate plaintiffs only for losses actually caused by a misrepresentation or omission.⁴⁵ So, plaintiffs must demonstrate that the defendant’s misrepresentation or omission caused the loss for which they seek to recover damages.⁴⁶

B. Dura’s Potential Impact on Remedies

The few opinions available on open-market damages generally limit plaintiffs’ recovery to out-of-pocket losses; yet, the damage issue has been subject to ongoing debate in the lower courts. The Supreme Court had the occasion to end this debate in *Dura* but opted to issue a narrow opinion instead. This section briefly examines *Dura*, both in terms of what the decision did and did not do, and aims to move beyond the current confusion over damages through exploring its sources.

In *Dura*, the plaintiffs alleged that Dura Pharmaceuticals, Inc. made false statements about its profits and about the Food and Drug Administration’s (“FDA”) likely approval of its asthmatic spray device. When Dura later disclosed that its earnings would not be as high as expected due to slow drug sales, its shares lost almost one-half of their value. Eight months later, when it announced that the FDA would not approve the device, its market price fell again

⁴¹ *Basic, Inc. v. Levinson*, 485 U.S. 224, 224 (1988). For an explanation of how *Basic* fits into the subsequent work of behavioral finance researchers, see Ribstein, *supra* note 6, at 148-50.

Academics have repeatedly challenged the validity of the efficient market theory. Although academic debate over market efficiency continues, as Donald Langevoort observes, the fraud-on-the-market theory can be justified regardless of whether markets are efficient. Donald C. Langevoort, *Taming the Animal Spirits of the Stock Markets: A Behavioral Approach to Securities Regulation*, 97 NW. U. L. REV. 135, 154 (2002) (citing Donald C. Langevoort, *Theories, Assumptions and Securities Regulation: Market Efficiency Revisited*, 140 U. PA. L. REV. 851, 876-86 (1992)).

⁴² See *Semerenco v. Cendant Corp.*, 223 F.3d 165, 178-79 (3d Cir. 2000); *In re Salomon Analyst Metromedia*, 2006 WL 1716873 (S.D.N.Y. June 23, 2006); *O’Neil v. Appel*, 165 F.R.D. 479, 500 (W.D. Mich. 1996); *In re Phillips Petroleum Sec. Litig.*, 738 F. Supp. 825, 836 (D. Del. 1990). Some have argued that the loss causation element makes no sense in fraud-on-the-market transactions because the injury flows directly from the misstatement. See, e.g., Fox, *supra* note 13, at 1549-50. This oversimplifies the issue. As we have seen, when a misrepresentation fails to produce economic damage, but the stock price declines because of market conditions, then a plaintiff should not be able to recover. The misstatement was (a) not material as evidenced by a lack of market response and (b) not the product of the later loss. To hold otherwise is to provide investor insurance for tough market conditions.

⁴³ *Dura Pharmaceuticals v. Broudo*, 544 U.S. 336, 341 (2005); *Basic*, 485 U.S. at 241; *Robbins v. Koger Props., Inc.*, 116 F.3d 1441, 1448 (11th Cir. 1997); see also Edward A. Dyl, *Estimating Economic Damages in Class Action Securities Fraud Litigation*, J. FORENSIC ECON. 12(1), at 1 (1999).

⁴⁴ 15 U.S.C. § 78u-4(b)(4) (2006).

⁴⁵ *Robbins v. Koger Props., Inc.*, 116 F.3d 1441, 1447 n. 5 (11th Cir. 1997).

⁴⁶ *Id.*

but recovered within a week. Even though stock price recovered quickly, plaintiffs argued that they suffered a loss by paying artificially inflated prices for Dura's stock.⁴⁷

Although a number of commentators anticipated a decision that plaintiffs could not plead loss causation without demonstrating a decline in stock value and thus a net loss,⁴⁸ the Court's decision settled only one issue: that a plaintiff who alleged and established that the defendant made a materially false statement had not done enough to establish loss causation without connecting the loss to the misrepresentation.⁴⁹ This holding may change the way that corporations reveal adverse information. For example, after *Dura*, the corporation may bundle adverse and favorable information, as in the gold-platinum hypothetical, in order to prevent a stock price decline.⁵⁰

The Court also recognized that intervening factors could cause a lower price instead of the misrepresentation, but then it added in dicta: "The same is true in respect to a claim that a share's higher price is lower than it would otherwise have been – a claim we do not consider here."⁵¹ The Court then reemphasized the importance of common-law deceit and misrepresentation actions in deciphering economic loss and damages.⁵²

C. The Evolution of Securities Fraud Damages

Even though modern-day securities fraud shares some elements with common-law deceit and misrepresentation actions, courts applying the common law dealt primarily with non-liquid markets and face-to-face transactions. Moreover, because of these differences, courts did not limit common-law damages to out-of-pocket losses.⁵³ Instead, they fashioned awards out of numerous damage theories including the benefit-of-the-bargain rule,⁵⁴ the out-of-pocket rule,⁵⁵

⁴⁷ *Dura*, 544 U.S. at 340. This type of allegation did not adequately plead loss causation because a purchaser could quickly sell the shares before the relevant truth began to leak out. Thus, a seller's alleged misrepresentation (and its associated inflated price) did not invariably lead to a loss, but might mean a later loss. Accordingly, loss causation limits a plaintiff's recovery for out-of-pocket damages when the loss caused by the fraud is actually less than the out-of-pocket measure. *See id.*

⁴⁸ *See, e.g., Coffee, Loss Causation After Dura: Something for Everyone, supra* note 6, at 5.

⁴⁹ Fox, *supra* note 13, at 1548.

⁵⁰ John C. Coffee, Jr., *Litigation: New Doctrine Spawns New Tactics*, N.Y.L.J. 5 (May 18, 2006, col. 1).

⁵¹ *Dura*, 544 U.S. at 343.

⁵² *Id.* As John Coffee observed, "to raise this issue is to suggest that it stands on the same logical footing as price inflation that results in a stock price decline." Coffee, *Loss Causation After Dura: Something for Everyone, supra* note 6, at 5.

⁵³ The elements for common-law fraud are similar to the elements for pleading securities fraud. At common-law, the plaintiff had to demonstrate by "clear and decisive proof" "that the defendant has made a representation in regard to a material *fact*"; "that such representation is false"; "that such representation was not actually believed by the defendant, on reasonable grounds, to be true"; "that it was made with intent that it should be acted on"; "that it was acted on by complainant to his damage; and, "that in so acting on it the complainant was ignorant of its falsity, and reasonably believed it to be true". So. Dev. Co. of Nevada v. Silva, 125 U.S. 247, 250 (1888). This case was cited by the Supreme Court in *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. at 343.

⁵⁴ *See, e.g., Osofsky v. Zipf*, 645 F.2d 107, 114 (2d Cir. 1981). *But see Smith v. Bolles*, 132 U.S. 125 (1889). In *Smith v. Bolles* the Supreme Court rejected the benefit-of-the-bargain rule because it included the "expected fruits of an unrealized speculation." It reasoned that when the asserted facts created only "speculation" they were not material. For a discussion of this case see Michael J. Kaufman, *No Foul, No Harm: The Real Measure of Damages Under Rule 10b-5*, 39 CATH. U. L. REV. 29, 35-36 (1989).

⁵⁵ *See, e.g., Levine v. Seilon, Inc.*, 439 F.2d 328, 334 (2d Cir. 1971) ("Under the 'general' laws regime of *Swift v. Tyson*, 41 U.S. 1, 10 (1842), the rule in the federal courts was that a defrauded buyer of securities is entitled

disgorgement,⁵⁶ and rescission.⁵⁷ One commentator noted that the cases contain “a mélange of rules” and that “all too often a court will give up and announce that the district court has discretion to fashion ‘a remedy to suit the particular case’ – as if there were no need for legal rules to evaluate the significance and effects of the facts of ‘the particular case.’”⁵⁸ Nevertheless, given the potential for *Dura* to affect class damages in new ways, this section traces the development from common-law deceit and misrepresentation remedies to remedies for face-to-face transactions to open-market fraud. It then explains why some of these common-law principles do not hold true for modern fraud-on-the-market actions.

(1) Common-Law Origins of Confusion

In the early 1600s, deceit claims existed only for what is today termed a breach of warranty. In the seminal common-law damages case, *Chandelor v. Lopus*, the Exchequer Chamber reversed the Kings Bench’s judgment in the plaintiff’s favor because no breach of warranty occurred – the defendant never warranted that the object in question was a “bezoar stone.”⁵⁹ Yet at least some justices believed that the defendant’s intent to deceive was actionable even without a warranty.⁶⁰ This line of thinking continued to develop through the years, and by the late eighteenth century, the law was relatively well-established that (1) if there was an express or implied warranty, the seller could be liable if the product did not conform to the warranty’s specifications and (2) if no warranty existed, the seller could be liable only where she made a false statement, knew of its falsity, and intended to deceive the buyer.⁶¹

Of course, a breach of warranty action is founded in contract law; deceit is a tort. Though the difference initially appears to be either the presence or absence of a warranty, this simplistic distinction caused multiple procedural and pleading issues since plaintiffs often

to recover only the excess of what he paid over the value of what he got, not, as some other courts had held, the difference between the value of what he got and what it was represented he would be getting.”)

⁵⁶ See, e.g., *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 155 (1972) (“In our view, the correct measure of damages under s 28 of the Act, 15 U.S.C. s 78bb(a), is the difference between the fair value of all that the mixed-blood seller received and the fair value of what he would have received had there been no fraudulent conduct, except for the situation where the defendant received more than the seller’s actual loss. In the latter case damages are the amount of the defendant’s profit.”) (internal citations omitted).

⁵⁷ See, e.g., *Rolf v. Blyth, Eastman Dillon & Co., Inc.*, 570 F.2d 38, (2d Cir. 1978). *But see* *Green v. Occidental Petroleum Corp.*, 541 F.2d 1335, 1342 (9th Cir. 1975) (Sneed, J., concurring in part and concurring in the result in part) (“The rescissory measure of damages does not properly measure that loss. The reason is that it permits a defrauded purchaser to place upon the defendant the burden of any decline in the value of the stock between the date of purchase and the date of disclosure of the fraud even though only a portion of that decline may have been proximately caused by the defendant’s wrong.”). As to the different types of damages, see W. PAGE KEETON, DAN B. DOBBS, ROBERT E. KEETON & DAVID G. OWEN, *PROSSER AND KEETON ON TORTS* § 110 (1984); Kaufman, *supra* note 54, at 30.

⁵⁸ *Easterbrook & Fischel, supra* note 3, at 612 (quoting *Hackbart v. Holmes*, 675 F.2d 1114, 1121 (10th Cir. 1982)).

⁵⁹ 79 Eng. Rep. 3-4, Cro. Jac. 4, Eng. Ct. Exch. 1603; Paula J. Dalley, *The Law of Deceit, 1790-1860: Continuity Amidst Change*, 39 AM. J. LEGAL HIST. 405, 412 (1995). A bezoar stone is a sort of stone found in the intestine of hooved animals that was believed to be a universal antidote against poisons. Unfortunately, the case of *Chandelor v. Lopus* does not explain how the buyer realized that the bezoar stone did not work.

⁶⁰ *Lopus v. Chandler* (K.B. 1606), *reprinted in* J.H. BAKER & S.F.C. MILSOM, *SOURCES OF ENGLISH LEGAL HISTORY, PRIVATE LAW TO 1750*, 521 (1986).

⁶¹ Dalley, *supra* note 59, at 413; *see also* *Stuart v. Wilkins*, 99 E.R. 15, 1 Dougl. 18 (K.B. 1778).

hedged their bets by alleging both breach of warranty and deceit.⁶² Hence, in common-law deceit and misrepresentation actions, the court chose among a buffet of remedies.⁶³ Depending upon the circumstances, a common-law claim for deceit could prompt the following counts in a complaint: (1) breach of warranty and breach of contract – requesting benefit-of-the-bargain, or “expectation” damages, to restore the plaintiff to the position she would have been in with the defendant’s contractual performance;⁶⁴ (2) misrepresentation – a tort – which could provide recoupment for out-of-pocket losses; and (3) unjust enrichment – an equitable claim – which might require the defendant to return the illicit profit from the transaction or rescind the transaction altogether.⁶⁵

(2) Remedies for Fraudulent Face-to-Face Transactions

Over the years, courts blurred the distinct remedies for these multiple causes of action, which contributed to modern-day confusion over the appropriate remedy for open-market securities fraud.⁶⁶ Still, the courts did not move directly from common-law deceit and misrepresentation into open-market fraud. They first applied common-law remedies to face-to-face transactions and typically awarded either recessionary damages based upon the defendant’s gain or out-of-pocket damages based upon the plaintiff’s loss.⁶⁷

The out-of-pocket measure, which originated in tort law,⁶⁸ requires the defendant to return the losses she proximately caused. Thus, this measure only reimburses plaintiffs who were economically harmed by the defendant’s misconduct.⁶⁹ In securities fraud, these damages compensate plaintiffs for “the difference between the price paid and the ‘real’ value of the

⁶² See *Bartholomew v. Bushnell*, 20 Conn. 271 (1850); Dalley, *supra* note 59, at 414-15 (“The best course, from the plaintiff’s point of view, would be to raise both claims and hope that, at trial, he would be able to prove either warranty or intent. The plaintiff could accomplish this maneuver by bringing one writ and offering evidence of both kinds, or by joining the two actions.”).

⁶³ Thompson, *supra* note 18, at 1184; Robert B. Thompson, *The Measure of Recovery Under Rule 10b-5: A Restitution Alternative to Tort Damages*, 37 VAND. L. REV. 349, 353-54 (1984).

⁶⁴ Note, however, that the Uniform Commercial Code does not recognize an implied warranty with regard to securities. See U.C.C. § 2-105(1), 8-306(2).

⁶⁵ See, e.g., *Janigan v. Taylor*, 344 F.2d 781, 786 (1st Cir. 1965); see also Thompson, *supra* note 63, at 353-54.

⁶⁶ The break-down between separate and distinct causes of action may have simply been confusion. As Dalley observes, “[i]n *Waters v. Mattingly*, 4 Ky. 244, 246 (1808), Judge Edwards clearly understood the difference between the requirement of warranty and the requirement of *sciens*, but unfortunately he thought the distinction arose from the distinction between a suppression *veri* and a suggestion *falsi*.” Dalley, *supra* note 59, at 41 n. 36.

⁶⁷ See *Randall v. Loftsgaarden*, 478 U.S. 647, 358-59 (1986); *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 155 (1972) (note, however, that this is not a fraud-on-the-market case); *Jordan v. Duff & Phelps, Inc.*, 815 F.2d 429, 441-42 (7th Cir. 1987); *Harris Trust & Sav. Bank v. Ellis*, 810 F.2d 700, 706-07 (7th Cir. 1987) (“In an action under § 10(b), the plaintiff cannot take advantage of the recessionary remedies provided elsewhere in the securities laws. . . . Sometimes remedies under the securities laws are based on defendants’ gain rather than plaintiffs’ loss, or plaintiff may have an election.”).

⁶⁸ *Kardon v. Nat’l Gypsum Co.*, 69 F. Supp. 512 (E.D. Pa. 1946), was the first case to invoke tort principles for an implied right of action under rule 10b-5. Judge Kilpatrick’s decision in *Kardon* was “adopted by an ‘overwhelming consensus of the District Courts and Courts of Appeals.’” *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*, 126 S.Ct. 1503, 1509 (2006) (quoting *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 730 (1975)). The Second Circuit later limited the breadth of the Rule 10b-5 private action in *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461 (2d Cir. 1952).

⁶⁹ Kaufman, *supra* note 54, at 129-30.

security, i.e., the fair market value absent the misrepresentations, at the time of the initial purchase.”⁷⁰ The “real value,” or “true value” as it is often termed, means the price absent the fraud.⁷¹ Accordingly, courts often determine whether the investor was a net winner or a net loser from the fraud.⁷² Under the out-of-pocket theory, an investor with net monetary gains has no damage and cannot recover.⁷³ It follows then that an investor who realized more than her initial investment – as in the gold-platinum hypothetical – could not recover.

In face-to-face transactions, courts also awarded common-law remedies based on contract law and equity. The frequency of these awards increased after Judge Aldrich’s opinion in *Janigan v. Taylor*.⁷⁴ Judge Aldrich thought disgorgement was appropriate because it was better “to give the defrauded party the benefit even of windfalls than to let the fraudulent party keep them.”⁷⁵ Therefore, courts reasoned that they should not treat one who committed fraud any

⁷⁰ *Robbins v. Koger Props., Inc.*, 116 F.3d 1441, 1447 n. 5 (11th Cir. 1997) (internal citation omitted); *see also Wool v. Tandem Computers, Inc.*, 818 F.2d 1433, 1436-37 (9th Cir. 1987); *Sirota v. Solitron Devices, Inc.*, 673 F.2d 566 (2d Cir. 1982); *Sharp v. Coopers & Lybrand*, 649 F.2d 587 (3d Cir. 1981); *Green v. Occidental Petroleum Corp.*, 541 F.2d 1355, 1344-46 (9th Cir. 1976) (concurring opinion); *Blackie v. Barrack*, 524 F.2d 891, 908-09 (9th Cir. 1975). The out-of-pocket measure is the most common in calculating damages in securities fraud class actions. *Blackie*, 524 F.2d at 908-09.

⁷¹ *Randall v. Loftsgaarden*, 478 U.S. 647, 661-62 (1986); *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 155 (1972); *Mathews v. Kidder, Peabody & Co., Inc.*, 260 F.3d 239, 249 (3d Cir. 2001); *Ambassador Hotel Co., Ltd. v. Wei-Chuan Inv.*, 189 F.3d 1017, 1030 (9th Cir. 1999); *Alexander*, *supra* note 2, at 1491; *Thompson*, *supra* note 18, at 1181. The difficulty with the out-of-pocket measure is that no simple means exists for determining the value on the day of the transaction. *Thompson*, *supra* note 18, at 1180. Further, some courts have used the value of the stock on a day other than the day that the transaction occurred, such as when the defendant disclosed the correction. *See, e.g., Harris v. Am. Inv. Co.*, 523 F.2d 220, 226 (8th Cir. 1975); *Richardson v. MacArthur*, 451 F.2d 35, 43-44 (10th Cir. 1971); *Esplin v. Hirsch*, 402 F.2d 94, 104-05 (10th Cir. 1968). It is the plaintiffs’ burden to provide evidence of the “true value” for each date during the class period. *Sowell v. Butcher & Singer, Inc.*, 926 F.2d 289, 297 (3d Cir. 1991). Consequently, this modified measure could increase plaintiffs’ damage calculation by including market changes such as a declining market rather than only loss from the fraud. *Thompson*, *supra* note 18, at 1191.

⁷² *See, e.g., In re Cardinal Health, Inc. Sec. Litig.*, 226 F.R.D. 298, 308 (S.D. Ohio 2005); *In re Comdisco Sec. Litig.*, 150 F. Supp. 2d 943 (N.D. Ill. 2001) (determining that a pension fund was “out of the running for designation of lead plaintiff” since it “derived a net gain of almost \$300,000 . . . from its purchases and sales during the Class Period”); *In re McKesson HBOC, Inc. Sec. Litig.*, 97 F. Supp. 2d 993, 996-97 (N.D. Ca. 1999) (rejecting the net seller as lead plaintiff and observing that a net purchaser might have more interest in the litigation because it was induced by the fraud to purchase shares and was left “holding the bag” when the fraud was revealed).

⁷³ *See, e.g., Arenson v. Broadcom Corp.*, 2004 WL 3253646 (C.D. Cal. Dec. 6, 2004) (granting defendants’ motion for summary judgment as to plaintiffs who benefited from the alleged inflation); *see also Fox*, *supra* note 13, at 1553 (noting that if the price increased, “application of the loss causation rule developed in the context of a traditional reliance-based action would bar recovery” because it “required that the purchased security decline in value from what was paid (or was sold at a loss)” and that the decline is “reasonably related to the falsity of the statement that induced the purchase”).

⁷⁴ 344 F.2d 781, 786 (1st Cir. 1965).

⁷⁵ *Id.*; *see also Randall v. Loftsgaarden*, 478 U.S. 647, 663 (1986) (citing *Janigan*, 344 F.2d at 786); *Rude v. Campbell Square, Inc.*, 411 F. Supp. 1040, 1050 (D.S.D. 1976). In *Janigan*, the defendant, who was president, general manager, and director of Boston Electro Steel Casting, Inc, purchased stock from his shareholders without telling them that the corporation was going through a revitalization. After two years, the stock’s value multiplied. The court reasoned that if it awarded the difference between the market price of the stock at the time of the sale and the price paid to plaintiffs, the damages would have been minimal. Instead, the court rationalized that the fair value of the stock when sold was not the market price, but the market price of what the stock would have been if the market knew what the defendant knew.

better than a defendant who only breached a contract.⁷⁶ And so, depending on what justice required, they began to use benefit-of-the-bargain awards, rescission, and disgorgement as remedies.⁷⁷

The benefit-of-the-bargain remedy is based in contract law and compensates plaintiffs for the amount they would have received, including profits, if the defendant performed as promised.⁷⁸ Both rescission and disgorgement⁷⁹ are equitable remedies that are also used in contract law. As applied to face-to-face securities fraud cases, courts have required defendants to disgorge, or return, their unjust enrichment so that the plaintiff recovers the fraudulently obtained profit.⁸⁰ Rescissory damages aim to rescind the transaction and to put the plaintiff in the same position she would have occupied if the transaction never occurred.⁸¹ These damages require that the defendant pay not only for the fraud but also for the change in market conditions.⁸² So, in the process of undoing a securities transaction, the plaintiff avoids both the harm from the fraud as well as the danger of failing market conditions.⁸³ Requiring the

⁷⁶ See, e.g., *United States v. Ben Grunstein & Sons, Co.*, 137 F. Supp. 197, 208-10 (D.N.J. 1956); *Stout v. Martin*, 104 S.E. 157 (W. Va. 1920).

⁷⁷ *Ben Grunstein & Sons, Co.*, 137 F. Supp. at 208-10; *Stout*, 104 S.E. at 157. Both the courts and the drafters of the Restatement of Torts recognized that benefit-of-the-bargain damages were preferable in fraud actions particularly when the out-of-pocket measure did not afford “just and satisfactory” compensation. *Id.* Courts agreed with this rationale. See, e.g., *Osofsky v. Zipf*, 645 F.2d 107 (C.A.N.Y. 1981); William Prosser, HANDBOOK OF THE LAW OF TORTS § 110, at 733-34 (1971); RESTATEMENT (SECOND) OF TORTS § 549(2), cmt. on (2) (1977).

⁷⁸ BLACK’S LAW DICTIONARY (8th ed. 2004).

⁷⁹ Disgorgement is “[t]he act of giving up something (such as profits illegally obtained) on demand or by legal compulsion.” BLACK’S LAW DICTIONARY (8th ed. 2004). In this context, disgorgement aims to prevent wrongdoers from unjustly enriching themselves, not to compensate victims. *S.E.C. v. Cavanagh*, 445 F.3d 105, 117 (2d Cir. 2006); *S.E.C. v. Tome*, 833 F.2d 1086, 1096 (2d Cir. 1987) (“[T]he primary purpose of disgorgement is not to compensate investors.”); *S.E.C. v. Blavin*, 760 F.2d 706, 713 (6th Cir. 1985).

⁸⁰ *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 155 (1972). “The primary purpose of disgorgement orders is to deter violations of the securities laws by depriving violators of their ill-gotten gains.” *S.E.C. v. Fischbach Corp.*, 133 F.3d 170, 175 (2d Cir. 1997). Although these funds are often used to compensate victims of the wrongdoing, the goal of compensation is secondary to that of deterrence. *Id.*; see also *S.E.C. v. Commonwealth Chem. Securities, Inc.*, 574 F.2d 90, 102 (2d Cir. 1978).

⁸¹ BLACK’S LAW DICTIONARY (8th ed. 2004). Merritt Fox has argued that rescissory damages should be used for securities fraud cases. Merritt B. Fox, *Demystifying Causation in Fraud-on-the-Market Actions*, 60 BUS. LAW. 507, 512-13 (2005).

⁸² Thompson, *supra* note 18, at 1183. This remedy is “rooted in the contract of sale” and as Judge Joseph Sneed believed:

This remedy imposes upon the wrongful seller the burden of any loss in the value of the stock between the date of sale and the disclosure date. This is appropriate because the wrongful seller as a direct consequence of his wrong shifted to the purchaser the risks the seller would have borne but for the wrongful sale. The seller’s obligation is to accept the return of the risk he wrongfully shifted in the contract of sale. That is, it springs from his contractual undertaking.

Green v. Occidental Petroleum Corp., 541 F.2d 1335, 1343 (9th Cir. 1976) (Sneed, J. concurring).

⁸³ Thompson, *supra* note 18, at 1182-83. Some courts have even applied a rescissory measure for open market situations. See, e.g., *U.S. v. Grabske*, 260 F. Supp. 2d 866 (N.D. Cal. 2002). The *Grabske* court pondered how they might apply rescissory damages as follows:

defendant to bear the risk of market decline differentiates rescissory damages from out-of-pocket damages, which seek to isolate the price due to fraud and permit recovery only for that difference.⁸⁴ Although this rationale makes sense as applied to face-to-face transactions where the plaintiff sells stock that skyrockets in value after the sale and the defendant acquires the stock by fraud, it does not hold true for secondary open-market transactions.⁸⁵

(3) Remedies for Fraud-on-the-Market

In face-to-face transactions, the wrongdoer's obligation to accept the returned risk of failing market conditions is founded in the sale contract.⁸⁶ In the open-market situation, on the other hand, the corporate defendant does not sell anything directly to the plaintiff.⁸⁷ Instead, the plaintiff purchases stock from others on the open market and the corporate defendant's

Assuming a sale and purchase of stock, true rescission would involve a return, on the one hand, of the purchase price and, on the other hand, of the stock purchased. In an open market setting the injured party "returns the stock" by selling it on the open market. The defendant "returns the purchase price" by compensating the injured party for any difference between the price that the injured party paid for the security and its trading price following the disclosure of the fraud.

Id. at 872 (internal citations omitted). Given the nature of the loss causation requirement after *Dura*, it stands to reason that private plaintiffs should no longer be permitted to recover rescissory damages. *See infra* Part III.A.1.

⁸⁴ *See* Doyle v. Union Bank & Trust Co., 59 P.2d 1171 (Mont. 1936); Poole v. Camden, 92 S.E. 454 (W. Va. 1916); Beare v. Wright, 103 N.W. 632, 634 (N.D. 1905); Thompson, *supra* note 18, at 1182-83.

⁸⁵ *See* Kaufman, *supra* note 54, at 43-44. Accordingly, a growing number of courts refuse to award rescissory damages in section 10(b) cases. *See, e.g.,* Mathews v. Kidder, Peabody & Co., Inc., 260 F.3d 239, 249 (3d Cir. 2001) ("[I]n most §10(b) cases, we are extremely hesitant to award rescissory damages and instead apply an 'out of pocket measure.'"); Hoxworth v. Blinder, Robinson & Co., Inc., 903 F.2d 186, 203 n. 25 (3d Cir. 1990) ("Although the Supreme Court has reserved the question whether a rescissory measure of damages is ever appropriate for defrauded buyers under Rule 10b-5, this court has expressed clear disapproval of a damage theory that would insure defrauded buyers against downside market risk unrelated to fraud."); Huddleston v. Hearman & MacLean, 640 F.2d 534, 555 (5th Cir. 1981), *modified on other grounds*, 459 U.S. 375 (1983). The Fifth Circuit explained its reasoning as follows:

[T]he rescissory measure permits the defrauded securities buyer to place upon the defendant the burden of any decline in the value of the securities between the date of purchase and the date of sale even though only a portion of that decline may have been proximately caused by the defendant's wrong Under these circumstances, the rescissory measure is unjust insofar as it compensates an investor for the nonspecific risks which he assumes by entering the market. Losses thus accruing have no relation to either the benefits derived by the defendants from the fraud or to the blameworthiness of their conduct.

Huddleston, 640 F.2d at 555.

⁸⁶ *See* Green v. Occidental Petroleum Corp., 541 F.2d 1335, 1343 (9th Cir. 1976) (Sneed, J., concurring).

⁸⁷ *See id.*; Fox, *supra* note 13, at 1548 ("Fraud-on-the-market actions such as *Dura* are very different from traditional reliance-based actions. The plaintiff in a traditional reliance-based action is typically a purchaser involved in either a face-to-face transaction in shares of a non-publicly traded issuer or an IPO.").

misrepresentations do not shift the risk of loss.⁸⁸ The corporation cannot return a purchase price it never received.⁸⁹

Nevertheless, enterprise liability foists most of the fraud's cost on diversified shareholders who are not responsible for the fraud.⁹⁰ Put another way, plaintiffs generally bring Rule 10b-5 fraud-on-the-market actions against nonissuing parties (the corporations); thus, there is no sale contract or privity between the plaintiff and defendant.⁹¹ When there is no direct transaction or contract between the plaintiff-investor and the corporate defendant (and thus no privity), it makes little sense to award contract-based damages.⁹² Consequently, remedies of contract rescission and rescissory damages cannot be justified on a restitution theory.⁹³

The justification for disgorgement is likewise misplaced. Disgorgement assumes that fraud unjustly enriched the defendant.⁹⁴ But, in the open market, the plaintiff does not exchange

⁸⁸ See Green, 541 F.2d at 1343; Alexander, *supra* note 2, at 1496; *cf* Thompson, *supra* note 63, at 386 (noting that “[r]isks of change in the market that occur within a reasonable time following the discovery of fraud shift to the defendants, while risks of market changes after that time fall on the plaintiff”).

⁸⁹ See Green, 541 F.2d at 1343; Alexander, *supra* note 2, at 1496. Because each purchase in the secondary open market corresponds to a sale, just as many market participants benefit from the fraud as are damaged. See *In re Clearly Canadian Sec. Litig.*, 875 F. Supp. 1410, 1415 n. 3 (N.D. Cal. 1995); Easterbrook & Fischel, *supra* note 3, at 635.

⁹⁰ Arlen & Carney, *supra* note 4, at 699.

⁹¹ *Ross v. Bank South, N.A.*, 885 F.2d 723, 743 (11th Cir. 1989) (Tjoflat, Judge, specially concurring); *In re Letterman Bros. Energy Sec. Litig.*, 799 F.2d 967, 972 (5th Cir. 1986); *Huddleston v. Herman & MacLean*, 640 F.2d 534, 554-55 (5th Cir. 1981), *aff'd in part and rev'd in part on other grounds*, 459 U.S. 375 (1983) (“Use of the rescissional measure is usually limited to cases involving either privity between plaintiff or defendant or some specific fiduciary duty owed by brokers to their customers.”); Philip J. Leas, Note, *The Measure of Damages in Rule 10b-5 Cases Involving Actively Traded Securities*, 26 STAN. L. REV. 371, 376 (1974).

⁹² *Ross*, 885 F.2d at 743 (finding rescission an inappropriate remedy in a Rule 10b-5 action against non-issuing parties). Judge Tjoflat explained his thoughts that rescission is inappropriate as follows:

In a Rule 10b-5 action against non-issuing parties, courts may not grant rescission as a remedy. Rescission is an equitable remedy that restores parties to a transaction to their status quo ante. Typically a buyer discovers a seller's fraud, promptly tenders the goods to the seller, and demands the return of his purchase price. The court then orders the seller to return the purchase price and uses its civil contempt power to coerce the seller's compliance with its order. This remedy is available, however, only against parties to a contract – a court may not order rescission in a buyer's action against a defrauding party who is not a party to the contract of sale. Thus, in the context of Rule 10b-5, where buyers often sue parties that are not in privity of contract with the buyer, rescission is unavailable.

Id.; *Huddleston*, 640 F.2d at 554-55; *see also* Thompson, *supra* note 18, at 1185 (“In open market transactions when the defendants have made misleading statements to the market, the plaintiffs trade not with the defendants but with strangers in the market. These alternative remedies are not likely to be available in that setting.”); Leas, *supra* note 91, at 376.

⁹³ Green, 541 F.2d at 1343.

⁹⁴ Disgorgement plays an important deterrence role in face-to-face transactions, but does not translate into open-market transactions. For some examples of how disgorgement operates in other securities enforcement actions, see *S.E.C. v. Gemstar-TV Guide Int'l, Inc.*, 401 F.2d 1031, 1047 (9th Cir. 2005). Disgorgement is generally paid to victims of wrongdoing only when the victims can establish an equitable claim to the funds. See *S.E.C. v. Drexel Burnham Lambert, Inc.*, 956 F. Supp. 503 (S.D.N.Y. 1997). When the proceeds of disgorgement do not go

money directly with the corporation and the corporation does not benefit directly from that profit.⁹⁵ Thus, there is no direct unjust enrichment to disgorge.⁹⁶

This is not to say that corporations never receive indirect benefits from undiscovered open-market fraud.⁹⁷ Indeed, depending upon the type of fraud, the corporation might receive incidental tax benefits, lower costs of capital, protection from hostile takeovers, temporary business advantages, and increased publicity, while its employees may experience increased job security.⁹⁸ In the short run, the corporation's increased share price may provide the capital to enter new businesses and update capital assets.⁹⁹ The agent committing fraud may temporarily benefit from higher firm share prices, job advancement, increased stock options, and increased prestige and reputation.¹⁰⁰ Yet all of these purported benefits are speculative and nearly impossible to value. Even assuming a court could value them, their value is probably a good deal less than losses of open-market purchasers.¹⁰¹ Consequently, if the corporation has to compensate class members for out-of-pocket losses, this compensation should purge it of any indirect benefits. One court observed that misstatements seldom benefit the corporate issuer and that "chickens have a way of coming home to roost."¹⁰² "When they do so in the form of securities class action plaintiffs, a corporation has hell (and usually a great deal of money) to pay."¹⁰³ In sum, even if the corporation received some incidental benefit from the initial undiscovered fraud, out-of-pocket damages will likely suffice.

to the victims, the money should be paid into the United States Treasury. *S.E.C. v. Fischbach Corp.*, 133 F.3d 170 (2d Cir. 1997); *Drexel Burnham Lambert, Inc.*, 956 F. Supp. at 503.

⁹⁵ See Prichard, *supra* note 23, at 930-37. Prichard proposes that even though corporations do not receive any pecuniary benefit from the fraud, their agents may be motivated by fear, greed, and Pollyannaism.

⁹⁶ Indeed, one commentator suggested that investors and their attorneys are the ones unjustly enriched by the fraud, not the corporation. Langevoort, *supra* note 21, at 651. I would not go that far. The corporation does receive some indirect benefits from the initial undiscovered fraud such as increased publicity, a higher share trading price, and, for the individuals who commit fraud, temporarily increased job security.

⁹⁷ In an auditor situation, Judge Posner noted that to assume that the corporation always benefits from the fraud ignores the distinction between "fraud on behalf of a corporation" and "fraud against it." *Cenco Inc. v. Seidman & Seidman*, 686 F.2d 449, 456 (7th Cir. 1982). Judge Posner elaborates on this distinction, noting that "[f]raud against the corporation usually hurts just the corporation; the stockholders are the principal if not only victims." *Id.* Defendants have attempted to employ this distinction in securities fraud cases by arguing that where the corporation received no benefit it should not be held liable. This argument, however, has been rejected by at least one court. See, e.g., *In re Cylink Sec. Litig.*, 178 F. Supp. 2d 1077, 1087-88 (N.D. Cal. 2001).

⁹⁸ See, e.g., *Plevy v. Haggerty*, 38 F. Supp. 2d 816, 833 (C.D. Cal. 1998); *Coffee*, *supra* note 4, at 29 ("Typically, managers hide bad news because they fear loss of their jobs (either from a dismissal or a hostile takeover), and they overstate favorable developments or inflate earnings in order to maximize the value of their stock options and other equity compensation); *Alexander*, *supra* note 2, at 1498; *Arlen & Carney*, *supra* note 4, at 702-03.

⁹⁹ These benefits could continue to provide increased revenues long after the litigation ends. Yet, even if a court required a corporation to disgorge its unjust enrichment, Section 78bb(a)'s "actual damages" requirement may limit the extent to which one could speculate about the fruits of fraud.

¹⁰⁰ See, e.g., *Plevy*, 38 F. Supp. 2d at 833; *Alexander*, *supra* note 2, at 1498.

¹⁰¹ *Alexander*, *supra* note 2, at 1498.

¹⁰² *In re Cylink Sec. Litig.*, 178 F. Supp. 2d at 1087-88.

¹⁰³ *Id.* Ironically, the judge's main concern was not whether corporations should be held vicariously liable for the acts of their agents when their agents do not act in concert with or for the benefit of the corporation. Instead, the judge was troubled that "[t]aking the corporation out of the class action for want of allegations of corporate benefit might well endanger [corporate issuer and insurance proceeds as] sources of recovery." *Id.*

Even though *Dura* indicated that modern securities actions resemble common-law deceit and misrepresentation actions, when awarding damages, courts should not ignore either the absence of a contract or the other disparities between face-to-face and open market transactions. Common law permitted disgorgement and recovery of benefit-of-the-bargain damages based on contract law and unjust enrichment principles. But these principles do not apply to open-market fraud because, apart from public offerings, the issuer is generally not the seller in a fraud-on-the-market case.¹⁰⁴

II. NORMATIVE THEORIES SUPPORTING PRIVATE 10B-5 ACTIONS

Compensating the plaintiff class for more than its out-of-pocket loss in, for example, the gold-platinum hypothetical, is problematic given the distinctions between common-law deceit and misrepresentation actions on the one hand and fraud-on-the-market actions on the other.¹⁰⁵ But, if compensating investors for more than their out-of-pocket losses fostered the goals of private class action litigation, then proposing legislative and judicial reforms to facilitate recovery might be a worthwhile endeavor. The corrective justice theory, upon which the idea of compensation is based, posits that injustice occurs when one party realizes a gain and the other a corresponding loss.¹⁰⁶ Theoretically, the class action then corrects the injustice by depriving one party's gain and restoring it to the parties with the loss.¹⁰⁷ But, because corporations do not receive a direct gain from the agent's fraud on the open market, it is implausible to contend that the principal function of the class action is to correct justice by restoring lost compensation to investors.¹⁰⁸

A. Compensation as a Theoretical Rationale for Private Class Actions

¹⁰⁴ Some commentators have gone further to argue that investors are not entitled to recover out-of-pocket losses. See, e.g., Langevoort, *supra* note 21, at 639. Langevoort notes that a "full out-of-pocket compensation in open-market cases is systematically excessive and dysfunctional, and not a system that a rational investor considering the issue *ex ante* would want, much less demand." *Id.* at 646.

¹⁰⁵ See Coffee, *Loss Causation After Dura: Something for Everyone*, *supra* note 6, at 5 ("[C]ourts should interpret loss causation to require a net stock market decline in the security's price in order to preclude what I termed 'phantom losses.' But the Court has not done that. Indeed, it has even suggested that new forms of phantom losses may be recoverable.").

¹⁰⁶ Ernest J. Weinrib, *Corrective Justice in a Nutshell*, 52 U. TORONTO L.J. 349, 349, 350 (2002); Gary Schwartz, *Mixed Theories of Tort Law: Affirming Both Deterrence and Corrective Justice*, 75 TEX. L. REV. 1801, 1823 (1997) (noting corrective justice's concern for compensating victims).

¹⁰⁷ Weinrib, *supra* note 106, at 349. Weinrib observes, "A correlatively structured remedy responds to and undoes an injustice only if that injustice is itself correlatively structured. In bringing an action against the defendant, the plaintiff is asserting that the two are connected as doer and sufferer of the same injustice The law then rectifies this injustice by reversing its active and passive poles, so that the doer of injustice becomes the sufferer of the law's remedy." Although this rationale readily applies to face-to-face transactions, it is problematic as applied to open market transactions for the same reasons that rescission and disgorgement are problematic. In this sense, the securities fraud class action is likely more in line with the notion of distributive justice. See *id.* at 351. I would be remiss in failing to point out that a wide divide exists between corrective justice scholars on the one hand and utilitarian scholars on the other. See Jefferey O'Connell & Christopher J. Robinette, *The Role of Compensation in Personal Injury Tort Law: A Response to the Opposite Concerns of Gary Schwartz and Patrick Atiyah*, 32 CONN. L. REV. 137, 139 (1999).

¹⁰⁸ See Schwartz, *supra* note 106, at 1824 ("For the fundamental rule of vicarious liability, the deterrence rationale gets the job done in a way that corrective justice does not.").

Perhaps ideally, the private securities class action would provide an efficient means for obtaining financial relief for the wronged investor. Still, when the subject security's value appreciates after fraud (generating a value higher than what the investor paid for the security), as in the gold-platinum hypothetical, the investor is already financially advantaged from owning the security.¹⁰⁹ Even absent this windfall, statistics show that securities class-action settlements recover only a small amount of investor loss,¹¹⁰ and that approximately seventy-percent of financial institutions with claims in settled securities class actions do not even submit them.¹¹¹ One study estimated that institutional investors failed to collect approximately \$1 billion a year from securities class-action settlements.¹¹² Statistics indicating that institutional investors are indifferent to settlement funds weakens the corrective justice and compensation arguments in favor of private class actions, especially where investors experienced no net loss from bundled favorable and adverse information.¹¹³

Despite this evidence, compensation is often thought of as a reason to permit fraud-on-the-market actions by private plaintiffs.¹¹⁴ Therefore, this section analyzes theories that undermine the compensation argument and observes that: (1) Congress did not enact securities laws to provide investor insurance; (2) private securities class actions redistribute wealth between diversified shareholders and leave no one better off except the attorneys; and (3)

¹⁰⁹ Merritt Fox adopts the opposite view and thinks that the plaintiff has suffered a loss in some sense of the word. He observes:

Assuming that she does not sell before full market realization of the true situation, the defendant's misstatement has made her worse off in an amount equal to its inflation of purchase price. But for the misstatement, she would have paid exactly that much less for the share, yet her return over her period of ownership (however long, and from whatever mix of dividends, distributions and sales proceeds that she receives) would have been just as great.

Fox, *supra* note 13, at 1553. Oddly, the U.S. government also took the position that this constitutes a loss. It indicated that a price decline "may not be a necessary condition for loss causation, however, because the inflation attributable to the fraud could be reduced or eliminated even if there were a net increase in price." Amicus Brief for the United States in Support of Petition for Cert. at 13, *Dura Pharm., Inc. v. Broudo*, 544 U.S. 336 (2005), available at 2004 WL 1205204 (May 28, 2004).

¹¹⁰ Investor losses continually exceed settlement values. Ronald I. Miller, Todd Foster, & Elaine Buckberg, *Recent Trends in Shareholder Class Action Litigation: Beyond the Mega-Settlements, is Stabilization Ahead?*, NERA ECONOMIC CONSULTING 7 (April 2006) (on file with author).

¹¹¹ *Investor Protection: A Review of Plaintiffs' Attorney Abuses in Securities Litigation and Legislative Remedies: Hearing on H.R. 5491 Before the House Comm. on Financial Services and the Subcomm. On Capital Markets, Insurance, and Government*, 109th Cong. 2d Sess. (June 28, 2006) (testimony of James D. Cox); James D. Cox & Randall Thomas, *Letting Billions Slip Through Your Fingers: Empirical Evidence and Legal Implications of the Failure of Financial Institutions to Participate in Securities Class Action Settlements*, 58 STAN. L. REV. 411 (2005) [hereinafter *Letting Billions Slip Through Your Fingers*]; James D. Cox & Randall Thomas, *Leaving Money on the Table: Do Institutional Investors Fail to File Claims in Securities Class Actions?*, 80 WASH. U.L. Q. 883 (2002).

¹¹² Cox & Thomas, *Letting Billions Slip Through Your Fingers*, *supra* note 111, at 412; A.C. Prichard, *Who Cares?*, 80 WASH. U. L. Q. 883, 883 (2002).

¹¹³ On average, only approximately 28% of eligible institutional investors file claims in class action settlements. Cox & Thomas, *Letting Billions Slip Through Your Fingers*, *supra* note 111, at 424.

¹¹⁴ Section 28(a) of the Securities Exchange Act contributes to this idea of compensation and courts readily assumed that damages developed for common-law fraud face-to-face transactions also applied to open-market transactions. Langevoort, *supra* note 21, at 645.

compensating investors for their cognitive errors reduces incentives to learn and creates perverse incentives to hold on to stocks that hint at fraud. Even though these observations apply to securities class actions as a whole, my focus here is that the class action's principal goal should not be compensating investors when they suffered no out-of-pocket losses.

(1) Securities Laws Were Not Enacted to Provide Investor Insurance

Congress enacted the securities laws to promote integrity in the open market, not to provide investor insurance.¹¹⁵ In fact, the loss causation element precludes securities laws from becoming an insurance program for any security purchased in reliance on a misstatement – regardless of whether the misstatement caused a change in value – by ensuring that the misdeed actually caused the economic loss.¹¹⁶

To be sure, failing to disclose material information that artificially inflates the security's price harms the investor who purchases at that price and does not sell the security before the corporation discloses adverse information. Nevertheless, investing in the stock market is an inherently risky business, and the corporate defendant cannot return the illicit profit because the seller – not the corporation – received it. In short, stock market investments should not be treated as the equivalent of placing money in a risk-free federally insured savings and loan plan.¹¹⁷ This is not to say that fraud should become another investment risk. Rather, when misstatements do not cause the loss or the market simply is not as strong as predicted, the class action should not function as a form of supplemental income. To minimize risk, investors can insulate themselves from the effects of market downturns and fraud by diversifying their portfolios.¹¹⁸ Thus, as set forth below, compensating investors for company-specific losses may not be necessary.

(2) Private Actions Redistribute Wealth between Diversified Shareholders

It is often said that securities class actions are a zero sum game for diversified investors and I will not attempt to rehash that literature here.¹¹⁹ I will, however, note that class actions

¹¹⁵ *Dura Pharm., Inc. v. Broudo*, 544 U.S. 336, 347 (2005) (“At the same time, allowing a plaintiff to forgo giving any indication of the economic loss and proximate cause that the plaintiff has in mind would bring about the harm of the very sort the statutes seek to avoid Such a rule would tend to transform a private securities action into a partial downside insurance policy.”); *Basic, Inc. v. Levinson*, 485 U.S. 224, 252 (White, J., joined by O’Connor, J., concurring in part and dissenting in part); H.R. Conf. Rep. No. 104-369, at 31 (1995); Langevoort, *supra* note 41, at 181 (“[T]here is very little reason to use the class action device as what is essentially an insurance system against market mood swings.”).

¹¹⁶ *Carlton v. Franklin*, 1990 WL 116788, at *3 (4th Cir. Aug. 2, 1990).

¹¹⁷ See generally *Brigden v. Scott*, 456 F. Supp. 1048 (D.C. Tex. 1978) (likening plaintiffs who invested in speculative real estate investments, received tax write-offs and benefits from the deal, and wanted rescission to roulette players). There have been a number of arguments that the gambling industry and securities industry should have similar regulation. See, e.g., Thomas Lee Hazen, *Disparate Regulatory Schemes for Parallel Activities: Securities Regulation, Derivatives Regulation, Gambling, and Insurance*, 24 ANN. REV. BANKING & FIN. L. 375, 395 (2005).

¹¹⁸ See generally *Prichard*, *supra* note 23, at 940-41 (“Holding a diversified portfolio effectively eliminates any possibility of being a net loser from fraud on the market, thereby assuaging the concerns of even the risk-averse shareholder.”).

¹¹⁹ See, e.g., *Coffee*, *supra* note 4, at 26; *Langevoort*, *supra* note 41, at 181 (“First, any award against the issuer or settlement is funded directly or indirectly out of the issuer shareholders’ pockets, as the fraud-on-the-market litigation system is premised almost exclusively on a system of vicarious liability. Second, investors tend to

cannot actually be a “zero sum” game when as much as thirty-percent of the recovery pays for litigation costs.¹²⁰ To explain, in open-market class litigation, a group of shareholders and former shareholders who purchased the defendant corporation’s stock during the relevant “class period” sues the corporation for a misstatement or omission even though the corporation itself has not purchased or sold its securities.¹²¹ When the litigation settles (or a judgment is entered), the corporation and thus, indirectly, its shareholders, bear the costs. Accordingly, securities class actions in the open market produce a wealth transfer between shareholders who own stock in the corporation and shareholders in the class.¹²²

This is particularly true when an investor spreads the risk of loss by diversifying her portfolio, minimizing the impact of a poor financial showing by any one company.¹²³ Diversification increases the likelihood that an investor will be in both in the plaintiff-class suing the corporation and in the shareholder group paying for the litigation.¹²⁴ The more an investor is diversified, the greater the likelihood that, on any given day, she will be a shareholder within the class period or in the group indirectly funding the settlement. Consequently, even though investors “win” on some days and “lose” on others, in the aggregate, they are essentially transferring their wealth from one pocket to another.¹²⁵ In sum, private securities class actions appear to be a costly means for diversified investors to make wealth transfers to themselves (and pay a substantial amount to their attorneys).¹²⁶

In fact, the primary beneficiaries of private securities-fraud class actions appear to be the attorneys.¹²⁷ Transactional costs such as attorneys’ fees as well as settlement payments to

be, directly or indirectly, diversified in their investments and are just as likely to gain a windfall from issuer ‘fraud-on-the-market’ as to end up a loser.”); Douglas M. Schwab et al., *A Completely New Approach to Rule 10b-5 Damages*, 1203 PLI/CORP. 347, 364-65 (2000); Prichard, *supra* note 23, at 938-39; Langevoort, *supra* note 21, at; Alexander, *supra* note 2, at 1502.

¹²⁰ Anjan V. Thakor et al., *The Economic Reality of Securities Class Action Litigation*, 3 (Oct. 26, 2005), available at [http://www.navigantconsulting.com/A559B1/navigantnew.nsf/vGNCNTByDocKey/PP6C93BCE4133/\\$FILE/NCI-TheEconomicRealityofSecuritiesClassActionLitigation_10.26.05_.pdf](http://www.navigantconsulting.com/A559B1/navigantnew.nsf/vGNCNTByDocKey/PP6C93BCE4133/$FILE/NCI-TheEconomicRealityofSecuritiesClassActionLitigation_10.26.05_.pdf) (last visited June 30, 2006) (on file with author).

¹²¹ Coffee, *supra* note 4, at 26.

¹²² *Id.*

¹²³ *Id.*; Prichard, *supra* note 23, at 940-41.

¹²⁴ Coffee, *supra* note 4, at 26. For example, say an investor focuses on the pharmaceutical industry and compiles a diversified portfolio of stocks for the numerous companies within that industry. If consumers avoid Merck’s painkiller, Vioxx, because of the ongoing class litigation, it does not mean that they will go without painkillers and cause a downturn in the entire pharmaceutical industry. Rather, they will use a different painkiller. An investor with diversified stocks within the pharmaceutical industry will suffer loss from the decrease in Merck’s stock but a gain from the increase in sales from other companies’ painkillers. Thus, there is no net loss.

¹²⁵ Coffee, *supra* note 4, at 26. For each shareholder who bought the stock at an artificially inflated price due to fraud, another shareholder has sold. Alexander, *supra* note 2, at 1496. Thus, one particular buyer’s loss is offset by the seller’s gain. If all investors are ignorant of the fraud and are diversified then there will be winners with windfalls just as often as there are losers. Academics have continued to debate the effects of this circularity. See, e.g. Arlen & Carney, *supra* note 4, at 698-700; Paul Mahoney, *Precaution Costs and the Law of Fraud in Impersonal Markets*, 78 VA. L. REV. 623, 635 (1992).

¹²⁶ Coffee, *supra* note 4, at 26; Arlen & Carney, *supra* note 4, at 700. A number of academics have recognized the circularity of the private securities fraud class action among diversified investors. See, e.g., Alexander, *supra* note 2, at 1498-99; Arlen & Carney, *supra* note 4, at 698-700; Mahoney, *supra* note 125, at 635.

¹²⁷ See Richard M. Phillips & Gilbert C. Miller, *The Private Securities Litigation Reform Act of 1995: Rebalancing Litigation Risks and Rewards for Class Action Plaintiffs, Defendants and Lawyers*, 51 BUS. LAW. 1009,

investors frequently fall upon the corporation's shareholders – often inequitably since the shareholders engaged in no wrongdoing. Even the SEC recently indicated that it will consider whether the violative conduct victimized shareholders when determining whether to impose hefty financial penalties on the corporation.¹²⁸ As Professor John Coffee argues, “[t]o punish the corporation and its shareholders in [a typical secondary open-market case] is much like seeking to deter burglary by imposing penalties on the victim for having suffered a burglary.”¹²⁹ The result is a net social gain that, if measured only by investor trading gains and losses, is zero.¹³⁰

(3) *Permitting Recovery beyond Out-of-Pocket Losses Reduces Incentives to Learn*

Securities class actions not only operate as a costly means for wealth redistribution, but may also have perverse incentives on investor motivation and education.¹³¹ Behavioral finance theorists present some tentative answers to market phenomenon left unexplained by traditional law and economics.¹³² They refute the assumption that investors are rational,¹³³ yet it is not clear

1013 (1996); Arlen & Carney, *supra* note 4, at 700; cf Jonathan R. Macey & Jeffrey P. Miller, *The Plaintiffs' Attorney's Role in Class Actions and Derivative Litigation: Economic Analysis and Recommendations for Reform*, 58 U. CHI. L. REV. 1 (1991) (observing that plaintiffs' attorneys may have divergent interests from the interests of the class).

¹²⁸ Press Release, Securities Exchange Commission, Statement of the Securities and Exchange Commission Concerning Financial Penalties (Jan. 4, 2006), *available at* <http://www.sec.gov/news/press/2006-4.htm> (last visited July 4, 2006). The SEC observed:

In cases in which shareholders are the principal victims of the violations, the Committee expects that the SEC, when appropriate, will seek penalties from the individual offenders acting for a corporate issuer. Moreover, in deciding whether and to what extent to assess a penalty against the issuer, the court may properly take into account whether civil penalties assessed against corporate issuers will ultimately be paid by shareholders who were themselves victimized by the violations. The court also may consider the extent to which the passage of time has resulted in shareholder turnover.

Id. (internal citations omitted).

¹²⁹ Coffee, *supra* note 4, at 5.

¹³⁰ Alexander, *supra* note 2, at 1496; Langevoort, *supra* note 21, at 646; Easterbrook & Fischel, *supra* note 3, at 639.

¹³¹ As Langevoort notes, “[f]ew rational investors would opt for a system that so systematically overcompensates when they know that investors generally will be funding those payments. And no rational investor would opt for an expensive litigation system to accomplish it Langevoort, *supra* note 21, at 650.

¹³² Langevoort, *supra* note 41, at 153 (“One of the contributions of the behavioral finance research is that it may help us explain otherwise puzzling marketplace behavior, even if it does not yield clear-cut answers on the appropriate response.”). For background on the literature of behavioral finance, see SERSH SHEFRIN, BEYOND GREED AND FEAR: UNDERSTANDING BEHAVIORAL FINANCE AND THE PSYCHOLOGY OF INVESTING, at Ch. 2 (2002); BEHAVIORAL LAW & ECONOMICS (Cass R. Sunstein ed., 2000); Jonathan Klick & Gregory Mitchell, *Governmental Regulation of Irrationality: Moral and Cognitive Hazards*, 90 MINN. L. REV. 1620 (2006), *available at* http://www.law.umn.edu/uploads/images/3289/Mitchell_Klick_Final.pdf; Stephen J. Choi & A.C. Prichard, *Behavioral Economics and the SEC*, 56 STAN. L. REV. 1, 14 (2003); Ronald L. Gilson & Reinier Kraakman, *The Mechanisms of Market Efficiency Twenty Years Later: The Hindsight Bias*, 28 J. CORP. L. 715 (2003); Langevoort, *supra* note 41, at 135; Robert Prentice, *Whither Securities Regulation? Some Behavioral Observations Regarding Proposals for its Future*, 51 DUKE L.J. 1397 (2002); Christine Jolls et al., *A Behavioral Approach to Law and Economics*, 50 STAN. L. REV. 1471 (1998).

¹³³ Ribstein, *supra* note 6, at 138; Philip E. Tetlock & Barbara A. Mellers, *The Great Rationality Debate*, 13 PSYCHOL. SCI. 94 (2002). Numerous works explicate the particular biases that investors might be subject to. See

how these insights relate to securities regulation.¹³⁴ As Larry Ribstein observed, if markets are not as efficient as once believed, then Congress may need to strengthen securities laws to provide additional insulation from investor misjudgment – i.e., the paternalistic view of behavioral economics.¹³⁵ On the other hand, if “noise” moves markets instead of actual information, then increased regulation and liability may lead to more harm.¹³⁶ Ribstein identifies one of the hazards related to class actions and notes that “[f]orcing corporations or insiders to pay damages linked to the market’s irrational response to disclosures may have perverse effects, including discouraging disclosure.”¹³⁷

But discouraging disclosure may be even less problematic than diminishing individual incentives to learn from past investment mishaps. Jonathan Klick and Greg Mitchell’s recent research indicates that making the private class action available to defrauded investors even where the investors experienced no out-of-pocket loss could reduce both their incentive to learn and their ability to make future decisions.¹³⁸ Klick and Mitchell argue that “moral hazards” appear when paternalistic regulations – such as securities laws – reduce individual incentives to act “deliberately and carefully.”¹³⁹ Similarly, individuals face “cognitive hazards” when these regulations restrict choices that might otherwise function as learning opportunities.¹⁴⁰ But moral and cognitive hazards do not exist solely in the vacuum of regulation. Plaintiffs’ attorneys’ intervention into investors’ lives may also restrict learning opportunities.

As we have seen, diversified investors, as corporate shareholders, fund a generous portion of securities-fraud settlements.¹⁴¹ Thus, few fully informed investors would choose expensive class litigation that essentially transfers wealth from one pocket to another.¹⁴² Yet, behavioral finance indicates that human rationality is bounded and that decision-makers must

Choi & Prichard, *supra* note 132, at 7-15 (noting that the number of biases makes one wonder how investors are ever able to make a positive market return); Dale Griffin & Amos Tversky, *The Weighing of Evidence and the Determinants of Confidence*, 24 COGNITIVE PSYCHOL. 411 (1992) (overconfidence bias); Amos Tversky & Daniel Kahneman, *Belief in the Law of Small Numbers*, in JUDGMENT UNDER UNCERTAINTY: HEURISTICS AND BIASES 23-24 (1982); Baruch Fischhoff, *Hindsight Is Not Equal to Foresight: The Effect of Outcome Knowledge on Judgment Under Uncertainty*, 1 J. EXPERIMENTAL PSYCHOL: HUM. PERCEPTION & PERFORMANCE 288, 288 (1975) (hindsight bias).

¹³⁴ Ribstein, *supra* note 6, at 138; Langevoort, *supra* note 41, at 153 (“Lawyers and policy makers cannot hope to resolve the academic dispute over market efficiency reflected in the foregoing finance scholarship.”).

¹³⁵ Ribstein, *supra* note 6, at 138.

¹³⁶ *Id.*; see generally J. Bradford De Long et al., *Noise Trader Risk in Financial Markets*, 98 J. POL. ECON. 703 (1990).

¹³⁷ Ribstein, *supra* note 6, at 138. Ribstein further observes that holding corporate agents liable for misrepresentations may “increase investors’ tendency toward overconfidence by convincing them that securities trading is safe, even if liability merely protects them only from a relatively narrow risk of misrepresentation.” *Id.* at 144.

¹³⁸ See Klick & Mitchell, *supra* note 132, at 1626.

¹³⁹ *Id.*; see also Ribstein, *supra* note 6, at 145.

¹⁴⁰ Klick & Mitchell, *supra* note 132, at 1626, 1633. Ribstein observes that the law may not have much effect on learning if investors do not know how it protects them and points out that investors who do learn may be replaced by a new naïve group. Ribstein *supra* note 6, at 145. Yet, this does not eliminate the potential perverse effects of class litigation on investor learning.

¹⁴¹ Prichard, *supra* note 23, at 958 (“The transaction costs of litigation leading to settlements that merely transfer wealth among shareholders are a pure social waste, unless class actions provide a substantial deterrent effect.”); Mahoney, *supra* note 125, at 636; Arlen & Carney, *supra* note 4, at 699-700.

¹⁴² See Langevoort, *supra* note 21, at 650.

select among numerous demands for their time and attention.¹⁴³ Consequently, investors are “rationally ignorant,” possibly about the true litigation costs, because it is unreasonable, if not impossible, to gather all relevant information before making a single decision.¹⁴⁴ Because the majority of non-attorney individuals do not have much information about the inner-workings of a securities-fraud class action, they are (a) likely to take their attorneys’ advice and proceed with a class action (and subsequent settlement) that they are inadvertently funding and (b) not likely to distinguish between recoveries that are out-of-pocket versus those based on contract law measurements, such as disgorgement or rescissory damages.¹⁴⁵ Although legal education would likely diminish this ignorance,¹⁴⁶ it is extraordinarily unlikely that an investor would squander the time, effort, and expense of a legal education just to determine whether a securities class action makes economic sense.

Without a firm doctrinal statement on securities-fraud damages, the class action is arguably available to investors, such as those in the gold-platinum hypothetical, who did not experience a net loss. Because individuals “learn by doing,”¹⁴⁷ compensating investors without out-of-pocket losses not only prevents them from learning from their past investment mistakes but provides a perverse incentive to ignore potential warning signs of future fraud in hopes of receiving additional money in a class action.¹⁴⁸ This, in turn, fosters rational ignorance and rewards the investor who stays aboard the metaphorical sinking ship when other investors heeded the warning signs long before. In short, if private litigation compensates investors without out-of-pocket losses once, this could (1) prevent individuals from learning from their investment mistakes and reward ignorance and (2) provide a perverse incentive to purposefully invest in companies with signs of fraud with the hope that they will again receive a litigation windfall.¹⁴⁹

¹⁴³ See ROBYN M. DAWES, RATIONAL CHOICE IN AN UNCERTAIN WORLD 50-56 (1988); Prentice, *supra* note 132, at 1454; Jolls et al., *supra* note 132, at 1471; Herbert A. Simon, *Rational Choice and the Structure of the Environment*, 63 PSYCHOL. REV. 129, 129 (1956).

¹⁴⁴ See Prentice, *supra* note 132, at 1454. There have been a number of initiatives to make corporate disclosures less dense and more useful through simplification. For example, before Congress passed the Sarbanes-Oxley Act, SEC Chairman Pitt urged public companies to “consider simplifying financial disclosures to make accounting statements useful to and utilizable by, ordinary investors.” Harvey L. Pitt, Remarks Before the American Institute of Certified Public Accountants (AICPA) Governing Counsel (Oct. 22, 2001), *available at* <http://www.sec.gov/news/speech/spch516.htm> (last visited Aug. 7, 2006). Making financial disclosures easier to read would certainly help in reducing the amount of information that investors might consider before investing. Yet, even still, it would be difficult to read every company’s full disclosures before making a single investment decision.

¹⁴⁵ See *generally* Ribstein, *supra* note 6, at 141 (“[I]nvestors are not equal in education, intelligence, or expertise.”).

¹⁴⁶ Cf. Klick & Mitchell, *supra* note 132, at 1652 (arguing that education affects an individual’s chances of picking the correct option).

¹⁴⁷ *Id.* at 1626 (“[R]esearch from developmental psychology indicates that individuals improve their decision-making skills over time through a ‘learning by doing’ process, and that paternalistic policies threaten interference in this self-regulatory process.”).

¹⁴⁸ Of course, this theory is not immune to the criticism that minimizing the incentive for private litigation in certain circumstances is paternalistic in and of itself. Yet, a steadfast avoidance of all paternalistic initiatives leads to a return to laissez-faire markets. See *generally id.* at 1653 (“Imposing no choice-set constraint or offering no insurance would represent a laissez-faire stance in which there is no paternalistic oversight of the biased behavior.”). Recall the stock market crash of 1929 and the Great Depression that followed, which counsels against this approach to securities regulation.

¹⁴⁹ There might be an interesting if not persuasive defense here. If individual or even institutional investors continually purchased securities that reeked of fraudulent behavior in hopes of obtaining a windfall recovery in a

This leaves open the question of whether laws or judicially tailored recoveries should “save investors from themselves.” Of course, taking away the choice to sue where investors suffer no net loss can be seen as yet another paternalistic intervention. Given that congressional members and judges also suffer from cognitive biases,¹⁵⁰ the question that follows then is whether an optimal level of paternalism exists and, if so, who is the administrator? This section raises more questions than it does answers, but Klick and Mitchell offer some preliminary observations on this point. They contend that “optimal paternalism represents a mechanism design problem in which a social planner must consider using more than just the sledgehammer of constraining choice sets *ex ante* or providing implicit social insurance through some form of *ex post* paternalism.”¹⁵¹ Thus, if one considers the judiciary an apt social planner, then at least one option is to negate social insurance by limiting investors to out-of-pocket losses in private class actions. The corollary is then that the class action is not available to net winners from fraud. Although arguably paternalistic, this option promotes investors’ incentives to learn from their past investment errors and takes one opportunity for class litigation away – and with it the perverse double-reward when the net stock price increases after fraud.

B. Private Class Actions Promote Deterrence

Because compensating defrauded investors without out-of-pocket loss encourages costly wealth transfers between diversified investors and provides disincentives to learn, compensation should not be the principal rationale underlying securities fraud class actions. Instead, in accord with Congress’s goal of ensuring market integrity, private litigation’s primary objective must be to deter fraud.¹⁵² The SEC commented that “the overriding purpose of Congress was not so much to impose liability for the benefit of investors injured by a defective registration statement but

securities class action, the defendants could argue that the plaintiffs did not rely on the misrepresentation. Lack of reliance has been a traditional defense in face-to-face transactions where reliance is unreasonable. *See, e.g.,* Royal Am. Managers, Inc. v. IRC Holding Corp., 885 F.2d 1011 (2d Cir. 1989). To make this argument in an open-market case, the defendants would have to challenge the efficient market hypothesis, which is made easier by the large body of literature on behavioral finance and noise traders. *See, e.g.,* Ribstein, *supra* note 6, at 138; Lynn A. Stout, *The Mechanisms of Market Inefficiency: An Introduction to the New Finance*, 28 J. CORP. L. 635 (2003); J. Bradford De Long et al., *Noise Trader Risk in Financial Markets*, 98 J. POL. ECON. 703, 713 (1990).

¹⁵⁰ *See* Christopher R. Drahozal, *A Behavioral Analysis of Private Judging*, 67-SPG LAW & CONTEMP. PROBS. 105 (2004); Jeffrey J. Rachlinski, Symposium, *The Uncertain Psychological Case for Paternalism*, 97 NW. U. L. REV. 1165, 1199-1201 (2003); William N. Eskridge, Jr. & John Ferejohn, Symposium, *Structuring Lawmaking to Reduce Cognitive Bias: A Critical View*, 87 CORNELL L. REV. 616, 630-31 (2002).

¹⁵¹ Klick & Mitchell, *supra* note 132, at 1653.

¹⁵² *See* Randall v. Loftsgaarden, 478 U.S. 647, 664 (1986); *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 151 (1972); Mahoney, *supra* note 125, at 636 (“Note that a redistribution among shareholders that does not enhance deterrence is every bit as bad as fraud itself. Just as fraud may lead to investments in lying and precautions so the possibility of using litigation as purely a redistributive tool will lead to excessive investment in litigation.”); Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669, 693-94 (1984). The courts and the SEC generally interpret securities laws to maximize deterrence. *See* Loftsgaarden, 478 U.S. at 664; *Affiliated Ute Citizens*, 406 U.S. at 151 (“Congress intended securities legislation enacted for the purpose of avoiding frauds to be construed ‘not technically and restrictively, but flexibly to effectuate its remedial purposes.’”).

rather to stimulate diligence on the part of those persons who are actually responsible for [its] preparation.”¹⁵³

Certainly, securities regulators want to deter the prospective practice of bundling adverse and favorable information to prevent a stock price drop and thus potentially prevent class action liability. And compensatory damages can, in certain circumstances, promote deterrence by compelling officers and directors to internalize the costs and benefits of their actions.¹⁵⁴ But, since class recovery redistributes wealth between diversified shareholders and could cause perverse effects on investor education and motivation, perhaps the class action is not the best vehicle for deterring this type of bundling.¹⁵⁵ One problem with using the class action to deter this practice is that its uncertain damage measures may not accurately pair penalties with the wrongful conduct’s social harm.¹⁵⁶ Without a firm statement on how to measure potential damages, both attorneys and corporate actors lack a defined starting point for calculating financial costs.¹⁵⁷ Thus, corporate actors have no gauge by which to judge detrimental effects of, for example, overly optimistic announcements. Presumably, if this measurement is known, the wealth-maximizing actor will avoid conduct that results in costly financial penalties and society then benefits from accurate corporate information.¹⁵⁸

Given the uncertainty of potential class action damages, how do corporate actors weigh their behavior?

¹⁵³ Brief for SEC as Intervenor, at 9-10 *Feit v. Leasco Data Processing Equip. Corp.*, 332 F. Supp. 544 (E.D.N.Y. 1971).

¹⁵⁴ See generally STEVEN SHAVELL, *ECONOMIC ANALYSIS OF ACCIDENT LAW* 5-21, 127-50 (1987); Robert Cooter, *Prices and Sanctions*, 84 COLUM. L. REV. 1523 (1984).

¹⁵⁵ See *infra* Part III.C.

¹⁵⁶ See generally Alexander, *supra* note 2, at 1493. This is not to say that uncertainty about how to measure damages is the only problem. Market reaction is also unpredictable. But, a firm damage measure at least provides a predictable starting point. Many commentators have explored ways in which the tort system does not lead to optimal deterrence because of the transactional costs of litigation and the disparity between social and private incentives. See, e.g., Susan Rose-Ackerman & Mark Geistfeld, *The Divergence Between Social and Private Incentives to Sue: A Comment on Shavell, Menell, and Kaplow*, 16 J. LEGAL STUD. 483 (1987); Steven Shavell, *The Social Verses the Private Incentive to Bring Suit in a Costly Legal System*, 11 J. LEGAL STUD. 333 (1982).

The deterrence theory is founded in the assumption that the officer or director is a rational actor and will change her behavior based on the costs and benefits of a situation. Kevin M. Carlsmith, John M. Darley, & Paul H. Robinson, *Why Do We Punish? Deterrence and Just Deserts as Motives for Punishment*, 83 J. PERSONALITY & SOCIAL PSYCHOLOGY 284, 285 (2002). Academics writing in the field of behavioral law and economics readily dispute the theory that humans are rational. See, e.g., Choi & Prichard, *supra* note 132, at 1; James A. Fanto, *Quasi-Rationality in Action: A Study of Psychological Factors in Merger Decision-Making*, 62 OHIO ST. L. J. 1333, 1343 (2001); Chris Guthrie et al., *Inside the Judicial Mind*, 86 CORNELL L. REV. 777, 778 (2001).

¹⁵⁷ I take for granted that corporate actors aim to maximize wealth. Of course, corporate actors may be motivated by other factors such as saving their jobs or covering previous wrongdoing. Yet, corporations generally hire managers to promote the corporation, to act in its best interests, and to make the corporation profitable. Thus, I assume, perhaps naively, that managers generally want to act in their own best interests, which would include keeping their jobs. Consequently, because part of their job is to maximize corporate profits, they must perform this task to act in their own self-interest.

¹⁵⁸ Alexander, *supra* note 2, at 1493. Note that this assumes that corporate actors aim to maximize wealth. This is not to say that corporate actors are not motivated by other factors. Indeed, corporate managers may be trying to save their jobs or cover previous wrongdoing. But because managers are generally hired for their ability to promote the corporation, I assume – perhaps naively – that managers generally want to act in the best interests of the corporation so that, if nothing else, they can at least hold on to their jobs.

(1) Maximizing Deterrence

Until would-be-violators can estimate how much a penalty might cost, they will be unable to adjust their behavior accordingly.¹⁵⁹ Put another way, if a would-be-violator feels that she could face exorbitant penalties regardless of her actions – a quasi-form of strict liability – then she may ignore potential penalties and engage in wealth-maximizing behavior.¹⁶⁰ She may then hope that the penalty costs less than the wealth received from that particular behavior.¹⁶¹ Wealth-driven corporate managers who contemplate violating the law must know the costs and the benefits before they can determine whether the benefits outweigh the expected liability.¹⁶² But most private securities class actions end in confidential settlement agreements. Even those that reach a judge or jury are subject to variable damages measures.¹⁶³

Although most cases never reach a jury, if attorneys could advise would-be-violators and would-be-litigants on the legal rule for awarding class damages, the rule could at least provide a starting point for both groups to modify their behavior. Or, perhaps initially more likely, they could agree upon a more realistic settlement value. John Calfee and Richard Craswell identified “difficulty measuring damages” as among several pertinent factors that thwart optimal deterrence in tort law.¹⁶⁴ Calfee and Craswell discuss the fallacy that excessive damage awards incentivize

¹⁵⁹ Erick Gerding explains the deterrence model from economic perspective as follows:

Were an economist to model the deterrence theory that undergirds the antifraud rules of the securities law, the decision by a securities issuer or a market intermediary (such as a gatekeeper) on whether to commit fraud would look something like $B > P_d * ((P_e * L_l) + L_r)$, where B represents the benefits to be realized from committing fraud, P_d represents the probability of the fraud being detected, P_e represents the probability of the securities laws being successfully enforced, L_l represents legal liability under the securities laws, and L_r represents market, reputational and other non-legal losses.

Rational actors contemplating violating the law will do so if the benefits, B, outweigh the expected liability.

Erik F. Gerding, *The Next Epidemic: Bubbles and the Growth and Decay of Securities Regulation*, 38 CONN. L. REV. 393, 427-28 (2006).

¹⁶⁰ Cf Prichard, *supra* note 23, at 959 (“The cost of litigating securities class actions, tied to potentially enormous judgments, ensures that even weak cases will produce a settlement if they are not dismissed before trial.”).

¹⁶¹ See John E. Calfee & Richard Craswell, *Some Effects of Uncertainty on Compliance with Legal Standards*, 70 VA. L. REV. 965, 966 (1984) (“If the legal standard is uncertain, even actors who behave ‘optimally’ in terms of overall social welfare will face some chance of being held liable because of the unpredictability of the legal rule.”).

¹⁶² See Gerding, *supra* note 159, at 428. A.C. Prichard identifies some of the costs of corporate fraud as reduced managerial accountability, higher cost of liquidity for traders, and capital allocation – by allowing firms to raise funds for noncost-justified investment projects. Prichard, *supra* note 23, at 937-45.

¹⁶³ Easterbrook & Fischel, *supra* note 3, at 612 (quoting *Hackbart v. Holmes*, 675 F.2d 1114, 1121 (10th Cir. 1982)).

¹⁶⁴ Calfee & Craswell, *supra* note 161, at 969. These factors included uncertainty about whether would-be-violators will be sued, and if so, uncertainty about the size of the damages or fine that they would have to pay if found liable. *Id.* Of course, even eliminating the uncertainty about whether there will be enforcement and the amount of damages does not eliminate all uncertainty. One of the primary fallacies of securities law is the concept of materiality. Given the myriad judicial approaches to materiality, an officer or director of a corporation may not know whether her comment or report will be considered “material.” See generally Gerding, *supra* note 159, at 438-40; Alexander, *supra* note 2, at 1494 (“For example, a corporation will have difficulty weighing the costs and

over-compliance with the law and, conversely, that insufficient awards prompt under-compliance.¹⁶⁵ Instead, uncertainty about the measure and level of damages can produce both under and over compliance (and under and over deterrence).¹⁶⁶ To be sure, this is less than idyllic when social planners aim for optimal deterrence and optimal paternalism.

(2) Preventing Substantive “Absolute” Liability and Promoting Predictability

The *Dura* Court’s dicta increased unpredictability in measuring damages by intimating that a corporation might be liable in a class action when its higher share price is lower than it would have been absent fraud. Unpredictability is evidenced by the increased likelihood that a corporation may find itself in the midst of a securities class action at some point – perhaps regardless of its precautions.¹⁶⁷ In 2006, NERA Economic Consulting reported that over a five-year period, the average public company has a ten-percent probability that it will face at least one shareholder class-action lawsuit.¹⁶⁸ Although there is a forty-percent chance that the court will dismiss the action,¹⁶⁹ the mere filing of the suit typically causes a drop in a company’s stock price.¹⁷⁰

Because it often takes months to achieve a final dismissal with prejudice, the corporation must report the litigation in its public SEC filings, which may decrease the willingness of new investors to purchase its securities. As is oft mentioned in the ever-popular class action critique, getting rid of even frivolous litigation is not free, particularly when the court is unable to determine (due in part to the variable damage calculations) from the face of pleadings whether the suit satisfies the pleading standards.¹⁷¹ If the complaint might eventually plead a prima facie

benefits of failing to disclose information if it is unsure about whether a court would consider that information ‘material.’”).

¹⁶⁵ Calfee & Craswell, *supra* note 161, at 986.

¹⁶⁶ *Id.* Several briefs in *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336, 346 (2005), identified the problem of over-deterrence in fraud-on-the-market situations. Brief for Chamber of Commerce of the United States as Amicus Curiae in Support of Petitioners, *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336, 346 (2005), available at 2004 WL 2069560, at *10; Brief of Washington Legal Found as Amicus Curiae in Supp. of Petitioners, *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336, 346 (2005), available at 2004 WL 2069563, at *27. The Supreme Court echoed this problem in its opinion by relying on the PSLRA and observing that the Act “makes clear Congress’ intent to permit private securities fraud actions for recovery where, but only where, plaintiffs adequately allege and prove the traditional elements of causation and loss.” 544 U.S. at 346.

¹⁶⁷ A.C. Prichard observes that if plaintiffs survive a motion to dismiss, then defendants usually settle because it is cheaper than litigation. Prichard, *supra* note 23, at 952. I would extend this period beyond the motion to dismiss stage and to the class certification stage. Defendants are generally willing to prolong the litigation if they have a decent argument that the plaintiffs’ cannot meet the certification standards for Federal Rule of Civil Procedure 23. Consequently, they will generally wait to settle until after the court certifies a class.

¹⁶⁸ Miller et al., *supra* note 110, at 3.

¹⁶⁹ *Id.*

¹⁷⁰ Coffee, *supra* note 4, at 5; Arlen & Carney, *supra* note 4, at 699 (“Revelation of the fraud, and of the corporation’s prospective liability has an immediate impact on the price of the issuing corporations stock: the price adjusts to reflect both the truth previously concealed by the fraud and the corporation’s expected liability for the fraud.”).

¹⁷¹ The Supreme Court observed in *Dura* that even though a plaintiff need only provide “a short and plain statement of the claim showing that the pleader is entitled to relief,” “it should not prove burdensome for a plaintiff who has suffered an economic loss to provide a defendant with some indication of the loss and the causal connection that the plaintiff has in mind.” *Dura*, 544 U.S. at 346. Accordingly, it is not far-fetched to think that the Supreme

case of fraud, the result is usually a dismissal without prejudice so that the plaintiffs can, if possible, correct the deficiency. This invariably leads to amendments and re-filing, which starts the cycle all over again. Clarifying that plaintiffs are entitled to recovery only their out-of-pocket losses could facilitate earlier dismissal of actions without net loss.

For now, the upshot of corporations experiencing at least a ten-percent probability of a securities class action means that the officers and directors must plan for such an occurrence.¹⁷² The result is not overly cautious and pessimistic statements (for corporate agents would not last long by failing to appropriately promote the corporation), but rather is a budgetary allocation for officer and director insurance as well as for class-action litigation. When the judicial system effectively holds defendants unconditionally liable by prompting them to build securities class actions into their budget – regardless of whether they have committed fraud – then defendants have little incentive to take excessive precautionary measures. If the funds (or the Directors and Officers Insurance policies)¹⁷³ are already available, what incentive does management have to be more realistic in its financial reports?¹⁷⁴ Though volatile market reactions generate a great deal of uncertainty as well, a clear damage rule could facilitate earlier dismissal of suits without net losses and give corporate planners at least some degree of predictability in calculating their conduct in financial terms.¹⁷⁵

III. LIMITING PRIVATE CLASS RECOVERY TO NET LOSSES

As espoused throughout this Article, one option for a doctrinal statement on damages in the open market is to restrict plaintiffs' recovery to out-of-pocket losses. This would provide compensation only for net monetary losses.¹⁷⁶ Although it seems relatively simple, this rule has broader practical and theoretical ramifications. First, unlike other common-law remedies, the out-of-pocket rule compensates plaintiffs only for the loss caused by the fraud and therefore aligns with the stringent loss causation requirements and the limitation on "actual damages" in 28 U.S.C. Section 78bb(a).¹⁷⁷ Second, it supplies a predictable foundation for judging the reliability of expert methodology that purports to prove economic loss and injury.¹⁷⁸ Third, limiting plaintiffs to their out-of-pocket losses facilitates earlier dismissal of suits that provide

Court would encourage dismissal of claims that fail to demonstrate economic loss. The variable, of course, is how that loss is measured.

¹⁷² See Coffee, *supra* note 4, at 17.

¹⁷³ See *id.* at 19; Prichard, *supra* note 23, at 925 ("Directors' and officers' ('D&O) insurance pays a portion of settlements and the corporation pays the remainder. Newer D&O policies reflect the company's exposure by providing coverage to the company as well as its officers. D&O insurance pays for settlements because a refusal to pay could expose the insurer to potential liability for bad faith refusal to settle."); Alexander, *supra* note 2, at 1497; *supra* note 4 and accompanying text.

¹⁷⁴ Granted, if the managers use their budgetary allocation for securities class action litigation then they will have to replenish it so they do have some incentive to avoid fraud and prevent corporate loss. Yet, managers without this sort of budgetary requirement at all might have greater incentives to avoid fraud.

¹⁷⁵ I recognize that limiting plaintiffs to out-of-pocket losses decreases the class action's deterrence value as applied to a corporation that attempts to avoid liability by bundling favorable and adverse information. There are, however, other adequate means for deterring that situation. See *infra* Part III.C.

¹⁷⁶ This complies with *Dura*'s requirement that "a plaintiff . . . show not only that had he known the truth he would not have acted but also that he suffered actual economic loss." *Dura*, 544 U.S. at 343.

¹⁷⁷ See *infra* Part III.A.1 and Part III.A.2.

¹⁷⁸ See *infra* Part III.A.3.

double-recoveries to investors and that create an incentive to invest purposefully in companies showing signs of fraud.¹⁷⁹ Finally, this limit could bolster the class action's deterrence value through increased predictability.¹⁸⁰

A. Out-of-Pocket Losses Provide the Best Fit for Modern Securities Fraud

Restricting the plaintiff class's recovery to its out-of-pocket loss recognizes that open-market fraud is a tort and that the company is being held vicariously liable. Despite the similarity of certain pleading requirements for both common law deceit and open-market fraud, open-market securities fraud class actions differ factually in significant ways. In open market transactions, there is typically no contract between the corporation and its public shareholders, there is no privity between the nonissuing corporate defendant and the plaintiffs, and the corporation does not receive a direct benefit from the fraud.¹⁸¹ Unlike other remedies that are contract and equity-based, the out-of-pocket measure resonates with the realities of open-market fraud.

(1) Out-of-Pocket Recoveries Comply with the Loss Causation Standard

The out-of-pocket measure also supports *Dura's* strengthened loss causation requirement. Despite its relative ambiguity, loss causation plainly mandates that plaintiffs tie the loss for which they seek damages to the defendant's misrepresentation or omission.¹⁸² It follows that, if liable, defendants should compensate plaintiffs only for those losses. Consequently, a typical rescissory measure of loss, which aims to restore the parties to the position they would have been in absent the fraud, should not be available since it would require the defendant to reimburse the plaintiff for losses caused by fraud and for losses caused by changes in the market.¹⁸³

In the same manner, loss causation prevents unjust enrichment damages. In the gold-platinum hypothetical, the corporation's stock price increased after the disclosure of no gold and the announced discovery of platinum. Thus, the corporation arguably received an indirect benefit from the platinum discovery.¹⁸⁴ But the platinum discovery cannot enter the damage equation because the defendant's indirect profit from that discovery is unconnected to the plaintiffs' gold-related losses. Apart from a possible attempt to avoid liability by bundling adverse and favorable news, there is no link between the stock price increase based on the platinum discovery and the alleged decrease from the absence of gold. In other words, there can be a lack of gold without the addition of platinum. A plaintiff is entitled to reimbursement only

¹⁷⁹ See *supra* Part II.A.1.

¹⁸⁰ See *supra* Part II.B.2. To be sure, it inhibits the class action's ability to deter corporations from bundling favorable and adverse information to avoid class action liability. But the SEC, Department of Justice, and exchanges can still deter that type of behavior. See *infra* Part III.C.

¹⁸¹ See *supra* page 17 (discussing the indirect benefits that corporations may receive from undiscovered fraud).

¹⁸² 15 U.S.C. § 78u-4(b)(4).

¹⁸³ See Thompson, *supra* note 18, at 1180 n. 12. Note, however, that the defendant would only be responsible for ninety days worth of changes since Congress had determined that this particular point in time is the appropriate period for market adjustment. 15 U.S.C. § 78u-4(e)(2) (2006).

¹⁸⁴ See *supra* page 17 (discussing the indirect benefits that a corporation might receive from undiscovered fraud)

for loss caused by the misrepresentation or omission.¹⁸⁵ Disgorgement is not an appropriate remedy for that loss because disgorgement purges indirect benefits obtained by the corporation; it does not award damages based on the loss caused by the misdeed.¹⁸⁶ Moreover, where the defendant would have obtained the benefit even without the fraud, disgorgement is not appropriate.¹⁸⁷ In short, even though *Dura* suggested that a plaintiff might bring an action when a share's higher price is lower than it would have been absent the fraud, a court should not require the corporation to purge itself of any indirect benefits it obtained from its unrelated positive news.¹⁸⁸

(2) *Out-of-Pocket Losses Conform with 28 U.S.C. § 78bb(a)'s "Actual Damages" Limit*

Restricting plaintiffs to out-of-pocket recoveries also aligns with Section 78bb(a)'s "actual damages" cap.¹⁸⁹ This section's language limits plaintiffs' to "actual damages" caused by the misdeed.¹⁹⁰ Most courts construe this term to mean some form of economic loss and limit awards to those that are strictly compensatory in nature.¹⁹¹ Accordingly, "actual damages" would not include speculative lost profits from benefit-of-the-bargain or expectation damages.¹⁹²

Some courts have, however, assessed rescissory damages even under the "actual damages" theory by reasoning that this award must be "reduced by any value received as a result of the fraudulent transaction."¹⁹³ The Supreme Court, in *Randall v. Loftsgaarden*, assumed, because neither party challenged it, that rescissory recoveries could sometimes be proper for a section 10(b) case.¹⁹⁴ It thought that "in some circumstances" there was authority allowing the section 10(b) plaintiff to choose between "undoing the bargain" or "holding the defendant to the

¹⁸⁵ *Robbins v. Koger Props., Inc.*, 116 F.3d 1441, 1447 n. 5 (11th Cir. 1997).

¹⁸⁶ Although, as I discussed above, the corporation may receive indirect benefits from the fraud. Yet, these benefits are quite speculative and their value is probably a good bit less than losses of open-market purchasers during that class period. *Alexander*, *supra* note 2, at 1498. Consequently, if the corporation has to compensate investors for out-of-pocket losses, this should more than suffice to purge any indirect benefit.

¹⁸⁷ *Thompson*, *supra* note 63, at 386-87.

¹⁸⁸ See *infra* page 17 (discussing the indirect benefits that a corporation may receive from fraud but concluding that these benefits do not exceed a potential out-of-pocket recovery). Perhaps it is the attorneys that are unjustly enriched? For an article suggesting the truth of this statement, see *Langevoort*, *supra* note 21, at 651.

¹⁸⁹ 28 U.S.C. § 78bb(a) (2006). See, e.g., *Pelletier v. Stuart-James Co., Inc.*, 863 F.2d 1550, 1557 (11th Cir. 1989); *Harris v. Union Elec. Co.*, 787 F.2d 355 (8th Cir. 1986); *Madigan, Inc. v. Goodman*, 498 F.2d 233 (7th Cir. 1974); *Levine v. Seilon, Inc.*, 439 F.2d 328 (2d Cir. 1971); *Estate Counseling Serv., Inc. v. Merrill Lynch, Pierce, Fenner, & Smith, Inc.*, 303 F.2d 527 (10th Cir. 1962). Not all courts have read the term "actual damages" to exclude benefit-of-the-bargain damages. See, e.g., *Osofsky v. Zipf*, 645 F.2d 107 (2d Cir. 1981); *John R. Lewis, Inc. v. Newman*, 446 F.2d 800 (5th Cir. 1971).

¹⁹⁰ This section states that "no person . . . shall recover, through satisfaction of judgment in one or more actions, a total amount in excess of his actual damages on account of the act complained of." 28 U.S.C. § 77bb(a); see also *In re Control Data Corp. Sec. Litig.*, 933 F.2d 616 (8th Cir. 1991). Some courts dispute that section 78bb contains a limit and contend, "there cannot be any one rule of damages prescribed which will apply in all cases, even where it is conceded that the finding must be limited to actual damages." *Osofsky*, 645 F.2d at 111.

¹⁹¹ *Pelletier v. Stuart-James Co., Inc.*, 863 F.2d 1550, 1557-58 (11th Cir. 1989); *Jones v. Miles*, 656 F.2d 103, 107 n. 8 (5th Cir. 1981).

¹⁹² *Pelletier*, 863 F.2d at 1557-58 (citing *Wolf v. Frank*, 477 F.2d 467, 478 (5th Cir. 1972)); *Harris v. Am. Inv. Co.*, 523 F.2d 220 (8th Cir. 1975); *Sound Video Unlimited, Inc. v. Video Shack, Inc.*, 700 F. Supp. 127 (S.D.N.Y. 1988).

¹⁹³ *Austin v. Loftsgaarden*, 675 F.2d 168 (8th Cir. 1982).

¹⁹⁴ 478 U.S. 647, 661-62 (1986).

bargain by requiring him to pay [out-of-pocket] damages.”¹⁹⁵ Yet, *Loftsgaarden* is distinguishable for our purposes: it concerned a situation where privity of contract existed and did not address an open-market context.

After the Court’s *Dura* decision, if presented with the issue of whether rescissory damages are appropriate to remedy open-market fraud, the Court would likely decide that defendants must reimburse plaintiffs only for economic losses actually caused by the misdeed. This would effectually bar rescissory damages that compensate plaintiffs for non-fraud related losses. Even if the “actual damages” language does not preclude rescissory damages, it seems that loss causation, which requires a causal connection between the loss and the misrepresentation or omission, would.¹⁹⁶ Accordingly, the loss causation element and the “actual damages” restriction confine litigants to recovery for their out-of-pocket losses.

(3) Proving Hypothetical Damages

Even though proving damages is never a simple endeavor, the out-of-pocket rule may require less speculation than other measures. For any defrauded purchaser to recover, she must establish the difference between the value of what she actually received and the value of what she would have received absent the misrepresentation.¹⁹⁷ In the gold-platinum situation, because the stock price never actually declined, any damage calculation would have to be based on speculation.¹⁹⁸ Granted, assessing damages in that hypothetical would be somewhat easier because both gold and platinum have a fixed market value. But this exercise becomes increasingly difficult without fixed values. Any attempt to measure damages must isolate the value of the misrepresentation (or omission) – i.e., the gold discovery – and remove from consideration both the platinum announcement and any added value that could accrue from the gold-platinum combination.

¹⁹⁵ *Id.* at 662 (internal citations omitted).

¹⁹⁶ *See supra* Part II.A.

¹⁹⁷ This value cannot include damages covering “the expected fruits of an unrealized speculation.” *Sigafus v. Porter*, 179 U.S. 116, 125 (1900). The Supreme Court adopted this fundamental rule as the basic measure of damages under 10(b) and Rule 10b-5. *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128 (1972); *see also* *Garnatz v. Stifel, Nicolaus & Co., Inc.*, 559 F.2d 1357 (8th Cir. 1977); *Foster v. Fin. Tech., Inc.*, 517 F.2d 1068 (9th Cir. 1975); *Rochez Bros. v. Rhoades*, 491 F.2d 402 (3d Cir. 1974); *Madigan, Inc. v. Goodman*, 498 F.2d 233 (7th Cir. 1974); *Wolf v. Frank*, 477 F.2d 467 (5th Cir. 1973); *Levine v. Selion, Inc.* 439 F.2d 328 (2d Cir. 1971); *Richardson v. MacArthur*, 451 F.2d 35 (10th Cir. 1971); *Janigan v. Taylor*, 344 F. 2d 781 (1st Cir. 1965). As one commentator observed, the out-of-pocket rule “allows recovery of the difference between the actual value of what the injured party gave and what he received.” *Harris v. Am. Inv. Co.*, 523 F.2d 220, 225 (8th Cir. 1975) (quoting Note, *Measurement of Damages in Private Actions Under Rule 10b-5*, 1968 WASH. U. L. Q. 165, 172 (1968); *see also* W. PROSSER, LAW OF TORTS § 110, at 733-34 (1971).

¹⁹⁸ John Coffee has termed this general type of loss “phantom losses.” He observed that “to permit recovery in this case hypothesized by the Court [in *Dura Pharmaceuticals v. Broudo*], is to permit recovery based on a double speculation – first, as to the original uncorroborated price inflation and, second, as to what would have been the later price increase in the absence of discovery of the original inflation.” Coffee, *Loss Causation After Dura: Something for Everyone*, *supra* note 6, at 5.

Given the speculative nature of claims where no price decline occurs after a corporation discloses a misrepresentation,¹⁹⁹ the plaintiff class should put forth sufficient evidence of out-of-pocket loss in the complaint to survive a motion to dismiss.²⁰⁰ Expert testimony on class losses would likely become a vital part of establishing plaintiffs' prima facie case.²⁰¹ But, even once a court establishes that only out-of-pocket losses are compensable, there is no single universally accepted expert model for proving these losses.²⁰²

The most typical model is the event study, which uses an expert to construct a "value line" that theoretically represents the stock's "true value" if purchasers knew the undisclosed information on each day of the class period. Then, in theory, the expert can assess individual loss for each class member by comparing the price actually paid with the value line construct.²⁰³ Because investors often buy and sell shares within the class period, the methodology for assessing loss should account for in-and-out traders and provide a mechanism to net their windfalls against their losses to determine net loss.²⁰⁴

¹⁹⁹ Claims where the stock price did not actually decline are speculative because the lack of a decline could mean that the market did not consider the information material. Consequently, plaintiffs would not be able to prove that they relied on a "material misrepresentation," and could not plead a prima facie case of securities fraud.

²⁰⁰ See *Dura Pharm., Inc. v. Broudo*, 544 U.S. 336, 342 (2005); see also *In re Daou Sys., Inc.*, 411 F.3d 1006 (9th Cir. 2005); cf *Anza v. Ideal Steel Supply Corp.*, 126 S.Ct. 1991, 2002 (2006) ("Certainly the plaintiff in this case, as in all tort cases involving damage to business, must demonstrate that he suffered a harm caused by the tort and not merely by external market conditions."). To state a claim for cases involving publicly traded securities, a plaintiff must allege the following elements: (1) a material misrepresentation; (2) scienter; (3) a connection with the purchase or sale of a security; (4) reliance; (5) *economic loss*; (6) loss causation. *Dura*, 544 U.S. at 342 (emphasis added).

²⁰¹ See generally *RMED Int'l, Inc. v. Sloan's Supermarkets, Inc.*, 2000 WL 310352 (S.D.N.Y. Mar. 24, 2000) (permitting expert testimony to help establish damages at trial); *In re Gaming Lottery*, 2000 WL 193125 (S.D.N.Y. Feb. 16, 2000) (permitting expert evidence as to damages by a Professor of Finance).

²⁰² See *In re Broadcom Corp. Sec. Litig.*, 2005 WL 1403756, at *2 (N.D. Cal. June 2, 2005) (concluding that the PSLRA "leaves it open for a court to select the most reliable method of damages proof that is available in the particular case"); John Finnerty & George Pushner, *An Improved Two-Trader Model for Measuring Damages in Securities Fraud Class Actions*, 8 STAN. J.L. BUS. & FIN. 213, 215 (2003).

²⁰³ Janet Cooper Alexander, *Do the Merits Matter?: A Study of Settlements in Securities Class Actions*, 43 STAN. L. REV. 1487, 1490-92 (1997). Janet Alexander explains the process in two-steps:

The first step is to determine the "per-share damages," the amount of the actual market price attributable to the nondisclosure on each day of the class period. The second step is to determine the aggregate damages of the class. To determine per-share damages, an expert economic witness constructs a "value line" which represents the "true value" of the stock – what purchasers would have been willing to pay if they had known the undisclosed information – on each day of the class period. The damages sustained by any particular member of the class can then, in theory, be determined by comparing the price actually paid with the value line for the date of the transaction.

Id. at 1491.

²⁰⁴ There are several proposals for damage models that take this into account. *E.g.*, Janet Cooper Alexander, *The Value of Bad News in Securities Class Actions*, 41 UCLA L. REV. 1421, 1458-62 (1994) Jon Koslow, Note, *Estimating Aggregate Damages in Class-Action Litigation Under Rule 10b-5 for Purposes of Settlement*, 59 FORDHAM L. REV. 811, 831-34 (1991). Given that the appropriate model may vary based upon the facts of the case, this article does not promote a particular model. Instead, given the loss causation requirement, it recommends that any appropriate model should account for in-and-out traders and provide a mechanism to net their windfalls against their losses. For an overview of some of the different types of models, see Robert A. Alessi, *The*

Despite widespread use of the event study to demonstrate market reaction, the study can show only that the market reacted to the disclosure; it cannot prove why.²⁰⁵ Even experts relying on the same data and facts often present competing inferences regarding the amount of harm.²⁰⁶ Add to this an extended period between the misrepresentation and the disclosure – as was the case in *Dura*²⁰⁷ – and there is an increased potential for non-related events to affect the market price.²⁰⁸ Loss causation requires plaintiffs to demonstrate a causal connection between the misrepresentation (or omission) and the economic loss.²⁰⁹ Assuming liability, it follows that defendants have to compensate plaintiffs only for economic losses caused by the fraud. Accordingly, courts must take precautions to ensure that experts’ methods extract non-related factors affecting price from their calculation.²¹⁰

Emerging Judicial Hostility to the Typical Damages Model Employed by Plaintiffs in Securities Class Action Lawsuits, 56 BUS. LAW. 483 (2001). Alessi observes that the Proportional Decay Model does not account for in-and-out purchasers and has thus been subject to *Daubert* scrutiny. *Id.* at 489-90.

Daniel Fischel and David Ross’s research provides some indicia of how important it is to take in-and-out purchasers into account when calculating damages. In one particular case, they observed that “many of these institutions were ‘out-and-in’ during 1990: these institutions sold approximately 14 million shares [23% of the 60 million shares] during the year prior to their purchases of shares that they held until year-end. Thus, only 77% of the retained shares were retained by shareholders who were not out-and-in.” Daniel R. Fischel & David J. Ross, *The Use of Trading Models to Estimate Aggregate Damages in Securities Fraud Litigation: A Proposal for Change*, in SECURITIES CLASS ACTIONS: ABUSES AND REMEDIES 135, 138 (National Legal Center for the Public Interest 1994).

²⁰⁵ Ribstein, *supra* note 6, at 157 (“An event study might show that the market reacted to the corrective disclosure, but it cannot show why.”); Langevoort, *supra* note 41, at 177 (“Event study methodology can still be utilized to test for whether or when adjustment has occurred—i.e., abnormal returns disappear—over substantial periods of time.”). Event studies generally start by identifying the change in price on the date of the disclosure and then use a regression analysis to eliminate market changes that are not caused by the fraud. The study then works backwards to establish a hypothetical price for each day. RONALD J. GILSON & BERNATRD S. BLACK, *THE LAW AND FINANCE OF CORPORATE ACQUISITIONS*, 185-228 (1995); Daniel R. Fischel, *Use of Modern Finance Theory in Securities Fraud Cases Involving Actively Traded Securities*, 38 BUS. LAW. 1, 17-19 (1982).

²⁰⁶ Ribstein, *supra* note 6, at 157; Alexander, *supra* note 204, at 1421; Kenneth Cone & James Laurence, *How Accurate are Estimates of Aggregate Damages in Securities Fraud Cases?*, 49 BUS. LAW. 505 (1994).

²⁰⁷ *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336, 342-43 (2005).

²⁰⁸ Langevoort, *supra* note 41, at 177-78.

²⁰⁹ *Dura*, 544 U.S. at 342.

²¹⁰ The primary means for ensuring that experts isolate damages caused by fraud is the *Daubert* analysis. Whenever plaintiffs use experts to demonstrate injury and economic loss, courts should test the method using the *Daubert* factors. *Kumho Tire Co. v. Carmichael*, 526 U.S. 137 (1999); *Daubert v. Merrell Dow Pharm., Inc.*, 509 U.S. 579 (1993). For additional information on how courts conduct the *Daubert* analysis, see L. Elizabeth Chamblee, Comment, *Between “Merit Inquiry” and “Rigorous Analysis”*: Using *Daubert* to Navigate the Gray Areas of Federal Class Action Certification, 31 FLA. ST. U. L. REV. 1041, 1051-54 (2004). If plaintiffs use expert evidence to counter a motion to dismiss alleging that they either lack standing or failed to state a claim because they suffered no economic loss, then the court should conduct a *Daubert* test (even at this early stage) to probe the expert’s methodology and validity. A motion opposing class certification or a motion for summary judgment may also present this issue. Issues of standing or failure to state a claim for lack of economic damages might appear in a motion opposing class certification in the form of a challenge to the adequacy of the representative under Federal Rule of Civil Procedure 23. As I have argued elsewhere, courts should use *Daubert* earlier in the litigation process to help determine whether plaintiffs have plead their prima facie case. Chamblee, *supra*, at 1041. The monetary amount may, because of various court rulings, change throughout the course of litigation. But the expert’s method and plaintiffs’ complaint should demonstrate that, if true, that plaintiffs suffered an economic injury. The court should then dismiss the action if (1) plaintiffs’ complaint fails to allege that they suffered an out-of-pocket loss where plaintiffs were net losers from the fraud or (2) plaintiffs’ expert’s method – not amount – of calculating damage cannot survive a *Daubert* inquiry.

B. Earlier Dismissal of Suits Providing Double Recovery

Though exact measures of loss generally come at the end of litigation, the calculation method is important at the outset to determine whether plaintiffs' experienced a net economic loss for purposes of pleading a prima facie case of securities fraud.²¹¹ It is axiomatic that plaintiffs must have an injury (an economic loss) before they can sue. As noted at the outset of this Article, Congress passed the PSLRA, in part, to facilitate earlier dismissal of securities class actions that do not plead a prima facie case. But, without a doctrinal statement limiting plaintiffs' compensation to their out-of-pocket losses, courts are often unable to determine from the initial pleadings whether plaintiffs' suffered compensable losses.

The important consideration in assessing loss is not the monetary amount, which will fluctuate based on rulings regarding the class period and in-and-out purchasers, but the method. The methodology should account for in-and-out traders and provide a mechanism to net plaintiffs' windfalls against their losses to determine net loss.²¹² The pivotal question is then: assuming that everything in the plaintiffs' complaint is true and that the expert's method for calculating out-of-pocket loss is sound, did these plaintiffs experience a net loss?

If the answer to that question is "no," then, when the defendant files a motion to dismiss based the plaintiffs' failure to state a claim, the court should consider dismissal. Granted, if the pleading error is an oversight and the possibility of compensable loss exists, then the court could either dismiss the action without prejudice and permit plaintiffs to correct the error or give plaintiffs leave to amend the complaint. But if, according to the stated facts in the complaint, plaintiffs could not establish a net loss under the out-of-pocket rule, then the court should dismiss the action with prejudice.

Increasing dismissals for cases without out-of-pocket loss accomplishes several goals.²¹³ First, it helps ensure that the damages roughly approximate the true financial harm of the violation.²¹⁴ Second, if damage awards compensate only out-of-pocket loss, courts may dismiss

²¹¹ In *Dura*, the Supreme Court affirmed that, to plead securities fraud, plaintiffs need to provide only a "short and plain statement" to comply with Federal Rule of Civil Procedure 8. *Dura Pharm., Inc. v. Broudo*, 544 U.S. 336, 346 (2005). The complaint must still "provide the defendant with 'fair notice of what the plaintiff's claim is and the grounds upon which it rests.'" *Id.* (quoting *Conley v. Gibson*, 335 U.S. 41, 47 (1957)). "But it should not prove burdensome for a plaintiff who has suffered an economic loss to provide a defendant with some indication of the loss and the causal connection that the plaintiff has in mind." *Id.*

²¹² Because the appropriate model may vary based upon the facts of the case and because experts are constantly increasing their knowledge base on this subject, this article does not promote a particular model. Instead, given the loss causation requirement, it observes that any appropriate model must account for in-and-out traders and provide a mechanism to net their windfalls against their losses. For an overview of some of the different types of models, see Alessi, *supra* note 204, at 483; Fischel & Ross, *supra* note 204, at 138. For additional information on conducting a *Daubert* analysis at the class certification stage, see Chamblee, *supra* note 210, at 1041.

²¹³ One of the primary criticisms with earlier dismissal is that it does not permit plaintiffs' the necessary discovery needed to develop their case. While there are many components to this debate, suffice it to say that additional discovery would probably not change whether plaintiffs' experienced a net loss based on the out-of-pocket rule. That information is primarily in the hands of plaintiffs.

²¹⁴ The social costs are a different story. Fraud, even when it ultimately makes investors wealthier, harms the market's integrity. But there are other mechanisms for deterring fraud besides the class action. These alternatives are increasingly important where investors do not suffer an economic loss.

securities class actions that present a potential double-reward for investors who have not experienced a true net loss. Third, compensating investors for only their out-of-pocket losses alleviates – but does not eliminate – the problem that securities class actions generally redistribute wealth among diversified shareholders. Finally, limiting recovery in this manner gives both parties’ guidance about value when negotiating settlements. If a corporate defendant feels it has a fair chance of dismissal, then it may feel less pressure to settle early in the litigation. Similarly, plaintiffs’ attorneys who are paid on a contingency fee basis are less likely to bring certain actions if they know that a court will not compensate plaintiffs with net gains.

C. Optimizing Deterrence through Increased Predictability

Reimbursing only out-of-pocket loss may also bolster the class action’s ability to deter fraud. Because “unpredictable damages” is one of the factors that undermines optimal deterrence,²¹⁵ a doctrinal statement that plainly confines plaintiffs to an out-of-pocket recovery could increase deterrence by increasing predictability. This restriction also improves deterrence by making it easier for judges to determine when to dismiss actions that do not allege compensable economic loss, as defined by the out-of-pocket standard. Admittedly, unpredictability also comes from uncertain market reaction to fraud and from variable expert calculation methods. Predicting damages when a corporation is trying to gauge the economic harm of issuing a restatement is almost impossible given the impulsive nature of market reaction. Still, in formulating a worst-case scenario, the certainty of knowing how a court will calculate loss and award damages helps. Even though setting a fixed method for assessing loss does not ameliorate problems with unpredictability, it does offer parties a predictable and reliable starting point for calculating potential damage awards.

Moreover, if we assume that corporate actors aim to maximize wealth and that they weigh their behaviors to determine which attributes are the most cost-effective, then they can adjust their behavior accordingly if the financial costs are known. This idea may assume too much given that plaintiffs often bring securities class actions based on significant market fluctuations rather than firm knowledge of corporate wrongdoing. Of course, social planners could also manipulate other variables to increase deterrence. Although each of these variables could merit its own law review article, collectively, they might include defining actionable conduct, making a sanction a predictable consequence of wrongful conduct, targeting sanctions at wrongdoers rather than at corporations, and providing specific guidelines for when sanctions might be imposed. Suffice it to say that, for our purposes, a doctrinal statement for awarding fraud-on-the-market damages will at least provide the start of increased predictability (and thus increased deterrence) even though it will not, on its own, produce optimal deterrence.

Because the securities class action functions to deter fraud, one of the primary concerns about limiting the class action’s availability to those who experienced a net loss is that corporate wrongdoing could go undeterred. Yet, alternative enforcement means, such as the Department of Justice, the exchanges, and the SEC, also deter fraud. Because most antifraud enforcement efforts do not come from private class actions, statistics suggest that limiting the availability of

²¹⁵ See *supra* page 27 (discussing Calfee and Craswell’s research that “difficulty measuring damages” is one of the factors that thwart optimal deterrence in tort law).

private class actions when investors do not experience a net loss does not mean that fraud will go undeterred or unpunished.²¹⁶

Statistics show that the exchanges, Department of Justice, and the SEC – not private class actions – already carry out most enforcement and deterrent efforts.²¹⁷ From 2000 to 2002, private plaintiffs initiated an average of only 205 securities class actions versus 5,101 actions initiated by the SEC, Department of Justice, States, National Association of Securities Dealers, and the New York Stock Exchange.²¹⁸ Further, as compared with the average from 2000-2002, the 2005 statistics indicate that SEC enforcement actions increased and private actions decreased.²¹⁹ In 2005, the SEC initiated 630 actions, which is a significant increase compared with the average of 528 from 2000-2002.²²⁰ Moreover, class action filings decreased from 247 in 2004 to 209 in 2005.²²¹

All in all, these statistics demonstrate that corporate fraud will not go unpunished or undeterred if plaintiffs cannot bring a class action when they do not experience a net monetary loss. Unlike in private securities class actions, the SEC need not prove damage, injury (economic loss), or reliance in order to maintain an enforcement action.²²² Consequently, the SEC's enforcement and deterrence efforts would not be affected by limiting private class actions to net losers who experienced out-of-pocket losses from the fraud. Thus, enforcement mechanisms exist to deter even the situation presented by the gold-platinum hypothetical where the share's higher price was lower than it might otherwise have been absent the fraud. Accordingly, social planners should consider limiting the securities class action's availability to investors who experienced out-of-pocket losses. This could result in at least a small measure of increased predictability and could bolster the private securities class action's deterrence value of traditional fraud that causes a stock price decline.

CONCLUSION

My intention in this Article is not to imply that simply limiting investors to their out-of-pocket losses will provide a quick "fix" for the ills of the securities class-action system. Instead, I hoped to highlight some of the intrinsic problems that could result from compensating investors with a net gain and from stretching traditional common-law remedies to fit modern securities-fraud class actions. Indeed, the out-of-pocket measure is the only common-law remedy that recognizes the distinctions between face-to-face transactions and open-market fraud, that

²¹⁶ See *infra* Appendix.

²¹⁷ See *infra* Appendix.

²¹⁸ Howell E. Jackson, Variation in the Intensity of Financial Regulation: Preliminary Evidence and Potential Implications 27 (Aug. 18, 2005), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=839250 (last visited July 5, 2006) (on file with author); *infra* Appendix. Yet, these comparatively few class action settlements and trials resulted in a total award of \$1,923,959,333, whereas the total public enforcement effort (not including arbitrations by the NASD or NYSE) resulted in sanctions of \$1,864,409,277. See *infra* Appendix.

²¹⁹ See *infra* Appendix.

²²⁰ See *infra* Appendix.

²²¹ See *infra* Appendix.

²²² S.E.C. v. Rana Research, Inc., 8 F.3d 1358, 1363 (9th Cir. 1993); S.E.C. v. Rind, 991 F.2d 1486, 1490 (9th Cir. 1993); BROMBERG & LOWENFELS, *supra* note 16, at § 9:1. The Department of Justice does not have to meet the normal standing requirements of private plaintiffs either. GFL Advantage Fund, Ltd. v. Colkitt, 272 F.3d 189, 206 n. 6 (3d Cir. 2001).

complies with the loss causation requirement, and that limits plaintiffs to their actual damages. Restricting investors to out-of-pocket losses also advances optimal deterrence by increasing predictability through a clear doctrinal damage calculation. Although experts will often differ over methodologies,²²³ identifying the appropriate damage measure at least provides a predictable starting point. Consequently, if the post-*Dura* courts encounter their own variation of the gold-platinum hypothetical, I am cautiously optimistic that they might consider the broader consequences of compensating investors for more than their out-of-pocket losses and limit damage awards accordingly.

APPENDIX

Public Enforcement Effort	(Annual Averages: 2000-2002) ²²⁴	2005
SEC Actions	528	630 ²²⁵
DOJ Prosecutions	101 ²²⁶	122 ²²⁷

Exchange Enforcement Effort	(Annual Averages: 2000-2002) ²²⁸	2005
NASD Actions	1,266	1,399 ²²⁹
NYSE Actions	240	196 ²³⁰
NASD Arbitrations Filed	6,725 ²³¹	6,074 ²³²
NYSE Arbitrations Filed	595	464 ²³³
Total Exchange Enforcement	8,826	8,133

²²³ Alexander, *supra* note 2, at 1488 (“Expert testimony is required to calculate damages, and that testimony is contradictory even when the experts purport to be using the same methodology.”); *see also* Alexander, *supra* note 204, at 1421; Cornell & Morgan, *supra* note **Error! Bookmark not defined.**, at 883; Koslow, *supra* note 204, at 811; Baruch Lev & Meiring de Villiers, *Stock Price Crashes and 10b-5 Damages: A Legal, Economic, and Policy Analysis*, 47 STAN. L. REV. 7 (1994).

²²⁴ Data in this column come from Jackson, *supra* note 218, at 27.

²²⁵ *Select SEC and Market Data Fiscal 2005* (Securities Exchange Commission) (2005), at 3, available at <http://www.sec.gov/about/secstats2005.pdf> (last visited July 5, 2006) (on file with author). In 2005, the SEC initiated 947 investigations, 335 civil proceedings, and 294 administrative proceedings. U.S. SECURITIES AND EXCHANGE COMMISSION, 2005 PERFORMANCE AND ACCOUNTABILITY REPORT 7 (2005), available at <http://www.sec.gov/about/secpar/secpar2005.pdf> (last visited August 2, 2006) (on file with author).

²²⁶ In July 2002, the DOJ started a corporate fraud task force. From the time it started the task force to the time of publishing its 2002 Annual Report, the DOJ opened more than 130 corporate fraud matters. UNITED STATES ATTORNEYS’ ANNUAL STATISTICAL REPORT: FISCAL YEAR 2002, at 29 (2002), available at http://www.usdoj.gov/usao/reading_room/reports/asr2002/02_stat_book.pdf (last visited July 19, 2006).

²²⁷ This figure represents the number of new corporate fraud matters opened in 2005 by the Department of Justice. UNITED STATES ATTORNEYS’ ANNUAL STATISTICAL REPORT: FISCAL YEAR 2005 at 27 (2005), available at http://www.usdoj.gov/usao/reading_room/reports/asr2005/05statrpt.pdf (last visited July 19, 2006).

²²⁸ Data in this column come from Jackson, *supra* note 218, at 27.

²²⁹ NASD website, <http://www.nasd.com/PressRoom/Statistics/index.htm> (last visited Aug. 18, 2006) (on file with author).

²³⁰ NYSE website, NYSE Enforcement, <http://www.nyse.com/regulation/howregworks/1022221394131.html> (last visited July 26, 2006). The NYSE reports that of the 196 cases it prosecuted, 58 were against member firms and 138 were against individuals.

²³¹ NASD – Arbitration & Mediation – Dispute Resolution Statistics, available at <http://www.nasd.com/ArbitrationMediation/NASDDisputeResolution/Statistics/index.htm> (last visited July 5, 2006) (on file with author).

²³² *Id.*

²³³ NYSE website, http://www.nyse.com/pdfs/ARB_STATISTICS_TWO_PAGES_6-1-06.pdf (last visited July 26, 2006) (on file with author).

Private Enforcement Actions	(Annual Averages: 2000-2002)	2004	2005
Class Action Filings in Federal Court	205 ²³⁴	247 ²³⁵	209 ²³⁶

²³⁴ Jackson, *supra* note 218, at 27.

²³⁵ Miller et al., *supra* note 110, at 2.

²³⁶ *Id.*