WHY PAY A FRAUD PLAINTIFF TO SUE?

By Richard A. Booth

Although the nation's top securities class-action law firm, Milberg Weiss, claims to have recovered $45 billion for aggrieved investors, it was recently indicted for making illegal payments to recruit investor plaintiffs. But why would a law firm need to pay a victim to sue? The answer is that most investors have nothing to gain from such actions. Indeed, investors in the aggregate end up worse off because of securities litigation.

A securities fraud class action typically arises from the failure of a publicly traded company to disclose material information in a timely fashion. The withheld information may be either good news or bad news. But bad news fraud is far more common because of the way damages are awarded.

The standard approach to damages in a bad news case is to award the difference between the price paid by the buyer and the market price after corrective disclosure. There are serious problems with this approach. Although it is easy to calculate damages if there is a single plaintiff, the calculation of aggregate damages in a class action is exceedingly difficult. Many shares may be bought and sold repeatedly during the fraud period. Trading volume is likely to be many times the number of damaged shares. But there is no way to determine up front how many *different* shares traded.

To make matters worse, the issuer pays the damages. Accordingly, the prospect of a court award itself causes the stock price to fall further. That additional decrease in price will cause an increase in damages, which in turn will cause a further decrease in price. This positive feedback mechanism magnifies the decrease in market price — and the potential award to plaintiffs — sometimes by several multiples of the decrease from the corrective disclosure.

Feedback will arise even in a perfectly efficient market. To be sure, the market may overreact to bad news. But the point is that even if the market is working perfectly, feedback magnifies damages.

Feedback is inherent in the class action system. For diversified, buy-and-hold investors who, though innocent of any fraudulent actions, are stuck with paying much of the penalty in a class action suit, the loss from feedback is a significant cost in addition to the cost of litigation. It makes damages far worse in bad news cases, and it reduces gains in good news cases. Moreover, issuers are deprived of capital to which they would have had access in an undistorted market. Securities fraud is a bad thing, but securities fraud litigation is even worse.

For diversified investors who do happen to trade during the fraud period, there are no benefits from class action suits over the long haul. A diversified investor is equally likely to be on the winning side of a given trade as on the losing side. Indeed, diversified investors are net losers from class action because of the costs of litigation. So it is no wonder that an investor would need a little inducement to sue.

The only case in which litigation may benefit a diversified investor is if insiders extract wealth from the market by trading during the fraud period. But in such cases, investors are fully compensated if the company recovers the insider gain. Issuer recovery avoids the problem of feedback and eliminates the need to determine the number of damaged shares. To be sure, this solution requires the company to sue insiders who may have engaged in improper trading. But if the company fails to sue, stockholders can maintain a derivative action.

Admittedly, an undiversified investor may suffer significant harm from securities fraud. An investor who forgoes the benefits of diversification and picks a single stock can lose his entire investment. But it does not follow that an undiversified investor should have a remedy if he voluntarily assumes the unnecessary risk that goes with failure to diversify. Through diversification, an investor can eliminate the risk that goes with investing in a single stock without any sacrifice of expected return. The only risk that remains is market risk — the risk that the market as a whole will rise or fall.

Moreover, it is costless to diversify. Complete diversification is available cheap, even for the smallest investors, through mutual funds or folios at fees that are less than those that go with a brokerage account. In short, it is so cheap and easy for investors to diversify that it is simply unnecessary for investors to take company-specific risk. Given that the fundamental goal of investing is to generate the greatest possible return at the lowest possible risk, it is irrational for an investor who can do so not to diversify.

The Supreme Court has clearly stated that securities law should be interpreted consistent with the needs of reasonable investors. Plaintiff class members should thus be presumed to be diversified and such actions should be dismissed for lack of harm in the absence of insider trading or the equivalent. A reasonable investor neither needs nor wants a remedy unless insiders have gained.

At the very least, the law should recognize that there is serious conflict between diversified and non-diversified investors. Diversified investors are effectively insured against simple securities fraud. The cost of litigation operates as a tax on the returns of diversified investors that subsidizes undiversified investors. Even if undiversified investors have a legitimate gripe, the fact is that about two-thirds of all stock is held by diversified institutional investors, and much of the remainder is held by diversified nonprofit institutions. There is no justification for protecting undiversified investors at the expense of other investors when diversification is free for the taking.

The clincher is that non-trading, buy-and-hold investors are the biggest losers from securities class actions. All investors suffer their share of attorney fees. But non-traders see the value of their stock in defendant companies fall by more — often much more — than it would but for the effects of litigation. Even if we are comfortable with wasting a few billion dollars on attorney fees (and bribes for plaintiffs), there is no good reason why holders should suffer losses that may be several times greater than they should be.

One could not design a system that makes much less sense. But the good news is that the courts can easily fix the system simply by re-characterizing securities fraud class actions as derivative actions in the name of the company. Whether the courts have the will to do so is another matter.

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