

TEXAS GULF SULPHUR REVISITED

By **Richard A. Booth**

It has been nearly forty years since the Second Circuit handed down its landmark opinion in *SEC v. Texas Gulf Sulphur Co.*¹ In TGS, the company had found an unusually rich deposit of ores near Timmins, Ontario. When rumors of the find began to circulate, the company issued a pessimistic press release while several officers and directors purchased stock and call options. When the company issued a corrective press release, the price of TGS stock rose dramatically.

TGS was a motherlode of legal issues. It was both a classic false press release securities fraud case (complete with duty to correct issues arising from rumors originating in the company) and it was an insider trading case. It even raised intriguing issues about the legality of an insider accepting stock options while in possession of material nonpublic information. The Second Circuit found violations of federal securities law – in particular Rule 10b-5 – in each of these transgressions. Although the Second Circuit did not get the theory right in every respect, the result would clearly be the same today. It has taken all the years in the meantime to sort out the details of what constitutes securities fraud and insider trading. Indeed, the process continues. Nevertheless, securities fraud and insider trading have become well established as independent causes of action under federal securities law.

TGS may well have been decided differently if it had not involved both a false press release and insider trading. Standing alone, the false press release might have been excused as a mistake of business judgment – a good faith effort to quell rumors while gathering facts. Similarly, insider trading might have been excused in the absence of the false press release because the case would then have turned on an omission rather than a misrepresentation. To be sure, the culprits in TGS bought stock from fellow stockholders to whom they owed a fiduciary duty. But no one knew in 1968 that that would matter.²

TGS is utterly silent on one key question: the appropriate remedy in a private civil action. Because TGS was an SEC enforcement action, it was not necessary for the court to address the issue. But if the court had done so, there is some chance that it would have concluded that those who traded on inside information should disgorge their gains to TGS the company – because that is the statutory remedy for short swing trading specified in Section 16(b). Instead, the courts (and Congress) have struggled since 1968 to define securities fraud and insider trading and to devise appropriate remedies for each.

It is my thesis here that the connection between securities fraud and insider trading matters. To be specific, I argue that a securities fraud class action should be dismissed for failure to state a claim unless it appears that insiders have used the occasion to misappropriate stockholder wealth. (And by *misappropriation of stockholder wealth* I mean something broader than what constitutes insider trading under current law.) Moreover, I argue that the appropriate remedy in such a case is for the culprits to disgorge their ill gotten gains to the issuer. Thus, such actions should be

¹ 401 F.2d 833 (2d Cir. 1968).

² See *United States v. Chiarella*.

characterized as derivative actions rather than as class actions. That in turn carries significant implications. As derivative actions based on insider gain, such actions could be maintained in state court as well as federal court, thus avoiding the strictures of SLUSA. Indeed, I suspect that most such actions would migrate to state court because they would be based primarily on allegations of breach of fiduciary duty (which is more expansive than insider trading as defined under federal law) and because state law remedies for breach of fiduciary duty are more generous than the strict out of pocket rule embodied in federal securities law.

A preliminary word on terminology is in order. Although insider trading is a form of securities fraud, I use the term *securities fraud* here to refer to cases in which the subject company has misled the market in some way (usually by issuing a false press release). Most cases involve the cover up of negative information that drives down the price of the subject company stock when it ultimately comes to light. Securities fraud can also involve withholding good news, but that much less common. Much the same is true about insider trading which may involve nonpublic information that is either bad news or good news. But in the case of insider trading it is not clear that one type of case predominates. In any event, for simplicity, the discussion here assumes that securities fraud and insider trading involve undisclosed *bad* news and accordingly that the victims of such fraud are those who buy the stock during the fraud period.

In most cases, securities fraud is litigated as a class action in federal court. Although there are some examples of actions under state law, it seems fair to say that most of the action is in federal court. Insider trading is usually the subject of federal criminal prosecution. There were a few early cases that suggested that state law might provide a remedy. But the law relating to insider trading varies considerably from state to state.

Although federal jurisdiction over these claims is well established, it is also well recognized that there are problems with the federal approach. In the case of securities fraud, the subject company pays the settlement or award. Thus, buyers are made whole at the expense of holders, while those who sell during the fraud period enjoy a windfall. In the case of insider trading, the culprit must disgorge his gains and usually pay a penalty of some multiple of his gains. Moreover, he often goes to jail. Theoretically, investors who traded contemporaneously can recover. But the recovery is typically miniscule.

It is arguable that both securities fraud and insider trading are victimless offenses. In both cases, the losers trade voluntarily for their own reasons. The losses they suffer would be suffered by someone fraud or no fraud. If the bad news had come out earlier when it should have, the stock would have fallen earlier and a different group of stockholders would have suffered. But the aggregate loss to the market would presumably have been the same.³

On the one hand, it seems obvious that securities fraud and insider trading are worrisome if not wrong. The financial world would probably be a better place without such shenanigans. On the other hand, the remedies we have seem to make little sense in the grander scheme of things.

³ This is not exactly true as things currently stand. Insider trading may add to trading volume. And a securities fraud class action (SFCA) will invariably cause an additional price change. But these discrepancies do not arise in the context of derivative action and the ultimate proposal here is to view private securities fraud actions as derivative.

This system may make *some* sense if one thinks of the reasonable investor as one who does his homework, finds a good stock, and invests his money. It makes some sense in such a world to protect investors who rely in good faith on the accuracy of publicly available information. It fosters confidence in the markets. And (as Martha Stewart would say) that is a good thing. Nevertheless, even in such a world, securities fraud class actions (SFCAs) penalize holders in order to make buyers whole. And there is no real remedy that benefits investors in a case of insider trading.

In the real world, however, the vast majority of investors are well diversified. And it is arguable that those who are not well diversified are irrational. Since securities law is designed to protect reasonable investors, it follows *a fortiori* that we need not worry about protecting *irrational* investors.⁴

The key question is what do diversified investors want from the securities laws? Ironically, a diversified investor is likely to prefer pretty much the polar opposite of what an undiversified investor would want.⁵ A diversified investor is not likely to care much about securities fraud except when it is accompanied by insider trading. In the absence of insider trading, securities fraud is a zero sum game for an investor who holds a well diversified portfolio and trades from time to time to keep it balanced. Such an investor is likely to gain as often as he loses from securities fraud in the absence of insider trading. Indeed, securities fraud litigation constitutes a dead weight loss for such an investor because the defendant company must bear the expense of defending itself and because the prospect of an award or settlement will cause the price of the subject stock to fall more than it otherwise would have fallen. Be that as it may, the fact that diversified investors suffer no loss in the aggregate from securities fraud (other than loss arising from the litigation itself) suggests that it may difficult to prove loss causation.⁶ On the other hand, such an investor *does* care about insider trading. Insider trading turns the zero sum game into a negative sum game. To be sure, the loss to any one investor from insider trading is still likely to be miniscule. Nevertheless, insider trading stacks the deck ever so slightly against the diversified investor.⁷

Think of the market as a pot in a poker game. In the absence of insider trading, every player faces the same odds. With insider trading, some traders are able to win a bit more often than they should. Although outsiders may still be winners overall (because on the average stocks increase in value over time), they will not enjoy their fair share of the gain. Insiders will have extracted

⁴ To be sure, some investors are rationally undiversified, for example, an investor who seeks control or significant voice in the issuer company. In such cases, however, the investor usually buys shares from another investor and has a personal cause of action against the seller in the event of fraud.

⁵ This is not to say that if we did live in world of undiversified investors the system would be ideal.

⁶ See *Dura Pharmaceuticals*.

⁷ Even though the amounts involved may be quite small when compared to the market capitalization of the company, issuer recovery in connection with insider trading may have important symbolic significance because it assures individual investors of equal treatment.

just a bit more than their fair share. In other words, even though the market pot grows over time, insider trading will result in slightly more of the gain going to insiders than should get.⁸ And returns to outsiders will be slightly lower they should be.

So what would a diversified investor want in the way of protection from the securities laws? The answer is quite simple. As a group, diversified investors would want insiders to disgorge their ill-gotten gains back into the pot. Although an individual player might argue that he would have won but for the cheater and thus should get the pot, a more likely outcome would be a do-over.⁹

What does this tell us about the law? It tells us that individual recovery makes no sense in the context of securities fraud and insider trading. Diversified investors care only about the unfair extraction of wealth from the pot. As long as they win and lose fair and square they have no complaint. The appropriate remedy is for the company to recover. Individual recovery by class action makes no sense. That is equivalent to giving the pot to the player with the second best hand rather than ejecting the cheater and replaying the hand. In short, the appropriate remedy is a derivative action by the issuer by which the cheaters disgorge their gains back to the company and make the pot whole once again.

Up to this point, I have used the phrase *insider trading* somewhat generically. In practice, insider trading has been difficult to define. Indeed, try as they might neither Congress nor the SEC has been able to settle on a definition. Rather, as a matter of federal law insider trading is best defined as using material nonpublic information for purposes of trading securities in violation of a duty to the source of the information not to use the information for personal gain. Although there are notable counterexamples, in most cases the source of the information is the issuer company and the duty runs to the issuer company. (The counter examples are not really relevant here.)

This definition of insider trading is arguably too narrow from the point of view of a diversified investor who is worried about playing in a fair game.¹⁰ What concerns a diversified investor is whether insiders take money out of the pot without assuming the same risks as the other players. To concoct an extreme example, the board of directors of an issuer company could in theory authorize the CEO to trade on inside information. Presumably, trading on inside information

⁸ Although it may go without saying, it seems fair to assume that insider trading hardly ever results in a loss for the insider.

⁹ To be sure, one could argue that all securities fraud and insider trading is zero sum. Thus, it is tempting think of insider investors and outsider investors as separate and adverse classes of investors. To some extent they are. But it is not necessary to view the classes as adverse to each other. The definition of securities fraud and insider trading may thus be seen as part of the substantive bargain between insiders and outsiders and thus as classically a matter of state corporation law.

¹⁰ In order to make out a case of securities fraud under Rule 10b-5 it must be alleged (and pleaded with particularity) that the defendant(s) acted with scienter. And one way to satisfy that standard is to point to instances of insider trading during the fraud period. Nevertheless, at least one empirical study has found that insider trading is not one of the most common factors cited as evidence of scienter. Pritchard & Sale. On the other hand, it seems fair to presume that the courts have tended to think of insider trading as it is defined in the case law and have not used the more expansive notion – diversion of stockholder wealth – that I use here.

under such circumstances would not constitute a breach of duty to the corporation and thus would not be illegal under federal law. Yet a diversified investor would presumably object vigorously to any such license to steal from the pot. This suggests that what constitutes insider trading broadly defined is not necessarily subject to negotiation. Investors are arguably entitled to rely on some ground rules that individual corporations cannot change – at least not midstream. Indeed, it seems likely that authorizing the CEO to engage in insider trading at will would be illegal under state law as a violation of the duty of care because it amounts to a something for nothing trade. It is worth noting that the duty of care is generally unwaivable. So maybe the federal common law of insider trading is pretty close to the correct definition after all.

Although the foregoing example may seem a bit farfetched, the current flap over timing and backdating option grants affords a good real world example of insider diversion of stockholder wealth that probably does not rise to the level of actionable insider trading. Presumably, a corporation's board of directors often (perhaps usually) possesses material nonpublic information at the time it grants options. And in the case of outright backdating, the board of directors knows that the value of the stock has risen in the meantime. The SEC has been remarkably sanguine about the backdating of options, seemingly viewing it as a mere administrative detail. The argument seems to be that since the board of directors has the power to grant options anyway, it can grant them *nunc pro tunc*. One member of the SEC has opined that such grants do not constitute insider trading:

Boards, in the exercise of their business judgment, should use all the information that they have at hand to make option grant decisions. An insider trading theory falls flat in this context where there is no counterparty who could be harmed by an options grant. The counterparty is the corporation -- and thus the shareholders! They are intended to benefit from the decision. ... In the best exercise of their business judgment, directors might very well conclude that options should be granted in advance of good news. What better way to maximize the value that the option recipient attaches to the option?¹¹

In other words, the argument seems to be that because the corporation itself is a party to the trade and is deemed to know the material nonpublic information at the time it voluntarily grants an option, there can be no insider trading involved. Aside from the possibility that the CEO and other high level employees may control what the board of directors knows and may sit idly by while the board of directors makes a windfall grant (as happened in TGS), it is not at all clear that public stockholders would approve of such tactics especially if they entail withholding information from the market that is otherwise ripe for disclosure.

Although timing and backdating does not appear to constitute insider trading under federal law, such practices may constitute a breach of fiduciary duty under state law. Thus, if securities fraud is characterized as derivative in nature, it does not matter whether such practices or any other diversion of stockholder wealth amounts to insider trading or any other recognized form of

¹¹ Atkins speech.

securities fraud. The only question is whether or not the practice is consistent with the reasonable expectations of stockholders.¹²

It is important not to get hung up on what constitutes insider trading. The point for present purposes is that diversified stockholders are likely to care about a broader range of wealth diversions than simply those that fit the technical definition of insider trading.

Using timing and backdating of options as an example, there are several ways that state law might address the issues in the context of a derivative action.¹³ First, such practices may constitute a breach of the duty of loyalty if the recipients participated in approving the questionable grant of options. Second, if the issuer company has adopted a stock option plan that has been ratified by the stockholders (or by the directors in the case of a grant by an authorized committee or individual), a questionable grant may be challenged as a violation of a rule of the corporation – essentially a breach of contract – if it is contrary to the terms of the stock option plan.¹⁴ Third, a questionable grant may be challenged as a violation of the duty of care or the

¹² Unlike most SFCAs, cases involving option practices are likely to be good news cases and damages are likely to be quite small because corrective disclosure will usually cause the value of the stock to drop back from a higher price to a lower price that is nonetheless somewhat higher than the price at which members of the plaintiff class bought their shares. In this situation, plaintiff lawfirms may choose to characterize the action as derivative rather than direct.

¹³ I assume here that there is no question that a grant of options at fair market value on the actual date of the grant is permissible on the theory that the options have value only if they increase in price. And I use the phrase *fair market value* here to comprehend both backdating and timing. With backdating, it is presumably known that the price of the stock has risen since the specified date. Otherwise the option would presumably be granted at the market price on the date of the grant. With timing, it seems fair to presume that there is reason to believe that the market price is lower than it should be. As a matter of finance theory, of course, all options have some value. But the point here is that the recipient enjoys a gain only if the underlying stock increases in value (because the recipient cannot sell the option). As such, a grant of at the money options does not involve the disposition of anything of value by the corporation. It is merely an agreement to sell stock at the current fair market value. The recipient enjoys a gain only if all stockholders enjoy a pro rata gain. One might argue that even under these conditions, the number of options granted may be so large that it effects an unacceptable dilution of the interests of other stockholders. That is not really a worry because the options have value to the recipient only if the price of the underlying stock increases. To be sure, the more options there are outstanding, the more they will mute any increase in price. But this too is less worrisome than one might think because those who grant options presumably understand that if they grant too many options they will reduce their own gain. In other words, if the goal is to maximize the gain to optionees, there is a mathematical limit on the number of options that should be granted that depends on the likely rate of growth of the issuer company. It should be emphasized that full and timely disclosure is crucial. Although existing stockholders have no reason to complain about the grant of at the money options, investors who buy into the company after options have been granted but before the grant is disclosed have good reason to complain. On the other hand, in the real world, the market may assume that worst and price companies on a fully diluted basis as if all stock available for options has been or will be used for options. If so, issuers have a strong incentive to disclose voluntarily. Finally, it is important to be realistic about the efficiency of the market. Insiders will always have a better sense of a company's prospects than will outsiders. Thus, it is impossible to eliminate all vestiges of timing and to think that there is any such thing as a truly fair grant of options. But a second best solution that draws the line at material non public facts – as does federal securities law generally – is probably good enough particularly in view of the fact that optionees must forgo the benefits of diversification.

¹⁴ See ALI, Principles of Corporate Governance. It would not seem necessary under such a theory to overcome the business judgment rule in the case of a clear breach. On the other hand, if the plan is ambiguous in some particular, the business judgment rule would presumably apply.

duty of good faith if the board of directors (or committee or agent thereof) failed to exercise reasonable business judgment in deciding to grant options at a price lower than fair market value on the actual date of the grant.¹⁵ Finally, such practices may violate the (relatively new) duty of candor.¹⁶ It is crucial for the market to be fully informed for options to work properly. Or if there has been a violation of SEC rules in connection with the grant, that too may constitute a per se violation. To be sure, there are elaborate SEC rules requiring extensive disclosures in connection with options. And the SEC is poised to adopt still more rules relating to backdating and timing.¹⁷ But such rules are necessarily reactive and incomplete. Moreover, they are rules and can be manipulated. This is not to say that such rules do not have value. They do if only to set minimum standards and to standardize disclosure. But there is an important role here for principles-based fiduciary duty and the case-by-case approach that it entails.

Although the interests of diversified stockholders and the problems with current federal practice relating to SFCAs and insider trading are reason enough to scrap the system we have in favor of a derivative approach, there are several additional arguments that should be noted at least in passing.

First, diversified investors would be far better off because the collateral damage and litigation expense associated with SFCAs would be a net savings to the system. Aggregate damages (and settlements) would be far lower than under current law because they would be limited to insider gains. Investors in the aggregate would see enhanced returns. On the other hand, an issuer company would be subject to suit whenever insiders divert stockholder wealth inappropriately whether or not the company has issued a misleading press release or committed other acts that constitute securities fraud. The bottom line is smaller awards but more of them. To be sure, a derivative action would be subject to dismissal by SLC. But the courts are quite able to monitor that process.¹⁸ Moreover, as I have argued elsewhere, issuer companies may well be more willing to police their own if they need not risk the devastation that comes with SFCAs as currently configured.

Second, SLUSA does not apply to derivative actions and most actions would likely migrate to state court. Although it is always possible to maintain a derivative action in federal court based on state law theories (assuming that the requirements of diversity jurisdiction can be met), it

¹⁵ See *In re Walt Disney Co. Derivative Litig.*, 2006 Del. LEXIS 307. The fact that the stockholders have ratified a stock option plan (and have thus authorized the board of directors to do what it already had the power to do) does not mean (as some seem to suggest) that backdating is permissible. Cox. To the contrary, a ratified stock option plan arguably constitutes a contract with the stockholders.

¹⁶ See *Malone v. Brincat*.

¹⁷ The problems associated with timing could be minimized with a well-crafted regime of full disclosure. Presumably, the market will react quickly to a significant grant as a signal of insider confidence. Indeed, if companies were required to announce grants a day or two or three *in advance*, the market could eliminate virtually all possibility of timing effects. On the other hand, it is also possible that issuer companies may use grants to send false signals to the market in order to prop up or increase stock price. Moreover, some companies may seek to minimize signaling effects by adopting a fixed calendar of grant dates. That in turn could lead to problems of earnings management.

¹⁸ See *Joy v. North*.

seems likely that both plaintiffs and defendants will prefer state courts – particularly the Delaware courts -- for a variety of reasons. An action in the Delaware Court of Chancery will be heard by a judge who specializes in such matters and who is accustomed to case-by-case adjudication that amounts to ongoing interpretation of the bargain between corporations and their managers and stockholders. And that is exactly the issue at stake in deciding whether a particular practice constitutes an inappropriate diversion of stockholder wealth. Moreover, although the potential award in a derivative action is much smaller than in an SFCA, the standard remedy in a breach of fiduciary duty case is rescissory damages rather than mere out of pocket loss.¹⁹

On the other hand, one might argue that the federal courts have exclusive jurisdiction under the 1934 Act and that securities fraud must therefore be litigated in federal court (except for actions arising under the 1933 Act which is not really relevant here), it is not clear that a derivative action seeking to recover diverted stockholder wealth from insiders (or a similar direct action by the corporation) must be characterized as a securities fraud action. Indeed, such an action is just as reasonably characterized as an action based on an alleged breach of fiduciary duty. Moreover, a state court may presumably refer to federal law and SEC rules (and whether there has been an apparent violation thereof) in deciding whether an insider acted reasonably. In other words, state courts may presumably refer to federal rules as evidence of whether a fiduciary violation has occurred much as in a case of negligence per se. Thus, federal law and SEC regulations would likely play a significant role in setting minimum standards – at least for disclosure. (And of course the SEC would still have enforcement power.) But the state courts would be free to apply stricter standards in case-by-case litigation under principles-based fiduciary duty law. While it may seem a bit odd to argue that notoriously vague notions of fiduciary duty are preferable to more or less bright line rules such as those promulgated by the SEC, fiduciary duty is more consistent with need to work out the evolving terms of the stockholder contract on an ongoing basis and that the state courts are better equipped to evaluate the evolving interests of stockholders. It is perhaps regrettable that fiduciary duty ultimately falls back onto a fairness standard. But it seems inevitable that it must do so where the ultimate issue is one of how to divvy up the wealth. In recent years, the courts have tended to shy away from fairness analysis and to gravitate to stockholder expectations as the norm. To be sure, this is a subtle shift but it does better capture the essence of what courts of equity do. For example, such an approach permits a court to consider the implications of stockholder diversification and to tailor stockholder rights and fiduciary duties accordingly. Here too, recent controversies relating to option practices provide a good illustration. It seems apparent that some level of timing and backdating is inevitable and consistent with the good faith administration of an option plan. The board of directors invariably has better information than public stockholders. Accordingly, stockholders cannot reasonably expect that options will be granted only in the extraordinary circumstance that the board of directors is flummoxed about the future. Similarly, it seems reasonable to grant a new employee options as of the date of hire even though the number of options may not be determined until some later date. Moreover, such grants may be naturally regulated if there are other employees who depend on options for a significant portion of their

¹⁹ One possible problem is that plaintiff law firms may shop for a more favorable forum rather than filing their actions in Delaware. That is essentially the problem that Congress sought to fix in SLUSA. To be sure, there are few cases involving the internal affairs of Delaware companies that have ever been litigated outside Delaware. If it arises, the problem can be easily fixed by amending the DGCL to require all such actions involving Delaware corporations to be litigated in Delaware courts.

compensation. On the other hand, if it appears that the board of directors (or optionees themselves) manipulated grant dates while in the possession of (disclosable) material facts or manipulated the books in order (say) to hold back a stock price increase until options could be granted, the result may be different. In short, a court of equity is well equipped to decide if options have been granted in a good faith attempt to create incentives to grow the value of the company as opposed to a scheme to capture past growth. In contrast, federal securities law and SEC rules are not well suited to a fact-intensive analysis of the situation as a whole and whether fiduciaries have acted consistently with stockholder expectations.

A closely related question is where does federal securities fraud law really come from? The simple answer is Rule 10b-5. But Rule 10b-5 simply outlaws fraud in connection with trading in securities without saying what constitutes fraud. It is arguable that Rule 10b-5 implicitly incorporates state law (or at least the common law) rather than creating any new law. One might even say that it merely provides federal jurisdiction for what would otherwise be a state law cause of action. In any case, the Supreme Court has repeatedly emphasized the common law roots of Rule 10b-5 – particularly in connection with insider trading – and has repeatedly limited the substantive reach of Rule 10b-5 consistent with the limitations of common law fraud. So it is somewhat odd that the states should have been forcibly displaced from much of a role in this area. On the other hand, it is also fairly clear that the federal courts have been much more expansive in their interpretation of the law of fraud (as it applies in connection with trading in securities) than the state courts were ever inclined to be.²⁰ And it may well be that that is exactly what Congress intended. But the most powerful force in the federalization of securities fraud is undoubtedly the plaintiff bar. The potential award in a SFCA is many times greater than the potential award in a derivative action. Moreover, once a case has been characterized as one involving securities fraud and filed in federal court, there is no going back to state court. Nevertheless, the law of fiduciary duty is fundamentally different from the law of fraud even as it has been retooled by the federal courts. Despite the fact that the state courts have sometimes used the word fraud as a synonym for breach fiduciary duty, true fraud depends on deception. To be sure, fiduciary duty can be satisfied through disclosure. But deception is not a required to make out a case for breach of fiduciary duty. The courts are free to weigh the equities and in effect to fill in the blanks in the stockholder contract with the terms that a reasonable investor would expect.

Third, because state law is likely to comprehend a broader range of offenses than federal insider trading law, it may be that a derivative approach to securities fraud will obviate the need for the criminal prosecution of insider trading. It is not entirely clear why issuers do not prosecute claims of insider trading. After all, the remedy for short swing trading set forth in Section 16(b) of the 1934 Act is disgorgement of gain (or loss avoided) to the issuer company. Moreover, Section 16(b) expressly contemplates enforcement by derivative action if the issuer fails to seek disgorgement. To be sure, actions arising under Section 16(b) are quite rare. But that is because it is triggered only by a purchase and sale within six months of each other. Although we now know that there are many other ways to engage in insider trading and that Section 16(b) has become little more than a trap for the unwary, it seems pretty clear that the framers of the 1934 Act thought that the remedy for insider trading should be disgorgement to the issuer company. But why is it that issuers seldom seek disgorgement on their own? (It is possible that the practice

²⁰ See *Affiliated Ute*.

is common but quietly handled. I doubt it.) One obvious reason that issuers do not often sue their own for insider trading is an inherent conflict of interest. It is often the case that the culprits have some or much power to decide whether the corporation should sue. Still, that does not explain why there are few derivative actions in connection with insider trading. On the other hand, it appears that the number of derivative actions brought in tandem with SFCAs has been increasing in recent years. Another somewhat less obvious reason for the disinclination of issuers to go after inside trading is that it might often amount to an admission of the company failed to disclose material information in a timely fashion and might therefore trigger the filing of an SFCA. Thus, as I have argued elsewhere, the disproportionate threat of SFCAs and their potentially devastating collateral consequences may prevent publicly traded companies from self-policing.

That raises another question: Why do we treat insider trading as a crime or civil offense? The answer is fairly simple. Private remedies do not seem to work. Presumably, a private civil remedy is always preferable to a criminal prosecution or civil enforcement action. Money damages are more scalable, whereas criminal sanctions and fines are invariably arbitrary. But again the problem may be with the plaintiff. A private civil action on behalf of investors is uneconomic. The amount of damages is likely to be relatively small – probably too small for a plaintiff firm to bother filing suit. And the amount that any one investor would recover is likely to be measured in cents rather than dollars. But the amounts involved are not so small that the issuer – who would get to keep the entire recovery – would decline to sue. Moreover, if issuers were more vigilant about insider trading, it might not be necessary to prosecute garden variety insider trading quite so vigorously. Indeed the SEC and DOJ might adopt a policy of non-prosecution in cases in which issuers themselves undertake to self-police. It might still be necessary to prosecute more exotic forms of insider trading – those that involve defendants other than conventional corporate insiders – but even in these cases action by the issuer company would often be a possibility.

Fourth, treating securities fraud as derivative is more consistent with underlying legal theory in the area. The primary foundation for insider trading is misappropriation of information usually from the issuer company. If the duty runs to the issuer company, the issuer company should be the one with standing to sue for disgorgement. On the other hand, one might argue that under the 1933 Act, it is defrauded investors who can sue. Indeed, it may well be that individual recovery became the rule in SFCAs by some sort of analogy to recovery under the 1933 Act. But the fact that individual investors recover under the 1933 Act derives from the fact that the company must disgorge the money it obtained from the fraudulent sale of stock. In other words, in an action under the 1933 Act the complaint is that the issuer diverted wealth from the aggregate stockholder pot – the market – and should give it back to the investors who were duped into parting with it. Moreover, the law is clear under the 1933 Act that damages are limited to the amount of money the issuer raised. Thus, in contrast to the effective result in SFCAs (where holders in effect pay buyers), disgorgement by the company in the a 1933 Act setting merely puts everyone back into the *status quo ante*. In short, the remedial scheme that we have under the 1933 Act is a powerful argument for treating securities fraud as an action in the name of the issuer and giving rise to recovery by the issuer rather than as an action in the name of individual investors giving rise to individual recovery.

The bottom line is that there is much to be gained from viewing most securities fraud actions as derivative rather than direct. (The exception involves cases in which the issuer company itself is a party to trading as in actions arising under the 1933 Act and in cases involving repurchases.) An action in the name of the issuer company – whether prosecuted by the company itself or as a derivative action – fits the remaining large majority of cases far better than the current system of SFCAs. Moreover, the collateral benefits are significant. But in order to be as effective as possible, such actions should proceed under state law and probably in state court. State law can address a broader range of issues than can federal law. State law can consider issues of fairness and stockholder expectations. In other words, state law can address the ultimate question of how to split the pot. In addition, state law can provide a remedy for violations of federal securities law and rules on the theory that the violation of federal standards is a *per se* violation of fiduciary duty. And the remedies available under state law are much more generous to stockholders than they are under federal law. Theoretically, a federal court applying state law could do all the same things that a state court could do. But somehow it seems unlikely that a federal court *would* do so. Indeed, if the action sounds primarily in fiduciary duty, and matters of federal securities law are treated as purely evidentiary, it is unclear that the federal courts would have jurisdiction except in the odd diversity case. To be sure, this proposal stands the current legal regime relating to securities fraud on its head. But so what. As Professor Marvin Chirelstein once said: "If it's better, I'm for it."