

The Missing Link Between Insider Trading and Securities Fraud

IT HAS BEEN NEARLY FORTY YEARS SINCE the Second Circuit handed down its landmark opinion in *SEC v. Texas Gulf Sulphur Co.*¹ In that case, the Texas Gulf Sulphur Company (TGS) found an unusually rich deposit of ores near Timmins, Ontario.² When rumors of the find began to circulate, the company attempted to downplay the event by issuing a pessimistic press release.³ In the meantime, several directors and officers purchased stock and call options.⁴ Several others received stock options as compensation.⁵ When the company issued a corrective press release, the price of TGS stock rose dramatically,⁶ and the insiders who had acquired stock and options enjoyed a handsome profit.⁷

Texas Gulf Sulphur was a mother lode of legal issues. It was both a classic false press release securities fraud case⁸ and an insider trading case.⁹ It even raised intriguing issues about the legality of an insider accepting stock options while in possession of material nonpublic information.¹⁰ The Second Circuit found violations of federal securities laws—in particular Rule 10b-5—in each of these transgressions.¹¹ Although the court did not get the theory right in every respect, the result would clearly be the same today.¹² But *Texas Gulf Sulphur* 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

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1. *SEC v. Tex. Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968) (en banc).

2. *Id.* at 840–43.

3. *Id.* at 842–45.

4. *Id.* at 841.

5. *Id.* at 841–43.

6. *Id.* at 847.

7. *Id.* at 842–47.

8. *Id.* at 848. It even included duty to correct issues arising from rumors originating in the company.

9. *Id.* at 847–48.

10. *Id.* at 849–50.

11. *Id.* at 842–43, 852.

12. For example, the *Texas Gulf Sulphur* court ruled that a cause of action could be stated under Rule 10b-5 even if an issuer is merely negligent in issuing a false press release. *Id.* at 860. The Supreme Court subsequently ruled that scienter is required. See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976).

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business judgment—a good faith effort to quell rumors while gathering facts.¹³ Similarly, insider trading might have been excused in the absence of the false press release because the case then would have turned on an omission rather than a misrepresentation.¹⁴ To be sure, the culprits in *Texas Gulf Sulphur* bought stock from fellow stockholders to whom they owed a fiduciary duty.¹⁵ But in 1968, no one knew that it would matter.¹⁶

Texas Gulf Sulphur is largely silent on one key question: the appropriate remedy in a private civil action. Because *Texas Gulf Sulphur* was an SEC enforcement action, it was not necessary for the court to address the issue. But if the court had done so, it probably would have concluded that those who traded on inside information should disgorge their gains to the company because disgorgement is the remedy for short swing trading under section 16(b) of the Securities Exchange Act of 1934.¹⁷ Instead, the courts (and Congress) have struggled for nearly forty years to define securities fraud and insider trading, and to devise appropriate remedies for each.¹⁸ In the meantime, securities fraud and insider trading have become well established as *independent* causes of action under federal securities law.

13. See *Basic Inc. v. Levinson*, 485 U.S. 224 (1988) (rejecting the consideration of business needs and affirming materiality as the sole consideration where information is ripe for disclosure).

14. See *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128 (1974) (holding that in an omission case, reliance may be inferred from materiality if the insider is a fiduciary); see also *Basic Inc.*, 485 U.S. at 224 (holding that in a misrepresentation case the plaintiff may rely on integrity of market).

15. *Tex. Gulf Sulphur*, 401 F.2d at 841–43.

16. See *United States v. O'Hagan*, 521 U.S. 642 (1997) (adopting the misappropriation theory and holding that insider trading may be based on duty to the employer/source of the information); *Carpenter v. United States*, 484 U.S. 19 (1987) (justices divide four to four on misappropriation theory); *Chiarella v. United States*, 445 U.S. 222 (1980) (holding that an insider who bought with knowledge of a tender offer planned by third party bidder did not violate any duty to target stockholders from whom he bought while suggesting misappropriation of information as an alternative theory); see also *Moss v. Morgan Stanley, Inc.*, 719 F.2d 5 (2d Cir. 1983) (holding that a selling stockholder may not sue the employer of an insider/purchaser for a violation based on a breach of duty to employer).

17. 15 U.S.C. § 78p(b) (2000).

18. Since 1968, the Supreme Court has issued at least thirty-one opinions addressing securities fraud under the 1934 Act and another four addressing insider trading. Those totals do not include a similar number of cases dealing with other aspects of securities regulation. Congress has passed two major acts addressing securities fraud (the Private Securities Litigation Reform Act of 1995 (PSLRA), Pub. L. No. 104-67, 109 Stat. 737 (codified in scattered sections of 15 U.S.C.) (passed over presidential veto, see 109 Stat. 765 (1995)), and the Securities Litigation Uniform Standards Act of 1998 (SLUSA), Pub. L. No. 105-353, 112 Stat. 3227 (codified in scattered sections of 15 U.S.C.)), and two major acts addressing insider trading (the Insider Trading Sanctions Act of 1984 (ITSA), Pub. L. No. 98-376, 98 Stat. 1264 (codified in scattered sections of 15 U.S.C.), and the Insider Trading & Securities Fraud Enforcement Act of 1988 (ITSFEA), Pub. L. No. 100-704, 102 Stat. 4677 (codified as amended in scattered sections of 15 U.S.C.)) not to mention a variety of other acts dealing with other aspects of securities regulation. This is an extraordinary level of effort considering the relatively narrow subject matter, particularly on the part of the Supreme Court which issues less than one hundred opinions per year. In contrast, there has been very little litigation at any level relating to the Securities Act of 1933, 15 U.S.C. § 77, although there have been a fair number of cases addressing the issue of what constitutes a security under both acts that have reached the Supreme Court. This pattern would seem to suggest that there may be fundamental problems with the design or interpretation of the 1934 Act.

It is my thesis 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. Rational investors diversify. For diversified investors, securities fraud (without misappropriation) is a zero-sum event. And securities fraud class actions generate deadweight losses. In other words, in the aggregate diversified investors lose from securities fraud class actions and would prefer a rule prohibiting such actions as long as the insiders have not misappropriated stockholder wealth.

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 characterized as derivative actions rather than as class actions. This distinction carries significant implications because such actions could be maintained in state court as well as federal court, thus avoiding the strictures of the Securities Litigation Uniform Standards Act (SLUSA).¹⁹ I suspect that 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 under federal securities law.²⁰

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's stock when the negative information ultimately comes to light. Securities fraud can also involve withholding good

19. See Securities Exchange Act of 1934 § 28, 15 U.S.C. § 78bb. SLUSA was enacted in 1998 effectively to require that all securities fraud class actions be litigated in federal court, because many securities fraud class actions were filed in state courts following the adoption of PSLRA in order to avoid the heightened pleading standards and other provisions of PSLRA. See Michael R. Dube, Note, *Motive and Opportunity Test Survives Congressional Death Knell in Private Securities Litigation Reform Act*, 42 B.C. L. REV. 619, 623 n.24 (2001). SLUSA includes a general exception for derivative actions because a derivative action is essentially an action by the corporation to recover for harm done to the corporation, and thus is usually based on principles of fiduciary duty that arises under state corporation law. See Exchange Act § 28(f), 15 U.S.C. § 78bb(f).

20. Under federal securities law, damages are limited to actual (out of pocket) loss suffered. See Exchange Act § 28, 15 U.S.C. § 78bb. Under state law, one may recover so-called rescissory damages—the monetary equivalent of the benefits that would have accrued to the victim if the transactions never occurred. See *Weinberger v. UOP, Inc.*, 457 A.2d 701, 714 (Del. 1983). Rescissory damages are similar to a benefit of the bargain measure, but they refer to the benefits that would have accrued to the plaintiff and not to the benefits that were in fact misappropriated by the defendant, though in many cases the two measures will be the same. Of course, the corporation recovers in a derivative action, and the amount recovered from insiders is likely to be far less than the amount that would be recovered by plaintiff stockholders in a successful securities fraud class action.

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news, as in *Texas Gulf Sulphur*, but that is much less common.²¹ Similarly, insider trading may involve nonpublic information that is either bad news or good news.²² But in the case of insider trading it is not clear that one type of case predominates.²³ 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.

I. THE EXISTING (FLAWED) SYSTEM OF SECURITIES LITIGATION

In most cases, securities fraud class actions and prosecutions for insider trading are filed in federal court. Indeed, under SLUSA securities fraud class actions must be litigated in federal court.²⁴ Although there are some older examples of actions under state law, today almost all securities fraud litigation is in federal court.²⁵ Insider trading is usually the subject of federal criminal prosecution.²⁶ There were a few early cases suggesting that state law might provide a remedy, but the law varied considerably from state to state.²⁷ In any event, federal law also predominates in this area.

Although federal jurisdiction over these claims is well established, it is also well recognized that there are problems with the federal approach.²⁸ In the case of securities fraud, the subject company pays the settlement or award.²⁹ Thus, in a bad news

21. Another example is *Basic Inc. v. Levinson*, 485 U.S. 224, 230 (1988). As I have argued elsewhere, it is much more common for a securities fraud class action to be based on bad news fraud than on good news fraud because of the way securities fraud class actions work. Specifically, because the company pays the damages, the prospect of a securities fraud class action causes the price of the subject stock to fall upon the announcement of bad news even further than it otherwise would, thus increasing the potential payout by the company through a positive feedback mechanism. In the case of good news fraud, negative feedback has the opposite effect and mutes the change in price, making litigation less lucrative for plaintiff lawyers. See Richard A. Booth, *The End of the Securities Fraud Class Action as We Know It*, 4 BERKELEY BUS. L.J. 1 (2007) [hereinafter Booth, *As We Know It*]. For a sawed-off version of my argument, see Richard A. Booth, *The End of the Securities Fraud Class Action?*, 29 REG. 46, 47 (2006).

22. 15 U.S.C. § 78j; Bruce Ingersoll, *SEC Charges Aide of Software Concern with Insider Trades*, WALL ST. J., Dec. 7, 1984, at 1.

23. I suspect that there is more insider trading in good news cases because it is probably somewhat less likely that such cases will draw the attention of enforcement agencies. Moreover, fewer investors complain about good news.

24. See *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*, 547 U.S. 71, 74–75 (2006).

25. But see *Malone v. Brincat*, 722 A.2d 5, 7 (Del. 1998).

26. See generally *United States v. O'Hagan*, 521 U.S. 642 (1997); *Carpenter v. United States*, 484 U.S. 19 (1987); *Chiarella v. United States*, 445 U.S. 222 (1980).

27. See *Freeman v. Decio*, 584 F.2d 186, 188–96 (7th Cir. 1978); *In re ORFA Sec. Litig.*, 654 F. Supp. 1449, 1456 (D.N.J. 1987); *Davidge v. White*, 377 F. Supp. 1084, 1089 (S.D.N.Y. 1974); *Brophy v. Cities Serv. Co.*, 70 A.2d 5, 8 (Del. Ch. 1949); *Diamond v. Oreamuno*, 248 N.E.2d 910, 915 (N.Y. 1969). But see *Schein v. Chasen*, 313 So. 2d 739, 747 (Fla. 1975) (rejecting a claim by a corporation under Florida law); *Goodwin v. Agassiz*, 186 N.E. 659, 660 (Mass. 1933).

28. See Janet Cooper Alexander, *Rethinking Damages in Securities Class Actions*, 48 STAN. L. REV. 1487, 1490–93 (1996); Donald C. Langevoort, *Capping Damages for Open-Market Securities Fraud*, 38 ARIZ. L. REV. 639, 641–43 (1996).

29. See Booth, *As We Know It*, *supra* note 21, at 5.

case, buyers are made whole at the expense of holders—because the company pays—while those who sell during the fraud period enjoy a windfall.³⁰ In an insider trading case, the guilty party must disgorge his gains and pay a penalty of up to three times the gain (or loss avoided).³¹ Moreover, the culprit often goes to jail.³² Theoretically, investors who trade contemporaneously can recover. The recovery, however, is typically miniscule because the aggregate recovery is limited to insider gains less any disgorgement ordered in connection with an SEC enforcement action.³³

Securities fraud class actions might make some sense if one thinks of the reasonable investor as one who does his homework and invests his money in a few good stocks (as opposed to a diversified investor who holds a portfolio of many stocks). In such a world, it may make sense to protect investors who rely in good faith on the accuracy of publicly available information. It fosters confidence in the markets.³⁴ As Martha Stewart would say, it's a good thing. Nevertheless, holders always lose in a securities fraud class action because the company pays the damages. Likewise, in the case of insider trading, the system confers no significant benefit to investors other than the deterrence that comes from criminal prosecutions that fit the crime little better than OJ's glove.³⁵

In the real world, the vast majority of investors are well-diversified.³⁶ Indeed, it seems likely that more than three-quarters of all stock is held by well-diversified

30. *Id.* at 27 n.73.

31. Securities Exchange Act of 1934 § 21A, 15 U.S.C. § 78u-1 (2006).

32. Paul Davies, *Latest Insider-Trading Case: Once Again, a Couple Charged*, WALL ST. J., May 11, 2007, at C1; John R. Emshwiller, *'Benron' Behind Bars*, WALL ST. J., Apr. 21, 2007, at A1; Dionne Searcey et al., *Qwest's Nacchio is Found Guilty in Trading Case*, WALL ST. J., Apr. 20, 2007, at A1.

33. Securities Exchange Act § 20A, 15 U.S.C. § 78t-1. This limitation presumably does not apply to actions by the issuer based on fiduciary duty under state law.

34. *Hedge Fund Activities in the U.S. Financial Markets*, Before the H. Subcomm. on Fin. and Hazardous Materials, 106th Cong. (1999) (testimony of Arthur Levitt, Chairman of the SEC), available at <http://www.sec.gov/news/testimony/testarchive/1999/tsty0499.htm>.

35. Indeed, it is arguable that both securities fraud and insider trading are victimless offenses. In both cases, the losers trade voluntarily for their own reasons. Moreover, 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. To be sure, insider trading may cause a slight increase in trading volume. But if the increase is noticeable it is likely also to cause the market to adjust even in the absence of a corrective press release, thus reducing the harm arguably suffered by outsiders who traded at the wrong time. In addition, the prospect of a securities fraud class action will also affect market prices as I discuss further below. But if securities fraud litigation is limited to derivative actions in which the issuer seeks recovery of funds misappropriated by insiders, as I propose here, the losses suffered by outside investors from both of these sources would be eliminated.

36. It is arguable that passive investors who are not well diversified are irrational. Securities law is intended to protect reasonable investors. See *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976). It follows *a fortiori* that we need not worry about protecting irrational investors. To be sure, some investors are rationally undiversified, such as an investor who seeks control or a significant voice in the issuer company. See Bruce H. Kobayashi & Larry E. Ribstein, *Outsider Trading as an Incentive Device*, 40 U.C. DAVIS L. REV. 21, 41–43 (2006) (arguing that undiversified investors may perform valuable control functions). It is unlikely that such an inves-

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investors.³⁷ Accordingly, it seems fair to presume that securities law should reflect the needs and preferences of diversified investors if they conflict with the needs and preferences of undiversified investors.³⁸ For a diversified investor who trades occasionally—for portfolio balancing, tax planning, and so forth—the risk of securities fraud is like any other company-specific risk.³⁹ You win some. You lose some. Only the average matters. Thus, a diversified investor is indifferent to securities fraud except when it is accompanied by insider trading or other forms of misappropriation. In the absence of misappropriation, securities fraud is a zero-sum game for such an investor. Such an investor is likely to gain as often as to lose from securities fraud in the absence of misappropriation. Indeed, securities fraud litigation consti-

tor relies on the kind of information that gives rise to a securities fraud class action. Moreover, such investors will often have a personal cause of action against identifiable sellers in the event of fraud.

37. According to Federal Reserve Board (FRB) data, as of year-end 2006 United States publicly traded companies had \$20.603 trillion outstanding in equity, of which \$5.483 trillion was held by households and nonprofit institutions. See Fed. Reserve, Flow of Funds Accounts of the United States, Flows and Outstandings Fourth Quarter 2006, 90 (Mar. 8, 2007), available at <http://www.federalreserve.gov/releases/z1/20070308/z1r-4.pdf> (Figures in Table L.213 do not include investment company shares.). Historically, nonprofits have accounted for about 9 percent of the equity holdings of the household sector. *Id.* at 109 (showing the annual data for 1988–2000 on Table L.100.a). Assuming that individual holdings equal 91 percent of the household sector (or about \$4.990 trillion), non-individuals—institutions—own about \$15.135 trillion or about 76 percent of all equities outstanding. Because institutions are fiduciaries, they are generally required to diversify under general principles of trust law or more specific statutes such as the Investment Company Act of 1940 and Employee Retirement Income Security Act of 1974 (ERISA). See, e.g., Investment Company Act of 1940 § 5, 15 U.S.C. § 80a-5(b) (stating that an investment company may not be classified as diversified if it has more than 5 percent of its assets invested in any one issuer); ERISA § 404(a)1, 29 U.S.C. § 1104(a)(1)(c). Thus, it seems fair to presume that institutions are diversified. FRB data also indicates that about 9.5 percent of families hold fifteen or more stocks. See Brian K. Bucks et al., *Recent Changes in U.S. Family Finances: Evidence from the 2001 and 2004 Survey of Consumer Finances*, FED. RES. BULL., Mar. 22, 2006, at A1, A15, available at <http://www.federalreserve.gov/pubs/bulletin/2006/financesurvey.pdf>. That is a shockingly low number. See William N. Goetzmann & Alok Kumar, *Why Do Individual Investors Hold Under-Diversified Portfolios?* 4–6 (Nat'l Bureau of Econ. Research, Working Paper No. 8686, 2005), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=627321. Nevertheless, if such investors are counted as diversified, total holdings of diversified investors are about \$15.609 trillion. Moreover, individuals ultimately hold the interests in the institutions that hold diversified portfolios. Studies indicate that an investor can achieve adequate diversification with as few as twenty different stocks. See Franco Modigliani & Gerald A. Pogue, *An Introduction to Risk and Return*, 30 FIN. ANALYSIS J. 68 (1974); see also James M. Park & Jeremy C. Staum, *Diversification: How Much is Enough?*, 1 J. ALTERNATIVE INV. 39 (1998). It is unnecessary for present purposes to know how much diversification is enough. It is sufficient to note that it is costless for an investor to diversify and that the risk of securities fraud (like other types of company-specific risk) can be eliminated through diversification. Most individual investors diversify by investing in mutual funds and similar pooled investment vehicles. Thus, even a very small investor may invest in a fully diversified portfolio of 200–300 different stocks. To be sure, funds charge a variety of fees in addition to the direct expenses of holding and trading portfolio securities. But there are comparable fees and expenses involved in maintaining an individual account.

38. See *TSC Indus.*, 426 U.S. at 449 (finding that the test for materiality is based on the needs of a reasonable investor); see also *Basic Inc. v. Levinson*, 485 U.S. 224, 231–32 (1988) (reaffirming *TSC Indus.*).

39. Bhattacharya and Galpin find that in the United States since 2000 about 24 percent of trading is attributable to stock picking whereas about 60 percent was so motivated during the 1960s. They also predict that the level of stock picking will continue to decline and stabilize at about 11 percent. See Utpal Bhattacharya & Neal E. Galpin, *The Global Rise of the Value-Weighted Portfolio* (Am. Fin. Assoc. FA 2007 Chi. Meetings Paper), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=849627; see also Meir Statman et al., *Investor Overconfidence and Trading Volume*, 19 REV. FIN. STUD. 1531 (2006).

tutes a deadweight loss for such an investor because the defendant company bears the expense of defending itself and the defendant company's stock price drops due to the prospect of an award or settlement.⁴⁰ On the other hand, a diversified investor does care about insider trading. Insider trading turns a zero-sum game into a negative-sum game. To be sure, the loss to any one investor from insider trading is likely to be miniscule. Nevertheless, insider trading stacks the deck ever so slightly against the diversified investor.⁴¹

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,⁴² they will not enjoy their fair share of the gain because insiders will have extracted just a bit more than their fair share. In other words, even though the market pot grows over time, insider trading allows insiders to receive slightly more of the gain than they should. Thus, returns to outsiders will be slightly lower than they should be.⁴³

Now, suppose that the players discover that one of them cheated on the last hand. Aside from possible gunplay, how would the group address the situation? Although the player with the second best hand might argue that he would have won the pot but for the cheater, a more likely remedy would be a do-over. The group would likely require the cheater to return his winnings to the pot and then replay the hand. They might also bar the cheater from further play.

Similarly, *ex ante*, diversified investors would want insiders to disgorge their ill-gotten gains back into the pot. Diversified investors care only about the unfair extraction of wealth from the pot. Indeed, diversified investors have no complaints as long as they win and lose fair and square. The appropriate remedy is for the company (the pot) to recover. Similarly, 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 replaying the hand. Thus, the appropriate remedy is a derivative action by which the cheaters disgorge their gains back to the company and make the pot whole once again. To extend the poker metaphor further, the players would likely be opposed to awarding the pot to the player with the second best hand because they would lose the bets they made during the course of the hand.

40. See Booth, *As We Know It*, *supra* note 21, at 17–18.

41. The deck is already naturally stacked against outside investors because inside investors know when not to trade. Jesse M. Fried, *Insider Abstention*, 113 YALE L.J. 455, 455 (2003). This is analogous to the edge enjoyed by the house in blackjack where the deck is naturally stacked against the players because the dealer deals to herself last.

42. Investors are usually winners overall because on the average stocks increase in value over time.

43. One could also argue that insider trading is a zero-sum game if one thinks of all investors—both insiders and outsiders—as a single pool. But it is more accurate to think of insider investors and outsider investors as separate and somewhat adverse classes of investors. See Richard A. Booth, *Stockholders, Stakeholders, and Bagholders (or How Investor Diversification Affects Fiduciary Duty)*, 53 BUS. LAW. 429 (1998).

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In a securities fraud class action, the company pays those who bought during the fraud period and those who sold keep their gains (losses avoided). Holders—those who neither bought nor sold—lose to the extent that the value of the company falls because of the payout.⁴⁴ Indeed, damages are further magnified through positive feedback because the value of the company falls more when the company must pay.⁴⁵ If the plaintiff class is big enough, the company may be wiped out.⁴⁶ The point is that holders, who would have seen the price of their stock fall anyway, lose even more because of the effects of securities fraud class actions.⁴⁷ In other words, in order to make active trading stock pickers whole, securities fraud class actions cause additional losses for rational investors who follow a conservative buy-and-hold strategy.⁴⁸ Diversified investors—the vast majority of investors—would be better off if securities fraud litigation was limited to cases where the company sought recovery of insider gains. Diversified investors have nothing to gain from individual recovery in a securities fraud class action.⁴⁹ The expense of litigation is thus a deadweight loss. More importantly, even if gains and losses net out because a diversified investor is equally likely to sell as to buy, a diversified investor always loses when he is a holder.⁵⁰ The bottom line is that in a world without securities fraud class actions investors would see better returns.⁵¹ In short, a diversified investor is likely to prefer pretty much the polar opposite of what an undiversified investor would want.

44. See Booth, *As We Know It*, *supra* note 21, at 11 n.23.

45. *Id.*

46. See LAURA E. SIMMONS & ELLEN M. RYAN, CORNERSTONE RES., POST-REFORM ACT SECURITIES SETTLEMENTS; 2005 REVIEW AND ANALYSIS 14 (2005), available at http://www.cornerstone.com/pdf/practice_securities/PostReformActSecuritiesSettle2005.pdf.

47. See Booth, *As We Know It*, *supra* note 21, at 11 n.23. As other legal scholars have noted, the market will not necessarily discount the share price of a defendant company by the maximum amount of damages payable (including feedback effects). Indeed, one would expect the market to adjust for the likelihood of recovery. See Bradford Cornell & James Ritten, *Market Efficiency, Crashes and Securities Litigation* 9–10 (Working Paper Series, 2005), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=871106. But that does not change the fact that the market falls further than it otherwise would.

48. This is not to say that one cannot be well diversified and also be an active trader. After all, such an investor should still favor a rule banning individual recovery.

49. Booth, *As We Know It*, *supra* note 21, at 10–18.

50. *Id.*

51. If securities fraud litigation were limited to issuer recovery of insider gains, the amounts involved would be much smaller than they are under current law, but because the corporation recovers the entire amount on behalf of all of its stockholders, it would be economic for the corporation to pursue even relatively small cases. See *Joy v. North*, 692 F.2d 880, 898–99 (2d Cir. 1982), *superseded by statute*, CONN. GEN. STAT. § 33-724 (2007). Moreover, issuers would be subject to a derivative action whenever insiders misappropriate stockholder wealth, whether or not the company has issued a misleading press release or has committed other acts that constitute securities fraud under federal law. In other words, there might be more litigation involving smaller recoveries. To be sure, the board of directors or a committee thereof can seek to dismiss a derivative action as not in the best interest of the corporation, and might well try to do so in many cases, but the courts are quite able to monitor that process. See *id.* at 887–88; *Zapata Corp. v. Maldonado*, 430 A.2d 779, 784 (Del. 1981). Moreover, issuer companies may be more willing to police their own if they do not have to risk the devastation that comes with securities fraud class actions as currently configured.

It would be quite easy for the courts to fix the system. First, the courts should dismiss cases that do not allege insider gains on the theory that the plaintiff class has suffered no harm.⁵² Second, the courts should classify cases that involve insider gains as derivative rather than direct.⁵³ Whether an action is derivative or direct is a matter for the courts.⁵⁴ So a court could so rule on its own motion. In addition, federal securities law presumes that the class member with the most at stake should serve as the lead plaintiff.⁵⁵ That class member is likely to be a well-diversified mutual fund or pension plan whose interests would be well served by the reforms suggested here.⁵⁶

II. A BRIEF HISTORY OF SECURITIES FRAUD LITIGATION

It is worth asking how federal securities law took this particular wrong turn in its evolution. It seems likely that individual recovery became the rule in securities fraud class actions by analogy to recovery under the Securities Act of 1933 (1933

52. Cf. *Dura Pharms., Inc. v. Broudo*, 544 U.S. 336, 346 (2005) (stating that the plaintiff must allege and prove loss causation). Moreover, in order to make out a case of securities fraud under Rule 10b-5, the plaintiff must allege (and plead with particularity) that the defendant acted with scienter. One way to satisfy that standard is to identify unusual instances of insider trading during the fraud period. See Paul A. Griffin & Joseph A. Grundfest, *When Does Insider Selling Support a "Strong Inference" of Fraud?*, 9 ASIAN-PAC. J. ACCT. & ECON. 159 (2002). Nevertheless, one empirical study has found that insider trading is not one of the most common factors cited by the courts as evidence of scienter. See Adam C. Pritchard & Hillary A. Sale, *What Counts as Fraud? An Empirical Study of Motions to Dismiss Under the Private Securities Litigation Reform Act*, 2 J. EMPIRICAL LEGAL STUD. 125, 136 (2005). 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.

53. The 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 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.

54. See *Tooley v. Donaldson, Lufkin, & Jenrette, Inc.*, 845 A.2d 1031, 1033 (Del. 2004).

55. See Securities Exchange Act of 1934 § 21D, 15 U.S.C. § 78u-4 (2006).

56. On the other hand, if the lead plaintiff argues that the action should be dismissed, the lead plaintiff might be an inadequate class representative under Federal Rule of Civil Procedure 23. In addition, even a well-diversified and enlightened plaintiff would worry that other lead plaintiffs in other cases would fail to follow suit and reason that one must recover when one can do so in order to offset losses from those cases in which one is a holder. But see James D. Cox & Randall S. Thomas, *Leaving Money on the Table: Do Institutional Investors Fail to File Claims in Securities Class Actions?*, 80 WASH. U. L.Q. 855, 875–77 (2002); see also ANJAN V. THAKOR, *THE ECONOMIC REALITY OF SECURITIES CLASS ACTION LITIGATION* 14 (U.S. Chamber Inst. for Legal Reform 2005) (suggesting that institutional investors may gain from securities fraud litigation when losses avoided are taken into consideration). It is also arguable that because of the conflicting preferences of diversified investors and undiversified investors, only diversified investors should be permitted as class members. Undiversified investors (stock pickers) presumably rely on a variety of factors in making their investment decisions and thus have varying stories to tell to the jury. In any case, only a diversified investor should be permitted to represent the class, even though a diversified investor might prefer that the action be dismissed or pursued as a derivative action.

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Act). Under the 1933 Act, all public offerings of securities must be registered with the SEC.⁵⁷ If there is a material misstatement of fact in the registration statement or prospectus, investors who bought the offered securities can sue for damages or rescission.⁵⁸ The issuer is absolutely liable.⁵⁹ The investor need not even prove reliance.⁶⁰ But recovery is limited to the amount of money raised by the issuer.⁶¹ Thus, the remedy under the 1933 Act is essentially one of disgorgement. Only those investors who bought securities that were part of the offering can recover.⁶²

In an initial public offering (IPO), this remedy presents no problem. All investors hold shares that were part of the offering.⁶³ But the 1933 Act requires registration of all public offerings, including subsequent offerings by companies that are already publicly traded.⁶⁴ In the case of a subsequent offering, the courts have held that only those investors who buy shares that are part of the offering can recover. This requires the tracing of shares that are part of the offering from investor to investor.⁶⁵ But if the company is already publicly traded, investors may read the offering materials and may rely on misstatements therein in connection with the purchase (or sale) of *outstanding* securities. Practically speaking, no one really knows whether after-market shares are part of the offering or not. But all suffer the same loss. Accordingly, buyers who bought already outstanding shares argued that they should be able to recover under the 1934 Act and Rule 10b-5 (assuming that they could meet the higher standard of proof required for such actions).⁶⁶ The courts agreed, viewing the distinction between new shares and old shares as essentially accidental.⁶⁷ So it became more or less automatic to add a count under the 1934 Act and Rule 10b-5 to all claims under the 1933 Act. Such claims soon took on a life of their own.⁶⁸

57. Securities Act of 1933 § 5, 15 U.S.C. § 77e.

58. Securities Act §§ 11–12, 15 U.S.C. §§ 77k–77l.

59. Securities Act § 12, 15 U.S.C. § 77l.

60. *Currie v. Cayman Res. Corp.*, 835 F.2d 780, 781–82 (11th Cir. 1988); *Gilbert v. Nixon*, 429 F.2d 348, 356 (10th Cir. 1970); *B.S. Int'l Ltd. v. Licht*, 696 F. Supp. 813, 827 (D.R.I. 1988).

61. Securities Act § 11, 15 U.S.C. § 77k.

62. *Id.*

63. Of course, insiders who may have owned shares before the IPO no longer hold their shares.

64. See, e.g., *Wielgos v. Commonwealth Edison Co.*, 892 F.2d 509, 518 (7th Cir. 1989).

65. See *Barnes v. Osofsky*, 373 F.2d 269, 271–73 (2d Cir. 1967).

66. *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461, 463–64 (2d Cir. 1952).

67. *Id.*

68. In addition, Federal Rule of Civil Procedure 23 was amended in 1966 to make it easier to maintain actions for damages and in particular securities fraud class actions. See FED. R. CIV. P. 23 advisory committee's note:

[A] fraud perpetrated on numerous persons by the use of similar misrepresentations may be an appealing situation for a class action, and it may remain so despite the need, if liability is found, for separate determination of the damages suffered by individuals within the class. On the other hand, although having some common core, a fraud case may be unsuited for treatment as a class action if there was material variation in the representations made or in the kinds or degrees of reliance by the persons to whom they were addressed.

There is, however, an important distinction between cases arising under the 1933 Act and cases arising under the 1934 Act that involve previously outstanding shares. 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 misappropriated investor wealth and should give it back. Thus, in contrast to the effective result in securities fraud class actions—where holders in effect pay buyers while sellers keep their windfall gains—disgorgement by the company under the 1933 Act simply returns investors to their financial position before the offering. In short, the remedial scheme under the 1933 Act is an argument for treating securities fraud under the 1934 Act and Rule 10b-5 as an action by the issuer rather than as an action by individual investors.⁶⁹

III. INSIDER TRADING REDEFINED

Up to this point, I have used the phrase *insider trading* somewhat loosely. In practice, insider trading has been difficult to define. Try as they might, neither Congress nor the SEC has been able to settle on a definition.⁷⁰ Thus, it has been up to the

Dolgow v. Anderson, 43 F.R.D. 472 (E.D.N.Y. 1968), was apparently the first securities fraud class action to be certified under the revamped rule that did not involve a claim under section 11 of the 1933 Act. It is clear that the *Dolgow* court was encouraged by the amendment of Federal Rule of Civil Procedure 23 and that it viewed the use of the class action in connection with 1933 Act claims as precedent for using the rule in connection with 1934 Act claims. Referring to the above advisory committee note, the *Dolgow* court stated:

This comment applies with particular force to a case involving tens of thousands of small shareholders. As the S.E.C. amicus brief makes patently clear, "since the difficulty of proving a violation under the securities laws often is great and the injury to individual investors may not be sufficiently large to justify on an individual basis the investigative and litigation expense involved, a class action may be the only meaningful method by which private rights may be effectively enforced."

Id. at 485.

69. The Supreme Court almost said as much in *Gustafson v. Alloyd Co.*, 513 U.S. 561, 575 (1995). *Gustafson* addressed the scope of then section 12(2) of the 1933 Act, which provides a civil remedy for any misstatement of material fact in a prospectus. Prior to *Gustafson*, most courts interpreted the word prospectus broadly to refer to any material (written or otherwise) used in connection with the sale of stock, whether or not the sale was part of an offering that would be comprehended by the 1933 Act. In *Gustafson*, the Supreme Court held that the remedy provided under then section 12(2) was indeed limited to offerings under the 1933 Act. See Richard A. Booth, *The Scope of Section 12(2) After Gustafson*, 9 INSIGHTS 8 (1995). The argument here is essentially parallel to the holding in *Gustafson*. The fact that the 1933 Act provides a remedy does not imply that there should be a similar remedy under the 1934 Act. In addition, it is worth noting that one of the thornier problems that arises in a securities fraud class action under the 1934 Act is that there is no way to determine how many different shares were bought during the class period, short of sending out claim forms, because it is likely that many shares were traded repeatedly during the fraud period. Thus, defendant companies must assume the worst in estimating damages and may be inclined to agree to a more generous settlement than if able to estimate damages more accurately. See Robert A. Alessi, *The Emerging Judicial Hostility to the Typical Damages Model Employed by Plaintiffs in Securities Class Action Lawsuits*, 56 BUS. LAW. 483 (2001). It is also arguable that a class action is appropriate in cases where the company has repurchased shares during the fraud period. But in such cases, as in 1933 Act cases, it is easy to determine the number of shares affected.

70. See Steve Thel, *Section 20(d) of the Securities Exchange Act: Congress, the Supreme Court, the SEC, and the Process of Defining Insider Trading*, 69 N.C. L. REV. 1261, 1262 (1991). As part of ITSFEA, Congress adopted Exchange Act section 20A providing a private remedy for investors who trade contemporaneously with insiders

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courts to define insider trading as a matter of case law.⁷¹ In general, the courts have defined insider trading as using material nonpublic information in violation of a duty to the source of the information not to use the information for personal gain.⁷² In most cases the source of the information is the issuer company and the duty is in the nature of a state law fiduciary duty running to the issuer company.⁷³ In other words, federal law depends on state law in this context. If there is no violation of state law, there is no violation of federal law.⁷⁴

This definition of insider trading is arguably too narrow for the purposes of diversified investors. Diversified investors are concerned with insiders who take money out of the pot contrary to the reasonable expectations of the outside investors and without assuming the same risks as the outside investors. For example, the board of directors of an issuer company might authorize the CEO to trade on inside information. Presumably, trading on inside information under such circumstances would not constitute a breach of duty to the corporation, and thus would not be illegal under federal law.⁷⁵ Yet a diversified investor would presumably object to any such license to steal from the pot.⁷⁶

who trade while in possession of nonpublic information. Securities Exchange Act of 1934 § 20A, 15 U.S.C. § 78t-1(a) (2006). Rather than define insider trading, section 20A provides that liability shall attach if the insider violates any provision of the Exchange Act. *Id.*; see *Makor Issues & Rights, Ltd. v. Tellabs, Inc.*, 437 F.3d 588, 605 (7th Cir. 2006).

71. See *United States v. O'Hagan*, 521 U.S. 642, 650 (1997); *Carpenter v. United States*, 484 U.S. 19, 24–26 (1987); *Dirks v. SEC*, 463 U.S. 646, 660 (1983) (holding that insider trading requires that the tipper violate his duty to the source of the information and that tippee knows that the information has been divulged in violation of his duty to the source); *Chiarella v. United States*, 445 U.S. 222, 234–36 (1980).

72. See *O'Hagan*, 521 U.S. at 652; see also *SEC v. Adler*, 137 F.3d 1325, 1337 (11th Cir. 1998) (holding that the use of information is required, as mere possession is not enough).

73. See *Dirks*, 463 U.S. at 653 n.10; see also *United States v. Chestman*, 947 F.2d 551, 568 (2d Cir. 1991) (finding that a family relationship does not necessarily give rise to a fiduciary duty that would preclude the use of nonpublic information); *Moss v. Morgan Stanley, Inc.*, 719 F.2d 5, 13 (2d Cir. 1983) (noting that an outsider who traded contemporaneously has no claim against an inside trader or employer because duty not to use the information runs to the employer). Although one would think that most cases of insider trading arise from an employee (or other agent) using nonpublic information about his or her own company, most of the cases that have found their way to the Supreme Court have been exceptions to this rule. See *O'Hagan*, 521 U.S. at 647–48 (involving a lawyer who traded on information about a firm client); *Carpenter*, 484 U.S. at 22–23 (involving a Wall Street Journal reporter who traded in advance of his own stories in violation of a workplace rule); *Chiarella*, 445 U.S. at 224 (involving an employee of a printer hired by tender offer bidder).

74. See *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 479 (1977).

75. See *id.* at 478–79; see also 17 C.F.R. § 240.14e-3 (2006) (exempting trading by authorized agents of tender offer bidder from general rule prohibiting trading while in possession of nonpublic information about planned tender offer).

76. 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 would be illegal under state law as a violation of the duty of care because it amounts to a something-for-nothing bargain. See generally Stephen M. Bainbridge, *Insider Trading under the Restatement of the Law Governing Lawyers*, 19 J. CORP. L. 1, 39 (1993). Moreover, it might be beyond the power of the board of directors to authorize a CEO to engage in insider trading at will. Like the board of directors itself, the CEO is a fiduciary and is subject to the duty of loyalty, which is generally unwaivable. See DEL. CODE ANN. tit. 8, § 102(b)(7) (2006). The board of directors can ratify conflict of interest transactions on the grounds that they are fair to the

The foregoing example may seem a bit farfetched, but the flap over timing and backdating in connection with grants of stock options affords a good 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 possesses material nonpublic information at the time it grants options.⁷⁷ In the case of outright backdating, the board of directors knows that the value of the stock has risen in the meantime.⁷⁸ The SEC has been remarkably sanguine about these practices, seemingly viewing them as mere administrative details.⁷⁹ 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*. Indeed, 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?*⁸⁰

In other words, the argument seems to be that because the corporation itself is a party to the trade and is deemed to know any material nonpublic information, there 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

corporation. *Id.* § 144; MODEL BUS. CORP. ACT § 8.60–.63 (2001). But it is not clear that the board can authorize conduct that would constitute a breach of fiduciary duty. In other words, the definition of securities fraud and insider trading may thus be seen as part of the substantive bargain between insiders and outsiders—classically a matter of state corporation law. The federal courts are stuck with state law as they find it, while state courts can make it up as they need it. Compare *Santa Fe Indus.*, 430 U.S. 462, with *Singer v. Magnavox Co.*, 380 A.2d 969, 978 (Del. 1977), *overruled by* *Weinberger v. UOP Inc.*, 457 A.2d 701 (Del. 1983). On the other hand, it is conceivable that the federal court might resort to some generalized notion of common law independent of that announced by the states. See, e.g., *Chestman*, 947 F.2d at 556–57. But federal securities law explicitly preserves state corporation law. See Securities Exchange Act of 1934 § 28, 15 U.S.C. § 78bb (2006). Moreover, the idea that there exists a federal common law has been rejected. See *Erie R.R. Co. v. Tompkins*, 304 U.S. 64, 78 (1938), *superseded by statute*, 28 U.S.C. § 1961 (2006).

77. Iman Anabtawi, *Secret Compensation*, 82 N.C. L. REV. 835, 868–70 (2004) (presuming that directors have insider information at the time of granting options and arguing that corporate boards have incentives to grant or otherwise act upon such options at times favorable to directors).

78. See, e.g., *Ryan ex rel. Maxim Integrated Prods., Inc. v. Gifford*, 918 A.2d 341, 355–56 (Del. Ch. 2007). See generally David I. Walker, *Some Observations on the Stock Option Backdating Scandal of 2006* (Boston Univ. Sch. of Law, Working Paper No. 06-31, 2006), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=929702.

79. *In re Tyson Foods, Inc. Consol. S'holder Litig.*, 919 A.2d 563, 592–93 (Del. Ch. 2007).

80. Paul S. Atkins, Chairman, SEC, Remarks Before the International Corporate Governance Network 11th Annual Conference (July 6, 2006), available at <http://www.sec.gov/news/speech/2006/spch070606psa.htm>.

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may sit by idly while the board of directors makes a windfall grant—as happened in *Texas Gulf Sulphur*—it is not clear that public stockholders would approve of such tactics, especially if they entail withholding ripe information from the market.

IV. MISAPPROPRIATION UNDER STATE LAW

Although timing and backdating do not appear to constitute insider trading under federal law,⁸¹ such practices may and likely do constitute a breach of fiduciary duty under state law.⁸² 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 securities fraud. The only question is whether or not the practice is consistent with the reasonable expectations of stockholders.⁸³ The point for present purposes is that diversified stockholders are likely to care about a broader range of acts and practices that divert their wealth rather than only those that fit the technical definition of insider trading.

Using timing and backdating of options as examples, there are several ways that state law might address the issues in the context of a derivative action.⁸⁴ First, such

81. Anabtawi, *supra* note 77, at 868 (“[A]ssuming full disclosure to, and approval by, a disinterested board or its committee, there is no state law fiduciary duty violation on the part of an executive who receives stock options while in possession of favorable material nonpublic information about his company.”).

82. *Ryan*, 918 A.2d 341; *Tyson Foods*, 919 A.2d at 593–98.

83. Unlike most securities fraud class actions, 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 law firms may choose to characterize the action as derivative rather than direct because the total award is likely to be higher than it would be if treated as a class action.

84. 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. 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 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 they will reduce their own gain if they grant too many options. 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. This limit 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 the worst and price companies on a fully diluted basis as if all stock available for

practices may constitute a breach of the duty of loyalty if the recipients participated in approving the questionable grant of options.⁸⁵ Second, if the issuer company has adopted a stock option plan, a questionable grant may be challenged as a violation of a standard of the corporation—essentially a breach of contract—if it is contrary to the terms of the stock option plan.⁸⁶ Third, a questionable grant may be challenged as a violation of the duty of care or the duty of good faith if the board of directors (or a committee 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.⁸⁷ Finally, such practices may violate the (relatively new) duty of candor.⁸⁸ If there has been a violation of SEC rules in connection with the grant, that too may constitute a per se violation of state law, just as speeding constitutes negligence per se in connection with an automobile accident. In other words, if a corporation violates a SEC rule and insiders enjoy a gain (even if coincidentally), a state court could find a breach of fiduciary duty.

This last legal theory is both important and problematic. The duty of candor theory is important because it is relatively easy for a well-advised board or committee to avoid violating the duty of care or the duty of loyalty. Indeed, if a stock option plan is carefully worded, timing and backdating may be permissible. Thus, the duty of candor may comprehend many questionable grants that are not covered by the duty of care or the duty of loyalty. Moreover, the duty of candor is focused on what matters most in the context of timing and backdating: candor. It is crucial for the market to be fully informed for options to work properly. First, options are used as compensation to create an incentive for managers to maximize stock price and reward them when stock price rises. Thus, it is important to assure that the grant occurs at the fair market price at the time of the grant. If the strike price is less than the fair market price (as it presumably is when timing or backdating is an issue), the optionee enjoys an immediate gain—albeit on paper. That is not neces-

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 almost always have a better sense of a company's prospects than outsiders. Thus, it is impossible to eliminate all vestiges of timing and 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.

85. See AM. LAW INST., *PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS* § 5.03 (2006) [hereinafter ALI, *PRINCIPLES OF CORPORATE GOVERNANCE*]; see, e.g., *Ryan*, 918 A.2d 341; *Tyson Foods*, 919 A.2d 563.

86. Cf. ALI, *PRINCIPLES OF CORPORATE GOVERNANCE*, *supra* note 85, § 5.09 (addressing effect of standard of the corporation in connection with duty of loyalty cases). 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 aspect, the business judgment rule would presumably apply.

87. See *In re Walt Disney Co. Derivative Litig. (Disney V)*, 906 A.2d 27 (Del. 2006). 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 that backdating is permissible. To the contrary, a ratified stock option plan arguably constitutes a contract with the stockholders.

88. See *Malone v. Brincat*, 722 A.2d 5 (Del. 1998).

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sarily a problem if that is the board's intention. Indeed many commentators have suggested that restricted stock is preferable to options as compensation. But it is misleading if the grant is characterized as a grant of options. Second, it is important for the market to know about the potential for dilution from the exercise of options. Market price depends on two numbers: the aggregate value of the firm and the number of shares outstanding. If the market does not know how many shares and options are outstanding, market prices are less trustworthy and options work less well.

The duty of candor theory is problematic because it is somewhat different from other forms of fiduciary duty. Obviously, the duty of candor is about disclosure.⁸⁹ So one might argue (loosely) that federal law has preempted the field and that state law should keep out.⁹⁰ To be more precise, the federal courts have exclusive jurisdiction of violations arising under the 1934 Act.⁹¹ So one might argue that all such cases must be filed in federal court. But that argument proves a bit too much. Many state corporation law cases sounding in breach of fiduciary duty involve important issues of disclosure.⁹² For example, one very common issue is whether a director or stockholder vote may be deemed to have ratified what would otherwise be a self-dealing transaction. The central question in most such cases is whether there was adequate disclosure of the conflicting interest.⁹³ Thus, it would seem difficult to argue that duty of candor cases must be litigated in federal court.⁹⁴

89. *De La Fuente v. Fed. Deposit Ins. Corp.*, 332 F.3d 1208, 1222 (9th Cir. 2003) (quoting *In re Seidman v. Office of Thrift Supervision*, 37 F.3d 911, 936 n.34 (3d Cir. 1994)) ("A fiduciary's duty of candor is encompassed within the duty of loyalty. The duty of candor requires corporate fiduciaries to disclose all material information relevant to corporate decisions from which they may derive a personal benefit.").

90. Indeed, the Delaware Supreme Court addressed this issue at length in *Malone*, 722 A.2d 5.

91. *Rodriguez de Quijas v. Shearson/Am. Express, Inc.*, 490 U.S. 477, 482 (1989).

92. See, e.g., *O'Reilly v. Transworld Healthcare, Inc.*, 745 A.2d 902 (Del. Ch. 1999); *Geller v. Allied-Lyons PLC*, 674 N.E.2d 1334 (Mass. App. Ct. 1997); *Berberman v. West Publ'g Co.*, 615 N.W.2d 362 (Minn. Ct. App. 2000); *Home Loan Corp. v. Tex. Am. Title Co.*, 191 S.W.3d 728 (Tex. App. 2006).

93. *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983).

94. Moreover, the law that has evolved under Rule 10b-5 is largely derived from state law. 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 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. See *Dirks v. SEC*, 463 U.S. 646 (1983); *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462 (1977). 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. See generally *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128 (1972). Moreover, once a case has been characterized as 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 of fiduciary duty, true fraud depends on deception. To be sure, fiduciary duty can be satisfied through disclosure. But deception is not 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.

Nevertheless, in a conventional breach of fiduciary duty case—whether it arises under the duty of care or the duty of loyalty—the nub of the matter is that the corporation has suffered financial harm at the hands of a director or officer or other agent.⁹⁵ In a duty of candor case—where the central issue is communication with stockholders—it is difficult to see how the corporation is harmed except in some intangible reputational way. On the other hand, if insiders take advantage of a misinformed market to extract a personal gain (even if unintentionally), investors lose even though the corporation itself suffers no financial harm.⁹⁶ Recovery by the corporation still makes sense in such circumstances. Investors have little incentive to sue insiders for recovery. The corporation is in a much better position to maintain such an action, and investors are made whole if the corporation recovers.

One problem is that a stockholder action based on the duty of candor might be deemed to be a (direct) class action and thus be precluded under SLUSA even though it seeks recovery by the corporation, because the ultimate beneficiaries of the recovery are the stockholders.⁹⁷ But that is true of any derivative action.⁹⁸ In fact, it is the very idea of a derivative action.⁹⁹ Moreover, there are innumerable examples of derivative actions (as well as actions directly by corporations) in which the essential claim is one of misappropriation, including actions alleging claims equivalent to insider trading.¹⁰⁰ Indeed, if anything, in doubtful cases the burden is on the party seeking to characterize an action as direct rather than derivative. In other words, there is a presumption that an action that *can* be characterized as derivative *should* be characterized as derivative.¹⁰¹

V. THE NEED FOR A STATE LAW REMEDY

While the duty of candor should survive federal challenge as grounds for a state law cause of action, one might still argue that there is no *need* for a state law remedy in connection with such controversies as insider trading or timing and backdating of option grants. After all, there is plenty of federal law relating to insider trading. There are elaborate SEC rules requiring extensive disclosures in connection with options. Moreover, state case law relating to fiduciary duty is notoriously vague. Indeed, the cases tend to be so fact specific that they have little precedential value.

95. See, e.g., *Boykin v. Arthur Andersen & Co.*, 639 So. 2d 504, 512 (Ala. 1994).

96. The Supreme Court of Delaware faced a similar problem in *Malone v. Brincat*, 722 A.2d 5 (Del. 1998), a case where it relied on the duty of candor to find a breach of fiduciary duty despite the fact that the disclosures in question were not connected to any request for stockholder action (such as a vote).

97. See *Bangor Punta Operations, Inc. v. Bangor & Aroostook R.R. Co.*, 417 U.S. 703 (1974). It is not entirely clear whether federal or state law would govern the characterization of an action as derivative or direct for purposes of SLUSA, though it seems likely that the federal courts would prevail in the event of a conflict.

98. See, e.g., *Bischoff v. Boar's Head Provisions Co.*, 436 F. Supp. 2d 626, 629 (S.D.N.Y. 2006) (describing the common law history of stockholders' rights in derivative actions).

99. *Id.*

100. See, e.g., *In re Ryan ex rel. Maxim Integrated Prods., Inc. v. Gifford*, 918 A.2d 341 (Del. Ch. 2007); *Tyson Foods, Inc., Consol. S'holder Litig.*, 919 A.2d 563 (Del. Ch. 2007).

101. Cf. *Tooley v. Donaldson, Lufkin, & Jenrette, Inc.*, 845 A.2d 1031 (Del. 2004).

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In many cases, the courts resort to nebulous notions of fairness that give directors, officers, and other corporate agents little guidance for the future. One might therefore argue that however flawed detailed SEC rules may be, they are superior to state case law construing the fiduciary duties of corporate actors.

There are four answers to this argument. First, treating such claims as derivative is more consistent with underlying legal theory. The primary foundation for insider trading is misappropriation of information—usually from the issuer company.¹⁰² Indeed, the federal courts have so held. If the duty runs to the issuer company, it follows that the issuer company has standing to sue for disgorgement.¹⁰³

Second, treating such claims as derivative is more consistent with existing law. 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. 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 relatively rare. But that is because it is triggered only by a purchase and sale (or sale and purchase) within six months of each other. Although section 16(b) has become little more than a trap for the unwary and we now know that there are many other ways to engage in insider trading, it seems clear that the framers of the 1934 Act thought that the remedy for insider trading should be disgorgement to the issuer company.¹⁰⁴ On the other hand, one might argue that the PSLRA¹⁰⁵ and SLUSA may be read to endorse individual recovery generally, although it is quite clear that both were intended to curtail perceived abuses in connection with securities fraud class actions. In addition, one might also argue that in the ITSFEA,¹⁰⁶ Congress endorsed individual recovery and issuer liability by creating a civil remedy for the benefit of contemporaneous traders and the extension of controlling person liability to civil fines for insider trading. Indeed, the fact that an employer (including presumably

102. *United States v. O'Hagan*, 521 U.S. 642 (1997).

103. *See, e.g., Gollust v. Mendell*, 501 U.S. 115 (1991).

104. *See also SEC v. Tex. Gulf Sulphur Co.*, 401 F.2d 833, 855 n.20 (2d Cir. 1968) (en banc). So why is it that issuers seldom seek disgorgement on their own? It is possible that the practice is common and quietly handled, but 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 the 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 securities fraud class actions has been increasing in recent years. *See SIMMONS & RYAN, supra* note 46, at 11; *see also Ryan*, 918 A.2d 341; *Tyson Foods*, 919 A.2d 563. Another somewhat less obvious reason for the disinclination of issuers to go after inside trading is that it might often amount to an admission that the company failed to disclose material information in a timely fashion and might trigger the filing of a securities fraud class action. Thus, as I have argued elsewhere, the disproportionate threat of securities fraud class actions and their potentially devastating collateral consequences may prevent publicly traded companies from self-policing. *See Booth, As We Know It, supra* note 21.

105. Pub. L. No. 104-67, 109 Stat. 737 (1995) (codified in scattered sections of 15 U.S.C.) (passed over presidential veto, *see* 109 Stat. 765 (1995)).

106. Pub. L. No. 100-704, 102 Stat. 4677 (1988) (codified as amended in scattered sections of 15 U.S.C.).

an issuer) may be held liable for an employee's insider trading under section 20A (albeit subject to a broad due care defense) is doubly inconsistent with the reforms suggested here. Still, section 20A(d) preserves other remedies, and it was well established at the time that the issuer has a remedy.¹⁰⁷

Third, as for the argument that the SEC has promulgated detailed rules relating to many of the practices discussed here, such rules are necessarily reactive and incomplete. SEC rules are invariably adopted with a view to regulating abusive practices—generally through disclosure—after such practices have come to light because of some scandal.¹⁰⁸ Moreover, SEC rules are inadequate precisely because they are detailed rules rather than principles.¹⁰⁹ Detailed rules can be manipulated. With a detailed rule, it is much easier to devise a strategy of minimal compliance and skate close to the edge.¹¹⁰ This is not to say that such rules do not have value.

107. The bigger question is: why do we treat insider trading as a crime or offense while other breaches of fiduciary duty are the subject of private litigation? The answer is that private remedies under federal law do not work well. Simple disgorgement affords no deterrent, and will likely constitute a miniscule recovery if spread over all contemporaneous buyers or sellers. But awarding compensation for trading losses to all contemporaneous buyers or sellers is overkill. See *Fridrich v. Bradford*, 542 F.2d 307 (6th Cir. 1976) (reversing a district court decision to award \$361,186.75 in compensation to outsiders against a trader who made \$13,000 and disgorged same amount in SEC enforcement action and holding that defendants did not purchase stock from plaintiffs and that defendants' acts of trading in no way affected plaintiffs' decision to sell), *superseded by statute*, Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, 102 Stat. 4677 (codified in scattered sections of 15 U.S.C.). Thus, Congress enacted ITSA in 1984 and then ITSFEA in 1988, providing for a fine of up to three times the gain or loss avoided (in addition to disgorgement). Although the logic of this penalty is clear, many defendants probably cannot pay it anyway. So it is not clear that it is much of a deterrent after all. Presumably, a private remedy is always preferable to a criminal prosecution or 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. In addition, 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 keep the entire recovery—would decline to sue. Moreover, state law is likely to comprehend a broader range of offenses. Of course the issuer can (and likely will) dismiss the offending employee. Cf. *Carpenter v. United States*, 484 U.S. 19 (1987). 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 where 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. Curiously, most of the leading insider trading cases—and therefore presumably the more difficult cases—seem to involve defendants who would not be deemed insiders under section 16 of the Exchange Act.

108. See, e.g., Arnold Rochvarg, *Enron, Watergate and the Regulation of the Legal Profession*, 43 WASHBURN L.J. 61, 75 (2003) (stating that the Sarbanes-Oxley Act of 2002 was in response to the Enron scandal); Lewis J. Sundquist III, Comment, *Proposal to Allow Shareholder Nomination of Corporate Directors: Overreaction in Times of Corporate Scandal*, 30 WM. MITCHELL L. REV. 1471, 1472 (2004) (arguing that the SEC's proposal to allow greater shareholder access to corporate proxy statements was a reaction to current corporate scandals).

109. See Larry E. Ribstein, *Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002*, 28 J. CORP. L. 1 (2002). Ribstein argues that reform should occur only after "careful[ly] weighing [the] costs and benefits [rather] than the circumstances"—such as Enron—that lead to calls for change. *Id.* at 47. Regulatory reform, he states, must occur in a more "deliberative setting." *Id.*

110. Compare the current debate about rules versus principles in accounting. See Denise Lugo, *Conceptual Framework, Revenue Recognition Top FASAC 2006 Survey of FASB's Priorities*, 38 SEC. REG. & L. REP. (BNA) 1884 (Nov. 6, 2006).

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SEC rules play an important role in setting minimum standards of disclosure and standardizing the format of disclosure.

Fourth, the argument that state law is vague misses the point of how state law works—particularly Delaware law. In Delaware, most cases relating to corporation law are handled by the Court of Chancery—a court of equity.¹¹¹ With the merger of law and equity in most other jurisdictions, it is easy to lose track of the distinction. But a court of equity is more or less free to fill in the blanks of incomplete contracts and indeed to reform a contract that does not comport with the bargain between the parties.¹¹² A corporation is in essence a contract between stockholders and managers (and possibly other constituencies as well).¹¹³ Moreover, it is a permanent contract, with a life independent of any of the parties, which is difficult to change, and which is incomplete in its particulars. Indeed, it is fair to say that the parties effectively agree to have the courts fill in the blanks when the parties cannot settle a dispute themselves (through voting and other control mechanisms). In other words, there is an important role here for a principles-based fiduciary duty and the case-by-case approach that it entails.

Neither is it true that this system fails to provide guidance for corporate actors. When in doubt, a fiduciary must ask whether an act or practice will be viewed as fair to the stockholders. It is not good enough for a transaction merely to comply with the letter of the law.¹¹⁴ It is regrettable that fiduciary duty is so often described in terms of fairness, though that may be inevitable 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 analyses, instead gravitating toward stockholder expectations as the norm.¹¹⁵ To be sure, this is a subtle shift, but it does capture better 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. The stockholders cannot reasonably expect that options will be granted only in the extraordi-

111. See, e.g., Leo E. Strine, Jr., "Mediation-Only" Filings in the Delaware Court of Chancery: Can New Value Be Added by One of America's Business Courts?, 53 DUKE L.J. 585, 588 (2003) (stating that the Delaware Court of Chancery is the court "entrusted with jurisdiction over corporation law disputes").

112. *Id.* at 588–90.

113. See, e.g., Oliver Hart, *An Economist's Perspective on the Theory of the Firm*, 89 COLUM. L. REV. 1757, 1764–66 (1989) (noting that the corporation can be viewed as a "nexus of contracts").

114. See *Paramount Commc'ns Inc. v. QVC Network Inc.* (*In re Paramount S'holders Derivative Litig.*), 637 A.2d 34 (Del. 1994).

115. See *In re Kemp & Beatley, Inc.*, 473 N.E.2d 1173 (N.Y. 1984); *Meiselman v. Meiselman*, 307 S.E.2d 551 (N.C. 1983); *Balvik v. Sylvester*, 411 N.W.2d 383 (N.D. 1987); *Davis v. Sheerin*, 754 S.W.2d 375 (Tex. App. 1988).

nary circumstance that the board of directors is clueless about the future. And it seems reasonable to grant options to a new employee on the date that he is hired even though the number of options may not be determined until some later date. On the other hand, the result may be different 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 to hold back a stock price increase until options could be granted. 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 extract existing value. In contrast, federal securities law and SEC rules are not well suited for a fact-intensive analysis of whether fiduciaries have acted consistently with stockholder expectations.

Finally, 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 has acted reasonably.¹¹⁶ In other words, state courts may presumably refer to federal rules as evidence of whether a fiduciary violation occurred (as in a case of negligence per se). Thus, if securities fraud class actions were replaced by derivative actions, federal law and SEC regulations would continue to play the lead role in setting minimum standards for disclosure, and 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 the need to work out the evolving terms of the stockholder contract on an ongoing basis, and the state courts are better equipped to evaluate the evolving interests of stockholders.

CONCLUSION

The bottom line is that there is much to be gained from viewing securities fraud actions arising under the 1934 Act and Rule 10b-5 as derivative rather than direct. An action in the name of the issuer company—whether prosecuted by the company itself or as a derivative action—fits the issuer far better than the current system of securities fraud class actions. 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

116. See, e.g., *Lange v. H. Hentz & Co.*, 418 F. Supp. 1376, 1383–84 (N.D. Tex. 1976). As the court stated in *FSLIC v. Shearson-Am. Express, Inc.*, 658 F. Supp. 1331, 1334 (D.P.R. 1987): “Although it is acknowledged that the mere failure to comply with New York Stock Exchange Rules does not constitute fraud per se, in the present context it may serve as evidence to support such claims” (citing *Miley v. Oppenheimer & Co.*, 637 F.2d 318, 333 (5th Cir. 1981)).

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how to split the pot. In addition, a state court may consider violations of federal securities laws on the theory that a 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 those available under federal law. Theoretically, a federal court applying state law could do all the same things that a state court could do. But 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 as Professor Jan Deutsch was fond of asking (really saying): so what? The better view is the one espoused by Professor Marvin Chirelstein: if it's better, I'm for it.