The Future of Securities Litigation

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INTRODUCTION

There was nothing surprising about the result in Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc., the latest decision of the United States Supreme Court dealing with securities fraud under Rule 10b-5. The holding in Stoneridge was little more than a reiteration of the settled point that there is no private right of action based on aiding and abetting securities fraud as the Court ruled fourteen years ago in Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A. To be sure, Central Bank had left open the possibility that a secondary defendant might somehow participate in a fraud perpetrated by another primary defendant and thus be liable under Rule 10b-5. But the Court clearly stated that to be held liable, the secondary defendant itself must have violated Rule 10b-5. In essence, the question in Stoneridge was what constitutes participation in securities fraud. Rule 10b-5 outlaws any “device, scheme, or artifice” to commit fraud in connection with the purchase or sale of securities. The Central Bank Court had not considered the possibility that the word “scheme” may be read to extend liability to anyone who contributes to a scheme to defraud. In other words, the plaintiffs in Stoneridge sought to impose liability for something like civil conspiracy to all participants in the scheme. The defendant argued that to be liable under Rule 10b-
5, a plaintiff must satisfy all the elements of the rule personally. To be specific, a plaintiff must prove (1) a material misrepresentation or omission by the defendant, (2) scienter, (3) a connection between the misrepresentation or omission and the purchase or sale of a security, (4) reliance upon the misrepresentation or omission, (5) economic loss, and (6) loss causation. In particular, the defendant argued that it had made no deceptive statement as required under the rule.

I. THE FACTUAL SETTING

In Central Bank, the defendant (Central Bank) served as indenture trustee for bonds issued by the Colorado Public Building Authority (PBA) in 1986 to finance a real estate development by the developer AmWest. The bonds were secured by land, and the indenture required that the value of the land be at least 160% of the outstanding principal and interest on the bonds. AmWest was required under the indenture to submit annual reports to the indenture trustee. In 1988, AmWest submitted a report showing no change in value. The underwriter of the bond issue expressed doubts about the report because land values had been falling in the area. Central Bank concluded that the report was too optimistic and that a new independent appraisal of the property was necessary. But, at the behest of AmWest and the PBA, Central Bank agreed to delay a new appraisal until after a new issue of bonds under the indenture. In the end, the issuer defaulted, and the bond investors sued under Rule 10b-5, claiming that Central Bank had aided and abetted the fraud. The Court ultimately disagreed, holding that nothing in the tortious means to accomplish an act not in itself illegal; and 3) (actual legal damage resulting to the plaintiff") (internal quotations omitted). In Ford, the court found that a vicarious liability claim could not be made because the plaintiff failed to demonstrate that the state owed a duty to him. 814 A.2d at 140–41. In Lloyd, the respondents took part in a conspiracy because they agreed to coordinate their activities so as to stifle competition within the automotive market. 916 A.2d at 285. Although the Stoneridge Court does not discuss it, it seems likely that most instances of fraud under Rule 10b-5 involve actors who satisfy only one or two of the required elements. See, e.g., Anderson v. Merrill Lynch Pierce Fenner & Smith, Inc., 521 F.3d 1278, 1283 (10th Cir. 2008). In a corporation, it is unlikely that any one person satisfies all of the elements of liability under Rule 10b-5. Contra SEC v. Lauer, No. 03-80612-CIV, 2008 WL 4372896, at *16–23 (S.D. Fla. Sept. 24, 2008) (holding a corporation’s control person personally liable after finding that his violative conduct satisfied all of the Rule 10b-5 elements).

8. See Brief in Opposition of Respondent Motorola, Inc. at 8–10, Stoneridge, 128 S. Ct. 761 (No. 06-43) (arguing the lack of a Rule 10b-5 violation where petitioner fails to show that Motorola made false statements and that Motorola owed a duty to shareholders).


10. Brief in Opposition, supra note 8, at 8–9.


12. Id.

13. Id.

14. Id.

15. Id. at 167–68.

16. Id. at 168.

17. Id.

18. Id.
statute supported aiding and abetting liability and that a secondary actor must be an actual participant in the fraud in order to be held liable.\textsuperscript{19}

In Stoneridge, the primary violator was Charter Communications, a struggling cable television provider.\textsuperscript{20} In order to beef up reported advertising revenue, Charter bought converter boxes at inflated prices from Scientific-Atlanta and Motorola, who in turn agreed to spend the excess on advertising to be broadcast over the Charter cable system.\textsuperscript{21} Investors who bought Charter stock during the fraud period filed a class action.\textsuperscript{22} But Charter was deeply in debt and nearly broke,\textsuperscript{23} so in the hope of collecting from someone, the plaintiffs also sued Scientific-Atlanta and Motorola on the theory that they had participated in the scheme because they knew (or were at least reckless in not knowing) that the purpose of the scheme was to permit Charter to report inflated advertising revenues.\textsuperscript{24}

II. HOLDING AND REASONING

Few likely expected the Court to hold for the plaintiff in Stoneridge. What is surprising about Stoneridge—at least at first blush—is the Court’s reasoning. Following Central Bank, Congress enacted the Private Securities Litigation Reform Act

\textsuperscript{19} Id. at 191. Another rationale for the holding would have been that as a bond trustee, Central Bank had virtually no liability to bondholders. It is standard practice in bond indentures to include a waiver of any and all liability to bondholders. See 15 U.S.C. § 77ppp (2006). Thus, the plaintiffs’ assertion of aiding and abetting liability was an attempt to circumvent well-settled practice in the bond market. See Central Bank, 511 U.S. at 190–91. It is highly unlikely that the Court would permit federal securities law to upset this convention. Id. at 169–70 (citing Brennan v. Midwestern United Life Ins. Co., 259 F. Supp. 673, 680–81 (N.D. Ind. 1966); Cleary v. Perfectune Inc., 700 F.2d 774, 777 (1st Cir. 1983); Kerbs v. Fall River Indus., Inc., 502 F.2d 731, 740 (10th Cir. 1974)). The result would have been total chaos, so it is quite unlikely that anyone expected any other result in Central Bank itself. The case is a classic example of the Supreme Court’s common practice of making new law in cases in which it matters little to the outcome. See infra note 69 and accompanying text, discussing Dura Pharmaceuticals, Inc. v. Broudo.

\textsuperscript{20} Stoneride Inv. Partners, LLC v. Scientific-Atlanta, Inc., 128 S. Ct. 761, 766 (2008). In the interest of full disclosure—and local color—I note that Charter is my internet service and cable television provider and that my set top boxes are manufactured by Motorola.

\textsuperscript{21} Id. at 766–67. The Court also noted that, as a result of the sham arrangements with Scientific-Atlanta and Motorola, Charter was able to inflate its revenue and operating cash flow by $17 million, a number reflected in its subsequent financial statements and SEC filings. Id. at 767.

\textsuperscript{22} Id.

\textsuperscript{23} See Chief of Charter Communications Resigns, N.Y. TIMES, Jan. 19, 2005, at C3. Charter’s annual report for fiscal year 2005 documented long-term debt in excess of $19 billion. Charter Communications, Inc., Annual Report (Form 10-K), at F-4 (Feb. 23, 2005). The attorneys for Stoneridge Investments also noted Charter’s debt and unfavorable financial position in seeking settlement at trial. See Transcript of Settlement Hearing at 7, In re Charter Comm’ns, Inc., Sec. Litig., 2005 WL 4045741 (E.D. Mo. June 30, 2005) (No. MDL 1506; 4:02-CV-1186 CAS) (“Charter is a significantly debt ridden company, has very little in the way of current earnings, has some cash flow, but nonetheless at the end of the day we would have been hard pressed to actually collect from this company rather than throwing it into bankruptcy.”); see also In re Charter Comm’ns, Inc., Sec. Litig., No. MDL 1506; 4:02-CV-1186 CAS, 2004 WL 3826761, at *3–4 (E.D. Mo. Oct. 12, 2004) (noting that the sham transactions were entered into even though they would have had “no legitimate effect on Charter’s operating cash flow”).

\textsuperscript{24} Stoneridge, 128 S. Ct. at 766–67.
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(PSLRA) of 1995. Among other things, PSLRA explicitly provided for aiding and abetting liability but only in an action by the Securities & Exchange Commission (SEC). That should have been enough for the Stoneridge Court. For all the talk about the power of Congress to change the law if it disagrees with the Court, one can hardly imagine a better example of Congress saying what it means. But the Court chose to focus its attention elsewhere—on the reliance requirement. This is not to say that the Court failed to note the implications of PSLRA. It is only to say that the Court relegated PSLRA to one of several factors bearing on statutory interpretation.

Rather than hang his hat on the convenient hook of congressional intent, Justice Kennedy (who also authored the Central Bank opinion) reasoned that the plaintiffs in Stoneridge failed to show reliance by Charter investors on any statement by the secondary defendants. The defendants had argued that because they did not speak to the market, they could not be held to have misled the market. Fraud requires deception. Here the secondary defendants agreed to the scheme cooked up by Charter. But they certainly did not deceive Charter in doing so, since Charter allegedly requested their participation. Justice Kennedy was quick to point out that conduct can be deceiving. One need not speak to deceive.

This seems clearly to be correct. How else could insider trading be illegal? It is a fraud that depends on stealth. To be sure, insider trading also requires that the defendant have some sort of duty to the source of the information not to use the information for personal gain or at least not to do so without disclosing the intent to do so to the source of the information. In a phrase: disclose or abstain.

29. Id. at 769, 771, 773.
30. Id. at 772-73.
31. Id. at 769.
34. Stoneridge, 128 S. Ct. at 770.
35. See id.
36. Id. at 768-69.
37. Id. at 769.
39. Id.
40. Id. at 661. There is a subtle ambiguity in the mantra of disclose or abstain. When the SEC incants these words, it usually means that the market (and especially other stockholders) must be informed first before one can trade on inside information. See, e.g., Chiarella v. United States, 445 U.S. 222, 228-29 (1980). But the phrase has been appropriated (or misappropriated) to suggest that an agent must inform his principal before using confidential information for personal gain. See O'Hagan, 521 U.S. at 652. To be sure, it is often said that the stockholders own the corporation. See, e.g., Richard A. Booth, Stockholders, Stakeholders, and Bagholders (or How Investor Diversification Affects Fiduciary Duty), 53 Bus. Law. 429, 430 (1998). Thus, insiders may be seen as their agents. See Amitai Aviram, Counter-Cyclical Enforcement of Corporate Law, 25 Yale J. on Reg. 1, 4 n.12.
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But it is the duty that comes first. Disclosure is just one way to satisfy the duty.41

Given the need to preserve conduct as fraud, it seems quite natural that Justice Kennedy would focus instead on reliance.42 As he notes, the Stoneridge plaintiffs did not rely on any statement by the secondary defendants.43 More important, there was no automatic presumption of reliance.44 The secondary defendants had no duty to speak that would trigger a presumption of reliance on an omission.45 They made no statement to the market that would trigger the presumption on the integrity of the market under the fraud-on-the-market theory.46

Having found no reliance or presumption thereof, the Court addresses the argument that the secondary defendants participated in the scheme cooked up by Charter upon which the plaintiffs clearly did rely.47 The Court explains that this argument does not answer the objection that the plaintiffs did not rely on the deceptive conduct of the secondary defendants.48 Sensing perhaps that this begs the question, the Court holds that the actions of the secondary defendants were too remote to be the subject of a private cause of action.49 In other words, those actions cannot be said to have been a proximate cause of the injury to plaintiffs.50 But the Court offers little guidance about what would constitute proximate cause other than to say that, “'[i]t was Charter, not respondents, that misled its auditor and filed fraudulent financial statements; nothing respondents did made it necessary or inevitable for Charter to record the transactions as it did.'”51 In this sense, Stoneridge preserves some hope for plaintiffs and their lawyers that some secondary defendants may still be within the reach of a private action under Rule 10b-5.52 As the

40. But in a classic principal and agent relationship, the principal can always forbid the agent to use confidential information. Restatement (Second) of Agency §§ 395–96 (1958). In other words, the agent is not necessarily free to pursue a personal profit simply because he informs the principal of his intent to do so. See id. at § 395. Therefore “disclose or abstain” seems to have taken on a life of its own.

41. O'Hagan, 521 U.S. at 654. The emphatic statement that conduct can be deceiving may be as important as anything else that the Court said in Stoneridge. See Stoneridge, 128 S. Ct. at 769. In one recent SEC enforcement action, the defendant hacked into a computer network, obtained nonpublic information about a stock, and then sold the stock shortly before it fell dramatically in price, SEC v. Dorozhko, No. 07 Civ. 9606 (NRB), 2008 WL 126612, at *3–5 (S.D.N.Y. Jan. 8, 2008). The district court ruled that the hacker's trading did not constitute insider trading because there could be no deceit without a fiduciary or similar duty not to use the information for personal gain. Id. at *20. Never mind that everyone has a duty not to steal.

42. Stoneridge, 128 S. Ct. at 769.
43. Id.
44. Id.
45. Id.
46. Id. Fraud-on-the-market is based on the idea that in a fully developed securities market, a company's stock price reflects all available information about a company. Basic Inc. v. Levinson, 485 U.S. 224, 241–42 (1988) (citing Peil v. Speiser, 806 F.2d 1154, 1160–61 (3rd Cir. 1986)).
47. Stoneridge, 128 S. Ct. at 770–72.
48. Id. at 770.
49. Id. at 769.
50. Id.
51. Id. at 770.
52. Id. at 773–74.
Court states: "secondary actors . . . are not necessarily immune [to] private suit. The securities statutes provide an express private right of action against accountants and underwriters in certain circumstances . . . and the implied right of action in § 10(b) continues to cover secondary actors who commit primary violations." So it is far from clear that Stoneridge changes much of anything except to foreclose the possibility that the word "scheme" has some special significance.

III. WHAT DOES IT MEAN?

Some scholars argue that the effect of Stoneridge is to limit the scope of the private right of action under Rule 10b-5 without limiting the scope of the rule as it might be used by the SEC or Department of Justice (DOJ). The government need not prove reliance in the same way that a private litigant must, because the government does not need to prove damages. Thus, it is arguable that Stoneridge is about who may sue and be sued in a private civil action. It is about something like standing (though obviously that concept does not fit well for defendants). In short, Stoneridge is just another example of the ongoing effort of the Supreme Court to confine the scope of Rule 10b-5 at least insofar as it may be used by private litigants. The problem is that there have been notable decisions that also limit the reach of the government. So why did the Court not focus more on PSLRA than on the common law elements of fraud? Congress itself had already fashioned a distinction between public and private actions under Rule 10b-5. Moreover, the SEC and the DOJ cannot completely ignore the reliance element of a fraud claim under Rule 10b-5. The government must prove materiality. And materiality implies reliance in omission cases. So if the goal is to limit private actions without affecting public actions, Stoneridge does not accomplish much.

53. Id. (citations omitted).
54. Id. at 770.
56. Pritchard, supra note 55, at 232 n.50 (citing United States v. Haddy, 134 F.3d 542, 549–51 (3d Cir. 1998)).
58. Stoneridge, 128 S. Ct. at 770–74.
60. See, e.g., Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 753–55 (1975); id. at 770 (Blackmun, J. dissenting).
64. 17 C.F.R. § 240.10b-5(b) (2008).
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There is another possible interpretation of Stoneridge that is much more far reaching. It seems clear that Stoneridge is really about causation—in this case trans-action causation. It is not likely a coincidence that another recent Supreme Court decision, Dura Pharmaceuticals, Inc. v. Broudo, was also about causation—in that case damages causation. Moreover, as noted above, Stoneridge is a case that could easily have been decided on other grounds. And Dura Pharmaceuticals is a case that the Court did not really need to take. Thus, it appears that the Court is particularly interested in causation.

It is unfortunate that the Court chose to focus on causation and the notoriously vague notion of proximate cause. As a result, the Court was more or less forced into a lame discussion of policy considerations, such as the possibility that the extension of liability to such schemes might drive foreign business away from US capital markets. It would have been much better if the Court had focused instead on making sense out of U.S. securities regulation.

For those of us who oppose securities fraud class actions (“SFCAs”), this suggests an opportunity—if not an invitation from the Court—to argue for a fundamental change. To be specific, the Court may well be receptive to the argument that, in cases such as Stoneridge, there is no fraud because there is no damage. Let me explain.

66. See Stoneridge, 128 S. Ct. at 776.
67. 544 U.S. at 346.
68. See supra note 19 and accompanying text.
69. Dura Pharmaceuticals concerned whether an investor pleading securities fraud could satisfy the loss causation requirement by alleging that the stock’s price on the date of purchase was inflated due to misrepresentation. 544 U.S. at 338. The Court held that in order to state a cause of action, there must be a causal connection between the information withheld and stock price. Id. at 346. In other words, the information must be material in the sense that it matters to the market enough to affect stock price. See id. at 344–45. The problem is that the plaintiffs can always argue that the information became known to some in the market before the official disclosure. See, e.g., Richard A. Booth, The End of the Securities Fraud Class Action as We Know It, 4 BERKELEY BUS. L.J. 1, 24 n.57 (2007) [hereinafter Booth, Securities Fraud Class Action]. Indeed, it may well strengthen the case so to argue because it suggests insider trading during the fraud period. So Dura Pharmaceuticals was one of those cases in which the Court can make new law without affecting the outcome of the case much. See Matthew Fry, Pleading and Proving Loss Causation in Fraud-On-The-Market-Based Securities Suits Post-Dura Pharmaceuticals, 36 SEC. REG. L.J. 31, 49 (2008). As Fry explains:

One reason the Court left so many ways to differentiate its opinion in Dura may have been because the facts presented in the case lent themselves to only one decision. The Supreme Court may have known that it was ignoring some of [the] broader policy concerns by focusing in on the narrow situation presented by the case.

Id. Although the issue was not raised in Stoneridge, a review of the trading in Charter stock during the fraud period raises the same questions.
70. See Stoneridge, 128 S. Ct. at 770; see also Dura Pharm., 544 U.S. at 345–46.
71. Stoneridge, 128 S. Ct. at 772 (noting that the extension of liability could have the effect of deterring overseas firms from doing business in the U.S., causing an increase in the cost of becoming a publicly traded company in the U.S. and shifting securities offerings to markets abroad).
72. See generally John C. Coffee, Jr., Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation, 106 COLUM. L. REV. 1534 (2006) (arguing for greater judicial scrutiny in the settlement allocation of securities class actions to ensure that settlement costs are borne by the culpable parties, not the innocent shareholders) [hereinafter Coffee, Reforming the Securities Class Action].
IV. BAD SECURITIES LITIGATION

Stoneridge is a classic stock-drop class action. The plaintiffs bought outstanding Charter stock in the open market at a time when the price was allegedly too high because the market had been given false information about Charter's finances. It is not a case alleging that Charter itself had fraudulently sold stock to the public at an inflated price. In other words, it is not a case in which Charter obtained money by a fraudulent public offering and should be made to give it back. In a stock-drop case—as in musical chairs—someone is going to suffer the loss one way or the other. The so-called fraud is nothing more than a delay of the inevitable. The loss suffered by those who buy during the fraud period—the period before the truth comes out—is nothing more than bad luck in buying at the wrong time.

73. The underlying securities fraud action in Stoneridge alleged that the respondents engaged in a scheme to produce misleading financial statements, which, in turn, affected stock price. Stoneridge, 128 S. Ct. at 766.
74. Id.
75. See supra note 73 and accompanying text. According to the amicus brief filed by the United States Solicitor General, the class period was November 8, 1999 (the date of the Charter IPO) through July 17, 2002. Brief for the United States as Amicus Curiae Supporting Affirmance at 5, Stoneridge, 128 S. Ct. 761 (No. 06-43). But the complaint contained no claim based on the Securities Act of 1933 (the 1933 Act). See generally Stoneridge, 128 S. Ct. at 766 (showing the Court only considered a private right of action under section 10(b) of the Securities Exchange Act of 1934 (the 1934 Act)). The scheme that formed the basis of the complaint was cooked up in August 2000 because Charter feared that its revenues would not meet market expectations. See id. Those results would have been reported on or about April 1, 2001. See Class Action Complaint at 12, In re Charter Communications, Inc., Sec. Litig., 2005 WL 4045741 (E.D. Mo. June 30, 2005) (No. MDL 1506; 4:02-CV-1186 CAS). Charter (CHTR) went public at $19 per share (for 170,000,000 shares) and closed at an all-time high of $26.31 on December 3, 1999. Answers.com, Charter Communications, http://www.answers.com/topic/charter-communications (last visited Sept. 28, 2008); DeepMarket Stock Blog, Historical Analysis of Charter Communications Inc — CHTR, available at http://www.deepmarket.com/history/cht (last visited Oct. 5, 2008).
77. See supra note 73 and accompanying text.
78. See Ian B. Lee, Fairness and Insider Trading, 2002 COLUM. BUS. L. REV. 119, 160–61 (discussing the losses suffered by outside traders who will unknowingly purchase during the fraud period regardless of whether or not insiders are also trading).
79. See Booth, Securities Fraud Class Action, supra note 69, at 24 n.57.
80. See generally Donald C. Langevoort, On Leaving Corporate Executives "Naked, Homeless and Without Wheels": Corporate Fraud, Equitable Remedies, and the Debate Over Entity Versus Individual Liability, 42 WAKE FOREST L. REV. 627, 634 (2007) (noting that bad luck stemming from corporate fraud will inevitably affect even active and diversified investors); Lee, supra note 77, at 160–61 (discussing how outside investors are
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The bad luck of buyers is offset—dollar for dollar—by the good luck of investors who happen to sell at the right time.80 In other words, securities fraud in the context of a stock drop action is a zero-sum game.81

A stock-drop action under Rule 10b-5 usually arises from the failure of a publicly traded company to disclose material information in a timely fashion.82 The disclosed information may be either good or bad news.83 In other words, an action may be triggered by news that causes the price of a stock to rise (in which case those who sold during the fraud period suffer harm) or by news that causes the price of a stock to fall (in which case those who bought during the fraud period unlucky in the sense that they do not know that the shares they purchase or sell have either inflated or deflated prices).

80. See Booth, Securities Fraud Class Action, supra note 69, at 10 (discussing how investor gains and losses offset each other, as for every investor who suffers a loss due to purchasing a share, there is an investor that gains due to the sale of a share).

81. Id. It is important to be clear that the focus here is on SFCAs arising under Rule 10b-5 and relating to trading in outstanding shares. See, e.g., Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., 128 S. Ct. 761, 767 (2008) (noting that the class action alleged violations of § 10(b) and Rule 10b-5). The argument does not apply to actions arising under the 1933 Act and relating to the public offer of shares by issuers and their agents. Richard A. Booth, Taking Certification Seriously—Why There Is No Such Thing as an Adequate Representative in a Securities Fraud Class Action, supra note 69, at 6. A stock-drop action is fundamentally different from an action based on a fraudulent offering by an issuer company. Richard A. Booth, What Is A Business Crime?, 3 J. Bus. & TECH. L. 127, 142–43 (2008) [hereinafter, Booth, Business Crime] (noting that in the case of a misstatement or omission made in the context of an offering, an investor has a direct cause of action against the issuer for taking the misled investor’s money). In a fraudulent offering, the company obtains funds under false pretenses and investors may recover under the 1933 Act. 48 Stat. 74, 82–84, 15 U.S.C. §§ 77k–77l (2006). In a stock-drop action, buyers of outstanding stock seek to recover losses when the stock declines in price as a result of the disclosure of bad news that allegedly should have been disclosed before the buyers bought. Booth, Securities Fraud Class Action, supra note 69, at 6. A stock-drop action is typically based on the antifraud provisions of the 1934 Act and specifically Rule 10b-5 thereunder. See 17 C.F.R. § 240.10b-5 (2008). These two types of actions may arise simultaneously if a publicly traded company issues additional stock. In such a case, those who buy the newly issued stock sue under the 1933 Act. See Joseph v. Wiles, 223 F.3d 1155, 1160 (10th Cir. 2000). And those who buy outstanding stock sue under Rule 10b-5. See, e.g., In re Oracle Sec. Litig., 829 F. Supp. 1176, 1179–80 (N.D. Cal. 1993). It is much easier to make out a case under the 1933 Act, but damages are limited to the difference between the offer price and the market price after decline. 15 U.S.C. § 77k(e). Under the 1934 Act, damages are the difference between purchase price and market price after decline. Levine v. Seilon, Inc., 439 F.2d 328, 334 (2d Cir. 1971). Thus, an individual who buys newly issued stock in the aftermarket at a price higher than the issue price would really have two claims, one under each act. See, e.g., Blatt v. Merrill Lynch, Pierce, Fenner & Smith Inc., 916 F. Supp. 1343, 1347 (D.N.J. 1996) (plaintiffs brought claims under the 1933 and the 1934 Acts). For the year 2006, only about 12% of cases involved fraudulent offerings. See CORNERSTONE RESEARCH, Securities Class Actions Filings, 2006: A YEAR IN REVIEW 20 (2007), available at http://securities.stanford.edu/clearinghouse_research/2006_YIR/20070102-01.pdf [hereinafter CORNERSTONE RESEARCH, 2006]. The focus here is on stock-drop actions under the 1934 Act. See Stoneridge, 128 S. Ct. at 766–67.


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suffer harm. There are notable examples of both types of fraud. But actions based on bad news are far more common. Thus, the discussion here is based on the premise that securities fraud involves the failure to disclose bad news in a timely way.

In a bad news case, the plaintiff class consists of all who purchased the stock in question during the fraud period and continue to hold it until corrective disclosure. The standard approach to damages in a bad news case is to award the difference between the price paid by the buyer and the market price after corrective disclosure. And it is the company (or its insurance company) that pays the award.

Although some investors may recover substantial sums in a class action, most investors lose from such actions. Most investors are diversified. And a diversified

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84. Booth, Securities Fraud Class Action, supra note 69, at 5–6.
85. See, e.g., Basic Inc. v. Levinson, 485 U.S. 224 (1988) (discussing fraudulent good news); In re Time Warner Inc. Sec. Litig., 9 F.3d 259 (2d Cir. 1993), cert. denied, 511 U.S. 1017 (1994) (discussing fraudulent bad news). There are many other forms of securities fraud, such as those based on face-to-face dealings and those resulting from corporate level mismanagement, but these are rarely amenable to class actions. See generally M. Owen Donley, III, A (Very Brief) Encyclopedia of Securities Fraud, BUS. L. TODAY, Apr. 16, 2007, at 35 (defining various types of securities fraud). SFCAs customarily result from an issuer’s failure to disclose material information to the market in a timely manner. See Prentice & Langmore, supra note 83, at 51.

86. Actions based on fraudulent bad news are more common because of the way damages are awarded in SFCAs. See Booth, Securities Fraud Class Action, supra note 69, at 6. Because the company pays, the stock price falls further—thus enhancing damages through positive feedback and making the SFCAs much more lucrative for a plaintiff’s lawyers. See id. at 5. In a good news action, the SFCAs has the effect of muting the price increase through negative feedback and ultimately reduces the potential award. Id. at 21. Data indicate that of the 104 SFCAs filed in 2006, only two involved good news. Richard A. Booth, Direct and Derivative Claims in Securities Fraud Class Actions (forthcoming).

87. See Booth, Securities Fraud Class Action, supra note 69, at 6 n.7; Booth, Taking Certification Seriously, supra note 81, at 2 n.6.
88. See Booth, Securities Fraud Class Action, supra note 69, at 6 n.8; Booth, Taking Certification Seriously, supra note 81, at 2 n.7.
89. See Coffee, Reforming the Securities Class Action, supra note 72, at 1550.
90. See Richard A. Booth, The End of Securities Fraud Class Actions?, 29 REGULATION 46, 46, 48 (2006) [hereinafter Booth, The End of Securities Class Actions]; see also Coffee, Reforming the Securities Class Action, supra note 72, at 1545–47.
91. A conservative estimate is that more than three-quarters of all stock in the United States is held by well diversified investors. See Richard A. Booth, The Missing Link Between Insider Trading and Securities Fraud, 2 J. BUS. & TECH. L. 185, 189–90 (2007) [hereinafter Booth, Missing Link]. Indeed, it is fair to say that it is irrational for most investors not to diversify. Booth, Taking Certification Seriously, supra note 81, at 22. By investing in a well diversified portfolio of stocks, an investor can eliminate company-specific risk without any sacrifice of return. Booth, Securities Fraud Class Action, supra note 69, at 7. For every company that underperforms, another will overperform. See id. Only the average matters. If it is possible to eliminate risk without any sacrifice of return, a rational investor will do so. Id. Accordingly, a rational investor diversifies. Id. Although it may go without saying, the focus here is on passive investors. The logic of diversification does not necessarily apply to an investor who seeks to exert control over a company or to pursue other idiosyncratic strategies. See id. at 15 n.40. For example, see Bruce H. Kobayashi & Larry E. Ribstein, Outsider Trading as an Incentive Device, 40 U.C. Davis L. Rev. 21, 38–46 (2006). On the other hand, there is nothing to keep such an investor from seeking to diversify if possible. Indeed, some private equity firms have grown large enough to diversify. See Robert C. Illig, What Hedge Funds Can Teach Corporate America: A Roadmap for Achieving Institutional Investor Oversight, 57 AM. U. L. Rev. 225, 291–92 (2007) [observing that “even a relatively small $100 million private
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investor is equally likely to sell or buy an overpriced stock.\textsuperscript{92} For such investors, gains and losses wash out over time.\textsuperscript{93} In other words, a diversified investor is likely to gain from the timely sale of an overpriced stock about as often as she loses from the untimely purchase of an overpriced stock.\textsuperscript{94} But the investor who innocently sells an overpriced stock need not disgorge her (effective) gain, and over time, such gains make up for losses.\textsuperscript{95} In other words, a diversified investor is effectively insured against securities fraud by virtue of being diversified.\textsuperscript{96} Thus, diversified investors are net losers to the extent of attorney fees and other costs of litigation, including such intangibles as management distraction.\textsuperscript{97} These costs without bene-

\textsuperscript{92} Booth, Securities Fraud Class Action, supra note 69, at 3.

\textsuperscript{93} See Anjan V. Thakor, The Economic Reality of Securities Class Action Litigation 6 (U.S. Chamber Institute for Legal Reform Oct. 2005). The Thakor study included 2,596 large institutional investors who traded in 476 securities that were the subject of class action settlements between December 22, 1995 and August 25, 2005 and found (based on modest assumptions about the timing of trades during fund reporting periods) that the institutions suffered losses of $43.8 billion and gains of $30.7 billion in the affected securities for a net loss of $13.1 billion before settlement. Id. at 8 Exhibit A. Interestingly, the institutions’ share of settlement proceeds in these cases was $11.9 billion (less $1.7 billion in attorney fees) for a net loss before attorney fees of just $1.2 billion. Id. The study also found evidence that the pre-settlement losses were attributable to new issues of securities during the fraud period. Id. at 15. Specifically, $1.5 billion in loss was attributable to IPOs and $10.6 billion in loss was attributable to the half of the non-IPO cases involving issuers who were relative net sellers of stock. Id. at 8 Exhibit A. Just $1 billion in loss was attributable to the half of cases involving companies classified as non-issuers. Id. (It is unclear why the study divided the remaining cases in half rather than according to whether the issuer was in fact a net seller or net buyer during the class period.).

\textsuperscript{94} See id. at 6.

\textsuperscript{95} See Booth, Securities Fraud Class Action, supra note 69, at 3.

\textsuperscript{96} Id. at 12–13.

\textsuperscript{97} See id. at 13–14.
fits are a deadweight loss that reduce investor returns.\textsuperscript{98} For a diversified investor, it is the equivalent of paying for two insurance policies against the same risk.\textsuperscript{99} This would be quite apparent—and quite controversial—if the law required sellers to give up their gains to reimburse buyers.

Diversified investors should oppose SFCAs for this reason alone. But diversified investors lose even more from SFCAs in cases in which they neither buy nor sell the subject stock—in cases in which they are mere holders of the subject stock.\textsuperscript{100} To be specific, the prospect of payout by the defendant company causes its stock price to fall even more than it would because of the disclosure of new negative information.\textsuperscript{101} Stock price goes down by some amount that reflects the bad news and by some additional amount that reflects the likely settlement with buyer-plaintiffs.\textsuperscript{102} That, in turn, increases the potential damages payable by the subject company, causing a further decrease in price.\textsuperscript{103} And so on.\textsuperscript{104} In other words, it triggers a

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\item Plaintiff attorney fees average at least 20\% of the recovery amount. See Gerald Gornish, Contesting Attorneys' Fees In Class Actions, INSTITUTIONAL INVESTOR ADVOC., 2d Quarter 2006, at 8–9, available at http://www.bibglaw.com/news/publications/advocate/2006/02/res/id=SA_file1/adv2006Q2.pdf; COMMITTEE ON CAPITAL MARKETS REGULATION, INTERIM REPORT OF THE COMMITTEE ON CAPITAL MARKETS REGULATION 72 (2006), available at http://www.capmktreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf (hereinafter PAULSON REPORT) (finding that plaintiffs' attorneys' fees are typically 25–35\% of the recovery). Defense attorneys earn about the same. See generally Tom Baker & Sean J. Griffith, Predicting Corporate Governance Risk: Evidence from the Directors' and Officers' Liability Insurance Market, 74 U. CHI. L. REV. 487, 495 n.29 (2007) (stating that "[a]ll one industry conference we attended, lawyers and claims managers disputed the total extent of the defense costs, but agreed that defense costs were at least 25\% of a typical class action settlement").
\item See supra notes 92–93 and accompanying text.
\item Booth, Missing Link, supra note 91, at 192.
\item Id.
\item One of the intractable technical problems with SFCAs is that there is no reliable way to determine the number of damaged shares short of soliciting claim forms from the plaintiff class because many of the damaged shares may have been traded repeatedly during the class period. Booth, Securities Fraud Class Action, supra note 69, at 7. This has given rise to several different (and statistically dubious) models that purport to estimate the number of damaged shares. For a description of the latest model, see Linda Allen, Meeting Daubert Standards in Calculating Damages for Shareholder Class Action Litigation, 62 BUS. LAW. 955, 962 (2007) (stating that the Theoretically-grounded Microstructure Trading Model ("TMTM") uses academic literature and public data to estimate "the categorization of aggregate trading volume into buys and sells, and . . . the average daily trading propensity"). Although there is no easy way to determine the number of damaged shares, the market may effectively estimate the number quite efficiently. See generally James Surowiecki, The Wisdom of Crowds (2004).
\item Booth, Securities Fraud Class Action, supra note 69, at 8.
\item Legal scholars noted long ago that the market seems to overreact to bad news and generally blamed it on market inefficiency. See Werner F. M. De Bondt & Richard Thaler, Does the Stock Market Overreact?, 40 J. FIN. 793, 795 (1985) (empirically evaluating the overreaction hypothesis and finding market inefficiencies); Baruch Lev & Meirng de Villiers, Stock Price Crashes and 10b-5 Damages: A Legal, Economic, and Policy Analysis, 47 STAN. L. REV. 7, 12 (1994) ("One is hard put to identify specific adverse events . . . that could account for the panic selling that wiped out one quarter of the total value of American stocks. Economists' inability to explain the 1987 crash by specific changes in fundamentals posed a daunting challenge, particularly to those who believe capital markets are efficient and investors rational.") (footnote omitted). But a perfectly efficient market will overreact to bad news—as a result of feedback—if it appears likely that the company will become the target of securities fraud litigation as a result. Booth, Securities Fraud Class Action, supra note 69, at 8. This is not the usual pie-in-the-sky argument that the market knows all. Rather the point is that even if the market is perfectly efficient it will overreact to bad news that is likely to give rise to a securities fraud class action in the
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positive feedback mechanism that has the effect of magnifying the potential pay-out. The effect on a target company can be devastating.

sense that the market price of the subject stock will fall by more than it should in light of the bad news. Id. In the real world, the market may fall even further as a result of true (inefficient) overreaction. See id. Needless to say, the calculus is somewhat different if the plaintiff class can recover from third parties as attempted in Stoneridge. To be sure, in many cases the settlement is paid by insurance. See Paulson Report, supra note 98, at 78 n.1 (noting that a 1995 study indicates that insurance pays about 68% of claims and that defendant companies pay about 31%). Moreover, there is reason to think that issuers collude with plaintiff lawyers to settle for amounts that will be covered by insurance. See Janet Cooper Alexander, Do the Merits Matter? A Study of Settlements in Securities Class Actions, 43 Stan. L. Rev. 497, 550–52 (1990). One might argue that feedback is unlikely to be significant because most of the cash for the settlement does not come from the defendant company. See Booth, Securities Fraud Class Action, supra note 69, at 8 n.14. But the fact that the settlement is paid by insurance does not eliminate feedback. See id. First, depletion of insurance by the settlement means that the company is exposed to the possibility of other claims that will not be covered by insurance. See Howard M. Garfield, Directors' and Officers' Liability Insurance: Current Issues in Settlement of Claims, 498 Practising L. Inst. Com. L. & Prac. Course Handbook Series, 463, 494–98 (1989). In other words, one may think of insurance as an off balance sheet asset that supports stock price. Second, insurance is likely to become more expensive for the settling company in the future (as well as for other companies). See Booth, Securities Fraud Class Action, supra note 69, at 8 n.14. Thus, the company will have higher insurance expenses in the future, returns will be lower in the future, and stock price will adjust downward accordingly. See generally id. So feedback sneaks back into the picture one way or the other. On the other hand, feedback will arise only to the extent that the market thinks the company will pay. Id. at 3. If it is true that issuers and plaintiff lawyers generally agree to settle for an amount that will be covered by insurance, presumably the market will react accordingly. See Janet Cooper Alexander, The Value of Bad News in Securities Class Actions, 41 UCLA L. Rev. 1421, 1427 (1994) (arguing that stock price drops following the disclosure of bad news result from three factors: "(1) the market value of the new information itself; (2) the anticipated costs of litigation over the disclosure; and (3) the value of the termination of subsequent purchasers' right to sue over the information." ) (emphasis added). In other words, market price will not necessarily fall by an amount that reflects the full amount of damages that might be awarded, if the market thinks that the case will be settled for some lesser amount. Cf. Id. at 8.

105. The extent of feedback ultimately depends on the number of shares represented by the plaintiff class. See Booth, Securities Fraud Class Action, supra note 69, at 8. For example, if the holdings of the plaintiff class are equal to 50% of the outstanding shares, the decrease in the price of the subject stock will be twice what it would have been in the absence of a class action. See generally id. The following formula expresses the relationship:

\[
\text{total decrease in market value} = \frac{\text{expected decrease}}{(1 - \% \text{ of shares damaged})}
\]

For example, if the expected decrease in firm value based solely on the revelation of bad news (without feedback) is 10% and the plaintiff class—those who bought during the fraud period—represent 40% of the shares, the total decrease in the value of the shares will be about 17%:

\[
\text{total decrease in market value} = .10 / (1 - .40) = \frac{.10}{.60} = .166
\]

If the plaintiff class represents 50% of the shares, the total decrease in value will be 20%—twice the decrease that would be seen if there were no threat of a SFCA. And if the plaintiff class represents 80% of the shares, the total decrease in value will be 50%—five times what it would have been if there were no threat of a SFCA. In other words, the company will be worth half what it would have been worth in such a case even though the bad news was that its value had fallen by 10%.

106. The Paulson Report notes that the chances are about 10% that any given company will become the target of securities litigation in any five year period. Paulson Report, supra note 98, at 74. This is a round-about way of saying that there are about 10,000 listed companies and about 200 SFCAs filed each year. In other words, two in every hundred companies are likely to get sued in any given year. But the report fails to connect the dots. If a diversified investor holds 500 different stocks through a mutual fund, ten stocks are likely to be the target of a securities fraud action each year. If the mutual fund has an annual turnover ratio of 40%—about the market average—then on the average it will be a buyer in two cases, a seller in two cases, and a holder in six
THE FUTURE OF SECURITIES LITIGATION

A diversified investor is likely to be a non-trading holder of many stocks that become the target of SFCAs.\(^7\) In such cases, non-trading holders effectively reimburse buyers because the issuer pays the settlement.\(^8\) Thus, although diversified investors break even as traders, they lose as holders.\(^9\) Accordingly, a diversified investor is not merely indifferent to securities fraud litigation.\(^10\) A diversified investor should be positively opposed to the system as it stands.\(^11\)

\(^7\) See supra note 106 and accompanying text.

\(^8\) See Booth, Securities Fraud Class Action, supra note 69, at 21.

\(^9\) See id. at 34.

\(^10\) See id. at 12.

\(^11\) As the Paulson Report points out, any given diversified investor may be on both sides of the recovery. See Paulson REPORT, supra note 98, at 79. If an investor holds shares in the defendant company and buys more during the fraud period, he may lose as much on the shares he holds as he recovers on the shares he bought. Id. For this insight, the Report cites Coffee, Reforming the Securities Class Action, supra note 72, at 1585 (stating that contemporary securities litigation "benefits three sets of actors—corporate insiders, plaintiffs' attorneys, and insurance companies—but not shareholders"); but see id. at 1555 (noting that while shareholders in general do not benefit from securities litigation, the Enron and WorldCom settlements were the largest in U.S. history, making shareholders of those companies relatively better off as a result of the litigation than shareholders of other companies).
Indeed, the Interim Report of the Committee on Capital Markets Regulation (the Paulson Report) finds that the public value of securities class action litigation is questionable because (1) the costs fall on the corporation and thus its stockholders (even though the company gained nothing from the fraud), (2) settlements account for a very small percentage of total investor losses, and (3) the settlement is effectively paid by investors who held shares at the time of the fraud to investors who bought during the fraud period. This litany of problems is really three ways of saying the same thing: SFCAs suffer from circularity.

V. GOOD SECURITIES LITIGATION

Despite the problems inherent in class actions, there may be a point to other forms of securities litigation. It is possible that insiders—the CEO and other high ranking officers—may gain from securities fraud. For example, Ken Lay, Jeff Skilling, Andy Fastow and other Enron insiders sold more than $800 million in Enron stock as the end drew near. In effect, they misappropriated $800 million from the market. This is not to suggest that insider trading as narrowly defined under federal law is the only way that insiders may do genuine financial harm to outsiders. For example, it is not clear that backdating options constitutes insider trading, but it is quite clear that it reduces returns to other stockholders. Moreover, even in the absence of insider gain, failure to be candid with the market may do harm to the reputation of all stockholders.

 Seriously, supra note 81, at 22. Not all stockholders are necessarily diversified. Paulson Report, supra note 98, at 80. Indeed, recent studies indicate that the average individual investor in the U.S. holds just four stocks even though one can eliminate virtually all company-specific risk by holding about twenty stocks. Booth, Securities Fraud Class Action, supra note 69, at 11. The Paulson Report expresses some concern about undiversified investors. See Paulson Report, supra note 98, at 80. But it is well settled that federal securities laws protect reasonable investors. See, e.g., TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 445 (1976) (observing that the issue of materiality under the federal securities laws is measured objectively and concerns the significance that a reasonable investor would attribute to an omitted or misrepresented fact). A passive investor who fails to diversify assumes more risk than necessary without the prospect of any additional return. Booth, Securities Fraud Class Action, supra note 69, at 7. That is irrational behavior for an investor. Id. Moreover, most investors are well diversified, because at least three-quarters of all stock is held through various institutional vehicles. Booth, Missing Link, supra note 91, at 189–90. Even if one is reluctant to deny a remedy to undiversified investors, presumably the interests of the great majority of investors should trump those of a small minority of investors where the two conflict. Id. at 190. This is not to say that an individual undiversified investor might not have a legitimate claim on occasion. See Booth, Securities Fraud Class Action, supra note 69, 15–16 n.40. For example, an investor who seeks to gain control of a target company is likely to be undiversified. Id. Such investors may sometimes be victims of fraud. See id. But such investors are likely to have claims against an identifiable seller (whether a stockholder or the company itself) and must likely show reasonable reliance on some falsehood propounded by a counterparty. See Dura Pharm., Inc. v. Broudo, 544 U.S. 336, 341 (2005).

112. See Paulson Report, supra note 98, at 78–79.

113. Id.


116. Booth, Missing Link, supra note 91, at 197.
of the company among investors and cause a drop in stock price. But who should recover for such wrongs? In a case of insider trading, it seems clear that the insider should give back the gain. But to whom? How do we figure out who was on the other side of a trade? And why should the counterparty recover just because she happened to buy stock from one of the culprits rather than someone else?

There is a simple solution: issuer recovery. The corporation should recover the ill-gotten gains of insiders. And if the corporation fails to seek recovery, a stockholder may file a derivative action on behalf of the corporation. If the corporation recovers, the value of the corporation increases dollar for dollar, and the recovery is effectively spread over all the stockholders. There is no problem of circularity. And there is no feedback effect because the company recovers. Investors are compensated to the extent of their true loss—the amount that insiders have extracted from the market—and not the amount of losses that would have

117. See id. at 201.
118. See Booth, Business Crime, supra note 81, at 131.
119. See id. at 143.
120. This seems quite obvious in a case of reputational harm. It would hardly make sense to make the corporation pay because it was harmed by one of its agents. See Coffee, Reforming the Securities Class Action, supra note 72, at 1585; Langevoort, supra note 79, at 632–33. Yet that is essentially the system we have with stock-drop actions. Coffee, Reforming the Securities Class Action, supra note 72, at 1585. It also seems clear that in a case of options backdating, the optionee should give back the ill-gotten options. That remedy addresses the harm to other stockholders—dilution—quite directly. Booth, Securities Fraud Class Action, supra note 69, at 31. Insider trading has always been a bit confusing on this score because it is not really clear why insider trading is illegal. See id. at 30. But the misappropriation theory seems now to be well settled. See generally United States v. O'Hagan, 521 U.S. 642, 652 (1997) ("[A] person commits fraud 'in connection with' a securities transaction, and thereby violates § 10(b) and Rule 10b-5, when he misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information."). Thus, it seems clear that the issuer can recover for the insider trading of its fiduciaries. See Moss v. Morgan Stanley Inc., 719 F.2d 5, 21 (2d Cir. 1983) (holding that if insider trading is based on a theory of misappropriation of information from the source of the information, the source of the information may have standing to sue but the counterparty to the trade does not). It is telling that the 1934 Act takes a similar position in section 16(b) which provides that the issuer may recover insider gain from short swing trading and that where the issuer fails to do so a stockholder may maintain a derivative action to that end. See 15 U.S.C. § 78p(b) (2006). This would seem to be a powerful argument for issuer recovery and against SFCAs under the 1934 Act and Rule 10b-5. Booth, Securities Fraud Class Action, supra note 69, at 28.
121. See Booth, Securities Fraud Class Action, supra note 69, at 9.
122. See id. at 31.
123. See id. at 26 (describing the problems associated with fraud that "involves the repurchase of stock by the issuing company").
124. Id. at 24.
occurred anyway. Moreover, the remedy is consistent with the fiduciary duty that insiders owe to the corporation.

Issuer recovery would be easy to implement. The courts could simply deem SFCAs to be derivative actions—actions in the name of the corporation by which the corporation recovers. The character of an action is a matter for the discretion

125. Id. at 19. It is arguable that stockholders suffer no loss from insider trading. Lee, supra note 77, at 165. There is little reason to think that insider trading causes a stock price to fall any more than it otherwise would. See Jonathan R. Macey, Securities Trading: A Contractual Perspective, 50 Case W. Res. L. Rev. 269, 275–76 (1999) (discussing that insider trading creates a more efficiently functioning market and will typically lead to more accurate stock prices). Still, the gain from insider trading could offset compensation expense. See Iman Anabtawi, Secret Compensation, 82 N.C. L. Rev. 835, 868–70 (2004) (discussing how a board of directors in possession of material and undisclosed good news regarding the company might provide its managers with stock options as a means of efficient compensation). Presumably, this tradeoff would be the subject of bargaining between the corporation and insiders if it were legal to do so (which is not necessarily to say that it is not). See id. On the other hand, other forms of misappropriation (such as backdating of options) dilute outside stockholder returns. See M.P. Narayanan et al., The Economic Impact of Backdating of Executive Stock Options, 105 Mich. L. Rev. 1597, 1600, 1605–24 (2007) (analyzing how the backdating of executive options causes losses to shareholders).

126. Anabtawi, supra note 125, at 861 (describing how the court in In re Cady, Roberts & Co. "decided that a corporate insider must abstain from trading in the shares of her corporation unless she has first disclosed all material inside information" due to the fiduciary duty that an insider owes to the corporation). The Paulson Report notes that individual defendants rarely pay any part of the settlement in a SFCA except in cases in which the company is insolvent and has tapped out its insurance. Paulson Report, supra note 98, at 78–79. But the Report stops short of suggesting that individuals should pay more (though it does endorse individual liability where appropriate). See generally id. This is not too surprising in that the Report finds that securities fraud litigation confers no benefits on investors. See generally id. (discussing data that illustrates how security class actions do not do a good job of compensating injured investors, if at all). Rather, the Report suggests a series of clarifications in the law defining securities fraud and proposes that corporations and their stockholders should be free to choose alternative dispute resolution methods. See id. at 80–81, 109–10. Specifically, the Report recommends that the SEC and the courts should clarify the meaning of materiality, scienter, and reliance. Id. at 12. In addition, the SEC should use its powers to prevent duplicative recovery in cases where there is both private litigation and a SEC enforcement action. See id. at 12–13. And plaintiff lawyers should be prohibited from engaging in practices that amount to paying clients to serve as plaintiffs. See id. at 82–83. The Report also addresses the overuse of criminal sanctions and the dangers of imposing excessive liability on auditors and outside directors. See id. at 84–91. The executive summary emphasizes the need for continued enforcement against individual wrongdoers. Id. at 11. But curiously, there is almost nothing to that end in the discussion of SFCAs. See generally id. Rather, the Report ultimately—and rather cryptically—recommends that corporations and their stockholders should be free to choose alternative dispute resolution methods. Id. at 109–12. This might be read as something of an endorsement for derivative actions. Neither of these recommendations addresses the real problem. In essence, the recommendation is that we should be more efficient about handling pointless litigation. See generally id.

127. See generally Booth, Securities Fraud Class Action, supra note 69, at 24.

128. As a practical matter, a court could so rule in a motion to certify on the rationale that conflicts within the plaintiff class render an action for individual damages inappropriate for class action treatment under Rule 23(b)(3) of the Federal Rules of Civil Procedure. See generally Fed. R. Civ. P. 23(b)(3). Specifically, the interests of buyers (who want the action to go forward) and buyer-holders (who do not) conflict in a way that cannot be resolved by the formation of subclasses. See Booth, Taking Certification Seriously, supra note 81, at 15–19. But both groups would favor a derivative action if there is insider misappropriation. See generally Booth, Securities Fraud Class Action, supra note 69, at 27. Federal Rule of Civil Procedure 23(b)(2) permits the court to certify an action as a class action if: "the party opposing the class has acted or refused to act on grounds that apply generally to the class, so that final injunctive relief or corresponding declaratory relief is appropriate respecting the class as a whole . . . ." Fed. R. Civ. P. 23(b)(2). That is essentially a description of a derivative action (or at least the part that involves compelling the corporation to sue the wrongdoers). See Booth, Taking Certification
of the courts. The fact that the parties style the action as a direct (class) action rather than as a derivative action does not make it so. The real harm from securities fraud (if any) comes from the misappropriation of stockholder wealth by insiders. Redistribution of inevitable losses among innocent investors is regrettably, but stockholders can easily protect themselves from that sort of harm through diversification. To be sure, in the absence of insider gain, the action will likely be dismissed. But that is as it should be. No harm, no foul.

Diversified investors should be positively opposed to SFCAs except in cases in which insiders have taken advantage of the situation to divert stockholder wealth through insider trading or other forms of misappropriation such as timing and backdating of options. In the absence of insider misappropriation, securities fraud is a zero-sum game. Buyer losses are offset by seller gains. Investors in the aggregate neither gain nor lose. But if insiders use the opportunity to extract

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Seriously, supra note 81, at 20. Interestingly, Federal Rule of Civil Procedure 23(b)(2) seems to permit such an action even in the absence of demand on the corporation. See generally Fed. R. Civ. P. 23(b)(2).

129. See, e.g., Bangor Punta Operations, Inc. v. Bangor & Aroostook R.R., 417 U.S. 703 (1974) (demonstrating the various points of view that courts can take on whether an action is a shareholder derivative action); Tooley v. Donaldson, Luften, & Jenrette, Inc., 845 A.2d 1031, 1035 (Del. 2004) (noting that it is the court that will determine the suit’s classification by examining the potential relief and the nature of the wrong).

130. Tooley, 845 A.2d at 1035 (“The Court of Chancery correctly noted that ‘[t]he Court will independently examine the nature of the wrong alleged and any potential relief to make its own determination of the suit’s classification . . ..’”).

131. Booth, Securities Fraud Class Action, supra note 69, at 27.

132. Id. at 18. But see Lawrence E. Mitchell, Vulnerability and Efficiency (of What?), 2 BERKELEY BUS. L.J. 153, 164 (2005) (arguing that shareholders still lose money when a corporation suffers because of managerial shirking or self-dealing).

133. Booth, Missing Link, supra note 91, at 193. Technically speaking, the issuer suffers no direct harm from many instances of misappropriation (such as insider trading). William J. Carney, Signalling and Cause in Insider Trading, 36 CATH. U. L. REV. 863, 877 (1987) (discussing why insider trading occurs and the harm caused to investors). Rather the claim is more one of unjust enrichment on the part of insiders. William W. Bradton, Self-Regulation, Normative Choice, and the Structure of Corporate Fiduciary Law, 61 GEO. WASH. L. REV. 1084, 1092 (1993) (discussing whether insider trading breaches the fiduciary duty even though the corporation suffers no harm). Still it is well established that a corporation may recover in such circumstances. See AM. LAW INST., PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 5.04 cmt. c (1994).

134. In addition, a derivative action is subject to procedural complications (such as the demand requirement and the possibility that the corporation may seek voluntary dismissal) that may make it less desirable than a direct action. Eric Talley, Taking the "I" Out of "Team": Intra-Firm Monitoring and the Content of Fiduciary Duties, 24 J. CORP. L. 1001, 1008 (1999) (discussing the procedural obstacles at play when bringing a derivative action). Moreover, the settlement of a derivative action based on misappropriation or other gain to the wrongdoer likely will not be covered by insurance. A.C. Pritchard, Justice Lewis F. Powell, Jr., and the Counterrevolution in the Federal Securities Laws, 52 DUKE L.J. 841, 864 (2003) (discussing the consequences on directors from lack of insurance coverage). Thus, although defendant companies could argue on their own initiative that SFCAs should be recast as derivative actions, they are unlikely to do so, because such claims would not be covered by insurance. See id. As I discuss further below, the SEC could help alleviate these problems by intervening in appropriate situations. See infra Part VI.

135. Booth, Securities Fraud Class Action, supra note 69, at 18.

136. Booth, Missing Link, supra note 91, at 190.

137. Booth, Securities Fraud Class Action, supra note 69, at 7.
gains, investors suffer a genuine loss. 138 In such cases, a diversified investor would prefer to have the issuer recover the ill-gotten gains by means of a derivative action or a direct action by the issuer. 139 But there is no situation in which a diversified investor would favor a system of securities regulation that includes SFCAs as we know them. 140 To be sure, an undiversified investor might favor a class action remedy. 141 An undiversified investor may suffer real harm from securities fraud. 142 An investor who forgoes the benefits of diversification and picks a single stock can lose her entire investment. 143 For such an investor, the benefits of SFCAs may outweigh the costs. 144 On the other hand, it is not clear that even undiversified investors should favor the existing system that causes stock price to fall more than it otherwise would. From an ex ante perspective such an investor is more likely to be a holder than to be a buyer and is thus more likely to lose as a result of feedback than to gain from being a member of the plaintiff class. 145

So why should the courts change this well-settled—even if confused and contradictory—system of private securities litigation that has evolved over the past forty or so years? The answer is that federal securities law is intended to protect reasonable investors. 146 Most investors are well diversified. 147 And it is arguable that it is irrational for most investors not to diversify. 148 Accordingly, federal securities law should be interpreted consistent with the interests of diversified investors. 149

138. Id. at 9.
139. Booth, Business Crime, supra note 81, at 143; Booth, Securities Fraud Class Action, supra note 69, at 5.
140. See Booth, Securities Fraud Class Action, supra note 69, at 5. It is ironic that the Court (per Justice Ginsburg) begins its recent Tellabs opinion with the statement that it "has long recognized that meritorious private actions to enforce federal antifraud securities laws are an essential supplement to criminal prosecutions and civil enforcement actions . . . ." Tellabs, Inc. v. Makor Issues & Rights, Ltd., 127 S. Ct. 2499, 2504 (2007) (discussing the importance of private actions in order to enforce securities laws). While the Court follows this statement with the qualification that it also recognizes that the system can be abused to impose unjustified costs on innocent companies and individuals, the tea leaves seem to indicate that the Justices are not inclined to scrap the system. See id.
141. Booth, Securities Fraud Class Action, supra note 69, at 5.
142. Id. at 10.
143. Id.
144. See id. at 4.
145. Booth, Taking Certification Seriously, supra note 81, at 4 n.11; see also Booth, Missing Link, supra note 91, at 192.
146. Booth, Securities Fraud Class Action, supra note 69, at 10.
147. Id. at 17 n.57.
148. Id. at 7.
149. One might ask how we ended up with the confused and contradictory system that we now have. The short answer is that under the 1933 Act investors who buy newly issued stock have an express cause of action against the issuer if there is any material falsehood in the registration statement or the prospectus. 15 U.S.C. §§ 77k-1 (2006). But the 1933 Act also provides that the issuer cannot be held liable for any more than the proceeds of the offering. 15 U.S.C. § 77k(e). As a result, the courts have ruled that only those investors who buy stock that is part of the offering may recover. If the issuer is already publicly traded—if the offering is one of additional stock—it is likely that other "investors [will] read the offering materials and may rely on [falsehoods] therein in connection with the purchase . . . of [already] outstanding [stock]." Booth, Missing Link, supra note 91, at 194. The investor would not likely know whether the shares he bought were part of the offering, but the courts nonetheless required plaintiffs to trace their shares back to the offering in order to have
VI. WHAT ABOUT DETERRENCE?

Some commentators have argued that although SFCAs do little good for investors, they are the most important source of deterrence we have.\textsuperscript{150} Although the threat of a stock-drop action constitutes wildly excessive deterrence aimed at the wrong target, eliminating corporate liability would so reduce the incentives to sue that we would lose the deterrent effect of private litigation.\textsuperscript{151} As John Coffee has stated, "one cannot safely eliminate corporate liability . . . without radically reducing the likelihood of private enforcement."\textsuperscript{152}

This is a peculiar argument. If there is so little at stake that the plaintiff bar will find it uneconomic to sue, so be it.\textsuperscript{153} Moreover, if diversified investors are effectively insured—by virtue of being diversified—against the possibility that they may buy at the wrong time, what exactly do we want to deter? The only real worry for a diversified investor is that insiders may take advantage of nonpublic information in some way to misappropriate stockholder wealth from the market.\textsuperscript{154} But there is little danger of undert deterrence here. There is plenty of motivation for plaintiff lawyers to file derivative actions.\textsuperscript{155} Who would not be motivated by the prospect of a fee equal to (say) one-third of the $800 million misappropriated by the officers of Enron?\textsuperscript{156} Besides, one of the major problems with SFCAs is that the potential dam-

\textsuperscript{150} See Coffee, Reforming the Securities Class Action, supra note 72, at 1547–48.

\textsuperscript{151} Id. at 1564 (arguing that a system of managerial liability is not possible until the likelihood of private enforcement is drastically reduced).

\textsuperscript{152} Id.

\textsuperscript{153} Maybe that is why plaintiff lawyers found it necessary to bribe plaintiffs to serve. See Richard A. Booth, Why Pay a Fraud Plaintiff to Sue?, WASH. POST, June 26, 2006, http://www.washingtonpost.com/wp-dyn/content/article/2006/06/25/AR2006062500527.html [hereinafter Booth, Why Pay].

\textsuperscript{154} See Booth, Securities Fraud Class Action, supra note 69, at 14.

\textsuperscript{155} See, e.g., id. at 3 (discussing the total plaintiff attorney fees earned due to SFCAs over the past ten years leading to 2007, a sum of approximately $7 billion); John C. Coffee, Jr., Understanding the Plaintiff’s Attorney: The Implications of Economic Theory for Private Enforcement of Law Through Class and Derivative Actions, 86 COLUM. L. REV. 669, 681 (1986) (discussing the incentive for plaintiff attorneys to pursue suits because of the low search costs involved).

\textsuperscript{156} In addition, it is possible that misappropriation or other acts of bad faith by insiders may do harm to the reputation of the business. See Booth, Securities Fraud Class Action, supra note 69, at 27. If so, it may be appropriate for the corporation to recover damages over and above the sums that insiders misappropriate. See Coffee, Reforming the Securities Class Action, supra note 72, at 1558–59. But because a SFCA also causes a
ages far exceed what is needed for effective deterrence. With issuer recovery, the amount of any recovery is likely to be quite small compared to amounts claimed in SFCAs, but it is likely to be significant for an individual defendant.

Legal scholars have suggested a variety of other fixes for the class action mess. Some have suggested a system of civil fines that limit the amount payable by the corporation. The problem with civil fines—as with criminal prosecution—is that they are not particularly scalable. Fines—and criminal prosecution—are pretty much one size fits all. And they fit no one particularly well.

The Paulson Report suggests that SEC fines be used to compensate investor victims and that private awards be reduced by such amounts. But that fix does not address the feedback problem. The market does not care where the money goes or the route it takes when the company pays. As long as the issuer remains on the hook for investor losses, feedback will magnify the loss.

Others have suggested that issuers be exempt from liability under Rule 10b-5 in cases in which the issuer itself does not sell stock. To be sure, that fix would leave

decrease in the market price of the subject company, it is impossible to know how much real damage has been done. Robert B. Thompson & Randall S. Thomas, The New Look of Shareholder Litigation: Acquisition-Oriented Class Actions, 57 Vand. L. Rev. 133, 153 n.81 (2004) (discussing whether damages are met by the actual recovery). In the absence of the threat of a class action, this element of damage would become much easier to measure and where appropriate the corporation could recover. See Malone v. Brincat, 722 A.2d 5, 13 (Del. 1998) (discussing the exceptions to the "Delaware carve-outs").

157. See Elkind v. Liggett & Myers, Inc., 635 F.2d 156, 170, 172 (2d Cir. 1980) (describing the potential for damages awarded in class action suits to be "draconian" and "exorbitant" and explaining that holding insider traders liable up to the amount gained by their illegal actions serves as sufficient deterrence against insider trading).

158. See Booth, Missing Link, supra note 91, at 192 n.51.

159. See, e.g., infra notes 160, 165 and accompanying text.

160. See Coffee, Reforming the Securities Class Action, supra note 72, at 1538. See generally Donald C. Langevoort, Capping Damages for Open-Market Securities Fraud, 38 Ariz. L. Rev. 639 (1996) (arguing that the current system encourages many low-merit litigations and excessive settlements and that capping damages using civil penalty statutes would still deter improper behavior from directors while reducing the number of suits with little merit); see also Janet Cooper Alexander, Rethinking Damages in Securities Class Actions, 48 Stan. L. Rev. 1487, 1508–12 (1995) (suggesting that civil fines could act as sanctions for regulatory violations instead of the current system which forces companies to pay compensatory damages to members of class action suits and that under a new regulatory system, the amount of damages would be easier to calculate).

161. See Booth, Missing Link, supra note 91, at 203 n.107.

162. See generally id. (discussing how a fine of up to three times the gain or loss avoided due to insider trading does not deter because many defendants probably cannot pay these fines).

163. See Paulson Report, supra note 98, at 82 (discussing different ways the SEC can prevent overlap of private lawsuits and Fair Funds Compensation). As the Report notes, the SEC has authority under the Fair Funds for Investors provision of the Sarbanes-Oxley Act to use funds obtained from civil penalties to compensate victims of securities fraud. Id. For the year 2004, class action settlements totaled nearly $5.5 billion while SEC monetary sanctions totaled $3.1 billion. Id. at 71.

164. See Booth, Securities Fraud Class Action, supra note 69, at 8–9 (discussing how the market may cause the market price of the company stock to fall more than it originally should).

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plaintiffs with nothing but an action against individual wrongdoers. But it does nothing to change the way damages are calculated against the remaining defendants. Moreover, there may be cases in which the issuer gains from securities fraud and should disgorge. For example, if the issuer repurchases shares while sitting on good news, selling stockholders may have a legitimate claim. So to exempt issuers is overbroad.

It is much simpler to clean up the class action mess with issuer recovery than with the other fixes that have been proposed. By definition, issuer recovery exempts the issuer because the issuer is the plaintiff. Thus, there is no need for an issuer exemption. Issuer recovery also limits damages to the amount of insider gain. It is a much more efficient way to limit damages because the limit is automatically scaled to the offense.

on Professor Grundfest's "Disimplying Private Rights of Action Under the Federal Securities Laws: The Commission's Authority", 108 HARV. L. REV. 438, 438–39 (1994) (arguing that there is "insufficient evidence to justify significant rule or legislative changes that would further burden private federal securities litigation"). For Professor Grundfest's response to Professor Seligman, see Joseph A. Grundfest, Why Disimply?, 108 HARV. L. REV. 727, 727–28 (1995) (arguing that the "courts deny that they are the appropriate forum for resolution of the securities class action policy debate" and that the facts are not as established as Professor Seligman would have us believe).

166. See Coffee, Reforming the Securities Class Action, supra note 72, at 1583 (explaining that exempting non-trading corporations as defendants would ensure only the guilty parties would be penalized).

167. See id. at 1585 & n.81. On the other hand, it should be apparent that it makes no sense to hold other defendants liable for all the losses suffered by buyers. See Fridrich v. Bradford, 542 F.2d 307, 318–19 (6th Cir. 1976) (discussing the importance of showing a causation link between losses suffered by buyers and the defendants in order to hold them liable).

168. See Booth, Securities Fraud Class Action, supra note 69, at 9.

169. See id. at 26.

170. See supra notes 166–70 and accompanying text.

171. See supra Part VIII.

172. See generally Booth, Securities Fraud Class Action, supra note 69, at 24.

173. If the issuer gains from the sale of overpriced stock, investors remain free to sue under the 1933 Act. See Booth, Missing Link, supra note 91, at 194. If the issuer gains from a repurchase of underpriced stock, sellers (who no longer own their stock) could maintain a direct (class) action against the issuer as the actual buyer. Id. at 195. There is no danger of feedback because damages would be limited to the actual gain enjoyed by the corporation. See Booth, Securities Fraud Class Action, supra note 69, at 26.

174. See Booth, Missing Link, supra note 91, at 189.

175. Civil fines and criminal prosecution are blunt instruments. The penalty is more or less all or nothing. See Booth, Business Crime, supra note 81, at 139. In contrast, in a civil action, the plaintiff must plead and prove damages. Id. Thus, with civil liability you know who lost what and who recovers. In addition, a private plaintiff must weigh the costs and benefits of filing a civil action. Id. In other words, civil remedies are both self-executing and self-regulating. Id. As Gordon Gekko might have said, the need to quantify the stakes clears the mind and focuses the will. Id. at 139 n.76. In contrast, neither a regulator nor a prosecutor must prove damages. See id. at 139. And neither has much of any reason not to prosecute an offense other than the prospect of losing. Id. On the other hand, simple compensatory damages may be insufficient deterrence. Id. at 134 n.55. If the only consequence of securities fraud is that one must disgorge ill-gotten gains, there is little reason not to give it a go. Id. at 131. A similar problem with insider trading is addressed under the Insider Trading & Securities Fraud Enforcement Act by providing for a treble the gain fine in addition to compensatory damages. See 15 U.S.C. § 77k (2006).
Issuer recovery is also consistent with the findings and recommendations in the Paulson Report.\textsuperscript{176} Indeed it is somewhat surprising that the Report fails to connect the dots and propose a similar solution.\textsuperscript{177} For example, the Report suggests that enforcement should focus more on individual wrongdoers.\textsuperscript{178} The Report also expresses general concern about the overuse of criminal sanctions.\textsuperscript{179} In addition, the Report suggests that recent revelations of lawyers bribing plaintiffs indicates that in many cases plaintiffs are not otherwise inclined to sue because they have not suffered any real loss (or would lose as much as holders as they gain as members of the plaintiff class).\textsuperscript{180} Finally, the Report also recommends that the SEC clarify the meaning of sc\textit{ienter}.\textsuperscript{181}

Although PSLRA stiffened pleading standards by requiring facts indicating a strong inference of \textit{scienter}, we seem to have lost track of the fact that \textit{scienter} means \textit{intent to defraud}—intend to (mis)appropriate the wealth of another by deception.\textsuperscript{182} However reprehensible it is for a company to lie to the market in the hope that bad news might be covered up, it is not fraud, and there is no \textit{scienter}, unless someone gains in the bargain.\textsuperscript{183}

\textsuperscript{176} See Paulson Report, supra note 98, at xii–xiii.
\textsuperscript{177} See generally id.
\textsuperscript{178} Id.
\textsuperscript{179} See id. at xii.
\textsuperscript{180} Id. at 82–84; see also Booth, Why Pay, supra note 153.
\textsuperscript{181} Paulson Report, supra note 98, at 80–81.
\textsuperscript{182} 15 U.S.C. § 78u-4(h)(2) (2006). See also Tellabs, Inc. v. Makor Issues & Rights, Ltd., 127 S. Ct. 2499, 2504 (2007); Basic Inc. v. Levinson, 485 U.S. 224, 260–61 (1988) (White, J., dissenting) (questioning whether there could be fraud where the perpetrator does not trade or otherwise gain); In re Time Warner Inc. Sec. Litig., 9 F.3d 259, 268, 273–75 (2d Cir. 1993) (Winter, J., dissenting) (arguing that corporate officers could not have expected alleged fraud to result in gain to the corporation and that accordingly there could be no \textit{scienter}). See generally Booth, Missing Link, supra note 91, at 193 & n.52 (arguing that courts should dismiss SFCAs in which the plaintiff class has not suffered harm because insider gains are not alleged or when the plaintiff has not alleged or pled with particularity that the defendant acted with \textit{scienter}).
\textsuperscript{183} See Basic Inc., 485 U.S. at 260–61 (White, J., dissenting) (questioning whether fraud may exist without a gain by the wrongdoer); In re Time Warner, 9 F.3d at 273–75 (arguing \textit{scienter} could not exist where the corporate officers would not have expected their allegedly fraudulent actions to benefit the corporation). Curiously, Professor Coffee seems to assume that SFCAs always involve insider gain. See Coffee, Reforming the Securities Class Action, supra note 72, at 1547–48. Not true. In 2006, only 42 of 110 cases (38%) involved allegations of insider trading, while 20 of 110 cases involved options backdating. See Cornerstone Research, 2006, supra note 81, at 14, 20. The Paulson Report also notes that few recent actions have named auditors as defendants—even though about 60% of cases appear to be based at least in part on allegations of improper accounting—probably because of the Supreme Court decision in Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164 (1994), foreclosing claims for aiding and abetting. Paulson Report, supra note 98, at 87; see also Coffee, Reforming the Securities Class Action, supra note 72, at 1550 & n.60; Price-WaterhouseCoopers LLP, 2007 Securities Litigation Study 11 (2008). Although the point is that the accounting profession remains exposed to litigation, the (unintended) suggestion is that many actions are based on illusory losses. See Coffee, Reforming the Securities Class Action, supra note 72, at 1550. Similarly, the report also suggests that the SEC should provide more guidance about what constitutes materiality and reliance. Paulson Report, supra note 98, at 80. In both cases, the thrust seems to be to assure that the actions that are litigated are the ones in which there has been genuine economic loss.
Arguably, the Stoneridge Court should have considered whether the conduct of the secondary defendants satisfied the *scienter* requirement. There is little doubt that the secondary defendants knew that Charter had asked them to overpay for set top boxes. But it is not at all clear that they knew or even suspected that Charter would mislead its own investors. There are other possible explanations.

The courts seem to have forgotten that *scienter* is more than some kind of knowledge that a statement is false. Rather *scienter* means intent to defraud. And intent to defraud connotes that the perpetrator seeks somehow to gain something of value by means of deception. So what was the gain for the Stoneridge defendants? Arguably, they got some free advertising time from Charter. Even if they had no use for the time, they could presumably sell it. But it was a product that no one much wanted, which was why Charter was giving it away in the first

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184. To be sure, this question was not before the Court. But arguably neither was the question of reliance. See *generally* Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., 128 S. Ct. 761, 769 (2008) (explaining that the rebuttable presumption of reliance present under the fraud-on-the-market theory or when "there is an omission of a material fact by one with a duty to disclose" did not apply in Stoneridge). One must wonder whether the Court is free to choose the issues that it does and does not address in the cases that it chooses to decide.

185. See id. at 767.

186. See id. at 766-67.

187. One possibility is that the secondary defendants would have used the free advertising and drawn others to actually buy advertising. Id. at 766. Incidentally, the scheme seems like one that might have been cooked up by middle managers without the consent of higher ups. See *generally id.* at 767 (noting that the involved "companies drafted documents to make it appear the transactions were unrelated and conducted in the ordinary course of business").

188. See Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 n.12 (1976) (defining "scienter" as "a mental state embracing intent to deceive, manipulate, or defraud").

189. See Tellabs, Inc. v. Makor Issues & Rights, Ltd., 127 S. Ct. 2499, 2506-12 (2007) (setting out the requirements for *scienter*); Booth, *Business Crime, supra* note 81, at 130. I am not a fan of resorting to the dictionary. Often as not, dictionary definitions seem to be used as some kind of judicial ice-breaker to begin the analysis in a vacuum.

190. United States v. Chenaur, 552 F.2d 294, 299 n.7 (1977) ("To act with 'intent to defraud' means to act knowingly, and with the specific intent to deceive; ordinarily for the purpose of either causing some financial loss to another or bringing about some financial gain to oneself."). To be sure, the Restatement (Second) of Torts § 526 defines *scienter* solely in terms of intent:

   The word 'fraudulent' is here used as referring solely to the maker's knowledge of the untrue character of his representation. This element of the defendant's conduct frequently is called 'scienter' by the courts. Intent and expectation of influencing the other's conduct by the misrepresentation are dealt with in §§ 531–536 as a separate and distinct element necessary to liability under the rule stated in § 525.

Restatement (Second) of Torts § 526 cmt. a (2006). On the other hand, the cases cited by the Restatement invariably involve some sort of gain to the perpetrator. See, e.g., Tenneco Oil Co. v. Joiner, 696 F.2d 768, 770 (1982) (where an oil company sued its landman for fraud because he obtained funds above and beyond his salary and expenses). Moreover, the Court has emphasized that federal securities law is different from common law fraud. See Stoneridge, 128 S. Ct. at 771 (responding to the argument that the reliance element would have been satisfied if this were a common law fraud action by observing that "Section 10(b) does not incorporate common-law fraud into federal law"); see also United States v. O'Hagan, 521 U.S. 642, 672 (1997) (indicating the SEC may prohibit acts that are not fraudulent under the common law). And it may be that the Court's emphasis on deceit is intended to capture the requirement of gain by the perpetrator.

191. See Stoneridge, 128 S. Ct. at 766.

192. See *generally id.*
place. There was no reason for the Stoneridge defendants not to take the deal. Indeed, it might have been some kind of breach of fiduciary duty not to take it.

Ironically, the federal courts have struck such a distinction in insider trading cases arising under Rule 10b-5. For example, in Dirks v. SEC, the Supreme Court declined to find insider trading in a case in which a whistle-blower conveyed material nonpublic information to an analyst who used the information to recommend that his clients sell the subject stock. The court reasoned that because the whistle-blower did not seek economic gain from the use of the information, it did not constitute an illegal stock tip. Subsequently, in United States v. O'Hagan, the Supreme Court, in upholding the misappropriation theory of insider trading, held that a fiduciary who [pretends] loyalty to the principal while secretly converting the principal's information for personal gain,.dupes or defrauds the principal.

The Stoneridge Court expressly distinguished Dirks because the tipper there sought no personal gain. To be sure, the Stoneridge defendants owed no fiduciary duty to Charter stockholders. But the point is that even in a situation in which the defendant is a fiduciary, personal gain is required under federal securities law. The rule could be otherwise. A breach of confidence without gain could be enough. But the Court wisely requires gain. The rule should be the same in a stock-drop case.

The obvious argument against issuer recovery is that no corporation will go after its own and that the corporation will likely do all it can to thwart any derivative

193. See id. at 766.
194. See id.
195. See Veco Corp. v. Babcock, 611 N.E.2d 1054, 1059 (Ill. App. Ct. 1993) (citing Smith-Shrader Co. v. Smith, 483 N.E.2d 283 (Ill. App. Ct. 1985)) ("Corporate officers . . . owe a fiduciary duty of loyalty to their corporate employer not to . . . hinder the ability of a corporation to continue the business for which it was developed."). For example, if the board of directors foregoes a tax exemption to which the corporation is entitled, it might well constitute a breach of fiduciary duty. See In re Walt Disney Co. Deriv. Litig., 906 A.2d 27, 62 (Del. 2006) ("Deliberate indifference and inaction in the face of a duty to act is . . . conduct that is clearly disloyal to the corporation.").
196. See, e.g., SEC v. Yun, 327 F.3d 1263, 1279 (11th Cir. 2003) (holding that proof of personal benefit is necessary to establish tipper-tippee liability under the misappropriation theory).
198. Id.
200. Id. at 663.
202. O’Hagan, 521 U.S. at 663. The Court also stated: "A company’s confidential information . . . qualifies as property to which the company has a right of exclusive use. The undisclosed misappropriation of such information . . . constitutes fraud akin to embezzlement." Id. at 654.
203. See Dirks, 463 U.S. at 672–74 (Blackmun, J., dissenting) (arguing that personal gain is not an element of duty because an insider’s duty is owed directly to the corporation’s shareholders).
204. See id.
205. See, e.g., O’Hagan, 521 U.S. at 663 (upholding the misappropriation theory of insider trading by distinguishing the facts of Dirks, in which the insiders did not act for personal gain).
action. That is undoubtedly true in a world with SFCAs. It is only natural that a company accused of fraud will circle the wagons. And no company would dare initiate an action against its own officers for fear that it would trigger a ruinous class action. Indeed, as the law currently works, it may even be rational to cover up bad news that is likely to give rise to a class action. If the news is bad enough that a class action would likely bankrupt the company, there may be nothing to lose from a cover up. Thus, it is arguable that SFCAs constitute a significant obstacle to effective corporate governance. That may explain at least in part the recent growth in the criminal prosecution of such controversies.

There is no reason to assume that a corporation will respond in the same way in the absence of the class action threat. In the current environment, one can hardly fault an outside director who concludes that it is contrary to the best interests of the corporation to pursue an action against a CEO. In the absence of the class action threat, however, outside directors would themselves be subject to potential legal action for failure to seek restitution when appropriate. As things stand, outside directors are practically immune to legal action.

Nevertheless, the question remains: What is to keep the company honest if it is not liable for misleading the market? In the absence of insider gain, there would seem to be no reason for a company not to lie to the market. There are at least two good answers.

First, companies act only through individuals who may be liable for any gain they enjoy or facilitate for others and for any loss they cause by harming the repu-

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206. See Booth, Securities Fraud Class Action, supra note 69, at 33–34 (arguing that many companies may be deterred from pursuing claims against their own agents because of the in terrorem effect of SFCAs). If a company were to pursue its own officers, shareholders may be encouraged to bring a SFCA suit. Id. Settling a SFCA is prohibitively costly because not only are the plaintiffs paid, but also the value of the stock also goes down. Id. Therefore, to avoid the consequences of SFCAs, companies would logically avoid pursuing their own agents and attempt to quash any derivative suits. Id.

207. See Coffee, Reforming the Securities Class Action, supra note 72, at 1567.

208. The increasing costs of class action settlements have deterred corporations from initiating actions against their officers. See Paulson Report, supra note 98, at 5 (noting that class action settlement costs have increased from $150 million in 1995 to $3.5 billion in 2005); see also Booth, Securities Fraud Class Action, supra note 69, at 33–34.

209. See generally Booth, Securities Fraud Class Action, supra note 69, at 34.

210. See generally Paulson Report, supra note 98, at 5 (noting the cost of class action settlements).

211. See Booth, Securities Fraud Class Action, supra note 69, at 34.

212. See Booth, Business Crime, supra note 81, at 140–44.

213. See Booth, The End of Securities, supra note 90, at 51 (stating that SFCAs are a significant impediment to corporate self policing and that SFCAs deter corporations from making claims against their own agents). In the absence of a class action threat, corporations have less incentive to cover up CEO misconduct. See generally Coffee, Reforming the Securities Class Action, supra note 72, at 1567 (articulating the effect of class actions on corporate conduct).

214. See Booth, Securities Fraud Class Action, supra note 69, at 33–34.

tation of the company.216 Under current law, individuals are (practically speaking) immune because the company's insurance pays.217 To be sure, non-trading insiders may be protected by the business judgment rule because issuer recovery is essentially a matter of state law.218 But the business judgment rule may not protect a non-trading insider from liability if there is a violation of SEC rules.219 Moreover, the SEC always has the authority to file a civil enforcement action in any such case and may presumably join a private action where appropriate.220

Second, given that equity is the primary form of compensation for most CEOs and other high level officers, insiders should have every incentive to assure that the market is fully informed.221 Where equity compensation is the norm, no company can afford to be blacked out of the market.222 Companies need to issue stock and options and to buy back stock to control for dilution.223 And officers who exercise options need to sell stock for tax planning and diversification.224 In other words, insiders themselves have every reason to keep their companies honest.225

Obviously, equity compensation did not prevent the most recent spate of frauds. Indeed, some have argued that equity compensation was ultimately to blame.226 But the incentives would be quite different if issuer recovery were the rule.227 As things currently stand, the issuer foots the bill and insiders often keep their gains.228

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216. See Top Flight Aviation v. Wash. County Reg'l Airport Comm'n, 224 F. Supp. 2d 966, 974 (D. Md. 2002) ("[A] corporation can operate only through the individuals who, as officers, directors, or stockholders, control the activities, policies, and management of the corporation."). See, e.g., Coffee, Reforming the Securities Class Action, supra note 72, at 1549, 1566, 1574, 1577 (stating that officers are often sued for liability in securities litigation alongside the corporation). Removing liability from the corporation and placing it on individual officers deters fraudulent conduct. See id. at 1579.

217. See generally Coffee, Reforming the Securities Class Action, supra note 72, at 1569–70; Paulson Report, supra note 98, at 78 ("[T]he potential deterrent function of securities class action litigation is debatable because virtually all costs fall on the corporation and its insurer.").


219. It is not clear that the business judgment rule affords protection against a clear violation of a SEC rule. See generally Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) (articulating scope of business judgment rule). Just as speeding constitutes negligence per se if one is involved in an accident even if speeding might otherwise be reasonable, the violation of an express SEC rule may constitute unprotected illegal behavior for state law purposes. See Booth, Missing Link, supra note 91, at 199.


221. Equity-based compensation, when properly designed and implemented, can encourage corporate disclosure by aligning the interests of insiders with shareholders. See Jensen & Murphy, supra note 106, at 57–58.

222. See generally, Booth, Missing Link, supra note 91, at 198–99 (noting that it is crucial for the market to be fully informed for options to work properly especially since options are used as compensation to create an incentive for managers to maximize stock price and reward them when stock price rises).


224. See id.

225. Contra Coffee, Reforming the Securities Class Action, supra note 72, at 1572–73.

226. See Jensen & Murphy, supra note 106, at 81–82 ("Providing equity-based incentives based on stock options grants failed to align executives' interests comprehensively with those of their firms in this period of generally overvalued equity.").

227. See generally Booth, Securities Fraud Class Action, supra note 69, at 24–27.

228. See Coffee, Reforming the Securities Class Action, supra note 72, at 1566–67.
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insiders are potentially liable to disgorge any gain—fault or no fault—as misappropriation under state law, they should be eager to ensure that the market is fully informed when they cash out.229 To be sure, one might argue that issuer recovery would cause officers to insist on even more compensation or costly insurance against such claims.230 But insurance is not generally available if there is personal gain involved.231 The same goes for indemnification.232

Admittedly, issuer recovery puts the board of directors in a peculiar position.233 In effect, the board becomes an arbiter for the competing claims of officers and stockholders.234 In some cases, the board may pursue claims against officers, while in other cases, the board may conclude that it is not in the best interest of the corporation to do so.235 But that is a good thing. Again, for a diversified investor, the only real worry is insider misappropriation.236 Everything else comes out in the wash. But it is not always clear what constitutes misappropriation.237 For example, although it seems quite clear that backdating options is usually inappropriate, it is not so clear that granting options at a time when the stock is trading at a low is problematic.238 Such decisions are judgment calls.239 The board of directors is well suited to striking the required balance between stockholder expectations and executive compensation.240 Moreover, to view the board of directors as an arbiter is consistent with the Paulson Report proposal that the SEC should explore the possibility of permitting companies to opt out of class actions and into alternative dispute

229. See Booth, Missing Link, supra note 91, at 201.
230. See Coffee, Reforming the Securities Class Action, supra note 72, at 1583–85.
231. D&O policies typically exclude coverage on the basis of fraudulent, dishonest, or criminal misconduct. See id. at 1555–56.
233. See Burks v. Lasker, 441 U.S. 471, 477–78 (1979) (explaining that corporate directors must determine whether to pursue a derivative action “brought by shareholders to enforce a claim on behalf of the corporation”).
234. See id. (“A derivative suit is brought by shareholders to enforce a claim on behalf of the corporation. . . . [D]irectors are authorized to determine that certain claims not be pursued on the corporation’s behalf.”) (citation omitted).
235. See id.; see also Booth, Missing Link, supra note 91, at 192 n.51.
236. See Booth, Securities Fraud Class Action, supra note 69, at 13–14 (articulating the effects of misappropriation on diversified investors).
That seems like an odd idea if one thinks of stockholders and the corporation as adversaries. If that is the model, why should one party to a potential dispute (the corporation) be permitted to dictate terms to the other (the stockholders)? But if one thinks of the typical dispute as one between stockholders and officers about how to share the corporate wealth, it is easy to see how the board of directors might officiate.

Finally, issuer recovery should reduce the need for criminal sanctions by freeing outside directors to do the right thing. The criminalization of controversies that traditionally have been seen as matters of corporate governance and fiduciary duty is due at least in part to the failure of boards of directors to monitor management with any real enthusiasm. But the danger of triggering a SFCA—with the potential for costs far in excess of any benefit to the stockholders—impedes vigorous action by the board of directors. If we eliminate this obstacle to effective monitoring by the board of directors, it may not be necessary to prosecute cases that do not involve a truly criminal enterprise.

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241. PAULSON REPORT, supra note 98, at 109–12. As I have argued elsewhere, it may make more sense to view a corporation as a partnership between stockholders and officers in which the officers effectively work for a piece of the action. See Richard A. Booth, Executive Compensation, Corporate Governance, and the Partner-Manager, 2005 U. ILL. L. Rev. 269 (2004). This view is consistent with recent scholarship about team production and may explain away much of the recent controversy about executive compensation. See generally Margaret M. Blair & Lynn A. Stout, A Team Production Theory of Corporate Law, 85 Va. L. Rev. 247 (1999) (explaining that the “principal-agent” model, which portrays a corporation as bundles of assets owned by shareholders who hire directors and officers to manage on their behalf, is less accurate than the “team production” model, which portrays a corporation as the combined investment of a team comprised of shareholders, directors, and officers). Coincidentally, Jensen and Murphy have argued that the board of directors should be viewed primarily as a management monitor and that the support role of the board be viewed as strictly subordinate to its role as management monitor. See Jensen & Murphy, supra note 106, at 53–56.


244. See generally Booth, Business Crime, supra note 81, at 134–40.

245. See generally id. at 140–44 (discussing the growth of criminal prosecution in matters arising from bankruptcy that were traditionally seen as matters of fiduciary duty and corporate governance); see also Larry E. Ribstein, The Perils of Criminalizing Agency Costs, 2 J. BUS. & TECH. L. 59, 60 (2007).


247. See generally PAULSON REPORT, supra note 98, at 84–86. Moreover, confusion about how to measure the loss from securities fraud also infects criminal prosecutions in that sentencing guidelines require the courts to estimate the loss from the fraud. See, e.g., United States v. Adelson, 441 F. Supp. 2d 506, 510 (S.D.N.Y. 2006) (concluding through expert testimony that “confounding factors” made it impossible to determine the actual loss attributable to fraudulent conspiracy). Not surprisingly, prosecutors and the courts have used the same (questionable) theories used to estimate stockholder losses in SFCAs with the result that sentences have been wholly out of proportion with the harm suffered by investors. See Edward A. Dyl, Estimating Economic Damages in Class Action Securities Fraud Litigation, 12 J. FORENSIC ECON. 1, 1 (1999) (discussing the inaccuracy of loss estimates in security fraud cases due to the high amount of settlement and the need for attorneys’ fees).
VII. MAKING IT HAPPEN

By recasting stock-drop actions as derivative actions, the courts could in one stroke eliminate the glaring market inefficiency of circular recovery, lower the cost of capital for issuers, emphasize individual responsibility, induce boards of directors and gatekeepers to become more vigilant, and reduce the need for criminal prosecution. What a deal. But aside from indications that the Supreme Court might welcome it, what will cause the courts to make such a radical change?

Legal scholars seem to agree that it is up to the courts to fix the problem. Although the courts might be reluctant to effect such a change, the SEC could presumably nudge them in right direction by using its broad power to grant exemptions under federal securities law. For example, the SEC might exempt issuers from class actions except in cases in which they have dealt in their own stock.

One might object that it is somehow inappropriate to focus here on the procedural form of the action. In other words, whether one has a cause of action should not depend on the procedural device one chooses to pursue. The easy answer is that Congress did exactly that in PSLRA and the Securities Litigation Uniform Standards Act (SLUSA) of 1998 by establishing special rules for securities fraud actions that take the form of class actions. Looking back, that seems like an extraordinary thing to do. On the other hand, it indicates that lawmakers somehow intuited the problem of circularity. Moreover, it is quite clear that the courts have considerable discretion in the management of class actions because they affect the rights of absent parties. That is the point of the certification requirement.

248. See supra text accompanying notes 172–246.
250. See generally Grundfest, Disimplying Private Rights, supra note 165, at 1011 (“[T]he Commission has broad authority to restructure large portions of the securities litigation process”).
252. See, e.g., T. Dean Malone, Comment, Castano v. Am. Tobacco Co. and Beyond: The Propriety of Certifying Nationwide Mass-Tort Class Actions Under Federal Rule of Civil Procedure 23 When the Basis of the Suit is a “Novel” Claim or Injury, 49 BAYLOR L. REV. 817, 829–30 (1997) (“Certifying courts must remember that Rule 23 is merely a procedural device and cannot be a mechanism for creating a new cause of action. Rather, courts should use Rule 23 only to allow adjudication of established rights. If a case contains a novel claim, a certifying court must be certain that class adjudication can occur without altering the litigants’ well-established rights.”).
253. Id.
derivative action is ultimately a type of class action.\textsuperscript{258} It would seem to follow (as the Delaware courts have known for a long time) that the courts have the power to decide what form an action should take.\textsuperscript{259} Here too, the SEC could play an important role by intervening in SFCAs at the certification stage.\textsuperscript{260}

Some scholars have expressed doubt that the courts will be willing to make the necessary changes in the law.\textsuperscript{261} I am more optimistic that the courts will do the right thing, particularly if plaintiff attorneys realize that there is a living to be made from prosecuting derivative actions.\textsuperscript{262} As I argue elsewhere, in addition to an action based on unjust enrichment, there are other elements of damages arising from securities fraud (such as reputational harm to the corporation) that a derivative plaintiff might pursue.\textsuperscript{263} Moreover, there is a fundamental conflict between the plaintiff class and the plaintiff corporation in a derivative action.\textsuperscript{264} A zealous derivative plaintiff should argue that the recovery for unjust enrichment and reputational harm should go to the corporation and not to the class.\textsuperscript{265} Moreover, the derivative plaintiff as a representative of the corporation should argue that the class action should be dismissed in order to prevent dissipation of corporate assets and derivative harm to the stockholders (including both buyers and non-trading holders).\textsuperscript{266} When the issue is so joined, the courts may have no choice but to fish or cut bait. It may not be possible to avoid making a decision between the mutually exclusive alternatives of class action and derivative action.\textsuperscript{267} Although it has become increasingly common for derivative actions to be filed along side SFCAs, no court has yet been forced to choose between the two as arguably it should.\textsuperscript{268}

Some scholars have also suggested that corporations or their stockholders may be able to fix things by means of charter or bylaw amendments that govern stockholder actions.\textsuperscript{269} Adam Pritchard has suggested that a corporation could specify


\textsuperscript{259} See Booth, Taking Certification Seriously, supra note 81, at 23.


\textsuperscript{261} See Pritchard, supra note 55, 28–45 (also expressing doubt about whether Congress or the SEC is likely to act).

\textsuperscript{262} As Pritchard notes, the fees to be made from class actions are not all that generous on average. So fees from derivative actions may suffice. \textit{id.} at 35–36.

\textsuperscript{263} See Richard A. Booth, Direct and Derivative Claims in Securities Fraud Class Actions (forthcoming).


\textsuperscript{266} See Booth, Taking Certification Seriously, supra note 81, at 13 n.32.

\textsuperscript{267} See id.

\textsuperscript{268} Id.

\textsuperscript{269} See generally Myriam Gilles, Opting Out of Liability: The Forthcoming, Near-Total Demise of the Modern Class Action, 104 MICH. L. REV. 373, 424 (2005) (suggesting that a company could include a class action waiver in its corporate charter).
that the fraud-on-the-market presumption of reliance does not apply to it. 270 A more straightforward approach would be a provision to the effect that in order to recover from the corporation in any action based on a purchase or sale of the company's stock—or other securities for that matter—the plaintiff must prove actual reliance. 271 As Pritchard recognizes, it might be argued that this limitation on liability constitutes an impermissible waiver of compliance under section 29 of the 1934 Act. 272 His response is that waiver of the presumption of reliance does not constitute a waiver of compliance. 273 I might argue further that neither does the waiver of an implied right of action constitute a waiver of compliance with the act or rules thereunder. 274 So perhaps a corporation could even adopt a rule that provides that it shall not be liable to any stockholder except in a situation in which the corporation itself has traded in its own securities. 275 Specifically, the corporation may be liable to buyers only if the corporation has sold securities and may be liable to sellers only if the corporation has bought securities. 276

As Pritchard also notes, the Supreme Court has addressed the waiver issue in only one setting—in connection with mandatory arbitration clauses—and there only in connection with one-on-one broker-customer disputes and broker-employee disputes—both of which tend to be small potatoes as compared to SFCAs that are imbued with public interest. 277 Moreover, the waiver in question in such cases is not one that relates to compliance with substantive provisions of the 1934

270. See Pritchard, supra note 55, at 34.
273. Id. at 40.
274. See id. at 34.
275. Id.
276. Id. The Paulson Report suggests that defendant corporations could adopt charter amendments that would require arbitration of such disputes. See PAULSON REPORT, supra note 98, at 110–11. See also Green Tree Fin. Corp. v. Bazzle, 559 U.S. 444, 451 (2003) (holding that mandatory arbitration clauses may extend to class actions and that whether it does is a question for the arbitrator to decide). Bazzle will undoubtedly lead to arbitration clauses that require arbitration but prohibit class arbitration. See Gilles, supra note 269, at 409–11; Samuel Estreicher & Michael J. Puma, Arbitration and Class Actions After Bazzle, 58 Disp. Resol. J. 13, 18 (2003). The question that then arises is whether the arbitration clause effectively prevents a plaintiff from pursuing a class action. One argument that it should do so is that the arbitration and class actions may be seen as substitutes for each other. Both are designed to reduce the cost of litigation in their own way. So there is an argument to be made that arbitration obviates the need for a class action. See generally Peter M. Mundheim, The Desirability of Punitive Damages in Securities Arbitration: Challenges Facing the Industry Regulators in the Wake of Mastrobuono, 144 U. Pa. L. Rev. 197, 202 (1995) (finding that arbitration reduces costs). But see Jean R. Stearnlight, As Mandatory Binding Arbitration Meets the Class Action, Will the Class Action Survive?, 42 WM. & MARY L. REV. 1, 108 (2000) (arguing that there may be constitutional, statutory, and contractual limits on arbitration that would prevent arbitration from effectively serving as a substitute to class actions). In the end, there is no reason not to prosecute class actions as efficiently as possible. See id. at 109 (finding that class-wide arbitration would have the same efficiencies as class-wide litigation, and that policy would support the arbitration over litigation); Richard A. Booth, Punitive Damages and Securities Arbitration in the Wake of Mastrobuono, 9 INSIGHTS, June 1995, at 20.
Act but rather the exclusive jurisdiction of the federal courts in connection with cases arising thereunder.\textsuperscript{278} On the other hand, the fact that the Court has signed off on the arbitration of disputes arising under the 1934 Act suggests that the Court might well approve a rule governing procedural aspects of securities litigation.\textsuperscript{279} For example, the corporation might adopt a rule providing that any SFCA filed against the corporation be deemed to be an action on behalf of the corporation—a derivative action—to recover any amount that may have been misappropriated from the corporation or any damage that may have been done to the corporation except to the extent that the corporation itself is alleged to have sold stock to or bought stock from the plaintiff class.\textsuperscript{280}

Arguably this provision is no waiver at all because it is consistent with virtually all applicable state and federal law.\textsuperscript{281} In other words, such a provision could be seen as a clarification of how the law should be applied in a situation in which the law itself is quite confused.\textsuperscript{282} First, state law generally favors derivative actions over class actions.\textsuperscript{283} That is, to the extent that an injury may be characterized as derivative it should be so characterized because recovery redounds to the benefit of the stockholders pro rata.\textsuperscript{284} And Congress expressly preserved derivative actions when it enacted SLUSA in 1998.\textsuperscript{285} Second, although federal law now provides for an individual remedy for insider trading, it also recognizes that the misappropriation theory is based on a duty that runs to the corporation.\textsuperscript{286} To be sure, the corpora-
tion may have no standing to sue under federal law unless it was a buyer or seller.287 But the corporation can always sue under state law.288 Third, federal securities law is almost all about unjust enrichment.289 The two express remedies under the 1933 Act essentially require the recipient to refund any investment made without full disclosure.290 Arguably, it was by a false analogy to the 1933 Act that SFCAs became established.291 And under the 1934 Act, the remedy for short-swing trading—a form of insider trading—is that the culprit must give up his gain (or loss avoided) to the issuer.292 Indeed, the statute specifically states that the action may be prosecuted as a derivative action if the issuer fails to sue.293

On the other side of the ledger there is the well-established institution of SFCAs as recognized by PSLRA and SLUSA.294 But that begs the question. The one and

287. See Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 730–31 (1975) (citing Birnbaum v. Newport Steel Corp., 193 F.2d 461 (1952)) ("[A] private damage action under § 10(b) and Rule 10b-5 [i]s limited to actual purchasers and sellers of securities").

288. See Brophy v. Cities Serv. Co., 70 A.2d 5, 8 (Del. Ch. 1949) (finding that the plaintiff corporation sufficiently stated a cause of action against its employee because a duty ran from the employee, who used the acquisition of secret knowledge relating to his employer's business to make a profit for himself, to the corporation); Diamond v. Oreamuno, 248 N.E.2d 910, 912 (N.Y. 1969) (affirming an order denying a motion to dismiss a complaint which, although absent an allegation of damage to the corporation itself, alleged officer and director accountability to the corporation for gains realized by selling corporate stock subsequent to learning of material inside information); Freeman v. Decio, 584 F.2d 186, 187 (7th Cir. 1978) (holding that Indiana law has never recognized a corporation's right to bring suit against corporate officers and directors for alleged illegal trading of corporate stock on the basis of material inside information); In re ORFA Sec. Litig., 654 F. Supp. 1449, 1455 (D.N.J. 1987) (finding that the derivative plaintiff did have a cause of action under New Jersey common law when seeking relief from individual corporate officers alleged to have benefited from insider trading); Davidge v. White, 377 F. Supp. 1084, 1087–88 (S.D.N.Y. 1974) (allowing the plaintiff, by applying Delaware law and following Brophy, to bring a cause of action under Delaware common law for breach of fiduciary duty, even though the plaintiff was not a purchaser or seller of the securities, and therefore had no standing under federal law). But see Schein v. Chasen, 313 So. 2d 739, 744–47 (Fla. 1975) (rejecting a claim by corporation under Florida law, holding that state precedent required "actual damage" to the corporation be alleged, and refusing to extend the fiduciary duty of common law set forth in Diamond to the defendants who benefited from insider trading, but who were not directors or officers of the corporation); Goodwin v. Agassiz, 186 N.E. 659, 660–61 (Mass. 1933) (rejecting the plaintiff's common law fraud claim against the directors of a corporation who purchased the plaintiff's stock because the information that the defendants knew was only a speculative theory, there was not a duty to disclose, and the corporation was not harmed from the nondisclosure of the information).

289. See SEC v. JT Wallenbrock & Assocs., 440 F.3d 1109, 1113 (9th Cir. 2006) (affirming that securities law is designed to deprive a wrongdoer of unjust enrichment); see also National Bankruptcy Review Commission, Final Report, Issues Identified by the Division of Enforcement and Office of General Counsel of the Securities and Exchange Commission app'x F-4, available at http://govinfo.library.unt.edu/nbrc/report/f4.pdf.


291. Booth, Missing Link, supra note 91, at 44.

292. Id. at 46.

293. Id.

only provision that provides for an individual right of action (other than under the 1933 Act) is section 18 of the 1934 Act. That section, which is seldom used, provides for an individual remedy in cases in which an investor can prove reliance on a false statement in a document filed with the SEC.

To be sure, waiver of the fraud-on-the-market presumption would preserve the possibility that one or more plaintiffs who could not prove reliance might nonetheless recover from the corporation. For example, a large investor such as a mutual fund might be able to prove that its analysts relied on specific false statements disseminated by the corporation. One might argue that it is crucial to preserve this possibility in order to avoid waiver. Moreover, one might argue that a derivative action is an inadequate alternative because the cause of action would belong to the corporation and because the corporation would not have standing to sue under federal law because of the Blue Chip Stamps doctrine which limits standing to those who purchase or sell securities. Neither of these considerations outweighs the advantages of derivative actions.

First, to say that a large investor such as a mutual fund might be fooled into making a significant investment has a hollow ring. It seems much more likely that a well-advised fund would either depend on diversification to protect itself from misinformation in run-of-the-mill trading decisions or do enough research to uncover the truth (or at least doubts about issuer representations) when contemplating a major position. Moreover, it seems likely that many significant investments will involve purchase of securities directly from the corporation or a major stockholder, in which case the buyer will likely have an action against the seller if any relief is appropriate.


296. Id. Ironically, it is a common practice at the SEC to exempt many documents from this provision by deeming them not to be filed documents. See Heit v. Weitzn, 402 F.2d 909, 915 (2d Cir. 1968) (holding that the corporation's annual report which allegedly contained false or misleading financial information was not considered a filed document for section 18 liability); see also In re Digi Int'l, Inc., Sec. Litig., 6 F. Supp. 2d 1089, 1103 (D. Minn. 1998) (holding that alleged reliance on quarterly financial statement fails to state a claim under section 18).

297. See Pritchard, supra note 55, at 34.

298. See id. at 38–39.

299. See id. at 35 n.11; Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 725 (1975) (holding that only purchasers and sellers of securities may bring suit for damages).

300. See, e.g., Michael E. Murphy, Dispelling Tina's Ghost from the Post-Enron Corporate Governance Debate, 43 Santa Clara L. Rev. 63, 77 n.66 (2002) (explaining the stringent diversification requirements placed on mutual funds by the Investment Company Act of 1940 and the Internal Revenue Code and that the requirements, such as not being able to invest more than 5% of the company's investment assets into the securities of one company, would reduce the likelihood that a mutual fund be fooled into making a large investment).

301. See Booth, Securities Fraud Class Action, supra note 69, at 11.

302. Thus, SFCAs are reminiscent of actions against accountants by third parties. See Frederick D. Green et al., Holding Accountants Liable: The Liability of Accounts to Third Parties, 15 EMP. RESP. & RTS. J. 23 (2003) (discussing the legal theories of accountant liability stemming from the Ultramares Doctrine). For some reason, the courts seem to have ignored the well-settled rule that a reader of financial statements may sue only if the
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Second, the possibility that Blue Chip Stamps would preclude a corporation from suing insiders in federal court is of little moment. Again, the corporation can always sue in state court. Moreover, it is not clear that the rule of Blue Chip Stamps applies in this setting. The rule is designed to limit the exposure of issuers to actions by holders. To say that this judge-made limitation on a judge-made cause of action precludes an issuer from enforcing federal securities law against its own insiders would be quite extraordinary, particularly in light of section 16(b) of the 1934 Act, which expressly provides for such an action in connection with short-w swing trading. So it is not at all clear that the courts would apply the rule to a corporate plaintiff seeking to sue in federal court.

Financial statements were prepared for the reader. Id. at 25, 26. Then again, federal securities law effectively renders all corporate disclosures for the benefit of investors, though one could argue that that is only really true where the issuer seeks to induce an investor to buy stock or other securities directly from the issuer or the issuer's agent. See Paul P. Brountas Jr., Rule 10-5 and Voluntary Corporate Disclosures to Securities Analysts, 92 Colum. L. Rev. 1517, 1532 (1992).


305. See Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit, 547 U.S. 71, 87 (2006) (holding that under SLUSA, state law class action claims brought by holders of securities, purchasers of securities, and sellers of securities are preempted); see also Richard A. Booth, Who Should Recover What for Late Trading and Market Timing?, 1 J. Bus. & Tech. L. 101 (2006) (discussing the applicability of the Blue Chip Stamps doctrine in connection with the recovery by mutual funds). Neither is it clear that the Blue Chip Stamps rule would preclude the corporation from recovering for the full amount of insider misappropriation if it bought or sold a token number of shares. See Recent Case, United States v. Bryan, 58 F.3d 933 (4th Cir. 1995), 109 Harv. L. Rev. 536, 536 (1995). Moreover, a derivative plaintiff who happened also to be a buyer may have standing to sue in federal court even though action is for the benefit of the corporation. Neal R. Pandozzi & David R. Werbel, Practice Guide: Getting Down to Business: A Pocket Guide to the Revised Rhode Island Business Corporation Act, 10 Roger Williams U. L. Rev. 719, 725 (2005). To be sure, these are strange arguments. But they are designed to deal with a rule—the Blue Chip Stamps rule—that grew out of a misguided turn of the law. Scott Jones, Note, Revisiting Birnbaum: Changed Conditions and the Providence of the Purchaser-Seller Rule, 2006 Colum. Bus. L. Rev. 603, 625-26 (2007). On the other hand, it might also be argued that the issuer cannot have been deceived if the issuer did not itself buy stock during the fraud period. See United States v. O'Hagan, 521 U.S. 642 (1997) (holding that, under a theory of misappropriation, criminal liability can be attached based on Section 10(b) of the Securities Exchange Act to a defendant who purchased stock in the corporation based on inside information). The statement in Stoneridge that conduct can be deceptive may be designed to head off this argument at the pass. Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., 128 S. Ct. 761, 769 (2008) ("Conduct itself can be deceptive, as respondents concede."). Still, in emphasizing that there can be no liability under federal law without deception and that O'Hagan could have escaped prosecution simply by disclosing that he intended to trade on inside information, the Court sought to distinguish federal law from the state law of fiduciary duty, perhaps because the Court was concerned that otherwise federal law would simply afford an alternative remedy that might supplant state law or that it might be argued that federal law was unnecessary in this context. O'Hagan, 521 U.S. at 654-55. The distinction is that under state law, disclosure would not cure such a breach of the duty of loyalty. See id. Either way the statement in O'Hagan that there must be actual deception based on a fiduciary duty (and presumably a breach thereof) is ultimately dictum. See id. at 654. The Court has never been faced with a case in which an insider announced his intent to trade on inside information. To be sure, Santa Fe Indus., Inc. v. Green, 430 U.S. 462 (1977) comes close. But the transaction there—a short form merger—was one that was expressly authorized by state law and one that would have been actionable if there had been any remedy available under state law at the time. Id. at 478.
Richard A. Booth

CONCLUSION

Stoneridge is hardly a landmark decision in the evolution of federal securities law or even private securities litigation thereunder. But it does suggest an opportunity for reform. The best hope is that plaintiff attorneys will see the promise of derivative actions as an effective alternative to class actions and will come to oppose class certification as contrary to the interests of the corporation and the non-trading stockholders that usually constitute a majority of the affected investors. Another approach is to focus on the true meaning of scienter and deceit. Neither can exist in the absence of gain. So unless the corporation somehow gains from fraud, the fraud is damnum absque iniuria—damage without a wrongful act. A fortiori, there is no causation. But when insiders use the opportunity for gain, they should be answerable individually. Finally, this rearrangement of the remedial scheme has the added and significant benefit of focusing deterrence where it matters and in proportion to the true harm involved.