OOPs! The Inherent Ambiguity of Out-of-Pocket Damages in Securities Fraud Class Actions

Law Working Paper N° 508/2020
March 2020

Richard A. Booth
Villanova University

ECGI Working Paper Series in Law

OOPs!
The Inherent Ambiguity of Out-of-Pocket Damages in Securities Fraud Class Actions

Working Paper N° 508/2020
March 2020

Richard A. Booth

Abstract

Most securities fraud class actions under SEC Rule 10b-5 involve revelation of negative information about the defendant company that should have been disclosed earlier – bad news that (allegedly) has been covered up by company agents. The standard remedy in such cases is out-of-pocket damages (OOPs). But this measure of harm is inherently ambiguous. Some courts interpret it as price inflation at the time of purchase. Others interpret it as the difference between the price paid and the price at which a stock settles after corrective disclosure. Although it might seem that these formulations are synonymous, the latter includes not only the difference in price that would have obtained if the truth had been known at the time of purchase but also any additional difference that might be caused by revelation of the truth. For example, the market may conclude that the company is likely to become the target of an SEC enforcement action or private securities litigation. Either way, the company is likely to suffer increased legal expenses. In addition, the company may suffer an increased cost of capital because the market perceives added risk that information about the company may be unreliable. These additional factors and possibly others – herein dubbed collateral damage – will be reflected in the decrease in price that occurs immediately upon corrective disclosure. But such collateral damage is harm suffered by the company that should be the subject of a derivative action – for the benefit of all stockholders – and not a direct (class) action. The clear implication is that OOPs should be measured as price inflation at the time of purchase– that is, price inflation narrowly defined net of any collateral damage. Indeed, because FRCP Rule 23 – which governs class actions – requires that a class action for damages be superior to any other means of resolving a dispute, Rule 23 itself requires that collateral damage be addressed in a derivative action simply because it can be so addressed. As demonstrated here, state corporation law is perfectly congruent with federal securities law such that a derivative action for collateral damage will lie whenever a meritorious claim can be stated under Rule 10b-5. Aside from simplifying the litigation process by providing for unitary corporate recovery, derivative actions avoid the circularity inherent in class actions while also addressing the problem of excessive deterrence by providing a perfectly tailored action against individual wrongdoers. Finally, because derivative actions quite clearly address corporate internal affairs, a corporation can assure that claims for collateral damage will be so addressed by adopting a bylaw to that effect.

Keywords: Rule 10b-5, out-of-pocket damages, price inflation, corrective disclosure, cost of capital, collateral damage, derivative action, direct action, securities fraud class action, Rule 23, superior, circularity, deterrence, internal affairs, bylaw

JEL Classifications: G11, G14, G34, K22, K41, M41, M42

Richard A. Booth
Martin G. McGuinn Chair in Business Law
Villanova University, Charles Widger School of Law
299 North Spring Mill Road
Villanova, PA 19805, United States
phone: +1 610 5197068
fax: +1 610 595672
e-mail: booth@law.villanova.edu

OOPs!

The Inherent Ambiguity of Out-of-Pocket Damages in Securities Fraud Class Actions

By Richard A. Booth

ABSTRACT

Most securities fraud class actions under SEC Rule 10b-5 involve revelation of negative information about the defendant company that should have been disclosed earlier – bad news that (allegedly) has been covered up by company agents. The standard remedy in such cases is out-of-pocket damages (OOPs). But this measure of harm is inherently ambiguous. Some courts interpret it as price inflation at the time of purchase. Others interpret it as the difference between the price paid and the price at which a stock settles after corrective disclosure. Although it might seem that these formulations are synonymous, the latter includes not only the difference in price that would have obtained if the truth had been known at the time of purchase but also any additional difference that might be caused by revelation of the truth. For example, the market may conclude that the company is likely to become the target of an SEC enforcement action or private securities litigation. Either way, the company is likely to suffer increased legal expenses. In addition, the company may suffer an increased cost of capital because the market perceives added risk that information about the company may be unreliable. These additional factors and possibly others – herein dubbed *collateral damage* – will be reflected in the decrease in price that occurs *immediately* upon corrective disclosure. But such collateral damage is harm suffered by the company that should be the subject of a derivative action – for the benefit of all stockholders – and not a direct (class) action. The clear implication is that OOPs should be measured as price inflation at the time of purchase– that is, price inflation narrowly defined net of any collateral damage. Indeed, because FRCP Rule 23 – which governs class actions – requires that a class action for damages be *superior* to any other means of resolving a dispute, Rule 23 itself requires that collateral damage be addressed in a derivative action simply because it *can* be so addressed. As demonstrated here, state corporation law is perfectly congruent with federal securities law such that a derivative action for collateral damage will lie whenever a meritorious claim can be stated under Rule 10b-5. Aside from simplifying the litigation process by providing for unitary corporate recovery, derivative actions avoid the circularity inherent in class actions while also addressing the problem of excessive deterrence by providing a perfectly tailored action against individual wrongdoers. Finally, because derivative actions quite clearly address corporate internal affairs, a corporation can assure that claims for collateral damage will be so addressed by adopting a bylaw to that effect.

KEYWORDS: Rule 10b-5, out-of-pocket damages, price inflation, corrective disclosure, cost of capital, collateral damage, derivative action, direct action, securities fraud class action, Rule 23, superior, circularity, deterrence, internal affairs, bylaw

JEL CODES: G11, G14, G34, K22, K41, M41, M42

OOPs!

The Inherent Ambiguity of Out-of-Pocket Damages in Securities Fraud Class Actions *

By Richard A. Booth **

In order to plead and prove securities fraud under SEC Rule 10b-5 on behalf of a class of buyers of a given stock, the representative plaintiff must show (1) that investors were deceived by an agent of the defendant corporation who, in speaking to the market and acting with scienter, misrepresented or omitted a material fact, and (2) that such deception *caused* the claimed loss.

As the Supreme Court has ruled, it is not enough simply to prove that investors bought at a price inflated by deception. Rather, plaintiff must show that market price reacted negatively to revelation of the truth.[1] Thus, the law is clear that only the loss caused by deception – net of other causal factors – can be recovered by buyers. As the Supreme Court stated in *Dura Pharmaceuticals, Inc. v. Broudo*:

> *** as a matter of pure logic, at the moment the transaction takes place, the plaintiff has suffered no loss; the inflated purchase payment is offset by ownership of a share that *at that instant* possesses

* To date, I have scrupulously avoided using colons in the titles of my articles – mostly just to be different – and I thus decline to do so now.

** Martin G. McGuinn Chair in Business Law, Villanova University, Charles Widger School of Law.

[1] *See* Dura Pharmaceuticals, Inc. v. Broudo, 544 U.S. 336 (2005). Arguably, this is a trivial requirement in that it is difficult to see how one would prove price inflation without showing that stock price declined when the market learned the truth. But the rule makes some difference at the pleading stage since it requires the plaintiff to specify how price inflation will be shown. In the absence of such a rule, a court might decide to cross the bridge of causation when the proceedings come to it.

Note also that a securities fraud claim may arise from the cover-up of either bad news or good news. In the former case, the plaintiff class comprises those who bought during the fraud period, while in the latter case the plaintiff class comprises those who sold during the fraud period. There are notable examples of good-news fraud cases (with seller classes). *See* Affiliated Ute Citizens v. United States, 406 U.S. 128, 155 (1972); Basic Inc. v. Levinson, 485 U.S. 224 (1988); SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968). But studies show that there about 50 bad-news cases for every one good news case. In other words, the overwhelming majority of SFCAs involve the cover up of bad news (with buyer classes). Accordingly, the discussion here assumes the context of a bad news case with a buyer class.

> equivalent value. Moreover, the logical link between the inflated share purchase price and any later economic loss is not invariably strong. *** When the purchaser subsequently resells such shares, even at a lower price, that lower price may reflect, not the earlier misrepresentation, but changed economic circumstances, changed investor expectations, new industry-specific or firm-specific facts, conditions, or other events, which taken separately or together account for some or all of that lower price. *** Given the tangle of factors affecting price, the most logic alone permits us to say is that the higher purchase price will *sometimes* play a role in bringing about a future loss. It may prove to be a necessary condition of any such loss, and in that sense one might say that the inflated purchase price suggests that the misrepresentation (using language the Ninth Circuit used) "touches upon" a later economic loss. But, even if that is so, it is insufficient. To "touch upon" a loss is not to *cause* a loss, and it is the latter that the law requires.[2]

Thus, the law is quite clear that investors may recover only for the loss actually caused by deception.[3] Accordingly, the standard measure of recovery in a successful securities fraud class action (SFCA) under SEC Rule 10b-5 is often said to be one of out-of-pocket damages – OOPs.[4] But few

2 Dura Pharmaceuticals, 544 U.S. at 342-43 (citations omitted).

3 In addition to the *Dura Pharmaceuticals* doctrine, Exchange Act §28(a)(1) provides:

> No person permitted to maintain a suit for damages under the provisions of this title shall recover, through satisfaction of judgment in [one] or more actions, a total amount in excess of the actual damages to that person on account of the act complained of. ***

4 *See* Affiliated Ute Citizens v. United States, 406 U.S. 128, 155 (1972) (ordinarily the correct measure of damages is the difference between the fair value of all that the [plaintiff] received and the fair value of what he would have received had there been no fraudulent conduct); Randall v. Loftsgaarden, 478 U.S. 647 (1986) (describing same as [OOP] measure of damages). As noted by the *Randall* Court, there is some authority for allowing plaintiff to choose between "undoing the bargain (when events since the transaction have not made rescission impossible) or holding the defendant to the bargain by requiring him to pay [OOP] damages." *Citing* LOUIS LOSS, FUNDAMENTALS OF SECURITIES REGULATION 1133 (1983). *See also* Blackie v. Barrack, 524 F.2d 891, 909 (9th Cir. 1975) ("While OOP loss is the ordinary standard in a 10b-5 suit, it is within the discretion of the district judge in appropriate circumstances to apply a rescissory measure"), *cert. denied,* 429 U.S. 816 (1976).

Note that under §11 of the 1933 Act, the measure of damages for material misstatement(s) of fact in a registration statement is the difference between the price paid and the value of the security as of the date of suit. There is no requirement that the plaintiff prove loss causation, but the defendant may assert an affirmative defense that the loss was caused such cases have ever gone to trial.[5] Cases that survive a motion to dismiss almost always settle because of the threat of devastating liability. Thus, there is little case law about how to calculate OOPs.

It could be argued that we do not really need to know how to calculate damages because few cases ever go to trial. Almost every case settles if it is not dismissed (or otherwise dispatched).[6] On the other hand, settlement negotiations are necessarily based on what the parties think they are likely to win or lose if a trial happens. Bargaining happens in the shadow of the law. Thus, the proper measure of damages matters.[7]

The question is: What exactly do the courts mean by out-of-pocket damages?

Intuitively, OOPs might seem to mean the difference between purchase price and market price after corrective disclosure. It seems only fair that buyers in a successful SFCA should be able to recover the difference between the too-high price they paid – because company agents had covered up negative information about the company (bad news) – and the price to which the stock fell when the truth came out. Indeed, Congress seems to have

other than by the alleged misstatement(s). In any event, the issuer cannot be held liable for anything more than the purchase price. In contrast, seller liability under §12(a)(2) for a false statement in a prospectus is rescissory and may in theory exceed issue price. But under §12(b) the seller may prove that the loss was caused other than by the false statement.

[5] *See* Kevin LaCroix, *Rare Securities Class Action Lawsuit Trial Results in Partial Verdict for Plaintiffs,* D&O Diary, February 5, 2019 (stating that out of 5200 cases filed since 1996 fewer than 25 cases have gone to trial). For one notable example, see *In re Vivendi Universal, S.A., Securities Litigation,* 838 F.3d 223 (2d Cir. 2016). *See also* GAMCO Investors, Inc. v. Vivendi Universal, S.A., 838 F.3d 214 (2d Cir. 2016) (finding that presumption of reliance was rebutted as to investor that touted a proprietary investment model).

[6] A case may be dismissed for failure to state a claim or resolved on motion for summary judgment or effectively killed because it fails to be certified as a class action as required under FRCP Rule 23.

[7] In addition, the law requires that notice to the plaintiff class in a SFCA include an estimate of damages that might be awarded if the case were tried or the reasons why the parties cannot agree on such an estimate. *See* Exchange Act §21D(a)(7). *See also* Exchange Act §21D(a)(6) (limiting award of attorney fees to reasonable percentage of amounts paid to class members). Note that both of these provisions were added by PSLRA. Moreover, the possibility that the members of a plaintiff class might be entitled to different measures of damages has been used as justification for denying class certification and thus effectively dismissing a claim. *See* Ludlow v. BP, PLC, 800 F.3d 674 (5th Cir. 2015).

approved this measure of damages. Exchange Act §21D(a)(7)(b), which was adopted as part of the Private Securities Litigation Reform Act (PSLRA) of 1995, provides:

> *** in any private action *** in which the plaintiff seeks to establish damages by reference to the market price of a security, the award of damages to the plaintiff shall not exceed the difference between the purchase *** price paid *** by the plaintiff *** and the mean trading price of that security during the 90-day period beginning on the date on which the information correcting the misstatement or omission that is the basis for the action is disseminated to the market.[8]

Admittedly, this provision does not *mandate* that damages be measured by reference to market price following corrective disclosure. On the other hand, it clearly contemplates and permits the possibility of measuring damages so. But to measure investor loss in this way is fraught with problems.

To be sure, when the truth comes out stock price falls to reflect the new information. But this is not the end of the story. If there is reason to think that litigation will follow because company agents had earlier misrepresented the facts, then stock price will fall by some additional amount to reflect not only the new information but also the probable cost of fines, settlements, and added legal expenses. Moreover, stock price may fall by some additional amount because the market has lost trust in company management. In other words, the market may adjust the company's cost of capital upward to reflect the extra risk that information about the company may not be as reliable as it should be.

There is no reason to think the market will wait to see if any of this comes to pass. Rather, there is every reason to think that market price will fall *immediately* upon corrective disclosure to reflect both the news that was covered up and the additional expenses attributable to the litigation that will follow – hereinafter *collateral damage.*

[8] 15 U.S.C. § 78u-4(e)(1). Note that the provision as quoted has been edited to speak only to the typical bad-news case in which an investor buys at an inflated price and the price falls when the truth comes out. The section also applies to the less typical good-news case in which an investor sells at a price depressed by fraud.

Consider the following example:

> Acme Blasting Cap Corporation (ABC) generates earnings from operations of $1,000,000 per year. It has zero long-term debt and $2M in cash in excess of the ordinary needs of the business. The company has 1,000,000 shares outstanding and a market capitalization of $12M. Thus, the market assigns the company a 10% capitalization (discount) rate. In other words, the stock trades for $12 per share with EPS of $1.00 (ignoring any return from excess cash).
>
> A major customer cancels a big contract, and ABC management expects returns to fall to $800,000 for the year unless a new customer can be found in the meantime, which management thinks is a fifty-fifty possibility. If the cancellation is disclosed immediately, stock price should fall to $11 per share other things equal. But ABC management does not disclose the bad news. Instead, the CEO in a regular conference call with investors and analysts reassures the market that the company expects to report earnings of $1.00 per share for the current year.
>
> Six months later the company reports earnings of $0.80 per share – having found no new customer. The market processes this earnings surprise quickly, concluding that it is likely that the company will be fined by the SEC and will be sued (successfully) by investors who bought during the six-month fraud period. As a result, the company will also suffer increased legal expenses. Thus, stock price falls not just to $10 but to $8 per share to reflect not only lower earnings but also the loss from the SEC enforcement action and private litigation likely to follow.
>
> It may also be that some of the additional decrease in price is due to the market's assigning an increased cost of capital to the company because of a loss of trust in management. For example, a return of $1,000,000 per year at 10% COE is worth $10M while the same return at 12% COE is worth $833,333.[9]

[9] Note that this example assumes that the market is working as it should: None of the price decrease is attributable to any sort of bad-news over-reaction by the market This is not to say that the market will get the price exactly right immediately. The ultimate cost of enforcement and litigation may be more or less than estimated by the market. And the market will continue to adjust going forward as new and better information emerges. But there is no doubt that fraud will give rise to added expense and or that the market will react by making its best guess as to what it will be. *Cf.* JAMES SUROWIECKI, THE WISDOM OF CROWDS (2004) (giving numerous examples of how large groups in general and markets in particular tend to process new information quite accurately). The idea also inspired a so-so CBS television 2017 series – *Wisdom of the Crowd* -- starring Jeremy Piven.

So what should be the measure of damages in this situation? Should a buyer who bought at $12 during the fraud period be able to recover the full $4 per share difference between purchase price and market price after corrective disclosure? Or should buyer recovery be limited to the one dollar per share difference that would have resulted if management had told the truth in the first place?

Note also that it is possible to calculate the price effect of a SFCA (assuming full recovery) if one knows the number of shares bought by new stockholders during the fraud period and the price drop from other factors. But it is impossible in practice to know the number of damaged shares without polling the stockholders for documentation of claims. *See* Richard A. Booth, *The End of the Securities Fraud Class Action As We Know It,* 4 Berkeley Bus. L. J. 1 (2007). *Cf.* In re Appraisal of Transkaryotic Therapies, Inc., Civil Action No. 1554-CC, 2007 Del. Ch. LEXIS 57 (May 2, 2007) (explaining why it is impossible to trace individual shares within book entry system of ownership records used by the market).

As is implicit in the above hypothetical, there is nothing mysterious about the fact that stock price drops more after a fraud comes to light than it would if the same news – minus the cover-up – were timely disclosed. The market is not stupid. It understands the cost of fraud and reacts as it would to any other new information. Nevertheless, scholars of law and finance have worried openly that the market might over-react to bad news. Indeed, Exchange Act §21D(a)(7)(b), the 90-day average-price rule set forth in the text above, was adopted as part of PSLRA precisely because Congress thought that the market tended to overreact to bad news. *See* 104th Congress First Session, Report 104-369, Securities Litigation Reform, Conference Report to Accompany HR 1058 (Nov. 28, 1995) at 42, n.25, citing Lev & de Villiers, *Stock Price Crashes and 10b–5 Damages: A Legal, Economic and Policy Analysis,* Standford (sic) Law Review, 7, 9–11 (1994). The presumable idea behind the 90-day average rule is that using an average price for the 90 days after corrective disclosure will allow for the market to readjust for any overreaction to bad news. *See* Richard A. Booth, *Windfall Awards Under PSLRA,* 59 Bus. Law. 1043 (2004). *See also* Janet Cooper Alexander, *The Value of Bad News in Securities Class Actions,* 41 UCLA L. Rev. 1421 (1994); Werner F. M. DeBondt & Richard Thaler, *Does the Stock Market Overreact?,* 40 J. Fin. 793 (1985); Werner F. M. DeBondt & Richard Thaler, *Further Evidence on Investor Overreaction and Stock Market Seasonality,* 42 J. Fin. 557 (1987) (all also discussing stock market over-reaction to bad news). Incidentally, the cost of fraud explains why there are so few good-news cases as compared to bad-news cases. *See supra* note 1. In a good-news case, the cost of fraud dampens the effect of corrective disclosure, whereas in a bad-news case, the cost of fraud magnifies the effect. The bottom line for the plaintiff bar is that there is more money to be made in bad news cases. And the swings are bigger in bad-news cases. *See* Richard A. Booth, *The End of the Securities Fraud Class Action As We Know It,* 4 Berkeley Bus. L. J. 1 (2007).

Some courts have been quite careful to describe the remedy as limited to the difference in price that should have been paid at the time of purchase. For example, as the Fifth Circuit has said:

> Congress has not specifically defined economic loss for purposes of a securities violation. It has provided an upper cap on damages. *** At the same time, the "out-of-pocket measure," sometimes called the "price inflation" metric, is often used. Under this theory, "a purchaser of securities may recover against a defendant only the 'difference between the price paid and the "[true]" value of the security . . . at the time of the initial purchase by the defrauded buyer.[10] While our court has not held that this metric is the exclusive way to measure damages in [Rule 10b-5] cases, we do insist that cognizable damage must be *caused* by the misstatements in question. That is, a loss does not constitute an "economic loss" for these purposes unless loss causation can be established.[11]

Other courts have described the remedy as extending to the entire loss suffered by the buyer. For example, as the Second Circuit has said:

> Loss causation "is the causal link between the alleged misconduct and the economic harm ultimately suffered by the plaintiff."[12] The PSLRA codified this judge-made requirement: "In any private action arising under this chapter, the plaintiff shall have the burden of proving that the act or omission of the defendant alleged to violate this chapter caused the loss for which the plaintiff seeks to recover damages."[13] We have described loss causation in terms of the tort-law concept of proximate cause, *i.e.*, "that the damages suffered by plaintiff must be a foreseeable consequence of any misrepresentation or material

10 *Citing* In re Letterman Bros. Energy Sec. Litig., 799 F.2d 967, 972 (5th Cir. 1986) (quoting Huddleston v. Herman & MacLean, 640 F.2d 534, 555 (5th Cir. 1981), *aff'd in part, rev'd in part on other grounds,* 459 U.S. 375, 103 S. Ct. 683, 74 L. Ed. 2d 548 (1983)); *see also* FindWhat Investor Grp. v. FindWhat.com, 658 F.3d 1282, 1311-12 (11th Cir. 2011); In re Enron Corp., Sec., 529 F. Supp. 2d 644, 716 (S. D. Tex. 2006).

11 Ludlow v. BP, PLC, 800 F.3d 674, 682 (5th Cir. 2015). The phrase *price inflation* is an unfortunate one. It might seem to suggest that the fraud (misrepresentation) had the effect of *increasing* the price of the subject stock. But the more common situation is that the fraud merely kept the price of the stock from falling, which is sometimes called *price maintenance*.

12 *Citing* Emergent Capital, 343 F.3d at 197.

13 15 U.S.C. § 78u-4(b)(4).

> omission,"[14]; but the tort analogy is imperfect. A foreseeable injury at common law is one proximately caused by the defendant's fault, but it cannot ordinarily be said that a drop in the value of a security is "caused" by the misstatements or omissions made about it, as opposed to the underlying circumstance that is concealed or misstated. Put another way, a misstatement or omission is the "proximate cause" of an investment loss if the risk that caused the loss was within the zone of risk *concealed* by the misrepresentations and omissions alleged by a disappointed investor.[15] Thus to establish loss causation, "a plaintiff must allege . . . that the *subject* of the fraudulent statement or omission was the cause of the actual loss suffered,"[16] *i.e.*, that the misstatement or omission concealed something from the market that, when disclosed, negatively affected the value of the security. Otherwise, the loss in question was not foreseeable.[17]

In other words, the Second Circuit seems to think that the plaintiff in our hypothetical should be able to recover the full $4 per share loss even though the difference in price at the time of purchase was just one dollar per share.

The question is whether a plaintiff buyer in a securities fraud action under SEC Rule 10b-5 (or the plaintiff class in a SFCA) should be limited to recovery only for the *price inflation* attributable to the misrepresentation? Or should a plaintiff buyer also be able to recover for the full amount of the loss suffered upon corrective disclosure? In other words, should a buyer recover for *both* price inflation (as narrowly defined) and any collateral damage, which but for the fraud would not have been suffered?[18]

[14] *Citing* Emergent Capital Inv. Mgmt., LLC v. Stonepath Group, Inc., 343 F.3d 189 at 197 (2003) (quoting Castellano v. Young & Rubicam, 257 F.3d 171, 186 (2d Cir. 2001)).

[15] *See* AUSA Life Ins. Co. v. Ernst & Young, 206 F.3d 202, 238 (2d Cir. 2000) (Winter, J., dissenting).

[16] *Citing* Suez Equity Investors, L.P. v. Toronto-Dominion Bank, 250 F.3d 87, 95 (2d Cir. 2001) (emphasis added by quoting court).

[17] Lentell v. Merrill Lynch & Co., 396 F.3d 161, 172-73 (2d Cir. 2005).

[18] Some legal scholars might quibble with the label *consequential damages* for the elements of loss in addition to price inflation (as narrowly defined) given that the concept of consequential damages is well established elsewhere in the law. To avoid such distraction, the phrase *collateral damage* is used here.

The question of how to calculate OOP damages has become even more important with the growth in event-driven SFCAs.[19] For example, following the Deepwater Horizon explosion and spill, investors who had bought BP stock during the run-up to the event argued that BP (as operator of the rig) had misrepresented its safety practices and thus had deceived the market into underestimating the risk inherent in its business. When the explosion and spill occurred, the market allegedly discovered that BP had covered up some of the risk. Stock price fell, and plaintiffs sued to recover their losses.[20] When the smoke cleared (so to speak), BP stock had lost about half of its value. Market capitalization had declined from about $120B to about $60B. In the end, BP paid out about $60B in direct expenses relating to the event. In other words, it could be argued that the entire decrease in BP stock price was attributable to collateral damage. While ordinarily the business judgment rule (in possible combination with an exculpatory charter provision) would preclude stockholder recovery for such loss, fraud-period buyers would undoubtedly argue that their losses flowed from price inflation – even though subsumed within the $60B loss suffered by the company. In short, it matters a lot how we measure damages in a SFCA.

[19] *See* Richard A. Booth, *Loss Causation and the Materialization of Risk Doctrine in Securities Fraud Class Actions,* 75 Bus. Law. xxx (2020); John C. Coffee, Jr., *The Changing Character of Securities Litigation in 2019: Why It's Time to Draw Some Distinctions,* CLS Blue Sky Blog, January 22, 2019.

[20] *See* Ludlow v. BP, PLC, 800 F.3d 674 (5th Cir. 2015). John Coffee has characterized *Matrixx Initiatives, Inc. v. Siracusano,* 563 U.S. 27 (2011), as an example of an event-driven claim. *See* John C. Coffee, Jr., *Event Driven Securities Litigation: Its Rise and Fall,* N. Y. L. J. (Online) (March 20, 2019). But *Matrixx* differs in that the claim therein was based on allegedly false public statements made by the company after it had learned of complaints about its product. Moreover, the statements made by the company, related to the prospect of future growth, noting the possibility of adverse effects from consumer complaints or lawsuits, but without noting that two such lawsuits had been filed. In addition, and during the class period, it was reported that the FDA was looking into such complaints, and the company responded with a press release stating that there had been no reports of adverse effects in the context of clinical studies. *Matrixx,* 563 U.S. at 31-36. In short, the allegedly false statements were made in direct response to and contradiction of known facts to the contrary. So it can hardly be said that *Matrixx* is a case in which events revealed the truth. Rather, the company made statements that were positively contrary to objective facts. To be sure, this suggests that event-driven cases must tend to involve false statements of opinion. But the fact is that they almost always do so. For a discussion of how a statement of opinion can rise to a statement of fact, see *Virginia Bankshares, Inc. v. Sandberg,* 501 U.S. 1083 (1991) (proxy fraud); *Omnicare, Inc. v. Laborers District Council Construction Industry Pension Fund,* 135 S. Ct. 1318, 191 L. Ed. 2d 253 (2015) (1933 Act) (both holding that statements of opinion relating to matters within the discretion of the speaker may constitute statements of fact and implying that mistaken though genuinely held opinions do not constitute misrepresentations).

The answer to the question of how to calculate OOPs is really quite simple – although a bit of a *non sequitur*. Aside from the loss attributable to price inflation at the time of purchase, all of the collateral damage described in the hypothetical case is loss suffered *by the corporation* that should be the subject of a derivative action. In other words, the answer to the puzzle of what we really mean by OOPs is that it *must* be price inflation as narrowly defined because the remainder of any loss is a loss that is suffered by the corporation as a whole and thus by all of the stockholders, including those who bought during the fraud period as well those who bought earlier and continue to hold through the end of the fraud period (legacy holders).

Direct Claims and Derivative Claims

For anyone steeped in the procedures of corporate litigation, it almost goes without saying that all of the losses described in the hypothetical – other than the loss from price inflation – are losses suffered by the corporation. It is the corporation that must pay any fine, settlement, or increased legal bills. Moreover, if some of the price decline derives from the market assigning a higher cost of capital (equity) to the corporation because of a loss of trust in management, that too is a harm suffered by the corporation.[21]

The implication of the foregoing analysis is that any loss in excess of that attributable to price inflation as narrowly defined should be the subject of a derivative action by which the corporation recovers from those who caused the loss – the CEO and other agents of the corporation who are responsible for the deception.[22]

To be clear, the derivative action advocated here is not the familiar tag-along derivative action that seeks indemnification on behalf of a corporation following settlement of an SEC enforcement action or a SFCA. As has been noted by others, such an action must await resolution of the primary federal claim and is thus often stayed during the pendency of the primary action. If the defendant corporation prevails, there is no need for indemnification.[23]

[21] To be sure, the CEO and other agents of the corporation may sometimes pay a fine or some portion of the settlement and may suffer some legal expenses (or other consequences) personally. But that does not affect the value of the corporation or its stock price.

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

[23] *See* Joseph A. Grundfest, *The Limits of Delaware Corporate Law: Internal Affairs, Federal Forum Provisions, and* Sciabacucchi, 75 Bus. Law. 1319, 1363-63 (2019) (discussing stay

In contrast, the argument here is that much (or most) of the claim in any meritorious SFCA is derivative *in the first place* and that the derivative action should take precedence over the class action.[24]

Needless to say, the proposition that much (or even most) of the loss from securities fraud should be recovered by the company rather than by investors is a radical idea. Under the extant regime, buyers are paid *by* the company. The treatment proposed here is akin to a pick-six in a football game: Rather than pay, the company recovers.

It is not the argument here (merely) that a derivative action is an equally good or alternative way to litigate collateral damage. Rather, the argument here is that the claim for collateral damage is a claim that belongs to the company. As such, the law *requires* that the claim be litigated as a derivative action.[25]

Moreover, FRCP Rule 23, the rule that governs class actions, positively requires that the action be litigated as a derivative action. Rule 23(b)(3) provides that in order for an action seeking money damages to be certified as a class action, it must be *superior* to any other means of resolving the dispute.[26] In other words, ties go to any alternative to a class action for damages.

litigation). *See, e.g.,* Brudno v. Wise, No. 19953, 2003 Del. Ch. LEXIS 35 (Apr. 1, 2003); Brenner v. Albrecht, No. 6514-VCP, 2012 Del. Ch. LEXIS 20 (Jan. 27, 2012).

[24] Delaware case law goes both ways on the question whether a parallel derivative action should be stayed during the pendency of a related SFCA. But the fact that the courts have recognized that such a derivative claim can be stated independently from a SFCA and thus can proceed simultaneously without being stayed is enough to make the point. *See* In re Molycorp, Inc., C.A. No. 7282-VCN, 2014 Del. Ch. LEXIS 77 (May 12, 2014). *See also* Pfeiffer v. Toll, 989 A.2d 683, 708 (Del Ch. 2010), *abrogated on other grounds,* Kahn v. Kolberg Kravis Roberts & Co., L.P., 23 A.3d 831 (Del. 2011) (holding that Pfeiffer adopted an unduly narrow interpretation of state law permitting corporate recovery for insider trading by agents that was too deferential to federal law).

[25] *See, e.g.,* Smith v. Waste Management, Inc., 407 F.3d 381 (5th Cir. 2005).

[26] *See* Marvin Frankel, *Some Preliminary Observations Concerning Civil* Rule 23, 43 F.R.D. 39 (1968); Green v. Wolf Corp., 406 F.2d 291, 301 (2d Cir. 1968).

Advantages (and Disadvantages) of Derivative Actions

Quite aside from what the law requires, there are distinct advantages in litigating such a claim as a derivative action.

First, a derivative action eliminates one source of loss altogether, namely the additional decrease in price that comes from the fact that the company must fund the settlement of a SFCA.[27] If the company recovers, this echo effect (or feedback effect) simply disappears.

Second, in the above hypothetical, if the market knows that the company will recover the amount of any settlement, stock price will not fall so far in the first place.[28] The equities seem quite clear. In a SFCA, buyer recovery from the company causes further loss for legacy holders. If the company itself recovers for such losses as are caused by fines and increased legal expenses and any increase in the cost of capital – losses suffered pro rata by all of the stockholders – all of the stockholders are made whole.[29] Seems like a no-brainer.

Third, litigating securities fraud claims as derivative actions carries distinct procedural advantages. If the action succeeds there is one unified payment to one plaintiff, namely the company itself. Stockholders effectively recover through an enhanced stock price. Accordingly, there is no need for

[27] Numerous scholars have noted this circularity problem – that stockholders effectively pay themselves. But as I have shown elsewhere, the fact that the company funds the settlement (even if ultimately through insurance) has the effect of increasing the size of claims through an echo effect (or feedback effect). *See* Richard A. Booth, *Sense and Nonsense About Securities Litigation,* 21 U. Penn. J. Bus. L. 1 (2018) (collecting sources). *See supra* note 9 (also discussing feedback). Note that feedback is not a problem with claims arising under the 1933 Act because (if meritorious) the remedy is for the company to disgorge funds obtained illegally. Feedback arises in SFCAs under Rule 10b-5 because the company funds the settlement even though it ordinarily has gained nothing in connection with the deception. As discussed further below, this fundamental distinction between the disgorgement remedy under the 1933 Act and the remedy for fraud (so-called) under Rule 10b-5 may imply significantly different treatment as a matter of corporate internal affairs. *See infra* text at notes 67-74.

[28] In the real world, settlements are covered by insurance. But for purposes of addressing the merits of a claim (and thus the instant analysis) the law ignores insurance. *See generally* W. PAGE KEETON, ET AL., PROSSER & KEETON ON TORTS §82 (5E 1984). Nevertheless, if existing direct stockholder claims are replaced with derivative company claims, the need for such insurance is eliminated altogether, and companies save even more. On the other hand, it will likely be necessary to provide enhanced insurance for directors, officers, and other agents of public companies (as discussed further below).

[29] *See* Smith v. Waste Management, Inc., 407 F.3d 381 (5th Cir. 2005).

individual notice or opt out rights as under a class action. And there is no need for class certification and the resolution of disputes over the definition of the class. Nor is there any need for individualized hearings as to dividing up the settlement among class members.[30]

On the other hand, derivative actions do raise their own unique procedural issues. In order for a stockholder plaintiff to maintain a derivative action, the stockholder plaintiff must first make a demand on the board of directors to prosecute the action on behalf of the corporation or else demand must be excused as futile.[31] The question whether demand will be excused invariably gives rise to a heavily litigated motion to dismiss. Moreover, even if demand is excused, the corporation may seek to dismiss the claim as contrary to its own best interests as a corporation.[32] Thus, it could be argued that the proposal here to convert SFCAs largely into derivative actions may be

[30] Technically, a derivative action may be classified as a Rule 23(b)(2) class action for a declaratory judgment or mandatory injunction – that the corporation should be compelled to sue the wrongdoers. *See* Wal-Mart Stores, Inc. v. Dukes, 564 U.S. 338 (2011). And indeed class actions and derivative actions were governed by a single rule before the 1966 revisions of the FRCP. *See* Robert A. Kessler, *Shareholder Derivative Actions: A Modest Proposal to Revise Federal Rule 23.1,* 7. U. Mich. J. L. Reform 90 (1973) (recounting history of Rule 23.1).

[31] *See* FRCP Rule 23.1. Note that Delaware has adopted the FRCP verbatim. So the same rules of procedure apply in Delaware courts as in federal courts, although interpretations of the rules may differ. The requirement of demand on the board of directors (BOD) derives from the fact that the BOD ordinarily has plenary management authority. In other words, the BOD is the corporation. Since the decision whether to file suit in connection with a claim of the corporation is ultimately a business decision like any other, it is the BOD that has the authority to decide the matter. A derivative action is an exception to this general rule, addressing situations where there is reason not to trust the BOD to do the right thing. Thus, it is up to the representative stockholder in a derivative action to plead and prove demand futility, which can be seen as a special case of applying the business judgment rule. In other words, the plaintiff must overcome the presumption that the judgment of the BOD should be trusted in connection with the decision whether or not to sue. The test for demand futility depends on whether the claim arises as a result of a predicate disabling conflict of interest or from a positive decision by the BOD or from inaction. *See* Zapata Corp. v. Maldonado, 430 A.2d 779 (Del.1981) (conflict); Aronson v. Lewis, 473 A.2d 805 (Del.1984) (no conflict); Rales v. Blasband, 634 A.2d 927 (Del.1993) (inaction). Although the prospect of liability may suffice in cases of inaction, it does not do so in cases of positive action. This apparent inconsistency may be explained by the fact that liability in a case of inaction depends on scienter whereas it does not do so in a case of self-dealing or other breach of the duty of loyalty. In other words, scienter is part of the claim itself in a case of inaction, but it is a futility factor (so to speak) in a case of positive action. But in the end, one will need to plead scienter one way or the other.

[32] *See* Zapata Corp. v. Maldonado, 430 A.2d 779 (Del.1981). *See also* Joy v. North, 692 F.2d 880 (2d Cir. 1982) (construing Connecticut law and applying the Zapata test).

motivated by an underlying attempt simply to curtail securities litigation and to undermine the salutary deterrent effects thereof.

Quite to the contrary, there is good reason to think that a meritorious derivative action will lie under state law in any situation in which a meritorious SFCA can be pleaded. Indeed, the chances of success in state court are about the same as they are in federal court – possibly better – because of the strict pleading requirements under federal law and the additional requirement of class certification, which does not apply in the context of a derivative action.[33] Thus, deterrence is not only preserved but also enhanced because a derivative action targets the individual wrongdoers.[34]

[33] Loss causation can also be a big hurdle. *See* Dura Pharmaceuticals, Inc. v. Broudo, 544 U.S. 336 (2005). Although federal law does not establish a heightened pleading standard for loss causation, PSLRA did add a provision expressly stating that the burden of proof resides with the plaintiff who must therefore say something on the subject. *See* Exchange Act §21D(b)(4). Under state law, there is some authority that loss causation need not be shown at the pleading stage. *See* Emerald Partners v. Berlin, 840 A.2d 641 (Del. 2003). But loss causation must ultimately be established in order to prove damages. *See* In re Rural/Metro Corp. Stockholders Litig., 102 A.3d 205, 224-26 (Del. Ch. 2014).

Moreover, it is inherently difficult to prove that disclosure of a particular fact caused the price drop giving rise to the claim. As a practical matter, a statistical event study is required. And as discussed further below, an event study cannot distinguish between price inflation as narrowly defined and collateral damage. In contrast, an event study is not necessarily required to make out a state-law derivative claim based on actual expenses suffered by the company rather than the derivative effect thereof on stock price. To be sure, an event study may be necessary to prove any harm flowing from an increase in the cost of capital. But such claims are icing on the cake. The cake itself is composed of objective expenses such as fines and legal fees. Moreover, as noted further below, such questions can be addressed using well-developed techniques of appraisal with which the Delaware courts are quite familiar.

Finally, as under federal law, most state-law derivative actions are effectively decided by a motion to dismiss. But under state law a claim need only be *reasonably conceivable* to survive a motion to dismiss. *See, e.g.,* In re Goldman Sachs Group, Inc. Shareholder Litigation, CA No. 5215 (VCG), 2011 Del. Ch. LEXIS 151 (Oct. 12, 2011). On the other hand, the standard for overcoming an exculpatory charter provision on grounds of bad faith are roughly equivalent to the particularity standard under federal securities law. *See* McPadden v. Sidhu, 964 A.2d 1262 (Del. Ch. 2008).

[34] *See infra* text and notes at notes 48-56.

The Evolution (or Revolution) in State Law

Two developments in the state law of fiduciary duty have coalesced to provide a state law remedy in any case in which a claim will lie under Rule 10b-5.

The first such development is the recognition that fiduciary duty includes a duty of candor that applies even in the absence of a request for stockholder action (such as ratification).[35] That is, the duty of candor extends beyond the well-recognized state law duty of disclosure that applies in the context of a stockholder vote.[36] It applies whenever management speaks. If management speaks, it must speak the truth. To do otherwise is a breach of fiduciary duty and is actionable under *state* law. But in order to state such a claim, the plaintiff must plausibly allege that management acted with scienter and that the corporation suffered harm as a result.[37]

[35] *See* Malone v. Brincat, 722 A.2d 5 (Del. 1998). Note that the *Malone* court was itself quite candid in noting that the duty of candor could provide a remedy for legacy holders following passage of the Securities Litigation Uniform Standards Act (SLUSA) of 1998, which was intended to curtail the growth of SFCAs under state law, which growth was itself a reaction to the tightening of federal standards and procedures embodied in PSLRA (1995). In essence, SLUSA provides that federal securities law preempts all direct stockholder causes of action under state law state law that are based on deception (except for actions relating to stockholder voting). SLUSA also contains an express exception for state law derivative actions – the so-called Delaware Carve-Out. Exchange Act 28(f)(5)(c); 15 USC 78bb(f)(5)(c).

Coincidentally, SCOTUS ruled in Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit, 547 U.S. 71 (2006), that a state law class action brought by a non-trading holder who claimed (among other things) that he and members of the class had been deceived into not selling stocks on which they later suffered losses must to be litigated in federal court under SLUSA even though the claim was doomed to be dismissed because a plaintiff must be a purchaser or seller in order to have standing to sue under Rule 10b-5. *See* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975) (holding that one must be a purchaser or seller to have standing to sue under Rule 10b-5). *See also* Birnbaum v. Newport Steel Corp., 193 F.2d 461 (2d Cir. 1952) (first adopting purchaser/seller requirement).

Although *Dabit* suggests that the federal courts may be hostile to state law actions that address claims traditionally subsumed within SFCAs under federal law, SLUSA says what it says about preserving state law derivative actions. On the other hand, what SLUSA actually says is that "the term 'covered class action' does not include an *exclusively* derivative action brought by one or more shareholders on behalf of a corporation." (emphasis added) *See also* Cyan, Inc. v. Beaver County Employees Retirement Fund, 138 S. Ct. 1061 (2018) (holding that SLUSA did not repeal concurrent federal and state jurisdiction under the Securities Act of 1933).

[36] *See, e.g.,* Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983).

[37] To be clear, duty of candor cases do not ordinarily involve a conflict of interest. So it is almost always necessary to overcome the business judgment rule to maintain a derivative

Neither of these requirements is problematic. If the company has suffered no harm, there is no need for a derivative action. And because scienter is required to state a federal claim for fraud under Rule 10b-5, the need to plead scienter to maintain a state law claim for breach of fiduciary duty merely matches the federal pleading hurdle.

The second such development is the recognition that in cases alleging a breach of fiduciary duty, a fiduciary who acts contrary to the interests of the corporation and does so *with scienter* loses the protection of any exculpatory charter provision under DGCL 102(b)(7), because actions other than in good faith are not covered thereby, and because scienter implies bad faith.[38] Moreover, the same standard applies to establish demand futility in the context of a derivative action.[39]

action. Moreover, a *Malone* claim will almost always be a case of positive action by someone – often the CEO who may also be a member of the BOD. So it will usually be necessary to prove bad faith (scienter) anyway in order to plead a breach of the duty of loyalty. *See supra* note 31. *And see* Clark v. Davenport, No. 2017-0839-JTL, 2019 Del. Ch. LEXIS 264 (July 18, 2019). For the record, it may be possible to extend the claim to the BOD generally on a failure of supervision theory. But such a claim verges on a *Caremark* claim which is notoriously difficult to prove. *See* In re Caremark Int'l., Inc. Derivative Litig., 698 A.2d 959, 967 (Del. Ch. 1996). Nevertheless, because the gravamen is inaction, the prospect of liability may suffice to establish demand futility.

38 *See* Stone v. Ritter, 911 A.2d 362 (Del. 2006). *See also* Desimone v. Barrows, 924 A.2d 908 (Del. Ch. 2007); American International Group, Inc. v. Greenberg, 965 A.2d 763 (Del. Ch. 2009). Although the *Stone* court does not use the word *scienter,* the court cites *Guttman v. Huang,* which does so with gusto. *See* Stone, 911 A.2d 362, 369-70 (quoting Guttman v. Huang, 823 A.2d 492, 506 (note 34) (Del. Ch. 2003)). On the other hand, *Stone* does refer repeatedly to a knowingness standard in connection with the duty to monitor. At first, the duty of candor might appear to be a subset of the duty of care. But its violation with scienter – which is almost always present because of the very nature of the duty – constitutes a breach of the duty of loyalty (as discussed further below). So it may be more accurate to see the duty of candor as a subset of the duty of loyalty. On the other hand, the remedy is one of damages rather than fair price (as is more usual with DOL cases). To be clear, a candor claim is not a *Caremark* duty to monitor claim, which is notoriously difficult to prove. In re Caremark Int'l., Inc. Derivative Litig., 698 A.2d 959, 967 (Del. Ch. 1996). *See* In re Massey Energy Co. Derivative & Class Action Litig., 160 A.3d 484, 497 (Del. Ch. 2017). In the end, nothing really turns on whether the duty of candor is more properly seen as DOC or DOL.

39 *See* Stone v. Ritter, 911 A.2d 362, 367 (Del. 2006) (noting that it is critical in a case of BOD inaction to overcome an exculpatory charter provision in order to excuse demand). *See also* Rattner v. Bidzos, No. 19700, 2003 Del. Ch. LEXIS 103 (Sept. 30, 2003) (Noble); In re Tyson Foods, Inc. Consolidated Shareholder Litigation, 919 A.2d 563 (Del. Ch. 2007) (Chandler); Desimone v. Barrows, 924 A.2d 908 (Del. Ch. 2007) (Strine) (all stating that a showing of scienter will suffice to overcome the presumption of propriety as to unconflicted directors).

The upshot is that a state law derivative action can be maintained in any case in which a SFCA can be maintained under Rule 10b-5. In other words, whenever a claim will lie under Rule 10b-5, it will also lie under the state law of fiduciary duty so long as some sort of harm to the corporation can be pleaded.[40]

Admittedly, this congruity assumes that the definition of *scienter* is the same under state corporation law as it is under federal securities law. But scienter is scienter is scienter whether one is in federal court or state court.[41] Indeed, the federal courts borrowed the scienter standard from the common law of fraud as developed by state courts.[42] Moreover, since a state law claim for breach of fiduciary duty in this context will arise under the duty of candor, the issue of scienter arises in connection with speech by corporate agents. Whatever, scienter might mean in other situations, it is difficult to see how the definition of scienter could possibly differ as between state law and federal law as applied to speech.[43]

40 Ironically, it could be argued that the advent of DGCL 102(b)(7) and exculpatory charter provisions have made it easier to overcome the business judgment rule because what it takes to do so has become better defined.

41 Thank you, Gertrude Stein.

42 *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976). *See also* Aaron v. SEC, 446 U.S. 680 (1980) (SEC enforcement action). *Cf.* Erie R. Co. v. Tompkins, 304 U.S. 64 (1938) (holding that federal courts must apply state law where applicable rather than developing independent body of federal common law).

43 There is some authority that it does so. *See* Official Committee of Unsecured Creditors of Integrated Health Services, Inc. v. Elkins, No. C.A. No. 20228-NC, 2004 Del. Ch. LEXIS 122, at *34, n.37 (Aug. 24, 2004); McPadden v. Sidhu, 964 A.2d 1262, 1273–74 (Del. Ch. 2008). But these authorities are limited to cases arising outside the duty of candor. *Cf.* Clark v. Davenport, No. 2017-0839-JTL, 2019 Del. Ch. LEXIS 264 (July 18, 2019):

> This court has characterized the standard for evaluating a claim under *Malone* as "similar to, but even more stringent than, the level of scienter required for common law fraud." *Metro Commc'n Corp. BVI v. Advanced MobileComm Techs. Inc.*, 854 A.2d 121, 158 (Del. Ch. 2004). For a common law fraud claim, a plaintiff can show reckless indifference, but *Malone* requires knowing misconduct. *Id.* at 158 n.88. Like common law fraud, a *Malone* claim requires "reasonable reliance." *Id.* at 157-58. This court has interpreted the Delaware Supreme Court as "set[ting] a high bar for *Malone*-type claims . . . to ensure that our law was not discordant with federal standards and that our law did not encourage a proliferation of disclosure claims outside the discretionary vote or tender context by exposing directors to an additional host of disclosure claims . . . ." *Id.* at 158 (footnote omitted). Similar policy concerns do not exist for scenarios covered by the special facts doctrine, where a fiduciary purchases or sells shares (or facilitates the purchase or sale) in a direct transaction with a stockholder beneficiary.

To be sure, the quantum of the remedy in a derivative action will be different from that of a SFCA even though the same facts are involved. On the one hand, a derivative award will not include the decrease in stock price from the correction of price inflation as narrowly defined. The corporation itself has no claim for price inflation.[44] On the other hand, the award will reflect the loss suffered by all of the stockholders and not just those who bought during the fraud period.

Moreover, it seems likely that the calculation of damages will be based on the actual costs of fraud suffered by the company. But this difference militates further for a derivative remedy. It is much easier to quantify the cost of fraud by reference to fines, legal bills, and such, than by reference to stock price, which can be affected by all sorts of extraneous factors.[45]

The one element of loss that may be difficult to measure is the loss that comes from any increase in the cost of capital that may result from a loss of investor trust in management – reputational harm.[46] Presumably, damages from any increase in the cost of capital will need to be addressed as in an appraisal proceeding, a process with which the Delaware courts are quite familiar.[47]

See generally Richard A. Booth, *Scienter in State Law Securities Litigation* (forthcoming).

[44] The traditional view is that corporation has no interest in the trading of its own stock. *See* Brophy v. Cities Serv. Co., 31 Del. Ch. 241, 70 A.2d 5 (1949).

[45] *See supra* text at note 2.

[46] *See, e.g.,* Jander v. Ret. Plans Comm. of IBM, 910 F.3d 620, 629-30 (2d Cir. 2018), *cert. granted,* Ret. Plans Comm. v. Jander, 2019 U.S. LEXIS 3791 (U.S., June 3, 2019). *Compare* Allen Ferrell & Atanu Saha, *The Loss Causation Requirement for Rule 10b-5 Causes of Action: The Implications of* Dura Pharmaceuticals v. Broudo, 63 Bus. Law. 163 (2007) (arguing that collateral or consequential damages should not be recoverable under Rule 10b-5) *with* Barbara Black, *Reputational Damages in Securities Litigation,* 35 J. Corp. L. 169 (2009) (arguing the opposite). *See also* Richard A. Booth, *Claim Character and Class Conflict in Securities Litigation,* in Elgar Handbook on Shareholder Litigation (Chapter 5) (2018) (showing that consequential claims are derivative in nature).

[47] *See, e.g.,* In re Rural/Metro Corp. Stockholders Litigation, 102 A.3d 205, 224-26 (Del. Ch. 2014). Needless to say, causation will remain an issue. Generally, the federal courts have addressed causation by means of event studies. *See* Jill E. Fisch, Jonah B. Gelbach & Jonathan Klick, *The Logic and Limits of Event Studies in Securities Fraud Litigation,* 96 Tex. L. Rev. 553 (2018). But event studies do not address the amount of compensation that it appropriate – a matter as to which the courts differ. *See* Richard A. Booth, *Loss Causation and the Materialization of Risk Doctrine in Securities Fraud Class Actions,* 75 Bus. Law. xxx (2020). Fortunately, the well-developed Delaware case-law relating to the appraisal remedy

Price Inflation Revisited

The question remains: What happens to the price inflation portion of the claim? Again, the corporation itself has no claim for price inflation. To return to the hypothetical, ABC has no claim based on its bad luck that it lost a customer. Things happen in business.

One possible answer is that we should simply ignore the price inflation portion of the claim. If the corporation recovers all of the collateral damage associated with the fraud, it is arguable that investors are made whole. They are left in exactly the same position as if there had been no fraud unless they can prove they would not have bought *at all* had the truth been known. But it is not clear that such a claim can be litigated in a class action since it depends explicitly on individual reliance.[48]

Needless to say, this too is a radical idea. While the argument above was that recovery should be limited to price inflation, the argument here is that there should be no recovery *at all* for price inflation and that recovery should be limited to derivative recovery for collateral damage. But this idea is not as crazy as it may seem.

Implications of Investor Diversification

First, most investors are diversified. Indeed, some sources indicate that half or more of all outstanding stock is held by indexed investors or almost-indexed investors. But such well-diversified investors are protected against price inflation (and deflation) by virtue of being diversified. They trade very little. But when they do trade (for purposes of portfolio balancing) they are equally likely to buy an underpriced stock as an overpriced stock. It all comes out in the wash.

seems able to do so. *See, e.g.,* Cede & Co. v. Technicolor, Civil Action No. 7129, 1990 Del. Ch. LEXIS 259 (Oct. 19, 1990) (discussing changes in risk as measured by beta coefficient resulting from subject transaction itself). Of course, it may also be possible to address reputational losses by a change in management.

48 *See* Ludlow v. BP, PLC, 800 F.3d 674 (5th Cir. 2015). Either way, such a claim if successful will give rise to a loss suffered by the corporation, which would give rise to a derivative action for indemnification. The sensible approach would seem to be for any individual plaintiffs to be joined to the derivative action in the first place. But that might be precluded by SLUSA. *See supra* note 35. And individual recovery might be precluded by Delaware law. *See* Richard A. Booth, *Derivative Suits and Pro Rata Recovery,* 61 Geo. Wash. L. Rev. 1274 (1993).

Moreover and perhaps more important, because indexed investors trade very little, they lose more on the shares they hold – because the company pays – than they ever recover on the shares they trade.[49] In effect, they subsidize active traders to the extent that defendant companies compensate plaintiff class members in SFCAs. To be sure, index investors are free to opt out of SFCAs. But to do so would be to forgo any offsetting share of compensation paid to the plaintiff class. So the choice to opt out is no choice at all – a Hobson's choice.[50]

Incidentally, it might be argued that if diversified investors are protected from price inflation losses, they are also protected from collateral damage. Not so. Diversification works because (over time) price-inflated buys will be offset by price-inflated sales. But there is no such offset when a director, officer, or other corporate agent lies to the market and causes collateral damage to stock price. There is no gain for good behavior – except maybe in prison. When agents of the corporation misbehave so as to cause collateral damage, it is a deadweight loss.

This implies that if diversified investors could *vote* to abolish SFCAs they would do so – assuming they understand their own best interest. Indeed, even a stock-picking investor might agree. A stock-picker is just as likely to lose when a holder as when a buyer. Think musical chairs. And even if one recovers as a class member in a SFCA, one never recovers fully. Moreover, plaintiff attorneys skim about 20% off the top of any settlement. From behind the veil of ignorance (so to speak), a truly rational stock-picker also would prefer a world without SFCAs – and all the more so if losses are mitigated as a result of derivative recovery by defendant corporations.[51]

Nevertheless, assuming that stock-pickers prefer to retain the rights they currently enjoy – to seek recovery for bad timing through SFCAs – the question remains whether they should be privileged to do so at the expense of diversified investors who are (or should be) adamantly opposed to SFCAs. Whom should we favor? Given that the vast majority of investors are diversified, the answer seems easy that the law should reflect the interests of diversified investors.

[49] *See* Richard A. Booth, *Sense and Nonsense About Securities Litigation,* 21 U. Penn. J. Bus. L. 1 (2018); Richard A. Booth, *Index Funds and Securities Fraud Litigation,* 64 S. C. L. Rev. 265 (2012).

[50] One might see this as another case of market failure. *See infra* text following note 64.

[51] *Cf.* JOHN RAWLS, A THEORY OF JUSTICE (1971) (discussing veil of ignorance). Indeed, it is not too strong to say that a truly risk-neutral stock-picker would oppose SFCAs.

To be sure, investors were not always so well-diversified. The market has evolved over time. When SFCAs first emerged in the 1960s, stockholders tended to hold a few good stocks based on fundamental research and other company-specific factors and because it was difficult and expensive to diversify. SFCAs made some sense in such a world. But with increased understanding of the benefits of diversification and ever less costly vehicles for achieving it, diversified investors have come to drive market prices. Because diversified investors assume less risk, they are willing to pay higher prices. So investors who neglect to diversify effectively choose to pay prices that reflect less risk than they actually assume as investors. Presumably, they do so because they perceive even more value in the stocks they pick. But they voluntarily assume the risk of mispricing by eschewing diversification. They should not be permitted effectively to tax rational diversified investors to insure against their own risky behavior.[52]

What About Deterrence?

Notwithstanding the fact that most investors might prefer to abolish SFCAs because the protection they purport to offer by way of compensation is illusory at best – and ultimately a drag on returns – SFCAs may be important because of their deterrent effects. In other words, the threat of a SFCA induces management to keep investors informed and discourages the dissemination of misinformation.

The easy answer is that the prospect of a derivative action is an even better deterrent, (1) because it operates against the individuals who misspeak to the market, and (2) because it is perfectly tailored to the harm actually caused.

SFCAs use the threat of devastating liability against the corporation and ultimately holders of its stock akin to mutually assured destruction. Indeed, SFCAs arguably provide cover for reckless speech. If corporate spokespeople know that their corporations will pay for any mistakes – and that as individuals they are unlikely to pay – they will be a bit less careful than they might otherwise be. In insurance and banking, they call it moral hazard. And here the moral hazard may be exacerbated because SFCAs are seen as an abusive mechanism by which opportunistic litigants can shake down the

52 To add insult to injury, index investors have effectively ceded first-mover gains to stock-pickers by virtue of holding a portfolio weighted by market capitalization – which leads them to buy high and sell low in the process of portfolio-balancing. *See* Richard A. Booth, *Sense and Nonsense About Securities Litigation,* 21 U. Penn. J. Bus. L. 1 (2018).

corporation – which is not even to mention that because the potential for liability is crushing, any SFCA that is not dismissed is settled for real money.

In addition, legal scholars seem largely to agree that SFCAs provide excessive deterrence for securities fraud. In other words, the punishment far outweighs the crime (so to speak). Intuitively, a much lesser penalty would do just as well – especially if aimed at individual offenders.[53] But no one has offered much of an explanation as to why SFCAs overdo the job of deterrence. In other words, no one has really quantified the problem. Until now.

The analysis here provides an answer. Specifically, SCFAs provide excessive deterrence because the corporation must compensate investors for losses that are inevitable. When bad luck happens – when the music stops – someone will lose. But if it happens that a corporate agent misspoke so as to delay market price correction, those who bought during the so-called fraud period may recover their loss – a loss that someone was going to suffer no matter what. And because the market reacts immediately, they can recover for any further price decrease attributable to collateral damage caused by the fraud including that caused by their own recovery. Really?

Again, the proposal here is that the primary remedy should be a derivative one for collateral damage. Indeed, it is arguable that investors suffer no real harm in the absence of collateral damage. The harm that some suffer simply because of timing is offset by gain enjoyed by others.

This observation suggests a possible refinement to legal doctrine: If an alleged misrepresentation does not cause collateral damage to the corporation, arguably it should not be actionable. No harm. No foul. To explain: If the market does not punish a company by reducing its stock price

[53] *See, e.g.,* Fridrich v. Bradford, 542 F.2d 307 (6th Cir. 1976) (reversing trial court award of $360,000 in damages to plaintiff class of contemporaneous traders where defendant netted $13,000 from insider trading). On the other hand, it is quite clear in cases of insider trading that mere disgorgement will not suffice to deter. Thus, Congress enacted the Insider Trading Sanctions Act (ITSA) in 1984 and then the Insider Trading & Securities Fraud Enforcement Act (ITSFEA) in 1988, imposing a fine of up to three times the gain (or loss avoided). ITSFEA also added §20A to the Exchange Act providing for a private cause of action for counterparties in cases of insider trading but limiting awards thereunder to an amount equal to defendant gain (or loss avoided). To be clear, the problem with SFCAs is somewhat different in that the defendant(s) need not (and usually do not) gain at the expense of the plaintiff class. Although no one ever recovers 100% anyway, the deterrence effect is completely uncoupled from the offense. Moreover, the settlement goes to the wrong people. Other than that, SFCAs seem to some to be a good idea. *See* James Cameron Spindler, *We Have a Consensus on Fraud on the Market – And It's Wrong,* 7 Harv. Bus. L. Rev. 67 (2017).

by some amount in excess of the loss that would be caused by the news itself, it is difficult to see how one can conclude that management did anything wrong. In other words, if the market adjusts stock price by just the amount one would expect based on new information – and no more – the market must see the alleged misrepresentation as an innocent mistake at worst – and possibly no mistake at all. To be sure, this idea is contrary to the idea that because the market overreacts to bad news, we need a rule to limit damages as was featured in PSLRA. But the argument that market overreaction is the problem and that damages should be limited to price inflation as narrowly defined is exactly backwards. Indeed, once it is recognized that the market cannot but react to the prospect of legal action against the issuer, it seems quite silly to think that the market will ever adjust merely by the quantum of price inflation if there is any reason to suspect fraud.[54] Indeed, in the absence of SFCAs, we could look to the market to see if market price decreased any more than it should have done because of the bad news alone. If not, the market must have concluded that management made a mere error in judgment in the way it handled the disclosure of the bad news.[55] Admittedly, such a rule would be akin to

[54] This insight may help explain why the federal courts have had such difficulty with materiality and scienter. If one assumes that a fraud may have occurred even in the absence of any *excess* change in price, one may look for material misstatements and indications of intent where they do not exist. Given that CEOs and other company agents routinely speak to the market about the status and prospects of issuer corporations, there is always plenty of material to scrutinize. To be sure, it is not necessarily easy to determine the precise amount price inflation and thus whether any excess price impact obtains. But it would help for the courts to recognize that fraud is unlikely to be shown unless there is some reason to think that the pleaded corrective disclosure gave rise to some excess price impact. On the other hand, one could argue that the idea of scienter is even more strained in the context of a state-law BFD claim where the connection to trading and markets seems more tenuous. But if the test is one of conscious indifference to the interests of the business and its value in the eyes of investors (as it is), scienter is arguably a better fit under state law than it is under federal law where scienter seems unconnected to any motivation at all. *See* Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 325 (2007).

[55] In effect, market prices can thus be used as an indication of whether the defendant(s) acted with scienter much as has been suggested with regard to materiality. *Cf.* Halliburton Co. v. Erica P. John Fund, Inc., 573 U.S. 258 (2014) (Halliburton II) (permitting defendant in SFCA to overcome presumption of buyer reliance by showing lack of price impact). On the other hand, there may be cases in which the price decrease is attributable to actionable mismanagement or some other breach of fiduciary duty (BFD). But that further strengthens the instant argument that a derivative action should take precedence. Otherwise, a securities fraud claim will be still further enhanced by losses from the BFD. *See* Richard A. Booth, *Loss Causation and the Materialization of Risk Doctrine in Securities Fraud Class Actions,* 75 Bus. Law. xxx (2020); John C. Coffee, Jr., *The Changing Character of Securities Litigation in 2019: Why It's Time to Draw Some Distinctions,* CLS Blue Sky Blog, January 22, 2019.

testing corporate speech by the business judgment rule rather than by scienter.[56] But if it is consistent with the interests of investors to do so, why not?

Another Thought

If abolition of SFCAs seems too radical, another possible fix – albeit a partial one – would be to exclude index investors and others whose investment strategies are inconsistent with a class action remedy. For example, index fund investors effectively buy high and sell low because the logic of indexing dictates holding stocks in proportion to market capitalization – which logic applies even if the investor thinks a given stock is mispriced. This strategy seems by its very nature to rebut the FOTM presumption.[57]

A court might also justify excluding index investors from a class because FRCP Rule 23 requires that the named plaintiff be an adequate representative for the class – which could be seen as disqualifying class of members whose interests conflict with those of the representative.[58] Again, as shown above, index investors should be adamantly opposed to SFCAs in principle.

One ambiguity in the ABC hypothetical set out above is whether price inflation (as narrowly defined) would be one dollar per share – reflecting the CEO's confidence that a new customer could be found – or two dollars per share reflecting the worse case scenario of finding no replacement – or something in between. If we rely on the market as a signal of the CEO's good faith in giving earnings assurance, we would expect market price to drop by two dollars when earnings are announced only if the market thinks the CEO acted in good faith. But note that price inflation as of the moment of the announcement would be only one dollar per share anyway (reflecting a fifty-fifty chance of finding a new customer). On the other hand, if the market concludes that the CEO acted in bad faith (with scienter), market price will presumably fall further – by four dollars per share in the hypothetical. But one could argue that price inflation as of the moment of the announcement was thus two dollars.

56 *Cf.* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968) (rejecting business judgement rule as defense in context of securities fraud action).

57 *See, e.g.,* GAMCO Investors, Inc. v. Vivendi Universal, S.A., 838 F.3d 214 (2d Cir. 2016) (finding that presumption of reliance was rebutted as to investor that touted a proprietary investment model).

58 The phrase *wag the dog* comes to mind.

Interesting as these ideas may be, it seems more likely that by recognizing the need so to parse the class, the court would conclude that common questions do not predominate or that a class action would be unmanageable – if only because one could not trust class members to be truthful about their investment strategies and other holdings.[59]

In the end, the idea that the courts should engage in such cherry-picking is inconsistent with the fraud-on-the-market (FOTM) doctrine, which presumes that investors trust market prices not to be skewed by misinformation. To be sure, the FOTM presumption is rebuttable: A defendant may show that market price was unaffected by the alleged deception.[60] Or the defendant may show that a particular plaintiff did not rely on market price – perhaps knew the truth and bought anyway.[61] But the fact that the presumption is rebuttable is inconsistent with the presumption itself. No one buys or sells a stock expecting the price to remain the same. Everyone expects the price to change. But they also expect the price to be fairly set when they buy or sell. Even if one is somehow compelled to buy or sell for other reasons, one expects the price to be fairly set. In short, we must presume that everyone who bought would have bought anyway. We cannot consider the motives of individual investors

Therein lies the final reason why we should dispense with SFCAs altogether. The FOTM presumption should be irrebuttable – except by showing that market price was unaffected – which is equivalent to disproving fraud anyway. But if the FOTM presumption is irrebuttable, we must consider whether individual class members would want a SFCA to proceed – which invariably will make the SFCA unmanageable.

This is not to say that we must abolish the private right of action under Rule 10b-5, although some have argued so.[62] Individual investors may be able to

[60] *See* Halliburton Co. v. Erica P. John Fund, Inc., 573 U.S. 258 (2014) (Halliburton II).

[61] *See* GAMCO Investors, Inc. v. Vivendi Universal, S.A., 838 F.3d 214 (2d Cir. 2016). It is also possible (if not likely) that such a buyer assumed that everyone knew the truth – like the economist who sees a $20 bill lying on the ground and neglects to pick it up on the assumption that if it were really there someone would have picked it up already.

[62] *See* Joseph Grundfest, *Disimplying Private Rights of Action Under the Federal Securities Laws: The Commission's Authority,* 107 Harv. L. Rev. 963 (1994); Joel Seligman, Commentary: *The Merits Do Matter: A Comment on Professor Grundfest's* "Disimplying Private Rights of Action Under the Federal Securities Laws: The Commission's Authority, 108 Harv. L. Rev. 438 (1994); Joseph Grundfest, *Why Disimply?* 108 Harv. L. Rev. 727 (1995); Joel Seligman, Commentary: *The Merits Still Matter: A Rejoinder to Professor Grundfest's Comment,* Why Disimply? 108 Harv. L. Rev. 748 (1995).

prove that they were *in fact* deceived – that they did in fact rely on a false statement – and that they would not have bought or sold *at all* if they had known the truth. And they might even recruit others to join the action. But it cannot be a *class* action under FRCP 23 as that rule is currently written.[63]

In the end, it is not crucial for present purposes that we figure out what to do about timing claims – the loss suffered from musical chairs. What matters most is that the derivative portion of the claim be treated as such and litigated first so as to mitigate the remaining loss if any.[64]

Market Failure and the Path to Reform

Although the case for litigating collateral damage claims as derivative claims is compelling, the practical problem is how to induce the parties or the courts to do the right thing. The problem is one of market failure. No one has an incentive to advocate for derivative actions. CEOs are unlikely to argue that they should be personally liable. Plaintiff attorneys stand to generate bigger fees with SFCAs. And both sides understand that the corporation has insurance for such claims. Moreover, insurers are happy to profit from selling such insurance. Indeed, they seldom even participate in the defense of SFCAs. So no one has much incentive to escape this broken system.

In theory, a court could act on its own motion to treat such claims as derivative. The parties do not get to decide the nature of the claim.[65] But it

[63] Yet another possible fix is to convert SFCAs to opt-in actions – as they were before 1966 and as they remain in most other countries. Some price effect would remain but it would be greatly diminished. Indeed, many cases would be too weak – after giving effect to any derivative recovery – to warrant any follow-on timing action. Note that this fix would have the practical effect of mandating a stay as to the SFCA and would likely retard the reaction of the market (while the remedy is sorted) so as to obviate any magnification of price decrease by the prospect of further payout – which muddies the waters under the extant regime.

To be clear, this reform could be limited to class actions for securities fraud claims under Rule 10b-5. It need not apply to other cases such as consumer cases or even 1933 Act cases. On the other hand, this fix might give rise to an opportunism problem, with (say) index investors piling on. But that result is not likely if one must agree in advance to pay one's share of legal fees (as is the practice in the UK). This suggests that Judge Frankel's analogy of class actions to the Book of the Month Club might better have been one to Planet Fitness.

[64] A good bumper sticker for a campaign of reform: LITIGATE TO MITIGATE

[65] *See, e.g.,* Smith v. Waste Management, Inc., 407 F.3d 381 (5th Cir. 2005). *Cf.* Bangor Punta Operations, Inc. v. Bangor & A. R. Co., 417 U.S. 703 (1974) (dismissing claim on

seems unlikely that a federal court – where SFCAs must be litigated – would order a large part of the claim to be treated as derivative since it is unclear that the corporation would have standing to maintain a derivative action under federal law.[66]

One possible solution to the problem is for individual corporations to adopt bylaws under DGCL 115 requiring that any claim made in a SFCA under Rule 10b-5 that *can* be treated as derivative must be so treated and must be litigated first. Notably, the Delaware Supreme Court in *Salzberg v. Sciabacucchi* has upheld a similar provision – a so-called federal forum provision (FFP) – requiring any claim under the Securities Act of 1933 to be litigated in a federal court sitting in Delaware.[67] Although the 1933 Act is a federal law, a claim arising thereunder can be filed in either federal or state court and cannot be removed to federal court if filed in state court.[68] To be sure, the provision at issue in *Salzberg* required such claims to be litigated in federal court.[69] But nothing in the reasoning thereof suggests that a bylaw requiring litigation of derivative claims in the Delaware Court of Chancery would be invalid.

Indeed, the argument for enforcing a bylaw requiring that claims for collateral damage be litigated as a derivative action in Delaware state court is much stronger than the argument for enforcing the FFP accepted by the *Salzberg* Court. In *Salzberg,* the Court of Chancery had ruled that the provisions in question were unenforceable because a claim under the 1933 Act is not a matter of corporate internal affairs and thus is not a proper

theory that it should have been litigated as a derivative action and plaintiff would have been ineligible to do so).

66 *But see* Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit, 547 U.S. 71 (2006), where the Court did exactly that. *See supra* note 35. On the other hand, Exchange Act §16(b) expressly contemplates a derivative action in parallel circumstances, suggesting that the courts might be sympathetic to a Rule 10b-5 action by the company given that the *Blue Chip* / *Birnbaum* doctrine is judge-made. *See id.*

67 Salzberg v. Sciabacucchi, No. 346, 2019; 2020 Del. LEXIS 100 (Mar. 18, 2020).

68 *See* Cyan, Inc. v. Beaver County Employees Retirement Fund, 138 S. Ct. 1061 (2018) (holding that SLUSA did not repeal concurrent federal and state jurisdiction under the Securities Act of 1933).

69 Thus, the provision at issue could not be challenged on grounds of supremacy, whereas there may be some such issue with a bylaw requiring derivative claims to be litigated in state court.

subject for a charter provision under DGCL 102.[70] This is no mere technicality. A corporation – as a legal person – cannot write the laws that apply to it any more than an individual can do so. But a corporation, as an elaborate contract, is quite free to specify how it will be governed internally subject to any mandatory rules imposed by the state of incorporation. In other words, a corporation is largely free to specify how disputes between and among its owners and itself will be resolved. Accordingly, the Chancery Court held that the 1933 Act is an external law regulating how corporations may sell securities to outsiders.[71] Nevertheless, the Delaware Supreme Court disagreed, ruling that the Chancery Court had applied an unduly narrow definition of internal affairs.[72]

Notwithstanding the somewhat strained reasoning of the Delaware Supreme Clourt in *Salzberg* – that a 1933 Act claim can be seen as a matter of corporate internal affairs – there is little doubt about derivative actions. A derivative action is a clearly internal remedy by which an existing investor can seek compensation on behalf of the corporation for harms suffered by the corporation. Ordinarily, it is up to the board of directors (BOD) to pursue such an action on behalf of the corporation because the BOD has plenary authority to manage the business. But the law recognizes that sometimes the BOD might fail to do the right thing. Thus, a derivative action is an exception to the general rule that the BOD runs the company. Hence the

[70] Sciabacucchi v. Salzberg, C.A. No. 2017-0931-JTL, 2018 Del.Ch.LEXIS 578 (December 19, 2018), *rev'd,* Salzberg v. Sciabacucchi, No. 346, 2019; 2020 Del. LEXIS 100 (Mar. 18, 2020).

[71] In general, the 1933 Act provides a rescissory remedy to investors who suffer losses if the corporation fails to disclose any material fact in connection with an offering of its securities. In other words, it is akin to a lemon law affording buyer of motor vehicles to obtain a refund or a new car in specified circumstances. Thus, the 1933 Act is not really a remedy for fraud. Rather, it is more in the nature of a federally imposed warranty. *But see* Joseph A. Grundfest, *The Limits of Delaware Corporate Law: Internal Affairs, Federal Forum Provisions, and* Sciabacucchi, 75 Bus. Law. 1319 (2019) (arguing that the internal / external distinction is inapposite).

[72] In fairness, the 1933 Act can be seen as a federally mandated provision of state corporation law, responding to unduly narrow interpretations thereof that precluded the prosecution of any derivative action by disappointed investors based on a BFD that occurred before purchase. *Compare* Old Dominion Copper Mining & Smelting Co. v. Lewisohn, 210 U.S. 206 (1908) (under federal rule a corporation may not challenge earlier transaction because stockholders consented at the time), *with* Old Dominion Copper Mining & Smelting Co. v. Bigelow, 89 N.E. 193 (Mass. 1909) (under Massachusetts rule a corporation may challenge an earlier transaction if subsequent sale of shares to public was contemplated at the time of the earlier transaction). *See generally* George D. Hornstein, *The Death Knell of Stockholders' Derivative Suits in New York,* 32 Cal. L. Rev. 123 (1944). This view of the 1933 Act is quite consistent with the provision of concurrent jurisdiction therein.

requirement that the stockholder plaintiff in a derivative action either make a demand on the BOD to pursue the claim or show in court that it would have been futile to make such a demand.[73]

Nothing could be more internal to the corporation than a derivative action. Thus, the *Salzberg* doctrine (if doctrine it is) applies *a fortiori* to the bylaw proposed here – which seeks to assure that claims belonging to the corporation are pursued by the corporation for the benefit of all of the stockholders.[74] It seeks to eliminate a subtle conflict of interest – the tendency of directors and officers to permit claims belonging to the corporation to be diverted to SFCAs and thus covered by D&O insurance. As such, the proposed bylaw is akin to an internal rule of the corporation that absolves directors from liability to the corporation for damages from negligent mismanagement as under DGCL 102(b)(7) – akin in the sense that the proposed bylaw may be seen as gloss on such exculpatory charter amendments because it specifies how non-exculpated claims should be handled.

Two necessary features of such a bylaw should be noted.

First, the bylaw should prohibit the corporation from seeking to stay derivative litigation during the pendency of any SFCA arising from the same set of facts. While this would seem to be implicit in the requirement that an SFCA be reviewed for lurking derivative claims, it cannot hurt to make it explicit that the derivative claim be litigated first. Indeed, the bylaw could go so far as to require the corporation to seek a stay of the SFCA.

Second, the bylaw should require the corporation to obtain insurance for its directors, officers, and other agents who may be made defendants in any such derivative action. Many extant D&O policies exclude claims by the corporation (sometimes in the guise of provisions excluding insured-versus-insured claims). But there is no reason why such insurance cannot be written if there is corporate demand for it.[75]

[73] *See supra* text at notes 31-32 and accompanying notes.

[74] It could be argued that the bylaw should not apply in the context of a good news case. In such a case, which would involve a class of sellers, a derivative action would provide no relief for the class and would instead reward buyers and holders. Coincidentally (or perhaps ironically), Rule 10b-5 originally applied only to sellers. *See* Richard A. Booth, *A Brief History of Securities Litigation* (forthcoming).

[75] *See, e.g.,* Richard A. Booth, *Reducing Risk Doesn't Pay Off,* Wall Street Journal, March 15, 1999, at A18 (discussing proposal by one insurance company to offer insurance against earnings surprises). *See also* Kevin LaCroix, *D&O Insurance to Fund Entire "Largest Ever" $139 Million News Corp. Derivative Suit Settlement,* THE D&O DIARY (Apr. 23, 2013); Kevin

In addition, the bylaw should require the corporation to treat the expense of such insurance as compensation – perhaps as an employee benefit. To be sure, accounting treatment does nothing to alter the cash flow of the underlying business. But accounting treatment can make the costs of securities litigation clear to stockholders (and others). It also serves to illustrate the risks assumed by CEOs and other HLOs and may induce some further restraint or at least rationality in connection with executive compensation.

Conclusion

Most securities fraud class actions under SEC Rule 10b-5 involve revelation of negative information about the defendant company that should have been disclosed earlier – bad news that (allegedly) has been covered up by company agents. The standard remedy in such cases is out-of-pocket damages (OOPs). But this measure of harm is inherently ambiguous. Some courts interpret it as price inflation at the time of purchase. Others interpret it as the difference between the price paid and the price at which a stock settles after corrective disclosure. Although it might seem that these formulations are synonymous, the latter includes not only the difference in price that would have obtained if the truth had been known at the time of purchase but also any additional difference that might be caused by revelation of the truth. For example, the market may conclude that the company is likely to become the target of an SEC enforcement action or private securities litigation. Either way, the company is likely to suffer increased legal expenses. In addition, the company may suffer an increased cost of capital because the market perceives added risk that information about the company may be unreliable. These additional factors and possibly others – herein dubbed *collateral damage* – will be reflected in the decrease in price that occurs *immediately* upon corrective disclosure. But such collateral damage is harm suffered by the company that should be the subject of a derivative action – for the benefit of all stockholders – and not a direct (class) action. The clear implication is that OOPs should be measured as price inflation at the time of purchase– that is, price inflation narrowly defined net of any collateral damage. Indeed, because FRCP Rule 23 – which governs class actions – requires that a class action for damages be *superior* to any other means of resolving a dispute, Rule 23 itself requires that collateral damage be addressed in a derivative action simply because it *can*

LaCroix, *About the AIG Derivative Settlement,* THE D&O DIARY (Sept. 11, 2008) (recounting cases in which derivative settlement was in fact covered by D&O insurance).

be so addressed. As demonstrated here, state corporation law is perfectly congruent with federal securities law such that a derivative action for collateral damage will lie whenever a meritorious claim can be stated under Rule 10b-5. Aside from simplifying the litigation process by providing for unitary corporate recovery, derivative actions avoid the circularity inherent in class actions while also addressing the problem of excessive deterrence by providing a perfectly tailored action against individual wrongdoers. Finally, because derivative actions quite clearly address corporate internal affairs, a corporation can assure that claims for collateral damage will be so addressed by adopting a bylaw to that effect.

APPENDIX

Form of Bylaw Requiring Derivative Litigation of Rule 10b-5 Claims

If the corporation shall be sued in a securities fraud class action (SFCA) under SEC Rule 10b-5, the claims made therein shall be litigated insofar as possible in a derivative action on behalf of the corporation in the courts of the State of Delaware and applying Delaware law. The corporation through counsel shall take any steps necessary to assure that claims made in a SFCA that can be treated as derivative rather than direct shall be so treated, including without limitation any portion of such claims that may be attributable to fines, penalties, and so forth paid by the corporation, legal fees and other expenses associated with defending the corporation, expenses and losses attributable to actionable mismanagement, and any increases in the cost of capital. Mindful of the fact that such a derivative action may expose the directors, officers, and agents of the corporation to an increased risk of liability for harms suffered by the corporation, the corporation shall obtain insurance for the benefit of its directors, officers, and agents in a coverage amount at least equal to the coverage amount of any insurance obtained by the corporation that would be available for the settlement of any SFCA. The premiums paid for any such insurance obtained hereunder by the corporation for the benefit of its directors, officers, and agents in a derivative action shall be treated for accounting purposes as executive compensation.

***

about ECGI

The European Corporate Governance Institute has been established to improve *corporate governance through fostering independent scientific research and related activities.*

The ECGI will produce and disseminate high quality research while remaining close to the concerns and interests of corporate, financial and public policy makers. It will draw on the expertise of scholars from numerous countries and bring together a critical mass of expertise and interest to bear on this important subject.

The views expressed in this working paper are those of the authors, not those of the ECGI or its members.

Electronic Access to the Working Paper Series

The full set of ECGI working papers can be accessed through the Institute's Web-site (https://ecgi.global/content/working-papers) or SSRN:

Finance Paper Series	http://www.ssrn.com/link/ECGI-Fin.html
Law Paper Series	http://www.ssrn.com/link/ECGI-Law.html