Price Inflation and Price Maintenance in Securities Fraud Class Actions

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Abstract

Most securities fraud class actions are based on allegations that the defendant company made some misrepresentation of material fact that had the effect of maintaining stock price at a level higher than what it would have been if the market had known the whole truth about the company. But some scholars have argued that this definition of fraud is inconsistent with the fact that there is no general duty under federal securities law requiring disclosure of information simply because it is material – because reasonable investors (like enquiring minds) would want to know: If the company can simply remain silent rather than voluntarily (mis)speaking to the market, it cannot be held liable simply because stock price would have fallen if investors had known the whole truth. How then can a company be liable if it does speak to the market in some way that merely confirms what the market already thinks? Thus, scholars who question the price maintenance theory argue that absent a duty to speak, a misrepresentation must cause stock price to increase to state a claim for fraud. Nevertheless, the courts have consistently upheld claims based on a theory of price maintenance without much explanation as to why they reject the argument that literal price inflation should be required to state a claim. Rather, the courts have relied on a general duty not to lie – at least in cases involving affirmative misrepresentations – together with a duty to update information that has become misleading and a duty to correct rumors (for example) that originate from sources within the company. SCOTUS has never opined on the price maintenance theory of fraud, although it has expressly recognized this gap in its securities fraud jurisprudence. The implications of this debate extend far beyond the mere definition of fraud. Scholars who advocate for the price inflation requirement argue that the company should be held liable only to the extent of price inflation. In contrast, the price maintenance theory suggests that the remedy should be based on the price paid and the price at which the stock settles following corrective disclosure. Price inflation is clearly a more precise (albeit limited) measure of loss. But it excuses even outrageous lies that merely maintain stock price. In contrast, the price maintenance theory depends on corrective disclosure to reveal the effect of the fraud. And since corrective disclosure may be accompanied by other items of good (or bad) news that have the effect of muting (or magnifying) price change, the price decrease following corrective disclosure often reflects more than merely undoing the misrepresentation. Mostly, scholars have worried that savvy companies will wait until they have some good news to announce before they correct an earlier misstatement – and thus soften the effects of bad news. But the much more common scenario is that corrective disclosure will come with additional bad news, which often permits buyers to make much larger claims, especially when corrective disclosure comes in the form of a dramatic event that reveals the earlier (alleged) misrepresentation. To recognize such claims means that investors will be that much more encouraged to sue, and companies will be that much more deterred from voluntary disclosure. Indeed, the primary policy motivation for requiring literal price inflation seems to be to limit the potential for compensatory damages to investor loss based on mispricing at the time of purchase – to net out the consequential losses that flow from corrective disclosure.

Keywords: price inflation, price maintenance, securities fraud class action, misrepresentation, corrective disclosure, deterrence, compensation, fraud on the market, rebuttable presumption, consequential damages, class certification, derivative action, fair and efficient adjudication, superior method of adjudication

JEL Classifications: G23, G28, G34, K22, K41

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ABSTRACT

Most securities fraud class actions are based on allegations that the defendant company made some misrepresentation of material fact that had the effect of *maintaining* stock price at a level higher than what it would have been if the market had known the whole truth about the company. But some scholars have argued that this definition of fraud is inconsistent with the fact that there is no general duty under federal securities law requiring disclosure of information simply because it is material – because reasonable investors (like enquiring minds) would want to know: If the company can simply remain silent rather than voluntarily (mis)speaking to the market, it cannot be held liable simply because stock price would have fallen if investors had known the whole truth. How then can a company be liable if it does speak to the market in some way that merely confirms what the market already thinks? Thus, scholars who question the price maintenance theory argue that absent a duty to speak, a misrepresentation must cause stock price to *increase* to state a claim for fraud. Nevertheless, the courts have consistently upheld claims based on a theory of price maintenance without much explanation as to why they reject the argument that literal price inflation should be required to state a claim. Rather, the courts have relied on a general duty not to lie – at least in cases involving affirmative misrepresentations – together with a duty to update information that has become misleading and a duty to correct rumors (for example) that originate from sources within the company. SCOTUS has never opined on the price maintenance theory of fraud, although it has expressly recognized this gap in its securities fraud jurisprudence.

The implications of this debate extend far beyond the mere definition of fraud. Scholars who advocate for the price inflation requirement argue that the company should be held liable only to the extent of price inflation. In contrast, the price maintenance theory suggests that the remedy should be based on the price paid and the price at which the stock settles following corrective disclosure. Price inflation is clearly a more precise (albeit limited) measure of loss. But it excuses even outrageous lies that merely maintain stock price. In contrast, the price maintenance theory depends on corrective disclosure to reveal the effect of the fraud. And since corrective disclosure may be accompanied by other items of good (or bad) news that have the effect of muting (or magnifying) price change, the price decrease following corrective disclosure often reflects more than merely undoing the misrepresentation. Mostly, scholars have worried that savvy companies will wait until they have some good news to announce before they correct an earlier misstatement – and thus soften the effects of bad news. But the much more common scenario is that corrective disclosure will come with additional bad news, which often permits buyers to make much larger claims, especially when corrective disclosure comes in the form of a dramatic event that reveals the earlier (alleged) misrepresentation. To recognize such claims means that investors will be that much

more encouraged to sue, and companies will be that much more deterred from voluntary disclosure. Indeed, the *primary policy motivation* for requiring literal price inflation seems to be to limit the potential for compensatory damages to investor loss based on mispricing at the time of purchase – to net out the consequential losses that flow from corrective disclosure.

For example, following the 2010 Deepwater Horizon blowout and oil spill, investors who had bought BP stock before the event sued to recover their losses, claiming that BP had misrepresented improvements to its safety practices as early as November 2007 and that the truth as to the inadequacy of such practices was revealed by the disaster. There is no doubt that BP stockholders lost about 25% of their investment. But was the loss caused by the fraud or rather by other factors (including the fact that bad things sometimes happen to good companies)? It is unlikely that BP statements about improvements to its safety practices had a discernible effect of affirmatively inflating BP stock price at the time they were made. So under a rule requiring affirmative price inflation, buyers of BP stock would have no claim. But if it suffices for the statements to be false and to have maintained stock price at a higher level than would have prevailed if BP had told the truth, buyers of BP stock may be entitled to compensation for the entire loss they suffered.

There is a third possibility between the two extremes of price inflation and price maintenance: We might measure the loss from fraud by the difference between the price paid and the price that would have prevailed if the market had known the truth at the time of deceit. Indeed, in *Halliburton II,* SCOTUS stated unequivocally that no securities fraud claim can proceed as a class action unless a misrepresentation affects market price at the time the misrepresentation is made. Nevertheless, the courts seem to be stuck with choosing between price inflation and price maintenance. Mispricing – *none-of-the-above* – does not appear to be an option offered by the case law even though it seems almost self-evident that the ultimate goal of antifraud law (and securities litigation) should be to minimize mispricing. But there may be a path to that result.

In *Halliburton II,* SCOTUS ruled that defendant companies must be afforded the opportunity to rebut the fraud-on-the-market (FOTM) presumption in connection with a motion to certify a case as a class action. Thus, defendant companies must be permitted to show that the effects of corrective disclosure came from sources other than fraud. To be sure, SCOTUS also seems to have ruled in *Goldman Sachs* that a class action may be certified if *any part* of the loss can be attributed to fraud – that to rebut the FOTM presumption a defendant must show that *all* of the loss came from other sources. But if the defendant shows that even some of the loss comes from sources other than mispricing, a court must consider the character of the loss claimed by the class plaintiff. Since losses other than from mispricing are almost always derivative in nature, they should give rise to a derivative action and recovery by the company.

As it happens, Rule 23 of the Federal Rules of Civil Procedure (FRCP) provides that a class action for damages may proceed as such only if it is *superior* to other modes of resolving the dispute. Since a derivative action is at least as good a way to address consequential losses, Rule 23 *requires* that any portion of a claim that can be litigated as such be so litigated. In addition, by so proceeding, the courts can also answer the otherwise difficult question of how much of the direct claim derives from mispricing, since the claim for mispricing is whatever remains after the derivative loss is determined. Moreover, to the extent that the subject company actually recovers in the derivative action, damages are mitigated in any subsequent class action. In other words, the solution proposed here – to litigate derivative claims first – is itself superior to both a rule requiring price inflation and the prevailing approach of relying on corrective disclosure in price maintenance cases. It is also mandated by extant law.

Nevertheless, someone must make the argument. No court will so rule on its own motion in the shadow of more than fifty years of securities fraud class actions even though it is abundantly clear that most of the claim in most cases is derivative rather than direct. As it happens, index funds are uniquely well suited to advocate for derivative actions to supplant class actions. Because index funds do very little trading in comparison to their substantial holdings of portfolio stocks, index funds stand to lose much more from defendant company settlements than they take in as their share of such settlements. Similarly, they stand to gain significantly if settlement funds (from insurance) are paid to the derivative plaintiff company. Indeed, it is arguable that index funds are compelled by their fiduciary duty to fund investors to advocate for derivative actions. Moreover, because index funds eschew any effort to pick winners – and instead invest solely based on market capitalization of portfolio companies – they have no reason to worry that they may offend portfolio company management and lose access to information that may afford special insight as to company prospects.

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KEY WORDS & PHRASES: price inflation, price maintenance, securities fraud class action, misrepresentation, corrective disclosure, deterrence, compensation, fraud on the market, rebuttable presumption, consequential damages, class certification, derivative action, fair and efficient adjudication, superior method of adjudication

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Price Inflation and Price Maintenance In Securities Fraud Class Actions

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Introduction – What is the Question?

Most securities fraud class actions (SFCAs) are based on allegations that the defendant company made some misrepresentation of material fact that had the effect of *maintaining* stock price at a level higher than would have prevailed if the market had known the (whole) truth about the company.[1] But some scholars have argued that this definition of fraud is inconsistent with the fact that there is no general duty requiring disclosure of information simply because it is material – because reasonable investors (like enquiring minds) would want to know.[2]

To expand: If a company can simply remain silent rather than voluntarily (mis)speaking to the market, it cannot be held liable simply because stock price would have fallen if investors had known the truth. How then can a company be liable if it does speak to the market in some way that merely confirms what the market already thinks?

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[1] *See* Merritt B. Fox & Joshua Mitts, *Event-Driven Suits and the Rethinking of Securities Litigation,* 78 Bus. Law. 1, xxx (2023). To be clear, this statement assumes that most such actions are based on the cover-up of BAD news that causes a stock's price to *drop* when the truth comes out, thus visiting a loss on those who *bought* during the fraud period (between the time of the original deception and corrective disclosure). But fraud may also the cover up of GOOD news that causes a stock's price to increase when the truth comes out, in which case fraud-period *sellers* suffer the loss. There are notable examples of such good-news fraud. *See, e.g.,* Basic Inc. v. Levinson, 485 U.S. 224 (1988); Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972); SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968). Nevertheless, the overwhelming majority of SFCAs (about 98%) involve the cover up of bad news. *See* Richard A. Booth, *The End of the Securities Fraud Class Action as We Know It,* 4 Berkeley Bus. L.J. 1 (2007). Accordingly, the discussion here assumes a bad news scenario. Although much of the analysis applies with equal force to good news cases, it may not do so in every conceivable situation.

The parenthetical (whole) is intended to acknowledge the fact that corrective disclosure might or might not involve all material information. It may reveal a misrepresentation thus causing a downward adjustment in stock price even though other negative information remains undisclosed. So it is important not to assume that stock price following corrective disclosure will not necessarily reflect the best possible estimate of company value.

[2] *See* Fox & Mitts, *supra* note 1 at xxx; Donald C. Langevoort, *Compared to What? Econometric Evidence and the Counterfactual Difficulty,* 35 J. Corp. Law 183, 186-87 (2009); James C. Spindler, *Why Shareholders Want Their CEOS to Lie More After Dura Pharmaceuticals,* USC CLEO Research Paper No. C06-10, USC Law Legal Studies Paper No. 06-16 (July 21, 2006). https://ssrn.com/abstract=920470 Charles R. Korsmo, *Information Bundling, Disclosure Timing, and Judicial Deference to Market Valuations,* 62 B.C. L. Rev. 572 (2021).

Donald Langevoort has explained it well:

> To illustrate, consider two companies A and B, both of which face comparable difficulties with the FDA. Company A lies to cover up the difficulties, while Company B says nothing. Assume that A's lie does not impact stock price because it was taken as non-news, and A's stock price remains constant. Because B said nothing, its stock price stays constant as well. When the truth is revealed because the FDA takes action, both companies' stock prices drop by the same amount, producing similar investor losses. Here, purchasers of A's shares are no worse off than purchasers of B's shares, yet purchasers of A's stock receive compensation for their full economic loss if we employ the truth-telling counterfactual. The alternative "no fraud" counterfactual, on the other hand, results in comparable treatment unless the Company A plaintiffs can show that the fraud did indeed distort the stock price, in which case their damages are the amount of the distortion.[3]

Thus, scholars who argue that price maintenance alone is insufficient to support a claim (at least in the absence of some duty to speak) further argue that to state a claim for fraud, a misrepresentation must have caused affirmative price inflation. In other words, new (but false) information must cause stock price to *increase.* And it follows that the company should be held liable only to the extent of the price *inflation* caused by such misinformation.[4]

Nevertheless, the courts have consistently upheld claims based on a theory of mere price maintenance often without much explanation as to why they reject the argument that literal price inflation should be required.[5] When they offer any explanation at all, the courts have relied on a general (background) duty not to lie.[6]

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[3] Langevoort, *supra* note 2, 35 J. Corp. Law at 186-87.

[4] *See, e.g.,* Fox & Mitts, *supra* note 1, 78 Bus. Law. at xxx.

[5] *See* Fox & Mitts, *supra* note 1, 78 Bus. Law. at xxx (stating that court have sleepwalked into this doctrine). *But see* Archdiocese of Milwaukee Supporting Fund, Inc. v. Halliburton Co., 597 F.3d 330, 335 (5th Cir. 2010), *vacated and remanded sub nom.,* Erica P. John Fund, Inc. v. Halliburton Co., 563 U.S. 804 (2011) (Halliburton I), *citing* Greenberg v. Crossroads Sys., Inc., 364 F.3d 657, 665 (5th Cir. 2004) (price maintenance requires more than mere confirmation); In re Vivendi, SA Securities Litigation, 838 F.3d 223, 253-61 (2d Cir. 2016); Glickenhaus & Co. v. Household Int'l, Inc., 787 F.3d 408, 418 (2d Cir. 2015); FindWhat Investor Group v. FindWhat.com, 658 F.3d 1282, 1317 (11th Cir. 2011) (holding that defendants whose fraud *prevents* preexisting inflation in a stock price from dissipating are just as liable as defendants whose fraud introduces inflation into the stock price in the first instance).

[6] *See* Basic, Inc. v. Levinson, 485 U.S. 224, 240 (note 18) (1988) (referring to "ever-present duty not to mislead"). Indeed, the duty to refrain from misrepresentation – the duty not to lie affirmatively – is so well fixed that the courts often do not even mention it. In

To be completely clear, the issue whether price maintenance should suffice relates only to cases involving affirmative misrepresentations. As the above example itself implies, a failure to disclose cannot give rise to a claim unless there is a duty to speak to the market. But the duty to disclose can come from many sources.[7] It can come from the requirement to make a periodic filing with the SEC or from a judicially found duty to update information that has become misleading or to correct rumors (at least if the rumor originates from sources within the company).[8] Thus, even scholars who advocate for a rule requiring literal price inflation allow that a claim should lie where a company is *obligated* to speak by law or circumstance.[9]

SCOTUS has never expressed a view on the price maintenance theory of fraud although it has expressly recognized this gap in its securities fraud jurisprudence. In short, the Court has reserved the question.[10]

contrast, a case based on an omission to state a material fact is more difficult to maintain since it requires a positive duty to disclose. *See* Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972).

[7] For example, the duty to disclose may often be found in general principles of common law. *See* id. (holding that defendant brokers owed a fiduciary duty to plaintiff sellers of securities to disclose that price was unfairly low). *See also* Malone v. Brincat, 722 A.2d 5 (Del. 1998) (holding that directors and officers can be liable for lying to the market under fiduciary duty of candor despite absence of affirmative duty to disclose). *Cf.* United States v. O'Hagan, 521 U.S. 642 (1997) (holding that attorney who traded on confidential client information was liable for insider trading based on breach of duty to client). Thus, it is arguable that any duty will do. It is not necessary that the duty be owed to the plaintiff(s).

[8] *See, e.g.,* In re Time Warner, Inc. Securities Litigation, 9 F.3d 259 (2d Cir. 1993). While such cases are technically frauds of omission, many (if not most) such cases are pleaded as price maintenance cases alleging that the original statement was false when made – which has the added advantage of extending the fraud period further back in time and thus maximizing the claim. *See, e.g.,* Goldman Sachs Group., Inc. v. Arkansas Teacher Retirement System, 141 S. Ct. 1951 (2021); Ludlow v. BP, PLC, 800 F.3d 674, 682 (5th Cir. 2015). *But see* Archdiocese of Milwaukee Supporting Fund, Inc. v. Halliburton Co., 597 F.3d 330, 337 (5th Cir. 2010), *vacated and remanded sub nom.,* Erica P. John Fund, Inc. v. Halliburton Co., 563 U.S. 804 (2011) (Halliburton I) (noting requirement that positive misrepresentation not be merely confirmatory of information already known to the market and previously digested).

[9] *See* Fox & Mitts, *supra* note 1, 78 Bus. Law. at xxx. Indeed, a duty to speak may arise any time a company's stock price would fall but for confirming the market's incorrect belief. Note that in *Goldman Sachs,* which is described by SCOTUS itself as a price maintenance case, the allegedly false statements appeared in SEC filings although the statements themselves were arguably voluntary. *See* Goldman Sachs Group., Inc. v. Arkansas Teacher Retirement System, 141 S. Ct. 1951, xxx (2021). Moreover, the statements may not have become untrue (if they were untrue) until sometime after they were made. So it is unclear how a rule requiring literal price inflation would apply. But it is quite clear that figuring out how the rule applies would entail plenty of new litigation.

Why Theory Matters

The implications of the price-maintenance theory extend beyond the mere definition of fraud to the measure of harm and thus to damages. The size of a claim depends on how the fraud is defined. A rule requiring literal price inflation implies that the remedy should be based on the amount of increase caused by a false statement.[11] In contrast, the price-maintenance theory implies that the remedy should be based on the price that would have prevailed if the market had known the truth.[12]

Nevertheless, both theories may be seen as attempting to determine mispricing at the time the buyer buys (or the seller sells). As such, both approaches would seem to serve the policy goal of assuring that market prices are as accurate as possible.[13]

On the other hand, the price maintenance theory can easily lead to compensation far in excess of mispricing at the time of a trade. When the truth comes out, stock price may fall much more than it would have fallen if the company had told the truth in the first

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[10] *See* Goldman Sachs Group., Inc. v. Arkansas Teacher Retirement System, 141 S. Ct. 1951 (2021).

[11] *See* Fox & Mitts, *supra* note 12, 78 Bus. Law. at xxx.

[12] *See* Langevoort, *supra* note 2 at xxx; Spindler, *supra* note 2 at xxx. Note also that in cases of omission, claimants may claim their entire loss. On the other hand, one can imagine a legal regime in which a showing of price inflation (however minimal) might trigger a claim for the entire loss suffered by buyers, which is essentially the regime we have with the price maintenance theory. Compensation might also be based on a valuation approach. *See* Frank Partnoy, *Market Prices vs. Fundamental Value: The Case for Using Discounted Cash Flow Analysis in Securities Class Actions,* 77 Bus. Law. 1059 (2022); Daniel R. Fischel, *Use of Modern Finance Theory in Securities Fraud Cases Involving Actively Traded Securities,* 38 Bus. Law. 1 (1982). *See also* Langevoort, *supra* note 2 at xxx (noting that valuation approach – as opposed to reliance on market prices – would avoid the issues raised by the price inflation versus price maintenance debate).

[13] As noted below, this is a policy goal that should be very important to index funds and their investors. See infra text at note xxx ff. Again, there is no general legal duty requiring publicly traded companies to disclose information simply because it would matter to investors – because it is material. But it is not necessarily a bad idea to require truth-telling (as Langevoort describes it) when the company chooses to speak on the theory that the company will not choose to speak unless circumstances dictate it. Thus, the rule of truth-telling – which is implicit in the price maintenance theory – may be seen as akin to the requirement to file a form 8-K when certain important events occur. Although a rule of truth-telling is thus somewhat fluid, it is still objective in that its applicability is triggered by a company's choosing to speak and thus may be seen as a legitimate way to expand the duty of disclosure.

place.[14] Hence, plaintiffs tend to rely on the price maintenance theory because it may support a much bigger claim. Moreover, and possibly more important, the more stock price falls, the easier it is to prove (by means of an event study) that the market for the stock is efficient and that new information caused the decrease.

Thus, one advantage of the literal price inflation rule is precision. If the fraud consists in a misrepresentation that affirmatively inflates the price, then the remedy matches the offense. And it is easy (in theory) to measure the increase in price caused by a statement that later turns out to be false.[15]

Moreover, the literal price inflation rule addresses the thorny problem of mixed signals that often go with corrective disclosure. As many scholars have noted, a savvy company that knows it has misspoken may wait to issue a correction until it also has some good news to release, which may result in a muted market reaction that fails to reflect the full price drop that would have occurred if the company had told the truth in the first place.[16] But curiously, these same scholars have ignored the possibility – indeed probability – that corrective disclosure might cause stock price to fall even more than it would have done if the company had timely told the truth.[17] In short, some scholars worry more

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[14] *See infra* text at note 16 ff. (debate over price maintenance tends to obscure the real issue – which is mispricing at the time of the trade).

[15] I say *in theory* because in practice plaintiffs will likely claim more if it they can argue that the company was obligated to speak when it spoke so as to cause price inflation. Indeed, this will always be so since the statement causing price inflation is ex hypothesis false and thus triggers a duty to correct.

[16] *See* Spindler, *supra* note 2.

[17] *See* Richard A. Booth, *Loss Causation and the Materialization of Risk Doctrine in Securities Fraud Class Actions,* 75 Bus. Law. 1791 (2020); Richard A. Booth, *Claim Character and Class Conflict in Securities Litigation,* in ELGAR HANDBOOK ON SHAREHOLDER LITIGATION (Chapter 5) (2018); Richard A. Booth, *What Counts as Price Impact for Securities Fraud Purposes?*, 9 Virginia L. & Bus. Rev. 37 (2015). *See also See* Barbara Black, *Reputational Damages in Securities Litigation,* 35 J. CORP. L.169, 175 (2009); 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). The one empirical piece focusing on the source of loss from securities fraud (arising from bad accounting) finds that on average about two-thirds of the price decrease following corrective disclosure derives from reputational harm whereas only about one-third of the loss derives from the inaccuracy reported numbers. *See* Jonathan M. Karpoff, D. Scott Lee & Gerald S. Martin, *The Cost to Firms of Cooking the Books,* 43 J. Fin. Quan. Analysis 581 (2008). *But see* Langevoort, *supra* note 2 (recognizing both possibilities). *See, e.g.,* Archdiocese of Milwaukee Supporting Fund, Inc. v. Halliburton Co., 597 F.3d 330, 336 (5th Cir. 2010), *vacated and remanded sub nom.,* Erica P. John Fund, Inc. v. Halliburton Co., 563 U.S. 804 (2011) (Halliburton I) (noting the problem of multiple items of bad news). *See also* Dura Pharmaceuticals, Inc. v Broudo, 544 U.S. 336, 342-43 (2005) (noting that price decrease may be the result of factors other than the alleged fraud such as changed economic circumstances, changed investor expectations, new industry-specific or firm-specific facts,

about how companies can mislead the market while other scholars worry more about how stockholders may seek to recover too much – a classic half full / half empty conflict of perspective.

The disadvantages of the literal price inflation rule are numerous. For one, few securities fraud class actions would survive a motion to dismiss since in practice most such actions are based on a price maintenance theory. Moreover, even in cases where a misrepresentation causes an increase in price, the price change is unlikely to be statistically significant. So even in cases where some price inflation occurs, it will often be insufficient to support a claim.[18] Of course, one might argue that this result is as it should be – that there are too many SFCAs as things stand. But to require literal price inflation would mean that companies would be free to make all sorts of false statements to support the prevailing market price even though they know it to be inflated.[19]

In contrast to a rule requiring literal price inflation, the price maintenance theory seems to presume that a duty to tell the truth springs into being because of a misrepresentation – because the measure of the claim is the change in price upon corrective disclosure, which change may encompass the effects of other facts that come out at same time. In other words, one *little* lie may trigger a claim for all of the difference between the prevailing market price and the price that would have obtained if the market had known the truth.[20] Thus, the price maintenance approach is likely to result in bigger claims and overcompensation for plaintiffs.[21]

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conditions, or other factors).

[18] *See* Fox & Mitts, *supra* note 1, 78 Bus. Law. at xxx (discussing threshold problem). This worry is based on the assumption that the courts and litigants would continue to use event studies to prove price impact, loss causation, etc. *But see* Partnoy, *supra* note 12 (suggesting alternative approach based on valuation). Note that it is not technically necessary to use the claim upon which an action is based to prove that the market for the subject stock is efficient. And it may be a better strategy in some cases for plaintiffs not to do so. But it might be a handicap when the time comes to prove loss causation.

[19] This worry assumes that companies know when stock price is higher than it should be and that they know what to say to keep it that way without causing further inflation. But experience seems to indicate that companies are not very good at understanding the market or predicting how the market will react to new information. *See, e.g.,* In re Time Warner, Inc. Securities Litigation, 9 F.3d 259 (2d Cir. 1993).

[20] Admittedly, the idea that a duty to tell the whole truth arises is a bit of an overstatement. There will always be some facts about the company that remain undisclosed. The market always wants more information. So the duty would be more precisely described as one to be as accurate as possible as to any matter about which the company chooses to speak. *See supra* note 1 (discussing similar ambiguity).

[21] Most scholars seem to agree that the central problem with SFCAs is that the prospect of crushing liability leads defendant companies to agree to large settlements in any case that cannot be dispatched short of trial. In other words, it is simply too risky to go to trial in any case that survives dismissal (or summary judgment) and is certified to proceed as a class

To be sure, the claim might sometimes be equal merely to the difference in price resulting from correction of the fact(s) previously thought by the market to be true (as implicit in the above example about problems with the FDA). But often corrective disclosure will be accompanied by other facts that cause market price to fall more (or less) than it would have fallen if the company had told the truth in the first place.[22] Indeed, it would be quite surprising if the price change from corrective disclosure exactly matched the price that would have prevailed if the company had told the truth. Again, this is illustrated (in a way) by the above FDA example. It is difficult to believe that stock prices of the two companies would fall by exactly the same proportion if the market cares at all about the fact that Company A lied. If so it must be that the market finds the lie totally excusable. Otherwise, it would punish Company A by some additional amount to reflect a loss of trust in its management.[23]

The possibility that the claim can encompass additional losses is especially problematic where the corrective disclosure derives from an event that reveals the untruth of the earlier statements by the company. For example, following the April 20, 2010 Deepwater Horizon blowout and oil spill, shares of BP (the operator of the rig) fell from $60.48 per share to $35.20 per share over the following ten weeks.[24] Predictably,

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action. As a result many questions that arise later in the proceeding – such as the measure of damages – are never resolved, further enhancing risk for defendant companies. These same forces induce plaintiff lawyers to sue more often than they might otherwise do, further exacerbating the foregoing problems.

[22] Most scholars have focused on the possibility that companies might wait to correct misstatements until they can also disclose some offsetting good news so that the net change in price will minimize any fraud claim. *See, e.g.,* Spindler, supra note 2; Korsmo, supra note 2.

[23] There are other problems with the example as discussed further below. For one, the statement by Company A is not necessarily about matters that are unique to it or that it is in the best position know – company-specific information. Rather, the statement might be seen as a forward-looking prediction about industry or regulatory conditions. *See, e.g.,* Wielgos v. Commonwealth Edison Co., 892 F.2d 509 (7th Cir. 1989).

[24] To be precise, BP shares fell from 60.48 at the close on April 20, 2010 to 35.20 at the close on July 20 (90 days later), for an average closing price of 40.35 during that period. Thus, BP decreased by 33% based on the average closing price. The benchmark S&P500 fell during the same period by about 8% based on average closing prices. Thus, an investor who bought BP stock on April 20 suffered a net loss of about 25% or about $15 per share. Note also that BP had about 3.13B shares outstanding at the time (as measured by units traded in the US). Thus, the company's aggregate value (its market capitalization) was about $189B as of April 20, 2010 and about $126B as of closing 90 days later, for a decline of about $63B. For the record, the total cost of the clean-up from the spill was about $62B as later reported. *See* Stephen Mufson, *BP's Big Bill for the World's Largest Oil Spill Reaches $61.6 Billion,* Washington Post, July 16, 2016.

investors who had bought BP stock before the event sued to recover their losses, claiming that BP had misrepresented improvements to its safety practices as early as November 2007 and that the truth as to the inadequacy of such practices was revealed by the events of April 20 and the following days. There is no doubt that BP stockholders lost about half of their investment. But was the loss caused by the fraud or rather by other factors (including the fact that bad things sometimes happen to good companies)?

Thus, one motivation for recent scholarly challenges to the price maintenance theory (and advocacy for requiring literal price inflation) is the perceived need to limit the size of fraud claims, which have expanded far beyond any loss attributable to mispricing at the time buyers buy (or sellers sell) no matter how mispricing is defined.[25] Presumably, the thinking is that massive claims are plausible only because claimants and courts have relied on the price change that goes with corrective disclosure (which seems only natural in the context of a price maintenance theory). And presumably, a rule requiring pleading and proof of literal price inflation would avoid this mistake. But even if the courts were to adopt such a rule, no claim would (or could) lie until the market discovers the truth and stock price corrects. SCOTUS has already so ruled: There can be no claim unless and until stock price drops.[26]

Indeed, it is difficult to see how things could be otherwise: There is no way to know that a false statement is false until the truth comes out. And given the price-correction requirement, there is no way to avoid the question whether defrauded buyers should be able to recover the entire loss they suffer. When stock price falls dramatically, buyers will sue for as much as possible. Besides, who is to say how much of a loss is actually caused by a fraud? It is much easier to assume that all of the loss suffered by a buyer is caused by a fraud. If not, it is not obvious how to parse the claim. Thus, courts may be inclined to favor larger claims if only because the loss is easier to quantify.[27]

Figures for the S&P500 are based on closing prices for the leading index fund based thereon (SPY) which fell from a 120.88 to 108.48 over the same ninety-day period with an average closing price of 111.06 (unadjusted). (It is not entirely clear whether the comparison between BP and the index should be based on the ninety-day average for the index or the closing price thereof on the 90th day (since the index is after all an average of 500 stocks). Note also that SPY paid a $0.531 dividend on 6/18/10, but that BP paid no dividends during the period. To be completely accurate, one would need to adjust the calculation for this dividend and for the relative risk inherent in BP stock as compared to the S&P500. As of today (in early 2024) BP is about 61% as risky as the index, which means that it tends to fall in price less than the index falls all else equal, which in turn suggests that the loss suffered by buyers was somewhat greater than the $15 as calculated here.

[25] *See* Fox & Mitts, *supra* note 1, 78 Bus. Law. at xxx. *See, e.g.,* Goldman Sachs Group., Inc. v. Arkansas Teacher Retirement System, 141 S. Ct. 1951 (2021) (about $13B); Ludlow v. BP, PLC, 800 F.3d 674 (5th Cir. 2015) (about $60B).

[26] *See* Dura Pharmaceuticals, Inc. v Broudo, 544 U.S. 336 (2005).

[27] The problem is compounded by the ambiguity inherent in the idea of transaction causation (and thus the FOTM doctrine). Although transaction causation seems at first to

To be sure, a rule requiring literal price inflation purports to limit claims to literal price inflation. But the rationale for the rule is that there is no general duty of disclosure. As the above example purports to show, a company that chooses to speak to the market when it is not required to do so should not be held liable for misspeaking (and merely confirming what the market already thinks) when it *could* have remained silent. But (again) this logic depends on the idea that the company could have remained silent. It does not apply where the company is obliged to speak (whether by law or circumstance).[28] It follows that plaintiffs will seek to argue that the defendant company was somehow duty-bound to speak when it did.

As noted above there are many situations in which a duty to speak may arise. Aside from the obvious (such as required filings with the SEC and other government agencies), a company may be obligated to correct earlier statements that have become untrue or to address rumors that may have arisen from company sources.[29]

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refer to somehow triggering an investor decision to buy or sell, it could just as easily refer to causing the transaction to be done at the wrong price (on the assumption that the transaction was going to happen anyway). *See* Ludlow v. BP, PLC, 800 F.3d 674 (5th Cir. 2015) (discussing distinction between claim based on mere pricing versus claim based on decision to buy at all). Note that the FOTM doctrine appears to be based on the assumption that investors will buy and sell for their own varying reasons and that the courts need not consider individual cases (even though the FOTM doctrine allows for rebuttal based on such individualized reasons). The problem is further compounded by the very idea of fraud, which falls somewhere on the border between tort (with consequential damages) and contract (with more limited benefit-of-the-bargain remedies at most). *See* Frank H. Easterbrook & Daniel R. Fischel, *Optimal Damages in Securities Cases,* 52 U. Chicago L. Rev. 611, 639-44 (1985) (suggesting that scienter requirement might justify recovery for entire loss suffered by buyers as opposed to some lesser measure such as one based on mispricing). These ambiguities together with the convenience of readily ascertainable (concrete) market prices may naturally incline the courts to place the burden on defendants to argue for some lesser measure of damage. *Cf.* Goldman Sachs Group., Inc. v. Arkansas Teacher Retirement System, 141 S. Ct. 1951 (2021) (burden on defendant to prove (complete) lack of price impact).

[28] It may be that the fact that a company chooses to speak acts as presumptive trigger for a duty to speak. This is not necessarily bad way to impose duty to disclose. If the company chose to speak, it must have determined that it was required to speak. It is akin to ratification in agency law, where after-the-fact affirmation of authority is deemed to amount to authorization in the first place. *See* Restatement (Third) of Agency § xxx.

[29] *See* In re Time Warner, Inc. Securities Litigation, 9 F.3d 259 (2d Cir. 1993) (discussing duty to update and duty to correct). For notable examples of situations in which companies were arguably compelled to respond to outside information, see Matrixx Initiatives, Inc. v. Siracusano, 563 U.S. 27 (2011) (negative television reports about company product); Basic, Inc. v. Levinson, 485 U.S. 224 (1988) (merger rumors). Moreover, it is quite common for voluntary statements to be included in required SEC filings (for example). *See, e.g.,* Goldman Sachs Group., Inc. v. Arkansas Teacher Retirement System, 141 S. Ct. 1951 (2021). Does such a voluntary statement thus become one as to which an affirmative duty

Again, even those scholars who favor a literal price inflation rule have argued that a claim for price maintenance should nonetheless lie where failure to speak would have resulted in a decline in price.[30] For example, if a company has made it a practice to confer with analysts before announcing earnings and then cancels a scheduled call, analysts might well conclude that the company is likely to announce disappointing earnings and that stock price will fall. So the company might hold the call anyway and reassure analysts that all is well. But how really does that situation differ from voluntarily speaking to the market? The point is that a plaintiff can always *argue* that the company was effectively compelled by circumstances to speak (or that the speech added something to the total mix of information available to the market).[31]

In short, it would make little or no difference in terms of stating a claim whether the law required literal price inflation other than to eliminate a very few cases in which the plaintiff cannot make a colorable argument for a duty to speak – to update or correct.[32] But it would make a huge difference to the amount that could be claimed if claims were limited to literal price inflation. Since most claims can be cast as duty-to-speak cases, most claimants will be able to argue for a measure of damages based on the full loss suffered upon corrective disclosure.

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of disclosure applied? Thus, one subtle reason for recognizing price maintenance claims is avoiding the need to litigate the issue whether a particular statement was truly voluntary. Note the requirement that forward looking statements be included in a filed document.

[30] *See* Fox & Mitts, *supra* note 1, 78 Bus. Law. at xxx.

[31] *See* In re Vivendi SA Securities Litigation, 838 F.2d 223 (2d Cir. 2015) (where the court suggests that price inflation might have dissipated in the absence of statements tending to maintain the situation). Note that a similar (questionable) argument was made in *Time Warner* in relation to the company's motive to cover up its plans for an unusual rights offering. Specifically, plaintiffs argued that the company sought to keep stock price as high as possible so that it would not fall too low when the truth came out. *See* In re Time Warner, Inc. Securities Litigation, 9 F.3d 259 (2d Cir. 1993).

[32] *Cf.* Goldman Sachs Group., Inc. v. Arkansas Teacher Retirement System, 141 S. Ct. 1951, at *19 (2021) (noting that in vigorously litigated cases burden matters only when evidence is in equipoise).

The Requirement of Loss Causation

The focus above has been on the duty to speak and the duty (if any) to speak the truth. As we have seen, the case for requiring literal price inflation is logically strong but practically weak. Thus, the real controversy appears to be the measure of the harm from fraud, in other words, loss causation.

Federal securities law limits recovery for fraud to the amount of the buyer (or seller) loss caused by the fraud.[33] But this standard begs the most important question: How much of buyer loss is really caused by the fraud?

One could argue that buyer loss is equal to the difference between the price paid and the price that prevails after the truth comes out. But this measure of loss is very different from the difference in price that would have obtained at the time of purchase.[34] Again, buyers will presumably argue that they would not have bought the subject stock *at all* if they had known the truth and thus that the fraud caused the entire loss they suffered.

In theory, the courts could address the question of loss causation early in the course of litigating a case – perhaps in connection with a motion to dismiss – as effectively happens with the question whether price maintenance will suffice to state a claim. But there is no obvious way to disprove loss causation short of trial on the merits. Indeed,

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[33] *See* Exchange Act 21D(b)(4). In addition, Exchange Act §21D(e) provides that "*** in any private action arising under this title 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 or sale price paid or received, as appropriate, by the plaintiff for the subject security 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."

[34] This is not a newly discovered issue for securities litigation. It was described (in a way) nearly forty years ago by Frank Easterbrook and Daniel Fischel in their seminal 1985 article on damages in securities cases. *See* Frank H. Easterbrook & Daniel R. Fischel, *Optimal Damages in Securities Cases,* 52 U. Chicago L. Rev. 611, 639-44 (1985). They saw the problem – *in a way* – because the problem they saw in cases arising from open market trades (as opposed to new offerings) was the mismatch between the gain for the company (if any) and the loss to buyers. In other words, they saw that companies might misspeak to the market when there was little or nothing to gain and that buyers might be able to sue the company for coincidental losses while sellers who sold at inflated prices could keep the gain. Although Easterbrook & Fischel recognized the problem, they had no good solution to offer. They understood that if liability lies in such cases – which nowadays account for almost all SFCAs – buyers would be over-compensated and companies would be over-deterred by the prospect of full recovery – and companies would be discouraged from speaking voluntarily to the market. But they reckoned that the need for plaintiffs to prove scienter would limit the number of such cases and that over-compensation would operate (somewhat appropriately) as a form of punitive damages. In short, they punted. Thus, Easterbrook & Fischel did not really see or anticipate problems with event-driven actions, but they did intuit the same problem of overcompensation.

SCOTUS has clearly ruled that loss causation is a common question of fact for the jury and not one that must be established in order to achieve class certification.

Proximate Cause

The central question is one of proximate cause: How much of the loss suffered by the plaintiff was really caused by the fraud and how much is just too remote.[35] The problem of proximate cause is among the most basic and familiar issues arising in the law. It has bedeviled first-year law students since the time of Langdell because it is ultimately as insoluble as the question how many angels can dance on the head of a pin.[36] It is further complicated in the context of securities fraud because it is deceptively easy to measure investor loss. But as shown here, investor loss can be measured in more than one way. To label the question as one of proximate cause is no answer.

Ironically, the *question* whether courts should require literal price inflation or whether price maintenance will suffice to state a claim for fraud may provide an *answer* to what we mean by loss causation in the context of a securities fraud class action. As noted above, both theories may be seen as attempting to determine mispricing at the time the buyer buys (or the seller sells). While the question remains whether price maintenance should suffice, there seems to be no question that the ultimate issue is how much too much did buyers pay when they bought.

To return to the BP example the question should be: How much too much did plaintiff investors pay when they bought BP stock while the fraud was ongoing – after the misrepresentation was made but before the truth came out. It is likely that the price difference at the time of investor purchase would have been minimal – that the price of BP stock might have been a few cents lower if the company had been 100% truthful about the improvements to its safety practices. Or it might have made no difference at all.[37] In any case, most of the loss flowed (so to speak) from the event itself.

Moreover, that loss would have been suffered fraud or no fraud. And it would have been suffered by all BP stockholders – both those who bought during the fraud period and those who held their shares from before – legacy stockholders. If the company had been truthful about its policies and practices and the market had known how the company was likely to act (or not), the market could have adjusted stock price accordingly. Again, the merits of the action (or inaction) are completely irrelevant. The

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[35] *See* Dura Pharmaceuticals, Inc. v Broudo, 544 U.S. 336, 342-48 (2005); Ludlow v. BP, PLC, 800 F.3d 674, 682 (5th Cir. 2015).

[36] *See* Palsgraf v. Long Island R. Co., 248 N.Y. 339 (1928) (absolving defendant railroad of liability to the plaintiff who was injured in a bizarre chain of events). *See supra* note 27 (noting tension between contract and tort in the law of fraud).

[37] *See* Richard A. Booth, *Loss Causation and the Materialization of Risk Doctrine in Securities Fraud Class Actions,* 75 Bus. Law. 1791 (2020). See also infra text at note xxx.

only loss caused by this deception is the difference in market price (if any) that would have resulted if the market knew the truth. But deception does not cause the loss that flows from the action (or inaction). This seems obvious when one thinks about it: The fact that the market was misled about some policy or practice (or specific act) does not *cause* the loss that flows therefrom. Indeed, it is difficult NOT to see the distinction once one does see it. It is quite silly (ungrammatical even) to say that misrepresentation *caused* the Deepwater Horizon disaster. It might have been caused by actionable mismanagement. Or it might have been a tragic accident. But it was *not caused* by anything BP said to the market.[38] In contrast, deception can in fact *cause* mispricing – quite literally.

Fraud on the Market

Yet another reason to think that buyer (or seller) recovery should be limited to mispricing at the time of trade can be found in the fraud on the market (FOTM) theory endorsed by SCOTUS in *Basic, Inc. v. Levinson* in 1988.[39] Under FOTM, it is presumed that investors rely on the integrity of the market price when they trade in stocks for which the market is shown to be efficient. Thus, plaintiffs need not prove reliance individually to prove a claim under Rule 10b-5. Rather, reliance is presumed if the subject stock is shown to be traded in an efficient market. The presumption permits the claim to be litigated as a class action. But the presumption can be rebutted if it is shown

[38] *Cf. supra* text at note 26 ff (discussing statutory requirement that causation be proved). To be sure, the blowout and spill might not have occurred if the company had acted consistent with its public statements (if in fact it did not do so). But that does not mean that the deception *caused* the loss. On the other hand, one might argue – consistent with the adage that sunshine is the best disinfectant – that disclosure is intended in part to prevent managers from actions for which they might feel ashamed. In that sense, one might say that deception is part of the causal chain in the sense that deception is a necessary part of the action – a but-for cause as it were. But if that is the argument one must at least show that the action is such that no one would likely undertake it without lying about it. *Cf.* Omnicare, Inc. v. Laborers Dist. Council Constr. Indus. Pension Fund, 135 S. Ct. 1318 (2015); Virginia Bankshares, Inc. v. Sandberg, 501 U.S. 1083 (1991) (both holding that a statement couched in terms of opinion or belief may be treated as a statement of fact based on duty of speaker to gather and digest underlying facts); Retirement Plans Committee of IBM v. Jander, 140 S. Ct. 592 (2020) (requiring pleading that fiduciary could not have decided in good faith not to purchase shares known to be overpriced). Indeed, *Goldman Sachs* itself may be seen a similar case in that the central allegation is that the firm claimed to be an (especially) ethical company, which begs the question as to what that means. One answer (I suppose) is that no ethical company would have done what Goldman Sachs did in that case (to create a security that was likely to lose value). But it is not clear that one counter-example would or should suffice render the generalization false.

[39] Basic Inc. v. Levinson, 485 U.S. 224 (1988).

that the subject stock was not (in fact) mispriced at the time buyers bought.[40] Thus, there can be no class action in the absence of *price impact* – if the subject stock was not mispriced when buyers bought. SCOTUS has said so quite clearly.[41]

It is tempting to jump to the conclusion a class claim should be limited to the extent of mispricing at the time of trade. But it is also clear that individual investors may still seek to recover individually – even in the absence of price impact – if they relied on some statement of material fact that turned out to be false, and that they would never have bought the subject stock but for the false statement, and that (therefore) they should be made whole to the full extent of the loss they suffered.[42] If an individual plaintiff can

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[40] As stated in *Basic* itself, the presumption may be rebutted if (for example) market makers knew the truth and priced the stock without regard to the allegedly false statement. *See* Halliburton Co. v. Erica P. John Fund, Inc., 573 U.S. 258 (2014) (Halliburton II). The presumption may also be rebutted if shown that plaintiff *did not* rely. *See, e.g.,* GAMCO Investors, Inc. v. Vivendi Universal, SA, 838 F.3d 214 (2d Cir. 2016) (affirming finding that FOTM presumption of reliance on market price had been rebutted as to plaintiff class member who followed proprietary strategy to determine mispriced stocks).

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

[42] *See* Ludlow v. BP, PLC, 800 F.3d 674, 682 (5th Cir. 2015). SCOTUS has come close to saying that for a fact to be material it must affect market price in some way. See Halliburton II, 573 U.S. at 283, quoting Halliburton I, 563 U.S. at 813, *supra* note 47. To be precise, SCOTUS has ruled a fact is material if it would be important to a reasonable investor in deciding whether to trade or how to vote. See Basic Inc. v. Levinson, 485 U.S. 224 (1988); *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438 (1976). Similarly, SCOTUS has also held that to be material a fact must be capable of making a difference to the outcome. *See* Virginia Bankshares, Inc. v. Sandberg, 501 U.S. 1083 (1991); Santa Fe Industries v. Green, 430 U.S. 462 (1977). *See also* Dura Pharmaceuticals, Inc. v Broudo, 544 U.S. 336 (2005), *supra* note 26 (holding that price must change upon corrective disclosure for claim to obtain). But SCOTUS has also said unequivocally that materiality is a common question that must be resolved at trial (or maybe on a motion for summary judgment if there is no dispute as to fact). *See* Amgen Inc. v. Connecticut Retirement Plans and Trust Funds, 568 U.S. 455, 460-461 (2013). On the other hand, one can imagine a situation in which a false statement causes a large number of investors to buy and an equally large number of investors to sell such that stock price is unaffected.

To be clear, a fact need not be so important that it would change the outcome. But presumably it must have been sufficiently important to affect the decision of some investors. *Cf.* Mills v. Electric Auto-Lite Co., 396 U.S. 375 (1970) (rejecting definition of materiality as a fact that merely *might* matter to investors). Thus, it seems fair to say that to be material a fact must have had *some* effect on price (or some votes). As SCOTUS states in Halliburton II, 573 U.S. at 279:

> By requiring plaintiffs to prove price impact directly, Halliburton's proposal would take away the first constituent presumption. Halliburton's argument for doing so is the same as its primary argument for overruling the *Basic* presumption altogether: Because market efficiency is not a yes-or-no proposition, a public, material

prove that the fraud caused the whole of their loss, why cannot a class of plaintiffs do so as well?

So the requirement of price impact to maintain a class action does not quite preclude the argument that fraud causes the entire loss even in the context of a class action. If plaintiffs can show some price impact – however minimal – the action may proceed as a class action. In other words, it appears that any price impact is enough to permit a SFCA to be certified. The further question of how much of the loss was caused by the fraud is a quite separate question for another day (of trial). There is no conclusive reason that a court could not permit plaintiffs to prove that the loss they suffered from fraud was some larger amount than the (initial) price impact of the misrepresentation. Consistency is the hobgoblin of little minds.[43]

Still, it is difficult to see how one could or should be able to recover if one paid a fair price at the time of trade. Everyone knows that stocks rise and fall in price as new information comes out. Moreover, even if we allow for some investors to make such claims, we know that many (if not most) investors rely solely on the integrity of the market and market prices. To wit: As much as half of all stock is held by index funds that buy and sell stocks in proportion to market capitalization and thus based solely on changes in share price relative to other stocks. So we know that index fund investors cannot claim to be harmed to any extent beyond mispricing at the time of trade.[44]

> misrepresentation might not affect a stock's price even in a generally efficient market. But as explained, *Basic* never suggested otherwise; that is why it affords defendants an opportunity to rebut the presumption by showing, among other things, that the particular misrepresentation at issue did not affect the stock's market price. For the same reasons we declined to completely jettison the *Basic* presumption, we decline to effectively jettison half of it by revising the prerequisites for invoking it.

As such, materiality would seem to be an inherently statistical question.

[43] Thank you, Ralph Waldo Emerson.

[44] This is not merely a commonsense assertion about how index funds behave. A quick look at a prospectus for any such (true) index fund reveals that holdings are adjusted regularly based solely on market capitalization. *See* Richard A. Booth, *The Duty to Diversify and the Logic of Indexing,* 75 UC L. J. (Hastings) xxx (2024). *See, e.g.,* Ludlow v. BP, PLC, 800 F.3d 674, 682 (5th Cir. 2015) (discussing possibility that some buyers might claim that they would not have bought the subject stock at all but for the misrepresentation whereas others might claim merely that the stock was mispriced thus requiring individualized inquiry and rendering class action certification inappropriate). Thus, one might say that FOTM is as much about class action law as I is about securities law.

Procedure to the Rescue

While the argument that mispricing at the time of trade should be the standard of recovery in a securities fraud class action IS almost irrefutable, the question remains how one might convince the courts so to rule at a stage in the proceedings that is early enough to matter. Few SFCAs ever go to trial. Most such actions settle if they survive a motion to dismiss and are certified to proceed as a class action. And the reason they settle is that the ultimate damage award may be so large as to threaten the very survival of the defendant company. In short, confusion about the measure of damages (and loss causation) is the central problem with SFCAs. The only way to fix the problem is to establish how much is really at stake and to do so early in the course of litigating the case.

SCOTUS has clearly ruled that loss causation is a matter of merits to be resolved at trial (or possibly on motion for summary judgment if there is no dispute of fact).[45] But loss causation arises late in the logic of process.[46] It seems only natural to determine first whether a fraud has occurred and only then to determine the loss. So it is unlikely that a court would ever rule early on that an alleged misrepresentation did not cause the loss suffered by buyers (or sellers) who can always argue that they will prove the matter at trial. But SCOTUS has also ruled that a defendant may rebut the FOTM presumption – and thus defeat class certification – by showing that the alleged misrepresentation did not affect market price – by showing lack of price impact.

Again, price impact is not necessarily the same thing as loss causation. Neither is it the same thing as materiality. Rather, price impact has evolved from the requirement to show market efficiency in order to have the FOTM presumption of reliance apply. As SCOTUS itself has stated in distinguishing price impact from materiality:

> Price impact is different. The fact that a misrepresentation "was reflected in the market price at the time of [the] transaction" – that it had price impact – is "*Basic*'s fundamental premise." [47]

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[45] Erica P. John Fund, Inc. v. Halliburton Co., 563 U.S. 804 (2011) (Halliburton I).

[46] To recover damages for violations of section 10(b) and Rule 10b-5, a plaintiff must prove (1) a material misrepresentation or omission by the defendant; (2) scienter; (3) a connection between the misrepresentation or omission and the purchase or sale of a security; (4) reliance upon the misrepresentation or omission; (5) economic loss; and (6) loss causation. Amgen Inc. v. Connecticut Retirement Plans and Trust Funds, 568 U.S. 455, 460-461 (2013) (quoting Matrixx Initiatives, Inc. v. Siracusano, 563 U.S. 27, 37-38 (2011)). It is curious that the Court lists loss causation after economic loss. *Cf.* Eisen v. Carlisle & Jacquelin, 417 U.S. 156 (1974) (precluding preliminary trial on merits for purposes of class certification).

[47] Halliburton II, 573 U.S. at 283, quoting Halliburton I, 563 U.S. at 813.

In other words, if a misrepresentation does not affect market price at the time the buyer buys, there is nothing on which all buyers as a class can have relied and there can be no *class* claim. The issue is the presumption of reliance and class certification. To be sure, *individual* buyers may nevertheless seek to prove that they relied on the misrepresentation and would not have bought the stock at all if they had known the truth (as opposed to the claim that they paid a too high price when they did buy). But such a claim cannot proceed as a class action because such reliance must be proved by each buyer.

The Logic of Event Studies

The usual way of showing price impact – or the lack thereof – is by means of an event study demonstrating correlation between corrective disclosure and a statistically significant change in stock price.[48] The standard practice with such event studies is to net out company-specific changes in price from background changes in market-wide and industry-wide prices. For example, if the defendant company's stock price falls by 10% upon corrective disclosure, but the S&P500 falls by 5% on the same day, then no more than 5% of the price change for the defendant company can be attributed to fraud.[49]

In addition, one must consider the specific volatility of the defendant company's stock.[50] Suppose the company's stock is 20% more volatile than the market as a whole – that it has a beta coefficient of 1.20. Then such stock would be expected to fall by 6% if the market falls by 5% even in the absence of any special news about the company. Thus, no more than 4% of out of the 10% decrease can be attributed to fraud.

It is also possible that the defendant company's industry (line of business) has been specially affected by some development (such as the prospect of new regulations) that causes stock prices of all companies in the industry to fall. So if industry prices fall by (say) 7% on the day of corrective disclosure, one must net out such changes as well –

[48] SCOTUS has never said that an event study is required to show price impact or any other matter of fact that must be proven in the context of a securities fraud claim. Nor has any other court done so. The most that can be said is that it is standard practice to show price impact by means of an event study and that it is unlikely that a class action can be certified in the absence thereof. Moreover, SCOTUS has said that a court can use common sense approaches as well to address such questions. *See* Goldman Sachs Group., Inc. v. Arkansas Teacher Retirement System, 141 S. Ct. 1951 (2021). *See also* Partnoy, *supra* note 12 (discussing implications); Langevoort, *supra* note 2 (noting alternatives).

[49] This example assumes that the defendant company as well as the industry collectively has the same volatility as the market. *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) (discussing comparison to industry index among other things).

[50] *See* id.

which changes must also be adjusted for the specific volatility of defendant company's stock. Assuming a beta of 1.00 for the industry, the 7% decrease becomes 8.4% adjusted for the beta of the defendant company. Thus, no more than 1.6% of out of the 10% decrease can be attributed to fraud.

Finally, one must consider the random movement of stock price – changes that occur in the absence of any news at all about the defendant company. Suppose that defendant company stock often moves up or down by as much as one percent for no discernible reason. If so, no more than 0.6% of the 1.6% net drop above can be attributed to fraud.[51]

Extending the Logic

The logic of event studies – that only a change in stock price *net* of background changes for other identifiable reasons – is not limited to market-wide or industry-wide changes in price. It also can apply to other potential intervening factors.

Suppose on the same day as corrective disclosure an utterly unrelated event causes a further decrease in stock price. For example, suppose a major customer of the defendant company announces it will not renew its contract with the defendant and instead will rely on a competitor vendor. As a result, defendant company profits can be expected to decrease by 2% -- which translates into a 2% decrease in stock price. Assuming all the facts above, this additional 2% drop (together with other adjustments) more than explains the original 10% decrease in price and thus would seem to preclude class certification.[52]

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[51] To be precise, the general rule is that the change in price must be sufficiently dramatic that it would occur no more than 5% of the time in the absence of company-specific news. In other words, it would be 95% certain that company-specific news (such as corrective disclosure) caused the price change.

Again, price impact is not the same thing as loss causation. Price impact is no more than a hurdle to be cleared for the FOTM presumption to apply. Presumably, *any* provable impact is enough to permit the action to proceed as a class action and to permit plaintiffs to prove their claims − which may be for the full amount of their loss. Thus, the defendant company presumably must show that there was zero price impact in excess of changes that can be explained by factors other than fraud. *See* Goldman Sachs Group., Inc. v. Arkansas Teacher Retirement System, 141 S. Ct. 1951 (2021) (burden on defendant to prove (complete) lack of price impact).

[52] *See* Archdiocese of Milwaukee Supporting Fund, Inc. v. Halliburton Co., 597 F.3d 330, 336 (5th Cir. 2010), *vacated and remanded sub nom.,* Erica P. John Fund, Inc. v. Halliburton Co., 563 U.S. 804 (2011) (Halliburton I) (discussing implicitly need to net out other causal factors).

Before *Halliburton II,* it was not clearly permissible for defendants to offer any *direct* evidence relating to price impact.[53] And by the word *direct,* SCOTUS seems to mean evidence that the alleged misrepresentation did or did not affect market price. Rather, litigants were limited to presenting evidence for the purpose of showing that the market for the subject stock was efficient – that it reacted to company-specific news – news *uniquely* about the defendant company. Accordingly, the evidence might be about any number of examples *other than* corrective disclosure relating to the alleged fraud.[54] But as SCOTUS ruled in *Halliburton II,* it makes little sense to exclude such (direct) evidence simply because it may show that the fraud did not affect market price since the very premise of the FOTM theory is that if market price is affected *by the fraud* reliance can be presumed.[55]

The obvious implication of *Halliburton II* is that defendants will seek (in effect) to disprove loss causation in the context of a class certification motion by showing that the alleged misrepresentation did not affect market price at the time buyers bought. One way to do so is to show that the price decrease upon corrective disclosure is attributable to other factors. For example, BP might have argued that the price decrease was wholly attributable to the prospect of its spending billions of dollars to clean up the oil spill and to settle related litigation. Indeed, as noted above, the ultimate cost was about $63B, which was almost exactly equal to the $62B loss in market capitalization from the stock price decrease following the Deepwater Horizon event.[56] The implication is that the (prospective) cost of cleanup accounts for the entire buyer loss and that the alleged misrepresentations about improved safety practices had no discernible price maintenance effect.

For another example, in the still pending *Goldman Sachs* case, the defendant company might have argued that the drop in its stock price was wholly attributable to the SEC enforcement action (which entailed a $550B fine and significant legal expenses attendant thereto) and the prospect of somewhat curtailed operations going forward because of enhanced SEC scrutiny. Again, it would not be surprising to find that the

[53] Halliburton II, 573 U.S. at 282-83.

[54] Thus, before *Halliburton II,* a class action could be certified even though the fraud itself appears not to have affected market price and the action is doomed to fail based (for example) on several *other* instances of price impact from the disclosure of company specific news (as noted by SCOTUS itself).

[55] The Court does not discuss cases where good news is mixed with bad news. But it does hint at the possibility that news may cause some to sell and some to buy, noting that such cases are likely to be quite rare.

[56] *See supra* note 23.

23% loss in value for GS was wholly attributable to factors other than alleged price maintenance from GS statements about its ethical culture.[57]

And for yet another example, Halliburton argued that the price decrease was attributable to new information about the prospect of liability for asbestos claims as a result of several sizable judgments it suffered and not to any misrepresentation as to the adequacy of reserves it had established against such claims.[58]

Before *Halliburton II,* plaintiffs could rely on any significant price change on the day of corrective disclosure for the narrow purpose of showing that the subject stock was efficiently priced – even if most (or all) of the change was attributable to the event constituting the disclosure and was not about adjustment for mispricing at the time the buyer bought. But an event study can show only that stock price was uniquely affected by the news – that the effects were company-specific. It cannot show which of various coincident company-specific factors caused what portion of the loss.

Halliburton II holds that defendants must be afforded the opportunity to prove that the alleged misrepresentation did not affect market price – and thus to defeat class certification. Presumably, if an event – whether an oil spill, or SEC enforcement action, or increased prospects for asbestos liability – can be shown to explain the *entire* price decrease, there can be no mispricing on which buyers could have relied, and there can be no class action.[59]

Needless to say, plaintiff lawyers were fond of things as they stood before *Halliburton II* since they could rely on the whole of the change in price for the subject stock as evidence of price impact and could (consistent therewith) claim economic loss equal thereto.[60] After *Halliburton II,* defendants can argue that some (or all) of the price

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[57] See Richard A. Booth, *What's a Nice Company like Goldman Sachs Doing in a Place like the Supreme Court? How Securities Fraud Class Actions Rip Off Ordinary Investors – And What to Do About It,* 66 Villanova L. Rev. Tolle Lege (July 8, 2021) (note 17).

https://www.villanovalawreview.com/article/25470-what-s-a-nice-company-like-goldman-sachs-doing-in-the-supreme-court-how-securities-fraud-class-actions-rip-off-ordinary-investors-and-what-to-do-abo

It is curious that GS did not make the argument from other causes.

[58] *See* Archdiocese of Milwaukee Supporting Fund, Inc. v. Halliburton Co, 597 F.3d 330 (5th Cir.), *vacated and remanded sub nom.* Erica P. John Fund, Inc. v. Halliburton Co., 563 U.S. 804 (2011) (Halliburton I). *See also* Wielgos v. Commonwealth Edison Co., 892 F.2d 509 (7th Cir. 1989).

[59] To be clear, plaintiffs may still rely on the whole of the price change to show that the stock is efficiently priced. But the defendant must be permitted to show that the price change was caused by factors other than the alleged fraud.

[60] *See* Langevoort, *supra* note 2.

change can be explained by events other than corrective disclosure of the original misrepresentation. And even if the plaintiffs can show that the stock of the defendant company is efficiently priced by reference to dozens of other events – that it reacts to company specific news – class certification will be precluded if the price impact in connection with the alleged fraud (and event) can be wholly explained by other factors.

What's Fraud Got to Do with It?

The obvious question is how a defendant might go about proving that some of the price change is attributable to factors other than undoing the effects of the misrepresentation. Again, event studies are useless for this purpose. Event studies can show only that stock price was uniquely affected by the news – that the effects were company-specific. An event study cannot show the precise cause of the price change where there is more than one cause.

One possibility is that analysts who follow the company might testify as to how the event affected prospects for the company. Or other analysts might testify as expert witnesses much as valuation experts testify in appraisal proceedings.[61] But suppose the defendant proves that (say) 90% of the price change can be explained by factors other than the fraud. Presumably, the remaining 10% is attributable to fraud. Does the claim survive even if that 10% drop is within the range of random price fluctuation for the stock and would flunk the test for statistical significance? [62]

Such was the apparent result in *Goldman Sachs* where the Court held (in effect) that any price impact from fraud would suffice for purposes of certification.[63] If defendants can prove other than by event study that some of the price impact derives from non-fraud factors, then plaintiffs must certainly be afforded the same leeway to prove that some portion thereof was attributable to fraud. And if so, it is difficult to imagine a situation in which a colorable case cannot be made sufficient to withstand a motion for summary judgment.

If the case survives and goes to trial, plaintiffs will be free to claim compensation for their entire loss. The fact that price impact was minimal does not preclude the argument by plaintiffs that their entire loss was caused by the fraud. Buyers can argue that but for the fraud, they would not have bought the subject stock rather than some other stock.[64]

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[61] *See* Partnoy, *supra* note 12.

[62] See supra note xxx.

[63] *See* Goldman Sachs Group., Inc. v. Arkansas Teacher Retirement System, 141 S. Ct. 1951 (2021). *See also* Halliburton II, 573 U.S. at 284 (concurring opinion by Ginsburg).

[64] Note that index investors buy stocks based on market capitalization.

Indeed, the argument is somewhat stronger because of the idea that reliance equates to *transaction causation* (as SCOTUS itself has said more than once).[65] If the fraud *induced* the trade – by causing an investor to buy a stock that the investor would not have bought *but for* the fraud – the buyer should recover in full, especially in light of the scienter requirement.[66] Nevertheless, defendants will argue that the fraud merely altered the terms – say by understating risk factors thus causing the stock to trade at a somewhat inflated price – and that buyers should recover (at most) only for mispricing at the time of trade.[67]

So it might seem that we are back at square one. Defendants will be inclined to settle for fear that plaintiffs will prevail – at least in the absence of a ruling one way or the other as to the correct measure of compensation. And the courts are not likely to decide the question until liability has been established (although there are notable examples to the contrary).[68] But not so fast.[69]

Once it is established that factors other than fraud are involved in the stock price decrease, it is impossible for a court to ignore the nature of claims made by the plaintiff class. For example, in the BP case, most (or all) of the loss can be explained by the prospective cost (broadly defined) of cleaning up the oil spill.[70] But that is a loss that was suffered by all BP stockholders pro rata. More precisely, it is a loss that was suffered by the company (BP) as a result of mismanagement (if anything). As such, the claim for compensation would seem to be derivative. To be sure, buyers might argue that the claim is also direct because they relied on statements to the effect that BP followed best (or at least reasonable) safety practices. So who is to say that buyers do not have an individual (direct) cause of action? [71]

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[65] *See* Halliburton II, 573 U.S. at 286. *See supra* note xxx (discussing ambiguous idea of transaction causation).

[66] *See* Easterbrook & Fischel, *supra* note 34.

[67] *See* Ludlow v. BP, PLC, 800 F.3d 674, 682 (5th Cir. 2015). It is tempting here to refer to the classic distinction between fraud in the inducement and fraud in the execution.

[68] There are a few cases in which courts have addressed damages first (before liability) presumably to determine whether there is any need to address liability at all or to induce settlement. *See, e.g.,* Mills v. Electric Auto-Lite Co., 396 U.S. 375 (1970) (on remand to CA7).

[69] Thank you, Lee Corso.

[70] *See supra* note xxx (discussing BP market capitalization before incident and after cleanup).

[71] Although one can imagine vigorous litigation as to claim character, such a dispute would seem to be preempted by the terms of FRCP Rule 23 (as discussed immediately below). Moreover, the Delaware Supreme Court has recently held (on other grounds) that a claim that can be seen as either derivative or direct must be treated as derivative. *See* Brookfield

Claim Character and Class Actions

As it turns out, there is an easy answer to the question of how to handle a claim that might be seen as both direct and derivative. Rule 23(b)(3) of the Federal Rules of Civil Procedure (FRCP) provides that a class action for damages may be maintained (and thus certified) only if a class action is *superior* to other available methods for the *fair* and *efficient* adjudication of the controversy.[72] In other words, the rule requires a *comparison* between available methods of litigating the case and further requires that a class action for damages be *better* than other ways of dealing with the case. Ties go to any other method of resolution. So if the larger part of a claim – or indeed any part of a claim –

Asset Management v. Rosson, 261 A.3d 1251 (Del 2021). On the other hand, there is some authority that the distinction does not matter in the context of federal securities litigation. *See* J. I. Case Co. v. Borak, 377 U. S. 426 (1964).

[72] The full text of Rule 23(a) and (b) is as follows:

(a) Prerequisites to a Class Action. One or more members of a class may sue or be sued as representative parties on behalf of all only if (1) the class is so numerous that joinder of all members is impracticable, (2) there are questions of law or fact common to the class, (3) the claims or defenses of the representative parties are typical of the claims or defenses of the class, and (4) the representative parties will fairly and adequately protect the interests of the class.

(b) Class Actions Maintainable. An action may be maintained as a class action if the prerequisites of subdivision (a) are satisfied, and in addition:

(1) the prosecution of separate actions by or against individual members of the class would create a risk of (A) inconsistent or varying adjudications with respect to individual members of the class which would establish incompatible standards of conduct for the party opposing the class, or (B) adjudications with respect to individual members of the class which would as a practical matter be dispositive of the interests of the other members not parties to the adjudications or substantially impair or impede their ability to protect their interests; or

(2) the party opposing the class has acted or refused to act on grounds generally applicable to the class, thereby making appropriate final injunctive relief or corresponding declaratory relief with respect to the class as a whole; or

(3) the court finds that the questions of law or fact common to the members of the class predominate over any questions affecting only individual members, and that a class action is <u>superior to other available methods for the fair and efficient adjudication</u> of the controversy. The matters pertinent to the findings include: (A) <u>the interest of members of the class in individually controlling the prosecution or defense of separate actions</u>; (B) the extent and nature of any litigation concerning the controversy already commenced by or against members of the class; (C) the desirability or undesirability of concentrating the litigation of the claims in the particular forum; (D) <u>the difficulties likely to be encountered in the management of a class action</u>. (emphasis added)

can be addressed in a derivative action, it *must* be so addressed. SCOTUS has ruled quite emphatically that the courts must apply the language of the rule literally and must find that a proposed class action meets the requirements specified therein.[73] If we actually apply the language of the rule in the context of an event-driven action, the argument for litigating the claim as derivative action (rather than direct) is irrefutable.[74]

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[73] *See* Comcast Corp. v. Behrend, 569 U.S. 27 (2013); Wal-Mart Stores, Inc. v. Dukes, 564 U. S. 338 (2011).

[74] It can be tempting to dismiss such thundering commands from SCOTUS as prompted by worry that the rationale for the decision itself is somewhat tenuous. But as exemplified here, the language of the rule is really quite instructive (even if it does favor my thesis in favor of derivative actions). Moreover and more important, there can be little doubt that the framers of the FRCP meant for every word of a rule to matter. But even if the superiority requirement originated with some compromise among the framers, it serves to acknowledge the costs associated with class actions (as discussed further immediately below) and to emphasize the need to consider alternative modes of litigation. That need does not go without saying. In the absence of any such requirement, the judge who must certify a class action might do so simply for lack of any reason *not* to do so (subject only to review based on abuse of discretion). Although I originally prepared to defend my thesis as based on one word in Rule 23(b)(3) – *superior* – it turns out that the argument is bolstered by the further reference to *fair and efficient* adjudication, which is not to mention the identification of other (presumably nonexclusive) factors to be considered that seem almost tailored to the question (in particular difficulties likely to be encountered in the management of a class action). I do not mean to suggest that the framers of Rule 23 anticipated the problems that might evolve with event-driven securities fraud claims (although some of them might have done so). But I am awed by how the process of legal reasoning inspired by the common law tradition can verge on a mystical ability to deduce the correct answer to such a complex question of process as whether a claim is direct or derivative. *Cf.* Desimone v. Barrows, 924 A.2d 908 (Del. Ch. 2007) (opinion by Strine discussing derivation of decision by careful application of principles of fiduciary duty applicable to directors). Still, despite the text of Rule 23 and the compelling logic thereof, no rule applies itself. Even with a rule as carefully crafted as Rule 23, someone must make the argument that a derivative action is superior. Moreover, it might be argued in response that if the rule really meant that derivative actions should trump class actions, someone would have noticed so by now. *But see infra* text at note xxx (discussing market failure).

Moreover, it almost goes without saying that representative actions – such as class actions and derivative actions – do not *belong* to the plaintiff first to file or to any other individual plaintiff for that matter. Indeed, this is particularly true of SFCAs in which the court (under PSLRA) must determine who should serve as lead plaintiff. *See generally* Richard A. Booth, *Who Owns a Class Action?* 58 Villanova L. Rev. Online: Tolle Lege 21 (2013). *See supra* note xxx.

Efficient Adjudication

But wait. There's more. Not only is a derivative action a viable alternative to a class action – and thus to be preferred under the rule – a derivative action is clearly more efficient than a class action since the claim is made on behalf of a single collective plaintiff – the corporation. There is no need to decide how to define the class, who is a member thereof, or who is entitled to what portion of the recovery. The company recovers and the stockholders benefit pro rata. In short, there is no need to certify that the action is appropriate to be litigated as a derivative action. Thus, a derivative action is not merely a viable alternative to a class action, a derivative action is itself superior to a class action in terms of efficiency.[75]

Moreover, recovery by the corporation mitigates the loss suffered by buyers. Under the extant approach, buyers routinely seek compensation for the entire loss between the price paid and the price following corrective disclosure. But if the company recovers, stock price should recover proportionally.

Finally, scholars generally agree that the loss from fraud should be measured by mispricing at the time the buyer buys. Some argue that it must take the form of literal price inflation. If so, it is easy enough to measure the loss. But if we measure the loss by the change in price upon corrective disclosure, it is not clear how to separate out the loss from mispricing from the loss attributable to the event itself – which is likely to be the much larger part of the loss. Here again, a derivative action addresses the problem: Once we determine the derivative loss, the remaining loss must be attributable to price inflation. Whatever part of the loss is not derivative (if any), must be direct.[76]

Fair Adjudication

As for considerations of fairness, there is no way in the context of a securities fraud action to mount a defense as to the wisdom of the business decisions that may have contributed to the loss suffered by the company. How can that be fair? As a matter of securities fraud law, the plaintiff need only plead and prove deception in connection with the action (or inaction) that caused the loss. Whether that action (or inaction) was reasonable as a matter of business judgment is completely irrelevant. All that matters is that the market was misled.

To be completely clear, the point here is not about causation itself. Rather, it is about who gets the *opportunity* to prove or disprove causation. More precisely, it is about the fair adjudication of the controversy as required by the express terms of Rule 23(b)(3) to be considered by the court in certifying a securities fraud action (or any action) as appropriate for class action treatment. In a derivative action, the defendant directors or

[75] Derivative actions have their own peculiar requirements which can be quite elaborate.

[76] *See supra* note xxx.

officers may defend their decisions as protected by the business judgment rule. And even if they fail to do so, they may defend themselves against liability for damages on grounds that their decisions did not in fact cause the loss.[77] In a securities fraud class action, there is no such opportunity: It is irrelevant whether the policy or practice followed by the company (albeit different from that described to the market) was reasonable as a matter of business judgment.

Stated as starkly as possible: If a claim such as the claim against BP arises without any deception, it must be litigated as a derivative claim against those who made the business decisions that caused the loss. The stockholders have no claim against the company because the company suffered a loss. But the company itself might have a claim for compensation (because of an actionably bad business decision). On the other hand, if it happens that buyer-stockholders can find some material misrepresentation about company policies or practices in connection with the action that caused the loss – some such statement that is merely inconsistent with the actions of directors or officers that might have led to the event – there is no need to prove anything about the merits of the decision itself, or its causal connection to the event, to recover for the entire loss they suffer. How can that be fair?

It is doubly unfair when the loss is also suffered by non-buyer (legacy) stockholders who ultimately lose again when the company pays and when those who made the decisions are denied any opportunity to argue for the wisdom of thereof – especially where most of the claim derives from the event as opposed to mispricing.[78] If we compare a class

[77] *See* Barnes v. Andrews, 298 Fed. 614 (S.D.N.Y.1924) (opinion by L. Hand) (it is not enough to prove a breach of the fiduciary duty of care alone, the plaintiff must also prove loss causation)(opinion by Learned Hand). *See also* Francis v. United Jersey Bank, 432 A.2d 814 (N.J.1981) (finding causation in failure to manage where violations were especially obvious and egregious). *Cf.* Smith v. Atlantic Properties, Inc., 422 N.E.2d 798 (Mass.App.1981) (failure to make a decision was itself cause of loss).

[78] No doubt plaintiffs and their attorneys would argue that it is unfair to permit defendants (in effect) to assert a defense that would not be recognized in the context of a securities fraud action where the entire loss is treated as resulting from the fraud. But the fact that those allegedly responsible are afforded an opportunity to defend themselves is no reason to *disfavor* a derivative action, especially given the express requirement under Rule23(b)(3) that the court weigh the fairness of alternative modes of litigating the claim. *See supra* note 33.

Admittedly, the recovery in a derivative action is distributed differently since the company recovers for the pro rata benefit of all stockholders – not just buyers – and recovers a different amount. But that is hardly an argument against proceeding by derivative action. Indeed, it amounts to an argument that the distribution of the recovery in a direct (class) action is part of the problem. In any event (and again), stockholders can diversify. So any rearrangement of recovery will likely wash out over time (if there is any reason to worry about it in the first place).

action to a derivative action – as required by Rule 23(b)(3) – there can be little doubt in the context of a securities fraud claim that a derivative action wins.[79]

The bottom line is that Rule 23(b)(3) compels that such claims be litigated as derivative actions. In other words, if we really think about the fair and efficient resolution of an event-driven claim, it is no contest: The derivative claim must be adjudicated first.

Classic Fraud Claims Reconsidered

The discussion above has focused on event-driven actions (so called) such as *Halliburton*, *Goldman Sachs*, and *BP*. But the analysis applies just as well to ordinary fraud claims such as the one described in the example at the beginning of this article.

Recall that in that example, two identical companies A and B both face identical problems with the FDA. Company A lies to cover up the difficulties, while Company B says nothing. Assume that A's lie does not affect stock price (because it was taken as non-news) and its stock price remains constant. Because B says nothing, its stock price stays constant as well. When the truth is revealed because the FDA takes action, both stock prices drop by the same amount (by the same percentage), producing similar investor losses. Nevertheless, buyers of A stock can recover for their full economic loss

[79] On the other hand, it is true that the precise composition of the body of stockholders who would benefit from a derivative action will differ from those who were harmed in the first place. In other words, the stockholder population during the fraud period (including buyers) will differ from the stockholder population at the time of any derivative action judgment. Those who sell their shares in the interim will miss out on the benefits of recovery, while those who buy in the interim will enjoy a windfall.

It is unclear whether we should find this worrisome since it is true of every derivative action. On the third hand, the prospect of derivative recovery should mitigate the loss suffered by buyers: If the market knows that the company will likely recover from the wrongdoers (or insurance) for any actionable misrepresentation, market price will fall that much less upon corrective disclosure. Moreover and perhaps more significant, market price will not fall because of the prospect of payout by the company in connection with a class action. So in the end is difficult to balance the equities of the two approaches. *Cf. Matsushita Electric Industrial Co., Ltd. v. Epstein*, 516 U.S. 367 (1996) (recognizing res judicata effect of settlement in state court derivative action as against pending federal court class action); *Bangor Punta Operations, Inc. v. Bangor & Aroostook Railroad Co.*, 417 U.S. 703 (1974) (dismissing direct action by corporation against former management where controlling stockholders had bought 97% of outstanding shares subsequent to actions allegedly causing the harm – and thus presumably at a fair price – because as stockholders they could not have maintained a derivative action); Smith v. Waste Management, Inc., 407 F.3d 381 (5th Cir. 2005) (ruling that settlement of Delaware derivative action was *res judicata* with respect to subsequent direct action based on the same facts plaintiff attempted to maintain individual direct fraud claim under Rule 10b-5 that should have been seen as derivative).

under the price-maintenance theory, while buyers of B stock have no claim. But if we require affirmative price inflation, neither class of buyers has a claim.[80]

The problem with this hypothetical is that it cannot happen in the real world. If Company A lies to the market, its stock price will almost certainly fall further (by a larger percentage) than that of Company B after the FDA speaks. For one thing, the market will have lost some trust in the management of Company A and as a result will impose a higher cost of capital (required rate of return) on the stock. For another thing, Company A may be sued by investors who bought the stock during the fraud period, or it may be sued by the SEC in an enforcement action (and may be fined as a result), or both.[81] Thus, Company A stock will almost certainly fall more than company B stock. If not, the market must have concluded that the lie was totally excusable and that there is no danger of legal action.

Moreover and perhaps more important, buyers of Company A stock will need to show that Company A stock fell by more than that of other comparable companies (such as Company B) in order to show price impact. If they cannot do so, then buyers cannot maintain a class action.[82] Thus, the assertion in the example – that Company A buyers can recover but Company B buyers cannot – is wrong for all practical purposes: If the two stocks fall by the amount (percentwise), then no one has a claim – at least no claim that can be litigated as a class action.

But if Company A stock falls further than Company B stock, the question is how much can be recovered by buyers of Company A stock? Should they be able to recover their entire loss? Or should recovery be limited to the loss *in excess* of the loss suffered by buyers of Company A stock?

It is unclear whether buyers of Company A stock should be able to recover for the portion of loss that is equal to the loss suffered by buyers of Company B stock. Why should buyers of Company A stock get to recover for a loss that would have happened

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[80] *See supra* text at note xxx ff. To be clear, if the statement by Company A caused its stock price to increase, buyers at that price would have a claim to the extent of price inflation and possibly to the extent of the entire difference between the price paid and the price following disclosure of the truth.

[81] It is also possible that management of Company B will have lost some trust with the market if investors conclude that they should have spoken when they chose not to do so. But given the facts of the hypothetical, Company B would not be exposed to either SFCA or SEC enforcement action. Note that the SEC need not prove reliance or damages in an enforcement action. Thus, the question whether price maintenance will suffice or affirmative price maintenance must be shown does not arise.

[82] To be clear, an individual buyer might be able to sue by proving reliance – by eschewing the FOTM presumption – and might be able then to claim damages for the entire difference between the price paid and price at which the stock settles after the FDA announcement.

no matter what – fraud or no fraud? Advocates of the price inflation theory would presumably argue that buyers of Company A stock have no claim for that portion of their loss. Still, it is an open question *as a matter of federal securities law* how much of buyers can recover if they can state a claim.

Nevertheless, it is quite clear the excess loss is *derivative* rather than direct. The harm is suffered by the corporation and by all of the stockholders pro rata. In other words, existing (legacy) stockholders are harmed just as much as buyers (whereas it is quite clear that existing stockholders have no claim of any sort simply because of the FDA action.[83] The point is that even in this ordinary run-of-the-mill securities fraud claim, it appears that the only genuine loss is derivative.

Finally, the result should be the same if Company A lied about expected earnings – a truly quintessential fraud claim – rather than about what it knew about the machinations of the FDA. In other words, if we change the example such that Company A lies by saying that it expects to report earnings consistent with projections while Company B remains silent, the analysis is the same as in the FDA example. No one would argue that a stockholder has a claim against a company simply because it reports disappointing earnings. But the example implies that buyer should have no claim unless the lie causes affirmative price inflation. A lie is a lie. There is nothing special about the subject being either external or internal to the company – at least not for these purposes. In short, there is nothing especially special about event-driven claims in this regard. Or one might say that *all* claims are ultimately event driven.

Thus, it turns out that the price-maintenance versus price-inflation debate reveals a completely different issue from the one it has sought to highlight. The point of the example is that buyers of Company A stock are no more deserving of a remedy than are buyers of Company B stock. But the example itself is problematic because there is every reason to think that Company A stock will decrease further to reflect a loss of trust in management and the possibility of litigation and because such claims are clearly derivative in nature. In other words, the debate reveals that the only claims that matter are derivative.[84]

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[83] This assumes (of course) that the FDA action is not some sort of enforcement proceeding based on wrongdoing by the company rather some unexpected turn of regulatory policy as implied by the example. *See, e.g.,* Wielgos v. Commonwealth Edison Co., 892 F.2d 509 (7th Cir. 1989).

[84] Note that the example depends on the existence of two identical companies that can be compared to each other quite easily. In the real world, such situations are rare if not nonexistent. So it is impossible to argue that one group of stock buyers should be treated the same (or differently) from another group of stock buyers. Since side-by-side comparison never happens, the courts need not ever face the question posed by the example. If the complaint alleges simply that Company A lied to the market that is the end of the story.

Who Will Help Me Make the Argument?

Admittedly, the easy answer that derivative claims trump direct claims raises some hard questions: What happens if there is no derivative action pending? Who will make the argument that some of the claim is derivative? The problem is aptly illustrated by *Goldman Sachs,* where the class claim was triggered by an SEC enforcement action and $550M fine against the firm – a classic scenario giving rise to a derivative action against the individual perpetrators as well as the board of directors (for failure to monitor).[85] Why did Goldman Sachs (the firm) fail to make the argument that the claim was derivative and instead rely on a naked assertion that generic statements cannot be material (an almost sure loser)? The obvious answer is that the firm is naturally inclined to circle the wagons against an external foe and disinclined to point fingers at their own – to form up a circular firing squad. In other words, it is hardly surprising that a firm would decline to argue that its own directors and officers are at fault. That is why we have derivative actions.

The class plaintiff would have no interest in doing so and cannot make the argument anyway: The class plaintiff cannot represent both buyers and the defendant firm. Someone else must assert the derivative claim. Moreover, the class plaintiff is likely to oppose the argument and to do so vigorously since the derivative claim reduces the direct claim dollar for dollar.[86]

On the other hand, most securities fraud class actions are accompanied by a parallel derivative action.[87] So the plot thickens: Why – if a derivative action has been joined – is

[85] *See, e.g.,* Stone v. Ritter, 911 A.2d 362, 369 (Del. 2006); Malone v. Brincat, 722 A.2d 5 (Del. 1998). *See also* Pfeiffer v. Toll, 989 A.2d 683 (Del. Ch. 2010) (holding that corporation could recover from individual wrongdoers for reputational harms caused by securities fraud notwithstanding pendency of federal SFCA); Kahn v. Kolberg Kravis Roberts & Co., 23 A.3d 831 (Del. 2011) (abrogating *Pfeiffer* to extent that it held corporation could not recover for insider trading by directors and officers).

[86] Note that a derivative claim covers entire loss suffered by the company, not merely the share of the loss suffered by buyers.

[87] *See* Laarni T. Bulan & Mathtew Davis, *Parallel Derivative Action Settlement Outcomes* (Cornerstone Research 2022); Stephen J. Choi, et al., *Piling On? An Empirical Study of Parallel Derivative Suits,* 14 J. Empirical Legal Studies 653 (2017); Jessica Erickson, *Corporate Governance in the Courtroom,* 51 Wm. & Mary L. Rev. 1749 (2010). On the other hand, the number of large monetary settlements appears to be increasing. *See* Kevin LaCroix, *Largest Derivative Lawsuit Settlements,* December 5, 2014 (updated July 20, 2023).

https://www.dandodiary.com/2014/12/articles/shareholders-derivative-litigation/largest-derivative-lawsuit-settlements/

the derivative plaintiff not motivated to press the case for derivative recovery? Why do derivative plaintiffs almost always eschew monetary recovery (for the company) and settle for governance reforms of dubious value?

The answer is one of market failure: The attorney fees awarded in a class action are likely to be far larger than those awarded in a derivative action – enough larger that a share thereof is likely to exceed the fee for a successful derivative action.[88] So the lawyers for a derivative plaintiff are likely to defer. And derivative plaintiffs are unlikely to object since they cannot recover individually in any event.[89]

Admittedly, the idea that class actions predominate over derivative actions because class actions are more lucrative for plaintiff attorneys is a cynical explanation for the status quo – although it is probably correct. But it begs the question why potential plaintiffs do not do more to fix things – why plaintiffs do not care. Indeed, PSLRA attempted to address the issue (in a way) by providing that the plaintiff with the largest claim should be designated as the named representative plaintiff in a class action (thus preëmpting any race to the courthouse). The idea was that institutional investors – who presumably appreciate the public policy implications of securities litigation – would assume control and would monitor the strategies and tactics of plaintiff attorneys.[90]

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[88] Fee in a derivative action is based on benefit to the corporation which must be determined by the court under Rule 23.1. Fee in a direct action is a matter of agreement between representative plaintiff and law firm as in any contingent fee action. Although the fee must be approved by the court as part of the settlement process under Rule 23, it will likely have been approved in advance because under PLSRA the court must decide who (among competing plaintiffs and law firms) will best represent the plaintiff class. Undoubtedly, the fee will be an important consideration in that process.

[89] There are several other closely related answers. One is that the idea that the company should both pay (in the direct action) and recover (in the derivative action) is too confusing. To be sure, the courts understand the idea of indemnification – that the company might (would) have a claim against the individual wrongdoers if it is held liable (as a company) to buyers in the class action. *See, e.g., Matsushita Electric Industrial Co., Ltd. v. Epstein*, 516 U.S. 367 (1996). But it is less well understood that the company often has a primary claim against the individual wrongdoers that does not depend on the company first being held liable in a SFCA. *See, e.g.,* Pfeiffer v. Toll, 989 A.2d 683 (Del. Ch. 2010) (BFD claim for disgorgement of secret profits from insider trading as well as possible claim for reputational harms). Another possible answer is that the class action must be tried in federal court, which in combination with the supremacy clause may suggest that the class action is somehow more important. Moreover, it is unlikely that Rule 10b-5 will support a derivative action, which implies that any derivative claim must be litigated in state court. *But see* Matsushita Electric Industrial Co., Ltd. v. Epstein, 516 U.S. 367 (1996) (recognizing res judicata effect of global state court settlement with regard to federal SFCA). Finally, and perhaps most important, it is likely that insurance will be depleted by the settlement of a class action and that there will be nothing left with which to settle a derivative action (assuming the derivative action will be litigated second).

[90] *See* Elliott J. Weiss & John S. Beckerman, *Let the Money Do the Monitoring: How 1 Institutional Investors Can Reduce Agency Costs in Securities Class Actions,* 104 Yale L. J.

Things have not quite worked out as planned. With one interesting exception, institutional investors (such as mutual funds) have declined to serve despite their large stakes. One theory as to why is that they fear offending defendant companies who would likely decline to engage with the offending investor by refusing to take calls and meetings to discuss performance – which calls and meetings might sometimes provide valuable inside information.

The one (interesting) exception is that government and union pension funds often do volunteer for duty as representative plaintiffs. Indeed, such entities serve as representative plaintiffs in a large proportion of such cases.[91] But their reasons for doing so are suspect. Such entities may be motivated by the prospect of scoring political points or securing side benefits. Moreover and more worrisome, they may (in effect) be paid to serve. For example, state government pension plans are often administered by elected officials to whose campaign funds plaintiff law firms are free to contribute.[92] The chances are that the recipients of such law firm largesse will be all too happy to let plaintiff lawyers call the shots. So it is unclear that government or union pension funds should be seen as adequate representative plaintiffs as required under Rule 23(a).

Still, there is one category of institutional investors who might be trusted to do the right thing for the right reason. An index fund, which is committed to holding stocks in proportion to market capitalization, has no need to engage with portfolio companies and thus nothing to lose from offending a company by serving as a representative plaintiff. Nevertheless, index funds seldom (if ever) do so. Indeed, they have been criticized for their failure to do their bit to engage with portfolio companies despite the fact that they hold (in the aggregate) more than half of all the stock held by publicly available investment companies.[93] But what the critics fail to note is that it would be a breach of fiduciary duty for index fund managers to use fund assets to such ends. Just as an index fund has nothing to gain from doing research – because it is committed to

2053 (1995); Elliott J. Weiss, *The Lead Plaintiff Provisions of the PSLRA after a Decade, or 'Look What's Happened to My Baby,'* 61 Vand. L. Rev. 543 (2008).

[91] *See* RAB Study. Indeed, such funds were involved as named plaintiffs in all of the primary cases discussed herein: *Goldman Sachs, Halliburton,* and *Ludlow* (BP).

[92] *See* Richard A. Booth, *Stock Drop Preface* (recounting demise of law firms and lawyers who illegally paid individuals to serve as SFCA plaintiffs). To be clear, pension plans are often managed (at least in part) by the same investment advisers who sponsor publicly available mutual funds. But the decision of the pension plan to serve as representative plaintiff is unlikely to reflect on the investment adviser.

[93] *See* Lucian A. Bebchuk & Scott Hirst, *Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy,* 119 Columbia L. Rev. 2029 (2019); Lucian A. Bebchuk & Scott Hirst, *Big Three Power, and Why it Matters,* 102 Boston U. L. Rev. 1547(2022).

investing in proportion to the market capitalization of portfolio companies – an index fund has nothing to gain from kibbitzing with portfolio companies to improve performance. The same logic militates against taking the lead in a SFCA. Moreover, fund managers seem to see the occasional settlement check as free money – a welcome windfall.[94]

The problem is that index funds have failed to understand fully their own interests in this issue area. An index fund will almost always will have held more of a fraud stock from *before* the fraud period than they will have bought *during* the fraud period. Thus, they lose more as legacy stockholders – because the company funds any settlement – than they gain with respect to shares bought during the fraud period.[95] Although the fund will receive some of the recovery, it will almost never break even. While some of the loss in defendant-company value will flow back to the fund in the form of recovery (less a pro rata share of attorney fees), most of the loss will go to fund recovery by other stockholders.

The bottom line is that index funds should be opposed to SFCAs.[96] But they cannot register their opposition by opting out of recovery. To do so would be to forgo their share of recovery which mitigates the losses they suffer from the decline in value suffered by defendant companies when they are targeted by such actions. To be sure, an index fund is always free to oppose class certification and may even have a fiduciary duty to fund investors to do so. But the expense of doing so combined with the slim chance of preventing *others* from prosecuting a class action militates against intervention.[97]

While the foregoing considerations almost certainly preclude index funds from doing anything merely to oppose SFCAs, the calculus is quite different with regard to derivative actions. As explained above, many event-driven SFCAs should be litigated as derivative actions (at least in the first instance) rather than as direct class actions. And if they are so litigated, the recovery (if any) goes to the company with the effect of restoring company value. For an index fund, this is a win-win proposition. With an SFCA, defendant company value declines when the fraud is revealed and declines by even more because of the prospect of payout. An index fund loses twice: First because

[94] Recount conversation with general counsel of major index fund sponsor.

[95] Admittedly, the settlement is typically covered by insurance. So the company does not usually fund any of the settlement. But that is irrelevant as a matter of law. Moreover, the settlement will typically deplete coverage that could offset other losses. And but for the prospect of SFCA liability, the company might not have needed to buy so much insurance.

[96] The same is undoubtedly true for many actively managed mutual funds.

[97] On the other hand, it is not uncommon for courts to make certification contingent on some maximum number of opt-outs, which might permit index funds acting in concert collectively to prevent many SFCAs from proceeding.

of the fraud, and second because it will foot more of the bill for the settlement. With a derivative action, the money flows the other way: If the company recovers, value is restored. But even if the derivative action fails to secure any recovery for the company, there will be no further decrease from funding the settlement.

In short, index funds are arguably duty-bound to their investors to advocate for derivative actions in most SFCAs of the sort discussed here (if not most SFCAs). They have everything to gain and nothing to lose. Just as it is a *per se* BFD to invest in a no-win proposition, it is a *per se* BFD to fail to secure a no-lose advantage.[98]

The one possible excuse an index fund might have for failing to step up is that a volunteer fund may end up footing the bill for benefits that flow to other index funds and other diversified investors – or footing the bill for a failed effort.[99] But presumably a fund can find a plaintiff firm that will work for a contingent fee. Indeed, one would think that most plaintiff firms would be thrilled to sign such a client. And when successful, the fund will presumably be reimbursed for any expenses.

In the end, there is no good excuse for the failure of index funds to make the argument outlined here – other than the possibility that no one has yet understood the argument. But once the argument is understood, it is difficult to see how an index fund would not be compelled – by its fiduciary duty to fund investors – to intervene in a class action of the sort described here.[100]

Thus, the worry that there might be no one to make the argument – since no one has yet done so – is transitional: It would take only a few successful efforts for derivative

[98] *See, e.g.,* Joy v. North, , 692 F.2d 880 (2d Cir. 1982). On the other hand, an economist might argue that there cannot BE a fifty-dollar bill lying on the sidewalk, because if there were, someone would have picked it up.

[99] Although one might sympathize with such worries about others freeriding on one's efforts, the fact the volunteer fund might still be compelled as a matter of fiduciary duty to fund investors if the risk adjusted gain to the fund exceeds cost of litigating the claim. *See* id.

[100] One likely explanation for the failure of fund managers to have understood how the interests of index funds differ from those of traditional actively managed funds is that no one specializes in advising index funds. In other words, there is no ISS or Glass Lewis who seeks to advise index funds based on their distinctive interests. As I argue elsewhere, although index funds are duty-bound to minimize what they spend on monitoring portfolio companies, they should nonetheless worry about big-picture trends and should be especially concerned about tactics that other investors might use to divert returns. SFCAs are precisely such a tactic. *See* RAB, *Proper Role* (forthcoming). Thus, a specialized adviser could significantly reduce monitoring expenses for index funds (if only by culling company-specific advice) as well as the expense of intervention (if only by identifying the cases calling for it). Such an adviser might also catalyze cooperation among index funds in addressing important cases, thus facilitating the sharing of expenses.

actions to supplant class actions. And those efforts are all the more likely to succeed, if the representative plaintiff is one of the Big Three index funds.[101]

CONCLUSION

In the end, the debate as to whether literal price inflation should required to plead securities fraud or rather that price maintenance will suffice is not likely to matter much since plaintiffs will almost always be able to argue that but for the alleged misrepresentation stock price would have fallen. But because the price maintenance theory implies that damages should be measured by the difference between the price paid by buyers and the price at which stock settles following corrective disclosure – as opposed to the likely minimal increase from literal price inflation – the price maintenance theory clearly encourages more litigation and more generous settlements by defendants who fear the possibly devastating consequences of going to trial. On the other hand, the debate itself reveals a fundamental contradiction in the way damages are measured. Whereas literal price inflation focuses on mispricing at the time buyers buy, price maintenance focuses on the price following corrective disclosure, which may be magnified by consequential losses, including reputational harm to the defendant company or losses from events that reveal the misrepresentation. Thus, the debate has tended to obscure a third possible approach to measuring loss, namely, mispricing at the time a buyer buys resulting from price maintenance. But one heretofore unnoticed implication of *Halliburton II* (2014) is that defendants may now introduce evidence in connection with class certification that price impact derives from sources other than fraud. Although *Goldman Sachs* (2021) seems to suggest that a defendant must show zero price impact from fraud to defeat a class action, it is enough to show that some portion of the loss derives from a claim that must be treated as a derivative claim for which the defendant company should recover, because FRCP Rule 23(b)(3), which governs class actions clearly requires that any claim that can be adjudicated other than by class action be so adjudicated.

[101] Note that there have been a few valiant efforts by derivative plaintiffs to press their claims but they have generally failed because of the quite erroneous notion that a federal-law securities fraud action is inherently more important than a state-law derivative action.

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