Digital Commons @ Georgia Law

Scholarly Works | Faculty Scholarship

1-1-2007

Reassessing Damages in Securities Fraud Class Actions

Elizabeth Chamblee Burch
University of Georgia School of Law, eburch@uga.edu

Repository Citation
Elizabeth Chamblee Burch, *Reassessing Damages in Securities Fraud Class Actions* (2007),
Available at: http://digitalcommons.law.uga.edu/fac_artchop/753

This Article is brought to you for free and open access by the Faculty Scholarship at Digital Commons @ Georgia Law. It has been accepted for inclusion in Scholarly Works by an authorized administrator of Digital Commons @ Georgia Law. For more information, please contact tstriepe@uga.edu.

REASSESSING DAMAGES IN SECURITIES FRAUD CLASS ACTIONS

ELIZABETH CHAMBLEE BURCH*

I. INTRODUCTION 349
II. MEASURING DAMAGES FROM OPEN-MARKET LOSS 355
A. Contextualizing Securities Laws to Frame an Understanding of Damage Awards 355
B. *Dura*'s Potential Impact on Remedies 359
C. The Evolution of Securities Fraud Damages 360
1. The Confusing Common Law Origins of Securities Fraud Remedies 361
2. Remedies for Fraudulent Face-to-Face Transactions 363
3. Remedies for Fraud-on-the-Market 367
III. NORMATIVE THEORIES SUPPORTING PRIVATE RULE 10B-5 ACTIONS 370
A. Compensation as a Theoretical Rationale for Private Class Actions 371
1. Securities Laws Were Not Enacted to Provide Investor Insurance 373
2. Private Actions Redistribute Wealth Among Diversified Shareholders 374
3. Permitting Recovery Beyond Out-of-Pocket Losses Reduces Incentives to Learn 376
B. Private Class Actions Promote Deterrence 380
1. Maximizing Deterrence 382
2. Preventing Substantive "Absolute" Liability and Promoting Predictability 383
IV. LIMITING PRIVATE CLASS RECOVERY TO NET LOSSES 385

Copyright © 2007 by Elizabeth Chamblee Burch.

* Assistant Professor, Cumberland School of Law, Samford University; B.A., Vanderbilt University; J.D., Florida State University. I am indebted to Greg Mitchell, of the University of Virginia School of Law, for his mentoring, time, and insights on an earlier version of this Article; to Joan Heminway, of the University of Tennessee College of Law, for her detailed securities knowledge and her extensive comments on an earlier version of this Article; as well as to Brannon Denning, Susan Housen, and Peggy Torrey for their invaluable comments and recommendations on previous drafts. Special thanks to Thomas Burch for his continuous feedback, discussion, and support throughout the writing process as well as to the editors of the *Maryland Law Review* for their hard work throughout the editorial process. If errors exist they are solely my own.

A. Out-of-Pocket Losses Provide the Best Fit for Modern Securities Fraud 386
1. Out-of-Pocket Recoveries Comply with the Loss Causation Standard. 386
2. Out-of-Pocket Losses Conform with 15 U.S.C. § 78bb(a)'s "Actual Damages" Limit 387
3. Proving Hypothetical Damages..... 389
B. Earlier Dismissal of Suits Providing Double Recovery 392
C. Optimizing Deterrence Through Increased Predictability 394
V. CONCLUSION 396

I. INTRODUCTION

Trading publicly listed securities on the open market is markedly different from traditional face-to-face securities transactions.[1] In turn, the modern-day fraud-on-the-market securities class action bears little factual resemblance to its common law predecessors, deceit and misrepresentation, which provided conventional contract-based remedies for fraud in face-to-face dealings.[2] And yet, even though securities laws have detailed pleading standards and nuanced requirements for "loss causation," no coherent doctrinal statement exists for calculating open-market damages in Rule 10b-5 securities fraud class actions.[3] In-

1. The key feature of face-to-face transactions for our purposes is that a securities purchaser buys securities directly from a corporation or a corporate agent and is thus in privity with the corporation or corporate agent. Consequently, these transactions differ notably from open-market transactions where investors trade securities with one another through the publicly traded securities market. *See generally* Steven A. Fishman, *Duty to Disclose Under Rule 10b-5 In Face-to-Face Transactions*, 12 J. CORP. L. 251, 256–57 (1987) (outlining characteristics that distinguish face-to-face transactions from open-market transactions).

2. *See* Janet Cooper Alexander, *Rethinking Damages in Securities Class Actions*, 48 STAN. L. REV. 1487, 1488 (1996) ("Securities class action litigation today has little in common with suits over the common law torts of fraud and misrepresentation from which the compensatory remedy was derived.").

3. *See* Frank H. Easterbrook & Daniel R. Fischel, *Optimal Damages in Securities Cases*, 52 U. CHI. L. REV. 611, 611–12 (1985) (detailing the lack of a standard computation for determining damages in securities cases). This Article's scope is limited exclusively to Rule 10b-5 actions involving secondary market transactions. Numerous securities class actions include claims under sections 11 and 12 of the 1933 Securities Exchange Act and, while the damages measure under section 11 is similar to Rule 10b-5 cases, this Article focuses on Rule 10b-5. Unlike section 11 or Rule 10b-5 cases, to plead a case under section 12, plaintiffs do not have to demonstrate that the misrepresentation or omission caused them economic harm. *In re* Daou Sys., Inc., 411 F.3d 1006, 1025, 1027, 1029 (9th Cir. 2005); Casella v. Webb, 883 F.2d 805, 808 & n.8, 809 (9th Cir. 1989); Rousseff v. E.F. Hutton Co., 867 F.2d 1281, 1284–85 (11th Cir. 1989) (per curiam).

stead, courts have endeavored to fashion common law deceit and misrepresentation remedies to fit open-market fraud.[4] The result is a relatively ineffective system with a hallmark feature: unpredictable remedies. This poses a significant fraud deterrence problem from both a practical and a theoretical standpoint.

Though precise calculations of loss generally come at the end of litigation, the legal standard for measuring that loss, and thus for calculating damages, is important at the suit's outset to determine whether plaintiffs experienced compensable loss for purposes of pleading a viable securities fraud action.[5] In 2005, the Supreme Court had an opportunity to clarify what constituted an open-market loss, which could have facilitated earlier dismissal of cases without reimbursable losses. Instead, dicta in *Dura Pharmaceuticals, Inc. v. Broudo*[6] further confused the issue of an appropriate remedy by (1) perpetuat-

---

4. Because a corporation acts only through its agents, the corporation is often required to compensate investors for its agents' acts. Lisa M. Fairfax, *Spare the Rod, Spoil the Director? Revitalizing Directors' Fiduciary Duty Through Legal Liability*, 42 HOUS. L. REV. 393, 412–14 (2005). The agents themselves may not even be named in the class action and, if they are, their portion of the settlement payment will likely come from directors' and officers' liability insurance. *Id.* at 413–14; *see also* Alexander, *supra* note 2, at 1498–99 (noting that liability insurance often causes directors and officers to contribute very rarely to class action settlements); Jennifer H. Arlen & William J. Carney, *Vicarious Liability for Fraud on Securities Markets: Theory and Evidence*, 1992 U. ILL. L. REV. 691, 699 (stating that most plaintiffs in securities fraud actions sue the corporation rather than its agents). To achieve optimal deterrence, John Coffee argues that agents should bear more of the costs of wrongdoing. John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay On Deterrence and Its Implementation* 23–24, 27–28 (Columbia Law Sch. Ctr. for Law & Econ. Studies, Working Paper No. 293, 2006), *available at* http://ssrn.com/abstract_id=893833. *But see* Sanjai Bhagat et al., *Managerial Indemnification and Liability Insurance: The Effect on Shareholder Wealth*, 54 J. RISK & INS. 721, 726–27 (1987) (noting that reputation costs, such as lost future earnings and unemployability, that result from losing a lawsuit may deter corporate agent wrongdoing). Unless the Department of Justice prosecutes the agents for criminal actions, at least half of their settlement payment will likely come from insurance policies paid for by the corporation. Alexander, *supra* note 2, at 1498–99.

5. Although a plaintiff must purchase or sell a security to have standing, she must also have experienced a loss that results in an injury. Barr v. Matria Healthcare, Inc., 324 F. Supp. 2d 1369, 1375–77 (N.D. Ga. 2004); *see also* Miller v. Asensio & Co., 364 F.3d 223, 230 (4th Cir. 2004) ("Requiring plaintiffs to demonstrate the fact of proximately caused damage to establish 10b-5 liability precludes wholly speculative claims and claims by plaintiffs who ultimately profit from, or experience no economic pinch as a result of, the challenged transaction."); Wolf v. Frank, 477 F.2d 467, 478–79 (5th Cir. 1973) (stating that plaintiffs have standing only when they can show actual damages rather than merely loss of speculative profits).

6. 544 U.S. 336 (2005). Several commentators have discussed the impact of *Dura*. *See, e.g.*, John C. Coffee, Jr., *Causation by Presumption? Why the Supreme Court Should Reject Phantom Losses and Reverse* Broudo, 60 BUS. LAW. 533 (2005) (arguing, pre-decision, that *Dura* presented an opportunity to preclude suits for "phantom losses"); John C. Coffee, Jr., *Loss Causation After* 'Dura'*: Something for Everyone*, 231 N.Y. L.J. 5 (2005) [hereinafter Coffee, *Loss Causation*] (discussing *Dura*'s ambiguous dicta regarding loss causation); Larry E. Ribstein,

ing the idea that courts can tailor remedies for open-market fraud by employing principles from common law deceit and misrepresentation actions despite the factual disparities between the two, and (2) opening the door to a new form of hypothetical loss where the stock price increases after an opportune disclosure of fraud.[7] Although *Dura* diminished plaintiffs' ability to sue based on alleged purchase price inflation, its dicta, which indicated that plaintiffs might be able to recover when their share prices did not increase as much as they otherwise would have without the discovery of fraud, muddied the water with regard to what constituted loss.

The Supreme Court's insinuation that a new form of hypothetical losses might be recoverable destabilizes the general notion that plaintiffs are entitled to compensation only for their out-of-pocket losses. Usually, when a corporation discloses a previous unfavorable misrepresentation or omission, its stock price drops. This decline indicates that the investing public considered the information relevant.[8] In *Dura*, the Court implied that an investor might recover damages when a stock's price does not *increase* as much as it would have absent the fraud.[9] In other words, if a corporation bundles adverse and favorable information that causes its stock price to increase, an investor without any net loss might be able to sue. This suggests that plaintiffs may not be limited to damages for traditional out-of-pocket losses.[10] A number of intrinsic problems could result from compensating investors for more than these losses. To cite but one example, providing investors with a double recovery, that is, one from the net stock price increase

---

Fraud on a Noisy Market, 10 LEWIS & CLARK L. REV. 137, 153–55 (2006) (noting that *Dura* failed to clarify the application of the fraud-on-the market theory).

7. *Dura*, 544 U.S. at 343–44. More specifically, *Dura* indicated that "private securities fraud actions resemble in many (but not all) respects common-law deceit and misrepresentation actions" and that litigants should examine these common law roots to determine whether a plaintiff suffered an injury and economic loss. *Id.* The *Dura* Court also noted, in a parenthetical, that "[t]he same is true in respect to a claim that a share's higher price is lower than it would otherwise have been—a claim we do not consider here." *Id.* at 343. As Coffee later observed, for the Court "to raise this issue is to suggest that it stands on the same logical footing as price inflation that results in a stock price decline." Coffee, *Loss Causation*, *supra* note 6. Even before *Dura*, some courts suggested in dicta that stockholders may experience an actionable loss if, because of the fraudulent conduct, a stock's appreciation does not rise as much as it otherwise would. Gebhardt v. ConAgra Foods, Inc., 335 F.3d 824, 831–32 (8th Cir. 2003).

8. Coffee, *Loss Causation*, *supra* note 6.

9. *See supra* note 7 and accompanying text.

10. Securities fraud cases on the open market have typically involved a decline in the stock price after the disclosure of wrongdoing.

and one from class action damages, could create a perverse incentive to invest purposefully in companies showing signs of fraud.[11]

To illustrate the potential effects of *Dura*'s dicta, consider the following situation:

> "*We've Found Gold!*," claims Corporation in a half-page press release in the *New York Times*. Corporation's stock price increases from $10 per share to $50 per share. An investor calls her broker and purchases ten shares at $50 per share. Three months later, Corporation announces in two-inch, bold, capital letters, *"We've Found Platinum!"* Beneath the capitals, miniscule text disclaims "*but not gold*." The investor's stock soars to $200 per share—but she wants to recover for the inflation in her purchase price based upon the gold misrepresentation.[12]

After *Dura*, assuming that she could meet the other elements of a claim, this investor may be able to maintain a securities class action against Corporation even though she did not suffer any out-of-pocket losses.[13] Although some have argued that courts should expand private litigation remedies to deter this type of opportune disclosure,[14] the better view is that courts should limit recovery to out-of-pocket losses and recognize that private remedies need not be invariably coextensive with enforcement by the Securities and Exchange Commission (SEC).[15]

---

11. One obvious ex ante indicium of fraud includes accounting restatements. Stephen J. Choi, *The Evidence on Securities Class Actions*, 57 VAND. L. REV. 1465, 1499 (2004).

12. This example is adapted from the Supreme Court's oral argument in *Dura*. Transcript of Oral Argument at 7–10, Dura Pharms., Inc. v. Broudo, 544 U.S. 336 (2005) (No. 03-932), 2005 WL 236546. If the gold-platinum scenario sounds too hypothetical, consider a pharmaceutical company that announces higher than expected profits to create a market frenzy and later issues both a revised 10K filing revealing its past financial woes and an announcement that it has received FDA approval for a new cancer-fighting drug.

13. The oral argument in *Dura* contemplates but does not resolve this scenario. *Id.* For another example, see *In re* Columbia Sec. Litig., 155 F.R.D. 466, 483 (S.D.N.Y. 1994) (observing that the failure of the price to drop as a result of alleged misrepresentations did not preclude a fraud-on-the-market claim because the misrepresentations might have prevented a rise in the price that otherwise would have occurred). Likewise, the court in *Gebhardt v. ConAgra Foods, Inc.* seemed to think that plaintiffs should be able to recover in this situation. 335 F.3d 824, 831–32 (8th Cir. 2003) (noting that "stockholders can be damaged in ways other than seeing their stocks decline. If a stock does not appreciate as it would have absent the fraudulent conduct, investors have suffered a harm.").

14. *See, e.g.*, Merritt B. Fox, *Understanding* Dura, 60 BUS. LAW. 1547, 1558–59 (2005) (arguing that courts should accept a variety of evidence to demonstrate price inflation and that a price drop is not necessary for recovery).

15. Although this Article is not necessarily a defense of the securities class action—particularly when investors have not suffered out-of-pocket losses—the securities class action has been defended in numerous circumstances. *See, e.g.*, James D. Cox, *Making Securi-*

Private class action litigation is problematic in the gold-platinum hypothetical because investors were already financially advantaged when the price appreciated above the purchase price. Yet permitting corporate agents to escape liability through opportune disclosures[16] impugns the stock market's integrity and could adversely affect the economy. Still, the option is not between private litigation and no enforcement. Even without a private remedy, the SEC, the Department of Justice, and the exchanges themselves can penalize corporate wrongdoing.[17] As such, limiting the availability of private class actions when investors do not experience an out-of-pocket loss does not mean that fraud would go undeterred or unpunished. Yet, without a clear doctrinal statement limiting recovery to out-of-pocket losses, the securities class action is arguably available to recoup the purchase price inflation in situations similar to the gold misrepresentation.

Compensating investors (who are corporate shareholders) when the net stock price increases injures investors by requiring them to pay significant transaction costs, such as attorneys' fees, to transfer wealth from one pocket to another. When investors sue a corporation, its shareholders indirectly bear those costs. Because investors are diversified, they may belong to the shareholder group indirectly paying for the litigation on one day and may be in the class of investors suing a corporation on the next. Thus, in the aggregate, compensating diversified investors when the net stock price increases is a costly means for wealth redistribution.

Part II begins with a brief overview of securities laws to provide a contextual framework for approaching damage awards. Part II then follows *Dura*'s directive to examine common law deceit and misrepresentation actions for guidance on economic loss and damages in modern securities fraud awards.[18] As a result, Part II also reviews courts'

---

ties Fraud Class Actions Virtuous, 39 ARIZ. L. REV. 497, 509–15 (1997) (defending securities class actions as a deterrence of securities violations through entity liability).

16. Under the federal securities laws, certain corporations have a duty to disclose all material information whether it is positive or negative. Fishman, *supra* note 1, at 260–61. The use of "disclosure" in this Article implies bad news and that any subsequent class litigation is comprised of purchasers who allege that they bought the security based on a misrepresentation or omission.

17. *E.g.*, SEC v. Rind, 991 F.2d 1486, 1490 (9th Cir. 1993). Unlike private actions, the SEC need not prove reliance or causation of damage or injury to maintain a claim. *E.g.*, SEC v. Rana Research, Inc., 8 F.3d 1358, 1363 n.4 (9th Cir. 1993); 5 ALAN R. BROMBERG & LEWIS D. LOWENFELS, BROMBERG AND LOWENFELS ON SECURITIES FRAUD & COMMODITIES FRAUD § 9:1 (2d ed. 2006).

18. Securities fraud damages have long vexed courts. Robert B. Thompson, *"Simplicity and Certainty" in the Measure of Recovery Under Rule 10b-5*, 51 BUS. LAW. 1177, 1179 (1996). Two suggestions in *Dura* could increase unpredictability in awarding damages and thereby decrease deterrence. First, *Dura* hints that plaintiffs might be able to sue when a security's

criteria for awarding common law contract- and equity-based damages to determine whether the criteria also apply to open-market securities violations.

Part III considers normative theories justifying the private securities class action as an enforcement tool. Even though recovering damages after plaintiffs experience a net gain is problematic under the current system, perhaps the system should change if recovery further promoted the goals of the securities class action. Yet, after analyzing compensation and deterrence as possible goals, I conclude that compensating plaintiffs for net gains redistributes wealth among diversified shareholders (minus significant transaction costs) and may cause perverse effects on investor education and motivation. Instead, deterrence is the most substantiated rationale for private recovery. Nevertheless, without defining a criterion for awarding damages, the unpredictable nature of remedies in private class actions may decrease deterrence. To foster optimal deterrence, courts need a distinct method for calculating open-market loss. Part IV proposes that this method limit recovery to out-of-pocket losses and thus compensate only net losers from the fraud. Part IV also identifies and discusses the practical and theoretical ramifications of this limitation.

My inquiry throughout this Article focuses exclusively on remedies for open-market securities fraud in class action lawsuits; I do not advocate changing remedies for face-to-face transactions or for more traditional nonclass suits. This Article takes for granted that the SEC, the Department of Justice, and the exchanges coexist with private litigation to deter fraud; that private class-based litigation can deter fraud with appropriate damage restrictions in place; that it is (sometimes) desirable to enforce Rule 10b-5 against non-issuing corporate defendants; and that courts will continue to use the fraud-on-the-market theory, at least for awhile, despite numerous academic challenges to the efficient capital markets hypothesis. These assumptions are subject to ongoing debate, but they are beyond the scope of this Article's focus on determining (1) whether the system should compensate investors through private actions when their stock price does not increase as much as it would have absent fraud, and (2) whether limiting investors to out-of-pocket losses in this regard could bolster fraud deterrence.

---

higher trading price is lower than it might have been absent the fraud. *Dura*, 544 U.S. at 343. Second, *Dura* observes that private securities fraud class actions resemble common law deceit and misrepresentation actions—actions which permitted damages apart from out-of-pocket losses. *Id.* at 343–44.

II. MEASURING DAMAGES FROM OPEN-MARKET LOSS

The appropriate method for calculating economic loss and awarding damages for open-market fraud has long proved problematic for courts.[19] In private securities fraud litigation, class actions or otherwise, damages are an essential prerequisite for maintaining a claim.[20] Yet because securities fraud class action cases generally settle before courts calculate damages, judicial opinions are scarce.[21] Accordingly, this Part begins with a brief overview of securities laws to contextualize the purpose of private remedies.

A. *Contextualizing Securities Laws to Frame an Understanding of Damage Awards*

As early as 1975, the Supreme Court recognized that the securities class action "presents a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general."[22] Consequently, during the 1990s, Congress passed the Private Securities Litigation Reform Act of 1995 (PSLRA)[23] to rein in prolific use of the 1933 and 1934 Exchange Acts.[24]

---

19. Thompson, *supra* note 18, at 1179.

20. 15 U.S.C. § 78u-4(b)(4) (2000); *see also Dura*, 544 U.S. at 341–42.

21. Miller v. Asensio & Co., 364 F.3d 223, 228 (4th Cir. 2004) ("The treatises note the 'relative paucity of decisions' dealing with damages in Rule 10b-5 cases." (quoting 2 THOMAS LEE HAZEN, THE LAW OF SECURITIES REGULATION § 12.12 (4th ed. 2002)); 5 BROMBERG & LOWENFELS, *supra* note 17, § 8.10 & n.6; Bradford Cornell & R. Gregory Morgan, *Using Finance Theory to Measure Damages in Fraud on the Market Cases*, 37 UCLA L. REV. 883, 884 & n.5 (1990); Donald C. Langevoort, *Capping Damages for Open-Market Securities Fraud*, 38 ARIZ. L. REV. 639, 648 (1996); Daniel P. Lefler & Allan W. Kleidon, *Just How Much Damage Did Those Misrepresentations Actually Cause and to Whom?: Damages Measurement in "Fraud on the Market" Securities Class Actions*, *in* SECURITIES LITIGATION & ENFORCEMENT INSTITUTE 2005, at 285, 289 (PLI Corp. Law & Practice, Course Handbook Series No. 6746, 2005); Thompson, *supra* note 18, at 1179.

22. Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 739 (1975).

23. Pub. L. No. 104-67, 109 Stat. 737 (1995) (codified as amended in scattered sections of 15 U.S.C.).

24. *Id.* (amending Securities Act of 1933, ch. 38, 48 Stat. 74 (codified as amended at 15 U.S.C. § 77z-1 (2000)) and Securities Exchange Act of 1934, ch. 404, 48 Stat. 881 (codified as amended at 15 U.S.C. § 78u-4)). The PSLRA has been criticized for making it more difficult to bring class actions in general rather than weeding out the non-meritorious ones. *See, e.g.*, A.C. Pritchard, *Markets as Monitors: A Proposal to Replace Class Actions with Exchanges as Securities Fraud Enforcers*, 85 VA. L. REV. 925, 960 (1999) ("But the procedural obstacles of the Reform Act do not screen out only frivolous suits: Instead, the Reform Act makes it harder to bring class actions, whatever their individual merit."). Certainly not everyone believed that securities class actions caused all of the pernicious effects that the proponents of the PSLRA and the Securities Litigation Uniform Standards Act (SLUSA) attributed to them. *See, e.g.*, Joseph A. Grundfest, *Why Disimply?*, 108 HARV. L. REV. 727, 743–44 (1995) (arguing that the SEC and courts are too readily persuaded that private securities litigation is the source of unnecessary cost and meritless suits).

In passing the PSLRA, Congress stated that private securities litigation was "an indispensable tool with which defrauded investors can recover their losses."[25] But it also alleged that the class action device, as then used in securities litigation, injured the entire U.S. economy.[26] The Act's supporters claimed that class action lawyers filed frivolous complaints[27] and targeted deep-pocketed defendants,[28] which produced blackmail settlements,[29] discouraged qualified people from serving on boards of directors,[30] and placed heavy economic burdens on both corporations and the economy as a whole.[31]

As a result of these arguments, Title I of the PSLRA limits recoverable damages and attorneys' fees,[32] creates a "safe harbor" for forward-looking statements,[33] requires sanctions for frivolous litigation,[34] and provides a mechanism to stay discovery pending a judicial review of a motion to dismiss.[35] The limit on recoverable damages entitles

---

25. Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit, 126 S. Ct. 1503, 1510 (2006) (quoting H.R. REP. NO. 104-369, at 31 (1995) (Conf. Rep.), *as reprinted in* 1995 U.S.C.C.A.N. 730, 730).

26. H.R. REP. NO. 104-369, at 31–32, *as reprinted in* 1995 U.S.C.C.A.N. at 730–31.

27. *See* Novak v. Kasaks, 216 F.3d 300, 306 (2d Cir. 2000) ("Legislators were apparently motivated in large part by a perceived need to deter strike suits wherein opportunistic private plaintiffs file securities fraud claims of dubious merit in order to exact large settlement recoveries.").

28. H.R. REP. NO. 104-369, at 31, *as reprinted in* 1995 U.S.C.C.A.N. at 730.

29. For a discussion of the general theory of blackmail in the class action setting, see L. Elizabeth Chamblee, *Unsettling Efficiency: When Non-Class Aggregation of Mass Torts Creates Second-Class Settlements*, 65 LA. L. REV. 157, 222–24 (2004).

30. S. REP. NO. 104-98, at 21 (1995), *as reprinted in* 1995 U.S.C.C.A.N. 679, 700.

31. *See* Chamblee, *supra* note 29, at 224 (stating that settlements from class action lawsuits are problematic because the result often reflects a company's fear of catastrophic loss instead of the merits of the plaintiff's position).

32. 15 U.S.C. § 78u-4(e) (2000).

33. "Deterrence is further undermined by the safe harbor that the Reform Act creates for forward-looking statements. The safe harbor immunizes such statements if they were not knowingly false when made, a departure from the ordinary standard of recklessness." Pritchard, *supra* note 24, at 962.

34. 15 U.S.C. § 78u-4(c); *see also* Choi, *supra* note 11, at 1472 ("PSLRA contains an explicit requirement that courts must review a class action on the merits . . . and impose sanctions, including the defendants' attorneys' fees, on frivolous litigation.").

35. 15 U.S.C. § 78u-4 (b)(3)(B); *see also* Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit, 126 S. Ct. 1503, 1511 (2006) (citing 15 U.S.C. § 78u-4 as authorizing a stay of discovery pending resolution of any motion to dismiss); Felton v. Morgan Stanley Dean Witter & Co., 429 F. Supp. 2d 684, 689–90 (S.D.N.Y. 2006) (same). Some have observed that these reforms crippled the securities class action and undermined its application to, for example, forward-looking statements. *See, e.g.*, Cox, *supra* note 15, at 520–21 (noting that discovery plays a particularly important role in suits alleging misrepresentation in forward-looking statements). Others have argued that the PSLRA may chill meritorious actions just as much as it does frivolous actions. *See generally* Hillary A. Sale, *Heightened Pleadings and Discovery Stays: An Analysis of the Effect of the PSLRA's Internal-Information Standard on '33 and '34 Act Claims*, 76 WASH. U. L.Q. 537 (1998) (arguing that the pleading requirements im-

plaintiffs to receive only the difference between the sale price of the security and the security's mean price over a ninety-day period following the disclosure of the information.[36] Title I also heightened pleading requirements for section 10(b) and Rule 10b-5 claims by mandating that plaintiffs specify each misleading statement and provide particular facts "giving rise to a strong inference that the defendant acted with the required state of mind."[37] Even though Congress has demonstrated a steadfast commitment to insuring market integrity, most of Congress's reforms have erected barriers to class action recovery.

Stringent pleading requirements are one of the principal barriers. Plaintiffs must allege the following elements to state a claim for cases involving publicly traded securities: (1) a material misrepresentation or omission; (2) scienter, i.e., a wrongful state of mind; (3) a connection with the purchase or sale of a security; (4) reliance; (5) economic loss; and (6) loss causation.[38] For loss causation and standing purposes, plaintiffs must allege an injury to a legally protected interest as well as a causal relationship between the injury (the economic loss) and the defendant's conduct.[39] Defendant's conduct

---

posed by PSLRA are outcome determinative and consequently lead to the dismissal of even meritorious suits). A major problem with the rule is that many times the use of discovery is the only way that plaintiffs can uncover viable facts to plead a strong inference of wrongdoing. *See* Pritchard, *supra* note 24, at 961 ("The discovery stay prevents plaintiffs from using discovery to draft a viable complaint."); *see also* Jordan Eth & Michael Dicke, *Insider Stock Sales in Rule 10b-5 Corporate Disclosure Cases: Separating the Innocent from the Suspicious*, 1 STAN. J.L. BUS. & FIN. 97, 105 (1994) (stating that direct evidence of scienter, a necessary element for a securities class action claim, is usually nonexistent at the pre-discovery stage of trial).

36. 15 U.S.C. § 78u-4(e)(1). Still, this leaves open the possibility of recovery insinuated by *Dura*, that a plaintiff might recover when the price does not increase as much as it otherwise would have. *See* Dura Pharms., Inc. v. Broudo, 544 U.S. 336, 343 (2005).

37. *Dura*, 544 U.S. at 345 (quoting 15 U.S.C. § 78u-4(b)(1)–(2)). Professors Grundfest and Pritchard have commented on the legislative ambiguity of "strong inference." Joseph A. Grundfest & A.C. Pritchard, *Statutes with Multiple Personality Disorders: The Value of Ambiguity in Statutory Design and Interpretation*, 54 STAN. L. REV. 627, 633–34 (2002) (noting that Congress intentionally made the strong inference standard ambiguous and sorting thirty-three appellate court interpretations of the standard into three distinct categories). The strong inference standard first appeared in Senate Bill 240. Private Securities Litigation Reform Act of 1995, S. 240, 104th Cong. § 36(b) (1995).

38. *Dura*, 544 U.S. at 341–42.

39. With regard to loss causation, "the plaintiff shall have the burden of proving that the act or omission of the defendant alleged to violate this chapter caused the loss for which the plaintiff seeks to recover damages." 15 U.S.C. § 78u-4(b)(4); *see also* Barr v. Matria Healthcare, Inc., 324 F. Supp. 2d 1369, 1379 (N.D. Ga. 2004). With regard to standing, the plaintiff must prove three elements: an injury in fact, a causal relationship between the injury and the challenged conduct, and a likelihood that the injury will be redressed by a favorable decision. Lee v. City of Chicago, 330 F.3d 456, 468 (7th Cir. 2003) (citing Lujan v. Defenders of Wildlife, 504 U.S. 555, 561 (1992)); *see also* Pasley v. Freeman, 100

must, therefore, proximately cause the plaintiffs' loss.[40]

Causation has two components: transaction causation and loss causation.[41] Because many individuals turn their finances over to investment brokers and might not be aware of a misstatement (or omission), much less have relied on it, plaintiffs may plead transactional causation by alleging "fraud-on-the-market" if the market is "efficient."[42] The fraud-on-the-market theory establishes a rebuttable presumption that investors rely on material representations made to the public in determining whether to buy or sell a particular security.[43]

Eng. Rep. 450, 457 (K.B. 1789) ("If, indeed, no injury is occasioned by the lie, it is not actionable: but if it be attended with a damage, it then becomes the subject of an action.").

40. *See* Theoharous v. Fong, 256 F.3d 1219, 1224 (11th Cir. 2001) ("A successful cause of action under Section 10(b) or Rule 10b-5 requires that the plaintiff prove (1) a misstatement or omission (2) of a material fact (3) made with scienter (4) upon which the plaintiff relied (5) *that proximately caused the plaintiff's loss.*" (quoting McDonald v. Alan Bush Brokerage Co., 863 F.2d 809, 814 (11th Cir. 1989)) (emphasis added)); Binder v. Gillespie, 184 F.3d 1059, 1063 (9th Cir. 1999) (same); Ross v. Bank S., N.A., 885 F.2d 723, 728 (11th Cir. 1989) (en banc) (same); Friedlander v. Troutman, Sanders, Lockerman & Ashmore, 788 F.2d 1500, 1503 n.3 (11th Cir. 1986) (quoting Diamond v. Lamotte, 709 F.2d 1419, 1422–23 (11th Cir. 1983) (same)); *In re* HealthSouth Corp. Sec. Litig., 213 F.R.D. 447, 457 (N.D. Ala. 2003) (same).

Section 10(b) of the Securities Exchange Act of 1934 forbids (1) the "use or employ[ment]" of any "deceptive device," (2) "in connection with the purchase or sale of any security," and (3) "in contravention of" SEC rules and regulations. 15 U.S.C. § 78j(b).

41. Robbins v. Koger Props., Inc., 116 F.3d 1441, 1447 (11th Cir. 1997); *see also* Emergent Capital Inv. Mgmt., LLC v. Stonepath Group, Inc., 343 F.3d 189, 196–97 (2d Cir. 2003) (distinguishing transaction causation from loss causation).

42. Basic Inc. v. Levinson, 485 U.S. 224, 247 (1988). For an explanation of how *Basic* fits into the subsequent work of behavioral finance researchers, see Ribstein, *supra* note 6, at 148–50.

Academics have repeatedly challenged the validity of the efficient market theory. Although academic debate over market efficiency continues, as Donald Langevoort observes, the fraud-on-the-market theory can be justified regardless of whether markets are efficient. Donald C. Langevoort, *Theories, Assumptions, and Securities Regulation: Market Efficiency Revisited*, 140 U. PA. L. REV. 851, 892–903 (1992).

43. *See* Semerenko v. Cendant Corp., 223 F.3d 165, 178–79 (3d Cir. 2000) (explaining the fraud-on-the-market theory of reliance); *In re* Salomon Analyst Metromedia Litig., 236 F.R.D. 208, 220 (S.D.N.Y. 2006) (same); O'Neil v. Appel, 165 F.R.D. 479, 500 (W.D. Mich. 1996) (same); *In re* Phillips Petroleum Sec. Litig., 738 F. Supp. 825, 836 (D. Del. 1990) (applying the fraud-on-the-market theory).

Some have argued that the loss causation element is inapplicable to fraud-on-the-market transactions because the injury "flows *directly* from the misstatement." *See, e.g.*, Fox, *supra* note 14, at 1549–50. This oversimplifies the issue. As we have seen, when a misrepresentation fails to produce economic damage, but the stock price declines because of market conditions, then a plaintiff should not be able to recover. The misstatement was (a) not material as evidenced by a lack of market response and (b) not the product of the later loss. To hold otherwise is to provide investor insurance for tough market conditions. *Dura,* 544 U.S. at 342–46 (rejecting the Ninth Circuit rule that an initially inflated price necessarily allows a plaintiff to recover damages, and holding that a plaintiff may only recover if he or she suffers economic losses caused by a defendant's misrepresentation).

Thus, the theory satisfies both reliance and transaction causation.[44] To satisfy the second causation component, loss causation, the plaintiffs must establish that the defendant "caused the loss for which the plaintiff[s] seeks to recover damages."[45] And yet, even though they are interrelated, loss causation, economic loss, and damages are each distinct. As measured by the out-of-pocket rule, damages compensate plaintiffs only for losses actually caused by a misrepresentation or omission.[46]

B. Dura*'s Potential Impact on Remedies*

The few opinions available on open-market damages generally limit plaintiffs' recovery to out-of-pocket losses; yet, the damage issue has been subject to ongoing debate in the lower courts.[47] The Supreme Court had the opportunity to end this debate in *Dura* but opted to issue a narrow opinion instead.[48] This Section briefly examines *Dura*, both in terms of what the decision did and did not do, and aims to progress beyond the current confusion over remedies by exploring its sources.

In *Dura*, the plaintiffs alleged that Dura Pharmaceuticals, Inc. made false statements about its profits and about the Food and Drug Administration's (FDA) likely approval of its asthmatic spray device.[49] When Dura later disclosed that its earnings would not be as high as expected due to slow drug sales, its shares lost almost one-half of their value.[50] Eight months later, when it announced that the FDA would not approve the device, its market price fell again.[51] This time, the stock price recovered within a week.[52] Even though the stock price recovered quickly, plaintiffs argued that they suffered a loss by paying artificially inflated prices for Dura's stock.[53]

---

44. *Dura*, 544 U.S. at 341–42; *Basic*, 485 U.S. at 241–42; *Robbins*, 116 F.3d at 1448; *see also* Edward A. Dyl, *Estimating Economic Damages in Class Actions Securities Fraud Litigation*, 12 J. FORENSIC ECON. 1, 1 (1999).

45. 15 U.S.C. § 78u-4(b)(4).

46. *Robbins*, 116 F.3d at 1447 n.5.

47. *See supra* Part II.A.

48. *Dura*, 544 U.S. at 346.

49. *Id.* at 339.

50. *Id.*

51. *Id.*

52. *Id.*

53. *Id.* at 340. This type of allegation did not adequately plead loss causation because a purchaser could quickly sell the shares before the relevant truth began to leak out. Thus, a seller's alleged misrepresentation (and its associated inflated price) did not invariably lead to a loss, but it might mean a later loss. Accordingly, loss causation limits a plaintiff's recovery for out-of-pocket damages when the loss caused by the fraud is actually less than

Although a number of commentators anticipated a decision that plaintiffs could not plead loss causation without demonstrating a decline in stock value and thus a net loss,[54] the Court's decision settled only one issue: a plaintiff who alleges and establishes that the defendant has made a materially false statement does not sufficiently establish loss causation without connecting the loss to the misrepresentation.[55] This holding may change the way that corporations reveal adverse information. For example, after *Dura*, the corporation may bundle adverse and favorable information, as in the gold-platinum hypothetical, in order to prevent a stock price decline.[56]

The Court also recognized that intervening factors could cause a lower price instead of the misrepresentation, but then it added in dicta: "The same is true in respect to a claim that a share's higher price is lower than it would otherwise have been—a claim we do not consider here."[57] The Court then reemphasized the importance of common law deceit and misrepresentation actions in deciphering remedies for economic loss.[58]

C. *The Evolution of Securities Fraud Damages*

Even though modern-day securities fraud shares some elements with common law deceit and misrepresentation actions, courts applying the common law dealt primarily with non-liquid markets and face-to-face transactions. Because of these differences, courts did not limit common law damage awards to out-of-pocket losses.[59] Instead, they

---

the out-of-pocket measure. *See id.* at 342–43 (stating that a higher purchase price will *sometimes* play a role in bringing about future loss).

54. *See, e.g.*, Coffee, *Loss Causation*, *supra* note 6, at 1 (stating that the Supreme Court was expected to define operative principles of loss causation in *Dura*, but instead the Court issued a narrow holding).

55. Fox, *supra* note 14, at 1550–51 (stating that the *Dura* Court crafted a narrow holding).

56. *See* John C. Coffee, Jr., *Litigation: New Doctrine Spawns New Tactics*, 235 N.Y. L.J. 1 (2006) (suggesting that *Dura* may encourage companies to release adverse and favorable information together in one disclosure package to avoid liability).

57. *Dura*, 544 U.S. at 343; *see also supra* note 7 and accompanying text.

58. *Dura*, 544 U.S. at 343.

59. The elements for common law fraud are similar to the elements for pleading securities fraud. At common law, the plaintiff had to demonstrate by "clear and decisive proof":

> [t]hat the defendant has made a representation in regard to a material *fact* . . . [t]hat such representation is false; . . . [t]hat such representation was not actually believed by the defendant, on reasonable grounds, to be true; . . . [t]hat it was made with intent that it should be acted on; . . . [t]hat it was acted on by complainant to his damage; and, . . . [t]hat in so acting on it the complainant was ignorant of its falsity, and reasonably believed it to be true.

S. Dev. Co. v. Silva, 125 U.S. 247, 250 (1888). The *Dura* Court cited *Southern Development Co.* for this proposition. 544 U.S. at 343.

fashioned awards out of numerous damage theories including the benefit-of-the-bargain rule,[60] the out-of-pocket rule,[61] disgorgement,[62] and rescission.[63] One commentator noted that the cases contain "a mélange of rules" and that "all too often a court will give up and announce that the district court has discretion to fashion 'a remedy to suit the particular case'—as if there were no need for legal rules to evaluate the significance and effects of the facts of 'the particular case.'"[64] Nevertheless, given the potential for *Dura* to affect class remedies in new ways, this Section traces the development from common law deceit and misrepresentation remedies to remedies for face-to-face transactions to open-market fraud. It then explains why some of these common law principles do not hold true for modern fraud-on-the-market actions.

1. *The Confusing Common Law Origins of Securities Fraud Remedies*

In the early 1600s, deceit claims existed only for what is today termed a "breach of warranty." In the seminal common law damages

---

60. *See, e.g.*, Osofsky v. Zipf, 645 F.2d 107, 114 (2d Cir. 1981) (applying the benefit-of-the-bargain rule to determine damages caused by the defendant's misrepresentation in proxy solicitation materials). *But see* Smith v. Bolles, 132 U.S. 125, 129–30 (1889) (rejecting the benefit-of-the-bargain rule because it included the "expected fruits of an unrealized speculation"). For a discussion of *Bolles*, see Michael J. Kaufman, *No Foul, No Harm: The Real Measure of Damages Under Rule 10b-5*, 39 CATH. U. L. REV. 29, 35–36 (1989).

61. In *Levine v. Seilon, Inc.*, for example, the court stated:

> Under the 'general' laws regime of Swift v. Tyson, the rule in the federal courts was that a defrauded buyer of securities is entitled to recover only the excess of what he paid over the value of what he got, not, as some other courts had held, the difference between the value of what he got and what it was represented he would be getting.

439 F.2d 328, 334 (2d Cir. 1971) (citation omitted).

62. For example, in *Affiliated Ute Citizens of Utah v. United States*, the Court stated:

> In our view, the correct measure of damages under § 28 of the Act, 15 U.S.C. § 78bb(a), is the difference between the fair value of all that the . . . seller received and the fair value of what he would have received had there been no fraudulent conduct, except for the situation where the defendant received more than the seller's actual loss. In the latter case damages are the amount of the defendant's profit.

406 U.S. 128, 155 (1972) (citation omitted).

63. *See, e.g.*, Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 38, 49 & nn.21–22 (2d Cir. 1978) (explaining and applying the rescission measure of damages). *But see* Green v. Occidental Petroleum Corp., 541 F.2d 1335, 1342 (9th Cir. 1976) (Sneed, J., concurring) (arguing that recission is an inappropriate measure of damages because it requires the defendant to compensate the plaintiff for losses in stock value not proximately caused by the defendant's wrong). As to the different types of damages, see W. PAGE KEETON ET AL., PROSSER AND KEETON ON TORTS § 110 (5th ed. 1984); Kaufman, *supra* note 60, at 30–31.

64. Easterbrook & Fischel, *supra* note 3, at 611–12 (quoting Hackbart v. Holmes, 675 F.2d 1114, 1121 (10th Cir. 1982)).

case, *Chandelor v. Lopus*,[65] the Exchequer Chamber reversed the Kings Bench's judgment in the plaintiff's favor because no breach of warranty occurred—the defendant never warranted that the object in question was a "bezar-stone."[66] Yet at least some justices believed that the defendant's intent to deceive was actionable even without a warranty.[67] The dissenters' line of thinking continued to develop through the years, and by the late eighteenth century, the law was relatively well established that (1) if there was an express or implied warranty, the seller could be liable if the product did not conform to the warranty's specifications, and (2) if no warranty existed, the seller could be liable only where she made a false statement, knew of its falsity, and intended to deceive the buyer.[68]

Of course, a breach of warranty action is founded in contract law whereas deceit is a tort. Though the difference initially appears to be either the presence or absence of a warranty, this simplistic differentiation caused multiple procedural and pleading issues because plaintiffs often hedged their bets by alleging both breach of warranty and deceit.[69] Hence, in common law deceit and misrepresentation actions, courts chose among a buffet of remedies.[70] Depending upon the circumstances, a common law claim for deceit could prompt the following counts in a complaint: (1) breach of warranty and breach of contract—requesting benefit-of-the-bargain, or "expectation" damages—to restore the plaintiff to the position she would have occupied with the defendant's contractual performance;[71] (2) misrepresenta-

---

65. 79 Eng. Rep. 3, Cro. Jac. 4 (Ex. Ch. 1603).

66. *Id.* at 3–4; *see also* Paula J. Dalley, *The Law of Deceit, 1790–1860: Continuity Amidst Change*, 39 AM. J. LEGAL HIST. 405, 412 (1995) (discussing *Chandelor v. Lopus*). A bezar stone is a hard gastric or intestinal mass found in the intestine of hooved animals that was believed to be a universal antidote against poisons. *Id.* at 412 n.27. Unfortunately, the court in *Chandelor* does not explain how the buyer realized that the bezar stone did not work.

67. *Chandelor*, 79 Eng. Rep. at 4; *see also* Lopus v. Chandelor (K.B. 1606), *reprinted in* J.H. BAKER & S.F.C. MILSOM, SOURCES OF ENGLISH LEGAL HISTORY 518–23 (1986).

68. Dalley, *supra* note 66, at 413; *see also* Stuart v. Wilkins, 99 Eng. Rep. 15 (K.B. 1778) (noting that an implied warranty will not arise unless the seller knows of the defect and still demands a sound price).

69. *See, e.g.*, Bartholomew v. Bushnell, 20 Conn. 271, 271 (1850); *see also* Dalley, *supra* note 66, at 415 (noting that a sophisticated plaintiff alleges both breach of warranty and deceit).

70. Thompson, *supra* note 18, at 1183–85; Robert B. Thompson, *The Measure of Recovery Under Rule 10b-5: A Restitution Alternative to Tort Damages*, 37 VAND. L. REV. 349, 353–54 (1984).

71. Note, however, that the Uniform Commercial Code does not explicitly recognize an implied warranty of merchantability or fitness with regard to securities. *See* U.C.C. § 2-105(1) (1977) (defining "goods" as exclusive of securities); *id.* § 2-314 (recognizing an implied warranty of merchantability for *goods*); *id* § 2-315 (recognizing an implied war-

tion—a tort—which could provide recoupment for out-of-pocket losses; and (3) unjust enrichment—an equitable claim—which might require the defendant to return the illicit profit from the transaction or rescind the transaction altogether.[72]

2. *Remedies for Fraudulent Face-to-Face Transactions*

Over the years, courts blurred the distinct remedies for these multiple causes of action, which contributed to modern-day confusion over the appropriate remedy for open-market securities fraud.[73] Still, the courts did not move directly from common law deceit and misrepresentation into open-market fraud. They first applied common law remedies to face-to-face transactions and typically awarded either rescissory damages[74] based upon the defendant's gain or out-of-pocket damages based upon the plaintiff's loss.[75]

The out-of-pocket measure, which originated in tort law,[76] requires the defendant to compensate for the losses she proximately

---

ranty of fitness for *goods*); *id.* § 8-306(2) (stating that "a person transferring a certified security to a purchaser for value *warrants only that*": (a) the transfer is "effective and rightful"; (b) "the security is genuine and has not been materially altered"; and (c) the transferor "knows of no fact which might impair the validity of the security." (emphasis added)).

72. *See, e.g.*, Janigan v. Taylor, 344 F.2d 781, 786 (1st Cir. 1965) (noting that "it is simple equity that a wrongdoer should disgorge his fraudulent enrichment"); *see also* Thompson, *supra* note 70, at 353–54 (outlining breach of warranty, misrepresentation, and unjust enrichment claims in securities fraud).

73. The distinction between causes of action for deceit and for breach of warranty may have been caused by the honest confusion of judges. As Dalley observes, "[i]n *Waters v. Mattingly*, 4 Ky. 244, 246 (1808), Judge Edwards clearly understood the difference between the requirement of warranty and the requirement of *sciens*, but unfortunately he thought the distinction arose from the distinction between a *suppressio veri* and a *suggestio falsi* . . . ." Dalley, *supra* note 66, at 413 n.36.

74. "Rescissory damages" has been spelled numerous ways over the years. Thus, citations throughout this Article may refer to rescissionary, recissory, or recessionary damages. The same holds true for "rescission," which has been spelled recision and recission.

75. *See* Randall v. Loftsgaarden, 478 U.S. 647, 658–59 (1986) (stating that Congress chose a rescissory remedy for securities fraud); Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128, 155 (1972) (applying common law damages to a securities fraud case); Jordan v. Duff & Phelps, Inc., 815 F.2d 429, 441–42 (7th Cir. 1987) (stating that securities law measures damages in two ways: (1) rescissory damages, which are based on the defendants' gain; and (2) market damages, which are based on the plaintiffs' loss); Harris Trust & Sav. Bank v. Ellis, 810 F.2d 700, 706 (7th Cir. 1987) ("In an action under § 10(b), the plaintiff cannot take advantage of the recessionary remedies provided elsewhere in the securities laws. . . . Sometimes remedies under the securities laws are based on defendants' gain rather than plaintiffs' loss, or plaintiff may have an election." (citations omitted)).

76. *Kardon v. National Gypsum Co.*, 69 F. Supp. 512, 513–14 (E.D. Pa. 1946), was the first case to invoke tort principles for an implied right of action under Rule 10b-5. Judge Kirkpatrick's decision in *Kardon* was "adopted by an 'overwhelming consensus of the District Courts and Courts of Appeals.'" Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit, 126 S. Ct. 1503, 1509 (2006) (quoting Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723,

caused. Thus, this measure only reimburses plaintiffs who were economically harmed by the defendant's misconduct.[77] In securities fraud, out-of-pocket damages compensate plaintiffs for "the difference between the price paid and the 'real' value of the security, *i.e.*, the fair market value absent the misrepresentations, at the time of the initial purchase."[78] The "real value," or "true value" as it is often termed, means the price absent the fraud.[79] Accordingly, courts often determine whether the investor was a net winner or a net loser from the fraud.[80] Under the out-of-pocket theory, an investor with net monetary gains has no loss and cannot recover.[81] Thus, an investor who

---

730 (1975)). The Second Circuit later limited the breadth of a Rule 10b-5 private action in *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461, 463–64 (2d Cir. 1952).

77. Kaufman, *supra* note 60, at 129–30.

78. Robbins v. Koger Props., Inc., 116 F.3d 1441, 1447 n.5 (11th Cir. 1997) (citing Huddleston v. Herman & MacLean, 640 F.2d 534, 556 (5th Cir. 1981), *aff'd in part, rev'd in part on other grounds*, 459 U.S. 375 (1983)); *see also* Wool v. Tandem Computers Inc., 818 F.2d 1433, 1437 (9th Cir. 1987) ("The out-of-pocket rule fixes recoverable damages as the difference between the purchase price and the value of the stock at the date of purchase." (internal quotation marks omitted)); Sirota v. Solitron Devices, Inc., 673 F.2d 566, 577 (2d Cir. 1982) (same); Sharp v. Coopers & Lybrand, 649 F.2d 175, 189 (3d Cir. 1981) (same); Green v. Occidental Petroleum Corp., 541 F.2d 1335, 1344–46 (9th Cir. 1976) (discussing out-of-pocket damages); Blackie v. Barrack, 524 F.2d 891, 908–09 (9th Cir. 1975) (discussing out-of-pocket and rescissory damages and stating that, in securities fraud class actions, the out-of-pocket measure is more common).

79. *Randall*, 478 U.S. at 661–62; *Affiliated Ute Citizens*, 406 U.S. at 155; Mathews v. Kidder, Peabody & Co., 260 F.3d 239, 249 (3d Cir. 2001); Ambassador Hotel Co. v. Wei-Chuan Inv., 189 F.3d 1017, 1030 (9th Cir. 1999); Alexander, *supra* note 2, at 1490–91; Thompson, *supra* note 18, at 1181. It is the plaintiffs' burden to provide evidence of the "true value" for each date during the class period. Sowell v. Butcher & Singer, Inc., 926 F.2d 289, 297 (3d Cir. 1991). Applying the out-of-pocket measure is difficult due to the challenge of determining the fair market value of the security at a time when the actual market price is inflated by the defendant's misrepresentation. Thompson, *supra* note 18, at 1181. Some courts have used the value of the stock on a day other than the day that the transaction occurred, such as when the defendant disclosed the correction. *See, e.g.*, Harris v. Am. Inv. Co., 523 F.2d 220, 226 (8th Cir. 1975); Richardson v. MacArthur, 451 F.2d 35, 43–44 (10th Cir. 1971); Esplin v. Hirschi, 402 F.2d 94, 104–05 (10th Cir. 1968). However, damages calculated based on the market price at a later date may inflate the plaintiffs' damages by including market changes unrelated to the misrepresentation. Thompson, *supra* note 18, at 1191.

80. *See, e.g.*, *In re* Cardinal Health, Inc. Sec. Litig., 226 F.R.D. 298, 308 (S.D. Ohio 2005) (rejecting "net gainers" as lead plaintiffs); *In re* Comdisco Sec. Litig., 150 F. Supp. 2d 943, 945–46 (N.D. Ill. 2001) (determining that a pension fund could not serve as lead plaintiff because the pension fund "derived a *net gain* of almost $300,000 . . . from its purchases and sales during the Class Period"); *In re* McKesson HBOC, Inc. Sec. Litig., 97 F. Supp. 2d 993, 996–97 (N.D. Cal. 1999) (rejecting the net seller as lead plaintiff and observing that a net purchaser might have more interest in the litigation than a net seller because the net purchaser was fraudulently induced to purchase shares and was left "holding the bag" when the fraud was revealed).

81. *See, e.g.*, Arenson v. Broadcom Corp., No. SA CV 02-301GLT, 2004 WL 3253646, at *2 (C.D. Cal. Dec. 6, 2004) (granting summary judgment against plaintiffs who benefited

realized more than her initial investment—as in the gold-platinum hypothetical—could not recover.

In face-to-face transactions, courts also awarded common law remedies based on contract law and equity. After Judge Aldrich's opinion in *Janigan v. Taylor*,[82] the frequency of equitable awards increased. Judge Aldrich thought disgorgement was appropriate because it was better "to give the defrauded party the benefit even of windfalls than to let the fraudulent party keep them."[83] Therefore, courts reasoned that they should not treat a defendant who committed fraud any better than a defendant who only breached a contract.[84] And so, depending on what justice required, courts began to use benefit-of-the-bargain awards, rescission, and disgorgement as remedies.[85]

The benefit-of-the-bargain remedy is based in contract law and compensates plaintiffs for the amount they would have received, including profits, if the defendant had performed as promised.[86] Disgorgement[87] and rescission are also equitable remedies used in

---

from the alleged price inflation); *see also* Fox, *supra* note 14, at 1553 (noting that if the price increased, "application of the loss causation rule developed in the context of a traditional reliance-based action would bar recovery" because it "required that the purchased security decline in value from what was paid (or was sold at a loss) and that the decline or loss is in some way reasonably related to the falsity of the statement that induced the purchase").

82. 344 F.2d 781 (1st Cir. 1965).

83. *Id.* at 786; *accord* Randall v. Loftsgaarden, 478 U.S. 647, 663 (1986) (citing Judge Aldrich's reasoning in *Janigan*); Rude v. Campbell Square, Inc., 411 F. Supp. 1040, 1050 (D.S.D. 1976) (same). In *Janigan*, the defendant, who was president, general manager, and director of Boston Electro Steel Casting, Inc., purchased stock from his shareholders without telling them that the corporation was going through a revitalization. 344 F.2d at 783, 785. After two years, the stock's value multiplied. *Id.* at 783. The court reasoned that if it awarded the difference between the market price of the stock at the time of the sale and the price paid to plaintiffs, the damages would have been minimal. *Id.* at 786. Instead, the court rationalized that the fair value of the stock when sold was not the market price, rather it was the market price of what the stock would have been if the market had the same information as the defendant. *Id.*

84. *See, e.g.*, United States v. Ben Grunstein & Sons Co., 137 F. Supp. 197, 209 (D.N.J. 1956) (observing that courts prefer the benefit-of-the-bargain rule over the out-of-pocket rule because the latter treats willful fraud more leniently than an honest breach); Stout v. Martin, 104 S.E. 157, 159 (W. Va. 1920) (agreeing with the consensus view that the benefit-of-the-bargain rule is a better measure of damages in cases of fraud).

85. *Ben Grunstein & Sons*, 137 F. Supp. at 209–10; *Stout*, 104 S.E. at 160. The drafters of the *Restatement of Torts* recognized that benefit-of-the-bargain damages were preferable in fraud actions particularly when the out-of-pocket measure did not afford "just and satisfactory" compensation. RESTATEMENT (SECOND) OF TORTS § 549 cmt. g (1977). Courts agreed with this rationale. *E.g.*, Osofsky v. Zipf, 645 F.2d 107, 114 (2d Cir. 1981); *see also* KEETON ET AL., *supra* note 63, § 110.

86. BLACK'S LAW DICTIONARY 168 (8th ed. 2004).

87. Disgorgement is "[t]he act of giving up something (such as profits illegally obtained) on demand or by legal compulsion." *I*d. at 501. In this context, disgorgement aims

contract law. As applied to face-to-face securities fraud cases, courts have required defendants to disgorge, or return, their unjust enrichment so that the plaintiff recovers the fraudulently obtained profit.[88] Rescissory damages aim to void the fraudulent transaction by restoring the plaintiff to the position she would have occupied absent the transaction.[89] These remedies require that the defendant pay not only for the fraud but also for the change in market conditions.[90] So, in the process of undoing a securities transaction, the plaintiff avoids both the harm from the fraud as well as the danger of failing market conditions.[91] Requiring the defendant to bear the risk of market decline distinguishes rescissory damages from out-of-pocket damages, which seek to isolate the price due to fraud and permit recovery only

---

to prevent wrongdoers from unjustly enriching themselves, not to compensate victims. *E.g.*, SEC v. Cavanagh, 445 F.3d 105, 117 (2d Cir. 2006); SEC v. Tome, 833 F.2d 1086, 1096 (2d Cir. 1987); SEC v. Blavin, 760 F.2d 706, 713 (6th Cir. 1985).

88. Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128, 155 (1972); *see also* SEC v. Commonwealth Chem. Sec., Inc., 574 F.2d 90, 102 (2d Cir. 1978) ("Disgorgement is . . . a method of forcing a defendant to give up the amount by which he was unjustly enriched."). Although these funds are often used to compensate victims of the wrongdoing, the goal of compensation is secondary to that of deterrence. *See* SEC v. Fischbach Corp., 133 F.3d 170, 175 (2d Cir. 1997) ("The primary purpose of disgorgement orders is to deter violations of the securities laws by depriving violators of their ill-gotten gains.").

89. BLACK'S LAW DICTIONARY, *supra* note 86, at 419. Merritt Fox has argued that rescissory damages should be used for securities fraud cases. Merritt B. Fox, *Demystifying Causation in Fraud-on-the-Market Actions*, 60 BUS. LAW. 507, 512–13 (2005).

90. Thompson, *supra* note 18, at 1182–83. As Judge Sneed explained, this remedy is "rooted in the contract of sale":

> This remedy imposes upon the wrongful seller the burden of any loss in the value of the stock between the date of sale and the disclosure date. This is appropriate because the wrongful seller as a direct consequence of his wrong shifted to the purchaser the risks which he would have borne but for the wrongful sale. The seller's obligation to accept the return of the risk he wrongfully shifted is rooted in the contract of sale. That is, it springs from his contractual undertaking.

Green v. Occidental Petroleum Corp., 541 F.2d 1335, 1343 (9th Cir. 1976) (Sneed, J., concurring).

91. Thompson, *supra* note 18, at 1182. Some courts have even applied a rescissory measure for open-market situations. *See, e.g.*, United States v. Grabske, 260 F. Supp. 2d 866, 873 (N.D. Cal. 2002). The Court of Appeals for the Ninth Circuit pondered how to apply rescissionary damages as follows:

> Assuming a sale and purchase of stock, true rescission would involve a return, on the one hand, of the purchase price and, on the other hand, of the stock purchased. In an open market setting the injured party "returns the stock" by selling it on the open market. The defendant "returns the purchase price" by compensating the injured party for any difference between the price that the injured party paid for the security and its trading price following the disclosure of the fraud.

In re Mego Fin. Corp. Sec. Litig., 213 F.3d 454, 460 (9th Cir. 2000) (citation and internal quotation marks omitted). Given the nature of the loss causation requirement after *Dura*, it stands to reason that private plaintiffs should no longer be permitted to recover rescissory damages. *See infra* Part IV.A.1.

for that difference.[92] Although this rationale makes sense as applied to face-to-face transactions where the plaintiff sells stock that skyrockets in value after the sale and the defendant acquires the stock by fraud, it does not hold true for secondary open-market transactions.[93]

3. *Remedies for Fraud-on-the-Market*

As discussed above, in face-to-face transactions, the wrongdoer's obligation to accept the returned risk of failing market conditions is founded in the sale contract.[94] In the open-market situation, on the other hand, the corporate defendant does not sell anything directly to the plaintiff.[95] Instead, the plaintiff purchases stock from others on the open market and the corporate defendant's misrepresentations do not shift the risk of loss.[96] The rationale is that the corporation cannot return a purchase price it never received.[97]

---

92. *See* Beare v. Wright, 103 N.W. 632, 634 (N.D. 1905) (finding that the plaintiff who elected to affirm the contract after learning of fraud was entitled only to out-of-pocket damages); Doyle v. Union Bank & Trust Co., 59 P.2d 1171, 1175 (Mont. 1936) (finding that a plaintiff was not entitled to out-of-pocket damages where she was unable to distinguish the actual value of the bond at the time of sale); Poole v. Camden, 92 S.E. 454, 458 (W. Va. 1916) (awarding recissory damages to plaintiff fraudulently induced to sell stock at below market value); Thompson, *supra* note 18, at 1182–83.

93. *See* Kaufman, *supra* note 60, at 43–44. Accordingly, a growing number of courts refuse to award rescissionary damages in section 10(b) cases. *See, e.g.*, Mathews v. Kidder, Peabody & Co., 260 F.3d 239, 250 (3d Cir. 2001) ("[I]n most § 10(b) cases, we are extremely hesitant to award rescissionary damages and instead apply an 'out of pocket measure.'"); Hoxworth v. Blinder, Robinson & Co., 903 F.2d 186, 203 n.25 (3d Cir. 1990) ("Although the Supreme Court has reserved the question whether a rescissionary measure of damages is ever appropriate for defrauded buyers under rule 10b-5, this court has expressed clear disapproval of a damage theory that would insure defrauded buyers against downside market risk unrelated to the fraud . . . ." (citation omitted)); Huddleston v. Herman & MacLean, 640 F.2d 534, 555 (5th Cir. 1981) ("[T]he rescissional measure is unjust insofar as it compensates an investor for the nonspecific risks which he assumes by entering the market. Losses thus accruing have no relation to either the benefits derived by the defendants from the fraud or to the blameworthiness of their conduct." (citations omitted)), *aff'd in part, rev'd in part on other grounds*, 459 U.S. 375 (1983).

94. *See supra* note 90 and accompanying text.

95. *Green*, 541 F.2d at 1343 (Sneed, J., concurring); *see also* Fox, *supra* note 14, at 1548 ("Fraud-on-the-market actions such as *Dura* are very different from traditional reliance-based actions. The plaintiff in a traditional reliance-based action is typically a purchaser involved in either a face-to-face transaction in shares of a non-publicly traded issuer or an IPO.").

96. *Green*, 541 F.2d at 1343 (Sneed, J., concurring); *see also* Alexander, *supra* note 2, at 1496 (noting that the transactions underlying securities class actions take place in an open market); Thompson, *supra* note 70, at 386 ("Risks of change in the market that occur within a reasonable time following the discovery of the fraud shift to the defendants, while risks of market changes after that time fall on the plaintiff.").

97. *Green*, 541 F.2d at 1343 (Sneed, J., concurring). Courts and commentators alike have commented on an interesting anomaly in open-market securities fraud cases: because every purchase has a corresponding sale, for every market participant damaged by the

Furthermore, through enterprise liability, it is the diversified shareholders who must bear the cost of the fraud even though they are not responsible for the fraud.[98] Put another way, plaintiffs generally bring Rule 10b-5 fraud-on-the-market actions against non-issuing parties (the corporations); thus, there is no sale contract or privity between the plaintiff and defendant.[99] When there is no direct transaction or contract between the plaintiff-investor and the corporate defendant (and thus no privity), it makes little sense to award contract-based damages.[100] Consequently, rescissory damages cannot be justified on a restitution theory.[101]

The justification for disgorgement is likewise misplaced. Disgorgement assumes that the fraud unjustly enriched the defendant.[102]

---

fraud there is another participant who benefited. *E.g.*, *In re* Clearly Canadian Sec. Litig., 875 F. Supp. 1410, 1415 n.3 (N.D. Cal. 1995); Alexander, *supra* note 2, at 1496; Easterbrook & Fischel, *supra* note 3, at 635.

98. Arlen & Carney, *supra* note 4, at 699–700.

99. Ross v. Bank S., N.A., 885 F.2d 723, 742 (11th Cir. 1989) (Tjoflat, J., specially concurring); *In re* Letterman Bros. Energy Sec. Litig., 799 F.2d 967, 972 (5th Cir. 1986); *see also* Huddleston v. Herman & MacLean, 640 F.2d 534, 554 (5th Cir. 1981) ("Use of the rescissional measure is usually limited to cases involving either privity between plaintiff and defendant or some specific fiduciary duty owed by brokers to their customers."), *aff'd in part, rev'd in part on other grounds*, 459 U.S. 375 (1983); Philip J. Leas, Note, *The Measure of Damages in Rule 10b-5 Cases Involving Actively Traded Securities*, 26 STAN. L. REV. 371, 376–77 (1974) (same).

100. *Ross*, 885 F.2d at 742 (Tjoflat, J., specially concurring) (explaining that rescission is an inappropriate remedy in a Rule 10b-5 action against non-issuing parties). Judge Tjoflat offered the following thoughts as to why rescission is inappropriate:

> Rescission is an equitable remedy that restores parties to a transaction to their status quo ante. Typically, a buyer discovers a seller's fraud, promptly tenders the goods to the seller, and demands the return of his purchase price. The court then orders the seller to return the purchase price and uses its civil contempt power to coerce the seller's compliance with its order. This remedy is available, however, only against parties to a contract—a court may not order rescission in a buyer's action against a defrauding party who is not a party to the contract of sale. Thus, in the context of Rule 10b-5, where buyers often sue parties that are not in privity of contract with the buyer, rescission is unavailable.

Id. (citations omitted); *see also Huddleston*, 640 F.2d at 554–55 (noting the inherent difficulties in applying rescissory damages absent privity or some special relationship between the parties); Thompson, *supra* note 18, at 1185 ("In open market transactions when the defendants have made misleading statements to the market, the plaintiffs trade not with the defendants but with strangers in the market. These alternative remedies are not likely to be available in that setting."); Leas, *supra* note 99, at 376–77 (arguing that rescissory damages should not apply to fraud-on-the-market actions because such damages are likely disproportionate to an individual defendant's moral culpability).

101. *Green*, 541 F.2d at 1343.

102. Disgorgement plays an important deterrence role in face-to-face transactions, as the Court of Appeals for the Ninth Circuit explained in *SEC v. Gemstar-TV Guide International, Inc.*, 401 F.3d 1031, 1047 (9th Cir. 2005), but it does not translate well into open-market transactions. Disgorgement is generally paid to victims of wrongdoing only when the victims can establish an equitable claim to the funds. SEC v. Drexel Burnham Lambert,

But, in the open market, the plaintiff does not exchange money directly with the corporation and the corporation does not benefit directly from that profit.[103] Thus, there is no direct unjust enrichment to disgorge.[104]

This is not to say that corporations never receive indirect benefits from undiscovered open-market fraud.[105] Indeed, depending upon the type of fraud, the corporation might receive incidental tax benefits, lower costs of capital, protection from hostile takeovers, temporary business advantages, and increased publicity, while its employees may experience increased job security. In the short run, the corporation's increased share price may provide the capital to enter new businesses and update capital assets.[106] The agent committing fraud may temporarily benefit from higher firm share prices, job advancement, increased stock options, and increased prestige and reputation.[107] Yet all of these purported benefits are speculative and nearly impossible

---

Inc., 956 F. Supp. 503, 507 (S.D.N.Y. 1997). When the proceeds of disgorgement do not go to the victims, the money should be paid into the United States Treasury. *Id.*; *see also* SEC v. Fischbach Corp., 133 F.3d 170, 177 (2d Cir. 1997) (affirming district court's decision to pay disgorged funds into the Treasury); *Drexel Burnham Lambert*, 956 F. Supp. at 508 (directing payment of disgorged funds into the Treasury where there was no equitable claim).

103. *See* Pritchard, *supra* note 24, at 930–37 (proposing that even though corporations do not receive any pecuniary benefit from the fraud, their agents may be motivated by fear, greed, and Pollyannaism).

104. Indeed, one commentator suggested that investors and their attorneys are the ones unjustly enriched by the fraud, not the corporation. Langevoort, *supra* note 21, at 651. As I explain below, because the corporation does receive some indirect benefits from the initial undiscovered fraud, I would not go that far. The class action may deter fraud where the SEC, exchanges, and Department of Justice lack either the interest or the resources to do so.

105. In an auditor situation, Judge Posner noted that to assume the corporation always benefits from the fraud ignores the distinction between "[f]raud on behalf of a corporation" and "fraud against it." Cenco Inc. v. Seidman & Seidman, 686 F.2d 449, 456 (7th Cir. 1982). "Fraud against the corporation usually hurts just the corporation; the stockholders are the principal if not only victims . . . ." *Id.* Defendants have attempted to employ this distinction in securities fraud cases by arguing that where the corporation received no benefit it should not be held liable. This argument, however, has been rejected by at least one court. *E.g.*, *In re* Cylink Sec. Litig., 178 F. Supp. 2d 1077, 1087–88 (N.D. Cal. 2001).

106. These benefits could continue to provide increased revenues long after the litigation ends. Yet, even if a court required a corporation to disgorge its unjust enrichment, § 78bb(a)'s "actual damages" requirement may limit the extent to which one could speculate about the fruits of fraud. *See infra* Part IV.A.2.

107. *See, e.g.*, Plevy v. Haggerty, 38 F. Supp. 2d 816, 833 (C.D. Cal. 1998) (listing the possible benefits a corporate agent may receive by committing fraud); Alexander, *supra* note 2, at 1498 (same); Arlen & Carney, *supra* note 4, at 702–03 (same); *see also* Coffee, *supra* note 4, at 39 ("Typically, managers hide bad news because they fear loss of their jobs (either from a dismissal or a hostile takeover), and they overstate favorable developments or inflate earnings in order to maximize the value of their stock options and other equity compensation.").

to value. Even assuming a court could value them, their value is probably a good deal less than the losses of open-market purchasers.[108] Consequently, if the corporation has to compensate class members for out-of-pocket losses, this compensation would also purge the corporation of any indirect benefits. One court observed that misstatements seldom benefit the corporate issuer and that "chickens have a way of coming home to roost."[109] "When they do so in the form of securities class action plaintiffs, a corporation has hell (and usually a great deal of money) to pay."[110] In sum, even if the corporation did receive some incidental benefit from the initial undiscovered fraud, an out-of-pocket remedy will likely suffice.

Even though *Dura* indicated that modern securities actions resemble common law deceit and misrepresentation actions, when crafting remedies, courts should not ignore either the absence of a contract or the other disparities between face-to-face and open-market transactions. Common law permitted disgorgement and recovery of benefit-of-the-bargain damages based on contract law and unjust enrichment principles. But these principles do not apply to open-market fraud because, apart from public offerings, the issuer is generally not the seller in a fraud-on-the-market case.[111]

III. NORMATIVE THEORIES SUPPORTING PRIVATE RULE 10B-5 ACTIONS

Compensating the plaintiff class for more than its out-of-pocket loss in the gold-platinum hypothetical, for example, is problematic given the distinctions between common law deceit and misrepresentation actions on the one hand and fraud-on-the-market actions on the other.[112] But if compensating investors for more than their out-of-pocket losses fostered the goals of private class action litigation, then

108. Alexander, *supra* note 2, at 1498.

109. *In re Cylink*, 178 F. Supp. 2d at 1087.

110. *Id.* at 1087–88. The judge's main concern was not whether corporations should be held vicariously liable for the acts of their agents when their agents do not act in concert with or for the benefit of the corporation. Instead, the judge was troubled that "[t]aking the corporation out of the class action for want of allegations of corporate benefit might well endanger the[ ] sources of recovery." *Id.* at 1088.

111. Some commentators have gone further to argue that investors are not entitled to recover out-of-pocket losses. *See, e.g.*, Langevoort, *supra* note 21, at 646 (arguing that "full out-of-pocket compensation in open-market cases is systematically excessive and dysfunctional, and not a system that a rational investor considering the issue ex ante would want, much less demand").

112. *See* Coffee, *Loss Causation*, *supra* note 6, at 1 ("[C]ourts should interpret loss causation to require a net stock market decline in the security's price in order to preclude what I termed 'phantom losses.' But the Court has not done that. Indeed, it has even suggested that new forms of phantom losses may be recoverable.").

proposing legislative and judicial reforms to facilitate greater recovery might be a worthwhile endeavor. The corrective justice theory posits that "[i]njustice occurs when . . . one party realizes a gain and the other a corresponding loss."[113] Theoretically, the class action then corrects the injustice by depriving one party's gain and restoring it to the parties with the loss.[114] However, because corporations do not receive a direct gain from the agent's fraud on the open market, it is implausible to contend that the principal function of the class action is to correct justice by restoring lost compensation to investors.[115]

A. *Compensation as a Theoretical Rationale for Private Class Actions*

Perhaps ideally, the private securities class action would provide an efficient means for obtaining financial relief for the wronged investor. Still, when the subject security's value appreciates after fraud (generating a value higher than what the investor paid for the security), as in the gold-platinum hypothetical, the investor is already financially advantaged from owning the security.[116] Even absent this windfall, statistics show that securities class action settlements recover

---

113. Ernest J. Weinrib, *Corrective Justice in a Nutshell*, 52 U. TORONTO L.J. 349, 349 (2002); *see also* Gary T. Schwartz, *Mixed Theories of Tort Law: Affirming Both Deterrence and Corrective Justice*, 75 TEX. L. REV. 1801, 1823 (1997) (noting corrective justice's concern for compensating victims).

114. Weinrib, *supra* note 113, at 349. Weinrib observes:

> A correlatively structured remedy responds to and undoes an injustice only if that injustice is itself correlatively structured. In bringing an action against the defendant, the plaintiff is asserting that the two are connected as doer and sufferer of the same injustice. . . . The law then rectifies this injustice by reversing its active and passive poles, so that the doer of injustice becomes the sufferer of the law's remedy.

Id. at 350. Although this rationale readily applies to face-to-face transactions, it is problematic as applied to open-market transactions for the same reasons that rescission and disgorgement are problematic. In this sense, the securities fraud class action is likely more in line with the notion of distributive justice. *See id.* at 351 (stating that distributive justice involves the sharing of a benefit or burden by linking parties through the benefit or burden they share). I would be remiss in failing to point out that a wide divide exists between corrective justice scholars and utilitarian scholars. *See, e.g.*, Jeffrey O'Connell & Christopher J. Robinette, *The Role of Compensation in Personal Injury Tort Law: A Response to the Opposite Concerns of Gary Schwartz and Patrick Atiyah*, 32 CONN. L. REV. 137, 139 (1999) (noting that "[u]tilitarian scholars and corrective justice scholars rarely acknowledge the value of opposing theories and frequently deride them").

115. *See* Schwartz, *supra* note 113, at 1824 ("For the fundamental rule of vicarious liability, the deterrence rationale gets the job done in a way that corrective justice does not.").

116. Merritt Fox adopts the opposite view and thinks that the plaintiff has suffered a loss in some sense of the word. He observes:

> Assuming that she does not sell before full market realization of the true situation, the defendant's misstatement has made her worse off in an amount equal to its inflation of purchase price. But for the misstatement, she would have paid exactly that much less for the share, yet her return over her period of ownership

only a small amount of investor loss,[117] and, of financial institutions with claims in settled securities class actions, around seventy percent do not even submit them.[118] One study estimated that institutional investors failed to collect approximately $1 billion a year from securities class action settlements.[119] Statistics indicating that institutional investors are indifferent to settlement funds weakens the corrective justice argument in favor of private class actions, especially where investors experienced no net loss from bundled favorable and adverse information.

Despite the evidence, compensation is often thought to be a reason to permit fraud-on-the-market actions by private plaintiffs.[120] Therefore, this Section analyzes theories that undermine the compensation argument, and it observes that (1) Congress did not enact securities laws to provide investor insurance; (2) private securities class actions redistribute wealth among diversified shareholders; and (3) compensating investors for their cognitive errors reduces incentives to learn and creates perverse incentives to hold on to stocks that hint at fraud. Even though these observations could apply to securities class actions as a whole, my focus here is that the class action's principal

---

> (however long, and from whatever mix of dividends, distributions and sales proceeds that she receives) would have been just as great.

Fox, *supra* note 14, at 1553. Oddly, the U.S. government also took the position that this constitutes a loss. Specifically, it indicated that a price decline "may not be a necessary condition for loss causation, however, because the inflation attributable to fraud could be reduced or eliminated even if there were a net increase in price." Brief for the United States as Amicus Curiae at 13, Dura Pharms., Inc. v. Broudo, 544 U.S. 336 (2005) (No. 03-932).

117. Investor losses continually exceed settlement values. RONALD I. MILLER ET AL., NERA ECON. CONSULTING, RECENT TRENDS IN SHAREHOLDER CLASS ACTION LITIGATION: BEYOND THE MEGA-SETTLEMENTS, IS STABILIZATION AHEAD?, 7 (2006).

118. *Investor Protection: A Review of Plaintiffs' Attorney Abuses in Securities Litigation and Legislative Remedies: Hearing on H.R. 5491 Before the Subcomm. on Capital Markets, Insurance, and Government Sponsored Enterprises*, 109th Cong. 6 (2006) (testimony of Professor James D. Cox, Duke University School of Law); James D. Cox & Randall S. Thomas, *Letting Billions Slip Through Your Fingers: Empirical Evidence and Legal Implications of the Failure of Financial Institutions to Participate in Securities Class Action Settlements*, 58 STAN. L. REV. 411, 412 (2005) [hereinafter Cox & Thomas, *Letting Billions Slip Through Your Fingers*]; James D. Cox & Randall S. Thomas, *Leaving Money on the Table: Do Institutional Investors Fail to File Claims in Securities Class Actions?*, 80 WASH. U. L.Q. 855, 870 (2002) [hereinafter Cox & Thomas, *Leaving Money on the Table*].

119. Cox & Thomas, *Letting Billions Slip Through Your Fingers*, *supra* note 118, at 412; A.C. Pritchard, *Who Cares?*, 80 WASH. U. L.Q. 883, 883 (2002).

120. Section 28(a) of the Securities Exchange Act contributed to this idea of compensation, and courts, without difficulty, accepted that damages developed for common law fraud face-to-face transactions also applied to open-market transactions. Langevoort, *supra* note 21, at 645.

purpose should not be to compensate investors when they suffered no out-of-pocket losses.

1. *Securities Laws Were Not Enacted to Provide Investor Insurance*

Congress enacted securities laws to promote integrity in the open market, not to provide investor insurance.[121] In fact, the loss causation element precludes securities laws from becoming an insurance program for any security purchased in reliance on a misstatement—regardless of whether the misstatement caused a change in value—by ensuring that the misdeed actually caused the economic loss.[122]

To be sure, failing to disclose material information that artificially inflates a security's price harms an investor who purchases at that price and does not sell the security before the corporation discloses adverse information. Nevertheless, investing in the stock market is an inherently risky business, and the corporate defendant cannot return the illicit profit because the seller—not the corporation—received it. In short, stock market investments should not be treated as the equivalent of placing money in a risk-free federally insured savings and loan plan.[123] This is not to say that fraud should become another investment risk. Rather, when misstatements do not cause the loss, or the market simply is not as strong as predicted, the class action should not function as a form of supplemental income. To minimize risk, investors can insulate themselves from the effects of market down-

---

121. Dura Pharms., Inc. v. Broudo, 544 U.S. 336, 347–48 (2005) ("[A]llowing a plaintiff to forgo giving any indication of the economic loss and proximate cause . . . would bring about harm of the very sort the statutes seek to avoid. . . . Such a rule would tend to transform a private securities action into a partial downside insurance policy." (citations omitted)); Basic Inc. v. Levinson, 485 U.S. 224, 252 (1988) (White, J., concurring in part and dissenting in part) (noting that there is no support for treating securities laws as "a scheme of investor's insurance"); H.R. REP. NO. 104-369, at 31 (1995) (Conf. Rep.), *as reprinted in* 1995 U.S.C.C.A.N. 730, 730 (stating that the purpose of securities laws is to maintain confidence in the securities markets); *see also* Donald C. Langevoort, *Taming the Animal Spirits of the Stock Markets: A Behavioral Approach to Securities Regulation*, 97 NW. U. L. REV. 135, 181 (2002) ("[T]here is very little reason to use the class action device as what is essentially an insurance system against market mood swings.").

122. Carlton v. Franklin, Nos. 89-2942 & 89-2972 to 89-2974, 1990 WL 116788, at *3 (4th Cir. Aug. 2, 1990).

123. *See generally* Bridgen v. Scott, 456 F. Supp. 1048, 1058 (S.D. Tex. 1978) (likening plaintiffs who invested in speculative real estate investments, received tax write-offs and benefits from the deal, and wanted rescission to roulette players). There have been a number of arguments that the gambling industry and securities industry should have similar regulation. *E.g.*, Thomas Lee Hazen, *Disparate Regulatory Schemes for Parallel Activities: Securities Regulation, Derivatives Regulation, Gambling, and Insurance*, 24 ANN. REV. BANKING & FIN. L. 375, 395 (2005).

turns and fraud by diversifying their portfolios.[124] Thus, as set forth below, compensating investors for company-specific losses may not be necessary.

2. *Private Actions Redistribute Wealth Among Diversified Shareholders*

It is often said that securities class actions are a zero-sum game for diversified investors, and I will not attempt to rehash that literature here.[125] I will, however, note that class actions cannot actually be a zero-sum game when as much as thirty percent of the recovery pays for litigation costs.[126] To explain, in open-market class litigation, a group of shareholders and former shareholders who purchased the defendant corporation's stock during the relevant class period sues the corporation for a misstatement or omission even though the corporation itself has not purchased or sold its securities. When the litigation settles (or a judgment is entered), the corporation and thus, indirectly, its shareholders, bear the costs.[127] Accordingly, securities class actions in the open market produce a wealth transfer between shareholders who own stock in the corporation and shareholders in the class.[128]

This is particularly true when an investor spreads the risk of loss by diversifying her portfolio, and thereby minimizes the impact of a poor financial showing by any one company.[129] Diversification in-

---

124. *See* Pritchard, *supra* note 24, at 940 ("Holding a diversified portfolio effectively eliminates any possibility of being a net loser from fraud on the market, thereby assuaging the concerns of even the risk-averse shareholder.").

125. Donald Langevoort explains the zero-sum game analysis as follows:

> First, any award against the issuer or settlement is funded directly or indirectly out of the issuer shareholders' pockets, as the fraud-on-the-market litigation system is premised almost exclusively on a system of vicarious liability. Second, investors tend to be, directly or indirectly, diversified in their investments and are just as likely to gain a windfall from issuer "fraud-on-the-market" as to end up a loser.

Langevoort, *supra* note 21, at 181 (citation omitted); *see also* Alexander, *supra* note 2, at 1502 (discussing the effects of diversification in securities class actions); Coffee, *supra* note 4, at 33 (same); Pritchard, *supra* note 24, at 939 ("In fraud on the market, for every shareholder who bought at a fraudulently inflated price, another shareholder has sold: The buyer's individual loss is offset by the seller's gain."); Douglas M. Schwab et al., *A Completely New Approach to Rule 10b-5 Damages*, *in* FINANCIAL FRAUD IN PUBLIC COMPANIES: PREVENTION, DETECTION & LITIGATION, at 347, 364–65 (PLI Corp. Law & Practice, Course Handbook Series No. B0-00O2, 2000).

126. ANJAN V. THAKOR ET AL., INST. FOR LEGAL REFORM, THE ECONOMIC REALITY OF SECURITIES CLASS ACTION LITIGATION 2 (2005), http://www.instituteforlegalreform.com/pdfs/EconomicRealityNavigant.pdf.

127. Coffee, *supra* note 4, at 32.

128. *Id.* at 32–33.

129. Pritchard, *supra* note 24, at 940; Coffee, *supra* note 4, at 33.

creases the likelihood that an investor will be both in the plaintiff class suing the corporation and in the shareholder group paying for the litigation.[130] The more an investor is diversified, the greater the likelihood that, on any given day, she will be a shareholder within the class period or in the group indirectly funding the settlement. Consequently, even though investors "win" on some days and "lose" on others, in the aggregate, they are transferring wealth from one pocket to another.[131] In sum, private securities class actions appear to be a costly means for diversified investors to make wealth transfers to themselves (and pay a substantial amount to their attorneys).[132]

In fact, the primary immediate beneficiaries of private securities fraud class actions appear to be the attorneys.[133] Transactional costs such as attorneys' fees and settlement payments to investors frequently fall upon the corporation's shareholders—often inequitably since the shareholders engaged in no wrongdoing. Even the SEC recently indicated that it will consider whether the violative conduct victimized shareholders when determining whether to impose hefty financial penalties on the corporation.[134] As Professor John Coffee argues,

---

130. Coffee, *supra* note 4, at 33. For example, say an investor focuses on the pharmaceutical industry and compiles a diversified portfolio of stocks for the numerous companies within that industry. If consumers avoid Merck's painkiller, Vioxx, because of the ongoing class litigation, it does not mean that they will go without painkillers and cause a downturn in the entire pharmaceutical industry. Rather, they will use a different painkiller. An investor with diversified stocks within the pharmaceutical industry may suffer loss from the decrease in Merck's stock but a gain from the increase in sales from other companies' painkillers. Thus, there is no net loss.

131. *Id.* For each shareholder who bought the stock at an artificially inflated price due to fraud, another shareholder has sold. Alexander, *supra* note 2, at 1496. Thus, one particular buyer's loss is offset by the seller's gain. If all investors are ignorant of the fraud and are diversified, then there will be winners with windfalls just as often as there are losers. Academics have continued to debate the effects of this circularity. *See, e.g.*, Arlen & Carney, *supra* note 4, at 698–700 (suggesting that the loss falls on individuals who were shareholders when the fraud is revealed); Paul G. Mahoney, *Precaution Costs and the Law of Fraud in Impersonal Markets*, 78 VA. L. REV. 623, 635 (1992) (arguing that the circularity undermines Rule 10b-5's effectiveness as a fraud deterrent).

132. Arlen & Carney, *supra* note 4, at 700; Coffee, *supra* note 4, at 33.

133. Arlen & Carney, *supra* note 4, at 700; Richard M. Phillips & Gilbert C. Miller, *The Private Securities Litigation Reform Act of 1995: Rebalancing Litigation Risks and Rewards for Class Action Plaintiffs, Defendants and Attorneys*, 51 BUS. LAW. 1009, 1013 (1996); *cf.* Jonathan R. Macey & Geoffrey P. Miller, *The Plaintiffs' Attorney's Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform*, 58 U. CHI. L. REV. 1, 12 (1991) (observing that plaintiffs' attorneys may have divergent interests from the interests of the class). Of course, the economy as a whole may benefit from increased deterrence of fraud.

134. Press Release, SEC, Statement of the Sec. & Exch. Comm'n Concerning Fin. Penalties (Jan. 4, 2006), *available at* http://www.sec.gov/news/press/2006-4.htm. The SEC observed:

> In cases in which shareholders are the principal victims of the violations, the Committee expects that the SEC, when appropriate, will seek penalties from the

"[t]o punish the corporation and its shareholders in [a typical secondary open-market case] is much like seeking to deter burglary by imposing penalties on the victim for having suffered a burglary."[135] If measured only by investor trading gains and losses, the resulting net social gain is zero.[136]

3. *Permitting Recovery Beyond Out-of-Pocket Losses Reduces Incentives to Learn*

Securities class actions not only operate as a costly means for wealth redistribution, they may also have perverse incentives on investor motivation and education.[137] Behavioral finance theorists present some tentative answers to market phenomenon left unexplained by traditional law and economics.[138] They refute the assumption that investors are rational,[139] but analysts have yet to relate these theories to

---

> individual offenders acting for a corporate issuer. Moreover, in deciding whether and to what extent to assess a penalty against the issuer, the court may properly take into account whether civil penalties assessed against corporate issuers will ultimately be paid by shareholders who were themselves victimized by the violations. The court also may consider the extent to which the passage of time has resulted in shareholder turnover.

Id.

135. Coffee, *supra* note 4, at 6.

136. Alexander, *supra* note 2, at 1496; Easterbrook & Fischel, *supra* note 3, at 639; Langevoort, *supra* note 21, at 646.

137. As Langevoort notes, "[f]ew rational investors would opt for a system that so systematically overcompensates when they know that investors generally will be funding those payments. And no rational investor would opt for an expensive litigation system to accomplish it." Langevoort, *supra* note 21, at 650.

138. Langevoort, *supra* note 121, at 153. For background on the literature of behavioral finance, see BEHAVIORAL LAW & ECONOMICS (Cass R. Sunstein ed., 2000); HERSH SHEFRIN, BEYOND GREED AND FEAR: UNDERSTANDING BEHAVIORAL FINANCE AND THE PSYCHOLOGY OF INVESTING 13–22 (2002); Stephen J. Choi & A.C. Pritchard, *Behavioral Economics and the SEC*, 56 STAN. L. REV. 1 (2003); Ronald J. Gilson & Reinier Kraakman, *The Mechanisms of Market Efficiency Twenty Years Later: The Hindsight Bias*, 28 J. CORP. L. 715 (2003); Christine Jolls et al., *A Behavioral Approach to Law and Economics*, 50 STAN. L. REV. 1471 (1998); Jonathan Klick & Gregory Mitchell, *Governmental Regulation of Irrationality: Moral and Cognitive Hazards*, 90 MINN. L. REV. 1620 (2006); Langevoort, *supra* note 121; Robert Prentice, *Whither Securities Regulation? Some Behavioral Observations Regarding Proposals for Its Future*, 51 DUKE L.J. 1397 (2002).

139. Ribstein, *supra* note 6, at 138; Philip E. Tetlock & Barbara A. Mellers, *The Great Rationality Debate*, 13 PSYCHOL. SCI. 94, 94 (2002). Numerous works explicate the particular biases to which investors might be subject. *See, e.g.*, Choi & Pritchard, *supra* note 138, at 7–14 (overconfidence bias, reliance on heuristics, and cognitive dissonance); Baruch Fischhoff, *Hindsight ? Foresight: The Effect of Outcome Knowledge on Judgment Under Uncertainty*, 1 J. EXPERIMENTAL PSYCHOL: HUM. PERCEPTION & PERFORMANCE 288 (1975) (hindsight bias); Dale Griffin & Amos Tversky, *The Weighing of Evidence and the Determinants of Confidence*, 24 COGNITIVE PSYCHOL. 411 (1992) (overconfidence bias); Amos Tversky & Daniel Kahneman, *Belief in the Law of Small Numbers*, *in* JUDGMENT UNDER UNCERTAINTY: HEURISTICS AND BIASES 23 (Daniel Kahneman et al. eds., 1982).

securities regulation.[140] As Larry Ribstein observed, if markets are not as efficient as we formerly believed, then Congress may need to strengthen securities laws to provide additional insulation from investor misjudgment—i.e., the paternalistic view of behavioral economics.[141] On the other hand, if "noise" moves markets instead of actual information, then increased regulation and liability may lead to more harm.[142] Ribstein identifies one of the hazards related to class actions and notes that "[f]orcing corporations or insiders to pay damages linked to the market's irrational response to disclosures may have perverse effects, including discouraging disclosure."[143]

But discouraging disclosure may be even less problematic than diminishing individual incentives to learn from past investment mishaps. Jonathan Klick and Greg Mitchell's recent research indicates that making the private class action available to defrauded investors even where the investors experienced no out-of-pocket loss could reduce both their incentive to learn and their ability to make future decisions.[144] Klick and Mitchell argue that "moral hazards" appear when paternalistic regulations—such as securities laws—reduce individual incentives to act "deliberately and carefully."[145] Similarly, individuals face "cognitive hazards" when these regulations restrict choices that might otherwise function as learning opportunities.[146] But moral and cognitive hazards do not exist solely in the vacuum of regulation. Plaintiffs' attorneys' intervention into investors' lives may also restrict learning opportunities.

As we have seen, diversified investors, as corporate shareholders, indirectly fund a generous portion of securities fraud settlements.[147]

---

140. Langevoort, *supra* note 121, at 152 ("Lawyers and policy makers cannot hope to resolve the academic dispute over market efficiency . . . ."); Ribstein, *supra* note 6, at 138.

141. Ribstein, *supra* note 6, at 138.

142. *Id.*; *see generally* J. Bradford De Long et al., *Noise Trader Risk in Financial Markets*, 98 J. POL. ECON. 703 (1990) (analyzing the effects of noise traders on the market).

143. Ribstein, *supra* note 6, at 138. Ribstein further observes that holding corporate agents liable for misrepresentations may "increase investors' tendency toward overconfidence by convincing them that securities trading is safe, even if liability merely protects them only from a relatively narrow risk of misrepresentation." *Id.* at 144.

144. *See* Klick & Mitchell, *supra* note 138, at 1626.

145. *Id.*; *see also* Ribstein, *supra* note 6, at 145 (arguing that increased securities regulations lessens investors' abilities to protect themselves).

146. *See* Klick & Mitchell, *supra* note 138, at 1626, 1647–49. Ribstein observes that the law may not have much effect on learning if investors do not know how it protects them, and he points out that investors who do learn may be replaced by a new naïve group. Ribstein *supra* note 6, at 145. Yet, this does not eliminate the potential perverse effects of class litigation on investor learning.

147. *See supra* notes 129–132 and accompanying text; *see also* Pritchard, *supra* note 24, at 957–58 ("The transaction costs of litigation leading to settlements that merely transfer

Few fully informed investors would choose expensive class litigation that essentially transfers wealth from one pocket to another.[148] Yet behavioral finance indicates that human rationality is bounded and that decisionmakers must select among numerous demands for their time and attention.[149] Consequently, investors are "rational[ly] ignoran[t]," possibly about the true litigation costs, because it is unreasonable, if not impossible, to gather all relevant information before making a single decision.[150] Because the majority of non-attorney individuals do not have much information about the inner-workings of a securities fraud class action, they are (1) likely to take their attorneys' advice and proceed with a class action (and subsequent settlement) that they are inadvertently funding, and (2) not likely to distinguish between recoveries that are out-of-pocket versus those based on contract law measurements, such as disgorgement or rescissory damages.[151] Although legal education would likely diminish this ignorance,[152] it is extraordinarily unlikely that an investor would squander the time, effort, and expense of a legal education just to determine whether a securities class action makes economic sense.

Without doctrinal consensus on a securities fraud remedy, the class action is arguably available to investors, such as those in the gold-platinum hypothetical, who did not experience a net loss. Because

---

wealth among shareholders are a pure social waste, unless class actions provide a substantial deterrent effect.").

148. Langevoort, *supra* note 21, at 650.

149. *See* Herbert A. Simon, *Rational Choice and the Structure of the Environment*, 63 PSYCHOL. REV. 129, 129 (1956) (arguing that economic theorists overestimate human decisionmaking abilities); *see also* ROBYN M. DAWES, RATIONAL CHOICE IN AN UNCERTAIN WORLD 50–56 (1988) (explaining Simon's theory of bounded rationality); Jolls et al., *supra* note 138, at 1477 (explaining that bounded rationality refers to limitations in human cognition); Prentice, *supra* note 138, at 1454–55 (noting that bounded rationality means decisionmakers must make choices based on incomplete and inaccurate information).

150. Prentice, *supra* note 138, at 1454–55. There have been a number of initiatives to make corporate disclosures less dense and more useful through simplification. For example, before Congress passed the Sarbanes-Oxley Act, SEC Chairman Pitt urged public companies to "consider simplifying financial disclosures to make accounting statements useful to, and utilizable by, ordinary investors." Harvey L. Pitt, Chairman, SEC, Remarks Before the AICPA (American Institute of Certified Public Accountants) Governing Council (Oct. 22, 2001), *available at* http://www.sec.gov/news/speech/spch516.htm. Making financial disclosures easier to read would certainly help in reducing the amount of information that investors might consider before investing. Yet, even still, it would be difficult to read every company's full disclosures before making a single investment decision.

151. *See* Ribstein, *supra* note 6, at 141 ("[I]nvestors are not equal in education, intelligence, or expertise.").

152. *See* Klick & Mitchell, *supra* note 138, at 1652 (suggesting that education affects the likelihood of an individual picking the correct option).

individuals "learn[ ] by doing,"[153] compensating investors without out-of-pocket losses not only prevents them from learning from their past investment mistakes, but it also provides a perverse incentive to ignore potential warning signs of future fraud in hopes of receiving additional money in a class action.[154] This, in turn, fosters rational ignorance and rewards the investor who stays aboard the metaphorical sinking ship when other investors heeded the warning signs long before. In short, if private litigation compensates investors who do not have out-of-pocket losses, this could (1) prevent individuals from learning from their investment mistakes and reward ignorance, and (2) provide a perverse incentive to invest purposefully in companies with signs of fraud in the hope that they will again receive a litigation windfall.[155]

This leaves open the question of whether laws or judicially tailored recoveries should "save investors from themselves." Of course, taking away the choice to sue where investors suffer no net loss can be seen as yet another paternalistic intervention. Given that congressional members and judges also suffer from cognitive biases,[156] the

---

153. *Id.* at 1626 ("[R]esearch from developmental psychology indicates that individuals improve their decision-making skills over time through a 'learning by doing' process, and that paternalistic policies threaten interference in this self-regulatory process.").

154. Of course, this theory is not immune to the criticism that minimizing the incentive for private litigation in certain circumstances is paternalistic in and of itself. Yet, a steadfast avoidance of all paternalistic initiatives leads to a return to laissez-faire markets. *See id.* at 1653 ("Imposing no choice-set constraint or offering no insurance would represent a laissez-faire stance in which there is no paternalistic oversight of the biased behavior."). Recall the stock market crash of 1929 and the Great Depression that followed, events which counsel against such an approach to securities regulation.

155. There might be an interesting if not persuasive defense here. If individual or even institutional investors continually purchased securities that reeked of fraudulent behavior in hopes of obtaining a windfall recovery in a securities class action, the defendants could argue that the plaintiffs did not rely on the misrepresentation. Lack of reliance has been a traditional defense in face-to-face transactions where reliance is unreasonable. *See, e.g.*, Royal Am. Managers, Inc. v. IRC Holding Corp., 885 F.2d 1011, 1015 (2d Cir. 1989) (noting that defendants may disprove reliance by demonstrating plaintiffs negligently failed to discover true facts). To make this argument in an open-market case, the defendants would have to challenge the efficient market hypothesis—a position made easier by the large body of literature on behavioral finance and noise traders. *See, e.g.*, De Long et al., *supra* note 142, at 711–13 (explaining how noise traders may affect prices); Ribstein, *supra* note 6, at 138 (arguing that research showing that markets and individuals may be irrational challenges the efficient capital market hypothesis); Lynn A. Stout, *The Mechanisms of Market Inefficiency: An Introduction to the New Finance*, 28 J. CORP. L. 635, 638 (2003) (suggesting behavioral finance literature creates a need to reevaluate the efficient market hypothesis).

156. *See* Christopher R. Drahozal, *A Behavioral Analysis of Private Judging*, 67 LAW & CONTEMP. PROBS. 105 (2004) (analyzing the susceptibility of arbitrators to cognitive illusions); William N. Eskridge, Jr. & John Ferejohn, Commentary, *Structuring Lawmaking to Reduce Cognitive Bias: A Critical View*, 87 CORNELL L. REV. 616, 630–31 (2002) (discussing the types of cognitive biases likely to affect judges); Chris Guthrie et al., *Inside the Judicial Mind*, 86

question that follows then is whether an optimal level of paternalism exists and, if so, who is the administrator? This Section raises more questions than it does answers, but Klick and Mitchell offer some preliminary observations on this point. They contend that "optimal paternalism represents a mechanism design problem in which a social planner must consider using more than just the sledgehammer of constraining choice sets ex ante or providing implicit social insurance through some form of ex post paternalism."[157] Thus, if one considers the judiciary an apt social planner, then at least one option is to negate social insurance by limiting investors to out-of-pocket losses in private class actions. The corollary then is that the class action should not be available to net winners from fraud. Although arguably paternalistic, this option promotes investor incentive to learn from past investment errors and takes away one opportunity for class litigation—and with it the perverse double reward when the net stock price increases after fraud.

B. Private Class Actions Promote Deterrence

Because compensating defrauded investors without out-of-pocket losses encourages costly wealth transfers among diversified investors and provides disincentives to learn, compensation should not be the principal rationale underlying securities fraud class actions. Instead, in accord with Congress's goal of ensuring market integrity,[158] private litigation's primary objective must be to deter fraud.[159] The SEC has commented that "the overriding purpose of Congress was not so much to impose liability for the benefit of investors injured by a defective registration statement but rather to stimulate diligence on the

---

CORNELL L. REV. 777 (2001) (studying how cognitive biases influence judges); Jeffrey J. Rachlinski, *The Uncertain Psychological Case for Paternalism*, 97 NW. U. L. REV. 1165, 1199–1201 (2003) (exploring how cognitive biases impact decisionmaking and noting that judges are sometimes affected by cognitive illusions).

157. Klick & Mitchell, *supra* note 138, at 1652–53.

158. *See* Randall v. Loftsgaarden, 478 U.S. 647, 664 (1986) (indicating that Congress intended the 1934 Act to deter fraud and promote disclosure); Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128, 151 (1972) (noting that Congress sought to improve business ethics through the 1934 Act).

159. Mahoney, *supra* note 131, at 636 ("Note that a redistribution among shareholders that does not enhance deterrence is every bit as bad as fraud itself. Just as fraud may lead to investments in lying and precautions, so the possibility of using litigation as a purely redistributive tool will lead to excessive investment in litigation."); *see also* Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669, 693–94 (1984) (arguing that protecting unsophisticated investors should not be the goal of securities regulation).

part of those persons who are actually responsible for [its] preparation."[160]

Certainly, securities regulators want to deter the prospective practice of bundling adverse and favorable information to prevent a stock price drop and thus potentially prevent class action liability. And compensatory damages can, in certain circumstances, promote deterrence by compelling officers and directors to internalize the costs and benefits of their actions.[161] But, because class recovery redistributes wealth among diversified shareholders and could cause perverse effects on investor education and motivation, perhaps the class action is not the best vehicle for deterring this type of bundling.[162] One problem with using the class action to deter this practice is that variable remedies may not accurately pair penalties with the wrongful conduct's social harm.[163] Without consensus on how to measure loss, both attorneys and corporate actors lack a defined starting point for estimating financial costs.[164] Thus, corporate actors have no gauge by

---

160. Joseph W. Bishop, Jr., *New Problems in Indemnifying and Insuring Directors: Protection Against Liability Under the Federal Securities Laws*, 1972 DUKE L.J. 1153, 1162 (quoting Brief for SEC as Intervenor, Feit v. Leasco Data Processing Equip. Corp., 332 F. Supp. 544 (E.D.N.Y. 1971)).

161. *See generally* STEVEN SHAVELL, ECONOMIC ANALYSIS OF ACCIDENT LAW 5–21, 127–51 (1987) (discussing theories of levels of care and their effect on deterrence, and analyzing damages based on the magnitude of liability); Robert Cooter, *Prices and Sanctions*, 84 COLUM. L. REV. 1523, 1552 (1984) (arguing that the potential cost of an activity can be internalized by individuals when deciding how to act).

162. *See infra* Part III.A.3.

163. *See* Alexander, *supra* note 2, at 1493 (noting that the practical calculation of loss in class actions is complex and uncertain). This is not to say that uncertainty about how to measure damages is the only problem. Market reaction is also unpredictable. But a fixed remedy at least provides a predictable starting point. Many commentators have explored ways in which the tort system does not lead to optimal deterrence due to the transactional costs of litigation and the disparity between social and private incentives. *E.g.*, Susan Rose-Ackerman & Mark Geistfeld, *The Divergence Between Social and Private Incentives to Sue: A Comment on Shavell, Menell, and Kaplow*, 16 J. LEGAL STUD. 483 (1987); Steven Shavell, *The Social Versus the Private Incentive to Bring Suit in a Costly Legal System*, 11 J. LEGAL STUD. 333 (1982).

The deterrence theory is founded on the assumption that the officer or director is a rational actor and will change her behavior based on the costs and benefits of a situation. Kevin M. Carlsmith et al., *Why Do We Punish? Deterrence and Just Deserts as Motives for Punishment*, 83 J. PERSONALITY & SOC. PSYCHOL. 284, 285 (2002). Academics writing in the field of behavioral law and economics readily dispute the theory that humans are rational. *See supra* note 139 and accompanying text; *see also* James A. Fanto, *Quasi-Rationality in Action: A Study of Psychological Factors in Merger Decision-Making*, 62 OHIO ST. L.J. 1333, 1342–47 (2001) (summarizing the application of behavioral science to law and economics).

164. I take for granted that corporate actors aim to maximize wealth. Of course, corporate actors may be motivated by other factors such as saving their jobs or covering previous wrongdoing. Yet, corporations generally hire managers to promote the corporation, to act in its best interests, and to make the corporation profitable. Thus, I assume, perhaps naïvely, that managers generally want to act in their own best interests, which would in-

which to judge the detrimental effects of, for example, overly optimistic announcements. Presumably, if this measurement is known, the wealth-maximizing actor will avoid conduct that results in costly financial penalties and society then benefits from accurate corporate information.[165]

Given the uncertainty of potential class action damages, how do corporate actors weigh their behavior?

1. *Maximizing Deterrence*

Until would-be-violators can approximate the cost of a penalty, they will be unable to adjust their behavior accordingly.[166] Put another way, if a would-be-violator feels that she could face exorbitant penalties regardless of her actions—a quasi-form of strict liability—then she may ignore potential consequences and engage in wealth-maximizing behavior.[167] She may then hope that the penalty costs less than the wealth received from that particular behavior.[168] Wealth-driven corporate managers who contemplate violating the law must know the costs and the benefits before they can determine whether the benefits outweigh the expected liability.[169] But most private secur-

---

clude keeping their jobs. Consequently, because part of their job is to maximize corporate profits, they must perform this task to act in their own self-interest.

165. Alexander, *supra* note 2, at 1493.

166. Erick Gerding explains the deterrence model from an economic perspective:

> Were an economist to model the deterrence theory that undergirds the antifraud rules of the securities law, the decision by a securities issuer or a market intermediary (such as a gatekeeper) on whether to commit fraud would look something like $B < > P_d *((P_e * L_l) + L_r)$, where B represents the benefits to be realized from committing fraud, P_d represents the probability of the fraud being detected, P_e represents the probability of the securities laws being successfully enforced, L_l represents legal liability under the securities laws, and L_r represents market, reputational and other non-legal losses.
>
> Rational actors contemplating violating the law will do so if the benefits, B, outweigh the expected liability.

Erik F. Gerding, *The Next Epidemic: Bubbles and the Growth and Decay of Securities Regulation*, 38 CONN. L. REV. 393, 427–28 (2006).

167. *Cf.* Pritchard, *supra* note 24, at 959 ("The cost of litigating securities class actions, tied to potentially enormous judgments, ensures that even weak cases will produce a settlement if they are not dismissed before trial.").

168. *See* John E. Calfee & Richard Craswell, *Some Effects of Uncertainty on Compliance with Legal Standards*, 70 VA. L. REV. 965, 966 (1984) ("If the legal standard is uncertain, even actors who behave 'optimally' in terms of overall social welfare will face some chance of being held liable because of the unpredictability of the legal rule.").

169. *See* Gerding, *supra* note 166, at 428 (noting that if the benefit outweighs the liability, a rational individual considering violating the law will do so). A.C. Pritchard identifies some of the costs of corporate fraud as reduced managerial accountability, higher cost of liquidity for traders, and, by allowing corporations to raise funds for non-cost-justified investment projects, improper capital allocation. Pritchard, *supra* note 24, at 937–45.

ities class actions end in confidential settlement agreements. Even those that reach a judge or jury are subject to variable remedies.[170]

Although most cases never reach a jury, if attorneys could advise would-be-violators and would-be-litigants on the remedy for securities violations, that baseline could at least provide a starting point for both groups to modify their behavior. Or, perhaps initially more likely, they could agree upon a more realistic settlement value. John Calfee and Richard Craswell identified the difficulty in measuring damages as one of several pertinent factors that thwart optimal deterrence in tort law.[171] Calfee and Craswell discuss the fallacy that excessive damage awards incentivize overcompliance with the law and, conversely, that insufficient awards prompt undercompliance.[172] Instead, they argue, uncertainty about the measure and level of damages can produce both undercompliance and overcompliance (and underdeterrence and overdeterrence).[173] To be sure, this is less than ideal when social planners aim for optimal deterrence and optimal paternalism.

2. *Preventing Substantive "Absolute" Liability and Promoting Predictability*

The *Dura* Court's dicta increased instability in measuring loss by intimating that a corporation might be liable in a class action when its higher share price is lower than it would have been absent the fraud.

---

170. Easterbrook & Fischel, *supra* note 3, at 611–12 (quoting Hackbart v. Holmes, 675 F.2d 1114, 1121 (10th Cir. 1982)).

171. Calfee & Craswell, *supra* note 168, at 969. These factors included uncertainty about whether would-be-violators will be sued and, if so, uncertainty about the size of the damages or fine that they would have to pay if found liable. *Id.* at 968–69. Of course, even eliminating the uncertainty about whether there will be enforcement and the amount of damages does not eliminate all uncertainty. One of the primary fallacies of securities law is the concept of materiality. Given the myriad of judicial approaches to materiality, an officer or director of a corporation may not know whether her comment or report will be considered "material." Alexander, *supra* note 2, at 1494 ("For example, a corporation will have difficulty weighing the costs and benefits of failing to disclose information if it is unsure about whether a court would consider that information 'material.'"); *see also* Gerding, *supra* note 166, at 438–40 (asserting that there are several possible deviations from the general idea of materiality based on market conditions and behavioral biases of actors).

172. Calfee & Craswell, *supra* note 168, at 986.

173. *Id.* Several briefs in *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336 (2005), identified the problem of overdeterrence in fraud-on-the-market situations. Brief of The Chamber of Commerce of the United States as Amicus Curiae in Support of Petitioners at 10, *Dura*, 544 U.S. 336 (2005) (No. 03-932); Brief of Washington Legal Foundation as Amicus Curiae in Support of Petitioners at 27, *Dura*, 544 U.S. 336 (2005) (No. 03-932). The Supreme Court echoed this problem in its opinion by relying on the PSLRA and observing that the Act "makes clear Congress' intent to permit private securities fraud actions for recovery where, but only where, plaintiffs adequately allege and prove the traditional elements of causation and loss." *Dura*, 544 U.S. at 346.

Unpredictability is evidenced by the increased likelihood that a corporation may find itself in the midst of a securities class action at some point—perhaps regardless of its precautions.[174] In 2006, NERA Economic Consulting reported that, over a five-year period, the average public company has a ten percent chance of facing a shareholder class action lawsuit.[175] Although there is a forty percent chance that the court will dismiss the action,[176] the mere filing of the suit typically causes a drop in a company's stock price.[177]

Because it often takes months to achieve a final dismissal with prejudice, the corporation must report the litigation in its public SEC filings, which may decrease the willingness of new investors to purchase its securities. As is often mentioned in the ever-popular class action critique, getting rid of even frivolous litigation is not free, particularly when the court is unable to determine (due in part to the variable calculations of loss) from the face of the pleadings whether the suit satisfies the pleading standards.[178] If the complaint might eventually plead a prima facie case of fraud, the result is usually a dismissal without prejudice so that the plaintiffs can, if possible, correct the deficiency. This invariably leads to amendments and re-filing, which starts the cycle all over again. Clarifying that plaintiffs are entitled to recover only their out-of-pocket losses could facilitate earlier dismissal of actions without net loss.

---

174. A.C. Pritchard observes that if plaintiffs survive a motion to dismiss, then defendants usually settle because settling tends to be cheaper than litigation. Pritchard, *supra* note 24, at 952. I would extend this period beyond the motion to dismiss stage and to the class certification stage. Defendants are generally willing to prolong the litigation if they have a plausible argument that the plaintiffs' cannot meet the certification standards for Federal Rule of Civil Procedure 23. Consequently, they will generally wait to settle until after the court certifies a class.

175. MILLER ET AL., *supra* note 117, at 3.

176. *Id.*

177. Coffee, *supra* note 4, at 6; *see also* Arlen & Carney, *supra* note 4, at 699 ("Revelation of the fraud, and of the corporation's prospective liability, has an immediate impact on the price of the issuing corporation's stock: the price adjusts to reflect both the truth previously concealed by the fraud and the corporation's expected liability for the fraud.").

178. The Supreme Court observed in *Dura* that the pleading requirements on plaintiffs are not unduly burdensome:

> [Pleading requires only] "a short and plain statement of the claim showing that the pleader is entitled to relief." . . .
>
> . . . [I]t should not prove burdensome for a plaintiff who has suffered an economic loss to provide a defendant with some indication of the loss and the causal connection that the plaintiff has in mind.

544 U.S. at 346–47 (quoting FED. R. CIV. P. 8(a)(2)). Accordingly, it is not far-fetched to think that the Supreme Court would encourage dismissal of claims that fail to demonstrate economic loss. The variable, of course, is how that loss is measured.

For now, the upshot of corporations experiencing at least a ten percent probability of a securities class action means that the officers and directors must plan for such an occurrence.[179] The result is not overly cautious and pessimistic statements (for corporate agents would not last long by failing to appropriately promote the corporation), but rather is a budgetary allocation for officer and director insurance as well as for class action litigation. When the judicial system effectively holds defendants unconditionally liable by prompting them to build securities class actions into their budget—regardless of whether they have committed fraud—then defendants have little incentive to take excessive precautionary measures. If the funds (or the directors' and officers' insurance policies)[180] are already available, why should management be more realistic in its financial reports?[181] Though volatile market reactions generate a great deal of insecurity as well, a consensus on the appropriate remedy (and thus what constitutes a loss) could facilitate earlier dismissal of suits where plaintiffs are unable to demonstrate net losses, and it could give corporate planners at least some degree of predictability in analyzing their conduct in financial terms.[182]

IV. LIMITING PRIVATE CLASS RECOVERY TO NET LOSSES

As espoused throughout this Article, one option for remedying open-market fraud is to restrict plaintiffs' recovery to out-of-pocket losses. This would compensate only net monetary losses.[183] Although it seems relatively simple, this rule has broader practical and theoretical ramifications. First, unlike other common law remedies, the out-of-pocket rule compensates plaintiffs only for the loss caused by the fraud and therefore aligns with the stringent loss causation requirements and the limitation on "actual damages" in 15 U.S.C.

---

179. Coffee, *supra* note 4, at 21.

180. *See id.* at 23–24 (noting that insurance usually pays settlement amounts); Pritchard, *supra* note 24, at 956 (explaining how corporations acquire directors' and officers' insurance to limit exposure); *see also supra* note 4 and accompanying text.

181. Granted, if managers use their budgetary allocation for securities class action litigation then they will have to replenish it. Consequently, they do have some incentive to avoid fraud and prevent corporate loss. Yet, managers without this sort of budgetary requirement at all might have greater incentives to avoid fraud.

182. I recognize that limiting plaintiffs to out-of-pocket losses decreases the class action's deterrence value as applied to a corporation that attempts to avoid liability by bundling favorable and adverse information. There are, however, other adequate means for deterring that situation. *See infra* Part IV.C.

183. This complies with *Dura*'s requirement that "a plaintiff . . . show not only that had he known the truth he would not have acted but also that he suffered actual economic loss." Dura Pharms., Inc. v. Broudo, 544 U.S. 336, 343–44 (2005).

§ 78bb(a).[184] Second, it supplies a predictable foundation for judging the reliability of expert methodology that purports to prove economic loss and injury.[185] Third, limiting plaintiffs to their out-of-pocket losses facilitates earlier dismissal of suits that provide double recoveries to investors and that create an incentive to invest purposefully in companies showing signs of fraud.[186] Finally, this limit could bolster the class action's deterrence value through increased predictability.[187]

A. *Out-of-Pocket Losses Provide the Best Fit for Modern Securities Fraud*

Restricting the plaintiff class's recovery to its out-of-pocket losses recognizes that open-market fraud is a tort and that the company is being held vicariously liable.[188] Unlike other remedies that are contract- and equity-based, the out-of-pocket measure resonates with the realities of open-market fraud.

1. *Out-of-Pocket Recoveries Comply with the Loss Causation Standard*

Despite its relative ambiguity, after *Dura*, the loss causation element plainly mandates that plaintiffs tie the loss for which they seek damages to the defendant's misrepresentation or omission.[189] It follows that, if liable, defendants should compensate plaintiffs only for those losses. Consequently, a typical rescissory measure of loss, which aims to restore the parties to the position they would have been in absent the fraud, should not be available because it would require the defendant to reimburse the plaintiffs for losses caused by both fraud and changes in the market.[190]

In the same manner, loss causation limits unjust enrichment damages. In the gold-platinum hypothetical, the corporation's stock price increased after the disclosure of no gold and the announced discovery of platinum. Thus, the corporation arguably received an in-

---

184. *See infra* Part IV.A.1–2.

185. *See infra* Part IV.A.3.

186. *See supra* Part III.A.3.

187. *See supra* Part III.B.2. To be sure, limiting plaintiffs' recovery to net losses inhibits the class action's ability to deter corporations from bundling favorable and adverse information to avoid class action liability. But the SEC, Department of Justice, and exchanges can still deter that type of behavior. *See infra* Part IV.C.

188. *See supra* notes 105–110 and accompanying text (discussing the indirect benefits that corporations may receive from undiscovered fraud).

189. 15 U.S.C. § 78u-4(b)(4) (2000).

190. *See* Thompson, *supra* note 18, at 1180 n.12 (asserting that when there is an overall market decline following fraud, rescission makes defendants pay the difference). Note, however, that the defendant would only be responsible for ninety days worth of changes because Congress has determined that this particular point in time is the appropriate period for market adjustment. 15 U.S.C. § 78u-4(e)(2).

direct benefit from the platinum discovery. But the platinum discovery cannot enter the damage equation because the defendant's indirect profit from that discovery is unconnected to the plaintiffs' gold-related losses. Apart from a possible attempt to avoid liability by bundling adverse and favorable news, there is no link between the stock price increase based on the platinum discovery and the alleged decrease from the absence of gold. In other words, there can be a lack of gold without the addition of platinum. A plaintiff is entitled to reimbursement only for loss caused by the misrepresentation or omission.[191] Disgorgement is not an appropriate remedy for that loss because disgorgement purges indirect benefits obtained by the corporation; it does not award damages based only on the loss caused by the misdeed. Moreover, where the defendant would have obtained the benefit even without the fraud, disgorgement is not appropriate.[192] In short, even though *Dura* suggested that a private plaintiff might bring an action when a share's higher price is lower than it would have been absent the fraud, a court should not require the corporation to purge itself of any indirect benefits it obtained from its unrelated positive news.[193]

2. *Out-of-Pocket Losses Conform with 15 U.S.C. § 78bb(a)'s "Actual Damages" Limit*

Restricting plaintiffs to out-of-pocket recoveries also complies with § 78bb(a)'s "actual damages" cap.[194] This section's language lim-

---

191. Robbins v. Koger Props., Inc., 116 F.3d 1441, 1447 n.5 (11th Cir. 1997).

192. Thompson, *supra* note 70, at 386–87.

193. Perhaps it is the attorneys that are unjustly enriched. For an article suggesting the truth of this statement, see Langevoort, *supra* note 21, at 651.

194. 15 U.S.C. § 78bb(a); *see also* Pelletier v. Stuart-James Co., 863 F.2d 1550, 1557 (11th Cir. 1989) (explaining actual damages limitation to mean some form of economic loss); Harris v. Union Elec. Co., 787 F.2d 355, 367 (8th Cir. 1986) (acknowledging that actual damages are measured by determining a plaintiff's out-of-pocket loss); Madigan, Inc. v. Goodman, 498 F.2d 233, 239–40 (7th Cir. 1974) (recognizing that only out-of-pocket losses are recoverable in fraud litigation); Levine v. Seilon, Inc., 439 F.2d 328, 333–35 (2d Cir. 1971) (stating that a plaintiff is only able to recover actual damages and rejecting other damage claims); Estate Counseling Serv., Inc. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 303 F.2d 527, 533 (10th Cir. 1962) (finding the demonstration of actual damages to be essential to a securities fraud claim). Not all courts have read the term "actual damages" to exclude benefit-of-the-bargain damages. *See, e.g.*, Osofsky v. Zipf, 645 F.2d 107, 114 (2d Cir. 1981) (allowing plaintiff to recover benefit-of-the-bargain damages where the defendant misrepresented the amount of consideration in proxy solicitation materials); John R. Lewis Inc. v. Newman, 446 F.2d 800, 805 (5th Cir. 1971) (upholding damages award that included a jury's determination of the fair market value of the stock that plaintiffs did not actually receive).

its plaintiffs to "actual damages" caused by the misdeed.[195] Most courts construe this term to mean some form of economic loss and limit awards to those that are strictly compensatory in nature.[196] Accordingly, "actual damages" would not include speculative lost profits from benefit-of-the-bargain or expectation remedies.[197]

Some courts have, however, assessed rescissory damages even under the "actual damages" theory by reasoning that this award must be "reduced by any value received as a result of the fraudulent transaction."[198] The Supreme Court, in *Randall v. Loftsgaarden*,[199] assumed, because neither party challenged it, that rescissory recoveries could sometimes be proper for a section 10(b) case.[200] It thought that "in some circumstances" there was authority allowing the section 10(b) plaintiff to choose between "undoing the bargain" or "holding the defendant to the bargain by requiring him to pay [out-of-pocket] damages."[201] Yet, *Randall* is distinguishable for our purposes: it concerned a situation where privity of contract existed and did not address an open-market context.[202]

After the Court's *Dura* decision, if presented with the issue of whether rescission is appropriate to remedy open-market fraud, the Court would likely decide that defendants must reimburse plaintiffs only for economic losses actually caused by the misdeed. This would effectively bar rescissory damages that compensate plaintiffs for non-fraud related losses. Even if the "actual damages" language does not preclude rescissory damages, it seems that loss causation, which requires a causal connection between the loss and the misrepresenta-

---

195. Specifically, this section states that "no person . . . shall recover, through satisfaction of judgment in one or more actions, a total amount in excess of his actual damages on account of the act complained of." 15 U.S.C. § 78bb(a); *see also In re* Control Data Corp. Sec. Litig., 933 F.2d 616, 622 (8th Cir. 1991) (affirming lower court's limitation of damages to losses caused by accounting fraud, the act complained of). Some courts dispute that § 78bb contains a limit and contend that "there cannot be any one rule of damages prescribed which will apply in all cases, even where it is conceded that the finding must be limited to actual damages." *Osofsky*, 645 F.2d at 111.

196. *Pelletier*, 863 F.2d at 1557–58; *see also* Jones v. Miles, 656 F.2d 103, 107 n.8 (5th Cir. 1981) ("Actual damages . . . has been interpreted to mean some form of economic loss and does not include punitive damages.").

197. *Pelletier*, 863 F.2d at 1557–58 (citing Wolf v. Frank, 477 F.2d 467, 478 (5th Cir. 1973)); Harris v. Am. Inv. Co., 523 F.2d 220, 225 (8th Cir. 1975); Sound Video Unlimited, Inc. v. Video Shack Inc., 700 F. Supp. 127, 142 (S.D.N.Y. 1988).

198. Austin v. Loftsgaarden, 675 F.2d 168, 181 (8th Cir. 1982).

199. 478 U.S. 647 (1986).

200. *Id.* at 661–62.

201. *Id.* at 662 (internal quotation marks omitted).

202. Privity of contract existed in *Randall* because the plaintiffs had purchased interests in a limited partnership organized by the defendant. *Id.* at 650.

tion or omission, would.[203] Accordingly, the loss causation element and the "actual damages" restriction confine litigants to recovery for their out-of-pocket losses.

3. Proving Hypothetical Damages

Even though proving damages is never a simple endeavor, the out-of-pocket rule may require less speculation than other measures. For any defrauded purchaser to recover, she must establish the difference between the value of what she actually received and the value of what she would have received absent the misrepresentation.[204] In the gold-platinum situation, because the stock price never actually declined, any damage calculation would have to be speculative.[205] Granted, assessing damages in that hypothetical would be somewhat easier because both gold and platinum have a fixed market value. But this exercise becomes increasingly arcane without fixed values. Any attempt to measure loss must isolate the value of the misrepresenta-

---

203. *See supra* Part III.A.

204. This value cannot include damages covering "the expected fruits of an unrealized speculation." Sigafus v. Porter, 179 U.S. 116, 125 (1900). The Supreme Court adopted this fundamental rule as the basic measure of damages under section 10(b) and Rule 10b-5. *See* Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128, 155 (1972) ("In our view, the correct measure of damages . . . is the difference between the fair value of all that the . . . seller received and the fair value of what he would have received had there been no fraudulent conduct . . . ."); *see also* Garnatz v. Stifel, Nicolaus & Co., 559 F.2d 1357, 1360 (8th Cir. 1977) (stating that damages are calculated by the difference between the purchase price of the securities and their actual value); Foster v. Fin. Tech. Inc., 517 F.2d 1068, 1072 (9th Cir. 1975) ("As in all 10b-5 cases, [plaintiffs'] damages are limited by what they would have realized if they had acted upon their claim when they first learned of the fraud or had reason to know of it."); Madigan, Inc. v. Goodman, 498 F.2d 233, 239 (7th Cir. 1974) ("A defendant was bound to make good the loss sustained, such as the moneys the plaintiff had paid out and interest, and any other outlay legitimately attributable to defendant's fraudulent conduct; but this liability did not include the expected fruits of an unrealized speculation." (internal quotation marks omitted)); Rochez Bros. v. Rhoades, 491 F.2d 402, 412–13 (3d Cir. 1974) (explaining that *Affiliated Ute Citizens* provides clear guidance for determining damages); Wolf v. Frank, 477 F.2d 467, 478 (5th Cir. 1973) (finding that the out-of-pocket rule does not cover expected speculative profit); Richardson v. MacArthur, 451 F.2d 35, 43 (10th Cir. 1971) (stating that the plaintiff is "entitled to be compensated only to the extent that he received less than what he was entitled to under the agreement"); Levine v. Seilon, Inc. 439 F.2d 328, 334 (2d Cir. 1971) (noting that, contrary to some courts' holdings, damages are not the difference between the value of what the buyer received and what was represented the buyer would be getting); Janigan v. Taylor, 344 F.2d 781, 786 (1st Cir. 1965) (recognizing that damages do not cover "the expected fruits of an unrealized speculation"); *see also* KEETON ET AL., *supra* note 63, § 110.

205. John Coffee has termed this general type of loss "phantom losses." *See supra* note 6. He observed that "to permit recovery in this case hypothesized by the Court [in *Dura*] is to permit recovery based on a double speculation—first, as to the original uncorroborated price inflation and, second, as to what would have been the later price increase in the absence of discovery of the original inflation." Coffee, *Loss Causation*, *supra* note 6.

tion (or omission)—i.e., the gold discovery—and remove from consideration both the platinum announcement and any added value that could accrue from the gold-platinum combination.

Given the speculative nature of claims where no price decline occurs after a corporation discloses a misrepresentation,[206] the plaintiff class should put forth in the complaint sufficient evidence of out-of-pocket loss to survive a motion to dismiss.[207] Expert testimony on class losses would likely become a vital part of establishing plaintiffs' prima facie case.[208] But, even once a court establishes that only out-of-pocket losses are compensable, there is no single universally accepted expert model for proving these losses.[209]

The most typical model is the event study, which uses an expert to construct a "value line" that theoretically represents the stock's "true value" if purchasers knew the undisclosed information on each day of the class period. Then, in theory, the expert can assess individual loss for each class member by comparing the price actually paid with the value line construct.[210] Because investors often buy and sell shares

---

206. Claims where the stock price did not actually decline are speculative because the lack of a decline could mean that the market did not consider the information material. Consequently, plaintiffs would not be able to prove that they relied on a "material misrepresentation," and could not plead a prima facie case of securities fraud.

207. *See* Dura Pharms., Inc. v. Broudo, 544 U.S. 336, 342 (2005) (finding that the Ninth Circuit was incorrect in stating that a plaintiff need only prove that "the price *on the date of purchase* was inflated because of the misrepresentation" (internal quotation marks omitted)); *see also In re* Daou Sys., Inc., 411 F.3d 1006, 1027 (9th Cir. 2005) (concluding that the plaintiffs' assertions of loss were sufficient to survive a motion to dismiss); *cf.* Anza v. Ideal Steel Supply Corp., 126 S. Ct. 1991, 2002 (2006) ("Certainly the plaintiff in this case, as in all tort cases involving damage to business, must demonstrate that he suffered a harm caused by the tort, and not merely by external market conditions."). For the elements of a claim involving publicly traded securities, see *supra* note 38 and accompanying text.

208. *See generally* RMED Int'l, Inc. v. Sloan's Supermarkets, Inc., No. 94 Civ. 5587 PKL RLE, 2000 WL 310352 (S.D.N.Y. Mar. 24, 2000) (permitting expert testimony to help establish damages at trial); *see also In re* Gaming Lottery Sec. Litig., No. 96 Civ. 5567 (RPP), 2000 WL 193125, at *3 (S.D.N.Y. Feb. 16, 2000) (permitting expert evidence as to damages by a professor of finance).

209. *See, e.g.*, *In re* Broadcom Corp. Sec. Litig., No. SACV01275GLTMLGX, 2005 WL 1403756, at *2 (S.D. Cal. June 2, 2005) (concluding that the PSLRA "leaves it open for a court to select the most reliable method of damages proof that is available in that particular case"); John Finnerty & George Pushner, *An Improved Two-Trader Model for Measuring Damages in Securities Fraud Class Actions*, 8 STAN. J.L. BUS. & FIN. 213, 215 (2003).

210. Alexander, *supra* note 2 at 1490–92. Professor Alexander explains the process in two steps:

> The first step is to determine the "per-share damages," the amount of the actual market price attributable to the nondisclosure on each day of the class period. The second step is to determine the aggregate damages of the class. To determine per-share damages, an expert economic witness constructs a "value line" which represents the "true value" of the stock—what purchasers would have been willing to pay if they had known the undisclosed information—on each day of the

within the class period, the methodology for assessing loss should account for in-and-out traders and provide a mechanism to net their windfalls against their losses to calculate net loss.[211]

Despite widespread use of the event study to demonstrate market reaction, the study can show only that the market reacted to the disclosure; it cannot prove why.[212] Even experts relying on the same data and facts often present competing inferences regarding the amount

---

> class period. The damages sustained by any particular member of the class can then, in theory, be determined by comparing the price actually paid with the value line for the date of the transaction.

Id. at 1491.

211. There are several proposals for damage models that take this into account. *See, e.g.*, Janet Cooper Alexander, *The Value of Bad News in Securities Class Actions*, 41 UCLA L. REV. 1421, 1458–62 (1994) (contending that "the trades of 'ins-and-outs' must be estimated through a statistical model," and proposing that damage awards be based on proof of individual claims, rather than on the proportional trading model); Jon Koslow, Note, *Estimating Aggregate Damages in Class-Action Litigation Under Rule 10b-5 for Purposes of Settlement*, 59 FORDHAM L. REV. 811, 831–34 (1991) (proposing a proportional trading model and an accelerated trading model). Given that the appropriate model may vary based upon the facts of the case, this Article does not promote a particular model. Instead, given the loss causation requirement, it recommends that any appropriate model should account for in-and-out traders and provide a mechanism to net their windfalls against their losses. For an overview of some of the different types of models, see Robert A. Alessi, *The Emerging Judicial Hostility to the Typical Damages Model Employed by Plaintiffs in Securities Class Action Lawsuits*, 56 BUS. LAW. 483 (2001). Alessi observes that the Proportional Decay Model does not account for in-and-out purchasers and has thus been subject to *Daubert* scrutiny. *Id.* at 487, 489–90.

Daniel Fischel and David Ross's research provides some indicia of how important it is to take in-and-out purchasers into account when calculating damages. Daniel R. Fischel & David J. Ross, *The Use of Trading Models to Estimate Aggregate Damages in Securities Fraud Litigation: A Proposal for Change*, *in* SECURITIES CLASS ACTIONS: ABUSES AND REMEDIES 131 (Edward J. Yodowitz et al. eds., 1994). In one particular case, they observed that "[m]any of these institutions were 'out-and-in' during 1990: these institutions sold approximately 14 million shares [23% of the 60 million shares] during the year prior to their purchases of shares that they held until year-end. Thus, only 77% of the retained shares were retained by shareholders who were not out-and-in." *Id.* at 138.

212. Ribstein, *supra* note 6, at 157; *see also* Langevoort, *supra* note 121, at 177 ("Event study methodology can still be utilized to test for whether or when adjustment has occurred—i.e., abnormal returns disappear—over substantial periods of time."). Event studies generally start by identifying the change in price on the date of the disclosure and then use a regression analysis to eliminate market changes that are not caused by the fraud. The study then works backwards to establish a hypothetical price for each day. *See generally* RONALD J. GILSON & BERNARD S. BLACK, THE LAW AND FINANCE OF CORPORATE ACQUISITIONS 185–228 (2d ed. 1995) (explaining how event studies measure market changes caused by new information). For an explanation of the market model, see Daniel R. Fischel, *Use of Modern Finance Theory in Securities Fraud Cases*, 38 BUS. LAW. 1, 17–19 (1982). Fischel explains:

> The [market] model is based on the observable correlation between the return on a particular security and the return on the entire market when viewed over time. Once this historically observed correlation is determined, it is possible to predict what the return of a given security should be on a certain date given the return for the market as a whole.

of harm.[213] Add to this an extended period between the misrepresentation and the disclosure—as was the case in *Dura*[214]—and there is an increased potential for non-related events to affect the market price.[215] Loss causation requires plaintiffs to demonstrate a causal connection between the misrepresentation (or omission) and the economic loss.[216] Assuming liability, it follows that defendants have to compensate plaintiffs only for losses caused by the fraud. Accordingly, courts must take precautions to ensure that experts' methods extract non-related factors affecting price from their calculation.[217]

B. Earlier Dismissal of Suits Providing Double Recovery

Though exact measures of loss generally come at the end of litigation, the calculation method is important at the outset to ascertain whether plaintiffs experienced a net economic loss for purposes of pleading a prima facie case of securities fraud.[218] It is axiomatic that

---

213. *Id.* at 17 (footnote omitted).

Alexander, *supra* note 211, at 1422; Kenneth R. Cone & James E. Laurence, *How Accurate are Estimates of Aggregate Damages in Securities Fraud Cases?*, 49 BUS. LAW. 505 (1994); Ribstein, *supra* note 6, at 157.

214. Dura Pharms., Inc. v. Broudo, 544 U.S. 336, 342–43 (2005).

215. Langevoort, *supra* note 121, at 177–78.

216. *Dura*, 544 U.S. at 342.

217. The primary means for ensuring that experts isolate damages caused by fraud is the *Daubert* analysis; whenever plaintiffs use experts to demonstrate injury and economic loss, courts should test the method using the *Daubert* factors. Kumho Tire Co. v. Carmichael, 526 U.S. 137 (1999); Daubert v. Merrell Dow Pharms., Inc., 509 U.S. 579 (1993). For additional information on how courts conduct the *Daubert* analysis, see L. Elizabeth Chamblee, Comment, *Between "Merit Inquiry" and "Rigorous Analysis": Using* Daubert *to Navigate the Gray Areas of Federal Class Action Certification*, 31 FLA. ST. U. L. REV. 1041, 1051–54 (2004). If plaintiffs use expert evidence to counter a motion to dismiss alleging that they either lack standing or failed to state a claim because they suffered no economic loss, then the court should conduct a *Daubert* test (even at this early stage) to probe the expert's methodology and validity. A motion opposing class certification or a motion for summary judgment may also present this issue. Issues of standing or failure to state a claim for lack of economic loss might appear in a motion opposing class certification in the form of a challenge to the adequacy of the representative under Federal Rule of Civil Procedure 23. As I have argued elsewhere, courts should use *Daubert* earlier in the litigation process to help determine whether plaintiffs have pled their prima facie case. *Id.* The monetary amount may, because of various court rulings, change throughout the course of litigation. But the expert's method and the plaintiffs' complaint should demonstrate, if true, that plaintiffs suffered an economic injury. The court should then dismiss the action if (1) plaintiffs' complaint fails to allege that they suffered an out-of-pocket loss where plaintiffs were net losers from the fraud or (2) plaintiffs' expert's method—not amount—of calculating damage cannot survive a *Daubert* inquiry.

218. In *Dura*, the Supreme Court affirmed that, to plead securities fraud, plaintiffs need to provide only a "short and plain statement" to comply with Federal Rule of Civil Procedure 8. 544 U.S. at 346. The complaint must still "provide the defendant with 'fair notice of what the plaintiff's claim is and the grounds upon which it rests.'" *Id.* (quoting Conley v. Gibson, 355 U.S. 41, 47 (1957)).

plaintiffs must have an injury (an economic loss) before they can sue. As noted at the outset of this Article, Congress passed the PSLRA, in part, to facilitate earlier dismissal of securities class actions that do not plead a prima facie case. But without a doctrinal statement limiting plaintiffs' compensation to their out-of-pocket losses, courts are often unable to verify from the initial pleadings whether plaintiffs suffered compensable losses.

The important consideration in assessing loss is not the monetary amount, which will fluctuate based on rulings regarding the class period and in-and-out purchasers, but the method. The methodology should account for in-and-out traders and provide a mechanism to net plaintiffs' windfalls against their losses to establish net loss. The pivotal question is then: assuming that everything in the plaintiffs' complaint is true and that the expert's method for calculating out-of-pocket loss is sound, did these plaintiffs experience a net loss?

If the answer to that question is "no," then, when the defendant files a motion to dismiss based on the plaintiffs' failure to state a claim, the court should consider dismissal. Granted, if the pleading error is an oversight and the possibility of compensable loss exists, then the court could either dismiss the action without prejudice and permit plaintiffs to correct the error or give plaintiffs leave to amend the complaint. But, if according to the facts stated in the complaint, plaintiffs could not establish a net loss under the out-of-pocket rule, then the court should dismiss the action with prejudice.

Increasing dismissals for cases without out-of-pocket losses accomplishes several goals.[219] First, it helps ensure that the remedy roughly approximates the true financial harm of the violation.[220] Second, if damage awards compensate only out-of-pocket losses, courts may dismiss securities class actions that present a potential double reward for investors who have not experienced a true net loss. Third, compensating investors for only their out-of-pocket losses alleviates—but does not eliminate—the problem that securities class actions generally redistribute wealth among diversified shareholders. Finally, limiting recovery in this manner gives both parties guidance about value when

219. One of the primary criticisms with earlier dismissal is that it does not permit plaintiffs the necessary discovery needed to develop their case. While there are many components to this debate, suffice it to say that additional discovery would probably not change whether plaintiffs experienced a net loss based on the out-of-pocket rule. That information is primarily in the hands of the plaintiffs.

220. The social costs are a different story. Fraud, even when it ultimately makes investors wealthier, harms the market's integrity. But there are other mechanisms for deterring fraud besides the class action. These alternatives are increasingly important where investors do not suffer an economic loss.

negotiating settlements. If a corporate defendant believes it has a fair chance of dismissal, then it may feel less pressure to settle early in the litigation. Similarly, plaintiffs' attorneys, who are paid on a contingency fee basis, are less likely to bring certain actions if they know that a court will not compensate plaintiffs with net gains.

C. Optimizing Deterrence Through Increased Predictability

Reimbursing only out-of-pocket loss may also bolster the class action's ability to deter fraud. Because "unpredictable damages" is one of the factors that undermines optimal deterrence,[221] confining plaintiffs to an out-of-pocket recovery could increase deterrence by increasing predictability. This restriction also improves deterrence by making it easier for judges to discern when to dismiss actions that do not allege compensable economic loss, as defined by the out-of-pocket standard. Admittedly, unpredictability also comes from uncertain market reaction to fraud and from variable expert calculation methods. Predicting damages when a corporation is trying to gauge the economic harm of issuing a restatement is almost impossible given the impulsive nature of market reaction. Still, in formulating a worst-case scenario, the certainty of knowing how a court will remedy loss and award damages helps. Even though setting a fixed method for assessing loss does not ameliorate problems with unpredictability, it does offer parties a starting point for tabulating potential damage awards.

Moreover, if we assume that corporate actors aim to maximize wealth and that they weigh their behaviors to ascertain which attributes are the most cost effective, then they can adjust their behavior accordingly if the financial costs are known. This idea may assume too much given that plaintiffs often bring securities class actions based on significant market fluctuations rather than firm knowledge of corporate wrongdoing. Of course, social planners could also manipulate other variables to increase deterrence. Although each of these variables could merit its own law review article, collectively they might include defining actionable conduct, making a sanction a predictable consequence of wrongful conduct, targeting sanctions at wrongdoers rather than at corporations, and providing specific guidelines for when sanctions might be imposed. Suffice it to say that, for our purposes, agreement on a remedy for fraud-on-the-market will at least provide the start of increased predictability (and thus increased deter-

---

221. *See supra* note 171 and accompanying text (discussing Calfee and Craswell's research that "difficulty measuring damages" is one of the factors that thwart optimal deterrence in tort law).

rence) even though it will not, on its own, produce optimal deterrence.

Because the securities class action functions to deter fraud, one of the primary concerns about limiting the class action's availability to those who experienced a net loss is that corporate wrongdoing could go undeterred. Yet there are alternative means of enforcement, such as the Department of Justice, the exchanges, and the SEC. Because most antifraud enforcement efforts do not come from private class actions, statistics suggest that limiting the availability of private class actions does not mean that fraud will go undeterred or unpunished.[222]

Statistics show that the Department of Justice, the exchanges, and the SEC—not private class actions—already carry out most enforcement and deterrent efforts.[223] From 2000 to 2002, private plaintiffs initiated an average of only 205 securities class actions as opposed to the 5,101 actions initiated by the SEC, Department of Justice, States, National Association of Securities Dealers (NASD), and the New York Stock Exchange (NYSE).[224] Further, as compared with the average from 2000 to 2002, the 2005 statistics indicate that SEC enforcement actions increased and private actions decreased.[225] In 2005, the SEC initiated 630 actions, which is a significant increase compared with the average of 528 from 2000 to 2002.[226] Moreover, class action filings decreased from 247 in 2004 to 209 in 2005.[227]

All in all, these statistics demonstrate that corporate fraud will not go unpunished or undeterred if plaintiffs cannot bring a class action when they do not experience a net monetary loss. Unlike in private securities class actions, the SEC need not prove damage, injury (economic loss), or reliance in order to maintain an action.[228] Conse-

---

222. *See infra* app.

223. *See infra* app.

224. Howell E. Jackson, *Variation in the Intensity of Financial Regulation: Preliminary Evidence and Potential Implications* 27 (Harvard, John M. Olin Center for Law, Econ. & Bus., Discussion Paper No. 521, 2005), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=839250; *see also infra* app. Yet, these comparatively few class action settlements and trials resulted in a total award of $1,923,959,333, whereas the total public enforcement effort (not including arbitrations by the NASD or NYSE) resulted in sanctions of $1,864,409,277. Jackson, *supra*, at 27.

225. *See infra* app.

226. *See infra* app.

227. *See infra* app.

228. SEC v. Rana Research, Inc., 8 F.3d 1358, 1363 n.4 (9th Cir. 1993); SEC v. Rind, 991 F.2d 1486, 1490 (9th Cir. 1993); BROMBERG & LOWENFELS, *supra* note 17, § 9:1 n.10. The Department of Justice does not have to meet the normal standing requirements of private plaintiffs either. GFL Advantage Fund, Ltd. v. Colkitt, 272 F.3d 189, 206 n.6 (3d Cir. 2001).

quently, the SEC's enforcement and deterrence efforts would not be affected by limiting private class actions to net losers who experienced out-of-pocket losses from the fraud. Thus, enforcement mechanisms exist to deter even the situation presented by the gold-platinum hypothetical, where the share's higher price was lower than it might otherwise have been absent the fraud. Accordingly, social planners should consider limiting the availability of the securities fraud class action to investors who experienced out-of-pocket losses. Such a limitation could result in at least a small measure of increased predictability and could bolster the private securities class action's deterrence ability against traditional fraud that causes a stock price decline.

V. CONCLUSION

My intention in this Article is not to imply that simply limiting investors to their out-of-pocket losses will provide a quick "fix" for the ills of the securities class action system. Instead, I hoped to highlight some of the intrinsic problems that could result from compensating investors with a net gain and from stretching traditional common law remedies to fit modern securities fraud class actions. Indeed, the out-of-pocket measure is the only common law remedy that recognizes the distinctions between face-to-face transactions and open-market fraud, complies with the loss causation requirement, and limits plaintiffs to their actual damages. Awarding investors only their out-of-pocket losses is a specific remedy that advances optimal deterrence through clarity and predictability. Although experts will often differ over methodologies,[229] identifying the appropriate remedy at least provides a knowable starting point. Consequently, if the post-*Dura* courts encounter their own variation of the gold-platinum hypothetical, I am cautiously optimistic that they might consider the broader consequences of compensating investors for more than their out-of-pocket losses and limit damage awards accordingly.

---

229. *E.g.*, Alexander, *supra* note 2, at 1488 ("Expert testimony is required to calculate damages, and that testimony is contradictory even when the experts purport to be using the same methodology."); *see also* Alexander, *supra* note 211, at 1421–22 (arguing that calculation of damages in securities class actions deserves more attention); Cornell & Morgan, *supra* note 21, at 883–84 (recommending the application of finance theory to determine damages in fraud-on-the-market cases); Koslow, *supra* note 211, at 811 (asserting that damage models based on finance theory fail to estimate accurately aggregate damages for the class); Baruch Lev & Meiring de Villiers, *Stock Price Crashes and 10b-5 Damages: A Legal, Economic, and Policy Analysis*, 47 STAN. L. REV. 7 (1994) (proposing a model for calculating damages that accounts for the sudden price drop after a disclosure).

APPENDIX

Public Enforcement Effort	(Annual Averages: 2000–2002)[230]	2005
SEC Actions	528	630[231]
DOJ Prosecutions	101[232]	122[233]

Exchange Enforcement Effort	(Annual Averages: 2000–2002)[234]	2005
NASD Actions	1,268	1,399[235]
NYSE Actions	240	196[236]
NASD Arbitrations Filed	6,725[237]	6,074[238]
NYSE Arbitrations Filed	595	464[239]
Total Exchange Enforcement	8,826	8,133

Private Enforcement Actions	(Annual Averages: 2000–2002)	2004	2005
Class Action Filings in Federal Court	205[240]	247[241]	209[242]

230. Data in this column come from Jackson, *supra* note 224, at 27.

231. SEC, SELECT SEC AND MARKET DATA FISCAL 2005, at 3, *available at* http://www.sec.gov/about/secstats2005.pdf. The SEC reported that, in 2005, it initiated 947 investigations, 335 civil proceedings, and 294 administrative proceedings. SEC, 2005 PERFORMANCE AND ACCOUNTABILITY REPORT 7 (2005), *available at* http://www.sec.gov/about/secpar/secpar2005.pdf.

232. In July 2002, the Department of Justice started a corporate fraud task force. From the time it started the task force to the time of publishing its 2002 Annual Report, the Department of Justice opened more than 130 corporate fraud matters. U.S. DEP'T OF JUSTICE, U.S. ATTORNEYS' ANNUAL STATISTICAL REPORT 29 (2002), *available at* http://www.usdoj.gov/usao/reading_room/reports/asr2002/02_stat_book.pdf.

233. This figure represents the number of new corporate fraud matters opened in 2005 by the Department of Justice. *Id.* at 27.

234. Data in this column come from Jackson, *supra* note 224, at 27.

235. NASD Statistics, http://www.nasd.com/PressRoom/Statistics/index.htm (last visited Dec. 3, 2006).

236. NYSE Enforcement, http://www.nyse.com/regulation/memberorganizations/1022221394131.html (last visited Dec. 3, 2006). The NYSE reports that of the 196 cases it prosecuted, 58 were against member firms and 138 were against individuals. *Id.*

237. NASD II Dispute Resolution Statistics, http://www.nasd.com/ArbitrationMediation/NASDDisputeResolution/Statistics/index.htm (last visited Dec. 3, 2006).

238. *Id.*

239. NYSE Arbitration Statistics, http://www.nyse.com/pdfs/ARB_STATISTICS_TWO_PAGES_6-1-06.pdf (last visited Dec. 3, 2006).

240. Jackson, *supra* note 224, at 27.

241. MILLER ET AL., *supra* note 117, at 2.

242. *Id.*