CAPPING DAMAGES FOR OPEN-MARKET SECURITIES FRAUD

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Practitioners and academics have known for some time that the standard measure of liability in open-market securities fraud cases can be excessive. The effort to award all affected marketplace traders their "out-of-pocket" damages creates the potential for recovery grossly disproportionate to the nature of the underlying violation. "Draconian" is the word often used.[1]

The seminal Rule 10b–5 case of the 1980's, *Basic Inc. v. Levinson,*[2] is a well-worn example. Basic Inc.'s officials denied involvement in on-going merger negotiations three times over a fourteen month period, presumably in order to preserve the confidentiality commonly deemed necessary to nurture such negotiations. As the story was told by the Supreme Court, there were no obvious claims of managerial corruption or self-dealing. Notwithstanding the lie's apparently utilitarian character, the Court said that it was actionable: neither corporate nor shareholder best interest is a defense to fraud.[3] The Court then endorsed both a broad definition of materiality with respect to speculative information and the fraud-on-the-market approach to the question of reliance, essentially giving all sellers the right to recover whether or not they even knew of the lie. Implicit in the Court's decision was the assumption that once liability was established, each of those sellers would have a claim to the difference between what the stock was trading at when the transaction occurred and its

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1. *See, e.g.*, Elkind v. Liggett & Myers Inc., 635 F.2d 156, 170 (2d Cir. 1980); Manor Drugs v. Blue Chip Stamps, 492 F.2d 136, 147 (9th Cir. 1973) (Hufstedler, J., dissenting), *rev'd*, 421 U.S. 723 (1975). *But see* FRANK A. EASTERBROOK & DANIEL FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 339–44 (1991) (arguing the efficiency in general of judicial approaches to measuring damages, though conceding that if scienter is a fuzzy construct, the out-of-pocket measure may overdeter).

2. 485 U.S. 224 (1988) (construing 17 C.F.R. § 240.10b–5). For expressions of concern about *Basic* that resemble those offered here, see Dennis Karjala, *A Coherent Approach to Misleading Corporate Announcements, Fraud and Rule 10b–5*, 52 ALB. L. REV. 957 (1988); Paul Mahoney, *Precaution Costs and the Law of Fraud in Impersonal Markets*, 78 VA. L. REV. 623 (1992). From the standpoint of materiality and the disclosure of forward-looking information, see Victor Brudney, *A Note on Materiality and Soft Information Under the Federal Securities Laws*, 75 VA. L. REV. 723 (1989).

3. This conclusion was so obvious that it was not even a significant issue in the case; the business judgment discussion was relegated to a footnote. *Basic*, 485 U.S. at 239–40 n.17.

hypothetical value had the truth been known.[4] If so, recovery would be a multi-million dollar one, even against such a relatively unfamiliar issuer.[5] Such a recovery would be a strikingly large amount for a case involving a well-meaning white lie where reasonable minds could differ—as the ensuing academic debate showed[6]—over whether a policy allowing this sort of concealment might actually *benefit* the capital marketplace instead of harm it.

Strangely, the recent Private Securities Litigation Reform Act hardly touched on the aggregate measure of damages.[7] To be sure, proportionate liability was a centerpiece proposal for reform, but largely as a mechanism for benefiting the collateral participant (usually accountants and lawyers[8]) in a fraud action rather than the primary defendant, the issuer itself. Most of the reform effort instead was directed at tightening the procedures and substantive standards for securities fraud actions. While some of these changes are useful mechanisms for addressing the problem of speculative and extortionate

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4. By all accounts, this out-of-pocket measure is the standard one in cases involving no privity and broad-based market trading. *See, e.g.*, Wool v. Tandem Computers Inc., 818 F.2d 1433 (9th Cir. 1987); Green v. Occidental Petroleum Corp., 541 F.2d 1335 (9th Cir. 1976) (Sneed, J., concurring). The hypothetical calculation is a difficult one, invoking event study methodology that works backwards from the accurate disclosure of the information in question to recompute (by reference to similarly situated stocks) its likely value without the fraud. *See* Janet C. Alexander, *The Value of Bad News in Securities Class Actions*, 41 UCLA L. REV. 1421 (1994); Bradford Cornell & R. Gregory Morgan, *Using Finance Theory to Measure Damages in Fraud on the Market Cases*, 37 UCLA L. REV. 883 (1990); Daniel Fischel, *Use of Modern Finance Theory in Securities Fraud Cases*, 38 BUS. LAW. 1 (1982). For concerns about the soundness of this approach, see *infra* notes 52–53 and accompanying text. In other types of fraud cases, of course, the courts have been much more flexible, invoking a wide variety of rescissionary, restitutionary and contract-based theories. *See* Robert Thompson, *The Measure of Recovery Under Rule 10b-5: A Restitution Alternative to Tort Damages*, 37 VAND. L. REV. 349 (1984).

5. For an application of the event study methodology to the *Basic* case, see Janine Hiller & Stephen Ferris, *Use of Economic Analysis in Fraud on the Market Cases*, 38 CLEV. ST. L. REV. 535 (1990). In *Basic*, the alleged fraud continued over 14 months. The price at the time the lies began was approximately $20 per share, rising steadily during the period. When the merger was finally announced, it was at approximately $45 per share. During the trading period, the typical daily volume of trading was in the 3000–5000 share range. The actual measure of damages is quite complicated, since it involves the recreation of a value line that reflects the hypothetical state of affairs had there been full disclosure. Event study methodology is regularly used in this regard. *See* Cornell & Morgan, *supra* note 4. Naturally, such recreation is difficult in cases where the misstated information was bundled together with other accurate information, or where it slowly leaked into the marketplace. In this sense, the event study methodology is a heuristic, not a precise determination. Indeed, plaintiffs and defendants rarely agree on what numbers the methodology should produce.

6. *Basic* generated a debate over the social utility of "white lies" in the securities markets. *See* Ian Ayres, *Back to* Basics: *Regulating How Corporations Speak to the Market*, 77 VA. L. REV. 945 (1991); Marcel Kahan, *Games, Lies and Securities Fraud*, 67 N.Y.U. L. REV. 750 (1992); Jonathan Macey & Geoffrey Miller, *Good Finance, Bad Economics: An Analysis of the Fraud on the Market Theory*, 42 STAN. L. REV. 1059 (1990). Obviously, one need not agree with the strong claim of utility to appreciate the concern over disproportionality.

7. Pub. L. No. 104–67, 109 Stat. 737 (1995). A very useful collection of materials and discussion of the reform debate—showing the parameters of what has been considered—is the *Senate Staff Report on Private Securities Litigation: Hearings Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs*, 103d Cong., 2d Sess. 166–333 (1994).

8. *See* Robert Mednick & Jeffrey Beck, *Proportionality: A Much Needed Solution to the Accountants' Legal Liability Crisis*, 28 VAL. U. L. REV. 867 (1994); Zoe-Vonna Palmrose, *The Joint and Several vs. Proportionate Liability Debate*, 1 STAN. J. L. BUS. & FIN. 53 (1995).

litigation,[9] others—like heavy pleading requirements, sanctions against plaintiffs and their attorneys, or an excessively deep harbor for forward-looking disclosure—raise the risk that too many meritorious claims will also be barred, deterred or weeded out by the more exacting requirements of pleading and proof. Corporate managers are often spin-artists, not always candid in airing their companies' strengths and weaknesses. And shareholder monitoring of managerial truth-telling is plagued by horrible informational asymmetries. Such difficulties are hardly resolved by making plaintiffs describe in detail the precise nature of the fraud at the outset of their case or face dismissal.

It strikes me as odd, then, that serious consideration was not given to attacking the problem differently: greatly reducing the amount of money at stake in open market fraud actions. Intuitively, reducing the amount at stake should reduce the incentive to bring class actions for reasons other than their merits as well as the incentive of corporate defendants to settle for too high a price—the alleged roots of the class action problem.[10] While lowering the amount at stake would not eliminate all abuse, it would reduce the settlement value of any given case, meritorious or not. And by eliminating the draconian threat, at least one incentive that drives risk-averse defendants to settle would be lessened.[11]

This Article considers the possibility of capping recovery[12] in cases involving false or misleading corporate publicity and periodic disclosure filings. I want to distinguish between those cases that involve privity or near-privity—where the primary defendant-issuer is a buyer or seller of the securities in question (e.g., cases of public offerings, tender offers, going private transactions)—from those that do not, and concentrate on the latter.

9. For instance, the procedural reforms regarding who controls the litigation from the plaintiffs' side (§ 101 of the Act, adding new § 21D to the Securities Exchange Act of 1934) may well reduce speculative litigation. *See* Elliott Weiss & John Beckerman, *Let the Money Do the Monitoring: How Institutional Investors Can Reduce Agency Costs in Securities Class Actions*, 104 YALE L.J. 2053 (1995).

10. *See, e.g.*, Janet C. Alexander, *Do the Merits Matter: A Study of Settlements in Securities Class Actions*, 43 STAN. L. REV. 497 (1991); Joseph Grundfest, *Disimplying Private Rights of Action Under the Federal Securities Laws: The Commission's Authority*, 107 HARV. L. REV. 961 (1994); Reinier Kraakman et al., *When Are Shareholder Suits in Shareholder Interests?*, 82 GEO. L.J. 1733 (1994); Jonathan Macey & Geoffrey Miller, *The Plaintiffs' Attorney's Role in Class Actions and Derivative Litigation: Economic Analysis and Recommendations for Reform*, 58 U. CHI. L. REV. 1 (1991); Roberta Romano, *The Shareholder Suit: Litigation Without Foundation?*, 7 J. L. ECON. & ORG. 55 (1991). In my testimony before the House Subcommittee on Telecommunications and Finance, I suggested this direction, as did Professor Janet Cooper Alexander. *See Hearings Before the Subcomm. on Telecommunications and Finance of the House Comm. on Energy and Commerce*, 103d Cong., 2d Sess. 88–89, 124–25 (Aug. 10, 1994). Little interest was expressed by members of Congress.

11. One of the puzzles in this area, of course, is why managers do not fight low-merit suits. One reason has to do simply with the cost and hassle of litigation. If this alone is the reason, then one might expect plaintiffs' lawyers to continue to bring all actions where an appropriate settlement can be obtained in light of this threat, regardless of the amount at stake. However, there is presumably much more to the story. *See* Alexander, *supra* note 10. If risk-aversion is also implicated, then an additional reason to settle will be influenced by the amount at stake. As the materials that follow make clear, my proposal does not depend on its role as a possible solution to the litigation problem. Yet I remain convinced that it would have a salutary effect on the issue.

12. I will use the word "cap" somewhat loosely. In fact, I am proposing a different method of approaching the question of remedies for fraud-on-the-market cases, although there may be some political or rhetorical virtue to maintaining the compensatory rationale.

This "fraud-on-the-market" category is a large one, and the subject of most of the attention with respect to allegedly abusive litigation. I will argue that in these non-privity cases, the case for the aggregate out-of-pocket measure is weak; indeed, that such awards are dysfunctional. This is so regardless of how one feels about the litigation "crisis," but becomes all the more disturbing if one considers the problem of speculative litigation a serious one. We need to refocus our attention from compensatory remedies to deterrence-based ones, and deterrence can very likely be achieved by capping damages by reference to some externally generated standard.

This is an approach with a history. In the 1970's, damage caps were a significant building block in the American Law Institute's Federal Securities Code, which ultimately received endorsement from the Securities and Exchange Commission ("SEC") before running out of political steam at the turn of the decade. The Code would have limited damages in false filing/false publicity cases where "knowledge" cannot be shown to be the greatest of $100,000, one percent of gross income (to a maximum of $1,000,000) for corporate defendants, or defendant's profits.[13] Under current law, damages are already capped in insider trading class actions to a maximum of the trader's profits,[14] although this may as much as anything reflect our disquiet about whether silent insider trading really is a fraud-on-the-market. In corporate law, Virginia has placed a presumptive $100,000 cap on directors' liability in derivative suits raising duty of care issues,[15] and other states have acted in related fashion.

My argument—which I happily concede is a synthesis (and mild extension) of the work of many others[16]—proceeds as follows. Part I of this Article will critique the compensatory out-of-pocket measure for fraud-on-the-market cases. Section A makes the now familiar point that by ignoring the inevitable open-market gains from a fraud, the aggregate measure of damages is excessive from a compensatory standpoint. Section B contends that whatever compensation comes via class actions in open market cases is funded directly or indirectly by other innocent investors, creating a system of pocket-shifting that takes little money out of the hands of those natural persons who contrived the fraud. This loss spreading cannot be justified on an "insurance" rationale for a variety of reasons, particularly when one takes into account the exceedingly high costs (largely in terms of plaintiffs' and defendants' legal fees) associated

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13. FED. SEC. CODE § 1708(c), (e) (Am. Law Inst. 1980).

14. *See* Securities Exchange Act § 20A, 15 U.S.C. § 78t–1 (Supp. 1996) (codifying the holding in Elkind v. Liggett & Myers Inc., 635 F.2d 156 (2d Cir. 1980)).

15. VA. CODE ANN. § 13.1–692.1 (Michie 1995) (cap is lower if compensation is lower). *See* James Hanks, Jr., *Evaluating Recent State Legislation on Director and Officer Liability Limitation and Indemnification*, 43 BUS. LAW. 1207 (1988). Because derivative suits raise somewhat different issues regarding the balance between compensation and deterrence, I will leave this issue to the side. For useful explorations on this subject, see John Coffee, *Litigation and Corporate Governance: An Essay on Steering Between Scylla and Charybdis*, 52 GEO. WASH. L. REV. 789 (1984); James Cox, *Compensation, Deterrence and the Market as Boundaries for Derivative Suit Procedures*, 52 GEO. WASH. L. REV. 745 (1984).

16. The basic outlines of my approach can be culled from many of the articles already cited (especially those in *supra* note 2), along with much of the argument found in Jennifer Arlen & William Carney, *Vicarious Liability for Fraud on Securities Markets: Theories and Evidence*, 1992 U. ILL. L. REV. 691. My contribution is largely in the form of synthesis, elaboration and specificity. After writing this Article, I discovered that Professor Janet Cooper Alexander has embarked on a similar endeavor, though one that brings her to a somewhat different reform proposal. See Janet C. Alexander, *Rethinking Damages in Securities Class Actions*, 48 STAN. L. REV. (forthcoming July 1996).

with the pocket-shifting process. Together, these two points are compelling in and of themselves, quite apart from any concern about excessive litigation. Section C, however, shows how the concern is then compounded to the extent that the prevailing system encourages an excessive amount of low-merit litigation, and further compounded by systematic biases that might distort the application of the out-of-pocket measure.

Part II then considers how a system could be designed that makes deterrence the prime directive of private securities litigation in non-privity cases. There is little reason to believe that, just by coincidence, the aggregate out-of-pocket measure will be equal to or less than the optimal deterrence measure. Much more likely, it will be excessive in terms of deterrence, leading to overprecaution through muted disclosure or silence as a result of fear of draconian liability. I then proceed to consider what sorts of caps or alternative measures would be appropriate. In so doing, this Article will also look at the question of entity liability *ab initio*: does it make sense to retain issuer liability at all in these non-privity cases, or should the focus instead be directed exclusively at controlling the behavior of the natural persons (usually managers) responsible for the fraud?

Finally, Part III attends briefly to the line-drawing problem between privity and non-privity. While the distinction is intuitive, there will be close cases. Managers and firms can extract various forms of indirect benefit by misleading the market: facilitation of insider trading, increased executive compensation, entrenchment, enhanced firm value for acquisition and stock sale purposes, etc. This Part will try to refine the appropriate line, and will also consider whether some or all of the lessons of Parts I and II should apply when there clearly is privity, as in the Securities Act context, or in the special case of proxy fraud.

I. THE OUT-OF-POCKET LOSS MEASURE FOR OPEN MARKET FRAUDS

A largely forgotten aspect of the evolution of Rule 10b–5 under the Securities Exchange Act is the ease with which privity was abandoned as a significant limitation on recovery. At least since *SEC v. Texas Gulf Sulphur Corp.*,[17] liability arises whenever a person (natural or entity) makes a material misstatement or actionable omission that is likely to affect the investing public, regardless of the person's self-interest in the matter. We often need a reminder of how controversial it was at common law to move beyond privity in fraud cases; in the negligent misrepresentation context, at least, courts were far more chary about such things.[18]

True, that old controversy relates to negligent misrepresentation and the problems associated with costs and overprecaution. Rule 10b–5 requires

17. 401 F.2d 833 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969). *See* David Ruder, Texas Gulf Sulphur—*The Second Round*, 63 NW. U. L. REV. 423 (1968). For a more recent application of this standard, see *In re* Ames Dep't Stores Inc., 991 F.2d 953 (2d Cir. 1993).

18. Ultramares Corp. v. Touche, 174 N.E. 441 (1931). *See generally* Joseph Bishop, *Negligent Misrepresentation Through Economists' Eyes*, 96 L.Q. REV. 360 (1980); John Siciliano, *Negligent Accounting and the Limits of Instrumental Tort Reform*, 86 MICH. L. REV. 1929 (1988).

scienter, and there is a fair body of learning that simply suggests that such concerns are inapposite with respect to intentional harms.[19] Yet by now most people familiar with the problem recognize that scienter has a good bit of indeterminacy to it, especially when we think of it in terms of awareness of the truth rather than motive to deceive and even more when we consider its recklessness component.[20] Matters of materiality[21] and duty are often difficult to work through confidently, and courts have not been solicitous in cases of reliance on counsel.[22] Given the circumstantial nature of most claims, moreover, the possibility of judicial error in determining intent in hindsight is high.[23] And—tentatively, at least—there is reason to worry about instances when there was no actionable intent but the case is brought anyway (either mistakenly or in disregard of the merits), imposing costs and pressures to settle even when the defense probably would win on the merits. Quite properly, most corporate lawyers would scoff at the idea that the scienter requirement under Rule 10b–5 effectively protects good faith conduct from litigation exposure.[24]

To this, we add the principal-agent problem. Assuming (as the law has) broad entity liability for "corporate" frauds instigated by managers and other agents,[25] there is an inevitable negligence component to the analysis. The knowledge and suspicions of a wide range of natural persons are automatically

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19. The RESTATEMENT (SECOND) OF CONTRACTS § 531 states a common law test quite comparable to that set forth in *Texas Gulf Sulphur*, 401 F.2d 833.

20. Recklessness is occasionally defined in objective terms (extreme departure from ordinary care), and even in its subjective form (something approaching conscious indifference) is subject to determination by inference. *See* VIII LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 3656–57 (3d ed. 1991). It will be a circumstantial case, usually, that forms the basis for a Rule 10b–5 case so far as state of mind is concerned. On the fuzziness of scienter, see James D. Cox, Ernst & Ernst v. Hochfelder: *A Critique and an Evaluation of its Impact Upon the Scheme of the Federal Securities Laws*, 28 HASTINGS L.J. 569 (1977); Mahoney, *supra* note 2, at 647–50; Paul Milich, *Securities Fraud Under Section 10(b) and Rule 10b-5: Scienter, Recklessness and the Good Faith Defense*, 11 J. CORP. L. 179 (1986). On the unwillingness to make purpose (as opposed to knowledge alone) relevant, see, e.g., SEC v. Falstaff Brewing Corp., 629 F.2d 62, 76 (D.C. Cir. 1980).

21. This is especially so under *Basic's* "probability-magnitude" test for speculative information, and the occasional recognition of qualitative rather than quantitative approaches to materiality. *See* JAMES COX ET AL., SECURITIES REGULATION: CASES AND MATERIALS ch. 2 (1991).

22. *See* Douglas Hawes & Thomas Sherrard, *Reliance on Advice of Counsel in Corporate and Securities Cases*, 62 VA. L. REV. 1 (1976).

23. Psychologists have given us ample evidence that no matter how hard people try, they have trouble eliminating the hindsight bias that comes in estimating the likelihood of an event occurring at some prior point when they are told that the event did indeed occur. *See, e.g.*, Hal Arkes & Cindy Schipani, *Medical Malpractice v. the Business Judgment Rule: Differences in Hindsight Bias*, 73 OR. L. REV. 587 (1994); Kim Kamin & Jeffry Rachlinski, *Ex Post Does not Equal Ex Ante: Determining Liability in Hindsight*, 19 L. & HUM. BEHAV. 89 (1995). Neither a judge nor a jury can be trusted to estimate with sensitivity the significance of red flags—whether for purposes of determining negligence or determining whether a person closed their eyes recklessly to danger signs—once they know of the massive "harm" that later ensued.

24. This, of course, is the motivation for statutory tightening of the scienter requirement and its pleading standards. *See supra* notes 9–10 and accompanying text. Given the ability to infer fraudulent intent, I doubt that this new protection is complete; to the extent that it is, it will bar many good cases from being brought. Some uncertainty as to "who knew what, and when did they know it" is inherent in securities litigation at the outset of the case.

25. I assume here that most forms of corporate misrepresentation are "committed" by the issuer, making the issuer primarily, rather than secondarily, liable. *See, e.g.*, Sharp v. Coopers & Lybrand, 649 F.2d 175, 182 n.8 (3d Cir. 1981), *cert. denied*, 455 U.S. 938 (1982). As a result, I doubt that recent restrictions on secondary liability are applicable to narrow the scope of issuer exposure in most cases.

attributed to the corporation.[26] These people may well disregard the law for partially self-serving reasons or because of some sort of psychological pressure or bias, but they will still be acting within the scope of their authority. From the issuer's standpoint (i.e., the interests and incentives of investors), the only mechanisms for controlling either managerial errors or deliberate bias in the disclosure process are found in the processes of optimal contracting, monitoring and supervision. In this sense, the question of issuer liability bears at least a strong resemblance to a negligence question, even if we assume that the underlying misrepresentations and omissions are truly deliberate. When we combine this concern with the inferential and broad nature of scienter in the first place, it is hard to see how *Ultramares*-type[27] concerns are not fully implicated.

Yet for compelling reasons—the distortions that false corporate disclosure can create regardless of whether the issuer is trading—privity was abandoned. I do not take issue with this choice: it is surely right given our desire to promote stock price accuracy (not to mention the incentives to cheat through lying even in the absence of privity). Rather, my concern is how readily courts then simply assumed that compensatory fraud measures of damages—developed at common law largely in privity settings involving face-to-face dealings—should be applied expansively to open market cases. Abetted by Section 28(a) of the Securities Exchange Act, the idea that each trader "harmed" by a fraud deserves full compensation became a given.[28] And with the compensatory goal so firmly established, it was logical to gradually relax the burden on such traders of showing that they were in fact harmed: through a broad definition of materiality,[29] through the presumption established in *Affiliated Ute Citizens v. United States*[30] of reliance on material omissions, and finally through widespread adoption of the fraud-on-the-market theory.[31] The

26. Indeed, there is the potential to attribute to the issuer the knowledge of a disparate group of managers so that even if no single manager has scienter, the corporation does. *See* Craig Griffin, *Corporate Scienter Under the Securities Exchange Act of 1934*, 1989 B.Y.U. L. REV. 1227.

27. Ultramares Corp. v. Touche, 174 N.E. 441 (1931).

28. There is no doubt that § 28(a), which mandates a compensatory approach to private remedies under the Act—thereby precluding punitive damages—contributed to this assumption. My argument here is not to be critical of the doctrinal history so much as to point the way to a better approach.

29. *See* Brudney, *supra* note 2.

30. 406 U.S. 128 (1972) (permitting a presumption of reliance in nondisclosure cases upon a showing of materiality).

31. As recognized by the Supreme Court in Basic Inc. v. Levinson, 485 U.S. 224 (1988), reliance on a misrepresentation is permitted to nearly anyone who did not know of the untruth, or who does not admit that they would have traded anyway even had they known, so long as the stock was traded in an efficient market. *See supra* note 2 and accompanying text. In general, this step has met with academic applause, even from very conservative scholars. *See, e.g.*, Daniel Fischel, *Efficient Capital Markets, the Crash, and the Fraud on the Market Theory*, 74 CORNELL L. REV. 907 (1989). For a critique of the fraud-on-the-market theory as leading to excessive damages and insufficient investor self-protection, see Mahoney, *supra* note 2; but see Nicholas Geogakopolous, *Frauds, Markets and Fraud-on-the-Market: The Tortured Transition of Justifiable Reliance from Deceit to Securities Fraud*, 49 U. MIAMI L. REV. 671 (1995) (arguing that the fraud-on-the-market theory is essential to optimal deterrence). In fact, the logic of the Court's opinion makes efficiency irrelevant for purposes of determining whether there was indirect causation, for if the theory underlying the presumption of reliance is that investors are entitled to assume that the stock price is "untainted" by fraud, that entitlement is hardly limited to widely-followed stocks. *See* Donald Langevoort, *Theories, Assumptions and Securities Regulation: Market Efficiency Revisited*, 140 U. PA. L. REV. 851, 900–03 (1992);

perceived need to compensate investors for skewed trading decisions also drove a gradual expansion of the duty to disclose by such means as a broad use of the half-truth doctrine and the duty to update.[32] Through each of these steps, the potential exposure of managers and firms grew larger. But the interplay of these otherwise sensible doctrines and the consequences of abandoning privity were never revisited. Compensation had become a doctrinal talisman.

This Part will show why 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. The argument is cumulative: these are points that are persuasive by themselves, but are all the more potent in the aggregate.

A. *Netting Out Gains and Losses*

Perhaps the most fundamental point in this analysis is one first made systematically by Frank Easterbrook and Daniel Fischel in their article on optimal damages in securities fraud actions in 1985.[33] In any non-privity fraud case, each loser—the buyer or seller disadvantaged by the fraud—is balanced by another winner: the person on the other side of the trade. Absent some evidence of hidden privity (e.g., insider trading), the winner is an innocent beneficiary of the fraud. Yet for obvious reasons, the law makes no effort to force the winners to disgorge their profits in order to fund the losers' recovery.

This simple insight leads to three conclusions. The first is that the aggregate potential recovery in all likelihood exceeds the *net* societal harm of the fraud,[34] which may be relatively small. The direct net harm to investors as a group may well be zero. Second, there will be systematic overcompensation over time to many investors. At least active traders with large, diversified portfolios have roughly the same chance of being winners as losers from securities fraud, and over time these gains and losses will tend to net out toward zero even in the absence of litigation. Therefore, compensating for the losses while ignoring the gains leads to excess returns over the course of a trading career. Third, the offsetting likelihood of gains and losses from this kind of fraud means that rational investors will not demand broad protection from it ex

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Jonathan Macey et al., *Lessons from Financial Economics: Materiality, Reliance, and Extending the Reach of* Basic Inc. v. Levinson, 77 VA. L. REV. 1017 (1991).

32. *See, e.g., In re* Time Warner Inc. Sec. Lit., 9 F.3d 259 (2d Cir. 1993); Greenfield v. Hublein Inc., 742 F.2d 751 (3d Cir. 1984), *cert. denied*, 469 U.S. 1215 (1985). *But see* Stransky v. Cummins Engine Co. Inc., 51 F.3d 1329 (7th Cir. 1995) (refusing to recognize a duty to update).

33. *See* Frank Easterbrook & Daniel Fischel, *Optimal Damages in Securities Cases*, 52 U. CHI. L. REV. 611 (1985) (revised and reprinted in EASTERBROOK & FISCHEL, *supra* note 1, ch. 12). *See also* Arlen & Carney, *supra* note 16, at 718–19; Mahoney, *supra* note 2, at 627–29. Recently, SEC Commissioner Stephen Wallman has taken note of this insight in discussing securities law reform. *See Wallman Discusses Securities Litigation Reform and Capital Formation*, Fed. Sec. L. Rep. (CCH) No. 1670, at 9–10 (July 12, 1995).

34. Part II of this paper will take into account—as Easterbook and Fischel and others have—the inefficiencies and other social harms associated with fraud (e.g., misallocation of resources, etc.). For now, we limit our discussion to the compensation of specific investors.

ante in the form of risk premiums.[35] In other words, an offer of full compensation is unnecessary to encourage capital formation efficiently.

This netting out will not be perfect, of course. On an individualized basis, there will doubtless be some investors who have little or no offsetting gains—who will indeed be net losers.[36] To this there are a variety of responses. First, there is the growing institutionalization of the markets. More and more, as Elliott Weiss and John Beckerman have shown,[37] the primary claimants in most suits are in fact active investors: smaller investors "receive only a very minor share of the amounts recovered in securities class actions."[38] At the very least, the demographics of the stock market are rapidly moving in a direction where the netting out phenomenon is more and more likely to dominate. Even if we concede that there are some victims with significant uncompensated losses, large numbers of claimants under the current regime will not fall into this category. Aggregate damage awards are still excessive insofar as they include the active trader, even if they may not be on an investor-by-investor basis. In other words, we are only debating the extent of the excess.

The other point is the flip side of this. The people most likely to fall outside the netting out phenomenon are the relatively more inactive individual investors. One might even fear that these people are disproportionately the victims of securities fraud: that the institutions have the comparative ability to get out of a stock before the market adjusts fully to the bad news (vice versa in the rarer good news case).[39] Concern for this type of victim, of course, is the basis for the "small investor" limitation on proportionate liability in the reform legislation.

This concern cannot be dismissed entirely. But we should take note of the relatively small amount of damages that these smaller investors suffer in the typical open market fraud. The *maximum* recovery of such inactive investors is likely to be well under a $1,000 (and given settlement incentives, as we shall see, recovery in fact rarely even comes close to that amount).[40] Probably, it is

35. In fact, sophisticated investors may see fraud as a profit opportunity to the extent that they believe that they can be among the first to sense its presence and sell or sell short in advance of the full market decline.

36. Perhaps one of the reasons that the insight noted above has not generated more political interest is because of the methodological assumptions that law and economics scholars use. Their interest is in efficiency: the ex ante impact of legal rules. Distributional concerns are unimportant. *See, e.g.*, EASTERBROOK & FISCHEL, *supra* note 1, at 315–52; Mahoney, *supra* note 2, at 626–30. This tendency may provoke those unpersuaded by the methodology or assumptions to dismiss the insights they generate. In this paper, I hope to show that these insights make sense within the context of a more politically realistic set of assumptions as well.

37. *See* Weiss & Beckerman, *supra* note 9, at 2088–94; *see also* Alexander, *supra* note 4, at 1448–51.

38. Weiss & Beckerman, *supra* note 9, at 2094.

39. *See, e.g.*, Randall Smith, *Conference Calls to Big Investors Often Leave Little Guys Hung Up*, WALL ST. J., June 21, 1995, at C1. The Weiss & Beckerman data suggest that this concern should not be overstated; institutions still dominate in aggregate loss claims.

40. One of the noteworthy aspects of research on class action abuses is how small a percentage—less than 10%—of his total claim each investor gets in the typical settlement. *See* FREDERICK C. DUNBAR & VINITA JUNEJA, NAT'L ECONOMIC RESEARCH ASSOCS., RECENT TRENDS II—WHAT EXPLAINS SETTLEMENTS IN SHAREHOLDER CLASS ACTIONS (1993). This alone suggests that the compensatory value of the current system is questionable. If investors' recovery is only a small percentage of their claims, then the insurance rationale disappears almost entirely. To be sure, this could be cured by making it easier for investors to recover (in contrast

closer to $100, if that. On an individual-by-individual basis, then, we have very little reason to fear that the net losses will be large.[41] While one can imagine some extraordinarily rare examples of large losses by inactive traders,[42] the highly salient instances of heart-rending, large loss victimization of individual investors are all privity-based: broker churning cases, sales of limited partnerships and other risky investments as sizable portions of a retirement portfolio, etc. These stories are commonly featured in the political rhetoric of opposition to litigation reform as a reason against change. Whatever their strength, they bear a remote relationship to the specific question we are considering.

We are left, then, with less reason to worry about compensation of investors from open-market frauds than most people assume. The concern has not been eliminated, but it is far less pressing. At the risk of jumping ahead too far, it is at least not the sort of concern that offers ready social justification for spending hundreds of millions of dollars on legal fees and other litigation-related costs to deliver some residual (in fact, typically inadequate) compensation to a handful of smaller investors.

B. Pocket-Shifting

To this first reason to doubt the functionality of the aggregate out-of-pocket measure, we couple a second. By all accounts, nearly all the money paid out as compensation in the form of judgments and settlements comes, one way or another, from investors themselves. Little if any of the sum is contributed by those who were the primary authors of the fraud; a recent study puts the figure at less than half of one percent.[43]

The explanation for this is not hard to come by. Most securities class actions are either settled or dismissed.[44] Judgments are rare. We know that nearly all settlements are funded by three sources: the issuer itself, the issuer's

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to the spirit of the reform legislation), but this raises other obvious problems in terms of a higher incidence of litigation.

41. On the role of this kind of concern in financial regulation generally, see Robert C. Clark, *The Soundness of Financial Intermediaries*, 86 YALE L.J. 1, 18–21 (1976).

42. One might add at this point that inactive investors are also less likely to have relied in fact on misrepresentations and actionable nondisclosure. In some sense, one can question whether such traders "deserve" compensation for trading in a market simply because fraud that did not mislead them affected the price of the security. An investor who does no research or investigation assumes the risk of various forms of mispricing, of which fraud-related mispricing is just one. As noise trading theorists have begun to emphasize, mispricing may well be a natural, commonplace and foreseeable risk that all investors face. *See generally* ROBERT J. SHILLER, MARKET VOLATILITY (1989); Andrei Shleifer & Robert Summers, *The Noise Trader Approach to Finance*, J. ECON. PERS. 19 (1990).

43. A study by Dunbar et al. indicates that in the average settlement, 68.2% comes from the insurer and 31.4% from the issuer, with only 0.4% coming from individual defendants. *See* FREDERICK C. DUNBAR ET AL., NAT'L ECONOMIC RESEARCH ASSOCS., RECENT TRENDS III: WHAT EXPLAINS SETTLEMENTS IN SHAREHOLDER CLASS ACTIONS? v (1995). As with the first point, this pocket-shifting concern is hardly a novel insight. *See, e.g.*, Arlen & Carney, *supra* note 16, at 698–700; Mahoney, *supra* note 2, at 635; Romano, *supra* note 10.

44. *See* Alexander, *supra* note 10. The common assumption is that settlement will occur if the defense fails in its effort to obtain dismissal on preliminary motions, or to defeat class certification. For an interesting discussion of whether a judge should take into account in certifying the class that some class members remain equity holders of the defendant issuer and thus will have conflicting interests in both questions of litigation strategy and settlement negotiation, see Ziemack v. Centel Corp., No. 92–C 3551, 1995 U.S. Dist. LEXIS 19188 (N.D. Ill., Dec. 19, 1995).

director and officer liability insurer, and ancillary defendants like accounting and law firms[45] (with their insurers if they have them). Except in unusual cases where the issuer finds a way of shifting some part of the loss to its dishonest managers,[46] money paid out by the issuer itself is essentially taken from the company's shareholders, who presumably had no direct responsibility for—and no direct pecuniary benefit from—the fraud. That much is clearly a form of pocket-shifting. Similarly, insurance money comes from premiums paid by the insurer's policy holders, including (but not limited to) the issuer. Indirectly, these are funded by a broader set of investors, but still not the culpable parties. Once more, the pocket-shifting character is readily visible.

Ancillary defendants pose a somewhat murkier problem. At least a significant portion of their contribution, however, can be attributed to fees taken to compensate them for litigation risk, in return for the services they rendered to their base of clients.[47] This much, too, is investor self-funding.

Thus, we can say with some confidence that investors fund a very sizable portion (perhaps nearly all) of their own compensatory system. Over time, in other words, the amount that some investors gain from any given settlement will show up on the other side of the capital marketplace ledger as roughly an equal charge to others.

Loss spreading, of course, is what insurance is all about; there is nothing about self-funding that is necessarily objectionable. But two points are clear. One is the relationship between this and the prior argument. What is being funded by investors themselves is excessive in the aggregate, and the concerns that sometimes lead to rational insurance decisions (the desire to spread large random losses) simply are not compelling here. The investor who is most likely to face a net loss situation almost always has only a small amount at stake. One might add an interesting demographic point. The group of people who might seem most in need of insurance—the relatively inactive investors—is for that reason alone more likely to be on the losing side of the self-funding process. This group's buy and hold strategies make it somewhat more likely that they will be non-trading shareholders of an issuer defendant (and suffer their share

45. Of course, after Central Bank v. First Interstate Bank, 114 S. Ct. 1439 (1994), the ability to reach such deep pockets is diminished, because there the Court eliminated private liability under a theory of aiding and abetting. However, as many persons have noted, the protection afforded ancillary defendants is not quite complete: there still may be a substantial reach to the notion of primary liability on the part of secondary participants. *See, e.g.*, James Cox, *Just Deserts for Accountants and Lawyers After* Bank of Denver, 38 ARIZ. L. REV. 519 (1996); Donald C. Langevoort, *Words from on High About Rule 10b-5:* Chiarella*'s History,* Central Bank*'s Future*, 20 DEL. J. CORP. L. 865 (1995); Marc Steinberg, *The Ramifications of Recent U.S. Supreme Court Decisions on Federal and State Securities Regulation*, 70 NOTRE DAME L. REV. 489 (1995).

46. *See* Dale Osterle, *Limits on Corporations' Protection of Its Directors and Officers from Personal Liability*, 1983 WISC. L. REV. 513. No doubt there will be some sense in which the loss will be borne by the wrongdoers: reduction of their compensation packages if they remain with the company and so forth. But this is unlikely to be a significant percentage of the total loss to the issuer. *See* Romano, *supra* note 10.

47. Among other places, this is emphasized in Judge Ralph Winter's often-cited article on excess litigation, *Paying Lawyers, Empowering Prosecutors, and Protecting Managers: Raising the Cost of Capital in America*, 42 DUKE L.J. 945 (1993). Even beyond this, monies paid by such ancillary defendants may come out of the pockets of innocent partners and shareholders in the firm if the firm has outside investors.

of the resulting loss) than members of the plaintiff class who stand to gain from the settlement or judgment.

It is in this light that, to me, the point is clinched. Few 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. These expenses, while far from hidden, bear sober reflection. Plaintiffs' attorneys' fees begin at around twenty percent of the amount of recovery,[48] and there are ample cases where the fees go much higher. Issuer shareholders also pay the defendants' legal fees, which are usually of the blue-chip variety that can substantially exceed the other side's. There is also the compensation paid to insurers and other service providers for administering the insurance system and putting themselves at risk with respect to large possible recoveries.[49] And there are the intangible costs associated with litigation that affect the profitability of the firm: uncertainty, adverse publicity, unproductive time spent in discovery, etc. Even if we concede some residually desirable, insurance-like, compensatory element to the current regime, it is dwarfed by the transaction costs involved.

C. Dysfunctional Litigation and Other Systemic Defects

The foregoing points demonstrate that the aggregate out-of-pocket loss regime is excessive and unnecessary. And that discussion implicitly assumed a regime where suits are brought on their merits, with a reasonable probability of success. This Article is not the place to continue the on-going debate over litigation reform. I will simply express my view that although I share Joel Seligman's skepticism that the available data proves that our securities class action system is broken,[50] I find it hard to believe that it isn't. The incentive structure created by (a) the ability of plaintiffs' lawyers to bring significant numbers of cases with sufficiently plausible factual allegations that will survive early motions to dismiss even if they have in fact little or no merit,[51] and (b) the ability of defendant managers to structure generous settlements using other people's money creates a profitable opportunity too tempting for lawyers to

48. The normal method of computing attorneys' fees remains the "lodestar" method: calculating the reasonable cost of the time spent by plaintiffs and then mutiplying by some factor to reflect risk and quality intangibles; 20–35% recoveries are typical. *See generally* John Coffee, *Understanding the Plaintiff's Attorney: The Implications of Economic Theory for Private Enforcement of Law Through Class and Derivative Actions*, 86 COLUM. L. REV. 669 (1986). There are, of course, instances where settlements are for little or no money to the plaintiff class: all of it goes to the plaintiffs' lawyers as compensation for their efforts in obtaining non-monetary relief that sometimes seems of questionable value. *See* Weiss & Beckerman, *supra* note 9, at 2064–79.

49. The uncertainties attendant to the litigation process naturally raise this cost. *See* Roberta Romano, *What Went Wrong with Directors' and Officers' Liability Insurance?*, 14 DEL. J. CORP. L. 1 (1989).

50. Joel Seligman, *The Merits Do Matter*, 108 HARV. L. REV. 438 (1994).

51. Obviously, the 1995 Reform Act may affect this. My concern, as stated above, is that the statutory reforms may be excessive; the question is whether there was a better way to attack the problem of dysfunctional litigation. I should mention that in my view, the problem is more low-merit (speculative) litigation than no-merit litigation. In any case—with many forms of disclosure at different times and under different circumstances—there is always some chance that with the aid of hindsight a fact-finder would find some statement material and fraudulent. This is one reason that the pressure to settle is so high.

pass up and too easy to rationalize in the name of championship of the little guy.[52]

Let me simply say that *to the extent that* the system is defective and significant numbers of actions are unjustified or settlements are excessive on the merits, then the foregoing argument becomes all the more compelling. What is involved in some unknown—but possibly large—percentage of lawsuits is not loss spreading at all, but unnecessary enrichment to some investors and their attorneys that managers pay out of other investors' pockets, coupled with wholly unproductive legal fees that must be paid to issuers' counsel by the same investors for delivering the money: a pure deadweight social loss. As noted at the beginning, my intuition is that the extraordinarily large exposure created by the aggregate out-of-pocket measure by itself affects both the decision to sue and the decision to settle, leading to a higher incidence of both and thus contributing to the problem.

Finally, we should take note of some other aspects of the compensatory regime about which we might well be concerned. A variety of scholars have noted recently the possibility that standard damage measure assumptions that are used for the purpose of settlement negotiations (presumably because they have some measure of judicial endorsement or encouragement) can themselves be overcompensatory.[53] Predictable tendencies such as stock price impoundment of expected litigation costs and recovery opportunities, the inability to factor out "in and out" trading effectively, and the possibility of noise trader overreaction can all bias upward the perception of the amount at stake.[54] Whatever their significance standing alone, any such skewing as a result of these ambiguities exacerbates the basic concerns we have identified about the compensatory system.

II. FROM COMPENSATION TO DETERRENCE

The foregoing argument strikes me as compelling (putting aside for a moment any difficulty we might worry about in differentiating between privity and non-privity cases). In fact, my experience suggests that the compensatory system has relatively few informed, non-self-serving defenders. Usually, the

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52. *See* sources cited in *supra* note 10. In this regard, I suspect that many plaintiffs' lawyers, in their naturally combative way, are sincere in their belief in the merits of the cases they bring and the righteousness of what they are doing. So, too, with defendants and their lawyers. But I also suspect that a good bit of this is what psychologists call self-serving inference: a form of self-deception that allows the profitable pursuit of self-interest in the name of reasonableness. *See* Theodore Eisenberg, *Differing Perceptions of Attorney Fees in Bankruptcy Cases*, 72 WASH. U. L.Q. 979 (1994); Donald Langevoort, *Ego, Human Behavior and Law*, 81 VA. L. REV. 853, 862–63 (1995).

53. *See, e.g.*, Cornell & Morgan, *supra* note 4; *see also* Kenneth Cone & James Laurence, *How Accurate are Estimates of Aggregate Damages in Securities Fraud Cases?*, 49 BUS. LAW. 505 (1994).

54. Many of these concerns are analyzed in Alexander, *supra* note 4, who notes among other things that stock prices after the announcement of information suggesting fraud have three components: (1) the market value of the information itself, (2) the anticipated costs of litigation over the disclosure, and (3) the value of the termination of subsequent purchasers' rights to sue. Courts, however, often assume that only item (1) is implicated. The concern about noise trader overreaction is explored in Baruch Lev & Meier deVilliers, *Stock Price Crashes and 10b-5: A Legal, Economic and Policy Analysis*, 47 STAN. L. REV. 7 (1994) (suggesting that if, as predicted, unsophisticated traders overreact to bad news, such stock price declines should not be charged to the issuer and other defendants).

out-of-pocket regime is defended instead because of its deterrence capacity: it is what is necessary to get selfish managers to behave. We are reminded over and over in the political debate of the savings and loan scandals and other notorious financial frauds. Stories are frequently told of executives prodded by their lawyers into making prompt and candid disclosure only after a vivid portrayal of the field day that the lawyers at Milberg, Weiss might have with any less forthcoming course of action.

This is met with an easy counterpoint, of course. There is no reason to assume that the aggregate out-of-pocket measure is the magic amount to use to deter fraud. If those measures are identical in any given situation, it would be coincidence. Once we abandon the compensatory ideal for non-privity cases, we carry a lot less heavy baggage in the search for an appropriate private remedy to take its place that can be justified in terms of optimal deterrence.

There is some controversy, of course, over the importance of deterrence in the absence of a compelling argument for a compensatory regime. Here, I will simply adhere to the orthodox position that some combination of the promotion of efficient allocation of economic resources via the promotion of truth-telling and a desire to deprive liars of any benefit that might come their way from a fraud justifies forceful legal intervention.[55] And I will also make the assumption that the cluster of civil and criminal remedies available as a matter of public enforcement are inadequate; the conventional view that private litigation is a necessary supplement to SEC enforcement is well-grounded. In fact, Part I suggests that we could abolish the open market fraud remedy entirely in a world with an optimally staffed SEC. But we are far from that world.

Another assumption is that overdeterrence is a significant risk and that the capital marketplace pays a price for damage measures that are excessively high. Part I provided some of the reason for concern here. Investors fund the recovery system through a variety of means, and litigation produces high transaction costs (i.e., legal fees and non-merit based settlements) that correlate with the amount at stake. Setting the damage figure higher than necessary is costly to investors for this reason alone. More importantly, there are significant costs associated with precaution in the face of excessive liability. Accounting and legal fees are higher. Managers will tend either to disclose too much (which is at least costly, often contrary to the company's business interests, and perhaps misleading by virtue of the dilution effect) or to say little or nothing at all when they want to keep secrets for fear of the uncertain consequences of addressing a subject in the first place given the dimly illuminated margins of the half-truth doctrine and the duty to update.[56] Even the SEC concedes that there may be too

55. *See* EASTERBROOK & FISCHEL, *supra* note 1. Having said this, we should take note of the arguments of those who suggest that the efficiency rationale is overstated with respect to secondary trading on the securities exchanges. *See* Mahoney, *supra* note 2, at 633–34; Lynn Stout, *The Unimportance of Being Efficient: An Economic Analysis of Stock Market Pricing and Securities Regulation*, 87 MICH. L. REV. 613 (1988). Short term mispricing in the secondary markets may not lead to a large amount of inefficiency in terms of economic resources generally. In this regard, it is worth noting the claim of Paul Mahoney that the goal of securities disclosure should not be efficient pricing but control of managerial opportunism. *See* Paul Mahoney, *Mandatory Disclosure as a Solution to Agency Problems*, 62 U. CHI. L. REV. 1047 (1995).

56. *See supra* note 32. This concern was raised explicitly by the First Circuit in a decision questioning the wisdom of the duty to update. Backman v. Polaroid Corp., 910 F.2d 10, 17 (1st Cir. 1990) (en banc).

little voluntary disclosure as a result of fear of litigation.[57] As noted earlier, one cannot say that because securities fraud is actionable only on a showing of scienter, it is readily subject to avoidance, especially when one considers the complexities of organizational dynamics and the agency cost problem. For these reasons—together with concern about the impact of low-merit litigation—we have cause to fear that any measure under consideration is too high, as well as that it might be too low.

The key, however, is in thinking through the problem in terms of deterrence, remembering (a) that natural persons acting as managers are the ones who commit fraud (although their thought processes will be affected by the organizational setting in which their actions are embedded[58]), and (b) those managers have ample opportunities to deflect the force of many money-based private enforcement mechanisms via indemnification, insurance, executive compensation arrangements and bankruptcy,[59] as well as their ability to influence the structure of settlements in a self-protective fashion.[60]

A. *Entity Versus Manager Liability*

Open-market securities frauds are instigated by natural persons, usually the senior managers of the issuer. Deterrence, then, should be directed at them, creating meaningful disincentives to cheat. Logically, such managers should face liability that assures that the expected cost of the fraud exceeds its expected benefits. To do this, the theoretically optimal damage measure is the expected benefit multiplied by a factor that reflects the subjective uncertainty of detection.[61]

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57. *See Safe Harbor for Forward Looking Statements, Sec. Act Release No. 7101*, [1994–95 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,436 (Oct. 13, 1994). On the chilling effect, see Ronald Kasznick & Baruch Lev, *To Warn or Not to Warn?: Management Disclosures in the Face of an Earnings Surprise*, 70 ACCT. REV. 113 (1995); Mahoney, *supra* note 2, at 651–55.

58. *See* John Coffee, *"No Soul to Damn, No Body to Kick": An Unscandalized Inquiry into the Problem of Corporate Punishment*, 79 MICH. L. REV. 386, 391–92 (1981). In this sense, insiders answer questions of materiality and duty by reference to a set of beliefs that may not be questioned internally, regardless of how an outsider might perceive the issue.

59. *See* EASTERBROOK & FISCHEL, *supra* note 1, at 340; Arlen & Carney, *supra* note 16, at 707–13.

60. *See supra* notes 10–11 and accompanying text.

61. *See* EASTERBROOK & FISCHEL, *supra* note 1, at 320–22; Arlen & Carney, *supra* note 16, at 707; Mitchell Polinsky & Steven Shavell, *The Optimal Use of Fines and Imprisonment*, 24 J. PUB. ECON. 89, 91 (1984). The risk of detection multiplier was the basis for the decision by Congress to use a "three times profits" civil penalty in its effort to combat insider trading. *See* Donald Langevoort, *Commentary: The Insider Trading Sanctions Act of 1984 and Its Effect on Existing Law*, 37 VAND. L. REV. 1273, 1275–80 (1984). The academic literature assumes a rational assessment of the risk of detection by a person facing a decision whether to violate the law. Though that may have something of a heuristic value, there is a good bit of behavioral literature that suggests that for a variety of cognitive, motivational and informational reasons, the risk of detection is subject to severe misestimation. Although the risk of overestimation is possible under some circumstances (high saliency of recent enforcement efforts), the risk of underestimation is probably more likely. *See, e.g.*, Jeff Casey & John Scholz, *Beyond Deterrence: Behavioral Decision Theory and Tax Compliance*, 25 L. & SOC'Y REV. 821 (1991); William Dickens, *Crime and Punishment Again: The Economic Approach with a Psychological Twist*, 30 J. PUB. ECON. 97 (1986). People have a tendency to think that they can control this risk, and may be motivated to dismiss risk-positive information as a stress reduction device. *See* Langevoort, *supra* note 52, at 865–67. This suggests the need for a high multiplier, but it also suggests some of the difficulties and heavy costs associated with deterring through monetary sanctions in the first place.

Current law employs a mixed strategy of liability, creating joint and several liability for the aggregate out-of-pocket damages to be shared by the managers, the issuer and any ancillary defendants. As noted above, the practical effect—as a result of settlement incentives and indemnification and insurance rules—shifts virtually all of the financial burden to the firm and the ancillary defendants. The managers' exposure from the class action is mainly indirect (i.e., some effect on future compensation, perhaps a reputational penalty, the distraction and hassle of the litigation and the risk of uninsurable or unindemnifiable liability).[62] There are, of course, also more direct forms of exposure, if the SEC or criminal prosecutors take an enforcement interest in the matter, which are also significant ex ante in the deterrence calculus.[63]

In both academic and practical analysis, this de-emphasis on managerial exposure in favor of entity liability in private litigation is usually considered acceptable. In part, this may largely be a result of the perception that compensation of fraud victims in open-market cases is the dominating goal of class action litigation, and compensation requires the deep pocket of the firm rather than the shallow ones of individual managers. As we have shown, however, obsession with compensation is misdirected in fraud-on-the-market cases.

Most scholarly analysis, however, supports the emphasis on entity liability even when the primary goal is optimal deterrence.[64] This is generally on the assumption that entity liability creates a more efficient control mechanism for managerial misbehavior: the firm is forced to adopt a mix of executive selection, contracting and monitoring strategies that will prevent or deter efficiently. These strategies substitute for the threat of direct liability to third parties that can so readily be blunted by bankruptcy, indemnification and insurance anyway.

But as Jennifer Arlen and William Carney have recently shown, there are substantial reasons to doubt the efficacy of entity liability in controlling securities fraud.[65] Their argument is based largely on a variant of the classic "last period" problem: that most open-market frauds are prompted by self-serving fears of corporate managers that adverse business developments will cause the loss of their jobs. Management thus lies to buy time (or other forms of cover) during which some turnaround in fortunes might occur, or at least to retain their income and perquisites for a bit longer. Under these circumstances, the managers' reputational and long-term pecuniary interests are already in

62. The weaknesses of these secondary deterrent impacts are considered in Romano, *supra* note 10; *see also* Kraakman et al., *supra* note 10, at 1759–60.

63. As discussed more fully below, the Securities Enforcement Remedies Act of 1990 was intended to increase the deterrence effect of securities law prohibitions with respect to both corporate and natural persons; officers and directors were a specific class of persons at whom the remedial reform was directed.

64. *See, e.g.*, EASTERBROOK & FISCHEL, *supra* note 1, at 340; Lewis Kornhauser, *An Economic Analysis of the Choice Between Enterprise and Personal Liability for Accidents*, 70 CAL. L. REV. 1345 (1982); Reinier Kraakman, *Corporate Liability Strategies and the Costs of Legal Controls*, 93 YALE L.J. 857 (1984); Alan Sykes, *The Economics of Vicarious Liability*, 93 YALE L.J. 1231 (1984).

65. Arlen & Carney, *supra* note 16. Their reasoning is endorsed in Kraakman et al., *supra* note 10, at 1759–60 & n.80. For other insights into the use of entity liability as a deterrence mechanism, see Michael Block, *Optimal Penalties, Criminal Law and the Control of Corporate Behavior*, 71 B.U. L. REV. 395 (1991), as well as other commentaries in the same symposium.

jeopardy, making their long-term contractual interests (express or implied) and their concern about the company's status or capital marketplace reputation less compelling.[66] Outside members of boards of directors and organized shareholder interests are poorly situated to monitor these agency risks effectively because of some combination of lack of time and information and built-in structural bias.[67] Arlen and Carney offer an empirical sampling of recent class actions to support their inferences.[68] To the extent that their analysis is right, then many forms of open-market securities fraud bear a closer family resemblance to insider trading, and we are left to wonder why the law makes insider trading largely a matter of individual liability, while self-serving securities fraud is addressed almost completely from an entity liability standpoint.

I agree with most of the Arlen–Carney conclusions, and so share their suspicion that entity liability for large dollar damages of the sort currently at stake in litigation may be unproductive from a deterrence standpoint. I am not willing to go as far as they do, however. The last period problem that they identify is a serious one, rendering standard contractual incentives less useful. But less does not mean nil. While there are some situations where the manager faces a clear likelihood of termination, many of the subjects of litigation (e.g., earnings declines) are ones that many managers can and do survive, especially in environments where shareholder and board monitoring is less than fully efficacious. Managers may even survive bankruptcy reorganization. In these circumstances, there will inevitably be some sensitivity to the long-term incentives the firm creates—perhaps a good deal—even if the manager senses that this *might* be the last period. The business conditions that tempt managers to lie are marked by a high degree of ambiguity, rendering the decision-making process complex and multi-directional.[69] Under ambiguity, the last period problem is more likely to introduce a self-serving bias in the assessment of the firm's best interests than deliberate disregard of them. The widespread perception that liability chills the disclosure process is an implicit admission that enterprise liability has some effect, even if its precise contours are hard to predict.[70]

Moreover, many of the observable forms of actionable fraud are not quite as susceptible to the last period characterization as Arlen–Carney suggest.

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66. Arlen & Carney, *supra* note 16, at 702–03.

67. Arlen and Carney point to such matters as the practical difficulty of gauging reputation, the insiders' control over information flow and the psychological reluctance of board members to question their own as limiting factors. On this last point, see James Cox & Harvey Munsinger, *Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion*, 48 LAW & CONTEMP. PROBS. 83 (1985). Recent history suggests that outside directors are more willing to act independently, suspicious of self-serving presentations by insiders. The extent of this shift is impossible to assess.

68. Arlen & Carney, *supra* note 16, at 720–40.

69. The effect of ambiguity on decisional processes is explored in Hillel Einhorn & Robin Hogarth, *Decision Making Under Ambiguity*, 59 J. BUS. S225 (1986). *See also* Robin Hogarth & Howard Kunreuther, *Risk, Ambiguity and Insurance*, 2 J. RISK & UNCERTAINTY 5 (1989).

70. There is a seeming paradox in arguing both that the current liability scheme unduly chills the disclosure process and that enterprise liability insufficiently deters managerial misbehavior. One might well conclude, however, that the chill is a real one so long as management feels no strong self-interest in falsity. When that event arises, we are in an environment of underdeterrence.

My sense is that many forms of open-market misrepresentations and truth-shadings are the product of organizational cultures and leadership styles in which reflective objectivity gives way under conditions of adversity to the sort of cognitive bias that promotes sustained optimism.[71] Organizational and personal optimism is highly adaptive, especially for younger firms. Creating a managerial culture in which people are willing to take risks, persevere against great odds and otherwise commit their loyalties to the firm depends on what is often an inflated belief in self- and firm-efficacy. Effective marketing also depends on subtle distortions of reality: optimism is adaptive here as well.[72] This kind of environment does not readily allow for cognitive separation between the optimism that fuels internal and product market cultures and a less sanguine information flow to investors. Without doubting the difficulties that law has in overcoming otherwise functional distortions of reality,[73] one cannot say with complete assurance that the threat of entity liability does not create incentives to try to dampen through organizational design techniques the risk that undue enthusiasm will adversely affect the capital markets.

Arlen–Carney may also overstate somewhat the weakness of monitoring mechanisms. True, institutional shareholder activism and outside director primacy are subject to predictable shortcomings. But evolution is in their direction,[74] and there are strategies that activist monitors can employ to deter fraud. For instance, law firms and accountants—parties less likely to see a period of stress as a final one—can be selected with greater board or institutional shareholder involvement and can be given roles in the formulation and review of publicity and disclosure.[75]

Finally, we should take note of the practicalities of deterrence through private litigation. As we will explore more fully in the next section, the amount at stake must be high enough to attract the interest of plaintiffs and their lawyers in pursuing risky and expensive litigation. It is at least plausible that the

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71. *See generally* Albert Bandura, *Human Agency in Social Cognitive Theory,* 44 AM. PSYCHOL. 1175 (1989); Jeff Greenberg et al., *Why Do People Need Self-Esteem: Converging Evidence that Self-Esteem Serves an Anxiety Buffering Function,* 63 J. PERS. & SOC. PSYCHOL. 913 (1992). Self-serving inference, noted earlier, is part of this cognitive bias. *See also* Langevoort, *supra* note 52, at 856–59.

72. The classic text on the role of "unrealistic" optimism for both personal and firm efficacy is MARTIN SELIGMAN, LEARNED OPTIMISM (1989). The downside risk of organizational cognitive bias is explored in Harry Levinson, *Why the Behemoths Fell: Psychological Roots of Corporate Failure,* 49 AM. PSYCHOL. 428 (1994). In their empirical study of class actions, Arlen and Carney identify as "last period" examples many cases that relate to product viability and marketing. *See* Arlen & Carney, *supra* note 16, at 725, 736 tbl. 2. Indeed, these kinds of cases are some of the best known in securities law. *See, e.g.,* Backman v. Polaroid Corp., 910 F.2d 10 (1st Cir. 1990); *In re* Apple Computer Sec. Litig., 886 F.2d 1109 (9th Cir. 1989). Realistically, these cases are better characterized as sustained optimism cases, for there is little apparent risk (especially at the high executive levels) of termination associated with such corporate developments.

73. *See* Langevoort, *supra* note 52, at 869–72.

74. *See* John Coffee, *Liquidity Versus Control: The Institutional Investor as a Corporate Monitor,* 91 COLUM. L. REV. 1277 (1991); Weiss & Beckerman, *supra* note 9.

75. I have written elsewhere that I am somewhat skeptical of claims that lawyer involvement can effectively prevent client fraud. *See* Donald Langevoort, *Where Were the Lawyers?: A Behavioral Inquiry into Lawyers' Responsibility for Clients' Fraud,* 46 VAND. L. REV. 75 (1993). Indeed, there are reasons to doubt that lawyers committed to client representation will readily spot red flags and danger areas. But this is largely a cost point; there is little doubt that one *could* design forms of lawyer involvement that overcome these risks. *See id.* at 115–17.

amount at stake will be beyond the capacity of the managers, or will be shifted back to the entity anyway through compensation, indemnification or insurance.

For these reasons, I doubt that the case is made for a complete shift away from entity liability. At the same time, however, the points made by Arlen and Carney are well taken. The costs of any proposed form of entity liability have to be looked at carefully, and their benefits viewed with considerable skepticism.[76]

B. Choosing the Right Deterrence Measure

Once we accept a role for enterprise liability and see the problem in terms of optimal precaution, we want firms as a whole to adopt precautionary procedures up to a point where the investment exceeds the net social cost threatened by the fraud adjusted to reflect the less-than-perfect rate of detection and enforcement. Simply to state that goal in this fashion, however, underscores its indeterminacy. Securities frauds have wildly differing social and economic costs (and benefits[77]) and risks of detection. The variables are impossible to measure with precision ex post, much less to predict ex ante on a formulaic basis. If we are to move from aggregate out-of-pocket loss to a deterrence measure, some rough heuristics have to be employed.[78]

In this section, we shall focus as a starting point on the American Law Institute's Federal Securities Code approach to capping damages for securities frauds.[79] As noted earlier, the Code arbitrarily limits entity exposure to the greater of one percent of gross income (to a maximum of $1,000,000) or profits, unless the fraud was a "knowing" one. If knowledge is shown, the measure defaults to the aggregate out-of-pocket standard. Managerial exposure is also capped at the greater of $100,000 or profits, with the same knowledge exclusion. These numbers would be adjusted for inflation, and, of course, were arrived at in the mid-1970's. Obviously, higher numbers would be chosen today. Some of the drafting history of the Code may also be useful to understand. One of the innovations of the Code was the extension of negligence-based "due diligence" liability to the preparation of the 10–K's of public companies, in recognition of the shift to a "company registration" model for disclosure by seasoned issuers.[80] In some ways, the cap on damages may have been something of a trade-off for this broadening of underlying exposure (although the ALI ultimately refused to endorse the broadening of primary

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76. It is equally true, though, that we can be skeptical of sanctions directed largely at managers, given relatively liberal indemnification and insurance rules. Yet if we toughen the standards—for example, by limiting such indemnification and insurance—the problem of overprecaution reemerges. Although the situation is unsatisfying, it may be best to leave matters where they are. Given the exclusions in most director and officer insurance policies for deliberate dishonesty or the equivalent, the individual manager still faces some risk of personal liability and—together with the other sorts of sanctions the manager faces if caught—leave some meaningful deterrence in place.

77. On the question of social benefit, see authorities cited in *supra* note 6.

78. It is worth noting the claim of Paul Mahoney that an optimal level of deterrence might well be achieved by simply eliminating the availability of the fraud-on-the-market theory. *See* Mahoney, *supra* note 2.

79. *See supra* note 13.

80. See FED. SEC. CODE §§ 1704–05 (introductory commentary at 703–06) (Am. Law Inst. 1980).

liability, choosing instead to leave the proper state of mind standard open for legislative resolution[81]).

Putting aside the exclusions, the presumptive caps are quite low. The $1,000,000 cap is very small for large corporations, even in 1977 dollars. That is not necessarily troubling, however, for as we have seen, massive entity exposure really isn't called for at the issuer level. The key is to choose a measure that causes companies to take monitoring and incentive-structuring tasks seriously. For managers, the $100,000 cap was more realistic in 1977, although both inflation and the almost geometric status-driven growth in executive compensation packages during the 1980's and 1990's have rendered the figure amusingly anachronistic.[82]

The best heuristic substitute for net social harm is a benefit-based measure, taking into account the significant probability of nondetection. This standard is intuitively logical for managers, for it puts them in a position, if they think rationally, of having to decide whether the expected enrichment from the fraud is worth the risk. In the aggregate for all wrongdoers, it is probably as good a proxy as any for entity liability as well.[83] Any less than this and deterrence will be incomplete. More than this and the dysfunction pointed to above comes into play.

Expected improper benefit, however, is a fuzzy concept; so too is actual benefit if we choose it as a proxy. In some cases, of course, there will be a direct, measurable benefit associated with even a non-privity fraud. Ancillary participants have the fees they will collect, for example.[84] But most open-market frauds are less measurably self-serving: the desire to keep a job, or hype the firm's business. Ego, status, peer pressure and a host of other intangibles come into play on the self-serving side of the ledger. While we could simply let a court guess at the expected or actual benefit ex post, this would be wildly indeterminate and uneven in application.[85]

There is another factor that we should take into account as well. Since we are focusing on the decision to cheat ex ante, the actor's awareness of wrongdoing—whether the misstatement or omission was unlawful and harmful—is relevant. Given scienter's slippery character, it is appropriate to

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81. *Id.*

82. Many of the latest statistics are found in Charles Elson, *The Duty of Care, Compensation and Stock Ownership*, 63 U. CIN. L. REV. 649 (1995). The Virginia legislation noted in *supra* note 15 makes the cap turn on aggregate compensation, with a limit of $100,000. This rather significant limitation should be understood, of course, in the context of the decision of many other states—following Delaware's lead—to allow corporations via charter provisions to remove liability entirely for simple duty of care breaches. *See* Hanks, *supra* note 15.

83. Since we want to affect the company's decision at the level of monitoring and supervision, the key is to pose a threat sufficiently serious that directors will consider it part of their general obligations. Given the relatively small self-interest that they have at stake, there is no reason to believe that this number must be excessively large.

84. Even here, there is a measurement problem when we remember that an accountant or lawyer's decision to participate in a client's fraud is not simply to get the fee associated with work on that project but to protect the expectation of future earnings from that client (and perhaps to protect the professional's reputation for loyalty generally).

85. Indeterminacy is a problem mainly to the extent that actors perceive the possibility of excessive damages, for there the excess precaution problem arises. The risk of small awards is less so long as it does not become predictable. *Cf.* Elliott Weiss & Lawrence White, *Of Econometrics and Indeterminacy: A Study of Investors' Reactions to "Changes" in Corporate Law*, 75 CAL. L. REV. 551 (1987).

distinguish between those frauds that are truly deliberate (having something like malice aforethought) and those where there is a more significant risk of judicial error or legitimate cause for uncertainty on matters such as materiality or duty. Drawing this distinction reduces the risk of overprecaution: there is far less cause for concern with respect to the truly deliberate scheme.

In this light, the Code's formulation is well-intentioned but incomplete. The quantitative caps are a step in the right direction, and can readily be adjusted to be meaningful in the 1990's. The Code also recognizes that benefit is relevant, and so loosens the cap to assure that it will be at least the amount of the benefit. But this is problematic, of course, for if we assume that there will be a significant number of such cases where the benefit exceeds the cap, the absence of a benefit multiplier to reflect the risk of detection raises the same problem as the pre-Insider Trading Sanctions Act approach to insider trading: the person disgorged his profits if caught, but had no reason to believe the detection was even likely.[86] The rational choice was often to trade or tip and risk the suboptimal sanction.

The Code's decision to take away the cap for knowing frauds makes some sense as well, for the distinction between the deliberate and the nondeliberate fraud is important in terms of precaution costs. This is especially so where liability could be premised on negligence rather than scienter, as in the Code's original formulation for false annual reports. Under the Code, "knowledge" was an undefined term, but separate from (and presumably higher than) scienter.[87] This lack of a definition could be troubling, however, given the rule of reversion to aggregate out-of-pocket damages. How coherently the courts would apply the knowledge exclusion would be hard to predict; given the choice not to define, we could expect substantial indeterminacy. In any event, under our approach, there is little reason to use aggregate out-of-pocket damages as a default rule. The measure should be larger for deliberate frauds, but one can be more precise.

The need to focus more precisely on expected benefit, awareness and deliberation, and risk of detection suggests that we look for an alternative to the Code as the source for a model. These matters, of course, were considered in the drafting of the civil penalty provisions of the Securities Enforcement Remedies Act and Penny Stock Reform of 1990.[88] The intent behind that statutory provision was precisely the same as we are considering here: finding an optimal level of deterrence.[89] Section 21(d)(3) tiers the penalty scheme, with the lowest level for relatively technical violations, the middle for intentional frauds and other deliberate harms, and the highest for intentional frauds that

86. *See* Donald Langevoort, *Commentary—The Insider Trading Sanctions Act of 1984 and Its Effect on Existing Law*, 37 VAND. L. REV. 1273, 1275–76 (1984). In the Sanctions Act, Congress decided to impose a civil penalty of three times profits made or losses avoided in order to introduce an appropriate level of deterrence. *Id.* at 1276.

87. *See* FED. SEC. CODE § 202(86), 202(147) (Am. Law Inst. 1980). The Code distinguishes between knowledge and scienter (defined in FED. SEC. CODE § 202(86)). Scienter is used in the standard sense of an awareness or reckless disregard of the underlying facts and the propensity of statements or omissions to mislead. FED SEC. CODE § 202(147).

88. Pub. L. No. 101–429, 104 Stat. 931 (1990) (codified as amended in scattered sections of 15 U.S.C.).

89. *See* H.R. REP. NO. 101–616, 101st Cong., 2d Sess. 13 (1990).

threaten or cause severe injury to investors.[90] The amount of the actual gain can move the penalty higher (but with no multiplier). Read reasonably, the distinction between the second and third tiers is what we wish to capture in terms of the actor's motivation and expectations in engaging in the violative conduct. The numbers could reflect some judgment as to average expected intangible benefit adjusted for detection.

My sense has long been that the numbers found in the 1990 legislation are too low, especially for companies.[91] Five hundred thousand dollars is an extremely low cap for large companies, especially given the risk of underdetection. We should recognize, however, that the civil penalty provision is per violation, and is part of a cluster of remedies to which a person committing securities fraud is exposed. Injunctions and disgorgement, the possibility of an officer-director bar order, and the threat of criminal prosecution are also present in terms of public enforcement. The drafters were also working in the context of private rights of action in an environment that assumed the sometimes draconian aggregate out-of-pocket measure of damages in class actions as a supplement to the Commission's enforcement efforts. Thus, there might have been some reason to tolerate an otherwise low civil penalty figure.[92]

If writing a statutory provision, I would use the civil penalty model in defining the maximum amount of recovery. The numbers would be higher (and I would revise the Commission's penalty authority commensurably). What numbers? One is forced to be arbitrary, and assuming that courts would have the power to award something less than the maximum in appropriate cases, the cap should not be all that low. Detection remains problematic: even more so if we have made private actions harder and more risky to bring. There are two ways to structure a cap. One—found in both the Code (for executives) and Section 21(d)(3)—is a simple dollar cap. This does seem somewhat insensitive to gradations among actors and situations even apart from the second-third tier distinction. As a result, it invites courts to assume that less than the maximum is to be awarded when the defendant is not either a sociopath or a blue-chip company or one of its executives. The other is a floating standard, as the Code uses for companies. I am inclined toward the latter, making the cap a percentage of some readily measurable figure (e.g., total market capitalization, net assets or gross income of the company in question) at the time the fraud began. For executives, it is tempting to make the cap a multiple of the executive compensation package or pecuniary total benefit received for the period immediately prior to detection of the fraud. Given the multiplier, the effort

90. Pursuant to § 21(d)(3) of the Securities Exchange Act, first tier offenses give rise to a civil penalty that cannot exceed $5000 per natural person or $50,000 per entity; the cap for second tier offenses rises to $50,000 and $250,000; for the third tier it is $100,000 and $500,000. Securities Exchange Act § 21(d)(3), 15 U.S.C. § 78 u(d)(3) (Supp. 1996).

91. This concern was raised by the author in the hearings on the proposed legislation in 1990. *See Hearings on H.R. 975 Before the Subcomm. on Telecommunications & Finance of the House Comm. on Energy and Commerce*, 101st Cong., 1st Sess. 116 (July 19, 1989).

92. As a matter of legislative history, the choice of the specific numbers to define the extent of liability appears based on those found in comparable civil penalty provisions already found in federal law (e.g., banking regulation). One gets the sense that the SEC did not want to appear to overreach in its request for this new authority, and hence limited its request to what other agencies had previously been given. *See* Statement of David S. Ruder, Chairman, Securities and Exchange Commission, printed in *Hearings*, *supra* note 91, at 36–37.

here is not toward mathematical precision but simplicity, and hence some proxy from the executive compensation tables could be used. Admitting to some arbitrariness, my sense is that for a large Fortune 500-type company, an appropriate level of deterrence for deliberate, serious management frauds could be achieved with a maximum direct exposure in the range of $10 million.[93] Courts could award less in appropriate cases, and there would be a lower tier for less deliberate frauds.[94] Here, of course, I have abandoned any pretense of rigor, and am simply working from intuition. No doubt people other than academics are best positioned to estimate the right cap (though we must be aware of self-serving inference from those too close to the action). My argument has succeeded if we are at the point of negotiating formulas or numbers.

Under this approach, of course, we want to make sure that the incentive of private plaintiffs to bring meritorious cases is not lost. This can easily be done by allowing for an award of reasonable attorneys' fees against the defendants in addition to the damage remedy, which would as a practical matter be paid by the issuer. Coupling this exposure with limited entity liability reinforces the deterrent effect at the firm level.

We should consider also whether the court in a private action under this deterrence-based "private attorney general" regime should also have certain of the alternative remedies that are available to the SEC in its enforcement actions. The case for disgorgement of tangible pecuniary benefits in addition to the penalty-based measures is strong, and there is a logic to expressly making available other forms of equitable relief as well. The officer-director bar is more interesting.[95] In general, I think that bars against those who instigate deliberate frauds causing serious harm to the capital markets should normally include a loss of position, at least temporarily. The "egregiousness" standard that has worked its way into the case law has been applied too rigorously.[96] If we are moving to a system that is truly based on the private attorney general construct, making a better-articulated bar order provision available in private actions seems sensible. At the same time, however, I admit to some nervousness here. Placing this threat in the hands of an opportunistic plaintiffs' lawyer may be offering too much leverage for unduly high dollar settlements of low-merit cases. Unable to shift the burden of bar orders to shareholders or insurers the way they can dollar penalties, managers in control of settlement negotiations

93. Individual sanctions would be in addition to this amount, so that the total award would be the sum of individual and entity liability. The larger the number of managers involved, the larger this total would be—a result that has considerable appeal.

94. It would be best to require a court to justify lowering the amount. It must be remembered that the deterrence objective is directed at future trading, and must be large enough to offset the uneven risk of detection. In insider trading cases, the courts, however, have been somewhat more solicitous of traders, sometimes even denying the penalty completely. *See, e.g.*, SEC v. Ingoldsby, [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,351 (D. Mass. May 15, 1990); Ann Flannery, *The Odds of Winning: Deciding Whether to Settle or Litigate with the SEC*, 3 INSIGHTS, no. 4, at 17 (1989).

95. *See* Securities Exchange Act § 21(d)(2), 15 U.S.C. § 78u(d)(2) (Supp. 1996). *See also* Jayne Barnard, *When Is a Corporate Executive Substantially Unfit to Serve?*, 70 N.C. L. REV. 1489 (1992).

96. For an instance of inexplicable reluctance on the part of a court to allow the imposition of a bar, see SEC v. Patel, 61 F.3d 137, 141–42 (2d Cir. 1995). The court essentially equated the bar order with the standards for injunctive relief. *See id.*

may be a bit too eager to arrive at a financial resolution where the merits matter less than they should.

The emphasis on private attorneys general bears two more postscripts. If indeed the value of private litigation in these kinds of cases is as an enforcement mechanism rather than in terms of compensation, should the money be payable to the government rather than distributed to investors? Even in insider trading cases, we continue to distribute disgorgement funds, and create a private action for disgorgement if the SEC has not gotten there first.[97] This is a close question, but the better argument is for distribution under some plan designed to minimize administrative costs and bias recovery in favor of smaller investors. As noted, there is some residual compensatory justification in open market fraud cases; distribution might thus have some small insurance rationale and somewhat greater investor relations value. It allows us to deflect more easily the concern that inevitably arises when civil remedies are used to accomplish criminal or quasi-criminal law objectives.[98]

The other has to do with the control of plaintiffs' lawyers. If they really do play a quasi-public role in engineering private actions, then they in some sense *are* securities professionals. I would give the SEC a Rule 2(e)-like authority[99] to bar (temporarily or permanently) from representative status in open-market fraud cases lawyers or firms found to have engaged in a pattern of prosecuting and settling actions that at the time of filing had no reasonable likelihood of success on the merits.[100]

III. THE PRIVITY/NON-PRIVITY DISTINCTION

The approach outlined above works very well in the standard false corporate filing and publicity setting, where privity is absent. The fact that the fraud may be self-serving via some indirect means is not important, for the liability measures adequately take account of expected benefit. There is also little reason to depart from the structure when the fraud is motivated by a desire to engage in or facilitate insider trading, for there are already separate deterrence-based remedies in place.[101] Thus, the line is properly drawn at the

97. *See* Securities Exchange Act § 20(a), 15 U.S.C. § 78t (1976). *See also* SEC v. Six Unknown Purchasers, 817 F.2d 1018 (2d Cir. 1987); Rory Flynn, *SEC Distribution Plans in Insider Trading Cases*, 48 BUS. LAW. 107 (1992). In her proposal for reform, Janet Cooper Alexander uses a public enforcement model. *See* Alexander, *supra* note 16.

98. *See* John Coffee, *Paradigms Lost: The Blurring of the Criminal and Civil Law Models—and What Can Be Done About Them*, 101 YALE L.J. 1875 (1992).

99. Under Rule 2(e) of the SEC's Rules of Practice, the Commission can bar from practice before it any professional found to have willfully violated the securities laws or to have engaged in improper professional conduct. 17 C.F.R. § 201.2(e) (1995).

100. To be sure, Rule 2(e) is controversial today, and any proposal for its expansion bears a heavy burden. Putting aside general concerns about the exercise of administrative discretion, this proposal does not implicate the primary concerns directed at 2(e)—that it chills the vigor of legal representation by allowing the SEC staff to attack the lawyer for the other side, or that it interferes with bargained-for choice of counsel by private clients. *See, e.g.*, Simon Lorne, *The Corporate and Securities Adviser, the Public Interest, and Professional Ethics*, 76 MICH. L. REV. 423 (1978).

101. On the interplay between insider trading and false publicity from a remedial perspective, see, e.g., Kaplan v. Rose, 49 F.3d 1363, 1379 (9th Cir. 1994) (insider trading is probative of scienter); *In re* Seagate Tech. II Sec. Litig., 843 F. Supp. 1341 (N.D. Cal. 1994) (refusing to extend disclosure duty created by insider trading rules to become the basis for a fraud-on-the-market suit).

point where it cannot fairly be said that the primary defendant is an issuer and directly or indirectly a purchaser or seller of securities from the class of plaintiffs in question.

What if it is? The interesting question is whether any limitation on liability is appropriate in the Securities Act context. The inclination to do so comes, of course, from the extensive role that issuer liability plays in that setting, so that the firm's current shareholders (among others) face a considerable burden as a result of promoter or managerial fraud.[102] My sense is that the current Securities Act damages measure is relatively sound.[103] The issuer benefits from the fraud, and in initial public offerings especially, pre-existing shareholders are likely to be insiders with some involvement in the wrongdoing. Moreover, the compensatory rationale is much more compelling in this context: the netting of fortuitous gains and losses is inapposite, and more individual investors have larger sums of money at stake. While the question is a close one, any reform in the Securities Act area, then, might better be in terms of the substantive standards of liability (e.g., does due diligence continue to make sense for all public offerings? Is issuer strict liability the best standard?) and of allocating liability among defendants, rather than remedy per se.[104]

Proxy fraud poses a hard problem, too. Shareholder approval of mergers and other extraordinary corporate action can be tainted by fraud, and in many cases investors will be giving up their existing shares as a result of the transaction. The courts have recognized the propriety of monetary damages in these types of cases, and issuer liability is standard.[105] There is a significant pocket-shifting element here, and the willingness to impose liability for negligent misrepresentations[106] increases the risk of overprecaution. On the other hand, this is an area where mandatory rather than voluntary disclosure dominates (eliminating much of the concern about a chill), and there will be numerous cases—such as going private transactions—which far more resemble "reverse" Securities Act problems than ones involving false publicity. Nor is the netting out concept likely to apply. My inclination here is even less strong than with respect to the Securities Act, but I would probably retain the presumption of compensatory damages here as well.

IV. Conclusion

Securities fraud is a bad thing, and all too common. But like most bad things, it has a proportionate response. There is little doubt that courts have

102. This point becomes stronger as one moves away from the initial public offering context (where insiders dominate the issuer prior to the offering) to a public offering by a seasoned issuer with relatively small insider ownership.

103. Under both sections 11 and 12 of the Securities Act, the measure of damages is rescissory; both allow for a reduction of the amount in question to reflect any drop in value unrelated to the fraud, a negative causation defense. 15 U.S.C.A. §§ 77k-*l* (1981). *See* Akerman v. Oryx Communications Inc., 810 F.2d 336, 340 (2d Cir. 1987).

104. These questions are the sorts currently being considered by the SEC's Advisory Committee on the Capital Formation and Regulatory Processes in connection with its deliberations over the move to a company registration model regarding capital raising by seasoned issuers.

105. *See, e.g.,* Mills v. Electric Auto Lite, 396 U.S. 375 (1970); Simon Lorne, *A Reappraisal of Fair Shares in Controlled Mergers*, 126 U. PA. L. REV. 956 (1978); William Painter, *Civil Liability Under the Federal Proxy Rules*, 64 WASH. U. L.Q. 425 (1986).

106. *See* Gould v. American-Hawaiian S.S. Co., 535 F.2d 761 (3d Cir. 1976).

fashioned damage remedies in open-market fraud cases on the assumption that all frauds have victims, and all victims deserve full compensation. But it is too easy to lose sight of the fact that in the capital marketplace, questions of what constitutes fraud, how to prove it, and who really is a victim have no precise answers. And obsession with the compensatory ideal instead of a struggle with these complexities can create too narrow-minded a search for deep pockets simply to make the ideal work, without worrying enough about who pays as a result.

Reform along the lines suggested here is rational, and readily justifiable in terms of investor interests. I would guess that reducing the amount at stake would indeed produce more sensitivity to the merits of a case on the part of both plaintiffs and defendants in the bringing, defense and settlement of securities law disputes. That, coupled with some limited procedural reforms, might well have been a better strategy than changing the substantive standards to make all suits harder to bring. Moreover, creating a more equitable and proportionate remedial scheme would likely have another important benefit. The familiar argument against mandatory capital punishment is that juries that think that the death penalty is undeserved will simply acquit, whether the defendant is guilty or not. I sense that some of the excessive judicial hostility to securities class actions that we have seen in recent years may be driven by a similar emotion: that protecting those who commit fraud may be preferable to subjecting them (and innocent investors) to draconian liability.[107] Proportionality might actually increase in the willingness to impose liability in the first place.

The recent efforts at litigation reform were predictable. Managers wanted to limit their and their firms' exposure, often without regard to the merits of the underlying suit. Making all suits harder to bring became the goal. The accountants' objectives were similar, with special attention made to gaining proportionate liability for themselves, not everyone else. The plaintiffs' lawyers fought their battle on the defensive against each of these initiatives. The SEC, when it was listened to at all, sounded a bit bureaucratic and arrogant: "leave it to us to fix." Establishment corporate lawyers were relatively silent, suggesting a certain measure of ambivalence either on the merits or in their own self-interest. Missing from all this was any significant voice asking hard questions about the real financial interests of investors, which are not perfectly aligned with those of either lawyers or managers. In the end, investors and the public will be buffeted from two directions. If meritorious suits really do become harder to bring, too much fraud will go unchallenged. In any event, the burden of whatever incidence of litigation remains—whether meritorious or not—will continue to be charged to the investing public, rather than the real wrong-doers, at excessive cost. In the political process, it seems, the loser always pays.

107. *See* John Coffee & Donald Schwartz, *The Survival of the Derivative Suit: An Evaluation and Proposal for Legislative Reform*, 81 COLUM. L. REV. 261, 316–17 (1981).