Shareholder Compensation as Dividend

James J. Park
Brooklyn Law School

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SHAREHOLDER COMPENSATION AS DIVIDEND

James J. Park*

This Article questions the prevailing view that securities-fraud actions suffer from a circularity problem. Because shareholder plaintiffs are owners of the defendant corporation, it is commonly argued that shareholder compensation is a payment from shareholders to themselves with substantial transaction costs in the form of attorney fees. But shareholder compensation is no more circular than a dividend, which is a cash payment to shareholders from the company they own with substantial transaction costs in the form of taxes. In fact, shareholder compensation is less circular than a dividend because it is a transfer to shareholders who purchased stock when the price was inflated by fraud from those who did not. Shareholder compensation serves an important loss-spreading function that is facilitated by the insurance market. Shareholder compensation may also capture some of the benefits of paying dividends, such as signaling and reducing agency costs, though it may do so more effectively if companies could resolve securities-fraud actions by paying a preemptive dividend.

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INTRODUCTION

This Article questions the prevailing view that securities-fraud-on-the-market class actions alleging violations of Rule 10b-5 ("securities-fraud actions") are fatally flawed because they suffer from a circularity problem. Shareholder plaintiffs are simultaneously owners of the defendant corporation from which any settlement of a securities-fraud action is paid. Thus, when a corporation compensates shareholders for securities fraud, the payment is seen as a circular transfer from shareholders to themselves with substantial transaction costs in the form of attorney fees and the costs of defending the suit.2


2. E.g., In re Cal. Micro Devices Sec. Litig., 168 F.R.D. 257, 272 (N.D. Cal. 1996) ("[S]ettlement payments . . . are to equity class members little more than the shifting of wealth from their right pocket to their left, and . . . class members were to be charged a twenty percent fee by class counsel for this 'service' . . . ."); Janet Cooper Alexander, Rethinking Damages in Securities Class Actions, 48 STAN. L. REV. 1487, 1503 (1996) ("[P]ayments by the corporation to settle a class action amount to transferring money from one pocket to the other, with about half of it dropping on the floor for lawyers to pick up."); Adam C. Pritchard, 'Basic' Error is Focus on Loss, NAT'L L.J.,
Shareholder Compensation as Dividend

But this circularity is no worse than the circularity of a dividend,\(^3\) which is a common way that corporations distribute cash to their shareholders. The economic benefit of a dividend is at best a wash because the cash that is paid out cannot be invested by the corporation, or the corporation must issue new debt or equity to fund the dividend. The prospect of receiving a dividend should thus be irrelevant to an investor's decision to purchase a stock. And like shareholder compensation, a dividend triggers a substantial transaction cost, the dividend tax.\(^4\)

Indeed, shareholder compensation is actually less circular than a dividend. While all shareholders receive a dividend, only shareholders who purchased stock while it was inflated by fraud are entitled to shareholder compensation. Shareholder compensation is thus essentially a transfer from shareholders who were not defrauded to shareholders who were defrauded. In light of this transfer, shareholder compensation is best justified as a loss-spreading mechanism that spreads the risk of buying stock at inflated prices. This loss-spreading function is facilitated by insurance, which ensures that even shareholders who benefited from the fraud by selling stock at inflated prices contribute to funding shareholder compensation. A system that relies on insurance is likely to be more effective in spreading losses from fraud than a system that relies solely on investors to diversify.

The circularity problem should also be viewed in light of the significant body of finance literature that explores why companies pay dividends

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3. This Article is not the first to liken shareholder compensation to a dividend. See, e.g., Janet Cooper Alexander, The Value of Bad News in Securities Class Actions, 41 UCLA L. Rev. 1421, 1444 (1994) ("If the issuer makes the [shareholder compensation] payment, however, it is in effect a dividend."); Patricia J. Hughes & Anjan V. Thakor, Litigation Risk, Intermediation and the Underpricing of Initial Public Offerings, 5 Rev. Fin. Stud. 709 (1992)); Statement of Joseph A. Grundfest to the Meeting of the Advisory Committee on the Auditing Profession 2 (Feb. 4, 2008) ("Any settlement or judgment paid by the corporation has the effect of a mandatory dividend that is likely to reduce the market value of the issuer's shares."); available at http://www.ustreas.gov/offices/domestic-finance/acap/submissions/02042008/Grundfest02042008.pdf. But this Article is the first to extensively analyze the issue and contend that some of the arguments used to explain dividends might have applicability to the issue of whether shareholder compensation is justified.

despite their circularity, a problem referred to as the dividend puzzle. Three explanations have been articulated for the payment of dividends. First, payment of a dividend sends a signal to the market about the company’s future prospects. Second, payment of a dividend may reduce agency costs by reducing free cash flow that might be wasted by managers. Third, payment of a dividend allows shareholders to further diversify.

Of these theories, the agency-costs explanation is most applicable to shareholder compensation. If a company does not have insurance, paying shareholder compensation can significantly reduce the amount of free cash flow available to managers who committed fraud. If a company does have insurance, the costs of shareholder compensation are spread out over time, but such costs may have a disciplining effect similar to debt. While in practice it is unlikely that reducing free cash flow is always beneficial to a company, the circularity problem must come to terms with the possibility that reducing free cash flow may reduce agency costs.

The remaining explanations for the payment of dividends apply with less force to the context of shareholder compensation. Rather than signaling that a company is doing well, shareholder compensation signals that a company may have committed fraud. Thus, managers have an incentive to obscure the signal of any shareholder compensation payment. Because shareholders typically receive compensation only for a fraction of their losses, any diversification effect of shareholder compensation is likely to be trivial.

However, the impact of shareholder compensation as a signal might be enhanced by changing the distribution mechanism of shareholder compensation so it more closely resembles a dividend. Corporations, acting through a committee of independent directors, could be permitted to preemptively pay a dividend that would cover some or all of the cost of the fraud to shareholders. Plaintiffs’ attorneys would receive a fee only if they recover an amount greater than the preemptive dividend, reducing the transaction cost of attorney fees and creating incentives to recover more for shareholders. A preemptive dividend would send a much stronger signal that the corporation treats fraud seriously than payment of a settlement by an insurance company.

The wide acceptance of the circularity problem has led to skepticism about whether securities-fraud actions fulfill a meaningful compensatory function. As a result, there have been a significant number of proposals to

5. In contrast, there have been few treatments of dividend policy in the legal literature. Zohar Goshen, Shareholder Dividend Options, 104 YALE L.J. 881, 884 (1995) (“T]he body of legal literature on dividend policy is sparse . . . .”).

6. See, e.g., Amanda M. Rose, Reforming Securities Litigation Reform: Restructuring the Relationship Between Public and Private Enforcement of Rule 10b-5, 108 COLUM. L. REV. 1301, 1302-03 (2008) (“Most commentators now agree that the private right of action implied under Sec-
revamp them. Ultimately, thinking of shareholder compensation as a dividend by itself is not enough to establish that securities-fraud actions are desirable for policy reasons. Indeed, it may be impossible to conclusively determine whether the benefits of shareholder compensation—loss spreading and reduction of agency costs—outweigh the substantial transaction costs of litigation.

But at the very least, the analogy shows that shareholder compensation should not be rejected on circularity grounds. Neutralizing the circularity problem will mean that deterrence will not have to play such a heavy role in justifying securities-fraud actions. The arguments for reform should shift from totally restructuring or even doing away with securities-fraud actions to incremental reforms such as continuing to clarify the law so that meritorious claims are more likely to survive while nonmeritorious claims can be screened out at the motion to dismiss stage by judges.

Part I of this Article describes the circularity problem. Part II describes the dividend puzzle and demonstrates that shareholder compensation is actually less circular than a dividend and serves an important loss-spreading function that is facilitated by the insurance markets. Part III examines whether some of the arguments justifying dividends, such as signaling and the reduction of agency costs, may be relevant to the payment of shareholder compensation. Part IV proposes that some of the signaling benefits of dividends might be better captured if companies had the option of distributing shareholder compensation through a preemptive dividend.

7. See, e.g., Arlen & Carney, supra note 1 (proposing that vicarious liability for securities fraud be replaced with a rule that focuses on agent liability); Richard A. Booth, The End of the Securities Fraud Class Action as We Know It, 4 BERKELEY BUS. L.J. 1 (2007) (proposing that liability for securities fraud be limited to insiders who enrich themselves through false disclosures); Coffee, supra note 1 (proposing elimination of vicarious liability for securities-fraud actions); Alicia Davis Evans, The Investor Compensation Fund, 33 J. CORP. L. 223 (2007) (proposing creation of investor compensation fund); Fox, supra note 1 (proposing that certifying investment banks rather than issuers should be liable for securities fraud); Joseph A. Grundfest, Why Disimply?, 108 HARV. L. REV. 727 (1995) (proposing that the SEC use rulemaking to define the boundaries of liability for securities-fraud action); Rose, supra note 6 (proposing that the SEC play an oversight role in screening securities-fraud actions).

8. See, e.g., Grundfest, supra note 7, at 728 ("[T]he appropriate policy response is to search for strategies that can filter out weaker claims earlier in the process while allowing more meritorious complaints to proceed.").
I. THE CIRCULARITY PROBLEM

In theory, securities-fraud actions compensate investors when they purchase stock at prices inflated by fraud, while deterring corporations and their agents from committing fraud. Though the deterrence rationale is largely accepted, most scholars have concluded that securities-fraud actions are inherently unable to compensate investors because of a circularity problem.

While the precise form of the argument varies and is usually mentioned only in passing, the circularity problem generally criticizes securities-fraud actions as resulting in meaningless transfers from a company to its shareholders. There are two variants of the circularity problem. The first is that shareholder compensation is circular because shareholders receive a payment from the corporation they own, which reduces funds that the corporation could use to make investments that might benefit those shareholders. In other words, the shareholder victims of the fraud pay for their

9. See, e.g., Dura Pharm., Inc., v. Broudo, 544 U.S. 336, 345 (2005) (noting that securities-fraud actions deter fraud and protect investors from losses caused by misrepresentations); Randall v. Loftsgaarden, 478 U.S. 647, 664 (1986) (noting that securities laws were intended not only to compensate investors but to deter fraud); Berner v. Lazzaro, 730 F.2d 1319, 1323 (9th Cir. 1984) ("Even in situations where an investor is not free from blame, private damage actions under these antifraud and antimanipulation provisions serve not only to compensate injured investors, but also to deter fraud and manipulation by exposing those contemplating unlawful conduct to the threat of private damage liability."); Tucker v. Arthur Andersen & Co., 646 F.2d 721, 727 n.7 (2d Cir. 1981).
10. Though, there is skepticism about whether the current regime is effective in deterring securities fraud. See, e.g., Coffee, supra note 1, at 1536–37, 1548–56 (arguing that while securities-fraud actions are needed for deterrence, the current liability structure fails to deter managers who are the primary initiators and beneficiaries of fraud).
11. See supra note 1.
12. Another variant of the circularity problem exists in the context of derivative litigation. If directors and officers are indemnified for judgments in derivative actions, such a payment would be circular because the corporation would both make and receive that payment. Thus, states such as Delaware limit indemnification for judgments relating to derivative actions. Del. Code Ann. tit. 8, § 145(a)–(b) (2001); see also Arnold v. Soc'y for Sav. Bancorp, Inc., 678 A.2d 533, 540 n.18 (Del. 1996); Sean J. Griffith, Uncovering a Gatekeeper: Why the SEC Should Mandate Disclosure of Details Concerning Directors' and Officers' Liability Insurance Policies, 154 U. Pa. L. Rev. 1147, 1165 n.58 (2006).
13. See, e.g., sources cited supra note 1. Another variant of this argument is that shareholder compensation is a circular distribution from current shareholders to selling shareholders. See, e.g., Alexander, supra note 2, at 1505; Barbara Black, Should the SEC Be a Collection Agency for Defrauded Investors?, 63 Bus. Law. 317, 331 (2008) ("The effect is to take corporate funds away from one group of investors, the current shareholders, and pay it to another group of investors, those who traded in the securities during the class damages period."); Michael A. Perino, Did the Private Securities Litigation Reform Act Work?, 2003 U. Ill. L. Rev. 913, 921 ("[S]ettlements often benefit former shareholders at the expense of current ones. In effect, they can amount to little more than a transfer payment with enormously high transaction costs in the form of a large contingency fee award.").
The second is that shareholder compensation is circular because diversified shareholders over time do not suffer harm from fraud because, while they may be victims of fraud with respect to some transactions, they may be beneficiaries of fraud with respect to other transactions. Both variants essentially criticize shareholder compensation on the ground that it involves a transfer with benefits that do not outweigh the substantial transaction cost of attorney fees.

The circularity problem arises in part because while the corporation is usually the primary defendant in a securities-fraud action, it arguably does not directly commit the fraud or realize the gains from the fraud. Typically, any gains from the fraud are captured by the shareholders who sold shares while the stock was inflated. Thus, the corporation cannot simply refund gains from the fraud. If it does not have insurance, it must pay shareholder compensation from its cash flow or issue additional debt or equity to fund the payment.

14. See, e.g., Coffee, supra note 1, at 1562 ("[I]n the case of at least the 'secondary market' securities class action, the victims and the shareholders are largely the same . . . .").

15. See, e.g., Frank H. Easterbrook & Daniel R. Fischel, Optimal Damages in Securities Cases, 52 U. CHI. L. REV. 611, 641 (1985) ("An investor with a diversified portfolio will be the hidden gainer in a [fraudulent] transaction . . . as often as he will be a loser"); A.C. Pritchard, Markets as Monitors: A Proposal to Replace Class Actions With Exchanges as Securities Fraud Enforcers, 85 VA. L. REV. 925, 939 (1999) ("In fraud on the market, for every shareholder who bought at a fraudulently inflated price, another shareholder has sold: The buyer's individual loss is offset by the seller's gain."). There is some empirical support for this argument. A study found that institutional investors break even from investments in companies where there is securities fraud and may even come out ahead. However, the study acknowledged that individuals who are not diversified are at substantial risk of losses. Anjan V. Thakor et al., U.S. Chamber Inst. for Legal Reform, The Economic Reality of Securities Class Action Litigation (2005), available at http://www.abanet.org/litigation/sponsors/docs/2005 Securities.pdf. But see Evans, supra note 7, at 234–35 (arguing that many investors are not diversified).

16. Plaintiffs' attorney fees for securities-fraud actions are at levels typical for contingency cases. See Theodore Eisenberg & Geoffrey P. Miller, Attorney Fees in Class Action Settlements: An Empirical Study, J. EMPIRICAL LEGAL STUD. 27, 50 (2004) (finding plaintiffs' attorney fees in securities-fraud actions average 25% of recovery). Defense costs may be lower but are still substantial, perhaps reflecting the need to hire sophisticated counsel. See Tom Baker & Sean J. Griffith, The Missing Monitor in Corporate Governance: The Directors' & Officers' Liability Insurer, 95 GEO. L.J. 1795, 1815 (2007) (citing estimates of defense costs of 25–35%, but concluding that average defense costs are likely to be about 11% of recovery); Coffee, supra note 1, at 1546 n.38 (discussing the findings of Baker & Griffith and observing that their 11% estimate seems low).

17. See Coffee, supra note 1, at 1556–66.

18. In contrast, suits brought under Section 11 of the Securities Act of 1933, where the allegation is that the corporation committed fraud with respect to a securities issuance, have not been questioned on circularity grounds. See, e.g., Coffee, supra note 1, at 1556–57 (limiting criticism of securities compensation to “fraud on the market” suits). In a section 11 case, the corporation allegedly realizes gains from the fraud because it raises more funds than it could have without the fraud. A section 11 case essentially seeks a refund of those fraudulent gains.

19. The circularity problem can be avoided when shareholders recover from the directors and officers of the corporation or third parties involved with the fraud. A number of commentators have persuasively argued that a system where agents are held liable is theoretically preferable to the current system where the corporation is vicariously liable. See, e.g., Arlen & Carney, supra note 1
This dynamic can be illustrated by examining a typical securities-fraud action. Suppose a corporation lies about its financial results, materially inflating its stock for a period. When the fraud is revealed, the market punishes the corporation by reducing the price of its stock.\textsuperscript{20} Any stock-price decline is likely to have at least three components.\textsuperscript{21} First, the stock will go down to its “true” value based on accurate information about the company. For example, the market might have to reduce its projections of the future cash flows of the company if those projections were inflated by fraud. As a result, the intrinsic or fundamental value of the stock as calculated by discounted cash-flow models should be lower and the stock price will decline.\textsuperscript{22} Call this a “Fundamental Decline.” Second, after a fraud is revealed, the market may no longer trust the corporation’s management to tell the truth.\textsuperscript{23} The market might then discount the stock to take into account this loss of credibility.\textsuperscript{24} Call this a “Credibility Decline.” Third, the stock will decline to take into account the costs of compensating shareholders and defending a securities-fraud action brought under Rule 10b-5. Call this a “10b-5 Decline.”\textsuperscript{25}

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\textsuperscript{20} One study finds that some of this decline comes on the date the lawsuit is filed, while part of it comes before the filing date in anticipation of the suit. Amar Gande & Craig M. Lewis, \textit{Shareholder Initiated Class Action Lawsuits: Shareholder Wealth Effects and Industry Spillovers}, J. FIN. & QUANTITATIVE ANALYSIS (forthcoming 2009), available at http://ssrn.com/abstract=891028.

\textsuperscript{21} Of course, some of the price decline might be attributed to additional factors. See Baruch Lev & Meiring de Villiers, \textit{Stock Price Crashes and 10b-5 Damages: A Legal, Economic, and Policy Analysis}, 47 STAN. L. REV. 7, 10 (1994) (“In crashes, extraneous factors—such as the type of people investing in a stock, how much information they have, the prevalence of automatic trading mechanisms and hedging (such as programmed trading or stop-loss orders), and the ability of specialists on the trading floor to provide liquidity—greatly affect a stock’s price.”).


\textsuperscript{23} This decline can be extremely significant. One study estimates that on average, for financial misstatements, the decline is 7.5 times the size of the legal penalties imposed on the company. Jonathan M. Karpoff et al., \textit{The Cost to Firms of Cooking the Books}, J. FIN. & QUANTITATIVE ANALYSIS (forthcoming 2009), available at http://ssrn.com/abstract=652121.

\textsuperscript{24} If securities-fraud actions are perceived to be without merit, the “Credibility Decline” is likely to be small. There is some evidence that for directors, the reputational effect of fraud allegations is minimal. See Eric Helland, \textit{Reputational Penalties and the Merits of Class-Action Securities Litigation}, 49 J.L. & Econ. 365 (2006).

\textsuperscript{25} See, e.g., Alexander, \textit{supra} note 3, at 1435 (“To the extent that investors predict that litigation will follow an adverse disclosure, the market’s reaction to the disclosure will include not only its valuation of the information disclosed, but also the anticipated direct and indirect costs of
There are at least two categories of shareholders who are affected by the fraud. First, there are former shareholders who benefited from the fraud. A shareholder may have purchased the stock before the stock was inflated and sold at the inflated price at a profit before the fraud was revealed. Call these shareholders the "Benefiting Shareholders." Second, there are shareholders who are damaged by the fraud because they did not sell before the fraud was revealed. These shareholders suffer from some or all of the Fundamental, Credibility, and 10b-5 Declines. Call these shareholders "Damaged Shareholders."26

We can further classify the Damaged Shareholders into two subcategories. First, there are Damaged Shareholders who buy at the inflated price within the class period and can recover through a securities-fraud action. Call these shareholders "Class Shareholders." A Class Shareholder is entitled to recover "actual damages," that is, an amount equal to the purchase price minus the true "value" of the stock absent the fraud.27 The Class Shareholder is clearly entitled to compensation for the Fundamental Decline, and is arguably entitled to recover for the Credibility and 10b-5 Declines.28

Litigation over the disclosure.") As Richard Booth argues, a 10b-5 Decline increases potential recoverable damages, which in turn could create a feedback effect that further increases the 10b-5 Decline. See Booth, supra note 7, at 19–23. But the size of the feedback effect may be minimal if the market values the stock using fundamental analysis based on its future earnings or dividends. See sources cited supra note 22. If the market perceives the costs associated with a securities-fraud action as a one-time, nonrecurring cost, then shareholder compensation should not significantly affect the future cash flows of the company. See, e.g., James J. Park, Assessing the Materiality of Financial Misstatements, 34 J. Corp. L. 513, 539–41 (2009) (citing literature indicating that the market tends to discount one-time events in valuing a stock).

26. Of course, there are shareholders who are unaffected by the fraud. A shareholder may have both purchased and sold stock within the period when the stock was inflated.

27. 15 U.S.C. § 78bb(a) (2006). According to the United States Supreme Court, the "correct measure of damages . . . is the difference between the fair value of all that the [plaintiff] received and the fair value of what he would have received had there been no fraudulent conduct." Randall v. Loftsgaarden, 478 U.S. 647, 661–62 (1986) (quoting Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128, 155 (1972)); see also Green v. Occidental Petroleum Corp., 541 F.2d 1335, 1342 (9th Cir. 1976).

28. The law is unclear as to the precise meaning of "actual damages." See Robert B. Thompson, "Simplicity and Certainty" in the Measure of Recovery Under Rule 10b-5, 51 Bus. Law. 1177, 1179 (1996). The Private Securities Litigation Reform Act of 1995 ("PSLRA") limits any recovery to the difference between the purchase price and the average trading price of the security ninety days after a corrective disclosure, 15 U.S.C. § 78u-4 (2006), but neglects to provide much substantive guidance as to damages. Thompson, supra, at 1177–78. The legislative history to the PSLRA suggests that damages should include "losses caused by the fraud and not by other market conditions." H.R. Rep. No. 104-369, at 42 (1995) (Conf. Rep.), reprinted in 1995 U.S.C.C.A.N. 730, 741. Commentators have differed as to whether 10b-5 Declines might be considered "losses caused by fraud." Compare Alexander, supra note 3, at 1434 (implying that 10b-5 Decline is not recoverable), with Booth, supra note 7, at 8 (implying that 10b-5 Decline is recoverable). Also, it is unclear whether the Credibility Decline is caused by the fraudulent statement, or would be considered a subsequent market event.
Second, there are Damaged Shareholders who bought the stock before the stock was inflated by the fraud. Because these shareholders did not purchase stock during the period of the fraud, they are not in the class of shareholders who might recover through a securities-fraud action. While these shareholders do not suffer the Fundamental Decline, they suffer from the Credibility and 10b-5 Declines. Call these shareholders “Non-Class Shareholders.”

The circularity problem arises partly from the fact that the law does not provide for recovery from the Benefiting Shareholders. The Benefiting Shareholders who capture the benefits of the fraud are not required to refund those benefits to the Damaged Shareholders. And this is not necessarily an unfair result, as the Benefiting Shareholders usually have nothing to do with the fraud. As a result, any shareholder compensation must come from the corporation, which is owned by the Damaged Shareholders (both Class and Non-Class), who therefore pay for the shareholder compensation.

The situation is worst for Non-Class Shareholders. These shareholders fund shareholder compensation but do not receive any payment because they purchased stock outside of the class period. While Non-Class Shareholders had the opportunity to benefit from the fraud by selling their shares, they did not and so are left holding the bag. Non-Class Shareholders did not commit any fraud, suffer from the Credibility and 10b-5 Declines, yet they must bear the costs of compensating the Class Shareholders.

29. Like Class Shareholders, some Non-Class Shareholders sell and others hold onto their stock.

30. Alexander, supra note 2, at 1497–98 (noting that Benefiting Shareholders are “not required to refund their windfalls”); see also Easterbrook & Fischel, supra note 15, at 639–40 (“Because the sellers are no longer investors in this firm, and because there are bystander-investors, a payment of damages by the firm would not be a wash. Damages computed on the basis of the investors who purchased [on the basis of fraud] would greatly exceed the optimal sanction.”).

31. Because of the Credibility and 10b-5 Declines, the amount that the Benefiting Shareholders benefit by (usually equal to the Fundamental Decline) is likely to be less than the losses to investors. Evans, supra note 7, at 229 (arguing that the losses of investors are likely to be greater than gains of investors on winning side).

32. Of course, there will be cases where some of the Benefiting Shareholders are insiders who know of the fraud and sell. A securities-fraud action might recover those gains directly from such parties, either on an insider-trading theory, or if the insider participated in the fraud, a securities-fraud action.

33. Some Damaged Shareholders will sell before shareholder compensation is actually paid. They still contribute to shareholder compensation in that the stock they sold is discounted by the 10b-5 Decline.

34. Lawrence Mitchell questions the assumption that such shareholders should be seen as “innocent.” Given the trend toward shareholder empowerment, there is a case for making shareholders accountable for failures in corporate governance. Lawrence E. Mitchell, The “Innocent Shareholder”: An Essay on Compensation and Deterrence in Securities Class-Action Lawsuits, 2009 Wis. L. Rev. 243, 287–91.
II. THE DIVIDEND PUZZLE AND SHAREHOLDER COMPENSATION

For decades, financial economists have tried to explain why corporations pay dividends, a problem commonly known as the “dividend puzzle.” A dividend, in essence, is a transfer of cash from the corporation to its shareholders. Many corporations pay a regular dividend, distributing a fixed amount on a periodic basis. In addition, a dividend can also be a one-time event, or “special dividend.” A dividend is typically paid to all shareholders, though a corporation can also issue preferred stock that entitles the holder to a “preferred dividend” that must be paid before common shareholders can receive a dividend.

Like shareholder compensation, dividends have a circularity problem. Because shareholders own the assets from which a dividend is paid, shareholders fund their own dividend. In addition, a dividend incurs a substantial transaction cost, the dividend tax. Given this similarity, it is useful to compare the circularity of shareholder compensation with the circularity of a dividend. Close examination reveals that shareholder compensation is less circular than a dividend. Shareholder compensation is a transfer from Non-Class to Class Shareholders that serves a loss-spreading function that is facilitated by insurance.

A. The Irrelevance of Dividends

Dividends are puzzling because they should be at best irrelevant to an investor’s decision to purchase a stock. In a world without taxes or other

35. See, e.g., Fischer Black, The dividend puzzle, J. PORTFOLIO MGMT., Winter 1976, at 5 (concluding that literature does not provide compelling explanation for dividend payments).

36. Open-market repurchases of the corporation’s own stock have similar effects as dividends. By increasing demand for the firm’s shares, such repurchases might increase the firm’s stock price. But the repurchases must be financed from the firm’s own capital, reducing the amount of capital that could be invested on behalf of shareholders. See William W. Bratton, The New Dividend Puzzle, 93 GEO. L.J. 845 (2005). In addition to buying its own shares in the market, a company can make a repurchase tender offer, where the company offers a fixed price for shares, usually at a premium over the market price. Jesse M. Fried, Insider Signaling and Insider Trading with Repurchase Tender Offers, 67 U. CHI. L. REV. 421 (2000).

37. BREALEY ET AL., supra note 22, at 444 (describing special dividend); Bratton, supra note 36, at 877 (same). Special dividends are now rarely paid by companies. See Harry DeAngelo et al., Special Dividends and the Evolution of Dividend Signaling, 57 J. FIN. ECON. 309, 310 (2000) (“[S]pecial dividends were once commonly paid by NYSE firms but have gradually disappeared over the last 40 to 45 years and are now a rare phenomenon.”).


39. See Merton H. Miller & Franco Modigliani, Dividend Policy, Growth, and the Valuation of Shares, 34 J. BUS. 411 (1961); see also Victor Brudney, Dividends, Discretion, and Disclosure, 66 VA. L. REV. 85, 86-87 (1980) (describing irrelevance theory); Frank H. Easterbrook, Two
transaction costs, a shareholder should not care whether a company pays a dividend. The benefit of any dividend received by the shareholder is offset by the reduction in the company’s cash, which could have been invested by the company, or by the cost of the debt or stock issued by the corporation to finance the dividend. In other words, the economic benefit of the dividend to shareholders is neutralized by the company’s cost of paying the dividend. Moreover, a shareholder can always create its own dividend by selling stock, converting any capital gains into cash. Thus, a rational shareholder should not pay more for a stock that pays a dividend than the shareholder pays for an equivalent stock that does not pay a dividend.

If the firm’s expected return from investing its capital is greater than the firm’s cost of capital, it might be irrational for an investor to prefer a dividend. Investors would benefit if the firm invested its capital and earned a higher return than if they received cash in the form of a dividend. If they received cash, they might not be able to reinvest the cash and achieve the same return. Of course, investors can always simply reinvest the dividend in the company’s stock, but there are substantial transaction costs to receiving a dividend, most notably taxes.

Given the reality that dividends are taxed, there should be less of an incentive to pay dividends. A shareholder who receives a dividend must immediately pay a tax, while the shareholder would not pay taxes on any appreciation in the stock until it sells the stock. Until the Jobs and Growth Tax Relief Reconciliation Act of 2003, which set the dividend tax rate at 15 percent, dividends were taxed as income at rates substantially higher than the tax paid on capital gains. At times, marginal income tax rates have been quite high, approaching well over 50 percent. The reduction in dividend tax mandated by the Jobs and Growth Tax Relief Reconciliation Act of 2003 is set to expire in 2010, meaning that unless the reduction is reenacted.


Bratton, supra note 36, at 861.

See, e.g., Fischer Black & Myron Scholes, The Effects of Dividend Yield and Dividend Policy on Common Stock Prices and Returns, 1 J. FIN. ECON. 1, 1-2 (1974) (“[T]he existence of differential taxes on income and capital gains should make the shares of corporations that pay low dividends more desirable, and thus a corporation can increase the value of its shares by reducing its payout ratio.”).


See Wilson, supra note 4, at 216, 219–20.
it is quite possible that dividend taxes will increase. Thus, shareholders have paid and may continue to pay a higher tax on a dividend than if they created their own dividend by selling shares that appreciated in value.

Despite their costs, dividends are paid by a substantial number of companies. And despite their supposed irrelevance, stocks are commonly valued using what is known as the dividend-discount model, which posits that the value of a stock is equal to the present value of its future dividend payments. A number of studies have established that dividend payments in the aggregate are associated with growth in stock prices. Moreover, a substantial number of investors prefer stocks that pay dividends over those that do not. Thus, while positing the irrelevance of dividends, the finance literature cannot get away from the reality that dividends do matter.

B. The Relevance of Shareholder Compensation

Though dividends are arguably irrelevant because of their complete circularity, shareholder compensation is not as circular as a dividend. While generally all shareholders receive a dividend payment, only Class Shareholders receive shareholder compensation. Thus, shareholder compensation is largely funded by Non-Class Shareholders. Unlike a dividend, the problem with shareholder compensation is not so much its circularity, but that Non-Class Shareholders bear the cost of the transfer. Defending shareholder compensation requires a theory for why such a transfer is justified.


47. However, it appears that the percentage of companies paying dividends has significantly declined from over 60% to about 40% over the last thirty years. See Brealey et al., supra note 22, at 443; see also Eugene F. Fama & Kenneth R. French, Disappearing Dividends: Changing Firm Characteristics or Lower Propensity to Pay?, 60 J. Fin. Econ. 3, 22 (2001) (finding proportion of industrial companies paying dividends declined from 60% to 20%).


50. Brealey et al., supra note 22, at 456.

51. Another difference may be that dividends tend to be consistent while shareholder compensation is a one-time payment. In terms of frequency, shareholder compensation may be more similar to open-market repurchases of a stock, which tend to be sporadic. See Murali Jagannathan et al., Financial Flexibility and the Choice Between Dividends and Stock Repurchases, 57 J. Fin. Econ. 355 (2000) (finding that dividends are paid consistently from “permanent” operating cash flows while repurchases are made periodically by firms with “temporary” nonoperating cash flows).
1. Shareholder Compensation as Transfer from Non-Class to Class Shareholders

While Class Shareholders fund their own compensation, they only do so in part. That is because Non-Class Shareholders also contribute to the shareholder-compensation payment but are not entitled to receive a share of that payment. Class Shareholders receive more than they put in, compensating them in part for their loss. Shareholder compensation benefits Class Shareholders more than a capital investment with those same funds, because the return from any capital investment is divided with Non-Class Shareholders while shareholder compensation is not.

To put it more concretely, suppose a company has ten shareholders, each with one share. The company distributes a total of $10 in dividends, with each shareholder receiving $1. The payment is circular. The benefit of the $1 dividend is offset by the shareholder's $1 pro rata share of the cost of the dividend.

Now suppose there is a securities fraud resulting in a Fundamental Decline of $2 per share. Five shareholders are Class Shareholders while five shareholders are Non-Class Shareholders. To compensate them for the Fundamental Decline, the company distributes $2 in shareholder compensation to each of the five Class Shareholders, resulting in a total payment of $10 to the Class Shareholders. The payment is not circular. While the shareholder-compensation payment costs each shareholder (both Class and Non-Class) $1, the Class Shareholders receive $2, while the Non-Class Shareholders receive $0. The Class Shareholder suffered a $2 Fundamental Decline, contributes $1 in shareholder compensation, and receives $2 in shareholder compensation—resulting in a net loss of $1. The Non-Class Shareholder suffered a $0 Fundamental Decline, contributes $1 in shareholder compensation, and receives $0 in shareholder compensation—resulting in a net loss of $1. The impact of shareholder compensation can be summarized as follows:

<table>
<thead>
<tr>
<th></th>
<th>Fundamental Decline</th>
<th>Contribution to Shareholder Compensation</th>
<th>Shareholder Compensation Received</th>
<th>Net Loss</th>
</tr>
</thead>
<tbody>
<tr>
<td>Class Shareholder</td>
<td>$2</td>
<td>$1</td>
<td>$2</td>
<td>$1</td>
</tr>
<tr>
<td>Non-Class Shareholder</td>
<td>$0</td>
<td>$1</td>
<td>$0</td>
<td>$1</td>
</tr>
</tbody>
</table>
In theory, shareholder compensation spreads the loss from the fraud so that each shareholder bears $1 of loss.  

Without shareholder compensation, the Class Shareholder would bear the entire $2 loss from the Fundamental Decline while the Non-Class Shareholder suffers no loss. Thus, shareholder compensation is not just a circular payment but can serve to spread shareholder losses from fraud.

To some extent, the degree of circularity of the payment will depend on the ratio of Class to Non-Class Shareholders. When the number of Class and Non-Class Shareholders is equal, $0.50 of every dollar in shareholder compensation received by the Class Shareholder comes from the contributions of the Class Shareholders. When there are fewer Class Shareholders than Non-Class Shareholders, the shareholder compensation will be less circular. If there is one Class Shareholder for every nine Non-Class Shareholders, only $0.10 of every dollar in shareholder compensation received by the Class Shareholder comes from its own contribution. When there are more Class Shareholders than Non-Class Shareholders, the payment will be more circular. If there are nine Class Shareholders for every one Non-Class Shareholder, $0.90 of every dollar of shareholder compensation received by the Class Shareholder comes from the contributions of the Class Shareholders. While the degree of circularity will vary based on the ratio of Class to Non-Class Shareholders, unless every shareholder is a Class Shareholder, shareholder compensation will be less circular than a dividend.

Admittedly, the compensatory effect of shareholder compensation may be offset by the transaction costs of securities-fraud actions as reflected by the 10b-5 Decline. In our earlier example, suppose there is a 10b-5 Decline of $1 after the fraud has been revealed. If the Class Shareholder who suffered a net loss of $1 with shareholder compensation suffers an additional loss of $1 from the 10b-5 Decline, the Class Shareholder suffers a net loss of $2. The Class Shareholder is in the same position as it would be in a

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52. Loss spreading occurs even when insurance covers the shareholder-compensation payment. While all shareholders bear the costs of insurance premiums, only Class Shareholders receive the insurance payout.

53. Because most frauds occur over discrete time periods, it may be more likely that there will be fewer Class Shareholders than Non-Class Shareholders. On the other hand, one article argues that it is likely that Class Shareholders will outnumber Non-Class Shareholders:

Because of the high volume of shares traded on the national stock exchanges, the number of shares in the potential plaintiff class is likely to exceed the number of shares held by the defendant shareholders. Accordingly, it is likely that the number of victims exceeds the number of the defendant firm's shareholders, in which case the loss spreading argument implies that losses should remain with the victims.

Arlen & Carney, supra note 1, at 719. However, the study acknowledges that it is difficult to know the ratio of Class to Non-Class Shareholders because many securities-fraud actions do not specify the exact dimensions of the Class. See id. at 731 ("Fraud on the Market cases are class actions and the plaintiffs, at the time the suit is filed, do not know the size of the class or the potential damages for each class member.").
world without shareholder compensation where it bears all of the cost of a $2 Fundamental Decline.

But it is unlikely that the 10b-5 Decline will be significant enough to completely offset the benefit of shareholder compensation. First, as a practical matter, as will be explained below, most companies have insurance that covers the costs of 10b-5 litigation, meaning that 10b-5 costs (primarily insurance premiums) should already be capitalized in the stock price. Second, while 10b-5 costs may be significant if the company does not have insurance, it is unlikely that they will affect more than one financial period, and thus should not significantly affect the future cash flows that determine the valuation of a stock. Thus, the 10b-5 Decline is unlikely to completely offset the benefit of shareholder compensation.

2. Distinguishing Between Non-Class and Class Shareholders

Despite the fact that shareholder compensation is not entirely circular, critics object that it is unfair to transfer funds from Non-Class Shareholders who had nothing to do with the fraud to Class Shareholders. Non-Class Shareholders essentially fund a dividend to Class Shareholders. In order to defend shareholder compensation, there must be a basis for having shareholders who did not participate in the fraud bear the cost of securities fraud.

As an initial matter, it is important to observe that the transfer from Non-Class to Class Shareholder is the result of a doctrinal compromise. In Blue Chip Stamps v. Manor Drug Stores, the Supreme Court held that only a purchaser or seller of a security has a private cause of action under Rule 10b-5. Thus, even though Non-Class Shareholders suffer from the Credibility and 10b-5 Declines, because they did not purchase or sell securities during the relevant time period, they cannot recover through a securities-fraud action.

The Court noted that it limited Rule 10b-5 in this particular way because of “policy considerations.” Without the limit set by Blue Chip, the potential liability for any securities fraud would be unmanageable. It would be difficult to calculate the precise harm to Non-Class Shareholders who did not purchase or sell securities during the class period. Thus, while there is an intuitive unfairness to transfers from Non-Class to Class Shareholders, that

54. See Park, supra note 25, at 539–41.
55. See, e.g., Coffee, supra note 1, at 1557 (“[S]ecurities litigation in this context inherently results in a wealth transfer between two classes of public shareholders—those in the class period and those outside it—and typically neither class is culpable.”).
57. Id. at 754–55.
58. Id. at 737.
59. See id. at 746–47.
state of affairs is a result of a considered doctrinal give and take, rather than an arbitrary decision to impose costs on Non-Class Shareholders.

Moreover, it is not uncommon for financing decisions to favor some shareholders over others.\textsuperscript{60} For example, when a company issues new shares of stock, existing shareholders may find that their stake in the company is diluted.\textsuperscript{61} Open market repurchases, where the company purchases its own stock, may favor selling shareholders over holding shareholders if the company purchases at a time when the stock is overvalued.\textsuperscript{62} In principle, shareholder compensation may be no worse than other tactics that benefit some shareholders at the expense of others.

The transfer from Non-Class Shareholders to Class Shareholders is best justified on the ground that Class Shareholders suffered from a Fundamental Decline, while the Non-Class Shareholders did not. While both Class and Non-Class Shareholders suffer from the Credibility and 10b-5 Declines, only Class Shareholders suffer the harm of purchasing stock at a price that does not reflect its true value. Fundamental Declines reflect the main harm of securities fraud, that markets are fooled into miscalculating the value of a stock. If the securities-fraud statutes are tied to the promotion of markets that price shares accurately, the law should focus on remedying fraud that prevents accurate pricing. Moreover, while Credibility and 10b-5 Declines might dissipate if management responds appropriately to the fraud, a Fundamental Decline is more likely to persist because it reflects a basic adjustment in the way the market should value a stock.

The main inequity that arises from requiring Non-Class Shareholders to compensate Class Shareholders is that both suffer from Credibility and 10b-5 Declines but only Class Shareholders might be compensated for such declines.\textsuperscript{63} But because most cases settle, and settlement funds do not specify which declines are being compensated, it is unclear that Class Shareholders are actually being compensated for Credibility and 10b-5 Declines. Any potential inequity relating to Credibility and 10b-5 Declines could be remedied by limiting the damages received by Class Shareholders to an amount equal to the Fundamental Decline, as some have already argued.\textsuperscript{64}

\textsuperscript{60.} See generally Iman Anabtawi & Lynn Stout, \textit{Fiduciary Duties for Activist Shareholders}, 60 STAN. L. REV. 1255, 1288-90 (2008) (noting that conflicts can arise when activist shareholders invest in various parts of a corporation's capital structure).

\textsuperscript{61.} See, e.g., Goshen, \textit{supra} note 5, at 913.

\textsuperscript{62.} See Bratton, \textit{supra} note 36, at 889. Of course, if the company purchases stock at a time when the stock is undervalued, such repurchases may benefit current shareholders.

\textsuperscript{63.} As discussed earlier, this is a result of the Supreme Court's decision in \textit{Blue Chip Stamps}. See \textit{supra} notes 56-59 and accompanying text.

\textsuperscript{64.} See Lev & de Villiers, \textit{supra} note 21. By limiting damages to the Fundamental Decline, securities-fraud actions would avoid the feedback effect that might occur by compensating shareholders for 10b-5 Declines. See, e.g., Booth, \textit{supra} note 7.
While Non-Class Shareholders are not directly responsible for committing securities fraud, they also do not commit the corporate torts or regulatory violations that result in damages and penalties for which shareholders commonly bear the cost. While it is unfair to single out Non-Class Shareholders when Benefiting Shareholders, who also do not suffer from the Fundamental Decline, contribute nothing, as will be discussed more below, some of this concern is mitigated by the fact that many companies purchase insurance for securities-fraud actions.

3. The Loss-Spreading Function of Shareholder Compensation

The transfer from Non-Class to Class Shareholders serves as a form of loss spreading. While loss spreading has been widely discussed as a justification for compensating victims of torts, it has not been recently defended in the context of shareholder compensation, largely because of the perception that shareholders can spread losses from fraud through diversification.

a. The Limits of Diversification

A common argument against the need for shareholder compensation is that investors can mitigate losses through diversification. The impact of fraud by any particular firm should be minimal for a diversified investor. While a diversified investor might end up purchasing stock inflated by

65. See Alexander, supra note 2, at 1497–98.

66. This Article is not the first to note that shareholder compensation serves a loss-spreading function. See Merritt B. Fox, Why Civil Liability for Disclosure Violations When Issuers Do Not Trade?, 2009 Wis. L. Rev. 297, 304 (“Through loss spreading, compensation can, however, somewhat reduce the amount of disutility in society arising from the risks of loss created by issuer misstatements.”); Langevoort, supra note 1, at 649 (“Loss spreading, of course, is what insurance is all about; there is nothing about self-funding that is necessarily objectionable.”). But given the skepticism about the effectiveness of shareholder compensation, it is the most recent to extensively defend loss spreading as the rationale for shareholder compensation.

67. See Guido Calabresi, The Costs of Accidents 39 (1970) (“The justification found most often among legal writers today for allocation of accident losses on a nonfault basis is that accident losses will be least burdensome if they are spread broadly among people and over time.”).

68. The commentators who have noted the loss-spreading function of shareholder compensation are skeptical about whether it is cost effective. See Arlen & Carney, supra note 1, at 730–34; Langevoort, supra note 1, at 649.

69. See, e.g., Arlen & Carney, supra note 1, at 719 (“Victims of Fraud on the Market are usually fully diversified investors, as are the shareholders who ultimately bear the costs under a rule of enterprise liability.”); Baker & Griffith, supra note 16, at 1822 (“The basic lesson of modern portfolio theory is that shareholders can eliminate idiosyncratic risk—that is, firm-specific losses not simultaneously experienced by other firms in the market—by holding a diversified portfolio of equity securities.”); Booth, supra note 7, at 7 (“[M]ost investors are diversified and as a result are effectively protected against simple securities fraud.”). An investor might also spread out its purchases of stock over time, the so-called dollar cost-averaging technique, so that it is less likely that any one purchase will be affected by fraud. Indeed, it is possible that some shareholders will simultaneously own stock that falls within and outside of the class. Coffee, supra note 1, at 1558–59.
fraud, such an investor might also sell stock inflated by fraud. The losses from purchasing inflated stock might be offset by the gains from selling inflated stock.

The possibility of diversification powerfully challenges the traditional justification for securities-fraud actions, the protection of investors. In theory, any investor who wants protection against fraud can obtain it at the low cost of diversifying her portfolio. Investors who do not obtain such protection may do so because they choose to take higher risks for the prospect of higher returns.

While a complete defense of the investor-protection rationale is beyond the scope of this Article, it is worth noting a few of the limits of diversification. The first is that some unsophisticated investors are not diversified because they are unaware of the risks of holding a large percentage of their portfolio in one stock. Some investors may be undiversified because much of their compensation comes in the form of the stock of the company for whom they work. Securities-fraud actions might be necessary to protect investors who are unable to diversify.

Moreover, the effectiveness of diversification rests on the assumption that fraud is relatively isolated. In a world where a substantial number of companies commit fraud, investors may be willing to pay less for the stock of any company because of the possibility of fraud. As a result, the whole market may suffer a fraud discount and even diversified investors will suffer from the costs of fraud. Substantial compliance with Rule 10b-5 is likely a prerequisite to the effectiveness of diversification as a loss-spreading technique.

Not all investors may benefit equally from diversification. If the gains and losses from fraud were randomly distributed, an investor could expect that gains and losses from fraud would even out. But the gains from fraud are not randomly distributed. Insiders of a company are more likely to capture the gains from fraud because they know when the company’s stock is inflated. Sophisticated investors may be more likely to tap into such inside

70. Of course, there are other rationales for securities-fraud actions such as deterrence. See Coffee, supra note 1, at 1548–56.

71. See Evans, supra note 7, at 234–35.


73. See, e.g., Nicholas L. Georgakopoulos, Frauds, Markets, and Fraud-on-the-Market: The Tortured Transition of Justifiable Reliance from Deceit to Securities Fraud, 49 U. MIAMI L. REV. 671, 702 (1995) (“If misrepresentations raise or lower prices on average, then uninformed traders averse to risk will not trade, lest they buy inflated stocks or sell undervalued stocks.”).

information that would allow them to capture the gains from fraud by selling at the right time.\textsuperscript{75} Thus, unsophisticated investors may be somewhat more likely to be on the losing side of fraud.\textsuperscript{76}

b. The Need for Loss Spreading Through Shareholder Compensation

As described earlier, shareholder compensation spreads losses from Class Shareholders to Non-Class Shareholders. The question is whether loss spreading through shareholder compensation performs a function that is distinct from what could be achieved through diversification.

Loss spreading through shareholder compensation is best justified as a way of protecting markets rather than investors. Risk-averse investors can protect themselves from fraud losses through diversification, but diversification does not protect markets from the distortion of fraud. By necessity, at least some investors in an efficient market must take substantial positions in stocks. If all investors were to protect themselves by buying index funds, the market would not function in identifying good and bad companies.

As others have argued, the benefit of shareholder compensation is that it makes investors more confident in taking substantial positions in individual stocks without discounting such purchases by the probability that the stock price is fraudulent.\textsuperscript{77} By spreading the burden of a Fundamental Decline among Non-Class Shareholders and Class Shareholders, shareholder compensation reduces the impact of fraud by putting shareholders who happened to purchase stock inflated by the fraud in the same position as those shareholders who happened to purchase stock not inflated by a fraud.\textsuperscript{78} Investors will purchase stock in a company with more confidence if they know that they share the risk of fraud with other investors.

Goshen and Parchomovsky argue that the essential role of securities regulation is to facilitate trading by sophisticated "information traders" who are not necessarily diversified.\textsuperscript{79} Such information traders take advantage of economies of scale in investing resources to collect and evaluate relevant

\textsuperscript{75} Access to information might explain the results of the Thakor study, supra note 15, which found that institutions tend to be net beneficiaries of fraud.

\textsuperscript{76} See, e.g., Georgakopulos, supra note 73, at 696 ("[E]ven diversified (uninformed) trading is subject to the risk of fraud if the resulting mispricings are biased or correlated.").

\textsuperscript{77} See id.; Zohar Goshen & Gideon Parchomovsky, The Essential Role of Securities Regulation, 55 DUKE L.J. 711 (2006); see also Jill E. Fisch, Confronting the Circularity Problem in Private Securities Litigation, 2009 Wis. L. Rev. 333, 345-48 (arguing that securities litigation is needed despite the circularity problem to compensate nondiversified informed traders).

\textsuperscript{78} Of course, some shareholders may own stock purchased both in and out of the class period. The economic benefit of shareholder compensation to those shareholders will depend on the circumstances. See Alexander, supra note 2, at 1505.

\textsuperscript{79} Goshen & Parchomovsky, supra note 77.
Frequent trading based on research by sophisticated investors makes markets more efficient.\(^8\) If all investors did nothing more than buy every stock, the market would not function.\(^9\)

Such information traders cannot rely on diversification because they take substantial positions in the stock of one company.\(^5\) Of course, such information traders should be expected to spend resources verifying whether the company's disclosures are true. But not all fraud can be discovered by outsiders, and if verification costs become too high, there will be a reduction in liquidity.\(^4\) Shareholder compensation might increase liquidity by reducing the costs of verifying whether a company's disclosures are accurate.\(^5\) An information trader would know that he would be compensated to some extent if the information he is relying on is inaccurate.\(^6\) Thus, he will need to spend less to verify those disclosures.\(^7\)

An objection might be that compensating information traders, who are more likely to fall within the Class because they trade frequently,\(^8\) may come at the expense of unsophisticated investors, who tend to buy and hold stock and may likely be Non-Class Shareholders.\(^9\) But unsophisticated

80. Id. at 723–24.

81. E.g., Jeffrey N. Gordon & Lewis A. Kornhauser, Efficient Markets, Costly Information, and Securities Research, 60 N.Y.U. L. Rev. 761, 802 (1985) (“Expenditures on security research by institutional investors will play a major role in any mechanism that leads to efficient markets.”).

82. See, e.g., id. at 789 (“If [the sophisticated trader] fails to acquire any costly information, however, the market might fail to be efficient.”).

83. See, e.g., Georgakopoulos, supra note 73, at 676 (“Market efficiency depends on informed trading that cannot be diversified.”).

84. See, e.g., id. at 698 (“Informed traders must be compensated for losses they incur due to misrepresentations, or they will not service the market and correct prices.”).

85. See, e.g., Goshen & Parchomovsky, supra note 77, at 737, 741.

86. Of course, it is unlikely that the shareholder compensation payment will cover all of the losses from fraud. Evans, supra note 7, at 237–38 (noting that recoveries represent roughly 2–3 percent of losses).

87. E.g., Frank H. Easterbrook & Daniel R. Fischel, Mandatory Disclosure and the Protection of Investors, 70 Va. L. Rev. 669, 677 (1984) (“A rule against fraud can reduce these [verification] costs, especially for new firms.”). One might also argue that mitigating the risk of fraud might not be a good thing because it reduces the incentives of sophisticated investors to seek out fraud. But there is still an incentive because of the risk that an investor will not be totally compensated for its loss. Moreover, there is still such an incentive for short sellers. Short sellers can benefit disproportionately if they discover fraud and so have an incentive to invest in detecting fraud. It might be better to leave fraud detection to specialists who can develop an expertise in fraud detection.

88. Admittedly, encouraging frequent trading might increase speculation and volatility. But speculation may be an important mechanism by which stocks adjust to their fundamental value. Such speculation might be limited by compensating Class Shareholders for only Fundamental Declines. By limiting compensation to declines that reflect misinformation affecting valuation models, shareholder compensation would be less likely to subsidize speculative trading.

89. See Arlen & Carney, supra note 1, at 733 (“In publicly held companies this would mean that a small group of passive investors would partially compensate a large group of similarly
investors often piggyback off the efforts of information traders who create a liquid, efficient market where all investors can buy and sell shares easily. Unsophisticated investors typically spend much less in verifying information than information traders. Thus, it might be appropriate to require unsophisticated investors to contribute to losses suffered by information investors who purchase stock inflated by fraud.

c. Insurance as Facilitator of Loss Spreading

In its loss-spreading role, shareholder compensation is in a sense a form of mandatory insurance for investors. The securities laws essentially require public corporations to insure shareholders against the risk of purchasing a stock that is inflated by fraud. Non-Class Shareholders bear much of the burden of this insurance scheme though they often have nothing to do with the fraud.

Some of the costs of shareholder compensation, however, are mitigated by the reality that most shareholder-compensation payments are made under insurance policies. In a sense, companies reinsure the risk of fraud by purchasing policies that cover the costs of securities-fraud actions. Since
1996, these entity-level policies have increased to the point where virtually all publicly traded companies have such insurance. This is a development that came after the earliest forms of the circularity problem were advanced. Because the validity of the circularity problem is now accepted almost without question, commentators have not extensively assessed how this new insurance regime affects the validity of the circularity problem.

While in a world without insurance, the substantial costs of shareholder compensation are mostly borne by Damaged Shareholders, in a world with insurance those costs are distributed among a wider range of parties. First, anyone who is a shareholder while the corporation pays insurance premiums contributes to the cost. This group would include Benefiting Shareholders, shareholders who sold years before the fraud took place, as well as investors who become shareholders after the fraud took place. Second, shareholders of other insured companies bear some of the costs. Third, some of the costs come out of the returns from investment of premiums by insurance

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96. As Coffee explains:

To end these uncertainties, insurers began to write "corporate entity coverage," which directly reimbursed the corporation for its own litigation expenses, its own settlement payments in securities cases, and certain other forms of litigation. This form of insurance appears to have first been offered in 1996, and thus is a relatively new development. Despite its recent appearance, entity insurance caught on quickly, and over 90% of D&O insureds reported having entity coverage as of 2002.

Coffee, supra note 1, at 1570 (citations omitted); see also Lawrence A. Cunningham, Choosing Gatekeepers: The Financial Statement Insurance Alternative to Auditor Liability, 52 UCLA L. Rev. 413, 443 (2004) ("The entity-insurance variation of D&O insurance first appeared in 1996, during the growth period for this coverage.").

97. See, e.g., Booth, supra note 7, at 8 (assuming that "the company pays the damages"); Langevoort, supra note 1, at 648–49 (assuming that issuer pays costs).

98. See, e.g., Fox, supra note 66, at 305 (noting that any insurance-funded settlements facilitate loss spreading); cf. Griffith, supra note 12, at 1163 (noting that D&O insurance spreads risk of loss from directors and officers to the company).

99. See, e.g., Cox, supra note 1, at 514 ("[I]nsurance serves a useful purpose of spreading the loss over a wider range of individuals than those who were the immediate victims of the managers' misbehavior. Such a result seems entirely consistent with the view that the securities class action is compensatory."); John J. Musewicz, Vicarious Employer Liability and Section 10(b): In Defense of the Common Law, 50 Geo. Wash. L. Rev. 754, 796–97 (1982) ("[T]here is a general sense of fairness in expecting all investors, who rely on an honest market, to bear the increased cost of employer insurance premiums, an increase caused by those employees and agents who render the market dishonest."). Insurance companies diversify by insuring a wide range of risks. See, e.g., George L. Priest, The Current Insurance Crisis and Modern Tort Law, 96 Yale L.J. 1521, 1542 (1987) ("Essentially, an insurer is an agent for the diversification of risks.").

In addition to loss spreading, a number of commentators have focused on the benefits of monitoring that might come about under certain mandatory insurance schemes. See, e.g., Miriam Hechler Baer, Insuring Corporate Crime, 83 Ind. L.J. 1035 (2008) (proposing compliance insurance as an alternative to corporate criminal liability); Cunningham, supra note 96 (proposing financial-statement insurance). While insurance companies can monitor companies for securities fraud, Baker and Griffith find that D&O insurers fail to monitor companies over the life of the insurance policy. See Baker & Griffith, supra note 16, at 1808. Moreover, loss spreading may create a moral hazard that decreases the incentive of the insured to avoid losses. See id. at 1817–21.
companies. Thus, insurance amplifies and perhaps enables the loss-spreading function of shareholder compensation.

Consider a simple example. Suppose there are ten companies, each of which pays $1 in insurance premiums for entity-level coverage.\(^{100}\) The insurance company invests the $10, and over time that investment grows to $15. Company A commits fraud and is liable for $10 in shareholder compensation (of which $2 goes to the plaintiffs' attorneys) and incurs $2 in defense costs for a total cost of $12. Without insurance, Company A and its shareholders would bear all of the cost of that $12 payment. With insurance, Company A and its shareholders bear the cost of only the $1 premium.\(^{101}\) The remaining $11 comes from the premiums paid by the other companies and the return on investments by the insurance company, leaving a profit of $3 for the insurance company.

While this is an idealized example, it is plausible that this fundamental dynamic is currently at work. A market for entity-level insurance will only exist if insurance companies find it profitable to provide such insurance.\(^ {102}\) Despite the significant costs of shareholder compensation, insurance companies are willing to write policies covering such costs, indicating that the costs are not unbearable.\(^ {103}\) While certainly the expense of strike suits and excessive attorney fees are still extremely problematic, the existence of a functioning insurance market may indicate that gradual rather than radical reform of shareholder compensation is appropriate.

A system that relies on corporations to purchase insurance is more effective than a system that simply relies on shareholders to diversify. Public corporations are generally much more sophisticated than individual retail investors in weighing the costs and benefits of investing in loss-spreading mechanisms. While the cost of diversification for any one investor is low, the cost of educating a substantial percentage of retail investors about appropriate investment strategies would be extremely high. Because it is more likely that an issuer will respond rationally to proper incentives at a lower cost, issuers are likely the “least cost avoider” relative to retail investors, and

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100. Assume for the sake of simplicity the premium is charged all in one year rather than every year.

101. To simplify the example, assume there is no deductible.

102. See, e.g., Cox, supra note 1, at 513 (“Insurance companies and casinos are both in the odds business—they earn their profits probabilistically.”).

103. See, e.g., Baker & Griffith, supra note 16, at 1822 (“Loading fees mean that the cost of buying insurance always exceeds the actuarial probability of loss (otherwise the insurer would be driven out of business).”). Of course, there have been times when insurers do not find it profitable to provide coverage for certain risks. See, e.g., Roberta Romano, Corporate Governance in the Aftermath of the Insurance Crisis, 39 EMORY L.J. 1155, 1158 (1990) (describing crisis in D&O insurance market from 1984 to 1987).
so the costs of securities fraud should be assigned to those issuers, who can then contract to spread those losses.104

Insurance reduces the circularity of shareholder compensation. When a corporation has no insurance, Class Shareholders fund a greater part of their own settlement than when a corporation has insurance. With insurance, a substantial part of shareholder compensation is funded by the premiums paid in the past and future by shareholders of the defendant corporation as well as any return on premiums invested by the insurance company.

Insurance also solves one of the most powerful objections against shareholder compensation, that Benefiting Shareholders who sell stock at inflated prices before the fraud is revealed contribute nothing to shareholder compensation. In fact, Benefiting Shareholders contribute to the costs of shareholder compensation in a world with insurance. They do so because they contribute to the premiums while they are shareholders of the company. Insurance can spread the costs of shareholder compensation to Benefiting Shareholders before such shareholders are even identified.105

In a world that did not require shareholder compensation, no such insurance system would arise. Without the rights and duties created by Section 10(b) of the Securities Exchange Act and Rule 10b-5, Class Shareholders would simply bear all of the costs of fraud. As a result, as argued above, investors would be more cautious, holding diversified portfolios rather than buying stocks of companies that they believe have significant potential. The market might become less efficient in pricing individual stocks. Stocks generally might suffer a fraud discount that would depress overall prices, especially in times where there is frequent fraud. Securities-fraud actions have played an important role in spurring the creation of a wider system of loss spreading.

One risk of this loss-spreading system is that it may do its job too well. If companies bear only a small cost of the fraud, they will have few incentives to prevent fraud. While insurance companies could theoretically monitor those companies for fraud, one study found that such monitoring generally does not occur.106 But there are significant costs of securities fraud that cannot be shifted to insurance companies. For example, the Credibility Decline may not be remedied by an insurance payment if the market suspects that a company has a tendency to commit fraud. The potential cost of a credibility discount to a particular company's stock may help ensure that loss spreading does not entirely eliminate the incentive to prevent fraud.

104. See generally Calabresi, supra note 67, at 133–97 (discussing allocation of costs to least cost avoider).

105. Of course, it is likely that the benefits the Benefiting Shareholder captures from the fraud will be greater than the cost of contributing to insurance coverage.

106. See Baker & Griffith, supra note 16, at 1808.
Given that it does not result in greater monitoring, entity-level insurance is seen by some as the result of agency costs. If shareholders can protect themselves by diversifying,107 and managers themselves control the risk of fraud,108 managers might be motivated to purchase such insurance to protect themselves and their bonuses against fluctuations in earnings. As one prominent study contends, "Corporations buy entity-level coverage under Side B and Side C of the D&O policy because they are run by selfish managers who are willing to invest corporate assets in negative net present value projects in order to protect their own compensation packages."109

While the personal interests of managers may be a factor, a more compelling reason for purchasing entity-level insurance is to mitigate the burden on Damaged Shareholders in footing the bill for shareholder compensation. Furthermore, entity-level insurance also helps ensure that Benefiting Shareholders contribute some amount to compensate Class Shareholders for their loss. Thus, entity-level insurance policies may not only be the result of agency costs, but a rational way of spreading the losses caused by securities fraud.

C. A Point About Attorney Fees

Even if it serves a loss-spreading role, the existence of substantial transaction costs is a strong argument against the efficiency of securities-fraud actions. As one text asks, "[a]s an investor ex ante, would you opt for a system that provided compensation for open market fraud out of corporate funds where some 20–30 percent of any recovery went to the plaintiffs' attorneys . . . ?"110 While shareholder compensation could be more efficient, it might be useful to examine whether it is any more inefficient than a dividend. As noted earlier, a similarity between dividends and shareholder compensation is that the payment of either triggers substantial transaction costs—taxes and attorney fees. In both cases, shareholders might retain more wealth by simply allowing the company to keep the cash without incurring such substantial fees.

One might argue that a tax is less harmful to societal interests than substantial attorney fees. Taxes are used for the benefit of the public while attorney fees unduly enrich a few parties—attorneys for the plaintiffs and defendants. But tax revenue can be used for wasteful projects that benefit

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107. See sources cited supra note 69.
108. See Griffith, supra note 12, at 1171 ("Entity-level coverage for the risk of shareholder litigation is particularly puzzling since the corporation controls the governance processes that create litigation risk.").
109. Id. at 1173; see also Baker & Griffith, supra note 16, at 1832–33.
110. COX ET AL., supra note 91, at 728; see also Langevoort, supra note 72, at 634–35.
only a small segment of the population. Attorney fees might be reinvested in meritorious suits that target significant fraud. While some of the transaction costs of taxes and attorney fees might be a deadweight loss, not all of it is.2

Another difference is that attorney fees increase the incentive to bring additional securities-fraud actions, while taxes provide an incentive in the opposite direction with respect to payment of dividends. As a result, attorney fees may result in overproduction of securities-fraud actions while taxes may result in underproduction of dividends. But attorneys must also balance the prospect of fees against the risk of dismissal and the cost of bringing a case. If it appears that securities-fraud actions are overproduced, it might make sense to increase the relative costs of bringing a suit or to reduce the incentive to sue.

In any event, at least to the shareholder, the end effect is the same. With both dividends and shareholder compensation, there is a significant cut that is taken out of the cash payment. Thus, from an efficiency standpoint, both dividends and shareholder compensation are somewhat similar. The point of the comparison is not to imply that substantial attorney fees awards are not problematic from the point of the shareholder. The point is that attorney fees are no more problematic than the well-established dividend tax. Congress has acted to manage the costs of the dividend tax by reducing it. Similarly, the solution to the inefficiency of shareholder compensation may be to find some way to reduce the amount of the "tax" that shareholders pay to attorneys rather than doing away with securities-fraud actions.

D. Summary

In conclusion, like dividends, shareholder compensation poses two puzzles. Why would rational shareholders who are injured want a payment from the company that comes partly from themselves? Why do shareholders need shareholder compensation when if they are diversified, they are just as likely to be winners as losers from securities fraud? Thinking of shareholder


112. See, e.g., Mitchell, supra note 34, at 246 n.8 ("It is worth noting that, as with all transaction costs, these are only waste if the recipients (in this case, plaintiffs' lawyers), put the money to less good use than do the corporation and insurance companies paying damages.").


114. See, e.g., John C. Coffee, Jr., Understanding the Plaintiff's Attorney: The Implications of Economic Theory for Private Enforcement of Law Through Class and Derivative Actions, 86 COLUM. L. REV. 669, 726 (1986) ("[T]he basic goal of reform should be to reduce the agency costs incident to this attorney-client relationship.").
compensation as a dividend suggests responses to these two forms of the circularity problem.

First, shareholder compensation is not a meaningless transfer from shareholders to themselves. Class Shareholders capture most of the benefits from shareholder compensation, which is largely funded by Non-Class Shareholders. This transfer is less circular than a dividend and justified because Class Shareholders suffered from the Fundamental Decline.

Second, shareholder compensation serves a distinct loss-spreading function. While diversification protects individual investors, it does not protect markets. Shareholder compensation creates a system where the costs of fraud are spread rather than falling solely on Class Shareholders. Insurance facilitates this system and ensures that even Benefiting Shareholders bear some of the costs of fraud. Corporations are better able to assess the costs and benefits of investing in loss-spreading measures than most individual investors.

Of course, it is difficult to quantify these benefits against the costs of shareholder compensation. And shareholder compensation may be more beneficial in some contexts than others. But this analysis shows that circularity in itself is not a reason to reject shareholder compensation. Far from being structurally flawed, shareholder compensation serves an important role in managing the costs of securities fraud.

III. THE SHAREHOLDER COMPENSATION PUZZLE

Thinking of shareholder compensation as a dividend suggests that some of the arguments explaining the payment of dividends might provide additional justification for the payment of shareholder compensation. A substantial body of finance literature has proposed three solutions for the dividend puzzle: (1) dividends are a way by which management can signal inside information to investors; (2) dividends lower agency costs by reducing free cash flow; and (3) dividends allow shareholders to diversify.

This Part describes each of the three explanations for dividends and then analyzes whether the explanation might be applicable to shareholder compensation. The signaling explanation in particular is not strong with respect to shareholder compensation because managers have an incentive to distort any signal. Any diversification effect of dividends is likely to be modest. However, the agency costs rationale may be relevant to the issue of shareholder compensation.
A. Signaling

1. Dividends

A corporation might pay a dividend to signal that it has strong future prospects. While public corporations are required to make disclosures and file audited financial statements, such filings tend to summarize past performance while only hinting at the future. By paying a dividend, management can convey that it expects that earnings or cash flow will increase over time, perhaps justifying a higher valuation for the stock. As Merton H. Miller and Kevin Rock explain the signaling theory, "In a world of rational expectations, the firm’s dividend (or financing) announcements provide just enough pieces of the firm’s sources and uses statement for the market to deduce the unobserved piece, to wit, the firm’s current earnings."115

Such a signal might be necessary because financial statements and other disclosures can be manipulated.116 Shareholders may be skeptical that publicly available information truly reflects the ability of the company to generate cash flow. By paying a dividend, the management is putting its money (or perhaps more accurately the company’s money) where its mouth is. Management is signaling through the dividend payment that it is confident that it can generate cash flow and that there is substance behind its projections for future earnings.

In contrast, cutting a dividend may be a signal that the company is in dire financial straits. The decision to reduce or eliminate a dividend may come about because the board or management is not confident that the company can generate enough cash to fund a dividend. The company may be suffering from declining cash flows and unable to raise money from the debt or equity markets without agreeing to reduce its dividend.

115. Merton H. Miller & Kevin Rock, Dividend Policy under Asymmetric Information, 40 J. FIN. 1031, 1031 (1985); see also Bratton, supra note 36, at 862–63 (describing signaling theory); Martin Feldstein & Jerry Green, Why Do Companies Pay Dividends?, 73 AM. ECON. REV. 17, 18 (1983) ("[D]ividends are a signal of the sustainable income of the corporation: management selects a dividend policy to communicate the level and growth of real income because conventional accounting reports are inadequate guides to current income and future prospects."); Fischel, supra note 39, at 709 ("[B]oth theory and empirical evidence seem to indicate that, although dividend policy has no independent impact on the value of the firm’s shares, changes in dividend payout frequently convey new information about the prospects of the firm.").

116. This was especially so in the early part of the twentieth century when there was weak financial disclosure. Steven A. Bank, Is Double Taxation a Scapegoat for Declining Dividends? Evidence From History, 56 TAX L. REV. 463, 471 (2003) ("Given the weakness of [early twentieth-century] financial disclosure, a liberal dividend policy served an important signaling function for current and potential stockholders.").
A criticism of the signaling theory is that the payment of a dividend is at best a weak signal. Many companies pay dividends, and so investors cannot learn much about a company solely from the decision to pay a dividend. Because dividends typically involve relatively small sums, they may be perceived as "cheap talk." Dividend decisions can be ambiguous and motivated by varying reasons. Management, knowing that dividends send a signal of financial health, may try to game the system by sending a false signal to buy time to turn the company around or to enrich themselves by selling stock before an imminent decline. The evidence is consistent with these criticisms in that the decision to pay a dividend is associated with only a small positive return.

Cutting a dividend, however, might send a stronger signal to investors. Studies show that investors tend to react more to the decision to reduce a dividend than a decision to pay a dividend. Given that dividend cuts are relatively rare, the decision by management to reduce a dividend sends a clear signal that something is wrong. It may be less likely that management would have a motive to fool the market into believing the prospects of the company are poor, so the signal is more credible.

Moreover, even if dividends do communicate information to investors, there is a question as to whether a dividend is the best way to send such a signal. There are other ways that management might credibly signal belief

117. See, e.g., Bratton, supra note 36, at 865–66 (summarizing finance literature establishing that dividend signal is weak); Easterbrook, supra note 39, at 651; Miller & Rock, supra note 115, at 1046 ("But in a world with rational expectations, dividends, for all their pleasant connotations, cannot turn a loser into a winner.").

118. See supra note 47.

119. See supra note 36.

120. See, e.g., Brudney, supra note 39, at 109–11 (describing different messages that could be conveyed by dividend decisions). Victor Brudney thus proposes that management be required to make disclosures about the basis for certain types of dividend decisions. See Brudney, supra note 39; see also William W. Bratton, Dividends, Noncontractibility, and Corporate Law, 19 CARDOZO L. REV. 409 (1997) (discussing Brudney’s disclosure proposal in light of incomplete-contracts model). But see Fischel, supra note 39 (criticizing Brudney’s proposal).


122. See, e.g., Bratton, supra note 36, at 868 (reporting that dividend cuts on average cause 6 percent drop in stock price); Miller & Rock, supra note 115, at 1046 ("The best place for empirical researchers to look for evidence of dividend signalling may well be among firms falling into adversity, not because they then start signalling, but because they stop.").

123. Though, in times of economic turmoil, many corporations reduce their dividends.

124. See, e.g., Bratton, supra note 36, at 866 ("The corporate governance system holds out plenty of ways to signal confidence about future performance.").
in the strength of a company's prospects. Publicly disclosed earnings projections are a standard by which management can manage the market's expectations of earnings. Management stock purchases might be a more credible signal than a dividend because management is risking its own money. Similarly, when management sells stock, it may be a signal that the prospects of a company are poor. Finally, any signaling theory must deal with the possibility that managers simply are not good at predicting earnings, further weakening the utility of any signaling.

2. Shareholder Compensation

Like a dividend, the payment of shareholder compensation can send a signal, though the signal differs from the signal sent by a dividend. Rather than signaling the strength of a company, payment of shareholder compensation signals a weakness—the company's managers may have committed fraud. As a result, managers, who influence whether shareholder compensation is paid, have incentives to weaken any signal by settling the case after years of stonewalling litigation. Any signal is weakened further because the decision to pay shareholder compensation is involuntary and the payment is covered by an insurance company.

A large shareholder-compensation payment may signal that a securities-fraud action had merit. As a result, shareholders may further question the

125. And the credibility of a dividend decision may be lessened if management does not make additional commitments to signal their belief. See Harry DeAngelo et al., Reversal of Fortune: Dividend Signaling and the Disappearance of Sustained Earnings Growth, 40 J. Fin. Econ. 341 (1996).

126. See id. at 364–65 ("[A]nother possibility is that . . . managers suffer from a behavioral bias—over-optimism—that leads them to overestimate future earnings when growth prospects fade.").

127. At least in terms of signaling, shareholder compensation is more analogous to a decision to cut a dividend than the decision to pay a dividend.

128. The size of the settlement might provide some signal as to the merit of the case, but the signal is difficult to precisely interpret. Janet Cooper Alexander famously argued that settlements of securities-fraud actions are unrelated to the merits, pointing to a small sample of settlements that fell within a similar range. See Janet Cooper Alexander, Do the Merits Matter? A Study of Settlements in Securities Class Actions, 43 Stan. L. Rev. 497, 514–15 (1991). More recent studies have criticized Alexander's methodology, and a study in 2008 establishes that settlements of securities-fraud actions vary significantly in size. See James D. Cox et al., There Are Plaintiffs and . . . There Are Plaintiffs: An Empirical Analysis of Securities Class Action Settlements, 61 Vand. L. Rev. 355, 384 (2008); see also Grundfest, supra note 7, at 743 (finding variance in settlement amounts, but also finding that a significant number of suits were likely to have been without merit). A key metric, according to Joseph Grundfest, is the difference between the settlement amount and the cost of defending the lawsuit. See id. at 740–41. If the settlement amount is lower or equal to the defense costs that would be incurred in defending the suit, it may signal that the parties believe that the case is likely without merit. See id. at 741. To the extent that the settlement amount is greater than the potential defense costs, the company may be signaling that it has identified an issue that must be addressed through a substantial payment. See id. And indeed, there appears to be evidence that directors and officers pay some reputational penalty for significant settlements, indicating that larger settlements may send a signal. See Helland, supra note 24. Though settlements differ in size, it is still difficult to conclude that settlements clearly signal the merit of a case. A large settlement might
credibility of management. Any such signal, however, can be obscured by settling the case rather than risking a trial. By couching any settlement as a decision to avoid the risk and cost of a trial, management can imply that the settlement is merely a cost of doing business rather than an indication that it defrauded shareholders. The signal can be obscured even further through delay. If years go by before any settlement, the market may not consider any signal conveyed by such a settlement to be relevant.

Shareholder compensation is likely to be a weaker signal than payment of a dividend because it is involuntary rather than voluntary. In most cases, management initiates a dividend, perhaps prompted by optimism of future cash flows. In contrast, shareholder compensation is a response to a lawsuit. Management cannot simply choose to walk away from a securities-fraud action without paying shareholder compensation. A settlement might have nothing to do with a concern for compensating shareholders, and is likely a decision made by management to avoid liability.

Any signal is weakened even further because as noted above, most shareholder settlements are covered by insurance policies purchased by the company to cover the costs of securities litigation. Usually, the insurance company simply pays the settlement without any apportionment of blame among individual managers who might be responsible for the fraud. The signal may not strictly reflect the merits of the case but rather the influence of a third party whose main interest is resolving the claim at an amount so that the premiums it receives cover the costs of the settlement.

The payment of shareholder compensation, however, does signal that management and shareholder plaintiffs have reached a consensus about the value of a case given the circumstances. In defending a securities-fraud action, companies with good governance will investigate the allegations carefully and address any deficiencies that are found. To the extent that the company is able to make rational assessments and respond appropriately, it might be able to reduce any Credibility Decline. However, it is difficult for

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129. To the extent that directors or officers are named in the suit, a board may have an incentive to settle the case to protect their peers. See Coffee, supra note 1, at 1566–67.

130. See id. at 1569–70.

131. There is evidence that policy limits often influence the size of settlements. See Tom Baker & Sean J. Griffith, How the Merits Matter: Directors’ and Officers’ Insurance and Securities Settlements, 157 U. Pa. L. Rev. 755 (2009). On the other hand, while a large settlement might indicate simply that the insurance company does not want to fight, or faces a significant amount of exposure, it can also be read as a recognition that there is enough merit to the claim that a substantial payment is necessary to resolve the case. Baker and Griffith found evidence that parties consider the “sex appeal” of the case in assessing settlements. Id. at 787–88.

132. See Grundfest, supra note 7, at 739 (“At the core of any settlement calculation lie the parties’ assessments of the probability and magnitude of any potential verdict.”).
the market to evaluate which companies are assessing the merits of securities-fraud actions in good faith.

As with dividends, there may be more effective ways of signaling that a company is responsive to fraud. Companies can address Credibility Declines by being more forthcoming in the future.\textsuperscript{133} Disciplining the offending managers, assessing the merits of the suit objectively, fixing internal controls that allowed the fraud, or delivering legitimate increases in earnings might send a signal that the company takes allegations of fraud seriously. Shareholder compensation is most likely to be an effective signal when combined with such measures.

B. Agency Costs

1. Dividends

Payment of dividends might reduce agency costs by reducing the ability of management to waste free cash flow.\textsuperscript{134} As defined by one commentator, “[f]ree cash flow is cash flow in excess of that required to fund all projects that have positive net present values . . . .”\textsuperscript{135} Management may have an incentive to retain shareholder funds to invest in projects that do not benefit shareholders.\textsuperscript{136} Management may do so to engage in empire building, or because they want to retain power over assets. Management may also be risk averse, preferring to keep a healthy cash cushion for a rainy day. Shareholders might be better off if the cash was returned to them so they can reinvest in more promising ventures. By lowering the amount of cash at management’s disposal, a dividend helps prevent managers from investing in wasteful projects that do not benefit shareholders.\textsuperscript{137}

Dividends might focus managers on running the company more efficiently. Because a dividend reduces free cash flow, managers must do more with less and make difficult decisions such as cutting costs. If managers

\textsuperscript{133} Studies differ on whether scandals result in significant manager turnover. Compare Anup Agrawal et al., Management Turnover and Governance Changes following the Revelation of Fraud, 42 J.L. & ECON. 309 (1999) (finding little evidence of higher management turnover in firms charged with fraud), with Greg Niehaus & Greg Roth, Insider Trading, Equity Issues, and CEO Turnover in Firms Subject to Securities Class Action, 28 FIN. MGMT. 52 (1999) (finding higher CEO turnover in firms accused of fraud compared to other firms that experience large stock price drops).

\textsuperscript{134} See, e.g., Bratton, supra note 36, at 866–67 (describing agency-cost explanation); Feldstein & Green, supra note 115, at 18 (“[S]hareholders distrust the management and fear that retained earnings will be wasted in poor investments, higher management compensation, etc.”).


\textsuperscript{136} See, e.g., id. (“Conflicts of interest between shareholders and managers over payout policies are especially severe when the organization generates substantial free cash flow.”).

\textsuperscript{137} See, e.g., Goshen, supra note 5, at 889 (“[Dividend] distributions themselves decrease funds available for suboptimal managerial investment and perquisite consumption.”).
borrow money to finance a dividend, the resulting debt might also provide discipline because managers will need to generate cash flow to make interest payments.\textsuperscript{138} Even if the relative amount of the dividend is small in relation to the company's cash flows, paying a regular dividend may keep management focused on maximizing shareholder wealth.

One commentator argues in a similar vein that dividends result in monitoring of management because investors will scrutinize a company anew whenever it issues new debt or equity to finance a dividend.\textsuperscript{139} An underwriter will do due diligence, examining the financial statements, competence of management, and general prospects of the company. While this may be less of a factor with well-established public corporations that can utilize shelf registrations,\textsuperscript{140} it might be an explanation with respect to less-established companies that cannot. In addition, debt markets can provide an additional set of monitors who will assess the prospects of the company on an ongoing basis.

There is some evidence that dividend payments are associated with companies with good corporate governance. One study finds that companies in legal regimes that focus on protecting investors are more likely to pay higher dividends than companies in legal regimes with less investor protection.\textsuperscript{141} This finding supports the thesis that dividends are a sign that a company is being run efficiently for investors rather than for management.\textsuperscript{142}

While dividends provide some checks on management, the effect may be trivial. Management must deal with a myriad of issues that discipline their use of shareholder cash. Most public companies issue debt regardless of whether they pay dividends and are thus subject to the monitoring of the

\begin{itemize}
\item \textsuperscript{138} See, e.g., Goshen, supra note 5, at 896–97 (describing disciplining effect of debt); Jensen, supra note 135, at 324 ("[D]ebt reduces the agency costs of free cash flow by reducing the cash flow available for spending at the discretion of managers.").

\item \textsuperscript{139} Easterbrook, supra note 39, at 654 ("The principal value of keeping firms constantly in the market for capital is that the contributors of capital are very good monitors of managers."); see also Bratton, supra note 36, at 869–70.

\item \textsuperscript{140} See Delayed or Continuous Offering and Sale of Securities, 17 C.F.R. § 230.415 (2008).

\item \textsuperscript{141} The study's authors summarize its findings as follows:

Empirically, we find that dividend policies vary across legal regimes in ways consistent with a particular version of the agency theory of dividends. Specifically, firms in common law countries, where investor protection is typically better, make higher dividend payouts than firms in civil law countries do. Moreover, in common but not civil law countries, high growth firms make lower dividend payouts than low growth firms. These results support the version of the agency theory in which investors in good legal protection countries use their legal powers to extract dividends from firms, especially when reinvestment opportunities are poor.

Rafael La Porta et al., Agency Problems and Dividend Policies around the World, 55 J. FIN. 1, 2 (2000).

\item \textsuperscript{142} One study finds that the market reacts more favorably to dividend announcements for firms that may be overinvesting than for firms that may not be overinvesting. Larry H.P. Lang & Robert H. Litzenberger, Dividend Announcements: Cash Flow Signalling vs. Free Cash Flow Hypothesis?, 24 J. FIN. ECON. 181 (1989).
\end{itemize}
capital markets. And too much debt can be a detriment to a company, requiring managers to spend time generating cash flow in the short run to finance its debt rather than investing in long-term projects. Moreover, there are many other mechanisms that can be used to discipline management—derivative suits, shareholder votes, and takeovers. Finally, because dividends are relatively common, and not all dividend-paying companies have efficient and disciplined managers, one can question whether dividends have a significant impact on reducing agency costs.

2. Shareholder Compensation

Like a dividend, shareholder compensation may help reduce agency costs. This is a more compelling rationale for shareholder compensation than signaling. If the company is not covered by insurance, shareholder compensation must come from free cash flow or the company must issue additional debt or equity to finance a shareholder compensation payment. A company issuing securities to pay shareholder compensation may subject itself to additional scrutiny by the capital markets. As a result, management might feel more pressure to use resources effectively, reducing the temptation to waste cash for projects that are not in the best interest of shareholders. Because of the pressure of operating the company with less cash, fraud-committing management will have to prove itself or face termination.

The agency-costs explanation questions a basic assumption of the circularity problem, that requiring a company to distribute cash to shareholders...
will necessarily reduce the value of the firm to an extent that offsets any benefit to shareholders who receive compensation. In some circumstances, paying out free cash flow may have ancillary benefits that add to rather than offset the benefit received by Class Shareholders. Such benefits are captured not only by Class Shareholders, but to the extent that agency costs overall are reduced, Non-Class Shareholders may benefit as well.147

And obviously, companies where managers commit fraud are especially prone to agency-cost problems. Managers commit fraud to create the perception that they are doing a good job and to enrich themselves by exercising stock options at an inflated value.148 They might also commit fraud to save their jobs when a company is on the brink of insolvency.149 The problem of managers who act in their own interests is not just a theoretical possibility with such companies, but a reality that must be addressed. Managers who commit fraud should be entrusted with fewer resources and work under constraints until they regain the trust of shareholders.

Of course, if insurance covers the shareholder compensation payment, the effect of shareholder compensation on agency costs may be reduced. With insurance, management can settle a case knowing it will not significantly reduce free cash flow.150 But even insurance requires payment of a significant deductible, and companies that commit securities fraud are likely to pay higher insurance premiums in the future, reducing free cash flow.151 A company that has committed securities fraud will likely pay more when obtaining a new policy because insurance companies consider corporate governance in setting the premium.152

In addition, the payment of insurance premiums may be similar to debt in that it reduces free cash flow available to management over time. Thus, even companies that do not suffer from securities fraud will see some reduction in free cash flow. As with dividends, it is likely that the impact of insurance premiums on agency costs will be modest, especially for large companies.

147. This effect would be in addition to any reduction in agency costs resulting generally from a mandatory-disclosure regime. See Paul G. Mahoney, Mandatory Disclosure as a Solution to Agency Problems, 62 U. Chi. L. Rev. 1047 (1995) (arguing that disclosure statutes help reduce agency costs).

148. See Coffee, supra note 1, at 1562–63.

149. See Arlen & Carney, supra note 1, at 694, 702–03.

150. See Baker & Griffith, supra note 131, at 796–98.

151. U.S. CHAMBER INST. FOR LEGAL REFORM, SECURITIES CLASS ACTION LITIGATION: THE PROBLEM, ITS IMPACT, AND THE PATH TO REFORM 17 (2008), available at www.instituteforlegalreform.com/get_ilr_doc.php?docId=1213 (“Even when a company’s insurance covers the settlement and litigation costs, the company ultimately ends up footing much of the bill because insurance premiums inevitably increase to reflect the higher risk of liability.”).

It is unlikely that the agency-costs effect of shareholder compensation would be the same for all companies. Small companies may find it more difficult to operate with less cash than large companies. Growing companies with many projects for profitable investment may suffer greater opportunity costs from reduced free cash flow than mature companies with fewer potential investments. Thus, shareholder compensation may be more effective in reducing agency costs with respect to large, mature companies than with respect to small, growing companies.

C. Diversification

1. Dividends

Shareholders might want a dividend to have the option of further diversifying their investments. A shareholder can consume the dividend, use it for other investments, or even use it to purchase more stock of the company paying the dividend. A shareholder might prefer to have a dollar in hand than the prospect of a future return.

There is some evidence that companies pay dividends because there are dividend constituencies, or investors with a special preference for companies that pay dividends. For example, retired individuals may be more interested in investing in established companies paying regular dividends that can be used as income than younger individuals who look for companies that do not pay dividends but have high growth prospects. When dividends are taxed as income, shareholders in lower tax brackets may be more inclined to hold shares in companies that pay higher dividends than

153. See, e.g., Feldstein & Green, supra note 115, at 17 (“[T]here is the desire on the part of small investors, fiduciaries, and nonprofit organizations for a steady stream of dividends with which to finance consumption.”); Fischel, supra note 39, at 703 (“A dividend payment does not affect risk; rather, it reduces the proportion of the investor’s assets in equities.”).

154. E.g., Brudney, supra note 39, at 88 (“[D]ividend distributions on share prices rest on the assumption that stockholders rationally tend to value a dividend in hand more highly than they do the capitalized value of the earnings expected from management’s reinvestment of the amount thus paid out.”); id. at 95 (“[T]here is evidence to suggest a systematic stockholder preference for individual investor power to make the reinvestment decision, and there are grounds to explain such a systematic preference.”).

155. See BREALEY ET AL., supra note 22, at 456.

156. Prior to the reduction of the dividend tax, dividends were more attractive for retired individuals who are more likely to pay lower marginal tax rates.

One explanation for the dividend puzzle is that mutual funds do not pay attention to the tax consequences of their investment decisions. Thus, they may not sufficiently influence companies to reduce dividend payments. See Mitchell L. Engler, A Missing Piece to the Dividend Puzzle: Agency Costs of Mutual Funds, 25 CARDOZO L. REV. 215 (2003).
shareholders in higher tax brackets, and some investors may be able to avoid the dividend tax entirely.\footnote{157}

The diversification rationale can be illustrated by the classic case \textit{Dodge v. Ford Motor Co.}\footnote{158} In that case, the Dodge Brothers, who were both shareholders and competitors of the Ford Motor Company ("Ford Motor"), sued for an injunction requiring Ford Motor to pay out a special dividend rather than invest those funds for capital improvements. The Dodge brothers agitated for a dividend payment by Ford Motor, presumably because they wanted the cash so they could invest in their own automobile business.\footnote{159} Putting aside the possible nefarious motive of undermining a competitor, this is an example where a dividend was desired for diversification. The Dodge brothers might have believed that they would have earned higher returns by investing the cash in their own business or some other stock than allowing Ford Motor to invest the money.

In modern times, the diversification explanation may not be so compelling because most shareholders tend to reinvest the dividend in purchasing the same stock.\footnote{160} Moreover, any diversification effect would be small, at best, especially for institutional investors. A dividend is typically equivalent to a small percentage of the value of the stock, which in turn may be only one of many stocks held by the investor.

Diversification may be a more compelling rationale for dividend payments for closely held corporations than public corporations. In a closely held corporation, a few shareholders own the company.\footnote{161} Because they may have a significant portion of their assets invested in the company, shareholders in closely held corporations are more likely to rely on dividend income as a primary source of income than the typical investor in a public corporation. Unlike public corporations, there is no active market where shares in closely held corporations can be traded. A shareholder of a closely held corporation may want the cash from a dividend to consume because it knows it will not sell its shares for a long time, if at all.\footnote{162}

It is possible that the payment of dividends by public corporations is a continuation of the practice of paying dividends by closely held corporations. The decline in the number of companies that pay dividends over the

\footnotesize{\begin{itemize}
\item \footnote{158} 170 N.W. 668 (Mich. 1919).
\item \footnote{159} Margaret M. Blair \& Lynn A. Stout, \textit{A Team Production Theory of Corporate Law}, 85 VA. L. REV. 247, 301 (1999).
\item \footnote{160} Easterbrook, \textit{supra} note 39, at 651.
\item \footnote{162} See, e.g., Bank, \textit{supra} note 116, at 472 ("For the 19th century investor, dividends frequently comprised the only foreseeable source of return on a stockholder’s investment.").
\end{itemize}}
last thirty years or so\textsuperscript{163} may be a reflection of the rise of highly transparent, efficient, liquid, public markets where shares are easily bought and sold and where investors can easily generate cash by realizing capital gains, perhaps making dividends a relic of the past.

2. Shareholder Compensation

As with dividends, shareholder compensation provides a modest opportunity for diversification. Class Shareholders who receive shareholder compensation can invest it in other securities, or keep the funds in cash. Class Shareholders may prefer diversification after a fraud because of the risk that management will commit fraud again.

But the diversification effect of shareholder compensation is trivial, especially for institutional investors.\textsuperscript{164} As one commentator notes, shareholder-compensation payments are often a small fraction of the assets managed by these institutions.\textsuperscript{165} Moreover, investors tend to recover only a small fraction of alleged losses.\textsuperscript{166} But it does appear that at least some investors care about such small amounts, as evidenced by the suits brought against institutions that failed to submit claims for shareholder compensation.\textsuperscript{167} And while shareholders recover only a fraction of their losses, that fact may be an argument for increasing rather than decreasing the potency of securities-fraud actions.

Another problem with the diversification explanation might be that shareholders who want to diversify after a fraud can do so more efficiently by selling a portion of their shares. Indeed, Class Shareholders who sell their shares are sending a strong signal that they would rather have cash than hold on to the company's shares. But some shareholders may believe that the fundamentals of the business are good, and might prefer to continue holding their shares. Shareholder compensation might be a modest way of allowing them to choose whether to reinvest in the company or diversify further.

IV. MAKING SHAREHOLDER COMPENSATION MORE LIKE A DIVIDEND

Thinking of shareholder compensation as a dividend suggests some novel ways of compensating shareholders for fraud. What if a company

\textsuperscript{163} See \textit{supra} note 47.

\textsuperscript{164} However, losses may be more significant for retail investors. See, e.g., Evans, \textit{supra} note 7, at 226.


\textsuperscript{166} See, e.g., Evans, \textit{supra} note 7, at 226.

could compensate shareholders for securities fraud through a dividend?\textsuperscript{168} Distribution of shareholder compensation as a dividend would address the problem that many shareholders fail to submit claims for shareholder compensation. One could also imagine a system that allowed companies to resolve meritorious securities-fraud actions preemptively, by paying a dividend that would cover part or all of the harm to shareholders.\textsuperscript{169} Such a dividend might send a strong signal that the corporation takes securities fraud seriously, perhaps remedying the Credibility Decline. Such a dividend might reduce the transaction cost of plaintiffs' attorney fees if it counted against the damages that would be recovered by a securities-fraud action. This Part discusses the potential for paying shareholder compensation as a dividend, either as a resolution to shareholder litigation or as a preemptive response to such actions.

A. Distributing Shareholder Compensation Through a Dividend

A significant practical problem with shareholder compensation is that many Class Shareholders do not collect it. In their influential study of institutional shareholders who are Class Shareholders, James Cox and Randall Thomas found that only about 30 percent of such shareholders submitted claims.\textsuperscript{170} While there is no empirical study of whether retail investors who

\textsuperscript{168.} Private litigants can seek injunctive relief through a securities-fraud action. See, e.g., Simon De Bartolo Group, L.P. v. Richard E. Jacobs Group, Inc., 186 F.3d 157, 170–71 (2d Cir. 1999). Rather than setting up a common fund, the parties could agree to injunctive relief requiring the corporation to pay a dividend to cover shareholder damages from the fraud. While it does not appear to be common, it is not unprecedented for a class-action settlement to be distributed as a dividend to shareholders. See, e.g., Wood v. Coastal States Gas Corp., No. 5719, 1978 WL 2514, at *2 (Del. Ch. Nov. 9, 1978) (describing settlement plan to distribute stock as a dividend); see also Dodge v. Ford Motor Co., 170 N.W. 668 (Mich. 1919) (requiring payment of dividend by Ford).

The lack of a common fund should not prevent collection of reasonable attorney fees. While fee awards have been premised on the creation of a common fund, see, e.g., Boeing Co. v. Van Gemert, 444 U.S. 472, 478 (1980), the Federal Rules of Civil Procedure were amended in 2003 to add FED. R. Civ. P. 23(h), which provides that “the court may award reasonable attorney's fees . . . by the parties' agreement.” This provision does not condition payment of attorney fees on the creation of a common fund.

\textsuperscript{169.} This Article is not the first to note the possibility of a dividend as a mechanism for compensating shareholders. See, e.g., Pritchard, supra note 15, at 947 (“Shareholders as a group would be further ahead if the resources spent on the lawsuit were simply paid to them as a dividend, without the lawsuit’s transaction costs.”). But this Article is the first in-depth treatment of the possibility.

are Class Shareholders submit claims, anecdotal evidence suggests it is likely that the percentage making such claims is also low.\(^{171}\)

The reasons for the failure to submit claims vary. Many Class Shareholders own a nominal amount of stock. If the Class Shareholder is diversified, the particular stock may represent only a small percentage of the investor's overall portfolio. Any share of the recovery may be for only a small percentage of the loss incurred. It is not surprising that investors may not take the trouble to fill out the paperwork to submit a claim for a relatively insignificant amount. An investor might rationally rather spend the time researching other investments that might result in a much larger payoff. In addition, some investors may not submit claims because they do not approve of securities-fraud actions.

The failure of investors to submit claims is a powerful argument against the effectiveness of securities-fraud actions as a compensatory device. If the investors who are allegedly harmed by a misrepresentation do not bother to claim funds, it is difficult to argue that securities-fraud actions play a significant compensatory role.\(^{172}\) At the very least, it is troubling that the aggregate compensation actually collected by investors may be in the same ballpark as the fees collected by the attorneys.\(^{173}\)

One way of addressing the problem of noncollection would be to distribute settlements or judgments in securities-fraud actions in part or in whole as a "preferred" dividend to Class Shareholders.\(^{174}\) That way, Class Shareholders who continue to hold their shares would not be required to submit a claim to receive their recovery.\(^{175}\) Such a distribution would guarantee that 100 percent of Class Shareholders (at least the ones who continue to hold on to the stock and do not opt out of the class-action settlement) collect some shareholder compensation. Doing so might also reduce some of the transaction costs of administering a fund and processing the claims of Class Shareholders.

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\(^{171}\) See, e.g., Alexander, supra note 2, at 1501 ("Though reliable empirical information is difficult to obtain, it appears that a significant number of class members—representing as many as forty percent of the shares in the class—do not file claims."); Christopher R. Leslie, The Significance of Silence: Collective Action Problems and Class Action Settlements, 59 FLA. L. REV. 71, 119–20 (2007) ("When settlements require class members to file statements or proofs of claim in order to receive their share of the common fund, 'response rates are often very small, and rarely exceed 50%.'").

\(^{172}\) See Pritchard, supra note 165, at 884 (concluding that Cox and Thomas’s results undermine the compensation rationale for securities-fraud class actions).

\(^{173}\) On the other hand, after the publication of the Cox and Thomas study, about forty institutional investors that failed to collect shareholder compensation were sued for breach of fiduciary duty. See Choi & Fisch, supra note 167, at 332.

\(^{174}\) Class Shareholders would be in a similar position as holders of preferred stock who are entitled to payment of a dividend before common shareholders.

\(^{175}\) Notice of a settlement would be circulated prior to payment of the preferred dividend. A Class Shareholder could still opt out of the settlement prior to payment of the preferred dividend. Any Class Shareholder who did not opt out would be considered to have accepted the terms of the settlement.
Shareholders, increasing the funds that are available to compensate shareholders.\textsuperscript{176}

But what of selling Class Shareholders, who are entitled to shareholder compensation but are not currently holding the stock? A selling Class Shareholder might be required to submit a claim for shareholder compensation, which would provide a modest incentive not to sell the stock. Or, any right to a preferred dividend could be transferred to the shareholder who purchased stock from the selling Class Shareholder. If the purchasing shareholder expects to receive a preferred dividend, the Class Shareholder might be able to sell the stock at a premium that reflects the value of any expected preferred dividend.

As a practical matter, it might be difficult for companies to identify Class Shareholders.\textsuperscript{177} If that is the case, an alternative proposal would be to go through the typical process of setting up a common fund and requiring Class Shareholders to submit claims; then pay out any unclaimed settlement funds through a dividend to all shareholders, whether they are in the Class or not in the Class. Courts may have the power to distribute any unclaimed funds in such a way under the cy pres doctrine, where such funds are put to their "next best use."\textsuperscript{178} Distributing some of the unclaimed funds to Non-Class Shareholders, who suffer from Credibility and 10b-5 Declines but have no cause of action under the \textit{Blue Chip Stamps v. Manor Drug Stores} precedent,\textsuperscript{179} might be a related and good use of such funds.\textsuperscript{180} Distributing funds through such a cy pres dividend would mitigate the problem of requiring Non-Class Shareholders to bear all of the costs of compensation.\textsuperscript{181}

\begin{itemize}
  \item \textsuperscript{176} However, any such benefits would be offset by the dividend tax. In order for this proposal to be economically viable, legislation that exempts a dividend that distributes shareholder compensation from a tax might be necessary.
  \item \textsuperscript{177} See, e.g., Cox & Thomas, \textit{Letting Billions}, supra note 170, at 419–20 (describing the difficulty of identifying possible claimants).
  \item \textsuperscript{179} 421 U.S. 723 (1975).
  \item \textsuperscript{180} Cy pres distributions that have gone to causes unrelated to the litigation such as charities have been controversial. \textit{See, e.g.}, George Krueger & Judd Serotta, \textit{Our Class Action System is Unconstitutional}, \textit{WALL ST. J.}, Aug. 6, 2008, at A13 (criticizing distribution of settlement proceeds to charity). But a dividend distributed to shareholders would be a more relevant use for settlement funds than a charity donation.
  \item \textsuperscript{181} On the other hand, such a payment would be more circular than restricting the payment of funds, claimed and unclaimed, to Class Shareholders. An objection to a cy pres dividend may be that the Class Shareholders should receive any unclaimed funds because they were the ones who suffered from a Fundamental Decline. In theory, a cy pres dividend could be limited to those Class Shareholders who submitted a claim. Such a dividend, however, might lead to overcompensation of the Class Shareholders.
  
  Another question is whether a cy pres dividend is necessary. In some cases, unclaimed shareholder-compensation funds could be returned to the company. Those funds could then be invested to
B. Preemptive Dividends

Exploring the idea further, what if a company could preemptively resolve part or all of its liability in a securities-fraud action by paying a dividend to compensate shareholders? A company could simultaneously send a stronger signal to investors and compete with plaintiffs' attorneys who file securities-fraud actions by paying such a "preemptive" dividend to compensate shareholders. A preemptive dividend could either be paid solely to Class Shareholders, like a preferred dividend, or to both Class and Non-Class Shareholders.\(^{182}\)

While the board of directors of a company typically makes decisions with respect to the payment of dividends,\(^ {183}\) the board might have a conflict of interest with respect to the payment of a preemptive dividend. As discussed earlier, managers who are board members might have been involved with the fraud and thus have an incentive not to acknowledge wrongdoing. Therefore, the decision to pay a preemptive dividend might be better delegated to a committee of independent directors. Such a committee could be modeled on the special litigation committees formed to assess shareholder-derivative suits,\(^ {184}\) or committees that bargain on behalf of minority shareholders with respect to a freeze out.\(^ {185}\) While independent committees are not always so independent, there is some evidence that they do not always defer to management.\(^ {186}\)

After a securities-fraud action is filed, a board could appoint an independent committee to look into the allegations. The appointment of such a committee in itself might be a signal that the corporation takes allegations of securities fraud seriously. The independent committee could hire an outside

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182. A general dividend is more likely because of the difficulty of identifying Class Shareholders before a case has been resolved.

183. See Del. Code Ann. tit. 8, § 170 (2001). Board decisions with respect to the payment of dividends are given a great amount of deference and are protected by the business judgment rule. See, e.g., David Michael Israel, Note, The Business Judgment Rule and the Declaration of Corporate Dividends: A Reappraisal, 4 Hofstra L. Rev. 73, 73 (1975) ("The application of the business judgment rule to the declaration of corporate dividends is one of the oldest and most widely accepted principles of corporation law.").


185. See Weinberger v. UOP, Inc., 457 A.2d 701, 709 n.7 (Del. 1983).

law firm to do an investigation. Or, a preemptive dividend could be distributed to all shareholders if the cost of identifying Class Shareholders is too great. If the independent committee determines there is no merit to the case, such a decision might send a signal to shareholders that any Credibility Decline is not merited.

Courts would reduce any subsequent class recovery in a securities-fraud action by the amount of any preemptive dividend payment. The Securities Exchange Act prohibits double recovery for damage caused by securities fraud, and a preemptive dividend would cover part of the damages from fraud. Of course, if the harm suffered is greater than the preemptive dividend, a securities-fraud action could be brought to recover the additional amount. The independent committee would have to consider the risk that if it pays an amount that is too low, a securities-fraud action would still be viable.

A preemptive dividend would be similar to a settlement in that it would not necessarily be an admission of liability by the company. The independent committee could choose to pay a preemptive dividend not because it finds that there is liability under the securities laws but because it determines that there is a basis for compensating shareholders for a loss. For example, the committee might have concluded that the stock price was in-

187. This would be a separate law firm from the firm retained to defend the company against the securities-fraud action. The internal investigation conducted by such a firm could be conducted in a way so that attorney-client privilege and the work-product doctrine protect information from disclosure. See, e.g., Admiral Ins. Co. v. U.S. Dist. Court, 881 F.2d 1486 (9th Cir. 1989) (holding that the attorney-client privilege covers interviews conducted with corporate employees).

188. The independent directors in making such a decision would be protected from liability for their decision. Either liability would be precluded, or the decision to pay a preemptive dividend would be protected by the business judgment rule. As a practical matter, a shareholder who is unhappy with the decision still has the remedy of the securities-fraud action. Thus, if the independent committee decides not to pay a preemptive dividend, it would be unlikely that a shareholder would have a valid derivative action against the committee.

189. A more radical proposal might preclude further liability if a preemptive dividend is paid as long as the amount of the preemptive dividend is reasonable.

190. See 15 U.S.C. § 78bb(a) (2006) ("[N]o person permitted to maintain a suit for damages under the provisions of [section 10(b)] shall recover, through satisfaction of judgment in one or more actions, a total amount in excess of his actual damages on account of the act complained of."); see also Jean C. Love, Actions for Nonphysical Harm: The Relationship Between the Tort System and No-Fault Compensation (With an Emphasis on Workers' Compensation), 73 CAL. L. REV. 857, 860 (1985) (noting that in tort suits where plaintiff has received workers compensation, "benefits are set off against the tort judgment to avoid double recovery").

flated but no one acted with scienter. Plaintiffs would not be permitted to use the fact that a preemptive dividend was paid as evidence in establishing liability in a subsequent securities-fraud action. In a sense, a preemptive dividend would allow the company to go around the plaintiffs' lawyers in resolving a substantial part of the claim, saving shareholders the attorney fees that they normally pay for a settlement.

A preemptive dividend would differ from a settlement in that it would not involve managers, insurance companies, and the attorneys defending the action in the decision to pay. Thus, a preemptive dividend would not reflect a self-interested cost-benefit analysis by managers involved in the fraud who can simply get the insurance company to foot the bill. It would not simply be a decision by an insurance company that the payment is an acceptable loss. And it would not be a decision by defense attorneys to settle the case to avoid the risk of a face-saving loss.

The decision to pay a preemptive dividend would thus send a clearer signal to investors than a settlement. A preemptive dividend would be proactive rather than reactive. By giving independent directors another mechanism for assessing the conduct of management, a preemptive dividend might increase their power to act on behalf of shareholders. Because management is not involved with the decision, a preemptive dividend might signal that current management is suspect and should be disciplined or replaced. An independent committee might also be able to act faster than the litigation process, addressing the problem that a signal becomes outdated with the passage of time. Of course, a preemptive dividend might initially hurt the stock price if it is interpreted as an admission of fraud, but to the extent that culpable management is replaced or deficient internal controls are fixed, a corporation could move beyond the fraud. In the future, shareholders might be more confident that the corporation has good governance and that there is a reduced chance of fraud in the future.

Importantly, plaintiffs' attorneys would not receive credit for the preemptive dividend. In other words, if a company pays a preemptive dividend worth $5 million, the shareholders save the 20 percent fee, or $1 million, that would have been paid if that payment had been obtained through a securities-fraud action. A plaintiffs' attorney would receive a fee only if he could obtain a settlement above that $5 million payment. If litigation is avoided, some of the costs of defending a lawsuit might also be saved. Of course, the shareholder would still be subject to the dividend tax, which may or may not be higher than the attorney fees and defense costs. In addition, a preemptive dividend might be more expensive than the net present value of

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193. As noted earlier, these costs can be substantial. See supra note 16.
a future settlement. Thus, an independent committee would have to estimate whether the benefits of a preemptive dividend would outweigh the costs.

Of course, the effect of a preemptive dividend will likely mean that plaintiffs' attorneys will simply seek higher recoveries, but to do so, they will have to accept greater amounts of risk. Suppose a plaintiffs' attorney thinks that there is a 50% chance he can recover up to $5 million for shareholders, while only a 5% chance that he can recover an additional $2 million. Without a preemptive payment, the plaintiffs' attorney would likely seek to recover only $5 million. The expected recovery for shareholders would be $2.5 million (50% of $5 million), and the attorney's expected fee would be $500,000 (20% of $2.5 million). With a preemptive dividend of $5 million, the plaintiffs' attorney will have to recover more than that amount to receive a fee. Suppose he argues that shareholders are entitled to an additional $2 million. The expected additional return for shareholders would be $100,000 (5% of $2 million), and the attorney's expected fee would be $20,000 (20% of $100,000). As a result, he may be less likely to pursue the case with a preemptive dividend, and if he does, he might deserve a fee.194

The ability to pay a preemptive dividend would essentially make the independent committee a competitor to the plaintiffs' attorney, which normally monopolizes the effort to obtain shareholder compensation for plaintiffs. By creating incentives for plaintiffs' attorneys to seek higher recoveries for shareholders, the problem that shareholders receive only a fraction of their losses might be partially addressed. To the extent that a plaintiffs' attorney obtains a significantly higher payment after a preemptive dividend, it is clearer that the plaintiffs' attorney has added value to the process. In a world without preemptive dividends, to the extent that a securities-fraud action has merit and will generate a significant settlement, a plaintiffs' attorney can earn a substantial fee for essentially being named class counsel. In some circumstances, plaintiffs' attorneys are fungible, and the company would pay a certain amount regardless of who is representing the class. It is in these circumstances that an independent committee would have the greatest incentive to pay a preemptive dividend. If it is likely to have to pay a certain amount anyway, the company might as well stop plaintiffs' attorneys from taking 20–30 percent of the settlement.

Of course, a significant disadvantage of the preemptive dividend is that it would not provide the finality of a class-action settlement. Thus, a preemptive dividend will be more attractive in cases where there is reasonable certainty about the amount of recoverable damages. When the recoverable damages are potentially much higher than the corporation is willing to pay out as a preemptive dividend, the corporation might be better off proceeding

194. Plaintiffs' attorneys may have an incentive to settle cases for too little because they are risk averse. See, e.g., John C. Coffee, Jr., Rescuing The Private Attorney General: Why The Model Of The Lawyer As Bounty Hunter Is Not Working, 42 Md. L. Rev. 215, 230–32 (1983).
with a class action settlement. When the recoverable damages are within the range of what the corporation is able to pay out as a preemptive dividend, a preemptive dividend might be a better way to proceed.

Because it is not a judgment or settlement, the cost of the preemptive dividend would likely not be covered by the insurance policy that would normally cover the cost of a securities-fraud action. Because the preemptive dividend would not be paid by insurance, a preemptive dividend might be more costly in the short run than settlement of a class action. Thus, a preemptive dividend might be more appropriate for a well-established company with easy access to the capital markets than for a cash-poor start-up.

In the long run, however, a preemptive dividend might not be as costly given that insurance premiums typically rise in response to a settlement while they might not rise in response to a preemptive dividend. If preemptive dividends become common, insurance premiums overall might decline as settlements that would normally be funded by insurance companies are replaced by preemptive dividends. Moreover, to the extent that it thwarts strike suits, a preemptive dividend might save a substantial amount in litigation costs, also in the long run reducing insurance premiums.

What of the Class Shareholders who decide to sell their stock before a preemptive dividend is paid? Such selling Class Shareholders would not receive a preemptive dividend and so their only remedy would have to come through a securities-fraud action. This might further lessen any finality that could be achieved by a preemptive dividend. One solution might be to allow selling Class Shareholders to collect a pro rata share of a preemptive dividend by submitting a claim. If they do not, they can be considered to have waived any claim for additional shareholder compensation.

Another problem with the preemptive dividend is that it might lead to a chilling effect where plaintiffs’ attorneys would not bring shareholder suits in the first place. If there is a substantial risk that they will not receive a return from their investment, it is unlikely that plaintiffs’ attorneys will spend resources in developing good cases, and it might be less likely that fraud would be discovered. But if a plaintiffs’ attorney does develop a good case with solid evidence, there will be a stronger case for obtaining damages greater than the amount of the preemptive dividend. Independent

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195. As a result, a preemptive dividend might not be as effective in spreading losses. Accordingly, it might make sense to limit use of a preemptive dividend to cases where the need for a strong signal is more compelling than the need for loss spreading.

196. One problem could arise if an independent committee could pay a preemptive dividend after plaintiffs’ attorneys have litigated a case for years, incurring substantial costs that might not be reimbursed. See, e.g., Zapata Corp. v. Maldonado, 430 A.2d 779, 787 (Del. 1981) (expressing concern that special litigation committee had been formed four years after start of litigation). But that may simply be part of the risk of bringing a securities-fraud action. Plaintiffs’ attorneys would have to assess the risk of a preemptive dividend in bringing suit. And if the case is strong, plaintiffs’ attorneys might still have some leverage if the dividend does not cover the full amount of damages suffered by Class Shareholders.
committees may be wary of paying too much, and so the amount of the dividend may not cover all of the potential damages. Plaintiffs' attorneys will likely argue that more compensation is necessary in cases with merit and more likely to take on the risk that their payment will be reduced through a preemptive dividend. As a result, damages may be ratcheted up in cases with merit while ratcheted down in cases without merit.

An additional issue is the possibility of gamesmanship. For example, a company might simply pay a dividend that it was already planning on paying. Such a dividend would not compensate shareholders for losses caused by the fraud. Such a tactic might be prevented by requiring any preemptive dividend to be in addition to any dividend that the company normally pays. Shareholders and plaintiffs' attorneys might be permitted to challenge whether a purportedly preemptive dividend can be considered compensation for a securities fraud on the ground that the company would have paid such a dividend anyway.

Coupled with other reforms, such as clarifying the applicable law, a preemptive dividend might help save the securities-fraud action as a meaningful tool in deterring fraud and protecting investors. The possibility of a preemptive dividend would give companies an alternative to stonewalling and delay in response to meritorious securities-fraud actions. A preemptive dividend would allow the company through its independent directors to send a strong signal that it will treat allegations of fraud seriously rather than acting defensively. A preemptive dividend might be a way of remedying the weak signal sent by traditional shareholder-compensation payments, which are made by insurance companies after years of litigation. By making such a payment, companies may be able to save some transaction costs while reversing part of the Credibility Decline.

CONCLUSION

Shareholder compensation is more of a puzzle than a problem. The circularity problem is just a variation of the long-standing question of why companies pay dividends. At the very least, shareholder compensation is no more circular than a dividend. And indeed, shareholder compensation is less circular than a dividend. Shareholder compensation benefits Class Shareholders who happen to have purchased stock at a time when the price was

197. In addition, there will always be companies who deny that they have done anything wrong and refuse to pay a preemptive dividend. To the extent that plaintiffs' attorneys do not know ex ante which companies will fight and which will pay a preemptive dividend, they will have incentives to file suits, though they might be more selective about doing so.

198. For example, the standard for determining what statements are considered to be material should be further clarified. See Park, supra note 25. Limiting damages to the Fundamental Decline might also help make securities-fraud actions more manageable. See supra note 64 and accompanying text. Finally, plaintiff and defense attorney fees relating to securities-fraud actions should also be reduced. See supra note 114 and accompanying text.
Shareholder compensation as dividend fraudulently inflated and is funded by Non-Class Shareholders who did not. This transfer is justified by the importance of compensating investors who suffer from Fundamental Declines.

Shareholder compensation is a loss-spreading mechanism that spreads the risk of fraud among shareholders. Shareholder compensation, which protects markets, is a necessary supplement to diversification, which protects individual investors. Shareholder compensation protects markets by helping to reduce the fraud discount that an investor would incorporate into the price of the stock. Insurance markets spread the costs of this mandatory insurance scheme among even more parties, and may be a more efficient way of spreading losses than a system that relies solely on diversification.

Some of the reasons for paying dividends have some applicability to shareholder compensation, though the analogy has limits. By reducing free cash flow, shareholder compensation can reduce agency costs and discipline managers who have demonstrated that they are in need of oversight. The signaling effect of any shareholder compensation tends to be ambiguous at best, while any diversification effect is trivial.

Shareholder compensation might better capture the signaling benefit if it is distributed as a preemptive dividend. In doing so, a corporation can send a clearer message to investors that it treats securities fraud seriously and is acting in the best interest of shareholders. Allowing corporations to resolve securities-fraud actions through a preemptive dividend might remedy the problems of a system where plaintiffs' attorneys may benefit more from securities-fraud actions than the shareholders.