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Adam C. Pritchard

University of Michigan Law School, acplaw@umich.edu

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Stoneridge Investment Partners v. Scientific-Atlanta: The Political Economy of Securities Class Action Reform

A. C. Pritchard*

I. Introduction

Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.1 is the latest in a series of recent Supreme Court decisions restricting securities class actions. The Court’s holding in Stoneridge—rejecting scheme liability that would have roped in third party defendants—is of a piece with the Court’s recent skepticism toward securities class actions. The Court’s recent decisions reflect a retrenchment from a two-decade-old decision by the Court, Basic, Inc. v. Levinson,2 which was the high-water mark for the implied cause of action the courts have found in the Securities Exchange Act § 10(b) and its implementing Rule 10b-5.3 Basic opened the doors wide to securities fraud class actions under Rule 10b-5 by creating a presumption of reliance for lawsuits involving securities traded in the secondary public markets—the fraud on the market theory (FOTM). The result of the Basic decision was an upsurge in securities class actions.

That upsurge was met by a predictable backlash from the targets of those suits: public companies and their officers and directors, accountants, and investment bankers. Those potential defendants complained that companies were unfairly targeted by securities class actions based on no more than a drop in the stock price, with the plaintiffs’ bar looking to extort settlements based on frivolous suits.

*Professor, University of Michigan Law School. Thanks to Alicia Davis Evans, Nico Howson, and Bob Thompson for helpful comments and suggestions.

And their complaints were heard by Congress and the Court, both of which have taken steps to rein in securities class actions. Congress enacted the Private Securities Litigation Reform Act,\(^4\) which imposes a series of procedural barriers for securities fraud class actions, and the Securities Litigation Uniform Standards Act,\(^5\) which checks efforts to evade the PSLRA’s barriers by resort to state court.\(^6\) The Court’s interpretations of those statutes have generally been considered defendant-friendly.\(^7\)

*Stoneridge* is certainly defendant-friendly; the Court put itself through serious intellectual contortions to get to its goal of exculpating secondary actors. *Stoneridge*’s interpretation of the reliance element, however, suggests that while the Court will resist expansion of the Rule 10b-5 cause of action, we cannot expect more fundamental reform from that quarter. In this essay, I compare the institutions and actors that might change how securities class actions work: the Court, Congress, the SEC, and shareholders.

I begin in Part II by explaining the wrong turn that the Court took in *Basic*. The *Basic* Court misunderstood the function of the reliance element and its relation to the question of damages. As a result, the securities class action regime established in *Basic* threatens draconian sanctions with limited deterrent benefit. Part III then summarizes the cases leading up to *Stoneridge* and analyzes the Court’s reasoning in that case. In *Stoneridge*, like the decisions interpreting the reliance requirement of Rule 10b-5 that came before it, the Court emphasized policy implications. Sometimes policy implications are invoked to broaden the reach of the Rule 10b-5 cause of action. More recently, policy implications have been invoked to narrow its reach. Part IV explores the policy choices made by Congress in the express private


\(^7\) See, e.g., Tellabs, Inc. v. Makor Issues & Rights, Ltd., 127 S. Ct. 2499 (2007); Merrill Lynch, Perce, Fenner & Smith, Inc. v. Dabit, 547 U.S. 71 (2006); Dura Pharmaceuticals, Inc. v. Broudo, 544 U.S. 336 (2005). My own view is that *Tellabs* was as generous to plaintiffs as the text of the PSLRA would allow. The opinion did, however, reverse a more generous, but implausible, interpretation from the Seventh Circuit.
causes of action in the securities laws, and the implications of those choices for securities fraud class actions under Rule 10b-5. The choices reflected in those explicit causes of action suggest that the Basic Court erred by failing to calibrate the damages measure in Rule 10b-5 class actions to accord with the attenuated version of reliance that it adopted. In secondary-market class actions, I argue, damages should be measured by disgorgement of unlawful gains rather than compensation of defrauded shareholders. Doing so would bring damages closer in line with social costs; more importantly, such a reform promises to make securities fraud class actions a more cost-effective mechanism for deterring fraud.

I then turn in Part V to the question of who can reform securities class actions. Which institution—the Court, Congress, the SEC, or shareholders—is most likely to bring about the needed changes to the damages measure? The available evidence suggests that the three government actors in this list are largely paralyzed from overhauling securities class actions in a meaningful way. I argue that shareholders, the parties who bear the costs of the current regime, must take matters into their own hands. I briefly outline the path by which shareholders could opt out of the current dysfunctional class action regime, replacing it with a more precisely targeted deterrent scheme focused on disgorgement. Part VI concludes.

II. The Basic Mistake

Congress did not create a private right of action when it enacted the anti-fraud provision in Exchange Act § 10(b). The courts, left to their own imagination in implying a cause of action under Rule 10b-5, have relied heavily on the requirements of the common law action for deceit. Reliance under the common law required the plaintiffs to allege that they had relied on the misstatement and that it affected their decision to purchase. Applying that model to the Rule 10b-5 cause of action, plaintiffs were required to allege that they read the misstatements that they claimed were distorting the price of a company’s stock before purchasing or selling that security.

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8 Dura Pharmaceuticals, 544 U.S. at 341 (2005) (private right of action under § 10(b) “resembles, but is not identical to, common-law tort actions for deceit and misrepresentation.”).
The Supreme Court, in a 4-2 vote with Justice Harry Blackmun writing for the majority, adopted a “fraud on the market” presumption of reliance in *Basic.* In *Basic,* the defendant company repeatedly denied that it was in merger negotiations. When the company eventually announced a merger at a substantial premium to its prevailing market price, disappointed shareholders who had sold during the time that the company was denying the merger negotiations brought suit. The Court (in another opinion by Justice Blackmun) had excused the reliance requirement in an earlier case, *Affiliated Ute Citizens of Utah v. United States,* in which the gravamen of the fraud had been deceptive nondisclosure in breach of a fiduciary duty. In that case, it was obviously impossible for the plaintiffs to plead actual reliance because the violation was a failure to speak, rather than a misstatement, so the Court concluded that materiality of the omission would “establish the requisite element of causation in fact.” The Court treated reliance as simply a subset of the tort concept of proximate causation (that is, whether the defendant’s conduct is sufficiently close to the plaintiff’s harm).

*Affiliated Ute*’s presumption of reliance did not extend, however, to affirmative misstatements. The reliance requirement for misstatements posed two obstacles to certifying a class of securities purchasers under Rule 10b-5, one rooted in the law and the other rooted in investor behavior. The legal obstacle lies in the standards for certifying a class action. If each member of the plaintiff class were required to allege that he had read and relied on the misstatement in making her decision to purchase, it would defeat the commonality requirement for class actions. The obstacle posed by investor behavior is that most purchasers of the company’s stock would not have read or heard the alleged misstatement, which would substantially limit

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9 Anthony Kennedy had not yet taken his seat as Lewis Powell’s replacement; Chief Justice William Rehnquist and Antonin Scalia recused themselves. Given their votes in other securities cases, it seems likely that the result would have been reversed if Kennedy, Rehnquist, and Scalia had participated.

10 406 U.S. 128 (1972) (fraudulent non-disclosure of certain conditions attaching to the transfer of commercial paper related to tribal trust assets).

11 *Id.* at 154.

12 Fed.R.Civ.P. 23(b)(3) (class action maintainable if “the court finds that the questions of law or fact common to the members of the class predominate over any questions affecting individual class members”).
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the size of the class. The FOTM presumption allows plaintiffs to skip the step of alleging personal reliance on the misstatement, instead allowing them to allege that the market relied on the misrepresentation in valuing the security. The plaintiffs in turn are deemed to have relied upon the distorted price produced by a deceived market. The empirical premise underlying the FOTM presumption is the efficient capital market hypothesis, which holds that efficient markets rapidly incorporate information—true or false—into the market price of a security. Thus, the price paid by the plaintiffs would have been inflated by the fraud, rendering the misstatement the cause in fact of the fraudulently induced purchase. The FOTM presumption assumes that purchasers would not have paid the prevailing market price if they knew the truth.\footnote{13}

The FOTM presumption avoids the evidentiary difficulties of showing actual reliance and, as a by-product, greatly expands the size of the class, thus increasing the potential amount of damages. Herein lies the problem: Once the FOTM presumption is in play, the potential damages available under Rule 10b-5 become enormous. Every investor who purchased during the time that a misstatement was affecting the company’s stock price—and did not sell it before the truth was revealed—has a cause of action and potential remedies under Rule 10b-5.\footnote{14} As a result, the question of damages takes on vital importance.

Blackmun and the Supreme Court punted on this question in Basic, brushing the point off in a footnote. Blackmun ducked the issue of damages at the insistence of Justice John Paul Stevens, who wanted it left for another day.\footnote{15} This is perhaps fortunate, because Blackmun might well have made things worse. He was focused solely on compensation; there is no evidence that he even considered disgorgement.\footnote{16} The elements of reliance and damages, however, 

\footnote{13}{The presumption also applies if the misstatement has depressed the price of the stock, although this scenario is much less common.}

\footnote{14}{Shareholders who purchased before the fraud are excluded by the “purchase or sale” requirement announced in Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975).}

\footnote{15}{Harry Blackmun, Conference Notes, Basic v. Levinson, No. 86-279 (November 4, 1987) (Harry A. Blackmun Collection, Library of Congress).}

\footnote{16}{Letter from Harry A. Blackmun to William J. Brennan, Jr., No. 86-279, Basic v. Levinson (January 15, 1988) (Thurgood Marshall Collection, Library of Congress) (“there are at least two theories of damages that a plaintiff could propose, and this opinion does not lend particular support to either . . . [T]he plaintiff could argue that}}
are not so easily severed. In adopting the FOTM presumption, Blackmun followed his earlier opinion in *Affiliated Ute*, which Blackmun characterized as holding that reliance was satisfied as long as ""the necessary nexus between the plaintiff’s injury and the defendant’s wrongful conduct had been established.""17

In *Affiliated Ute*, the connection between reliance and damages was self evident. The fraudulent transaction at issue fit neatly into the tort action for deceit. The plaintiffs’ losses corresponded to the defendants’ gains; the defendants had withheld material information about the value of the securities that they were purchasing from the plaintiffs. The ordinary “out of pocket” measure of tort damages—the difference between the price paid to the victim and the security’s “true” value—makes sense in this context. In this scenario, requiring that the defendant compensate the plaintiff for her losses corrects the distortions caused by fraud in two ways. First, requiring compensation to the victim discourages the defendant from committing fraud. Second, compensation discourages investors from spending resources trying to avoid fraud.18

Expenditures on committing fraud and avoiding fraud are the real social costs that the anti-fraud cause of action is trying to prevent, and they underlie the reliance element of the tort action for deceit. Expenditures by both the perpetrator and the victim due to fraud are a social waste, so discouraging those expenditures by requiring compensation makes sense when the corporation is benefiting from the fraud. Indeed, fraud may influence how investors direct their capital. Firms selling securities in the primary market disclose more information in an effort to attract investors. If those disclosures are fraudulent, investors will pay an inflated price for those securities and companies will invest in projects that are not cost-justified. That risk of fraud will lead investors to discount the value of securities,

he would not have sold had he known about the merger discussion, and thus that he should receive the difference between the price at which he sold ($18) and the eventual merger price ($42). Alternatively, one could argue that a plaintiff should recover the difference between the price he sold ($18) and what the price would have been had defendants not misrepresented the facts ($20).”

17 Basic, 485 U.S. at 243.

18 Paul G. Mahoney, Precaution Costs and the Law of Fraud in Impersonal Markets, 78 Va. L. Rev. 623, 630 (1992) (“If fraud is not deterred, market participants will take expensive precautions to uncover fraud so as to avoid entering into bargains they would not have concluded in an honest market.”).
thus raising the cost of capital for publicly traded firms. Fraud is worth deterring when the defendant is a party to the securities transaction, and requiring compensation ensures that fraud does not pay.

Basic’s FOTM presumption, however, does not require that the defendant have purchased or sold the security whose price was allegedly affected by the misstatement. In fact, in the overwhelming majority of securities fraud class actions, plaintiffs’ attorneys sue the corporation and its officers for misrepresenting the company’s operations, financial performance, or future prospects that inflate the price of the company’s stock in secondary trading markets. Because the corporation has not sold securities (and thereby transferred wealth to itself), it has no institutional incentive to spend real resources in executing the fraud—and thus no reason to encourage investor reliance.

On the other side of the equation, secondary-market fraud does not create a net wealth transfer away from investors, at least in the aggregate. 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. If we assume all traders are ignorant of the fraud, we can expect them to win as often as lose from fraudulently distorted prices. With no expected loss from fraud on the market, shareholders do not need to take precautions against the fraud. Thus, secondary-market fraud fits awkwardly in the confines of a tort action for deceit, which is premised on misrepresentation in a face-to-face transaction. In face-to-face transactions, parties naturally take precautions to manage the risk of fraud.

Oddly enough, the status of many shareholders as passive price takers in the secondary market was one of the rationales offered by the Basic Court for adopting the FOTM presumption. The Court has it exactly backwards: Because these shareholders are passive, they are not relying in the economically relevant sense, which is to say, they are not making a choice to forego verification. Verification is not an option for the passive investor; checking the accuracy of a


corporation’s statements is a task that can be taken on only by an investment professional, and even these sophisticated actors are unlikely to succeed in uncovering fraud. Passive investors can protect themselves against fraud much more cheaply through diversification. Fraud, like other business reversals, is a firm-specific risk, so assembling a broad portfolio of companies essentially eliminates its effect on an investor’s portfolio. The few bad apples will be offset by the gains from the honest companies. The irony of the FOTM presumption, intended to protect passive investors, is that the ultimate passive investors—holders of index funds—have already protected themselves against fraud in the secondary market, and at a very low cost.

Notwithstanding the ability of shareholders to protect themselves through diversification, the FOTM presumption, when coupled with the “out of pocket” tort measure of damages, puts the corporation on the hook to compensate investors who come out on the losing end of a trade at a price distorted by misrepresentation. The current rule applied by the lower courts holds corporations responsible for the entire loss of all of the shareholders who paid too much for their shares as a result of fraudulent misrepresentations. Critically, the “out of pocket” measure of damages provides no offset for the windfall gain on the other side of the trade. The investors lucky enough to have been selling during the period of the fraud do not have to give their profits back. Given the trading volume in secondary markets, the potential recoverable damages in securities class actions can be a substantial percentage of the corporation’s total capitalization, easily reaching hundreds of millions of dollars, and sometimes billions. With potential damages in this range, class actions are a big stick to wield against fraud. More importantly, the “out of pocket” measure exaggerates the social harm caused by FOTM because it fails to account for the windfall gains of equally innocent shareholders who sold at the inflated price. Absent insider trading, the losses and gains will be a wash for shareholders in the aggregate, even though some individual shareholders will have suffered substantial losses.

The case for deterring fraud with enormous damages is weaker when the corporation does not benefit from the fraud. The standard argument for vicarious liability in this context is that it will encourage the company to take precautions to prevent the fraud. A similar argument applies to third parties, such as accountants and investment banks. This argument, however, assumes that fraud sanctions are being imposed accurately. Securities fraud class actions are inevitably scattershot. Distinguishing fraud from mere business reversals is difficult. The external observer may not know whether a drop in a company’s stock price is attributable to a prior intentional misstatement about its prospects (i.e., fraud) or a result of risky business decisions that did not pan out (i.e., misjudgment or bad luck). Unable to distinguish the two, plaintiffs’ lawyers must rely on limited publicly available indicia (SEC filings, press releases from the company, evidence of insider trading by the managers alleged to be responsible for the fraud, the rare instance of a public revelation by a whistle-blower, etc.) when deciding whom to sue. Thus, a substantial drop in stock price following news that contradicts a previous optimistic statement may well produce a lawsuit.

That leaves courts with the difficult task of sorting the meritorious cases from those with weak evidence of fraud (so-called strike suits). Courts and jurors, with hindsight, may have difficulty distinguishing false statements (which were known to be false at the time) from unfortunate business decisions. Both create a risk of liability and thus provide a basis for filing suit. If plaintiffs can withstand a motion to dismiss, defendants generally will find settlement more attractive than litigating to a jury verdict, even if the defendants believe that a jury would share their view of the facts. From the company’s perspective, the enormous potential damages make the merits of the suit a secondary consideration in the decision of whether or not to settle. The math is straightforward: A 10 percent chance of a $250 million judgment means that a settlement for $24.9 million makes sense. For many companies facing a securities fraud class action, the choice is settle or risk the very real possibility of a jury verdict that threatens bankruptcy.

22 See Janet Cooper Alexander, Rethinking Damages in Securities Class Actions, 48 Stan. L. Rev. 1487, 1511 (1996) (“The class-based compensatory damages regime in theory imposes remedies that are so catastrophically large that defendants are unwilling to go to trial even if they believe the chance of being found liable is small.”).
If the threat of bankruptcy-inducing damages were not enough, any case plausible enough to get past a judge may be worth settling just to avoid the costs of discovery and attorneys’ fees, which can be enormous in these cases. Securities fraud class actions are expensive to defend because the focus of litigation will often be scienter: What did the defendants know, and when did they know it? The most helpful source for uncovering those facts will be the documents in the company’s possession. Producing all documents relevant to the knowledge of senior executives over many months or even years—for example, all email sent or received by the top management team—can be a massive undertaking for a corporate defendant. Having produced the documents, the company can then anticipate a seemingly endless series of depositions, as plaintiffs’ counsel investigates whether the executives’ recollections square with the documents. Beyond the cost in executives’ time, the mere existence of the class action may disrupt relationships with suppliers and customers, who will be understandably leery of dealing with a business accused of fraud.\(^\text{23}\)

The recent experience of JDS Uniphase is illustrative.\(^\text{24}\) After five years of litigation, the company was eventually exonerated by a jury after a trial—one of only four securities class actions to go to verdict out of 2,105 suits filed since 1995. The company knew that it was risking bankruptcy if it lost, but was unable to come to terms with the plaintiffs. JDS gambled and won—but only after paying a reported $50 million in legal fees. Even if JDS had been certain that it would prevail at trial, it would have been economically rational to settle the case when it was filed for $49 million. Combine this calculus with one other data point: The median settlement in securities fraud class actions was $6.4 million from 2002 to 2007.\(^\text{25}\) Given JDS’s experience, it is difficult to argue that any suit likely to be

\(^{23}\) See, e.g., Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 742–43 (1975). The cost of discovery has been ameliorated somewhat by the PSLRA, which limits discovery while a motion to dismiss is pending. 15 U.S.C. § 78u-4(b)(3)(B).


\(^{25}\) NERA Economic Consulting, Recent Trends in Shareholder Class Action Litigation: Filings Stay Low and Average Settlements Stay High—But Are These Trends Reversing? (September 2007). The average settlement was $23.2 million during that period.
filed that gets past a motion to dismiss can be defended for less than $6.4 million. This means that at least half of the suits that produce a settlement are settling for essentially nuisance value.

In sum, the combination of the potential for enormous judgments and the cost of litigating securities class actions means that even weak cases may produce a settlement if they are not dismissed at the complaint stage. The deterrent effect of class actions is thus diluted, because both wrongful and innocent conduct is punished. This possibility of extracting multimillion dollar settlements from strike suits has driven post-Basic efforts to rein in securities class actions. I turn now to the Court’s part in those efforts.

III. Stoneridge

As noted above, Stoneridge is the latest salvo in the Court’s efforts to combat strike suits. The Court’s most controversial post-Basic effort to curtail securities class actions also happens to be the precursor to Stoneridge: Central Bank of Denver v. First Interstate Bank of Denver. Central Bank, like Stoneridge, was written by Justice Anthony Kennedy. The issue presented in Central Bank was whether private civil liability under § 10(b) (the authorizing statute for Rule 10b-5) extends to aiders and abettors of the violation. The issuer of the securities in the case was the Public Building Authority, which raised $26 million in bonds to finance public improvements at planned residential/commercial development in Colorado. Central Bank acted as indenture trustee for the bonds. The bonds were secured by liens on real property, with a covenant requiring that the assessed value of that land must be at least 160 percent of the bonds’ outstanding principal and interest. Additional covenants required AmWest Development—the developer—to give annual reports showing that the 160 percent test was being met.

Before an issue of the bonds in 1988 (but after a previous issue in 1986), AmWest gave Central Bank an updated appraisal showing no change in value of land from 1986. But the senior underwriter of the 1986 bond issue sent Central Bank notice questioning the 1986 valuation because property values had dropped in the region.


27 See Ernst & Ernst v. Hochfelder, 425 U.S. 185, 214 (1976) (holding that Rule 10b-5’s “scope cannot exceed the power granted the Commission by Congress under § 10(b)”).

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Central Bank asked its in-house appraiser to review the 1988 appraisal, who concluded that it was too optimistic. Instead of insisting on a new independent appraisal, Central Bank agreed to delay the outside full appraisal until after the 1988 bond offering. The building authority later defaulted and the bondholders filed suit against Central Bank, alleging that the bank had aided and abetted the Building Authority’s Rule 10b-5 violation.

Blackmun assigned the opinion to Kennedy, who had voted at conference to uphold the aiding and abetting cause of action.\(^{28}\) After further review, however, Kennedy switched his vote.\(^{29}\) The open-ended nature of aiding and abetting liability clearly raised concerns about strike suits for Kennedy. He warned that uncertainty over the scope of liability could induce secondary actors to settle “to avoid the expense and risk of going to trial.”\(^{30}\) The risk of having to pay such settlements could cause professionals, such as accountants, to avoid newer and smaller companies, and “the increased costs incurred by professionals because of the litigation and settlement costs under 10b-5 may be passed on to their client companies, and in turn incurred by the company’s investors, the intended beneficiaries of the statute.”\(^{31}\)

In an effort to increase Rule 10b-5’s predictability, Kennedy’s opinion adopted a two-part framework for addressing the scope of the private right of action under § 10(b), a significant departure from the free-wheeling approach of \textit{Basic}.\(^{32}\) In the first step of the inquiry,


\(^{29}\) Letter from Anthony M. Kennedy to Harry A. Blackmun, Re: Central Bank v. First Interstate, No. 92-854 (February 17, 1994) Harry A. Blackmun Papers, Library of Congress. (“After working through the cases, particularly \textit{Blue Chip Stamps}, \textit{Ernst & Ernst}, \textit{Pinter}, and \textit{Musick}, I came to the conclusion that our precedents require us to confine the 10b-5 cause of action to primary violators, without extension to aiders and abettors.”).

\(^{30}\) Central Bank, 511 U.S. at 189.

\(^{31}\) \textit{Id.}

\(^{32}\) I apply the two-step inquiry of \textit{Central Bank} to the relationship between reliance and damages below.
Kennedy examined the text of § 10(b) to determine the scope of the conduct prohibited by the provision. He had little difficulty determining that the text of § 10(b) “prohibits only the making of a material misstatement (or omission) or the commission of a manipulative act.” This, in Kennedy’s view, was sufficient to resolve the question: aiding and abetting was not prohibited by § 10(b).

Nonetheless, Kennedy set forth a second-step to the inquiry:

When the text of § 10(b) does not resolve a particular issue, we attempt to infer how the 1934 Congress would have addressed the issue had the 10b-5 action been included as an express provision in the 1934 Act. For that inquiry, we use the express causes of action in the securities Acts as the primary model for the § 10(b) action. The reason is evident: Had the 73d Congress enacted a private § 10(b) right of action, it likely would have designed it in a manner similar to the other private rights of action in the securities Acts. . . .

The plaintiffs’ argument also failed under this second step, because the explicit causes of action afforded by Congress in the Securities Act and the Exchange Act were similarly silent on the question of aiding and abetting.

In passing, Kennedy noted one additional problem with the plaintiffs’ argument, which would have important consequences in Stone-ridge: “Were we to allow the aiding and abetting action proposed in this case, the defendant could be liable without any showing that the plaintiff relied upon the aider and abettor’s statements or

33 Central Bank, 511 U.S. at 177.

34 Id. at 178 (citations and internal quotation marks omitted). The Court has used the approach of looking to express causes of action to infer appropriate elements under the implied cause of action under Rule 10b-5 in other cases. Lampf, Pleva, Lipkind, Purpis & Petigrow v. Gilbertson, 501 U.S. 350 (1991) (applying statute of limitations from Securities Act claims to Rule 10b-5 claim); Musick, Peeler & Garrett v. Employers Ins. of Wausau, 508 U.S. 286, 297 (1993) (finding an implied right of contribution under Rule 10b-5 based on express right of contribution under explicit causes of action in the Exchange Act).

35 Whether the question is resolved under the first or the second step of this inquiry has potentially significant consequences. When the Court interprets § 10(b), it is defining not only the limits of the private cause of action, but also the reach of the SEC’s authority. When it constructs the hypothetical cause of action in the second step, only the private cause of action is implicated.
actions.’’36 The Court left the door open for some liability for secondary participants, such as accountants, investment bankers, and lawyers, but only if they have exposed themselves to that risk by acting in a way that induces investor reliance. The bottom line after Central Bank is that a defendant must make a misstatement (or omission) on which a purchaser or seller of a security relies. Kennedy did not explain further the connection between reliance and the scope of Rule 10b-5; that issue would reemerge in Stoneridge.

If Central Bank was intended to enhance predictability, Kennedy’s effort failed. What did it mean to “make” a misstatement? What sort of reliance was required? Not surprisingly, the lower courts arrived at different answers to these questions. The Ninth Circuit found that substantial participation in the making of a misstatement would suffice, even without public attribution of that statement to the defendant.37 The Second Circuit adopted a narrower approach, finding participation in the making of a statement insufficient; public attribution of the statement to the defendant was required.38

This split over the interpretation of Central Bank’s holding brought the question of the scope of a primary violation of Rule 10b-5 back to the Court in Stoneridge. The Stoneridge plaintiffs attempted an end run around Central Bank: Instead of alleging that the secondary defendants had made or participated in the making of a misstatement, the plaintiffs alleged that the secondary defendants were part of a “scheme to defraud,” thus invoking a separate provision of Rule 10b-5’s anti-fraud prohibition.39

The scheme alleged by the plaintiffs in Stoneridge involved two suppliers of the cable company Charter Communications. The plaintiffs’ complaint alleged that Charter engaged in a massive accounting fraud that inflated Charter’s reported operating revenues and cash flow. The plaintiffs also named as defendants two equipment suppliers who provided cable set-top boxes to Charter, Scientific-Atlanta, and Motorola. The plaintiffs alleged that Charter paid the suppliers $20 extra for each set-top box in return for the supplier’s agreement

36 Central Bank, 511 U.S. at 180.
37 In re Software Toolworks Inc. Sec. Litig., 50 F.3d 615, 628–629 (9th Cir. 1994).
38 Wright v. Ernst & Young, LLP, 152 F.3d 169, 175 (2d Cir. 1998).
to make additional payments back to Charter in the form of advertising fees. Charter then capitalized the $20 extra expense (shifting the accounting cost into the future) while treating the advertising fees as current income, artificially boosting Charter’s current accounting revenues at the expense of future income. The suppliers had no direct role in preparing or disseminating the fraudulent accounting information, nor did they approve Charter’s financial statements. The plaintiffs alleged, however, that the vendors facilitated Charter’s deceptions by preparing false documentation and backdating contracts. The district court granted the suppliers’ motion to dismiss, relying on *Central Bank* to hold that the vendors were not primary violators for Rule 10b-5 purposes. The court of appeals affirmed, concluding that the suppliers had not engaged in any deception because they had made no misstatements, had no duty to disclose to Charter’s investors, and had not engaged in manipulation of Charter’s shares.\(^{40}\)

The Supreme Court, by a vote of 5–3 (with Justice Stephen Breyer recused), affirmed. Justice Kennedy, writing for the Court, rejected the appellate court’s holding that there was no deception, noting that “[c]onduct itself can be deceptive.”\(^{41}\) He instead hung the affirmance on the other doctrinal point from his *Central Bank* decision, the incompatibility of aiding and abetting liability with the “essential element” of reliance.\(^{42}\) He concluded that Blackmun’s presumptions of reliance from *Affiliated Ute* and *Basic* did not apply because the suppliers had no fiduciary duty to Charter’s shareholders and the suppliers’ statements were not disseminated to the public. In this case, investors relied on Charter for its financial statements, not the cable set-top box transactions underlying those financial statements. Why did Kennedy focus on the defendants’ conduct, rather than the plaintiffs, when assessing reliance? According to Kennedy, “reliance is tied to causation, leading to the inquiry whether [suppliers’] acts were immediate or remote to the injury.”\(^{43}\) Kennedy, following Blackmun’s lead, was treating the reliance inquiry as a species of the tort concept of proximate cause.

\(^{40}\) In re Charter Communications, Inc. Sec. Litig., 443 F.3d 987, 990–93 (8th Cir. 2006).

\(^{41}\) Stoneridge, 128 S.Ct. at 769.

\(^{42}\) Id.

\(^{43}\) Id. at 770.
Like Central Bank, Kennedy’s principal concern was the specter of unlimited liability. According to Kennedy, "[w]ere this concept of reliance to be adopted, the implied cause of action would reach the whole marketplace in which the issuing company does business."44 If accepted, the plaintiff’s theory threatened to inject the § 10(b) cause of action into "‘the realm of ordinary business operations.’"45

Kennedy’s rationale for limiting the concept of reliance could have more naturally been put into the "‘in connection with the purchase or sale of any security’” language from § 10(b). Kennedy pointed to that language, but said that it did not control in this case because the "‘in connection with’” requirement goes to the "‘statute’s coverage rather than causation.’"46 Another reason for not putting the limit into that doctrinal category is that the Court had only recently affirmed a very broad scope for that requirement.47 A more substantial reason is that cabining Rule 10b-5 through the "‘in connection with the purchase or sale’” requirement would limit not only private plaintiffs but, potentially, the SEC, whose enforcement authority is limited by the reach of the statute. Kennedy conceded that the SEC’s enforcement authority might reach commercial transactions such as those between Charter and its suppliers, but he was reluctant to grant the same freedom to the plaintiffs’ bar.48

Given the need to cabin the plaintiffs’ bar, but maintain the SEC’s discretion, the reliance requirement was an attractive tool. The reliance requirement, despite being an "‘essential element,’” has no basis in the language of § 10(b), but is instead derived from the common law of deceit.49 More importantly for Kennedy’s purposes, reliance does not apply in enforcement actions brought by the SEC, or criminal prosecutions brought by the Justice Department.50 Putting the

44 Id.
45 Id.
46 Id.
48 Stoneridge, 128 S.Ct. at 770–771 ("Were the implied cause of action to be extended to the practices described here . . . there would be a risk that the federal power would be used to invite litigation beyond the immediate sphere of securities litigation and in areas already governed by functioning and effective state-law guarantees.").
49 See, e.g., List v. Fashion Park, Inc. 340 F.2d 457 (2d Cir. 1965).
50 Geman v. SEC, 334 F.3d 1183, 1191 (10th Cir. 2003) ("The SEC is not required to prove reliance or injury in enforcement cases."); United States v. Haddy, 134 F.3d 542, 549–51 (3d Cir. 1998) (government need not prove reliance in criminal case).
limit on secondary party liability in the reliance element allowed the Court to have its cake—unfettered government enforcement—and eat it too—constrain the scope of private actions.

The importance of the SEC’s enforcement efforts had been reinforced by Congress’s response to Central Bank. Rebuffing calls to restore aiding-and-abetting liability, Congress instead gave that authority only to the SEC.  Accepting the plaintiff’s argument in Stoneridge, Kennedy reasoned, would thus “undermine Congress’ determination that this class of defendants should be pursued by the SEC and not by private litigants.” The Court’s rationale for the need to constrain private litigants echoed and amplified the policy concerns of Central Bank. Expanding liability would undermine the United States’ international competitiveness and raise the cost of capital because companies would be reluctant to do business with American issuers. Issuers might list their shares elsewhere to avoid these burdens.

Most telling was the Court’s treatment of the basic question of the existence of the implied private right of action. Kennedy made it clear that the initial implication of a private cause of action had been a mistake; under current doctrine, private causes of action are based only on explicit instruction from Congress. Having now recognized the mistake, the Court was not going to compound the error: “Concerns with the judicial creation of a private cause of action caution against its expansion. The decision to extend the cause of action is for Congress, not for us. Though it remains the law, the § 10(b) private right should not be extended beyond its present boundaries.” Thus, Stoneridge stands for the proposition that the

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52 Stoneridge, 128 S.Ct. at 771.
53 Id. at 772.
54 Id. (“Though the rule once may have been otherwise, it is settled that there is an implied cause of action only if the underlying statute can be interpreted to disclose the intent to create one.”) (citations omitted). See also Id. at 779 (Stevens, J., dissenting) (“A theme that underlies the Court’s analysis is its mistaken hostility towards the § 10(b) private cause of action. The Court’s current view of implied causes of actions is that they are merely a relic of our prior heady days.”) (citations and internal quotation marks omitted).
55 Id. at 773.
Rule 10b-5 cause of action is now frozen, at least when it comes to the expansion of liability.\textsuperscript{56}

IV. Fixing the Mistake

How do we fix the problem created by Basic? One way of getting at this question is through revisionist history. How would the reliance question in Basic have come out if we applied the two-step inquiry from Central Bank? Step 1: What does the statutory text tell us? Nothing; Congress did not mention reliance in §10(b), hardly a surprise given that it did not intend to create a private cause of action. That silence sends us to the second step, which attempts to glean Congress’s intent with respect to the implied cause of action under Rule 10b-5 by looking to the explicit private causes of action in the securities laws. What do those explicit causes of action tell us about the appropriate relation between damages and reliance under Rule 10b-5? They tell us that the Court has made a mistake in thinking about the implied right of action under Rule 10b-5 as a species of the tort action for deceit. The focus should be deterrence; a more apt model for the FOTM action would be unjust enrichment.\textsuperscript{57}

There are six explicit causes of action relevant to our inquiry.\textsuperscript{58} The first two come from the Securities Act of 1933. How do these causes of action treat reliance? Section 11 of that law allows the plaintiff to sue a corporate issuer, along with its officers and directors, for damages if the company has a material misstatement in its registration statement for a public offering.\textsuperscript{59} Section 11 has no reliance requirement. Plaintiffs do not need to have read the registration statement that is alleged to be misleading. Damages, however, are

\textsuperscript{56}See Id. ("when [the aiding and abetting provision of the PSLRA] was enacted, Congress accepted the § 10(b) private cause of action as then defined but chose to extend it no further.").

\textsuperscript{57}On the unjust enrichment measure under Rule 10b-5, see Thompson, supra note 21.

\textsuperscript{58}Two other provisions, §15 of the Securities Act, 15 U.S.C. §77o, and §20 of the Exchange Act, 15 U.S.C. §78t, extend liability to control persons of violators of those laws. It seems reasonable to conclude, however, that the control person benefited from the wrongdoing of its affiliate if the affiliate benefited. Even then liability is excused if the control person can show that it acted in good faith and was not complicit in the wrongdoing.

\textsuperscript{59}15 U.S.C. §77k.
limited to the offering price. The corporate issuer’s liability exposure cannot be greater than its benefit from the fraud. Section 12(a)(2) provides a parallel cause of action for material misstatements in a prospectus or an oral statement made in connection with a public offering. Section 12(a)(2) also does not require reliance, but its remedy is rescission—plaintiffs who prevail are entitled to put their shares back to the seller in exchange for their purchase price (or rescissory damages, if the plaintiff has sold before bringing suit). Under either formula, damages are limited to the amount that the seller received from the investor. This parallels the unjust enrichment measure, not the out-of-pocket measure from tort.

Turning to the Exchange Act private causes of action, § 28 preserves existing rights and remedies, but bars plaintiffs from recovering “a total amount in excess of his actual damages on account of the act complained of.” This provision clearly bars double recovery, but has also been construed to bar punitive damages. It tells us nothing, however, about the relation between reliance and damages.

Section 9(e) allows for recovery in cases of market manipulation. Section 9 does not require reliance, and it is silent on the measure of damages. There is little doubt, however, that the defendant in a manipulation case is benefiting from the fraud. Manipulation requires a showing of intent, and it is hard to conjure up incentives for market manipulation other than extracting profits from that market. Although reliance is not required, § 9 does impose a challenging standard requiring the plaintiff to show that his transaction “price . . . was affected by” the manipulation, a difficult task in the face of the myriad influences that can affect the price of a security. The requirement that plaintiff tie his losses to the manipulation inevitably means that there will be some correspondence between the plaintiff’s losses and the defendant’s gains.

60 Id. at § 77k(g).
61 Id. at § 77l(a)(2).
62 Under certain circumstances, § 12(a) allows for recovery from persons who have solicited on behalf of the seller. See Pinter v. Dahl, 486 U.S. 622 (1988).
66 There is little case law on this subject, as § 9(e) “has been virtually a dead letter so far as producing recoveries is concerned.” Louis Loss & Joel Seligman, Securities Regulation 4279 (3rd Ed. 2004).
More illuminating are the two explicit causes of action allowing for recovery from insider traders. Neither cause of action requires reliance, but both limit damages to the benefit that the insider trader obtained from his violation. They are therefore modeled on unjust enrichment, and not the tort model of deceit. First, § 16(b) allows shareholders to bring derivative suits on behalf of the corporation to recover “short swing” gains made by insiders trading in the company’s shares (that is, profits gained, or losses avoided, for “round trip” transactions—buy/sell or sell/buy—within six months of each other). The remedy is limited to the defendant’s benefit from the violation, in this case the profits the insider gained (or the losses he avoided) within the six-month period that defines the offense. Second, § 20A creates a private cause of action for insider trading, this time for conduct that violates § 10(b) because the insider has breached a duty of disclosure. The provision allows investors who have traded contemporaneously with insiders to recover damages from those insider traders. Reliance is excused in such cases by Affiliated Ute, but damages once again are limited to “the profit gained or loss avoided in the transaction.” Moreover, even that measure is reduced by any disgorgement obtained by the SEC based on the same violations. Thus, where the Exchange Act excuses reliance, recovery is limited to the defendant’s gain, not the plaintiff’s loss.

Completing our survey of the explicit causes of action in the principal securities laws, § 18 of the Exchange Act comes closest to the Rule 10b-5 FOTM class action. Section 18 allows investors who have relied on a corporation’s filings with the SEC to recover damages for misstatements in those filings. Section 18 does not limit damages, thus standing in sharp contrast to the other causes of action. It is also unique in requiring that a plaintiff demonstrate that he purchased or sold “in reliance upon” the misstatement in

70 Id. § 78r.
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the company’s filings with the SEC.\textsuperscript{71} Damages are limited to the "damages caused by such reliance," an implicit recognition by the 1934 Congress of the connection between reliance and the social costs of fraud. Section 18 is best understood as a statutory expansion of the tort cause of action for deceit, premised on the assumption that SEC filings are in reality communications directed toward shareholders. Shareholders who rely on them have invested in information and should be compensated if the communications are false or misleading.

The basic principle that emerges from these explicit causes of action is that damages should be limited to some measure of the defendant’s benefit (the disgorgement measure of unjust enrichment), unless the plaintiff can show actual reliance on the misstatement, in which case the out-of-pocket measure from the action for deceit is appropriate.\textsuperscript{72} The choices made by Congress in these explicit causes of action are consistent with my argument in Part II that the damages measure currently used in FOTM actions is simply too large because the damages available do not track the social costs of secondary-market fraud. If we limit § 10(b) damages in the way the explicit securities causes of action do, only those plaintiffs who can show actual reliance would be entitled to recover the "out of pocket," compensatory measure of losses, assuming that they can show that the losses were proximately caused by the defendant’s misstatement. This follows the pattern of § 18, but that does not render the Rule 10b-5 cause of action redundant. Rather than being limited to misstatements in SEC filings, plaintiffs could also recover if they relied on press releases or statements by company officers. Such plaintiffs are investing in information; if we believe that their investments are worthwhile, we need to compensate those plaintiffs when their reliance has been fraudulently manipulated.\textsuperscript{73}

\textsuperscript{71} Id. § 78r(a). Section 18 further stands out in allowing the court to assess reasonable attorneys’ fees against the losing party, which no doubt goes a long way toward explaining the provision’s disuse.

\textsuperscript{72} The Court noted the actual reliance requirement of § 18 in Basic, 485 U.S. at 243, but essentially ignored it.

\textsuperscript{73} Mahoney, supra note 18, at 632 (arguing that wealth transfer can serve as a proxy for investment in lying, precaution costs and allocative losses where fraud results in transfer from victim to fraudster).
For plaintiffs who cannot make a showing of actual reliance (the passive price takers), a disgorgement rule would bring about a substantial departure from current practice.\textsuperscript{74} Under the current “out of pocket” rule, corporations are liable for all losses resulting from public misstatements by their agents. If we limited the remedy for Rule 10b-5 to a benefits rule when the plaintiffs could not demonstrate actual reliance, we would force defendants to disgorge their gains (or possibly expected gains, for those who fail in their scheme) from the fraud. So if a corporation were issuing securities while distorting the market price of its stock, it would be required to disgorge to investors the amount by which it inflated the price of the securities.

In most FOTM cases, however, the corporation has not benefited from the misrepresentation that is the basis of the class action. Indeed, the corporation is usually the victim of the fraud. The corporation is victimized when executives are awarded a bonus that is undeserved because they create the appearance of having met the target stock price. The corporation is also victimized when CEOs keep their job for a bit longer than they should because they create the appearance of adequate performance.\textsuperscript{75} The proper remedy in such cases is for the executives to return the bonus or salary earned from the fraud. And if the executives benefit from the fraud by cashing out stock options at an inflated price, those profits also can be disgorged.

Reformulating damages under Rule 10b-5 to focus on disgorgement will sharpen the deterrent effect of securities class actions. The “out of pocket” measure of damages currently used encourages plaintiffs’ lawyers to pursue the wrong party—the corporation. The current regime for secondary-market class actions largely produces an exercise in “pocket shifting.”\textsuperscript{76}

\textsuperscript{74} I have previously proposed such a move in Should Congress Repeal Securities Class Action Reform? Cato Policy Analysis No. 471 (2003), reprinted in After Enron: Lessons for Public Policy (William A. Niskanen, ed., 2004).


\textsuperscript{76} Janet Cooper Alexander, Rethinking Damages in Securities Class Actions, 48 Stan. L. Rev. 1487, 1503 (1996) (“Payments 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.”).
Traditionally, class action settlements have not included a contribution from corporate officers individually. Plaintiffs’ lawyers forgo that source of recovery because they can reach a settlement much more quickly if they do not insist on a contribution from the individual defendants. The only reason that officers and directors are named is to improve the plaintiffs’ lawyers’ bargaining position. The big money for plaintiffs’ attorneys is in pursuing the corporation and its insurers, and the officers and directors are happy to buy peace for themselves with the corporation’s money. The dirty secret of securities class actions is that companies and their insurers pay the costs of settlement, which effectively means that shareholders are paying the costs of settlements to shareholders. Settlement payments and insurance premiums reduce the cash flow available for dividends and share repurchases.

A disgorgement measure of damages would take away the corporation’s exposure when it did not benefit from the fraud, thereby increasing the attorneys’ incentive to pursue the executives responsible for the fraud. Instead of relying on the corporation’s coffers for their payday, plaintiffs’ lawyers would have to extract settlements from executives’ bonuses and stock options. Deterrence is maximized by sanctioning the person who is most at fault for the fraud, so turning the sights of the class action bar on the culpable individuals would give us substantially more deterrent bang for our class action buck. And reducing the potential dollar figures involved would eliminate the ability of plaintiffs’ lawyers to extract nuisance settlements in weak cases. If defendants believe they can prevail at trial, a small probability of losing an enormous judgment will no longer tip the balance in favor of settlement. We can expect more cases would be tried to a jury, which would give us a much better picture of what Rule 10b-5 actually prohibits. As it stands now, we are mainly making informed guesses based on judicial resolution of motions to dismiss, which apply a standard much more generous to the plaintiffs.

77 See Arlen & Carney, supra note 75, at 719 (“Although compensating victims may be a laudable goal, enterprise liability does not serve the goal of just compensation because it simply replaces one group of innocent victims with another: those who were shareholders when the fraud was revealed. Moreover, enterprise liability does not even effect a one-to-one transfer between innocent victims: a large percentage of the plaintiffs’ recovery goes to their lawyers.”).
V. The Political Economy of Securities Class Action Reform

The answer to the problem created by Basic is straightforward—fix the damages measure. Getting to that answer in the real world, however, is considerably more complicated. How can we shift from deceit to unjust enrichment, thereby recalibrating the damages rule for §10(b) suits to focus on deterrence? Which body—the Supreme Court, Congress, the SEC, or shareholders acting collectively—is most likely to bring about the needed reform?78

A. The Supreme Court?

The Court does not hear a lot of securities cases, averaging about one case per year. The Court’s wariness here is not surprising, given the dearth of prior experience that the current justices have in the field. The members of the Court are all former government officials, academics, appellate advocates, etc. Simply put, they are not equipped to confront the highly technical field of securities law. It has been more than 20 years since the last justice with substantial experience as a corporate lawyer—Lewis F. Powell, Jr.—retired from the Court.79

Unfortunately, Powell retired before Basic was decided (though one of his last votes to grant certiorari in a securities case was Basic Inc. v. Levinson). The Court’s efforts since his departure do not instill confidence; its forays into this area have been occasionally impenetrable80 and sometimes bizarre.81 The Court is at its most coherent when it simply regurgitates the SEC’s party line.82 In sum, the Court

78 I have previously made a similar proposal for reforming securities fraud enforcement, suggesting that it could be implemented through the exchanges. See A. C. Pritchard, Markets as Monitors: A Proposal to Replace Class Actions with Exchanges as Securities Fraud Enforcers, 85 Va. L. Rev. 925 (1999). The exchanges have not taken me up on the suggestion.


80 See Virginia Bankshares, Inc. v. Sandberg, 501 U.S. 1083, 1109 (1991) (Scalia, J., concurring) (describing the Court’s opinion as a “psychic thicket”).


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is essentially rudderless when it ventures into the deep waters of securities regulation. 83

Looking at the question of reliance, it is difficult to extract any consistent guiding principle from Affiliated Ute, Basic, Central Bank, and Stoneridge. Justice Stevens, dissenting in Stoneridge (as he had in Central Bank), hammered on this point:

Basic is surely a sufficient response to the argument that a complaint alleging that deceptive acts which had a material effect on the price of a listed stock should be dismissed because the plaintiffs were not subjectively aware of the deception at the time of the securities’ purchase or sale. This Court has not held that investors must be aware of the specific deceptive act which violates § 10(b) to demonstrate reliance. . . .

The fraud-on-the-market presumption helps investors who cannot demonstrate that they, themselves, relied on fraud that reached the market. But that presumption says nothing about causation from the other side: what an individual or corporation must do in order to have “caused” the misleading information that reached the market. The Court thus has it backwards when it first addresses the fraud-on-the-market presumption, rather than the causation required. 84

It is fair to say that Justice Blackmun, who wrote Affiliated Ute and Basic, would have reached a different outcome in Stoneridge. As Blackmun noted in his memo to the file after reviewing the Affiliated Ute briefs, “I feel we should plump for a high standard in this area, and that this is in line with the intent of Congress in enacting the legislation.” 85 Blackmun set a “high standard” in Affiliated Ute and Basic; Kennedy ratcheted it down in Central Bank and Stoneridge.

The point is not that one side or the other is correct in their divining of congressional intent. That quest seems futile. Rule 10b-5’s reliance element is nowhere to be found in the language of § 10(b).

83 See Donald C. Langevoort, Words from on High About Rule 10b-5: Chiarella’s History, Central Bank’s Future, 20 Del. J. Corp. L. 865, 868 (1995) (“[S]cholars and learned practitioners are giving the Court’s securities law opinions low grades for logic, clarity, and usefulness in future cases.”).

84 Stoneridge, 128 S.Ct. at 776 (Stevens, J., dissenting).

85 Harry A. Blackmun, Memo, No. 70-78—Affiliated Ute Citizens v. United States (10/18/71), Harry A. Blackmun Papers, Library of Congress.
or Rule 10b-5; the Court borrowed it from the common law of deceit. But the Court does not refer to the common law when it is interpreting the reliance requirement for the Rule 10b-5 private cause of action. In Stoneridge, Kennedy brusquely rejected the argument that the plaintiffs had adequately pled reliance under common law standards: “Even if the assumption is correct, it is not controlling. Section 10(b) does not incorporate common-law fraud into federal law.”

It would seem more accurate to say that the incorporation is selective: The Court borrows the common law element of reliance, without really explaining why, but then disregards it when inconvenient, as it did in adopting the FOTM theory in Basic and Kennedy’s rejection of common law standards in Stoneridge. The Court treats the reliance element as a do-it-all tool to implement its policy choices of the moment, without fully understanding the implications of those choices. It is charting its own common law course but its interventions are episodic; the Court takes an insufficient number of securities cases to develop this “common law” in any meaningful manner.

The interpretive approach of Central Bank purports to depart from the common law interpretation that typified Rule 10b-5 for many years. Cases like Affiliated Ute and Basic focused on assuring recovery for the plaintiffs, with little regard for the costs created by private litigation. Generally, the Court used a common law, policy-oriented approach when it was expanding Rule 10b-5, viewing the private cause of action as an “essential supplement” to the SEC’s enforcement efforts. Central Bank promised a textual, formalist approach when the Court turned to reining in the reach of the private cause of action. Stoneridge, with its return to a fuzzy “requisite causal connection” notion of reliance, fails to deliver on that promise, instead returning to an essentially common law mode of decision-making. The opinion does little more than tell us that the defendants’ conduct was “too remote” for plaintiffs to rely on. The bottom line is that both factions of the Court manipulate the reliance element to achieve their preferred scope for the securities fraud cause of action.

86 Stoneridge, 128 S.Ct. at 771.
88 Stoneridge, 128 S.Ct. at 769 (quoting Basic, 485 U.S. at 243).
89 Id. at 770.
Moreover, the Court has offered scant guidance on Rule 10b-5 damages, addressing the issue only twice. The first time was in *Affiliated Ute*, which applied the out-of-pocket measure in the context of a face-to-face transaction involving fraudulent nondisclosure in breach of fiduciary duty. The Court said this about damages:

In our view, the correct measure of damages under § 28 of the Act is the difference between the fair value of all that the . . . seller received and the fair value of what he would have received had there been no fraudulent conduct, except for the situation where the defendant received more than the seller’s actual loss. In the latter case, damages are the amount of the defendant’s profit.\(^90\)

In this face-to-face transaction, the Court invokes both the out-of-pocket measure and unjust enrichment. The Court’s only opportunity to consider the appropriate measure of damages in a case in which the defendant did not benefit because it was not a party to the transaction (the standard scenario in FOTM class actions) was *Basic* itself, and there, as I have noted, the Court passed on the question.\(^91\) And the Court is unlikely to ever have an opportunity to consider the damages question because companies almost invariably settle rather than risk bankruptcy.

In Part IV I argued that what was required was a fundamental rethinking of the relationship between reliance and damages. We do not know what the Court thinks about damages in FOTM cases, but it appears oblivious to the connection between precaution costs and reliance. The Court’s other recent forays into securities fraud class actions have been reactions to Congress’s activity in the area, generally involving interpretive questions arising under the PSLRA.\(^92\) The Court has made it clear that it intends to defer to Congress in this area: “It is the federal lawmaker’s prerogative . . . to allow, disallow, or shape the contours of—including the pleading and proof requirements for—§ 10(b) private actions.”\(^93\) Thus, we

\(^90\) *Affiliated Ute*, 406 U.S. at 155.

\(^91\) See *supra*, note 15 and accompanying text. The Court’s other foray into Rule 10b-5 damages focuses on the need to deprive the defendant of his benefit from the fraud. *Randall v. Loftsgaarden*, 478 U.S. 647 (1986).

\(^92\) See, e.g., *Dura Pharmaceuticals*, 544 U.S. 336; *Tellabs*, 127 S. Ct. 2499.

\(^93\) *Tellabs*, 127 S. Ct. at 2512.
should not expect the Court to be anything more than a passive observer here, looking to Congress to take any bold step toward reform.

B. Congress?

Is it realistic to expect Congress to take such a step? Probably not. Congress had its opportunity to tackle the relation between reliance and damages at a moment in time when there was tremendous momentum for reform of securities class actions—and it ducked.

In 1995, Congress reacted to the flood of securities class actions that Basic spawned. Accountants and the high-tech sector clamored for relief from the “stock price drop” suits that were besetting them; money flowed into campaign coffers from these proponents, as well as from the opposition (plaintiffs’ lawyers). High on the wish list of reforms was a reversal of Basic. The House of Representatives considered sweeping changes to securities class actions in the Common Sense Legal Reforms Act of 1995. As originally introduced, that bill would have eliminated the FOTM presumption. The SEC opposed the provision, however, and it was abandoned in favor of a codification of the doctrine that would have set forth more clearly when the presumption would apply. By the time the bill came out of conference as the PSLRA, even this codification of the FOTM presumption had been abandoned.

Instead of changing the FOTM presumption and out-of-pocket damages formula that create the economic incentive to bring strike suits, Congress chose to erect a series of procedural barriers to make them harder to pursue. The effect of these restrictions has been to

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98 For a discussion of these provisions, see Marilyn F. Johnson, Karen K. Nelson, & A.C. Pritchard, Do the Merits Matter More? The Impact of the Private Securities Litigation Reform Act, 23 J. L. Econ. & Org. 627 (2007).
force plaintiffs to focus on objective evidence—such as restatements, insider trading, and SEC enforcement actions—as the basis for bring-
ing suit. 99 This means that securities class actions are now brought
when the evidence of fraud is relatively obvious. And not surpris-
ingly, cases continue to be brought when the damages calculation
is greatest, with large stock price drops and heavy trading. 100 This
means that the companies punished hardest by the market are also
the ones that are most likely to face a class action. If securities
class actions are a “necessary supplement” to SEC enforcement, 101
Congress’s reforms have ensured that the supplement is directed
where it is least needed.

Why did Congress back away from undoing Basic’s FOTM pre-
sumption? One answer is that the original House bill offered nothing
in its place. Requiring plaintiffs to plead actual reliance largely elimi-
nates class actions, leaving fraud deterrence exclusively in the hands
of the SEC and the Justice Department. Another reason may be
that eliminating compensation is a political non-starter. The “pocket
shifting” element of secondary-market class actions has been well
known for a long time, but it does not seem to have influenced
legislative thinking. Congress’s latest contribution on the subject
came in the Sarbanes-Oxley Act in 2002, which includes a provision
requiring the SEC to use recoveries from its enforcement actions to
compensate investors. 102 Providing compensation to widows and
orphans sells well on the campaign trail, even if the widows and
orphans can protect themselves against the risk of fraud through
portfolio diversification. Compensating defrauded investors takes
some of the sting out of putting all of their eggs in one basket, hardly
the investment strategy that our public policy should promote.
Never let it be said that Congress does not look out for the finan-
cially reckless!

99 Stephen J. Choi, Karen K. Nelson, & A.C. Pritchard, The Screening Effect of
100 Johnson et al., supra note 98.
102 15 U.S.C. § 7246(a). Under that provision, the SEC has collected at least $8
billion for distribution to harmed investors since 2002. See 2006 Performance and
Accountability Report, U.S. Securities and Exchange Commission (available at http:/
C. The SEC?

As noted above, the SEC opposed eliminating the FOTM presumption when Congress considered that move back in 1995. Is there any reason to think that the SEC’s views have changed in the intervening years? Not really. The SEC consistently sides with the plaintiffs’ bar in its amicus role, and even minor deviations from that role bring a firestorm of criticism from the plaintiffs’ bar and its allies. The SEC’s support for the plaintiffs’ bar in part reflects its own institutional interests. The agency favors broad interpretations of its governing statutes; as we saw in Stoneridge, a narrow interpretation of § 10(b) could reduce the SEC’s enforcement discretion. The SEC’s commitment to the plaintiffs’ bar goes beyond that interest, however, because it sides with the plaintiffs’ bar even on issues that relate purely to the terms of the implied Rule 10b-5 cause of action, such as the reliance issue in Basic. This commitment can be ascribed only to ideology, as the agency staff views its investor protection role broadly and sees plaintiffs’ lawyers as allies in that fight.

The staff’s affinity for the plaintiffs’ bar only rarely meets any resistance from the commissioners. The SEC has consistently supported the FOTM presumption, beginning in Basic and continuing to the present day. The majority of the commissioners wanted to file a brief siding with the plaintiffs in Stoneridge, but the agency

103 And has for a long time. See Pritchard, supra note 78 at 923 (quoting Lewis Powell complaining that “SEC usually favors all π. I can’t recall a case in which this was not so.”)


105 Brief of the Securities and Exchange Commission, Amicus Curiae, In re Worldcom Securities Litigation, 2nd Cir. 03-9350 (April 2004) (available at http://www.sec.gov/litigation/briefs/wchevesi_amicus.htm#summaflowry) (noting SEC’s support for FOTM presumption in Basic and arguing for application of presumption to reports by securities analysts). See also Donald C. Langevoort, Basic at Twenty: Rethinking Fraud-on-the-Market, Working Paper, Georgetown University Law Center (2008) (“[T]he Basic opinion was for all practical purposes authored by the SEC and the Solicitor General’s Office. The key arguments, analysis, quotes and citations that one finds in the Courts’ holdings on both materiality and reliance come directly out of the amicus curiae brief filed on behalf of the SEC.”).

106 The vote was 3-2. See Paul Atkins, Just Say ‘No’ to the Trial Lawyers, Wall St. J., Oct. 9, 2007, at A17. Chairman Christopher Cox voted with the majority, despite having introduced the bill that in 1995 that would have reversed Basic. Joel Seligman, The Transformation of Wall Street 663–64 (3d Ed. 2003). The SEC had filed a brief
was overruled by the Solicitor General, who sided with the defendants.\textsuperscript{107} The SEC has the authority to make the necessary changes to Rule 10b-5,\textsuperscript{108} but it is unrealistic to expect reform to come from that quarter.

\textbf{D. Shareholders?}

That brings us to our last, best hope for reforming securities fraud class actions: shareholders. Shareholders have the right incentives for evaluating reforms because they are forced to internalize both the benefits and the costs of securities class actions. Shareholders benefit from securities class actions if those suits generate deterrence. Deterrence promotes accurate share prices and thereby reduces the cost of participation in the securities markets. These benefits flow to corporations as well because they translate into a lower cost of capital. Shareholders (at least some of them) are also the beneficiaries of the compensation paid out in securities class actions, modest though it may be. On the other side of the equation, all shareholders ultimately bear the costs of securities fraud class actions, which include the payment of attorneys’ fees on both sides of the litigation, the cost of experts, and the distraction costs to executives arising from defending the lawsuit. Directors and officers (D&O) insurance will cover some of these costs, but the premiums to secure that insurance are ultimately paid by the shareholders. Less tangible, but perhaps more substantial, are costs firms incur to avoid being sued: more money spent on lawyers’ fees for flyspecking disclosure documents, higher auditors’ fees, new projects that are rejected because of the risk of suit, and less forthcoming disclosure. These costs are

\footnote{107}{Brief for the United States as Amicus Curiae Supporting Affirmance, 2007 WL 2327639 (August 15, 2007). The government’s argument was essentially adopted by the Court, as it frequently has been in securities cases since Powell retired.}

not covered by insurance. How does the balance tip between these benefits and costs? Perhaps shareholders should be allowed to weigh for themselves.109

My suggestion is that shareholders change the damage measure in Rule 10b-5 securities fraud class actions involving the company, its officers, and directors, to focus on deterrence rather than compensation. Specifically, shareholders could adopt an unjust enrichment model by making a partial waiver of the FOTM presumption of reliance in the corporation’s articles of incorporation.110 The waiver would stipulate to a disgorgement measure of damages, requiring violators to give up the benefits of the fraud, if the FOTM presumption were invoked in a securities class action. This partial waiver would not limit shareholder-plaintiffs who could plead actual reliance on a misstatement; they could still seek the tort out-of-pocket measure of damages. Thus, in an FOTM suit, the company itself would be liable only when making an offering or repurchasing shares. It would be liable only for out-of-pocket compensation to plaintiffs who actually relied to their detriment.111 Executives who violated Rule 10b-5 would be liable to repay their compensation tied to the stock price (bonuses, stock, and options) during the time that price was fraudulently manipulated; here the FOTM presumption could be invoked.112


112 Such cases would likely implicate the executives’ duty of loyalty under state corporate law. Under state corporate law, the cause of action would be derivative, rather than direct, so the recovery would properly go to the corporation, rather than the shareholder members of the class. It is clear, however, that the federal cause of action would be direct under Rule 10b-5 because plaintiffs must have been a purchaser or seller to have standing per Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975), so the disgorgement could be paid to the shareholders who purchased during the class period. For an argument that Rule 10b-5 actions should be treated as deriv-
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Obviously, the damages paid under a disgorgement measure are unlikely to afford full compensation, but settlements currently compensate for only a small percentage of investor losses. More fundamentally, compensation is not the cure for securities fraud in the secondary market; diversification is. The goal of securities fraud class actions should be that of unjust enrichment: deterrence. The purpose of the FOTM version of the Rule 10b-5 cause of action should be to deprive wrongdoers of the benefits they obtained by violating Rule 10b-5.

This goal is well served by my proposal, which focuses sanctions on actual wrongdoers, unlike the current regime. In addition, the requirements for invoking the FOTM presumption could be relaxed. If we are focused on defendants’ gains from the fraud, rather than shareholders’ losses, the informational efficiency of the market for the security is unimportant. Under the current regime, smaller companies largely get a free pass from securities class actions because the market for their shares is not efficient enough to invoke the FOTM presumption. Relaxing the FOTM standards would widen the range of companies that could be sued in a Rule 10b-5 action—a clear gain for deterrence.

The main objection to this proposal is that it reduces the incentive to bring suit. The argument would be that if plaintiffs’ lawyers cannot expect a payday in the hundreds of millions of dollars, they cannot be expected to sue. Deterrence would suffer as a result. One answer to this objection is that the average settlement is not the billion dollar payday that attracts big publicity, but much smaller, and suits nonetheless get filed. According to a leading economic consulting firm, the average settlement was $13.5 million from 1996 to 2001 and $23.6 million from 2002 to 2007.113 More modest still are median settlements; the median settlement was $4.7 million from 1996 to 2001 and $6.4 million from 2002 to 2007.114 These figures suggest that the lure of relatively modest settlements is sufficient incentive to bring suit in a substantial number of cases. Moreover,
they are not grossly out of line with typical compensation packages for CEOs these days.\textsuperscript{115} And litigation would be less expensive if the remedy sought were disgorgement because some very expert-intensive issues, such as loss causation, would drop out, and others, such as damages, would become much simpler to calculate.

Remember, too, that out-of-pocket damages would be available to plaintiffs who could show actual reliance. Those plaintiffs are likely to be institutional investors, who may have substantial losses in a given security that is affected by fraud. Those individual actions could be consolidated with the main proceeding for disgorgement, thus economizing on discovery costs and streamlining adjudication.

The incentive to bring suit can be bolstered, however, if shareholders deem it necessary. Rather than simply having the court award attorneys’ fees based on a percentage of recovery (the “common fund” doctrine currently employed), the corporation could commit to paying an hourly fee to attorneys who succeed in bringing securities claims against the corporation, its officers, or directors. The fee could be subject to a review for reasonableness by a judge or arbitrator, and perhaps include a multiplier to reflect the risk of suit. This one-way fee shifting would effectively allow the corporation to pay the plaintiffs’ bar to monitor for fraud. It is surely within the corporation’s power to pay for that valuable service, and those attorneys’ fees could be covered by the company’s D&O insurance.

Any judgments obtained by the plaintiffs’ lawyers, however, are unlikely to be covered by the company’s D&O policy because such policies typically exclude coverage when there has been a finding of fraud or self-dealing. A Rule 10b-5 suit seeking disgorgement involves both. Indemnification by the corporation would also be barred in the event of a judgment because indemnification requires a finding of “good faith,”\textsuperscript{116} which is hard to square with the finding of fraudulent intent needed to establish liability under § 10(b).\textsuperscript{117}

\textsuperscript{115} This relatively low median has two obvious implications for the current regime: First, most suits are settling for a small percentage of investor losses; and second, half of the suits are settling for essentially nuisance value. If a suit has gotten past a motion to dismiss, it is unlikely that it could be defended for less than $6.4 million dollars.

\textsuperscript{116} Del. Gen. Corp. L. § 145(a).

\textsuperscript{117} Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976). See also Coffee, supra note 108, at 1567–68 (collecting cases holding that securities law liabilities cannot be indemnified).
A settlement avoids an adjudication that the officer or director acted with fraudulent intent, but it would not entitle the officer or director to automatic indemnification; the board of the company would still need to make a finding of good faith.\textsuperscript{118} If the settlement were not covered by D&O insurance, a requirement of a finding of good faith would require a close look from the company’s board of directors if it chose to indemnify an officer. Under the current regime, the corporation is typically a party to the lawsuit, so it is easy to justify a settlement as avoiding the risk of catastrophic liability to the corporation. Under a disgorgement regime, plaintiffs’ lawyers will be less likely to sue the corporation because of the difficulty of showing the requisite benefit to the corporation from the fraud.

Can shareholders do this? Do legal barriers prevent shareholder-led reform of securities fraud class actions? We can test this.\textsuperscript{119} Under Exchange Act Rule 14a-8, shareholders can make proposals to be included in the company’s proxy statement, including suggestions that the directors amend the articles of incorporation.\textsuperscript{120} The rule allows companies to exclude shareholder proposals for a variety of reasons, but they must submit their rationale for exclusion to the SEC for review.\textsuperscript{121} If the SEC agrees with the company, the agency issues a “no action” letter allowing the proposal to be excluded. A proposal recommending that the directors amend the articles would be excludable only if it “would, if implemented, cause the company to violate any state, federal, or foreign law to which it is subject.”\textsuperscript{122}

Does the proposal violate state law? Unlikely. Delaware affords corporations broad latitude to include provisions in their articles of

\textsuperscript{118} See Waltuch v. Conticommodity Services, Inc., 88 F.3d 87 (2d Cir. 1995) (construing Del. Gen. Corp. L. § 145(c) to require automatic indemnification only when the officer or director has avoided making a settlement payment). Jack Coffee has proposed requiring the corporation to disclose how they arrived at the determination that an officer should be indemnified. See Coffee, supra note 108, at 1576.

\textsuperscript{119} The suggestion here applies to companies that are already public. Companies that are not yet public could include such a provision in their charter before making their initial public offering.

\textsuperscript{120} Exchange Act Rule 14a-8. Any amendment approved by the board would also have to be approved by the shareholders. Del. G. Corp. L. § 241.

\textsuperscript{121} Exchange Act Rule 14a-8(j).

\textsuperscript{122} Exchange Act Rule 14a-8(i)(2). Rule 14a-8 provides other bases for exclusion, but none apply to the proposal here.
incorporation “creating, defining, limiting and regulating the powers of the corporation, the directors, and the stockholders . . . if such provisions are not contrary to the laws of this State.”\textsuperscript{123} This language has been read to authorize provisions unless they can be said to “clash[] with fundamental policy priorities that clearly emerge from the Delaware General Corporation Law or our common law of corporations.”\textsuperscript{124} No such priorities are apparent in Delaware corporate law.\textsuperscript{125} Delaware generally views anti-reliance clauses as enforceable as a matter of contract law.\textsuperscript{126} Corporations adopting the proposal will need to highlight the provision in their periodic SEC filings to maximize the likelihood that a court will apply the reliance waiver. If they do so, state law is unlikely to block the adoption of the disgorgement proposal.

The more substantial argument would be that the proposal violates federal law because it runs foul of § 29 of the Exchange Act, which voids “[a]ny condition, stipulation, or provision binding any person to waive compliance with any provision of this title or of any rule or regulation thereunder.” Read broadly, § 29 would bar any provision affecting a right created by the Exchange Act. And written broadly, an anti-reliance provision could arguably waive compliance with § 10(b) (although SEC and criminal enforcement would still be available).\textsuperscript{127} The Supreme Court has not addressed

\textsuperscript{123} Del. Gen. Corp. L. § 102(b)(1).
\textsuperscript{124} Jones Apparel Group, Inc. v. Maxwell Shoe Co., Inc., 883 A.2d 837, 843 (Del. Ch. 2004).
\textsuperscript{125} Del. Gen. Corp. L. § 102(b)(7), which allows corporations to exempt their directors from paying money damages for breaches of the duty of care, would not apply to the disgorgement proposal because the provision is limited to breaches of fiduciary duty.
\textsuperscript{126} See MBIA Insurance Corp. v. Royal Indemnity Co., 426 F.3d 204, 218 (3rd Cir. 2005) (“When sophisticated parties include a broad but unambiguous anti-reliance clause in their agreement, the Delaware Supreme Court will likely indulge the assumption that they said what they meant and meant what they said.”). Cf. In re Appraisal of Ford Holdings, Inc. Preferred Stock, 698 A.2d 973, 974 (Del. Ch. 1997) (certificate can stipulate fair value of preferred stock for appraisal under § 262).
\textsuperscript{127} Reliance waivers have received mixed treatment in the courts. Compare AES Corp. v. The Dow Chemical Co., 325 F.3d 174, 182 (2003) (“[T]o hold that a buyer is barred from relief under Rule 10b-5 solely by virtue of his contractual commitment not to rely would be fundamentally inconsistent with Section 29(a).”); Caiola v. Citibank, N.A., 295 F.3d 312, 330 (2d Cir. 2002) (“A disclaimer [of reliance] is generally enforceable only if it tracks the substance of the alleged misrepresentation.”) (citations and internal quotations omitted); Rogen v. Ilikon Corp., 361 F.2d 260, 268 (1st Cir. 1966) (“Were we to hold that the existence of this provision constituted the basis (or
waiver of reliance clauses; it has only interpreted § 29 in connection with mandatory arbitration clauses. After initially concluding that arbitration provisions conflicted with the anti-waiver provisions in the securities law, the Court reversed course, concluding that forum selection clauses and arbitration provisions were enforceable.

In response to the claim that arbitration amounted to a waiver of the Exchange Act’s conferral of ‘‘exclusive jurisdiction’’ to the federal courts in § 27, the Court declined to read § 29 so broadly:

§ 29(a) forbids . . . enforcement of agreements to waive ‘‘compliance’’ with the provision of the statute. But § 27 itself does not impose any duty with which persons trading in securities must ‘‘comply.’’ By its terms, § 29(a) only prohibits waiver of the substantive obligations imposed by the Exchange Act. Because § 27 does not impose any statutory duties, its waiver does not constitute a waiver of ‘‘compliance with any provision’’ of the Exchange Act under § 29(a).

The proposed amendment to the articles of incorporation does not excuse compliance with the anti-fraud provision—it simply alters the remedy available under certain circumstances. Indeed, by focusing on deterring the most culpable actors, the disgorgement proposal promises greater compliance with Rule 10b-5 without waiving claims based on actual reliance. Finally, it is difficult to see the FOTM presumption as a ‘‘substantive obligation[] imposed by the Exchange

a substantial part of the basis) for finding non-reliance as a matter of law, we would have gone far toward eviscerating Section 29(a).’’); with Rissman v. Rissman, 213 F.3d 381, 384 (7th Cir. 2000) (‘‘[A] written anti-reliance clause precludes any claim of deceit by prior representations.’’); Harco Corp. v. Segui, 91 F.3d 337, 343–344 (2nd Cir. 1996) (upholding no reliance clause in contract between sophisticated commercial parties); One-O-One Enterprises, Inc., v. Caruso, 848 F.2d 1283 (D.C. Cir. 1988) (same).


131 Shearson/American Express, 482 U.S. at 228.
Act.” It is a procedural device, created by the courts, not Congress, intended to facilitate class actions.

Will shareholders vote for such a proposal? Interests will vary. All investors have an interest in deterrence; the proposed regime compares favorably with the current system on that ground. Interests will diverge, however, in compensation, which would be reduced under the proposed regime. The relatively low rate of participation in securities class action settlements suggests that shareholders as a class do not value compensation all that highly. Shareholders who are holders, trading infrequently, are likely to favor the proposal because they are typically on the paying end of litigation and settlement. Investors who index, whether individual or institutional, are likely to see things the same way as holders. Indexers have protected themselves against the firm-specific risk of fraud; they are unlikely to favor paying large premiums to lawyers for additional insurance that they do not need. The votes of institutional investors who actively pick stocks are harder to handicap. On the one hand, they are more likely to have been trading during a fraud period, so they are more likely to be members of an FOTM class. On the other, the proposed regime would still allow such investors to pursue an individual or joint action if they have relied on a misstatement.

We will get prompt feedback if investors make the wrong assessment with their vote. If waiving the FOTM presumption of reliance undermines deterrence (or signals a management likely to commit fraud), we would expect to see a stock price drop for the firm that has adopted the amendment. That will be powerful evidence for opponents who think that the proposal is misguided, which they will no doubt raise if another company proposes such an amendment. My instinct is that the market reaction will be positive for companies that opt out. My greater worry is that managers will be reluctant to opt into a disgorgement regime because it arguably increases their personal exposure. Optimistically, one could argue that refusing to adopt the disgorgement regime here would signal that a management team felt it had something to hide. Implementing the regime may require the efforts of institutional investors to press this case

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132 Of course, these investors are also more likely to have gotten a windfall gain from the fraud if they sold during the period that the stock price was inflated. This would be true regardless of the regime, however, so it is unlikely to influence their votes on the proposal raised here.
and push outside directors to adopt the proposal over the managers’ objections.

VI. Conclusion

The Supreme Court has now been struggling for 20 years with the wrong turn it took in *Basic*. *Stoneridge*, like the Court’s earlier reliance decisions in *Affiliated Ute, Basic*, and *Central Bank*, uses the reliance element to expand or contract the private cause of action under Rule 10b-5 based on no discernible principle. The FOTM regime established in *Basic* shifts money from one shareholder pocket to another at enormous expense. *Stoneridge* limits the adverse consequences of that regime, which does provide some benefit to shareholders. The decision is a step in the right direction, but it fails to grapple with the fundamental problem: Out-of-pocket damages should be tied to actual reliance. The appropriate model for reform is found in the explicit causes of action provided by Congress, which limit plaintiffs to rescission or disgorgement if they cannot plead reliance.

The disgorgement amendment to the articles of incorporation proposed here promises greater deterrence at a lower cost. The Court, Congress, and the SEC have all had the opportunity to fix the problem created by *Basic*, but none of these institutions has risen to the occasion. Shareholders bear the costs of the FOTM regime, and shareholders fortunately have the power to fix it. Will shareholders clean up the mess that the Supreme Court has created with securities class actions? Stay tuned.