Halliburton II: A Loser's History

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HALLIBURTON II: A LOSER’S HISTORY

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INTRODUCTION

The Supreme Court was presented with an opportunity to bring fundamental reform to securities class actions last term in *Halliburton Co. v. Erica P. John Fund, Inc.* The Court ducked that opportunity, passing the buck to Congress to undo the mess that the Court had created a quarter century prior in *Basic Inc. v. Levinson.* Congress’s history in dealing with securities class actions suggests that reform is unlikely to come from the legislature anytime soon. The Securities and Exchange Commission appears to be satisfied with the status quo as well. With these institutional actors resisting reform, corporations and their shareholders may resort to self-help in dealing with the cost and distraction created by securities class actions. Paradoxically, resistance to reform of securities class actions may result in self-help measures that eliminate securities class actions—and their deterrent value—altogether.

I. INVASIVE SPECIES? A LOSER’S PERSPECTIVE

Securities fraud class actions can be seen as a judicial invasive species: carelessly introduced, hell on the native fauna, and almost impossible to eradicate. Judges thoughtlessly unleashed this parasite when they took it upon themselves to develop a remedy for fraud infecting secondary securities markets (i.e., transactions between investors); no statute compelled them to do it. Nothing in the relevant statute and its implementing regulation—in this case, § 10(b) of the

*Frances and George Skestos Professor of Law, University of Michigan. This essay expands on a piece that Todd Henderson and I wrote, From Basic to Halliburton: Judges Made the Securities Class Action Mess, but Who Can Clean It Up? 37:4 Regulation 20 (Winter 2014-2015). I benefitted from comments by participants at a symposium sponsored by the Duke Journal of Constitutional Law & Public Policy. I wish to acknowledge the generous support of the William W. Cook Endowment of the University of Michigan.
Securities Exchange Act of 1934\textsuperscript{1} and Rule 10b-5\textsuperscript{2}—authorizes a private cause of action for securities fraud. Instead, the courts, egged on by the Securities and Exchange Commission (SEC), invented it out of whole cloth, ignoring more limited private causes of action explicitly created by Congress.\textsuperscript{3} Since the private cause of action under Rule 10b-5 was first discovered by the courts,\textsuperscript{4} the Supreme Court has at various times expanded and contracted its scope. In general, however, the § 10(b) private right of action has grown from what then-Justice William Rehnquist called a “legislative acorn” into a “judicial oak.”

Kudzu is more like it. This invasive species of securities fraud class actions went from nuisance to menace—endangering shareholders of public companies and the competitiveness of the U.S. capital markets—when the Supreme Court handed down Basic Inc. v. Levinson.\textsuperscript{5} In Basic, the Supreme Court held that plaintiffs need not show individual reliance on alleged corporate misrepresentations but instead could rely on the market price having incorporated those misstatements: the “fraud-on-the-market” (FOTM) presumption. The FOTM presumption allows plaintiffs’ lawyers to certify a class action for securities fraud. Class certification is a big deal: defendants inevitably face enormous costs from litigating and settling these suits, thus creating an enormous incentive for plaintiffs’ lawyers to bring cases for nuisance value alone.

After Basic there was a huge spike in securities litigation.\textsuperscript{6} But those lawsuits almost never resolved the question of whether corporate fraud had actually occurred. Stock prices dropped, by reason of fraud or otherwise, suits were brought, and settlements—totaling many billions of dollars—were paid. Plaintiffs’ lawyers took home billions in fees as their cut for acting as middlemen in effecting

\begin{enumerate}
\item 17 C.F.R. § 240.10b-5 (West 2015).
\item Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 737 (1975).
\item 485 U.S. 224 (1988).
\item Vincent E. O’Brien, The Class-Action Shakedown Racket, WALL ST. J., Sept. 10, 1991, at A20 (reporting that the rate at which securities class actions were filed nearly tripled from the date of the Basic Inc. v. Levinson decision in 1988 to June 1991).
\end{enumerate}
these transfers; companies paid their own lawyers similar sums for defending them. By the mid-1990s, the parasites of the securities bar were thriving, stunting the growth of American companies. Along with their rise came calls for reform from corporate America.

Congress responded to the flood of cases unleashed by Basic by tweaking the rules of securities class action in 1995, but it left the fundamental framework intact. The politics of the situation—plaintiffs’ lawyers on one side, similarly deep-pocketed corporate defendants on the other—resulted in a wary stalemate. The political gridlock could readily be interpreted as legislative acquiescence. The Supreme Court tried to trim the oak it created in a series of controversial decisions. But neither Congress nor the Court was willing to eradicate the invasive species and replant. The number of cases being filed did not change, and securities class actions became a fixture in the public corporation landscape.

The Supreme Court’s recalcitrance might be excused by the fact that it was never squarely faced with the issue of whether to overrule Basic. That opportunity arose in Halliburton Co. v. Erica P. John Fund, Inc.—commonly known as Halliburton I. Halliburton II finally presented the question of whether the Court should repudiate FOTM—a potentially pivotal moment in the history of securities fraud class actions. Overruling Basic’s FOTM presumption would have presented an opportunity to rebuild securities fraud class actions from the ground up on a more coherent foundation based upon an understanding of modern securities markets. Instead of pursuing fundamental reform, the Court tinkered around the periphery, adding a new battle of the experts to these cases, taking them further away from actually adjudicating the question of fraud. The Court’s Halliburton II decision arguably makes a bad situation worse, as I explain below. At the very least, it will make these suits more expensive for shareholders without any discernible benefit in terms of deterring corporate fraud. In other words, more costs with no benefits. How did we get here?

The outcome in *Halliburton II* is personally disappointing; incremental reform seemed within grasp. I have been advocating generally for reform of securities class actions since beginning my academic career more than fifteen years ago, and I advocated for a particular reform in *Halliburton II*. That plea was rebuffed by the Supreme Court. That response was disappointing to me as a reformer interested in promoting deterrence and efficiency. But it is puzzling to me as a scholar who focuses on the history of securities law in the Supreme Court. No one thinks that the justices are stupid, but more than a quarter century of tinkering with securities fraud class actions by the Court has produced a regime that is impossible to defend. Presented with an opportunity to fix securities class actions, the Court’s response is judicial abdication: it’s not our problem, man. Given that the principal impetus fueling securities fraud class actions came from the Supreme Court, why won’t the Court take responsibility for eradicating this noxious weed? Serious question: Why won’t the justices step up and fix this mess?

In this essay, I attempt to answer that question. History is written by the victors, the saying goes. But maybe the losers can offer a useful—if inevitably critical—perspective, too. The future, after all, is not yet written. A better historical understanding of the Supreme Court’s development of securities class actions might offer some guidance for that future. In *Halliburton II*, the Court missed an opportunity to reduce wasteful litigation and redirect legal resources toward deterring actual corporate fraud. The Court ducked. Why are we left with judicial inaction while the invasive species of securities fraud class actions continues to spread?

I believe the answer is rooted in the Court’s incremental approach to securities fraud class actions, uninformed by empirical data on how these lawsuits work in the real world. Meaningful reform of securities fraud class actions must begin with reining in the grossly inflated measure of damages that the lower courts have assumed to be applicable in such cases. Unfortunately, the Supreme Court has never shown any interest in that reform. Moreover, reforming the damages

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11. George Orwell, *As I Please*, TRIBUNE, Feb. 4, 1944 (“A Nazi and a non-Nazi version of the present war would have no resemblance to one another, and which of them finally gets into the history books will be decided not by evidential methods but on the battlefield. . . . History is written by the winners.”).
measure would require bold initiative, something that has been largely lacking from the Court’s securities jurisprudence since it handed down *Basic*. Indeed, its incremental approach to securities class actions has created a regime that may allow the fundamental question of damages to be kicked down the road indefinitely. The Court’s inertia is reinforced by the SEC, which stands in the way of damages reform for securities fraud class actions. The Court has repeatedly invited Congress to weigh in on securities class action reform, but the legislature sits on the sidelines, paralyzed by classic political gridlock. Given this sorry history, the future may see corporations and their shareholders resorting to self-help by eliminating the option of securities fraud class actions altogether. That alternative would eliminate not only the wasteful wealth transfers of securities fraud class actions, but also their deterrent value.

II. RELIANCE AND SECONDARY MARKET SECURITIES FRAUD CLASS ACTIONS

Congress did not create a general private cause of action for fraud when it enacted the Securities Exchange Act in 1934. Instead, it opted to create narrow causes of action for specific types of misconduct, such as market manipulation.\(^\text{12}\) Congress did, however, authorize the SEC to adopt antifraud rules that the agency could then enforce. The SEC exercised that rulemaking authority in 1940 when it adopted Rule 10b-5.\(^\text{13}\) Rule 10b-5, like § 10(b), the statutory provision that authorizes it, says nothing about a private cause of action. The courts, however, have not been deterred by that void and have implied a sweeping cause of action under Rule 10b-5. In the absence of a statutory directive, courts have relied heavily on the requirements of the common law action for deceit (the typical cause of action for fraud) in fleshing out the details of that implied Rule 10b-5 cause of action.\(^\text{14}\) At common law, plaintiffs were required to allege that they had relied on a fraudulent misstatement and that it induced them to make the purchase. So for a fraud claim involving a company’s common stock, an investor-plaintiff would have to show that they read the misstatements that allegedly distorted the price of a


\(^{13}\) 17 C.F.R. § 240.10b-5 (West 2015).

\(^{14}\) Dura Pharm., Inc. v. Broudo, 544 U.S. 341, 361 (2005) (stating that a private right of action under § 10(b) “resembles, but is not identical to, common-law tort actions for deceit and misrepresentation”).
company’s stock before they purchased (or sold). The problem, however, is that for companies whose shares are publicly traded, many (perhaps most) of the investors buying and selling the company’s shares will not have read the misstatement, or even been aware of it. Consequently, they will not be able to claim reliance in the traditional sense. Thus, the reliance requirement posed a substantial obstacle to bringing a case involving secondary market fraud under Rule 10b-5.

The problem is particularly acute for class actions. If all plaintiffs were required to allege, individually, that they had read and relied upon the misstatement in making their decision to purchase or sell, a class could not be certified because it would have too many factual questions that were not common to the class (a prerequisite to class certification).

Moreover, individual investors would rarely have sufficient losses to justify the expense of bringing suit on their own, even if they could satisfy the reliance requirement.

To overcome this obstacle to class certification, the Supreme Court effectively gutted the reliance requirement for most claims of secondary market fraud, albeit in a surreptitious way. The gutting took two steps, both choreographed by Justice Harry Blackmun. Justice Blackmun first excused the reliance requirement for fraudulent omissions with his opinion for the Court in Affiliated Ute Citizens of Utah v. United States. The gravamen of the fraud in Affiliated Ute was deceptive non-disclosure in breach of a fiduciary duty. This first step in Affiliated Ute was understandable and perhaps inevitable. In the case of non-disclosure, it was impossible for the plaintiffs to plead actual reliance because the violation was a failure to speak, rather than a misstatement. In such a situation, the Court concluded that materiality of the omission would “establish the requisite element of causation in fact.” The holding was unsurprising in that context—how can you rely on something left unsaid?—but Justice Blackmun’s approach would lead to mischief going forward. In Affiliated Ute, the Court treated reliance simply as a species of the tort concept of proximate causation: Is the defendant’s conduct sufficiently close to

15. See FED. R. CIV. P. 23(b)(3) (A class action is 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.”).

the harm to the plaintiff? Framed this way, the question seems deceptively easy; Torts 101 as it were.

The complexity of the reliance issue became more apparent, however, when the Court returned to the issue fifteen years later. The logic of Affiliated Ute’s presumption of reliance did not cover affirmative misstatements, so the obstacle that reliance creates for class certification remained in those cases. The Court in Basic Inc. v. Levinson, urged on by the SEC, and with Justice Blackmun again writing for the majority, effectively completed the dismantling of the reliance requirement by adopting the “fraud-on-the-market” presumption of reliance. 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, and that, in turn, they relied on a market price that was distorted by the deception. The economic premise underlying the FOTM presumption is the efficient capital market hypothesis, which holds that 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, establishing a causal connection between the fraud and the purchase. For Justice Blackmun, the economic analysis was painfully obvious: “Who would knowingly roll the dice in a crooked crap game?”

Justice Byron White, dissenting in Basic, worried the economics were more complicated: “[T]he Court, I fear, embarks on a course that it does not genuinely understand, giving rise to consequences it cannot foresee.” Presciently, Justice White noted that adopting the appropriate measure of damages was critical to the implementation of the Court’s new FOTM regime. Justice White also noted, however, that Justice Blackmun and the Court’s majority had ducked that question. What neither Justice White nor Justice Blackmun could have anticipated, however, is that the Court would fail to address the critical question of damages for the twenty-five plus years after handing down Basic. The economic waste that followed the adoption of the FOTM presumption could have been mitigated if the Court had adopted a measure of damages appropriate to the FOTM

18. Id. at 254 (White, J., dissenting).
19. Id. at 254 n.5.
reliance regime. We are still waiting for the Supreme Court to address this question.

III. DAMAGES

Why did the Court pass on the critical question of damages? The easy answer is that it was not presented in Basic Inc. v. Levinson, which was before the Court on a motion to dismiss (damages issues would typically not be reached by an appellate court until after a jury verdict). At least one justice (John Paul Stevens), however, recognized that the damages question was a challenging one; Justice Stevens asked Justice Blackmun to note in the Court’s opinion that the Court was not resolving it. This is perhaps fortunate, as Justice Blackmun might well have made things worse. The available evidence suggests he was focused solely on compensation; there is no evidence that he even considered disgorgement, the typical remedy provided for in the explicit causes of action in the federal securities laws.

The elements of reliance and damages are not so easily severed. In adopting the fraud-on-the-market presumption, Justice Blackmun saw himself as merely following his earlier opinion in Affiliated Ute Citizens of Utah v. United States; which Justice 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.” 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 (or by) the victim and the security’s “true” value—


21. Letter from Harry A. Blackmun to William J. Brennan, Jr., No. 86-279, Basic v. Levinson (Jan. 15, 1988) (Thurgood Marshall Collection, Library of Congress) (“[T]here 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 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.”).


fits 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: no upside. Second, compensation discourages investors from spending resources trying to avoid the consequences of fraud.

Expenditures on committing and avoiding fraud are the real social costs that the anti-fraud cause of action is trying to prevent. The wealth transfer from the victim to the defendant is relevant only insofar as it induces those expenditures. That policy goal is clear; more subtle is the connection between those costs and 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 defendant is benefiting from the fraud. 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 generally, thus raising the cost of capital for publicly traded firms. The upshot is that fraud should be punished when the defendant benefits from the securities transaction affected by fraud. Requiring a defendant to compensate a victim ensures that fraud does not pay. Compensation and deterrence are neatly aligned.

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 in that market (and thereby transferred wealth to itself), it has no institutional incentive to spend real resources in executing the fraud—and thus no reason to

24. 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.”).
encourage the investor reliance that the FOTM presumption seeks to promote.

On the investor 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.\textsuperscript{25} Assuming all traders are ignorant of the fraud, they can expect to win as often as they lose from fraudulently distorted prices.\textsuperscript{26} With no expected loss from fraud on the market, shareholders have little incentive to take precautions against the fraud. Thus, secondary-market fraud fits awkwardly in the confines of the tort action for deceit, which so neatly fits misrepresentations in face-to-face transactions. In face-to-face transactions, parties naturally take precautions to manage the risk of fraud (verification), so deterring fraud in those transactions deters expenditures on precautions, the real social cost engendered by 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 Basic 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 and instead rely on statements. Verification is not an option for the passive investor (the intended beneficiary of the FOTM presumption); checking the accuracy of a corporation’s statements is a task that can be only undertaken by an investment professional, and even these sophisticated actors will uncover fraud only rarely (and profit handsomely when they do, suggesting that it may not be essential to compensate them when they do not). 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 losses from the few bad apples will be offset by the (discounted) gains from the honest companies.

\begin{quote}
\textsuperscript{26} Alicia Davis Evans, \emph{Are Investors’ Gains and Losses from Securities Fraud Equal Over Time? Some Preliminary Evidence} (Univ. of Mich. Law Sch. Law & Econ. Working Papers, Paper No. 13, Oct. 25, 2010) (demonstrating that diversified traders’ gains and losses from securities fraud average out to essentially zero).
\end{quote}
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 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 attributed to the corporation. 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 (they did not commit fraud). 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, for companies whose stock traded on the New York Stock Exchange (NYSE) or Nasdaq. 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 (for which there are other remedies), the losses and gains will be a wash for shareholders in the aggregate, even though some individual shareholders will have suffered substantial losses.

That seems wasteful, but the waste becomes more salient in light of the fact that no real compensatory purpose is served by securities fraud class actions. Despite the enormous sums being spent on litigation, shareholders typically get pennies on the dollar for their losses. Worse yet, the settlements are paid from either corporate coffers or directors’ and officers’ insurance (for which the premia were paid by the corporation). The net result is that settlements are being paid at the expense of former and current shareholders.

Shareholders as a class are undeniably net losers from this circular exercise, as lawyers (and experts) take home the real money in exchange for their efforts in keeping the securities fraud class action industrial complex running.

Are these gigantic expenditures on lawyers deterring corporate fraud? We don’t really know. Sorting cases of actual fraud from mere business reverses is a difficult task—fact intensive and requiring subtle judgments. It should be no surprise that a system charged with that task is expensive. If securities class actions succeed in accurately sorting fraud from non-fraud, it might well justify the enormous sums spent on lawyers. But if lawyers are paid billions without reducing the probability or magnitude of corporate fraud, then from a social welfare perspective these payments to lawyers are a deadweight loss. Making sensible policy choices about securities fraud class actions necessitates grappling with that question. But there is no evidence that judges—and in particular the justices who sit on the Supreme Court—are up to that task, notwithstanding their willingness to conduct a high stakes policy experiment with securities fraud class actions.

IV. THE DELUGE AND THE RESPONSE

The fraud-on-the-market presumption of reliance was intended to facilitate securities fraud class actions. Measured by this criterion, Basic was a tremendous success. The number of securities fraud class actions increased dramatically after Basic Inc. v. Levinson validated the FOTM presumption.

Although the FOTM presumption ensures that private plaintiffs would have incentives to sue, the out-of-pocket measure of damages assumed by lower courts means that the incentives to sue were excessive. The FOTM presumption generates too many suits because defendants’ incentive to settle these cases has only a tenuous connection with the merits: even a small prospect of losing at trial puts a big thumb on the scale toward settlement, even if the company has done nothing wrong. The math is simple: a one percent chance of losing a $2 billion judgment makes it economically rational to cut a check for $20 million, even ignoring the massive costs of mounting a defense. 28 Even supremely confident defendants will settle meritless

cases rather than risk the very real possibility of a jury verdict that threatens bankruptcy. Such settlements are wasteful; investors do not benefit when companies pay settlements that have little to do with the merits of the case. Unless settlements are targeting fraud with a high degree of accuracy, securities class actions are little more than a costly form of insurance against business reverses. Investors ultimately foot the bill while lawyers profit.

Even in cases of actual fraud, the FOTM regime raises a lot of questions. To start, consider that any lies were told not by “the company”—an artificial legal construct—but by executives who spoke on its behalf.” These officers may have benefitted from these lies (along with any shareholders who sold shares after the lie but before the fraud was revealed), but these officers do not pay damages to compensate those who bought after the lies and held their shares. The company pays those losing investors, which effectively means current shareholders (who did not profit from the lies) pay for them. This transfer of wealth, from innocent current shareholders to former shareholders—with a big chunk going to lawyers—serves no obvious retributive purpose. And with wrongdoing managers typically not paying any portion of the damages, the case for deterrence is shaky at best.

What are the consequences of the Supreme Court’s policy experiment? The incentives unleashed by Basic spawned a flood of securities fraud suits, often targeting start-up firms with high volatility, regardless of connection to actual fraud. When the stock prices of these firms fell, plaintiffs’ lawyers filed suits, and then combed disclosures for potential misstatements. Settlements followed quickly, however, obviating any need to prove fraud. The upshot was a tax on risk, which raised the cost of capital for start-up firms.

In response, Republicans made securities class action reform a centerpiece of their Contract with America in 1994. When the Republicans took control of Congress that year, they passed the

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.”).


30. See id. 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.”).
Private Securities Litigation Reform Act of 1995 (PSLRA), with the substantial Democratic support necessary to override President William Clinton’s veto of the bill.\textsuperscript{31} The PSLRA made a number of reforms intended to reduce the extortionate threat of securities class actions. Most notably, it raised the standards for pleading fraud, delayed discovery until after a hearing on a motion to dismiss, and changed the selection of lead counsel from a race to the courthouse to a presumption in favor of the attorney chosen by the shareholder-plaintiff with the largest economic stake in the outcome.\textsuperscript{32} The effect of these restrictions has been to force plaintiffs to focus on objective evidence, such as restatements, insider trading, and SEC enforcement actions, as the basis for bringing suit.\textsuperscript{33} This means that securities class actions are now brought when the indicia of fraud are relatively obvious, so they serve no purpose in uncovering fraud. And not surprisingly, cases continue to be brought when the damages calculation is greatest, with large stock price drops and heavy trading.\textsuperscript{34} This means that post-PSLRA, 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,\textsuperscript{35} Congress’s reforms in the PSLRA have ensured that the supplement is directed where it is least needed.

This failure is the result of Congress not dealing with the underlying drivers of these suits: the FOTM presumption and the incoherent measure of damages. The House of Representatives considered eliminating the FOTM presumption,\textsuperscript{36} but the SEC opposed the provision\textsuperscript{37} and it was abandoned in favor of a codification of FOTM which would have set forth more clearly when

\begin{itemize}
\item \textsuperscript{32} For a discussion of these provisions, see Marilyn F. Johnson, Karen K. Nelson, & A.C. Pritchard, \textit{Do the Merits Matter More? The Impact of the Private Securities Litigation Reform Act}, 23 J. L. ECON. & ORG. 627 (2007).
\item \textsuperscript{34} Johnson et al., supra note 31, at 641, Table 4.
\item \textsuperscript{35} Bateman Eichler, Hill Richards, Inc. v. Berner, 472 U.S. 299, 310 (1985).
\end{itemize}
By the time the bill came out of conference, this codification of the FOTM presumption also had been abandoned. The result was stalemate on the FOTM presumption.

Why did Congress back away from undoing Basic’s FOTM presumption? One answer is that the original House bill offered nothing in its place. Requiring plaintiffs to plead actual reliance eliminates class actions for frauds affecting secondary markets, 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 contribution on the subject of compensation came in the Sarbanes-Oxley Act in 2002, which includes a “Fair Funds” provision allowing the SEC to use recoveries from its enforcement actions to compensate investors. This provision of compensation is perverse from a policy perspective, as compensating defrauded investors takes some of the sting out of putting all of their eggs in one basket—not exactly a shrewd investment strategy. As noted above, widows and orphans can better protect themselves against the risk of fraud through portfolio diversification (and at far less cost). The Fair Funds provision is evidence that providing compensation to widows and orphans sells well on the campaign trail, even if the expenditures on compensation are largely a social waste.

Meanwhile, the Supreme Court heard several big cases with Basic’s FOTM presumption lurking in the background. Its restrictive decisions suggest that the Court viewed the system—one that it had created—as fundamentally broken. In Central Bank of Denver v. First Interstate Bank of Denver the Court held that there was no aiding and abetting liability for private securities fraud suits. The Court extended this ruling to cover alleged schemes to defraud in Stoneridge Investment Partners v. Scientific Atlanta and in Janus Capital Group, Inc. v. First Derivative Traders, which limits liability to the legal entity that actually makes a misstatement. In another series of cases, the

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43. 131 S. Ct. 2296 (2011).
Court narrowly interpreted the concept of causation. In *Dura Pharmaceuticals, Inc. v. Broudo,* the Court held that it was not enough for plaintiffs to show they bought shares at prices inflated by lies; they also had to show that the revelation of the lies caused the stock price to drop. The cases, which repeatedly erected incremental barriers to plaintiffs bringing securities class actions, make sense only if the justices perceive securities fraud class actions as a highly dysfunctional system for deterring corporate fraud. That dysfunction is apparent to even casual observers, but incremental reform is not going to fix it. The grossly distorted measure of damages lurks in the background.

Moreover, the Court’s cases did not go all in one direction. Although one could reasonably view this series of cases as the Supreme Court’s attempt to tame the beast it unleashed upon the corporate world, in more recent cases the Court balked at killing the beast altogether, or even substantially weakening it. In *Tellabs Inc. v. Makor Issues & Rights* the Court interpreted the PSLRA’s pleading standard to require that plaintiffs show that the inference of a fraudulent intent was as strong as any innocent explanation, the least stringent interpretation the language of the statute could plausibly support. In *Erica P. John Fund, Inc. v. Halliburton (Halliburton I)* the Court refused to extend the *Dura* rule to the class certification stage—it held that plaintiffs do not have to show loss causation at the class certification stage to invoke the FOTM presumption. Similarly, in *Amgen Inc. v. Connecticut Retirement Plans and Trust Funds* the Court held that plaintiffs are not required to prove alleged misstatements were material (that is, something a reasonable investor would care about when making an investment decision) at the class action certification stage. Instead, the plaintiff would only be required to prove materiality at trial. The Court refused to fashion special rules for certifying securities class actions, notwithstanding its apparently skeptical view of the merits of many of these claims. Or perhaps the Court saw the PSLRA’s pleading standard as reducing the incidence of frivolous suits to an acceptable level.

This pattern of cases seems to mirror the stalemate in Congress; tinkering around the edges with incremental reform, but no real

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44. 544 U.S. 336 (2005).
47. 133 S. Ct. 1184 (2013).
appetite for tackling the fundamental flaw. Against this background, it came as a surprise in Amgen when four justices—Scalia, Thomas, Kennedy, and Alito—urged the Court to reconsider Basic altogether.48 Their signal suggested a heretofore unrevealed willingness to consider reform of the Court’s FOTM policy experiment. The opportunity presented itself when the Court’s remand in Halliburton I came back for consideration in Halliburton II.

V. HALLIBURTON II

The defendants in Halliburton II argued that Basic Inc. v. Levison should be overruled and that plaintiffs should have to show they relied on alleged misstatements.49 Given the constraints of Rule 23 of the Federal Rules of Civil Procedure, such a decision would have made securities fraud class actions effectively impossible, undoing the deluge unleashed by Basic. Moreover, private enforcement under § 10(b) would have been substantially reduced, likely left to institutional investors to bring some form of “mass action,” constrained by the need for each investor to prove reliance. Corporate fraud would not have been left entirely unchecked, since there would still be the threat of government enforcement, state law claims, and a variety of other potential federal law claims for private plaintiffs to pursue. But it would certainly have been a bold judicial stroke, and one that might have finally provoked Congress to act.

Halliburton’s argument for overruling Basic was premised on empirical research raising doubts about the efficient capital market hypothesis, which was the basis of the Basic Court’s conclusion that plaintiffs can rely on the market to quickly incorporate all information (true or false) into stock prices. Tackling that question would require the justices to digest a good deal of sophisticated financial economics. The Court’s track record hardly suggests that the justices are ready for that learning experience. Chief Justice Roberts fretted at the Halliburton II oral argument that the justices were not well positioned to evaluate the financial economics: “How am I supposed to review the economic literature and decide which [side in this case] is correct . . . ?”50 Chief Justice Roberts’s question implicitly suggested that overturning Basic would be an uphill battle, not on the

merits, but instead, simply because of judicial incapacity to assess the relative strength of the arguments presented.

A glimmer of hope arose at the oral argument, however, when Justice Kennedy asked Halliburton’s lawyer to “address the position taken by the law professors, I call it the midway position, that says there should be an event study.” The “law professors” were myself and Todd Henderson of the University of Chicago. We filed an amicus brief in which we argued that instead of scrapping Basic’s FOTM presumption altogether, the Court should instead require plaintiffs to show “price impact” in order to certify a class. Price impact means the alleged misrepresentations caused the stock price to rise or stay steady when it otherwise would have fallen. Our proposal would have reformed, rather than scrapped, FOTM class actions. This argument went to the second question presented in Halliburton II: “Whether, in a case where the plaintiff invokes a presumption of reliance to seek class certification, the defendant may rebut the presumption and prevent class certification by introducing evidence that the misrepresentations did not distort the market price of its stock.”

Our proposal introduced a twist on that question by urging that plaintiffs bear the burden of proof at the class certification stage to show price impact. The policy goal underlying our proposal was to eliminate debates about the efficiency of markets, which are irrelevant to the question of whether fraud occurred. Requiring plaintiffs (or, rather, the plaintiffs’ lawyers) to show price impact would discourage them from bringing weak cases for their settlement value. We argued that disputes over market efficiency were dragging district courts into costly and uncertain territory which those judges were ill-equipped to manage. The strongest argument, however, is that the market efficiency requirement biases suits towards firms trading in obviously efficient markets (like the NYSE) instead of arguably less efficient ones (like the OTC Pink Sheets). This is perverse because the probability of fraud is considerably lower for publicly traded firms on the large exchanges relative to more thinly traded over-the-counter stocks. Companies whose securities trade in “inefficient” markets—e.g., smaller companies trading in the over-the-counter market and debt issuers—are essentially immune to securities class actions, even though these issuers are more likely to commit

51. *Id. at 17.*
52. *Brief of Law Professors, supra note 9.*
fraud because they generally lack the elaborate internal controls and Big Four auditors employed by the largest companies. The FOTM presumption targets anti-fraud enforcement where it is least needed.

That is a fairly sophisticated theory, with a lot of moving parts. Much of it is probably difficult to grasp for someone not immersed in the field of securities fraud class actions. Our strategic assessment, however, was that reform of the FOTM presumption was more likely than its abandonment, and this reform would be simple enough for the justices to grab onto if they were looking for a fix. And a compromise solution might have particular appeal for justices who are struggling to understand the relevant economic theories.

As oral argument unfolded, it seemed our strategic calculation might pay off. Justice Kennedy raised the possibility of “the law professors’ theory of an event study at the certification stage” with counsel for the class, who struggled to come up with a rejoinder. Justice Scalia seemed to be jumping on the bandwagon when he inquired whether the PSLRA would be compatible with a price impact requirement, or as he termed it “Basic writ small.” The seeming clincher came when Deputy Solicitor General Malcolm Stewart, arguing as amicus on behalf of the government and the SEC, responded to a question from Justice Elena Kagan. She asked Stewart to address the impact “on individual decision-making with respect to securities... if the law professors’ position was adopted.” After some meandering, Justice Kennedy nudged Stewart back to Justice Kagan’s question. Stewart’s response: “I don’t think that the consequences would be nearly so dramatic [as overturning Basic]. In fact if anything, that would be a net gain to plaintiffs, because plaintiffs already have to prove price impact at the end of the day.”

Most tealeaf readers (myself included) thought that Stewart’s response was the pivotal moment of the oral argument. It appeared that the lawyer for the SEC had conceded that requiring a showing of price impact would not be a big deal. Indeed, Stewart (erroneously) suggested that it might make plaintiffs better off. For justices looking

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54. Id. at 40–41.
55. Id. at 47–48.
56. Id. at 49.
57. Id. at 50.
58. Stewart was wrong because his answer ignores the reality that securities class actions always settle if they are not dismissed, so the lawsuits never get to “the end of the day.”
for an “intermediate position” that would bring reform without unduly disrupting existing practice—a conservative ideal straight out of Edmund Burke’s playbook—the advocate for the principal regulator of the securities markets told them that they had found it. Reform, though modest, had won!”

Not so fast. When the *Halliburton II* opinion was handed down a few months later, the Court rejected our price impact argument, instead preserving the requirement that plaintiffs show market efficiency to invoke the FOTM presumption. Rather perplexingly, however, the Court did allow defendants to prove there was no price impact from the alleged misrepresentation. From a policy perspective, this move seems like a clear mistake. The *Halliburton II* decision does nothing to discourage plaintiffs’ lawyers from going after the deepest pockets—they are still incentivized to target firms that trade in more efficient markets. But the decision adds a new battle of the experts—without jettisoning the old one—that will further increase the already enormous cost of litigating these cases.

*Halliburton II*'s price impact defense will encourage defendants to put on economists to testify that the alleged misstatements did not affect the market price. Plaintiffs will respond with their own economists who will testify that it did. Trial judges will be charged with sorting out the mess. Markets vary in the speed with which they incorporate information. Moreover, the significance of the information matters as well, so it can be a challenging task to establish whether a statement affected the market price. That challenge can be particularly daunting if a company releases multiple pieces of information at the same time or if corrective disclosure reaches the market in dribs and drabs. With the burden of proof on defendants, many trial judges, faced with conflicting economic evidence that they are scarcely equipped to evaluate, will opt to certify a class. The most that defendants can realistically hope to achieve is that the price impact inquiry will limit some unduly expansive class periods. Consequently, the watered-down role for price impact evidence adopted by the Court in *Halliburton II* is likely to have minimal real-world effect on the mix of cases pursued by plaintiffs. Despite the limited prospects for success and the added litigation expense, it will be the rare defendant that does not take advantage of the opportunity

afforded by the *Halliburton II* decision. Insurers will raise premia paid by companies for directors’ and officers’ insurance to compensate for the additional expert fees. Recall that those premia are ultimately born by shareholders.

Why did the Court make a legal move that was such an obvious policy mistake? The Court fell back on stare decisis—it was reluctant to overturn (or even reform) a decades-old precedent that had become such a central feature of modern securities fraud litigation. The Court took its timid approach because to do otherwise would require it to choose sides in a dispute about financial economics for which it was poorly equipped. Chief Justice Roberts is certainly correct that issues of financial economics relevant to price impact are beyond the ken of most judges. Unfortunately, the *Basic* FOTM presumption, which the Court preserved in *Halliburton II*, requires trial judges to make similarly fraught economic decisions in determining market efficiency in every securities fraud class action. By choosing to retain the FOTM presumption, the Court did choose a side, or rather, chose to stick with the side it had previously chosen in *Basic*. The side it chose pushes in the direction of excessive amounts of litigation, targeting the wrong actors, and yielding dubious deterrence of fraud. Worse yet, the Court added a price impact defense that requires trial judges to tackle a second set of challenging economic questions, on top of the existing inquiry into market efficiency. Those inquiries have nothing to do with whether or not fraud occurred.

Why throw trial court judges into that briar patch? Counting the votes in the majority, Justice Kennedy’s vote with the majority’s timid approach is the most puzzling. His questions at oral argument suggested that he was open to reforming the FOTM presumption, but perhaps he was simply committed to finding a compromise that appeared to be “doing something.” Chief Justice Roberts’s opinion makes clear that he was looking for any changes to be at least colorably consistent with *Basic*, so that he could not be accused of overruling prior precedent.60 And one can presume that Justice Ginsburg and the other concurring justices would have preferred the status quo but were willing to cede some ground if it meant forestalling dramatic change.61 What we do not know is whether the

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60. See, e.g., *Halliburton II*, 134 S. Ct. 2398, 2415–16 (arguing that a “price impact” defense is consistent with *Basic*).

61. Id. at 2417 (Ginsburg, J., concurring) (“The Court’s judgment . . . should impose no
dissenting justices attempted to bargain with Justice Kennedy (as Justice Scalia’s comments at oral argument about “Basic writ small” suggested they might be willing to do), or whether they were committed to overruling Basic altogether. The answer to that question will wait for a future history, after the current justices’ internal papers are released.

What we do know from the published opinion in Halliburton II is that the Court expects Congress to make substantive reform to securities class actions, despite the fact that the Court created the current securities class action regime out of whole cloth. Of course, the Court could have overruled Basic, and given Congress the same invitation to create an explicit private right of action in the statute. This is effectively what happened in the wake of Central Bank of Denver—Congress responded by adding a public right of action for aiding and abetting in § 20(e) of the Securities Exchange Act. But Congress is unlikely to take the Court up on its invitation to reform securities fraud class actions, given that it ducked fundamental reform the last time it entered the fray.

VI. WHO CAN FIX THIS MESS?

With its decision in Halliburton II, the Supreme Court has made it painfully clear that it is not going to reform securities class actions. Although judicial modesty may be a virtue, it is an odd response when the Court’s policy experiment made the mess in the first instance. Moreover, the Court’s deference to Congress seems misplaced when the politicians have demonstrated that they have no appetite for reform. And why should they? The legislature didn’t make this mess. The Court’s commitment to stare decisis also likely carries little weight with the shareholders who (involuntarily) foot the multi-billion dollar bill for the Court’s ill-considered experiment in fraud deterrence policy. Indeed, the Court’s continued tinkering around the edges of securities class actions has made a bad situation worse, raising the implicit fraud-on-the-market tax on public corporations. Halliburton II just raises the levy.

The fact of the matter is that the Court simply lacks the requisite institutional expertise for reform, even if it had the appetite. The

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62. See id. at 2411 (majority opinion) (“As with any other element of that cause of action, Congress may overturn or modify any aspect of our interpretations of the reliance requirement, including the Basic presumption itself.”).
members of the Court are all former government officials, academics, appellate advocates, etc. They are all highly talented lawyers, but simply put, they are not equipped to confront the highly technical field of securities law, which cannot be separated from financial economics. It has been almost 30 years since the last justice with substantial experience as a corporate lawyer—Lewis F. Powell, Jr.—retired from the Court. The Basic Inc. v. Levinson fiasco immediately followed his departure. The current Court has made it clear that it prefers to leave the field to Congress. Halliburton II suggests that the Court’s deference may come, in part, from the realization that the justices are not up to the task of reforming securities class actions. That task requires both an economist’s expertise in financial markets and an institutional understanding of how securities class actions work. The intersection of those skill sets is a rare enough commodity; expecting it to show up on the Supreme Court is wholly unrealistic.

Perhaps reform could come from Congress? Not likely. As noted above, Congress punted on the question of the FOTM presumption when it adopted the PSLRA in 1995. Why? The political reality was that two powerful constituencies were diametrically opposed. For the plaintiffs’ bar, the FOTM presumption was the foundation of their (lucrative) livelihood. Repealing it would be an existential threat and they responded with political resources commensurate to that threat. On the other side of the battle was corporate America, particularly the high tech sector, wailing that lawsuits were chilling growth and destroying jobs. Neither side had the political clout to declare outright victory—the result was a stalemate. Congress tightened the screws on securities class actions, but left FOTM suits largely alone. With big donors on both sides, the FOTM presumption was simply too politically hot to handle and the status quo prevailed. Nothing has changed to alter that political calculus in the last twenty years.

Perhaps the SEC, an independent agency, could rise above the political fray? Its opposition to reform during the legislative process leading up to the PSLRA is hardly promising, and the SEC’s subsequent positions are no more encouraging. The SEC consistently sides with the plaintiffs’ bar in its amicus role, as it did in Halliburton II. The SEC’s support for the plaintiffs’ bar in part reflects its own

institutional interests because the agency favors broad interpretations of its governing statutes.\textsuperscript{64} The SEC's commitment to the plaintiffs' bar goes beyond that interest, however, as it sides with the plaintiffs' bar even on issues that relate purely to the terms of the implied Rule 10b-5 cause of action, like the price impact issue in \textit{Halliburton II}. Those issues have no effect on the SEC's enforcement agenda; the SEC does not have to prove reliance in its enforcement cases.\textsuperscript{65} The SEC's longstanding commitment to the plaintiffs' bar can only be ascribed to ideology, as the agency staff views its investor protection role broadly. Plaintiffs' lawyers are viewed (perhaps simplistically) as allies in that fight. The SEC has the authority to reform Rule 10b-5 class actions,\textsuperscript{66} but given the agency's track record, it is unrealistic to expect reform to come from that quarter.

Who's left? Perhaps shareholders will take matters into their own hands. Shareholders have the right incentives for evaluating reforms because they are forced to internalize both the benefits and 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, shareholders (all of them this time) also ultimately bear the costs of securities fraud class actions, including the payment of attorneys' fees on both sides of the litigation, the cost of experts (ramped up by \textit{Halliburton II}), and the distraction costs to executives arising from defending the lawsuit. Directors' and officers' insurance will cover most of the direct costs, but the premia for that insurance are ultimately paid by the shareholders. Less tangible, but perhaps larger, are costs firms incur to avoid being sued: more money spent on lawyers' fees for flyspecking disclosure documents, higher auditors' fees, and less forthcoming disclosure.

\textsuperscript{64} See, e.g, \textit{Ernst & Ernst v. Hochfelder}, 425 U.S. 185, 197–99 (1976) (rejecting the SEC argument—advanced as amicus in a private suit—for a negligence standard in Rule 10b-5 actions).

\textsuperscript{65} \textit{Geman v. SEC}, 334 F.3d 1183, 1191 (10th Cir. 2003) (“The SEC is not required to prove reliance or injury in enforcement actions.”); \textit{United States v. Haddy}, 134 F.3d 542, 549–51 (3d Cir. 1998) (stating that the government need not prove reliance in criminal cases).

These costs are not covered by insurance. How does the balance tip between the benefits of deterrence and its costs? Perhaps shareholders should be allowed to weigh for themselves.

The most sensible option would be to allow shareholders to change the damage measure in Rule 10b-5 securities fraud class actions involving the company, its officers, and directors.67 Instead of compensation, which is theoretically dubious and rarely achieved in practice, shareholders might want to focus on deterrence. Specifically, shareholders could adopt an unjust enrichment model through a partial waiver of the FOTM presumption of reliance in the corporation’s articles of incorporation. 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 standard out-of-pocket measure of damages in these cases (i.e., compensation would be available to them). Thus, in a FOTM suit, the company itself would only be liable when making an offering or repurchasing shares. It would only be liable for out-of-pocket compensation to plaintiffs who actually relied to their detriment. Deterrence, however, would still be served. 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 the price was fraudulently manipulated; here the FOTM presumption could be invoked.

Obviously the damages paid under a disgorgement measure are unlikely to afford full compensation, but compensation is not the answer to securities fraud in the secondary market. Investors protect themselves through diversification; settlements currently only compensate for a trivial percentage of investor losses. 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. Disgorgement is closely tailored to that goal.

Can shareholders amend corporate charters to fix this badly broken system? The staff of the SEC takes the position that such waivers are illegal. Section 29 of the Securities Exchange Act 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 Securities 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). The Supreme Court has not addressed 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 because they did not affect any “substantive obligations” imposed by the Securities Exchange Act.

The SEC, however, takes the position that the FOTM presumption is a substantive obligation of the Securities Exchange Act, despite the fact that it was created by the Supreme Court, not Congress. Moreover, the Supreme Court has described the FOTM presumption as “a substantive doctrine of federal securities-fraud law” in Amgen Inc. v. Connecticut Retirement Plans and Trust Funds and in Halliburton II, although the Court has not explained why. So a waiver of the FOTM presumption—the single reform that would most closely tie securities fraud class actions to deterrence—may be a non-starter under current law.

A more blunderbuss response to the problem of securities fraud class actions would be for shareholders to amend the corporate charter to require that such disputes be settled in arbitration, without the ability to consolidate individual cases into a class action.

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consistent series of decisions from the Supreme Court interpreting the Federal Arbitration Act strongly supports the enforceability of such a provision. The SEC’s staff of course disagrees, taking the position that arbitration clauses violate § 29 of the Securities Exchange Act, notwithstanding the contrary Supreme Court precedent.

Would investors favor such clauses? An arbitration clause is something of a nuclear option, eliminating both the deterrent value of securities class actions and the waste they engender. Investors presumably all favor deterrence, but their interests may diverge on the availability of compensation, which would be substantially curtailed under an arbitration regime. The relatively low rate of participation by retail shareholders in securities class action settlements suggests that they do not value compensation all that highly. Shareholders who are holders, trading infrequently, are likely to favor an arbitration regime because they are typically on the paying end of litigation and settlement in class actions. 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 through diversification; 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 a FOTM class. On the other, the proposed regime would still allow such investors to pursue arbitration, which might be feasible if they made a large (losing) bet on a stock.

Of course, we will get prompt feedback if investors make the wrong call in voting to adopt an arbitration clause. If eliminating FOTM class actions undermines deterrence, we would expect to see a stock price drop for a firm that requires arbitration of securities disputes. That will be powerful evidence for opponents of arbitration. If on the other hand, the stock price response is positive, shareholders

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73. AT&T Mobility LLC v. Concepcion, 131 S. Ct. 1740 (2011); Am. Express Co. v. Italian Colors Rest., 133 S. Ct. 2304 (2013).
are likely to follow that pioneering firm’s lead in requiring arbitration. We should at least encourage shareholders to experiment so that we can get an answer to the question of whether shareholders—those whom the current system is supposed to benefit—value it as much as the lawyers and the SEC do.

Even more draconian than arbitration would be a fee-shifting rule. Corporations might amend their by-laws to adopt a “loser pays” regime for shareholders bringing suit against the corporation, its officers, and directors. A few of these provisions have already popped up, and there is reason to believe that the Delaware courts, at least, will uphold them. For those who think that shareholder litigation has some role to play in keeping officers and directors accountable, this development is likely to be viewed with alarm. Notably, so far the provisions have been asymmetrical: the shareholder pays if he loses, but the corporation is not obliged to pay if it loses. This feature is likely to make such provisions difficult to enforce if challenged, although the in terrorem effect of them may deter shareholder litigation in the short run.

CONCLUSION

The Supreme Court has struggled for a generation with the wrong turn it took in Basic Inc. v. Levinson. The fraud-on-the-market regime established in Basic shifts money from one shareholder pocket to another shareholder pocket at enormous expense. In Halliburton II, the Court extinguished any hope that it would fix its prior error. The Court’s institutional commitment to stare decisis—perhaps coupled with an awareness of its own limitations with the subject matter—kept it from making any meaningful change. Congress and the SEC have both had the opportunity to fix the problem created by Basic, but those institutions are either paralyzed by gridlock (Congress) or ideologically committed to the status quo (the SEC).

Shareholders bear the costs of the FOTM regime, and shareholders have the power to end those costs by adopting arbitration or fee-shifting provisions. That “nuclear option” comes at a cost, however, as it eliminates entirely the deterrent value of securities class actions. Will shareholders clean up the mess that the Supreme Court has created with securities class actions? Stay tuned.