PRICE INFLATION AND PRICE MAINTENANCE IN SECURITIES FRAUD CLASS ACTIONS

RICHARD A. BOOTH*

ABSTRACT

Most securities fraud class actions allege that the defendant company lied to the market to maintain a higher stock price than what would have prevailed if investors had known the truth. But there is no general duty requiring disclosure of information simply because it is material. Accordingly, some scholars argue that to state a claim for fraud, a misrepresentation must cause stock price to increase absent a duty to speak. The implications of this debate extend beyond the mere definition of fraud. A price-inflation requirement would imply minimal liability as measured by the price increase (if any) caused by an alleged misrepresentation. In contrast, the price-maintenance theory seems to imply liability for the difference between the price paid and the price prevailing after corrective disclosure. After analyzing these two possibilities, this Article considers a third possibility: One might measure the loss by the difference between the price paid and the price that would have been paid if the market had known the truth. The Supreme Court has ruled that defendant companies must be permitted to show that the effects of corrective disclosure come from sources other than fraud. But losses other than from such mispricing are almost always derivative and should give rise to recovery by the company. Moreover, the rule is that a class action for damages must be superior to other modes of resolving the dispute. It follows that any portion of a claim that can be litigated as a derivative action must be so litigated. And to the extent that the subject company recovers in the derivative action, damages will be mitigated in any subsequent class action.

* Martin G. McGuinn Chair in Business Law, Villanova University Charles Widger School of Law.

TABLE OF CONTENTS

INTRODUCTION 135
I. WHY THEORY MATTERS 137
II. THE DUTY TO DISCLOSE 142
III. THE REQUIREMENT OF LOSS CAUSATION 144
A. Proximate Cause 149
B. Fraud on the Market 152
C. Price Impact 154
IV. CLAIM CHARACTER AND CLASS ACTIONS 159
A. Efficient Adjudication 161
B. Fair Adjudication 162
V. CLASSIC FRAUD CLAIMS RECONSIDERED 163
VI. PLAINTIFF INCENTIVES AND INDEX FUNDS 165
VII. CONCLUSION 171

30 STAN. J.L. ECON. & BUS. 133

INTRODUCTION

Most securities fraud class actions are based on allegations that the defendant company made some misrepresentation of material fact that had the effect of *maintaining* stock price at a level higher than would have prevailed if the market had known the whole truth about the company.[1] But some scholars have argued that this idea of fraud is inconsistent with the fact that there is no general duty requiring disclosure of information simply because it is material.[2] Scholars who argue that price maintenance alone is insufficient also argue that to state a claim for fraud, a misrepresentation must have caused affirmative price inflation. Such scholars also argue the company should be held liable only to the extent of the price inflation caused by such misinformation.[3]

One distinguished scholar of securities law has explained it well by means of a simple example: Consider two identical companies, ABC and XYZ, both of which face difficulties with a regulatory agency. ABC lies to cover up the difficulties, while XYZ says nothing. Assume that the ABC lie does not affect stock price because it is taken as non-news, and ABC stock price remains constant. Because XYZ says nothing, its stock price stays constant as well. When the truth is revealed because the agency takes action, both ABC and XYZ stock prices drop by the same (percentage) amount,

---

1. *See* Merritt B. Fox & Joshua Mitts, *Event-Driven Suits and the Rethinking of Securities Litigation*, 78 BUS. LAW. 6, 40 (2023). To be clear, this statement assumes that most such actions are based on the cover-up of *bad* news that causes a stock's price to *drop* when the truth comes out, thus visiting a loss on those who *bought* during the fraud period (between the time of the original deception and corrective disclosure). But fraud may also cover up *good* news that causes a stock's price to increase when the truth comes out, in which case fraud-period *sellers* suffer the loss. There are notable examples of such good-news fraud. *See*, *e.g.*, Basic Inc. v. Levinson, 485 U.S. 224 (1988); Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972); SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968). Nevertheless, the overwhelming majority of securities fraud class actions (about 98%) involve the cover up of bad news. *See* Richard A. Booth, *The End of the Securities Fraud Class Action as We Know It*, 4 BERKELEY BUS. L.J. 1 (2007). Accordingly, the discussion here assumes a bad news scenario. Although much of the analysis applies with equal force to good news cases, it may not do so in every conceivable situation. *Cf.* Dura Pharmaceuticals, Inc. v. Broudo, 544 U.S. 336, 343 (2005) (noting similar distinction).

   The parenthetical (whole) is intended to acknowledge the fact that corrective disclosure might or might not involve all material information. It may reveal a misrepresentation thus causing a downward adjustment in stock price even though other negative information remains undisclosed. So, it is important not to assume that stock price following corrective disclosure will not necessarily reflect the best possible estimate of company value.

2. *See* Fox & Mitts, *supra* note 1, at 16-21; Donald C. Langevoort, *Compared to What? Econometric Evidence and the Counterfactual Difficulty*, 35 J. CORP. LAW 183, 186-87 (2009); James C. Spindler, *Why Shareholders Want Their CEOs to Lie More After Dura Pharmaceuticals*, 95 GEO. L.J. 653, 659-66 (2007).

3. *See*, *e.g.*, Fox & Mitts, *supra* note 1, at 3-7.

producing similar investor losses. Buyers of ABC shares are no worse off than buyers of XYZ shares, yet buyers of ABC stock can sue for damages based on a price-maintenance theory. But if we require a showing of price inflation, both companies are treated the same unless the ABC plaintiffs can show that the fraud did indeed distort the stock price, in which case their damages are the amount of the distortion.[4]

Nevertheless, courts have consistently upheld claims based on a theory of mere price maintenance, usually without much explanation as to why they reject the argument that literal price inflation should be required.[5] When they offer any explanation at all, the courts have relied on a general duty not to lie.[6] But even scholars who advocate for a rule requiring literal price inflation allow that a claim should lie for price maintenance where a company is *obligated* to speak by law or circumstance.[7] A duty to speak can come from many sources.[8] It can come from a requirement to make

4. Langevoort, *supra* note 2, at 186-87. Note that this passage has been edited for readability.

5. *See* Fox & Mitts, *supra* note 1, at 17 n.37 (stating that court have sleepwalked into this doctrine); *but see* Archdiocese of Milwaukee Supporting Fund, Inc. v. Halliburton Co., 597 F.3d 330, 335 (5th Cir. 2010), vacated and remanded sub nom., Erica P. John Fund, Inc. v. Halliburton Co., 563 U.S. 804 (2011) [hereinafter *Halliburton I*], and citing Greenberg v. Crossroads Sys., Inc., 364 F.3d 657, 665 (5th Cir. 2004)) (price maintenance requires more than mere confirmation); In re Vivendi, SA Securities Litigation, 838 F.3d 223, 253-61 (2d Cir. 2016); Glickenhaus & Co. v. Household Int'l, Inc., 787 F.3d 408, 418 (2d Cir. 2015); FindWhat Investor Grp. v. FindWhat.com, 658 F.3d 1282, 1317 (11th Cir. 2011) (holding that defendants whose fraud *prevents* preexisting inflation in a stock price from dissipating are just as liable as defendants whose fraud introduces inflation into the stock price in the first instance).

6. *See* Basic Inc. v. Levinson, 485 U.S. 224, 240 n.18 (1988) (referring to "ever-present duty not to mislead"). Indeed, the duty to refrain from misrepresentation—the duty not to lie affirmatively—is so well fixed that the courts often do not even mention it. In contrast, a case based on an omission to state a material fact is more difficult to maintain since it requires a positive duty to disclose. *See* Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972). To be completely clear, the issue whether price maintenance should suffice relates only to cases involving affirmative misrepresentations, rather than mere omissions.

7. *See* Fox & Mitts, *supra* note 1, at 19-21. Indeed, a duty to speak may arise any time a company's stock price would fall but for confirming the market's incorrect belief. Note that in *Goldman Sachs,* which is described by the Supreme Court itself as a price-maintenance case, the allegedly false statements appeared in SEC filings although the statements themselves were arguably voluntary. *See* Goldman Sachs Grp., Inc. v. Arkansas Tchr. Retirement Sys., 594 U.S. 113, 119-20 (2021) [hereinafter *Goldman Sachs*]. Moreover, the statements may not have become untrue (if they were untrue) until sometime after they were made. So it is unclear how a rule requiring literal price inflation would apply. But it is quite clear that figuring out how the rule applies would entail plenty of new litigation.

8. For example, the duty to disclose may often be found in general principles of common law. *See id*. (holding that defendant brokers owed a fiduciary duty to plaintiff sellers of securities to disclose that price was unfairly low); *see also* Malone v. Brincat, 722 A.2d 5 (Del. 1998) (holding that directors and officers can be liable for lying to the market under fiduciary duty of candor despite absence of affirmative duty to disclose); *cf.* United States

periodic filings or disclosures under federal or state law, from a judicially found duty to update information that has become misleading, or to correct rumors originating from sources within the company.[9] Moreover, as discussed further below, it is almost always possible to recast a price-maintenance claim as one based on a duty to correct, albeit at the cost of a somewhat reduced class size.[10]

The Supreme Court has never expressed a view on the price-maintenance theory of fraud, although it has expressly recognized this gap in its securities fraud jurisprudence.[11] So it seems likely that the Court will take up the matter in the not-too-distant future.

I. WHY THEORY MATTERS

As suggested by the hypothetical above, the implications of the price-maintenance theory extend beyond just the definition of fraud. The price-maintenance theory also impacts the measure of harm and thus damages. In other words, the size of a claim depends on how the fraud is defined. A rule requiring literal price inflation seems to imply that the remedy should be based on the price increase caused by a false statement.[12] In contrast, the price-maintenance theory seems to imply that the remedy should be based on the difference between the price paid and the price following corrective disclosure.[13] But both theories may be seen as attempting to determine

v. O'Hagan, 521 U.S. 642 (1997) (holding that attorney who traded on confidential client information was liable for insider trading based on breach of duty to client). Thus, it is arguable that any duty will do. It is not necessary that the duty be owed to the plaintiff(s).

9. *See*, *e.g.*, In re Time Warner, Inc. Sec. Litig., 9 F.3d 259 (2d Cir. 1993). While such cases are technically frauds of omission, many (if not most) such cases are pleaded as price-maintenance cases alleging that the original statement was false when made—which has the added advantage of extending the fraud period further back in time and maximizing the claim. *See*, *e.g.*, *Goldman Sachs*, 594 U.S. 113 (2021); Ludlow v. BP, PLC, 800 F.3d 674, 682 (5th Cir. 2015); *but see Halliburton I*, 597 F.3d at 337 (noting the requirement that positive misrepresentation not be merely confirmatory of information already known to and digested by the market).

10. See *infra* Part II.

11. *See Goldman Sachs*, 594 U.S. at 120 n.1 ("Although some Courts of Appeals have approved the inflation-maintenance theory, this Court has expressed no view on its validity or its contours. We need not and do not do so in this case.").

12. *See* Fox & Mitts, *supra* note 1, at 4-6.

13. *See* Langevoort, *supra* note 2, at 186; Spindler, *supra* note 2, at 687-89. This logic seems to imply that buyers may claim their entire loss in omission cases. On the other hand, one can imagine a legal regime in which a showing of price inflation (however minimal) might trigger a claim for the entire loss suffered by buyers, which is essentially the regime we have with the price-maintenance theory. Compensation might also be based on a valuation approach. *See generally* Frank Partnoy, *Market Prices vs. Fundamental Value: The Case for Using Discounted Cash Flow Analysis in Securities Class Actions*, 77 BUS. LAW. 1059 (2022); Daniel R. Fischel, *Use of Modern Finance Theory in Securities Fraud Cases Involving Actively Traded Securities*, 38 BUS. LAW. 1 (1982); *see also* Langevoort, *supra* note 2, at 183;

mispricing at the time the buyer buys (or the seller sells). As such, both approaches would seem to serve the policy goal of assuring that market prices are as accurate as possible.[14] But the debate over price maintenance versus price inflation tends to obscure the real issue, which is mispricing at the time of the trade.

The price-maintenance theory can easily lead to compensation far more than mispricing at the time of a trade. When the truth comes out, stock price may fall much more than it would have fallen if the company had told the truth in the first place.[15] Understandably, plaintiffs would want to rely on the price-maintenance theory if it supports a bigger claim. Moreover, the more stock price falls, the easier it is to prove (by means of an event study) that the market for the stock is efficient and that previously undisclosed information caused the decrease. Most courts seem to agree with this approach to calculating buyer loss without giving much thought to the matter.[16] This is understandable since it is so easy to measure investor loss by reference to objective market prices—the price paid and the price following corrective disclosure. For example, it is a common and accepted practice among plaintiffs pleading loss causation to calculate loss based on the decline in market price on the day of corrective disclosure and then to work backwards chronologically to the date of the misrepresentation to construct an "inflation ribbon" to establish the loss suffered by investors who bought on various days during the fraud period.

One advantage of the literal price inflation rule is precision. If the fraud consists of a misrepresentation that affirmatively inflates the price, the remedy matches the offense. And it is easy (in theory) to measure the increase in price caused by a statement that later turns out to be false. Moreover, the literal price inflation rule addresses the thorny problem of mixed signals that often go with corrective disclosure. As many scholars have noted, a savvy company that knows it has misspoken may wait to issue a correction until it also has some good news to release, which may result in a muted market reaction that fails to reflect the full price drop that would have occurred

Fox & Mitts, *supra* note 1 (suggesting that valuation approach—as opposed to reliance on market prices—would avoid the issues raised by the price-inflation versus price-maintenance debate).

14. As noted below, this is a policy goal that should be very important to index funds and their investors. *See infra* Part VI. Again, there is no general legal duty requiring publicly traded companies to disclose information simply because it would matter to investors—because it is material. But it is not necessarily a bad idea to require truth-telling (as Langevoort describes it) when the company chooses to speak on the theory that the company will not choose to speak unless circumstances dictate it. Thus, the rule of truth-telling—which is implicit in the price-maintenance theory—may be seen as akin to the requirement to file a Form 8-K when certain important events occur. Although a rule of truth-telling is somewhat fluid, it is still objective in that its applicability is triggered by a company's choosing to speak and so may be seen as a legitimate way to expand the duty of disclosure.

15. *See infra* Part III.

16. *See* Fox & Mitts, *supra* note 1, at 17 n.37.

30 STAN. J.L. ECON. & BUS. 133

if the company had told the truth in the first place.[17] But curiously, these same scholars often ignore the possibility—indeed probability—that corrective disclosure might cause stock price to fall even more than it would have done if the company had timely told the truth.[18] In short, some scholars worry more about how companies can mislead the market, while other scholars worry more about how stockholders may seek to recover too much—a classic half-full-half-empty conflict of perspective.

The disadvantages of the literal price inflation rule are numerous. For one, few securities fraud class actions would survive a motion to dismiss, since, in practice, most such actions are based on a price-maintenance theory. Moreover, even in cases where a misrepresentation causes an increase in price, the price change is unlikely to be statistically significant. So even in cases where some price inflation occurs, it will often be insufficient to support a claim.[19] Of course, one might argue that this result is as it should be—that there are too many securities fraud class actions as things stand. But to require literal price inflation would mean that companies would be free to make all sorts of false statements to support the prevailing market price even though they know it to be inflated.[20]

---

17. *See* Spindler, *supra* note 2.

18. *See* Richard A. Booth, *Loss Causation and the Materialization of Risk Doctrine in Securities Fraud Class Actions*, 75 BUS. LAW. 1791 (2020); Richard A. Booth, *Claim Character and Class Conflict in Securities Litigation*, in ELGAR HANDBOOK ON SHAREHOLDER LITIGATION (Chapter 5) (2018); Richard A. Booth, *What Counts as Price Impact for Securities Fraud Purposes?*, 9 VA. L. & BUS. REV. 37 (2015); *see also* Barbara Black, *Reputational Damages in Securities Litigation*, 35 J. CORP. L. 169, 175 (2009); Allen Ferrell & Atanu Saha, *The Loss Causation Requirement for Rule 10b-5 Causes of Action: The Implications of* Dura Pharmaceuticals v. Broudo, 63 BUS. LAW. 163 (2007). The one empirical piece focusing on the source of loss from securities fraud (arising from bad accounting) finds that on average, about two-thirds of the price decrease following corrective disclosure derives from reputational harm, whereas only about one-third of the loss derives from the inaccurately reported numbers. *See* Jonathan M. Karpoff, D. Scott Lee & Gerald S. Martin, *The Cost to Firms of Cooking the Books*, 43 J. Fin. Quan. Analysis 581 (2008); *but see* Langevoort, *supra* note 2 (recognizing both possibilities). *See, e.g.*, *Halliburton I*, 597 F.3d at 336 (noting the problem of multiple items of bad news); *see also* Dura Pharmaceuticals, Inc. v Broudo, 544 U.S. 336, 342-43 (2005) (noting that price decrease may be the result of factors other than the alleged fraud such as changed economic circumstances, changed investor expectations, new industry-specific or firm-specific facts, conditions, or other factors).

19. *See* Fox & Mitts, *supra* note 1, at 14-21 (discussing this threshold problem). This worry is based on the assumption that the courts and litigants would continue to use event studies to prove price impact, loss causation, etc.; *but see also* Partnoy, *supra* note 12 (suggesting an alternative approach based on valuation). Note that it is not technically necessary to use the claim upon which an action is based to prove that the market for the subject stock is efficient. And it may be a better strategy in some cases for plaintiffs not to do so. But it might be a handicap when the time comes to prove loss causation.

20. This worry assumes that companies know when stock price is higher than it should be and that they know what to say to keep it that way without causing further inflation. But experience seems to indicate that companies are not very good at understanding the market or predicting how the market will react to new information. *See, e.g.*, *In re Time*

PRICE INFLATION AND PRICE MAINTENANCE

In contrast to a rule requiring literal price inflation, the price-maintenance theory seems to presume that a duty to tell the whole truth manifests because of a misrepresentation—because the measure of the claim is the change in price upon corrective disclosure, which change may encompass the effects of other facts that come out at same time. In other words, one little lie may trigger a claim for the *entire* difference between the prevailing market price and the price that would have obtained if the market had known the whole truth.[21]

Accordingly, the price-maintenance approach is likely to result in bigger claims and overcompensation for plaintiffs.[22] To be sure, the claim might sometimes be equal merely to the difference in price (and no more) resulting from correction of an isolated misrepresentation, as is implicit in the ABC example. But again, corrective disclosure often will be accompanied by other facts that cause market price to fall more (or less) than it would have fallen if the company had told the truth in the first place.[23] Indeed, it would be quite surprising if the price change from corrective disclosure exactly matched the price that would have prevailed if the company had told the truth. This is illustrated, in a way, by the ABC example. It is difficult to believe that stock prices of the two companies would fall by exactly the same proportion if the market cares at all about the fact that ABC lied. If so, it must be that the market finds the lie totally excusable. Otherwise, it would punish ABC by some additional amount to reflect a loss of trust in its management.[24]

Warner, 9 F.3d at 261. Nevertheless, plaintiffs in *Goldman Sachs* alluded to the point three times during oral argument before the Supreme Court in asserting that the firm traded at a higher multiple of earnings than other comparable firms because it had fooled the market into thinking it was in some way better.

21. Admittedly, the idea that a duty to tell the whole truth arises is a bit of an overstatement. There will always be some facts about the company that remain undisclosed. The market always wants more information. So, the duty would be more precisely described as one to be as accurate as possible regarding any matter about which the company chooses to speak. *See* Fox & Mitts, *supra* note 1, at 29-30 (discussing similar ambiguity).

22. Most scholars seem to agree that the central problem with securities fraud class actions is that the prospect of crushing liability leads defendant companies to agree to large settlements in any case that cannot be dispatched short of trial. In other words, it is simply too risky to go to trial in any case that survives dismissal (or summary judgment) and is certified to proceed as a class action. As a result, many questions that arise later in the proceeding—such as the measure of damages—are never resolved, further enhancing risk for defendant companies. These same forces induce plaintiff lawyers to sue more often than they might otherwise do, further exacerbating the foregoing problems.

23. Most scholars have focused on the possibility that companies might wait to correct misstatements until they can also disclose some offsetting good news so that the net change in price will minimize any fraud claim. *See, e.g.*, Spindler, *supra* note 2.

24. There are other problems with the example as discussed further below. For one, the statement by ABC is not necessarily about matters that are unique to it or that it is in the best position know— company-specific information. Rather, the statement might be seen as a forward-looking prediction about industry or regulatory conditions. *See, e.g.*, Wielgos v. Commonwealth Edison Co., 892 F.2d 509 (7th Cir. 1989). The idea that some (or much)

30 STAN. J.L. ECON. & BUS. 133

The possibility that the claim can encompass additional losses is especially problematic where the corrective disclosure comes from an *event* that reveals the untruth of earlier statements by the company. For example, in the ten weeks following the Deepwater Horizon blowout and oil spill on April 20, 2010, shares of BP (the operator of the rig) fell from $60.48 per share to $35.20 per share.[25] Investors who had bought BP stock before the event sued to recover their losses, claiming that BP had lied about improvements to its safety practices beginning in November 2007, and that the truth as to the inadequacy of such practices was revealed by the events of April 20 and the following days. There is no doubt that BP stockholders lost money. But was the loss caused by fraud or rather by other factors including the fact that bad things sometimes happen to good companies?

One motivation for recent scholarly challenges to the price-maintenance theory (and advocacy for requiring literal price inflation) is the perceived need to limit the size of fraud claims, which have expanded far beyond any loss attributable to mispricing at the time buyers buy or sellers sell.[26] The idea is that massive claims are

---

of stock price decline upon corrective disclosure likely comes from reputational harm has been discussed at some length by scholars since 2007. *See supra* note 20. Curiously, this work is not cited in the most recent work, which also neglects to consider seriously the character of such claims. *See, e.g.*, Fox & Mitts, *supra* note 1, 78 BUS. LAW., at 32-33; Marc Ian Gross, *#Reputation Matters! A Critique of the Event-Driven Suits Model*, 79 BUS. LAW 263 (2024).

25. To be precise, BP shares fell from $60.48 at the close on April 20, 2010 to $35.20 at the close on July 20 (90 days later), for an average closing price of $40.35 during that period. In other words, BP decreased by 33% based on the average closing price. The benchmark S&P 500 fell during the same period by about 8% based on average closing prices. So an investor who bought BP stock on April 20 suffered a net loss of about 25% or about $15 per share. Note also that BP had about 3.13 billion shares outstanding at the time (as measured by units traded in the US). Thus, the company's aggregate value (its market capitalization) was about $189 billion as of April 20, 2010 and about $126 billion as of closing 90 days later, for a decline of about $63 billion. For the record, the total cost of the clean-up from the spill was about $62 billion as later reported. *See* Stephen Mufson, *BP's Big Bill for the World's Largest Oil Spill Reaches $61.6 Billion*, WASH. POST (Jul. 16, 2016), https://perma.cc/8SMY-B6V5.

Figures for the S&P 500 are based on closing prices for the leading index fund based thereon (SPY), which fell from $120.88 to $108.48 over the same ninety-day period, with an average closing price of $111.06 (unadjusted). It is not entirely clear whether the comparison between BP and the index should be based on the ninety-day average for the index or the closing price thereof on the 90th day (since the index is after all an average of 500 stocks). Note also that SPY paid a $0.531 dividend on June 18, 2010, but that BP paid no dividends during the period. To be completely accurate, one would need to adjust the calculation for this dividend and for the relative risk inherent in BP stock as compared to the S&P 500. As of today (in early 2024), BP is about 61% as risky as the index, which means that it tends to fall in price less than the index falls all else equal. This in turn suggests that the loss suffered by buyers was somewhat greater than the $15 per share as calculated here.

26. *See* Fox & Mitts, *supra* note 1, at 3-7.

plausible only because claimants and courts have relied on the price change that goes with corrective disclosure. Presumably, a rule requiring pleading and proof of literal price inflation would avoid this mistake. But even if the courts were to adopt such a rule, no claim will lie until the market discovers the truth and the stock price corrects.

The Supreme Court clearly ruled in *Dura Pharmaceuticals, Inc. v Broudo* that there can be no claim unless and until stock price drops.[27] Indeed, it is difficult to see how things could be otherwise. There is no way to know that a false statement is false until the truth comes out. And given this price-correction requirement, there is no way to avoid the question whether defrauded buyers should be able to recover the entire loss they suffer. When stock price falls dramatically, buyers will sue for as much as possible. Moreover, it is much easier to assume that the entire loss suffered by a buyer is caused by fraud. If not, it is not obvious how to parse the claim. So courts may be inclined to favor larger claims if only because the loss is easier to quantify.[28]

II. THE DUTY TO DISCLOSE

One possible way to fix the overcompensation problem is to require literal price inflation and to limit claims thereto. But the rationale for the rule is that there is no general duty of disclosure. It does not apply where the company is obliged to speak (whether by law or circumstance).[29] Again, even those scholars who favor a literal

27. 544 U.S. 336, 347 (2005).

28. The problem is compounded by the ambiguity inherent in the idea of transaction causation (and thus the FOTM doctrine). Although transaction causation seems at first to refer to somehow triggering an investor decision to buy or sell, it could just as easily refer to causing the transaction to be done at the wrong price (on the assumption that the transaction was going to happen anyway). *See* Ludlow v. BP, PLC, 800 F.3d 674 (5th Cir. 2015) (discussing the distinction between a claim based on mere pricing versus a claim based on the decision to buy at all). Note that the FOTM doctrine appears to be based on the assumption that investors will buy and sell for their own varying reasons and that the courts need not consider individual cases (even though the FOTM doctrine allows for rebuttal based on such individualized reasons). The problem is further compounded by the very idea of fraud, which falls somewhere on the border between tort (with consequential damages) and contract (with more limited benefit-of-the-bargain remedies at most). *See* Frank H. Easterbrook & Daniel R. Fischel, *Optimal Damages in Securities Cases,* 52 U. CHI. L. REV. 611, 639-44 (1985) (suggesting that the scienter requirement might justify recovery for entire loss suffered by buyers as opposed to some lesser measure such as one based on mispricing). These ambiguities together with the convenience of readily ascertainable (concrete) market prices may naturally incline the courts to place the burden on defendants to argue for some lesser measure of damage. *Cf. Goldman Sachs*, 594 U.S. at 114-15 (burden on the defendant to prove a complete lack of price impact).

29. It may be that the fact that a company chooses to speak acts as presumptive trigger for a duty to speak. This is not necessarily a bad way to impose a duty to disclose. If a company chooses to speak, then it must have determined that it was required to speak. This rationale is akin to that seen for ratification in agency law, where after-the-fact affirmation of authority is deemed to amount to authorization in the first place. *See* Restatement

30 STAN. J.L. ECON. & BUS. 133

price-inflation rule have argued that a claim for price maintenance should nonetheless lie where failure to speak would have resulted in a decline in price.[30] So even if the courts were to follow the price-inflation requirement, plaintiffs would undoubtedly find ways to argue that the defendant company was somehow duty-bound to speak when it did.

As noted above, there are many situations in which a duty to speak may arise. Aside from the obvious (such as required filings with government agencies), a company might be obligated to correct or update earlier statements that have become untrue or to address rumors that may have arisen from company sources.[31] For example, if a company has announced a plan to form strategic partnerships with other companies in related businesses, but it finds that no other companies are interested in such arrangements, the company might be compelled to say something about abandoning the plan. To be sure, the first such statement might be wholly voluntary when made and, thus, might not define when the fraud period begins. But any subsequent statements might be prompted by a perceived need to confirm or correct the first statement. Accordingly, such statements could be seen as effectively compelled, since any failure to repeat them would be conspicuous.

Similarly, if a company has made it a practice to confer with analysts before announcing earnings and then cancels a scheduled call, analysts might well conclude that the company is likely to announce disappointing earnings and that its stock price will fall. So the company might hold the call anyway and reassure analysts that all is well. While one might characterize this as voluntary speech, it may also be seen as compelled by circumstance and established practice.

Even in the context of required disclosure, it can be unclear whether a particular statement is compelled or voluntary. Indeed, in the *Goldman Sachs* case, company statements about ethical policies and practices upon which the claim was based were contained in annual filings with the Securities & Exchange Commission (SEC) even

(Third) of Agency § 4.01.

30. *See* Fox & Mitts, *supra* note 1, at 3-7.

31. *See generally* In re Time Warner, *supra* note 9 (discussing duty to update and duty to correct). For notable examples of situations in which companies were arguably compelled to respond to outside information, see Matrixx Initiatives, Inc. v. Siracusano, 563 U.S. 27 (2011) (negative television reports about company product); *Basic Inc.*, 485 U.S. 224 (merger rumors). Moreover, it is quite common for voluntary statements to be included in required SEC filings (for example). *See, e.g.*, *Goldman Sachs*, 594 U.S. 113. Does such a voluntary statement thus become one as to which an affirmative duty of disclosure applies? And does it suffice that the speaker felt compelled to make the statement or is the duty to speak one that must be established objectively? Thus, one subtle reason for recognizing price-maintenance claims is avoiding the need to litigate the issue of whether a particular statement was truly voluntary. Note also that most forward-looking statements cannot be used as the basis for a private securities fraud action as long as the speaker does not have actual knowledge that the statement is false. *See* Exchange Act § 21E.

though there was no express requirement that the company address such matters. One might say the same about the statements made by BP about safety improvements. The question then becomes whether such speech is compelled or voluntary. It is easy to imagine how plaintiffs and defendants might spin the facts to make the best possible case for their side. It is also easy to imagine that a court will decide that the question is one of fact that must be determined at trial, preserving plaintiff leverage for settlement.

Finally, it is almost always possible to argue that failure to speak would have resulted in a decrease in price.[32] There is no obvious way to refute such an allegation. So long as a plaintiff offers some context as to why price would (or even might) have declined, a court is likely to accept the allegation as sufficient to survive a motion to dismiss, especially since such cases are almost always based on a significant price correction when the truth is revealed.[33]

The point is that a plaintiff can almost always argue that the defendant company was effectively compelled to speak. Any competent litigator can recast a price-maintenance claim as one based on compelled speech, albeit sometimes at the cost of omitting the first instance thereof as the beginning of the fraud period and thus somewhat reducing the size of the plaintiff class. So in terms of stating a claim, it would make little practical difference whether or not the law requires literal price inflation, other than to eliminate a few peculiar cases in which the plaintiff cannot make a colorable argument for a duty to speak.[34] For the same reason, it is easy to see why the courts have tolerated claims based on allegations of price maintenance and have not insisted on literal price inflation.

III. THE REQUIREMENT OF LOSS CAUSATION

As shown above, the case for requiring literal price inflation is logically strong but practically weak: Almost any claim can be cast as a duty-to-speak case, and even those who argue that literal price inflation should be required in the absence of a duty to speak allow that price maintenance suffice where there *is* a duty to speak. Indeed, they allow that it suffice for a plaintiff to allege that share price would have fallen but for the alleged misrepresentation. In short, the exceptions to the requirement of literal

32. *See* In re Vivendi, SA Securities Litigation, 838 F.3d 223, 257-59 (2d Cir. 2016) (where the court suggests that price inflation might have dissipated in the absence of statements tending to maintain the situation). Note that a similarly questionable argument was made in *Time Warner* in relation to the company's motive to cover up its plans for an unusual rights offering. Specifically, plaintiffs argued that the company sought to keep stock price as high as possible so that it would not fall too low when the truth came out. *See In re Time Warner*, 9 F.3d at 269.

33. *Cf.* Mills v. Electric Auto-Lite Co., 396 U.S. 375 (1970) (rejecting defining a material fact as one that merely *might* matter to investors).

34. *Cf. Goldman Sachs*, 594 U.S. at 126-27 (noting that in vigorously litigated cases, burden matters only when evidence is in equipoise).

30 STAN. J.L. ECON. & BUS. 133

price inflation swallow the proposed rule.[35] Finally, although a pure price-maintenance claim might not suffice in the absence of some assertion that price would have fallen but for the alleged misrepresentation, few such claims (if any) are ever made.[36]

Moreover, the matter seems already to have been settled by *Dura Pharmaceuticals* wherein the Supreme Court ruled that the allegation of mere price inflation without a follow-on price correction does not suffice to state a claim.[37] But in so ruling, the Court did not foreclose the argument that loss should be measured by overpayment—*how much too much* a buyer paid at the time of purchase. Quite to the contrary, the Court seemed to favor such an approach when it stated:

> Normally, in cases such as this one (*i.e.*, fraud-on-the-market cases), an inflated purchase price will not itself constitute or proximately cause the relevant economic loss . . . [But if] the purchaser sells later after the truth makes its way into the marketplace, an initially inflated purchase price *might* mean a later loss. But that is far from inevitably so. When the purchaser subsequently resells such shares, even at a lower price, that lower price may reflect, not the earlier misrepresentation, but changed economic circumstances, changed investor expectations, new industry-specific or firm-specific facts, conditions, or other events, which taken separately or together account for some or all of that lower price.[38]

The clear implication is that intervening factors should be netted out. The Court confirmed this interpretation by referencing the policy goals of federal securities law:

> The securities statutes seek to maintain public confidence in the marketplace. They do so by deterring fraud, in part, through the availability of private securities fraud actions. But the statutes make these latter actions available, not to provide investors with broad insurance against market losses, but to protect them against those economic losses that misrepresentations actually

35. It is arguable that the phrase *price maintenance* is seldom intended to be taken literally and is almost always used as shorthand for a collection of situations in which a duty to speak is implied by circumstances.

36. For example, plaintiff's counsel in *Goldman Sachs* made the point three times during oral argument before the Supreme Court that Goldman traded at a higher multiple of earnings than other similar firms presumably because it had convinced the market that it was more ethical than other firms. Nevertheless, Justice Barrett described the case as one alleging price maintenance.

37. Fox & Mitts blithely dismiss this holding as unfortunate language. *See* Fox & Mitts, *supra* note 1, at 11 n.22.

38. *Dura Pharmaceuticals*, 544 U.S. at 342-43.

cause.[39]

In other words, the goal is to assure that prices are fair, which implies that recovery should be measured by the difference between the price paid by buyers and the price they should have paid. In sum, the Court clearly rejected price inflation as sufficient cause to allege a claim of fraud, and just as clearly left open the idea that loss should be measured by the effect of a misrepresentation on market price. Indeed, the Court virtually endorsed the idea.

Again, those who advocate for a literal price inflation requirement seem to be motivated as much by the problem of exorbitant claims in event-driven securities fraud class actions as they are by any concern for doctrinal purity.[40] But price maintenance can just as well be seen as implying that loss should be measured by the difference between the price a buyer paid and the price that should have been paid when the buyer bought. To be sure, it is simpler to measure loss by reference to objective market prices. But to do so will often incorporate intervening factors contrary to what *Dura Pharmaceuticals* teaches.[41]

For example, the question in the BP case should have been: How much too much did plaintiff investors pay when they bought BP stock? It is likely that the price

39. *Id.* at 345.

40. *See* Fox & Mitts, *supra* note 1, at 3-7. Again, the loss suffered by BP investors from the Deepwater Horizon blowout and oil spill is a prime example. By limiting investor recovery to the amount of literal share price inflation (if any) from statements by BP regarding improved safety practices and procedures, advocates of the price inflation rule hope to reign in the prospect of mega-settlements and the attendant incentives for plaintiffs to sue—as well as disincentives for issuer-company candor.

41. *See* Ludlow v. BP, PLC, 800 F.3d 674 (5th Cir. 2015) (discussing both approaches). This is not a newly discovered issue for securities litigation. It was described (in a way) nearly forty years ago by Frank Easterbrook and Daniel Fischel in their seminal 1985 article on damages in securities cases. *See* Frank H. Easterbrook & Daniel R. Fischel, *Optimal Damages in Securities Cases*, 52 U. CHI. L. REV. 611, 639-44 (1985). They saw the problem—*in a way*—because the problem they saw in cases arising from open market trades (as opposed to new offerings) was the mismatch between the gain for the company (if any) and the loss to buyers. In other words, they saw that companies might misspeak to the market when there was little or nothing to gain and that buyers might be able to sue the company for coincidental losses while sellers who sold at inflated prices could keep the gain. Although Easterbrook and Fischel recognized the problem, they had no good solution to offer. They understood that if liability lies in such cases—which nowadays account for almost all securities fraud class actions—buyers would be over-compensated, and companies would be over-deterred by the prospect of full recovery—and companies would be discouraged from speaking voluntarily to the market. But they reckoned that the need for plaintiffs to prove scienter would limit the number of such cases and that over-compensation would operate (somewhat appropriately) as a form of punitive damages. In short, they punted. Thus, Easterbrook and Fischel did not really see or anticipate problems with event-driven actions, but they did intuit the same problem of overcompensation.

30 STAN. J.L. ECON. & BUS. 133

difference at the time buyers bought—during the fraud period after the misrepresentation was made but before the truth came out—would have been minimal. The price of BP shares might have been a few cents lower if the company had been 100% truthful about improvements to its safety practices, reflecting a somewhat higher risk of the event that ultimately happened. Or it might have made no difference at all.[42] To view investor loss from fraud in this way is to see that most of the loss flowed (so to speak) from the event itself. In other words, most of the difference between $60.48 per share at the close on April 20, 2010, and the average closing price of $40.35 per share over the following ninety days reflected the prospect of the $60 billion in cleanup expenses and lower earnings going forward, to name just two factors.

Moreover, the loss suffered by buyers would have been suffered with or without fraud. If BP had told the market that it had decided not to change its practices because it would be more expensive than justified by any risk reduction, the market could have adjusted share price accordingly.[43] But the event would have occurred anyway. Deception did not cause the loss. This seems obvious when one thinks about it: The fact that the market was misled about some policy or practice does not *cause* the loss that flows therefrom. Indeed, it is difficult *not* to see the distinction once one does see it. It is quite silly—ungrammatical, even—to say that misrepresentation *caused* the Deepwater Horizon disaster. It might have been caused by actionable mismanagement. Or it might have been a tragic accident. But it was not *caused* by anything BP *said* to the market.[44] In contrast, deception can in fact *cause* mispricing by

42. *See* Richard A. Booth, *Loss Causation and the Materialization of Risk Doctrine in Securities Fraud Class Actions*, 75 BUS. LAW. 1791 (2020); *see also infra* Part V.

43. To be sure, one could argue that BP would never have told the truth about its failure to improve practices (or its affirmative decision not to do so) because it would be an embarrassment for the company. Sunshine is the best disinfectant and all that. So the cover-up may be seen as part of a package that includes reputational losses if not also the physical consequences—a sort of conspiracy of factors.

44. *Cf. supra* note 26 and accompanying text (discussing the statutory requirement that causation be proved). To be sure, the blowout and spill might not have occurred if the company had acted consistent with its public statements (if in fact it did not do so). But that does not mean that the deception *caused* the loss. On the other hand, one might argue––consistent with the adage that sunshine is the best disinfectant—that disclosure is intended in part to prevent managers from actions for which they might feel ashamed. In that sense, one might say that deception is part of the causal chain in the sense that deception is a necessary part of the action—a but-for cause as it were. But if that is the argument one must at least show that the action is such that no one would likely undertake it without lying about it. *Cf.* Omnicare, Inc. v. Laborers Dist. Council Constr. Indus. Pension Fund, 135 S. Ct. 1318 (2015); Virginia Bankshares, Inc. v. Sandberg, 501 U.S. 1083 (1991) (both holding that a statement couched in terms of opinion or belief may be treated as a statement of fact based on duty of speaker to gather and digest underlying facts); Retirement Plans Committee of IBM v. Jander, 140 S. Ct. 592 (2020) (requiring pleading that fiduciary could not have decided in good faith not to purchase shares known to be overpriced). Indeed, *Goldman Sachs* itself may be seen a similar case in that

keeping market price higher than it should have been and causing buyers to pay more than would have been a fair price when they bought.

The overcompensation problem is compounded by legal procedure preventing resolution of the issue until trial on the merits. Even if it is clear that the loss from securities fraud should be measured by the difference between the price paid and the price that should have been paid at the time of the trade, it is not clear how the issue can be resolved early enough in the life of a case to matter. The Supreme Court has clearly ruled that loss causation is a matter of merits to be resolved at trial. It is not something that must be shown for class action certification, although a defendant must be afforded the opportunity at that time to rebut the presumption of reliance by showing lack of price impact.[45] But few securities fraud class actions ever go to trial. A case will almost always be settled—whether it is meritorious or not—if it survives a motion to dismiss and is certified to proceed as class action, because the ultimate damage award may be so large that it threatens the very survival of the defendant company. In other words, defendants tend to focus on the worst-case scenario and to sue for peace (so to speak).[46]

Still, there is a way to address the issue before trial. Although loss causation is a question of fact, the question of how to measure the loss is a different question. It is a

---

the central allegation is that the firm claimed to be an (especially) ethical company, which begs the question as to what that means. One answer (I suppose) is that no ethical company would have done what Goldman Sachs did in that case (to create a security that was likely to lose value). But it is not clear that one counterexample would or should suffice render the generalization false.

45. Compare *Halliburton I* (loss causation need not be shown for class certification) with Halliburton Co. v. Erica P. John Fund, Inc., 573 U.S. 258 (2014) [hereinafter *Halliburton II*] (defendant must be afforded opportunity to show that alleged misrepresentation did not affect market price (price impact)). To recover damages for violations of section 10(b) and Rule 10b-5, a plaintiff must prove (1) a material misrepresentation or omission by the defendant; (2) scienter; (3) a connection between the misrepresentation or omission and the purchase or sale of a security; (4) reliance upon the misrepresentation or omission; (5) economic loss; and (6) loss causation. *See* Amgen Inc. v. Connecticut Retirement Plans and Trust Funds, 568 U.S. 455, 460-61 (2013) (quoting Matrixx Initiatives, Inc. v. Siracusano, 563 U.S. 27, 37-38 (2011)). It is curious that the Court lists loss causation after economic loss. *Cf.* Eisen v. Carlisle & Jacquelin, 417 U.S. 156 (1974) (precluding preliminary trial on merits for purposes of class certification).

It does not help that loss causation arises late in the list of elements (and the logic of proving a case). It seems only natural to determine first whether a fraud has occurred and only then to determine the loss. So it is unlikely that a court would ever rule early on that an alleged misrepresentation did not cause the loss suffered by buyers (or sellers) who can always argue that they will prove the matter at trial. *But see* Mills v. Electric Auto-Lite Co., 396 U.S. 375 (1970), where the Seventh Circuit addressed damages first in order to decide whether the case was meritorious and should proceed. *See generally infra* Part III.C.

46. The problem is compounded by the inherent uncertainty of class size, and consequently, the number of shares for which a claim might be made. *See* Richard A. Booth, *The End of the Securities Fraud Class Action as We Know It*, 4 BERKELEY BUS. L.J. 1, 7 (2007).

question about the rule to be applied, it is not about the merits. As such, it is a question of law for the court to decide.

As a matter of law, the question of how to measure buyer loss is one that a court could address early on in connection with a motion to dismiss or a motion for summary judgment. But the practical question remains how one might convince a court to rule thereon without getting into the merits.[47]

There are at least three possible ways to raise the question. First, one might argue in a motion to dismiss or motion for summary judgment that a misrepresentation cannot be the *proximate* cause of an event (such as the Deepwater Horizon disaster).[48] Second, one might argue in the context of a motion to certify an action as a class action to limit the class claim to mispricing by showing losses in excess of mispricing do not raise common questions of fact or law. Third, one might argue also in the context of a motion to certify that some or much of the price impact from corrective disclosure should give rise to a derivative action.

A. Proximate Cause

To be sure, the Supreme Court has ruled that loss causation is a common question of fact in the context of a securities fraud class action. It is a question for the jury to be resolved by a trial on the merits. It is not a matter that must be established for class certification.[49] Nevertheless, the Court has also recognized—in the context of a motion to dismiss in *Dura Pharmaceuticals* itself—that a complaint for securities fraud must allege *proximate* cause and that price inflation without a price correction does not constitute proximate cause.[50]

The problem of proximate cause has vexed law students since the time of Langdell (if not before) because it can resist reduction to a sharply defined rule. Proximate cause is a judgment call about whether some injury is too remote to be compensable even if the injury to the plaintiff would not have occurred *but for* some act of the defendant. The classic case is *Palsgraf v. Long Island Railroad Co.*, where the plaintiff sued the LIRR whose employees were helping a third person who dropped a package, which then exploded and caused a heavy scale to topple onto the plaintiff. In reversing the award of damages to the plaintiff (Palsgraf), the court ruled that the injury was too remote to justify holding the railroad liable.

Although proximate cause might seem at first to be a question of fact, it is ultimately a fact to be determined by the court—if indeed it is a fact at all. As such, it

47. The problem is reminiscent of traditional common law forms of action.

48. Indeed, a misrepresentation cannot even be a but-for cause. But that is likely a question of fact, whereas proximate cause is a question of law that can be raised in a motion to dismiss. *See Dura Pharmaceuticals*, 544 U.S. 336 (2005).

49. *See Halliburton I*, 563 U.S. at 804.

50. *See Dura Pharmaceuticals*, 544 U.S. at 337.

may be seen as a question of law.[51]

As it happens, the Supreme Court has addressed proximate cause in the context of securities fraud in some detail. In *Holmes v. Securities Investor Protection Corporation,* the defendant (Holmes) conspired with others to manipulate the stock price of six small companies in which two brokerage firms had invested.[52] When the fraud was exposed, the brokerage firms failed, and the securities they held for their customers were lost (including securities that were unaffected by the manipulation). Securities Investor Protection Corporation (SIPC) stepped in to replace the lost securities for the customers (as it is required to do up to statutory limits) and then sought to recover from Holmes (and other conspirators) by means of a civil RICO action predicated on a securities fraud claim under Rule 10b-5.[53] The Supreme Court ruled that SIPC could not recover from Holmes because the manipulation was not the proximate cause of the losses suffered by customers, describing proximate cause as a *judicial* tool used to limit a person's responsibility for the consequences of their acts.[54] Although the Court did find that the manipulation was a *but-for* cause of the failure of the brokerage firms, it ultimately ruled that this was not the proximate cause of the customer losses:

> [T]he link is too remote between the stock manipulation alleged and the customers' harm, being purely contingent on the harm suffered by the broker-dealers. That is, the conspirators have allegedly injured these customers only insofar as the stock manipulation first injured the broker-dealers and left them without the wherewithal to pay customers' claims . . . . The broker-dealers simply cannot pay their bills, and only that intervening insolvency connects the conspirators' acts to the losses suffered by the nonpurchasing customers and general creditors.[55]

The Court went on to quote (or, more precisely, re-quote) Justice Oliver Wendell Holmes (presumably no relation to the *Holmes* plaintiff) who stated the rule quite

---

51. It is often said that materiality is a mixed question of law and fact. *See* TSC Industries, Inc. v. Northway, Inc. 426 U.S. 438, 450 (1976).
52. Holmes v. Sec. Inv. Protection Corp., 503 U.S. 258 (1992).
53. To be specific, SIPC sought to recover under RICO relying on securities fraud as the predicate offense.
54. *Holmes*, 503 U.S. at 268.
55. *Id.* at 271. To be clear, SIPC insures the holdings of brokerage firm customer (today up to $500) as measured by the value of the securities in each customer account. In *Holmes*, some customers held the manipulated stocks, but such holdings would not have accounted for much of the payout by SIPC because such holdings had very little value in the end. In other words (and as stated by the Court in so many words), the payout by SIPC was not triggered by the manipulation itself (since customer losses therefrom would not have been covered) but rather by the insolvency of the brokerage firm. Thus, the reference to non-purchasing customers is gratuitous.

succinctly: "The general tendency of the law, in regard to damages at least, is not to go beyond the first step."[56]

In addition, the *Holmes* Court noted that recovery by SIPC might duplicate recovery by the brokerage firms who had every incentive to seek compensation—and who had in fact done so through their trustees in bankruptcy. Moreover, SIPC would share in any such recovery.[57] In other words, someone other than SIPC was more directly harmed and had standing to sue for compensation that would redound (at least in part) to the benefit of the plaintiff.

Finally, the concurring opinion of Justice Scalia is also helpful:

> The ultimate question here is statutory standing: whether the so-called *nexus* . . . between the harm of which this plaintiff complains and the defendant's so-called predicate acts is of the sort that will support an action under civil RICO. One of the usual elements of statutory standing is proximate causality. It is required . . . because it has always been the practice of common-law courts (and probably of all courts, under all legal systems) to require as a condition of recovery . . . that the injury have been proximately caused by the offending conduct. Life is too short to pursue every human act to its most remote consequences; "for want of a nail, a kingdom was lost" is a commentary on fate, not the statement of a . . . cause of action against a blacksmith.[58]

While the idea that proximate cause is a question of law might prompt some pushback, there is little doubt that standing is a matter of law and one that a court may consider in connection with a motion to dismiss. Expanding on this point, Justice Scalia notes that the courts also may consider whether a particular loss is within the statutory zone of interest and that statutes are seldom so complete that they expressly address all such questions. For example, he doubts whether a stockholder who suffered a heart attack upon reading a false earnings report could recover his medical expenses under Rule 10b-5.[59]

Finally, Justice Scalia notes—as if with *Palsgraf* in mind—that proximate cause will certainly vary depending on the nature of the offense but that the test should be the same for a particular offense from one case to the next. So it is usually possible to craft a rule. *Palsgraf* is notable because it was a one-off situation where the court was left to rule—more or less in a vacuum—that the injury was too remote to be actionable.[60] In

56. Associated General Contractors of Cal., Inc. v. Carpenters, 459 U.S. 519, 534 (1983) (quoting Southern Pacific Co. v. Darnell-Taenzer Lumber Co., 245 U.S. 531, 533 (1918)).

57. *Holmes*, 503 U.S. at 273-74.

58. *Id.* at 286-87.

59. *Id.* at 288.

60. *Cf.* Richard A. Booth, *Limited Liability and the Efficient Allocation of Resources*, 89 NW. L. REV. 140 (1994) (noting that law does not require a business to maintain capital sufficient to

any event, it seems clear that proximate cause as deployed in *Palsgraf* is a matter of law and not one of fact. And it is all the more clear that proximate cause should be seen as a matter of law in the context of a securities fraud class action.[61]

B. Fraud on the Market

Yet another way to limit buyer recovery to mispricing at the time of trade can be found in the practical application of fraud-on-the-market ("FOTM") theory as endorsed by the Supreme Court in *Basic, Inc. v. Levinson.*[62] Under FOTM, it is presumed that investors rely on the integrity of market price when they trade in stocks for which the market is shown to be efficient. In such cases, plaintiffs need not show individual reliance to prove a claim under Rule 10b-5. Reliance is presumed. And this presumption permits the claim to be litigated as a class action. But the presumption can be rebutted if it is shown that the subject stock was not in fact mispriced at the time buyers bought.[63] Thus, there can be no class action in the absence of *price impact*—if the subject stock was not mispriced because of the alleged fraud.[64]

It is tempting to argue based on the logic of FOTM that a class claim should be limited to the extent of mispricing at the time of trade. But it is also clear that individual investors may still seek to recover individually—even in the absence of price impact—if they can show reliance on a misrepresentation (without the benefit of the FOTM presumption), and can further show that they would never have bought the subject stock at all but for the false statement.[65] So if an individual plaintiff can prove that the

---

cover every conceivable eventuality such as freak accidents causing unusually extensive harm).

61. On the other hand, Justice Scalia laments that because the cause of action under Rule 10b-5 is judicially implied, the proximate cause analysis is more akin to legislation than interpretation. But that observation seems to reaffirm that proximate cause is a question of law. *See id*. at 289. And finally, it may be worthwhile to consider whether proximate cause should be seen as a question of subject matter jurisdiction, which can be raised at any time whether by a party or the court itself.

62. Basic, Inc. v. Levinson, 485 U.S. 224 (1988).

63. As stated in *Basic Inc.* itself, the presumption may be rebutted if (for example) market makers knew the truth and priced the stock without regard to the allegedly false statement. *See Halliburton II*, 573 U.S. 258. The presumption may also be rebutted if shown that plaintiff *did not* rely. *See, e.g.*, GAMCO Invs., Inc. v. Vivendi Universal, SA, 838 F.3d 214 (2d Cir. 2016) (affirming finding that FOTM presumption of reliance on market price had been rebutted as to plaintiff class member who followed proprietary strategy to determine mispriced stocks).

64. *Halliburton II*, 573 U.S. at 282 ("[p[rice impact is thus an essential precondition for any Rule 10b-5 class action").

65. *See Ludlow*, 800 F.3d 674, 682. The Supreme Court has come close to saying that a fact must affect market price in some way for it to be material. *See Halliburton II*, 573 U.S. 258, 283 (quoting *Halliburton I*, 563 U.S. 804, 813). To be precise, the Court has ruled that a fact is material if it would be important to a reasonable investor in deciding whether to trade or

fraud caused the whole of their loss, one could argue a class of plaintiffs should be free to do so as well.

The bottom line is that the requirement of price impact to maintain a class action does not quite preclude the argument that fraud causes the entire loss even in the context of a class action. If plaintiffs can show some price impact—however minimal—the action may proceed as a class action. Any price impact will do. The further question of how much of the loss was caused by the fraud is a separate question for another day—for trial. Or so a court would likely rule.[66]

On the other hand, a plaintiff must also show that a class action is manageable and that, among other things, damages can be calculated for absent class members

---

how to vote. *Basic Inc.*, 485 U.S. at 224; TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976). Similarly, the Court has held that to be material a fact must be capable of making a difference to the outcome. Virginia Bankshares, Inc. v. Sandberg, 501 U.S. 1083, 1097-98 (1991); *see also* Dura Pharmaceuticals, 544 U.S. at 347 (noting that price must change upon corrective disclosure for claim to obtain). But the Court has also said unequivocally that materiality is a common question that must be resolved at trial (or perhaps on a motion for summary judgment if there is no dispute as to fact). *See* Amgen Inc. v. Connecticut Retirement Plans and Trust Funds, 568 U.S. 455, 482 (2013).

To be clear, a fact need not be so important that it would change the outcome. But presumably it must have been sufficiently important to affect the decision of some investors. *Cf.* Mills v. Electric Auto-Lite Co., 396 U.S. 375 (1970) (rejecting defining a material fact as one that merely *might* matter to investors). Thus, it seems fair to say that to be material a fact must have had *some* effect on price (or some votes). As the Supreme Court states in *Halliburton II*, 573 U.S. 258, 279:

> "By requiring plaintiffs to prove price impact directly, Halliburton's proposal would take away the first constituent presumption. Halliburton's argument for doing so is the same as its primary argument for overruling the *Basic* presumption altogether: Because market efficiency is not a yes-or-no proposition, a public, material misrepresentation might not affect a stock's price even in a generally efficient market. But as explained, *Basic* never suggested otherwise; that is why it affords defendants an opportunity to rebut the presumption by showing, among other things, that the particular misrepresentation at issue did not affect the stock's market price. For the same reasons we declined to completely jettison the *Basic* presumption, we decline to effectively jettison half of it by revising the prerequisites for invoking it."

As such, materiality would seem to be an inherently statistical question. On the other hand, one can imagine a situation in which a false statement causes a large number of investors to buy and an equally large number of investors to sell such that stock price is unaffected. *Cf. Goldman Sachs*, 594 U.S. at 127 (noting that in vigorously litigated cases burden matters only when evidence is in equipoise).

66. Although it may go without saying, the Court's repeated insistence on compartmentalizing the various elements of fraud—while understandably motivated as a way of laying down clear rules for lower courts to follow—makes it difficult for courts to consider the big picture and arguably leads to more complication rather than less. In contrast, a court of equity (such as the Delaware Court of Chancery) is free to consider all of the facts as a whole and to credit the relevance of a particular fact for more than one purpose.

without the need for individual trials on the merits of individual claims.[67] But we know that many (possibly most) investors rely solely on the integrity of the market and market prices since as much as half of all stock is held by index funds that buy and sell stocks in proportion to market capitalization—based solely on changes in share price relative to other stocks. So we know that index fund investors cannot claim to be harmed beyond mispricing at the time of trade.[68]

As a result, a class action will entail inquiry into individual investor strategy unless the plaintiff limits the claim to mispricing at the time of trade. Thus, the FOTM presumption will in fact limit claims to mispricing not because of any limit on compensable loss but rather because there is no common question of fact or law with respect to claims beyond mispricing. Some buyers might be able to prove larger claims but many others cannot.[69]

C. Price Impact

Although the Supreme Court has ruled that loss causation is a matter of fact (merits) to be resolved at trial, it has also ruled that a defendant may rebut the FOTM presumption (and thus defeat class certification) by showing that the alleged misrepresentation did not affect market price. Again, price impact is not necessarily the same thing as loss causation or materiality. Rather, it has evolved from the requirement to show market efficiency for the FOTM presumption of reliance to apply. As the Court itself has stated in distinguishing price impact from materiality: "Price impact is different. The fact that a misrepresentation was reflected in the market price at the time of the transaction—that it had price impact—is *Basic*'s fundamental premise."[70]

67. *See supra* text at notes 16-19 (discussing the idea of a price inflation ribbon).

68. This is not merely a commonsense assertion about how index funds behave. A quick look at a prospectus for any such (true) index fund reveals that holdings are adjusted regularly based solely on market capitalization. *See* Richard A. Booth, *The Duty to Diversify and the Logic of Indexing*, 75 UC L. J. (Hastings) 555, 562-65 (2024); *Ludlow*, 800 F.3d 674, 682 (discussing possibility that some buyers might claim that they would not have bought the subject stock at all but for the misrepresentation whereas others might claim merely that the stock was mispriced thus requiring individualized inquiry and rendering class action certification inappropriate). So one might say that FOTM is as much about class action law as it is about securities law.

69. *See, e.g.*, *GAMCO Invs.*, 838 F.3d. Note that GAMCO was apparently an individual action in which the plaintiff sought to rely individually on the FOTM presumption. Moreover, the plaintiff was found not to have relied on the integrity of the market but rather its own proprietary trading strategy, thus rebutting the presumption of reliance. In contrast, the question whether market price was affected at all (price impact) is a different basis for rebutting the presumption. *Basic* contemplates both modes of rebuttal.

70. *Halliburton II*, 573 U.S. at 283 (quoting *Halliburton I*, 563 U.S. at 813) (punctuation adjusted).

In other words, if a misrepresentation does not affect market price at the time the buyer buys, there is nothing on which *all* buyers as a class could have relied and there can be no *class* claim. The issue is the presumption of reliance for purposes of class certification. To be sure, *individual* buyers may nevertheless seek to prove that they relied on the misrepresentation and would not have bought the stock *at all* if they had known the truth (as opposed to the claim that they paid a too high price when they did buy). But such a claim cannot proceed as a class action because such reliance must be proved by each buyer.

The usual way of showing price impact—or the lack thereof—is by means of an event study showing correlation between corrective disclosure and a statistically significant change in stock price.[71] The standard practice with such event studies is to net out company-specific changes in price from background changes in market-wide and industry-wide prices. For example, if the defendant company's stock price falls by 10% upon corrective disclosure but the S&P 500 falls by 5% on the same day, then no more than 5% of the price change for the defendant company can be attributed to fraud.[72]

In addition, one must consider the specific volatility of defendant company share price.[73] Suppose ABC Company shares are 20% more volatile than the market as a whole—that ABC has a beta coefficient of 1.20. If so, ABC shares would be expected to fall by 6% when the market falls by 5% even in the absence of any special news about ABC. Thus, no more than 4% of the 10% decrease can be attributed to fraud. It is also possible that the defendant company's industry (line of business) has been specially affected by some development (such as the prospect of new regulations) that causes stock prices of all companies in the industry to fall, entailing further adjustment.[74]

71. The Supreme Court has never said that an event study is required to show price impact or any other matter of fact that must be proven in the context of a securities fraud claim. Nor has any other court done so. The most that can be said is that it is standard practice to show price impact by means of an event study and that it is unlikely that a class action can be certified in the absence thereof. Moreover, the Court has said that a court can use common sense approaches as well to address such questions. *Goldman Sachs*, 594 U.S. at 122; *see also* Partnoy, *supra* note 12, at 1063 (discussing implications); Langevoort, *supra* note 2 (assessing a number of alternative counterfactuals).

72. This example assumes that the defendant company as well as the industry collectively has the same volatility as the market. *See* Jill E. Fisch, Jonah B. Gelbach & Jonathan Klick, *The Logic and Limits of Event Studies in Securities Fraud Litigation*, 96 TEX. L. REV. 553 (2018) (discussing, among other things, comparisons to industry indices).

73. *See id.*

74. To be precise, the general rule is that the change in price must be sufficiently dramatic that it would occur no more than 5% of the time in the absence of company-specific news. In other words, it must be 95% certain that company-specific news (such as corrective disclosure) caused the price change. Again, price impact is not the same thing as loss causation. Price impact is no more than a hurdle to be cleared for the FOTM presumption to apply. Presumably, *any* provable impact is enough to permit the action to proceed as a class action and to permit plaintiffs to prove their claims—which may be for the full

The logic of event studies—that only a change in stock price *net* of background changes for other identifiable reasons—is not limited to market-wide or industry-wide changes in price. It also can apply to other potential intervening factors.

Suppose that on the same day as corrective disclosure an unrelated event causes a further decrease in stock price. For example, suppose a major customer of the defendant company announces it will not renew its contract with the defendant and instead will rely on a competitor vendor. As a result, defendant company profits can be expected to decrease by 2%—which translates into a 2% decrease in stock price. Assuming all the facts above, this additional 2% drop (together with other adjustments) more than explains the original 10% decrease in price and would seem to preclude class certification.[75]

Before *Halliburton II,* it was not clearly permissible for defendants to offer any *direct* evidence relating to price impact.[76] And by "direct," the Court seems to mean evidence that the alleged misrepresentation did or did not affect market price. Rather, litigants were limited to presenting evidence for the purpose of showing that the market for the subject stock was efficient. In other words, litigants previously could only bring forth direct evidence regarding price impact only to show that the market reacted to company-specific news *uniquely* about the defendant company. Accordingly, the evidence might be about any number of examples *other than* corrective disclosure relating to the alleged fraud.[77] But as the Court ruled in *Halliburton II,* it makes little sense to exclude direct evidence simply because it may show that the fraud did not affect market price since the premise of the FOTM theory is that if market price is affected *by the fraud* reliance can be presumed.[78]

The obvious implication of *Halliburton II* is that defendants can (in effect) try to disprove loss causation in the context of a class certification motion by showing that the price decrease upon corrective disclosure is attributable to some factor other than correction of the alleged lie.

For example, BP might have argued that the drop in its stock price was wholly attributable to the prospect of its spending billions of dollars to clean up the oil spill

---

amount of their loss. Thus, the defendant company presumably must show that there was zero price impact in excess of changes that can be explained by factors other than fraud. *See Goldman Sachs*, 594 U.S. at 114 ("[d]efendants bear the burden of persuasion to prove a lack of price impact").

75. *See generally Halliburton I*, 563 U.S. (discussing the implicit need to net out other causal factors).

76. *Halliburton II*, 573 U.S. at 282-83.

77. Thus, before *Halliburton II,* a class action could be certified even though the fraud itself appears not to have affected market price and the action is doomed to fail based (for example) on several *other* instances of price impact from the disclosure of company specific news (as noted by the Supreme Court itself).

78. The Court does not discuss cases where good news is mixed with bad news. But it does hint at the possibility that news may cause some to sell and some to buy, noting that such cases are likely to be quite rare.

and to settle related litigation. Indeed, as noted above, the ultimate cost was about $63 billion, which was almost exactly equal to the $62 billion loss in market capitalization from the stock price decrease following the Deepwater Horizon event.[79]

For another example, Goldman Sachs might have argued (and did argue) that the drop in its stock price was wholly attributable to the SEC enforcement action (which entailed a $550 million fine and significant legal expenses attendant thereto) and the prospect of somewhat curtailed operations going forward because of enhanced SEC scrutiny.

For yet another example, Halliburton might have argued (and did argue) that the drop in its stock price was attributable to new information about the prospect of liability for asbestos claims as a result of several sizable judgments it suffered and not to any misrepresentation as to the adequacy of reserves it had established against such claims.[80]

Before *Halliburton II,* plaintiffs could rely on any significant price change on any day (as coupled with company-specific news) for the narrow purpose of showing that the subject stock was efficiently priced. And they could do so by reference to the price change from the alleged corrective disclosure even if most (or all) of the change was attributable to the event constituting the disclosure and was not about adjustment for mispricing at the time the buyer bought. But an event study can show only that stock price was uniquely affected by the news—that the effects were company-specific. It cannot show which of various coincident company-specific factors caused what portion of the loss.

Halliburton II holds that defendants must be afforded the opportunity to prove that the alleged misrepresentation did not affect market price, which then gives defendants the ability to defeat class certification. Presumably, if an event—whether it be an oil spill, SEC enforcement action, or increased likelihood of asbestos liability—can be shown to explain the *entire* price decrease, there can be no mispricing on which buyers could have relied, and there can be no class action.[81]

After *Halliburton II*, defendants can argue that some (or all) of the price change can be explained by events other than corrective disclosure of the original misrepresentation. And even if the plaintiffs can show that the stock of the defendant company is efficiently priced by reference to other events—that it reacts to company-specific news—class certification will be precluded if the price impact in connection with the alleged fraud (and event) can be wholly explained by other factors.

The obvious question is how a defendant might go about proving that some of the price change is attributable to factors other than undoing the effects of the

79. *See supra* note 23 and accompanying text.

80. *See Halliburton I*, 563 U.S. at 812; *see also Wielgos*, 892 F.2d at 518.

81. To be clear, plaintiffs may still rely on the whole of the price change to show that the stock is efficiently priced. But the defendant must be permitted to show that the price change was caused by factors other than the alleged fraud.

misrepresentation.[82] The answer is that it should not matter. Once it is established that factors other than fraud are involved in the stock price decrease, it is impossible for a court to ignore the nature of claims made by the plaintiff class.

For example, in the BP case, most (or all) of the loss can be explained by the prospective cost of cleaning up the oil spill.[83] But that is a loss that was suffered by all BP stockholders pro rata. More precisely, it is a loss that was suffered by the company, BP, because of mismanagement (if anything). As such, the claim for compensation would seem to be derivative.[84]

Here again, *Holmes v. SIPC* is instructive. The *Holmes* Court ruled that SIPC could not recover against the accused stock manipulator who caused the subject brokerage firms to fail because the manipulation was not the proximate cause of investor losses. The brokerage firms could sue the manipulator, and the customers (as well as SIPC) might benefit from any recovery by the firms. But to permit SIPC to sue the manipulator could lead to double recovery. Since the brokerage firms had every incentive to sue the manipulator (and indeed had done so through their trustees in bankruptcy), the Court ruled that the manipulation was not the *proximate* cause of investor losses.

The situation in an event-driven securities fraud class action is the same. To the extent the loss is caused by mismanagement or questionable business practices, the claim is a derivative one that belongs to the company. The only claim that remains is the claim of mispricing at the time buyers bought.

Undoubtedly, plaintiffs will seek to distinguish *Holmes* as involving more easily separable claims, one for losses suffered by brokerage firm customers (many of whom did not buy the manipulated stocks) and another for losses suffered by the brokerage firms who held their capital in those stocks. But the latter will likely take the form of a class action on behalf of everyone who bought the manipulated stocks (including the

82. This question was addressed in excruciating detail in *Arkansas Tchr. Retirement Sys. v. Goldman Sachs Grp., Inc.*, following remand by the Supreme Court. 77 F.4th 74 (2d Cir. 2023). Therein, the Second Circuit reversed the decision of the district court (per Judge Paul Crotty) certifying the class. In essence, the Second Circuit reasoned that the subject stock price drop was less likely than not to have been affected (impacted) by earlier statements by Goldman Sachs regarding its ethical culture. The decision (the third decision by the Second Circuit relating to class certification of this case) prompted a vigorous dissent by Judge Richard Sullivan (who concurred in the bottom conclusion of Judges Wesley and Chin), who saw the majority's reasoning as needlessly complicating the analysis.

83. *See supra* note 28 (discussing BP market capitalization before incident and after cleanup).

84. Although one can imagine vigorous litigation as to claim character, such a dispute would seem to be preempted by the terms of FRCP Rule 23 (as discussed immediately below). Moreover, the Delaware Supreme Court has recently held (on other grounds) that a claim that can be seen as either derivative or direct must be treated as derivative. *See* Brookfield Asset Mgmt. v. Rosson, 261 A.3d 1251, 1277 (Del. 2021). On the other hand, there is some authority that the distinction does not matter in the context of federal securities litigation. *See* J. I. Case Co. v. Borak, 377 U.S. 426 (1964).

brokerage firms and their customers who held those stocks), and any recovery in connection therewith will mitigate the losses suffered by SIPC. Litigation is inherently messy.

Relatedly, plaintiffs in an event-driven class action may also argue that relegating some of their claim (likely most of their claim) to a derivative action is more complicated than necessary and unlikely to succeed because of the many limitations on such actions (including the business judgment rule).[85] It is easier, they might argue, for buyers to recover all of the loss they suffer: It is simpler for the courts so to calculate damages, and it serves the goal of deterring fraud.

There are several answers. First, convenience is no excuse. There is ample precedent that the difficulty of measuring damages is no reason not to try.[86] Second, the existing regime *overserves* deterrence. Commentators largely agree that the prospect of a massive award is the reason that few class actions ever go to trial.[87] And companies would be much more likely to volunteer information if the consequences of getting it wrong were not so steep. Third, because it is the defendant company that pays in a successful securities fraud class action, it is nonbuyer stockholders who foot the bill, which is inflated because the prospect of payout causes stock price to fall even further when the truth comes out. In other words, the system magnifies claims.[88] In contrast, derivative recovery by the company (if any) mitigates the claim.[89] Here again, *Holmes* is on point. Finally, and decisively, the rules governing class actions effectively require that a claim that can be handled as a derivative claim must be so handled as explained in the next section.

IV. CLAIM CHARACTER AND CLASS ACTIONS

As it turns out, there is an easy answer to the question of how to handle a claim that might be seen as both direct and derivative. Rule 23(b)(3) of the Federal Rules of Civil Procedure (FRCP) provides that a class action for damages may be maintained

85. *See* Marc Ian Gross, *#Reputation Matters! A Critique of the Event-Driven Suits Model*, 79 BUS. LAW 263 (2024) at n.10, n.118, n.124.

86. *See, e.g.*, Miley v. Oppenheimer & Co., 637 F.2d 318, 327 (5th Cir. 1981) (neither the difficulty of the task nor the guarantee of imprecision in results can be a basis for judicial abdication from the responsibility to set fair and reasonable damages in a case).

87. *See supra* note 49; *see also* Schleicher v. Wendt, 618 F.3d 679 (7th Cir. 2010) (collecting authorities).

88. *See* Richard A. Booth, *The End of the Securities Fraud Class Action as We Know It*, 4 BERKELEY BUS. L.J. 1 (2007). The effect is to redistribute investor wealth away from diversified investors and to stock-picking investors. *See* Richard A. Booth, *Index Funds and Securities Fraud Litigation*, 64 S.C. L. Rev 265, 271-73 (2012).

89. *See* Richard A. Booth, *What's a Nice Company Like Goldman Sachs Doing in a Place Like the Supreme Court? How Securities Fraud Class Actions Rip Off Ordinary Investors — And What to Do About It*, 66 VILL. L. REV. TOLLE LEGE 53 (2022).

(and thus certified) only if a class action is *superior* to other available methods for the *fair* and *efficient* adjudication of the controversy.[90] In other words, the rule requires a *comparison* between available methods of litigating the case and further requires that a class action for damages be *better* than other ways of dealing with the case. Ties go to any other method of resolution. So, if the larger part of a claim—or any part of a claim—*can* be addressed in a derivative action, it *must* be so addressed. The Supreme Court has ruled quite emphatically that the courts must apply the language of the rule literally and must find that a proposed class action meets the requirements specified therein.[91] Moreover, while the superiority requirement alone is enough to require a derivative action, the argument is bolstered by the further reference to *fair and efficient* adjudication, which is not to mention the identification of other (presumably nonexclusive) factors to be considered that seem almost tailored to the question (in particular difficulties likely to be encountered in the management of a class action).[92]

90. *See* FED. R. CIV. P. 23(b), which states (emphasis added):

> (b) Types of Class Actions. A class action may be maintained if Rule 23(a) is satisfied, and if:
>
> [. . .]
>
> (3) the court finds that the questions of law or fact common to class members predominate over any questions affecting only individual members, and that a class action is <u>superior to other available methods for fairly and efficiently adjudicating</u> the controversy. The matters pertinent to the findings include: (A) <u>the class members' interest in individually controlling the prosecution or defense of separate actions</u>; (B) the extent and nature of any litigation concerning the controversy already begun by or against class members; (C) the desirability or undesirability of concentrating the litigation of the claims in the particular forum; (D) <u>the likely difficulties in managing a class action</u>.

91. *See* Comcast Corp. v. Behrend, 569 U.S. 27, 33 (2013); Wal-Mart Stores, Inc. v. Dukes, 564 U.S. 338, 348-49 (2011). It can be tempting to dismiss such thundering commands from the Supreme Court as prompted by worry that the rationale for the decision itself is somewhat tenuous. But in this case, the language of the rule is really quite instructive. Moreover, there can be little doubt that the framers of the FRCP meant for every word of a rule to matter. And even if the superiority requirement originated with some compromise among the framers, it serves to acknowledge the costs associated with class actions and to emphasize the need to consider alternative modes of litigation. In the absence of any such requirement, the judge who must certify a class action might do so simply for lack of any reason *not* to do so (subject only to review based on abuse of discretion).

92. I do not mean to suggest that the framers of Rule 23 anticipated the problems that might evolve with event-driven securities fraud claims (although some of them might have done so). But I am awed by how the process of legal reasoning inspired by the common law tradition can verge on a mystical ability to deduce the correct answer to such a complex question of process as whether a claim is direct or derivative. *Cf.* Desimone v. Barrows, 924 A.2d 908 (Del. Ch. 2007) (opinion by former Chief Justice Strine discussing derivation of decision by careful application of principles of fiduciary duty applicable to directors).

30 STAN. J.L. ECON. & BUS. 133

In short, if one actually applies the language of the rule in the context of an event-driven action, the argument for litigating the claim as derivative action (rather than direct) is irrefutable.

A. Efficient Adjudication

Rule 23 requires a court to consider efficiency. Not only is a derivative action a viable alternative to a class action—and thus to be preferred under the rule—a derivative action is more efficient than a class action since the claim is made on behalf of a single collective plaintiff, the corporation. There is no need to decide how to define the class, who is a member thereof, or who is entitled to what portion of the recovery. The company recovers and the stockholders benefit pro rata. In short, there is no need to certify that the action is appropriate to be litigated as a derivative action. Thus, a derivative action is not merely a viable alternative to a class action—it is actually superior to a class action in terms of efficiency.[93]

Moreover, recovery by the corporation mitigates the loss suffered by buyers. Under the extant approach, buyers routinely seek compensation for the entire loss between the price paid and the price following corrective disclosure. But if the company recovers, stock price recovers proportionally.

Finally, scholars generally agree that the loss from fraud should be measured by mispricing at the time the buyer buys. Some argue that it must take the form of literal price inflation. If so, it is easy enough to measure the loss. But if we measure the loss by the change in price upon corrective disclosure, it is not clear how to distinguish the loss from mispricing from the loss attributable to the event itself (which is likely to be the much larger part of the loss). Again, a derivative action addresses the problem: Once we determine the derivative loss, the remaining loss must be attributable to price inflation. Whatever part of the loss that is not derivative—if any—must be direct.[94]

Still, despite the text of Rule 23 and the compelling logic thereof, no rule applies itself. Even with a rule as carefully crafted as Rule 23, someone must make the argument that a derivative action is superior. And it might be argued that if the rule really *meant* that derivative actions should trump class actions, someone would have noticed so by now. *But see infra* Part VI (discussing market failure in making the derivative claim argument). Finally, it almost goes without saying that representative actions—such as class actions and derivative actions—do not *belong* to the plaintiff first to file or to any other individual plaintiff for that matter. Indeed, this is particularly true of securities fraud class actions in which the court, under the Private Securities Litigation Reform Act (PSLRA), must determine who should serve as lead plaintiff. *See generally* Richard A. Booth, *Who Owns a Class Action?* 58 VILL. L. REV. TOLLE LEGE 21 (2013).

93. Derivative actions have their own peculiar requirements which can be quite elaborate. *See*, *e.g.*, Fox & Mitts, *supra* note 1, at 32-33; Gross, *supra* note 2, at 290-91. But those requirements ultimately derive from the interests of the corporation's stockholders and as such are no reason to favor class actions over derivative actions.

94. *See supra* notes 81-84 and accompanying text.

B. Fair Adjudication

Additionally, Rule 23 requires a court to consider fairness, which also militates in favor of a derivative action. There is no way in the context of a securities fraud class action for a company to mount a defense as to the wisdom of the business decisions that may have contributed to the loss suffered. As a matter of securities fraud law, the plaintiff need only plead and prove deception in connection with the action (or inaction) that caused the loss. Whether that action (or inaction) was reasonable as a matter of business judgment is completely irrelevant. All that matters is that the market was misled.

To be clear, the point here is not about causation itself, but rather who gets the opportunity to prove or disprove causation. More precisely, it is about the fair adjudication of the controversy as required by the express terms of Rule 23(b)(3) to be considered by the court in certifying any action as appropriate for class action treatment. In a derivative action, the defendant directors or officers may defend their decisions as protected by the business judgment rule. And even if they fail to do so, they may defend themselves against liability for damages on grounds that their decisions did not in fact cause the loss.[95] In a securities fraud class action, there is no such opportunity: It is irrelevant whether the policy or practice followed by the company (albeit different from that described to the market) was reasonable as a matter of business judgment.

If a claim such as that against BP arises without any deception, it must be litigated as a derivative claim against those who made the business decisions that caused the loss. The stockholders have no claim against the company because the company suffered a loss. But the company itself might have a claim for compensation (because of an actionably bad business decision). On the other hand, if it happens that buyer-stockholders can find some material misrepresentation about company policies or practices in connection with the action that caused the loss (some such statement that is merely inconsistent with the actions of directors or officers that might have led to the event) there is no need to prove anything about the merits of the decision itself, or its causal connection to the event, to recover for the entire loss they suffer. How can that be fair?

It is doubly unfair when the loss is also suffered by non-buyer (legacy) stockholders who ultimately lose again when the company pays—especially where

95. *See* Barnes v. Andrews, 298 Fed. 614, 616 (S.D.N.Y. 1924) (opinion by L. Hand) (it is not enough to prove a breach of the fiduciary duty of care alone—the plaintiff must also prove loss causation); *see also* Francis v. United Jersey Bank, 432 A.2d 814, 829 (N.J. 1981) (finding causation in failure to manage where violations were especially obvious and egregious). *Cf.* Smith v. Atlantic Properties, Inc., 422 N.E.2d 798, 803 (Mass. App. Ct. 1981) (failure to make a decision was itself a cause of loss).

30 STAN. J.L. ECON. & BUS. 133

most of the claim derives from the event as opposed to mispricing.[96] If we compare a class action to a derivative action—as required by Rule 23(b)(3)—there can be little doubt in the context of a securities fraud claim that a derivative action wins.[97]

The bottom line is that Rule 23(b)(3) compels that event-driven claims be litigated as derivative actions. In other words, if we really think about the fair and efficient resolution of an event-driven claim, it is no contest: The derivative claim must be adjudicated first.

V. CLASSIC FRAUD CLAIMS RECONSIDERED

The discussion above has focused on (so-called) event-driven actions such as

96. No doubt plaintiffs and their attorneys would argue that it is unfair to permit defendants (in effect) to assert a defense that would not be recognized in the context of a securities fraud action where the entire loss is treated as resulting from the fraud. But the fact that those allegedly responsible are afforded an opportunity to defend themselves is no reason to *disfavor* a derivative action, especially given the express requirement under Rule 23(b)(3) that the court weigh the fairness of alternative modes of litigating the claim. *See supra* note 33. Admittedly, the recovery in a derivative action is distributed differently since the company recovers for the pro rata benefit of all stockholders—not just buyers––and recovers a different amount. But that is hardly an argument against proceeding by derivative action. Indeed, it amounts to an argument that the distribution of the recovery in a direct (class) action is part of the problem. In any event (and again), stockholders can diversify. So any rearrangement of recovery will likely wash out over time (if there is any reason to worry about it in the first place).

97. On the other hand, it is true that the precise composition of the body of stockholders who would benefit from a derivative action will differ from those who were harmed in the first place. In other words, the stockholder population during the fraud period (including buyers) will differ from the stockholder population at the time of any derivative action judgment. Those who sell their shares in the interim will miss out on the benefits of recovery, while those who buy in the interim will enjoy a windfall. It is unclear whether we should find this worrisome since it is true of every derivative action. Furthermore, the prospect of derivative recovery should mitigate the loss suffered by buyers: If the market knows that the company will likely recover from the wrongdoers (or insurance) for any actionable misrepresentation, market price will fall that much less upon corrective disclosure. Moreover and perhaps more significantly, market price will not fall because of the prospect of payout by the company in connection with a class action. So in the end is difficult to balance the equities of the two approaches. *Cf.* Matsushita Electric Industrial Co., Ltd. v. Epstein, 516 U.S. 367, 880-81 (1996) (recognizing the res judicata effect of a settlement in a state court derivative action against a pending federal court class action); Bangor Punta Operations, Inc. v. Bangor & Aroostook Railroad Co., 417 U.S. 703, 718 (1974) (dismissing direct action by corporation against former management where controlling stockholders had bought 97% of outstanding shares subsequent to actions allegedly causing the harm—and thus presumably at a fair price—because as stockholders they could not have maintained a derivative action); Smith v. Waste Management, Inc., 407 F.3d 381, 386 (5th Cir. 2005) (ruling that the settlement of a Delaware derivative action was res judicata with respect to subsequent direct action based on the same facts upon which plaintiff attempted to maintain an individual direct fraud claim under Rule 10b-5 that should have been seen as derivative).

Halliburton, *BP*, and *Goldman Sachs*. But the analysis applies just as well to ordinary fraud claims, such as the one described in the example at the beginning of this article.

Recall that, in that example, two identical companies ABC and XYZ both face identical problems with a regulator. ABC lies to cover up the difficulties, while XYZ says nothing. The ABC lie does not immediately affect stock price (because it is seen as non-news). Because XYZ says nothing, its stock price also remains constant. When the truth is revealed because the regulator acts, both stock prices drop by the same amount (by the same percentage), producing similar investor losses. Nevertheless, buyers of ABC stock can recover for their full economic loss under the price-maintenance theory, while buyers of XYZ stock have no claim. But if we require affirmative price inflation, neither class of buyers has a claim.[98]

The problem with this hypothetical is that it cannot happen in the real world. If ABC lies to the market, its stock price will almost certainly fall further (by a larger percentage) than that of XYZ after the regulator acts. For one thing, the market undoubtedly will have lost some trust in the management of ABC and as a result will impose a higher cost of capital (required rate of return) on the stock. For another thing, ABC may be sued by investors who bought the stock during the fraud period, or it may be sued by the SEC in an enforcement action (and may be fined as a result), or both.[99] In short, ABC stock will almost certainly fall more than XYZ stock. If not, the market must have concluded that the lie was totally excusable and that there is no danger of legal action.

Perhaps more important, buyers of ABC stock will need to show that it fell by more than that of other comparable companies (such as XYZ) to show price impact. If they cannot do so, then buyers cannot maintain a class action.[100] So the assertion in the example, that ABC buyers can recover but XYZ buyers cannot, is wrong for all practical purposes: If the two stocks fall by the same amount (percentwise), then no one has a claim—at least no claim that can be litigated as a class action. But if ABC stock falls further than XYZ stock, the question becomes how much can be recovered by buyers of ABC stock. Should they recover their entire loss? Or should recovery be limited to

98. *See supra* note 4 and accompanying text. To be clear, if the statement by ABC caused its stock price to increase, buyers at that price would have a claim to the extent of price inflation and possibly to the extent of the entire difference between the price paid and the price following disclosure of the truth.

99. It is also possible that management of XYZ will have lost some trust with the market if investors conclude that they should have spoken when they chose not to do so. But given the facts of the hypothetical, XYZ would neither be exposed to a securities fraud class action nor a SEC enforcement action. Note that the SEC need not prove reliance or damages in an enforcement action. Thus, the question of whether price maintenance will suffice or whether affirmative price inflation must be shown does not arise.

100. To be clear, an individual buyer might be able to sue by proving reliance—by eschewing the FOTM presumption—and might be able then to claim damages for the entire difference between the price paid and price at which the stock settles after the regulator announcement.

30 STAN. J.L. ECON. & BUS. 133

the loss in excess of the loss suffered by buyers of XYZ stock?

It is unclear whether ABC buyers should be able to recover for the portion of loss that is equal to the loss suffered by XYZ buyers. Why should ABC buyers get to recover for a loss that would have happened no matter what—fraud or no fraud? Indeed, it is the centerpiece of arguments for the price inflation theory that buyers of ABC stock should have no claim for that portion of their loss. But it is quite clear the excess loss in this example is derivative rather than direct. The harm is suffered by the corporation and by all of the stockholders pro rata. In other words, existing stockholders are harmed just as much as new buyers (whereas it is quite clear that existing stockholders have no claim of any sort simply because of regulator action).[101] The point is that even in this ordinary run-of-the-mill securities fraud claim, it appears that the only genuine loss is derivative.

Finally, the result should be the same if ABC lied about expected earnings, a truly quintessential fraud claim, rather than about what it knew about the machinations of the regulator. If we change the example such that ABC lies by saying that it expects to report earnings consistent with projections while XYZ remains silent, the analysis is the same. No one would argue that a stockholder has a claim against a company simply because it reports disappointing earnings. There is nothing special about the subject of the lie for these purposes. So there is nothing especially special about event-driven claims in this regard. Or one might say that *all* claims are ultimately event driven.

It turns out that the price-maintenance versus price-inflation debate reveals a completely different issue from the one it has sought to highlight. The point of the example is that ABC buyers are no more deserving of a remedy than are XYZ buyers. But the example itself is problematic because there is every reason to think that ABC stock will decrease further to reflect a loss of trust in management and the possibility of litigation and because such claims are clearly derivative in nature. In other words, the debate reveals that the only claims that matter are derivative.[102]

VI. PLAINTIFF INCENTIVES AND INDEX FUNDS

Admittedly, the easy answer—that derivative claims trump direct claims—raises

101. This assumes that the regulator action is not some sort of enforcement proceeding based on wrongdoing by the company, but rather some unexpected turn of regulatory policy as implied by the example.

102. Note that the example depends on the existence of two identical companies that can be compared to each other quite easily. In the real world, such situations are rare if not nonexistent. So it is impossible to argue that one group of stock buyers should be treated the same (or differently) from another group of stock buyers. Since side-by-side comparison never happens, the courts need not ever face the question posed by the example. If the complaint alleges simply that ABC lied to the market, that should be the end of the story.

some hard questions. What happens if there is no derivative action pending? Who will make the argument that some of the claim is derivative?

The problem is aptly illustrated by *Goldman Sachs,* where the class claim was triggered by an SEC enforcement action and a $550 million fine against the firm—a classic scenario giving rise to a derivative action against the individual perpetrators as well as the board of directors (for failure to monitor).[103] Why did Goldman Sachs fail to make the argument that the claim was derivative and instead rely on a naked assertion that generic statements cannot be material, which was almost certainly a losing argument? The obvious answer is that a firm is naturally inclined to circle the wagons against an external foe and avoid pointing fingers at their own. In other words, it is hardly surprising that a firm would decline to argue that its own directors and officers are at fault. That is why we have derivative actions.

Neither can the class plaintiff make the argument: The class plaintiff cannot represent both buyers and the defendant firm. Someone else must assert the derivative claim. Moreover, the class plaintiff is likely to oppose the derivative claim and to do so vigorously since the derivative claim reduces the direct claim dollar for dollar.[104]

On the other hand, most securities fraud class actions are accompanied by a parallel derivative action.[105] So the plot thickens: Why—if a derivative action has been joined—is the derivative plaintiff not motivated to press the case for derivative recovery? Why do derivative plaintiffs almost always eschew monetary recovery (for the company) and settle for governance reforms of dubious value?

The answer is one of market failure: The attorney fees awarded in a class action are likely to be far larger than those awarded in a derivative action—enough greater that a share thereof is likely to exceed the fee for a successful derivative action.[106] So

103. On this generally, see, e.g., Stone v. Ritter, 911 A.2d 362, 369 (Del. 2006); Malone v. Brincat, 722 A.2d 5, (Del. 1998); *see also* Pfeiffer v. Toll, 989 A.2d 683 (Del. Ch. 2010) (holding that corporation could recover from individual wrongdoers for reputational harms caused by securities fraud notwithstanding pendency of federal securities fraud class action); Kahn v. Kolberg Kravis Roberts & Co., 23 A.3d 831 (Del. 2011) (abrogating *Pfeiffer* to extent that it held corporation could not recover for insider trading by directors and officers).

104. Note that a derivative claim covers the entire loss suffered by the company, not merely the share of the loss suffered by buyers.

105. *See, e.g.*, Laarni T. Bulan & Matthew Davis, *Parallel Derivative Action Settlement Outcomes* (Cornerstone Research 2022); Stephen J. Choi, et al., *Piling On? An Empirical Study of Parallel Derivative Suits,* 14 J. Empirical Legal Studies 653, (2017); Jessica Erickson, *Corporate Governance in the Courtroom,* 51 WM. & MARY L. REV. 1749, 1776-80 (2010). On the other hand, the number of large monetary settlements appears to be increasing. *See* Kevin LaCroix, *Largest Derivative Lawsuit Settlements* (Dec. 5, 2014), https://perma.cc/W3NT-VFP.

106. The fee in a derivative action is based on the benefit to the corporation as determined by the court under Rule 23.1. The fee in a direct action is a matter of agreement between representative plaintiff and plaintiff's counsel as in any contingent fee action. Although the fee must be approved by the court as part of the settlement process under Rule 23, it would likely have been approved in advance because under the PSLRA, the court must

30 STAN. J.L. ECON. & BUS. 133

the lawyers for a derivative plaintiff are likely to defer. And derivative plaintiffs are unlikely to object since they cannot recover individually in any event.[107]

Admittedly, the idea that class actions predominate over derivative actions because class actions are more lucrative for plaintiff attorneys is a cynical explanation for the status quo (although it is probably correct). But it begs the question why potential plaintiffs do not do more to fix things—why plaintiffs do not care. Indeed, PSLRA attempted to address the issue (in a way) by providing that the plaintiff with the largest claim should be designated as the named representative plaintiff in a class action, preempting any race to the courthouse. The idea was that institutional investors—who presumably appreciate the public policy implications of securities litigation—would assume control and would monitor the strategies and tactics of plaintiff attorneys.[108]

Things have not worked out as planned. With one interesting exception, institutional investors (such as mutual funds) have declined to serve despite their large stakes. One theory is that they fear offending defendant companies who would likely decline to engage with the offending investor by refusing to take calls and meetings to discuss performance (which calls and meetings might sometimes provide valuable inside information).

The one interesting exception is that government and union pension funds often do volunteer for duty as representative plaintiffs. Indeed, such entities serve as

decide who (among competing plaintiffs and law firms) will best represent the plaintiff class. Undoubtedly the fee would be an important consideration in that process.

107. There are several other closely related answers. One is that the idea that the company should both pay (in the direct action) and recover (in the derivative action) is too confusing. To be sure, the courts seemingly understand the idea of indemnification—that the company might (would) have a claim against the individual wrongdoers if it is held liable (as a company) to buyers in the class action. But it is less well understood that the company often has a primary claim against the individual wrongdoers that does not depend on the company first being held liable in a securities fraud class action. *See, e.g.*, Pfeiffer v. Toll, 989 A.2d 683 (Del. Ch. 2010) (breach of fiduciary duty claim for disgorgement of secret profits from insider trading, as well as possible claim for reputational harms). Another possible answer is that the class action must be tried in federal court, which in combination with the supremacy clause may suggest that the class action is somehow more important. Moreover, it is unlikely that Rule 10b-5 would support a derivative action, which implies that any derivative claim must be litigated in state court. *But see* Matsushita Electric Industrial Co. v. Epstein, 516 U.S. 367 (recognizing the res judicata effect of global state court settlement with regard to federal securities fraud class action). Finally, and perhaps most importantly, it is likely that insurance would be depleted by the settlement of a class action and that there would in turn be nothing left with which to settle a derivative action (assuming that the derivative action is litigated second).

108. *See generally* Elliott J. Weiss & John S. Beckerman, *Let the Money Do the Monitoring: How Institutional Investors Can Reduce Agency Costs in Securities Class Actions*, 104 YALE L. J. 2053 (1995); Elliott J. Weiss, *The Lead Plaintiff Provisions of the PSLRA after a Decade, or 'Look What's Happened to My Baby,'* 61 VAND. L. REV. 543 (2008).

representative plaintiffs in a large proportion of such cases.[109] But their reasons for doing so are suspect. Such entities may be motivated by the prospect of scoring political points or securing side benefits. Moreover, they may (in effect) be paid to serve. For example, state government pension plans are often administered by elected officials to whose campaign funds plaintiff law firms are free to contribute.[110] The chances are that the recipients of such law firm largesse will be all too happy to let plaintiffs' lawyers call the shots. So it is unclear that government or union pension funds should be seen as adequate representative plaintiffs as required under Rule 23(a).

Still, there is one category of institutional investors who might be trusted to do the right thing for the right reason. An index fund, which is committed to holding stocks in proportion to market capitalization, has no need to engage with portfolio companies and nothing to lose from offending a company by serving as a representative plaintiff. Nevertheless, index funds seldom (if ever) step up. Indeed, they have been criticized for their failure to do their bit to engage with portfolio companies despite the fact that they hold (in the aggregate) more than half of all the stock held by publicly available investment companies.[111] But what the critics fail to note is that it would be a breach of fiduciary duty for index fund managers to use fund assets to such ends. Just as an index fund has nothing to gain from doing research—because it is committed to investing in proportion to the market capitalization of portfolio companies—an index fund has nothing to gain from kibbitzing with portfolio companies to improve performance. The same logic militates against taking the lead in a securities fraud class action. Moreover, fund managers seem to see the occasional settlement check as free money—a welcome windfall.[112]

The problem is that index funds have failed to appreciate their own interests. An

---

109. Such funds were involved as named plaintiffs in all of the primary cases discussed herein. *See Goldman Sachs*, 594 U.S. 113; *Halliburton I*, 597 F.3d 330; *Ludlow*, 800 F.3d 674. In the BP case, the named plaintiffs were Thomas P. Dinapoli (Comptroller of the State of New York) and the Ohio Public Employees Retirement System in addition to Ludlow the individual.

110. To be clear, pension plans are often managed (at least in part) by the same investment advisers who sponsor publicly available mutual funds. But the decision of the pension plan to serve as representative plaintiff is unlikely to reflect on the investment adviser.

111. *See* INVESTMENT COMPANY INSTITUTE, 2024 INVESTMENT COMPANY FACT BOOK 28-29 (reporting that as of year-end 2023 index funds held 18% of the entire US stock market as compared to the 13% thereof held by actively managed funds); *see also* Lucian A. Bebchuk & Scott Hirst, *Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy*, 119 COLUM. L. REV. 2029 (2019) (noting the large sizes of index funds as well as their propensity to underinvest in stewardship); Lucian A. Bebchuk & Scott Hirst, *Big Three Power, and Why it Matters*, 102 B.U. L. REV. 1547 (2022) (discussing other implications of index fund size).

112. I once had occasion at a conference focusing on securities litigation to discuss (privately) the costs and benefits of securities fraud class actions for index funds with the general counsel of major index fund sponsor, who expressed this opinion.

index fund will almost always have held more of a fraud stock from *before* the fraud period than they will have bought *during* the fraud period. So they lose more as legacy stockholders—because the company pays any settlement—than they gain with respect to shares bought during the fraud period.[113] Although the fund will receive some of the recovery, it will almost never break even. While some of the recovery will flow back to the fund (less a pro rata share of attorney fees), most of the recovery will go to more active traders.

The bottom line is that index funds should be opposed to securities fraud class actions.[114] But they cannot register their opposition by opting out of recovery. To do so would be to forgo their share of recovery which mitigates the losses they suffer from the decline in value suffered by defendant companies targeted by such actions. To be sure, an index fund is always free to oppose class certification and may even have a fiduciary duty to fund investors to do so. But the expense of doing so combined with the slim chance of preventing others from prosecuting a class action militates against intervention.[115]

While the foregoing considerations almost certainly preclude index funds from doing anything merely to oppose securities fraud class actions, the calculus is quite different regarding derivative actions. As explained above, many event-driven securities fraud class actions should be litigated as derivative actions rather than as direct class actions. And if they are so litigated, the recovery (if any) goes to the company with the effect of restoring company value. For an index fund, this is a win-win proposition. With a securities fraud class action, defendant company value declines when the fraud is revealed and declines by even more because of the prospect of payout. An index fund loses twice; first because of the fraud, and second because it will foot more of the bill for the settlement. With a derivative action, the money flows the other way. If the company recovers, value is restored. But even if the derivative action fails to secure any recovery for the company, it will minimize the decrease from

113. *See generally* Richard A. Booth, *Index Funds and Securities Fraud Litigation,* 64 S.C. L. REV. 265 (2012). To be sure, settlements are typically covered by insurance and are not usually funded by the company, even in part. But that is irrelevant as a matter of law, and the settlement will typically deplete coverage that could offset other losses. Moreover, but for the prospect of securities fraud class action liability, the company might not have needed to buy so much insurance.

114. The same is undoubtedly true for many actively managed mutual funds. The larger the fund, the more likely it is that fund has held more of a given stock from before the fraud period than it bought during the fraud period since there are only so many stocks available for investment therein. *See* Booth, *supra* note 115, at 265 ("an index fund almost always holds more shares than it buys during the fraud period"); *see also* Richard A. Booth, *The Duty to Diversify and the Logic of Indexing,* 75 U.C. L. J. 555 (2024).

115. On the other hand, it is not uncommon for courts to make certification contingent on some maximum number of opt-outs, which might permit index funds effectively to veto some class actions. *See* Booth, *supra* note 89, at 88-89 (observing that funds acting in concert may collectively prevent many securities fraud class actions from proceeding).

any class action settlement.

In short, index funds are arguably duty-bound to their investors to advocate for derivative actions event-driven cases (if not most cases). They have everything to gain and nothing to lose. Just as it is a per se breach of fiduciary duty to invest in a no-win proposition, it is a per se breach of fiduciary duty to fail to secure a no-lose advantage.[116]

One possible excuse an index fund might have for failing to step up is that a volunteer fund may end up footing the bill for benefits that flow to other index funds and other diversified investors—or footing the bill for a failed effort.[117] But presumably a fund can find a plaintiff law firm that will work for a contingent fee. Indeed, one would think that most plaintiff firms would be thrilled to sign such a client. And when successful, the fund will presumably be reimbursed for any expenses.

In the end, there is no good excuse for the failure of index funds to make the argument outlined here—other than the possibility that no one has yet understood the argument. But once the argument is understood, it is difficult to see how an index fund would not be compelled (by its fiduciary duty to fund investors) to intervene in a class action of the kind described here.[118]

Thus, the worry that there might be no one to make the argument—since no one has yet done so—is transitional. It would take only a few successful efforts for derivative actions to supplant class actions. And those efforts are all the more likely to succeed if the representative plaintiff is one of the Big Three index funds.[119]

116. *Cf.* Joy v. North, 692 F.2d 880, 886 (2d Cir. 1982) (holding that a no-win decision constitutes breach of fiduciary duty). On the other hand, an economist might argue that there would likely not be a fifty-dollar bill lying on the sidewalk here, because if there were, someone would have already picked it up.

117. Although it is understandable to worry about freeriding, the volunteer fund might still be compelled to act as a matter of fiduciary duty (to the fund's investors) if the risk-adjusted gain to the fund exceeds the cost of litigating the claim.

118. One likely explanation for the fund managers' failure to understand how the interests of index funds differ from those of traditional actively managed funds is that no one specializes in advising index funds. In other words, there is no ISS or Glass Lewis who seeks to advise index funds based on their distinctive interests. Although index funds are duty-bound to minimize what they spend on monitoring portfolio companies, they should nonetheless worry about big-picture trends and should be especially concerned about tactics other investors might use to divert returns. Securities fraud class actions are precisely such a tactic. A specialized adviser could significantly reduce monitoring expenses for index funds (if only by culling company-specific advice) as well as the expense of intervention (if only by identifying the cases calling for it). Such an adviser might also catalyze cooperation among index funds in addressing important cases, thus facilitating the sharing of expenses.

119. Note that there have been a few valiant efforts by derivative plaintiffs to press their claims, but they have generally failed because of the quite erroneous notion that a federal-law securities fraud action is inherently more important than a state-law derivative action.

30 STAN. J.L. ECON. & BUS. 133

VII. CONCLUSION

On one hand, the debate as to whether literal price inflation should be required to plead securities fraud (because there is no general duty of disclosure) or whether price maintenance will suffice to state a claim may not matter much insofar as plaintiffs will almost always be able to argue that the defendant company was obligated to speak by law or circumstance. But because the price-maintenance theory implies that damages should be measured by the difference between the price paid by buyers and the price at which stock settles following corrective disclosure, it clearly encourages more litigation and more generous settlements by defendants who fear the potentially devastating consequences of going to trial. On the other hand, the debate itself reveals a fundamental contradiction in the way damages are measured. Whereas literal price inflation focuses on mispricing at the time buyers buy, price maintenance focuses on the price following corrective disclosure, which may be magnified by consequential losses from events that reveal the misrepresentation. Thus, the debate has tended to obscure the possibility that loss in a price-maintenance case might also be measured by mispricing at the time a buyer buys. One unnoticed implication of the Supreme Court decision that defendant companies may show lack of price impact is that defendants may now introduce evidence in connection with class certification that price impact derives from sources other than fraud. Although the Court has suggested that a defendant must show zero price impact from fraud to defeat a class action, it should be enough to show that some portion of the loss is derivative to trigger the requirement under FRCP Rule 23(b)(3) that any claim that can be adjudicated other than by class action be so adjudicated.