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Index Funds and Securities Fraud Litigation

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INDEX FUNDS AND SECURITIES FRAUD LITIGATION

Richard A. Booth*

Most legal scholars agree that securities fraud class actions do little good for investors. Most investors are well diversified and thus are just as likely to sell an overpriced stock as to buy one. Moreover, since the defendant company ultimately pays in a successful class action, holders effectively pay buyers. Although this circularity is widely recognized, few have noted that because of the anticipated payout, the prospect of a class action causes stock price to decline by more than it otherwise would, thus generating additional feedback loss for both buyers and holders. In this Article, I describe a method by which one can measure the net effect of class actions on fund investors who are both buyers and holders of a fraud-affected stock. Since an index fund almost always holds more shares than it buys during the fraud period, an index fund almost always loses more than it gains. Thus, class actions systematically penalize rational index fund investors for the benefit of irrational and undiversified stock-picking investors. Accordingly, index funds should oppose class actions as contrary to the best interests of investors. To be sure, one possible problem is that in the absence of the deterrent effect of class actions, there might be more securities fraud. The answer is that whenever there is a meritorious class claim, the corporation itself will also have a claim against the individual wrongdoers for any increase in the cost of capital resulting from reputational harm and any direct expenses relating to enforcement proceedings. In a class action, these elements of loss are imbedded in the price decrease that occurs when the fraud is discovered. But these losses are in fact suffered by the corporation and should be the subject of a derivative action for the benefit of the corporation—and thus all of the stockholders—rather than a class action for the benefit only of those who bought shares during the fraud period. Although the corporation's claim may be smaller than the class claim in the aggregate, it is likely to be quite substantial from the point of view of individual wrongdoers, thus constituting a significant deterrent to fraud. Happily, the Federal Rules of Civil Procedure provide a fix for the problem. First, a claim that can be handled as a derivative claim must be handled as such and must be resolved first before any class claim may be addressed. Second, no class action may proceed unless the court certifies it as a proper class action. No action may be so certified if there is any other equally good way to litigate the issues—such as by means of a derivative action. But someone must first make the argument. It is puzzling that no one has done so, especially because derivative actions eliminate feedback losses and serve to restore stock price. There are several possible explanations. One is that insurance does not cover derivative claims as it does class claims. Moreover, directors and officers who are likely to be defendants in a derivative action may prefer to circle the wagons and present a unified defense together

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with the corporation in the context of a class action. Another factor militating against derivative actions is that aggregate attorney fees are likely to be higher in class actions than in derivative actions, which may incline plaintiff lawyers to favor class actions even though investors would be better served by derivative actions. On the other hand, until now, no one has quantified the costs and benefits of class actions for real-world investors. Since index funds almost always lose more than they gain, they should oppose class actions and favor derivative actions. Indeed, index funds owe a duty to their investors to do so.

I. INTRODUCTION	266
II. SECURITIES FRAUD CLASS ACTIONS AND INVESTOR WELFARE	275
III. INDEX FUNDS AND THE RATIONAL INVESTOR	280
A. <i>Index Funds and Diversification</i>	283
B. <i>Index Funds and Trading</i>	286
C. <i>Index Funds and Securities Fraud Class Actions</i>	287
IV. DERIVATIVE ACTIONS VERSUS CLASS ACTIONS	292
A. <i>Derivative Actions and Deterrence</i>	296
B. <i>Practice and Procedure</i>	299
C. <i>Class Certification</i>	303
D. <i>Remaining Direct Claims</i>	305
V. MARKET FAILURE AND THE SURVIVAL OF CLASS ACTIONS	308
A. <i>The Role of Directors' and Officers' Insurance</i>	309
B. <i>Other Unindicted Co-Conspirators</i>	311
C. <i>Other Factors</i>	313
D. <i>Index Funds</i>	317
VI. CONCLUSION.....	319
APPENDIX	321

I. INTRODUCTION

In the typical securities fraud class action arising under Securities and Exchange Commission (SEC) Rule 10b-5,¹ the plaintiff class consists of investors who buy a stock when the price is allegedly inflated because of a false

1. Rule 10b-5 is codified at 17 C.F.R. § 240.10b-5 (2012).

statement by the issuer corporation.² When the truth comes out, the stock price drops.³ Under federal law, buyers have a claim against the issuer company for the difference between the price they paid during the fraud period and the price at which the stock ultimately settles after corrective disclosure.⁴

One would think that investors should be happy that the legal system affords them a remedy for their losses. But one would be wrong. Although some investors may see securities fraud class actions as an important source of protection, diversified investors should regard such lawsuits as nothing more than an unnecessary tax on returns.⁵ First, since investors who sell a stock when it is overpriced keep their gains and since a diversified investor is just as likely to sell as to buy, gains and losses wash out over time.⁶ So, diversified investors have no need for a class action remedy. Second, class actions ultimately cause bigger losses for nontraders—mere holders—than they would otherwise suffer.⁷ Because the defendant company pays, stock price declines by more than it

2. See *Archdiocese of Milwaukee Supporting Fund, Inc. v. Halliburton Co.*, 597 F.3d 330, 334 (5th Cir. 2010), *vacated sub nom. Erica P. John Fund, Inc. v. Halliburton Co.*, 131 S. Ct. 2179, 2187 (2011); see also *Greenberg v. Crossroads Sys., Inc.*, 364 F.3d 657, 662 (5th Cir. 2004) (citing *Nathenson v. Zonagen Inc.*, 267 F.3d 400, 415 (5th Cir. 2001)) (noting that the plaintiff must allege and present evidence that a false, non-confirmatory positive statement positively affected the stock price). The focus here is on securities fraud involving outstanding stock and not fraud involving the sale of stock by the issuer in a public offering. The latter is governed by the Securities Act of 1933 (1933 Act), under which the remedy is essentially one of disgorgement by the issuer. See 15 U.S.C. §§ 77q(a), 77t(d) (2006). In contrast, the focus here is on fraud in connection with already outstanding stock where the company itself is not, necessarily, involved in the sale or purchase of stock.

3. Although most securities fraud actions are brought as a result of a decrease in stock value, this is not always that case. See Richard A. Booth, *The End of the Securities Fraud Class Action as We Know It*, 4 BERKELEY BUS. L.J. 1, 5–6 (2007) [hereinafter Booth, *The End of the Securities Fraud Class Action*]; see, e.g., *Basic Inc. v. Levinson*, 485 U.S. 224, 228 (1988) (involving a class action for injury sustained from the sale of “shares at artificially depressed prices in a market affected by petitioners’ misleading statements and in reliance thereon”).

4. To be precise, under the Securities Exchange Act of 1934 (1934 Act), as amended by the Private Securities Litigation Reform Act of 1995 (PSLRA), the price must be determined by averaging closing prices for ninety days after corrective disclosure. See Private Securities Litigation Reform Act of 1995 § 21D(e), 15 U.S.C. § 78u-4(e) (2006). See generally Richard A. Booth, *Windfall Awards Under PSLRA*, 59 BUS. LAW. 1043, 1045 (2004) [hereinafter Booth, *Windfall Awards*] (critiquing the formula for damages contained in the PSLRA).

5. See generally Elizabeth Chamblee Burch, *Reassessing Damages in Securities Fraud Class Actions*, 66 MD. L. REV. 348, 374–76 (2007) [hereinafter Burch, *Reassessing Damages*] (theorizing that diversified investors should view the transaction costs associated with private securities fraud class actions as an unnecessary tax on returns).

6. See Booth, *The End of the Securities Fraud Class Action*, *supra* note 3, at 3; see also BURTON G. MALKIEL, *A RANDOM WALK DOWN WALL STREET* 359, 368–69 (9th ed. 2007) (noting that “[e]ach investor shares proportionately in the net income and in the capital gains and losses of the fund’s portfolio,” and “the fund offsets unavoidable gains by judiciously selling other securities on which there is a loss”).

7. See Richard A. Booth, *Class Conflict in Securities Fraud Litigation*, 14 U. PA. J. BUS. L. 701, 714–16 (2012) [hereinafter Booth, *Class Conflict*].

otherwise would as a result of corrective disclosure.⁸ In other words, the prospect of payout magnifies the decline and further increases the prospect of payout.⁹ Thus, holders suffer bigger losses because of this feedback effect.¹⁰ As for buyers, recovery (if any) is reduced by attorney fees and other expenses of litigation.¹¹ Clearly, diversified investors would be better off in a world without

8. See Booth, *The End of the Securities Fraud Class Action*, *supra* note 3, at 3, 5.

9. See *id.* at 3. As discussed in Part II, this process reaches a natural limit depending on the size of the plaintiff class.

10. This is true even for undiversified investors who might thus oppose securities fraud class actions, as a matter of principle, when considering the matter behind a Rawlsian “veil of ignorance”—not knowing whether they will be buyers or holders when a fraud arises. See JOHN RAWLS, *A THEORY OF JUSTICE* 12 (1971).

11. Under the rules governing class actions, the attorney fees of the plaintiff class are paid out of the recovery. See FED. R. CIV. P. 23(h). Since 1996, there have been more than 2,800 securities fraud class actions filed seeking compensation for investors who typically bought stocks at prices inflated by defendant company misrepresentations. See CORNERSTONE RES., SECURITIES CLASS ACTION FILINGS: 2010 YEAR IN REVIEW 3 fig.2, 32 fig.29 (2011) [hereinafter 2010 FILINGS], available at http://securities.stanford.edu/clearinghouse_research/2010_YIR/Cornerstone_Research_Filings_2010_YIR.pdf (listing the number of securities fraud class actions filed per year since 1996 and noting that, from 2006 to 2010, 10b-5 claims accounted for a substantial majority of total claims); see also CORNERSTONE RES., SECURITIES CLASS ACTION CASE FILINGS: 2006 MID-YEAR ASSESSMENT 14, Exhibit 9 (2006) (finding that 10b-5 claims accounted for 93% of total filings in 2005); *infra* app. (listing figures for each year). In the aggregate, these lawsuits have resulted in \$1.816 trillion in damages, or disclosure dollar losses, for defendant companies and have settled for aggregate payments of approximately \$64 billion, represented by market capitalization losses. See 2010 FILINGS, *supra*, at 24 (listing the total amount of disclosure dollar loss per year since 1996); ELLEN M. RYAN & LAURA E. SIMMONS, CORNERSTONE RES., SECURITIES CLASS ACTION SETTLEMENTS: 2010 REVIEW AND ANALYSIS 2 fig.2 (2011) (listing the total amount of settlement dollars in 2010 and in the preceding years); see also *infra* app. (listing figures for each year). A rough, but conservative estimate of about 20% of the settlement amount typically goes toward plaintiff attorney fees. See ANJAN V. THAKOR ET AL., U.S. CHAMBER INST. FOR LEGAL REFORM, THE ECONOMIC REALITY OF SECURITIES CLASS ACTION LITIGATION app. III, Exhibit A (2005), available at <http://www.instituteforlegalreform.com/doc/the-economic-reality-of-securities-class-action-litigation> (finding, in a sample of 482 class actions, that \$3.1 billion in attorney fees were paid in connection with settlements totaling \$19.8 billion—roughly 16%); Theodore Eisenberg & Geoffrey P. Miller, *Attorney Fees and Expenses in Class Action Settlements: 1993–2008*, 7 J. EMPIRICAL LEGAL STUD. 248, 258–59 & tbl.3 (2010) (finding average fees of 23%); Denise N. Martin et al., *Recent Trends IV: What Explains Filings and Settlements in Shareholder Class Actions*, 5 STAN. J.L. BUS. & FIN. 121, 141 (1999) (finding average fees of 32%).

class actions since they would break even.¹² In short, the cure is worse than the disease.¹³

The problems with securities fraud class actions are most apparent when viewed in the context of an index fund: a mutual fund that seeks to match the performance of the market as a whole by holding the stocks that compose an index such as the S&P 500.¹⁴ A typical index fund trades almost exclusively for purposes of portfolio balancing in order to hold shares in proportion to market capitalization.¹⁵ In other words, an index fund periodically buys additional shares of portfolio stocks that have risen in value and sells shares of portfolio stocks that have fallen in value relative to other portfolio stocks.¹⁶ When an index fund trades, it almost always buys a few additional shares of a stock that it already owns or sells a few shares of a stock that it continues to hold.¹⁷ Thus, an index fund usually holds many more shares than the number it buys or sells.¹⁸ As a result, an index fund almost always loses more as a holder than it gains as a buyer from the settlement of a class action.

It is ironic that the law should cause more harm to investors than they would otherwise suffer. But it is doubly ironic that the cost of securities litigation falls disproportionately on diversified buy-and-hold investors—investors who seek to maximize returns and minimize expenses by eschewing any effort to beat the market, often by investing through index funds that offer complete

12. See Booth, *The End of the Securities Fraud Class Action*, *supra* note 3, at 10–11. To be sure, there might be more fraud in the absence of the deterrent effect of securities fraud class actions, and investors might thus be worse off despite the untoward side effects thereof. See, e.g., John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation*, 106 COLUM. L. REV. 1534, 1564 (2006) (asserting that “one cannot safely eliminate corporate liability in securities class actions without radically reducing the likelihood of private enforcement”). But there are other more efficient means of deterrence. See *infra* Part IV.A (discussing the use of stockholder derivative actions to recoup losses suffered by the company as a result of the securities fraud).

13. See, e.g., Kevin LaCroix, *Private Securities Litigation: Important Deterrent or Wasteful Churn?*, D&O DIARY (Oct. 26, 2008, 3:27 PM), <http://www.dandodiary.com/2008/10/articles/securities-litigation/private-securities-litigation-important-deterrent-or-wasteful-churn/> (reporting that, according to Stanford Law School Professor Joseph Grundfest, private securities litigation is a mechanism ““for moving money around for the benefit of the people moving the money around””).

14. See Alan R. Palmiter & Ahmed E. Taha, *Mutual Fund Investors: Divergent Profiles*, 2008 COLUM. BUS. L. REV. 934, 985 (citing 4 TAMAR FRANKEL & ANN TAYLOR SCHWING, *THE REGULATION OF MONEY MANAGERS: MUTUAL FUNDS AND ADVISORS* § 31.02[J], at 31-101 (2d ed. Supp. 2012)).

15. See *id.* (citing MALKIEL, *supra* note 6, at 360). An index fund may also trade in reaction to the inflow and outflow of cash from the fund because the lower management and transaction costs provide more fund liquidity. See *id.*

16. See Booth, *Class Conflict*, *supra* note 7, at 717 & n.29; William A. Birdthistle, *The Fortunes and Foibles of Exchange-Traded Funds: A Positive Market Response to the Problems of Mutual Funds*, 33 DEL. J. CORP. L. 69, 72–73 (2008).

17. See Booth, *Class Conflict*, *supra* note 7, at 716 (“In the real world, a diversified investor often buys more of a stock that is already in her portfolio or sells some but not all of the shares of a stock in her portfolio simply to rebalance the portfolio.”).

18. See *id.*

diversification and rock-bottom expenses.¹⁹ Indeed, many (if not most) investment advisers counsel their clients to diversify and refrain from trading except for purposes of portfolio balancing and tax planning.²⁰ In short, securities fraud class actions effectively penalize the most rational investors for the benefit of irrational investors who decline to diversify and who seek to pick winners.

Numerous legal scholars have noted the circularity inherent in securities fraud class actions: because the defendant company pays, the cost of settlement is ultimately borne by the stockholders.²¹ In other words, investors effectively compensate themselves.²² Most legal scholars have concluded that such a remedy cannot be justified as a compensation scheme, although most also believe that class actions serve an important deterrent function.²³ But few

19. See Booth, *The End of the Securities Fraud Class Action*, *supra* note 3, at 5 (“A second fundamental problem with [securities fraud class actions] is that the defendant company pays the damages. As a result, the value of the defendant company is reduced by the amount of the payout in addition to any decline in the stock price of the company that results from disclosure of new information. In a bad-news case, this reduction in value itself results in a further decline in stock price and sets up a positive feedback mechanism that can lead to a total decline in price that may be several times the decline that would have resulted simply from the disclosure of negative information.”).

20. See, e.g., MALKIEL, *supra* note 6, at 186–90 (describing and illustrating modern portfolio theory and the principles of diversification); ROBERT W. HAMILTON & RICHARD A. BOOTH, *BUSINESS BASICS FOR LAW STUDENTS: ESSENTIAL CONCEPTS AND APPLICATIONS* § 3.2, at 36 (3d ed. 2002) (asserting that “rational investors diversify”); Booth, *Class Conflict*, *supra* note 7, at 712 (noting that diversified investors may trade for purposes of tax planning and portfolio balance); Isabella Steger, *First Lesson in Managing Money: Diversify*, WALL ST. J. (June 10, 2012, 12:12 PM), <http://online.wsj.com/article/SB10001424052702303665904577449980295801666.html> (interviewing David Chang, the head of Franklin Templeton in Greater China, who supports diversification as a matter of both fund management and investor education).

21. See, e.g., Coffee, *supra* note 12, at 1536 (“Rather, because the costs of securities class actions—both the settlement payments and the litigation expenses of both sides—fall largely on the defendant corporation, its shareholders ultimately bear these costs indirectly and often inequitably.”).

22. *Id.* at 1558.

23. See *id.* at 1534, 1572–73 (questioning the “moral entitlement” of investor plaintiffs seeking recovery in securities fraud class actions and considering whether “the deterrent benefits can justify these costs”); Jill E. Fisch, *Confronting the Circularity Problem in Private Securities Litigation*, 2009 WIS. L. REV. 333, 336, 340 (noting two goals of private securities litigation: compensation for investor loss and deterrence of managerial misconduct); Merritt B. Fox, *Civil Liability and Mandatory Disclosure*, 109 COLUM. L. REV. 237, 281 (2009) [hereinafter Fox, *Civil Liability and Mandatory Disclosure*] (acknowledging the weakness of the compensation justification for securities fraud class actions, but noting their deterrence value); Merritt B. Fox, *Why Civil Liability for Disclosure Violations When Issuers Do Not Trade?*, 2009 WIS. L. REV. 297, 332 [hereinafter Fox, *Why Civil Liability?*] (“Despite the weakness of its compensatory justification, the cause of action serves important deterrence functions . . .”); Amanda M. Rose, *Reforming Securities Litigation Reform: Restructuring the Relative Relationship Between Public and Private Enforcement of Rule 10b-5*, 108 COLUM. L. REV. 1301, 1322, 1363–64 (2008) (noting the widespread criticism of damages under Rule 10b-5 class actions, but suggesting that Securities and Exchange Commission oversight of these lawsuits would mitigate the negative aspects of both private and public enforcement schemes). But see Thomas A. Dubbs, *A Scotch Verdict on “Circularity” and Other Issues*, 2009 WIS. L. REV. 455, 455–60, 463 (discussing the problem of

commentators have recognized that class actions actually magnify investor losses in two distinct ways.²⁴

First, since a diversified investor is effectively insured against securities fraud by virtue of being diversified, the cost of securities litigation in attorney fees, other expenses, and management distraction is a deadweight loss that serves only to reduce portfolio return.²⁵ In other words, the class action remedy is akin to buying an insurance policy on a risk that one has already hedged away, *for free*, through diversification.²⁶ Investors would do better to self-insure through diversification than to rely on transfer payments to each other by which holders pay buyers but buyers get back only what is left after attorney fees and other litigation expenses are deducted.²⁷

Second, if the plaintiff class is one of buyers, as it almost always is, the cost of settlement in a successful securities fraud class action is borne exclusively by those who held the stock during the fraud period.²⁸ In theory, buyers are made whole by their recovery.²⁹ But even if buyers recover only part of their loss, holders pay.³⁰ In other words, class actions clearly effect an internal

circular compensation under Rule 10b-5 and concluding that more research needs to be done on the subject); James C. Spindler, *Vicarious Liability for Bad Corporate Governance: Are We Wrong About 10b-5?*, 13 AM. L. & ECON. REV. 359, 397–98 (2011) (concluding that Rule 10b-5 class actions serve their compensatory purposes well).

24. *But see* Booth, *The End of the Securities Fraud Class Action*, *supra* note 3, at 3 (describing how securities fraud class actions cause additional investor losses because of the feedback effect that arises from payout by defendant company to plaintiff class).

25. *See* Booth, *Class Conflict*, *supra* note 7, at 716; *see also* Burch, *Reassessing Damages*, *supra* note 5, at 374–76 (explaining how litigation expenses should be viewed as an unnecessary tax to diversified investors).

26. Diversification is effectively costless since it is usually cheaper to hold a mutual fund than to maintain a brokerage account as would be necessary to hold one or a few stocks. *See* Booth, *Class Conflict*, *supra* note 7, at 711 n.16; *see also* Booth, *The End of the Securities Fraud Class Action*, *supra* note 3, at 12–13 (“[A] diversified investor . . . is effectively insured against loss from simple securities fraud . . .”).

27. *See supra* notes 25–26 and accompanying text.

28. *See* Booth, *The End of the Securities Fraud Class Action*, *supra* note 3, at 8 n.14 (noting that, when the company sued pays damages, “[t]he award goes to those who bought or sold during the class period at the expense of longer term investors who did not trade during the fraud period”); *see also* Coffee, *supra* note 12, at 1556–57 (noting that the class action plaintiffs aim to recover “from equally nonculpable continuing shareholders”).

29. *See* Booth, *The End of the Securities Fraud Class Action*, *supra* note 3, at 4. The effects are somewhat different in good-news cases where buyers effectively pay a portion of their gains to seller plaintiffs. *See id.* at 8 & nn.14–15. Although good-news cases are quite rare, *see id.*, such cases have figured quite prominently in the development of the law in this area. *See, e.g.*, *Basic Inc. v. Levinson*, 485 U.S. 224, 228 (1988) (involving a class action for injury sustained from the sale of “shares at artificially depressed prices in a market affected by petitioners’ misleading statements and in reliance thereon”); *SEC v. Tex. Gulf Sulphur Co.*, 401 F.2d 833, 839–42, 847 (2d Cir. 1968) (considering 10b-5 claims of insider trading related to a stock purchase made just prior to a press release regarding news that would double the stock price in one month).

30. *See* Booth, *The End of the Securities Fraud Class Action*, *supra* note 3, at 8 n.14. To be sure, the claim may be covered by insurance, but the defendant company pays for the insurance.

redistribution of corporate wealth.³¹ Thus, investors who tend to be holders should oppose class actions in principle.

Nevertheless, it is puzzling to think that diversified investors should be indifferent to securities fraud.

The answer to this puzzle is that when buyers sue for securities fraud, their losses may come from three sources, all of which are impounded in the lower stock price of the defendant company: (1) lower expected return, (2) higher cost of capital, and (3) direct expenses of litigation and enforcement—such as attorney fees and other litigation expenses, civil and criminal fines, and damages or settlement amounts payable to buyers.³² Moreover, an increase in cost of capital may come from two sources: a market perception of more risk inherent in the business of the subject company or harm to the reputation of the subject company—a loss of trust—resulting from the fraud.³³ In a class action, all of these losses are represented in the aggregate decrease in stock price.³⁴

Not all of these losses are the result of fraud. Losses that flow from lower expected returns and higher expected risk will occur one way or the other, albeit sooner rather than later in the absence of fraud.³⁵ Diversified investors are indifferent to these losses because they wash out over time, fraud or no fraud.³⁶ But the losses that flow from a higher cost of capital resulting from reputational harm and the cost of litigation and enforcement are different. In a world *with* class actions, buyers can recover for these losses because they are built into the decrease in stock price.³⁷ In a world *without* class actions, buyers too would

The bottom line is that one can and should ignore insurance for purposes of analyzing the merits of securities fraud class actions. See *infra* Parts II, V.A.

31. See, e.g., Coffee, *supra* note 12, at 1583 (arguing that Rule 10b-5 litigation “essentially produces pocket-shifting wealth transfers that injure shareholders”); Fisch, *supra* note 23, at 334 (identifying the “circularity problem” of private securities litigation which “merely transfers funds from one set of shareholders to another”). Although most commentators who have noted the circularity problem have tended to focus on the aggregate—or “macro”—effects of class actions, commentators who have focused on these “micro” distributional effects have tended to justify the result on some sort of theory that holders owe something to buyers. See Lawrence E. Mitchell, *The “Innocent Shareholder”: An Essay on Compensation and Deterrence in Securities Class-Action Lawsuits*, 2009 WIS. L. REV. 243, 292 (“It is shareholders themselves who have the power and thus the responsibility to protect the integrity of our financial markets through their voting and trading.”); James J. Park, *Shareholder Compensation as Dividend*, 108 MICH. L. REV. 323, 331–32, 338–39 (2009) (distinguishing shareholders who purchased stock during the period of fraud from those who purchased prior to this period, and arguing that the latter group of “Non-Class Shareholders” should compensate the “Class Shareholders” because these shareholders were the ones who suffered directly as a result of the fraud). But see Amanda M. Rose & Richard Squire, *Intraportfolio Litigation*, 105 NW. U. L. REV. 1679, 1697 (2011) (propounding the theory that litigation between companies whose stock is held in the same portfolio has the beneficial effect of reallocating capital to its highest and best use).

32. See Booth, *Class Conflict*, *supra* note 7, at 709–10.

33. See *id.*

34. See *id.*

35. See Booth, *The End of the Securities Fraud Class Action*, *supra* note 3, at 10 & n.21.

36. See *supra* note 6 and accompanying text.

37. See Booth, *Class Conflict*, *supra* note 7, at 708–09, 714–15.

suffer these genuine losses—even if the buyers are diversified investors.³⁸ In a world *with* class actions, these losses are effectively transferred to holders through feedback.³⁹ Most commentators seem to view this redistribution of stockholder wealth as an unfortunate side effect of class actions.⁴⁰ At worst, it is a necessary evil if we are to preserve the deterrent effect that goes with securities litigation.⁴¹ Besides, for diversified investors it all comes out in the wash.⁴²

Not so. First, the cost falls almost solely on holders and thus disproportionately on index funds—the investment of choice for the most rational investors.⁴³ Second, and more important, the genuine losses that flow from securities fraud are losses that affect all stockholders in the same way.⁴⁴ Thus, they are claims that should be asserted derivatively on behalf of the corporation.⁴⁵ If the corporation is made whole, both buyers and holders are

38. *See id.*

39. *See* Booth, *The End of the Securities Fraud Class Action*, *supra* note 3, at 3, 8 n.14. For purposes of analysis, the discussion here generally assumes that buyers recover 100% of their losses. On the one hand, it seems appropriate to analyze the law on its own terms, even if real world cases typically settle for cents on the dollar, since the strength of the plaintiff's case—and hence the plaintiff's bargaining power—depends on the damages that the plaintiff might be awarded if the case were litigated to judgment. This is irrespective of whether the defendant would be able to pay. In other words, the parties negotiate in the shadow of the law. On the other hand, the analysis here does not depend on full recovery. For example, any amount paid by the defendant company to settle a class action results in a decrease in the value of the defendant company for the benefit of buyers. *See id.* at 5. Thus, if the plaintiff class recovers anything at all, holders in the aggregate lose to the same extent. *See id.*

40. *See* Coffee, *supra* note 12, at 1583; *see also* Fisch, *supra* note 23, at 334 (acknowledging the “circulatory problem” of private securities litigation, which “merely transfers funds from one set of shareholders to another”).

41. *See* Coffee, *supra* note 12, at 1586; *see also* Fisch, *supra* note 23, at 338 (noting that, due to the criticisms of securities fraud class actions, “commentators have turned to deterrence as an alternative justification for private litigation”).

42. *See supra* note 6 and accompanying text.

43. *See supra* notes 6, 7, 18, and 19.

44. *See, e.g.,* Barbara Black, *Reputational Damages in Securities Litigation*, 35 J. CORP. L. 169, 181 (2009) (noting that, in cases of securities fraud, “all shareholders suffer loss in value of their investments resulting from the market’s reassessment of the integrity of management and internal controls”).

45. *See, e.g.,* Pfeiffer v. Toll, 989 A.2d 683, 699 (Del. Ch. 2010) (asserting that a claim is “fundamentally derivative . . . because it arises out of the misuse of corporate property—that is, confidential information—by a fiduciary of the corporation, for the benefit of the fiduciary and to the detriment of the corporation” (quoting *Latesco, L.P. v. Wayport, Inc.*, C.A. No. 4167-VCL, 2009 WL 2246793, at *6 (Del. Ch. July 24, 2009) (internal quotation marks omitted), *abrogated on other grounds by* *Kahn v. Kolberg Kravis Roberts & Co.*, 23 A.3d 831 (Del. 2011)). Although commentators have noted that some of the loss from securities fraud flows from such sources, few have connected the dots with the possibility of a derivative action for the benefit of the corporation. *See* Black, *supra* note 44, at 182 (arguing that “allowing recovery for reputational damages furthers the policy . . . that investors should be able to rely on the corporation’s financial statements”); *see also* Allen Ferrell & Atanu Saha, *The Loss Causation Requirement for Rule 10b-5 Causes of Action: The Implication of Dura Pharmaceuticals, Inc. v. Broudo*, 63 BUS. LAW. 163, 185 (2007) (criticizing the “back-casting” approach to the calculation of damages per share, which makes “it difficult to estimate with any degree of reliability the inflation during the damage period using the price drop

made whole.⁴⁶ Moreover, the threat of a derivative action provides a perfectly tailored deterrent for securities fraud—one that compensates investors solely for the genuine harm they suffer.⁴⁷ Legal scholars have noted that class actions seem to constitute excessive deterrence in that they encourage too many lawsuits, but no one has offered a cogent explanation as to why.⁴⁸ A logical explanation is that in a class action, plaintiffs can, in theory, recover for their total loss, including the portion of the loss that would happen even in the absence of fraud.⁴⁹ As a result, there are too many class actions, and defendant companies invest too much in prevention and defense.⁵⁰ In short, a derivative action is clearly superior to a class action as a remedy for securities fraud.

This Article proceeds as follows:

Part II outlines the law and practice of securities fraud class actions and describes the problems created by the fact that the defendant company ultimately funds any settlement. Foremost is the problem of feedback: since the defendant company pays in any successful class action, stock price falls more than it otherwise would, increasing the amount of the class claim and foisting collateral damage on holders. Although most claims are paid by insurance, the corporation ultimately pays because the expense of insurance—including increases in premiums going forward—reduces returns and thus reduces market capitalization.

Part III describes the rationale for, and operation of, index funds as well as their importance for conservative investors. This Part also analyzes the effect of securities fraud class actions on returns in various trading scenarios and finds that index funds almost always lose more than they gain from a class action. Accordingly, index fund investors should favor the abolition of class actions.

Part IV explores the methods by which an index fund might oppose a securities fraud class action. Although there are good reasons why a court should decline to certify a securities fraud action as a class action, the better fix is for an index fund to advocate for a derivative action, seeking to recover for the losses suffered by the corporation from any increase in the cost of capital and

associated with the disclosure”); Baruch Lev & Meiring de Villiers, *Stock Price Crashes and 10b-5 Damages: A Legal, Economic, and Policy Analysis*, 47 STAN. L. REV. 7, 34 (1994) (arguing that there should be no recovery for consequential “crash damages” resulting from disclosures made in connection with securities fraud). *But see* Fox, *Civil Liability and Mandatory Disclosure*, *supra* note 23, at 240, 290 (proposing a system of issuer liability under federal securities law in which “any shareholder could bring a suit on behalf of the corporation against an officer, director, or external certifier”).

46. *See* Booth, *The End of the Securities Fraud Class Action*, *supra* note 3, at 24 (“Diversified investors can be made whole by issuer recovery of insider gains.”).

47. *See id.*

48. *See* Booth, *Class Conflict*, *supra* note 7, at 702; *see also* Rose, *supra* note 23, at 1322 (noting that some commentators believe “excessive securities litigation continues to overdeter, harming the competitiveness of U.S. capital markets by driving issuers abroad”).

49. *See supra* note 2 and accompanying text.

50. *See supra* note 11.

any expenses associated with enforcement. Since class actions are often justified by their supposed benefits in deterring fraud, this Part also considers the deterrent effect of derivative actions and argues that they offer superior deterrence in every situation in which a meritorious class action would lie. Whenever a class action that would survive a motion to dismiss can be pleaded, a derivative action that would survive a motion to dismiss may also be pleaded. In addition, this Part considers the details of practice and procedure relating to class actions and derivative actions. In the end, it is up to the court to decide whether a claim is direct or derivative.⁵¹ And the law is clear that if a claim *can* be litigated as a derivative claim, it *must* be so litigated.⁵² It matters not that the plaintiff styles the claim as a direct class claim if the claim is in fact derivative.⁵³ In addition, Rule 23 of the Federal Rules of Civil Procedure (FRCP), which governs class actions, provides that a claim for damages may be certified as a class action only if it is *superior* to any other means of litigating the claim.⁵⁴ Indeed, it is arguable that a claim for damages may be certified as a class action only if there is no other way to litigate the claim.⁵⁵ Since a derivative action is clearly superior as to the part of a claim that affects all stockholders in the same way, FRCP Rule 23 mandates that the claim be litigated as a derivative action.⁵⁶

Finally, Part V considers why class actions survive as the dominant form of securities litigation when derivative actions are clearly superior. There are several powerful forces at work in favor of class actions and against derivative actions, including the larger attorney fees generated by class actions, the lack of insurance coverage for derivative actions, the failure of litigants to recognize the costs associated with class actions, and a body of law and precedent that entrenches the status quo from several different angles. Ultimately, index funds—which almost always lose more than they gain from class actions—are the most likely litigants to advocate for derivative actions to supplant direct actions.⁵⁷ But for index funds to step up to the task, it is crucial that they understand the respective costs and benefits of class actions and derivative actions as explained herein.

II. SECURITIES FRAUD CLASS ACTIONS AND INVESTOR WELFARE

In the typical Rule 10b-5 class action, the plaintiff class consists of investors who buy a stock when its price is allegedly inflated because of a false statement

51. See Booth, *The End of the Securities Fraud Class Action*, *supra* note 3, at 24.

52. See Tooley v. Donaldson, Lufkin, & Jenrette, Inc., 845 A.2d 1031, 1037 (Del. 2004) (citing Bokar v. Getty Oil Co., 262 A.2d 246 (Del. 1970)).

53. See Kramer v. W. Pac. Indus., Inc., 546 A.2d 348, 352 (Del. 1988) (quoting Lipton v. News Int'l, PLC, 514 A.2d 1075, 1078 (Del. 1986)).

54. FED. R. CIV. P. 23(b)(3).

55. See *supra* note 52.

56. See FED. R. CIV. P. 23(b)(3).

57. See *supra* notes 14–18 and accompanying text.

made by the issuer corporation.⁵⁸ When the truth comes out, stock price drops, and buyers file suit against the issuer company. But only the buyers may sue.⁵⁹ And since the company, or its insurer, pays, it is the other stockholders who effectively lose.⁶⁰ In other words, holders pay buyers.⁶¹

Moreover, because the prospect of payout increases the potential for loss, it also increases the class claim and further increases the loss.⁶² For example, suppose that Binford Tool Company's stock is trading at \$20 per share based on projected earnings of \$2 per share. Management learns that a major customer plans to cancel its contract with the company. As a result, actual earnings are likely to fall to \$1.50 per share for the coming year. Nevertheless, in a conference call with investors and analysts, Binford management reassures the market that the company is on target to meet expectations. But for this misrepresentation, one might expect stock price to fall from \$20 to \$15 when the truth becomes public. But because management lied to the market, and because the company will likely be sued in a securities fraud class action, the stock price falls further to \$10. To be sure, some of the additional \$5 decrease may be attributable to the market's perception that Binford is a riskier business than previously thought or to a loss of trust in management both of which may result in an increase in the cost of capital. But some of the additional decline is presumably attributable to the prospect of payout.⁶³ Thus, a securities fraud class action causes some of the loss that it seeks to recover.

58. See *supra* note 2 and accompanying text. As noted above, it is also possible that a fraud may involve the cover-up of good news such that sellers suffer the loss, but the vast majority of securities fraud class actions involve the cover-up of bad news rather than good news. See *supra* note 29. Thus, the discussion here assumes that the fraud involves the cover-up of bad news and hence a class comprising buyers.

59. *Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit*, 547 U.S. 71, 79 (2006) (citing *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461, 464 (2d Cir. 1952)); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 731 (1975) (citing *Birnbaum*, 193 F.2d at 463–64).

60. See *supra* notes 21–22 and accompanying text.

61. Again, the focus here is on fraud involving outstanding stock where the issuer company itself is not involved in any sale or purchase. Where the company itself sells stock to the public by means of fraud, the 1933 Act provides for a disgorgement remedy by which the company must compensate buyers. See *supra* note 2; see, e.g., *SEC v. Commonwealth Chem. Sec., Inc.*, 574 F.2d 90, 96 (2d Cir. 1978) (explaining that “the SEC makes the proceeds of disgorgement available to injured parties”). In such a case, the pre-fraud stockholders, if any, effectively give back their ill-gotten gains of underpriced capital. See, e.g., *id.* at 95 (explaining that by disgorging profits, the court is “exercising [its] discretion to prevent unjust enrichment”).

62. See *Booth, Class Conflict*, *supra* note 7, at 706 & n.8. Mercifully, the process reaches a mathematical limit based on the size of the plaintiff class.

63. The market makes this assessment more or less instantaneously. See Jeffrey S. Glaser, Comment, *The Capital Asset Pricing Model: Risk Valuation, Judicial Interpretation, and Market Bias*, 50 BUS. LAW. 687, 694 (1995). In the real world, the truth may come out in stages. See, e.g., *Dura Pharm., Inc. v. Broudo*, 544 U.S. 336, 339 (2005) (involving the progressive disclosure of bad news). Moreover, corrective disclosures may be mixed with other disclosures such that it is difficult to isolate the effects of fraud. See, e.g., *Archdiocese of Milwaukee Supporting Fund, Inc. v. Halliburton Co.*, 597 F.3d 330, 340 (5th Cir. 2010), *vacated sub nom.* *Erica P. John Fund, Inc. v. Halliburton Co.*, 131 S. Ct. 2179, 2187 (2011) (reasoning that a press release correcting a

One might justify this system as a form of investor insurance.⁶⁴ But most investors are already effectively insured because they are well diversified by virtue of investing through institutions such as mutual funds and pension plans.⁶⁵ Indeed, more than two-thirds of all stock is held through such institutions.⁶⁶ A diversified investor is just as likely to sell an overpriced stock and gain as to buy one and lose.⁶⁷ So it all comes out in the wash. The costs of securities litigation—in attorney fees, other expenses, and management distraction—are a deadweight loss that serves only to reduce aggregate investor return.⁶⁸ An undiversified investor who puts all of his eggs in one basket might be happy to forgo some return as a fee for such insurance just as one buys fire insurance on one's home. But for a diversified investor, the deadweight loss is the equivalent of buying an extended warranty on a toaster. It is better to self-insure.

Moreover, diversified investors lose when they are mere holders of a fraud-affected stock—which is most of the time.⁶⁹ Most investment advisers agree that a buy-and-hold strategy makes the most sense for most investors.⁷⁰ But even a buy-and-hold investor needs to rebalance his portfolio from time to time.⁷¹ For such an investor, securities fraud class actions may generate more in additional feedback loss than the amount of the recovery.⁷²

For example, suppose that Rearguard Fund holds a portfolio of 1,000 stocks with a total value of \$10 billion, including \$80 million in Binford. In the course of rebalancing its portfolio, Rearguard buys another \$20 million in Binford during the fraud period so that it now holds a total of \$100 million. When Binford falls from \$20 per share to \$10 per share, Rearguard loses a total of \$50 million on its investment. But Rearguard has a claim only for the \$10 million loss on the \$20 million purchase that it made during the fraud period, though.⁷³ Assuming that plaintiff attorney fees and other expenses will reduce the recovery

company's prior estimate of "asbestos reserves" was not misleading or deceptive; therefore, the "press release was not an actionable corrective disclosure"). These are serious practical problems in litigating securities fraud claims. See, e.g., Donald C. Langevoort, *Basic at Twenty: Rethinking Fraud on the Market*, 2009 WIS. L. REV. 151, 179–80 (arguing that the use of an event study—i.e., scientific expert testimony to establish loss causation in private securities litigation—"no longer offers a clean assessment of the intrinsic value of the fraud"). But these difficulties do not affect the analysis here. Therefore, for the sake of clarity, the assumption here is that the corrective disclosure happens all at once and in isolation from other news that might affect stock price.

64. See Langevoort, *supra* note 63, at 165–66.

65. See *supra* notes 25–27 and accompanying text.

66. Booth, *Class Conflict*, *supra* note 7, at 711.

67. See *id.* at 706.

68. See *id.*

69. See *id.*

70. See Burton G. Malkiel, Op-Ed., 'Buy and Hold' Is Still a Winner, WALL ST. J., Nov. 18, 2010, at A23.

71. *Id.*

72. See Booth, *Class Conflict*, *supra* note 7, at 706–07.

73. See 15 U.S.C. § 77k(e) (2006); see, e.g., *In re Cendant Corp. Litig.*, 264 F.3d 201, 228 & n.8 (3d Cir. 2001) (limiting stockholder recovery to the difference between the amount paid at purchase and amount received when sold).

by 20%,⁷⁴ Rearguard can recover no more than \$8 million. Rearguard also suffers a loss on the stock that it held before the fraud, which has fallen in value from \$80 million to \$40 million. To keep things simple, assume for now that the decrease in price is attributable solely to lower than expected return plus feedback from the prospect of a class action in which 50% of the outstanding shares are likely to recover their losses in full. In such a case, bad news explains the first \$5 per share of loss, and feedback explains the next \$5 per share of loss.⁷⁵ In contrast, in a world *without* class actions, Binford would decrease from \$20 to \$15. The Rearguard investment would have declined from \$100 million to \$75 million for a loss of \$25 million. In a world *with* class actions, Rearguard loses \$50 million less the recovery of \$8 million for a total net loss of \$42 million. In other words, Rearguard loses an additional \$17 million on its holdings because Binford must pay to settle the class claim.

Needless to say, Rearguard would prefer that the class action simply be dismissed. To be sure, the law provides that one can always opt out of a class action,⁷⁶ but it does no good for Rearguard to opt out. By opting out, the fund forgoes any recovery, and its net loss would be \$50 million. Thus, the fund will reluctantly file a claim in the class action despite its preference that the action be dismissed.

The idea that some investors lose more than they gain from a class action is based on the fact that stock price falls more than it should because of feedback. But it could be argued that if the award is paid by insurance (as it usually is), there would be no feedback because the company would not use its own funds. Thus, there would be no reason for anyone to object to class certification. In practice, many cases are settled for whatever amount of insurance is available. There are several responses to this argument.⁷⁷

First, we should evaluate securities litigation on its own merits. The law—as it currently stands—is that the defendant company compensates traders who suffer a loss. Although securities fraud class actions almost always settle if they are not dismissed, bargaining happens in the shadow of the law. The starting point for settlement negotiations is the potential award. The fact that the bill may be paid by insurance is irrelevant. There would be no bill but for the

74. See *supra* note 11.

75. In a case in which the plaintiff class comprises 50% of the outstanding shares and the class recovers its loss in full, the effect is to double the decrease in price that would occur in the absence of any recovery from the defendant corporation. See *infra* note 127 and Tables 1 & 2. If the class is smaller or would recover less, the magnification effect is less, and vice versa. See *infra* note 127 and Tables 1 & 2. For a derivation of the algorithm by which the feedback effect can be predicted, see Booth, *The End of the Securities Fraud Class Action*, *supra* note 3, at app. The mathematics of feedback is discussed in more detail in Part III.A.

76. FED. R. CIV. P. 23(c)(2)(B)(v).

77. This discussion of the role insurance in securities fraud class actions is taken almost verbatim from my discussion of the same issue in an earlier article, but it is somewhat condensed and clarified with additional footnotes acknowledging certain open questions of fact. See Richard A. Booth, *Class Conflict in Securities Fraud Litigation*, 14 U. PA. J. BUS. L. 701, 718–19 (2012).

imposition of liability. That is one reason why evidence of insurance is generally inadmissible.⁷⁸

Second, if insurance is depleted by securities litigation it will be unavailable for other purposes. If the company must pay other claims out of its own pocket, it may fail altogether. In a sense, insurance is part of the capitalization of the company in that it protects the company from unforeseeable major expenses. So it is not costless—nor a matter of sunk cost—for the insurer to pay.⁷⁹

Third, if the insurance company pays, the insured will pay higher rates for insurance in the future. That reduces expected return and thus stock price. In the end it really makes no difference whether the insurance company pays. When the insurance company pays, it really only finances the award. In effect, the defendant company pays over time. Thus, there is good reason to think that feedback happens whether or not the award is paid by insurance.⁸⁰

Fourth, when an insurance company pays, rates go up for all potential defendant companies. Every successful securities fraud action increases the risk of future such actions. When insurance rates go up, investor return goes down. Feedback echoes throughout the market. Diversified investors may lose even more as holders of other stocks.⁸¹

78. See FED. R. EVID. 411; see also Richard Squire, *How Collective Settlements Camouflage the Costs of Shareholder Lawsuits*, 62 DUKE L.J. 1 *passim* (2012) (arguing that the structure of insurance contributes to excessive settlements). But see Christopher C. French, *Response, Segmented Settlements Are Not the Answer: A Response to Professor Squire's Article, How Collective Settlements Camouflage the Costs of Shareholder Lawsuits* 3–11 (Dec. 15, 2012) (unpublished manuscript) (on file with *South Carolina Law Review*).

79. This argument is somewhat stronger if the amount of liability insurance available covers many different types of risk. It is somewhat weaker if the amount available to cover securities fraud class actions—whether in the form of D&O coverage or otherwise—is segregated for that purpose alone. See generally TOM BAKER & SEAN J. GRIFFITH, *ENSURING CORPORATE MISCONDUCT: HOW LIABILITY INSURANCE UNDERMINES SHAREHOLDER LITIGATION* 65–66 (2010). But even if coverage is strictly compartmentalized, depletion of available coverage for one action makes it unavailable for another action arising during the relevant policy period. Moreover, there are many other risks other than those of securities fraud class actions that may be covered by a D&O policy.

80. On the other hand, it has been argued by some commentators that D&O insurance premium rates depend little on claims experience and (implicitly) that insurance companies make little or no effort to determine whether a company seeking coverage is more or less likely to be the target of an action that will trigger a claim. See *id.* at 119–20.

This is quite difficult to believe, although it may be that insurance companies simply refuse to write coverage if the buyer is seen as too risky or if the buyer is likely to cancel coverage in the future—because of business failure or otherwise—such that the payments on claims cannot be recouped. It is also possible that having tried somehow to predict which companies will be the target of securities fraud class actions and having failed to do so, insurance companies regard such risk as utterly random. But if there is nothing that potential target companies can do to manage such risk, it would seem to indicate that there is something wrong with the law of securities fraud, which after all is supposed to be some sort of *intentional* wrong.

81. In other words, even if insurance companies fail to set rates based on claims expectations and experience, presumably they set rates high enough overall to make a profit. If indeed insurance companies fail to set rates based on any individualized assessment of likely claims, it would seem to undermine the argument that litigation between portfolio companies makes sense because investors prefer companies to bear their own individual risks so that capital will be allocated more efficiently.

The situation is quite different when a third party such as a tort victim makes a claim against a corporation, she wants to collect as much as possible. It does not matter if insurance coverage for other claims is thus reduced or if premiums increase and the market value of the company declines or indeed if the company is rendered bankrupt in the process. But if the claimant is a group of stockholders, the interests of those who would collect conflict with those who would not. Indeed, even for stockholders who would collect there is a downside in that they may do more harm to the value of the stock they hold than they recover on the stock they bought. The situation is similar to that of an automobile owner who declines to make a claim for fear that his rates will increase or his insurance will be cancelled.

In short, the fact that securities fraud class action settlements are often paid by insurance is ultimately irrelevant to the question whether such actions are consistent with the interests of investors.

III. INDEX FUNDS AND THE RATIONAL INVESTOR

As the title suggests, this Article focuses on how index funds fare in the context of securities fraud class actions and seeks to determine whether securities fraud class actions are consistent with the interests of index funds given that index funds tend to engage in minimal trading and thus tend to hold many more shares of a given stock than they buy or sell.⁸²

One important reason for this focus is that approximately 15% of all mutual fund assets are held in the form of index funds.⁸³ Another good reason for this focus is that an investment strategy employing index funds is the most rational strategy for most investors.⁸⁴ Thus, an index fund may be seen as a model of the

See Rose & Squire, *supra* note 31, at 1697. Moreover, one could argue that diversified investors should prefer portfolio companies that buy as little insurance as possible. *See* Richard A. Booth, *Manager's Journal: Reducing Risk Doesn't Pay Off*, WALL ST. J., Mar. 15, 1999, at A18.

82. *See supra* notes 15–18 and accompanying text.

83. INV. CO. INST., 2011 INVESTMENT COMPANY FACT BOOK 33 (51st ed. 2011). Moreover, index funds have grown dramatically in recent years—up from about 5% in 1996—in part because of the introduction of exchange-traded funds (ETFs) in 1993. *Id.* But it is arguable that many ETFs are not true index funds in that many seek to track segments of the market, not to mention that they are used for active trading. *See* Tom Lauricella & Diya Gullapalli, *Not All Index ETFs Are What They Seem to Be: Critics See Active Management in Some New Fund Offerings; Using 'Intuitive Factor Analysis,'* WALL ST. J., July 21, 2006, at C1; *see also* Erin E. Arvedlund, *Wall Street Pushes Designer Index Funds: Customized Products Aimed at Wealthy Investors Offer Tax Advantages, but Carry Steep Fees*, WALL ST. J., Aug. 25, 2005, at D1 (noting that “exchange-traded funds, or ETFs . . . resemble index funds but trade like stocks”). According to one source, true index funds constitute about 10% of the fund market. John C. Bogle, Op-Ed., *'Value' Strategies*, WALL ST. J., Feb. 9, 2007, at A11. On the other hand, the argument that not all purported index funds are true index funds applies to any fund that follows a strategy that may entail buying additional shares of a stock already held.

84. *See, e.g.,* MALKIEL, *supra* note 6, at 363 (“In short, the index fund is a sensible, serviceable method for obtaining the market’s rate of return with absolutely no effort and minimal expense.”).

reasonable investor.⁸⁵ Therefore, a good way to analyze securities fraud class actions is to ask how they serve the interests of index funds and index fund investors.

Accordingly, it is important to understand how an index fund works and why investors choose to invest in such vehicles. As noted above, an index fund is a mutual fund that seeks to match the performance of the market as a whole by holding the stocks that compose a broad-based index such as the S&P 500.⁸⁶ The basic goal of the indexing strategy is to maximize diversification and to minimize fund management expenses.⁸⁷

Diversification is important because, by investing in many different stocks, an investor can eliminate all of the risk that goes with investing in an individual company—company-specific risk—without any sacrifice of return.⁸⁸ The only risk that remains is the risk that the market as a whole will rise or fall—risk that cannot be diversified away.⁸⁹

Moreover, studies focusing on the performance of presumably sophisticated mutual fund managers have found repeatedly that no one can beat the market consistently except perhaps with illegal inside information.⁹⁰ The fact that the market is efficient is not to say that investors can expect only to break even.⁹¹ The market tends to go up over time, and over time stocks generate returns that are about 7% in excess of the risk-free rate of return.⁹² So the market is different from a casino where the house ultimately wins. Nevertheless, no one can reasonably expect to do better than the market average.⁹³

85. *See id.*

86. *See supra* note 14 and accompanying discussion. The S&P 500 is the model for about 37% (by value) of all index funds. INV. CO. INST., *supra* note 83, at 33.

87. *See* MALKIEL, *supra* note 6, at 358–60.

88. *See id.* at 188–89.

89. *See, e.g., id.* at 363 (“If the market goes down, your portfolio is guaranteed to follow suit.”). Company-specific risk is sometimes called unsystematic risk or alpha risk, while market risk is sometimes called systematic risk or beta risk. *See id.* at 198. Although it is possible to reduce the risk that goes with equities by investing some portion of one’s portfolio in bonds and other asset classes, this reduction in risk also reduces return. *See id.* at 198–201. One might call this diversification, albeit in a different form.

90. As Jeremy Irons states in the movie *Margin Call*, the only way to succeed on Wall Street is to be first, be smarter, or cheat. MARGIN CALL (Lionsgate 2011); *see also* Glaser, *supra* note 63, at 695 (“[A]bsent being an insider, an investor does not have access to any information that the market does not already know.”). There is even some doubt that one can beat the market with inside information. *See* MALKIEL, *supra* note 6, at 221. More precisely, studies show that no one can beat the market any more often than can be explained by chance. *Id.* In other words, given that there are about 10,000 mutual funds in the United States, one would expect a few to beat the market ten years running if only by chance. This is not to say that the market is necessarily correct about the price of any individual stock. It is only to say that no one can pick winners consistently. On the other hand, although the market may well be wrong about individual stocks, it seems quite unlikely that the market is ever wrong about equities in general.

91. MALKIEL, *supra* note 6, at 180.

92. *See id.* at 185, 326.

93. This is really a tautology. Although the children of Lake Wobegon may all be above average, investors can never do better on the average than the average of how they do. *See*

It is important to emphasize that one need not subscribe to the efficient market theory to adopt the logic of diversification.⁹⁴ It is *always* good to eliminate unnecessary risk.⁹⁵ Indeed, one might even say that it is irrational not to do so.⁹⁶ But if the strategy is to eliminate all company-specific risk, there is no reason to waste time and money picking individual stocks.⁹⁷ Thus, diversification and the efficient market are two *independently sufficient* reasons to eschew stock picking.

If there is nothing to be gained from picking individual stocks, it follows that one should avoid spending too much on research and should avoid trading except when necessary. Thus, the traditional advice to buy-and-hold is ultimately sound as long as one also diversifies.⁹⁸ Indeed, numerous studies show that the one factor that ultimately affects fund returns is fund expenses.⁹⁹ For example, a fund with an expense ratio of 0.5% of assets under management (AUM) typically beats a fund with an expense ratio of 2.0% by 1.5%.¹⁰⁰ In the end, reducing expenses is a sure thing. Beating the market is not. For the vast

generally Edward B. Fiske, *Lessons*, N.Y. TIMES, July 12, 1989, at B8 (explaining the concept of Garrison Keillor's mythical village, Lake Wobegon).

94. Richard A. Booth, *Discounts and Other Mysteries of Corporate Finance*, 79 CALIF. L. REV. 1055, 1060 (1991) [hereinafter Booth, *Mysteries of Corporate Finance*] ("The logic of the efficient market and diversification does not apply to the bidders who buy control of whole companies.").

95. See, e.g., Glaser, *supra* note 63, at 689–90 (discussing the capital asset price model and the goals of modern portfolio theory to eliminate risk).

96. The iron law of investing is that if one assumes more risk, one must get more return. See MALKIEL, *supra* note 6, at 201. Similarly, if one can eliminate some risk, one should be willing to accept somewhat lower return and to pay more for a stock. See *id.* It follows that diversified investors will drive up the price of stocks and that undiversified investors must therefore pay too much if they fail to diversify. Richard A. Booth, *The Suitability Rule, Investor Diversification, and Using Spread to Measure Risk*, 54 BUS. LAW. 1599, 1606 (1999) [hereinafter Booth, *The Suitability Rule*]. Given that more than two-thirds of all stock is held by mutual funds, pension plans, and the like, and that many well-advised individual investors are similarly diversified, it follows that diversified investors do, in fact, dominate the market. See *supra* note 66 and accompanying text. On the other hand, if one can identify an investment that offers the prospect of extraordinary return, it may nonetheless be rational to bet the farm. For example, if a portfolio of stocks offers a return of 10% per unit of risk and a particular stock offers a return of 40% with three units of risk, it is not irrational to invest all of one's money in the latter. Ask any hedge fund manager. See Richard A. Booth, *The Buzzard Was Their Friend—Hedge Funds and the Problem of Overvalued Equity*, 10 U. PENN. J. BUS. EMP. L. 879, 881 (2008) [hereinafter Booth, *The Buzzard Was Their Friend*]. Incidentally, this example is roughly consistent with research that indicates that alpha risk accounts for about 70% of the risk that goes with investing in an individual stock. See Booth, *The Suitability Rule*, *supra*, at 1605–07.

97. See Glaser, *supra* note 63, at 689.

98. See Malkiel, *supra* note 70, at A23.

99. See Palmiter & Taha, *supra* note 14, at 985 (citing MALKIEL, *supra* note 6, at 359).

100. See MALKIEL, *supra* note 6, at 358–63, 378. In other words, the expenses associated with active management and stock-picking are a deadweight loss for a diversified investor. See Booth, *Class Conflict*, *supra* note 7, at 712. Additionally, management fees generally do not include the direct expenses of trading, such as brokerage commissions. See *id.* Thus, actively managed funds with higher turnover ratios have higher operating expenses too.

majority of investors, the argument for investing in an index fund is irrefutable.¹⁰¹ To be sure, an individual investor might build her own diversified portfolio and manage it according to the same principles that govern an index fund,¹⁰² but such an investor will have the same interests vis-à-vis securities fraud class actions as an index fund.

A. *Index Funds and Diversification*

At first blush, it may not be obvious why investing in an index fund is a prudent way to diversify since it is not necessarily apparent why mimicking the composition and performance of the S&P 500 (or any other index) would eliminate company-specific risk. The answer is that investing in an index is not itself the point. Rather, the point is to eliminate company-specific risk by investing in the market as a whole.¹⁰³ Again, portfolio theory indicates that it is possible to diversify away company-specific risk but not market risk.¹⁰⁴ It follows that by investing in the market as a whole, one can eliminate all of the risk that can be eliminated since the market is, by definition, the average of its component companies.¹⁰⁵ Accordingly, the S&P 500 measures the performance of the market by averaging the performance of the 500 largest domestic companies weighted in proportion to the market capitalization (total equity

101. See *supra* notes 84–85 and accompanying text.

102. Still, the fees associated with maintaining a brokerage account are likely to be much higher than those for investing in an index fund. See MALKIEL, *supra* note 6, at 359 (stating index funds have lower fees than other types of investments, including actively managed funds). Moreover, as discussed further below, it is important to monitor the mix of stocks in one's portfolio to be sure that it remains balanced according to market capitalization. With an index fund, the fund managers do the monitoring for a minimal fee because there is little judgment or discretion involved in indexing. See Palmiter & Taha, *supra* note 14, at 986. This suggests another subtle advantage of index funds. Since investing in stocks according to market capitalization is a purely ministerial task that can be reduced to a simple formula and loaded into a computer, which also saves on expenses, there is little danger that fund managers will diverge from the avowed strategy. See FRANKEL & SCHWING, *supra* note 14, § 31.02[J], at 31-101 to -102. In contrast, it is a known practice for advisers of actively managed funds to sell losers and buy winners in advance of reporting portfolio composition in order to appear savvy to investors. Booth, *The Suitability Rule*, *supra* note 96, at 1608 n.39. Such window-dressing, as the practice is known, adds to turnover and operating expenses. *Id.* Moreover, the herd mentality implicit in such practices may result in a fund taking more losses than it should and paying too much for the stocks that it buys. Index funds avoid these hidden costs of active management by the simple expedient of confining adviser discretion. See, e.g., Shefali Anand, *Tight-Fisted Investing*, WALL ST. J., May 4, 2009, at R3 (discussing the importance of keeping fees low). But see Aaron Lucchetti, *What Ails Index Funds and How to Fix Them*, WALL ST. J., Oct. 7, 2002, at R1 (noting how index funds have “started to suffer from their own popularity,” with many having “‘structural problems’ that eat into shareholders’ returns by boosting operating costs”).

103. See *supra* notes 88–89 and accompanying text.

104. See *supra* note 89 and accompanying text.

105. See Glaser, *supra* note 63, at 696, 699.

value) of each.¹⁰⁶ So index funds do not necessarily invest in indices.¹⁰⁷ Rather, they merely follow the same logic in an effort to eliminate all company-specific risk.¹⁰⁸ In other words, the point is not to invest in an index but rather to eliminate as much risk as possible as cheaply as possible. To be sure, there is some debate about whether the S&P 500 is the best measure of the market. Some critics argue that the S&P 500 is too narrow, even though it reflects 85%

106. See HAMILTON & BOOTH, *supra* note 20, at 389. It is important that the average is weighted according to size. See *id.* at 179. If the point is to measure the performance of the market as a whole, it is important to factor in the relative market value of the individual companies that compose it. See *id.* For example, if investors in the aggregate hold \$372 billion in Apple and \$154 billion in Coke, and both companies pay a dividend of \$5 billion to stockholders, the return on Apple is 1.34% and the return on Coke is 3.25%. The unweighted average of the two is 2.30%. But the return of \$10 billion on the total investment of \$526 billion is 1.90%. Although investors might claim that their average return is 2.30%, clearly the overall return on the portfolio is 1.90%. Thus, it is vital to measure return by means of a weighted average in order to measure return accurately. See *id.* To measure return by a simple unweighted average is to count the return of smaller investments too much and of larger investments too little. See *id.* Similarly, an investor who seeks to invest in the market as a whole, and thus to avoid company-specific risk, should invest in stocks in proportion to their market capitalization. To invest an equal amount in each company is in effect to invest too much in smaller companies and too little in larger companies at least as long as the idea is to invest in the market as a whole. See generally Carolyn Geer, *Index Funds Get a Makeover*, WALL ST. J., Feb. 7, 2011, at R1 (explaining different weighting methods and their effects on index fund performance).

107. Indeed, it is important for an index fund to invest in substantially more (or fewer) stocks than exactly the five hundred that compose the S&P 500 at any given time. Since the S&P 500 is, by definition, composed of the five hundred biggest U.S. stocks as measured by market capitalization, it follows that companies must periodically be added to and dropped from the index as they grow and shrink. See Messod D. Beneish & Robert E. Whaley, *An Anatomy of the "S&P Game": The Effects of Changing the Rules*, 51 J. FINANCE 1909, 1912–13 (1996). Studies indicate that companies that are added to the index enjoy an immediate and permanent bump up in price. See MALKIEL, *supra* note 6, at 364; Honghui Chen et al., *The Price Response to S&P 500 Index Additions and Deletions: Evidence of Asymmetry and a New Explanation*, 59 J. FINANCE 1901, 1907–09 & tbl.1 (2004). Presumably, companies that are dropped from the index suffer the opposite effect. See *id.* at 1910. The thinking is that this price effect is attributable to increased demand for index stocks because of various trading strategies that involve the S&P 500 and component stocks. See *id.* at 1901–02, 1908. One would think that such strategies involve selling index stocks just as often as buying them, but it may be that increased liquidity enhances the efficiency of pricing, or at least reduces the perceived risk of mispricing. See *id.* at 1902–03, 1922. In any event, if an index fund invests in stocks that are on the bubble of inclusion, it is important also to invest in stocks that are somewhat smaller than index stocks so that when an old index stock is dropped, one will own shares in the new index stock, and the gain on the latter will offset the loss on the former. See generally Booth, *The Buzzard Was Their Friend*, *supra* note 96, at 893–95 & n.51 (summarizing trading strategies and stock picking for hedge funds); Birdthistle, *supra* note 16, at 80–81 (noting that investors in exchange traded funds (ETFs) and Standard & Poor's Depository Receipts (SPDRs) may purchase and resell shares for enhanced trading liquidity). In the alternative, an index fund could avoid bubble stocks altogether by investing in say the four hundred largest stocks rather than in all five hundred. Incidentally, this suggests that SPDRs are a bit riskier than index funds. See *id.* at 77 (“[A]ny investor who purchased a SPDR would, in a single share, be invested in the entire S&P 500, and the value of that SPDR would fluctuate in accordance with the rise and fall of the S&P 500.”).

108. See *supra* notes 87–89 and accompanying text.

of the market by value.¹⁰⁹ Others complain that it comprises only domestic stocks.¹¹⁰ Still others argue that there are better ways to diversify, such as according to return on equity.¹¹¹ But no one seems to question the method by which the S&P 500 is maintained—by adjusting component stocks according to market capitalization.¹¹² Thus, for present purposes, it is not important whether the S&P 500 is the best measure of market performance. It is the method that matters.

109. Richard A. Booth, *Why Stock Options Are the Best Form of Executive Compensation (And How to Make Them Even Better)*, 6 N.Y.U. J. L. & BUS. 281, 352 app. (2010). The S&P 500 measures the performance of a particular segment of the market, namely, large capitalization stocks. See HAMILTON & BOOTH, *supra* note 20, at 389; see also MALKIEL, *supra* note 6, at 363 (“The S&P 500 omits the thousands of small companies that are among the most dynamic in the economy.”). There is no doubt that small capitalization stocks tend to generate more return, but it is important that the S&P 500 is efficiently priced and that it falls somewhere on the so-called capital market line. See *id.* at 203–06. Whatever doubt there might once have been about whether the S&P 500 is efficiently priced has presumably been eliminated by program trading and SPDRs, which provide ample opportunities for arbitrage and ultimately drive the index itself to an efficient price. See Quentin C. Chu & Wen-Liang Gideon Hsieh, *Pricing Efficiency of the S&P 500 Index Market: Evidence from the Standard & Poor's Depository Receipts*, 22 J. FUTURES MARKETS 877, 897 (2002).

110. One response is that the biggest United States companies presumably conduct business worldwide and invest wherever they can maximize return. So there is no a priori reason to think that a portfolio that includes a dollop of foreign stocks should do any better than the S&P 500. On the other hand, United States stocks are presumably subject to certain country risks that are unique to the United States. Evidence on this question is somewhat mixed. Some sources suggest that international markets tend to follow the United States market, or perhaps vice versa, while other sources seem to show that portfolios with a healthy dose of foreign stocks do better than purely domestic portfolios. See, e.g., Burton G. Malkiel, Op-Ed., *‘Buy and Hold’ Is Still a Winner*, WALL ST. J., Nov. 18, 2010, at A23 (“Even though portfolios in the U.S. market actually lost money in the first decade of the 21st century, emerging-market stocks enjoyed returns of more than 10% per year. Every portfolio should have substantial holdings in the fast-growing emerging economies of the world.”). But it is always possible that they do so because they entail more risk. One question that tends to be ignored in most such studies is how much to invest in foreign stocks. See *id.* In most cases, the assumption seems to be that some nice, round amount like 30% should be invested in foreign stock. But see MALKIEL, *supra* note 6, at 365–66 & tbl. (recommending an index fund portfolio including 16% investment in international stocks). But by the logic of index investing, presumably one should invest in a global portfolio of stocks according to the market capitalization of each, presumably as measured in dollars. See *supra* note 106 and accompanying text.

111. See John C. Bogle, Op-Ed., *‘Value’ Strategies*, WALL ST. J., Feb. 9, 2007, at A11; Geer, *supra* note 106, at R1; Jeremy J. Siegel, Op-Ed., *The “Noisy Market” Hypothesis*, WALL ST. J., June 14, 2006, at A14; John Spence, *Bogle and Siegel Clash Over Ideas for Index Funds*, WALL ST. J., Aug. 21, 2006, at C7; see also Joanna L. Ossinger, *The Dimensions of a Pioneering Strategy*, WALL ST. J., Nov. 6, 2006, at R1 (discussing efforts to find or create alternative indices).

112. Although Standard & Poors also maintains an equal-weighted version of the S&P 500, there is an obvious inconsistency in identifying stocks by market capitalization and investing an equal amount in each. See *S&P 500 Equal Weight Index Factsheet*, S&P DOW JONES INDICES, <http://www.spindices.com/indices/equity/sp-500-equal-weighted> (follow “Factsheet” hyperlink; then click “S&P 500 Equal Weight Index Factsheet” hyperlink) (last visited Oct. 25, 2012).

B. Index Funds and Trading

Although a diversified buy-and-hold strategy appears to be the best strategy for most investors, it is nonetheless necessary to do some trading for purposes of portfolio balancing.¹¹³ If a fund fails to rebalance its portfolio periodically, it is inevitable that some stocks will become overweighted while others will become underweighted, with the result that the portfolio will take on unnecessary risk.¹¹⁴ Thus, there is a certain amount of trading implicit even in the maintenance of an index.¹¹⁵ For example, annual turnover in the S&P 500 is about 6%, owing to changes in the market capitalization and identity of component stocks.¹¹⁶ Moreover, an index fund (like any other fund) must buy or sell depending on whether investor cash is flowing into or out of the fund.¹¹⁷ The index itself has no investors and thus need not worry about investing new cash and paying investors who want to cash out. So there is a bit more trading implicit in the management of an index fund. For example, average annual turnover among Vanguard index funds is about 14% per year.¹¹⁸ Finally, some trading may be desirable as a matter of tax planning.¹¹⁹

Since the typical index fund trades primarily for purposes of portfolio balancing in order to hold shares in proportion to their market capitalization, an index fund typically buys additional shares of portfolio stocks that have risen in value and sells shares of portfolio stocks that have fallen in value relative to other portfolio stocks.¹²⁰ It follows that when an index fund trades, it almost always buys a few additional shares of a stock that it already owns or it sells a

113. See Booth, *The Buzzard Was Their Friend*, *supra* note 96, at 894 n.51.

114. See Booth, *The Suitability Rule*, *supra* note 96, at 1613 & n.57.

115. *Id.*

116. See Booth, *Class Conflict*, *supra* note 7, at 713 (citing Booth, *The Buzzard Was Their Friend*, *supra* note 96, at 897).

117. Thus, there is an important difference between an indexed mutual fund and an ETF. Compare *Mutual Funds*, U.S. SEC. & EXCH. COMM'N, <http://www.sec.gov/answers/mutfund.htm> (last modified Dec. 14, 2010) (mutual fund investors cannot purchase mutual fund shares from other investors on a secondary market), with *Exchange-Traded Funds (ETFs)*, U.S. SEC. & EXCH. COMM'N, <http://www.sec.gov/answers/etf.htm> (last modified Dec. 14, 2010) (ETF investors can purchase mutual fund shares from other investors on a secondary market), and *Closed-End Funds*, U.S. SEC. & EXCH. COMM'N, <http://www.sec.gov/answers/mfclose.htm> (last modified May 7, 2007) (closed-end funds invest in more illiquid securities than mutual funds on the secondary market), and *Unit Investment Trusts (UITs)*, U.S. SEC. & EXCH. COMM'N, <http://www.sec.gov/answers/uit.htm> (last modified May 8, 2007) (unit investment trusts do not actively trade portfolios).

118. See Booth, *The Buzzard Was Their Friend*, *supra* note 96, at 897.

119. See MALKIEL, *supra* note 6, at 361; Booth, *The Buzzard Was Their Friend*, *supra* note 96, at 894 n.51.

120. See *supra* note 16. To be sure, a stock that rises in value should rise in market capitalization proportionally, and vice versa, other things equal. But it is quite possible for a stock to increase in value even as market capitalization decreases, as when a company repurchases its own shares. See, e.g., Booth, *Mysteries of Corporate Finance*, *supra* note 94, at 1087 ("It is well known that companies often repurchase their own stock in order to support or increase the market price.").

few shares of a stock that it continues to hold.¹²¹ Thus, an index fund usually holds many more shares than the number it buys or sells.

C. *Index Funds and Securities Fraud Class Actions*

Again, holders effectively pay buyers in a securities fraud class action,¹²² and index funds almost always hold more shares than they buy.¹²³ It follows that index funds almost always lose more than they recover as a result of securities fraud class actions. In other words, the additional loss suffered by index funds from payout to buyers almost always exceeds the amount that the index fund recovers as a result of any settlement.¹²⁴ If an index fund stands to lose more than it gains, the fund should presumably be opposed to certification of the action as a class action—indeed, the fund arguably has a duty to its holders to oppose certification in any such case.¹²⁵

Table 1 sets forth the various combinations of gains and losses a fund might face where the defendant company suffers a loss in value from \$10 per share to \$9 per share, not including any further feedback loss from the effects of a securities fraud class action. Since the feedback effect depends on the size of the plaintiff class,¹²⁶ the columns show the effects of various class sizes ranging from 10% to 80% of outstanding shares as set forth in the top row. For clarity, the first row of numbers in the body of the table sets forth the fundamental loss of \$1 per share that buyers and holders would suffer in the absence of a securities fraud class action. The second row shows the effect of class size on the total loss suffered by buyers who bought at \$10 per share.¹²⁷ This is the

121. See *supra* note 17 and accompanying text. An index fund that follows an index religiously, such as SPDRs do, would presumably trade all or nothing when stocks are added to or deleted from the index. See *supra* note 107. But in practice, index funds are not so devout, holding portfolios that are a good deal larger than the S&P 500 presumably in part to avoid the need for unnecessary trading at the edges. Cf. *supra* note 109 (explaining that the opportunities for arbitrage provided by program trading and SPDRs tend to drive the S&P 500 to an efficient price).

122. See *supra* notes 58–61 and accompanying text.

123. See *supra* notes 17–18 and accompanying text.

124. See *infra* Tables 1 & 2. To be sure, there may be some exceptional cases where the fund is a buyer of an unusually large portion of shares, such as when the market value of a fraud-affected stock increases dramatically during the fraud period. See *infra* Tables 1 & 2. For example, if a stock's net value doubles over the market as a whole, then all other things equal, an index fund will double its holdings in that stock.

125. See, e.g., Booth, *Class Conflict*, *supra* note 7, at 772 (arguing that an index fund has a “fiduciary duty to its investors to serve their interests”; therefore, “the fund should decide how to proceed based on the interests of the fund as a whole”).

126. *Id.* at 706 & n.8.

127. Again, the effect of feedback depends on the number of shares in the plaintiff class. *Id.* The greater the number of shares represented, the greater the effect of feedback because the payout by the defendant company causes a further loss in value. *Id.* But the process eventually reaches a limit. Assuming that the plaintiff class recovers fully, the total loss in value with feedback is:

$$\text{total loss with feedback} = \text{fundamental loss} \div (1 - \text{percentage of damaged shares})$$

Id. app. at 768.

amount per share of the plaintiff class claim. The third row shows the amount of feedback damages per share, which is the difference between the fundamental loss and the total loss with feedback.¹²⁸ This is also the loss per share suffered by holders because the company is liable.¹²⁹ The fourth row shows the net per share recovery of the plaintiff class after average attorney fees of 20%. Finally, the body of Table 1 shows the recovery and loss for an investor who holds 1,000 shares at the time of corrective disclosure for various combinations of shares bought during the fraud period and shares held before the fraud period—ranging from zero bought and 1,000 held to 500 bought and 500 held.¹³⁰ For example,

In Table 1, the formula is applied to the dollar loss. Thus, if 50% of shares are represented in the plaintiff class, the loss is:

$$\$1.00 \div (1.00 - 0.50) = \$1.00 \div 0.50 = \$2.00$$

The formula may be applied equally well to the percentage loss. For further explanation and derivation of the formula, see Booth, *The End of the Securities Fraud Class Action*, *supra* note 3, app. at 35–36. Feedback depends on the actual payout by the defendant company, or the prospect thereof. *Id.* at 8. If the company settles for less than the total claim asserted by the plaintiff class, as is typical, the feedback effect will be accordingly reduced. *See id.* at 20–22. Accordingly, class size should be estimated as the number of damaged shares multiplied by the expected percentage recovery. *See id.* at 20, 35. For example, if the plaintiff class comprises 40% of outstanding shares and the company pays out claims at fifty cents on the dollar, the effect is the same as if the class of 20% recovers in full.

Another real world problem is that there is no good way to determine the number of shares represented in the plaintiff class short of litigating the case and soliciting claims. *See generally* Robert A. Alessi, *The Emerging Judicial Hostility to the Typical Damages Model Employed by Plaintiffs in Securities Class Action Lawsuits*, 56 BUS. LAW. 483, 483 (2001) (noting the “increasing judicial skepticism over the viability of plaintiffs’ class action damages model,” which employs “sweeping assumptions, suspect methodologies, and unfounded conclusions”). Trading volume is no indication of class size since many shares in the plaintiff class may have been traded numerous times during the fraud period. *See id.* at 484–85 (noting that “a share traded may have a much greater than proportional probability of being re-traded during the Class Period due to the disproportionate influence on trading of short-term traders, arbitrageurs, and similar market participants” (quoting *In re Oracle Sec. Litig.*, 829 F. Supp. 1176, (N.D. Cal. 1993))). On the other hand, we do know that average turnover among mutual funds is about 58% per year. INV. CO. INST., *supra* note 83, at 28 fig.2.6. We also know that active stock-picking, or price-discovery trading, is limited to about 25% of the market, which is consistent with the fact that mutual funds hold about one-third of all equities and that about three-quarters of all equities are held in well-diversified funds or accounts. *See Booth, The Buzzard Was Their Friend*, *supra* note 96, at 894 & n.51. Assuming that market-wide turnover is about 300% per year and that 75% of shares trade at a 60% turnover rate—roughly equal to that of mutual funds—it follows that 25% of shares trade at a turnover rate of 240%. Given that the average class period is about 300 days—five-sixths of a year—it seems likely that the average class comprises 50% of outstanding shares as held by less active traders and 25% of shares as held by more active traders for a total of 75% of outstanding shares. Since some less active traders will happen to have engaged in some in-and-out trading during the class period, this number is probably a bit on the high side. *See Costello v. Oppenheimer & Co.*, 711 F.2d 1361, 1369 n.9 (1983) (“The term ‘in and out’ trading denotes the sale of all or part of a customer’s portfolio, with the money reinvested in other securities, followed by the sale of the newly acquired securities.”).

128. *See supra* note 127.

129. *See supra* notes 4, 7 and accompanying text.

130. Although the table could be extended to include combinations up to zero shares held and one thousand shares purchased, there is no point in doing so since investors who buy more shares

for an investor who bought 100 shares and held 900 shares in a securities fraud class action in which the plaintiff class comprises 10% of the outstanding shares, the gain from recovery would be \$89, and the loss from feedback would be \$100 for a net loss of \$11.¹³¹ Note that where the net result is negative, the numbers are shown in bold. As is apparent from the chart, combinations falling in the northeast half of the Table—above the separator (***)—result in net losses for the investor.

than they hold always benefit from a securities fraud class action for class sizes up to 80% of outstanding shares. Moreover, the table could be extended to include classes larger than 80% of outstanding shares, but so large a class is almost inconceivable. Indeed, with a class of 90% of outstanding shares, a mere 10% price drop results in a stock price of zero with feedback. But a company that is worth zero is presumably bankrupt and thus judgment-proof.

131. See *infra* Table 1.

TABLE 1. EFFECT OF CLASS SIZE ON FEEDBACK LOSS
RELATED TO SECURITIES FRAUD CLASS ACTIONS

Class Size		10%	20%	30%	40%	50%	60%	70%	80%
Fundamental Loss		1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
With Feedback		1.11	1.25	1.43	1.67	2.00	2.50	3.33	5.00
Excess		0.11	0.25	0.43	0.67	1.00	1.50	2.33	4.00
Net Recovery (80%)		0.89	1.00	1.14	1.33	1.60	2.00	2.67	4.00
BUY (recovery)	0	0	0	0	0	0	0	0	0
HOLD (excess loss)	1000	111	250	429	667	1,000	1,500	2,333	4,000
NET		-111	-250	-429	-667	-1,000	-1,500	-2,333	-4,000
BUY (recovery)	100	89	100	114	133	160	200	267	400
HOLD (excess loss)	900	100	225	386	600	900	1,350	2,100	3,600
NET		-11	-125	-271	-467	-740	-1,150	-1,833	-3,200
		***	***						
BUY (recovery)	200	178	200	229	267	320	400	533	800
HOLD (excess loss)	800	89	200	343	533	800	1,200	1,867	3,200
NET		89	0	-114	-267	-480	-800	-1,333	-2,400

BUY (recovery)	300	267	300	343	400	480	600	800	1,200
HOLD (excess loss)	700	78	175	300	467	700	1,050	1,633	2,800
NET		189	125	43	-67	-220	-450	-833	-1,600
					*****	*****			
BUY (recovery)	400	356	400	457	533	640	800	1,067	1,600
HOLD (excess loss)	600	67	150	257	400	600	900	1,400	2,400
NET		289	250	200	133	40	-100	-333	-800
							***	***	*****
BUY (recovery)	500	444	500	571	667	800	1,000	1,333	2,000
HOLD (excess loss)	500	56	125	214	333	500	750	1,167	2,000
NET		389	375	357	333	300	250	167	0

As Table 1 shows, an index fund is likely to be a net loser in the most probable scenarios. Assuming a turnover rate of 14%—a recent average of eight major Vanguard general stock index funds¹³²—an index fund will be a net loser except where the class is quite small and the fund has engaged in unusually heavy trading.¹³³ If we refine Table 1 to show the results for turnover rates between 10% and 20% as shown in Table 2, it appears that the fund will lose at turnover rates up to 18% where the class consists of 20% of the outstanding shares.¹³⁴ Thus, except when the plaintiff class is quite small, the fund loses more from feedback than it gains from recovery.

132. See Booth, *The Buzzard Was Their Friend*, *supra* note 96, at 897.

133. See *supra* Table 1. It would be quite unusual for an index fund to double its holdings in a given stock since that would imply that the company itself has doubled in value except (obviously) where the index fund is a first time buyer of the subject stock.

134. See *infra* Table 2.

TABLE 2. EFFECT OF CLASS SIZE ON FEEDBACK LOSS RELATED TO SECURITIES FRAUD CLASS ACTIONS LIMITED TO TURNOVER RATES BETWEEN 10% AND 20%

Class Size		10%	20%	30%	40%	50%	60%	70%	80%
Fundamental Loss		1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
With Feedback		1.11	1.25	1.43	1.67	2.00	2.50	3.33	5.00
Excess		0.11	0.25	0.43	0.67	1.00	1.50	2.33	4.00
Net Recovery (80%)		0.89	1.00	1.14	1.33	1.60	2.00	2.67	4.00
BUY (recovery)	100	89	100	114	133	160	200	267	400
HOLD (excess loss)	900	100	225	386	600	900	1,350	2,100	3,600
NET		-11	-125	-271	-467	-740	-1,150	-1,833	-3,200

BUY (recovery)	120	107	120	137	160	192	240	320	480
HOLD (excess loss)	880	98	220	377	587	880	1,320	2,053	3,520
NET		9	-100	-240	-427	-688	-1,080	-1,733	-3,040
BUY (recovery)	140	124	140	160	187	224	280	373	560
HOLD (excess loss)	860	96	215	369	573	860	1,290	2,007	3,440
NET		29	-75	-209	-387	-636	-1,010	-1,633	-2,880
BUY (recovery)	160	142	160	183	213	256	320	427	640
HOLD (excess loss)	840	93	210	360	560	840	1,260	1,960	3,360
NET		49	-50	-177	-347	-584	-940	-1,533	-2,720
BUY (recovery)	180	160	180	206	240	288	360	480	720
HOLD (excess loss)	820	91	205	351	547	820	1,230	1,913	3,280
NET		69	-25	-146	-307	-532	-870	-1,433	-2,560

BUY (recovery)	200	178	200	229	267	320	400	533	800
HOLD (excess loss)	800	89	200	343	533	800	1,200	1,867	3,200
NET		89	0	-114	-267	-480	-800	-1,333	-2,400

Based on the foregoing analysis, it seems clear that index funds usually lose more than they gain from securities fraud class actions.¹³⁵ The only scenario in which an index fund might benefit from a class action is an unlikely situation in which the class is small but the fund has traded quite actively.¹³⁶

135. Both Thakor and Davis-Evans assume in their studies that funds engage in all or nothing trading. Neither study considers holder losses. See, e.g., THAKOR ET AL., *supra* note 11, at 1 n.2 (explaining that study focuses on the buying and selling of securities). Note also that the foregoing analysis, as set forth in Tables 1 and 2, does not reflect any financial benefit that might redound to investors from recovery by the corporation.

136. See *supra* Tables 1 & 2. Again, there is no good way to know the size of the plaintiff class up front. See *supra* note 127. So it is conceivable that an index fund might be a relatively large net buyer of a stock that has increased dramatically in price even where the class turns out to be relatively small because most of the trading is attributable to in-and-out trading. See *supra* note

IV. DERIVATIVE ACTIONS VERSUS CLASS ACTIONS

How should index funds respond to the costs foisted on them by securities fraud class actions? To be sure, the rules governing securities fraud class actions provide that a member of the plaintiff class can always opt out.¹³⁷ But, in doing so, one would forgo any recovery and still suffer the loss from feedback.¹³⁸ Indeed, the Tables above quantify these effects.¹³⁹ For example, if the plaintiff class comprises 30% of the outstanding shares, and an index fund holds 800 shares and buys 200 shares, the fund will lose \$114 if it remains in the class, but it will lose \$343 if it opts out.¹⁴⁰ Clearly, it does no good to opt out.¹⁴¹

A better way for index funds to respond is to oppose certification of the case as a class action. Under FRCP Rule 23(c), the court must certify that the case is appropriate for class action treatment, and any member of the plaintiff class may be heard on the matter.¹⁴² There are several well-recognized grounds on which an index fund might oppose certification, but the best argument is that the representative plaintiff cannot adequately represent a class that includes buyer-holders—such as index funds—that would prefer the action be dismissed.¹⁴³ The

127. But assuming that average turnover for index funds is about 14%, that the average turnover among all mutual funds is about 58%, and that the little in-and-out trading is attributable to either, it seems unlikely that an index fund will often account for more than about one-quarter of the plaintiff class. In other words, if an index fund has increased its holdings by 25%, say from 800 shares to 1,000 shares, it is likely that managed mutual funds have increased their holdings by at least the same percentage, if not more, such that the plaintiff class will represent a large percentage of the shares outstanding—after all, there are only so many shares to go around. Incidentally, many ordinary, managed, non-index mutual funds or fund families will find that they too fall in the red zone. A single corporate investment adviser may manage numerous funds within a fund family. See Norm Champ, Deputy Dir., Office of Compliance Inspections & Examinations, U.S. Sec. & Exch. Comm’n., Speech to the New York City Bar, *What SEC Registration Means for Hedge Fund Advisors* (May 11, 2012), available at <http://www.sec.gov/news/speech/2012/spch051112nc.htm> (demonstrating that one investment advisor may manage more than one fund). Thus, the decision whether to support or oppose a class action may be made on the basis of the interests of several funds in the aggregate rather than fund-by-fund. See *id.* If so, it is much more likely that non-index funds will find that their interests coincide with those of index funds.

137. FED. R. CIV. P. 23(c)(2)(B)(v).

138. See Booth, *Class Conflict*, *supra* note 7, at 715.

139. See *supra* Tables 1 & 2.

140. See *supra* Table 1.

141. On the other hand, some investors may be tempted to opt out in order to seek a bigger recovery that need not be shared with other class members and to avoid many of the onerous class action requirements added by Private Securities Litigation Reform Act (PSLRA). See Booth, *Class Conflict*, *supra* note 7, at 747 & n.100. As discussed further below, this opportunistic strategy foists additional costs on other stockholders, including both holders and buyers who remain in the class, whether out of necessity or otherwise. See *infra* Part IV.D.

142. FED. R. CIV. P. 23(c)(1)(A), (c)(2)(B)(iv).

143. See Booth, *Class Conflict*, *supra* note 7, at 701, 742. In the alternative, one could argue that the claims of a buyer-only plaintiff are atypical if a majority of the class consists of buyer-holders. See *id.* at 749. In addition, one could argue that index funds eschew reliance on the integrity of the market, seeking instead to avoid the risk of mispricing through diversification, and thus cannot be included in a class of investors presumed to rely on the integrity of the market under

named plaintiff may respond that she does not seek to represent the interests of holders and may thus seek to define the class in such a way as to exclude all buyer-holders or any buyer-holder who would be a net loser from the class action.¹⁴⁴ But it is not clear that a representative plaintiff may gerrymander the class in such a way.¹⁴⁵ More important, it is not clear that a class as so defined is

the fraud on the market theory as adopted in *Basic Inc. v. Levinson*, 485 U.S. 224, 241–42 (1988). See Booth, *Class Conflict*, *supra* note 7, at 749–51.

144. See Booth, *Class Conflict*, *supra* note 7, at 745.

145. See *id.* Defining the class as investors who favor prosecution of the action comes close to a prohibited opt-in action since it effectively leaves individual buyers to decide whether to join the class. See FED. R. CIV. P. 23(b)–(c)(2) (of the three types of class actions authorized under FRCP Rule 23, two are mandatory and the other allows class member exclusion only upon request). It is arguable that everyone who may have a claim should have access to a class action remedy, if only to express a preference about whether the action should proceed, which in turn suggests that plaintiff may not unreasonably limit the definition of the class. See *id.* In any event, the law is clear that opt-in actions are prohibited under Rule 23(c). See FED. R. CIV. P. 23(c); see also, e.g., *Kern v. Siemens Corp.*, 393 F.3d 120, 124 (2d Cir. 2004) (“[S]ubstantial legal authority supports the view that by adding the ‘opt out’ requirement to Rule 23 in the 1966 amendments, Congress prohibited ‘opt in’ provisions by implication.”). This is not to say that an opt-in action might not make sense. They are standard practice in the European Union where those who choose to opt in must agree to pay their share of attorney fees. See Tiana Leia Russell, *Exporting Class Actions to the European Union*, 28 B.U. INT’L L.J. 141, 178–79 (2010) (citing Thomas D. Rowe, Jr., *Shift Happens: Pressure on Foreign Attorney-Fee Paradigms from Class Actions*, 13 DUKE J. COMP. & INT’L L. 125, 128 (2003)). The class plaintiff may also argue that she represents buyer-holders only as buyers. See Booth, *Class Conflict*, *supra* note 7, at 745. This argument raises a related, fundamental question about class actions—whether a class plaintiff must represent the interests of real people or isolate the interests that are consistent with the class claim. See generally Elizabeth Chamblee Burch, *Optimal Lead Plaintiffs*, 64 VAND. L. REV. 1109, 1127–29 (2011) [hereinafter, Burch, *Optimal Lead Plaintiffs*] (discussing due process concerns relating to the lead plaintiff’s representation of class interests). Needless to say, individuals often choose not to sue for all sorts of reasons even when they have good claims. So it is not clear that anyone can represent the interests of a class that includes members who in isolation would choose to not sue. See *Hansberry v. Lee*, 311 U.S. 32, 45 (1940) (explaining that the selection of a class representative “whose substantial interests are not necessarily or even probably the same as those whom they are deemed to represent, does not afford that protection to absent parties which due process requires”). On the other hand, it is arguable that most buyers would choose to sue or remain in a plaintiff class if any individual buyer chooses to sue or the class action goes forward. See *supra* notes 140–41 and accompanying text. This suggests that individual or opt-out actions should also be prohibited. That seems unlikely, as does any rule that would undo the fraud on the market presumption. *Basic Inc.*, 485 U.S. at 241–42. As discussed further below, there is a more promising approach focusing on the portion of class claims that are in fact losses suffered by the corporation and that should be addressed first as derivative claims. See *infra* Part IV.A. In other words, buyers should be precluded from individual recovery at least as against the corporation, even by means of an individual opt-out action, on the theory that the cost is foisted on other stockholders. See *Smith v. Waste Mgmt., Inc.*, 407 F.3d 381, 385–86 (5th Cir. 2005) (“Requiring derivative enforcement of claims belonging in the first instance to the corporation also prevents an individual shareholder from incurring a benefit at the expense of other shareholders similarly situated.” (quoting *Cowin v. Bresler*, 741 F.2d 410, 414 (D.C. Cir. 1984)) (internal quotation marks omitted)); see also *Bangor Punta Operations, Inc. v. Bangor & Aroostook R.R.*, 417 U.S. 703, 721–22 (1974) (“[A]ny recovery obtained in [a derivative] action would belong to the corporation, not to the minority shareholders as individuals, for the shareholder in a derivative action enforces not his own individual rights, but rights which the corporation has.”).

ultimately ascertainable.¹⁴⁶ As is apparent from Tables 1 and 2, the interests of potential class members change as the size of the class changes. As the class gets smaller, more buyer-holders might favor certification. But that would increase the size of the class and prompt many buyer-holders to oppose certification.¹⁴⁷ The numbers may equilibrate somewhere, but it is difficult to say where that would be.¹⁴⁸ Still, one potential problem with the foregoing argument is that holders have no standing to sue and thus may have no standing to object on grounds that relate to their status as holders.¹⁴⁹ In any event, the courts may be disinclined to give much weight to arguments that merely seek to deny a remedy to other litigants.

The best way for an index fund to oppose a class action is to advocate for a derivative action. (The best defense is a good offense.) As noted above, when buyers sue for securities fraud, their losses—all of which are impounded in the lower stock price of the defendant company—may come from three sources: (1) lower expected return, (2) higher cost of capital, and (3) enforcement losses, including costs suffered by the defendant company such as attorney fees and other expenses of litigation, civil and criminal fines, and damages or settlement amounts payable to buyers.¹⁵⁰ Moreover, an increase in the cost of capital may come from two sources. It may be the result of a market perception of more risk inherent in the business of the subject company. Or it may be the result of harm to the reputation of the subject company resulting from the fraud—a loss of trust.¹⁵¹ In a securities fraud class action all of these losses are represented in the

146. See *Miles v. Merrill Lynch & Co. (In re Initial Pub. Offering Sec. Litig.)*, 471 F.3d 24, 42, 45 (2d Cir. 2006) (holding that although separate inquiry from class certification rules, a class must be sufficiently ascertainable).

147. See *supra* note 127 and Tables 1 & 2.

148. The class plaintiff might also argue that the class should be defined to include only buyers who did not own any shares at the beginning of the class period. See *Coffee*, *supra* note 12, at 1556–57. There are two potential problems with so defining the class: First, there may be too few such buyers to justify a class action. See FED. R. CIV. P. 23(a)(1) (requiring that class members be so numerous that joinder is impractical). And even if there are a substantial number of such investors, it is likely to be a much smaller universe than a class of all buyers, including buyer-holders, and possibly so small that the incentive for a plaintiff's lawyer to represent such a class would be insufficient to justify prosecution of the action. See *In re Cendant Corp. Litig.*, 246 F.3d 201, 254–55 (3d Cir. 2001) (discussing the attorney-client tension with respect to ideal plaintiff class size). Second, it is not clear how one could monitor the composition of any such class. Some buyer-holders might attempt to join the class even though they do not fall within the definition, figuring that they need not disclose the fact that they are also holders. See *supra* note 143. Although there may be nothing inherently wrong with permitting all buyers into the class, buyer-holder interlopers might dilute the recovery for buyer-only class members if the settlement pot is negotiated accordingly. See 15 U.S.C. § 78u-4(a)(4) (2006) (“The share of any final judgment or of any settlement that is awarded to a representative party serving on behalf of a class shall be equal, on a per share basis, to the portion of the final judgment or settlement awarded to all other members of the class.”).

149. See *supra* note 17 and accompanying text.

150. See *supra* note 32 and accompanying text.

151. See *supra* note 33 and accompanying text.

aggregate decrease in stock price.¹⁵² But enforcement and reputation losses are clearly derivative in nature. They affect all stockholders—both buyers and holders—in the same way because they are harms that are suffered in the first instance by the corporation.¹⁵³ In other words, stockholders lose because the corporation has suffered a loss, and their stock has declined in value.¹⁵⁴

Derivative actions avoid the problems of feedback and circularity.¹⁵⁵ When the corporation recovers from individual wrongdoers, the stockholders recover because their stock rises in value accordingly.¹⁵⁶ Thus, an index fund should clearly favor a derivative action over a class action. In a successful derivative action, the fund gains from a recovery in stock price, whereas in a successful class action, the fund usually loses because of feedback.¹⁵⁷

The law is quite clear: claims that *can* be asserted by the corporation *must* be asserted by the corporation, and they must be asserted *before* any individual stockholders may assert direct claims.¹⁵⁸ The inescapable implication is that the losses suffered by the corporation from reputational harm and enforcement costs must be litigated and settled before the losses to individual stockholders may be addressed.¹⁵⁹

152. See *supra* note 34 and accompanying text.

153. See *supra* notes 44–45 and accompanying text.

154. See *supra* notes 44–45 and accompanying text.

155. See *supra* notes 59–62 and accompanying text.

156. See Booth, *The End of the Securities Fraud Class Action*, *supra* note 3, at 24.

157. See *supra* Tables 1 & 2. As discussed further below, a fund need not file a separate derivative action. This is because the court must both certify a class action and specify its type, and because a derivative action is a type of class action, meaning an index fund may intervene at the certification hearing and argue that the action should be treated as a derivative action. See FED. R. CIV. P. 23(c)(1)(C); *infra* Part IV.C. Indeed, the court could do so on its own motion. See, e.g., *Wal-Mart Stores, Inc. v. Dukes*, 131 S. Ct. 2541, 2562 (2011) (“[M]ost issues arising under Rule 23 . . . [are] committed in the first instance to the discretion of the district court.” (quoting *Califano v. Yamasaki*, 442 U.S. 682, 703 (1979))).

158. See *Tooley v. Donaldson, Lufkin, & Jenrette, Inc.*, 845 A.2d 1031, 1036 (Del. 2004); see also *LaSala v. Bordier et Cie*, 519 F.3d 121, 130 n.9 (3d Cir. 2008) (“Delaware law generally does not allow shareholders to assert breach-of-fiduciary-duty claims directly, unless the shareholders can show damage distinct from the damage to the corporation.” (citing *Tooley*, 845 A.2d at 1034)). It is not clear that there should be a cause of action for the other two types of damages. The decrease in price from new information about fundamentals is a loss that will happen one way or another—as in musical chairs, the only question is the timing. See Booth, *The End of the Securities Fraud Class Action*, *supra* note 3, at 10 & n.21. But diversified investors are indifferent to such losses because they gain as often as they lose. See *supra* note 6 and accompanying text. Finally, feedback damages arise only because the company pays. If there is no remedy for fundamental loss, there is no feedback. See *supra* notes 7–10 and accompanying text. On the other hand, if we retain a remedy for fundamental loss, then feedback is another form of loss suffered by the corporation as a result of securities litigation. It is a loss that is suffered by all of the stockholders, and the company should also have a claim against the individual wrongdoers for compensation. Paradoxically, recovery for this derivative loss would eliminate feedback in the end—yet another form of circularity. In short, by process of elimination, no claim remains against the defendant corporation—all that remains are claims by the corporation against individual wrongdoers. The bottom line is that securities fraud should be seen as derivative rather than direct.

159. See *supra* note 158.

A. *Derivative Actions and Deterrence*

Before digging into the details of the legal arguments against class certification and in favor of a derivative action, it is important to address some obvious—but answerable—objections to litigating securities fraud by means of derivative action.

First, while most scholars agree that securities fraud class actions ill-serve investors, many argue that, as an important deterrent to fraud, investors would be worse off without such a remedy.¹⁶⁰ Indeed, the Supreme Court has stated that private securities litigation is an important supplement to enforcement by the SEC and other government agencies that do not have the resources to optimally police fraud.¹⁶¹ But there is no reason why private enforcement must take the form of a class action. The threat of a derivative action is also a deterrent to fraud.¹⁶² Indeed, since the only genuine harm that flows from securities fraud is derivative in nature, the threat of a derivative action is perfectly proportional to the wrongful behavior to be deterred.¹⁶³ In contrast, a class action entails excessive deterrence since it overcompensates buyers by including within the measure of damages losses that investors can diversify away.¹⁶⁴ Thus, a class action remedy offers a windfall to investors and induces too many lawsuits.¹⁶⁵

160. See Coffee, *supra* note 12, at 1572, 1586; Rose, *supra* note 23, at 1309.

161. See *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 313 (2007). Although it seems possible, and even likely, that fraud might increase in the absence of a class action remedy, there does not appear to be any data supporting this proposition. See, e.g., Fisch, *supra* note 23, at 338 (explaining that some critics of the deterrence justification for securities fraud class actions “observe that securities litigation does not deter individual wrongdoers because they do not pay damages”—the corporation does). Moreover, this justification ignores the costs associated with enforcement. See, e.g., *Tellabs, Inc.*, 551 U.S. at 313 (“Private securities fraud actions . . . can be employed abusively to impose substantial costs on companies and individuals whose conduct conforms to the law.”). There can be no doubt that the threat of a class action increases the risk associated with voluntary disclosure. Cf. *Matrixx Initiatives, Inc. v. Siracusano*, 131 S. Ct. 1309, 1322 (2011) (“Silence, absent a duty to disclose, is not misleading under Rule 10b–5.” (quoting *Basic Inc. v. Levinson*, 485 U.S. 224, 239 n.17 (1988))). It may well be that investors would prefer more disclosure to a class action remedy. See, e.g., *id.* at 1321 (“The question remains whether a reasonable investor would have viewed the nondisclosed information ‘as having significantly altered the “total mix” of information made available.’” (quoting *Basic Inc.*, 485 U.S. at 232) (internal quotation marks omitted)).

162. Booth, *Class Conflict*, *supra* note 7, at 702; see also Thomas M. Jones, *An Empirical Examination of the Incidence of Shareholder Derivative and Class Action Lawsuits, 1971–1978*, 60 B.U. L. REV. 306, 306 (1980) (stating that shareholder suits include derivative and class action lawsuits, both of which deter fraud).

163. See *supra* note 158.

164. See *supra* note 6 and accompanying text.

165. Deterrence alone cannot justify a remedy that serves no compensatory purpose. See Janet Cooper Alexander, *Rethinking Damages in Securities Class Actions*, 48 STAN. L. REV. 1487, 1502 (1996) (“The justification for damages must then be stated purely in terms of deterrence or retribution, not compensation.”). But see Coffee, *supra* note 12, at 1547 (“But if the securities class action fails as a mechanism for compensation, it can still perform admirably as a form of deterrence.”). When the plaintiff in a simple tort action sues for compensation, the fact that the

Second, another likely objection is that the individual defendants in any derivative action—directors and officers—may seek to hide behind the business judgment rule by arguing that they sought only to serve the corporation’s best interests.¹⁶⁶ Although their actions may have turned out to be fraud as a matter of federal securities law, individual defendants will argue that they acted in good faith and thus cannot be held liable for any breach of fiduciary duty.¹⁶⁷ Accordingly, the corporation may seek to dismiss the action as unlikely to

defendant must pay also happens to deter future reckless acts precisely in proportion to the harm that they may cause. See *Mathie v. Fries*, 121 F.3d 808, 817 (2d Cir. 1997) (noting that the purpose of punitive damages “is to punish wrongdoer and deter others”). If the victim suffers no loss, there is nothing to deter. See *Cooper Distrib. Co. v. Amana Refrigeration, Inc.*, 63 F.3d 262, 281 (3d Cir. 1995) (“[A] plaintiff must suffer injury to recover punitive damages.”). Moreover, to provide a remedy in excess of the harm suffered will inevitably result in frivolous lawsuits with random deterrent effects. See generally *Suja A. Thomas, Frivolous Cases*, 59 DEPAUL L. REV. 633, 637 (2010) (explaining that damages caps, which limit actual and punitive damages, are used to deter frivolous lawsuits). This explains, at least in part, why Congress found it necessary to include in the PSLRA enhanced provisions designed to punish frivolous lawsuits. See 15 U.S.C. § 78u-4 (2006); see also *LaSala v. Bordier et Cie*, 519 F.3d 121, 128 (3d Cir. 2008) (citing S. REP. NO. 104-98, at 35 (1995)) (explaining that Congress intended the PSLRA to allow courts to more easily dismiss abusive, frivolous securities class actions). But the real problem is that class actions offer recovery for losses that investors would incur even in the absence of fraud—losses that arise because of risks inherent in business and investing. Booth, *Class Conflict*, *supra* note 7, at 764 & n.140. In other words, since buyers may be able to recover not only for the loss that arises from fraud but also for the loss that would have occurred fraud or no fraud, a class action remedy induces investors to sue more often than they should. See *id.*

The prospect of a derivative action against the individual wrongdoers replaces the deterrent that most scholars agree is the only real justification for securities fraud class actions. See *supra* note 23 and accompanying text. Moreover, since a derivative remedy would eliminate recovery for the decrease in market price that will happen one way or another, the potential recovery is much more in line with the true economic loss from securities fraud. It is also much more amenable to accurate measurement, since in a class action there is no good way to estimate the number of damaged shares, which should facilitate more efficient settlement. See Booth, *Class Conflict*, *supra* note 7, at 757 n.122. Even if these claims are ultimately covered by insurance, it is the company that will recover. See *supra* note 30. Thus, the very idea of insurance and indemnification is transformed into one in which the company seeks to insure itself, for its own benefit, against the possibility of management malfeasance. See *supra* Part II. Incidentally, company self-insurance is likely to improve corporate governance, which some commentators have suggested is the only remaining justification for securities fraud class actions. See William W. Bratton & Michael L. Wachter, *The Political Economy of Fraud on the Market*, 160 U. PA. L. REV. 69, 69, 121 (2011) (explaining how fraud on the market litigation benefits corporate governance by forcing transparency and reducing barriers to shareholder and manager agency relationships).

166. See *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984) (citing *Kaplan v. Centex Corp.*, 284 A.2d 119, 124 (Del. Ch. 1971); *Robinson v. Pittsburgh Oil Ref. Corp.*, 126 A. 46 (Del. Ch. 1924)) (“[The business judgment rule] is a presumption that in making business decisions the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.”), *overruled by* *Brehm v. Eisner*, 746 A.2d 244, 254 (Del. 2000) (overruling *Aronson* only with respect to its use of an abuse of discretion scope of review).

167. See, e.g., *Brehm*, 746 A.2d at 251 (discussing the “legal presumption that the [board’s] conduct was a proper exercise of business judgment”—a presumption that provides “statutory protection for a board that relies in good faith on an expert advising the Board”).

succeed and contrary to its own best interests.¹⁶⁸ The simple response to this objection is that the business judgment rule does not protect a corporate fiduciary from liability for a knowing violation of the law.¹⁶⁹ And since liability under Rule 10b-5 also requires a knowing violation of the law, where there is a Rule 10b-5 claim there is also a derivative claim.¹⁷⁰ Thus, any fraud that is actionable

168. See, e.g., *Emerald Partners v. Berlin*, 787 A.2d 85, 98–99 (Del. 2001) (holding that court must determine whether director defendants satisfied the entire fairness standard before determining if they are exculpated by the business judgment rule); *Brehm*, 746 A.2d at 267 (dismissing the plaintiff stockholders complaint because it failed to meet the “very large—though not insurmountable burden” of showing that the defendants were not protected by the business judgment rule); *Aronson*, 473 A.2d at 818 (reversing the lower court’s denial of motion to dismiss on the grounds that plaintiff failed “to create reasonable doubt as to the applicability of the business judgment rule”), overruled by *Brehm*, 746 A.2d at 254 (overruling *Aronson* only with respect to its use of an abuse of discretion scope of review); *Zapata Corp. v. Maldonado*, 430 A.2d 779, 788–89 (Del. 1981) (establishing a two-step test to be applied when ruling on a corporation’s motion to dismiss based on business judgment rule); see also *Joy v. North*, 692 F.2d 880, 891 (2d Cir. 1982) (adopting the business judgment rule and dismissing the shareholder action). See generally 2 PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS §§ 7.07–.10 (1992) [hereinafter PRINCIPLES OF CORPORATE GOVERNANCE] (explaining dismissals of derivative actions, including the procedures for requiring dismissal, and standards of judicial review).

169. See, e.g., *In re Goldman Sachs Grp., Inc. S’holder Litig.*, No. 5215 VCG, 2011 WL 4826104, at *20 (Del. Ch. Oct. 12, 2011) (“[A] fiduciary of a Delaware corporation cannot be loyal to a Delaware corporation by knowingly causing it to seek profit by violating the law.” (quoting *In re Massey Energy Co.*, No. 5430 VCS, 2011 WL 2176479, at *20 (Del. Ch. May 31, 2011))); *In re Walt Disney Co. Derivative Litig.*, 907 A.2d 693, 763 (Del. Ch. 2005) (finding that actions are made in good faith if they “do not represent a knowing violation of law or evidence a conscious and intentional disregard of duty”). The same standard applies in connection with any exculpatory provision under section 102(b)(7) of Delaware General Corporation Law, any argument that a derivative action should be dismissed for failure to make a demand on the board of directors, and any attempt to have the action voluntarily dismissed as contrary to the best interests of the corporation. See DEL. CODE ANN. tit. 8 § 102(b)(7) (2011).

170. To be precise, both require scienter. See *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 313 (2007) (citing *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976)). The converse is not necessarily true. There may well be state claims that are not cognizable under federal law. See, e.g., *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 473–74 (1977) (no claim under Rule 10b-5 for breach of fiduciary duty in the absence of misrepresentation or omission where there is a duty to speak). It is also conceivable that scienter might be interpreted differently under state law from the way it is interpreted under federal law. See, e.g., *State v. Larsen*, 865 P.2d 1355, 1360 (Utah 1993) (refusing to interpret “willfully” in the Utah securities fraud statute to require “scienter”). But this seems unlikely since the concept of scienter derives from the common law. See *Aaron v. SEC*, 446 U.S. 680, 705 (1980) (Blackmun, J., dissenting). Thus, there is every reason to think that federal and state courts will look to each other for any jurisprudence on the subject. To be sure, different courts may rule differently on the same facts, but that is a risk even from one federal court to another. See *Ernst & Ernst*, 425 U.S. at 193 n.12 (explaining that courts have disagreed as to whether negligence satisfies the scienter requirement). In the end, there is no reason to think that scienter means something different in federal court from what it means in state court. See *Booth, Class Conflict*, *supra* note 7, at 723–24 (explaining that the scienter requirement is the same in federal and state courts). Thus, one subtle benefit of the approach advocated here is that it could help clarify the meaning of scienter. In a class action, one of the first questions to be addressed is whether the alleged wrongdoers acted with scienter. See *Tellabs, Inc.*, 551 U.S. at 313 (citing *Ernst & Ernst*, 425 U.S. at 193–94 & n.12). The PSLRA virtually mandates an early hearing focused on this issue. See 15 U.S.C. § 78u-4(b) (2006). If the alleged wrongdoers did not act with

under federal law should also be actionable under state law.¹⁷¹ So there is no reason to worry that plaintiffs may be deprived of their day in court. Thus, direct and derivative claims are perfectly congruent.¹⁷²

B. Practice and Procedure

Given that a derivative action is a perfect substitute for a class action to the extent of the genuine harm suffered by most investors in a Rule 10b-5 action, the

scienter, the action will be dismissed, and the decrease in price will be chalked off as an ordinary risk that investors assume when they buy a stock. *See id.* § 78u-4(b)(3) (stating that a court should grant a motion to dismiss if the complaint fails to adequately plead the state of mind requirement). In contrast, a derivative plaintiff must ultimately show that some portion of the loss was the result of wrongdoing. *See* 2 PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 168, § 7.01 (explaining that for a derivative action to prevail, the plaintiff must show an injury or breach of duty). If the loss is wholly attributable to bad news and not in any part attributable to managerial misbehavior, there is no claim even if there is evidence of scienter. *See* Booth, *Direct and Derivative Claims in Securities Fraud Litigation*, 4 VA. L. & BUS. REV. 277, 296, 303 (2009) [hereinafter Booth, *Derivative Claims*]. In a class action, the issue is never addressed in isolation because the claim is for all of the loss from whatever source. *See id.* at 301. Thus, there is always a chance that the action may proceed, even though no part of the loss is actually attributable to fraud because the issue of scienter is addressed in a hypothetical vacuum, and because there will always be apparent financial harm in the form of a decrease in price plus any feedback loss that may be tacked on by the market in anticipation of class certification. *See id.* Therefore, in a class action, the court must decide whether there is scienter without considering whether it gave rise to any financial harm. *See* Booth, *Class Conflict*, *supra* note 7, at 722 n.39. Presumably, the courts will get it wrong in both directions on occasion: sometimes they will find scienter even where there is no genuine financial harm, and sometimes they will find no scienter even though there is genuine financial harm. If the court must find both scienter and financial harm for the action to proceed, the risk of over-deterrence and under-deterrence are both reduced. *See id.* In other words, the need to find financial harm acts as a double check on any finding of scienter, and vice versa. This is not to suggest that the elements of scienter, materiality, and loss causation should somehow be merged conceptually, but neither is it to deny that these elements are interdependent.

171. *See supra* note 170.

172. As noted above, the equities are somewhat different in a good-news case where buyers gain and sellers lose. *See supra* notes 26, 29. In such a case, buyers may gain even more if the corporation recovers damages in a derivative action, and sellers, who are no longer stockholders, gain nothing from a derivative action. *See supra* note 59 and accompanying text. In other words, sellers have no remedy without a class action short of any possible individual recovery in a derivative action, but the only loss sellers suffer is the loss that goes with mispricing—a loss that can be diversified away. Since sellers do not hold fraud-affected shares after corrective disclosure, they do not suffer any loss from enforcement costs or increases in the cost of capital, the genuine loss from securities fraud. *See supra* notes 32–34 and accompanying text. So there is no reason to worry that sellers have no remedy. On the other hand, one might argue that in a regime of derivative actions there might be a perverse incentive to withhold good news for the benefit of prospective buyers. Indeed, why would anyone sue in such circumstances? The answer is that good-news fraud is just as likely to cause enforcement and cost of capital losses as is bad-news fraud. *See* Booth, *The End of the Securities Fraud Class Action*, *supra* note 2, at 18–19; Booth, *Mysteries of Corporate Finance*, *supra* note 94, at 1075–76. Buyers and holders thus lose in the sense that stock price would have been even higher but for the fraud. Moreover, since the defendants in any derivative action are the individual wrongdoers, there is no reason to think that they will be motivated to lie to the market for the benefit of buyers.

question becomes how to choose between the two. How should a court decide whether an action should be treated as a derivative claim or a direct claim? As it turns out, this too is an easy question to answer.

First, a derivative action always wins a tie. The question of whether an action is derivative or direct arises often in corporate litigation.¹⁷³ It is well settled that if a claim can be litigated in a derivative action, it must be so litigated.¹⁷⁴ Moreover, derivative claims must be addressed before—or, at least logically, prior to—any direct claims.¹⁷⁵ In other words, the corporation should recover first for any claims that it might have, and only after the corporation is made whole should individuals recover for any remaining direct claims.¹⁷⁶

Second, FRCP Rule 23(b)(3), the rule that governs class actions for damages, requires that the court find that a class action is superior to any other means of litigating the claim.¹⁷⁷ This is not a matter of discretion: an action may proceed as a class action only if the court certifies it by finding that it is appropriate to proceed as such.¹⁷⁸ And the court may do so only if it finds that a class action is superior to—better than, not equal to—other ways of proceeding.¹⁷⁹ The Official Comments to the FRCP state unequivocally that the rules are not intended to alter substantive law.¹⁸⁰ Presumably, this includes the law relating to whether a claim is derivative or direct. In short, the court really has no choice in the matter. If a claim is derivative, it must be litigated as such.¹⁸¹

At this point it may go without saying that a derivative action is clearly superior to a class action. But it may be helpful to repeat here the several reasons stated above.

First, because most investors are well diversified, the only genuine loss they suffer from securities fraud (but for the effects of class actions) is the loss that flows from an increase in the cost of capital owing to reputational harm or from

173. See, e.g., *Bangor Punta Operations, Inc. v. Bangor & Aroostook R.R.*, 417 U.S. 703, 721–22 (1974) (“[R]ecovery obtained in [a derivative] action would belong to the corporation, not to the minority shareholders as individuals, for the shareholder in a derivative action enforces not his own individual rights, but rights which the corporation has.”); *LaSala v. Bordier et Cie*, 519 F.3d 121, 131 (3d Cir. 2008) (referring to direct and derivative claims as “two overlapping types of harm that are treated differently by Delaware law”); *Tooley v. Donaldson, Lufkin, & Jenrette, Inc.*, 845 A.2d 1031, 1036 (Del. 2004) (“The decision whether a suit is direct or derivative may be outcome-determinative.”).

174. See *supra* note 158 and accompanying text.

175. See *supra* notes 158–59 and accompanying text.

176. See *supra* note 159 and accompanying text.

177. FED. R. CIV. P. 23(b)(3).

178. *Id.*

179. *Id.*

180. See 28 U.S.C. § 2072(b) (2006) (providing that federal rules of procedure, including the FRCP, “shall not abridge, enlarge or modify any substantive right”).

181. See FED. R. CIV. P. 23(b)(3); *supra* note 158 and accompanying text.

the costs of litigation.¹⁸² Since these losses are derivative, a derivative remedy is precisely proportional to the harm suffered by investors.¹⁸³

Second, class actions cause stock price to fall more than it otherwise would because the company pays, thus creating collateral damage in the form of feedback.¹⁸⁴ In other words, class actions cause additional harm to investors and reduce return.¹⁸⁵ There is no such problem with a derivative action, by which the company recovers from the individual wrongdoers.¹⁸⁶

182. Whether or not an investor chooses to diversify, all investors are *free* to diversify and thus *able* to avoid the risk that goes with being undiversified. *See supra* note 26 and accompanying text. Since it is costless to diversify, investors are clearly the cheaper cost avoiders with regard to the risk of simple mispricing. *See supra* note 26. Accordingly, investors should be deemed to have assumed the risk that goes with being undiversified—the risk that prices may change without notice. As in musical chairs, an investor knows from the outset that she may be left holding the bag. At first blush, this argument might seem to prove too much in that it suggests that diversified investors should also be indifferent to securities fraud. After all, a diversified investor is equally likely to sell as to buy a fraud-inflated stock, so it all comes out in the wash. This is not so. *See supra* note 6 and accompanying text. Although a diversified investor is indifferent to the ups and downs of individual stocks in normal circumstances, securities fraud *always* causes stock price to decline. *See Booth, The End of the Securities Fraud Class Action, supra* note 3, at 14. To return to the example above, in which the stock of Binford Corporation might be expected to fall from \$20 to \$15 because of bad news, but instead falls from \$20 to \$10 because of a cover-up, consider a diversified investor who is equally likely to buy or sell Binford. *See supra* Part II. In the absence of fraud, the investor has a fifty-fifty chance of a \$5 loss, but where there is fraud, the investor has a fifty-fifty chance of a \$10 loss. Clearly, the investor cares about fraud. No stock ever *increased* in value *because* of securities fraud, so the risk of fraud cannot be diversified away. *See Booth, The End of the Securities Fraud Class Action, supra* note 3, at 14 & n.35.

183. *See Booth, Class Conflict, supra* note 7, at 702, 760.

184. *See supra* note 8 and accompanying text.

185. *See supra* note 9 and accompanying text.

186. To be sure, feedback is a problem only for holders: although feedback increases the loss for buyers, buyers recover for this loss, at least in theory. *See supra* notes 28–31 and accompanying text. In other words, feedback, in the aggregate, is equal to the amount that holders pay buyers, so feedback loss falls solely on holders. *See supra* notes 30–31 and accompanying text. On the other hand, if aggregate recovery is merely equal to feedback loss—which, by definition, it must be at a minimum—even buyers may be worse off to the extent of fees and expenses. *See supra* notes 11–13 and accompanying text. In any event, one could argue that since feedback falls solely on holders who have no standing to sue, it should be ignored for purposes of assessing superiority. But it is difficult to believe that the courts would or should ignore the obvious consequences of a decision to certify a class action, once the effects are explained as they are herein. Indeed, since feedback is a cost of fraud suffered by the corporation because of a class action triggered by securities fraud, it should give rise to a subsequent derivative claim just as a civil or criminal penalty would. *See, e.g., In re Cendant Corp. Sec. Litig.*, 109 F. Supp. 2d 273, 278–79 (D.N.J. 2000) (noting that the derivative plaintiff would always have a subsequent claim for any improvident settlement to which the defendant corporation might agree in a class action), *aff'd*, 264 F.3d 201 (3d Cir. 2001). Thus, in deciding whether to certify, a court should consider the fact that a class action may—indeed should—give rise to an additional derivative claim and, thus, even more litigation. From there, it is a small step to the idea that if the corporation can recover from the individual wrongdoers, we should skip the class action and proceed directly to a derivative action. In other words, the court should address the derivative claim first. Finally, although it should go without saying, a derivative action also fixes the opt-out problem discussed above. *See supra* note 145. Since the recovery goes to the corporation, there is nothing for an individual stockholder to gain by suing individually. *See*

Third, class actions constitute excessive deterrence because plaintiffs can recover for all of their losses, including the loss that would happen even in the absence of fraud.¹⁸⁷ As a result, there are too many securities fraud class actions.¹⁸⁸ Moreover, defendant companies invest too much in prevention and defense and settle too readily.¹⁸⁹ Although one might argue that we should deter fraud however we can, the fact is that too much deterrence makes managers reluctant to speak at all.¹⁹⁰ Presumably, investors want as much information as they can get, and they are willing to accept an occasional mistake if it means more information. In short, investors dislike fraud but not so much that they would pay more to prevent it than the fraud actually costs.¹⁹¹ Thus, a derivative remedy is perfectly tailored to investor interests. If investors were fully informed and could vote on the matter, they would presumably choose to abolish securities fraud class actions in favor of derivative actions.¹⁹²

All of these problems go away if the claim is prosecuted as a derivative action.¹⁹³ To be clear, these are not mere policy considerations. FRCP Rule 23(b)(3) requires that a class action for damages be superior to all other modes of litigating the claim.¹⁹⁴ In other words, a class action for damages is reserved for situations in which there is no alternative.¹⁹⁵ There is simply no doubt that a derivative action is the superior way to litigate securities fraud arising under Rule 10b-5.

supra note 145. Moreover, there is no right to opt out of a derivative action. The concept itself is nonsense since the corporation is the real plaintiff. *See supra* note 145. And even if one conceives of a derivative action as a FRCP Rule 23(b)(2) class action by the stockholders seeking to compel the corporation to sue—which it is as discussed further below—there is no right to opt out of a class action under Rule 23(b)(2). *See infra* notes 200–10 and accompanying text.

187. *See supra* notes 48–49 and accompanying text.

188. *See supra* note 50 and accompanying text.

189. *See supra* note 50 and accompanying text.

190. Indeed, the Supreme Court has suggested that corporations can avoid the uncertainties of securities law—such as what constitutes a material statement of fact—by choosing not to speak when in doubt. *See Matrixx Initiatives, Inc. v. Siracusano*, 131 S. Ct. 1309, 1321 (2011).

191. *See* Frank H. Easterbrook & Daniel R. Fischel, *Optimal Damages in Securities Cases*, 52 U. CHI. L. REV. 611, 626 & n.20 (1985).

192. One possible objection is that a plaintiff lawyer will be less motivated to file a derivative action because of the smaller potential recovery and fee. *See supra* note 148. The obvious response is that the incentive to file a class action is larger than it should be. *See supra* notes 48–49 and accompanying text. Moreover, the potential recovery in a derivative action is greater than the derivative portion of a class action claim because, in effect, a derivative claim is asserted on behalf of all stockholders rather than buyers only, which should please the plaintiffs' bar. *See supra* notes 45–46 and accompanying text. Thus, the threat of a derivative action is a more significant deterrent than one might at first think. *See supra* notes 160–63 and accompanying text.

193. *See* Booth, *Class Conflict*, *supra* note 7, at 760.

194. FED. R. CIV. P. 23(b)(3).

195. *See id.*

C. *Class Certification*

Despite their clear superiority, there is an obvious practical problem with the idea that securities fraud claims should be handled as derivative actions: presumably, someone must make the argument. Needless to say, the standard practice is for plaintiffs or their attorneys to file class actions.¹⁹⁶ Although it is common for a derivative action to be filed alongside a class action, such actions are almost always settled in exchange for nonmonetary consideration such as corporate governance reforms.¹⁹⁷ In other words, derivative action plaintiffs and their attorneys seem not to be a terribly zealous lot. Rather, they seem content to play second fiddle to a class action—rather than lead guitar. There are several possible reasons why this pattern prevails (as discussed further below). But there would seem to be little that the courts can do when plaintiffs frame their claims primarily as class action claims. Not so.

First, it is not up to the parties to seek direct relief when derivative relief is proper.¹⁹⁸ The question of whether an action is derivative or direct is akin to a question of subject matter jurisdiction: it is one for the court to decide on its own motion if necessary, regardless of whether the parties raise the issue.¹⁹⁹ Indeed, the court has no choice in the matter.

Second, a court must certify that an action is appropriate to be litigated as a class action for an action to proceed as such.²⁰⁰ Thus, the court must determine which one of three permissible types of class actions is appropriate.²⁰¹ Securities fraud actions are invariably certified as class actions for damages under FRCP Rule 23(b)(3).²⁰² But Rule 23(b)(2) also permits certification where “the party opposing the class has acted or refused to act on grounds that apply generally to the class, so that final injunctive relief or corresponding declaratory relief is appropriate respecting the class as a whole.”²⁰³ That is a perfect description of a derivative action. A derivative action is an action by a stockholder seeking to compel the corporation to assert its rights against a wrongdoer.²⁰⁴ Because the corporation has refused or neglected to act on behalf of its stockholders, it is appropriate for a representative stockholder to seek what amounts to a mandatory injunction compelling the corporation to sue the wrongdoers.²⁰⁵ Indeed, derivative actions were historically described as equitable actions brought on behalf of the stockholders as a class seeking to compel the

196. See 2 PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 168, § 7.02.

197. See Booth, *Class Conflict*, *supra* note 7, at 725–26.

198. See *id.* at 740.

199. See *id.*; see also FED. R. CIV. P. 23(c)(1)(C) (allowing for the amendment or alteration of a class certification order at any time prior to final judgment).

200. See FED. R. CIV. P. 23(c)(1).

201. See FED. R. CIV. P. 23(b)–(c).

202. See Booth, *Derivative Claims*, *supra* note 170, at 309.

203. FED. R. CIV. P. 23(b)(2).

204. See FED. R. CIV. P. 23.1; BLACK’S LAW DICTIONARY 509 (9th ed. 2009).

205. See FED. R. CIV. P. 23.1.

corporation to sue. (Incidentally, this explains why derivative actions are typically treated as matters of equity.²⁰⁶) To be sure, there is a separate rule that governs derivative actions: FRCP Rule 23.1.²⁰⁷ But this does not change the fact that Rule 23(b)(2) also contemplates such actions.²⁰⁸ Rule 23.1 simply provides additional detail about how derivative actions must proceed.²⁰⁹ Moreover, the law is clear that Rule 23(b)(3) is a last resort. An action may be certified thereunder only if it cannot be certified under any other provision.²¹⁰ Thus, it is clear that a court may recast a securities fraud class action as one seeking injunctive relief and indeed must do so.

In short, although the plaintiff may try to proceed under one rule or the other, it is ultimately up to the court to decide how to manage the action.²¹¹ After all, both class actions and derivative actions are representative actions.²¹² They do not *belong* to the plaintiff. Rather, the plaintiff is a fiduciary for the class or the corporation.²¹³ Witness the fact that in neither case may the action be dismissed or settled without the approval of the court.²¹⁴

To be sure, it is not clear that a derivative action of the type contemplated here may be tried in federal court because the corporation is neither a buyer nor a seller and may not have standing to sue under Rule 10b-5.²¹⁵ But neither is it clear that the purchaser–seller rule applies to a derivative action. Indeed, there are good reasons to believe that it does not. For example, section 16(b) of the Securities Exchange Act of 1934 (1934 Act) expressly contemplates a derivative action to recover gains from short-swing trading.²¹⁶ Moreover, although the

206. *Wal-Mart Stores, Inc. v. Dukes*, 131 S. Ct. 2541, 2557 (2011) (citing *Amchem Prods., Inc. v. Windsor*, 521 U.S. 591, 613 (1997)).

207. *See* FED. R. CIV. P. 23.1. It is no coincidence that the rules appear adjacent to each other in the Federal Rules of Civil Procedure.

208. *See* Booth, *Class Conflict*, *supra* note 7, at 755 (citing FED. R. CIV. P. 23(b)(2)).

209. *See* FED. R. CIV. P. 23.1.

210. *See supra* note 195 and accompanying text.

211. *See* FED. R. CIV. P. 23(d); *see also* *Wal-Mart Stores, Inc. v. Dukes*, 131 S. Ct. 2541, 2562 (2011) (citing BLACK’S LAW DICTIONARY 1366 (9th ed. 2009)) (demonstrating that courts ultimately decide whether to allow class certification).

212. *See* BLACK’S LAW DICTIONARY 1417 (9th ed. 2009).

213. *See supra* notes 204–05 and accompanying text.

214. *See* FED. R. CIV. P. 23(e); *Zapata Corp v. Maldonado*, 430 A.2d 779, 788 (Del. 1981).

215. *See supra* note 59 and accompanying text. Although there may be some cases in which the company itself was a purchaser or seller of its own stock, most securities fraud class actions that arise under Rule 10b-5 involve no trading at all by the company. *See* Booth, *Class Conflict*, *supra* note 7, at 703 n.1. Again, the focus here is on claims relating to trading in outstanding shares. Claims arising under the 1933 Act are fundamentally different. *See id.* There, it is perfectly proper for buyers to recover against the issuer who offered shares under false pretenses. *See* Booth, *Derivative Claims*, *supra* note 170, at 282. There may also be cases arising under Rule 10b-5 in which the company has bought back shares on the open market or has sold shares other than pursuant to an offering under the 1933 Act. *See id.* at 311–12 & n.66. Again, the company may be a proper defendant in such cases. *See id.* But the focus here is on cases arising as a result of misrepresentations or actionable omissions to speak, on which buyers and sellers of outstanding stock rely in connection with trades not involving the issuer corporation.

216. *See* Securities Exchange Act of 1934 § 16(b), 15 U.S.C. § 78p(b) (2006).

Securities Litigation Uniform Standards Act (SLUSA)²¹⁷ requires that direct class actions based on a theory of nondisclosure arising under state law be removed to federal court²¹⁸—and thus dismissed if brought on behalf of holders—the so-called Delaware carve-out thereto expressly exempts derivative actions.²¹⁹ Thus, it is quite clear that such claims may be asserted in state court and are not preempted by federal law.²²⁰ To be sure, a federal court might be required to dismiss such a derivative action if it finds that the corporation has no standing to sue under federal law. Although that outcome seems unlikely given that the 1934 Act expressly contemplates derivative actions under section 16(b), such an action may always be heard in state court.

D. Remaining Direct Claims

The question remains as to how the direct claims of buyers should be handled once a derivative action has been settled. In other words, after the derivative portion of the claim is settled, buyers are still left with shares that have declined in value because of the bad news. Arguably, they should have a remedy if they bought in reliance on the integrity of the market. There are several responses to this argument.

First, it is not clear that these losses are the result of fraud. The losses that flow from lower expected returns and higher expected nonactionable risk will occur one way or the other, albeit sooner rather than later in the absence of fraud.²²¹ The derivative losses that flow from reputational harms and enforcement costs are different in that they are the genuine losses from fraud.²²² Since these genuine losses are all addressed by a derivative action, investors are made whole.²²³ As a group, the stockholders are in the same position as if there had been no fraud at all. If the corporation recovers, the stockholders are restored to where they would have been in the absence of fraud.²²⁴ Thus, it is not clear that there is any real claim that remains after the derivative action has been litigated and settled.²²⁵

217. See Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, 112 Stat. 3227 (codified as amended in scattered sections of 15 U.S.C.).

218. See 15 U.S.C. § 78bb(f)(2) (2006).

219. See *id.* § 78bb(f)(3)(A)(i)–(ii); see also Booth, *Class Conflict*, *supra* note 7, at 735 (“SLUSA expressly preserves state court jurisdiction over derivative actions in a provision popularly known as the Delaware carve-out.”).

220. See, e.g., *LaSala v. Bordier et Cie*, 519 F.3d 121, 128–129 (3d Cir. 2008) (citing 15 U.S.C. §§ 78bb(f)(1), 78bb(f)(5)(B) (1998)) (“To be preempted by SLUSA an action must (1) make use of a procedural vehicle akin to a class action . . .”).

221. See *supra* note 35 and accompanying text.

222. See *supra* notes 35–37, 44 and accompanying text.

223. See *supra* notes 45–46 and accompanying text.

224. See *supra* notes 45–46 and accompanying text.

225. See *supra* notes 174–76 and accompanying text. It is quite clear that under federal securities law a plaintiff is limited to recovery of actual losses (also known as out-of-pocket losses or OOPs). See Securities Act of 1933, 15 U.S.C. 77(k)(e) (2006). If the market does not react to an

Second, the direct claims of buyers, if any, are reduced by the prior settlement of the derivative portion thereof.²²⁶ In other words, buyers effectively recover at least a portion of their losses through a derivative action, and although a derivative recovery is effectively spread over all the stockholders,²²⁷ it may often be as much as a buyer could expect in a direct class action.²²⁸ Thus, even if there is some good reason to compensate investors for losses that would happen anyway, it makes sense to deal with the derivative losses first, since, by doing so, the direct claims of buyers are thereby reduced in amount.

Third, any insurance owned by the corporation is likely to be depleted by a derivative action.²²⁹ Since most securities fraud class actions settle for the amount of insurance available,²³⁰ buyers may not find it worth the candle to assert direct claims by means of a class action.

Fourth, as a practical matter, feedback would be reintroduced into the system if buyers were permitted to sue the corporation directly for individual losses following a class action—thus giving rise to another derivative action.²³¹ On the other hand, it is possible that the individual claims of buyers could be litigated as a supplement to the derivative action—with some amount of the derivative recovery paid directly to buyers. Although the law frowns on individual

alleged fraud in some way other than to adjust stock price by the same amount as it would have attained in the absence of fraud, it is difficult to see why there should be any remedy. Indeed, there is substantial authority that if the market does not react to a corrective disclosure at some point, there is no claim. See *Archdiocese of Milwaukee Supporting Fund, Inc. v. Halliburton Co.*, 597 F.3d 330, 336–37 (5th Cir. 2010), *vacated sub nom. Erica P. John Fund, Inc. v. Halliburton Co.*, 131 S. Ct. 2179, 2187 (2011). Similarly, some courts have ruled that if a corrective disclosure does not move the market price, it cannot be material. *In re Burlington Coat Factory Sec. Litig.*, 114 F.3d 1410, 1425 (3d Cir. 1997). Thus, it is not clear that there is any claim left after the derivative claim is litigated. If there is no derivative claim, arguably there can be no fraud. If a stock falls in price merely by an amount that reflects new information about future prospects—and not by any additional amount that can be traced to reputational harm or enforcement costs—it is difficult to see how a plaintiff could prove damages causation. Ironically, some commentators seem to take precisely the opposite view that the only genuine losses from fraud are the losses that derive from fundamentals, whereas increases in the cost of capital owing to reputational harm, together with feedback and other enforcement costs, should be viewed as non-compensable collateral damage that does not flow from the fraud itself. See, e.g., Bradford Cornell & James C. Rutten, *Collateral Damage and Securities Litigation*, 2009 UTAH L. REV. 717, 717 (“We conclude that while collateral damage can have a material impact on securities prices, declines associated with collateral damage are not, and should not be, recoverable under section 10(b) of the Securities Exchange Act of 1934.”).

226. See *supra* notes 158–59 and accompanying text.

227. See *supra* note 46 and accompanying text.

228. See *supra* notes 28–31. In the aggregate, average recovery is only about 3% of the loss claimed, but that 3% has totaled to about \$64 billion since 1996. See *supra* note 11.

229. See Tom Baker & Sean J. Griffith, *Predicting Corporate Governance Risk: Evidence from the Directors’ & Officers’ Liability Insurance Market*, 74 U. CHI. L. REV. 487, 487–89 (2007).

230. See *id.* at 487–88.

231. See *supra* note 145.

recovery, there is nothing to prevent a corporation from using a portion of its recovery to buy back a few shares from buyers at a premium.²³²

Finally, policy considerations militate against affording any remedy for buyers following a derivative action, at least as against the corporation. Again, diversified investors are indifferent to losses other than derivative losses because they wash out over time.²³³ Since the vast majority of investors are well-diversified, there is an inherent conflict between diversified and undiversified investors. Assuming that securities law should be based on the interests of reasonable investors, it seems clear that the interests of diversified investors should trump those of undiversified investors.²³⁴

Aside from deterrence, some commentators have suggested that it is important to provide a remedy for undiversified stock-picking investors because they perform a vital price discovery service for the remainder of the market. For example, Jill Fisch has argued that securities fraud class actions should be seen as designed to protect undiversified investors who invest in research and who ultimately make the market as efficient as it is.²³⁵ As she states:

Passive diversified investing may be a rational strategy for a particular investor, but this strategy is devastating for the market as a whole. Investors will not acquire information unless they have the opportunity to profit on that information by trading. More specifically, for an investor to benefit from firm-specific research, the potential profit from that research must exceed the costs of research and analysis. Thus, informed trading requires investors to limit their diversification and concentrate their holdings in a limited number of issuers. Indexed investors, in contrast, seriously threaten market efficiency.

As a result, informed traders are a critical component of the market that enables mandated disclosure to serve as a corporate-governance mechanism. Yet, informed traders incur costs that are not borne by other investors. They incur the costs of research. They incur the reduced liquidity and increased risk associated with limiting their

232. See Park, *supra* note 31, at 339.

233. See *supra* note 6 and accompanying text. Moreover, even undiversified long-term holders will tend to lose more often than they gain and thus would likely oppose a class action remedy as long as there is a derivative remedy. See *supra* note 10 and accompanying text. Again, investors assume the risk of mispricing and can hedge it away if they choose to do so. See *supra* note 26 and accompanying text.

234. See *supra* note 20 and accompanying text.

235. Fisch, *supra* note 23, at 346–47; see also Booth, *The Buzzard Was Their Friend*, *supra* note 96, at 901 (arguing that securities fraud class actions serve as an insurance policy against some types of losses for undiversified investors). One might even argue that index fund investors are neither real investors nor are they among the class of investors that are intended to be protected by the federal securities laws. Cf. *Int'l Bhd. of Teamsters v. Daniel*, 439 U.S. 551, 563–64 (1979) (finding that Congress did not intend for non-contributory pension plan benefits to come within the coverage of the 1933 and 1934 Acts).

diversification. And they incur, disproportionately, the costs of securities fraud because, relying on firm-specific disclosure to trade, they are more likely than diversified investors to be net losers.²³⁶

Nevertheless, Fisch recognizes that diversified investors enjoy a windfall under the current scheme.²³⁷ Accordingly, she suggests that some sort of limitation on the fraud on the market presumption might be appropriate.²³⁸ Although it is not clear that undiversified stock-picking investors (such as hedge funds) need any remedy to encourage them to continue to do what they do—let alone a remedy that comes at the expense of diversified buy-and-hold investors—there is no reason that an individual buyer cannot file suit under Rule 10b-5 if the buyer has in fact detrimentally relied on some misrepresentation by an issuer.²³⁹ To be sure, an individual investor who recovers from an issuer does so at the expense of other stockholders,²⁴⁰ and that may motivate other stockholders to sue. But there will always be a substantial number of stockholders who would or should oppose a class action and favor a derivative action.²⁴¹ And since a derivative action should take precedence over any direct action by individual stockholders and dispose of a portion of any direct claim, there may be little left for direct claimants to sue about anyway.²⁴²

V. MARKET FAILURE AND THE SURVIVAL OF CLASS ACTIONS

Given the almost universal disdain for securities fraud class actions and the obvious superiority of derivative actions, it is curious that no one appears to have argued that a derivative action should trump a class action and that the corporation should recover real money from the individual wrongdoers. It is all the more curious since the amount at stake could be relatively significant in that

236. Fisch, *supra* note 23, at 346–47.

237. *See id.* at 348.

238. *Id.* at 348–49.

239. *See* 17 C.F.R. § 240.10b-5 (2012).

240. *See supra* note 21 and accompanying text. This is essentially the situation that occurs when big investors opt out of a class action in an effort to maximize their individual recovery. *See supra* note 145. To be sure, a class member always has the right to opt out and go it alone, but the courts often preclude such opportunism, as a matter of corporation law, by recasting the action as derivative, effectively forcing all stockholders to opt in to the action. *See supra* note 145. In other words, there is substantial case authority that a claim that can be asserted derivatively must be asserted derivatively. *See supra* note 145.

241. *See supra* Parts I, II.

242. *See supra* notes 158–59 and accompanying text. It is unlikely that any direct claim would succeed where a derivative claim has failed. Moreover, a stock-picking value investor—such as a hedge fund—presumably understands the additional risk it assumes by declining to diversify and factors that additional risk into its investment strategy. *See supra* note 26 and accompanying text. To afford such an investor a remedy for simple mispricing is to subsidize such activities for no apparent reason.

it equals the loss suffered by all holders—not only buyers.²⁴³ Thus, the incentive for an enterprising plaintiff lawyer to prosecute a derivative action should often be quite substantial.²⁴⁴

A. *The Role of Directors' and Officers' Insurance*

The most likely explanation for the survival of class actions as the dominant mode of private securities litigation is that directors' and officers' (D&O) insurance does not cover (successful) derivative actions.²⁴⁵ Again, class actions typically settle for the amount of insurance funds available.²⁴⁶ Arguably, if there is no insurance, there is no incentive to sue.²⁴⁷

D&O insurance typically comes in three flavors.²⁴⁸ So-called Side A coverage insures individual managers against liability to stockholders.²⁴⁹ Typically, it applies only when the corporation cannot indemnify and thus requires the corporation to indemnify if legally permissible.²⁵⁰ Side B coverage insures the corporation against indemnification payments.²⁵¹ Side C coverage insures the corporation against liability to stockholders.²⁵² The obvious gap in this scheme is that nothing covers the directors and officers for liability to the corporation. Moreover, even if such coverage were available, D&O insurance typically excludes claims for fraud or personal enrichment.²⁵³ It also excludes insured-against-insured claims.²⁵⁴ Thus, although a corporation is free to buy

243. See *supra* note 46 and accompanying text.

244. To be sure, a shift to a derivative remedy would eliminate feedback losses. See *supra* note 158 and accompanying text. So the incentive to sue would not be as substantial as one might at first think. On the other hand, the plaintiff attorney's fee might be augmented in recognition of the elimination of feedback and the concomitant savings enjoyed by the corporation, at least in the first few such cases. The few cases in which derivative plaintiffs have asserted their claims with any vigor seem to be based more on worries about how such claims might be compromised by settlement of the class claim. See *In re Cendant Corp. Sec. Litig.*, 109 F. Supp. 2d 235, 246 (D.N.J. 2000), *aff'd*, 264 F.3d 201 (3d Cir. 2001). On the other hand, the prospect of a derivative action might cause the market to react less to securities fraud in the first place. Although that might be unfortunate for plaintiff attorneys, it is hard to see how anything that would make the market less volatile could be bad.

245. See Baker & Griffith, *supra* note 229, at 498 n.49.

246. *Id.* at 487–88.

247. Clearly, this cannot literally be true. If it were, then the best defense for a potential target corporation would be to eschew insurance altogether and go naked. Moreover, a corporation is the ultimate deep pocket. So there is no reason to think that in the absence of insurance, there would be no securities litigation. Thus, it is really quite curious that so many cases settle for whatever insurance is available.

248. *Id.* at 499.

249. *Id.*

250. *Id.* at 499 n.51.

251. *Id.* at 499.

252. *Id.*

253. *Id.* at 500.

254. *Id.* One obvious question is why D&O insurance affords any coverage in a securities fraud action, given the exclusion for fraud. The answer may be that the exclusion does not apply if

any insurance that is available—even in situations in which the corporation would be precluded from indemnifying the individual defendant—apparently insurance that covers the corporation for losses at the hands of its officers and directors—or that covers officers and directors for such liability—is not readily available.²⁵⁵

The bottom line is that even though the potential damages in a derivative action may be quite substantial, the chances that the individual wrongdoers will be able to pay any significant amount are quite slim.²⁵⁶ Thus, plaintiff lawyers have no incentive to pursue a derivative remedy—at least not to the exclusion of a class action remedy.²⁵⁷

On the other hand, the fact that individual wrongdoers may not be able to pay does not necessarily mean that the lawyer for the derivative plaintiff cannot be paid and paid well. In a derivative action, it is the corporation that pays the attorney fees, typically in proportion to the benefit conferred on it by the derivative action.²⁵⁸ The problem is that much of the benefit of a derivative action may be hidden from view in that it consists of avoiding the loss to the corporation that would result from a payout to the plaintiff class—feedback loss.²⁵⁹ So it may be appropriate to compensate the plaintiff lawyer in a derivative action with a relatively large portion of any recovery, or even to have the corporation pay out of its own pocket. Still, this argument is likely to work only in the first few cases since the market may come to expect derivative recovery.

the case is settled. *Cf. Merritt-Chapman & Scott Corp. v. Wolfson*, 321 A.2d 138, 143 (Del. Super. Ct. 1974) (permitting indemnification of director-officer who pleaded no contest to criminal charges), *superseded by statute*, DEL. CODE ANN. tit. 8 § 145 (2011), *as recognized in* *Mass. Mut. Life Ins. Co. v. Certain Underwriters at Lloyd's of London*, C.A. No. 4791-VCL, 2010 WL 3724745 (Del. Ch. 2010). Or it may be that the fraud exclusion applies only to fraud as traditionally defined, where the insured has sought to secure a benefit for someone by false pretenses. *See* BLACK'S LAW DICTIONARY 731 (9th ed. 2009). Finally, although an insurance company might argue that securities fraud is not covered, that would seemingly preclude the sale of such insurance, which presumably generates profits for the insurance company.

255. Corporation law prohibits the corporation from indemnifying directors and officers if they are found liable to the corporation. *See* MODEL BUS. CORP. ACT §§ 8.51(d), 8.57 (2010). It is also impermissible for the certificate of incorporation to absolve directors or officers for a breach of the duty of good faith. *See* DEL. CODE ANN. tit. 8, § 102(b)(7) (2011).

256. *See* Booth, *Derivative Claims*, *supra* note 170, at 302.

257. This is not to suggest that derivative actions are anomalous under current law. The threat that the stockholders might seriously prosecute a derivative action for real money against individual wrongdoers may add to the pressure to settle, precisely because the individual defendants would be required to pay out of their own pockets. So it is easy to see why derivative actions continue to be filed alongside class actions. *See supra* note 197 and accompanying text.

258. *See* Booth, *Derivative Claims*, *supra* note 170, at 324. The theory is that the corporation should pay because all of the stockholders benefit from the recovery in a derivative action in proportion to their stockholdings. *See* 2 PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 168, § 7.17.

259. *See supra* notes 9–10 and accompanying text.

Thus, it is at least understandable why plaintiff lawyers may prefer the status quo to a derivative regime. There is little doubt that aggregate attorney fees are likely to be greater in a class action than in a derivative action²⁶⁰—possibly great enough that the share that goes to the plaintiff lawyer in a tag-along derivative action may be even more than might be expected from a stand-alone derivative action.

Ultimately, these problems are temporary. Once the shift from class action to derivative action has been accomplished, there is no doubt that insurance companies will come forward with products designed to protect directors and officers from liability to the corporation.²⁶¹

B. Other Unindicted Co-Conspirators

The foregoing story does not explain why insurance companies do not object to covering claims that should not be covered under existing policies as written, given that a substantial portion of any meritorious claim should be treated as derivative.²⁶² The cynical answer to this question is that insurance companies can sell bigger policies if they cover class action claims. Although the insurance company might save a bit on claims it denies, it would likely lose much more in future sales. A somewhat less cynical answer is that it might be fraudulent for an insurance company to sell a policy that covers a defendant company for class action damages or settlements and then to argue that the loss suffered by the

260. See Booth, *Derivative Claims*, *supra* note 170, at 279.

261. There are many examples of such creativity on the part of insurance companies. For example, American International Group (AIG), of all companies, recently announced a new form of insurance called ReputationGuard that will provide coverage for damage control in the event of scandal. See Erik Holm, *Got a Crisis? Tap AIG (Really)*, WALL ST. J., Oct. 12, 2011, at C1; see also *Disgrace Insurance Tailored for Celebrity Pitchmen* (NPR radio broadcast Nov. 22, 2010), available at <http://www.npr.org/2010/11/22/131504268/the-last-word-in-business> (describing insurance that covers a company for the cost of an advertising campaign that must be scrapped because it features a celebrity who has misbehaved—like Tiger Woods). Such coverage is not far removed in concept from coverage for an increase in the cost of capital as a result of securities fraud by directors and officers. See Richard A. Booth, *Reducing Risk Doesn't Pay Off*, WALL ST. J., Mar. 15, 1999, at A18 (criticizing the idea of corporations buying insurance against decreased earnings). To be sure, there will be issues to be ironed out in defining any new form of insurance that might be sold to cover directors and officers for liability to the corporation, but these issues are really no different from the issues that arise in writing D&O policies under the current legal regime. See generally Tom Baker & Sean J. Griffith, *How the Merits Matter: Directors' and Officers' Insurance and Securities Settlements*, 157 U. PA. L. REV. 755, 804 (2009) (exploring issues that occur in issuing D&O insurance); Sean J. Griffith, *Uncovering a Gatekeeper: Why the SEC Should Mandate Disclosure of Details Concerning Directors' and Officers' Liability Insurance Policies*, 154 U. PA. L. REV. 1147, 1196 (2006) (exploring the issues that occur in issuing D&O insurance). Incidentally, if derivative actions do come to displace class actions—as they should—and if a new form of D&O insurance thus comes to be written, directors and officers should arguably pay for it. Needless to say, management would likely demand more compensation as a result, so the corporation may end up paying either way, but as long as the cost is treated as compensation expense, it seems safe to leave regulation to the market.

262. See *supra* notes 44–47 and accompanying text.

insured should have been treated as a derivative claim, thus exposing directors and officers to personal liability. In any event, it is difficult to fault insurance companies for writing coverage consistent with existing law.

Needless to say, directors and officers have no incentive to argue in favor of a derivative action. Aside from being disinclined to urge the corporation to sue themselves, a class action permits the corporation and management to circle the wagons and present a united defense.²⁶³ Moreover, by eliminating issues relating to individual wrongdoing, the defense can avoid much of the discovery and expense that goes therewith.²⁶⁴

Finally, although the courts could rule on their own motion that class claims should be recharacterized as derivative claims, at least in part,²⁶⁵ they have not done so. The easy answer as to why not—offered by a very thoughtful federal district court judge—is that no one has made the argument—at least not to

263. Note that the failure of management to argue—against interest—for a derivative action could be seen as a breach of fiduciary duty. Management has a duty to act in the best interest of the corporation. *See, e.g.*, DEL. CODE ANN. tit. 8, § 102(b)(7) (2011) (stating that directors owe a duty of loyalty to the corporation and its stockholders). By neglecting to assert that the action should be prosecuted derivatively, or by the corporation itself, management arguably foists its own potential liability onto the corporation because, under existing law, the corporation can be held liable for the entire decline in stock price. *See supra* note 4 and accompanying text. It is akin to burning down a house to cover up a robbery. One might even liken it to the corporate income tax, which has been said to cost more in compliance than it raises in revenue.

264. Again, this may disserve the corporation by permitting the plaintiff to impute to the corporation all of the knowledge and actions of individual directors and officers even though no one of them alone might have had the requisite scienter to support a claim. *See, e.g.*, *City of Monroe Emps. Ret. Sys. v. Bridgestone Corp.*, 399 F.3d 651, 656–58, 690–91 (6th Cir. 2005) (affirming the dismissal of claims against the individual defendants as directors and officers of a corporation, but nonetheless holding that the facts supported scienter for corporate defendants where the corporation engaged in a variety of tactics to keep the scope of a safety problem hidden from safety regulators). The question whether an individual actor must have acted with scienter, or at least have had the requisite knowledge and authority, has only recently come to the fore. *See, e.g.*, *City of Roseville Emps. Ret. Sys. v. Horizon Lines, Inc.*, 442 F. App'x 672, 676 (3d Cir. 2011) (discussing plaintiff's contention that it may plead scienter against the corporation without successfully pleading a claim against any individual). It is interesting that this question has never been settled, even though it came up very early in the evolution of securities litigation under Rule 10b-5, albeit before it was clear that scienter was required. *See SEC v. Tex. Gulf Sulphur Co.*, 401 F.2d 833, 855 (2d Cir. 1968) (citing 15 U.S.C. §§ 771(a)(2), 77q(a)(2)–(3) (2006); *Barnes v. Osofsky*, 373 F.2d 269, 272 (2d Cir. 1967); *Fischman v. Raytheon Mfg. Co.*, 9 F.R.D. 707, 710–11 (S.D.N.Y. 1949), *rev'd*, 188 F.2d 783, 789 (2d Cir. 1951)). It may also be that worries about how to identify individual wrongdoers has discouraged the development of a derivative remedy. Indeed, this has been an obstacle in efforts to recover from individuals in class actions. In contrast, the idea that the corporation is liable for the acts of its directors and officers avoids this problem by ignoring it. As a matter of corporation law, the board of directors is viewed as a single unit for purposes of liability, at least in the absence of formal objection by one or more individual members. *See MODEL BUS. CORP. ACT* § 8.30 (2010). No such doctrine applies to the officers as a group. On the other hand, insurance against derivative liability could fix the problem of who is responsible by covering the directors and officers as a group. *See supra* note 256 and accompanying text. Indeed, the law is clear that a corporation is free to buy whatever insurance it can obtain, even if the coverage offered exceeds the permissible scope of indemnification. *See supra* note 255 and accompanying text.

265. *See supra* note 199 and accompanying text.

him.²⁶⁶ Although it is not a complete answer, it is a pretty good answer. Moreover, one can hardly fault a judge—or anyone else—for failure to ideate. Although it may seem obvious—once the argument is laid out as it is here—that derivative claims are imbedded within class claims, there is a first time for everything.²⁶⁷

C. Other Factors

There are numerous other factors that tend to muddle thinking on the proper characterization of securities fraud claims.

One such factor is the weight of history. It may be that no one has considered the possibility that a cause of action so well established as the direct class action by buyers for damages can be challenged by private litigants.²⁶⁸

Another closely related factor is that financial recovery by the corporation seems to be totally at odds with individual recovery from the corporation by those who bought shares. What would be the sense in recovery both *in favor of* the corporation and *against* the corporation? Needless to say, the problem with this argument lies in the premise that a remedy against the corporation makes sense. Nevertheless, given that the direct class action remedy is so well

266. I posed this question to Judge Lewis Kaplan following a lecture he delivered on October 29, 2009, at the University of Pennsylvania Law School. Judge Lewis Kaplan, Lecture at University of Pennsylvania Law School (Oct. 29, 2009). *But see* LaSala v. Bordier et Cie, 519 F.3d 121, 137 (3d Cir. 2008) (concluding that a claim remained derivative despite having been assigned to plaintiff class).

267. For example, before 1976, no one seems to have thought of the possibility that a corporation could seek dismissal of a derivative action in which its own directors were named as the defendants. *See* Gall v. Exxon Corp., 418 F. Supp. 508, 509 (S.D.N.Y. 1976); *see also* Zapata Corp. v. Maldonado, 430 A.2d 779, 781 (Del. 1981) (citing Abbey v. Control Data Corp., 603 F.2d 724 (8th Cir. 1979); Lewis v. Adams, No. 77-266C (N.D. Okla. Nov. 15, 1979); Siegal v. Merrick, 84 F.R.D. 106 (S.D.N.Y. 1979); Maldonado v. Flynn, 485 F. Supp. 274 (S.D.N.Y. 1980), *aff'd in part, rev'd in part*, 671 F.2d 729, 732 (2d Cir. 1982)) (addressing the split among federal courts on whether the business judgment rule “enables boards . . . to terminate derivative suits”); Auerbach v. Bennett, 393 N.E.2d 994, 1000 (N.Y. 1979) (“Derivative claims against corporate directors belong to the corporation itself. . . the decision whether and to what extent to explore and prosecute such claims lies within the judgment and control of the corporation’s board of directors.”). Moreover, the argument that class claims are, in fact, derivative is based on an understanding of both finance and civil procedure that is not likely in the wheelhouse of many.

268. It is easy enough to see how a cause of action evolved under Rule 10b-5 at a time when most investors were undiversified. Since investors who buy new shares in an offering may sue under the 1933 Act, *see supra* note 2, it must have seemed terribly unfair that those who buy shares on the open market during the offering have no remedy unless they can somehow trace the shares they bought to the offering. *See* Richard A. Booth, *The Missing Link Between Insider Trading and Securities Fraud*, 2 J. BUS. & TECH. L. 185, 194 (2007). Thus, it is understandable how the courts were persuaded to imply a remedy under Rule 10b-5. Although the rationale behind the 1933 Act’s remedy of disgorgement of funds raised under false pretenses does not apply unless the company itself has sold shares, *see id.*, it is easy enough to see how the courts might imply a remedy under Rule 10b-5 if they are focused instead on investor protection.

established, it takes a radical rethinking of the legal regime—such as set forth here—to see the sense in recovery of money damages by the corporation.²⁶⁹

Yet another factor is that there may be doubt about how to proceed in federal court and indeed whether the corporation even has standing to sue under Rule 10b-5.²⁷⁰ While a derivative action may be heard pursuant to the court's supplemental jurisdiction over state law claims arising from the same facts as a Rule 10b-5 action on behalf of a buyer class,²⁷¹ it is not so clear that a federal court may hear a stand-alone derivative action or exercise supplemental jurisdiction if the derivative action is treated as the main event and the direct class action is treated as incidental thereto.²⁷² Since the corporation is typically neither a buyer nor seller of its own stock in situations giving rise to class actions, it could be argued under *Blue Chip Stamps* that the corporation has no standing to sue and that a derivative action should therefore be dismissed to the extent that it is based on a theory of fraud under federal securities law.²⁷³ Indeed, the possibility of sanctions under FRCP Rule 11 may deter some lawyers from making many of the arguments proposed here.²⁷⁴

269. It has also been suggested that federal law may have preempted state law as it relates to issues of disclosure, but the weight of authority seems to be to the contrary. See *Pfeiffer v. Toll*, 989 A.2d 683, 701–02 (Del. Ch. 2010) (rejecting the argument that the federal insider trading regime leaves no room for a state corporate remedy), *abrogated on other grounds by Kahn v. Kolberg Kravis Roberts & Co.*, 23 A.3d 831 (Del. 2011).

270. See *supra* note 215 and accompanying text.

271. See 28 U.S.C. § 1367(a) (2006).

272. See Booth, *Derivative Claims*, *supra* note 170, at 316 & n.81.

273. See *supra* note 215 and accompanying text.

274. See Booth, *Derivative Claims*, *supra* note 170, at 323–24 & n.97. There may be cases in which the issuer corporation has either sold or bought stock in connection with the fraud, aside from cases arising under the 1933 Act. In such cases, it may be appropriate for the corporation to be liable to the extent of any gain enjoyed by the corporation. But the focus here is on securities fraud claims that do not depend on any trading by the corporation. One interesting (and likely) possibility is that the defendant corporation itself may have repurchased shares during the class period, for example, in order to offset a grant of stock options. Booth, *The End of the Securities Fraud Class Action*, *supra* note 3, at 29 n.81. If so, the corporation itself may be a member of the plaintiff class. See *id.* (citing *United States v. O'Hagan*, 521 U.S. 642, 661–62 (1997)). On the other hand, it seems unlikely in any meritorious case that the corporation would have bought overpriced shares, since it is ultimately up to management to order a repurchase. See, e.g., *In re Citigroup Inc. S'holder Derivative Litig.*, 964 A.2d 106, 136–37 (Del. Ch. 2009) (involving claim that corporation repurchased overpriced shares). To be sure, a corporation might be tempted to sell shares under such circumstances, but corporations seldom sell shares to the general public outside the scope of the 1933 Act. See *supra* note 215. Needless to say, the situation is different in a good-news case, where it is entirely possible that the corporation may purchase shares—possibly on autopilot—in advance of a release of good news. See, e.g., *SEC v. Tex. Gulf Sulphur Co.*, 401 F.2d 833, 847 (2d Cir. 1968) (involving claim against defendants who purchased shares in between the corporation's discovery of “good news” and its official and full public disclosure of that news). If so, it may be appropriate for the corporation to disgorge its gains. See *supra* note 2. But since good-news cases are quite rare, so too is this situation. See *supra* note 29.

Needless to say, a derivative action can always be pursued in state court,²⁷⁵ but it is not clear that a federal court would defer to a state court.²⁷⁶ If anything, the state court would likely defer.²⁷⁷ Or the derivative action might be removed to federal court if only for purposes of settlement. Either way, we are back where we started with the class action taking precedence over the derivative action.

Although the *Blue Chip Stamps* doctrine is somewhat worrisome, there is good reason to think that it should not apply in connection with a derivative action.²⁷⁸

First, section 16(b) of the 1934 Act expressly contemplates derivative actions in the case of short-swing trading, even though the corporation is neither a buyer nor a seller of its own stock.²⁷⁹ While this section applies narrowly to permit the corporation to force disgorgement of short-swing profits by statutory insiders,²⁸⁰ it must be kept in mind that the right of buyers to sue under Rule 10b-5 is a judicially implied cause of action subject to judicially imposed limitations on standing.²⁸¹ In contrast, section 16(b) is an express cause of action running to the issuer corporation in circumstances in which the corporation neither buys nor sells its own stock.²⁸² This would seem to be a rather strong indication that if there is a private cause of action under Rule 10b-5, an issuer corporation should be able to assert it in the context of a derivative action.²⁸³ Moreover, Congress was quite careful to preserve derivative actions by exempting them from preemption or mandatory removal under SLUSA.²⁸⁴ Indeed, SLUSA defines a covered cause of action in the same terms used by the Supreme Court in *Blue Chip Stamps*—a class action based on a misrepresentation in connection with the purchase or sale of securities.²⁸⁵

275. See *supra* notes 170–71 and accompanying text.

276. See Booth, *Class Conflict*, *supra* note 7, at 725 & n.48.

277. Compare Brenner v. Albrecht, No. 6514 VCP, 2012 WL 252286, at *6–7 (Del. Ch. Jan. 27, 2012) (granting stay on theory that derivative recovery depends on loss from class action) with Pfeiffer v. Toll, 989 A.2d 683, 695–708 (Del. Ch. 2010) (emphasizing consistency and interdependence but differing goals of state and federal law and advocating coordination with federal action rather than deference), *abrogated on other grounds by* Kahn v. Kolberg Kravis Roberts & Co., 23 A.3d 831 (Del. 2011). See also *In re Massey Energy Co.*, No. 5430 VCS, 2011 WL 2176479, at *20–21 (Del. Ch. May 31, 2011) (discussing likelihood of success of derivative action in such circumstances).

278. See Booth, *Derivative Claims*, *supra* note 170, at 312–13 (citing *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 731 (1975)).

279. See *id.* at 313.

280. See Securities Exchange Act of 1934 § 16(b), 15 U.S.C. § 78p(b) (2006).

281. See *Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit*, 547 U.S. 71, 80 (2006) (citing *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 737 (1975)).

282. See *supra* note 215 and accompanying text.

283. See *supra* note 215 and accompanying text.

284. See *supra* notes 217–20 and accompanying text.

285. See *Dabit*, 547 U.S. at 82–84 (citing 15 U.S.C. § 78bb(f)(1)(A)–(B) (2006); *Blue Chip Stamps*, 421 U.S. at 737, 749).

Second, Rule 10b-5 largely depends on state law fiduciary duties running to the issuer corporation for purposes of determining whether there is a duty to disclose.²⁸⁶ For example, under the prevailing misappropriation theory, a seller of stock who has knowledge of material nonpublic information indicating that it is overpriced is guilty of insider trading only if that seller owes a duty to the source of the information—typically the issuer corporation—not to use the information for personal gain.²⁸⁷ Thus, the courts have held that an open-market buyer of overpriced stock has no implied claim against a seller since the seller's breach, if any, is one of a duty running to the corporation not to use inside information for personal gain.²⁸⁸ Under these circumstances, it would be quite odd to say that the corporation has no claim.²⁸⁹

Finally, many observers seem to think that legislation or an SEC rule would be required to effect any change from the status quo. Accordingly, some scholars have argued that the SEC should adopt a rule abolishing the implied cause of action under Rule 10b-5.²⁹⁰ Others have argued for a system in which the SEC would act as a gatekeeper or supervisor for private securities litigation, in an effort both to preserve the benefits of private litigation and to curb its excesses.²⁹¹ The essential idea is that a private action would require SEC review and permission in order to proceed.

Neither of these unlikely steps is necessary.

First, the courts have the power and the responsibility to recharacterize securities fraud class actions as derivative actions as explained at length

286. See Booth, *Class Conflict*, *supra* note 7, at 735.

287. See *United States v. O'Hagan*, 521 U.S. 642, 652 (1997) (concluding that, under the misappropriation theory, a fiduciary who engages in insider trading defrauds the principal in connection with the purchase or sale of securities by misappropriating the principal's information for personal gain).

288. See *Moss v. Morgan Stanley Inc.*, 719 F.2d 5, 13, 14, 15 (2d Cir. 1983).

289. As the Supreme Court stated in *Dabit*, "it is enough that the fraud alleged 'coincide' with a securities transaction—whether by the plaintiff or by someone else." 547 U.S. at 85; *see also* SEC v. Zandford, 535 U.S. 813, 820, 822 (2002) ("It is enough that the scheme to defraud and the sale of securities coincide."); *Wharf (Holdings) Ltd. v. United Int'l Holdings, Inc.*, 532 U.S. 588, 594 (2001) (framing the Rule 10b-5 inquiry around whether the fraud "amounted to a misrepresentation . . . in connection with the sale of the option"); *Superintendent of Ins. of N.Y. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 12 (1971) (stating that where fraud was used in connection with a sale of a security, there is redress under Rule 10b-5).

290. See Bratton & Wachter, *supra* note 165, at 75–76; Joseph A. Grundfest, *Disimplying Private Rights of Action Under the Federal Securities Laws: The Commission's Authority*, 107 HARV. L. REV. 961, 965–66 (1994).

291. See Bratton & Wachter, *supra* note 165, at 166; Fox, *Civil Liability and Mandatory Disclosure*, *supra* note 23, at 292–94; Fox, *Why Civil Liability?*, *supra* note 23, at 320–21; Rose, *supra* note 23, at 1354–56; *see also* Coffee, *supra* note 12, at 1538 (asserting that the imposition of significant financial damages is beneficial to the overall goal of deterrence but that those damages need to be shifted to fall more on the culpable and less on the innocent); Fisch, *supra* note 23, at 320–21, 339–40, 349–50 (proposing a complete redesign of the civil liability system whereby the beneficial deterrent effect on disclosure violations is at least as good as the current system but the damages bear a much closer relation to the actual social harm caused by the violation).

above.²⁹² Derivative actions afford an elegant solution to many of the problems that go with class actions.²⁹³ Most important, by limiting recovery to the true loss suffered by investors, derivative actions eliminate the excess incentive to sue and the excess deterrence that goes with it.²⁹⁴ In other words, derivative actions provide optimal deterrence against securities fraud.²⁹⁵

Second, as noted above, a derivative action will lie whenever a class action can survive a motion to dismiss.²⁹⁶ In both cases, the action will proceed if and only if the plaintiff can show scienter.²⁹⁷ While there may be subtle variations in the way federal and state courts define scienter—as there are in federal court anyway—the universe of cases in which a class action may be maintained is essentially congruent with that in which a derivative action may be maintained.²⁹⁸

Third, derivative actions are superior to the alternative of supervised private securities litigation because they avoid the need for the SEC to choose which cases will proceed and the politics that inevitably would go with such administrative discretion. In a regime based on derivative actions, the market would decide on the cases to file based solely on the merits—the likelihood of success—as a measure of potential recovery that is consistent with the true loss suffered by investors.

D. Index Funds

The ultimate question—the proverbial elephant in the room—is why index funds have failed to oppose securities fraud class actions and to advocate for a derivative remedy.

One possible explanation is that, up until now, no one has connected the dots as set forth herein. In other words, it may be that no one has noticed that a portion of the typical class claim is actually derivative, rather than direct. It is also possible that no one has noticed the cost. While it is difficult not to notice a big settlement check, it may not be so clear how the prospect of litigation might have enhanced the loss upfront by even more than the amount recovered.²⁹⁹

292. *See supra* Part IV.

293. *See supra* Part IV.

294. *See supra* notes 47–50 and accompanying text.

295. *See supra* notes 47–50 and accompanying text.

296. *See supra* note 170 and accompanying text.

297. *See supra* note 170.

298. Again, there is no reason to worry about the possibility of voluntary dismissal by the corporation since the business judgment rule does not protect a breach of the duty of candor made with scienter. *See supra* note 169 and accompanying text. In other words, whenever there is a meritorious claim under Rule 10b-5, there will be a meritorious claim for a breach of state law fiduciary duties by the individual wrongdoers. *See supra* note 170 and accompanying text.

299. Moreover, the loss from feedback presumably happens immediately upon corrective disclosure. *See supra* note 63 and accompanying text. Thus, an index fund manager might view the loss as so much water under the bridge and reason that it makes sense to seek whatever recovery

It is also possible that funds worry that in the absence of securities fraud class actions, there might be so much more securities fraud that investors would be worse off.³⁰⁰ Indeed, as noted above, legal scholars generally agree that class actions make little sense as a compensation scheme but that they serve an important deterrence function.³⁰¹ So index fund managers might reckon that there may be some value in the deterrent effect of securities fraud litigation even though the cost is borne disproportionately by index fund investors.³⁰² While altruism may be nice, it does not seem likely that fund managers would knowingly sacrifice return for the benefit of investors who follow inferior strategies.³⁰³ Even if they did, fund holders would presumably object that it constitutes a breach of fund managers' fiduciary duty to fund investors.³⁰⁴

It is also possible that index funds have considered the matter and concluded that there is nothing that can be done to avoid the costs associated with recovery by other investors, but it is difficult to believe that no index fund appears to have made any effort to oppose securities fraud class actions. Thus, in the end, the most likely explanation would seem to be that index funds simply do not appreciate the costs associated with class actions.³⁰⁵

Finally, and perhaps most likely, some funds may be reluctant to take the lead—irrespective of the form of the action—for fear of offending important customers. For example, a fund adviser might worry that a defendant company would eliminate the fund as a choice in its menu of options for employee retirement plans. Or, it may be that fund advisers might lose other business in connection with investment management for defendant companies. Or a

might be available. Needless to say, this does not change the fact that the loss is the result of a payout by the defendant company that would not happen but for the class action. *See supra* notes 9–10 and accompanying text. Moreover, if the court refuses to certify the class, market price will presumably rebound to reflect the fact that the feedback loss did not come to pass as expected. *See supra* notes 9–10 and accompanying text. If the loss can thus be recouped, it makes sense to oppose class certification. Still, a big settlement check is a bird-in-hand.

300. *See supra* note 12.

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

302. *See supra* notes 7, 19 and accompanying text.

303. *See* HAMILTON & BOOTH, *supra* note 20, at 36 (asserting that “rational investors diversify”).

304. On the other hand, fund managers might figure that diversified investors should be indifferent to securities fraud anyway and should thus view any recovery at all as gravy, which would also preserve whatever beneficial deterrent effect may go with class actions. The fallacy, as noted above, is that enforcement and reputation losses cause stock prices to fall further than they otherwise would fall, thus dragging down the average return enjoyed by diversified investors. *See supra* notes 7–10 and accompanying text. In other words, a diversified investor is indifferent only to losses that cannot be prevented. *See supra* notes 88–89 and accompanying text. Moreover, given attorney fees and other litigation expenses, the recovery from a class action can never make up for the loss generated by the class action itself. *See supra* note 25 and accompanying text. Thus, the idea that a diversified investor is indifferent to securities fraud is total double-think.

305. The same goes for index fund investors. If fund investors understood the costs, presumably someone would have filed a derivative action against his fund to compel the fund to protect investor interests.

managed fund might lose access to information about defendant companies. On the other hand, fund managers might choose initial cases involving companies that are likely to fail as a result and that offer little prospect of other investment management business anyway.³⁰⁶ Indeed, it appears that fund managers often opt out in such cases and pursue individual remedies precisely because there is no apparent downside.³⁰⁷ Presumably, it would take only a few such derivative actions to prompt the plaintiff bar to follow the lead. So it is not clear that a fund manager would need to risk much to get the ball rolling. Moreover, and more important, it is the right thing to do to serve fund investor interests.³⁰⁸

VI. CONCLUSION

Most legal scholars agree that securities fraud class actions do little to compensate investors. First, diversified investors are indifferent to the normal ups and downs of stock prices. Second, since the defendant company funds the settlement in a successful class action, holders effectively pay buyers. So stock price falls by an additional amount when a fraud is discovered to reflect not only the fraud but also the anticipated payment in a class action. Despite the inherent circularity, class actions survive, in part because the cost to holders is hidden while the benefit—a big settlement check—is quite visible. Since a diversified fund investor is almost always also a holder in any case in which it is a buyer, it suffers a bigger initial loss because of the class action remedy.

In this Article, I describe a method by which one can measure the *net* effect of class actions on fund investors who are both buyers and holders of a fraud-affected stock. As it turns out, index funds almost always lose more than they gain. Thus, securities fraud class actions systematically penalize rational investors for the benefit of undiversified stock-picking investors who happen to buy during the fraud period. Accordingly, index funds should oppose securities fraud class actions as contrary to the best interests of fund investors.

306. Moreover, there are some funds that need not worry about offending potential customers for investment management and pension services—for example, TIAA-CREF comes immediately to mind. See, e.g., Kevin LaCroix, *Are Securities Class Action Opt-Out Actions Back?*, D&O DIARY (Aug. 1, 2011, 4:06 AM), <http://www.dandodiary.com/2011/08/articles/optouts/are-securities-class-action-optout-actions-back/> (discussing numerous investment management and pension services opting out of a large securities class action lawsuits and specifically listing TIAA-CREF as a large institutional investor that opted out of a large class action lawsuit). In addition, state, local, and union pension funds would seem to be likely candidates, although they may be more inclined to make political hay by suing corporations. See, e.g., *id.* (listing several state and local pension funds opting out of a large class action lawsuit). It will be interesting to see if such funds become less active in the wake of the Supreme Court's decision in *Citizens United v. Fed. Election Comm'n*, 130 S. Ct. 876, 913 (2010).

307. See, e.g., LaCroix, *supra* note 306 (remarking on the increased prevalence of securities class action opt outs and discussing a particular securities fraud class action lawsuit where investment funds opted out under the impression that they would recover more than they would if they remained in the class).

308. See *supra* note 125 and accompanying text.

One possible problem is that in the absence of the deterrent effect of private securities litigation, there might be more securities fraud and investors might be worse off. The answer is that whenever there is a meritorious class claim, the corporation itself will also have a claim against the individual wrongdoers who perpetrated the fraud. Although the corporation's claim is limited to the costs of litigation and any increase in its cost of capital resulting from reputational harm, the claim is quite substantial from the point of view of individual defendants and thus constitutes a significant deterrent. In a class action, these elements of loss are imbedded in the decrease in price that occurs when the fraud is discovered. But these losses are suffered by the corporation—all of the stockholders—and thus should be the subject of a derivative action for the benefit of the corporation, not a class action for the benefit only of those who bought during the fraud period. Not only is feedback loss eliminated, but the corporation is also restored in value to the extent of any recovery.

The clear implication is that index funds should oppose securities fraud class actions and favor derivative actions. Indeed, index funds owe a duty to their investors to do so. Happily, the Federal Rules of Civil Procedure provide a solution. No action may proceed as a class action unless the court certifies it as a proper class action, and no action may be so certified if there is a better way to litigate the issues. The law is clear that a claim that *can* be handled as a derivative claim *must* be handled as a derivative claim. The only problem is that someone must make the argument.

APPENDIX: SECURITIES FRAUD CLASS ACTIONS BY YEAR

Year	Number of Filings	Foreign	DDL \$B	Settle #	Settle \$M
1996	111	6	14		
1997	174	6	42	14	150
1998	242	18	80	29	444
1999	209	10	140	65	1123
2000	216	12	250	90	4701
2001	180	14	198	95	2108
2002	224	21	201	111	3008
2003	192	16	77	94	2693
2004	228	27	144	110	3626
2005	182	25	93	119	10182
2006	119	13	52	90	18603
2007	177	29	158	108	7600
2008	223	30	221	97	2798
2009	168	20	84	101	3793
2010	176	28	72	86	3119
TOTALS	2821	275	1826	1209	63948

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