Stockholders always lose in a securities fraud class action.

The Missing Link Between Insider Trading and Securities Fraud

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It has been nearly 40 years since the Second Circuit handed down its landmark opinion in *SEC v. Texas Gulf Sulfur Company*. In that case, Texas Gulf Sulfur (TGS) had found an unusually rich deposit of ores near Timmins, Ontario. When rumors of the strike began to circulate, the company downplayed the event by issuing a pessimistic press release. In the meantime, several directors and officers purchased stock and call options. Several others received stock options as compensation. When the company issued a corrective press release, the price of TGS stock rose dramatically and the insiders who had acquired stock and options enjoyed a handsome profit.

The resulting litigation raised a mother lode of legal issues. It was both a classic false press release securities fraud case (complete with duty-to-correct issues arising from rumors originating in the company) and an insider trading case. It even raised intriguing issues about the legality of an insider accepting stock options while in mere possession of material nonpublic information. The Second Circuit found violations of federal securities law — in particular Rule 10b-5 — in each of those transgressions. Although the court did not get the law right in every respect, the result would clearly be the same today. But the case may well have been decided differently if it had not involved *both* a false press release and insider trading. Standing alone, the false press release might have been excused as a mistake of business judgment — a good-faith effort to quell rumors while gathering facts.

The decision in *TGS* is largely silent as to the appropriate remedy in a private civil action. Because the decision came in an enforcement action, it was not necessary for the court to address that issue. But if the court had done so, there is a good chance that it would have concluded that those who traded on inside information should disgorge their gains to the issuer, TGS, because that is the statutory remedy for short swing trading specified in Section 16(b) of the Exchange Act.

In the meantime, securities fraud and insider trading have become well established as independent causes of action and the courts and Congress have struggled to devise appropriate remedies for each. But the connection between securities fraud and insider trading matters. A securities fraud class action should be dismissed for failure to state a claim unless it appears that insiders have used the occasion to misappropriate stockholder wealth. (By "misappropriation" I mean something broader than what constitutes insider trading under federal law.) There are two related reasons: First, rational investors diversify, making securities fraud without misappropriation a zero-sum game. Second, securities fraud class actions generate deadweight losses for diversified investors. In the aggregate and over time, diversified investors suffer reduced returns from securities fraud class actions — not from securities fraud. A rational investor would therefore prefer the abolition of such actions except where there is diversion of stockholder wealth by insiders.

The appropriate remedy for misappropriation is for the culprits to disgorge their ill-gotten gains to the issuer. Such

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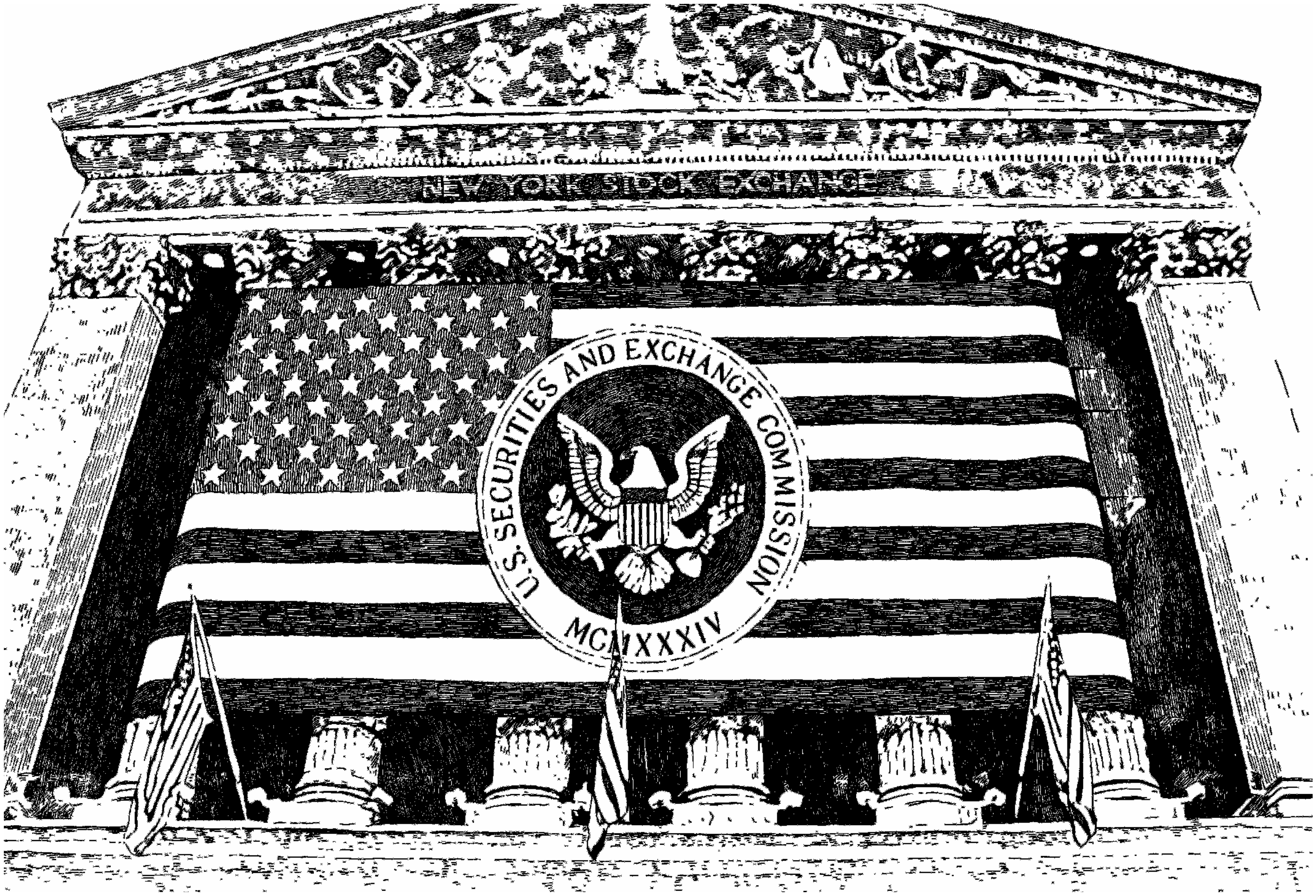

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actions should be characterized as derivative actions rather than class actions — that is, actions brought by shareholders on behalf of the corporation rather than on behalf of shareholders themselves. That in turn carries significant implications. A derivative action based on insider gain may be maintained in state court as well as federal court, thus avoiding the strictures of the Securities Litigation Uniform Sanctions Act (SLUSA). Indeed, most such actions likely would migrate to state court because they would be based primarily on allegations of breach of fiduciary duty (which is more expansive than insider trading as defined under federal law) and because state law remedies for breach of fiduciary duty are more generous than the strict out-of-pocket rule embodied in federal securities law.

THE EXISTING (FLAWED) SYSTEM

Most securities fraud cases involve the cover-up of bad news that drives down the price of the subject company stock when it ultimately comes to light. Securities fraud can also involve withholding good news — as in *TGS* — but that is much less common. In most cases, securities fraud is litigated as a class action in federal court. Indeed, under SLUSA securities fraud class actions *must* be litigated in federal court. Likewise, insider trading is usually the subject of federal criminal prosecution. There were a few early cases that suggested that state law might provide a remedy, but the law varied considerably from state to state. In any event, federal law also predominates in this area.

Although federal jurisdiction over these claims is well established, it is also well recognized that there are problems with the federal approach. In the case of securities fraud, the subject company pays the settlement or award. Thus, in a bad news case, buyers are made whole at the expense of holders — because the company pays — while those who sell during the fraud period effectively enjoy a windfall. As for insider trading, the culprit must disgorge gains and may pay a penalty of up to three times that amount. Moreover, the culprit often goes to jail. Theoretically, investors who traded contemporaneously can recover. But the recovery is likely to be miniscule when spread over many plaintiffs because it is limited to insider gains.

In the real world, the vast majority of investors are well diversified. Indeed, more than three-quarters of all stock is held by well-diversified investors. Accordingly, it seems fair to presume that securities law should reflect the needs and preferences of diversified investors. For a diversified investor who trades occasionally — for portfolio balancing, tax planning, and so forth — the risk of securities fraud is like any other company-specific risk: you win some, you lose some. Only the average matters. Thus, a diversified investor is indifferent to securities fraud except when it is accompanied by insider trading or other forms of misappropriation.

Think of the market as the pot in a poker game. In the absence of insider trading, every player faces the same odds. With insider trading, some traders are able to win a bit more often than they should. Although outsiders may still be winners overall (because, on the average, stocks increase in value over time), they will not enjoy their fair share of the gain.

So what happens if the players discover that one of them cheated on the last hand? Aside from possible gunplay, how would the group address the situation? Although the player with the second-best hand might argue that he would have won the pot but for the cheater, a more likely remedy would be a do-over. The group would likely require the cheater to return his winnings to the pot and then replay the hand. (They might also bar the cheater from further play, but that is another article.)

Similarly, *ex ante*, diversified investors would want insiders to disgorge their ill-gotten gains. Individual recovery by class action makes no sense: that is equivalent to giving the pot to the player with the second-best hand rather than replaying the hand. The appropriate remedy is for the company to recover. In other words, the appropriate remedy is a derivative action by which the cheaters disgorge their gains back to the company and make the pot whole once again.

That is not the system we have. In a bad-news securities fraud class action, the company pays those who bought during the fraud period. And those who sold keep their gains (or losses avoided). Holders — those who neither bought nor sold — lose to the extent that the value of the company falls further because of the payout. Indeed, because the value of the company falls more, damages are further magnified through positive feedback. Holders, who would have seen the price of their stock fall anyway, lose even more because of the effects of securities fraud class actions. (Incidentally, that is why bad news cases are so much more common than good news cases: the system of securities fraud class actions actually magnifies the damages in bad news cases, while it mutes the price increase in good news cases.)

Diversified investors — the vast majority of investors — would be better off if securities fraud litigation were limited to cases in which the company sought recovery of insider gains. Diversified investors have nothing to gain from individual recovery in a securities fraud class action. The expense of litigation is thus a deadweight loss. But more important, even if gains and losses net out because a diversified investor is equally likely to sell as buy, a diversified investor always loses when he is a holder. The bottom line is that in a world without securities fraud class actions, investors would see better returns.

BRIEF HISTORY OF SECURITIES FRAUD LITIGATION

So how is it that federal securities law took this particular wrong turn in its evolution? It seems likely that individual recovery became the rule in securities fraud class actions by analogy to recovery under the Securities Act of 1933. Under that act, all public offerings of securities must be registered with the SEC. If there is a material misstatement of fact in the registration statement or prospectus, investors who bought the offered securities can sue for damages or rescission. The issuer is absolutely liable. The investor need not even prove reliance. But recovery is limited to the amount of money raised by the issuer. Thus, the remedy under the act is essentially one of disgorgement. And only those investors who bought securities that were part of the offering may recover.

In an initial public offering (IPO), this remedy is simple to administer. After an IPO, all of the public stockholders hold shares that were part of the offering. But the 1933 Act also requires registration of subsequent offerings by companies that are already publicly traded. In such cases, the courts have held that only those investors who buy shares that are part of the offering can recover. That requires the tracing of shares from investor to investor. The perceived problem is that with a subsequent offering, investors may read the offering materials and rely on misstatements therein. Practically speaking, no one knows whether shares bought on the open market are part of the offering or not, but all buyers suffer the same loss. Accordingly, buyers who bought *outstanding* shares argued that they should be able to recover under the 1934 Securities Exchange Act and Rule 10b-5. The courts agreed, viewing the distinction between new shares and old shares as essentially accidental. So it became more or less automatic to add a count under the 1934 Act and Rule 10b-5 to claims under the 1933 Act. It was a small step to assert such claims outside the context of an offering.

There is, however, an important distinction between cases arising under the 1933 Act and cases involving outstanding shares. The fact that individual investors recover under the 1933 Act derives from the fact that the company must disgorge the money it obtains from the sale of stock. In an action under the 1933 Act, the complaint is that the issuer has misappropriated investor wealth and should give it back. In contrast to the result in a securities fraud class action — where holders in effect pay buyers and sellers keep their windfall gains — disgorgement by the company under the 1933 Act simply returns investors to the status quo ante.

MISAPPROPRIATION AND INSIDER TRADING

What worries a diversified investor is whether insiders take money out of the pot contrary to reasonable expectations and without assuming the same risks as the other players. At first, this sounds like insider trading. But insider trading has proved difficult to define. Neither Congress nor the Securities and Exchange Commission has been able to settle on a definition. Thus, it has been up to the courts to define insider trading as a matter of case law. In general, the courts have defined insider trading as using material nonpublic information in violation of a duty to the source of the information not to use the information for personal gain.

This definition of insider trading is arguably too narrow from the point of view of a diversified investor who is worried about playing in a fair game. The flap over timing and backdating in connection with the grant of stock options affords a good example of insider diversion of stockholder wealth that probably does not rise to the level of actionable insider trading. Presumably, a corporation's board of directors often possesses material nonpublic information at the time it grants options. And in the case of outright backdating, the board of directors knows that the value of the stock has risen in the meantime. But because the corporation itself is a party to the trade, it is deemed to know any material nonpublic information. There is no insider trading.

Although timing and backdating do not appear to constitute insider trading under federal law, such practices may, and likely do, constitute a breach of fiduciary duty under state law. Thus, if securities fraud is characterized as derivative in nature, it does not matter whether such practices or any other diversion of stockholder wealth amounts to insider trading or any other recognized form of securities fraud. The only question is whether or not the practice is consistent with the reasonable expectations of stockholders.

Using timing and backdating of options as examples, there are several ways that state law might address these issues in the context of a derivative action. First, such practices may constitute a breach of the duty of loyalty if the recipients participated in approving the questionable grant of options. Aside from the possibility that the CEO and other high-level employees may control what the board of directors knows and may sit idly by while the board of directors makes a windfall grant — as happened in *TGS* — it is not at all clear that public stockholders would approve of such tactics, especially if they entail withholding ripe information from the market. Second, if the issuer has adopted a stock option plan, a questionable grant may be challenged as a violation of a standard of the corporation — essentially a breach of contract — if it is contrary to the terms of the stock option plan. Third, a questionable grant may be challenged as a violation of the duty of care or the duty of good faith if the board of directors (or a committee thereof) failed to exercise reasonable business judgment in deciding to grant options at a price lower than fair market value on the actual date of the grant. Finally, such practices may violate the duty of candor.

The duty of candor is key in this setting because it is easy for a well-advised board or compensation committee to avoid a violation of the duty of care or the duty of loyalty. And if the stock option plan is carefully worded, timing and backdating may be permissible. Thus, the duty of candor may comprehend many questionable grants when the other theories do not. Moreover, the duty of candor is focused on what matters most in the context of timing and backdating: it is crucial for the market to be fully informed for options to work properly.

First, the idea of using options as compensation is to create an incentive for managers to maximize stock price and to reward them when stock price rises. Thus, it is important to assure that the grant occurs at the fair market price at the time of the grant. If the strike price is less than the fair market price (as it presumably is when timing or backdating is an issue), the optionee enjoys an immediate gain (albeit on paper). That is not necessarily a problem if that is what the board intends. But it is misleading if the grant is characterized as a grant of options.

Second, it is important for the market to know about the potential for dilution from the exercise of options. Market price depends on two numbers: the aggregate value of the firm and the number of shares outstanding. If the market does not know how many shares and options are outstanding, market prices are less trustworthy and options work less well.

The duty of candor is somewhat different from other forms of fiduciary duty. Obviously, the duty of candor is about disclosure. So one might argue (loosely) that federal law has preempted the field and that state law should keep out. To be more precise, the federal courts have exclusive jurisdiction of violations arising under the 1934 Act. So one might argue that all such cases must be filed in federal court. But that argument proves a bit too much. Many (if not most) state corporation law cases involve important issues of disclosure. For example, one very common issue is whether a director or stockholder vote may be deemed to have ratified what might otherwise be a self-dealing transaction. And the central question in most such cases is whether there was adequate disclosure of the conflicting interest. So it would seem difficult to argue that duty of candor cases must be litigated in federal court.

Nevertheless, in a conventional breach of fiduciary duty case, the nub of the matter is that the corporation has suffered financial harm at the hands of a director or officer or other agent. In a duty of candor case, it is difficult to see how the corporation is harmed except in some intangible reputational way. On the other hand, if insiders take advantage of a misinformed market to extract personal gain, investors lose even though the corporation itself suffers no financial harm. Recovery by the corporation still makes sense in such circumstances. The corporation is in a much better position to maintain such an action and investors are made whole if the corporation recovers.

One problem is that a stockholder action based on the duty of candor might be deemed to be a (direct) class action, precluded under SLUSA even though it seeks recovery by the corporation. After all, the ultimate beneficiaries of the recovery are the stockholders. But that is true of any derivative action. It is the very idea of a derivative action. Indeed, if anything, in doubtful cases the burden is on the party that seeks to characterize an action as direct rather than derivative. In other words, there is a presumption that an action that *can* be characterized as derivative *should* be so characterized.

THE NEED FOR A STATE LAW REMEDY

While the duty of candor should survive federal challenge as grounds for a state law cause of action, one might still argue that there is no need for a state law remedy in connection with such controversies as insider trading or timing and backdating of option grants or other forms of consensual misappropriation. There is plenty of federal law relating to insider trading. And there are elaborate SEC rules requiring extensive disclosures in connection with options. Moreover, state case law relating to fiduciary duty is notoriously vague. The cases tend to be so fact-specific that they have little precedential value. In many cases, the courts seem to resort to nebulous notions of fairness that give directors, officers, and other corporate agents little guidance for the future. One might therefore argue that however flawed the detailed SEC rules may be, they are superior to state case law construing the fiduciary duties of corporate actors.

There are several responses to this:

First, treating misappropriation claims as derivative is more consistent with underlying legal theory. The primary foundation for insider trading is misappropriation of information — usually from the issuer company. The duty not to use the information for personal gain is a state law fiduciary duty that runs to the issuer company. Federal law depends on state law in this context. If there is no violation of state law, there is no violation of federal law. If the duty runs to the issuer company, the issuer company should sue for disgorgement.

Second, treating such claims as derivative is more consistent with federal law. The remedy for short swing trading set forth in §16(b) of the 1934 Act is disgorgement of gain (or loss avoided) to the issuer company. And §16(b) expressly contemplates enforcement by derivative action if the issuer fails to seek disgorgement. To be sure, actions arising under §16(b) are relatively rare, but that is because it is triggered only by a purchase and sale within six months of each other. Although we now know that there are many other ways to engage in insider trading, it seems clear that the framers of the 1934 Act thought that the remedy for insider trading should be disgorgement to the issuer company. It is no answer to say that the 1933 Act clearly contemplates individual recovery. The 1933 Act is about disgorgement, not compensation.

Third, as for the argument that the SEC has promulgated detailed rules relating to many of the practices discussed here, such rules are necessarily reactive and incomplete. SEC rules are invariably adopted with a view to regulating abusive practices — generally through disclosure — after such practices have come to light because of some scandal. Moreover, SEC rules are inadequate precisely because they are detailed rules rather than principles. Detailed rules can be manipulated. With a detailed rule, it is much easier to devise a strategy of minimal compliance and skate close to the edge.

Fourth, the argument that state law is vague misses the point of how state law works — particularly Delaware law. In Delaware, most cases relating to corporation law are handled in the Chancery Court — a court of equity. With the merger of law and equity in most other jurisdictions, it is easy to lose track of the distinction. But a court of equity is more or less free to fill in the blanks of incomplete contracts and to reform a contract that does not comport with the bargain between the parties. A corporation is, in essence, a contract between stockholders and managers (and possibly other constituencies as well). Moreover, it (1) is a permanent contract with a life independent of any of the parties that (2) is difficult to change and that (3) all know to be incomplete in its particulars. Indeed, it is fair to say that the parties effectively agree to have the courts fill in the blanks in any situation in which the parties cannot settle the matter themselves through voting and other control mechanisms. In other words, there is an important role here for principles-based fiduciary duty and the case-by-case approach that it entails. It is not true that this system fails to provide guidance for corporate actors. When in doubt, a fiduciary must ask whether an act or practice is consistent with stockholder expectations. It is not good enough that a transaction merely comply with the letter of the law.

It is regrettable that fiduciary duty has become so bound up with notions of fairness. That is only natural where the ultimate issue is one of how to divvy up the wealth. In recent years, the courts have tended to shy away from fairness analysis and to gravitate to stockholder expectations as the norm. To be sure, this is a subtle shift but it does better capture the essence of what courts of equity do. For example, such an approach permits a court to consider the implications of stockholder diversification and to tailor stockholder rights and fiduciary duties accordingly. It may seem a bit odd to argue that vague notions of fiduciary duty are preferable to more-or-less bright line rules such as those promulgated by the SEC. But fiduciary duty is more consistent with the need to work out the evolving terms of the stockholder contract on an ongoing basis. And state courts are better able to evaluate the evolving interests of stockholders.

Here too, recent option controversies provide a good illustration. Some level of timing and backdating is inevitable and consistent with the good-faith administration of an option plan. The board of directors invariably has better information than public stockholders, so the stockholders cannot reasonably expect that options will be granted only when the board is clueless about the future. But if the board grants options while disclosable material facts are kept under wraps or if earnings are managed (say) to hold back a stock price increase until options can be granted, stockholders will not be so tolerant. A court of equity is well equipped to decide if options have been granted in a good-faith attempt to create incentives to grow the value of the company as opposed to a scheme to extract existing value. In contrast, federal securities law and SEC rules are not well suited to a fact-intensive analysis of the situation as a whole and whether fiduciaries have acted consistently with stockholder expectations. A federal court can do little more than look to the letter of the law.

This is not to say that federal law should not matter. A state court may presumably refer to federal law and SEC rules in deciding whether an insider has acted reasonably. If there has been a violation of SEC rules, that may constitute a per se violation of state law much as speeding constitutes negligence per se in connection with an automobile accident. In other words, if a corporation violates an SEC rule and insiders enjoy a gain (even if coincidentally), a state court may find a breach of fiduciary duty. Thus, federal law and SEC regulations would continue to play the lead role in setting minimum standards for disclosure. And the SEC would still have enforcement power. But the state courts would be able to apply stricter standards in case-by-case litigation under principles-based fiduciary duty law.

Although the Supreme Court recently reiterated "that private securities litigation is an indispensable tool with which defrauded investors can recover their losses — a matter crucial to the integrity of domestic capital markets," the truth is that private securities litigation is stuck in the 1960s when most stock was held by undiversified stock-picking investors. Securities fraud class actions might make some sense if one thinks of the reasonable investor as one who does his homework and invests his money in a few good stocks and not as a diversified investor who holds a portfolio of many stocks. It makes some sense in such a world to protect investors who rely in good faith on the accuracy of publicly available information — doing so fosters confidence in the markets. As Martha Stewart would say, that is a good thing. Nevertheless, holders always lose in a securities fraud class action because the company pays the damages. And in the case of insider trading, the system confers no significant benefit to investors other than the deterrence that comes from criminal prosecutions that fit the crime little better than O. J. Simpson's gloves fit his hands. Investors have grown up. So should the law. R