What's a Nice Company like Goldman Sachs Doing in a Place like the Supreme Court?

How Securities Fraud Class Actions Rip Off Ordinary Investors – And What to Do About It

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ABSTRACT

This essay considers the issues raised in the latest securities fraud class action to reach the Supreme Court – Goldman Sachs Group, Inc. v. Arkansas Teacher Retirement System – and finds that the claims asserted therein against Goldman Sachs on behalf of open-market buyers of its common stock are claims that should have been asserted on behalf of Goldman Sachs (by means of a derivative action) and against the individuals who caused the losses at issue. The losses suffered by individual buyers of Goldman Sachs stock during the extraordinarily long forty-month alleged fraud period are minimal if they exist at all. Moreover, the law is quite clear that claims on behalf of the company arising from the same constellation of facts should take precedence over any claims on behalf of individual buyers. Yet the practice that has evolved is the opposite: Class claims take priority, and company claims are settled for governance reforms of dubious value rather than for real money. The forces that have led to this classic example of market failure are both fascinating and sinister. But the bottom line is that ordinary investors – such as investors in well-diversified mutual funds and index funds – end up losing far more than they gain from class actions. Indeed, index fund investors effectively pay out about twenty dollars for every dollar they recover. Thus, the best hope for reforming the system is for index funds to step up and intervene to assert the interests of diversified investors in favor of litigating such claims as derivative actions rather than as class actions.

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KEY WORDS: securities fraud, class action, Rule 10b-5, derivative action, fraud-on-the-market, rebuttable presumption, price impact, corrective disclosure, price inflation, echo effect, certification, superior, circularity, disgorgement, reputational harm, reversion to the mean, mitigation, diversification, index fund, stock-picking, market failure, efficiency paradox, deterrence

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Note: This piece was written after the March 29, 2021 oral argument in Goldman Sachs Group, Inc. v. Arkansas Teacher Retirement System (ATRS) but before SCOTUS handed down its June 21 decision. The postscript that follows the conclusion hereof discusses the Court's decision and the implications thereof. This piece was published online in 66 Villanova L. Rev. Tolle Lege (July 8, 2021) but is slightly revised here to address some incidental errors and omissions.¹ The postscript was also published in 66 Villanova L. Rev. Tolle Lege (26 July 2021).²

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Since 1967, the Supreme Court has heard 68 cases relating to Rule 10b-5, the SEC's catch-all anti-fraud rule, which has been interpreted to permit investors to sue for damages when they are deceived by a misstatement of material fact in connection with the purchase or sale of a security. That is more than one case every year for a court that decides only about 80 cases in a year. Securities fraud must be rampant. Or else something is awry with how the law works.

The latest such case – Goldman Sachs Group, Inc. v. Arkansas Teacher Retirement System (ATRS) – was argued on March 29. It arose because Goldman Sachs stock price fell from about $184 (as of April 15, 2010) to about $134 (as of June 10, 2010) in part because of an enforcement action filed by the SEC against the company on April 16, 2010.³ Plaintiff buyers of Goldman Sachs common stock (ticker: GS) argue that they were defrauded because the company held itself out as "dedicated to complying fully with the letter and spirit of the laws, rules, and ethical principles that govern us" and affirmed that "our continued success depends upon unswerving adherence to this standard." Plaintiffs claim that this was a lie, that Goldman Sachs stock was overpriced as a result, and that as buyers they paid too much when they bought. According to plaintiffs, the lie was revealed when the SEC filed suit based on the firm’s marketing of a collateralized mortgage obligation (CMO) called ABACUS. To be specific, plaintiffs claim that the SEC action exposed Goldman Sachs as a firm that was anything but


committed to lofty ethical principles. Thus, statements to the contrary were misrepresentations.

There is no doubt that much (or most) of the price decrease in GS was attributable to the government crackdown. (Goldman Sachs ultimately paid a $550M fine to settle the matter with the SEC.) Nevertheless, ATRS claims that revelation of the firm’s true colors caused the loss they suffered at least in part and that they should be made whole to the tune of about $50 per share.

The *Goldman Sachs* case involves the rebuttable fraud-on-the-market (FOTM) presumption, by which buyers may be presumed to have relied on a false statement of material fact if it affected market price. If the false statement causes market price to rise or remain too high, and the price falls when the truth comes out – at the time of a *corrective disclosure* – buyers may sue to recover their losses. To be clear, the SEC did not sue Goldman Sachs because ABACUS was inconsistent with statements about the firm’s commitment to compliance. Rather, the SEC sued because ABACUS was created in part to enable one firm client to sell it short (at what turned out to be a substantial gain) and thus allegedly violated the firm’s duty to its customers who bought the product. But the SEC enforcement action gave plaintiffs the corrective disclosure they needed to invoke the FOTM theory – albeit a corrective disclosure in the guise of an event (the SEC filing) rather than any express admission by the company that earlier statements had been wrong. Thus, plaintiffs sought to recover *from the company* for the difference between the price they paid and the market price following corrective disclosure – after the truth came out.

The *Goldman Sachs* case differs from an ordinary securities fraud class action claim involving an alleged misrepresentation about earnings or business prospects. For example, suppose Acme Blasting Cap Company (ABC) stock trades at $20 per share because the market thinks it will generate return of $2 per share – ten times earnings. In a conference call with analysts, the CEO


5. Note that a securities fraud claim under Rule 10b-5 may arise from the cover-up of either bad news or good news. In the former case, the plaintiff class comprises those who bought during the fraud period, while in the latter case the plaintiff class comprises those who sold during the fraud period. There are notable examples of good-news fraud cases (with seller classes). See Affiliated Ute Citizens v. United States, 406 U.S. 128, 155 (1972); Basic Inc. v. Levinson, 485 U.S. 224 (1988); SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968). But my own study shows that there are about 60 bad-news cases for every one good news case. See Richard A. Booth, *Class Conflict in Securities Fraud Litigation*, 14 U. Pa. J. Bus. L. 701 notes 3 & 106 (2012). In other words, the overwhelming majority of securities fraud class actions involve the cover up of bad news (with buyer classes). Accordingly, the discussion here assumes the context of a bad news case with a buyer class.

6. The courts have recognized that an event may serve as corrective disclosure because otherwise a company could avoid any stockholder claim simply by remaining silent and refusing to acknowledge any earlier misstatement as incorrect. See Richard A. Booth, *Loss Causation and the Materialization of Risk Doctrine in Securities Fraud Class Actions*, 75 Bus. Law. 1791 (2020).
confirms that expectation – saying that the company is on track to make its numbers even though the CEO knows that there is a fifty-fifty chance that earnings will be only one dollar per share when reported (because an important customer has indicated it might cancel a big order which might or might not be offset by an order from another customer). Three months later the company announces earnings of one dollar per share. And stock price immediately falls to $10 per share. Under Rule 10b-5, buyers who bought ABC stock during the three-month fraud period may sue as a class to recover the difference between the price they paid and the market price following corrective disclosure. In other words, buyers as a group may sue the company to recover their loss of $10 per share. There is no need for each class member to prove reliance on the statement by the CEO – which was heard only by a handful of analysts. Indeed, there is no need for any plaintiff to prove reliance, which means that such actions may be litigated as class actions. And that is important because few individual buyers will have lost enough to bother to make a claim. Without a class action remedy, most such fraud will go unavenged. Or so the argument goes.

The ultimate question in Goldman Sachs is whether the alleged corrective disclosure made any difference at all to stock price. Under a 2014 SCOTUS decision – Halliburton II – the defendant must be afforded an opportunity to rebut the FOTM presumption before the action can proceed as a class action. Goldman Sachs argues that the price decrease was attributable to the SEC announcement and not to any revelation that its earlier generic statements about compliance were false. Indeed, during oral argument, Justice Alito suggested that such statements were akin to the claim, "We are a nice company," and unlikely to matter much to investors. Moreover, Goldman Sachs had acknowledged all along that its business entails conflicts of interest that require active monitoring and had done so in the same filings in which

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7. More precisely, the price following corrective disclosure is deemed (by statute) to be the "the mean trading price during the 90-day period beginning on the date on which the information correcting the misstatement or omission is disseminated to the market." Exchange Act §21D(a)(7)(b), 15 U.S.C. § 78u-4(e)(1). The history and rationale for this rule (adopted as part of the Private Securities Litigation Reform Act of 1995) is itself quite fascinating. See Richard A. Booth, OOPs! The Inherent Ambiguity of Out-of-Pocket Damages in Securities Fraud Class Actions, 46 J. Corp. L. 319, Note 9 (2021).

8. They may sue the company because the CEO is presumed to speak for the company. Ergo, it was the company that deceived them. See Makor Issues & Rights, Ltd. v. Tellabs Inc., 513 F.3d 702 (7th Cir. 2008) (opinion by Posner). This point is discussed at length in Richard A. Booth, Deconstructing Scienter, 15 Virginia L. & Bus. Rev. xxx (2021) (forthcoming).

9. Indeed, the federal class action rule, Rule 23 of the Federal Rules of Civil Procedure (FRCP), was adopted in 1966 in its current form with securities litigation in mind, albeit mostly cases arising under the 1933 Act and not under Rule 10b-5.


11. Transcript of Oral Argument at 15. See also id., at 36, 62 (Roberts), 38 (Thomas).
it claimed to be committed to compliance. Finally, and probably most important, the facts relating to ABACUS were well known to the market before the SEC filed suit.

If the loss was caused wholly by a new development (such as the SEC enforcement action), there can be no claim – because there was no lie or cover-up. But a three-judge panel of the Second Circuit Court of Appeals held that even if most of the loss was attributable to the SEC action, the presumption remains as long as some of the price decrease can be attributed to corrective disclosure.

What is the Question?

To be clear, the Goldman Sachs case raises several related issues. For one, can an event serve as corrective disclosure? The answer to that question is pretty well settled in the affirmative, but SCOTUS has never expressly agreed. For another, what does it take to rebut the presumption of price impact – the presumption that a particular item of misinformation affected market price? This is the narrow question before the Court. More precisely, the question is whether offering some rebuttal evidence is enough or whether the plaintiff must offer other evidence to rebut the rebuttal. But these questions imply a logically prior question: What exactly do we mean by price impact in this context?

Stock prices fall for all sorts of reasons. How do we know how much market price fell because Goldman Sachs lied about its ethical standards and how much it fell for other reasons – like the government crackdown on practices previously thought to be kosher? Suppose I buy a used Ford Pinto for $1000 from a guy in a plaid suit and discover that I overpaid by $100 because the mileage had been rolled back. On my way to the dealership to demand a refund, I get bumped from behind, and the gas tank explodes, totaling the car. Can I sue the guy in the plaid suit for the entire $1000 purchase price?

The test in a case like Goldman Sachs is (or should be) whether the market would have reacted to corrective disclosure in the absence of the triggering event – if the company had simply fessed up as to the alleged lie. Suppose the firm had said: "We sometimes provide (and make markets in) financial products for which there is investor demand even though as a firm we might not choose to invest in such products." How much would stock price have dropped? Not much (if any) since the statement is an apt description of a large segment of the securities

12. See ATRS, 955 F.3d at 273-74.


14. ATRS, 955 F.3d at 270, 277-78. See also Waggoner v. Barclays PLC, 875 F.3d 79 (2d Cir. 2017) (so holding).

15. See Transcript of Oral Argument at 12, 40, where Justice Breyer seems to raise a similar question.
business. It is as if Captain Renault arrived on the scene and exclaimed, "I'm shocked ... shocked to find that market making is going on in here." Whatever the (minimal) decrease that might follow such a disclosure, that is the amount of price inflation – the excess price caused by the (supposed) deception.

Moreover, the remainder of the loss beyond correction of any price inflation is a loss suffered by the firm. If Goldman Sachs employees violated the law by dealing in such financial products, it is the company that should recover from individual wrongdoers for the harm they did to company reputation (not to mention the loss from the fine). Indeed, the SEC sued both Goldman Sachs and its vice president Fabrice Tourre (AKA Fabulous Fab) who designed and marketed ABACUS and who later paid an individual fine of more than $825,000. To be sure, a company is unlikely to sue its own employees. But there is a mechanism by which company stockholders can compel the company do precisely that: The stockholders may sue derivatively to recover from the individual wrongdoers on behalf of the company. If the derivative action succeeds, the company recovers, and stock price is restored for the benefit of all the stockholders.

Admittedly, it can be a bit difficult to grasp the idea that Goldman Sachs as a firm suffered most of the harm in this case – especially since the firm likely made a ton of money from ABACUS. Nevertheless, the firm is an institution comprising more than 30,000 professional employees and thousands of stockholders. Withal, it is also a systemically important institution. It is the 65th largest company in the S&P 500. As such, Goldman Sachs is a significant cog in the machine that is the US economy – not to mention the banking system thereof. To be sure, one might argue that the firm has deep pockets and can afford to make buyer stockholders whole. But the firm – which was worth about $94B before the SEC action was announced – lost about $22B in value as a result of the events by which plaintiffs claim $13B in damages. At some


17. See ATRS, 955 F.3d at 480. GS stock price fell from 184.27 (on 4/15/10) to 134.12 (on 6/10/10) – as adjusted for a 0.35 dividend on 5/27/10 (133.77 + 0.35) – a 37.39% loss. See ATRS, 955 F.3d at 479-80. During the same period, the S&P500 (SPX) fell from 1211.67 to 1086.84 – a 11.49% loss. But that comparison must be adjusted for the fact that the risk inherent in GS differs from that of SPX. As of 4/15/10, GS had a beta 1.2796 (according to my own calculations) indicating that it was about 28% riskier than the market as a whole (as measured by SPX). Thus, one would have expected GS to fall by 11.49% * 1.2796 or 14.70% for no other reason than that the market as whole declined. So the excess decline in price – which might have been caused by the alleged fraud – was 22.69% (37.39% – 14.70%). According to its 2010 10K, GS had about 515M common shares outstanding as of EOY 2009 and about 508M common shares outstanding as of EOY 2010. Thus, I estimate that it had about 510M shares outstanding as of corrective disclosure for a total market capitalization of about $94B before the loss in value from the alleged fraud. Thus, the roughly 23% loss from the fraud suffered by GS stockholders translates to about $22 billion in the aggregate. But only those stockholders who bought during the fraud period have standing to make a claim under Rule 10b-5. Because shares can be (and are) traded often, there is no easy way to determine how many shares will be represented in the plaintiff class. 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 (2001). Nevertheless, the Goldman Sachs plaintiffs somehow estimate that their claim is one for $13B which suggests that
point, one must worry about whether the firm can survive – as perhaps the DOJ should have worried about the accounting firm Arthur Andersen in the wake of the Enron debacle.  

**Say It Ain’t So Lloyd**

Some of the lost GS value came from the SEC fine and attendant expenses. And some may have come from tarnish to the Goldman Sachs brand. But it is difficult to believe that these losses accounted for more than a billion or so of the total $22B in lost value. The remainder of the loss almost certainly came from lost prospects because the CMO party was busted. In other words, before the SEC crackdown, the market assumed that Goldman Sachs (and other banks) would eventually get back to business and making money as they had before.

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they think about 60% of stockholders are represented in the plaintiff class (assuming they make no adjustment for the echo effect discussed below).

Note that I make no adjustment here for the statutory rule that the loss shall be determined based on an average of closing prices over the 90 days following corrective disclosure. See *supra* note 5. For the record, the raw average closing price for GS for the 90 days following 6/10/2010 (without any adjustment for dividends) was 143.38 as compared to 113.80 on 6/10/2010, while the average closing price for SPX over the same period was 1085.75 as compared to 1086.84. Thus, the price of GS increased by 25.99% as compared to a decrease of 0.10% for SPX over the same period. Adjusted for beta, that translates to a price increase of just over 20% for GS which would almost totally offset the 23% decrease through the end of the fraud period. To be clear, this is no more than a rough estimate of how the ninety-day rule would work out since corrective disclosure occurred in discrete installments over a period of 56 days. Presumably, the rule must be applied with regard to each such event of disclosure. It is anyone’s guess how a court might handle this calculation if called upon to do so.

It is also possible (if not probable) that the SEC action affected the prices of other similar banks by signaling a government crackdown. Ideally, one would construct a portfolio of other bank stocks for comparison. But to get a rough idea of the effect on other banks, I have used Morgan Stanley (MS), which appears to be the primary competitor for GS. Using the same dates as above, MS stock price fell from 30.88 to 25.64 as adjusted for a 0.05 dividend during the period (25.59 + 0.05) for a 20.44% decline. On the other hand, MS had a beta of 1.6943 as of 4/15/10 indicating that we should expect its price to fall more than GS. So we should adjust the MS price decline accordingly. That is, with SPX down by 11.49% we would expect MS to fall by 19.47% anyway. So it appears that MS fell by 0.97% sympathetically (as it were) because of the SEC enforcement action (assuming no other company specific explanations for the extra loss). In other words, it appears that the SEC action did have some effect on the industry. Again, we need to adjust that 0.97% decrease for beta – for the relative sensitivity of GS versus MS. (1.2796 / 1.6943 = 0.7552 and 0.97% * 0.7552 = 0.74%) So we might conclude that 0.74% of the loss suffered by GS was attributable to a general increase in the cost of capital for the investment banking industry. So the company-specific decline for GS might be reduced further to 22.69% minus 0.74% or 21.95% after adjusting for industry affects. On the other hand, it is also possible that the decline suffered by MS was somewhat softened by the fact that it might now be a stronger competitor of GS and might even divert some GS business to itself that it would not otherwise have enjoyed.

To summarize, there are three or four possible sources of loss in the *Goldman Sachs* case:

- fines and attendant legal expenses
- diminished prospects for profit going forward (future earnings)
- reputational harm (loss of trust)
- correction of price inflation (exposure of unethical practices)

The first is the most concrete and is clearly derivative in nature. The second is almost certainly the largest, but it is unclear whether anyone can recover for this element of loss which came from fundamental changes to the business of banking. The last two items are more difficult to prove and to measure. But the important point is that they are two sides of the same coin – two different ways of describing the same element of loss.

As asserted *three times* by plaintiff counsel at oral argument, GS traded at a premium as compared to shares of competitors.\(^{19}\) Thus, the claim is that plaintiff buyers paid *more* for GS than they would have paid for shares of competitor banks all else equal. Assuming this allegation is true (as we and the courts must do for the sake of argument), then the claim must be that the market was fooled into thinking that Goldman Sachs was better. But it is also possible that Goldman Sachs really was better and squandered its competitive advantage by marketing ABACUS and running afoul of the SEC. In other words, the superior reputation of Goldman Sachs was either illusory or it was real and then lost because of bad business behavior.

The first possibility – that the firm's competitive advantage was illusory – might or might not give rise to a fraud claim. If the firm's superior reputation is the product of demonstrably false advertising, it might constitute fraud. But if the firm's superior reputation is the product of caché that simply evolved on its own like the latest fashion – firm-specific irrational exuberance – it can just as easily disappear of its own accord and likely will do so eventually.

The second possibility – that the firm's competitive advantage was real and was squandered – would certainly give rise to a derivative claim. Indeed, it is the essence of a claim for reputational harm. The only difference is that the decrease is one from a superior reputation to a normal reputation rather than a decrease from a normal reputation to an inferior reputation.

In other words, what is unusual about the *Goldman Sachs* case is that it involves a firm that was seen as superior to others – one that returned to earth (so to speak) when it was revealed to be merely mortal (or mix your own metaphor).

It is helpful here to consider an analogy involving bond ratings. Imagine a company XYZ whose bonds are rated AA while competitors' bonds are merely rated A. It turns out that some of the

\(^{19}\) Transcript of Oral Argument, at 62, 69, 88.
past profits booked by XYZ have come from illegal operations. As a result, XYZ bonds are downgraded to B. In retrospect, it is unclear why the XYZ bonds were ever rated AA. But they might never have been downgraded if not for revelation of the illegal operations. It is also quite clear that the further demotion to B (junk bond status) is the result of bad business behavior and a loss of trust.

The *Goldman Sachs* case is similar in that the loss may derive either from the dissipation of a distinct advantage or from affirmative punishment by the market (or both). But the argument that Goldman Sachs was viewed as special complicates the analysis. If the firm had a genuine edge that was squandered by miscreant employees on ABACUS, the harm is pretty clearly derivative. But if the edge was illusory – derived from some intangible aura of mysterious origin that the firm sought to exploit for as long as possible – it is unclear that any claim will lie. Investors might have wanted to know that all glory if fleeting, but for the firm to broadcast the point would have eliminated its edge in the meantime. Indeed, one could argue that the firm had a duty to exploit its undeserved reputation for as long as possible.

Still, if the loss derives from the market’s belief that the firm was better than other similar firms, the question is whether the market fooled itself or if Goldman Sachs fooled the market. If the firm did something positively deceptive to create or perpetuate a false image – like bribing the rating agency – there might be a fraud claim to be made out. But the claim would be akin to one for the difference between the yield on AA bonds and A bonds – the loss caused by the mistaken bond rating. The further loss because of the further downgrade from A to B represents affirmative punishment by the market. It would clearly give rise to a derivative claim (as would a claim by the company to recoup the bribe in the example).

The market will tell us whether it perceives any such fraud. If GS merely reverts to the mean – as to the mere A rating it should have had all along – and the market does not punish the company for its mendacity, the market must not think the company did anything wrong. No harm. No foul. To be sure, buyers of GS may have paid too much because the stock was overpriced for a while. That is always a risk with investing. In other words, if there is no extra loss there is no fraud. But if there is extra loss, it gives rise to a derivative claim. So no matter how you slice it, at least some of the claim is derivative.

**What Is the Problem?**

Although claims such as the one in *Goldman Sachs* belong at least in part to the company, the prevailing practice is that class action plaintiffs can recover individually for their entire loss. The problem is that if buyers recover from the company, existing stockholders lose twice: They suffer (derivatively) the loss suffered by the company and they suffer again when the firm pays the buyers. In effect, the recovery that goes to the buyers comes from non-buyer (legacy) stockholders. It is the financial equivalent of a pick-six in football.
To make matters worse, the prospect of payout by the company causes stock price to fall that much more because of the payout itself. And it does so immediately. The market does not wait to see if a class action is filed. So if buyers can recover from the company, the amount they stand to recover is magnified by their own claim for damages through a bizarre echo effect – rather like the feedback that results from holding a microphone too close to a speaker. This echo (or feedback) effect also helps explain why plaintiff lawyers prefer class actions to derivative actions. Since plaintiff lawyers get paid a share of the recovery – since they work on commission (as it were) – they are naturally inclined to proceed by class action rather than derivative action. But it is not up to the plaintiffs simply to claim the claim (so to speak). The court decides to whom a claim belongs – especially in the context of representative litigation such as a class action where the interests of absent parties are at stake.

This is an important point and not just some throw-away legal truism. Both lawyers and layfolk tend to gloss over the procedural step by which the court decides whether a case may proceed as a class action. A plaintiff has no entitlement to litigate on behalf of a class. The court must certify that the action is the proper subject of a class action (and that the plaintiff is a proper plaintiff to maintain it) precisely because the rights of others are at stake. If the action settles – as it almost always will do if it proceeds – all of the absent class members will be bound unless they choose affirmatively to opt out. Thus, the rules prohibit settlement without approval of the court. Indeed, the rules also prohibit dropping the case (voluntary dismissal) unless the court approves. On reflection, these are extraordinary rules. They seem to fly in the face of the idea that everyone deserves their day in court. Quite to the contrary, the court can decide if you are worthy to make a claim. A plaintiff must in effect prove their case before a court will allow them to prove their case. And just to be clear, there is no hyperbole here: Goldman Sachs is a case in point. The issue before SCOTUS is not liability itself. The (well disguised) issue is whether the case may proceed as a class action.

To add further irony, defendant companies are unlikely to protest that the action should be a derivative action. Companies and their managers would rather circle the wagons against a common foe than form up a circular firing squad by seeking company recovery from their own managers. To make matters even worse, insurance typically covers class claims against the company, but often does not cover derivative claims by which managers are found liable to the company. In short, no one has an incentive to get it right. Economists call it market failure.

So how might the courts fix the problem since the parties are not likely to do so? As it turns out, the rule governing class actions – Rule 23 of the Federal Rules of Civil Procedure – provides a solution. It says (in effect) that a class action should be the last resort. If there is any other equally good way to resolve a dispute, that alternative trumps a class action. To be precise, the rule says a court can certify an action for damages as a class action only if proceeding by class action is superior to all other ways of resolving the issues. Ties always go to any alternative mode of proceeding. In other words, the possession arrow always points away from class actions.
Even in the absence of such unambiguous guidance, it is clearly preferable for the company to recover. In the *Goldman Sachs* case, the loss from the fine and the concomitant decline in the value of the business is a loss suffered by all of the stockholders and not merely those who bought their stock during the fraud period. Since it was the business that was harmed by the malfeasance of its managers (if any). It is clearly more efficient for the company to recover a lump sum that redounds to the benefit of all stockholders *pro rata* than it is to send each stockholder a check that in many cases will cost more to process than it is worth.

Moreover and more important, derivative recovery mitigates any class claim that remains. To the extent the company is likely to recover, stock price falls that much less in the first place. It follows that if some of the claim is derivative, we should address the derivative claim first and see what loss remains (if any). Again, some of the claim will always be derivative because it is implausible that the company will not have suffered some harm (as a company) if it can be proved that someone in authority committed a fraud such that the company can be held liable. So if there is a class claim, there will always be a derivative claim. But the converse is not true: There need not be a fraud claim. It is quite possible for derivative claim to arise without any individual claim. That is, it is easy to imagine a case in which compensation to the company would make every stockholder whole.

*Goldman Sachs* is just such a case. It is scarcely conceivable that those who bought the stock during the fraud period suffered any additional compensable loss beyond the claim that might be asserted by the company. The Second Circuit itself implicitly recognized that most of the loss came from the SEC crackdown. In other words, the court certified the class action on the thinnest possible justification – that even if stock price were restored by company recovery, some compensable loss *might* remain from the cover-up of the truth.

**The Law and the Law of Large Numbers**

Arguably, *Goldman Sachs* is an easy case because the market would not likely have reacted to the supposed corrective disclosure standing alone – in the absence of the SEC action. In a more typical case like that of ABC described above, fraud-period buyers would have avoided some loss if the CEO had disclosed that there was a fifty-fifty chance that earnings would be one dollar per share rather than two dollars per share as expected. All else equal, stock price should have fallen to $15 at that point although it later fell to $10 when it turned out that the worse case scenario had come to pass.

In a class action under Rule 10b-5, buyers can recover the $10 difference between what they paid ($20) and stock price following corrective disclosure ($10). But *Goldman Sachs* reveals a subtle issue. Should buyers recover their full $10 loss or just the $5 difference between what they paid and what they would have paid if the market had known all the facts?

Buyers would no doubt argue that they lost $10 and should recover in full. But if so they are better off because of the fraud (so called) than they would have been if there had been no
fraud. If the CEO had told the whole truth and buyers had paid $15, they would have no claim based on the further decline to $10. To be sure, the buyers might argue that they would not have bought at all at $15. But that gets into speculation about exactly why each buyer bought and runs afoul of the spirit of the FOTM presumption, which quite sensibly ignores individual reliance and presumes that investors rely on market prices to be fairly set. Indeed, the FOTM doctrine arguably precludes consideration of individual investor motivations. Don’t ask. Don’t tell.

While it seems clear that buyer claims should be limited to the $5 per share by which price was inflated, it is not at all clear that the company should compensate buyers simply because the CEO reassured the market that the company was on track to make its numbers. Even if we allow that the CEO was reckless in saying that everything was hunky-dory with the business, the question remains whether investors really want to be compensated when they buy a mispriced stock.

Most investors are well-diversified. They hold the stocks they hold through a mutual fund or pension plan that holds the stocks of 500 or more different companies. Indeed, the single largest segment of the investor population (by value) invests through index funds and does so because it affords maximum diversification for a minimal management fee.

Moreover, it is arguable that a reasonable (retail) investor must diversify since by doing so one can avoid company-specific risk without any reduction in expected return. The law of large numbers guarantees it. And the iron law of investing is that one must demand more return in exchange for taking more risk. Thus, if one can avoid some risk for the same return, one should do so.

Diversification is (or was) the only free lunch in the market. But since diversified investors take less risk, they are willing to pay more for stocks, which drives up prices generally. It follows that investors who decline to diversify pay too much. The market has eaten their free lunch. To be sure, individual investors are free to follow whatever strategy they want to follow. But that does not make it reasonable not to diversify. Since the law seeks to protect reasonable investors, the courts should interpret the law with their interests in mind. Indeed, that is what the courts profess to do.

The point here is that index investors do not care about timing losses. Because they are diversified, they are equally likely to buy or sell a stock that is overpriced or underpriced. Over the long haul, a purchase of a stock that is overpriced will be offset by a purchase of a stock that is underpriced. Diversified investors have effectively hedged away the risk of mispricing. They are effectively insured – albeit self-insured – against such worries.

The implication is that index investors have no need for a class action remedy. The truth is bound to come out at some point. And the price decline will be what it will be. Que sera sera.
The loss will happen to someone. As in musical chairs, the loss will fall where it will falls when the music stops.

The idea that index investors should disfavor class actions because they do not need protection against mispricing is an understatement (which itself is an understatement). Index investors should be passionately opposed to class actions because when the company pays buyers, the company will decline in value by the amount of the payout. In effect, legacy holders – those who held the subject stock from before the fraud period – pay class-member buyers. Moreover, because diversified investors tend to trade very little – and mostly do so for purposes of portfolio balancing – they will almost always hold more stock from before the fraud than they bought during the fraud period.

To be specific, annual trading by index funds equals about 4% of holdings by value. By comparison, market-wide turnover for all stocks is about 80% annually. Thus, for every dollar effectively paid out by index funds through value lost from class action settlements, about five cents is recovered – months or years later – and about one cent of that goes to the plaintiff attorneys who represent the class. So the cost of class actions is a deadweight loss even in the best case. But in practice, it is worse for index funds that pay about twenty cents for every cent they recoup. It makes no sense to sue for $1,000 if it costs $20,000 to do so.

Admittedly, investors who choose a few good stocks – stock-pickers – might see some value in the extant system. They must always worry that they will be the chump who buys at just the wrong time. And the result might be financial ruin. But even they will sometimes be holders rather than buyers. Indeed, they are equally likely to lose as win from class actions (although they win more when they win than they lose when they lose). But it is not clear that even undiversified stock pickers should favor retention of a class action remedy.

Recognizing the illogic of the circularity inherent in securities fraud class actions, some scholars have suggested that it actually makes sense for holders to pay buyers (as in a class action) because as holders they are in some sense responsible for the fraud perpetrated on innocent new investors by the companies they own – perhaps by analogy to early Madoff investors who depended on later victims even though they may not have known it. But the analogy breaks down where the company itself has sold no stock and gains nothing from the so-called fraud.

Yet another common response to the foregoing story is that defendant companies do not really pay the settlement in a class action. Rather, settlements are almost always fully funded by insurance. The argument seems to be why should we not let disappointed stock-pickers recoup some of their losses if the company does not pay anyway? The easy reply – as every first-year law student learns – is that insurance is irrelevant to the merits of a dispute. More important, it is defendant companies that pay for the insurance. And the insurance company must make a profit. So it is even more expensive in the grand scheme if insurance companies cover the claims. If there were no class actions, there would be no need for companies to buy such insurance coverage but for the fact of class actions.
Still another common retort is that law is irrelevant because cases always settle. Some laws – like junk genes – do not really matter. But it is no excuse for bad legal doctrine that it seldom dictates the outcome of a trial. Bargaining happens in the shadow of the law. The law as interpreted by the courts tells us what plaintiffs can claim in damages and thus determines where settlement negotiations begin. So it is important to get the rules right even if cases almost never go to trial.

**How Did We Get into this Mess?**

How did this counterproductive remedy – which is unique to US law – ever evolve? The answer lies in the history of federal securities law. Under the Securities Act of 1933, investors who buy shares in an initial public offering can recover any loss they suffer as a result of a material misstatement or omission in the prospectus. No questions asked. The company must disgorge the funds it raises by false pretenses. That is a perfectly sensible rule and one that ultimately assures that capital flows where it will do the most good. But suppose an already-public company sells additional shares in a subsequent offering. The shares bought by a new investor may be new shares or existing shares. The disgorgement remedy applies only to new shares that are part of the new offering because the company is liable only to give back the ill-gotten funds. So buyers must be able to show they bought new shares not existing shares.\(^\text{20}\)

Clever plaintiff lawyers and sympathetic courts found a solution to the limitations of the 1933 Act. If buyers could show that a false statement in the prospectus caused the stock in question to trade at a higher price than should have obtained, then a fraud claim might lie in addition to the no-questions-asked disgorgement claim under the 1933 Act. The claim need not be limited by the amount of a new offering. It is but a short step from there to the system we have today: If buyers can be compensated even as to shares not part of an offering, there is no reason why the remedy should be limited to situations in which there happens to be an offering in progress. In other words, there is no obvious reason why the misstatement must appear in a prospectus. Any public misstatement should do. Thus, the securities fraud class action was born.

It is understandable how class actions came to be. And once upon a time, they may have been a good idea. But we have outgrown the need for them as investors have become ever more diversified. With the growth of mutual funds since the 1970s, and the advent of index funds in the meantime, ordinary investors have no need for such a remedy – which today does nothing but reduce aggregate return.

The real mystery is why securities fraud class actions *survive* when they disserve most investors – especially the most rational investors who eschew stock-picking and active trading by investing in index funds. One answer is that investors do not understand how they are getting

\[^{20}\text{See Barnes v. Osofsky, 373 F.2d 269 (2d Cir. 1967).}\]
fleeced by the system. When a fat settlement check arrives in the mail – a shiny new penny – it is easy to lose sight of who really pays. A still better answer is that the system works great for plaintiff lawyers – whose cut can be 20% or more of the pot that has totaled more than $100 billion since 1996.\textsuperscript{21} It works out pretty well for defense lawyers too.

Indeed, class actions work all the better for plaintiff lawyers because a class action magnifies the damages through the echo effect noted above. If you do the math, it turns out that a 10% decrease in stock price becomes a 20% decrease if the plaintiff class includes 50% of the stockholders. And if the class includes 90% of stockholders, a 10% drop in stock price becomes a 100% drop, wiping out all of the value of the defendant company – all because of the echo effect.\textsuperscript{22} To be completely clear, the echo effect arises when the law works as it is meant to work. It is no mere by-product of market over-reaction to bad news. Rather, it is the natural side-effect of a cure that is worse than the disease. To be sure, cases that survive a motion to dismiss and that are certified as class actions almost always settle. But they do so in part because the law magnifies the potential effects of suffering a loss. Again, bargaining happens in the shadow of the law.

\textbf{What About Deterrence?}

Even legal scholars who like the idea of class actions – because they see the need for some sort of private remedy to deter public companies from lying to the market – mostly agree that the extant system leads to excessive litigation. The prospect of a massive award equal to as much as the full amount of the price decrease times the number of shares outstanding encourages plaintiff lawyers to sue and causes defendants to settle any case that both survives a motion to dismiss and is certified as a class action. As a result, only a handful of cases have ever gone to trial.

Some have argued that you can never over-deter fraud.\textsuperscript{23} Without some sort of remedy, fraud might become (more) rampant. Traders might stop trading (as much) if they are exposed to the risk of loss without the potential for compensation. The market would become less efficient.


\textsuperscript{22} Incidentally (or not), although the echo effect magnifies the damages in bad news cases – in which the cover-up involves negative information that causes stock price to fall and buyers to sue – the echo effect shrinks the damages in good news cases involving seller plaintiffs. In such cases, the prospect of payout mitigates the price effect of the good news. As a result (and as noted above), bad news cases outnumber good news cases by about sixty to one. See Richard A. Booth, \textit{Class Conflict in Securities Fraud Litigation}, 14 U. Pa. J. Bus. L. 701 notes 3 & 106 (2012).

\textsuperscript{23} See James C. Spindler, \textit{We Have a Consensus on Fraud on the Market – And It’s Wrong}, 7 HARV. BUS. L. REV. 67 (2017).
On the other hand, the cost of over-deterrence is real. If the punishment for misspeaking to the market is too extreme, companies will stop speaking to the market except when absolutely required to do so. Investors will have less information than they might otherwise enjoy.

In the end, either we compensate investors for their losses, or we do not. It is not obvious that there is any middle ground. But there are several responses.

First, it is unlikely that traders care much about a class action remedy. At best they will recoup a few cents on the dollar months or years later. So it is unlikely that the lack of a remedy would discourage trading even at the margin because the remedy is quite remote (if not random). But even if we allow that stock-picking might be unduly discouraged, we should consider whether class actions unduly encourage stock-picking. If I know it makes no difference whether I do my homework, why should I do it? I can trade based on hunches, tips, and whims, making the market more volatile and less efficient than it would be in the absence of a class action remedy. It is really quite curious that scholars who support class actions emphasize the need to protect stock-pickers to the exclusion of worries about subsidizing their activities: The FOTM theory positively encourages investors to trust market prices and thus discourages diversification at the margin. Thus, proponents of index funds might argue just as strenuously that class actions encourage irrational investment strategies as opponents of index funds argue that they undermine market efficiency. The end result is a draw.

Second, any reduction in market efficiency is bound to be self-correcting. If a significant number of traders stop looking for mispriced stocks, mispricing will become more common, attracting more traders. The market will equilibrate. In other words, the efficiency paradox is no paradox at all. It is simply a description of how markets work. So in the end, it seems likely that class actions play at most a minor role in keeping the market efficient. But they play a much more significant role from a management point of view in the success or demise of individual businesses. In other words, the benefits for investors are minimal, but the costs for defendant companies are significant.

Quite aside from the foregoing arguments about why traders and stock pickers do not need a remedy, an equally powerful argument can be made that index investors need class actions to


25. News of the occasional big recovery might create the impression that the remedy is more robust than it really is – just as those who play the lottery tend to focus on big winners. Note also the parallel to the moral risk argument about insurance and bank bail-outs: If I know I am protected against loss, I will take more risk than I would do otherwise.

26. In other words, traders will invest in research until the last dollar they spend affords them a dollar of gain. The efficiency paradox itself is a variation on Zeno’s paradox that you can never get from point A to point B if you think of each step as getting you halfway there.
be abolished. Class actions are a drain on aggregate returns. They do nothing more than move money from one group of investors to another minus a cut for plaintiff attorneys. More important, class actions aggravate the situation by diverting what should be derivative recovery to class recovery.

The question is: Who should prevail in the class struggle between diversified and undiversified investors? The answer is quite easy: Since reasonable investors diversify, and since most investors are indeed diversified, and since the risk of mispricing (or bad timing) is a risk that ordinary stockholders can easily avoid through diversification, the case against class actions is overwhelming.

In the end, the biggest hang-up about getting rid of class actions – the remedy that almost everyone loves to hate – is the idea that individual investors need to be compensated. But that idea derives from a false analogy with disgorgement actions under the 1933 Act. Issuer companies almost never gain from so-called securities fraud. So there is nothing to disgorge. And there is no demonstrable need to subsidize trading and stock-picking. Quite to the contrary, there is every reason to discourage ordinary investors from both. And as for deterrence, derivative actions offer a just-right Goldilocks solution. By holding wrongdoers liable for the tangible harm they visit on their companies (such as SEC fines), the law might instill a sense of individual responsibility that is missing with the potential for a ludicrous award against the company that can be dismissed as a form of big-game ambulance chasing.

Whatever we might decide about the need to compensate stock-pickers for price inflation, it is clear that any derivative claim should be resolved first (if only because it mitigates any direct claim). The harm from price inflation (if any) should be the last to be addressed.

**Why Doesn't Somebody Do Something?**

Why is it that no plaintiff law firm has built a practice seeking to displace class actions and to capture the fees that go with derivative actions? The answer is that they may have done so but the results are contorted by a variety of factors that the courts have failed to sort out and control. Indeed, it is quite common really for a derivative action to be filed based on the same underlying facts as those giving rise to a class action. But this naturally leads to confusion about what plaintiffs really want. Those prosecuting the class action want the company to pay. Those prosecuting the derivative action want the company to recover. It can make the courts crazy.

The *Goldman Sachs* case illustrates why the class action prevails. The class action asserts a claim for $13 billion in easily measured damages. But a derivative action would make a claim to recoup $550 million from the fine plus maybe legal fees paid by the company to defend itself against the SEC and perhaps some difficult to calculate damage to company reputation. It is easy to imagine that thinking ahead to when the time comes to apply to the court for attorney fees, the lawyer for the derivative action might prefer a small share of big aggregate fee to the whole of a much smaller fee. To play with the numbers above, if we assume that the derivative
action might recover a billion or so for the company, and we assume that the fee will be 20% of that, the best case is a fee of $200 million. In contrast, the class action might generate recovery of $13 billion and a fee of $2.6 billion. The derivative lawyer would be quite happy to take (say) 10% of the class fee in exchange for throwing the game regarding the derivative action. Working backwards, the derivative lawyer might agree to seek (or accept) non-monetary governance reforms on the part of the corporation rather than to insist on a cash settlement for the benefit of the corporation – which would raise all sorts of inscrutable questions about why the company should both pay and recover. That way the derivative lawyer can credibly claim to have obtained something of value for the corporation and thus to have earned a share of the fee awarded by the court.

The question remains: Why do investors continue to sue when it is against their interest to do so? The answer is that plaintiff lawyers are very good at finding investors who will lend their name to a lawsuit for a price. Up until about 2006, investors were often paid – quite illegally – to serve as plaintiffs. When that practice was exposed, the leading plaintiff firm in the securities fraud class action business was indicted. Name partners were disbarred and went to jail. Since 2006, most such actions have been filed by union and public pension plans as representative plaintiffs rather than by individual investors. Indeed, in the action against Goldman Sachs, the named plaintiff is the Arkansas Teacher Retirement System.

Needless to say, ATRS is a well-advised and well-diversified institutional investor who should know better. But such pension plans are typically governed by politicians to whom it is quite legal to make campaign contributions. Moreover and perhaps more important, those who run such funds may generate even more political capital by going after big business and extracting a big settlement. Indeed, in the Goldman Sachs case, those who run ATRS can claim to have done something about the practices that led to the 2008 credit crisis. That is not necessarily a bad thing. But the fact remains that the cost that falls on diversified investors far exceeds the benefits they receive. That looks a lot like a breach of fiduciary duty to fund participants.

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28. See Richard A. Booth, Things Happen, 55 Villanova Law Review 57 (2010). Although much has been made of ABACUS as an example of Wall Street venality, one can make a case for why ABACUS might have been a good thing for the markets and the economy in general. By creating a vehicle that permitted investors to go short in mortgage-backed securities, it might have been possible to control the overheated housing market. Some such thought may have prompted Lloyd Blankfein famously to state to Congress that the firm was doing God’s work. In any event, the fact that Goldman Sachs itself assumed the risk of default by writing credit default swaps on ABACUS belies the idea that the product was created for the purpose of generating losses.

Stop the Madness

Now that we know the problem, how do we stop the cycle of self-destruction?

One noted critic has proposed that we dis-imply a private right of action under Rule 10b-5.\textsuperscript{30} Since the SEC adopted the rule, the SEC can say what it means. The problem with this solution is that the rule covers lots of other situations in which we need a remedy – ranging from insider trading to broker-dealer churning of customer accounts. Moreover, it is not necessary to mess with the meaning of fraud if the courts will only do their job of prioritizing derivative actions. But the courts and litigants are set in their ways. How do we disrupt the status quo?

One possibility is that index funds might opt out of class actions. But that does not change the fact that any settlement will be paid by the company and thus will come out of the pockets of all the stockholders, including index funds. For an index fund to forgo a share of any recovery exacerbates the problem – another case of market failure.

On the other hand, the courts do sometimes grant class certification contingent on some maximum number of opt outs. Thus, it might be possible for index funds to subvert many class actions. But that might leave those with large claims – such as hedge funds – to collect from defendant companies without the need to share the pot with small investors. Indeed, high-rollers have begun to opt out of class actions in recent years -- because by doing so they are free to settle without court approval and need not share the proceeds – a practice that is worrisome in its own way.\textsuperscript{31}

Another possibility is that the courts might recharacterize class actions as derivative actions on their own motion because it is up to the courts to decide whether a claim is direct or derivative. It is a matter of law akin to subject matter jurisdiction. But courts do not like to act other than at the behest of litigants. Nevertheless, a woke court might ask the parties to brief the question.


\textsuperscript{31} The practice raises nice questions about whether some claims \textit{ought} to be prosecuted as class actions for the benefit of small investors. See Std. Fire Ins. Co. v. Knowles, 568 U.S. 588 (2013) (holding that representative plaintiff cannot bind absent potential class members before certification as to agreement to seek less than $5M in damages so as to prevent removal to federal court under Class Action Fairness Act); Richard A. Booth, \textit{Back to the Future of Arbitration}, 41 Regulation (Cato), No. 2, at 14 (Summer 2018) (arguing that class actions are better fitted to litigating relatively small consumer claims than is arbitration supplemented by possibility of punitive damages). But (again) these questions can be avoided altogether if we proceed first by derivative action thus assuring that the benefit of a remedy is shared pro rata by all. Accordingly, there is no right to opt out of a derivative action. Incidentally, the same is true of class actions other than those for damages under Rule 23(b)(3).
A much more promising strategy is for big investors to intervene and urge the courts to deny class certification – as well as enjoin independent direct actions by large claimants – until any derivative action is resolved. It will not suffice for the court simply to acknowledge the existence of a parallel derivative action (which is pretty much what happens anyway).  

As shown here, the argument to be made is complicated. It will not be easy to persuade a court to do the right thing – to address the derivative action first and exclusively – because the well-established practice is precisely the opposite. Moreover, the class action is (and must be) litigated in federal court while the derivative action is typically litigated in state court (and often cannot be litigated in federal court). So the federal court must be persuaded to defer to the state court. Given these complications, it is important that the arguments be made by someone with a genuine feel for the position to be maintained. Index funds are by far best situated to make the case – both against class actions and for derivative actions – for all the reasons explained here about why class actions disserve deserving diversified investors.

Ironically, index funds have been criticized for their failure to take the lead in prosecuting securities fraud class actions. The critics see it as a simple case of free-riding on the efforts of so-called quality shareholders. The supposedly sinister story is that investors invest in index funds because they offer maximum diversification with the lowest possible management fees. Thus, the theory is that index funds can offer rock-bottom fees because they shirk their responsibilities as stockholders. They fail in their duty to be good corporate stewards. But the inconvenient truth is that index funds should be positively opposed to class actions. They

32. One complication is that some courts see parallel derivative actions as based on a (potential) claim for indemnification (for any payout in connection with the class action) as opposed to a claim for harm suffered directly by the corporation in its own right. Needless to say, if the action is one for indemnification, it makes sense to defer to the class action. But if the derivative action is one based on a claim by the corporation that it has suffered harm in its own right, the derivative action should not only not be stayed, it should be resolved first. See, e.g., Pfeiffer v. Toll, 989 A.2d 683, 708 (Del Ch. 2010), abrogated on other grounds, Kahn v. Kolberg Kravis Roberts & Co., L.P., 23 A.3d 831 (Del. 2011). Note that a derivative action based on the same allegations as made in Goldman Sachs (as well as some other allegations) was filed and dismissed by the Delaware Chancery Court in 2011. See In re Goldman Sachs Group, Inc. Shareholder Litigation, Civil Action No. 5215-VCG, 2011 Del. Ch. LEXIS 151 (Ch. Oct. 12, 2011) (opinion by Glasscock). Arguably, that decision should be res judicata with regard to the case pending before SCOTUS although one must jump through numerous doctrinal hoops to reach that conclusion. Similar thorny (but fascinating) legal questions arise under FRCP 23 in deciding whether a particular case should fall in a particular subpart of the rule. See, e.g., Wal-Mart Stores, Inc. v. Dukes, 564 U.S. 338 (2011) (supposed claim for declaratory relief under Rule 23(b)(2) should be treated instead as claim for individual damages under Rule 23(b)(3) but could not be certified thereunder because individual questions predominate).


34. It is difficult to miss the religious overtones (guilt trip) in this thesis. See Luke 16:1–13. See supra, note 70. It has also been suggested that index funds might even be operated at a loss in order to gain market share for the management firm (which often runs other funds as well) thus to gain better (private) access to information from portfolio companies. See Bebchuk & Hirst, supra at 2043-71.
should prefer that the remedy be abolished if they thought hard enough about it. So an index fund would not make a good lead plaintiff anyway.

Nevertheless, it is true that the logic of indexing dictates that fund expenses be kept as low as possible. And it would not be costless for an index fund to serve as lead plaintiff in a derivative action. On the other hand, the benefits may be significant. Replacing class actions with derivative actions could generate more than $300 billion in aggregate market capitalization.\textsuperscript{35}

This is not to say that all will be well if only index funds make the right arguments. There is every reason to expect opposition to any initiative to promote derivative actions over class actions. For example, class counsel might argue that index funds should be excluded from the class. The argument has some merit, but it also runs counter to the FOTM doctrine. On the one hand, index investors implicitly trust in the integrity of the market and are thus the very definition of an investor that FOTM seeks to serve. Nevertheless, the practice of indexing entails buying stocks that have risen in value and selling stocks that have fallen in value. Thus, one might argue that index funds make it a practice to buy high and sell low – which is quite the opposite of what stock-pickers do. Thus, it might be argued that even though index investors rely on market prices in some sense, they also implicitly advocate against reliance on the information that is provided by the federal scheme of securities regulation in that they abjure any effort to choose stocks based thereon while depending on the efforts of others to do so. In other words, they positively advocate ignoring the substance of disclosure and so should be excluded from the definition of any plaintiff class.\textsuperscript{36}

Undoubtedly, there will be other such obstacles and other such issues to be resolved before we reach the promised land of a legal system mostly free from securities fraud class actions. It is possible that SCOTUS could get us one step closer when it decides the \textit{Goldman Sachs} case by vacating the decision below to certify the action as a class action – with instructions to consider evidence of price impact relating solely to correction of alleged price inflation. That would go some distance toward the goal since it implies that only this narrow element of loss is compensable. The court could arguably do so since the narrow issue presented is whether the plaintiff has any burden to offer positive evidence of price impact following rebuttal. It would seem to go without saying that the Court is thus licensed to discuss the object of the evidence – what it must tend to prove. Indeed, it would seem difficult to discuss the matter without also discussing exactly what is to be presumed. But then again, the issue of how a rebuttable presumption works applies in all sorts of settings. So the Court may want to avoid tying what it says too closely to the subject matter of securities fraud class actions. Thus, SCOTUS may punt by ruling that the trial court retains the discretion to evaluate the significance of rebuttal

\textsuperscript{35} See RICHARD A. BOOTH, STOCK DROP, Preface (forthcoming).

\textsuperscript{36} While this argument may sound a bit strained, a variation thereon has been accepted by the courts. See GAMCO Investors, Inc. v. Vivendi Universal, S.A., 838 F.3d 214 (2d Cir. 2016) (finding that presumption of reliance was rebutted as to investor that touted a proprietary investment model).
evidence in light of the import of the proposition to be presumed in the context of the case or controversy to be resolved so as to avoid any hard and fast rule that the plaintiff must (or need not) offer reply evidence. If I were inclined to bet on the outcome, that is the bet I would make. I suppose I would be happy to win, but it would be a missed opportunity to make some real progress toward fixing our dysfunctional system of securities litigation.

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POSTSCRIPT

RELIANCE AND LOSS CAUSATION – KNOW THE DIFFERENCE

The foregoing piece was written after the March 29, 2021 oral argument in Goldman Sachs v. Arkansas Teacher Retirement System (ATRS) but before SCOTUS handed down its June 21 decision. Thus, the piece is an amalgam of advice, prediction, and wishful thinking. Perhaps mostly the last. As one might expect, SCOTUS vacated and remanded the decision of the Second Circuit. Why else would the Court take a case if not to reverse the decision below?

To recap the argument in the original piece, if the plaintiff-investor loss was caused wholly by a new development (here the SEC filing), there can be no claim, because there was no lie or cover-up. But the Second Circuit ruled that even if most of the loss was attributable to the SEC enforcement action, it is enough that some of the price decrease can be attributed to corrective disclosure.37 The Supreme Court (per Justice Barrett) implicitly agreed, holding that "[I]n assessing price impact at class certification, courts should be open to all probative evidence on that question – qualitative as well as quantitative – aided by a good dose of common sense."38 On the other hand, the Court also stated that the "final inference – that the back-end price drop equals front-end inflation – starts to break down when there is a mismatch between the contents of the misrepresentation and the corrective disclosure."39

The Court also considered the question of what it takes to rebut the presumption of price impact — the presumption that a particular item of misinformation affected market price. Specifically, the question before the Court was whether the defendant’s offering some rebuttal


39 Id. at *15.
evidence is enough or whether the plaintiff must then offer other evidence to rebut the rebuttal. On this question, the Court ruled that the defendant bears the burden of proof (by preponderance) that the alleged corrective disclosure had no impact on price – over a vigorous dissent by Justice Gorsuch – but asserted that it would seldom matter.

Both of these questions imply a logically prior question: What exactly do we mean by price impact in this context? Stock prices fall for all sorts of reasons. How do we know how much market price fell because Goldman Sachs lied about its ethical standards and how much it fell for other reasons—like the government crackdown on practices previously thought to be kosher?

There was never much doubt that the Court would agree with the many circuits that have held that an event can serve as corrective disclosure. But the Goldman Sachs Court did so without even acknowledging the question except to note the mismatch between misrepresentation and disclosure. Nevertheless, even to recognize the discrepancy is significant. By doing so, the Court lays the foundation for limiting damages to the amount of price inflation attributable to the false statement alleged in the claim. To be sure, the Goldman Sachs Court expressly eschewed the opportunity to express any opinion as to the contours of a price inflation maintenance theory. Nevertheless, the Court stated that "Under that theory, price impact is the amount of price inflation maintained by an alleged misrepresentation – in other words, the amount that the stock’s price would have fallen “without the false statement.” While the statement is a bit garbled, the implication is clear: The claim relates to the loss caused by the false statement and not the additional loss caused by independent events. Time will tell what the lower courts do with this tidbit.

The problem has been lurking in the rebuttable fraud-on-the-market (FOTM) presumption since its conception. As the Court noted in 1988 when it endorsed FOTM in Basic, Inc. v. Levinson, there are at least two ways that the presumption might be rebutted. It might be shown that the market knew the truth (and that stock price reflected it) or that the plaintiff (or a given


42 Id. at *11 (note 1).

43 Id. at *14-15, citing Glickenhaus & Co. v. Household Int’l, Inc., 787 F. 3d 408, 415 (CA7 2015). Note that Justice Barrett relied heavily on the jurisprudence of the Seventh Circuit (from which she ascended) in crafting the Court’s Goldman Sachs opinion. Indeed, she sat on the panel for the Allstate decision. See supra note 38.

44 Cf. Jander v. Ret. Plans Comm. of IBM, 910 F.3d 620, 630-31 (2d Cir. 2018), vacated and remanded, 140 S.Ct. 592, reinstated, 962 F.3d 85 (2d Cir. 2020) (discussing test for breach of fiduciary duty (BFD) that turns on what a fiduciary could not have believed at the time of making subject decision).
claimant) affirmatively did not rely on the false statement upon which the claim is based.\footnote{See Basic Inc. v. Levinson, 485 U. S. 224 (1988).}

\textit{Goldman Sachs} suggests another possibility – that the market did not care. The problem with the first and last modes of rebuttal is that they are based on showing a lack of loss causation – which is a separate element of a fraud claim. Even if it matters to a reasonable investor whether Goldman Sachs is a nice company, the market knows how the business works.

There is little doubt that Justice Barrett was mindful of the distinction and careful to focus on materiality rather than loss causation. Materiality is a familiar source of confusion for the Court (as noted by Justice Breyer during oral argument). Indeed, \textit{Basic} itself addressed the definition of materiality, rejecting a proposed bright line rule that news of a merger could not be material until the corporate parties had agreed on price and structure. (The \textit{Basic} Court reiterated a rule of reason – that a fact is material if a reasonable investor would want to know it.) But materiality is an ambiguous term. It may refer to whether the alleged misstatement mattered to a reasonable investor in the sense that it may have caused some investors to buy (or not to buy). Or it may refer to whether the alleged misstatement affected the market price. In the end, the two are one in the same because the market is the investors it comprises. If a fact (or misrepresentation) is material, it must cause some investors to act differently and thus must cause some difference in market price – except in the unusual case in which new information causes equal numbers of investors to buy as it does to sell – which may have prompted Justice Barrett’s observation that the burden of proof as to the FOTM presumption will seldom matter. It seems quite clear that Justice Barrett was thinking about loss causation. But she was able to couch the Court’s opinion in the familiar language of materiality rather than to introduce a new source of confusion, while simultaneously opening to door to consideration of how to measure direct investor loss.

The very short opinion in \textit{Goldman Sachs} (fewer than 3500 words) suggests that Justice Barrett may be the new voice of the Court for securities law cases – and a brilliant one at that. But it remains to be seen how much work can be done by the concept of materiality alone without a frank discussion of loss causation. Quite aside from the rule of reason reiterated in \textit{Basic}, the Court has also rejected the idea that materiality should be measured by statistical significance while instructing the lower courts to consider all evidence (which presumably includes statistical analyses).\footnote{See Matrixx Initiatives, Inc., v. Siracusano, 563 U.S. 27 (2011).} It is understandable that when in doubt the Court would fall back on the role of the jury as fact-finder.\footnote{See Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308 (2007).} But the Court has also been willing to find that a fact cannot be material as a matter of law because there is nothing that stockholders can do with the information.\footnote{See Santa Fe Industries, Inc. v. Green, 430 U.S. 462 (1977); Virginia Bankshares, Inc. v. Sandberg, 501 U.S. 1083 (1991).} To be sure, these cases might be distinguished because they involve stockholder
rights rather than market-moving information. But that is ultimately a distinction without a difference.

Similarly, Goldman Sachs allows for the possibility that a court might find that a fact had zero price impact, but it provides little guidance for a case in which a fact has some price impact but does not account for all of the decrease in stock price – other than to permit the court to add a good dose of common sense (whatever that means). The obvious way to address this issue in a mismatch case like Goldman Sachs is to limit the inquiry to the portion of investor loss (if any) that cannot be explained by the event that is alleged to constitute corrective disclosure. Otherwise, a plaintiff who can show that a misrepresentation – like "we are a nice company" – caused even a miniscule portion of the loss will be able to claim compensation for the entire loss and can bargain for a big settlement. Thus, there is a deep connection between the seemingly unrelated issues that were before the Court in this case.

In the end, the Court ruled that: "Because we conclude that the Second Circuit may not have properly considered the generic nature of Goldman's alleged misrepresentations, we vacate and remand for the Court of Appeals to reassess the District Court's price impact determination." Again, the best way to focus attention on this issue is to address derivative claims first and thus to net out any portion of the loss suffered by all of the stockholders (as I argue in the primary piece). That approach would also obviate most of the worry about overstepping the role of the factfinder as to materiality and the closely related possibility of evidentiary equipoise as to rebuttal of the FOTM presumption. Indeed, I suspect defendants would be quite happy to bear the burden of proof as to the amount of loss that would have occurred from corrective disclosure in the absence of any coincident events if only they would be permitted by the trial court to do so (at least for now).