On the Liability of Corporate Directors to Holders of Securities for Illegal Corporate Acts: Can the Tension Between the “Net-Loss” and ”No-Duty-to-Disclose” Rules be Resolved

Geoffrey Rapp*

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ON THE LIABILITY OF CORPORATE DIRECTORS TO HOLDERS OF SECURITIES FOR ILLEGAL CORPORATE ACTS: CAN THE TENSION BETWEEN THE "NET-LOSS" AND "NO-DUTY-TO-DISCLOSE" RULES BE RESOLVED

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I. INTRODUCTION

On November 5, 1999, a federal district judge in Washington, D.C. handed down a decision suggesting that the software megafirm Microsoft had engaged in illegal anti-competitive business practices for two decades. In the wake of this decision, the media noted that private antitrust plaintiffs were lining up to file civil actions to recover damages suffered as a consequence of Microsoft's illegal conduct. Companies which experienced low sales and diminished market share as a result of Microsoft's illegal acts, ranging from rival software firms to Internet startups, were seen as potential litigants, as were consumers who purchased

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* Adjunct Professor, Wayne State University Law School; Law Clerk Cornelia G. Kennedy (U.S. Court of Appeals for the Sixth Circuit); J.D., Yale Law School; A.B., Harvard College (Economics).

1. See Bill Straub, Chesley v. Microsoft: Two Giants Face Off, CINCINNATI POST, Jan. 12, 2000, at 1A.

2. See, e.g., id.; Lee Gomes, Microsoft Agrees to Settle Suit by Caldera, ASIAN WALL ST. J., Jan. 12, 2000, at 7 (describing forty private law suits filed in the wake of Judge Jackson's ruling that Microsoft had engaged in anti-competitive behavior); David Wilson, Experts Are Divided on Strategy for Microsoft Class Action Suits, SAN JOSE MERCURY NEWS, Nov. 23, 1999 ("a wave of class action suits builds across the country . . . "); reprinted in KNIGHT-RIDDER TRIB. BUS. NEWS, Court Decision on Microsoft Could Embolden Litigation: Private Lawsuits Expected in the Wake of Federal Action, KAN. CITY STAR, Nov. 9, 1999, at D10 ("a flurry of fresh lawsuits . . ").
Microsoft products at inflated prices.³

One immediate consequence of the judge's ruling was that the value of Microsoft stock plummeted, falling by nearly five percent in the following week and a half.⁴ The media paid little attention to the possibility that this result of the judge's decision (rather than the judge's legal findings) could prompt litigation against Microsoft. Millions of Americans hold stock in Microsoft.⁵ Their investment portfolios took a hit once the federal judge found Microsoft behaved as a monopolist. Yet the media did not seem to think that these investors would have any claim against the directors of Microsoft for the illegal acts that led to the decline in the value of Microsoft shares.⁶

The absence in the business press of any suggestion that Microsoft shareholders might seek to recoup their losses through a derivative action against the company's directors is not surprising. Courts have created a muddled law governing the liability of corporate directors to holders of securities for the illegal acts of a corporation.⁷ This confusion has led to an absence of attention. Conflicting judicial opinions have led the media, and perhaps even legal scholars,⁸ to shy away from the topic.

This Article explores the liability of corporate directors to

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³ See, e.g., sources cited supra note 2.
⁴ See Arthur M. Lewis, Rethinking: Microsoft Stock, S.F. CHRON., Nov. 16, 1999, at C1; cf. Richard Croft, Investing Options: How to Play the Microsoft Game, NAT. POST, Nov. 16, 1999, at D3 ("The growth in the company's share price will be hampered by Judge Jackson's ruling.").
⁵ See Straub, supra note 1, at 1A.
⁶ A review of articles mentioning "pending" or "likely" litigation turns up no articles suggesting shareholder claims against Microsoft directors.
⁷ See United States v. Matthews, 787 F.2d 38, 48 (2d Cir. 1986) ("The full extent of the obligation to disclose such information is uncertain in light of existing cases."). For a review of the case law concerning general liability of directors for the illegal acts of the corporation, see Norwood P. Beveridge, Does the Corporate Director Have A Duty Always to Obey the Law?, 45 DEPAUL L. REV. 729 (1996).
⁸ See Eric D. Roiter, Illegal Corporate Practices and the Disclosure Requirements of the Federal Securities Laws, 50 FORDHAM L. REV. 781, 782 (1982) ("The decisions in this area do not lend themselves to such an undertaking; a number have been settled by consent, and others have been decided with little attempt by the courts to enunciate principled standards.").
shareholders for the illegal acts of corporations. It suggests that there is a tension between two lines of cases that results in the systematic injustice for a specific class of holders of corporate securities. The first line of cases — from the state courts — consists of Shareholder Derivative Suits ("SDSs") filed by aggrieved shareholders against directors, and establishes the so-called "net-loss" principle. To sue a company's directors for damages resulting from illegal acts (typically a decline in share price resulting from imminent governmental punishment), a shareholder would need to establish that the loss in share price resulting from the illegal act outweighs the gain in share price resulting from the increased sales or profits the illegal act produced. The idea is that a shareholder who enjoyed the run-up in the value of Microsoft common stock that resulted from Bill Gates's aggressive and evidently illegal industrial strategy should not now be able to sue to recover the decline in share value resulting from the federal district court's holding that that strategy violated the Sherman Act. Only if the illegal acts resulted in a "net loss" could directors be held to have breached their fiduciary obligation to maximize share price.

The second line of cases from the federal courts approaches the liability of corporate directors for illegal acts of the corporation not from the perspective of the duty to maximize corporate value under state law, but rather from the perspective of the duty to disclose under federal securities laws. This line of cases holds that corporate directors are not liable for failing to disclose that a corporation is engaged in an illegal act. Couched in the Fifth Amendment's protection against self-incrimination, these cases

12 See Roeda, 814 F.2d at 26-28; see also Amalgamated Clothing & Textile Workers Union v. J.P. Stevens Co., 475 F. Supp. 328, 331-32 (S.D.N.Y. 1979) vacated as moot, 638 F.2d 7 (2d Cir. 1980).
conclude that there is no affirmative duty to disclose.\textsuperscript{13}

This Article suggests that a tension between the net loss principle and the no-duty-to-disclose rule produces systematic injustice for a specific class of shareholder: those who bought the stock after the market had taken into account the positive results of the illegal conduct such as higher sales, higher profits, and faster growth, but before the disclosure that the corporation was engaged in illegal conduct. Because of the no-duty-to-disclose rule, these shareholders did not know that the corporation in which they were investing was engaged in illegal acts, and thus cannot be said to have accepted the risk of government sanction for the chance of high returns. Even if there was no net loss, however, these shareholders will have suffered mightily. Particularly, these shareholders bought after the stock price had risen on account of the benefits of the corporation's illegal acts and therefore did not enjoy any of the gains from the illegal conduct. Nevertheless, they will suffer all of the pain once that conduct is discovered or disclosed.

This injustice might not be something to worry about. The "efficient markets hypothesis" of financial economists holds that stock prices reflect future expectations of earnings based on all presently available information.\textsuperscript{14} A strong-form "efficient markets" hypothesis suggests that insider trading would produce market valuations discounted by the risk that the company's illegal acts would be discovered.\textsuperscript{15} However, the best evidence suggests that this strict form efficient markets hypothesis is not valid in the real world, particularly in light of aggressive anti-insider trading laws.\textsuperscript{16}

A second way to make sense of this tension is to argue that it is not a significant problem, given the criminal law's deterrent effects.

\textsuperscript{13} See United States v. Matthews, 787 F.2d 38, 49 (2d Cir. 1986).


\textsuperscript{16} See id. at 1091.
on illegal behavior by corporations. Perhaps criminal law combined with the incentive pay structure facing corporate directors so deters illegal acts by corporations that one need not worry that investors will regularly suffer injustice. However, the nature of option pay — with directors rewarded for stock gains but not sufficiently punished for losses — means that directors will take more risks with respect to the law than shareholders might hope. As a result, the deterrent effect of criminal law is not substantial enough to discount the injustice resulting from the tension between the no-duty-to-disclose rule and the net-loss rule.

The fact that this tension exists is in some sense surprising, given the historic pattern of the development of American corporate law. The regulation of corporate law has been increasingly federalized with the emphasis now placed on financial markets governed by federal securities regulation. At the same time, state laws remain in effect. One would tend to think that the presence of two overlapping sources of corporate law would create redundancies. Specifically, a given issue would tend to be governed by too much, rather than too little, corporate law. That any shareholders would not receive adequate protection would therefore be surprising. The tension described in this Article is an example of an issue "slipping through the cracks." Perhaps the overlapping nature of state and federal corporate law leads both state lawmakers and federal securities regulators to assume that the other is or will be responsible for protecting a particular class of shareholder. As this Article will argue, such faith is misplaced.

17. The tension between investor preference and manager behavior, of course, arises from the agency costs inherent in the relationship. Since monitoring is an imperfect and expensive solution, manager-agents engage in "hidden actions" against interests of the shareholder-principals. For a description of the literature on the principal-agent problem, see Geoffrey C. Rapp, Agency and Choice in Education, 8 EDUC. ECON. 37, 38-39 (2000).
19. See id.
20. See id.
Part I of this Article describes the emergence of the net-loss and no-duty-to-disclose rules in corporate law. It includes a review of the major cases establishing and defining the two doctrines, and the proffered justifications for each. Part II of the Article describes the tension between these two rules and how this tension systematically deprives a class of shareholders of its right to recover. Part III of the Article considers whether the efficient markets hypothesis or the criminal law provides a reason for discounting the tension between these two rules. Finally, Part IV suggests avenues for reform.

II. THE EMERGENCE OF AND JUSTIFICATION FOR THE NET-LOSS AND NO-DUTY-TO-DISCLOSE RULES

Corporate directors generally have a legal duty to obey the law. Directors who knowingly cause the corporation to disobey the law, under the American Law Institute’s Principles of Corporate Governance, violate their fiduciary duty of care. In theory, at least, shareholders have a right to recover from corporate directors for the illegal acts in which they cause a corporation to engage. In the modern era, however, very few courts have held directors liable to shareholders for illegal acts.

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the states or federal government are the more appropriate regulator of corporate disclosure . . . ."

22. See Beveridge, supra note 7, at 729 (“It is taken for granted that the corporate board of directors has a duty to adopt and enforce policies and procedures regarding institutional compliance with law.”) (citing Corporate Director’s Guidebook 1994 Edition, 49 BUS. LAW. 1243, 1249, 1251, 1267 (1994)); see also Melvin A. Eisenberg, The Duty of Care of Corporate Directors and Officers, 51 U. PITT. L. REV. 945 (1990) (“Corporate directors and officers are under three general legal duties: the duty to act carefully, the duty to act loyally, and the duty to act lawfully.”).

23. See PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS §§2.01(b)(1) cmt. g, 4.01 cmt. d (1994) [hereinafter PRINCIPLES OF CORPORATE GOVERNANCE].

24. See Beveridge, supra note 7, at 730.

25. In 1977, one scholar found no modern cases of that sort. See John C. Coffee, Jr., Beyond the Shut-Eyed Sentry: Toward a Theoretical View of Corporate Misconduct and an Effective Legal Response, 63 VA. L. REV. 1099, 1173 (1977). In the intervening years, at least one court has found such liability.
This is primarily due to two competing principles: (1) shareholders must show the illegal act resulted in a net loss, and (2) corporations have no duty to disclose illegal acts under federal securities laws.

A. THE NET-LOSS RULE

The "net-loss" rule emerged in a line of New York SDSs concerning corporate antitrust law abuses. Like all SDSs, these suits faced a number of procedural and substantive obstacles. The basic theory of a shareholder derivative suit is that managers/directors of a corporation are liable to the corporation for failing to exercise reasonable care or act with loyalty with respect to the corporation. Shareholders have standing derived

See discussion infra Part I(B)(3). Other than those described in that Part, there are several defenses available to corporate directors sued by shareholders for their illegal acts, which may help explain the absence of rulings against directors. One particularly powerful defense is reliance on the advice of legal counsel. Where corporate directors relied on the opinion of counsel as to the legality of the corporation's behavior, they are only liable to the extent that their reliance was unreasonable. See Spirt v. Bechtel, 232 F.2d 241, 246-48 (2d Cir. 1956); see also Beveridge, supra note 7, at 741; Douglas W. Hawes & Thomas J. Sherrard, Reliance on Advice of Counsel as Defense in Corporate and Securities Cases, 62 VA. L. REV. 1 (1976) (describing the doctrine of reliance). State laws indemnifying corporate directors may be another bar to actions based on the illegal conduct of corporations. See Beveridge, supra note 7, at 745-750, (although such statutes will likely not apply where the circumstances indicate the directors knowingly and willfully caused the corporation to violate the law).


28. See Beveridge, supra note 7, at 736-37.

29. See id. at 737 ("After the commencement of the derivative action, the board created a special litigation committee.").

30. See id. at 730 ("The conventional wisdom seems to be that the shareholders may have the right to hold the board of directors liable if it was the directors that caused the corporation to break the law.").
from their partial ownership of the corporation.\textsuperscript{31}

The first SDSs based on harm resulting from illegal acts of corporations did \textit{not} embrace the idea that shareholders need to show a net loss in order to recover from corporate directors.\textsuperscript{32} In the classic and since over-ruled 1909 New York case of \textit{Roth v. Robertson}, the minority shareholder in an amusement park company sued the majority shareholder and manager after the corporation paid a bribe to avoid having to shut down its Niagara Falls roller coaster on Sundays (in compliance with state law).\textsuperscript{33}

Relying on the now-defunct doctrine of \textit{ultra vires}, the state court declared the bribe to be beyond the purposes of the corporation and ordered the defendant to pay back the corporate treasury.\textsuperscript{34} There was no clear harm to the corporation.\textsuperscript{35} Instead, it benefited from the bribe, remaining open on Sundays and deriving profits as a result, and the court's order simply forced the majority shareholder to pay the cost of the bribe out of his own pocket.\textsuperscript{36}

\textbf{1. The Emergence of the "Net-Loss" Rule in New York Shareholder Derivative Suits and its Adoption Elsewhere}

More recent New York cases have declined to follow \textit{Roth} and instead established a "net-loss" rule.\textsuperscript{37} The rule emerged during the

\textsuperscript{31} See Lawrence E. Mitchell, \textit{The Fairness Rights of Corporate Bondholders}, 65 N.Y.U. L. REV. 1165, 1192-93 (1990) ("Under classical corporate theory stockholders are the owners of the corporation and, therefore, are the appropriate constituents to enforce the duty of loyalty through litigation designed to redress harm to their assets.") (citing Kusner v. First Pa. Corp., 395 F. Supp. 276, 284 (E.D. Pa. 1975) rev'd on other grounds, 531 F.2d 1234 (3d Cir. 1976)).

\textsuperscript{32} See \textit{Roth v. Robertson}, 118 N.Y.S. 351 (N.Y. Sup. Ct. 1909) ("[F]or reasons of public policy, we are clearly of the opinion that payments of the corporate funds for such purposes as those disclosed in this case must be condemned, and officers of a corporation making them held to a strict accountability and be compelled to refund the amounts so wasted, for the benefit of the stockholder . . . .").

\textsuperscript{33} See \textit{id}.

\textsuperscript{34} See id. at 351-54.

\textsuperscript{35} See Beveridge, \textit{supra} note 7, at 736.

\textsuperscript{36} See id.

middle of the twentieth century. To prove damages, plaintiff shareholders would need to show actual harm to the corporation. The mere imposition of a fine by a governmental authority was not enough to prove harm. The net-loss principle has since been adopted by other leading jurisdictions.

What is the foundation of the net-loss rule? Courts do not want investors to be able to profit from the illegal acts of the companies in which they hold securities. If a company engages in an illegal act that increases stock prices, shareholders enjoy that income. If the company’s illegal behavior is discovered and stock prices fall, but not below the level at which the stock traded before the company began to break the law, it would be unjust to allow a shareholder to recover from the company for the decline in stock price. To hold otherwise would in effect establish that the shareholder is entitled to the profits of the illegal acts, in spite of the government’s imposition of punishment. Courts are understandably reluctant to reach such a result on policy grounds.

That the net-loss rule emerged in the context of antitrust cases may be somewhat surprising. Directors of companies which

38. See, e.g., Borden, 231 N.Y.S.2d at 903; Spinella, 62 N.Y.S.2d at 263.
39. See Miller, 507 F.2d at 763 n.5 (“Under New York law, allegation of breach even of a federal statute is apparently insufficient to state a cause of action unless the breach caused independent damage to the corporation.”).
40. See Spinella, 62 N.Y.S.2d at 263.
41. See, e.g., Citron v. Merritt-Chaptman & Scott Corp., 407 A.2d 1040, 1045 (Del. 1979) (finding no liability where illegal actions benefited the corporation). The A.L.I. suggests that the net-loss principle was called into doubt by a 1969 New York decision, *Diamond v. Oreamuno*, 24 N.Y.2d 494 (1969). See PRINCIPLES OF CORPORATE GOVERNANCE, supra note 23, § 7.18 cmt. e (arguing that *Oreamuno* expresses concern that the net-loss rule ignores the possibility that “an intangible loss to the corporation might arise from adverse publicity and stigmatization.”). Commentators have objected to the A.L.I.’s characterization. See Beveridge, supra note 7, at 744 (“That [the belief that *Oreamuno* cast doubt on the validity of the net-loss rule in New York] is not at all true.”).
42. See Borden, 231 N.Y.S.2d at 903 (“No damage is to be inferred from the conduct of corporate business which happens to violate the Sherman Anti-Trust [sic] Act unless the acts constituting such violation also cause independent
violate antitrust laws—like Microsoft in the example discussed above—may always defend themselves by saying that they reasonably relied upon the advice of counsel. Bribery and other clear violations of the law are more common in the recent case law as a basis for illegal-act liability suits.

2. The American Law Institute Approach

Under the ALI’s Principles of Corporate Governance, the net-loss rule should be modified in three ways. First, courts would be prohibited from offsetting losses from one transaction against profits from a distinct but identical transaction. Second, courts could refuse to offset profits that they find contrary to public policy. Third, corporations would have the burden of proving that the illegal act resulted in profits.

These are sensible modifications. If a company’s directors cause it to offer bribes to two separate officials, and the result of one leads to a net gain and the other to a net loss, those directors should nevertheless be liable for the loss resulting from the “bad” bribe. Moreover, giving courts the de jure power to decline to

damage to the corporation, and were against the interests and the benefits of the corporation.

43. See supra note 25 and accompanying text.
44. See cases cited supra note 11.
45. A plaintiff bears the burden of proving causation and the amount of damages suffered by, or other recovery due to, the corporation or the shareholders as the result of a defendant’s violation of the standard of conduct [of the Principles]. The court may permit a defendant to offset against such liability any gains to the corporation that the defendant can establish arose out of the same transaction and whose recognition in this manner is not contrary to public policy. PRINCIPLES OF CORPORATE GOVERNANCE, supra note 23, § 7.18(c).
46. See id. at § 7.18(c), cmt. e.
47. See id.
48. See id.
49. But see Beveridge, supra note 7, at 745 (“There is no justification for any of these changes. The court should have the authority to decide in a particular case whether or not a corporation has suffered damages as a result of an illegal course of conduct.”).
50. See Principles of Corporate Governance, supra note 23, § 7.18 cmt. e (“Only if the five [bribes] were part of the ‘Osame transaction’ can the gains on
apply the net-loss rule on policy grounds merely states the factual, since courts occasionally ignore the rule anyway when policy considerations justify doing so. Lastly, putting the burden on the corporation to prove that the illegal acts led to particular profits means that the party with the most information about the sources of various income streams will be the one with the incentive to assist the court in understanding from where a particular income stream comes.  

B. The No-Duty-To-Disclose Rule

Under federal securities laws, corporate directors have an affirmative duty of disclosure under certain circumstances. Rule 10b-5 of the Securities Exchange Act of 1934 makes it illegal for any individual "[t]o make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstance under which they were made, not misleading." Under federal court precedent, this rule creates a private cause of action.

In the wake of revelations of illegal acts and impending governmental sanctions, disgruntled shareholders have sought to sue directors for failing to disclose that their respective corporations had engaged in illegal conduct. Courts have been hostile to such suits and have ruled that corporations have no

51. See id. ("Such an allocation of the burden of proof is justified by the superior access of the defendants to the relevant facts.").


55. In a 1982 article, one commentator noted that "private litigants have met
affirmative duty to disclose their illegal acts unless governmental proceedings are pending or known to be contemplated.  

1. Alpha Industries: Reliance on (Irrelevant) Precedent

In *Roeder v. Alpha Industries, Inc.*, the United States Court of Appeals for the First Circuit rejected a claim that corporate directors had a duty to disclose illegal acts. The defendant, a defense firm, had paid a $57,000 bribe to obtain a contract from Raytheon, one of the nation's leading defense firms. The plaintiff had purchased Alpha Industries stock after the payment of the bribe but before the company announced that one of its Vice Presidents would be indicted. The stock price had fallen from $21 per share at the time of purchase to just over $11 per share at the time of sale.

The federal district court ruled that the bribery was not "material" under Rule 10b-5 until the U.S. Attorney was likely to indict a company official and, therefore that Alpha Industries officers and directors had no obligation to disclose the company's illegal acts. Writing for the First Circuit, Judge Bownes overruled the district court on the issue of whether bribery was material.

with a singular lack of success in proxy suits brought to recover money damages or restitution from corporate managers who have paid bribes or made questionable payments to improve corporate earnings." Roiter, supra note 8, at 804.

56. Under SEC rules, companies must disclose criminal activity when governmental proceedings are pending or known to be contemplated. See 17 C.F.R. 229.103; see also Vanyo & Kopel, supra note 52, at 40. The litigation described in this section concerns whether a duty to disclose illegal acts exists prior to those circumstances.

57. See *Roeder v. Alpha Indus., Inc.*, 814 F.2d 22 (1st Cir. 1987).

58. See id. at 23.

59. See id. at 24.

60. See id.

61. 17 C.F.R. § 10b-5.

62. See *Alpha Indus.*, 814 F.2d at 24.

63. See id. at 25. The test for materiality, the judge wrote, is whether information "might have [been] considered important" by a "reasonable investor." *Id.* (citing Affiliated Ute Citizens Bank of Utah v. United States, 406 U.S. 128, 153-54 (1972); see also *Cook v. Avien*, Inc., 573 F.2d 685, 693 (1st Cir. 1978)); *SEC v. Joseph Schlitz Brewing Co.*, 452 F. Supp. 824, 830 (E.D. Wis.)
Relying on precedent that there was no duty to disclose absent statutory obligations or insider trading, however, Judge Bownes affirmed the dismissal of plaintiff's securities fraud suit.

Other than citing precedents, the First Circuit provided no analysis as to why there should be no duty to disclose illegal acts. Indeed, its suggestion that illegal acts were material indicates that the Court of Appeals appreciates the harm done to the plaintiff by the corporation's misconduct. The court seems wedded to authorities holding that there is no affirmative duty to disclose, authorities which are based on entirely different factual circumstances.

2. Matthews: Fifth Amendment Concerns

Facing a slightly different set of facts, the Second Circuit reached a similar conclusion concerning the lack of a duty of corporate directors to disclose illegal acts. The defendant in the Matthews case was simultaneously charged with conspiring to bribe members of the New York State Tax commission and with breaching controlling securities laws by failing to disclose that conspiracy. At trial, the defendant was acquitted of conspiracy but convicted of securities violations. Considering his appeal on

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1978). Because it bears on the question about the competency of management, information about bribery may be "critically important to investors." Alpha Indus., 814 F.2d at 25.


65. See Alpha Indus., 814 F.2d at 22, 31 ("[W]e rule that the complaint fails because it does not allege facts giving rise to a duty to disclose."). The First Circuit also rejected plaintiff's RICO claim because of failure to show causation and a pattern of misconduct. See id. at 30.


67. See id. at 39.

the securities conviction, the Second Circuit held that the defendant had not failed to disclose any true facts because the evidence of conspiracy was thin.69

The Second Circuit's decision not to find the existence of a duty to disclose is bound up with a concern for the Fifth Amendment protection from self-incrimination.70 This may be the most powerful factor in shaping the no-duty-to-disclose rule. Because disclosed illegal acts could be introduced as evidence against corporate directors in a criminal trial, such disclosure, courts feel, cannot be mandated in light of the Fifth Amendment.

The Matthews court also explicitly rejected the idea that shareholders had a right to evaluate the morality of directors' conduct.71 However, one might make the argument that investors have a right to disclosure of illegal acts so as to avoid moral complicity in those acts.72 For example, one could argue that an investor who is morally repulsed by child labor is owed disclosure of ongoing illegal labor practices so that the investor can remove her money from the "tainted" company. That argument is not taken up in this Article, but might provide further cause to

corporation is not considered a "person" under the Fifth Amendment and therefore is not entitled to protection from self-incrimination); see also Braswell v. United States, 487 U.S. 99, 109-10 (1988) (holding that a custodian of corporate records is not entitled to Fifth Amendment protection where producing corporate records will personally incriminate the custodian).

69. See Matthews, 787 F.2d at 45-56.

70. See id. at 46 (holding that defendant has no obligation to "state to all the world that he was guilty of the uncharged crime of conspiracy"). The Second Circuit quoted the SEC's former General Counsel Harvey L. Pitt as saying: "To ask people to accuse themselves and indict and convict themselves is silly. So why should that be required in proxy statements? Such a disclosure statement... runs counter to what the Fifth Amendment is all about." Id. at 45 n.4.

71. See id. at 49 ("Matthews was not legally required to confess that he was guilty of an uncharged crime in order that Southland's shareholders could determine the morality of his conduct.").

72. See Note, Disclosure of Payments to Foreign Government Officials Under the Securities Acts, 89 HARV. L. REV. 1848, 1863 (1976) ("The argument that many investors are interested in avoiding ownership of companies whose conduct is socially or morally undesirable as well as in making money, and that the reasonable investor would therefore consider ethically significant information important, has gathered some strength in recent years.").
reconsider the no-duty-to-disclose rule.

3. **Crop Growers: Sec Intent**

In a 1997 case, a District of Columbia federal court offered a new explanation for the no-duty-to-disclose rule: SEC intent. The government charged the Crop Growers Corporation, a holding company, with several counts of campaign finance and securities law violations. The charges arose as a result of independent counsel Donald Smalz's investigation of Secretary of Agriculture Mike Espy.

In rejecting the government's claim that Crop Growers had a duty to disclose its illegal campaign finance activities, Judge Kessler pointed to the *Matthews* and *Alpha Industries* decisions. He went on to argue that the SEC could have adopted a formal requirement that directors disclose ongoing illegal acts. The Judge noted that when the SEC approved rules requiring disclosure of criminal convictions and pending criminal proceedings it "considered requiring disclosure of questionable or

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74. See id. at 340-41.
75. See id.
76. See id. at 345-47.
77. See id. at 346. The *Matthews* Court also noted the SEC's failure to adopt language establishing an affirmative duty to disclose. See Matthews v. United States, 787 F.2d 38, 38 ("Attempts to enlarge upon the disclosure requirements... provoked enormous disagreement... among respected practitioners and were described by various commentators as controversial, unclear, fuzzy, and inconsistent.") (second ellipsis in original) (citing John M. Fedders, Speech at ABA Committee Meeting on Failure to Disclose Illegal Conduct, in 14 SEC. REG. & L. REP. (BNA) 2057, Nov. 26, 1982); see also George S. Branch & James A. Rubright, *Integrity of Management Disclosures Under the Federal Securities Laws*, 37 BUS. L., 1447, 1451 n.16 (1982); Ralph C. Ferrara et al., *Disclosure of Information Bearing on Management Integrity and Competency*, 76 NW. U. L. REV. 555, 564 (1981); Note, *Disclosure of Corporate Payments and Practices: Conduct Regulation Through Federal Securities Laws*, 43 BROOK. L. REV. 681 (1977); Burt Schorr, *SEC's Fuzziness on What Illicit Dealings Should be Reported Limits Disclosure*, WALL ST. J., Mar. 29, 1976, at 26 col. 1.
illegal payments."^{79} However, the Commission "failed to adopt such a requirement."^{80} Since "the SEC clearly knows how to write specific disclosure requirements into its regulations, and has chosen not to do so for uncharged criminal conduct,"^{81} it intended there to be no affirmative duty to disclose illegal acts.

4. Exceptions: Courts Finding Duty to Disclose

Several courts have broken ranks and held that there is an affirmative duty to disclose illegal acts.^{82} However, so far only district courts have done so.^{83} In one such case, Judge Sifton of the

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80. *Id.*
81. *Id.*
83. See, e.g., *id.*; *In re Par Pharm. Sec. Litig.*, 733 F. Supp. 668 (S.D.N.Y. 1990) (finding a duty to disclose bribes paid to F.D.A. regulators so as to avoid misleading investors); *Ballan v. Wilfred Amer. Educational Corp.*, 720 F. Supp. 241 (E.D.N.Y. 1989); *SEC v. Joseph Schlitz Brewing Co.*, 452 F. Supp. 824 (1978) (finding a duty to disclose illegal transfers to Spanish affiliates); *SEC v. Beefpackers, Inc.*, [1997-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,079 (D. Neb. 1977) (failure to disclose existence of cash fund for bribing meat inspector rendered defendant's annual report materially misleading). Only one circuit court affirmed such a holding. *See SEC v. Fehn*, 97 F.3d 1276 (9th Cir. 1996). The facts of these cases are quite specific. In *Par Pharmaceuticals*, defendant directors had bragged about their success at achieving speedy SEC approval without disclosing that such speed was a direct result of more than a dozen bribe payments. *See Par Pharmaceuticals*, 733 F. Supp. at 675-77 (stating: [B]y comparing Par's success in this regard to other companies in the industry and to its own previous performance, and by projecting continued success in obtaining rapid approvals, the statements conveyed to a reasonable investor the false impression that Par had a particular expertise in obtaining FDA approvals constituting a legitimate competitive advantage over other companies and that this advantageous expertise was responsible for its success in obtaining FDA approvals.).

The *Schlitz Brewing* case is also based on special circumstances: the size of the payments, not the payments themselves, motivated the Court's finding that the company needed to disclose. *See Schlitz*, 452 F. Supp. 824 at 829. These cases do not generally hold that there is an affirmative duty to disclose, absent the need to correct prior misleading statements. *See, e.g., Par Pharmaceuticals*, 733 F.
Eastern District of New York held that Professional Care, Inc. breached its duty to disclose. Professional Care provided various services to health care facilities, and was indicted for Medicaid fraud. On the day of the indictment, the value of common stock in the company fell from $7.25 to $4 per share. Because of its illegal conduct, the company was no longer able to obtain Medicaid funds, which no doubt severely undermined its future prospects and harmed shareholders.

Still, these courts are the exception rather than the rule. In general, courts side with Crop Growers, Matthews and Alpha Industries and hold that there is no affirmative duty to disclose illegal acts prior to imminent governmental action. The

Supp. at 678. In Fehn, the facts the Ninth Circuit decided needed to be disclosed involved a past conviction for illegal acts that potentially carried future liability, as well as the identity of a corporate promoter which the defendant's filings had obscured. See Fehn, 97 F.2d at 1290. In Ballan, defendants failed to assert the Fifth Amendment interest at the trial court level, and were therefore precluded from relying on Matthews. See Ballan, 720 F. Supp. at 241. Moreover, the investigation in Ballan was well under way, and the court found that the defendants "launched a scheme to conceal the investigations." Id. at 244. The SEC has also punished corporate directors for the very particular failure to disclose bribes paid to foreign officials. See generally Note, Disclosure of Payments, supra note 72, at 1857. In these cases, the SEC's primary objection has tended to be to corporation's deceptive accounting practices; where bribes were paid out of broadly labeled "general funds," the SEC has not been unified in supporting a duty to disclose. See id. at 1859.
84. Greenfield, 677 F. Supp. at 112.
85. See id. at 112 n.1.
86. See id. at 112.
underlying concern for the Fifth Amendment rights of corporate directors trumps the interest of potential investors in avoiding companies run by risk-seekers with little respect for the law.

III. THE TENSION BETWEEN NET-LOSS AND NO-DUTY-TO-DISCLOSE

The net-loss rule and the no-duty-to-disclose rule are in conflict. As a result, one class of shareholders is systematically deprived of the opportunity to be compensated justly for losses arising from the illegal acts of corporations. The wronged class consists of holders of securities who bought their shares after the appreciation in stock price attributable to the company's illegal but profitable acts and before the announcement of those illegal acts.88 This class suffers the loss associated with the punishment of the corporation and enjoys none of the gains arising from the company's illegal acts. Because of the operation of the no-duty-to-disclose rule, this class cannot be imagined to have consented to the illegal acts. Likewise, from a business perspective, this class has not consented to the risky behavior of the corporation.89

The case of bribery of a defense contractor provides a clear example of this problem. Imagine a fictional defense contractor, XYZ, Inc. On January 1, 2000, the company's stock trades at $10 a share. The company has a $10 million contract with the Navy.

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88. This is not precisely the plaintiff class represented by Roeder in the Alpha Industries case. See Roeder v. Alpha Indus., Inc., 814 F.2d 22, 24 (D. Mass. 1987). In that case, the plaintiff claimed to represent all shareholders who had acquired their shares after the bribe but before the public announcement of impending indictments. See id. That plaintiff class may, therefore, have enjoyed some of the gains resulting from the bribe.

89. Under traditional agency principles, an agent cannot be held liable for illegal acts when the principle knew of or had reason to know that the law was broken. See Restatement (Second) of Agency § 34 cmt. g (1958).
On January 3, the chief executive officer of XYZ decides to pay a $500,000 bribe to an Air Force Procurements Officer to obtain a contract to provide its product to the Air Force as well. Analysts delight in the new contract and upgrade their estimates for XYZ. The increased publicity the new contract gives XYZ enables the company to obtain several deals with foreign governments. Over the next year, the increase in earnings experienced by the company leads the stock price to rise to $20 a share.

On January 1, 2001, the company receives word that a grand jury is convening to indict its CEO for bribery. As a result of the indictment, the company will no longer be able to sell weapons to either the Navy or the Air Force. On January 3, 2001, the company spokesman holds a press conference and announces this bad news. In the next few days of trading, the stock price falls to $11 a share.

Now imagine two investors, A and B. A invested in one hundred shares of XYZ on January 1, 2000. She watched in delight the news of the new contracts and the rise in stock price. B observes the investment success of investors such as A and is impressed by the return on XYZ stock. B goes on the world wide web in December, 2000 and reads XYZ’s annual report, which, unsurprisingly, does not mention the bribe. She then logs on to E-trade and purchases 50 shares of XYZ, Inc.

Neither investor has a valid cause of action. A’s lack of a cause of action is not of significant concern. Even after the collapse of the stock price, A has not experienced a “net loss.” She has in fact made ten percent. However, in just a few short days, B lost forty-five percent of her investment. Yet because the company’s stock increased ten percent overall as a result of its illegal bribe, she cannot recover for breach of the duty to maximize stock value. Because XYZ had no duty to disclose prior to receiving notice that a grand jury was convening, the company does not owe B for its failure to mention the bribe in its annual report, in spite of the fact that it gave rise to the most significant risk the company faced in the next year, the indictment.

If there were a duty to disclose illegal acts, then B’s predicament would not inspire much sympathy. After all, if the annual report mentioned the bribe and noted the risk of discovery and the significance of the punishment (something it is obviously
difficult to imagine a company actually doing), then a court could say that B made an informed decision to invest in a risky asset.

Yet she was not so informed. The tension between the net-loss rule, which prevents her recovery, and the no-duty-to-disclose rule, which prevented her from making a fully-informed choice, results in her inability to obtain just recovery in a court of law.

In addition to and because of the inability of the class of shareholders represented by B to recover for its losses, the net-loss/no-duty-to-disclose rules have the potential to induce a bias towards certain kinds of investments. Shareholders cannot recover for losses unless there is a net loss and have no way of finding out whether a corporation is engaged in illegal behavior. As a result, they may be induced to invest in companies that are least likely to be affected by the discovery and punishment of illegal behavior. Empirical studies have indicated that, in the case of bribery, large, well-established firms suffer far smaller drops in share value as a result of governmental sanctions than their smaller counterparts. The no-duty-to-disclose/net-loss dynamic may lead investors to artificially favor larger, well-established firms. One could make an argument that firms like these, which have high capital to labor ratios, are the least efficient investments, from an economy-wide perspective. The same amount of financial support could enable a smaller firm to increase productivity more than a larger firm could. As a result, the net-loss/no-duty-to-disclose regime may actually be hampering economic growth. Certainly, it is inhibiting investors from properly diversifying their portfolios.

It is impossible to get a precise handle on the number of shareholders who, like one of the aforementioned hypothetical investors, are victimized by the gap between the no-duty-to-disclose and net-loss rules. No empirical studies of derivative suits

90. See Jonathan M. Karpoff et al., Defense Procurement Fraud, Penalties, and Contractor Influence, 107 J. POL. ECON. 809 (1999) (finding that stock prices for the top one hundred defense firms fall by significantly less in the face of government penalties than the stock prices of their smaller counterparts).

91. Numerous scholars have commented on the role that the legal treatment of investments and corporations, and the law generally, can affect economic growth. See, e.g., India's Wayward Children, 12 MINN. J. GLOBAL TRADE 323 (2000) (exploring how foreign direct investment laws have affected India's economic growth rates in the post-independence era).
based on illegal acts have been done. Searching for cases describing these rules is not a substitute for empirical analysis because many of these cases settle before reaching trial, and certainly before appeals courts write the sort of opinion that ends up in case books and reporters.  

A. Sidebar: Is There Anything Special About Illegal Acts?

Thus far, this Article has presented the assumption, as the cases and secondary sources cited above have done, that there is something special about illegal corporate behavior, as opposed to simply risky corporate behavior. That is to say, is there any reason to be concerned whatsoever about compensating shareholders for illegal corporate behavior, over and above the causes of action which already lie for corporate directors who fail to exercise due care?

Without resorting to the argument that there are moral implications to investing in a company that engages in illegal acts, there are two responses available. First, courts will not be concerned about Fifth Amendment issues when the conduct in question is not illegal, and thus will be less hesitant in finding disclosure obligations. As a result, an individual who invests in a company that engages in risky but perfectly legal conduct will be less likely to fail in pursuing a 10b-5 failure-to-disclose case.

Second, illegal conduct, unlike merely risky conduct, could have lasting reputational effects for corporations, resulting in far greater losses and perhaps rendering the market for the security illiquid. Directors who engage in illegal behavior show an especially high tolerance for risk: they are simply betting that their corporations will not be discovered or prosecuted successfully, rather than betting on whether one investment will be more profitable than another. Because the long-term effects of illegal conduct on securities' values is potentially so much greater, it may

92. See, e.g., In re Caremark Int'l Inc. Derivative Litig., 698 A.2d 959 (Del. Ch. 1996) (evaluating a settlement between corporate directors and shareholders in case concerning liability for civil and criminal fines for violation of federal and state laws applicable to health care providers).

93. See supra text accompanying notes 71-72.
make sense to go to special lengths to deter such conduct.

IV. CAN THIS TENSION BE RESOLVED?

The previous Part argued that the no-duty-to-disclose and net-loss rules systematically deprive a specific class of shareholders of the opportunity to recover from corporate directors for the illegal acts of corporations. There are at least two ways in which defenders of the two rules could argue that this injustice is illusory. First, they could assert that the efficient markets hypothesis indicates that no true loss could have occurred. Second, they could argue that criminal law so deters illegal conduct by corporations as to make the issue irrelevant, although not necessarily uninteresting.

A. The Strong-Form Efficient Markets Hypothesis

The first possible way to resolve the tension between the no-duty-to-disclose and net-loss rules is to turn to a particularly strong form of the efficient markets hypothesis ("EMH"). The EMH should by now be familiar to students of corporations and securities law. Derived from the work of Nobel laureate financial economists such as Harry Markowitz, Merton Miller and William Sharpe, the basic idea of EMH is that stock prices reflect the expected future earnings of a corporation given all available information. Traders discount the impact of future windfalls and future losses by the chances that favorable or unfavorable outcomes will occur.

The EMH has taken several forms in the theoretical and empirical literature. The so-called "strong" form of the EMH offers the best way to resolve the tension between the no-duty-to-disclose and net-loss rules. This version of the EMH stresses the role of insider trading. Even if information is not publicly

95. See Macey et al., supra note 14, at 1022-23.
available, it will be used as a basis for trading by insiders. If there is some likelihood that a corporation will face an unfavorable scenario in the future, but only insiders are aware of this likelihood, such insiders will trade on that knowledge, through purchasing options, or selling their stock at opportune times. Non-insiders would not have access to the same information, but they would be able to observe the behavior of insiders. Based on the trading behavior of insiders, other investors would make decisions that in the end bring the stock price in line with what it would be if the information upon which the insiders were basing their trades were publicly available. The strong-form EMH thus holds that stock prices “fully reflect” future expectations based on all information, whether or not that information is publicly-available.\(^6\)

In contrast, the “semi-strong” and “weak” forms of the EMH down-play the significance of insider trading. Under a semi-strong EMH, stock prices accurately reflect the expected future earnings of a corporation based on all publicly-available information.\(^7\) Under a “weak” EMH, stock prices accurately reflect all available information on past stock price and nothing else.\(^8\) The logic of these forms of the EMH is the same as that of the strong form. Specifically, that trading will be based on expectations of the future and that stock prices will change in response to information that affects those expectations.\(^9\) A semi-strong or weak EMH, however, denies that non-insiders are able to accurately observe the behavior of insiders, and thus that information exclusively available within the company will be accurately priced.

If the stronger form EMH is in fact valid, then the tension described in the Part II might be dismissed. If a company is engaged in illegal acts and insiders are aware, the fact that it does not disclose those acts will not mean that a purchaser of the company’s stock will be making an investment without a sense of the risk of his investment. Insiders who have knowledge of the illegal act will trade in the stock according to their rational

\(^{97}\) See id.
\(^{98}\) Macey et al., supra note 14, 1023.
\(^{99}\) Id.
estimates of the future gains, such as high profits, sales or growth and losses, decline in stock prices resulting from governmental sanction, with each state-of-the-world discounted according to its likelihood. Non-insiders will observe the trades of insiders, and thus the stock price will reflect the risk that the company’s illegal acts will be detected or disclosed and punished and will account for the possibility of punishment. A purchaser who buys stock after a run-up resulting from the disclosed profits of non-disclosed illegal acts would not be in need of recovery. At the time that he bought the stock, its price was diminished by the probability of detection and the significance of governmental sanction.  

Under a semi-strong or weak EMH, however, the purchaser of shares inflated as a result of non-disclosed illegal acts would still have a claim. Such a person would have purchased shares that were not priced to reflect the potential risk of the discovery and punishment of the corporation’s past illegal acts. 

Economists have wrestled with the EMH. Although there is no clear consensus, the majority of financial economists side with a semi-strong-form EMH. Even if a strong-form EMH is valid

100. In some sense, this argument is the inverse of the “fraud-on-the-market” theory the Supreme Court defined in the basic decision. Basic, Inc. v. Levinson, 485 U.S. 224 (1988). The Court essentially held that, when financial markets are efficient, a plaintiff relied on misinformation even when he never actually came across the misleading statements. See generally, Macey et al., supra note 14, at 1029 (explaining the “fraud-on-the-market” theory). The argument described here is that, where markets are strong-form efficient, a plaintiff is presumed to have had full-information concerning the corporation’s illegal acts even where that information was never made public.

101. See Richard W. Jennings et al., Securities Regulation 240 (8th ed. 1998) (“The weight of the evidence underlying the ‘semi-strong’ version has accumulated to the point that there is no serious challenge today to its claim that the market absorbs and reflects new information with great speed.”). The Supreme Court recognized this consensus in a recent decision. See Basic, Inc. v. Levinson, 485 U.S. at 246 (“Recent empirical studies have tended to confirm Congress’ premise that the market price of shares traded on well-developed markets reflects all publicly available information, and hence, any material misrepresentations.” (emphasis added)). Recently, some financial economists and legal scholars have begun to question the very premise of the EMH, arguing that markets are not in fact efficient. If that is true, then the argument against ignoring the net-loss/no-duty-to-disclose conflict becomes even stronger. For a review of this literature, see Geoffrey Rapp, Proving Markets Inefficient: Courts’
theory, however, modern anti-insider trading regulations make it wrong as a matter of fact.\textsuperscript{102} Because of aggressive enforcement of anti-insider trading laws, the mechanism by which insider knowledge of a corporation’s illegal acts is translated into the price of publicly-traded securities is defeated.

\textbf{B. Criminal Penalties and Option Pay Structures}

A second way to resolve the tension between the no-duty-to-disclose and net-loss rules is to argue that unlawful acts by corporations are now so rare that the issue is of no significance. Criminal law, it could be argued, has solved the problem. Because criminal law can punish both individual directors and the corporation, such a punishment affects the value of directors’ stock options and incentive packages, and thus, deters corporate directors from pursuing illegal opportunities.

It is true that corporations, now more than ever, are subject to criminal as well as civil law. The Supreme Court long ago rejected the 19th-century rule that corporations cannot have criminal intent.\textsuperscript{103} Corporations can be fined “and even ‘put to death’ under the Federal Sentencing Guidelines, which allow imposition of a fine sufficient to divest the organization of all of its net assets in an appropriate case.”\textsuperscript{104} These guidelines have created incentives for corporations to create “compliance programs to detect violations of law” and to “promptly... report violations to appropriate public officials when discovered . . . .”\textsuperscript{105}

The empirical evidence, however, suggests that criminal law has not eliminated corporate illegality. Bribery remains quite


\textsuperscript{102} \textit{See, e.g., Dan Fischel, Insider Trading and Investment Analysts: An Economic Analysis of Dirks v. Securities and Exchange Commission, 13 Hofstra L. Rev. 127, 133 (1984) (arguing that courts reduce the efficiency of the stock market by prohibiting insider trading).}

\textsuperscript{103} \textit{See Beveridge, supra note 7, at 730 (citing New York Central & Hudson River R.R. v. United States, 212 U.S. 481, 494-95 (1909)).}

\textsuperscript{104} \textit{See id. (citing United States Sentencing Commission, Guidelines Manual § 8C1.1).}

\textsuperscript{105} \textit{In re Caremark Int’l Inc. Derivative Litig., 698 A.2d 969 (Del. Ch. 1996).}
common, particularly in the government-procurement context.106

Moreover, the incentive pay structures in which corporate directors operate encourage risk-taking and illegal acts. As Judge Frank Easterbrook noted, "compensation through trading opportunities amounts to paying managers in lottery tickets. The price of stock reflects the expected outcomes of the firm's projects, so that only unusually good outcomes produce profitable trading opportunities."107 In other words, a corporate director has no reason to prefer an average outcome to a disastrous outcome. The only outcome that raises directors' utility is a better-than-expected outcome. What better way is there to achieve surprisingly good results than to engage in illegal acts which need not be disclosed to the public?

V. CONCLUSION

Neither the strong-form efficient markets hypothesis nor the deterrent power of the criminal law offers a means of reconciling the tension between the net-loss and no-duty-to-disclose rules. To avoid continued injustice for shareholders such as those described in Part III, some modification of the existing rules is necessary.

The most obvious remedy would be to eliminate one of the rules. For example, courts could eliminate the no-duty-to-disclose-

106. See Beveridge, supra note 7, at 732 ("One need only glance at a newspaper to see that criminal wrongdoing by corporations is commonplace."); see also Andy Pasztor, U.S. To Charge Litton Unit with Fraud, WALL ST. J., Sept. 24, 1993, at A3 (reporting that one federal operation led to the conviction of sixty-five corporations and individuals for criminal conduct); Karpoff et al., supra note 90.

107. Frank H. Easterbrook, Insider Trading as an Agency Problem, in PRINCIPALS AND AGENTS: THE STRUCTURE OF BUSINESS 84, 87-88 (John Pratt and Richard Zekchauer, eds.) (1984); see also Kenneth E. Scott, Insider Trading, Rule 10b-5, Disclosure and Corporate Privacy, 9 J. LEG. STUD. 801 (1980); Frank H. Easterbrook, Criminal Procedures as a Market System, 12 J. LEG. STUD. 289. But cf. RICHARD S. GRUNER, CORPORATE CRIME AND SENTENCING 45 (1994) (arguing that top managers will avoid criminal acts because the benefits go to the firm but the consequences tend to fall on the individuals). What Gruner's argument ignores is that option-driven directors are far more sensitive to stock gains than the average shareholder. As option-based compensation has come to dominate corporate America, his argument has less merit.
illegal-acts rule. Realistically, elimination of the no-duty-to-disclose rule would be unlikely to affect the amount of information available to the investing public.\textsuperscript{108} However, it would provide a basis for aggrieved shareholders to obtain justice. The weakness of this approach is that it solves too much, since it would allow all shareholders, even those who had profited from the illegal act, to recover for the breach of the duty to disclose. Moreover, requiring disclosure of illegal conduct would benefit the future purchasers of a security, who would have an accurate sense of its risk, at the expense of current holders of the security, as disclosure would cut share price.\textsuperscript{109}

The second obvious solution would be to eliminate the net-loss rule. Again, such an approach solves too much. Eliminating the net loss rule would help shareholders who bought after the market had processed the fruits of the company's illegal acts. But it would also allow shareholders who had purchased their securities prior to the run-up in share price resulting from the illegal acts to profit from the illicit corporate behavior.

A third possibility would be to eliminate insider trading laws. That would help make the capital markets more efficient. Under the present regime, which provides harsh penalties for those found to have engaged in insider trading, markets do not function according to a "strong" efficient markets hypothesis. Freeing up insiders to trade on their knowledge of a corporation's illegal acts might go a long way to bringing reality closer to theory. Perhaps resolving the tension described in Part III should merely be thought of as another argument in favor of eliminating insider-trading provisions.\textsuperscript{110} The problem is that such a reform would run up against all of the other disadvantages of liberalizing the insider trading rule, which have been extensively argued elsewhere.

Perhaps the best solution would be to make an exception in

\textsuperscript{108} See Amalgamated Clothing & Textile Workers Union v. J.P. Stevens & Co., 475 F. Supp. 328, 332 (S.D.N.Y. 1919) (stating that such a requirement "would [be] a silly, unworkable rule. It would not promote increased disclosure, but would serve only to support vexatious litigation and abusive discovery.").

\textsuperscript{109} See Note, Disclosure of Payments, supra note 72, at 1861.

\textsuperscript{110} For a lengthy argument in favor of allowing insider trading, see generally Henry G. Manne, Insider Trading & The Stock Market 101, 102 (1966) (arguing that insider trading enhances market efficiency).
the net-loss rule for the class who buys after the illegal act's results are priced but before the disclosure of impending governmental sanctions. 111 There would be some difficulty of determining who is in that class. Modern financial economics is, however, an increasingly sophisticated field, and economists would be able to assist courts in identifying the aggrieved class. So-called "event studies" are a powerful tool "because they allow the investigator to discern whether information that is used in an allegedly fraudulent action is important to investors and to determine the value of the information." 112 Coupled with new powerful computer technology, which makes increasingly complex financial calculations less costly and time-consuming, these techniques can overcome the difficulty of defining the aggrieved class.

Any abrogation of the net loss rule, of course, puts more power in the hands of plaintiffs' lawyers. Critics question the propriety of such a shift, 113 in so far as plaintiffs lawyers may sometimes file "phantom" derivative actions or face incentives to collude with defendant directors and settle against the interests of a plaintiff class. Still, under the present regime, one class of shareholder is systematically deprived of its right to recover. That lawyers would take a substantial share of any recovery is not a defense of the status quo. Moreover, the threat of litigation would, over the course of time, lead corporations to adjust their behavior so as to engage in fewer illegal acts. Thus, over time, plaintiffs' lawyers would not enjoy abnormal litigation returns. 114

Courts should implement this change, despite the complexity

111. For those who purchased during the increase in stock value, only partial recovery would be permitted. That is, if the illegal act was committed on December 1st with the stock price at $10, X bought at $15 on December 15, the stock reached $20 on December 20 before the disclosure of impending indictment on December 30, resulting in a decline in the value of shares to $12, then X could recover just the $3 per share X lost, rather than the $8 per share someone who purchased on December 20 would be able to recover.


113. See Beveridge, supra note 7, at 778, 778 n.310.

114. Cf. Geoffrey Rapp, Reconsidering Educational Liability, 18 YALE L. & POL. REV. 463 (2000) (arguing that over time lawyers' return from educational liability suits would diminish, as would the incentive to file suits, as schools adjust their behavior to avoid new-found liability).
ruling on such suits would involve. Judges should seek expert assistance from financial economists. There is simply no good reason for judges to sit by while shareholders are systematically denied just recompense.
Notes & Observations