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The challenges facing the audit profession, while profound and worthy of careful regulatory and legislative attention, are hardly unique. Indeed, a material portion of the profession's liability exposure arises in securities fraud litigation alleging a material misrepresentation or omission that affects aftermarket prices. A large academic literature explains that the rule for calculating damages in these cases makes no economic sense, and fails both as a matter of deterrence and compensation. That rule, widely known as the "out of pocket" damage formula, exposes all defendants, not just auditors, to damage claims that are irrationally large and that can easily bankrupt even the most solvent institutions, while failing, in the aggregate, to achieve the essential purposes of the federal securities laws. Another large literature explains that the current regime fails adequately to deter securities fraud because it allows the individuals responsible for the fraud to externalize their liability through corporate payments, indemnification and insurance.

Rules of law that seek to apportion liability among defendants in these cases are certainly welcome. These rules do not, however, address the root cause of the problem: proportionate allocation of a disproportionate damage award that bears no rational economic relationship to the economic harm caused by the fraud remains an irrational award.

The policy implications of this observation are straightforward. The damage rule in these cases should be changed so that defendants are liable for amounts that reflect the true economic harm caused by misrepresentations and omissions, and not an irrationally large amount that has no relationship to the true magnitude of the economic harm caused by the fraud, and that fails to achieve the law's primary goals of deterrence and compensation. The compensation should also, to the extent possible, be sought from the individuals responsible for the fraud, and not from the corporate entity which is, after all, owned by the same class of shareholders who claim to be harmed by the fraud and who therefore effectively wind up suing themselves in these aftermarket lawsuits.

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Highly simplified, the “out-of-pocket” damage rule operates as follows in a lawsuit alleging an aftermarket fraud: for each day on which the fraud is “alive” in the market, the fact-finder calculates the difference between the actually observed price at which the security transacted and the price at which the security would have traded, had the truth been told, and after all prices are adjusted to correct for market fluctuations and other factors unrelated to the alleged fraud. Each shareholder who acquired the security in the aftermarket, and who continued to hold the security through the corrective disclosure, then has a claim measured by the per share difference between the price paid and the price that would have prevailed had the truth been told.

Putting aside all the obvious statistical complexities associated with such a damage award formula, the fundamental premise upon which the entire enterprise is based is profoundly flawed. As many scholars have pointed out, for every share that is purchased by an innocent investor at an inflated price, the very same share is sold at precisely the same inflated price by a different innocent investor. The damage rule therefore measures neither the profit earned by the parties responsible for the fraud, nor does it measure the actual social harm caused by the mis-pricing induced by the fraud. Instead, it measures the wealth transfer from one innocent investor to another innocent investor. This wealth transfer is not, however, a rational measure of the harm caused by the fraud, and is, instead, likely to result in a dramatic exaggeration of that harm.

Put another way, in an aftermarket fraud, for every shareholder harmed by, say, $1.00 per share because she or he purchased the share at an inflated price, there is another shareholder who actually benefits from the fraud because she or he sells into the fraud and profits by selling the share for $1.00 more than it is worth, had the truth been told. If one million shares change hands during the period the fraud is alive then the out of pocket rule would lead to a damage exposure of $1 million, and if ten billion shares change hands, then the damage exposure would be $10 billion. Neither of these dollar amounts, however, measure the actual economic harm caused by the fraud. That harm is more rationally calculated by the value of capital that is misallocated as a consequence of the mis-pricing induced by the fraud, and bears no rational relation to the damage exposure calculated by the out of pocket rule.

This wealth-transfer problem is exacerbated in situations in which the recovery is paid by the defendant corporation. Any settlement or judgment paid by the corporation has the effect of a mandatory dividend that is likely to reduce the market value of the issuer’s shares. The wealth reduction caused by this mandatory dividend is anticipated by the market at the time of the corrective disclosure and is therefore incorporated into the price decline that is contemporaneous with that disclosure. It follows that a portion of the wealth reduction that anticipates the settlement is actually absorbed by the corporation’s shareholders as of the date of the corrective disclosure. Because these shareholders include the members of the plaintiff class, it also follows that the plaintiff class itself inevitably bears a fraction of the cost of the litigation and settlement that is borne by the corporation. Put another way, once you work your way through the math, it can be demonstrated that in every plaintiff class action lawsuit in which the corporation contributes to the settlement, “the market reacts adversely to the action’s filing because it expects that the eventual settlement of the action will be borne by the shareholders as a group"[1] and the plaintiff class is, in effect, suing itself

These problems are compounded by the fact that the very large majority of class action securities fraud settlements are funded by insurance or by corporate payments. Only in the rarest of cases, such as Enron or WorldCom, are individual executives or directors forced to contribute to the settlements. Accordingly, these settlements have weak deterrent effects. The individuals who are *de facto* responsible for the alleged fraud are not asked to contribute from their own pockets because of the fraud, and are therefore able to externalize the consequences of their own actions.

These observations have led many leading scholars to voice dismay over the *status quo*. Judge Frank Easterbrook and Professor Daniel Fischel have explained that "over the long run, any reasonably diversified investor will be a buyer half the time and a seller half the time. Such an investor perceives little good in a legal rule that force his winning self to compensate his losing self over and over."[2] Thus, "the chance of being on the losing or winning side of the transaction when the stock price is distorted by a securities transaction can be assumed to be random. The more trades investors make, the more likely that, in the aggregate, their gains from trading while material facts are withheld will equal their losses."[3] Indeed, much of the literature voices the refrain that "active traders with large, diversified portfolios have roughly the same chance of being winners as losers from securities fraud, and over time these gains and losses will tend to net out to zero."[4]

The argument is not that aftermarket fraud is harmless. That is a false strawman. The argument is instead that the current measure leads to inflated liability exposure that fails to serve the purposes of the law. The proper measure of damages and compensation is less than "the gross transfer of wealth" measure generated by the out of pocket rule.[5]

While plaintiffs' may strive mightily to avoid recognizing the clear implications of this analysis, the academic community now overwhelmingly supports this view, and does so "from across the ideological spectrum."[6]

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[1] Coffee, John C., Jr., Reforming the Securities Class Action: An Essay On Deterrence and Its Implementation, Columbia Law School, The Center for Law and Economic Studies, Working Paper No. 293 (Oct. 2006) at 7.

[2] Easterbrook, Frank H. and Daniel R. Fischel, Optimal Damages in Securities Cases, 52 U. Chi. L. Rev. 611, 641 (1985).

[3] Alexander, Janet C., Rethinking Damages in Securities Class Actions, 48 Stanford l. Rev. 1487, 1502 (1996).

[4] Langevoort, Donald, Capping Damages for Open Market Securities Damages, 38 Ariz. L. Rev. 639, 646 (1996).

[5] Easterbrook and Fischel, *supra* note 2, at 641-642.

[6] Langevoort, Donald C., On Leaving Corporate Executives Naked, Homeless, and Without Wheels, 42 Wake Forest L. Rev. 627, 629 (2007) ("What is notable is how many scholars from across the ideological spectrum have now joined the doubters of enterprise liability, at least with respect to private securities fraud litigation.") (citations omitted).

The conclusion is clear. The class action securities fraud litigation system is broken. It fails efficiently to deter fraud and fails rationally to compensate those harmed by fraud. Its greatest proponents seem to be the class action counsel and others who profit as a consequence of the irrationally large damage exposures generated by the current regime. The concerns raised by the audit profession thus give us all reason to look more deeply into the operation of the private class action securities fraud litigation mechanism, and to search for more effective means of punishing the individuals who are responsible for fraud while providing rational aggregate compensation for the true economic harm caused by the fraud.