

## Compared to What? Econometric Evidence and the Counterfactual Difficulty

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Two contributions to this symposium on the use of expert econometric evidence in securities fraud litigation—one by Esther Bruegger and Fred Dunbar, and the other by Frank Torchio—touch on a question that is much bigger than their specific subjects: how much of what is important in these cases should we leave exclusively to the financial economists, letting their event studies and other forms of quantitative proof determine the outcome of the lawsuits? This is a question with a long history. In the 1980s, a vision of fraud-on-the-market litigation emerged that was not simply (or even mainly) about corrective justice or the practicalities of class action case management. It instead presented an elegant, economics-driven way of identifying and remedying serious harm to price integrity in the financial markets while at the same time controlling litigation abuse by carefully weeding out those spurious cases which do not involve significant fraud or harm. That vision made econometric evidence the test on crucial matters of materiality, reliance, causation, and damages. Daniel Fischel and Frank Easterbrook gave the vision strong intellectual coherence and legitimacy.<sup>1</sup>

The elegant vision—indeed, any use of event studies or other econometric evidence—says that we are to measure the historic state of the world resulting from the alleged fraud against a counterfactual world of no fraud to test whether there really was fraud and, if so, assess the out-of-pocket damages.<sup>2</sup> “No fraud” is understood to mean “if the truth had been told.” As Easterbrook put it in one of his early judicial opinions, “[t]he usual measure of damages in a case under Rule 10b-5 is the difference between what the stock fetched and what it would have been worth had all of the information been disclosed.”<sup>3</sup> The subsequent market reaction to corrective disclosure thus becomes the

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1. See Daniel R. Fischel, *Use of Modern Finance Theory in Securities Fraud Cases Involving Actively Traded Securities*, 38 BUS. LAW. 1 (1982) (analyzing the traditional and market models and determining the market models to be more provable); Frank H. Easterbrook & Daniel R. Fischel, *Optimal Damages in Securities Cases*, 52 U. CHI. L. REV. 611 (1985) (discussing the applicability of market models and tools to securities cases and damage awards). Even before Easterbrook and Fischel, the outlines for this vision were expressed in a seminal fraud-on-the-market decision by then-district court Judge Patrick Higginbotham in *In re LTV Securities Litigation*, 88 F.R.D. 134 (N.D. Tex. 1980).

2. See generally Frederick C. Dunbar & Arun Sen, *Counterfactual Keys to Causation and Damages in Shareholder Class-Action Lawsuits*, 2009 WIS. L. REV. 199 (examining the implications of counterfactual analysis in light of recent judicial decisions).

3. *Flamm v. Eberstadt*, 814 F.2d 1169, 1179–80 (7th Cir. 1986); see also *In re Royal Dutch/Shell Transp. Sec. Litig.*, 404 F. Supp. 2d 605, 610 (D.N.J. 2005) (“The out-of-pocket rule permitted a purchaser to recover the difference between the purchase price and the true value of the securities absent the alleged fraud as

baseline from which to estimate the difference between the transaction price and the hypothetical fair value, because only that event reveals the market's assessment of the value of what was not disclosed.

As others and I have written about at length elsewhere,<sup>4</sup> many conceptual and practical difficulties come about from trying to make stock price evidence so determinative, which has led to a fracturing of contemporary fraud-on-the-market doctrine. The emphasis on corrective disclosure is problematic because the corrective disclosure can be both over- and under-inclusive.<sup>5</sup> Corrective disclosure often reveals either too much (information beyond that known or knowable at the time of the fraud, or extraneous information bundled together with the correction)<sup>6</sup> or too little (excluding information already impounded into the market price through leakage or other informal mechanisms) to be a particularly precise baseline.

These problems are well known, and vigorously debated by practitioners, judges, and academics. I wonder, however, whether in obsessing over them we have missed a deeper question about corrective disclosure—is it necessarily the right counterfactual in the first place?<sup>7</sup> After all, there is another way of thinking about “no fraud”: the hypothetical state of the world had the defendant never said anything false or misleading. And this is perfectly sensible. Although U.S. securities law may have been tending toward a general affirmative duty to reveal all material information in its early years, this shifted noticeably in the 1980s. Today, the most accurate statement of the case law—though some plaintiffs' lawyers still choke on it—is that companies have no duty to reveal the material adverse facts in their possession simply because the market is assuming something more positive. For there to be nondisclosure liability, either the SEC must have imposed a duty to disclose the information in question in a 10-K or other filing, or the company must be responsible for the market's misimpression, either because of something it previously said that is still “alive” in the market or because something it is saying contemporaneously is materially misleading because it omits the truth.<sup>8</sup> As

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measured by the correction in the market price following curative disclosure . . .”).

4. See Donald C. Langevoort, *Basic at Twenty: Rethinking Fraud on the Market*, 2009 WIS. L. REV. 151 (2009). In part, at least, the doctrinal battles stem from the Supreme Court's inability to articulate a coherent explanation for how the presumption of reliance relates to assumptions about market efficiency in the seminal fraud-on-the-market case, *Basic Inc. v. Levinson*, 485 U.S. 224 (1988). Langevoort, *supra*, at 156–66. Perhaps the best examples in this genre are *In re Merck & Co. Securities Litigation*, 432 F.3d 261 (3d Cir. 2005) and *Oscar Private Equity Investments v. Allegiance Telecom, Inc.*, 487 F.3d 261 (5th Cir. 2007), the latter of which was written by Judge Patrick Higginbotham. For an analysis of these cases, see Langevoort, *supra*, at 173–77, 184–89. For other expressions of concern from very different perspectives, see Alon Brav & J.B. Heaton, *Market Indeterminacy*, 28 J. CORP. L. 517, 535–36 (2003); Larry E. Ribstein, *Fraud on a Noisy Market*, 10 LEWIS & CLARK L. REV. 137 (2006).

5. Corrective disclosure takes on a particularly important role in assessing “loss causation” (i.e., whether plaintiffs suffered financial harm as a result of the fraud), especially after *Dura Pharmaceuticals Inc. v. Broudo*, 544 U.S. 336 (2005). For a discussion of the many problems raised by *Dura*, see Jill E. Fisch, *Cause for Concern: Causation and Federal Securities Fraud*, 94 IOWA L. REV. 811 (2009).

6. See James A. Spindler, *Why Shareholders Want Their CEO's to Lie More After Dura Pharmaceuticals*, 95 GEO. L.J. 653, 674–85 (2007).

7. For a discussion of this counterfactual difficulty in the specific context of fraud by securities analysts, see Donald C. Langevoort, *Taming the Animal Spirits of the Stock Markets: A Behavioral Approach to Securities Regulation*, 97 NW. U. L. REV. 135, 179–81 (2002).

8. See JAMES D. COX ET AL., *SECURITIES REGULATION: CASES AND MATERIALS* 691–95 (6th ed. 2009)

courts have pointed out repeatedly, this leaves ample room for permissible nondisclosure of quite important and troubling news.<sup>9</sup> On top of this, many courts have decided that companies can lawfully express “general optimism” to the public even when they possess bad news.<sup>10</sup> As a result, we simply cannot say that the counterfactual to an alleged misrepresentation is necessarily the revelation of the truth. If there was no duty to disclose and silence was a realistic option, then that actually may be the more likely counterfactual “no fraud” state of the world.

The choice of counterfactual has important practical and monetary implications, which is well illustrated by Frank Torchio’s paper.<sup>11</sup> He argues—contrary to claims made by some defense lawyers and their experts—that we cannot conclude from lack of an identifiable price impact at the time of the alleged fraud that there was neither fraud nor harm. For example, if the market had been anticipating earnings of \$3 per share, then lying by reporting earnings of \$3 would probably have little if any impact on the price of the stock. Yet if the true earnings were \$2.50, the \$3 lie would be harmful in the sense that telling the truth would have moved the price downward. Courts that simply assume that the lack of a price impact at the time of the alleged misrepresentation necessarily undermines plaintiffs’ case are wrong—an example of expert testimony put forth by the defense lawyers getting in the way of common sense.

He is absolutely right, but only if the “truth-telling” world is the right counterfactual. To stay with the example, assume that the market was expecting earnings of \$3, and the company privately discovers that earnings are only \$2.50. If it said nothing or engaged in mere puffery, in all likelihood the expectations would not change. If we were to use that counterfactual instead of the truth-revelation one, there are no damages at all to recover. In this alternative counterfactual world, in other words, we *do* need to find that stock price moved because of the fraud for there to be damages, and the damages are limited to that distortion.<sup>12</sup> Perhaps this is what the defense lawyers and experts were arguing.

Which is the right counterfactual, then? If we are talking about required quarterly earnings reports, then Torchio’s seems right. Companies must report specific financial information in their 10-Qs and 10-Ks in a timely fashion pursuant to SEC rules. True, companies sometimes can and do simply not file.<sup>13</sup> But even in those unusual circumstances, they are supposed to reveal what they do know while they are working on their delayed filing. Moreover, the practical reality is that a failure to file—or refusal to make any sort of expected disclosure—is a signal to the market that will itself usually cause a strong negative reaction. In our example, the company’s choice to say nothing when the market was expecting an announcement of \$3 per share would surely

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(explaining the criteria for nondisclosure liability).

9. See, e.g., *Roeder v. Alpha Indus., Inc.*, 814 F.2d 22, 26 (1st Cir. 1987) (finding no automatic duty to disclose bribery scheme, even if material).

10. See COX ET AL., *supra* note 8, at 606–09 (discussing the “puffery” doctrine).

11. Frank Torchio, *Proper Event Study Analysis in Securities Litigation*, 35 J. CORP. L. 159 (2009).

12. This would involve using an event study looking at abnormal returns immediately following the alleged fraud, or some comparable statistical technique, such as the one Bruegger and Dunbar suggest in their article. See Esther Bruegger & Frederick C. Dunbar, *Estimating Financial Fraud Damages with Response Coefficients*, 35 J. CORP. L. 11 (2009).

13. See 17 C.F.R. § 240.12b-25 (2009) (requiring notifications of inability to timely file all or any required portion of particular forms).

destabilize the price.<sup>14</sup> In sum, if we treat mandatory disclosure as an entitlement on which the market can reasonably rely, then reliance should be encouraged and protected.

But now consider an area where there is no mandatory disclosure obligation. Suppose a pharmaceutical company is having troubles with Food & Drug Administration (FDA) inspectors, who are threatening it with the possibility of significant sanctions, which the company is trying to head off. Assume further that this is something about which there is no immediate line-item disclosure requirement.<sup>15</sup> However, in some public statement, the company says or suggests that its dealings with the FDA are unproblematic, which is materially false. That is to say, the company commits fraud. If the market had no reason to expect serious FDA problems, there would probably be little or no measurable market reaction to that statement or implication—it would be taken as non-news.<sup>16</sup> If the truth had been revealed, on the other hand, presumably there would have been a significant price drop based on fear of the FDA sanction.

Choosing the right counterfactual here is far more problematic. If the point of fraud-on-the-market liability is to compensate investors for detrimental reliance, we do not need to award them damages when they are not any worse off because of the fraud. Awarding damages based on an unrealistic assumption that investors would have been given the whole truth but for the lie produces significant overcompensation insofar as it gives the plaintiff class a recovery based on the market value of the truth even though investors never had any reasonable expectation of or entitlement to the truth.<sup>17</sup> The only way to avoid this is to limit damages to the amount, if any, by which the misstatement distorted the stock price—something assessable by an event study looking for abnormal returns on the date of the alleged fraud, and not on the date of the subsequent corrective disclosure.

To illustrate, consider two companies A and B, both of which face comparable difficulties with the FDA. Company A lies to cover up the difficulties, while Company B says nothing. Assume that A's lie does not impact stock price because it was taken as

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14. A good example of this difficulty, and of the problem more generally, is *Basic Inc. v. Levinson*, 485 U.S. 224, 226–30 (1988), where the company allegedly lied to cover up the existence of private merger negotiations (which were, at most, at a very preliminary stage). The Supreme Court acknowledged that Basic Inc. could, and probably should, simply have said “no comment” rather than reveal the privileged discussions. *Id.* at 239 n.17. Had it done that, however, it is far from clear what the price impact would have been—perhaps the market would have been suspicious that something important was up.

15. There are dozens of such cases involving alleged nondisclosure of troubles with the FDA. □

non-news, and A's stock price remains constant. Because B said nothing, its stock price stays constant as well. When the truth is revealed because the FDA takes action, both companies' stock prices drop by the same amount, producing similar investor losses. Here, purchasers of A's shares are no worse off than purchasers of B's shares, yet purchasers of A's stock receive compensation for their full economic loss if we employ the truth-telling counterfactual. The alternative "no fraud" counterfactual, on the other hand, results in comparable treatment unless the Company A plaintiffs can show that the fraud did indeed distort the stock price, in which case their damages are the amount of the distortion.

To date, courts have ignored this problem almost entirely by simply invoking the truth-telling counterfactual as a matter of course. Given the ambiguities associated with choosing the right counterfactual and the desire to deter securities fraud, I sympathize with that result. However, we should recognize the windfall this produces for plaintiffs in an unknown—but probably sizable—number of cases where, had company officials thought a bit more carefully before speaking, the officials would have simply said nothing or mumbled more effective platitudes rather than being entirely candid.

I would venture a guess that one other reason for glossing over this problem is that the econometricians require an event to study, and corrective disclosure is the event most likely to produce statistically significant results. By definition, corrective disclosure reveals the truth and thus offers no help in imagining a world where there was neither fraud nor truth-telling. One of the important contributions of the Bruegger and Dunbar article<sup>18</sup> is that it offers the possibility of another statistical technique for getting at the price distortion directly, at least in certain cases. However, this technique works only in certain circumstances, so that the gravitational pull of event studies based on corrective disclosure is likely to remain strong.

My point is that the law should not gloss over all this. Damages in no-duty cases are considerably larger under the truth-telling counterfactual than under the alternative—well above what the compensatory goal strictly requires. Whether automatically applying that counterfactual is good policy or not is debatable.<sup>19</sup> But instead, the issue lies buried. The allure of expert econometric evidence is that it promises to reduce the anxiety judges and juries feel when confronted with seemingly unanswerable questions of causation in a complex world. The downside to making the science so determinative is that judges and other non-expert policy-makers may not notice when very important questions of law are assumed away in all the number crunching.

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18. Bruegger & Dunbar, *supra* note 12.

19. Perhaps the best way to describe the consequence of simply assuming that truth-telling provides the right counterfactual is that it operates as something of a penalty default—better justified in terms of its deterrence function than for compensatory reasons. But that then brings us to the much larger debate (well beyond the scope of this commentary) about whether the deterrence function is particularly well served given that firms and their shareholders, rather than the individual wrongdoers, fund most settlements and judgments in fraud-on-the-market cases. *See, e.g.*, John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation*, 106 COLUM. L. REV. 1534 (2006) (proposing ways to redirect securities litigation penalties toward culpable actors); Merritt B. Fox, *Civil Liability and Mandatory Disclosure*, 109 COLUM. L. REV. 237 (2009) (recommending a new system of liability to increase incentives to comply with disclosure rules).