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Bias of Damage Awards and Free Options in Securities Litigation[1]

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Damage measures in securities fraud cases are very imprecise because they are based on security price changes that reflect both the correction of previous misrepresentation and other independent information. Consequently, potential plaintiffs have a valuable "free option" to decide whether or not to file suit, and average damage awards are greater than actual damages, much greater when markets are volatile. The "Private Securities Litigation Reform Act of 1995" was intended to curb abusive litigation and to address the problem of excessive damage awards. Motivated by a misdiagnosis that excess awards are due to temporary price drops, the Act limits damages to the difference between the purchase price and the time-averaged trading price from the release of the corrective information until 90 days later or until the sale of the security, whichever is first. Unfortunately, the Act's modified measure of damages suffers from a more severe free-option problem than did the traditional measure. Also, the Act introduced an additional new option to time the sale of the security; the effects of these options may be mitigated by the impact of the positive drift in stock prices over time, if the time-averaged price is not adjusted for market movements. As a result, the bias can be larger or smaller under the new Act, depending on how severe the free-option problem is. We propose an alternative approach to addressing the issue of

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excessive damages: courts should adopt a threshold of measured damages below which no damage would be awarded. The threshold would depend on several factors, most notably the volatility of the stock in the period under question. That is, damages will be awarded only if measured damages exceed the threshold, and awards would be capped by the formula presented in the Reform Act. *Journal of Economic Literature* Classification Numbers: K22, G38. © 2000 Academic Press

INTRODUCTION

The "Private Securities Litigation Reform Act of 1995"[2] (called the *Reform Act* hereafter) is intended to curb abusive securities fraud litigation. Among other things, the Reform Act caps the award of damages, raises the standard for what investors must allege at the pleading stage, and reforms the joint-and-several liability rule to limit the financial liability of accountants and underwriters.

In this paper we focus on the impact of the Reform Act on limiting excessive damage awards. According to the Reform Act, the maximum award of damages to plaintiffs is based on the 90-day average trading price after the corrective information is disseminated to the market. (As an exception, the average is taken up to the date of sale if the security is sold before the end of 90 days.) The stated intention of such a "bounce-back" period is to avoid market overreaction, i.e., the market crash effect, on the day when the corrective information is released, "thereby limiting damages to those losses caused by the fraud and not by other market conditions."[3] To support this argument, the Conference Report particularly cited Lev and de Villiers (1994) to argue that the stock price immediately following the disclosure does not reflect the true value of the security, and therefore, it is more appropriate to use the mean trading price over several days after the disclosure is made.

While damage awards and settlements in such securities fraud cases may be excessive, and this is consistent with our model, we disagree with the cause diagnosed by Lev and de Villers (1994). First, numerous articles examine whether markets tend to overreact or not, and many find little support for significant overreaction. To the extent that statistically significant overreaction is found, its average magnitude is insignificant for practical purposes.[4] Second, directly addressing whether there exists such a "market overreaction" after bad news is released to the market, Beaver *et al.* (1996) examined all stocks traded on the NYSE, AMEX, and Nasdaq in 1993

[2] Public Law 104-67, 104 H.R. 1058, 1995.

[3] Conference Report 104-369 (to accompany H.R. 1058) Nov. 28, 1995, at p. 42.

[4] See Boudoukh *et al.* (1994) and the related literature cited in that paper. While Lev and de Villers (1994) cited some research which suggests that the market may overreact to the bad news, implying a positive drift term for the stock in the post announcement period, there is a large body of literature which concludes that the opposite is true, at least when the corrective information is in the form of earnings announcement. For examples, see Ball and Brown (1968); Foster *et al.* (1984); and Bernard and Thomas (1989).

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