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Price Drop Damages

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Abstract

Assessing damages is often hard. When a reference asset---like stock---that is affected by misconduct trades in a liquid market, there is an appealing shortcut: *price drop damages*. The logic is simple: a court can leverage the fact that the price of this asset will reflect the consensus view among market participants of harm caused by the misconduct. But because market prices also reflect the expected value of any legal remedy, price drop damages are biased. We develop a simple model that allows us to characterize the magnitude and direction of this bias. We show that price drop damages understate harm when the expected net award flowing to purchasers of the reference asset positive, as in a corporate derivative case. In contrast, when the net recovery is negative, as in a securities fraud case, they overstate harm. Our analysis thus identifies, and offers a means to weigh contextually, an overlooked downside to leveraging the wisdom of crowds.