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# Immaterial Lies: Condoning Deceit in the Name of Securities Regulation

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## IMMATERIAL LIES: CONDONING DECEIT IN THE NAME OF SECURITIES REGULATION

*Stefan J. Padfield*<sup>†</sup>

*The message that pervades society is that it's O.K. to lie—you can get away with it. One of the things I found in my research is that when you confront people with their lies, they very rarely display remorse. Lying is not seen as being morally reprehensible in any strong way.*<sup>1</sup>

*If investor confidence is to come back . . . , the law must advance.*<sup>2</sup>

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<sup>1</sup> Eben Harrell, *Why We Lie So Much*, TIME (Aug. 19, 2009), available at <http://www.time.com/time/health/article/0,8599,1917215,00.html> (quoting Robert Feldman, a professor of psychology at the University of Massachusetts, during a question and answer session regarding Feldman's most recent book, *THE LIAR IN YOUR LIFE: HOW LIES WORK AND WHAT THEY TELL US ABOUT OURSELVES*).

<sup>2</sup> H.R. REP. NO. 73-1383 1383, at 5 (1934). Specifically, the quoted language is from “then-Chairman of the House Committee on Interstate and Foreign Commerce, Representative Sam Rayburn, who sponsored the bill that eventually led to the passage of the 1934 [Securities] Exchange Act.” Elisse B. Walter, Comm’r, Sec. Exch. Comm’n, Speech at Northwestern University School of Law’s Forty-eighth Annual Corporate Counsel Institute: U.S. SEC Comm’r, SEC Rulemaking — “Advancing the Law” to Protect Investors (Oct. 2, 2009), available at <http://www.sec.gov/news/speech/2009/spch100209ebw.htm>.

## ABSTRACT

*The financial crisis of 2008 is raising the issue of investor trust and confidence in the market once again. Investors are questioning how managers could have taken such significant risks in the subprime-lending and credit-default-swap markets without, apparently, providing adequate disclosure to the market. The pending flood of lawsuits following in the wake of this financial crisis provides an opportunity, however, for courts to restore some of this lost trust.*

*This Article argues that one of the ways courts can do this is by curtailing their overdependence on using materiality as the basis for dismissing what they deem to be frivolous lawsuits under Rule 10b-5. There are at least four good reasons for doing so. First, condoning managerial misstatements on the basis of immateriality arguably has a negative impact on investor confidence because whenever courts find a misstatement to be immaterial as a matter of law they are effectively concluding that shareholders will receive no relief even where the statement was made with full knowledge of its falsity and with the requisite intent to defraud. Second, the materiality “safety valve” doctrines that have evolved to assist courts in dismissing frivolous suits are often in direct conflict with Supreme Court guidance as to both the proper definition and analysis of materiality in the context of Rule 10b-5. Third, when the courts routinely categorize managerial misstatements as immaterial to dismiss frivolous suits, they create a tension with the disclosure rules, which are premised on ideals of full and fair disclosure and often turn on materiality determinations. Finally, dependence on materiality is unnecessary because other elements of Rule 10b-5, such as scienter, have been strengthened to the point where they allow courts to deal with frivolous suits without having to rule on materiality.*

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## I. INTRODUCTION

Rule 10b-5<sup>3</sup> of the Securities Exchange Act of 1934<sup>4</sup> is the primary vehicle for challenging alleged corporate securities fraud.<sup>5</sup> In order to

<sup>3</sup> 17 C.F.R. § 240.10b-5 (2010).

<sup>4</sup> Ch. 404, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a–78mm (2006)).

make out a Rule 10b-5 claim, a plaintiff must show that there was (1) a misrepresentation or actionable omission of fact, (2) that is material, (3) made with scienter, (4) in connection with the purchase or sale of security, (5) that was justifiably relied upon by the plaintiff, and (6) that proximately caused the plaintiff's loss.<sup>6</sup> A fact is generally judged to be material in the context of securities regulation if there is a substantial likelihood that a reasonable investor would consider it important in deciding whether to buy or sell a security.<sup>7</sup> Put another way, a fact is material if there is a substantial likelihood that a reasonable investor would have viewed the fact as significantly altering the total mix of information available.<sup>8</sup> The Supreme Court has cautioned that materiality is a fact-intensive issue, rarely to be decided on a motion to dismiss.<sup>9</sup>

Following the Supreme Court's decision in *Basic Inc. v. Levinson*,<sup>10</sup> which allowed class action plaintiffs to take advantage of a "fraud on the market" presumption of reliance, the prospect of crippling damage awards skyrocketed.<sup>11</sup> Concern soon mounted that the concomitant increase in the potential cost to corporations for failing to settle these suits would translate into an increase in the filing of frivolous "strike suits."<sup>12</sup> In response to this concern, courts began to look for various "safety valves" to dismiss these claims.<sup>13</sup>

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<sup>5</sup> See, e.g., Matthew T. Bodie, *Information and the Market for Union Representation*, 94 VA. L. REV. 1, 66-67 (2008) ("[F]ederal securities law has several express and implied causes of action based on misrepresentations. Perhaps the most important antifraud provision is Rule 10b-5 . . . ." (footnote omitted)).

<sup>6</sup> Rubinstein v. Collins, 20 F.3d 160, 166 (5th Cir. 1994).

<sup>7</sup> See *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976) (defining materiality in the context of a proxy solicitation); *Basic Inc. v. Levinson*, 485 U.S. 224, 232 (1988) (adopting the *TSC* definition of materiality in the context of a purchase or sale of a security).

<sup>8</sup> *TSC Indus.*, 426 U.S. at 449.

<sup>9</sup> See *id.* at 450 ("Only if the established omissions are 'so obviously important to an investor, that reasonable minds cannot differ on the question of materiality' is the ultimate issue of materiality appropriately resolved 'as a matter of law' by summary judgment." (quoting *Johns Hopkins Univ. v. Hutton*, 422 F.2d 1124, 1129 (4th Cir. 1970))).

<sup>10</sup> 485 U.S. at 250.

<sup>11</sup> See Donald C. Langevoort, *Basic at Twenty: Rethinking Fraud on the Market*, 2009 WIS. L. REV. 151, 153 (2009) ("Soon after *Basic*, the number of such suits rose dramatically, adding fuel to the political firestorm of securities class-action lawsuits and eventually leading Congress to enter the field with the Private Securities Litigation Reform Act of 1995 (PSLRA)." (footnote omitted)).

<sup>12</sup> Another concern was that the costs would be borne by the very individuals allegedly harmed—the shareholders. See *Basic*, 485 U.S. at 262 (White, J., concurring and dissenting) ("And who will pay the judgments won in such actions? I suspect that all too often the majority's rule will 'lead to large judgments, payable in the last analysis by innocent investors, for the benefit of speculators and their lawyers.'" (quoting *SEC v. Tex. Gulf Sulphur Co.*, 401 F.2d 833, 867 (2d Cir. 1968) (en banc) (Friendly, J., concurring))).

<sup>13</sup> See, e.g., Langevoort, *supra* note 11, at 151 ("In the twenty years since the Supreme Court of the United States' decision in *Basic Inc. v. Levinson*, lower court decisions have

The focus of these safety valves was often the issue of materiality. Courts used doctrines such as: “puffery,” “bespeaks caution,” “truth-on-the-market,” and bright-line rules tied to the price movements of stock,<sup>14</sup> to dismiss claims by concluding that the alleged misrepresentation or omission was immaterial as a matter of law.

There are a number of problems, however, with overdependence on materiality safety valves. First, courts’ repeated declarations that management is free to lie, so long as that lie is immaterial, arguably sends the message to executives that it is often okay to embellish the truth—and sends the message to investors that they should adopt an attitude of *caveat emptor* (“buyer beware”) when it comes to the statements of corporate executives. One might argue that it is overly pejorative to characterize these disclosures as lies. However, when a court grounds dismissal on a finding of immateriality, it is effectively saying that there is no basis for liability even if it were proven that an executive misstated the facts with intent to deceive (i.e., there was a lie).<sup>15</sup> Second, the safety valves themselves twist the definition of materiality to the point that they seemingly make a mockery of the Supreme Court’s declarations on the issue. Finally, courts’ excessive reliance on these safety valves creates a conflict with the disclosure rules, which often turn on determinations of materiality. Fortunately, there is a better way: focusing on the other elements of Rule 10b-5.

With the financial crisis of 2008 raising the issue of investor trust and confidence in the market once again, investors are questioning how managers could have taken such significant risks in the subprime lending and credit default swap markets without apparently providing adequate disclosure to the market.<sup>16</sup> The pending flood of lawsuits following in the wake of this financial crisis provides an opportunity,

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insisted on proof of market efficiency, materiality, and loss causation more stringent than the Court’s presumption of reliance seemingly requires.”).

<sup>14</sup> See discussion *infra* Part II.E.

<sup>15</sup> See, e.g., THE AMERICAN HERITAGE COLLEGE DICTIONARY 799 (4th ed. 2002) (defining a lie as “[a] false statement deliberately presented as being true . . . . Something meant to deceive or give a wrong impression.”).

<sup>16</sup> See, e.g., SEC Charges Former Officers of Subprime Lender New Century with Fraud, SEC Litigation Release No. 21327 (Dec. 7, 2009), available at <http://www.sec.gov/litigation/litreleases/2009/lr21327.htm> (“Defendants . . . failed to disclose important negative information, including dramatic increases in early loan defaults, loan repurchases, and pending loan repurchase requests.”); SEC Files Securities Fraud Charges Against Former Countrywide Executives, SEC Litigation Release No. 21068A (June 4, 2009), available at <http://www.sec.gov/litigation/litreleases/2009/lr21068a.htm> (“The SEC alleges that Mozilo, Sambol, and Sieracki actually knew, and acknowledged internally, that Countrywide was writing increasingly risky loans . . . . Despite these severe concerns about the increasing risks that Countrywide was undertaking, Mozilo, Sambol, and Sieracki hid these risks from the investing public.”).

however, for courts to restore some of this lost trust by refusing to label lies immaterial unless absolutely necessary.<sup>17</sup>

## II. BACKGROUND ON THE ELEMENT OF MATERIALITY IN RULE 10B-5

In this Part, I will briefly review the role of Rule 10b-5 in securities regulation generally, including its various elements. I will then focus on the definition of the critical element of materiality, including its fact-intensive nature and questions surrounding the status of the “reasonable investor” whose judgment is deemed determinative. Finally, I will conclude this Part by reviewing the various materiality safety valves that have arisen to assist judges in dismissing what they deem to be frivolous lawsuits, including the doctrines of “puffery,” “bespeaks caution,” “truth-on-the-market,” and bright-line price-movement rules.

### A. *Securities Regulation and the Role of Rule 10b-5*

Section 10(b) of the Securities Exchange Act of 1934 provides in relevant part that “[i]t shall be unlawful for any person . . . [t]o use . . . any manipulative or deceptive device . . . in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.”<sup>18</sup> Rule 10b-5, promulgated by the Securities and Exchange Commission pursuant to § 10(b), further provides in relevant part:

It shall be unlawful for any person . . . [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 the light of the circumstances under which they were made, not misleading . . . in connection with the purchase or sale of any security.<sup>19</sup>

“For more than twenty-five years, the primary private remedy for fraud available under the Securities Exchange Act has been the one implied from SEC Rule 10b-5.”<sup>20</sup> Justice Rehnquist has famously

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<sup>17</sup> Cf. Alison Smale, *Leaders in Davos Admit Drop in Trust and Uncertainty Ahead*, N.Y. TIMES, Jan. 31, 2010, at A8 (“If there was one takeaway from the annual gathering of business and political leaders in Davos this year, it was this: trust in governments, corporations and above all banks has become as elusive as sure footing on the icy streets of this Alpine resort.”).

<sup>18</sup> 15 U.S.C. § 78j (2006).

<sup>19</sup> 17 C.F.R. § 240.10b-5 (2010). See generally *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975) (limiting standing of private plaintiffs under Rule 10b-5 to purchasers and sellers).

<sup>20</sup> 3 THOMAS LEE HAZEN, TREATISE ON THE LAW OF SECURITIES REGULATION § 12.4[1] (6th ed. 2009). There are meaningful distinctions between the use of Rule 10b-5 in

characterized the implied private right of action under Rule 10b-5 as “a judicial oak which has grown from little more than a legislative acorn.”<sup>21</sup> While there is much debate, recent empirical work continues to suggest that this “judicial oak” provides a net gain to society.<sup>22</sup>

### B. *The Elements of Rule 10b-5*

In order to make out a claim under Rule 10b-5, a plaintiff must prove that there was “1) a misstatement or omission 2) of material fact 3) occurring in connection with the purchase or sale of a security, that 4) was made with scienter and 5) upon which the plaintiff justifiably relied, 6) and that proximately caused injury to the plaintiff.”<sup>23</sup> In the following pages, I will explore the concept of materiality in greater depth and hopefully demonstrate that it has been excessively and inappropriately relied upon in the rush to dismiss securities suits deemed to be unmeritorious. I will then explain how other elements of Rule 10b-5, like scienter and loss causation, are much better positioned, particularly in light of recent precedent, to carry the load when it comes to battling frivolous litigation. Nonetheless, it may be worthwhile to pause briefly here to discuss one of the elements I do not address in greater depth later—the necessity of pleading a misstatement.<sup>24</sup>

It is commonly said that there is no “fraud by hindsight” under our securities laws.<sup>25</sup> To that end, a complaint:

must . . . “indicate why the alleged misstatements would have been false or misleading at the several points in time in which

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administrative, civil (public and private), and criminal actions. See Joan MacLeod Heminway, *Hell Hath No Fury Like an Investor Scorned: Retribution, Deterrence, Restoration, and the Criminalization of Securities Fraud Under Rule 10b-5*, 2 J. BUS. & TECH. L. 3, 4–5 (2007) (discussing distinctions between civil and criminal enforcement of Rule 10b-5). I will be focusing on the private civil context.

<sup>21</sup> *Blue Chip Stamps*, 421 U.S. at 737.

<sup>22</sup> See C.S. Agnes Cheng et al., *Institutional Monitoring Through Shareholder Litigation*, 95 J. FIN. ECON. 356, 356 (2010) (“Our study suggests that securities litigation is an effective disciplining tool for institutional owners.”); Brian Carson McTier & John K. Wald, *The Causes and Consequences of Securities Class Action Litigation 1* (Apr. 23, 2009) (unpublished manuscript, at 1), available at <http://ssrn.com/abstract=1393857> (“Overall the results suggest that class action lawsuits drive firms to reduce overinvestment and increase focus.”).

<sup>23</sup> *Rubinstein v. Collins*, 20 F.3d 160, 166 (5th Cir. 1994).

<sup>24</sup> See *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 473 (1977) (“The language of § 10(b) gives no indication that Congress meant to prohibit any conduct not involving manipulation or deception.”).

<sup>25</sup> Cf. Mitu Gulati et al., *Fraud by Hindsight*, 98 NW. U. L. REV. 773, 774 (2004) (“In the context of securities regulation, hindsight can mistakenly lead people to conclude that a bad outcome was not only predictable, but was actually predicted by managers.”).



it is alleged they were made.” Merely alleging “that defendants made statements ‘and then showing in hindsight that [they were] false’” does not satisfy the [Private Securities Litigation] Reform Act.<sup>26</sup>

Particularly in the case of litigation related to the subprime-lending crisis, failure to plead a misstatement may be a particularly viable basis for dismissal. However, this issue will turn on the contentious question of who knew what when.

In his book *How Markets Fail*, John Cassidy makes a strong case against the proposition that no one knew trouble was brewing in the housing market before the crisis hit.<sup>27</sup> He notes that “[a]s early as 2002, some commentators, [himself] included, were saying that in many parts of the country real estate values were losing touch with incomes.”<sup>28</sup> Furthermore, the assertion by key financial market players like Jamie Dimon, chief executive officer of J.P. Morgan Chase & Co., that “we just missed that housing prices don’t go up forever,” borders on the incredible.<sup>29</sup> Nonetheless, failure to plead a misstatement should be a viable basis for dismissing frivolous suits in at least some cases, thereby precluding any need to rely on materiality.

### C. The Definition of Materiality

Materiality has been described as a “notoriously slippery concept, ‘unpredictable and elusive’ in application.”<sup>30</sup> Part of the problem is

<sup>26</sup> *In re MoneyGram Int’l, Inc. Sec. Litig.*, 626 F. Supp. 2d 947, 973 (D. Minn. 2009) (first alteration in original) (citation omitted) (quoting *In re Cerner Corp. Sec. Litig.*, 425 F.3d 1079, 1083 (8th Cir. 2005) and *Elam v. Neidorff*, 544 F.3d 921, 927 (8th Cir. 2002)). Fraud by hindsight may also be relevant to the analysis of scienter. See *id.* at 981–83 (relying on combination of external “red flags,” which alone would support only fraud-by-hindsight, and internal communications to find recklessness).

<sup>27</sup> JOHN CASSIDY, *HOW MARKETS FAIL: THE LOGIC OF ECONOMIC CALAMITIES passim* (2009); see also James Kwak, *The Cover -Up*, THE BASELINE SCENARIO (Apr. 12, 2010, 9:59 PM), <http://baselinescenario.com/2010/04/12/magnetar-financial-crisis-cover-up/> (“[P]lenty of people saw the crisis coming. In late 2009, people like Nouriel Roubini and Peter Schiff were all over the airwaves for having predicted the crisis. Since then, there have been multiple books written about people who not only predicted the crisis but bet on it, making hundreds of millions or billions of dollars for themselves.”). But see Allen Ferrell & Atanu Saha, *Securities Litigation and the Housing Market Downturn*, 35 J. CORP. L. 97, 119 (2009) (“[W]e conclude that the evidence is consistent with the proposition that the serious housing market downturn was not generally foreseen by sophisticated market participants prior to the fourth quarter of 2007.”).

<sup>28</sup> CASSIDY, *supra* note 27, at 18.

<sup>29</sup> Jim Kuhnenn & Daniel Wagner, *Bankers Apologize for Actions That Led to Crisis*, ABC NEWS, Jan. 13, 2010, <http://abcnews.go.com/Business/wireStory?id=9547906>.

<sup>30</sup> Richard C. Sauer, *The Erosion of the Materiality Standard in the Enforcement of the Federal Securities Laws*, 62 BUS. LAW. 317, 319 (2007) (quoting *SEC v. Bausch & Lomb Inc.*, 565 F.2d 8, 10 (2d Cir. 1977)). See generally Joan MacLeod Heminway, *Materiality Guidance in the Context of Insider Trading: A Call for Action*, 52 AM. U. L. REV. 1131, 1138 (2003)

that in application, the standard is supposed to strike an efficient balance between informing investors on the one hand, while not burying them in unnecessary information on the other. As the Supreme Court noted in *Basic*, “certain information concerning corporate developments could well be of ‘dubious significance.’”<sup>31</sup> It was important, the Court noted, that the standard for defining materiality was not set too low because “a minimal standard might . . . lead management ‘simply to bury the shareholders in an avalanche of trivial information.’”<sup>32</sup> On the other hand, in the very same opinion the Court firmly rejected the notion that investors should be spared the details of what goes on during premerger negotiations because they might not be able to discount the information properly.

The . . . rationale . . . stands soundly rejected . . . “It assumes that investors are nitwits, unable to appreciate—even when told—that mergers are risky propositions up until the closing.” Disclosure, and not paternalistic withholding of accurate information, is the policy chosen and expressed by Congress.<sup>33</sup>

And the difficult line drawing is not limited to premerger negotiations or inside information about subprime exposure, but also includes issues like the health status of important corporate insiders. For example, is the health of Apple Inc.’s Steve Jobs material to investors?<sup>34</sup>

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(“The facial simplicity of the basic legal standard governing materiality masks the complexities encountered by transaction planners, litigants, the SEC, the U.S. Department of Justice (‘DOJ’), and courts in interpreting and applying that standard.”)

<sup>31</sup> *Basic Inc. v. Levinson*, 485 U.S. 224, 231 (1988) (quoting *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 448 (1976)).

<sup>32</sup> *Id.* (quoting *TSC Indus.*, 426 U.S. at 448).

<sup>33</sup> *Id.* at 234 (quoting *Flamm v. Eberstadt*, 814 F.2d 1169, 1175 (7th Cir. 1987)).

<sup>34</sup> See Yukari Iwatani Kane & Joann S. Lublin, *Apple Mum On Jobs’s Treatment, Diagnosis*, WALL ST. J., June 30, 2009, at B1 (“Apple and its directors have consistently kept a tight lid on Mr. Jobs’s health, even though the CEO is regarded as key to the company’s strategy and direction.”); *cf. id.* (“In 1992, Steven J. Ross, who was then chairman and co-CEO of Time Warner Inc., died after a year-long battle with prostate cancer. The media giant said Mr. Ross was still running the show during much of that time. He actually was working from home only a few hours a day, a friend later said.”). See generally Allan Horwich, *When the Corporate Luminary Becomes Seriously Ill: When Is a Corporation Obligated to Disclose That Illness and Should the Securities and Exchange Commission Adopt a Rule Requiring Disclosure?*, 5 N.Y.U. J. L. & BUS. 827 (2009) (analyzing public corporations’ legal obligations to disclose facts about the health of their “luminary” employees); Joan MacLeod Heminway, *Personal Facts About Executive Officers: A Proposal for Tailored Disclosures to Encourage Reasonable Investor Behavior*, 42 WAKE FOREST L. REV. 749, 756–57 (2007) (arguing an executive’s personal information may be material for purposes of securities regulation). It is important to note here

In the following Sections, I will explore the key aspects of the definition of materiality under Rule 10b-5. I will start with the basic definition set forth by the Supreme Court in its *TSC Industries, Inc. v. Northway, Inc.*<sup>35</sup> and *Basic* decisions. I will then take a closer look at the fact-intensive nature of the application of that definition, as well as questions surrounding the “reasonable investor” whose perspective we are to take when applying the definition.

### 1. The TSC/Basic Definitions

In *TSC Industries*, the Supreme Court considered a claim of fraud in connection with a proxy solicitation under Rule 14a-9<sup>36</sup> and concluded that “[a]n omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote.”<sup>37</sup> Alternatively, the Court held that “there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information made available.”<sup>38</sup> This standard was later carried over to the Rule 10b-5 context.<sup>39</sup>

As discussed above, the Court rejected the view that “all facts which a reasonable shareholder *might* consider important” were material for purposes of securities regulation.<sup>40</sup> It did so because “if the standard of materiality is unnecessarily low . . . the corporation and its management [may] be subjected to liability for insignificant omissions or misstatements, . . . [and this] may cause it simply to bury the shareholders in an avalanche of trivial information.”<sup>41</sup> On the other hand, the Court cautioned that satisfying one’s burden as to

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that silence, even when in possession of material information, does not create liability under the securities laws absent a duty to speak. See *Chiarella v. United States*, 445 U.S. 222, 228 (1980) (“[O]ne who fails to disclose material information prior to the consummation of a transaction commits fraud only when he is under a duty to do so.”).

<sup>35</sup> 426 U.S. 438 (1976).

<sup>36</sup> 17 C.F.R. § 240.14a-9 (2010) (prohibiting certain false or misleading statements in connection with the solicitation of proxies).

<sup>37</sup> 426 U.S. at 449.

<sup>38</sup> *Id.* Some courts have relied solely on the “total mix” definition of materiality. 5C ARNOLD S. JACOBS, DISCLOSURE & REMEDIES UNDER THE SECURITIES LAWS § 12:32 (2010) (collecting cases).

<sup>39</sup> See *Basic Inc. v. Levinson*, 485 U.S. 224, 232 (1988) (“We now expressly adopt the *TSC Industries* standard of materiality for the § 10(b) and Rule 10b-5 context.”); *cf. id.* at 238 (concluding that the definition of materiality in the context of speculative information or contingent events—like premerger negotiations—turned on a balancing of the probability and magnitude of the event).

<sup>40</sup> *TSC Indus.*, 426 U.S. at 445 (quoting *Northway, Inc. v. TSC Indus., Inc.*, 512 F.2d 324, 330 (7th Cir. 1975)).

<sup>41</sup> *Id.* at 448.

materiality “does not require proof of a substantial likelihood that disclosure of the omitted fact would have caused the reasonable investor to change his vote.”<sup>42</sup> Rather, “[w]hat the standard does contemplate is a showing of a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder.”<sup>43</sup>

## 2. A Fact-Intensive Analysis

The courts frequently utter a common refrain asserting that the analysis of materiality is extremely fact-intensive and thus is rarely to be decided on the basis of pretrial motions to dismiss or summary judgment. The Supreme Court itself has declared that “[o]nly if the established omissions are ‘so obviously important to an investor, that reasonable minds cannot differ on the question of materiality’ is the ultimate issue of materiality appropriately resolved ‘as a matter of law’ by summary judgment.”<sup>44</sup> Nonetheless, courts frequently dismiss securities cases based on immateriality.<sup>45</sup> As Professors Bainbridge and Gulati note, this result is, at first blush, puzzling:

[I]f a high percentage of securities disclosure cases are dismissed at the motion to dismiss stage on grounds that the information in question was immaterial, but each opinion has in it the caveat that materiality is ordinarily an issue for the finder of fact, and it is only in the rare case that it can be decided at the motion to dismiss stage, things do begin to look suspicious.<sup>46</sup>

<sup>42</sup> *Id.* at 449.

<sup>43</sup> *Id.*

<sup>44</sup> *Id.* at 450 (quoting *Johns Hopkins Univ. v. Hutton*, 422 F.2d 1124, 1129–30 (4th Cir. 1970)); *see also id.* (noting that materiality determinations are “peculiarly ones for the trier of fact”).

<sup>45</sup> *See* Stephen M. Bainbridge & G. Mitu Gulati, *How Do Judges Maximize? (The Same Way Everybody Else Does—Boundedly): Rules of Thumb in Securities Fraud Opinions*, 51 EMORY L.J. 83, 116 n.94 (2002) (“Of the 91 (out of 100) cases that were decided at the motion to dismiss stage, 64 involved materiality determinations in favor of the defendants (i.e., over 70 percent.”); David A. Hoffman, *The “Duty” To Be a Rational Shareholder*, 90 MINN. L. REV. 537, 542 (2006) (“In this Article, I present evidence that courts dismiss securities claims on the ground of presumed immateriality in *half of opinions considering materiality.*”). *But see* Stephen J. Choi & Adam C. Pritchard, *The Supreme Court’s Impact on Securities Class Actions: An Empirical Assessment of Tellabs* 34 (Univ. of Mich. Law Sch. Law & Econ. Research Paper Series, Paper No. 09-016 and N.Y. Univ. Sch. of Law Law & Econ. Research Paper Series, Paper No. 09-34, 2009), *available at* <http://ssrn.com/abstract=1457085> (listing materiality as fifth basis for dismissal in a review of Supreme Court securities class actions). As to the Choi & Pritchard study, it is worth noting that if one combines “Forward Looking Safe Harbor,” “Materiality,” and “Puffery” into one category, it ranks second behind only scienter. *See id.*

<sup>46</sup> Bainbridge & Gulati, *supra* note 45, at 115 (internal quotations omitted).

A possible answer to this puzzle is that courts use materiality determinations as a safety valve for frivolous litigation, which is only effective<sup>47</sup> if the pressure is released pretrial.

### 3. *No Bright-Line Rules*

In addition to the admonition that materiality is largely a question of fact (though ultimately a mixed question of fact and law) rarely to be decided pretrial, the Supreme Court has also warned against the use of bright-line rules.<sup>48</sup> Specifically, while the Supreme Court acknowledged, “[a] bright-line rule indeed is easier to follow than a standard that requires the exercise of judgment in the light of all the circumstances,” it ultimately concluded that “ease of application alone is not an excuse for ignoring the purposes of the Securities Acts and Congress’ policy decisions.”<sup>49</sup> Thus, “[a]ny approach that designates a single fact or occurrence as always determinative of an inherently fact-specific finding such as materiality, must necessarily be overinclusive or underinclusive.”<sup>50</sup>

Having briefly discussed the basic definition of materiality, as well as its fact-intensive nature and incompatibility with bright-line rules, I want to round out this initial exploration of the definition of materiality with an examination of the requirement that we take the perspective of the “reasonable investor” in conducting an analysis of materiality under Rule 10b-5. Who is a “reasonable investor” for purposes of materiality determinations? This is not at all clear.

### 4. *Who is the Reasonable Investor and Why Don’t We Ask Her What She Thinks?*<sup>51</sup>

The Wheat Report<sup>52</sup> summarized the dilemma of defining the reasonable investor as follows:

At what audience should disclosure be aimed? Is the literature elicited by the Commission’s requirements intended primarily

<sup>47</sup> See discussion *infra* Parts III.B.

<sup>48</sup> See *TSC Indus.*, 426 U.S. at 450 (“The issue of materiality may be characterized as a mixed question of law and fact, involving as it does the application of a legal standard to a particular set of facts.”).

<sup>49</sup> *Basic Inc. v. Levinson*, 485 U.S. 224, 236 (1988).

<sup>50</sup> *Id.*

<sup>51</sup> Cf. Joan MacLeod Heminway, *Female Investors and Securities Fraud: Is the Reasonable Investor a Woman?*, 15 WM. & MARY J. WOMEN & L. 291 (2009) (discussing women as investors and whether the reasonable investor is a woman).

<sup>52</sup> SEC, DISCLOSURE TO INVESTORS: A REAPPRAISAL OF FEDERAL ADMINISTRATIVE POLICIES UNDER THE ’33 AND ’34 ACTS (The Wheat Report) (1969), available at <http://sechistorical.org/museum/papers/1960>.

to aid the unsophisticated? Is it, on the contrary, designed to assist the assiduous student of finance who searches for every clue to the intrinsic value of securities? Or should the Commission strive to meet the needs of a hypothetical “reasonable” investor of “reasonable” sophistication? Throughout its history, the Commission has struggled with these questions. They may well be unanswerable.<sup>53</sup>

More recently, I commented that a review of the cases revealed conceptions of the reasonable investor “stretching from ‘sophisticated’ to ‘average’ to ‘naïve.’”<sup>54</sup>

It seems clear, as far as the SEC is concerned, that the reasonable investor, for purposes of materiality determinations, is the unsophisticated retail investor.<sup>55</sup> As Donald Langevoort has noted: “The Securities and Exchange Commission thinks of itself as the investors’ advocate, by which it means retail investors—individuals and households—as opposed to institutional investors.”<sup>56</sup> He goes on to point out that the “history of rules, interpretations, and enforcement by the SEC is filled with references to both the need to promote retail-level investor confidence to give depth and liquidity to the nation’s financial markets and the desire to level the playing field between the meek and the privileged.”<sup>57</sup> This in spite of the fact that, “[t]he last thirty years or so have brought a rapid shift toward institutionalization in the financial markets in the United States—in other words, a shift toward investment by mutual funds, pension funds, insurance companies, bank trust departments, and the like.”<sup>58</sup> Meanwhile, Joan MacLeod Heminway has noted that court cases “indicate expressly or impliedly that the reasonable investor is a sophisticated trader, an experienced participant in securities markets who researches

<sup>53</sup> *Id.* at 51–52; cf. Stanley Keller, *Securities Act Reform*, in 1 36TH ANNUAL INSTITUTE ON SECURITIES REGULATION 1021, 1023 (Practising Law Inst. ed., 2004) (“[A] Commission study chaired by Commissioner Francis Wheat . . . resulted in the Wheat Report published in 1969 that recommended expanded periodic disclosure under the Exchange Act and coordination of the Securities Act and Exchange Act disclosure requirements.”).

<sup>54</sup> Stefan J. Padfield, *Is Puffery Material to Investors? Maybe We Should Ask Them*, 10 U. PA. J. BUS. & EMP. L. 339, 365 (2008).

<sup>55</sup> See Stephen J. Crimmins, *Investor Protection Provisions of the Dodd-Frank Act*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (July 11, 2010, 12:11 PM), <http://blogs.law.harvard.edu/corpgov/2010/07/11/investor-protection-provisions-of-the-doddfrank-act/> (noting that the Dodd-Frank Act directs the SEC to study “the level of financial literacy of retail investors, and what means might be most effective to further educate them”).

<sup>56</sup> Donald C. Langevoort, *The SEC, Retail Investors, and the Institutionalization of the Securities Markets*, 95 VA. L. REV. 1025, 1025 (2009).

<sup>57</sup> *Id.* at 1025–26.

<sup>58</sup> *Id.* at 1026.

investment prospects and has the ability to understand what the research reveals.”<sup>59</sup>

In response to this quandary, I have written previously that “[p]erhaps the best view, then, is that the term ‘reasonable investor’ is meant simply to make the standard an objective one, excluding idiosyncratic investing decisions, rather than favoring a particular level of sophistication.”<sup>60</sup> This should not come as any surprise given my repeated criticism of the various materiality safety valves described herein. As Joan MacLeod Heminway has pointed out, “[a] conception of the reasonable investor as sophisticated is the root of several key common law defenses to claims of materiality (‘mere puffery,’ ‘truth-on-the-market,’ and ‘bespeaks caution’).”<sup>61</sup> Somewhat relatedly, David Hoffman has pointed out that to equate the reasonable investor with “homo economicus” (my words, not his) for purposes of materiality determinations under Rule 10b-5 is to impose a “duty” to be a rational shareholder—a duty that is “novel in scope” and “ungrounded in principle.”<sup>62</sup> Accordingly, I have also proposed elsewhere that if the materiality test really is intended to turn on the reactions of reasonable investors, then perhaps we should ask them directly what they deem material rather than engage in debate.<sup>63</sup>

<sup>59</sup> Heminway, *supra* note 51, at 301.

<sup>60</sup> Padfield, *supra* note 54, at 345–46. An idea I have been toying with lately is the possibility of a “target-group” standard. *Cf.* 3 HAZEN, *supra* note 20, at § 12.9[3][A] (“When a defendant targets unreasonably naive or careless investors, the more objective reasonable person standard will not preclude a finding of materiality.”). *See generally* John M. Newman, Jr. et al., *Basic Truths: The Implications of the Fraud-on-the-Market Theory for Evaluating the “Misleading” and “Materiality” Elements of Securities Fraud Claims*, 20 J. CORP. L. 571, 572 (1995) (arguing that the “reasonable investor” should be replaced by the “professional investor” for purposes of determining materiality in fraud-on-the-market claims because those are the investors that impact efficient market prices). I believe such a standard would differ from Margaret Sachs’s “least sophisticated” standard in that it would allow for a “highly sophisticated” standard in connection with appropriate transactions. *See* Margaret V. Sachs, *Materiality and Social Change: The Case for Replacing “the Reasonable Investor” with “the Least Sophisticated Investor” in Inefficient Markets*, 81 TUL. L. REV. 473 (2007) (arguing for the adoption of a lower materiality standard in inefficient markets, which could be counterbalanced by the adoption of a higher scienter standard).

<sup>61</sup> Heminway, *supra* note 51, at 302.

<sup>62</sup> Hoffman, *supra* note 45, at 538 (“Courts require investors to investigate their purchases, to coldly process risk, to disregard oral statements of optimism, and in general to be *economically rational*. If investors fail to meet these expectations, judges deny them the protection of the securities laws. In this way, courts impose on public securities investors a special kind of legal duty, novel in scope and, I will argue, ungrounded in principle.”).

<sup>63</sup> *See* Padfield, *supra* note 54, at 362–63 (“The legislative and judicial developments of federal securities laws and regulations are similar to those of Lanham Act false advertising law. . . . The significance of this relationship for our purposes is that it begs the question of why survey evidence is an accepted part of the evidentiary makeup of a Lanham Act case, particularly as to the issue of materiality, but not securities regulation cases.”); *cf.* Crimmins, *supra* note 55 (“The SEC will be able to engage in ‘investor testing programs’ and other initiatives to gather information from investors [under the Dodd-Frank Act].”).

So what is the point of all this? Well, if one perceives the courts' materiality determinations to be unduly restricting the definition of "reasonable investor" in this context, then a shift of focus onto other elements of Rule 10b-5 to dismiss frivolous suits may be appropriate. Even if one is unsure as to the proper definition of the reasonable investor for these purposes, the conclusion is the same if one prefers that legislatures and administrative bodies with relevant expertise define this sort of concept rather than courts. Only if one agrees with a narrow definition of the reasonable investor and believes judges are the proper dispensers of that judgment, should one support the court's continued routine dependence on materiality as grounds for dismissal. But even then, I will argue further that there are other good reasons why one might nevertheless want judges to avoid depending on materiality to dismiss frivolous suits if at all possible.

*D. The Fraud-on-the-Market Presumption and "Frivolous" Litigation as the Greatest Threat to Our Economy*

In *Basic*, the Supreme Court adopted the fraud-on-the-market presumption of reliance and unleashed, at least according to much of the business community, a flood of unmeritorious securities litigation. This litigation was premised on the notion that the potential for catastrophic damages generated by the large classes of plaintiffs now capable of being formed would force companies to settle cases rather than risk their assets at trial.<sup>64</sup> These concerns continue to this day, and recent legislative responses include enactment of the Private Securities Litigation Reform Act of 1995<sup>65</sup> (the "PSLRA") and the Securities Litigation Uniform Standards Act of 1998<sup>66</sup> (the "SLUSA"). The PSLRA imposed higher procedural hurdles on filing for federal securities fraud class actions than existed for any other type of private litigation.<sup>67</sup> Meanwhile, the SLUSA "significantly limit[ed] the ability of plaintiff-investors to seek redress for securities fraud under state law and through the state courts."<sup>68</sup> I will spend

<sup>64</sup> See, e.g., Barbara Black, *Eliminating Securities Fraud Class Actions Under the Radar*, 2009 COLUM. BUS. L. REV. 802, 809 (2009) ("As a result of the *Basic* presumption . . . securities fraud class actions increased in number.").

<sup>65</sup> Pub. L. No. 104-67, 109 Stat. 737 (1995) (codified as amended in scattered sections of 15 and 18 U.S.C.).

<sup>66</sup> Pub. L. No. 105-353, 112 Stat. 3227 (1998) (codified primarily in 15 U.S.C. § 77p and 18 U.S.C. § 78bb).

<sup>67</sup> See Lisa L. Casey, *Shutting the Doors to State Court: The Securities Litigation Uniform Standards Act of 1998*, 27 SEC. REG. L.J. 141, 144-48 (1999) (discussing how the PSLRA changed the pleading standards for scienter and fraud).

<sup>68</sup> *Id.* at 142.



more time fleshing out the heightened pleading standards of the PSLRA later in this Article.<sup>69</sup>

The legitimacy of all the wailing and gnashing of teeth regarding frivolous litigation is hotly debated.<sup>70</sup> Donald Langevoort has commented, “[a]s the noted securities law scholar Joel Seligman pointed out at the time and subsequent research seems to have confirmed, there probably is a stronger correlation between the merits and both the filing and settlement of these actions than critics have claimed.”<sup>71</sup> Meanwhile, Barbara Black has argued, “the post-PSLRA securities fraud class action is reasonably effective in achieving both compensatory and deterrence goals.”<sup>72</sup> Regardless of what one may think of the merits of the various arguments surrounding frivolous securities litigation post-*Basic*, it would be difficult to deny that judges and courts jumped into the fray feet first, and their favorite tool for combating frivolous suits was often materiality.

#### *E. The Evolution of Materiality “Safety Valves”*

Professors Bainbridge and Gulati have said the following about what I call “safety valves” and they have called judicial “rules of thumb,” that is “decisionmaking heuristics or shortcuts”:

[T]he heuristics we identify are substantive law doctrinal rules of thumb enabling a judge to avoid analysis of a case’s full complexities. . . . [They] not only become doctrine but can come to dominate the ongoing evolution of substantive law. . . . [T]he real puzzle is that federal judges are

<sup>69</sup> See discussion *infra* Part IV.E.

<sup>70</sup> See, e.g., J. Robert Brown, *Overturning Stoneridge and the Symbolic Passing of an Era*, THE RACETOTHEBOTTOM.ORG (Aug 14, 2009, 6:00 AM), <http://www.theracetothetbottom.org/shareholder-rights/overturning-stoneridge-and-the-symbolic-passing-of-an-era.html> (“In the last years of the Bush administration, the growing tenor was that securities litigation was harming markets in the United States. Superficial analysis asserted that litigation was responsible for any number of ills, including the decline in foreign listings on the NYSE. It was never a particularly well reasoned approach (which is not to say that there are not problems with litigation that ought to be addressed) and was often tendentious in its call for reforms.” (omitted emphasis in original)).

<sup>71</sup> Langevoort, *supra* note 11, at 155 (citing Joel Seligman, *The Merits Do Matter: A Comment on Professor Grundfest’s “Disimplying Private Rights of Action Under the Federal Securities Laws: The Commission’s Authority,”* 108 HARV. L. REV. 438, 444–49 (1994)). See generally Stephen J. Choi, *The Evidence on Securities Class Actions*, 57 VAND. L. REV. 1465, 1466 (2004) (discussing “the American experience with securities class actions”). But see Langevoort, *supra* note 11, at 155 (“Even if we agree that a large percentage of fraud-on-the-market suits are based on at least plausible suspicions rather than imaginary factual claims, however, there is another cause for concern: the possibility that issuer damage liability may be disproportionate to the underlying conduct, particularly in a setting in which liability standards are severely indeterminate.”).

<sup>72</sup> Black, *supra* note 64, at 806.

claiming—at least implicitly—a level of expertise about the workings of markets and organizations that, in some areas, not even the most sophisticated researchers in financial economics and organizational theory have reached.<sup>73</sup>

Before engaging in a discussion of the particular materiality safety valves, I want to pause here to address the notion that judges and courts should have more freedom to practice policymaking from the bench in private actions arising under Rule 10b-5, than in other settings, because the private right of action under Rule 10b-5 is judicially implied. Indeed, and as quoted above, Justice Rehnquist famously described the private right of action under Rule 10b-5 as “a judicial oak which has grown from little more than a legislative acorn.”<sup>74</sup> A.C. Pritchard has noted that Justice Powell “considered the judge-made remedy under Rule 10b-5 to be a species of federal common law, and thus appropriate for judges to consider policy in defining its limits.”<sup>75</sup>

On the other hand, Donald Langevoort has noted that the Supreme Court rejected precisely such a policy-driven analysis of materiality in *Basic*:

A more serious policy—the one that [Judge] Easterbrook had emphasized—was the need to preserve some zone of secrecy for merger negotiations that generally work to benefit investors. But the Court asked what this had to do with materiality. Materiality is not supposed to carry the baggage of policy design but simply ask about the significance of what is misrepresented or concealed.<sup>76</sup>

I would simply submit that even if judges and courts have some greater freedom to make policy from the bench in private actions arising under Rule 10b-5 than in other contexts, then let them say that is what they are doing—rather than hiding behind interpretations of

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<sup>73</sup> Bainbridge & Gulati, *supra* note 45, at 83–84.

<sup>74</sup> *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 737 (1975).

<sup>75</sup> A.C. Pritchard, *Justice Lewis F. Powell, Jr., and the Counterrevolution in the Federal Securities Laws*, 52 DUKE L.J. 841, 865 (2003).

<sup>76</sup> Donald C. Langevoort, *Investor Protection and the Perils of Corporate Publicity: Basic Inc. v. Levinson*, in *THE ICONIC CASES IN CORPORATE LAW* 257, 263 (Jonathan R. Macey ed., 2008); see also *Basic Inc. v. Levinson*, 485 U.S. 224, 234–35 (“[T]he importance of secrecy during the early stages of merger discussions, also seems irrelevant to an assessment whether their existence is significant to the trading decision of a reasonable investor. . . . The ‘secrecy’ rationale is simply inapposite to the definition of materiality.”).

materiality that at times sound like they sprang from the lips of Humpty Dumpty.<sup>77</sup>

Thus, allow me to expressly state what I hope is the obvious theme running through this Article: While there may have been a time when it was appropriate to rely on materiality as a safety valve to prevent the excess buildup of frivolous litigation, that time has passed. We now have better alternatives that allow us to continue our vigilance against strike suits without doing the damage we have arguably done previously to the concept of materiality specifically and, in the process, investor confidence generally. In that vein, I believe it appropriate to revive a quote from former SEC Chairman Manuel F. Cohen, which—while issued over forty years ago—rings particularly true in this context: “[W]e cannot always rely on past solutions as we approach current or developing problems. Nor can we assume that methods which were entirely proper, even praiseworthy, at an earlier time are necessarily beneficial in a changed environment.”<sup>78</sup>

At the same time, I do not mean to suggest that the other elements of Rule 10b-5 do not suffer from their own doctrinal controversies. In fact, I am quite likely to critique the application of those other elements in future writing projects, and I try to point out at least some of the issues surrounding those other elements in this Article. Nor am I to be understood to be urging abdication of the responsibility of courts to clean up the materiality doctrine “mess” I describe herein. Rather, what I am saying is that there should be enough cases where dismissal on the basis of failure to satisfy some other element of Rule 10b-5 rather than materiality, like scienter, would be much less controversial, and do much less harm in terms of investor trust and confidence, than continuing to stretch the definition of materiality. This is particularly so where courts are tempted, for whatever reason, to dismiss cases on the basis of both materiality and some other element of Rule 10b-5.

I will now provide a brief overview of the various materiality safety-valve doctrines, followed by a discussion of why these doctrines are problematic and courts no longer need to depend on them.

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<sup>77</sup> See LEWIS CARROLL, *THROUGH THE LOOKING GLASS AND WHAT ALICE FOUND THERE* 66 (1983) (“‘When I use a word,’ Humpty Dumpty said, in a rather scornful tone, ‘it means just what I choose it to mean—neither more nor less.’”).

<sup>78</sup> Manuel F. Cohen, Chairman, U.S. Sec. & Exch. Comm’n, Address Before the Investment Bankers Association of America (Nov. 30, 1965), *quoted in* Milton H. Cohen, “*Truth in Securities*” *Revisited*, 79 HARV. L. REV. 1340, 1340 (1966).

### 1. Puffery

The puffery doctrine can be found in a variety of areas of the law, including: mail fraud, securities fraud, common-law fraud, legal ethics, common-law contracts, Uniform Commercial Code warranty cases, promissory misrepresentation, [and] false advertising.<sup>79</sup> It generally seeks to protect sellers from liability for mere “sales talk.”<sup>80</sup> As early as 1887, the Supreme Court of Massachusetts asserted that “[t]he law recognizes the fact that men will naturally overstate the value and qualities of the articles which they have to sell. All men know this, and a buyer has no right to rely upon such statements.”<sup>81</sup>

An example of use of the puffery doctrine in the securities litigation context can be found in the 2006 Seventh Circuit opinion in the case of *Makor Issues & Rights, Ltd. v. Tellabs, Inc.*<sup>82</sup> In *Tellabs*, the court used the doctrine to immunize managerial statements asserting that product demand was “exceeding [their] expectations” and the company felt “very, very good about the robust growth [it was] experiencing.”<sup>83</sup> The court concluded: “[t]his is precisely the type of statement that the marketplace views as pure hype, and accordingly discounts entirely,” and dismissed the claims.<sup>84</sup> However, in an informal survey, sixty-two percent of investors found that the first statement was material and thirty-three percent found that the second statement was material.<sup>85</sup> It is important to note, in reflecting on these numbers, that when a court dismisses a case based on immateriality, it is effectively saying that it has concluded, as a matter of law, that zero percent of reasonable investors would consider the statement material.<sup>86</sup>

<sup>79</sup> David A. Hoffman, *The Best Puffery Article Ever*, 91 IOWA L. REV. 1395, 1396–97 (2006) (footnotes omitted).

<sup>80</sup> Jennifer O’Hare, *The Resurrection of the Dodo: The Unfortunate Re-emergence of the Puffery Defense in Private Securities Fraud Actions*, 59 OHIO ST. L.J. 1697, 1698 (1998); see also Hoffman, *supra* note 79, at 1441–42 (describing the “puffery paradox,” as one where “[s]ellers increasingly rely on persuasive, puffing, speech, but are protected from liability because such speech is assumed not to work”).

<sup>81</sup> *Kimball v. Bangs*, 11 N.E. 113, 114 (Mass. 1887).

<sup>82</sup> 437 F.3d 588 (7th Cir. 2006), *vacated on other grounds*, 551 U.S. 308 (2007).

<sup>83</sup> *Id.* at 597 (internal quotations omitted).

<sup>84</sup> *Id.* at 598 (citing *In re Allaire Corp. Sec. Litig.*, 224 F. Supp. 2d 319, 331 (D. Mass. 2002)).

<sup>85</sup> Padfield, *supra* note 54, at 368.

<sup>86</sup> See *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 450 (1976) (“Only if the established omissions are ‘so obviously important to an investor, that reasonable minds cannot differ on the question of materiality’ is the ultimate issue of materiality appropriately resolved ‘as a matter of law’ by summary judgment.” (quoting *Johns Hopkins Univ. v. Hutton*, 422 F.2d 1124, 1129–30 (4th Cir. 1970))).

## 2. *Bespeaks Caution and the PSLRA*

“[U]nder the ‘bespeaks caution’ doctrine, the presence of meaningful cautionary language can preclude a finding that investors were misled by projections or other forward-looking statements.”<sup>87</sup> The bespeaks-caution doctrine was codified in section 21E of the Securities Exchange Act of 1934 as part of the PSLRA.<sup>88</sup> Of particular relevance here, given the focus on the impropriety of sanctioning “immaterial lies,” is the fact that the legislative formulation of the bespeaks-caution doctrine facially immunizes knowingly false statements made with an intent to deceive.<sup>89</sup>

At least some courts have avoided this seemingly unpalatable result by concluding that any cautionary language provided in such a context could not be meaningful. For example, the district court in *In re Nash Finch Co.*,<sup>90</sup> concluded that “cautionary language can not be ‘meaningful’ when defendants know that the potential risks they have identified have in fact already occurred, and that the positive statements they are making are false.”<sup>91</sup> But, as other courts have held, this conclusion is arguably contrary to the express terms of the statute. For example, the court in *In re Humana, Inc. Securities Litigation*,<sup>92</sup> endorsed the literal reading of the statute when it held that “Plaintiffs’ allegation that the Defendants had actual knowledge of the internal control problems ‘does not save the claim because the

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<sup>87</sup> Stefan J. Padfield, *Who Should Do the Math? Materiality Issues in Disclosures That Require Investors to Calculate the Bottom Line*, 34 PEPP. L. REV. 927, 935 (2007); see also *In re Donald J. Trump Casino Sec. Litig.*, 7 F.3d 357, 371 (3d Cir. 1993) (“[W]hen an offering document’s forecasts, opinions or projections are accompanied by meaningful cautionary statements, the forward-looking statements will not form the basis for a securities fraud claim if those statements did not affect the ‘total mix’ of information the document provided investors. In other words, cautionary language, if sufficient, renders the alleged omissions or misrepresentations immaterial as a matter of law.”). But see *Slayton v. Am. Express Co.*, 604 F.3d 758, 772 (2d Cir. 2010) (concluding that the defendant’s statement that “potential deterioration in the high-yield sector . . . could result in further losses in AEFA’s portfolio” was too vague to constitute meaningful cautionary language) (alteration in original).

<sup>88</sup> See 15 U.S.C. § 78u-5(c)(1)(A)(i) (2006) (setting forth the requirement that the forward-looking statement be “accompanied by meaningful cautionary statements” in order to receive the protections of the safe harbor); see also 15 U.S.C. § 77z-2 (2006) (codifying a parallel provision under the Securities Act of 1933).

<sup>89</sup> Cf. Allan Horwich, *Cleaning the Murky Safe Harbor for Forward-Looking Statements: An Inquiry into Whether Actual Knowledge or Falsity Precludes the Meaningful Cautionary Statement Defense*, 35 J. CORP. L. 519, 520 (2010) (“[A]ctual knowledge of the weaknesses in a projection, including lack of a good faith belief in the projection, is not relevant to reliance on the meaningful cautionary statement safe harbor.”).

<sup>90</sup> 502 F. Supp. 2d 861 (D. Minn. 2007).

<sup>91</sup> *Id.* at 873; see also *Asher v. Baxter Int’l Inc.*, 377 F.3d 727, 734 (7th Cir. 2004) (explaining that cautionary language would not be effective if the issuer intentionally omitted important risk factors).

<sup>92</sup> No. 3:08CV-00162-JHM, 2009 WL 1767193 (W.D. Ky. June 23, 2009).

existence of the meaningful cautionary statement renders the issuer's state of mind irrelevant."<sup>93</sup>

### 3. Truth on the Market and the Simple-Math Rule

The truth-on-the-market defense has its roots in the "total mix" definition of materiality. As Peter Huang describes it, "the truth-on-the-market defense argues that an issuer's statements or omissions cannot be misleading if there already is countervailing information, such as analysts' reports, in the public domain that is therefore part of the 'total mix' of information that is available."<sup>94</sup> This defense has particular relevance to ongoing subprime-crisis litigation. One of the primary arguments of defendants in these cases is that either (1) no one knew there was a problem until it was too late, or (2) to the extent people knew there was a problem, that information was public knowledge and so a particular defendant's failure to disclose this information was immaterial.

This approach has already reaped dividends. For example, the court in *Landmen Partners Inc. v. Blackstone Group, L.P.*,<sup>95</sup> concluded that "to the extent that Plaintiff alleges Blackstone should have disclosed the conditions of the [real estate] market generally, such omissions are not actionable. 'Sections 11 and 12(a)(2) do not require the disclosure of publicly available information.'"<sup>96</sup> Apparently, the fact that one of Blackstone's four business segments was real estate and described itself on March 22, 2007, as seeing "high levels of growth" in the real estate industry and "strong investor demand for real estate assets"<sup>97</sup> was not a problem because, for example, home builder DR Horton had publicly announced on March 8 that 2007 "is going to suck."<sup>98</sup> One can certainly wonder whether issuer statements do not take on even more materiality when they come at a time of market uncertainty.<sup>99</sup>

A variant of the truth-on-the-market doctrine that I have written about previously is what I call the "simple math" rule.<sup>100</sup> The simple-

<sup>93</sup> *Id.* at \*15 (quoting *Beaver Cnty. Ret. Bd. v. LCA-Vision Inc.*, No. 1:07-CV-750, 2009 WL 806714, at \*14 (S.D. Ohio Mar. 25, 2009)).

<sup>94</sup> Peter H. Huang, *Moody Investing and the Supreme Court: Rethinking the Materiality of Information and the Reasonableness of Investor*, 13 SUP. CT. ECON. REV. 99, 118 (2005).

<sup>95</sup> 659 F. Supp. 2d 532 (S.D.N.Y. 2009).

<sup>96</sup> *Id.* at 545 (quoting *In re Merrill Lynch & Co., Inc. Research Reports Sec. Litig.*, 272 F. Supp. 2d 243, 249–50 (S.D.N.Y. 2003)).

<sup>97</sup> *Id.* at 538 (quoting *Consol. Am. Class Action Compl.* ¶ 88).

<sup>98</sup> *Bleak Housing Outlook for US Firm*, BBC NEWS (Mar. 8, 2007), <http://news.bbc.co.uk/2/hi/business/6429815.stm>.

<sup>99</sup> *Cf.* CASSIDY, *supra* note 27, at 18 (describing battle of experts regarding subprime risks in buildup to crisis).

<sup>100</sup> *See* Padfield, *supra* note 87, at 928 (defining the simple-math rule); *cf.* Hoffman, *supra*

math rule states that even if an issuer has not disclosed a particular fact, that omission will be deemed immaterial if the information necessary to deduce that fact has been disclosed. In other words, “[t]he courts have generally agreed that readers can put two and two together, and make somewhat more elaborate calculations or comparisons.”<sup>101</sup> A negative correlate of the simple-math rule is the “buried-facts” doctrine, which states, “a disclosure is deemed inadequate if it is presented in a way that conceals or obscures the information sought to be disclosed.”<sup>102</sup> For example, “[t]he doctrine applies when the fact in question is hidden in a voluminous document or is disclosed in a piecemeal fashion which prevents a reasonable shareholder from realizing the ‘correlation and overall import of the various facts interspersed throughout’ the document.”<sup>103</sup> As I noted in an earlier piece, not all applications of the simple-math rule leave one convinced that “material omission” has a common understanding:

*Werner v. Werner* . . . held that failure to disclose the magnitude of the gain flowing to interested directors in connection with a transaction they were recommending to shareholders was immaterial because shareholders could calculate that magnitude by: (1) recognizing that a planned removal of a right of first refusal under an equity incentive plan, as set forth in the relevant 1997 proxy statement, would benefit management; (2) then looking “to the 1993 and 1994 annual reports to determine how many shares were issued each year pursuant to the Restricted Stock Plan”; (3) then using those same reports to “determine the approximate fair market value (‘FMV’) of Restricted shares at the date of issuance”; (4) then employing the equation “[FMV 1997- FMV in 1993] x number of shares issued in 1993 + [FMV 1997- FMV 1994] x number of shares issued in 1994]” in order to “compute the amount of money the management defendants would have gotten for their shares had the right of first refusal been exercised”; and then finally, (5) comparing “the amount yielded by the above equation to the \$66 million

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note 45, at 581–82 (describing the truth-the-on-market doctrine as the “‘understand consequences’ technique”).

<sup>101</sup> Alan R. Bromberg & Lewis D. Lowenfels, 2 Bromberg & LOWENFELS ON SECURITIES FRAUD & COMMODITIES FRAUD § 5:237 (2d ed. 2010).

<sup>102</sup> *Werner v. Werner*, 267 F.3d 288, 297 (3d Cir. 2001).

<sup>103</sup> *Id.* (quoting *Kas v. Fin. Gen. Bankshares, Inc.*, 796 F.2d 508, 516 (D.C. Cir. 1986)).

the management defendants would actually receive in the Recapitalization as proposed.”<sup>104</sup>

I noted in conclusion that “[a]t least some would agree that this labyrinth-like disclosure of a material fact is not consistent with a philosophy of full and fair disclosure.”<sup>105</sup>

#### 4. Bright-Line Price-Movement Rules

Finally, some courts espouse the view that “[b]ecause in an efficient market ‘the concept of materiality translates into information that alters the price of the firm’s stock,’ if a company’s disclosure of information has no effect on stock prices, ‘it follows that the information disclosed . . . was immaterial as a matter of law.’”<sup>106</sup> Other courts, while recognizing that stock price movement may be a strong indicator of materiality, do not limit themselves in this way.<sup>107</sup> For example, the court in *Reiss v. Pan American World Airways, Inc.*,<sup>108</sup> held that “hindsight is of limited value and the fact that ultimate disclosure of the [information] affected [the] stock price is not compelling.”<sup>109</sup>

### III. THE PROBLEM OF OVERDEPENDENCE ON MATERIALITY

Having laid the foundation for a deeper discussion of the problems created by an overdependence on materiality as a judicial safety valve for frivolous suits, we turn now to a discussion of those problems. The three primary arguments are that (1) when courts dismiss on materiality grounds they are immunizing lying; (2) the materiality safety valves are in conflict with the purposes of our securities regulation regime and Supreme Court precedence; and, (3) excessive characterization of disclosures as immaterial creates conflicts with the SEC’s disclosure regime.

<sup>104</sup> Padfield, *supra* note 87, at 943–44 (footnotes omitted) (quoting *Werner*, 267 F.3d at 299–300).

<sup>105</sup> *Id.* at 944 (footnote omitted). It is also arguably inconsistent with the Supreme Court’s admonition that “not every mixture with the true will neutralize the deceptive.” *Va. Bankshares, Inc. v. Sandberg*, 501 U.S. 1083, 1097 (1991).

<sup>106</sup> *Oran v. Stafford*, 226 F.3d 275, 282 (3d Cir. 2000) (omission in original) (quoting *In re Burlington Coat Factory Sec. Litig.*, 114 F.3d 1410, 1425 (3d Cir. 1997)).

<sup>107</sup> *See, e.g.*, *No. 84 Emp’r-Teamster Joint Council Pension Trust Fund v. Am. W. Holding Corp.*, 320 F.3d 920, 935 (9th Cir. 2003) (concluding that the plaintiff sufficiently pled materiality even where the relevant disclosure had no immediate effect on stock price).

<sup>108</sup> 711 F.2d 11 (2d Cir. 1983).

<sup>109</sup> *Id.* at 13.



*A. When Courts Dismiss on Materiality Grounds  
They Are Immunizing Lies*

Should management be free to lie to investors with the intent to deceive them?<sup>110</sup> Every time a court dismisses a Rule 10b-5 claim for lack of materiality, it is effectively answering that question in the affirmative. This is so because materiality is a necessary element of a Rule 10b-5 claim and its absence thus destroys the claim regardless of a plaintiff's ability to carry his or her burden on the other elements. In fact, one could argue that in order for dismissal on the basis of immateriality to have any real meaning the court must assume the other elements—like falsity and intent to deceive—are satisfied when reaching its conclusion. This practice alone should reduce the frequency of dismissals based on immateriality because assuming the matter is important enough for management to lie about inherently suggests materiality.<sup>111</sup> As the Supreme Court has noted in a related context:

Shareholders know that directors usually have knowledge and expertness far exceeding the normal investor's resources, and the directors' perceived superiority is magnified even further by the common knowledge that state law customarily obliges them to exercise their judgment in the shareholders' interest. Naturally, then, the shareowner faced with a proxy request will think it important to know the directors' beliefs about the course they recommend and their specific reasons for urging the stockholders to embrace it.<sup>112</sup>

Indeed, some courts in the past have suggested, "any false statement or omission by company management, if intentional, should be considered material because it reveals a lack of management integrity that is presumably important to investors."<sup>113</sup> But the general

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<sup>110</sup> *Cf.* *Malone v. Brincat*, 722 A.2d 5, 10–11 (Del. 1998) ("The directors' fiduciary duties include the duty to deal with their stockholders honestly. Shareholders are entitled to rely upon the truthfulness of all information disseminated to them by the directors they elect to manage the corporate enterprise.").

<sup>111</sup> *See* *SEC v. Tex. Gulf Sulphur Co.*, 401 F.2d 833, 851 (2d Cir. 1968) ("[A] major factor in determining whether . . . [there is] a material fact is the importance attached to . . . [it] by those who knew about it.").

<sup>112</sup> *Va. Bankshares, Inc. v. Sandberg*, 501 U.S. 1083, 1091 (citation omitted).

<sup>113</sup> *Sauer*, *supra* note 30, at 332; *see also* *Gebhardt v. Conagra Foods, Inc.*, 335 F.3d 824, 829–30 (8th Cir. 2003); *Talma Trust v. Molex, Inc.*, 429 F. Supp. 2d 960, 979 (N.D. Ill. 2006); *cf.* *Barbara Black, Reputational Damages in Securities Litigation*, 35 J. CORP. L. 169, 172, 175 (2009) (asking whether investors can "recover damages resulting from declines in the stock price attributable to the market's reassessment of the integrity of management" and concluding that "there is no basis in law or policy for denying plaintiffs recovery for reputational

rule, as stated by the Supreme Court, is that: “It is not enough that a statement is false or incomplete, if the misrepresented fact is otherwise insignificant.”<sup>114</sup> Nonetheless, the concept of immunizing lies, particularly on the part of corporate management, raises troubling issues in these difficult times.

Trust is a critical, if not *the* critical, ingredient to the success of the capital markets (and of the free market economy in general). . . . From the inception of federal securities legislation in the 1930s, to the Sarbanes-Oxley Act of 2002, to the policies under consideration in Washington, D.C., today, it has long been understood that in the face of economic calamity, the restoration and/or preservation of trust—especially investor trust—in our financial institutions and markets has been paramount.

And if further proof of the indispensability of trust was needed, it has been forcefully provided by the financial services industry crisis and the unusually strong recession currently afflicting much of the globe throughout 2008–2009. By most accounts, a breach of trust—in the form of fairly reckless risk-taking by some, and in the form of dereliction of duty by others—has precipitated the crisis and, indirectly, the recession. And the lack of trust that these breaches engendered has figured prominently in the persistence of our economic woes (from banks fearful of lending, to investors fleeing the capital markets).<sup>115</sup>

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damages”). *But see* Jonathan R. Macey & Geoffrey P. Miller, *Good Finance, Bad Economics: An Analysis of the Fraud-on-the-Market Theory*, 42 STAN. L. REV. 1059, 1091 (1990) (“[M]anagement should be allowed to deny rumors which it knows to be correct and even to make affirmative misstatements if doing so is necessary to protect aggregate share value.”).

<sup>114</sup> *Basic Inc. v. Levinson*, 485 U.S. 224, 238; *see also* *Greenhouse v. MCG Capital Corp.*, 392 F.3d 650, 660 (4th Cir. 2004) (“[N]ot all lies are actionable; the securities laws are only concerned with lies about *material facts*.”).

<sup>115</sup> Ronald J. Colombo, *Trust and Financial Regulation*, 55 VILL. L. REV. (forthcoming 2010) (manuscript at 3) (footnotes omitted), available at <http://ssrn.com/abstract=1481327>; *see also* Lynn A. Stout, *Trust Behavior: The Essential Foundation of Securities Markets* 1 (UCLA Sch. of Law Law & Econ. Research Paper Series, Paper No. 09-15, 2009), available at <http://ssrn.com/abstract=1442023> (“[M]any investors rely on trust. Indeed, trust may be essential to a well-developed securities market. . . . When trust is not met by trustworthiness but instead is abused, trust tends to disappear. These lessons carry significant implications for our understanding of modern securities markets.”); *cf.* Michael R. Siebecker, *Trust & Transparency: Promoting Efficient Corporate Disclosure Through Fiduciary-Based Discourse*, 87 WASH. U. L. REV. 115, 115 (2009) (“Consumers and investors simply cannot trust the existing disclosure regime to provide reliable information necessary to monitor CSR [Corporate Social

In light of this, we may rightly be concerned when our courts routinely immunize lying in the name of securities regulation.<sup>116</sup> As Donald Langevoort has said, the Supreme Court in *Basic* “was not persuaded . . . that making life easier for lawyers or business people was as important a value as the pursuit of truth.”<sup>117</sup>

Ultimately, my argument here is tempered by the fact that I am not trying to convince judges deciding a Rule 10b-5 claim never to dismiss on the basis of immateriality, but rather to consider the implications of such a dismissal fully and rely on other grounds where sufficient, so as to avoid the problems I describe herein.<sup>118</sup>

*B. The “Safety Valve” Materiality Doctrines Are in Conflict  
with the Purposes of Our Securities Regulation Regime  
and Supreme Court Guidance*

As discussed above, the primary “safety valves” involving materiality include the puffery, bespeaks-caution, truth-on-the-market, and price-movement doctrines. This subsection will first examine problems associated with the puffery doctrine in detail, followed by a shorter examination of problems associated with the other three doctrines.

*1. Puffery*

There are numerous criticisms of the puffery doctrine. For purposes of this Article, I have grouped these criticisms into four “challenges.” First, the challenge presented by the findings of behavioral economics, which demonstrate that individuals are more susceptible to puffery than the doctrine asserts. Second, the challenge presented by the fact that protection of puffery is firmly rooted in the

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Responsibility] compliance. That lack of trust will cause the market for CSR to collapse, as consumers and investors stop offering rewards for responsible business behavior.”) *But cf.* Ronald J. Colombo, *Trust and the Reform of Securities Regulation* (May 14, 2010) (unpublished manuscript), available at <http://ssrn.com/abstract=1608115> (“[T]rust is complicated, existing in a variety of forms. Some forms, predicated primarily upon reasoned calculation, respond well to law and regulation. But other forms, predicated primarily upon relationship and emotion, respond poorly to law and regulation.”).

<sup>116</sup> *Cf.* Michael H. LeRoy, *Do Courts Create Moral Hazard?: When Judges Nullify Employer Liability in Arbitrations*, 93 MINN. L. REV. 998, 1003 (2009) (“[J]udicial review can serve as government insurance by relieving employers of liability for socially undesirable conduct. . . . [C]ourts create moral hazard by vacating a high percentage of employee wins at arbitration.”).

<sup>117</sup> Langevoort, *supra* note 76, at 269.

<sup>118</sup> *Cf.* *United States v. O’Hagan*, 521 U.S. 642, 658 (1997) (“[A]n animating purpose of the Exchange Act[is] to insure honest securities markets and thereby promote investor confidence.”).

doctrine of caveat emptor—a doctrine expressly rejected by our current system of securities regulation. Third, the challenge presented by the fact that when statements are analyzed in isolation in order to determine whether they constitute “puffing,” the total-mix aspect of the materiality definition is ignored. Finally, the challenge presented by market realities. This last challenge is nicely summed up by David Hoffman in his description of the “unwholesome” puffery paradox, whereby “[s]ellers increasingly rely on persuasive, puffing, speech, but are protected from liability because such speech is assumed not to work.”<sup>119</sup>

*a) Behavioral Economics*

Professor Langevoort has cogently asked: “Is it clear that typical investors do not rely on puffery? There is little research that studies this specifically, and so many judges are guessing.”<sup>120</sup> In a previous article, I tried to shed some light on this question by surveying a group of investors to determine their responses to statements deemed immaterial puffery by courts.<sup>121</sup> The survey results showed that “while the judges in the four surveyed cases concluded that no reasonable investor could find the statements challenged therein to be material because they constituted non-actionable puffery, between 33% and 84% of reasonable investors surveyed deemed the statements material.”<sup>122</sup>

These results are consistent with at least some of the findings of behavioral economics.<sup>123</sup> As Peter Huang has explained, “[r]ecent research in psychology and the neurosciences reveals that humans comprehend and face risk utilizing two fundamental systems, one analytic and the other experiential.”<sup>124</sup> Huang goes on to define what he calls “moody investing” as “investing that is (at least, partially) non-cognitive.”<sup>125</sup> He then concludes, “[m]oody investing means that the puffery defense is flawed because vague, promotional, or

<sup>119</sup> Hoffman, *supra* note 79, at 1441–42.

<sup>120</sup> Donald C. Langevoort, *Taming the Animal Spirits of the Stock Markets: A Behavioral Approach to Securities Regulation*, 97 NW. U. L. REV. 135, 184 (2002).

<sup>121</sup> See Padfield, *supra* note 54, at 340–41.

<sup>122</sup> *Id.* at 341.

<sup>123</sup> See generally Hoffman, *supra* note 45, at 545–62 (reviewing the implications of behavioral law and economics for materiality determinations in securities regulation cases).

<sup>124</sup> Huang, *supra* note 94, at 102; see also Paul Slovic et al., *Risk as Analysis and Risk as Feelings: Some Thoughts About Affect, Reason, Risk, and Rationality*, 24 RISK ANALYSIS 311 (2004) (exploring the proper integration of the analytic and experiential systems in rational decision making); Valerie F. Reyna, *How People Make Decisions that Involve Risk: A Dual-Process Approach*, 13 CURRENT DIRECTIONS PSYCHOL. SCI. 60 (2004) (describing a new approach to dual-process reasoning, called the “fuzzy-trace theory”).

<sup>125</sup> Huang, *supra* note 94, at 102–03.

hyperbolic statements can have real impacts on moods and therefore should not be deemed immaterial as a matter of law.”<sup>126</sup>

Clearly, not everyone is jumping on the behavioral economics bandwagon.<sup>127</sup> Stephen Bainbridge notes that “the relevant question to ask about the assumptions of a theory is not whether they are descriptively realistic, for they never are, but whether they are sufficiently good approximations for the purpose in hand,” and “[t]he extent to which behavioral economics calls into question more traditional modes of economic analysis remains sharply contested.”<sup>128</sup> Professor Bainbridge does acknowledge, however, that “[a]t the very least . . . it seems clear that attention must be paid to the possibility that behavioral analysis sheds light on policy issues.”<sup>129</sup> Nonetheless, Ivan Preston noted in 1998, “no behavioral studies have reported the finding, assumed by the law, that consumers typically see puffery or other loophole claims as meaningless.”<sup>130</sup> I am not aware of any studies having been conducted in the interim to seriously challenge that conclusion.

#### b) *The Doctrine of Caveat Emptor*

The historical basis of the puffery defense is rooted in the doctrine of caveat emptor. As Richard J. Leighton describes it, “[t]he puffing defense is one of the few remaining vestiges, if not the only one, of the ancient doctrine of *caveat emptor* (‘let the buyer beware’).”<sup>131</sup> However, the doctrine of caveat emptor is diametrically opposed to the doctrine of full and fair disclosure underlying our securities regime. As the Supreme Court noted in *SEC v. Capital Gains*

<sup>126</sup> *Id.* at 115.

<sup>127</sup> See, e.g., Darian Ibrahim, *Rational Choice or Behavioral Law and Economics?*, THE CONGLOMERATE (Sep. 4, 2009), <http://www.theconglomerate.org/2009/09/rational-choice-or-behavioral-law-and-economics.html> (“The behavioral camp has much to offer. But several observations made by others persuade me not to dip my toes too deep into the behavioral waters.”).

<sup>128</sup> Stephen M. Bainbridge, *Mandatory Disclosure and Securities Regulation: A Behavioral Analysis*, PROFESSORBAINBRIDGE.COM (Jan. 29, 2010, 11:00 AM), <http://www.professorbainbridge.com/professorbainbridgecom/2010/01/mandatory-disclosure-and-securities-regulation-a-behavioral-analysis.html>.

<sup>129</sup> *Id.*

<sup>130</sup> Ivan L. Preston, *Puffery and Other “Loophole” Claims: How the Law’s “Don’t Ask, Don’t Tell” Policy Condone Fraudulent Falsity in Advertising*, 18 J.L. & COM. 49, 82–83 (1998). Cf. *id.* at 81 (“Rotfeld & Rotzoll showed five ads containing 13 puffing claims to 100 subjects, who 80.5 percent of the time reported these claims to be conveyed to them. The same research asked about 17 fact claims that might be implied by the puffery claims. While the law’s assumption, as with the Bruskin research, is that such perceptions do not occur, the subjects saw the puff-implied fact claims conveyed 44.7 percent of the time.” (footnote omitted)).

<sup>131</sup> Richard J. Leighton, *Making Puffery Determinations in Lanham Act False Advertising Cases: Surveys, Dictionaries, Judicial Edicts and Materiality Tests*, 95 TRADEMARK REP. 615, 637 (2005).

*Research Bureau, Inc.*,<sup>132</sup> “[a] fundamental purpose, common to the [’33 and ’34 Act], was to substitute a philosophy of full disclosure for the philosophy of *caveat emptor* and thus to achieve a high standard of business ethics in the securities industry.”<sup>133</sup> In fact, Justice Powell referred to puffery as one of the evils the ’33 Act was intended to address.<sup>134</sup>

Perhaps for these reasons, it was not too long ago that a leading treatise declared that the puffery defense had “all but gone the way of the dodo.”<sup>135</sup> In addition to the inappropriateness of favoring a doctrine rooted in *caveat emptor*, this apparent disappearance made sense because the puffery defense was grounded on two additional underlying assumptions rarely applicable in typical 10b-5 actions: (1) “that the parties are on equal footing, with equal access to information,” and (2) “that the purchaser has no reason to trust a seller’s sales talk.”<sup>136</sup> However, the puffery defense has since made a Phoenix-like return in spite of these concerns.<sup>137</sup>

### c) Ignoring the Total Mix

Courts generally ignore context when applying the puffery doctrine, contrary to the “total mix” aspect of the definition of materiality. For example, Jennifer O’Hare has noted that in applying the puffery defense in securities litigation “courts have improperly limited their focus to the *words* or *language* of the company’s statement, while ignoring such important factors as who made the statement and where the statement was made.”<sup>138</sup> This is in stark contrast to the *bespeaks-caution* doctrine<sup>139</sup> (discussed in more detail below), which immunizes otherwise material forward-looking

<sup>132</sup> 375 U.S. 180 (1963).

<sup>133</sup> *Id.* at 186.

<sup>134</sup> See *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 759 n.4 (1975) (Powell, J., concurring) (“The evil addressed was the tendency of the seller to exaggerate, to ‘puff,’ and sometimes fraudulently to overstate the prospects and earning capabilities of the issuing corporation.”).

<sup>135</sup> 7 LOUIS LOSS & JOEL SELIGMAN, *SECURITIES REGULATION* 3424 (3d ed. 1991).

<sup>136</sup> O’Hare, *supra* note 80, at 1705.

<sup>137</sup> See 7 LOSS & SELIGMAN, *supra* note 135, at 3424 (“[A]las, however, the puffing concept in the securities context, which for decades had all but gone the way of the dodo, has recently experienced a revival.” (footnote omitted)); O’Hare, *supra* note 80, at 1698 (“More recently . . . courts have extended the protections of the puffery defense to *non-broker* defendants, such as corporate officers and directors.”).

<sup>138</sup> O’Hare, *supra* note 80, at 1700 (emphasis in original); cf. *Va. Bankshares, Inc. v. Sandberg*, 501 U.S. 1083, 1093 (1991) (“[C]onclusory terms in a commercial context are reasonably understood to rest on a factual basis that justifies them as accurate, the absence of which renders them misleading.”), *quoted in United States v. Skilling*, 554 F.3d 529, 553 (5th Cir. 2009), *vacated in part on other grounds*, 130 S. Ct. 2896 (2010).

<sup>139</sup> See discussion *infra* Parts II.E.2.

misstatements by relying on the fact that they were presented in the context of meaningful cautionary language. As Professors Bainbridge and Gulati have noted: “If putting the statement into context lends credence to a decision to dismiss, the bespeaks caution doctrine is invoked. If taking a statement out of context makes dismissal more plausible, however, puffery is invoked.”<sup>140</sup>

*d) Contradicted by Market Realities*

Finally, both experimental literature and the prevalence of puffery in the marketplace belie the conclusion that puffery is immaterial. For example, David Hoffman has noted, “[e]xperimental literature analyzing puffery confirms that individuals are unable to ignore vague optimism and expressions of confidence.”<sup>141</sup> Meanwhile, Professors Bainbridge and Gulati properly do not ignore the fact that “[a]necdotally, it does not take much time watching investment programs on television to notice that even quite vague statements of optimism by corporate managers are considered important by the investment news media.”<sup>142</sup> When “a major factor in determining whether information [is] material is the importance attached to it by those who knew about it,” then the fact that those who market their companies rely so much on puffery patently contradicts the assertion that puffery is immaterial.<sup>143</sup>

Some have argued that puffery deserves to be protected because it is shareholder-friendly. In other words, do shareholders really want management to forego the sales talk?<sup>144</sup> As the court in *Eisenstadt v. Centel Corp.*<sup>145</sup> noted: “Where puffing is the order of the day, literal truth can be profoundly misleading, as senders and recipients of letters of recommendation well know.”<sup>146</sup> However, the Supreme Court responded to similar concerns in *Basic* by concluding that “creating an exception to a regulatory scheme founded on a prodisclosure legislative philosophy, because complying with the

<sup>140</sup> Bainbridge & Gulati, *supra* note 45, at 123.

<sup>141</sup> Hoffman, *supra* note 45, at 587.

<sup>142</sup> Bainbridge & Gulati, *supra* note 45, at 120.

<sup>143</sup> SEC v. Mayhew, 121 F.3d 44, 52 (2d Cir. 1997).

<sup>144</sup> See Larry Ribstein, *The Bear Stearns Hedge Fund Prosecution: Spin or Fraud?*, IDEOBLOG (Oct. 12, 2009, 7:33 PM), <http://busmovie.typepad.com/ideoblog/2009/10/the-bear-stearns-hedge-fund-prosecution-spin-or-fraud.html> (“[I]mposing criminal liability for spin could encourage misleadingly pessimistic disclosures that end up hurting rather than helping investors.”).

<sup>145</sup> 113 F.3d 738 (7th Cir. 1997).

<sup>146</sup> *Id.* at 746.

regulation might be ‘bad for business,’ is a role for Congress, not this Court.”<sup>147</sup>

Having discussed a variety of the objections to the puffery doctrine, I will now turn to the other three materiality safety valves I have previously identified.

## 2. *Bespeaks Caution: Contrary to the Admonition Against Bright-Line Rules*

The goal of thwarting frivolous litigation has been deemed to be so lofty that under the express terms of the PSLRA a defendant could rely on the codified *bespeaks-caution* doctrine even where the plaintiff proved that the challenged statement “was made with actual knowledge . . . that the statement was false or misleading.”<sup>148</sup> As mentioned above, the fact that this doctrine—at least as codified under the PSLRA (and as interpreted by at least some courts)—can be used to immunize knowingly false statements issued with the intent to defraud seemingly makes a mockery of “investor protection” under the securities laws. Furthermore, the very concept of cautionary statements making forward-looking statements immaterial is arguably facially incoherent.<sup>149</sup>

Of course, one can argue that this is the price that investors must pay in order to encourage corporations to issue the forward-looking statements so valued by the market. And indeed, the history leading up to codification of the *bespeaks-caution* doctrine suggests this is, at least partly, the case.<sup>150</sup> However, even if one accepts the need for some type of safe-harbor provision in this area, the *bespeaks-caution* doctrine as currently applied arguably functions very much like a bright-line rule.<sup>151</sup> At the very least, such an application of the

<sup>147</sup> *Basic Inc. v. Levinson*, 485 U.S. 224, 240 n.17 (1988).

<sup>148</sup> 15 U.S.C. § 78u-5(c)(1)(B)(i) (2006).

<sup>149</sup> See Hoffman, *supra* note 45, at 588 (“Courts assume that individuals can hear a source saying two things—‘I express the following beliefs about the future’ and ‘Don’t rely on anything I just said’—and make a rational decision about which statement is worthy of credence. This is nonsense.”). See also Heminway, *supra* note 51, at 305 (“[T]he *bespeaks caution* defense exists because a reasonable (sophisticated) investor would not find forward-looking statements accompanied by meaningful cautionary language (1) important to her investment decision making or (2) significant to the total mix of available information.” (footnote omitted)).

<sup>150</sup> See Jeanne Calderon & Rachel Kowal, *Safe Harbors: Historical and Current Approaches To Future Forecasting*, 22 J. CORP. L. 661, 664–65 (1997) (noting that “[i]n the early 1970s, the SEC reversed its position prohibiting submission of forward-looking information,” but that it soon saw the need to provide a safe harbor to encourage disclosure).

<sup>151</sup> See Hoffman, *supra* note 45, at 586 (“Over time, as I have explored, courts have become more willing to apply ‘puffery’ and ‘*bespeaks caution*’ doctrines which are (1) bright-line rules that focus on the language of disclosures . . . .”); *id.* at 588 (“Notably, both doctrines create incentives for corporations to use words that they hope will induce reliance, but which



doctrine runs counter to the Supreme Court's admonition that bright-line rules are an anathema to the fact-intensive analysis of materiality.<sup>152</sup>

It is beyond the scope of this Article to explore alternative formulations of the bespeaks-caution doctrine that might run less afoul of the Supreme Court's rejection of bright-line rules, or be less objectionable in terms of immunizing deceit. It is, however, very much within the scope of this Article to suggest that such concerns support relying on some other ground (e.g., scienter) to dismiss unmeritorious suits whenever possible.

### 3. Truth-on-the-Market: The Misplaced Materiality Defense

The truth-on-the-market doctrine is primarily a doctrine designed to allow a defendant to rebut the fraud-on-the-market presumption of reliance. As the Supreme Court noted in *Basic*, proving that the market makers "were privy to the truth" may rebut the "presumption of reliance" in a fraud-on-the-market case.<sup>153</sup> Nonetheless, some courts have also used it to find alleged misstatements immaterial as a matter of law. For example, the Second Circuit, in *Ganino v. Citizens Utilities Co.*,<sup>154</sup> opined, "Under this [truth-on-the-market] corollary, a misrepresentation is immaterial if the information is already known to the market because the misrepresentation cannot then defraud the market."<sup>155</sup>

When so utilized, the truth-on-the-market doctrine, like the bespeaks-caution doctrine, has its roots in the total-mix definition of materiality.<sup>156</sup> For example, in *In re Merck & Co., Securities Litigation*,<sup>157</sup> the Third Circuit held that failure to disclose the bottom-line impact of financial misstatements was immaterial as a matter of law where the data to calculate the bottom was disclosed to

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may be rendered legally irrelevant; they are bright-line rules that enable fraud.").

<sup>152</sup> See *Basic*, 485 U.S. at 236 (noting that while the bright-line rule "seems to be directed solely at the comfort of corporate managers . . . ease of application alone is not an excuse for ignoring the purposes of the Securities Acts"); *id.* ("Any approach that designates a single fact or occurrence as always determinative of an inherently fact-specific finding such as materiality, must necessarily be overinclusive or underinclusive.").

<sup>153</sup> *Id.* at 248.

<sup>154</sup> 228 F.3d 154 (2d Cir. 2000).

<sup>155</sup> *Id.* at 167 (citing *Provenz v. Miller*, 102 F.3d 1478, 1492 (9th Cir. 1996); *Associated Randall Bank v. Griffin, Kubik, Stephens & Thompson, Inc.*, 3 F.3d 208, 213-14 (7th Cir. 1993)).

<sup>156</sup> See Padfield, *supra* note 87, at 934 ("[U]nder the total mix of information analysis, public availability of the truth may offset a misleading disclosure.").

<sup>157</sup> 432 F.3d 261 (3d Cir. 2005).

investors.<sup>158</sup> The court, however, noted the interplay of materiality and fraud-on-the-market presumption of reliance, which is only available in the case of efficient markets: “If these analysts—all focused on revenue—were unable for two months to make a handful of calculations, how can we presume an efficient market at all?”<sup>159</sup> Given the problem of overdependence on materiality discussed in this Article, hopefully the courts will keep the truth-on-the-market doctrine where it belongs—in their analysis of reliance.<sup>160</sup> Of course, dismissing a case for lack of reliance does not completely solve the “condoning deceit” problem because the court could still be dismissing an action where plaintiff has proven a misstatement of material fact made with intent to deceive.<sup>161</sup> Nonetheless, I submit that telling plaintiffs that they did not rely on materially misleading statements arguably negatively impacts investor trust in the market less than telling them they were unreasonable for considering managerial statements important.<sup>162</sup>

#### 4. Bright-Line Price Movement

Finally, courts that have the “clearest commitments”<sup>163</sup> to the efficient-market hypothesis have often extended that hypothesis to conclude that “the materiality of disclosed information may be measured post hoc by looking to the movement, in the period immediately following disclosure, of the price of the firm’s stock.”<sup>164</sup> This bright-line price-movement rule is also not without its critics. To begin with, as noted above, the Supreme Court specifically cautioned

<sup>158</sup> *Id.* at 270–71. See generally Padfield, *supra* note 87, at 928–29 (arguing that the “Simple Math” rule applied in *Merck* should be replaced by a “Reasonably Available Data” rule).

<sup>159</sup> *In re Merck*, 432 F.3d at 270.

<sup>160</sup> *Cf.* Nathenson v. Zonagen Inc., 267 F.3d 400, 415 (5th Cir. 2001) (“While we agree with *Burlington* and the district court as to the requirement, in cases depending on the fraud-on-the-market theory, that the complained of misrepresentation or omission have actually affected the market price of the stock, we conclude that it is more appropriate in such cases to relate this requirement to reliance rather than to materiality. That is how both *Basic* and *Abell* approach the matter.”).

<sup>161</sup> *Cf.* Mark Klock, *What Will It Take to Label Participation in a Deceptive Scheme to Defraud Buyers of Securities a Violation of Section 10(b)? The Disastrous Result and Reasoning of Stoneridge*, 58 U. KAN. L. REV. 309, 334 (2010) (“The poor reasoning by the *Stoneridge* majority—that fraud calculated to mislead the certifying accountants was too remote to meet § 10(b)’s reliance requirement—appears to be driven by the eagerness to create what the majority incorrectly perceives as a ‘pro-business’ rule to discourage litigation.”).

<sup>162</sup> The same may be said of some of the other alternative grounds for dismissal suggested below, such as loss causation.

<sup>163</sup> *In re Merck*, 432 F.3d at 269 (quoting Nathaniel Carden, Comment, *Implications of the Private Securities Litigation Reform Act of 1995 for Judicial Presumptions of Market Efficiency*, 65 U. CHI. L. REV. 879, 886 (1998)).

<sup>164</sup> *Oran v. Stafford*, 226 F.3d 275, 282 (3d Cir. 2000).

against the use of bright-line rules in making materiality determinations when it stated, “[a]ny approach that designates a single fact or occurrence as always determinative of an inherently fact-specific finding such as materiality, must necessarily be overinclusive or underinclusive.”<sup>165</sup> As I noted in an earlier article, allegiance to this bright-line price-movement rule led the Third Circuit to effectively conclude that “an article appearing on the front page of the [*Wall Street Journal*]’s ‘Money & Investing’ section (in the popular ‘Heard on the Street’ column) was not news,”<sup>166</sup> because the disclosed information had been disseminated earlier and the relevant stock price did not move (though it did in response to the *Journal*’s article).<sup>167</sup>

The bright-line price-movement test of materiality also relies heavily on event studies. As James Park describes:

In securities class actions, litigants often rely upon event studies in arguing whether a misstatement is material. An event study measures the stock market’s reaction to a piece of news by comparing the change in a company’s stock price with its average return or the market’s average return over a time period. To the extent that the company’s stock price diverges from normal market movements in a statistically significant way, there is an abnormal return that can be attributed to the tested event.<sup>168</sup>

However, these event studies are themselves the subject of much criticism. At least one study has concluded that “the standard approach is plagued by systematic, downward bias . . . . As an empirical matter, then, use of the standard approach can be expected to lead to substantial anti-plaintiff bias in securities litigation . . . .”<sup>169</sup> Furthermore, evidence of market price reaction may be delayed in ways that make overdependence on price movement suspect for purposes of determining materiality.<sup>170</sup> It is this problem of “noise”

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<sup>165</sup> *Basic Inc. v. Levinson*, 485 U.S. 224, 236 (1988); see also *No. 84 Emp’r-Teamster Joint Council Pension Trust Fund v. Am. W. Holding Corp.*, 320 F.3d 920, 934 (9th Cir. 2003) (“Pursuant to *Basic*, we reject Defendants’ argument for adoption of a bright-line rule requiring an immediate market reaction. The market is subject to distortions that prevent the ideal of ‘a free and open public market’ from occurring.” (quoting *Basic*, 485 U.S. at 246)).

<sup>166</sup> Padfield, *supra* note 87, at 957.

<sup>167</sup> See *id.* (discussing *In re Merck*, 432 F.3d at 270).

<sup>168</sup> James J. Park, *Assessing the Materiality of Financial Misstatements*, 34 J. CORP. L. 513, 533 (2009) (footnotes omitted).

<sup>169</sup> Jonah B. Gelbach et al., *Valid Inference in Single-Firm, Single-Event Studies* (Claremont McKenna Coll., Robert Day Sch. of Econ. & Fin., Working Paper No. 2009-17, 2009), available at <http://ssrn.com/abstract=1442222>.

<sup>170</sup> See Sauer, *supra* note 30, at 324 (“Exposure of a company’s accounting woes, for

surrounding stock price movement that limits the argument that if there is no impact on the price of a security, then there are no damages.<sup>171</sup>

One scholar has even argued the growing dependence on event studies in securities fraud suits could constitute a violation of the Seventh Amendment:

The interrelated questions of materiality, reliance, loss causation, and damages all require an event study for their resolution. . . . As such, a defrauded investor who fails to offer a reliable event study performed by a qualified expert has little chance of prevailing. The dispositive role now played by event studies, however, is inconsistent with the Seventh Amendment and the federal securities laws. Rather, an event study requirement poses an unconstitutional and unwarranted barrier to meritorious securities fraud suits.<sup>172</sup>

Finally, overdependence on stock price movement may also incentivize insiders to disclose information to the market in a way that minimizes their risk of liability at the expense of market efficiency.<sup>173</sup> In this age of fragile investor trust, courts should be very hesitant to encourage this kind of behavior.

Having discussed various doctrinal, as well as practical, problems associated with the materiality safety valves, I turn now to the issue of conflict with the SEC's disclosure rules.

example, may not occur until after it has been acquired by another company and its stock is no longer publicly traded. Or fraud may occur in connection with the sale of a security for which there is no public market. More commonly, market data is available in some form but is difficult to interpret. Further, by the time information is disclosed by an issuer, it may have leaked into the market from another source, or subsequent events may have rendered it stale and therefore unimportant to investors.”)

<sup>171</sup> Cf. 3 HAZEN, *supra* note 20 § 12.9[3][C] (“Although the absence of an impact on the market price certainly will make it more difficult to prove materiality, it should not be an absolute bar to a finding of materiality.”).

<sup>172</sup> Michael J. Kaufman & John M. Wunderlich, *Regressing: The Troubling Dispositive Role of Event Studies in Securities Fraud Litigation*, 15 STAN. J.L. BUS. & FIN. 183, 187 (2009); cf. John M. Wunderlich, *Tellabs v. Makor Issues & Rights, Ltd.: The Weighing Game*, 39 LOY. U. CHI. L.J. 613, 672 (2008) (“Along with the Court’s desire to curb excessive discovery in securities litigation, the Court also sought to assuage concerns about the pleading standard’s impact on the Seventh Amendment.”).

<sup>173</sup> See Patrick J. Coughlin et al., *What’s Brewing in Dura v. Broudo? The Plaintiffs’ Attorneys Review the Supreme Court’s Opinion and Its Import for Securities-Fraud Litigation*, 37 LOY. U. CHI. L.J. 1, 26 (2005) (“[S]ecurities-fraud perpetrators could just as easily ‘walk down’ the stock price by the selective disclosure of seemingly unrelated ‘bad’ news concerning the company and thereby avoid a sudden stock-price reaction, and insulate themselves from liability.”).

*C. Excessive Characterization of Disclosures as Immaterial  
Creates Conflicts with Disclosure Regime*

The disclosure requirements under our securities laws have been described as involving “a delicate and complex balancing act” between requiring too much and too little disclosure, with the “legal concept of materiality provid[ing] the dividing line.”<sup>174</sup> In fact, Thomas Hazen has gone so far as to say that “the hallmark of disclosure for both the 1933 Act registration statement and all 1934 Act filings is embodied in the concept of ‘materiality.’”<sup>175</sup> For example, Regulation S-K, Item 303, which provides instructions for the “Management’s Discussion and Analysis” section of an issuer’s registration statement, references the concept of materiality in guiding disclosure on liquidity, capital resources, results of operations and off-balance sheet arrangements.<sup>176</sup> The Commission has even promulgated a “catch all” disclosure rule that turns on materiality: “In addition to the information expressly required to be included in a statement or report, there shall be added such further material information, if any, as may be necessary to make the required statements, in the light of the circumstances under which they are made not misleading.”<sup>177</sup>

This dependence on materiality in regulating disclosure appears only to be increasing. For example, Regulation Fair Disclosure, promulgated in 2000, prohibits companies registered under the Exchange Act from selectively disclosing material information to certain market professionals.<sup>178</sup> And the Sarbanes-Oxley Act of 2002<sup>179</sup> requires registered companies to disclose “all material off-balance sheet transactions . . . that may have a material current or future effect” on the issuer’s financial condition or results of operations.<sup>180</sup> Even more recently, on August 8, 2008, the Advisory

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<sup>174</sup>Sauer, *supra* note 30, at 317; *see also id.* at 318 (“Except for those disclosure items specifically required by regulatory fiat, public companies need not disclose information that does not cross the threshold of materiality.”). *But see id.* at 320 n.12 (“There are, however, many disclosure provisions that are not subject to materiality requirements, including the ‘books and records’ and ‘internal controls’ provisions [of the Securities Exchange Act of 1934].”).

<sup>175</sup>THOMAS LEE HAZEN, *THE LAW OF SECURITIES REGULATION* § 3.4[2] (6th ed. 2009).

<sup>176</sup>*See* 17 C.F.R. § 229.303 (2010).

<sup>177</sup>17 C.F.R. § 240.12b-20 (2010).

<sup>178</sup>17 C.F.R. § 243.100 (2010); *see also* Laura S. Unger, Comm’r, *Special Study: Regulation Fair Disclosure Revisited*, U.S. SEC. & EXCH. COMM’N (Dec. 2001), <http://www.sec.gov/news/studies/regfdstudy.htm> (“[L]iability under Reg. FD hinges on the element of materiality.”).

<sup>179</sup>Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.).

<sup>180</sup>15 U.S.C. § 78m(j) (2006).

Committee on Improvements to Financial Reporting rendered its final report to the SEC, in which it stated, among other things:

The FASB or the SEC, as appropriate, should supplement existing guidance to reinforce the following concepts:

- Those who evaluate the materiality of an error should make the decision based upon the perspective of a reasonable investor[;]
- Materiality should be judged based on how an error affects the total mix of information available to a reasonable investor, including through a consideration of qualitative and quantitative factors.<sup>181</sup>

It is also worth noting that the definition of materiality also impacts “gatekeepers” like accountants in carrying out their duties. For example, section 10A of the Exchange Act requires covered auditors to employ “procedures designed to provide reasonable assurance of detecting illegal acts that would have a direct and material effect on the determination of financial statement amounts.”<sup>182</sup> Similarly, attorneys are subject to a congressional mandate to “report evidence of a material violation of securities law . . . by the company or any agent thereof.”<sup>183</sup>

To the extent that courts routinely find disclosure immaterial on the basis of safety-valve doctrines that twist the definition of materiality to the breaking point, they weaken the effectiveness of these rules by creating unnecessary confusion about the definition of materiality.<sup>184</sup> By relying more on grounds other than materiality to

<sup>181</sup> ADVISORY COMM. ON IMPROVEMENTS TO FIN. REPORTING, U.S. SEC. & EXCH. COMM’N, FINAL REPORT 80 (2008), available at <http://www.sec.gov/about/offices/oca/acifr/acifr-finalreport.pdf> (setting forth numerous points regarding “materiality” and what is “material”).

<sup>182</sup> 15 U.S.C. § 78j-1 (2006); see, e.g., *In re KPMG LLP*, Exchange Act Release No. 50,564, 83 SEC Docket 3052 (Oct. 20, 2004) (“KPMG auditors’ materiality determinations were unreasonable in that they only considered quantitative materiality . . . and failed to also consider qualitative materiality.”).

<sup>183</sup> 15 U.S.C. § 7245 (2006); see also Implementation of Standards of Professional Conduct for Attorneys, 68 Fed. Reg. 6296, 6303 (Feb. 6, 2003) (codified at 17 C.F.R. pt. 205) (“The final rule does not define the word ‘material,’ because that term has a well-established meaning under the federal securities laws and the Commission intends for that same meaning to apply here.” (footnote omitted)).

<sup>184</sup> Cf. Andrea M. Matwyshyn, *Material Vulnerabilities: Data Privacy, Corporate Information Security, and Securities Regulation*, 3 BERKELEY BUS. L.J. 129, 186 n.218 (2005) (“As part of 10K annual reports, public entities are required to disclose all ‘material’ events in the life of the business that may impact a shareholder’s investment in the entity. The definition of materiality, however, is in flux and much discretion regarding whether an event is ‘material’ for disclosure purposes remains with the company engaging in the disclosures.”).

dismiss securities claims, the courts can continue to release the pressure created by frivolous suits while at the same time arguably allowing the definition of materiality for purposes of up-front disclosure decisions to suffer less distortion. Of course, this is all a matter of degree. And it is not my purpose here to argue that courts should never dismiss on the basis of immateriality. There may be any number of cases where judicial resolution of an issue of materiality will help, rather than hinder, effective application of the disclosure rules. But the seemingly almost indiscriminate application of safety-valve doctrines like puffery is unnecessary in these days of heightened pleading standards, etc., and is likely to unduly water down the materiality standard.<sup>185</sup>

#### IV. THE SOLUTION: SHIFT FOCUS TO OTHER ELEMENTS OF RULE 10B-5

##### A. *Dependence on Materiality Unnecessary*

At the same time that excessive application of the materiality safety valves is arguably causing problems, it is highly unlikely that courts could not have dismissed most of these cases on some other basis. In the following sections I hope to show that with today's heightened pleading standards and recent Supreme Court decisions on the issues of scienter and loss causation, there is simply no need to lean on materiality as heavily as in the early days following *Basic*. Add to that the challenges plaintiffs face from market efficiency arguments, the particular limitations on the liability of secondary actor defendants, statutes of limitations, and the possibility of sanctions, and it should be the rare case where a pretrial materiality determination is necessary to stop a strike suit from going forward.<sup>186</sup> Securities lawsuits filed in the wake of the financial crisis will

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<sup>185</sup> Cf. Hoffman, *supra* note 45, at 565, 586 (citing the theory that higher rates of judicial immateriality findings "reduce disclosure pressures," but concluding that their purpose is to change investor behavior).

<sup>186</sup> For example, in the class action context courts now have many acceptable ways to get "dirty" with the facts without having to do an end run around *Eisen v. Carlisle & Jacquelin*, 417 U.S. 156 (1974), via a pretrial inquiry into materiality. *See id.* at 177 ("We find nothing in either the language or history of Rule 23 that gives a court any authority to conduct a preliminary inquiry into the merits of a suit in order to determine whether it may be maintained as a class action."). *See generally* Patricia Groot, Note, *Fraud on the Market Gets a Minitrial: Eisen Through In re IPO*, 58 DUKE L.J. 1143, 1143-44 (2009) ("Since the early 1980s, opposing attorneys have used *Eisen v. Carlisle & Jacquelin* and *General Telephone Co. of the Southwest v. Falcon* to battle over the proper class certification process in securities class action lawsuits." (footnotes omitted)). My thanks to Professor James D. Cox for this particular perspective on what courts were likely doing, at least in part, when they developed their overdependence on the pretrial materiality inquiry.

certainly raise materiality issues but, as is almost always the case, many of the other elements of Rule 10b-5 will be up for grabs as well. For example, as Allen Ferrell and Atanu Saha note, while investors will likely have little problem identifying significant price drops associated with certain disclosures connected to the downturn in the real estate market,

[T]he existence of such a statistically significant and substantial negative price reaction is hardly the end of the analysis necessary to assess the claim that investor losses attributable to this price reaction result in recoverable damages. There are still the questions of whether, and if so when, disclosure deficiencies by financial institutions occurred, whether the requisite scienter associated with these disclosure deficiencies existed, and whether investor losses are attributable to these disclosure deficiencies (this last issue being the requirement of loss causation in Rule 10b-5 causes of action).<sup>187</sup>

### B. Scienter

The most likely candidate for replacing materiality as the safety valve of choice is scienter.<sup>188</sup> Following passage of the PSLRA, a securities class-action plaintiff must plead particular facts giving rise to a strong inference that the speaker acted with the requisite intent to defraud, or at least acted recklessly in the face of knowledge that his or her misrepresentation would be traded on by investors.<sup>189</sup> In *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*,<sup>190</sup> the Supreme Court further clarified that “[a] complaint will survive . . . only if a reasonable person would deem the inference of scienter cogent and at least as compelling as any opposing inference one could draw from the facts alleged.”<sup>191</sup> Given that little serious discovery has taken

<sup>187</sup> Ferrell & Saha, *supra* note 27, at 97–98.

<sup>188</sup> See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976) (holding that no “private cause of action for damages will lie under § 10 (b) and Rule 10b-5 in the absence of any allegation of ‘scienter’—intent to deceive, manipulate, or defraud”).

<sup>189</sup> See 15 U.S.C. § 78u-4(b)(2) (2006); see also Tracy Bishop Holton, *Stating Causes of Action for Securities Fraud Under the Private Securities Law Reform Act of 1995*, in 26 CAUSES OF ACTION 109, 126–27 (Clark Kimball, ed., 2d ed. 2004) (“The Ninth Circuit now employs the most stringent standard for pleading scienter under the PSLRA, holding that reckless conduct, following the enactment of the PSLRA, *only* suffices to plead scienter if it rises to the level of ‘deliberate recklessness.’ The First, Third, and Sixth Circuits in contrast apply a more relaxed standard, concluding that recklessness suffices to meet the scienter requirement.” (citation omitted)).

<sup>190</sup> 551 U.S. 308 (2007).

<sup>191</sup> *Id.* at 324; cf. N. PETER RASMUSSEN, FRAUD LITIGATION AFTER *DURA*, *STONERIDGE*



place at the time of a motion to dismiss, and that the PSLRA actually stays discovery pending resolution of the motion to dismiss, the bar for plaintiffs on this element is extremely high.<sup>192</sup> I contend that dismissing a suit on the basis of scienter does much less harm to investor confidence than telling them that they are “unreasonable” for putting stock in management statements concerning the well-being of their corporation.

A recent subprime-related case helps illustrate this point. In *In re Radian Securities Litigation*,<sup>193</sup> the court dismissed plaintiffs’ claims that Radian had failed to adequately disclose its subprime exposure by concluding that the “plaintiffs’ allegations . . . do not establish either motive and opportunity or conscious misbehavior or recklessness on the part of the defendants. The plaintiffs therefore have not raised [the necessary] strong inference of scienter.”<sup>194</sup> The court went on to note:

Even if these allegations were sufficient to establish either motive and opportunity or conscious misbehavior or recklessness, however, the Court also concludes that an inference of scienter with respect to the plaintiffs’ allegations is neither cogent nor at least as compelling as the plausible opposing inferences suggested by the defendants.<sup>195</sup>

Certainly, pleading scienter is not a completely insurmountable obstacle. “[R]ecent circuit court cases have reached different conclusions on the question of whether an inference may be drawn

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AND *TELLABS: SWIMMING UPSTREAM?* 8 (2008), available at <http://business.cch.com/securities/Law/news/12-11-08a.pdf> (“In some circuits, the *Tellabs* [decision] actually lowered the pleading standard.”).

<sup>192</sup> See 15 U.S.C. § 78u-4(b)(3)(B) (2006) (“In any private action arising under this chapter, all discovery and other proceedings shall be stayed during the pendency of any motion to dismiss . . . .”); cf. *Grimes v. Donald*, 673 A.2d 1207, 1216 n.11 (Del. 1996) (discussing ways for shareholders to gain information predisclosure using various “tools at hand” like publicly available sources and access to books and records), overruled on other grounds by *Brehm v. Eisner*, 746 A.2d 244 (Del. 2000).

<sup>193</sup> 612 F. Supp. 2d 594 (E.D. Pa. 2009).

<sup>194</sup> *Id.* at 608.

<sup>195</sup> *Id.*; see also *In re PMI Group Inc. Sec. Litig.*, Nos. C 08-1405 SI, C 08-1406 SI, 2009 WL 1916934, at \*7–8 (N.D. Cal. July 1, 2009) (finding that complaint sufficiently alleged material misrepresentations related to subprime exposure, as well as loss causation, but granting motion to dismiss for failure to adequately plead scienter). *But see In re Downey Sec. Litig.*, No. CV 08-3261-JFW (RZx), 2009 WL 736802 (C.D. Cal. Mar. 18, 2009) (dismissing subprime securities suit on basis of lack of scienter, but also ruling in favor of defendants on materiality, loss causation and lack of misrepresentation); *In re Aetna Inc. Sec. Litig.*, No. 07-4451, 2009 WL 1619636 (E.D. Pa. June 9, 1999) (dismissing securities claim for failure to plead scienter, but also opining on the puffery and bespeaks-caution defenses).

that senior management must be aware of matters involving the company's 'core operations' . . . ."<sup>196</sup> In addition, "collective scienter' may be actionable in the absence of a sufficient inference of scienter attributable to a particular individual."<sup>197</sup> Plaintiffs may also still be able to rely on confidential witnesses in at least some jurisdictions.<sup>198</sup> Pleading motive and opportunity may also remain sufficient, at least in some jurisdictions.<sup>199</sup> There also may be some push back from Congress against what at least some see as an excessively business-friendly securities regulation regime.<sup>200</sup> Regardless, it does appear that the extent to which taking on additional risk during a financial bubble may constitute evidence of recklessness will be an issue in litigation arising out of the financial crisis.<sup>201</sup>

<sup>196</sup> RASMUSSEN, *supra* note 191, at 2.

<sup>197</sup> *Id.*; see also Bradley J. Bondi, *Dangerous Liaisons: Collective Scienter in SEC Enforcement Actions*, 6 N.Y.U. J.L. & BUS. 1, 3 (2009) ("While most courts have rejected the collective scienter theory, a handful of courts have permitted some derivation of collective scienter.").

<sup>198</sup> Compare *Higginbotham v. Baxter Int'l, Inc.*, 495 F.3d 753, 756–57 (7th Cir. 2007) ("One upshot of the approach that *Tellabs* announced is that we must discount allegations that the complaint attributes to five 'confidential witnesses' . . . . It is hard to see how information from anonymous sources could be deemed 'compelling' or how we could take account of plausible opposing inferences."), with *In re Bausch & Lomb, Inc. Sec. Litig.*, 592 F. Supp. 2d 323, 342 (W.D.N.Y. 2008) ("However, several district courts in this circuit have considered allegations based on confidential sources after *Tellabs* without discounting them.").

<sup>199</sup> See *Institutional Investors Grp. v. Avaya, Inc.*, 564 F.3d 242, 277 n.51 (3d Cir. 2009) ("The Second Circuit has continued to treat motive and opportunity allegations as a separate category, but it does not appear to have explicitly examined whether that practice is consistent with *Tellabs*.").

<sup>200</sup> See J. Robert Brown, *Restoring American Financial Stability Act of 2009: Repealing the PSLRA*, THE RACETOTHEBOTTOM.ORG (Nov. 28, 2009, 6:00 AM), <http://www.theracetothetbottom.org/preemption-of-delaware-law/restoring-american-financial-stability-act-of-2009-repealing.html> (discussing proposed American Financial Stability Act).

<sup>201</sup> *Cf. In re Ambac Fin. Grp., Inc. Sec. Litig.*, 693 F. Supp. 2d 241, 269–70 (S.D.N.Y. 2010) ("We also find that a reasonable person would deem plaintiffs' inference of scienter 'at least as compelling as any opposing inference one could draw from the facts alleged.' Defendants argue in their submissions that Ambac's financial woes were caused by the global economic collapse and that this is a 'fraud by hindsight' case. . . . [However, t]he conduct that plaintiffs allege, if true, would make Ambac an active participant in the collapse of their own business, and of the financial markets in general, rather than merely a passive victim." (citation omitted) (quoting *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 324 (2007))); Kevin LaCroix, *Ambac Financial Subprime Securities Suit Dismissal Motions Substantially Denied*, THE D & O DIARY (Feb. 23, 2010) <http://www.dandodiary.com/2010/02/articles/subprime-litigation/ambac-financial-subprime-securities-suit-dismissal-motions-substantially-denied/> ("[R]ejecting the 'hey, the whole economy tanked' argument is important. There are a number of companies about whom it might be alleged, as was alleged here of Ambac, that they were 'an active participant in the collapse of their own business, and of the financial markets in general, rather than merely a passive victim.'"). *But see* *Slayton v. Am. Express Co.*, 604 F.3d 758, 776 n.9 (2d Cir. 2010) ("We emphasize that under the [forward-looking statement] statutory safe harbor, the plaintiffs must show more than recklessness—an objective inquiry—they must show actual subjective knowledge.").

The conclusion of a recent review of subprime litigation is a great example of why focusing on scienter rather than materiality may be preferable. As Jonathan Eisenberg points out, scienter “turns out to be the perfect predictor of outcomes across all 16 cases” reviewed.<sup>202</sup> As Kevin LaCroix summarizes, “If plaintiffs were not relying on claims that required pleading scienter (i.e., the ’33 Act claims) or convinced the court that the scienter allegations were sufficient, they survived the motion to dismiss.”<sup>203</sup> Furthermore, “in the Section 10(b) cases in which the plaintiffs met the standard for pleading scienter, ‘they also convinced the court to reject the merits of the other defenses asserted in the motion to dismiss.’”<sup>204</sup>

### C. Loss Causation

Loss causation can also often offer a sound basis for dismissing a frivolous suit without making a materiality determination.<sup>205</sup> As mentioned earlier, while it is true that the remaining alternative grounds for dismissing frivolous suits do not perfectly address the “condoning lies” problem like relying on scienter does, it seems fair to argue that in terms of restoring investor trust, a judicial pronouncement that, for example, “you cannot prove your loss was caused by the lie” is still better than “the lie is unimportant.”

In *Dura Pharmaceuticals, Inc. v. Broudo*,<sup>206</sup> the Supreme Court held that it was “Congress’ intent to permit private securities fraud actions for recovery where, but only where, plaintiffs adequately allege and prove the traditional elements of causation and loss.”<sup>207</sup> While the precise meaning of *Dura* continues to be contested,<sup>208</sup> it is fair to say generally that in order to successfully carry their burden on loss causation, plaintiffs must do more than merely allege an artificially inflated stock price and subsequent loss—the connection

<sup>202</sup> Jonathan Eisenberg, *Subprime Securities Class Action Decisions: Who’s Winning, Who’s Losing and Why?*, BLOOMBERG L. REP.: CLASS ACTIONS (2010), available at <http://www.skadden.com/Index.cfm?contentID=51&itemID=1962>.

<sup>203</sup> Kevin LaCroix, *Who’s Winning and Who’s Losing the Dismissal Motions in Subprime Securities Suits?*, THE D & O DIARY (Jan. 15, 2010, 4:36 AM), <http://www.dandodiary.com/2010/01/articles/subprime-litigation/whos-winning-and-whos-losing-the-dismissal-motions-in-subprime-securities-suits>.

<sup>204</sup> *Id.* (citing Eisenberg, *supra* note 202).

<sup>205</sup> See Jonathan C. Dickey et al., *Subprime-Related Securities Litigation: Where Do We Go From Here?*, 22 INSIGHTS: CORP. & SEC. L. ADVISOR 2, 7 (Apr. 2008) (citing loss causation as one of “key defenses”).

<sup>206</sup> 544 U.S. 336 (2005).

<sup>207</sup> *Id.* at 346.

<sup>208</sup> See, e.g., T. Gorman, *Part IV: Pleading Requirements Under Dura—A Circuit Split*, SEC ACTIONS (July 30, 2009, 11:35 AM), <http://www.secactions.com/?p=1350> (“Following the Supreme Court’s decision in *Dura*, the circuit courts have adopted two and perhaps three positions on pleading loss causation.”).

between the two must be made express.<sup>209</sup> “Following *Dura*, pleading loss causation often has evolved into ‘minitrials’ at very early stages in the proceedings, and plaintiffs are expected to present expert testimony that specifically links the alleged fraud to the financial losses.”<sup>210</sup>

Failure to plead loss causation can be a particularly powerful defense in a market where overall stock prices have fallen rapidly in response to the recent crisis.<sup>211</sup> As N. Peter Rasmussen notes, this is so because “investors can find it difficult to attribute stock price declines to company-specific fraud rather than general market conditions.”<sup>212</sup> As the Tenth Circuit stated in *In re Williams Securities Litigation–WCG Subclass*,<sup>213</sup> “[t]he plaintiff bears the burden of showing that his losses were attributable to the revelation of the fraud and *not* the myriad other factors that affect a company’s stock price.”<sup>214</sup>

The need to link the alleged misstatement to the loss arguably also permits issuers to time their corrective disclosures in such a way as to make loss causation all the more difficult to prove. As the Fifth Circuit stated in *Oscar Private Equity Investments v. Allegiance Telecom, Inc.*,<sup>215</sup> “when unrelated negative statements are announced

<sup>209</sup> *Cf. id.* (discussing the several pleading standards the circuit courts employ for a loss causation claim).

<sup>210</sup> RASMUSSEN, *supra* note 191, at 2. *Cf. In re MIVA, Inc. Sec. Litig.*, No. 2:05-cv-201-FtM-29DNF, 2009 WL 3821146, at \*\*9–13 (M.D. Fla. Nov. 16, 2009) (accepting magistrate judge’s recommendation to grant the defendants’ motion for summary judgment where the plaintiffs presented extensive expert analysis on the effect of nine alleged misstatements, but failed to specifically connect the two statements that survived dismissal to the loss).

<sup>211</sup> *But cf.* Steven J. Toll, *Coming to Terms with Loss Causation after Dura: A Response to Professors Partmoy, Ferrell, and Saha*, 35 J. CORP. L. 189, 189 (2009) (arguing that loss causation presents no great obstacle to plaintiffs); Jonah B. Gelbach et al., *Does Dura Matter? Loss Causation and the Implications of Dura Pharmaceuticals v. Broudo 2* (July 31, 2009) (unpublished manuscript), available at <http://ssrn.com/abstract=1442026> (suggesting that *Dura* will not have much of an effect).

<sup>212</sup> RASMUSSEN, *supra* note 191, at 2; see also Kevin M. LaCroix, *Subprime-Related Securities Litigation: An Interim Update*, THE D & O DIARY (Sep. 9, 2009), <http://www.dando-diary.com/2009/09/articles/subprime-litigation/subprimerelated-securities-litigation-an-interim-update> (“[I]n both the lawsuit that Luminent Mortgage Corporation filed against Merrill Lynch and in the First Marblehead subprime-related securities class action lawsuit, the courts quoted with approval language from a prior RICO case in which the Second Circuit said ‘when the plaintiff’s loss coincides with a market-wide phenomenon causing comparable losses to other investors, the prospect that plaintiffs’ loss was caused by fraud decreases.’”).

<sup>213</sup> 558 F.3d 1130 (10th Cir. 2009).

<sup>214</sup> *Id.* at 1137 (emphasis added). *But see* J. Robert Brown, *Using Loss Causation to Repeal Rule 10b-5: In re: Williams Securities Litigation (Part 5)*, THE RACETOTHEBOTTOM.ORG (Mar. 24, 2009, 6:00 AM), <http://www.theracetothetbottom.org/securities-issues/using-loss-causation-to-repeal-rule-10b-5-in-re-williams-sec-3.html> (“The impact of Williams is to make it harder to bring meritorious fraud suits. It is an approach not required by the antifraud provisions and not required by *Dura*. It is consistent with the position of this Blog that the new administration may discover that the biggest obstacle to reform lies not in Congress but in the courts.”).

<sup>215</sup> 487 F.3d 261 (5th Cir. 2007).

contemporaneous of a corrective disclosure, the plaintiff must prove ‘that it is more probable than not that it was this negative statement, and not other unrelated negative statements, that caused a significant amount of the decline.’<sup>216</sup> Thus, we should not be surprised if these type of “mixed message” cases routinely crop up for dismissal.

To be sure, as with other elements of Rule 10b-5, there remain unsettled questions about what is required to effectively plead loss causation. Some courts may resolve this current uncertainty in a plaintiff-friendly manner.<sup>217</sup> In addition, further clarification will likely also come from the Supreme Court sooner or later and there is at least some chance (however small) that subsequent Supreme Court rulings will lessen the burdens on plaintiffs in terms of pleading loss causation.<sup>218</sup> For the time being, however, failure to plead loss causation appears to be a strong defense.

Of course, as with other alternatives, the fact that loss causation can effectively serve the safety valve role is of little worth vis-à-vis the issues discussed herein if courts continue to dismiss on the basis of loss causation *and* materiality. For example, in another subprime-related case, *In re Downey Securities Litigation*,<sup>219</sup> the court dismissed the plaintiffs’ claims on the basis of, among other things (including lack of scienter), failure to adequately plead loss causation.<sup>220</sup> Unfortunately, the court in *Downey* also unnecessarily opined on the materiality of the alleged misrepresentations, concluding that statements affirming the company’s “strong” capital position were “too vague to be actionable.”<sup>221</sup> The court’s

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<sup>216</sup> *Id.* at 270 (quoting *Greenberg v. Crossroads Sys., Inc.*, 364 F.3d 657, 666 (5th Cir. 2004)).

<sup>217</sup> *Cf.* *Alaska Elec. Pension Fund v. Flowserve Corp.*, 572 F.3d 221, 235 (5th Cir. 2009) (per curiam) (holding that the district court erroneously placed the burden of proving loss causation on the plaintiff at precertification stage). The court elaborated: “To be successful, a securities class-action plaintiff must thread the eye of a needle made smaller and smaller over the years by judicial decree and congressional action. Those ever higher hurdles are not, however, intended to prevent viable securities actions from being brought.” *Id.*

<sup>218</sup> See Nate Raymond, *In 5th Circuit, Justice O’Connor Revives Flowserve Securities Class Action*, LAW.COM (June 23, 2009), [http://www.law.com/jsp/tal/digestTAL.jsp?id=1202431650631&Fifth\\_Circuit\\_Revives\\_Flowserve\\_Securities\\_Class\\_Action](http://www.law.com/jsp/tal/digestTAL.jsp?id=1202431650631&Fifth_Circuit_Revives_Flowserve_Securities_Class_Action) (“[T]he question of loss causation at the class certification stage seems headed to the Supreme Court, given the continuing controversy among the circuits on how to deal with loss causation in the wake of the Supreme Court’s ruling in *Dura Pharmaceuticals.*”); cf. N. Peter Rasmussen, *5th Circuit Remains Hostile to Securities Class Actions*, JIM HAMILTON’S WORLD SEC. REG. (Feb. 22, 2010, 9:48 AM), <http://jimhamiltonblog.blogspot.com/2010/02/5th-circuit-remains-hostile-to.html> (“While all fraud plaintiffs must *plead* loss causation under the Supreme Court’s *Dura* decision, they must *prove* loss causation in the 5th Circuit at the class certification stage.”).

<sup>219</sup> No. CV 08-3261-JFW (RZx), 2009 WL 736802 (C.D. Cal. Mar. 18, 2009).

<sup>220</sup> *Id.* at \*14–15.

<sup>221</sup> *Id.* at \*6 (quoting *In re Calpine Corp. Sec. Lit.*, 288 F. Supp. 2d 1054, 1088 (N.D. Cal. 2003)).

conclusion that as a matter of law assurances of a “strong” capital position are too vague to be actionable seems highly questionable and was, as is so often the case, unnecessary.

*D. Reliance and Rebutting the Fraud-on-the-Market Presumption*

Reliance can also serve as its own safety valve. While defendants in many of the relevant cases face the presumption of reliance created under the fraud-on-the-market theory adopted in *Basic*, that presumption is rebuttable.<sup>222</sup> As the Supreme Court said in *Basic*, “[a]ny showing that severs the link between the alleged misrepresentation and either the price received (or paid) by the plaintiff, or his decision to trade at a fair market price, will be sufficient to rebut the presumption of reliance.”<sup>223</sup> For example, as discussed above, this is where the truth-on-the-market defense may properly be applied without creating the problems associated with dismissing claims on the basis of immateriality. The truth-on-the-market defense should be particularly salient in current and pending subprime-related litigation because:

Based on the global fact story that is emerging, it would seem that defendants in some of the cases will have powerful defenses to reliance based upon the publicly-disclosed facts concerning the downturn in the subprime market, and the copious risk factor disclosure that companies were publishing, and Wall Street analysts were writing about, during the time period of late 2006 through the summer of 2007.<sup>224</sup>

In addition, there may be cases where the market is in fact not efficient for purposes of applying the presumption.<sup>225</sup> Finally, following the Supreme Court’s recent opinion in *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*,<sup>226</sup> certain

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<sup>222</sup> See *Basic Inc. v. Levinson*, 485 U.S. 224, 248 (1988); cf. 14 WILLIAM MEADE FLETCHER ET AL., FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 6864 (perm. ed., rev. vol. 2003) (“While reliance in nondisclosure cases is presumed from materiality, affirmative evidence of nonreliance may defeat this presumption.”).

<sup>223</sup> *Basic*, 485 U.S. at 248.

<sup>224</sup> Dickey, *supra* note 205, at 6. See also *Subprime-Related Securities Litigation: Early Trends*, GIBSON DUNN (Mar. 23, 2009), <http://www.gibsondunn.com/publications/pages/SubprimeRelatedSecuritiesLitigationEarlyTrends.aspx> (providing a general overview of trends in subprime-related securities litigation).

<sup>225</sup> See, e.g., *Cammer v. Bloom*, 711 F. Supp. 1264, 1285–87 (D.N.J. 1989) (setting forth five factors “which, if alleged, might give rise to an inference that [the defendant’s company] traded in an efficient market”).

<sup>226</sup> 552 U.S. 148 (2008).

defendants may be too far removed from the securities transaction for their actions to have been relied upon by plaintiffs.<sup>227</sup> I will briefly address dismissal of secondary actors, pleading standards, statutes of limitations and sanctions in the following section.

*E. Dismissing Secondary Actors, Pleading Standards,  
Statutes of Limitations, and Sanctions*

Why rule on the materiality of certain misstatements if you can just dismiss the case because the defendants are not proper parties under Rule 10b-5? While “[i]n many instances of significant financial fraud, issuers lack the resources to compensate harmed investors, and plaintiffs have turned to third-party defendants such as vendors, financial institutions and gatekeepers,” the Supreme Court’s decision in *Stoneridge* “significantly narrowed the scope of actions against third-party defendants.”<sup>228</sup> In *Stoneridge*, the Court “concluded that the private right of action did not reach suppliers, who entered into sham transactions with a cable operator, because investors in the cable company did not rely upon the suppliers’ statements or representations.”<sup>229</sup> In other words, reliance may well be the critical element when dealing with secondary actors.<sup>230</sup> Add to *Stoneridge* the Supreme Court’s prior decision in *Central Bank of Denver v. First Interstate Bank of Denver*,<sup>231</sup> where the Court denied a private aiding and abetting claim under Rule 10b-5, and you have a meaningful barrier between plaintiffs and many of the parties they would like to sue.<sup>232</sup> Both *Stoneridge* and *Central Bank* certainly have their

<sup>227</sup> *Id.* at 166–67 (“In these circumstances the investors cannot be said to have relied upon any of respondents’ deceptive acts in the decision to purchase or sell securities; and as the requisite reliance cannot be shown, respondents have no liability to petitioner under the implied right of action.”).

<sup>228</sup> RASMUSSEN, *supra* note 191, at 2; *cf.* LaCroix, *supra* note 201 (“One of the characteristics of many of these subprime and credit crisis related lawsuits is the extent to which the plaintiffs are seeking to impose liability on the gatekeepers of the target companies.”).

<sup>229</sup> Gail O’Gradney, *Recent Cases—Supreme Court: Secondary Actors Not Liable For Participation in Scheme Under § 10(b)*, 26-02 FLETCHER CORP. L. ADVISER ARTICLE I (Feb. 2008).

<sup>230</sup> *See, e.g.*, *Pac. Inv. Mgmt. Co. v. Mayer Brown LLP*, 603 F.3d 144, 148 (2d Cir. 2010) (rejecting “creator” standard and holding “that a secondary actor can be held liable in a private damages action brought pursuant to Rule 10b-5(b) only for false statements attributed to the secondary-actor defendant at the time of dissemination. Absent attribution, plaintiffs cannot show that they relied on defendants’ own false statements.” (footnote omitted)), *reh’g and reh’g en banc denied*, July 26, 2010; *cf. id.* at 160 (“[P]laintiffs’ Rule 10b-5(a) and (c) claims for ‘scheme liability’ are foreclosed by the Supreme Court’s decision in *Stoneridge*.”).

<sup>231</sup> 511 U.S. 164 (1994).

<sup>232</sup> *See* Thomas O. Gorman, *Dura and Iqbal, Two Decisions Having an Impact*, SEC ACTIONS (Oct. 22, 2009, 2:42 AM), <http://www.secactions.com/?p=1615> (“While the complaint alleges a series of misstatements, after the Supreme Court’s decision in *Central Bank of Denver* . . . , there is no liability for aiding and abetting. Accordingly, the auditors can only be held

critics,<sup>233</sup> and legislation has even been introduced seeking to overturn the decisions,<sup>234</sup> but as of this writing, the decisions stand as another set of litigation safety valves—available in cases involving secondary actors—that do not require a court to opine on materiality.

Turning to pleading standards, while the safety-valve role of heightened pleading standards has already been discussed in connection with pleading scienter and loss causation, recent Supreme Court decisions suggest heightened pleading standards may favor defendants in securities cases even may broadly. As Jonathan Tuttle explains:

Since the 1995 passage of the Private Securities Litigation Reform Act (“PSLRA”), defendants in civil securities class actions have focused their attacks on the adequacy of complaints on the PSLRA’s stringent requirements for pleading scienter and the specificity requirements for pleading fraud found in Fed. Rule Civ. Proc. 9(b). More recently, however, three Supreme Court decisions have breathed new life – and new force – into the general pleading standards of Fed. Rule Civ. Proc. 8(a). These cases, *Dura v. Broudo*, *Bell Atlantic v. Twombly* and *Ashcroft v. Iqbal*, provide opportunities for defense lawyers to attack securities class action complaints on a much more basic level and create

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liable, if at all, for misstatements or omissions they made.”); cf. 2 HAROLD S. BLOOMENTHAL, SECURITIES LAW HANDBOOK § 27:58 (2009) (noting that there is disagreement as to the viability of group pleading both for purposes statement attribution and scienter).

<sup>233</sup> See Franklin A. Gevurtz, *Law Upside Down: A Critical Essay on Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, 103 NW. U. L. REV. COLLOQUY 448, 448–49 (2009) (“*Stoneridge* . . . is worth academic discussion because it illustrates how utterly irrational the law governing private securities fraud actions has become.”); Klock, *supra* note 161, at 336 (“The result of the Court’s holding creates moral hazard, whereby economic incentives to behave ethically are removed and positive economic incentives to engage in unethical conduct are created.”).

<sup>234</sup> See J. Robert Brown, *Overturning Stoneridge and the Symbolic Passing of an Era*, THE RACETOTHEBOTTOM.ORG (Aug 14, 2009, 6:00 AM), <http://www.theracetothetbottom.org/shareholder-rights/overturning-stoneridge-and-the-symbolic-passing-of-an-era.html> (“[T]he 2009 Liability for Aiding and Abetting Securities Violations Act (S. 1551) would authorize actions against ‘any person that knowingly or recklessly provides substantial assistance to another person in violation of’ federal securities laws. . . . In introducing the Bill, Senator Specter specifically noted that it was intended to overrule both *Stoneridge* and *Central Bank*.”); see also Crimmins, *supra* note 55 (“Section 929-O of the Act provides for the SEC to impose aiding and abetting liability on persons who ‘recklessly’ provide substantial assistance to someone who violates the Exchange Act. . . . In addition, the Act provides, for the first time, for aiding and abetting liability under the Securities Act, the Investment Company Act and the Investment Advisers Act. The Act . . . directs the GAO to study whether private plaintiffs should also be allowed to sue aiders and abettors.” (citations omitted)).



new obstacles for plaintiffs trying to survive a motion to dismiss.<sup>235</sup>

The requirements in *Dura* for effectively pleading loss causation have already been discussed.<sup>236</sup> In *Bell Atlantic Corp. v. Twombly*,<sup>237</sup> the Court imposed a “plausibility” standard for reviewing claims under the Sherman Act.<sup>238</sup> In *Ashcroft v. Iqbal*,<sup>239</sup> the Supreme Court extended the *Twombly* plausibility standard to all civil actions.<sup>240</sup> At least one commentator has noted the possibility that courts may read *Iqbal* as imposing pleading requirements even more stringent than the PSLRA.<sup>241</sup> *Iqbal* may also impact the pleading of loss causation in courts applying Federal Rule of Civil Procedure 8(a) to *Dura*.<sup>242</sup> At the very least, while much uncertainty about the implications of *Iqbal* exists, the strong negative response to the decision from at least some quarters suggests the decision should not be taken lightly.<sup>243</sup>

<sup>235</sup> Jonathan R. Tuttle, *Back to Basics: Taking Advantage of Rule 8(a)’s New Teeth to Attack Securities Complaints*, in SECURITIES LITIGATION & ENFORCEMENT INSTITUTE 2009, at 379, 381 (Practising Law Inst. ed., 2009).

<sup>236</sup> See *supra* Part IV.C. Cf. Mark Herrmann, et al., *Plausible Denial: Should Congress Overrule Twombly and Iqbal?*, 158 U. PA. L. REV. PENNUMBRA 141, 162 (2009), available at <http://www.pennumbra.com/debates/debate.php?did=24> (arguing that “*Dura* may have facilitated part of the analysis in *Twombly*, but it is light years away from *Iqbal*.”).

<sup>237</sup> 550 U.S. 544 (2007).

<sup>238</sup> See *id.* at 556 (“In applying these general standards to a § 1 claim, we hold that stating such a claim requires a complaint with enough factual matter (taken as true) to suggest that an agreement was made. Asking for plausible grounds to infer an agreement does not impose a probability requirement at the pleading stage; it simply calls for enough fact to raise a reasonable expectation that discovery will reveal evidence of illegal agreement.”).

<sup>239</sup> 129 S. Ct. 1937 (2009).

<sup>240</sup> See *id.* at 1949 (“To survive a motion to dismiss, a complaint must contain sufficient factual matter, accepted as true, to ‘state a claim to relief that is plausible on its face.’ A claim has facial plausibility when the plaintiff pleads factual content that allows the court to draw the reasonable inference that the defendant is liable for the misconduct alleged.” (citation omitted) (quoting *Twombly*, 550 U.S. at 570)).

<sup>241</sup> See Nicholas Tymoczko, Note, *Between the Possible and the Probable: Defining the Plausibility Standard After Bell Atlantic Corp. v. Twombly and Ashcroft v. Iqbal*, 94 MINN. L. REV. 505, 535–36 (2009) (arguing that “[t]o read *Twombly* and *Iqbal* as requiring that plaintiffs plead facts sufficient to exclude ‘more likely explanations’ would make Rule 8’s general pleading requirements even more stringent than the PSLRA’s heightened fact pleading requirements” and that while this result would be “ridiculous,” some courts are apparently already doing that).

<sup>242</sup> Cf. Evan Hill, Comment, *The Rule 10B-5 Suit: Loss Causation Pleading Standards in Private Securities Fraud Claims After Dura Pharmaceuticals, Inc. v. Broudo*, 78 FORDHAM L. REV. 2659, 2659 (2010) (“[I]n *Dura*’s wake, the circuit courts have fashioned divergent standards with respect to pleading loss causation. The courts currently apply pleading standards ranging from the lenient and generally applicable Federal Rule of Civil Procedure 8(a) to the stringent and fraud-specific Rule 9(b).”); See generally, Kenneth Crowley & Yuri Mikulka, *The New Breed of Financial-Crisis Class Actions: New Theories, New Defendants and New Defenses*, ANDREWS SEC. LITIG. & REG. REP., July 14, 2009, at 1 (“According to *Iqbal*, the heightened pleading standards apply not only to intent, but to other elements of a claim.”).

<sup>243</sup> See, e.g., Tony Mauro, *Groups Unite to Keep Cases on Docket: Plaintiffs’ Lawyers Seek to Stop Dismissals After Iqbal Decision*, NAT. L.J., Sept. 21, 2009, at 1 (“Sen. Arlen

Turning to statutes of limitations, plaintiffs generally must bring a Rule 10b-5 claim within two years of discovery and five years of the violation.<sup>244</sup> If plaintiffs' lawyers complain about it, there is a good chance defendants will want to rely upon it. Following the voluntary dismissal of *McClellan v. Regions Financial Corporation*,<sup>245</sup> a subprime-related case, the attorney for the plaintiffs complained, "there's a problem with securities law time limits in cases like *Regions*, where subprime investments were concealed for years."<sup>246</sup> Certainly, time may often be on the side of defendants, particularly in the more complex corporate fraud cases.<sup>247</sup>

Finally, if the real concern motivating dependence on materiality safety valves is frivolous litigation, courts may want to consider increasing (appropriately, of course) their use of sanctions. For example, attorneys for plaintiffs in the securities class action of *In re Australia and New Zealand Banking Group Ltd. Securities Litigation*<sup>248</sup> were ordered to pay all the defendants' attorney fees

Specter, (D-Pa.), introduced a bill in July that would return pleading standards to the pre-*Twombly* status.").

<sup>244</sup> See Joseph Robertson, Note, *Inquiry Notice Gone Awry: A Doctrine Abused in Debenedictis v. Merrill Lynch*, 94 CORNELL L. REV. 1491, 1492 n.5 (2009) ("[S]ince Congress passed the Sarbanes-Oxley Act in 2002, the courts have applied a two-years-after-discovery period with a five-year ultimate bar to these claims."); *Friedman v. Rayovac Corp.*, 295 F. Supp. 2d 957, 974–76 (W.D. Wis. 2003) (discussing the statute of limitations for claiming a violation of the Securities Act). Cf. James Hamilton, *Leahy Antifraud Amendment Approved by Senate Conferees*, JIM HAMILTON'S WORLD SEC. REG. (June 23, 2010, 2:05 PM), <http://jimhamiltonblog.blogspot.com/2010/06/leahy-antifraud-amendment-approved-by.html> ("The Leahy Amendment would add new Section 1079A to the bill to amend the US criminal code to increase the statute of limitations for securities fraud violations from five to six years . . .").

<sup>245</sup> Notice of Voluntary Dismissal at 1, *McClellan v. Regions Fin. Corp.*, No. 2:09-cv-01976-UNAS-RBP (N.D. Ala. Nov. 13, 2009) (entering the plaintiff's voluntary dismissal of his claims under Federal Rule of Civil Procedure 41(a)).

<sup>246</sup> Sheri Qualters, *Securities Fraud Suits Resurface*, NAT. L.J., Nov. 23, 2009, at 1. *McClellan* was apparently a proxy fraud claim, which would be subject to an even shorter statute of limitations. See *Alaska Elec. Pension Fund v. Olofson*, No. 08-2344-CM, 2009 WL 1580296, at \*4 (D. Kan. June 3, 2009) ("A plaintiff must bring claims under Section 14(a) of the Exchange Act within 'one year after the plaintiff discovers the facts constituting the violation, and in no event more than three years after such violation.'" (quoting *In re iBasis, Inc. Derivative Litig.*, 532 F. Supp. 2d 214, 220 (D. Mass. 2007))).

<sup>247</sup> See David Ingram, *Senators Express Impatience with Scope of Fraud Prosecutions*, NAT. L.J., Dec. 10, 2009, <http://www.law.com/jsp/nlj/PubArticleNLJ.jsp?id=1202436218454&slreturn=1&hblogin=1> ("Robert Khuzami, director of enforcement for the Securities and Exchange Commission, and Kevin Perkins, assistant director of the Federal Bureau of Investigation, said cases against executives and directors are especially difficult because the defendants are relatively sophisticated. 'Many times they are developing defenses as they go along, and it takes a long time to unwind those,' Perkins said."). But see *Merck & Co. v. Reynolds*, 130 S. Ct. 1784, 1798 (2010) ("[T]erms such as 'inquiry notice' and 'storm warnings' may be useful . . . [b]ut the limitations period does not begin to run until the plaintiff thereafter discovers or a reasonably diligent plaintiff would have discovered 'the facts constituting the violation' . . .").

<sup>248</sup> No. 08 Civ. 11278(DLC), 2010 WL 1875728 (S.D.N.Y. May 11, 2010).

after failing to perform the necessary diligence to ensure a claim was proper, such failure rising in the eyes of the court to “gross negligence bordering on recklessness.”<sup>249</sup> The PSLRA mandates judicial review for, and imposition of, sanctions for frivolous litigation.<sup>250</sup>

## V. CRITICISMS

I want to briefly address some possible objections to my suggestion that courts reduce their dependence on materiality as a means to thwart frivolous suits because such dependence effectively and unnecessarily condones lying, twists the definition of materiality to the breaking point, and creates conflicts with the disclosure rules.

One possible criticism is that a reduction in judicial “guidance” on the issue of materiality would hurt more than it would help. One might respond to this argument, however, by pointing out that there is at least some evidence to suggest that “the accumulated body of published case law provides limited guidance for decision-making,”<sup>251</sup> suggesting that the loss would not be that great.

Another possible criticism is that judicial “leniency” in granting dismissals on the basis of materiality is necessary to offset the costs associated with the SEC’s “zealousness” in bringing cases and defining materiality in such a way as to provide maximum protection to the retail investor.<sup>252</sup> Again, if cost is the issue, one may reply that the uncertainty associated with judicial materiality determinations is also costly.<sup>253</sup> More importantly, I am not arguing that courts should give up their safety valve “operator” function. Rather, I am arguing that they should stop depending on materiality as their primary tool whenever possible.<sup>254</sup>

What about the argument that shifting the focus of Rule 10b-5 claims to other elements will result in an increased cost for experts, since loss causation and reliance (for example) are often fact-intensive issues? The answer is that courts are already engaging in

<sup>249</sup> *Id.* at \*6.

<sup>250</sup> 15 U.S.C. § 78u-4(c) (2006) (listing sanctions for abusive litigation).

<sup>251</sup> Sauer, *supra* note 30, at 319.

<sup>252</sup> *Cf.* Larry Ribstein, *The Regulatory Risks of Behavioral Finance*, IDEOBLOG (Oct. 5, 2009, 9:14 AM), <http://busmovie.typepad.com/ideoblog/2009/10/the-regulatory-risks-of-behavioral-finance.html> (“[L]et us not forget that regulators can be irrational too . . .”).

<sup>253</sup> *Cf.* Sauer, *supra* note 30, at 319 (“Th[e] continuing uncertainty has increased the cost of generating and verifying financial information and has added to the amount of litigation burdening the corporate world.”).

<sup>254</sup> This may be more difficult in some types of securities litigation outside the Rule 10b-5 context. *See* Eisenberg, *supra* note 202 (noting that Sections 11 and 12(a)(2) of the Securities Act do not require a plaintiff to prove scienter); 14 FLETCHER ET AL., *supra* note 222, § 6864 (“The liability imposed by Section 11 and Section 12(a)(2) of the Securities Act of 1933 generally does not require a plaintiff to show reliance.” (footnotes omitted)).

these analyses, likely to ensure that when the case is appealed there will be multiple grounds upon which to affirm. This actually suggests another cost of my approach—that is, the cost of some cases being reversed that might have been upheld had the alleged misstatement also been found to be immaterial. But, it is the rare case that is reversed but for materiality, and as to those cases where the issue does manifest, I believe the overall benefit of reducing judicial dependence on materiality should outweigh the cost.

#### VI. CONCLUSION

Courts create a number of problems when they rely excessively on materiality in dismissing what they deem to be frivolous claims. First, the repeated immunization of lies both condones corporate deceit and mocks investor trust. Second, the various safety-valve doctrines conflict with the Supreme Court's guidance on the definition and analysis of materiality. Finally, the "watering down" of materiality creates problems for those trying to determine what disclosures are required under the SEC's rules, which often mandate a materiality assessment. The time is right for courts to look to the other elements of Rule 10b-5 to dismiss claims they deem frivolous. This is so because satisfying those other elements has become more difficult since the Supreme Court's decision in *Basic*, and the current financial crisis provides both the need and opportunity to restore investor confidence by ceasing to call lies immaterial.