

June 2004

## The Law and Economics of Securities Fraud: Section 29(a) and the Non-Reliance Clause

David K. Lutz

Follow this and additional works at: <https://scholarship.kentlaw.iit.edu/cklawreview>



Part of the [Law Commons](#)

---

### Recommended Citation

David K. Lutz, *The Law and Economics of Securities Fraud: Section 29(a) and the Non-Reliance Clause*, 79 Chi.-Kent L. Rev. 803 (2004).

Available at: <https://scholarship.kentlaw.iit.edu/cklawreview/vol79/iss2/19>

This Notes is brought to you for free and open access by Scholarly Commons @ IIT Chicago-Kent College of Law. It has been accepted for inclusion in Chicago-Kent Law Review by an authorized editor of Scholarly Commons @ IIT Chicago-Kent College of Law. For more information, please contact [jwenger@kentlaw.iit.edu](mailto:jwenger@kentlaw.iit.edu), [ebarney@kentlaw.iit.edu](mailto:ebarney@kentlaw.iit.edu).

# THE LAW AND ECONOMICS OF SECURITIES FRAUD: SECTION 29(A) AND THE NON-RELIANCE CLAUSE

DAVID K. LUTZ\*

## INTRODUCTION

Section 10(b) of the Securities Exchange Act of 1934 (the “Act” or “Exchange Act”), and Rule 10b-5<sup>1</sup> promulgated thereunder, prohibit the use of manipulative and deceptive devices in connection with the purchase or sale of securities. Rule 10b-5 primarily applies to three broad categories of fraud: (1) misrepresentations or omissions in corporate disclosure documents; (2) insider trading; and (3) manipulation.<sup>2</sup> Although manipulation may be a factor in persuading a party to sign a contract, the applicability of Rule 10b-5 to contracts for the sale or exchange of stock is premised on claims of misrepresentations or omissions in the contract forming the basis of the parties’ transaction.<sup>3</sup>

\* J.D. candidate, Chicago-Kent College of Law, Illinois Institute of Technology, 2004. I would like to thank Professor Kevin Haynes, Michael Kasdin, and Ryan Liebl for their helpful comments and advice throughout the writing of this Note.

1. Section 10(b) makes it:

[U]nlawful for any person, directly or indirectly, . . . [t]o use or employ, in connection with the purchase or sale of any security . . . , any manipulative or deceptive device or contrivance 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.

15 U.S.C. § 78j (2000). Pursuant to this Section, the SEC promulgated Rule 10b-5 which provides, in pertinent part:

It shall be unlawful for any person, directly or indirectly, . . . (a) To employ any device, scheme, or artifice to defraud, (b) To 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, or (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with purchase or sale of any security.

17 C.F.R. § 240.10b-5 (2003).

2. JOHN C. COFFEE, JR. & JOEL SELIGMAN, *SECURITIES REGULATION* 1044 (9th ed. 2003).

3. Although manipulating a party into signing a sales document may be a basis of fraud liability, Section 29(a) only addresses the effect of contractually agreeing to waive compliance with provisions of the Act, not whether the party was fraudulently induced into signing the contract. *See Shearson/American Express, Inc. v. McMahon*, 482 U.S. 220, 230 (1987) (“Section 29(a) is concerned, not with whether brokers maneuver[ed] customers] into an agreement, but with whether the agreement weaken[s] their ability to recover under the [Exchange] Act.” (alterations in original) (internal quotations marks omitted)).

The Act's anti-fraud provisions may be avoided, however, if the parties include a clause specifying that the purchasing party is relying solely on representations contained in the final written contract, thereby eliminating the possibility that an aggrieved party may plausibly claim reliance on any oral or written representations that are excluded from the final contract. This clause may take a number of different forms, but the substance and effect of the clause will be substantially similar.<sup>4</sup>

However, the use of an integration or non-reliance clause ("NRC") to preclude reasonable reliance produces tension between the parties' ability to freely contract and the policy underlying the Act's anti-waiver provisions.<sup>5</sup> Section 29(a) provides that "[a]ny condition, stipulation, or provision binding any person to waive compliance with any provision of this chapter or of any rule or regulation thereunder . . . shall be void."<sup>6</sup> To determine whether standard clauses, such as a non-reliance clause or an integration clause, violate Section 29(a), a court must determine whether the operation of the clause produces a waiver of compliance or whether the clause merely limits and defines the boundaries of the parties' transaction.<sup>7</sup>

The use of NRCs to limit fraud liability in the purchase and sale of securities is a widespread practice. Over the years, courts have taken different approaches to interpreting the effect of such clauses,<sup>8</sup>

4. For example, the clause may be an integration clause, providing that all of the parties' earlier dealings and written agreements are integrated into the final agreement. Additionally, the clause may be a non-reliance clause, providing that the parties may not rely on any representations not contained in the final written agreement. The effect of both clauses is substantially similar because both preclude a party from relying on prior agreements or negotiations that did not find their way into the final written contract. Some courts, however, have noted that an integration clause is less explicit in reference to reliance, and therefore may have less evidentiary value than a non-reliance clause to prove the lack of reliance. See *In re DaimlerChrysler AG Sec. Litig.*, 294 F. Supp. 2d 616, 623 (D. Del. 2003).

5. As Professor Robert Prentice puts it,

on the one hand, it seems unfair to put sellers in the potentially untenable position of telling the truth *in writing* but then being subjected to litigation anyway by a buyer who falsely claims that he was orally lied to. On the other hand, it seems to me (although apparently not to Judges Posner and Easterbrook) equally unfair to allow sellers to lie orally and then to hide behind written provisions that they know full well the buyers are unlikely to read or to understand if they do read.

Robert Prentice, *Contract-Based Defenses in Securities Fraud Litigation: A Behavioral Analysis*, 2003 U. ILL. L. REV. 337, 347-48 (2003) (emphasis in original).

6. 15 U.S.C. § 78cc (2000).

7. See *Harsco Corp. v. Segui*, 91 F.3d 337, 343 (2d Cir. 1996).

8. Compare *Rogen v. Iikon Corp.*, 361 F.2d 260, 268 (1st Cir. 1966) (holding that an NRC precludes reasonable reliance as a matter of law), with *Harsco Corp.*, 91 F.3d at 343 (holding that an NRC weakens a party's ability to recover for fraud, but such a weakening does not violate Section 29(a)).

and the extent to which a selling party may limit liability by requiring the purchaser to rely solely on representations contained in the final written agreement, thereby precluding a finding of “reasonable reliance” on any representations made during the course of the negotiations or sale.<sup>9</sup>

Recently, in *AES Corp. v. Dow Chemical Co.*,<sup>10</sup> the U.S. Court of Appeals for the Third Circuit addressed whether the inclusion of an NRC in a stock purchase agreement precludes a finding of reasonable reliance as a matter of law.<sup>11</sup> The court found that Section 29(a) is violated by holding that a party can completely avoid Section 10(b) fraud liability by simply including an NRC in the final written agreement.<sup>12</sup> The Third Circuit thereby created a circuit split.<sup>13</sup> Other circuits have concluded that an NRC is an enforceable contractual provision that ensures the parties’ dealings, and any subsequent litigation, proceed on the basis of a common understanding embodied in the final written agreement, thus promoting efficiency in contractual dealings.<sup>14</sup>

Although the practical issue of inserting an NRC into an agreement is fairly straightforward, the use of an NRC raises questions regarding the proper function of securities regulation and challenges the assumptions by which legal interpretation is performed. The circuit split, therefore, not only represents a split of judicial interpretation, but also stands for a much more fundamental and widespread problem. What assumptions should drive legal analysis and rulemaking? What values are served by regulating the securities industry?

This Note will argue that enforcing an NRC to preclude reasonable reliance as a matter of law, based on a contract negotiated at

9. Compare *AES Corp. v. Dow Chem. Co.*, 325 F.3d 174, 180–81 (3d Cir. 2003) (holding, as a matter of law, that an NRC precludes reasonable reliance on representations made outside of the final agreement), *cert. denied*, 124 S. Ct. 805 (2003), with *Citibank, N.A. v. Itochu Int’l Inc.*, No. 01 Civ. 6007, 2003 WL 179784, at \*1 (S.D.N.Y. Apr. 4, 2003) (precluding the plaintiff from claiming reasonable reliance on representations outside of the final written agreement).

10. *AES Corp.*, 325 F.3d 174.

11. *Id.* at 176.

12. *Id.* at 180–81.

13. Compare *Harsco Corp.*, 91 F.3d at 343 (holding that the use of an NRC to preclude reasonable reliance as a matter of law does not violate Section 29(a)), with *AES Corp.*, 325 F.3d at 180–81. The extent of the circuit split may be disputed, however, because most courts that interpret NRCs do not interpret the clauses under Section 29(a). For example, the Seventh Circuit, D.C. Circuit, and the First Circuit have concluded that NRCs are enforceable contractual provisions, but did not interpret the clauses under Section 29(a). These courts, however, interpret the issue in such a way as to eliminate the need to address Section 29(a). See *infra* Part III.D.

14. See *Rissman v. Rissman*, 213 F.3d 381, 384 (7th Cir. 2000).

arm's length between sophisticated parties, does not violate Section 29(a).<sup>15</sup> Following such a rule allows for the advancement of congressional goals—including investor protection—and reduces the occurrences of fraud that many critics seek to prevent. Advancing the goals of investor protection does not require the abandonment of law and economics or legal rules. While many critics argue that an NRC is simply a mechanism that allows parties to get away with fraud, the NRC is a valuable tool that will reduce fraud by forcing parties to insist on a complete and efficient contract. In this regard, adopting a rule that enforces NRCs against sophisticated parties addresses the concerns of critics who argue against more radical and far-reaching proposals to reform securities regulation.<sup>16</sup>

This Note will not address arguments relating to the enforcement of NRCs against unsophisticated individual investors.<sup>17</sup> While much of the analysis that follows can be applied to such investors, the scope of this Note is limited to the evaluation of Section 29(a) and the NRC within the specific context of a negotiated agreement between sophisticated parties. Many critics extend their analysis to include both sophisticated and unsophisticated investors,<sup>18</sup> but the purpose of what follows is to simply address one portion of a very complex problem.

15. This Note primarily focuses on the issues of interpreting Section 29(a) in conjunction with an NRC. While using the recent decision of *AES Corp. v. Dow Chemical Co.*, 325 F.3d 174, to put the argument in context, I do not undertake to offer an in-depth analysis of the cases, and the factual issues of such cases, forming the circuit split. The theoretical issues and policy concerns addressed throughout this Note, however, are all directly applicable to the circuit split and the Third Circuit's decision, and an overview of the issues in the cases will aid in the understanding of the arguments that follow.

16. See, e.g., Stephen Choi, *Regulating Investors Not Issuers: A Market-Based Proposal*, 88 CAL. L. REV. 279 (2000) (advocating for securities industry regulations that classify investors into categories); Elaine A. Welle, *Freedom of Contract and the Securities Laws: Opting Out of Securities Regulation by Private Agreement*, 56 WASH. & LEE L. REV. 519, 528–32 (1999) (providing an overview of deregulation proposals).

17. Likewise, this Note will not directly address transactions between “sophisticated” investors (who are not corporate entities but are merely more experienced or wealthy investors) and their brokers. Such investment transactions do not directly implicate Section 29(a) or the NRC (but may depending on the contractualization of the sale and the specific clauses contained therein), but rather involve a discussion concerning the broker's accurate disclosure of risk and why sophisticated investors will tend to make more risky investment decisions. Section 29(a) is not applicable to fraudulent misrepresentations by brokers to induce customers into buying securities. See *supra* note 3. I seek to focus on negotiated contracts between sophisticated parties, not on the relationship between a sophisticated party and its broker. For a good discussion on the broker-sophisticated investor relationship, see Donald C. Langevoort, *Selling Hope, Selling Risk: Some Lessons For Law From Behavioral Economics About Stockbrokers and Sophisticated Customers*, 84 CAL. L. REV. 627 (1996).

18. See, e.g., Prentice, *supra* note 5, at 378.

Because I realize that sophisticated investors tend to have the same behavioral and cognitive vulnerabilities as unsophisticated investors, I am concerned with the contractualization of securities fraud jurisprudence even in cases involving corporate entities.

Part I of this Note will evaluate the issue of reasonable reliance under Rule 10b-5 generally, and move on to an analysis of reasonable reliance specifically in the context of Section 29(a) when the contract contains an NRC. Part II will present the two major theories driving the interpretation of securities regulation—law and economics and behavioralism—and evaluate the behavioralists’ attempt to undermine two fundamental assumptions of the law and economics movement—rationality and the preference for rules over standards. Part II will also offer an analysis of legal rulemaking and conclude that precise rules operate to reduce transaction costs and increase efficiency. In conclusion, Part III will argue that Section 29(a) is not violated by finding, as a matter of law, that the plaintiff cannot claim reasonable reliance on representations not included in the final agreement when the contract contains an NRC. Such a finding provides a precise rule for contracting parties to adhere to, which thereby reduces transaction costs, reduces fraud, and provides for efficient outcomes.

## I. THE INTERPRETATION OF SECTION 29(A)

Section 29(a) of the Act is a provision directly addressing the enforceability of contractual clauses that seek to waive compliance with or avoid regulation under federal securities laws.<sup>19</sup> The issues involved in the interpretation and application of Section 29(a), therefore, hinge on whether the contracting parties are attempting to limit or waive the rights provided by the Act, and consequently the ability to recover for the violation of such rights. The importance of Section 29(a) in the context of fraud is whether the use of an NRC can preclude the finding of reasonable reliance as a matter of law. To understand the importance of such a finding, a brief overview of the elements necessary to plead a Section 10(b) fraud claim is appropriate.

### A. *Pleading Fraud Under Section 10(b)*

A successful cause of action for securities fraud under Section 10(b) and Rule 10b-5 requires the plaintiff to demonstrate that the

Although corporate entities are the contracting parties, the investing decisions are made by all-too-human beings who may have been misled by oral fraud that I do not countenance.

*Id.* Prentice also notes, “even sophisticated investors can be trusting and vulnerable to deception.” *Id.* at 418.

19. Section 29(a) provides that waivers of compliance shall be void, and Section 29(b) provides the conditions under which a contract will be void. 15 U.S.C. § 78cc (2000).

defendant, in connection with the purchase or sale of a security, knowingly (or recklessly) made a misstatement or omission of material fact upon which the plaintiff reasonably (or justifiably) relied, and this reliance caused the plaintiff's injury.<sup>20</sup> A finding of reasonable reliance requires the plaintiff to exercise the diligence that a reasonable person would have exercised to protect his own interests.<sup>21</sup>

The issue of reasonable reliance is primarily disputed in two factual settings. First, the plaintiff relied on oral or written representations that are contradicted by the offering memorandum or prospectus.<sup>22</sup> Second, the plaintiff relied on oral or written misrepresentations (or omissions) that were not included in the final written agreement, and the contract contained an NRC or an integration clause.<sup>23</sup> The second factual category exists because contracting parties seek to foreclose a factually specific judicial review of the reasonableness of the plaintiff's reliance where the final written contract contains an NRC. In other words, an NRC is a contractual mechanism seeking to limit the parties' representations to the four corners of the final contract, precluding an aggrieved party from claiming reliance on any representations that are not included in that contract.

Two leading cases with respect to a plaintiff's reliance on oral statements contradicted by a written offering memorandum are *Kennedy v. Josephthal & Co.*<sup>24</sup> and *Zobrist v. Coal-X, Inc.*<sup>25</sup> Both cases held, as a matter of law, that a Rule 10b-5 cause of action could not be sustained where the plaintiff claimed reliance on oral representations contradicted by the final writing. Although the two cases do not implicate Section 29(a) or an NRC, the court's analysis in both cases demonstrates the judicial approach to the interpretation of reliance within the context of a Rule 10b-5 claim.<sup>26</sup>

In *Kennedy*, the plaintiffs purchased a limited partnership interest in a venture involved in the business of mining coal.<sup>27</sup> The broker,

20. *Semerenko v. Cendant Corp.*, 223 F.3d 165, 174 (3d Cir. 2000).

21. *Straub v. Vaisman & Co., Inc.*, 540 F.2d 591, 597-98 (3d Cir. 1976).

22. *See, e.g., Kennedy v. Josephthal & Co., Inc.*, 814 F.2d 798, 801 (1st Cir. 1987); *Zobrist v. Coal-X, Inc.*, 708 F.2d 1511, 1514 (10th Cir. 1983).

23. *See, e.g., Citibank, N.A. v. Itochu Int'l Inc.*, No. 01 Civ. 6007, 2003 WL 1797847, at \*2 (S.D.N.Y. Apr. 4, 2003); *One-O-One Enters., Inc. v. Caruso*, 848 F.2d 1283, 1285 (D.C. Cir. 1988).

24. 814 F.2d 798.

25. 708 F.2d 1511.

26. Both courts describe the issue as "justifiable reliance," which is equivalent to the element of reasonable reliance. The courts use the two terms interchangeably.

27. 814 F.2d at 800.

the defendant in the action, told the plaintiffs that the investment was safe and the partnership would be profitable despite the low price for coal. The offering memorandum, however, disclosed that the investment involved a high degree of risk and that the mining operations would be unprofitable because of the then low price of coal. The plaintiffs signed documents stating that they read the offering memorandum and appreciated the risks involved.

In upholding the district court's grant of summary judgment in favor of the defendant, the First Circuit held that

[j]ustifiable reliance may be decided as a matter of law and we can think of no facts as egregious as these that would not fully support such a ruling. When they closed their eyes and passively accepted the contradictions between [the defendant's] statements and the offering memorandum, appellants could not be said to have justifiably relied on the misrepresentations.<sup>28</sup>

In *Zobrist*, another case involving a coal partnership, the Tenth Circuit held that knowledge of statements contained in the offering memorandum are imputed, as a matter of law, to investors who do not read the documents.<sup>29</sup> Although the defendant broker told the plaintiffs the investment was a "sure thing," the first page of the memorandum, along with the risk section, disclosed the investment's high risk.<sup>30</sup> After imputing knowledge of the statements to the plaintiffs, the court held that justifiable reliance could not be established as a matter of law.<sup>31</sup>

Courts do not, however, articulate a clear rule to determine justifiable reliance as a matter of law. A number of factors are used to examine whether a plaintiff's reliance on misrepresentations is justified, including: (1) the sophistication of the plaintiff; (2) the existence of a long-standing personal or business relationship; (3) access to relevant information; (4) concealment of the fraud; (5) the existence of a fiduciary relationship; (6) the opportunity to detect fraud; (7) whether the plaintiff initiated the stock transaction; and (8) the generality or specificity of the misrepresentations.<sup>32</sup> With no single factor being determinative, the court must balance all factors to determine whether a plaintiff's reliance was justified.<sup>33</sup>

28. *Id.* at 805.

29. 708 F.2d at 1518.

30. *Id.* at 1514.

31. *Id.* at 1518.

32. *Kennedy*, 814 F.2d at 804.

33. *Id.*



Courts adopt a standard-based approach to a determination of reasonable reliance, balancing eight factors to determine whether the issue can be decided as a matter of law.<sup>34</sup> The absence of a clear rule produces uncertainty in contractual dealings and forces the parties to encounter litigation on the other end of the deal. The standard-based balancing approach employed by the courts increases the costs imposed on contracting parties by requiring an *ex ante* balancing and individual determination of the factors listed above. As will be argued throughout this Note, the resulting uncertainty produces high transaction costs and inefficient outcomes.

To counteract the high transaction costs associated with *ex ante* balancing, many parties opt to include a contractual device that limits the buyer's ability to claim reliance on any representations not included in the final written agreement. Such a device forecloses the need for balancing, because the party contractually agrees that it is only entitled to rely on a specifically identified set of representations. The NRC thereby lowers the transaction costs associated with the uncertain balancing necessary for the courts' standard-based approach, and determines, by agreement, the rule governing the judicial interpretation of the contract.

### *B. The Judicial Interpretation of the Non-Reliance Clause*

The judicial interpretation of an NRC requires courts to determine two primary issues. First, the court must determine if the inclusion of an NRC violates Section 29(a) by limiting or weakening the parties' ability to recover under the Exchange Act. Second, the court must determine whether an NRC establishes a clear rule of non-reliance, or whether such a clause is merely an additional factor to consider in the standard-based balancing approach employed by courts when the contract does not include an NRC.

In *Shearson/American Express Inc. v. McMahon*,<sup>35</sup> the Supreme Court noted that "Section 29(a) is concerned, not with whether brokers maneuver[ed customers] into an agreement, but with whether the agreement weakens their ability to recover under the [Exchange] Act."<sup>36</sup> Therefore, as the Court correctly notes, the scope of Section 29(a) is limited to a contractual provision purporting to waive a

34. *Id.*

35. 482 U.S. 220 (1987).

36. *Id.* at 230 (alterations in original) (internal quotation marks omitted).

party's rights under the Act, not whether the seller induced a party to purchase through fraud or misrepresentations.<sup>37</sup> An NRC, therefore, does not seek to eliminate the ability of an aggrieved buyer to bring a fraud action, it only seeks to require that the party base such a fraud action on representations made in the final written agreement.

The circuits, however, split on the proper interpretation of Section 29(a) and, specifically, on whether Section 29(a) is violated if the use of an NRC is held to preclude a finding of reasonable reliance as a matter of law, thereby defeating a securities fraud claim based on any misstatement other than those contained in the final agreement.<sup>38</sup> The effect of such a provision is to eliminate the ability of a plaintiff to plead reasonable reliance on any facts, omissions, or misrepresentations that are not included in the final written agreement. This effect leads some courts to hold that such a preclusion is a "waiver" within the meaning of Section 29(a) and is therefore void.<sup>39</sup>

In 1966, in *Rogen v. Ilikon Corp.*,<sup>40</sup> the First Circuit found no material difference between a clause stating, for example, that "the party waives any rights based on the misrepresentations of the seller," and a clause stating, "the purchaser is not relying on the seller's representations."<sup>41</sup> The court warned that "[w]ere we to hold that the existence of [the clause] constituted the basis (or a substantial part of the basis) for finding non-reliance as a matter of law, we would have gone far toward eviscerating Section 29(a)."<sup>42</sup>

The clause in *Rogen*, however, is far from the typical NRC found in a contemporary stock purchase agreement. The contract at issue there did not include any representations in the final agreement and disclaimed *any* obligation to make full disclosure.<sup>43</sup> A typical NRC, on the other hand, merely confines reliance on any representations made during the course of negotiations to the four corners of the contract. Such a clause in no way disclaims an obligation regarding disclosure,

37. *Id.* at 230–31.

38. See *AES Corp. v. Dow Chem. Co.*, 325 F.3d 174, 181 (3d Cir. 2003) ("It would offend Section 29(a) to bar its claim based solely on a contractual commitment not to claim reliance."), *cert. denied*, 124 S. Ct. 805 (2003).

39. *Id.* at 180.

40. 361 F.2d 260 (1st Cir. 1966).

41. *Id.* at 268.

42. *Id.*

43. Specifically, the plaintiffs "acknowledged that they are fully familiar with the business and prospects of the corporation, are not relying on *any representations or obligations to make full disclosure* with respect thereto, and have made such investigation thereof as they deem necessary." *Id.* at 265 (emphasis added) (internal quotation marks omitted).

and affirmatively states the representations that form the basis for the parties' transaction. *Rogen*, therefore, is unpersuasive when arguing that a contract containing an NRC similarly waives a party's rights and obligations under the Act.

Thirty years later, in *Harsco Corp. v. Segui*,<sup>44</sup> the Second Circuit addressed an NRC that "outline[d], with great specificity, the representations and warranties that [the plaintiff] agreed to rely upon—and not rely upon—in purchasing all of [the defendant's] outstanding stock."<sup>45</sup> The clause at issue in *Harsco* is a more typical use of an NRC than the contract addressed in *Rogen*, because the *Harsco* contract contained specific representations on which the buyer was entitled to rely while not disclaiming disclosure obligations,<sup>46</sup> while the *Rogen* contract disclaimed any obligation to disclose and contained no representations on which the purchaser was entitled to rely.<sup>47</sup>

The *Harsco* court agreed that an NRC weakens a party's ability to recover for fraud, but held that "such a 'weakening' does not constitute a forbidden waiver of compliance."<sup>48</sup> In support of its holding, the court recognized the sophistication of the investors, the time and intensity of the negotiations, and the fact the both parties were represented by counsel.<sup>49</sup> The court observed that "[h]ere there is a detailed writing developed via negotiations among sophisticated business entities and their advisors. That writing, we conclude, defines the boundaries of the transaction. Harsco brings this suit principally alleging conduct that falls outside those boundaries."<sup>50</sup> In so holding, the court distinguished the contract at issue in *Rogen* by observing that there, the contract did not contain a provision similar to an NRC, and was formed amid a disparity of bargaining power that allowed the purchaser to be "duped" into forfeiting his rights.<sup>51</sup> The court properly characterized the contract and the NRC by finding that, "[u]nlike a contractual provision which prohibits a party from suing at all, the contract here reflects in detail the reasons why [the plaintiff] bought

44. 91 F.3d 337 (2d Cir. 1996).

45. *Id.* at 343 (internal quotation marks omitted).

46. *Id.*

47. *Rogen*, 361 F.2d at 265; see also *supra* note 43.

48. *Harsco*, 91 F.3d at 343.

49. *Id.*

50. *Id.*

51. *Id.* at 344.

[defendant's company]—in essence, [plaintiff] bought the representations and . . . nothing else.”<sup>52</sup>

In *One-O-One Enterprises, Inc. v. Caruso*,<sup>53</sup> the District of Columbia Circuit Court of Appeals weighed in on the effect of NRCs in federal securities fraud actions. Then-Judge Ginsburg, writing for the court, held that:

Were we to permit plaintiffs' use of the defendants' prior representations (and defendants' nondisclosure of negotiations inconsistent with those representations) to defeat the clear words and purpose of the Final Agreement's integration clause, contracts would not be worth the paper on which they are written. On a matter of such large significance to the parties' bargain, silence in a final agreement containing an integration clause—in the face of prior explicit representations—must be deemed an abandonment or excision of those earlier representations.<sup>54</sup>

Although the court's reasoning was sound, a key deficiency in the opinion was the failure to interpret, or even mention, Section 29(a). Although it was interpreting the fraud claim under Section 10(b), the court did not discuss the extent to which the clause at issue weakened or waived the plaintiff's ability to recover under the Act. Section 29(a) was relevant to the court's analysis because the contract at issue contained an NRC, and therefore contractually limited the representations on which the plaintiff was entitled to rely. The court's reasoning, however, is consistent with the holdings of other courts that preclude reliance because of the inclusion of an NRC.

The First Circuit revisited the issue in *Jackvony v. RIHT Financial Corp.*<sup>55</sup> It diverged from its reasoning in *Rogen* and followed the holding of *Harsco*, holding that the plaintiff could not establish reasonable reliance when the alleged misrepresentations were not contained in the final written agreement.<sup>56</sup> In rejecting the plaintiff's contention of reasonable reliance based on representations made prior to, but not included in, the final written agreement, the court, speaking through now-Justice Breyer held that “his argument fails in light of the later written contract, with its explicit statement that it contains the parties' entire bargain.”<sup>57</sup>

52. *Id.*

53. 848 F.2d 1283 (D.C. Cir. 1988).

54. *Id.* at 1287 (internal quotation marks and citations omitted).

55. 873 F.2d 411 (1st Cir. 1989).

56. *Id.* at 417.

57. *Id.* at 416.

In *Rissman v. Rissman*,<sup>58</sup> the Seventh Circuit articulated a clear rationale, founded in the proper interpretation of securities law generally, for precluding a party from claiming reliance on representations not contained in the final written agreement.<sup>59</sup> In an opinion written by Judge Easterbrook, the court held that:

Securities law does not permit a party to a stock transaction to disavow [non-reliance clauses]—to say, in effect, “I lied when I told you I wasn’t relying on your prior statements” and then to seek damages for their contents. Stock transactions would be impossibly uncertain if federal law precluded parties from agreeing to rely on the written word alone. Without such a principle, sellers would have no protection against plausible liars and gullible jurors.<sup>60</sup>

Although, like other circuits, the court failed to mention Section 29(a), it specifically identified the proper function of an NRC and, as this Note will argue more fully below, the reason why such clauses must be enforced: “A non-reliance clause . . . ensures that both the transaction and any subsequent litigation proceed on the basis of the parties’ writings, which are less subject to the vagaries of memory and the risks of fabrication.”<sup>61</sup>

### C. AES Corp. v. Dow Chemical Co.

By the time the Third Circuit ruled on the use of NRCs, the question seemed well settled in the other federal circuits. The consensus was that an NRC provides for a mutual understanding regarding the boundaries of the transaction and the specific representations on which the parties are entitled to rely. The Third Circuit, however, was unimpressed by the reasoning of its sister circuits, and held that Section 29(a) is violated by an NRC that precludes a plaintiff from showing reasonable reliance on representations outside the agreement as a matter of law.<sup>62</sup>

The plaintiff in *AES* alleged that the defendant artificially inflated the stock price of the target company by misrepresenting the completion date and future profitability of a power plant being built abroad.<sup>63</sup> The documents underlying the transaction, however, con-

58. 213 F.3d 381 (7th Cir. 2000).

59. *Id.* at 383.

60. *Id.* (internal quotation marks omitted).

61. *Id.* at 384.

62. *AES Corp. v. Dow Chem. Co.*, 325 F.3d 174, 180 (3d Cir. 2003), *cert. denied*, 124 S. Ct. 805 (2003).

63. *Id.* at 176.

tained no representations concerning the estimated completion date or the potential future profitability of this specific plant.<sup>64</sup> The final written contract, as well as the confidentiality agreement signed before the commencement of negotiations and the offering memorandum, contained an NRC providing that the plaintiff was entitled to rely solely on the representations specifically identified in the agreement.<sup>65</sup>

The district court granted the defendant's motion for summary judgment, finding that "Section 29(a) of the Exchange Act does not bar the enforcement of a clause disclaiming representations and warranties not appearing in a final agreement negotiated between sophisticated parties in an arm's length transaction."<sup>66</sup> The court relied on *Harsco*, and the fact that the plaintiff was a sophisticated buyer who was not in an inferior or unfair position in relation to the seller, to reach its conclusion.<sup>67</sup>

On appeal, the Third Circuit reversed the district court's holding, and found "the conclusion inescapable that enforcement of the non-reliance clauses to bar [the plaintiff's] fraud claims as a matter of law would be inconsistent with Section 29(a)."<sup>68</sup> The court held that such a provision is an anticipatory waiver of any claim based on the fraudulent misrepresentations of the party, and therefore, is a waiver prohibited by Section 29(a).<sup>69</sup> The court followed the First Circuit's reasoning in *Rogen*, which the Second Circuit had rejected in *Harsco*, and failed to distinguish the important factual differences between the cases.<sup>70</sup> In effect, the *AES* court transformed the NRC from a mechanism precluding reasonable reliance to another factor in an already complex balancing test. Although the court provided no persuasive justification for why an NRC operates to waive compliance with the provisions of the Act, and exactly why Section 29(a) is violated, the decision casts doubt on the continued viability and usefulness of the NRC.<sup>71</sup>

64. *Id.* at 177.

65. *Id.* at 176-77.

66. *AES Corp. v. Dow Chem. Co.*, 157 F. Supp. 2d 346, 353-54 (D. Del. 2001).

67. *Id.*

68. *AES Corp.*, 325 F.3d at 180.

69. *Id.*

70. *Id.*

71. The Third Circuit did, however, give evidentiary value to the NRC in the multi-factor standard-based test adopted by the court. *Id.* at 183. Therefore parties are likely to continue using NRCs.

The divergent judicial interpretation of Rule 10b-5 cases, based on whether a contractual mechanism precludes reliance, displays courts' infidelity to the underlying principles of securities regulation and fraud actions. Why does a contractual device seeking to enforce the very same holding the court will ultimately reach change the validity of the clause? An NRC simply seeks to contractually enforce the same decisions courts reach time and time again—that a plaintiff cannot rely on oral statements contradicted by the final writing. The sole difference between the two lines of cases is that an NRC is a contractual instrument that implicates Section 29(a), where cases that contain no NRC do not. Most courts, until *AES*, simply ignored Section 29(a) and followed the *Kennedy-Zobrist* reasoning, even when the contract contained an NRC or integration clause. These cases, at least impliedly, demonstrate that a plaintiff does not have a *right* to rely on prior oral representations and a clause explicitly stating such does not waive a *right*, because such a right does not exist.<sup>72</sup>

Before a full discussion of this fundamental problem can take place, however, the nature and purpose of securities regulation must be fully explored. Courts' recent tendencies to side with the plaintiff in the summary judgment phase of the case demonstrates a subtle shift in the views of why Congress decided to regulate securities in the first place. Does securities regulation promote efficiency in capital markets, serve the community, or protect the investor? Does regulation serve all of these goals, some, or none?

## II. THE FUNCTION OF SECURITIES REGULATION

The interpretation of securities law must begin from an understanding of why the securities industry is regulated in the first place. Securities law is seen as a field of public law that orders and regulates the private contracting behavior of individual investors.<sup>73</sup> The recognition of this principle explains, in part, the conflicting views regarding

72. See *Citibank, N.A. v. Itochu Int'l Inc.*, No. 01 Civ. 6007, 2003 WL 1797847, at \*1 (S.D.N.Y. Apr. 4, 2003) ("This Court . . . will hold plaintiffs to the agreement to which they bargained. Plaintiffs' securities fraud . . . claims cannot be based upon representations outside of the Agreement."). Later in the same case, the court addressed an indemnification provision that prohibited the plaintiff from suing at all. In interpreting this provision, the court noted, "[s]uch a broad-sweeping waiver clause is exactly the type of contractual provision that [Section 29(a)] and the case law forbid." *Id.* at \*3.

73. See Edmund W. Kitch, *Regulation of the Securities Market*, in 3 *ENCYCLOPEDIA OF LAW AND ECONOMICS* 814 (Boudewijn Bouckaert & Gerrit De Geest eds., 2000) ("The literature on securities regulation is diffuse and unfocused because securities regulation is understood as a field of public law that cuts across every aspect of the securities industry.").

the proper function of securities regulation. On one hand, law and economics scholars argue that securities regulation is designed to promote the freedom of contract, and thereby allow investors to rationally maximize their own utility by freely bargaining for economic benefit.<sup>74</sup> Others argue that regulation is aimed at “fairness, equity, the protection of investors, the need for public confidence in capital markets, and the deterrence of fraud.”<sup>75</sup> Behavioralists point to the limits of human cognition and judgment to refute the ideal of perfect rationality, and argue that individual action is predictably irrational, and that legal rules should be shaped around observations of human behavior.<sup>76</sup>

The conflict between contractual efficiency and the paternalist pursuit of social welfare is exemplified by the anti-waiver provisions of Section 29(a). This section will provide a brief overview of two different theories of human behavior and legal interpretation—law and economics and behavioralism—and discuss how these theories apply to an analysis of securities regulation and the application of legal rules.

#### A. *The Law and Economics Perspective*

The law and economics perspective on legal analysis uses explanatory and descriptive models, based on economic principles, to account for human activity and the actions and decisions of legal bodies.<sup>77</sup> The basic agent in law and economics analysis is *homo economicus*—a rational, competitive, self-interested actor seeking to maximize individual utility.<sup>78</sup> The basic criterion for assessing the actions of the individual, and the rules developed and implemented by legal actors, is efficiency.<sup>79</sup> The analysis of legal rules, public agencies, and individuals, therefore, is couched in terms of economic, as opposed to social, principles.

The law and economics perspective is derived, in part, from the most basic underpinnings of contract law. The law of contracts is

74. See Richard A. Posner, *The Economic Approach to Law*, 53 TEX. L. REV. 757, 761 (1975) (“The basis of an economic approach to law is the assumption that the people involved with the legal system act as rational maximizers of their satisfactions.”).

75. Welle, *supra* note 16, at 521.

76. See Prentice, *supra* note 5, at 358–421.

77. See Denis J. Brion, *Norms and Values in Law and Economics*, in 1 ENCYCLOPEDIA OF LAW AND ECONOMICS, *supra* note 73, at 1042–44.

78. *Id.* at 1042.

79. *Id.* at 1043.



based “on a model consisting of two alert individuals, mindful of their self-interest, hammering out an agreement by a process of hard bargaining.”<sup>80</sup> Law and economics supplements this traditional notion of contracting behavior by recognizing that individuals are not only “mindful of their self-interest,” but are seeking to maximize their utility, and are not only “alert,” but they are also rational.<sup>81</sup> The primary objective of a written contract is not only to provide and explain the essential terms of the bargain, but also to create a legally enforceable instrument exposing both parties to potential legal sanctions for failing to uphold the negotiated agreement.<sup>82</sup> Law and economics assumes that, because of such risk exposure, contracting parties will negotiate for the terms that most closely align with their self-interest, while remaining mindful of the potential consequences of opportunistically taking advantage of the other party.<sup>83</sup>

From this perspective, contracting behavior is purely economic. A and B desire to engage in a transaction that is mutually beneficial. Although the two parties will both benefit from the bargain, their interests in the details of the transaction will inevitably conflict, leading to negotiations detailing the allocation of benefits and risks within the agreement to the respective parties. The information available to the parties during the course of the negotiations is imperfect, and the cost of gaining perfect knowledge will often lead to inefficient outcomes because the transaction costs of pursuing perfect knowledge will outweigh the benefits derived from achieving it. Contracts, therefore, are potentially inefficient instruments with gaps resulting from the parties’ failure to foresee or predict every possible circumstance under which the contract will or will not be performed. The only solution is to create and enforce efficient legal rules that assist the parties

80. JOHN D. CALAMARI & JOSEPH M. PERILLO, *THE LAW OF CONTRACTS* 6 (4th ed. 1998).

81. See Brion, *supra* note 77.

82. Judge Posner identifies five economic functions served by contracts: “(1) to prevent opportunism, (2) to interpolate efficient terms, (3) to prevent avoidable mistakes in the contracting process, (4) to allocate risk to the superior risk bearer, and (5) to reduce the costs of resolving contract disputes.” RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 98 (6th ed. 2003).

83. See Lynn A. Stout, *The Investor Confidence Game*, 68 *BROOK. L. REV.* 407, 410–15 (2002). The rational expectations investors assumes that sophisticated corporate actors are looking for the opportunity to lie, cheat, and steal, so the investor is cold and calculating when approaching the transaction. As Professor Stout puts it, “[the rational expectations investor] assumes that corporate insiders and securities professionals will steal her money if they can do so, just as she assumes that the other player in a chess game will take her queen if she leaves it exposed.” *Id.* at 410.

in properly determining the substantive rights and obligations forming the basis of the agreement and predicting how legal institutions will interpret these rights and obligations.

Creating legal rules to promote efficient contracting must be predicated on the rational choices of parties and the enforcement of these choices. The assumption of perfect rationality enables courts to interpret claims based on the terms of the contract and enforce the provisions to which the parties voluntarily consented. An efficient contract, therefore, embodies a voluntary exchange in which two or more parties, rationally acting in their self-interest, agree to a specific distribution of risks, costs, and potential liabilities. The value of a contract as a commercial instrument depends on the court's willingness to enforce the provisions of the contract as written, enabling rational parties to determine the costs and benefits of the exchange.<sup>84</sup>

The rational choice theory underlying the law and economics perspective provides an explanation as to why certain voluntary exchanges take place while others do not.<sup>85</sup> An exchange occurs when there is a cooperative surplus between the parties—both parties gained from the exchange with little or no transaction costs.<sup>86</sup> If a voluntary exchange does not take place, the transaction costs outweighed the benefits to one or all of the parties. The key to promoting efficient voluntary exchanges, therefore, is to limit the transaction costs that impede an exchange and to correct for those costs when they are significant. In legal terms, rules should be shaped to encourage cooperative surpluses while minimizing the transaction costs associated with voluntary exchanges.

Limiting transaction costs is essential to an efficient exchange. In the context of securities regulation, Congress mandates a specific al-

84. See, e.g., *One-O-One Enters., Inc. v. Caruso*, 848 F.2d 1283, 1287 (D.C. Cir. 1988) (“Were we to permit plaintiffs’ use of the defendants’ prior representations (and defendants’ nondisclosure of negotiations inconsistent with those representations) to defeat the clear words and purpose of the Final Agreement’s integration clause, contracts would not be worth the paper on which they were written.” (internal quotation marks and citations omitted)).

85. See generally Thomas S. Ulen, *Rational Choice Theory in Law and Economics*, in 1 ENCYCLOPEDIA OF LAW AND ECONOMICS, *supra* note 73, at 790.

86. *Id.* at 803.

Rational choice theory offers no prediction about the particular proportions in which voluntary traders will divide a cooperative surplus; it merely suggests that if such a cooperative surplus exists and, very importantly, if there are no serious impediments to exchange (that is, no transaction costs), traders will find a way to divide that cooperative surplus so that both of them are better off than they would have been if they had not traded.

*Id.*

location of transaction costs to promote the existence of cooperative surpluses, while shifting the costs to the actors best able to bear them. Mandatory disclosure requirements, for example, impose substantial transaction costs on publicly traded companies by requiring full and continuous disclosure of material information. While these costs are high, shifting the costs associated with gathering material information to the individual investor would, in most cases, greatly outweigh any benefit derived from a voluntary exchange. The mandatory disclosure regime thereby encourages voluntary exchanges by minimizing transaction costs and creating cooperative surpluses where all parties will benefit from the transaction.

Like mandatory disclosure, the broad anti-fraud provisions of the Act impose transaction costs on actors seeking to buy or sell securities. For example, if A enters into a stock purchase agreement with B, and B employs a manipulative or deceptive device in the sale, B's transaction costs are increased by the exposure to potential liability. In the same way, the anti-fraud provisions lower A's transaction costs by providing recovery if the sale is fraudulent. Rule 10b-5, therefore, encourages efficient voluntary exchanges by reducing the incentive to deceive and increasing cooperative surpluses by providing protection from fraud.

The interpretation of contracts largely depends on what motivates rational actors to enter into a contract in the first place.<sup>87</sup> Contract theorists identify three primary motivations to contracting behavior: transaction cost economizing, risk distribution, and incentive alignment.<sup>88</sup> A contract can be an instrument to economize transaction costs by reducing *ex post* costs (such as litigation) and *ex ante* costs (such as information gathering). As argued above, the mandatory disclosure regime reduces *ex ante* costs by requiring corporations to disclose material information to the investing public. Likewise, engaging in fraudulent activities increases *ex post* costs by exposing the party to fraud claims and potential liability. As will be argued fully below, contractual devices seeking to limit the possibility of litigation are aimed at minimizing *ex post* transaction costs, thereby economizing transaction costs and producing efficient outcomes.

87. See Scott E. Masten, *Contractual Choice*, in 3 ENCYCLOPEDIA OF LAW AND ECONOMICS, *supra* note 73, at 26.

88. *Id.*

Risk distribution contracts are motivated by a desire to shift risk to the party best able to bear it.<sup>89</sup> The most obvious form of risk distribution is an insurance contract, where one party will compensate for the loss of another because a superior financial position enables the party to do so. The motivation of risk distribution is closely aligned with transaction cost economizing, in that contracting parties will seek to shift the risk of increased transaction costs resulting from the contract. Litigation, for example, is a large transaction cost associated with the performance of a contract. A party seeking to minimize the possibility that this transaction cost will detract from the benefit of the bargain can include clauses in the contract that shift potential risks to the other party. An NRC accomplishes risk distribution by minimizing the possibility of litigation while transferring the risk of loss to the party agreeing to rely only on specific representations. The party making such an agreement should be compensated for accepting such a risk when all the representations the party desires to rely on are not included in the final agreement.

Incentive alignment contracts are motivated by a desire to engage in a mutually beneficial transaction.<sup>90</sup> Both parties seek to gain maximum benefit at minimum cost, leading to a negotiated agreement where costs, benefits, risks, and liabilities are allocated so as to allow each contracting party to realize the benefit of the bargain. Incentive alignment is a primary motivation for most contracts because parties enter into agreements to gain a benefit through a relationship with another party. The three theories of contracting are not mutually exclusive and multiple motivations will often be present. For example, transaction cost economizing and risk distribution motivate the parties to structure their contract in a way so as to allow for incentive alignment.

The rational choice theory and the motivations for contracting are interrelated. Limiting transaction costs and creating cooperative surpluses is the primary goal of a party entering into a contractual agreement. A party motivated by a desire to economize transaction costs, distribute risk, or align incentives will only engage in the transaction if a cooperative surplus exists. The *ex ante* determinations of contracting parties must be legally enforced *ex post*, because without such enforcement the transaction costs associated with contracting,

89. "In pure insurance or risk-transfer transactions, the objective is to shift risk to the less risk-adverse transactor or 'low-cost risk bearer.'" *Id.* at 26–27.

90. *Id.* at 27.

and the inability to distribute and accept risk, will lead to inefficient outcomes. Efficiency depends on a party's ability to freely and rationally enter contracts by assessing the costs, risks, and benefits derived from the exchange.

### B. *The Behavioralist Perspective*

Critics of the law and economics movement challenge two fundamental assumptions. First, the assumption of perfect rationality fails to properly describe reality and the law and economics movement's usefulness in shaping legal rules and public policy is undermined by failing to account for systemic irrational behavior.<sup>91</sup> Second, law and economics focuses on economically defined individual choice, and ignores the social costs and objectives of securities regulation.<sup>92</sup> Regulation should therefore be more paternalistic and restrict individual choices that undermine social goals.<sup>93</sup>

#### 1. The Assumption of Rationality

Law and economics employs a model based on the assumption of perfect rationality to shape legal rules and implement public policy.<sup>94</sup> Since actors will predictably seek to maximize individual utility, legal rules can be shaped on the assumption that two rational actors will contract to achieve efficient bargains. Behaviorists, however, challenge the law and economics assumption of perfect rationality and argue that individual actors will fall prey to cognitive illusions and errors in judgment that make assuming rationality inconsistent with reality.<sup>95</sup> Behaviorists point to empirical data demonstrating that

91. See generally Prentice, *supra* note 5.

92. This argument is based, in part, on the observation that by focusing solely on rationally maximizing utility, the law and economics approach omits much more than it provides. But, as Judge Posner points out, "a theory cannot be overturned by pointing out its defects or limitations but only by proposing a more inclusive, more powerful, and above all more useful theory." Posner, *supra* note 74, at 774. Law and economics, therefore, does not pretend to be a theory without limitation, but only as the most useful of several competing theories. While behaviorists are attempting to overtake the law and economics approach to be the more useful legal theory, the lack of sufficient empirical and theoretical justification for the behavioralist approach, at least thus far, hinders its ability to provide a high degree of usefulness—at least in the context of legal rulemaking and promulgation.

93. See *infra* note 103.

94. See *supra* Part II.A.

95. Prentice, *supra* note 5, at 358–78. Prentice asks the question, "[w]hat would lead an investor who has received and relied upon oral factual representations and/or promises from her broker or some other seller . . . to sign a contract containing a disclaimer, and/or a merger clause?" *Id.* at 358. He then answers the question by outlining eleven sets of behavioral factors that may influence such a decision: rational ignorance; overoptimism, overconfidence, and the

individuals systematically deviate from economically defined rational behavior and will predictably act irrationally when making decisions, leading behavioralists to conclude that the “behavioral approach is dramatically more descriptive of reality than the widely-accepted law and economics approach.”<sup>96</sup>

Predicting human behavior, and specific reactions to a set of circumstances, is a powerful tool for legal rulemaking and policy formulation. If behavior can be predicted accurately, legal bodies can promulgate and interpret potential rules and regulations with an understanding of the way in which individuals will tend to react. By definition, however, irrational behavior is very difficult to predict, leading to a limited usefulness in legal interpretation. Behavioralists respond, however, that such cognitive illusions affect individuals with uncanny consistency and therefore are proper criteria to judge and predict human behavior and instinctual responses in a given situation.<sup>97</sup>

Critics argue that behavioralists rely on an incomplete data set, and “simplify and overgeneralize findings on human cognition and rationality to make these findings seem simultaneously important and

illusion of control; the inability to accurately calculate the probability of future events; the false consensus effect and personal positivity bias; the inability to detect deception; insensitivity to the source of information; over-reliance on oral communications; status quo bias; social proof; anchoring and adjustment; and anticipated regret. *Id.*

96. Robert A. Prentice, *The Case of the Irrational Auditor: A Behavioral Insight Into Securities Fraud Litigation*, 95 NW. U. L. REV. 133, 135 (2000).

97. See Prentice, *supra* note 5. Professor Jeffrey Rachlinski makes a good argument as to why this premise is mistaken.

[T]he primary lesson that legal scholars have taken from the cognitive psychology of judgment and choice, the notion that people make systematically erroneous choices, is mistaken. At the very least, it has been overlearned and overapplied by legal scholars. The principle lesson of cognitive psychology is not that people make mistakes. Rather, the lesson is that people develop complex, contextual strategies for making choices. They develop rules of thumb and rely on ad hoc perceptions, emotions, accumulated memory, and loose associations. Although reliance on heuristics creates vulnerabilities in judgment, people are also highly adaptive decisionmakers. Individuals often learn to restructure problems so as to avoid, or at least reduce, the difficulties that the limitations of human cognition would otherwise impose. Indeed, some individuals never adopt the particular cognitive perspective that produces errors in judgment. Furthermore, individuals can delegate decisionmaking to privately employed experts with better judgment.

Jeffrey J. Rachlinski, *The Uncertain Psychological Case for Paternalism*, 97 NW. U. L. REV. 1165, 1168 (2003). It is exactly this capacity to delegate that undermines much of the behavioralist argument when applied to sophisticated corporate actors. AES, for example, is a large international corporation employing over 30,000 employees, and presumably has both an in-house legal department and extensive outside legal representation. Even if a number of these individual actors fall prey to cognitive errors, the extensive numbers of experts offering counsel to the corporation would give it ample opportunity to restructure the transaction so as to avoid such errors.

simple enough to be incorporated into legal policy.”<sup>98</sup> Behavioral research, for example, demonstrates that behavior not only substantially varies from individual to individual but also that individual behavior is predicated on such social variables as education, training, and cultural background, and on emotional and cognitive variables such as the individual’s mood at the time the decision is made.<sup>99</sup> Therefore, individual behavior is fundamentally unpredictable because so much depends on the specific individual’s background, emotional state, and cognitive capacity. The incredible number of complex variables affecting a decision at any given moment makes the task of shaping a legal rule or evaluating a policy based on human behavior nearly impossible. The only way around such a conclusion is to point to a limited number of circumstances where the empirical data supports a specific finding, while ignoring the great weight of empirical evidence.<sup>100</sup>

The law and economics model of contracting emphasizes the minimization of transaction costs, efficiently aligning incentives, and allocating risk. Therefore, if a party possesses the information and incentive to enter into a voluntary exchange, an efficient contract should result. The assumption of rationality, however, assumes that individuals will make good choices, that they are capable of gaining adequate information, and are in a position to properly assess risks and costs. Behavioralists argue that individuals consistently make poor decisions, and legal rules should be shaped so as to protect individuals from their own choices. Rules governing voluntary exchanges must therefore account for poor judgment, and the obligation of legal bodies is premised on a paternalistic restriction of individual choice—protecting the investor and society from their own stupidity.

## 2. The Paternalistic Justification for Behavioralism

The behavioralist argument is premised on notions of social obligation.<sup>101</sup> The interpretation of securities regulation is therefore prop-

98. See Gregory Mitchell, *Why Law and Economics’ Perfect Rationality Should Not Be Traded For Behavioral Law and Economics’ Equal Incompetence*, 91 GEO. L.J. 67, 72 (2002).

99. *Id.* at 86–87.

100. *Id.* (“The legal decision theorists’ underlying empirical argument ignores, however, a growing body of empirical research demonstrating that individuals vary widely, and predictably, in their propensities to act *rationally*. In other words, this research tells us that cognitive biases do *not* affect us all with uncanny consistency.” (first emphasis added)).

101. The behavioralist argument is closely linked with other scholars who emphasize the importance of investor protection. See, e.g., Welle, *supra* note 16. Yet, behavioralists also recog-

erly framed as an issue involving social, as opposed to economic, principles and objectives.<sup>102</sup> Legal rules and regulations must therefore serve to limit individual choice to protect society from their own horrible decisions. Specifically, notions of efficiency and rationality are undermined by the behavioralist observation that individuals will enter into contracts that are truly not in their best interest, and judicial or regulatory intervention is necessary to restrict individual choice to achieve fair and utility maximizing bargains.<sup>103</sup>

Law and economics emphasizes transaction costs in determining whether contracting parties will enter into an efficient agreement. If the benefits derived from the contract exceed the costs associated with the bargain, a cooperative surplus exists, and the parties execute an efficient agreement. Transaction costs, however, are purely eco-

nize that the social principles calling for the advancement of investor protection are also linked to efficiency concerns. As Prentice explains,

[p]roviding contractual cover for fraudsters is a particularly questionable notion because strong enforcement of antifraud provisions (a) has been empirically linked to efficient equity markets, and (b) develops the norms that are so helpful in promoting trust which is, in turn, critical to the performance of honest and efficient equity markets.

Prentice, *supra* note 5, at 355–56 (footnotes omitted). Scholars who can be deemed “communitarians” or follow “social law and economics” judge rules, standards, and individual decisions based on underlying social welfare goals. In this way, such an approach is directly linked to the behavioralist abandonment of rationality to protect the individual investor. Professor Brion explains this view by noting:

[T]he proper determinant of the use of property is not self-interest of the title-holder but instead the emergent values of the community in which it is located. In the law of harms, liability is based on a breach of a duty of care toward the physical and psychic integrity of others rather than on a failure to exercise economic rationality in pursuing wealth-increasing personal gain.

Brion, *supra* note 77, at 1047.

102. Welle, *supra* note 16, at 534 (“The policies that the securities laws have been said to promote include such socially-directed objectives as the protection of investors, the elimination of manipulative and deceptive practices, the promotion of full disclosure, the encouragement of high ethical standards, and the provision of effective sanctions for violation.”). Note, however, that Professor Welle makes the assertion that “Congress enacted the securities laws to promote socially-directed values, such as fairness, equity, the protection of investors, the deterrence of fraud, and the promotion of ethical standards” without recognizing the relationship such values have to efficiency and economic concerns. *Id.* at 539. *Contra* Prentice, *supra* note 5, at 355–56.

103. This argument is based on the implicit assumption that individuals, even while initially acting irrationally, cannot adapt to act rationally under similar circumstances in the future. The irrational decisionmaker is likewise capable of delegating the task to someone without such vulnerabilities. As Professor Rachlinski explains:

The cognitive psychology of judgment and choice does not, therefore, support abandoning individual judgment in every instance in which people rely on a misleading heuristic. Even heuristically driven individual choice can be trusted far more than legal scholars have realized, so long as individuals can learn better decisionmaking strategies or delegate their choices to those who have. Merely linking a cognitive bias in judgment to a decision that law could regulate should not support implementing a constraint on individual choice.

Rachlinski, *supra* note 97, at 1168.



conomic in nature and disregard other costs that may lead to inefficient or irrational outcomes. The cognitive errors and misguided judgments of contracting parties impose a cost and threaten the efficiency of the contract. Such cognitive costs must be accounted for when analyzing individual contracting behavior.

Cognitive costs, behavioralists argue, must be accounted for in legal analysis in order to achieve the social goals underlying securities regulation.<sup>104</sup> Opponents of law and economics argue that private law is becoming increasingly more conservative, preferring “rules over standards, certainty over flexibility, law over facts, and individualism over community.”<sup>105</sup> Securities regulations, they argue, “promote specific values and pressure parties to behave in a selfless fashion.”<sup>106</sup> In other words, securities regulation is based on social principles and is aimed at protecting the individual investor from sophisticated corporate actors that will, if given the chance, opportunistically defraud the trusting investor.<sup>107</sup>

Opponents of law and economics do not dispute the economic effects of securities regulation but argue that such effects must be taken into account only to the extent they are consistent with the basic theoretical framework—that securities regulation is designed to serve social purposes and the violation of such regulations has dramatic social consequences.<sup>108</sup> This position goes further, however, and argues that regulation not only produces social consequences, but also

104. While cognitive costs may be explained and examined by behavioralists, no real attempt is made to incorporate these costs into a useful paradigm for evaluating legal behavior. Law and economics, for example, addresses and incorporates transaction costs when analyzing an individual's contracting behavior. In the same way, behavioralists should address to what extent cognitive costs can be transacted around or bargained away. In the case of sophisticated corporate entities, cognitive costs are transacted around simply by the sheer number of people working on a specific transaction. For example, in *AES Corp. v. Dow Chemical Co.*, 325 F.3d 174 (3d Cir. 2003), AES did not send one employee to negotiate the deal with Dow Chemical but sent many and retained outside representation, and thus drastically limited the cognitive costs that could potentially impede the value of the exchange. While observations on human behavior may be interesting, “[s]cholars will come to recognize that merely identifying how a cognitive error might play out in a legal context is not sufficient to support a change in law or policy.” Rachlinski, *supra* note 97, at 1225.

105. Welle, *supra* note 16, at 524.

106. *Id.* at 541.

107. The “trusting investor” is a term employed by some scholars as the counterpart to the law and economics theory's rational investor, or the “rational expectations investor.” See Stout, *supra* note 83, at 415–20.

108. Welle, *supra* note 16, at 542.

has a socializing and educational function that is destroyed by the pursuit of economic efficiency.<sup>109</sup>

Opponents depart from the law and economics contractarian in two additional positions. First, they challenge the “unrealistic model of contract formation where all transactions are negotiated by sophisticated, fully-informed parties of equal bargaining power, capable of protecting their own self interests and of arriving at mutually beneficial agreements that will maximize utility for both parties.”<sup>110</sup> Second, they prefer legal standards over rules, arguing that “[s]tandards allow decisionmakers to take into account the totality of the circumstances, to adapt to changing circumstances, and to treat like cases alike.”<sup>111</sup>

Behavioralists and other opponents of law and economics challenge the law and economics model as unrealistic and based on faulty underlying assumptions.<sup>112</sup> First, individual investors have little power to change the individual terms of a stock purchase because the deal is often presented on a take-it-or-leave-it basis.<sup>113</sup> The assumption of rationality, and the underlying implicit assumption that individuals are capable of maximizing their utility, does not account for disparities in bargaining power that place the investor in a difficult position for negotiating favorable terms. Additionally, investors may be unable to assess the risk associated with an investment, may not understand the importance of specific terms, and may fall prey to various other errors in a judgment.<sup>114</sup> Securities laws, therefore, should not be based on a model which assumes perfect rationality, because such a model fails adequately to protect the investor who is in an unequal bargaining position, and is in many cases incapable of overcoming behavioral hurdles that impede the ability to maximize individual utility.

A central ideal of the law and economics movement is that specific legal rules will produce efficient outcomes because the consequences and possible interpretations of specific actions are clearly defined and easily predictable.<sup>115</sup> Opponents argue that “rules produce errors of under-inclusiveness that can result in guilty behavior

109. *Id.* at 541 (“The securities laws set standards that serve to socialize, to educate, and to direct individuals toward more morally appropriate forms of behavior.”).

110. *Id.* at 576.

111. *Id.* at 557.

112. *Id.* at 576.

113. *Id.* at 578.

114. Prentice, *supra* note 5, at 358–78.

115. *See infra* Part II.C.

escaping sanctions, produce unequal treatment in similar cases, provide opportunities to evade prosecution, and conceal bias.”<sup>116</sup> Although bright-line legal rules will arguably produce efficient outcomes, the critic is left with one nagging question: “What about justice?”<sup>117</sup> The underlying theme of the rejection of the law and economics position is the pursuit of social justice.<sup>118</sup> Articulating precise rules will allow sophisticated parties to manipulate individual investors, while employing standards allows courts to proceed on a case-by-case basis, reducing the chance that justice will be sacrificed by the application of a bright-line rule.<sup>119</sup>

Opponents also argue that the fundamental purpose of securities regulation is to protect the investor, thereby building confidence in the markets.<sup>120</sup> This argument is based on both the congressional intent behind securities laws and the nature of the regulations promulgated thereby. At the heart of securities regulation is the pursuit of full disclosure, allowing any investor to become fully informed about a particular investment before an investment decision is made. Critics point to disclosure provisions as providing support for the argument that securities laws are primarily aimed at investor protection.<sup>121</sup> The average investor, of course, is in no position to uncover material facts through his own efforts, and must rely on the mandatory disclosure requirements to acquire the information needed to make an informed investment decision. The company and the investor are in inherently unequal bargaining positions, and without requiring companies to disclose everything the investor is vulnerable to manipulation and fraud. Viewed in this way, “a fundamental purpose of the securities laws is to protect those who cannot protect themselves.”<sup>122</sup>

116. Welle, *supra* note 16, at 559.

117. *Id.* at 569. Yet, what this simple thought ignores is that justice has many different meanings and many different contexts. While Welle would seem to equate justice with fairness, justice may also mean efficiency, especially within the context of legal procedures and rulemaking. As Judge Posner observes, “[t]he demand for justice is not independent of its price.” Posner, *supra* note 74, at 778.

118. See POSNER, *supra* note 82, at 558 (“Some legal scholars are hostile to economic analysis of law because they think it undermines legal rights by dissolving all issues into a cost-benefit analysis.”).

119. See Welle, *supra* note 16.

120. See generally Welle, *supra* note 16.

121. *Id.* Full disclosure, however, does not necessary support the behavioralist position or the goal of investor protection. If, for example, investors cannot be trusted to make good decisions even when armed with good information, disclosure may do more harm than good by encouraging overconfidence. See Rachlinski, *supra* note 97, at 1177.

122. Welle, *supra* note 16, at 545.

### C. Rules Versus Standards

A choice between efficiency and social goals relates to the adoption of rules or standards to achieve the desired outcome. Standards allow judges to adopt flexible approaches to problems and to focus on the specific factual circumstances of each individual case,<sup>123</sup> while rules specifically define categorical outcomes based on a broad application to a recurring factual scenario.<sup>124</sup> A standard inevitably requires judges to consider and balance a number of relevant factors before a decision is made, while a rule simply requires a judge to apply facts to the rule without a detailed inquiry into the context of each case.<sup>125</sup>

A simple example will help identify the analytical and practical distinctions between a rule and a standard.<sup>126</sup> The state legislature sets the speed limit on interstate highways at seventy miles per hour, and any driver exceeding this set speed has violated the law. The clear rule governing the speed of automobiles on highways provides for an easily predictable result—if you are driving over seventy miles per hour, you know you are breaking the law. The state patrol has no need to balance factors that may make a specific speed reasonable

123. It is important to note, however, that judges may not be applying the standards. Since many times standards, especially complex standards, will involve multiple disputed issues of fact, the case is not properly resolved on a motion for summary judgment. Therefore, in some instances a lay jury will be applying the standard and this may, in turn, further decrease the predictable application of the standard. Whether the fact that the lay juries give content to standards, whereas judges and lawyers give content to rules, makes standards more accessible to individuals is a disputed question that is not addressed here. See Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L.J. 557, 598–99 (1992).

124. *Id.* at 561–62 (“One can think of the choice between rules and standards as involving the extent to which a given aspect of a legal command should be resolved in advance or left to an enforcement authority to consider.”).

125. An important distinction to make is the extent to which the following analysis applies to commands promulgated as rules or standards. Within the context of Section 29(a) and the issue of reasonable reliance, the command is not promulgated by a legislature or agency. Rather, the rule is developed under a line of precedent, framed as a rule applicable to all cases that implicate the terms of the rule. Judge Posner, for example, notes that “an accumulation of precedents dealing with the same question may create a rule of law having the same force as an explicit statutory rule.” POSNER, *supra* note 82, at 553. For example, this Note argues for a rule precluding sophisticated parties from claiming reliance on any representations outside the final written agreement. Such a rule will be applied when interpreting legal claims under other rules, namely Rule 10b-5. When laws are promulgated as standards, or a hybrid rule-standard such as the required analysis for a violation of 10b-5, “predictability will be enhanced by precedent to the extent precedent transforms standards into rules.” Kaplow, *supra* note 123, at 611. Likewise, the interpretation of vague statutory commands by judicial bodies provides specific legal rules. Judge Posner observed that “even in statutory fields, many of the specific rules of legal obligation are judicial glosses on broad statutory language.” POSNER, *supra* note 82, at 553.

126. This example is based on an example used in Isaac Ehrlich & Richard A. Posner, *An Economic Analysis of Legal Rulemaking*, 3 J. LEGAL STUD. 257, 258 (1974).

because the legislature determined that any speed in excess of seventy miles per hour is per se unreasonable.

If the legislature instead drafted a law that made it illegal to drive at “unreasonable speeds,” the application of this standard to individual drivers would be unclear. The state patrol officer would need to make initial determinations concerning the reasonableness of the driver’s speed based on the weather conditions, traffic congestion, lighting conditions, and various other factors. Following this initial determination, the driver may challenge the officer’s conclusions and argue to the court that the speed was in fact reasonable and that the officer’s conclusion was erroneous.

As the above example illustrates, “[t]he difference between a rule and a standard is a matter of degree—the degree of precision.”<sup>127</sup> Both the rule and the standard may potentially prohibit the same conduct. Based on the rule, driving seventy-one miles per hour results in a law violation, and, based on the standard, seventy-one miles per hour may be an unreasonable speed but it may not. The key difference between the rule and the standard, therefore, is the degree of specificity. Under the rule, a driver traveling at seventy-one miles per hour knows he is not driving at a reasonable speed, while the standard would require the driver to consult a number of factors before determining whether or not seventy-one miles per hour is a reasonable speed based on the then existing conditions.

Employing standards increases transaction costs in two ways: by requiring actors to make *ex ante* decisions regarding the possible variant applications of the standard to particular conduct, and by requiring a review of that determination by a judicial body and enforcement body *ex post*.<sup>128</sup> First, the driver must consult a number of factors to determine the reasonable travel speed. Second, the enforcement body must evaluate this determination based on their own view of what is reasonable under the existing conditions. Finally, the judicial body must review both the decision of the driver and the enforcement official to determine whether the speed was in fact reasonable. By requiring multiple evaluations of the reasonableness of particular conduct,

127. *Id.*

128. An additional transaction cost associated with either a rule or a standard is the promulgation cost. Formulating a rule entails a larger promulgation cost because the rulemaking body must determine in advance much more than would be required under a standard. See Kaplow, *supra* note 123, at 568–69. For the purposes of this Note, the analysis of promulgation costs is excluded because the rule (or standard) at issue has already been promulgated and the only issue is whether that command should be interpreted as a rule or standard.

standards impose great transaction costs on both individual actors and judicial bodies. The application of standards usually results in the sacrificing of efficiency.

A rule would consider the activity lawful if the driver traveled at a speed equal to or lesser than seventy miles per hour. The individual can therefore avoid criminal sanction by following the rule and driving at the set reasonable speed. Under a standard, however, the unlawful activity is ill-defined and the driver must not only avoid traveling at a speed in excess of clearly defined unreasonable speeds, but must also avoid "all other behavior that is within the penumbra of the vague standard."<sup>129</sup> This result will force the individual, especially a risk averse individual, to forgo valuable activity based on the uncertainty of the standard.

The choice of a rule or standard will necessarily depend on the underlying goal of regulating specific conduct. For example, a determination of whether the death penalty is appropriate in capital cases requires consulting a number of case-specific factors, such as malice and the nature of the crime. Society has deemed murder to have no redeeming value, and therefore the vagueness of the standard does not deter valuable conduct based on uncertainty. Likewise, society recognizes that all murderers may not deserve the death penalty in all cases and a per se rule requiring execution would run contrary to the underlying social goals.

An analysis of contracting and bargaining behavior requires a different focus. Under the criminal law, the choice of a rule or a standard is based on prohibiting specific conduct. The law of contracts, however, focuses on parties bargaining for economic benefits or entitlements. Criminal law and the law of contracts, therefore, serve two fundamentally different purposes, and the application of rules or standards to individual conduct in the contract setting gives rise to a new set of costs and benefits.

In the contract setting, establishing clear rules encourages the efficient allocation of benefits and risks. When the parties have a clear view of the rules that govern the contract being executed, the possible risks and benefits from the transaction can be easily allocated *ex ante*.<sup>130</sup> The *ex post* transaction costs are limited, because the rule es-

129. Ehrlich & Posner, *supra* note 126, at 263.

130. See Louis Kaplow, *General Characteristics of Rules*, in 5 ENCYCLOPEDIA OF LAW AND ECONOMICS, *supra* note 73, at 510.

establishes how a judicial body will interpret the application of the rule to this specific contract. A standard, however, would increase both the *ex ante* and *ex post* transaction costs by requiring the parties to gather information and deliberate on the possible judicial interpretations of the contract and litigate whether the parties' interpretation of the contract was incorrect.<sup>131</sup> Both the risks and costs associated with the bargain are increased by the standard, and efficiency is sacrificed as a result.

In adopting the Exchange Act, Congress articulated a clear rule prohibiting contractual waivers of compliance with the provisions of the Act. The judicial interpretation of Section 29(a), however, makes the application of the section dramatically less clear. As discussed in Part I of this Note, *AES* transformed a rule—that an NRC precludes a finding of reasonable reliance on representations made outside of the final contract—into a standard. The effect of this transformation is to increase the transaction costs associated with private contracting behavior by creating uncertainty *ex ante* and by prolonging judicial review and litigation *ex post*.<sup>132</sup> As the next section will argue, establishing a clear rule that an NRC precludes a finding of reasonable reliance as a matter of law will lower these transaction costs and produce efficient outcomes.

Rules will be cheaper for private parties to interpret when deciding upon their own conduct and for adjudicators to apply to past behavior. Precisely because more has been determined in advance, there will be less need for parties to conduct their own studies and to predict legal outcomes and for adjudicators to devote effort to determine whether a violation should be deemed to have occurred.

*Id.*

131. Kaplow, *supra* note 123, at 569 (“Because a standard requires a prediction of how an enforcement authority will decide questions that are already answered in the case of a rule, advice about a standard is more costly.”).

132. Also, note that changing a legal command from a rule to a standard may be more costly than changing a standard into a rule. The primary function of a rule is to aid in the accurate prediction of the application of a legal command. When courts transform what once was a clear legal command into a complex or vague standard, the party loses the ability to conform behavior to the command. This observation, however, does not suggest that rules cannot be changed or altered following promulgation, but such changes may increase the costs associated with rules. As Professor Kaplow explains:

It should be noted that making initial legal commands more rule-like does not imply that they cannot be changed if new information becomes available. The prospect of change does reduce the benefit of rules, but it does not follow that there will be no benefit from providing guidance in the interim. Indeed, many detailed regimes that are designed by regulatory agencies have a more rule-like character, with occasional revision, and detailed statutes, such as tax codes, are made more precise but often revised later.

Kaplow, *supra* note 130, at 512. For the reduced benefit of rules due to the prospect of change, see *infra* note 156.

The behavioralists' abandonment of the rationality assumption produces at least one important consequence in the context of rule-making. If lawmakers assume that individuals will systematically behave irrationally, rules cannot be formulated to efficiently regulate such behavior. For example, building on an earlier example, if the state legislature desires to set the speed limit on state highways at a reasonable speed, an initial determination must be made regarding what specific speed would in fact be reasonable. According to behavioralists, the legislature should assume that individuals will act irrationally, falling prey to cognitive errors and poor judgment. For example, setting the speed limit at seventy miles per hour assumes that such a speed is reasonable and that drivers will in most cases not exceed this set speed. If the legislature assumes rational behavior, the speed limit will be followed in most instances because the benefit gained from exceeding the speed limit is outweighed by the resulting cost of paying the fine. Therefore, setting a clear rule, and the penalty for violating the rule, will allow the state to efficiently regulate speeds on their highway.

Assuming irrationality, however, confuses the issues and makes it more difficult for lawmakers to develop clear rules to regulate human conduct. The behavioralist assumes that individuals will be overconfident and overoptimistic, so the driver sees no need to obey the speed limit because he will not get caught. Likewise, the fine imposed is irrelevant to the irrational driver because he is unable to properly calculate the probability of future events and will not be deterred by a potential monetary fine. The only solution for the behavioralist is to adopt a standard-based approach, restricting the driver's choice to drive up to seventy miles per hour. The state legislature could pass a law stating that individuals must drive at a reasonable speed, and the state patrol officer, and ultimately a judicial body, will evaluate reasonableness *ex post*. The driver is irrational and incapable of following the set speed limit and must be regulated by the paternalistic state.

This regulation, however, increases transaction costs in a number of ways. First, the individual driver is assessed information costs because of the uncertainty as to what constitutes a reasonable speed. Second, the state patrol officer is assessed increased enforcement costs because the officer must now make an individual determination regarding each vehicle's speed and can no longer rely on a rule that predetermined reasonableness. Third, the judicial system will be as-



sessed costs by litigants challenging the individual determinations. These costs result from a standard that is incapable of efficiently regulating human conduct. In other words, assuming irrationality makes adopting a rule impossible.

### III. THE LAW AND ECONOMICS OF SECURITIES FRAUD

Section 29(a) provides a clear rule that parties to a contract are prohibited from opting out of regulation and waiving compliance with the provisions of the Act.<sup>133</sup> What constitutes “opting out” and waiving compliance, however, has been subjected to a confused interpretation by courts and legal scholars. The critical issue under Section 29(a) is whether the use of an NRC or similar provision constitutes a prohibited waiver of compliance or provides a mechanism for contracting parties to efficiently allocate risks and liabilities associated with the underlying transaction. The previous section discussed the practical and analytical distinctions between a rule and a standard, and drew on simple examples to illustrate the benefits of each. In the contract setting, however, the discussion of rules and standards takes on an additional importance.

#### A. *The Assumptions Driving Rulemaking: The Superiority of Rationality*

The assumptions driving the promulgation and application of rules and standards must be addressed before determining whether a rule or a standard is preferable within the context of Section 29(a) and the NRC. Law and economics scholars point to efficiency as the main criterion, arguing that individuals will rationally seek to maximize their utility.<sup>134</sup> Behavioralists assume irrationality, arguing that investors will succumb to flaws in judgment and cognitive illusions, and that policy formulation and rulemaking should take account of such irrationality.<sup>135</sup>

Behavioralists point to a number of tendencies that undermine the assumption of rationality.<sup>136</sup> Such tendencies are supported by empirical evidence that, behavioralists contend, demonstrates predictable and consistent reactions to a particular environment or set of

133. 15 U.S.C. § 78cc. (2000); *see also supra* note 19.

134. *See supra* Part II.A.

135. *See supra* Part II.B.

136. *Id.*

circumstances.<sup>137</sup> The usefulness of such empirical evidence is highly disputed,<sup>138</sup> however, and the true efficacy of behavioral observations as a source of rules or standards remains in doubt.<sup>139</sup>

Much of behavioralist analysis is premised on the observation that investors do not read contracts, do not understand contracts, and overemphasize the reliability of oral disclosures.<sup>140</sup> Even if such an observation is true, as it clearly is in certain circumstances, its validity in the context of securities regulation must be tested against the typical form of contracting for the purchase and sale of securities. A key deficiency in the behavioralist argument, in this regard, is the unfounded assumption that all contracts are form contracts with unnegotiated terms and conditions.<sup>141</sup> Based on an assumed form contract, the behavioralist is confident in making the conclusion that “[t]he verbal and legal obscurity of preprinted terms renders the cost of searching out and deliberating terms exceptionally high.”<sup>142</sup> For the behavioralist argument to carry any weight, the contract in question must be a form contract and the individual investor must neither read nor understand the terms of such a contract.

Throughout his article, Professor Prentice assumes that the NRC is contained in a form contract that the investor will neither read nor understand. Yet, contracts between sophisticated parties ordinarily entail negotiated agreements, whereby long, complex, and intense negotiations are reduced to writing in a final agreement. Even though form contracts would rarely be used in such a transaction, Prentice extends his analysis to include sophisticated parties because “the investing decisions are made by all-too-human beings”<sup>143</sup> who “can be trusting and vulnerable to deception.”<sup>144</sup>

Prentice, therefore, challenges the assumption of rationality even within the context of sophisticated corporate actors. Yet, in the corporate context, the assumption of rationality is necessary to execute efficient exchanges. While the observation that individual investors may succumb to errors in judgment and behavioral hurdles make the assumption of rationality not entirely accurate in some circumstances,

137. *Id.*

138. See Mitchell, *supra* note 98, at 72.

139. *Id.*

140. See *supra* Part II.B.

141. Prentice, *supra* note 5.

142. *Id.* at 362.

143. *Id.* at 378.

144. *Id.* at 418.

the argument fails when applied to sophisticated corporate actors. Corporations have boards of directors, independent committees, CEOs, consultants, and teams of counselors and attorneys.<sup>145</sup> To argue that a court cannot assume that such a conglomeration is rationally acting in its self-interest is to argue that rationality is impossible to assume under any conditions. Clearly this is not the case, and if it were the case, the law of contracts would lose much of its force.

In *AES*, the parties to the transaction entered into negotiations with the goal of aligning incentives and reaching a mutually beneficial agreement. An assumption of rationality by the court would have allowed it to determine the appropriate amount of deference that ought to be given to AES's consent to the NRC. Clearly, AES engaged in the negotiations to maximize their utility, and, likewise, were perfectly capable of achieving this result. Using an assumption of rationality to analyze specific conduct does not require an assumption that individuals will always maximize their utility. AES did not fall prey to cognitive illusions that would support assuming irrationality, because the entire organization, and presumably its attorneys, negotiated and consented to the final agreement—NRC and all. Although the end result disappointed AES, there were no behavioral obstacles that prevented AES from insisting on including all representations in the final agreement and, quite clearly, they should have done so.<sup>146</sup> Although the behavioralist may point to a number of explanations as to why AES committed such an error, no gain is derived from the court compensating for AES's lack of foresight and prolonging litigation where the ultimate result is clear.<sup>147</sup> The Third Circuit should have assumed that all parties to the transaction acted rationally, and in so acting consented to the terms of the contract and the representations contained therein, voluntarily distributing the benefits, risks, and liabilities accordingly.

145. This capacity to delegate gives actors the ability to eliminate, or at least minimize, cognitive errors. *See supra* note 104.

146. And surely AES will do so next time. Part of the value of rules is that they allow actors to learn from their mistakes and conform their behavior to the rule in the future. If the Third Circuit did not allow AES to escape the NRC, the company would insist that all representations be included in the final written agreement in future transactions. Because of the Third Circuit's decision, however, AES may be able to get more than they bargained for in future transactions by not disclosing the representations on which they are in fact relying.

147. *AES Corp. v. Dow Chem. Co.*, 325 F.3d 174, 182 (3d Cir. 2003), *cert. denied*, 124 S. Ct. 805 (2003) ("While AES may have an uphill battle here and summary judgment for the defendants may be appropriate at some point, we decline to give controlling significance to the existence of a non-reliance clause in a vacuum.").

### B. Preferring Rules over Standards

The behavioralist's emphasis on standards seeks to promote a more flexible approach to judicial decisionmaking than bright-line rules can provide.<sup>148</sup> Under Section 29(a), therefore, the behavioralist argues that contractual provisions seeking to limit liability or allocate risks must be interpreted under a flexible standard that is mindful of the underlying policy rationale for the section.<sup>149</sup>

Proponents of standards, especially within the context of securities regulation, emphasize the underlying goal of investor protection as a basis for their critique. Professor Elaine Welle, for example, argues that rules permit undesirable conduct to escape punishment, prevent equal treatment, encourage evasion, mask bias, and do not necessarily result in greater efficiency and certainty. Professor Welle argues that complex standard-based inquiries may result in greater certainty and efficiency than bright-line rules could produce.<sup>150</sup>

The primary difficulty in using a flexible standard to interpret violations of Section 29(a) is that contracting parties will be unable to assess the probability that a specific contractual provision will be enforceable and will be incapable of predicting how a court will interpret the parties' rights and obligations under the contract. The standard approach is predicated on a broad inquiry into the overall fairness of the transaction and the fidelity of the contract to the social principles underlying the regulation of securities, leaving the parties with both an incomplete contract and an uncertain understanding of how the contract will be interpreted in a court of law.<sup>151</sup> The resulting transaction will, therefore, be inefficient because the transaction costs associated with developing a contract that is mutually beneficial and predictably enforceable will impair the contracting parties' ability to rely on the performance of the obligations embodied in the agreement.

148. See Welle, *supra* note 16, at 559 ("Because a rule, by definition, constitutes an abstraction, it captures the background principles and policies incompletely, and therefore produces errors of under- and over-inclusiveness.").

149. *Id.* at 557.

150. *Id.* at 567–68. As the sole example to illustrate this point, Professor Welle uses the example of the flexible investment contract test used to define what constitutes a security. *Id.* Within the context of this Note, the investment contract test is irrelevant because Welle uses the example to counter deregulation proposals and applies the analysis primarily to unsophisticated investors ("bright-line tests would catch unsophisticated investors and practitioners by surprise and create a bonanza for fraudulent promoters"). *Id.* at 568. Nevertheless, her analysis fails to offer a clear argument as to how clearly defined rules would catch anyone by surprise.

151. *Id.*

In *AES*, the court held that the inclusion of an NRC in a contract will serve as an additional factor to determine the issue of reasonable reliance.<sup>152</sup> Specifically, the court observed that an NRC “may establish an absence of reliance and, when un rebutted, may even provide a basis for summary judgment in the defendant’s favor.”<sup>153</sup> The problem with the court’s approach, however, is that the selling party, in this case Dow Chemical, will not have a clear understanding of how a court will ultimately interpret the contract. *AES* agreed to a negotiated agreement that provided that they were solely relying on specific representations, yet argued after the fact that they relied on alleged fraudulent misrepresentations made during the course of the sale. In effect, *AES* said, “I lied when I told you I wasn’t relying on your prior statements’ and then sought damages for their contents.”<sup>154</sup> The Third Circuit, in allowing *AES* to get away with such a position, is dramatically impairing a party’s ability to rely on the performance of obligations embodied in a contract.

The use of standards to interpret the enforceability of contracts is fundamentally inconsistent with the basic purpose and operation of contracts. Although courts invoke equitable principles to void contracts based on public policy grounds, the benefit of a contract is to produce a common understanding of the parties’ rights and obligations, the expected performance, and the possible liability for breach. If the parties cannot rely on the courts to enforce the contract as drafted, the contract loses much of its viability as a commercial instrument.<sup>155</sup>

Using clear rules to adjudicate contractual disputes provides parties with the capability to predict how a court will interpret their underlying rights and obligations.<sup>156</sup> Contracts for the purchase or sale of

152. *AES Corp.*, 325 F.3d at 183.

153. *Id.* at 180.

154. *Rissman v. Rissman*, 213 F.3d 381, 383 (7th Cir. 2000).

155. See POSNER, *supra* note 82.

156. The ability to predict how a court will interpret the contract may be undermined if judges are unwilling to apply the rule, and therefore create exceptions, manipulate facts, and distinguish cases. See Welle, *supra* note 16, at 570. It is doubtful, however, based on the analysis of a majority of the cases addressing the issue, that judges would find the application of a rule enforcing an NRC against sophisticated parties to be so morally repugnant that they would feel compelled to try and escape its application. Additionally, if a law is susceptible to change (such as the susceptibility represented by the current circuit split regarding the proper interpretation of an NRC and Section 29(a)) any articulated rule may lose some of its value by the resulting uncertainty. As Professor Kaplow notes, “[t]he more room there is for argument about changed conditions, the more such argument will be offered, at greater cost and with less certainty in guiding behavior.” Kaplow, *supra* note 123, at 617. Judge Posner agrees that the pressure for change can undermine the predictability of rules: “Rules create pressure for exceptions, and the

securities are inherently speculative,<sup>157</sup> in that neither party has perfect information regarding the possible future contingencies that may affect the value of the transaction, resulting in a need for clear rules that dictate the parties' rights and obligations after the contract is executed.<sup>158</sup> Without clear rules, contracting to buy or sell securities would be incredibly costly, because parties would be unable or unwilling to accept the risk that a court will strike down the agreement by employing a broad unpredictable standard.<sup>159</sup>

Section 29(a) provides a clear rule on which parties should be able to rely when drafting contracts.<sup>160</sup> As long as the party is not seeking to "opt out" of regulation, or binding the other party to waive their rights under the Act, Section 29(a) has not been violated. The use of an NRC, however, confuses courts because such provisions do not technically waive compliance or the rights afforded by the Act, but they do limit the parties' ability to bring valid future causes of action. To formulate a rule applicable to NRCs, the courts must look to the general rationale embodied in Section 29(a) and conclude that an NRC is a necessary provision that efficiently allocates risks and liabilities between the contracting parties.

The Third Circuit's analysis in *AES* demonstrates the confused judicial interpretation of Section 29(a) and the NRC. The court first noted that NRCs "reflect the fact that the seller was unwilling to vouch for the accuracy of the information it was providing and the fact that the buyer was willing to undertake to verify the accuracy of that data for itself."<sup>161</sup> This holding reflects the proper understanding of an NRC by recognizing that Dow Chemical did not accept liability for (or "vouch" for, as the court puts it) any representations outside the final agreement, and AES accepted this lack of liability and undertook to verify any representations on which they sought to rely.

combination of a rule and its exceptions may be little different in practical terms from a standard, especially if ad hoc exceptions are allowed to multiply in order to improve the fit between a rigid rule and a changing social context." POSNER, *supra* note 82, at 557.

157. This conclusion is based on the simple notion that future prices of securities cannot be guaranteed, and any investment in a stock will involve risk and uncertainty of profit.

158. See George G. Triantis, *Unforeseen Contingencies: Risk Allocation in Contracts*, in 3 *ENCYCLOPEDIA OF LAW AND ECONOMICS*, *supra* note 73, at 100.

159. See Masten, *supra* note 87, at 26 ("Without some form of assurance that others will, when the time comes, uphold their end of the bargain, individuals will be justifiably reluctant to make investments, forego opportunities, or take other actions necessary to realize the full value of the exchange.").

160. 15 U.S.C. § 78cc (2000).

161. *AES Corp. v. Dow Chem. Co.*, 325 F.3d 174, 181 (3d Cir. 2003), *cert. denied*, 124 S. Ct. 805 (2003).

The court continued, “[c]learly, in such circumstances, a buyer who relies on seller-provided information without seeking to verify it has not acted reasonably.”<sup>162</sup> In other words, the court concluded that AES could not prove reasonable reliance and, therefore, had no viable 10b-5 action.

In spite of this analysis, the court concluded that, “[w]e are unwilling . . . to hold that the extraction of a non-reliance clause, even from a sophisticated buyer, will always provide immunity from Rule 10b-5 fraud liability.”<sup>163</sup> Yet, in the same paragraph, the court noted that a buyer who relies on information that is not included in the final agreement, and information for which the seller assumes no liability, does not act reasonably in relying on such representations. This confused logic yields that the very mechanism by which this conclusion is possible, the NRC, violates Section 29(a) because it waives a right that the buyer really does not have in the first place.

Before *AES*, courts articulated a clear rule applicable to the enforcement and validity of NRCs: a plaintiff could not claim reasonable reliance on representations not included in the final written agreement.<sup>164</sup> Such a rule is clearly founded in the law of contracts and premised on the need to provide contracting parties with the capability to reduce long-term and complex negotiations to a written agreement. The rule puts both purchasers and sellers on notice that in order to claim reliance on a representation made during the course of negotiations, the representation *must* be reduced to writing. Such a rule does not contradict a broad social policy or offend typical notions of fairness or justice—it simply allows contracting parties to efficiently allocate risks and liabilities in a contract, and to understand the rights and obligations of both parties to a transaction.

In transforming the NRC into another factor in a complex balancing test, *AES* increases the transaction costs associated with entering into a contract. A party is now incapable of reducing long, complex, and intense negotiations to a final written agreement that serves as the entire bargain of the parties. This, in effect, allows purchasing parties to say one thing, mean another, and dupe the selling party into believing they are only relying on certain representations. In such circumstances, the selling party is incapable of protecting themselves from fraud claims because they cannot possibly know

162. *Id.*

163. *Id.*

164. *See, e.g., Harsco Corp. v. Segui*, 91 F.3d 337, 343 (2d Cir. 1996).

every statement or fact that was disclosed during the due diligence process. Adopting a rule providing that an NRC demonstrates conclusive proof of non-reliance in a contract between sophisticated parties forces the purchasing party to disclose all the representations on which they are in fact relying. This approach reduces fraud, and claims for fraud, by producing a common understanding of the transaction.<sup>165</sup>

The parties to the contact at issue in *AES* were all sophisticated business entities, and the contract resulted from long and complex negotiations and due diligence. Presumably, during this process *AES* developed a working understanding of the important aspects of the deal, and the representations that informed that understanding. Nevertheless, *AES* sat down at the drafting table and signed a contract that contained an NRC yet did not contain any representations on which they were in fact relying. As in *Harsco*, “[h]ere there is a detailed writing developed via negotiations among sophisticated business entities and their advisors.”<sup>166</sup> Despite this fact, the Third Circuit permitted the “use of the defendant[’s] prior representations . . . to defeat the clear words and purpose of the Final Agreement’s integration clause,”<sup>167</sup> and, in effect, made the contract not worth the paper on which it was written.

### C. *Protecting the Investor and Reducing Fraud*

The interpretation of Section 29(a) and an NRC must be based on clear rules that assume the investor’s ability to rationally maximize individual utility. Without such rules, the transaction costs associated with buying or selling securities will place a substantial burden on issuers, individual investors, and the financial markets. A goal of efficiency and an assumption of rationality do not undermine the Congressional goals of investor protection. On the contrary, lowering

165. While the rule advocated throughout this Note may seem unduly harsh to plaintiffs, even behavioralists may see the value in such an approach. If courts consistently let plaintiffs get away with poor decisions, which may or may not be attributable to cognitive errors, the plaintiff has no motivation to make better choices in the future (or no reason to). As Professor Rachlinski notes, “[p]eople are also less likely to adopt better cognitive processes for making decisions when they do not suffer all of the costs of erroneous choices directly.” Rachlinski, *supra* note 97, at 1222. Likewise, when an individual initially makes an error, suffering the consequences for that error will make it more likely that the individual will correct their behavior in the future. Ulen, *supra* note 85, at 795 (“Even if people make mistakes when they make their first market choices, they have an opportunity to learn through repeated transactions.”).

166. *Harsco*, 91 F.3d at 343.

167. *One-O-One Enters., Inc. v. Caruso*, 848 F.2d 1283, 1287 (D.C. Cir. 1988).



transaction costs, producing clear rules, and providing mechanisms to easily allocate risk and liability protect the investor and reduce fraud. Such a rule would put both parties on notice that all representations must be included in the final agreement, and if they are not, that the parties cannot rely on or be liable for the omitted representations. Fraud is decreased by forcing the parties to reduce their agreement to writing, enforcing the agreement as written, and denying recovery to plaintiffs who fail to follow the rules.

Using 29(a) to justify the use of a standard to determine reasonable reliance presents an undesirable approach to the interpretation of contracts for the purchase and sale of securities. Behavioralists and other critics, however, argue that a multi-factor balancing produces more fair and just results. With no factor being determinative, the court is able to undertake a fact-specific analysis of the particular transaction, taking into account each factor used to determine reasonable reliance. The behavioralist is presumably satisfied with such an approach because the court is able to assess the extent to which cognitive errors inhibited the plaintiff's judgment, and address these concerns in the ultimate determination of reasonable reliance. Such inquiries, however, will typically involve questions of fact that are not properly resolved on summary judgment. In effect, this allows plaintiffs to avoid summary judgment or a motion to dismiss by simply claiming that they were duped or fell prey to a flawed behavioral instinct.

While such a position may be valid within the context of a fraudulent broker and trusting individual investor, the position loses much of its force when applied to sophisticated corporate entities. AES, for example, is a company that operates power plants in twenty-seven countries, producing annual sales of over \$8.4 billion. The company has over 30,000 employees, including forty-four officers and nine directors.<sup>168</sup> To argue that AES should be afforded the opportunity to allege cognitive errors is to completely abandon concerns of judicial economy and practical reality. AES can manage to profitably run a large international business but its managers are incapable of comprehending the significance of an NRC they signed on three separate occasions? The question seems to answer itself.

168. See AES Corporation Corporate Overview, [http://www.corporate-ir.net/ireye/ir\\_site.zhtml?ticker=AES&script=2100](http://www.corporate-ir.net/ireye/ir_site.zhtml?ticker=AES&script=2100) (last visited Apr. 10, 2004); AES Corporation Officers and Directors, [http://www.corporate-ir.net/ireye/ir\\_site.zhtml?ticker=AES&script=2200](http://www.corporate-ir.net/ireye/ir_site.zhtml?ticker=AES&script=2200) (last visited Apr. 10, 2004).

The efficient outcome is reached by transforming the standard into a rule that prohibits sophisticated investors from claiming reasonable reliance on any representations made outside of the final written agreement. In fashioning this rule, the court assumes that sophisticated corporate investors enter into transactions to rationally maximize utility and are therefore capable of aligning incentives, accepting risk, and binding themselves to specific liabilities. By assuming rationality the court is able to apply a rule to all similar transactions. The court's consistent application of the rule will allow parties to easily predict the enforceability and legal effect of the contractual provisions, and thereby allow parties to efficiently align incentives, distribute risk, and minimize transaction costs.

While such a rule may at first glance appear to favor the defendant, the operation of the rule will protect buyers from contracts containing NRCs with few or no actual representations. By requiring buyers to explicitly state and agree to specific representations on which they are relying, the buyer is protected, and therefore the seller is liable, for the accuracy of such representations. Therefore, just as the rule would foreclose a factually specific judicial review of reasonable reliance when the plaintiff claims reliance on representations made outside of the contract, reliance will be *per se* reasonable when the representation is included in the final agreement.

Such a rule, while assuming rationality and valuing efficiency, serves the congressional goal of investor protection. While sophisticated corporate actors will not necessarily "behave in a selfless fashion"<sup>169</sup> and volunteer liability for any and all representations, a sophisticated buyer can rightfully insist that all representations on which it is relying are included in the final contract—protecting the investor from fraud as to those specific representations.

The primary advantage of enforcing clearly defined rules based on an assumption of rationality is that investors and issuers will be able to easily predict the extent of their risk and the nature of their liabilities associated with a particular transaction. The rule providing that NRCs preclude a finding of reasonable reliance on anything outside of the contract as a matter of law, for example, provides the investor with the ability to bargain for the inclusion of specific representations in the final agreement. The following example will help illustrate the mechanics of such a transaction and the effect of

169. Welle, *supra* note 16, at 541.

including an NRC in the final written agreement. S and P enter into a transaction to exchange S stock for P assets. The current value of S stock is \$10 per share and the contract is for the exchange of 1000 shares of S for specific P assets. During the course of the negotiations, S makes three oral representations to P concerning the future value of S stock. In drafting the final agreement, P would disclose that he is relying on all three representations in making the decision to execute the transaction and should insist that all three representations be included in the final written agreement. If S is willing to assume liability for all three representations, each will be included in the final written agreement, along with an NRC, and both P and S will have a clear understanding of the underlying transaction and any subsequent disputes or litigation can proceed on the basis of the final agreement. If S, however, is unwilling to stand by all three representations, the two parties must negotiate for the inclusion of each specific representation in the agreement. If P cannot in good faith agree to a transaction without S assuming liability for representation one, for example, P can walk away from the deal or negotiate a decrease in the purchase price based on the increased amount of risk associated with S's refusal to accept liability. On the other hand, if S agrees to include all three representations in the agreement, the purchase price should be increased based on the increased amount of risk and liability exposure. These negotiations will produce an efficient result where each party negotiated the specific representations on which reliance was justified, risk and liability were allocated between the parties, and the purchase price was adjusted accordingly.

The law and economics of securities fraud, therefore, is premised on the application of a clear rule dictating the enforceability of NRCs, the parties' recognition that reliance is reasonable only to the extent that the party is relying on representations included in the final agreement, and the parties' ability to allocate risk, liability, and benefit between themselves. Such an analysis protects the investor from needing to rely on oral representations, because if the investor is in fact relying on an oral statement, he can justifiably insist that the representation be included in the final agreement. The outcome will be efficient because both parties understand the nature of the risk and liabilities assumed with a clear picture of the representations forming the basis for the agreement.

D. *Section 29(a) and the Non-Reliance Clause: Why AES Corp. v. Dow Chemical Co. is Wrong*

In *AES*, the Third Circuit misinterpreted Section 29(a) and misconstrued that nature and effect of an NRC. In reaching its holding, the Third Circuit stated that:

[Section 29(a)] is designed to protect rights created by the Exchange Act, and it expressly forecloses contracting parties from defining the boundaries of their transaction in a way that relieves a party of the duties imposed by that Act. We do not dispute that there may be economic efficiency in allowing private parties the freedom to fashion their own bargains. But Congress has made a decision to limit that freedom when it comes to anticipatory waivers of Exchange Act claims. Accordingly, we conclude that we must side with the First Circuit Court of Appeals in *Rogen* rather than with the *Harsco* court.<sup>170</sup>

This reasoning aptly demonstrates the misunderstanding by both courts and legal scholars regarding the purpose and effect of an NRC, and the extent to which Section 29(a) applies to such clauses. The primary confusion is based on what constitutes an “anticipatory waiver” and the specific effect of an NRC.

Throughout this Note, I argued for the adoption of a rule enforcing NRCs against sophisticated parties in contracts negotiated at arm’s length. The discussions of rationality, rules versus standards, and investor protection all advance the reasons as to why such a rule is preferable to a standard based on an assumption of irrationality. The issue remains open, to an extent, as to how such a rule can escape the prohibition of Section 29(a). While much of the answer is contained throughout the course of my argument, that argument is condensed and repeated here for reinforcement.

Section 29(a) prohibits parties, whether voluntary or not, from waiving their rights under the Act. Therefore, a contractual clause seeking to limit the rights of a party, or that party’s right to recover for potential claims, is void and unenforceable. Cases interpreting the use of an NRC, while not explicating the effect of Section 29(a), hold that a sophisticated (and in most cases unsophisticated) party does not have the right to rely on oral communications or written representations that are not contained in the final written agreement. This is so because that party cannot claim that any reliance on those representations was reasonable. The party, lacking the ability to claim rea-

170. *AES Corp. v. Dow Chem. Co.*, 325 F.3d 174, 183 (3d Cir. 2003) (internal quotation marks and alterations in original omitted), *cert. denied*, 174 S. Ct. 805 (2003).

sonable reliance, does not have the right to rely on those representations. A clause explicitly acknowledging that the party has no right to rely on representations made outside of the final written agreement, therefore, does not waive a right or the potential for recovery. Since no right to rely exists, the NRC does not waive a right and therefore does not violate Section 29(a).

### CONCLUSION

The interpretation of Section 29(a) and an NRC raises fundamental questions concerning the purposes of securities regulation and the nature of legal rulemaking. The debate among courts and scholars demonstrates the complex and competing rationales for regulating the securities industry, and the discussion between the behavioralists and law and economic scholars demonstrates the disagreement as to what concerns should drive legal rulemaking.

The NRC results in efficient contracting by allowing individual parties to freely negotiate and allocate risk and liabilities. The NRC is not a waiver of compliance as prohibited by Section 29(a) because a party is still able to bring a fraud action based on the representations contained in the final written agreement and, in most cases, does not have the right to rely on representations made outside of the final contract. The clause provides contracting parties with the ability to clearly define the boundaries of their transaction, proceed on a common understanding of their resulting rights and obligations, and produce efficient outcomes.

The law and economics of securities fraud is based on the understanding that through clear rules requiring representations to be contained in a final written agreement, parties will be able to reduce fraud by negotiating for the terms on which each party may rely. By negotiating for the representations, the parties will allocate risk and liabilities between themselves based on the representations included, and the purchase price will be adjusted accordingly. The NRC, therefore, creates an efficient outcome and prevents a party from being defrauded by requiring all representations to be included in writing.