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The Circuits Confused the Market: Why the Third Circuit's *Malack* Decision Confirms the Need for a Uniform Approach to the Fraud-Created-the-Market Theory

James Maruna*

I. INTRODUCTION

John and Jane Smith worked hard, and they saved up a small sum of money over time. Jane's brother-in-law told the Smith's about a new housing development project in which he recently invested. The municipality would issue bonds to finance the project. John, knowing how volatile the stock market was lately, thought that purchasing a bond would be a smart investment for the family's nest egg. The development company sent over some materials, which John skimmed; after all, the United States Securities and Exchange Commission (SEC) approved the offering. He invested and waited for results. Unfortunately for the Smiths, the development company lied about its legal authority to issue bonds. The company had an attorney falsify some documents that it submitted to the SEC. Predictably, the development went under, and John lost his money.

Under a traditional securities fraud claim, the Smiths cannot recover. The Smiths cannot prove that they relied on the misstatements in the marketing materials to purchase the investment because John skimmed rather than read the materials. Some circuit courts recognize another theory of reliance called fraud created the market (FCTM). FCTM expands traditional securities fraud laws and would allow the Smiths to recoup their investment.¹

Various circuit courts have accepted FCTM as a way to prove reliance in a § 10(b) securities fraud claim.² In 2010, the Third Circuit heard the case of *Malack v. BDO Seidman, LLP*.³ The Third Circuit

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1. See *Ross v. Bank S., N.A.*, 885 F.2d 723 (11th Cir. 1989); *T.J. Raney & Sons, Inc. v. Fort Cobb, Okla. Irrigation Fuel Auth.*, 717 F.2d 1330 (10th Cir. 1983); *Shores v. Sklar*, 647 F.2d 462 (5th Cir. 1981) (en banc).

2. A § 10(b) claim is the principal mechanism by which a plaintiff may seek recovery for securities fraud. See *Ross*, 885 F.2d at 723; *T.J. Raney*, 717 F.2d at 1330; *Shores*, 647 F.2d at 462.

3. *Malack v. BDO Seidman, LLP*, 617 F.3d 743 (3d Cir. 2010).

rejected FCTM as an acceptable means of proving reliance.⁴ The Supreme Court has not addressed the validity of FCTM. With the Third Circuit's decision, three circuits allow FCTM and three reject the theory.⁵ Due to this split, the success of certain securities fraud claims depends solely on the venue where a plaintiff files the lawsuit.⁶ Plaintiff attorneys now have an incentive to forum shop.⁷

This issue is ripe for Supreme Court review. In reviewing FCTM, the Supreme Court should adopt a partial application of FCTM based on the Tenth Circuit's legal unmarketability standard. Under this standard, a plaintiff will fail on her FCTM claim unless the plaintiff can prove that the security issuer lacked the legal authority in the first place to even issue the security. This solution prevents FCTM from creating de facto investor insurance, which would increase frivolous securities litigation.

II. SECURITIES FRAUD HISTORY

A. *Development of Federal Securities Regulations*

The development of securities fraud laws in the United States shows a desire to protect the investor without going so far as to create de facto investor's insurance. Prior to 1933, the securities markets of this country operated under a laissez-faire doctrine.⁸ There was no federal cause of action for securities fraud, and the purchaser of a security operated under the premise of *caveat emptor*.⁹ In the midst of the

4. *Id.*

5. Compare *Ross*, 885 F.2d at 723, *T.J. Raney*, 717 F.2d at 1330, and *Shores*, 647 F.2d at 462, with *Malack*, 617 F.3d at 743, *Ockerman v. May Zima & Co.*, 27 F.3d 1151 (6th Cir. 1994), and *Eckstein v. Balcor Film Investors*, 8 F.3d 1121 (7th Cir. 1993).

6. A plaintiff filing in the Fifth, Tenth, or Eleventh Circuit may raise an FCTM reliance theory whereas that same theory is unavailable to a plaintiff filing in the Third, Sixth, or Seventh Circuit.

7. Forum shopping produces a significant problem because it can increase the inconvenience and expense of a defendant. Having to try a case in a distant jurisdiction at great cost may force a defendant to settle a claim it would otherwise defend on the merits in its home jurisdiction. See Richard Maloy, *Forum Shopping? What's Wrong with That?*, 24 QUINNIPIAC L. REV. 25, 29 (2005).

8. Matt Silverman, *Fraud Created the Market: Presuming Reliance in Rule 10b-5 Primary Securities Market Fraud Litigation*, 79 FORDHAM L. REV. 1787, 1793 (2011). A laissez-faire doctrine means that the government has little to no intervention in private securities trading.

9. *Id.*; see, e.g., Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669 (1984). *Caveat emptor* is Latin for "let the buyer beware." BLACK'S LAW DICTIONARY 252 (9th ed. 2009). The purchaser of a security assumes the risk and is responsible for any steps to minimize the investment risks such as performing due diligence before investing. While *caveat emptor* was the prevailing view, that does not mean that there were no securities regulations. As Easterbrook and Fischel discussed, all fifty states had legislation forbidding fraudulent actions in connection with securities. Easterbrook & Fischel, *supra* note 9, at 670.

Great Depression, Congress sought to regulate the securities markets for the first time. Congress intended the legislation to promote full disclosure of a company's or a security issuer's financial information and, therefore, provide enough information to allow investors to make informed decisions on their own accord.¹⁰

To encourage disclosure to potential investors, Congress passed the Securities Act of 1933 (the Securities Act)¹¹ and the Securities Exchange Act of 1934 (the Exchange Act).¹² These laws serve two main functions. First, the acts prohibit an individual from committing a fraud on the market.¹³ Second, the acts provide requirements for mandatory disclosures when securities are first offered and for periodic disclosures thereafter.¹⁴ The two acts function similarly but regulate different interests. The Securities Act regulates securities sold in the primary market whereas the Exchange Act regulates a security already offered and traded in a secondary market.¹⁵ The primary market is the initial market that all securities pass through when they are initially made available to the public in an initial public offering (IPO). In contrast, the secondary market is where the holder of a security resells its shares to another interested investor. An investor who calls her broker and wants to purchase a share of Google purchases that share on the secondary market.

To further the policy goal of allowing investors to make informed decisions, the Securities Act requires that companies disclose material information regarding the offered security.¹⁶ Companies offer this information through a prospectus, an overview of the offering that highlights material information about a security.¹⁷ Investors use this information to evaluate a security's potential reward against the security's potential risk.¹⁸ The policy is that an investor with more information will make more informed decisions.

10. See, e.g., Easterbrook & Fischel, *supra* note 9.

11. 15 U.S.C. §§ 77a–77aa (2006).

12. *Id.* §§ 78a–78pp.

13. Easterbrook & Fischel, *supra* note 9, at 670.

14. *Id.* at 669. Disclosure requirements include the following: “descriptions of the issuer's business, past business performance, information about the issuer's officers and managers, audited financial statements of past business performance, executive compensation, risks of the business, tax and legal status, and the terms and information about the securities used.” *Securities Act of 1933*, CORNELL UNIV. LAW SCH. LEGAL INFO. INST., http://www.law.cornell.edu/wex/securities_act_of_1933 (last visited Apr. 11, 2013).

15. Silverman, *supra* note 8, at 1793.

16. § 77g. Material information “means information that would affect a reasonable investor's evaluation of the company's stock.” *Securities Act of 1933*, *supra* note 14.

17. *The Laws that Govern the Securities Industry*, U.S. SEC. & EXCH. COMM'N, <http://www.sec.gov/about/laws.shtml> (last visited Apr. 11, 2013).

18. *Id.*

The Exchange Act provides additional protection to investors. First, the Exchange Act created the SEC.¹⁹ The SEC monitors the security initially by requiring that companies present certain materials in a registration statement before it is offered to the public for purchase.²⁰ Second, the Securities Act provides a cause of action against an individual who violates the statute.²¹

B. *There Are Six Elements for a Securities Fraud Claim*

If a plaintiff wishes to recover from a company's manipulative or deceptive practices in regulated securities disclosures, she may pursue an action under § 10(b).²² Judges refer to § 10(b) as a "catchall" clause enacted to provide enforcement against fraud that the statute does not specifically discuss.²³ Rule 10b-5 creates a cause of action against individuals violating § 10(b). This cause of action tracks common law fraud. To prevail under a § 10(b) claim, a plaintiff must show the following six elements: (1) a material misrepresentation; (2) scienter; (3) a connection with the purchase or sale of a security; (4) reliance; (5) an economic loss; and (6) loss causation.²⁴

To prove that a fraud took place, the plaintiff must indicate that the information omitted or misrepresented is "material."²⁵ A fact is material if "there is a substantial likelihood that a reasonable shareholder would consider it important."²⁶ This definition is conclusory. The courts provided additional guidance that "there must be a substantial likelihood that the disclosure of the . . . fact would have been viewed by the reasonable investor as having significantly altered the total mix of information made available."²⁷ Unfortunately, this definition still leaves some ambiguity as to when a fact is material. In cases where the question is a close call, the practitioner should follow the Supreme Court's general policy guidance: the threshold for whether or not a fact is material is particularly high.²⁸ This high threshold is based on

19. § 78d.

20. See *Securities and Exchange Commission Forms List*, *supra* note 17 (containing a current list of information that must be disclosed when filing for a new SEC registration).

21. §§ 77a-77aa. The Exchange Act does not codify a private right of action. Instead, only the SEC can bring action. However, courts have read a private right of action into the Exchange Act since the 1940s.

22. § 78j.

23. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 202-03 (1976).

24. *Dura Pharm., Inc. v. Broudo*, 544 U.S. 336, 341-42 (2005).

25. *Basic Inc. v. Levinson*, 485 U.S. 224, 231-32 (1988).

26. *Id.* at 231 (quoting *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976)) (internal quotation marks omitted).

27. *Id.* at 231-32 (quoting *TSC*, 426 U.S. at 449) (internal quotation marks omitted).

28. *Id.* at 234.

policy concerns.²⁹ Disclosure should provide investors with useful information so that they may make well-informed decisions.³⁰ A lower materiality standard would produce the opposite effect. In order to protect itself from potential litigation, a company's management would provide every minute detail to the investor.³¹ A low materiality standard would lead to investors being inundated with irrelevant information.³² This overabundance of minutia would cut against the purpose of disclosure laws—to provide investors with information to make well-informed decisions.³³

The second element of a securities fraud action is scienter.³⁴ To prevail on a securities fraud action, the plaintiff must show that the defendant intentionally or willfully manipulated a disclosure to influence the security's price.³⁵ Courts adopted scienter as an element in securities fraud litigation by looking at the Securities Act's plain language.³⁶ Section 10(b) makes it unlawful to use or employ "any manipulative or deceptive device or contrivance in contravention of" the SEC's rules.³⁷ In *Ernst & Ernst v. Hochfelder*, the Supreme Court found that the "words 'manipulative or deceptive' used in conjunction with 'device or contrivance' strongly suggest" that the statute proscribes an element of knowing or intentional misconduct.³⁸ The Court found that the word manipulative in connection with the securities market is essentially a term of art implying intentional or willful conduct designed to deceive or defraud investors by artificially affecting the price of a security.³⁹

29. See Easterbrook & Fischel, *supra* note 9, at 672.

30. *Id.*

31. *Basic*, 485 U.S. at 231–32. For example, if it became necessary to disclose every potential cost with a project, volumes of superfluous information about donut prices for the construction workers and any information that may exist about a possible spike in the per donut price will need to be disclosed to potential investors. After all, donuts are costs, and costs affect profitability.

32. *Id.*

33. *Id.*

34. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 202 (1976).

35. *Id.* at 207.

36. 15 U.S.C. §§ 77a–77aa (2006).

37. § 78j(b).

38. *Ernst & Ernst*, 425 U.S. at 197.

39. *Id.* at 199. Some argue that the language of § 10(b) should apply to all actions, including negligent actions. The Court dismissed this contention by citing to the legislative history. A spokesman for the statute's drafters stated that § 10(b) was designed to be a "catchall clause to enable the [SEC] to deal with new manipulative (or cunning) devices." *Id.* at 203 (internal quotation marks omitted). The Court reasoned that no drafter would use the words *manipulative* or *cunning* if the intent was to create only a negligent standard. *Id.*

The third element is that the fraud must be connected with the purchase or sale of a security.⁴⁰ This means that an actual transaction must take place, as opposed to a situation where the plaintiff claimed that the fraud prevented her from completing another transaction.⁴¹ The plaintiff must have taken an affirmative action with regard to the shares. This rule is best illustrated by explaining the types of persons that cannot bring an action: (1) an individual who decided not to purchase a share because of the gloomy representations from the stock's issuer,⁴² (2) an actual shareholder who alleges that she decided not to sell her shares because the defendant issued falsely optimistic projections or omitted actual negative projections,⁴³ and (3) others related to an issuer who suffered a loss in the value of their investment due to corporate or insider activities in connection with the purchase or sale of securities.⁴⁴

The fourth element is reliance.⁴⁵ Reliance in this context means that the plaintiff relied upon the defendant's material misrepresentation or omission and purchased the security only because of this material defect.⁴⁶ Practitioners sometimes refer to this as "transaction causation" because the plaintiff must tie the transaction to the actual misrepresentation.⁴⁷

The fifth element is economic loss.⁴⁸ This element is simply the quantifiable loss that the plaintiff sustained because of the fraud.⁴⁹ The sixth element is loss causation.⁵⁰ Under this element, the plaintiff must tie the economic loss sustained in the fifth element back to the defendant's actual material misrepresentation.⁵¹

III. THEORIES OF RELIANCE

For a plaintiff to prevail on the reliance element, she must show that she relied on a material misrepresentation or omission and would not

40. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 731 (1975).

41. *Id.*

42. *Id.* at 737.

43. *Id.* at 737–38. It may be possible for individuals in this class to work around this rule by bringing a derivative action.

44. *Id.* at 738. Likewise, it may be possible for individuals in this class to work around the rule by bringing a derivative action.

45. *See infra* Part III.

46. *Basic Inc. v. Levinson*, 485 U.S. 224, 248–49 (1988).

47. *Dura Pharm., Inc. v. Broudo*, 544 U.S. 336, 341–42 (2005).

48. 15 U.S.C. § 78u-4(b)(4) (2006).

49. *Id.*

50. *Dura Pharm.*, 544 U.S. at 342.

51. *Id.*

have purchased the security had it not been for the material defect.⁵² The most common method for proving reliance is offering actual proof that the defendant's misrepresentation or omission induced the plaintiff to make an investment decision she otherwise would not have made.⁵³ This proof is difficult to offer. First, individuals engaging in deceptive acts are cognizant of the law and will take steps to conceal affirmative evidence of their fraudulent activity. Second, providing proof of reliance in cases involving multiple parties is difficult and expensive.⁵⁴ Because a security's market involves many investors, practitioners bring suits as part of a class action. In these large cases, the practitioner would need to produce a specific act of reliance for each member of the class.

Plaintiffs can create a rebuttable presumption of reliance through three methods, two of which are recognized by the Supreme Court.

A. *Reliance Without Proof*

The first method to prove reliance occurs when a party with a duty to disclose omits a material fact.⁵⁵ The Supreme Court articulated this standard in *Affiliated Ute Citizens of Utah v. United States*.⁵⁶ The Court held that to prove reliance all the plaintiff needed to show was that the defendants withheld facts that a reasonable investor would consider important when making a decision whether or not to sell shares.⁵⁷ Materiality means that a reasonable investor may consider the information substantially important in making a decision.⁵⁸ In *Affiliated Ute*, the defendants misrepresented the price that investors would pay for the shares on the secondary market.⁵⁹ Had the plaintiffs known the true value, they would have either not sold the shares or asked for more money.

A plaintiff can establish a duty to disclose in a few different ways. First, there are the traditional codified fiduciary relationships that require disclosure, such as a corporation's registration statement.⁶⁰ Second, the *Affiliated Ute* court held that where an individual essentially

52. *Basic Inc. v. Levinson*, 485 U.S. 224, 248–49 (1988).

53. Michele D. Johnson & Colleen C. Smith, "Fraud Created the Market" *Theory of Reliance Loses Traction*, PLI (Oct. 8, 2010, 9:58 AM), <http://seclawcenter.pli.edu/2010/10/08/%E2%80%9Cfraud-created-the-market%E2%80%9D-theory-of-reliance-loses-traction/>.

54. *Id.*

55. *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128 (1972).

56. *Id.*

57. *Id.* at 153–54.

58. *Id.*

59. *Id.* at 153.

60. *The Laws that Govern the Securities Industry*, *supra* note 17.

creates a market for certain shares, she absorbs a duty to disclose material information about those shares.⁶¹

While the *Affiliated Ute* presumption aids some plaintiffs, it has a number of drawbacks. First, the presumption is not available when the claim is based on a misstatement rather than an omission.⁶² This creates an incentive for a defendant to disclose everything and lie about the numbers in the disclosure rather than risk omitting bad information. This does not prevent fraud.

Second, this presumption does not create a cause of action against auditors or other third parties, like attorneys or auditors hired by the company, who do not directly owe the plaintiff a duty.⁶³ An auditor owes a duty to the corporation that hires her to review the books. This is troublesome because a company may seek to escape liability by saying that it relied on the information provided by its outside auditor. As the duty exists only between the auditor and company, the company would be the gatekeeper in determining whether or not it pursues action against an auditor. In other words, a disingenuous auditor could inflate the company's projections. A plaintiff could rely on that information to purchase the stock, and when she sustains a loss, she may have no cause of action.⁶⁴

To expand a plaintiff's ability to prove reliance without actual proof, the Supreme Court recognized a second method, the fraud-on-the-market (FOTM) theory. The FOTM theory assumes a free and open market.⁶⁵ This means that the market is so unencumbered by control that, once a company makes information available to the public, investors incorporate the information into the stock's price.⁶⁶ This includes all positive and all negative information about a company. If a company makes misleading statements, the market will assume those statements are true.⁶⁷ This will cause the price of the shares to rise or fall. Reliance is appropriate because in today's modern economy indi-

61. *Affiliated Ute*, 406 U.S. at 153.

62. THOMAS LEE HAZEN, *THE LAW OF SECURITIES REGULATION* § 12.10 (5th ed. 2005). Under *Affiliated Ute*, a company can claim that it has acquired literally all of the tea in China, but so long as the prospectus discloses all of the information that it is required to disclose, it does not matter if the information is filled with misstatements.

63. *Id.*

64. For example, the auditor could lie and say that a company with record losses had its best year ever, and yet despite this egregious lie, because the auditor's duty is only owed to the company that hired her, the investor would have no claim against the auditor. Only the company itself would have a claim against the auditor.

65. *Basic Inc. v. Levinson*, 485 U.S. 224, 246-47 (1988).

66. *Id.*

67. *Id.*

viduals rely on the market as a neutral hand to evaluate a stock's price.⁶⁸

A plaintiff must show three things to prevail on an FOTM theory. First, the plaintiff must show that the information in question was material.⁶⁹ Second, the plaintiff must show that the market is efficient because it contained a large number of transactions.⁷⁰ Third, a company must have publicly disseminated the misinformation.⁷¹

The FOTM presumption is rebuttable. Any showing that severs the link between the misstatement and the price paid by the plaintiff will rebut the presumption of reliance.⁷² The link can be severed in many ways. First, a defendant can show that the market participants knew the truth behind the misrepresentation; therefore, the misrepresentation did not affect market price.⁷³ Second, a defendant can show that the investor's reliance was unreasonable.⁷⁴ An unreasonable investor ignores known or obvious risks.⁷⁵ The defendant can sever the link by showing that the plaintiff believed the information was false but nevertheless made the investment.⁷⁶ In other words, FOTM does not reward the investor who sticks her head in the sand.

While FOTM greatly expanded reliance theory, it still excluded a large block of investors. The FOTM presumption assumes an efficient market.⁷⁷ An efficient market requires significant trading volume.⁷⁸ The problem is that many investors purchase securities in markets where there are a small number of transactions. In these smaller markets, there is insufficient transactional volume to assume that investors incorporated all public statements into the price.⁷⁹ Therefore, an

68. *Id.* The presumption that every buyer or seller relies on the market's integrity is supported by the view that no one buys a stock to lose money. The Supreme Court rhetorically asked, "Who would knowingly roll the dice in a crooked crap game?" *Id.* at 247.

69. HAZEN, *supra* note 62, § 12.10.

70. *Id.* The market must contain active transactions because this transactional activity is what causes the fraudulent information to become absorbed into the security's price. If the market has almost no activity, the security does not change hands enough times and the fraudulent information is never absorbed into the price. Therefore, an investor cannot claim that she relied on the price and that transitively she relied on the fraudulent information.

71. *Id.*

72. *Basic*, 485 U.S. at 248.

73. *Id.*

74. Johnson & Smith, *supra* note 53.

75. *Id.*

76. *Basic*, 485 U.S. at 249; Johnson & Smith, *supra* note 53.

77. Johnson & Smith, *supra* note 53.

78. HAZEN, *supra* note 62, § 12.10.

79. See Brad M. Barber et al., *The Fraud-on-the-Market Theory and the Indicators of Common Stocks' Efficiencies*, 19 J. CORP. L. 285, 291 (1994) (stating that larger volume of securities trades ensures that the information will be quickly and accurately impounded in the security's price). In these smaller markets, the security does not turn over as quickly as a larger, more

investor in this type of market cannot prove reliance by saying she relied on the market alone. This market is called an inefficient market. Investors in inefficient markets cannot invoke FOTM.⁸⁰ Therefore, some courts have recognized a third type of reliance called FCTM.⁸¹

B. *Fraud Created the Market*

FCTM creates an assumption that the availability of a security in either an efficient or an inefficient primary market indicates that the security is genuine and worthy of an investor's reliance.⁸² Unlike FOTM where investors rely on the integrity of the market price for the security, in FCTM the investor relies on the integrity of the market itself. In other words, the investor assumes that the market's very existence is genuine.⁸³ In FCTM, a market would not exist without a defendant's misrepresentation. This is due to the fact that investors do not make many transactions in these markets. Under an FOTM analysis, the plaintiff needs to show that the market has sufficient transactional volume so that a judge can declare it qualifies as an efficient market.⁸⁴ As discussed above, not all securities are purchased on these active, efficient markets.⁸⁵ Some securities are purchased on smaller, inefficient markets. A plaintiff cannot raise an FOTM claim in these smaller markets because there is inadequate transactional activity for the security to have exchanged hands a sufficient number of times and incorporate all public misstatements into the price.⁸⁶ The investor cannot claim that she relied on the misstatement because the misstatement may not be incorporated into the security's price at the time she purchased it. The inability to raise FOTM theory is often fatal to a plaintiff's claim.⁸⁷ As this limitation leaves many investors

developed market, so the investor cannot reasonably rely that by the time she purchases the security all public statements have been incorporated into the security's price.

80. An example of an efficient market is the New York Stock Exchange (NYSE) whereas an inefficient market is the market for tax-free bonds on a municipal development. On the NYSE, thousands of transactions occur each day by individuals reading, researching, and reacting to public comments. In the municipal bond example, only a handful of transactions occur over the life of the security, and the individuals trading the security may not know all information disclosed by the security's issuer. Therefore, there is no guarantee that the price of the bond encompasses all information, good or fraudulent, made about the security.

81. See Johnson & Smith, *supra* note 53.

82. *Id.*

83. *Ross v. Bank S., N.A.*, 885 F.2d 723, 729 (11th Cir. 1989).

84. HAZEN, *supra* note 62, § 12.10.

85. See *supra* Part III(A).

86. HAZEN, *supra* note 62, § 12.10.

87. *Id.*

with no legal recourse, some courts adopted the more expansive FCTM theory.

FCTM allows a plaintiff to rely on the market's stability even if the market is undeveloped.⁸⁸ Since the Fifth Circuit first accepted FCTM in 1981, the circuit courts have split over its application.⁸⁹ The Fifth Circuit, Eleventh Circuit, and Tenth Circuit recognize FCTM whereas the Seventh Circuit, Sixth Circuit, and now Third Circuit do not recognize the theory.⁹⁰ Furthermore, the circuits that recognize FCTM do not agree on FCTM's application and limitations. Courts analyzing FCTM claims evaluate two criteria: (1) whether the defendant could only market the security through fraud,⁹¹ and (2) whether the plaintiff reasonably purchased the securities in reliance on the market.⁹² A security that can be marketed only through fraud is called "unmarketable," and the courts define unmarketable in three ways: (1) legal unmarketability, (2) factual unmarketability, and (3) economic unmarketability.⁹³

A security is legally unmarketable when, absent the fraud, the law would not allow a regulatory agency to issue the security.⁹⁴ Few securities can meet this standard. For example, suppose that a development corporation attempts to raise municipal bonds to construct a retirement community. For a court to find the bonds unmarketable under this theory, the defendant must have falsified documents about its legal authority to perform a construction project. Because it lacked authority to complete the project, the municipality would never have allowed the security to come to market.

Factual unmarketability asks whether or not the security is patently worthless. Under this theory, a security is patently worthless when, absent the fraud, some regulatory entity would not have allowed the security to come on to the market at its real price and interest rate.⁹⁵ In other words, courts must determine whether a regulatory agency

88. *Id.* A common market where the courts have applied FCTM is the market for tax-free municipal bonds for construction projects. The market is limited to a small number of investors who may not read all prospectus material.

89. Johnson & Smith, *supra* note 53.

90. *Compare* Ross v. Bank S., N.A., 885 F.2d 723 (11th Cir. 1989), T.J. Raney & Sons, Inc. v. Fort Cobb, Okla. Irrigation Fuel Auth., 717 F.2d 1330 (10th Cir. 1983), and Shores v. Sklar, 647 F.2d 462 (5th Cir. 1981) (en banc), with Malack v. BDO Seidman, LLP, 617 F.3d 743 (3d Cir. 2010), Ockerman v. May Zima & Co., 27 F.3d 1151 (6th Cir. 1994), and Eckstein v. Balcov Film Investors, 8 F.3d 1121 (7th Cir. 1993).

91. THOMAS LEE HAZEN, THE LAW OF SECURITIES REGULATION § 12.10(6)(c) (6th ed. 2009).

92. *Id.*

93. Silverman, *supra* note 8, at 1808.

94. Ockerman, 27 F.3d at 1160.

95. Ross, 885 F.2d at 736 (Tjoflat, J., concurring).

would have allowed the security to come on the market at the fraudulent price and interest rate if the agency knew all the relevant information about the security at the time it released the security on to the market.⁹⁶

Economic unmarketability is similar to factual unmarketability. Both inquire as to whether or not a security is patently worthless. Under economic unmarketability, however, a security is patently worthless when no one would buy the security, even if offered at any price.⁹⁷ Thus, a security is patently worthless when no one would buy it, even at a price as low as \$0.01. This theory is problematic because a security almost always has value, even if just salvage value.⁹⁸

IV. CIRCUIT COURT OVERVIEW

The circuit courts created a complicated, inconsistent, and at times illogical approach to FCTM. A practitioner raising a claim on an FCTM theory must answer two questions. First, the practitioner must determine whether or not the jurisdiction accepts FCTM. Second, if FCTM is permitted, the practitioner must determine which unmarketability theory the circuit court accepts.

Starting with the Fifth Circuit, several other circuits recognized modified versions of FCTM.⁹⁹ However, after the Seventh Circuit's decision in *Eckstein*, every circuit to consider FCTM rejected the theory.¹⁰⁰ At present, six circuits have considered the question of whether to allow FCTM.¹⁰¹ This split, combined with the inconsistent definition of unmarketability, requires a universal, binding answer from the Supreme Court. FCTM is ripe for Supreme Court review.

A. *Circuits Accepting FCTM: 1981–1993*

1. Fifth Circuit: *Shores* and *Abell*

In *Shores*, the plaintiff brought a class action suit against the entities involved in approving construction bonds. The plaintiffs sought to re-

96. The two cases considering factual unmarketability, *Shores* and *Ross*, do not indicate how a court makes this determination. Presumably, the value is adduced from expert opinions.

97. *Id.*

98. *See id.* (questioning the practicability of economic unmarketability since the likelihood of any security having absolutely no financial value is essentially nil).

99. *See Shores v. Sklar*, 647 F.2d 462 (5th Cir. 1981) (en banc); *see also Ross*, 885 F.2d at 723; *T.J. Raney & Sons, Inc. v. Fort Cobb, Okla. Irrigation Fuel Auth.*, 717 F.2d 1330 (10th Cir. 1983).

100. *See Eckstein v. Balcor Film Investors*, 8 F.3d 1121 (7th Cir. 1993); *see also Malack v. BDO Seidman, LLP*, 617 F.3d 743 (3d Cir. 2010); *Ockerman v. May Zima & Co.*, 27 F.3d 1151 (6th Cir. 1994).

101. *See supra* notes 99–100.

cover damages because the bonds that he purchased defaulted.¹⁰² The plaintiff contended that the defendants fabricated a materially misleading offering circular¹⁰³ that induced the municipality to issue the bonds and the public to subsequently purchase the bonds.¹⁰⁴ However, the plaintiff was not aware that the offering circular existed when he decided to purchase the bonds.¹⁰⁵ The district court considered this fatal to his claim.¹⁰⁶ The Fifth Circuit, sitting en banc, reversed and became the first circuit to recognize FCTM.¹⁰⁷

The Fifth Circuit adopted a factual unmarketability theory.¹⁰⁸ The court agreed that the plaintiff's failure to read the circular precluded a claim under the Rule 10b-5(b) provision, "unlawful . . . [t]o make any untrue statement of a material fact."¹⁰⁹ However, the court allowed the claim to go forward by looking to Rule 10b-5's general fraud provisions.¹¹⁰ The court justified its holding by stating that securities laws operate to give investors confidence in the market.¹¹¹ Therefore, it makes sense to protect investors who rely on the market by punishing those who abuse the investor's reliance.¹¹² This minor distinction created FCTM.

Seven years later, the Fifth Circuit defined unmarketable in *Abell v. Potomac Insurance Co.*¹¹³ Once again the plaintiffs could not prove reliance because they failed to read the circulars.¹¹⁴ The *Abell* court noted that the bonds in *Shores* still had value because the company's underlying assets still backed the securities at issue; however, the company in *Shores* was a sham because it never intended to start a viable business. Therefore, the company could never generate enough reve-

102. *Shores*, 647 F.2d at 463–64.

103. An offering circular provides an investor with important highlights about the security without the need to read the long-form prospectus. *Offering Circular*, INVESTOPEDIA, <http://www.investopedia.com/terms/o/offeringcircular.asp> (last visited Apr. 12, 2013).

104. *Shores*, 647 F.2d at 464.

105. *Id.*

106. *Id.*

107. *Id.*

108. *Id.* at 469–70; *see also* *Ross v. Bank S., N.A.*, 885 F.2d 723, 736 (11th Cir. 1989) (Tjoflat, J., concurring) (coining the Fifth Circuit's unmarketability standard as "factual unmarketability" and previously presiding as a Fifth Circuit judge when *Shores* was decided).

109. 17 C.F.R. § 240.10b-5(b) (2012).

110. Specifically, the court looked at the general fraud language found in two sections of Rule 10b-5. First, Rule 10b-5(a) states, "unlawful . . . [t]o employ any device, scheme, or artifice to defraud." *Id.* Second, Rule 10b-5(c) states, "unlawful . . . [t]o engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person." *Id.*

111. *Shores*, 647 F.2d at 470.

112. *Id.* at 469.

113. *Abell v. Potomac Ins. Co.*, 858 F.2d 1104, 1119–20 (5th Cir. 1988).

114. *Id.* at 1117–18.

nue to pay the interest on the bonds.¹¹⁵ To avoid greatly expanding FCTM, the Fifth Circuit adopted a factual unmarketability theory.¹¹⁶ Under this theory, a bond is unmarketable when at least one regulatory agency would have refused to issue the bond at the price and interest rate that it actually was issued had the agency known of all salient facts at the time of issuance.¹¹⁷

2. Tenth Circuit

In *T.J. Raney & Sons, Inc. v. Fort Cobb, Oklahoma Irrigation Fuel Authority*, a bond issuer used proceeds from the sale of construction bonds for a variety of projects, none related to the actual purpose for which the bonds were initially issued.¹¹⁸ In fact, the Fort Cobb, Oklahoma, Irrigation and Fuel Authority was not a valid public trust, and Oklahoma law prohibited the company from issuing any bonds.¹¹⁹ The company had an attorney fraudulently pass on the validity of the bonds.¹²⁰

The Tenth Circuit allowed FCTM.¹²¹ The court adopted a legal unmarketability theory.¹²² The court asked—If the defendant disclosed all of the information, would a regulatory agency decide that the information was so bad that the agency could not by law allow the security to enter the market?¹²³ The court reasoned that, at a minimum, securities law should permit the purchaser to assume that a legally existing entity issued the securities.¹²⁴ The court also commented that its holding would not create investor insurance because it applies only in the narrow cases, like this, where the issuing authority had no legal authority to issue a bond in the first place.¹²⁵

3. Eleventh Circuit

In 1989, the Eleventh Circuit held that FCTM was permissible in the case of *Ross v. Bank South, N.A.*¹²⁶ In *Ross*, bond purchasers sued

115. *Id.* at 1122.

116. *Ross v. Bank S., N.A.*, 885 F.2d 723, 736 (11th Cir. 1989) (Tjoflat, J., concurring).

117. *Id.*

118. *T.J. Raney & Sons, Inc. v. Fort Cobb, Okla. Irrigation Fuel Auth.*, 717 F.2d 1330, 1331–32 (10th Cir. 1983).

119. *Id.* at 1333.

120. *Id.* at 1331–32.

121. *Id.* at 1333.

122. *Id.*

123. *Johnson & Smith, supra* note 53.

124. *T.J. Raney*, 717 F.2d at 1333.

125. *Id.*

126. The Eleventh Circuit was created by splitting the Fifth Circuit in 1981. Ten judges who heard *Shores* while on the Fifth Circuit also heard *Ross* on the Eleventh Circuit.

a housing developer after the project failed.¹²⁷ The developer planned to use occupancy fees from the development to repay the bonds.¹²⁸ The municipality required the venture to presell 50% of the housing units before commencing construction.¹²⁹ When the economy declined, the developer waived the deposit requirements and “sold” the units primarily to friends and family in sham transactions.¹³⁰ After the project failed, two investors sued for fraud.¹³¹ Of note, neither investor read the developer’s marketing materials, which clearly warned that the investments were “extremely risky.”¹³²

The court applied what is known as economic unmarketability.¹³³ Even at salvage prices, the bonds had value, so they did not qualify as unmarketable under this definition.¹³⁴

B. *Circuits Rejecting FCTM: 1993–Present*

1. Seventh Circuit

In *Eckstein v. Balcor Film Investors*, a partnership raised money to fund low-budget movies.¹³⁵ The company needed to raise \$35 million to commence operations.¹³⁶ The films flopped and the investors lost money.¹³⁷ Two groups of investors sued for securities fraud.¹³⁸ The first group read the materials and invested because of the rosy revenue projections.¹³⁹ They argued that, “but for the misrepresentations and omissions” of the rosy projections, the film company would never have secured enough funding to meet the \$35 million minimum.¹⁴⁰ The second group consisted of investors that never read the prospectus materials.¹⁴¹ Unable to claim reliance on the marketing materials, they attempted to sue under an FCTM theory.¹⁴²

127. *Ross v. Bank S., N.A.*, 885 F.2d 723, 727 (11th Cir. 1989).

128. *Id.*

129. *Id.*

130. *Id.* at 730–31.

131. *Id.* at 727.

132. *Ross*, 885 F.2d at 734.

133. *Id.* at 736 (Tjoflat, J., concurring).

134. *Id.*

135. *Eckstein v. Balcor Film Investors*, 8 F.3d 1121, 1123 (7th Cir. 1993).

136. *Id.*

137. *Id.*

138. *Id.*

139. *Id.*

140. *Eckstein*, 8 F.3d at 1123.

141. *Id.*

142. *Id.* at 1130.

The Seventh Circuit rejected FCTM.¹⁴³ The court found the fact that the federal securities laws do not qualify as “merit regulation” persuasive.¹⁴⁴ Simply, the security registration process does not examine the genuineness of an investment’s projections. The mere existence of a security on the market does not mean that the security is a good investment.¹⁴⁵

2. Sixth Circuit

The Sixth Circuit expressed significant concern with FCTM and, for all practical purposes, rejected the theory. In 1990, the circuit first expressed doubt in *Freeman v. Laventhol & Horwath*.¹⁴⁶ The court declined to rule on FCTM in *Freeman* because of a procedural issue.¹⁴⁷ In 1994, the court declined to endorse FCTM in *Ockerman v. May Zima & Co.*

In *Ockerman*, bond investors sued the developer of a housing project and feasibility consultant for securities fraud.¹⁴⁸ The marketing materials inflated the anticipated occupancy rates in the project’s first year and did not mention that the developer’s two identical projects produced results far below expectations.¹⁴⁹

The court expressed doubt about the viability of an FCTM claim. The court reasoned that unlike in an efficient market, like the NYSE, the primary market does not contain enough investors closely reading marketing materials for someone to rely on the market being genuine.¹⁵⁰ Therefore, a presumption of reliance on the market itself is illogical.¹⁵¹ The court also discussed the application of various unmarketability theories. Economic unmarketability was not available to the plaintiffs because the bonds were not completely worthless, as evidenced by the project’s later sale, albeit at a substantial loss.¹⁵² The legal unmarketability theory was not available because the record was silent as to any facts which would have required an issuing agency to avoid issuing the bond had it known the true facts at that time it

143. *Id.* at 1130–31.

144. *Id.*

145. *Eckstein*, 8 F.3d at 1131.

146. *Freeman v. Laventhol & Horwath*, 915 F.2d 193, 200 (6th Cir. 1990).

147. *Id.* The proponent of the theory did not certify the theory on appeal.

148. *Ockerman v. May Zima & Co.*, 27 F.3d 1151, 1153 (6th Cir. 1994).

149. *Id.*

150. *Id.* at 1160.

151. *Id.*

152. *Id.*

issued the bonds.¹⁵³ The court did not discuss factual unmarketability.¹⁵⁴

While the Sixth Circuit did not expressly reject FCTM, no further cases in the Sixth Circuit have raised an FCTM presumption. Additionally, the Third Circuit in *Malack* and the Seventh Circuit in *Eckstein* characterized the Sixth Circuit as rejecting FCTM.¹⁵⁵ For all practical purposes, an FCTM claim in the Sixth Circuit is not viable.

V. THE *MALACK* DECISION

A. *Facts of the Case*

In 2010, a circuit court considered, for the first time in sixteen years, whether a plaintiff may invoke FCTM in order to presume reliance. In *Malack*, the Third Circuit held that the plaintiff may not use FCTM for reasons of practicality and policy.¹⁵⁶ Malack and other investors purchased notes directly from American Business over a two-and-a-half-year period.¹⁵⁷ American Business promised to pay interest above the prime rate on the notes, but the investors could neither cash the notes nor find a market to sell them.¹⁵⁸ The company issued the notes pursuant to its 2002 and 2003 registration statements and prospectuses filed with the SEC.¹⁵⁹ American Business hired BDO Seidman LLP (BDO), an accounting firm, to audit the opinions necessary to gain SEC approval.¹⁶⁰ On January 21, 2005, American Business filed for Chapter 11 bankruptcy protection and converted the proceedings to Chapter 7 liquidation on May 17, 2005.¹⁶¹ Malack and other investors suffered substantial losses.¹⁶²

Because American Business went bankrupt and had no assets, Malack needed an entity to recover against. He filed a putative securities fraud class action against the accounting firm, BDO.¹⁶³ Malack's theory of liability was that BDO deficiently audited American Busi-

153. *Ockerman*, 27 F.3d at 1153.

154. *See id.*

155. *See Eckstein v. Balcor Film Investors*, 8 F.3d 1121, 1130 (7th Cir. 1993) (stating that in *Freeman* the Sixth Circuit outright rejected FCTM).

156. *Malack v. BDO Seidman, LLP*, 617 F.3d 743, 756 (3d Cir. 2010).

157. *Id.* at 745.

158. *Id.* American Business indicated that part of the high return was because the notes would not involve underwriters or brokers in contravention of normal business processes for issuing a security. Malack and the other investors seemingly ignored this suspicious behavior.

159. *Id.*

160. *Id.*

161. *Malack*, 617 F.3d at 745.

162. *Id.*

163. *Id.*

ness.¹⁶⁴ If BDO had properly performed its job, it would not have issued American Business clean audit opinions.¹⁶⁵ Without clean audit opinions, the SEC would not have let American Business register the notes.¹⁶⁶ Without registration, American Business could not market the notes.¹⁶⁷ If American Business never marketed the notes, then Malack and other investors would have never purchased the notes and lost money.¹⁶⁸

Malack wanted to bring a § 10(b) and a Rule 10b-5 action against BDO.¹⁶⁹ Since proving reliance for each potential member of the class proved costly and difficult, Malack invoked one of the three reliance presumptions. The *Affiliated Ute* presumption was unavailable because Malack targeted BDO, the auditor, and the *Affiliated Ute* presumption does not allow a plaintiff to recover against a third party without a duty to the plaintiff.¹⁷⁰ The *Basic* FOTM presumption was not available because it required an efficient market, and this small market for American Business's notes did not involve enough transactional volume to be considered efficient. Therefore, Malack relied on an FCTM theory.

The district court declined to certify the class under an FCTM theory and found that the proposed class did not satisfy the predominance requirement of Rule 23 of the Federal Rules of Civil Procedure.¹⁷¹ As part of its decision, the district court found that the proposed class was not entitled to presume reliance under an FCTM theory.¹⁷²

164. *Id.*

165. *Id.*

166. *Malack*, 617 F.3d at 745.

167. *Id.*

168. *Id.*

169. *Id.* Section 10(b) and Rule 10b-5 are the principal securities fraud claims provided by the Securities Act and the SEC rules. For more information, see *supra* Part II(B).

170. See HAZEN, *supra* note 62, § 12.10. The auditor has a duty to the corporation, not the plaintiff.

171. *Malack*, 617 F.3d at 746. "Preponderance" tests whether the proposed classes are sufficiently cohesive to warrant adjudication by representation. In order to determine whether common or individual issues predominate a case, the district court must formulate some prediction as to how specific issues will play out at trial. *In re Hydrogen Peroxide Antitrust Litig.*, 552 F.3d 305, 310 (3d Cir. 2008). The district court assessed the likelihood that the parties could successfully meet all six elements of a § 10(b) claim and determined that meeting reliance was not a likely outcome.

172. *Malack*, 617 F.3d at 746.

B. *The Third Circuit's Analysis*

Malack asked the Third Circuit to embrace the Tenth Circuit's legal unmarketability approach to FCTM.¹⁷³ The Third Circuit rejected this request and affirmed the district court's holding that Malack may not presume reliance under an FCTM theory.¹⁷⁴ Specifically, Malack argued that "common sense and probability" justified the Third Circuit to accept FCTM.¹⁷⁵ The court rejected both arguments.

First, Malack argued that common sense suggested that a security's presence on the market indicated that the security was genuine.¹⁷⁶ Therefore, an investor may reasonably assume the security is free of fraud because it is on the market.¹⁷⁷ The Third Circuit disagreed.¹⁷⁸ For Malack's presumption to make any sense, some entity involved in the process of taking the security to market must act as a bulwark against the fraud.¹⁷⁹ No such entity existed.

The parties involved in bringing a security to market all have incentive to sell the stock at a high price.¹⁸⁰ If the security sells for a higher price, they receive more money. Malack's common-sense argument failed because the notion that self-interested parties would make decisions that are burdensome and economically irrational ironically cut against common sense.¹⁸¹

The SEC does not act as a bulwark against fraud because it does not conduct "merit regulation."¹⁸² The SEC focuses on the adequacy and clarity of the issuer's disclosures.¹⁸³ At no time does the SEC determine the legitimacy of the security's price; nor does the SEC endorse any of the documents involved in the security's issuance.¹⁸⁴ In fact, many securities exist on the market even though the issuer or some third party made incomplete disclosures.¹⁸⁵ Therefore, Malack's common-sense argument failed.¹⁸⁶

173. *Id.* at 749.

174. *Id.*

175. *Id.*

176. *Id.*

177. *Malack*, 617 F.3d at 749.

178. *Id.* at 752.

179. *Id.* at 749.

180. *Id.* at 749–50. The parties involved in bringing a security to the market include the promoter, underwriter, auditor, and lawyer.

181. *Id.* at 750.

182. *Malack*, 617 F.3d at 750.

183. *Id.*

184. *Id.*

185. *Id.*

186. *Id.* at 751. Malack's counsel conceded at oral argument that if BDO had fully disclosed all facts about the security, it still would have been issued on the market. The court reasoned

Second, Malack argued for FCTM based on “the probability argument.”¹⁸⁷ Malack did not supply the court with a definition of “probability,” so the court had to supply its own definition. The court determined probability to mean that, because most securities on the market are free from fraud, an investor may reasonably rely on the high probability that his security is not tainted by fraud.¹⁸⁸ The court rejected this argument.¹⁸⁹

The Third Circuit expressed concern that relying on the probability theory would create de facto investor insurance that allowed an investor to recover her losses should the security decline in value.¹⁹⁰ Permitting Malack’s theory would allow any investor to point to the security’s existence on the market, raise a fraud claim, invoke the FCTM reliance presumption, and recover her economic losses.¹⁹¹ Investor insurance does not comport with the goals of securities laws.¹⁹² Unlike the consumer-oriented legislation of the 1960s and 1970s, securities laws leave investors open to significant potential harm.¹⁹³ This cuts against the broad reading of securities laws for which Malack argued. Therefore, the probability argument failed.

The Third Circuit also found that two other considerations weighed against allowing FCTM. First, the court reasoned that FCTM does not further the actual goal of the securities laws—informing investors through disclosures.¹⁹⁴ Citing prior Supreme Court decisions, the Third Circuit noted that the purpose of the securities laws is promot-

that since the security would have gone to market with or without the allegedly fraudulent audit, then no common-sense connection existed between BDO’s audit and Malack’s ability to purchase the note.

187. *Malack*, 617 F.3d at 751.

188. *Id.* at 751–52.

189. *Id.*

190. *Id.* The theory works as follows: John buys a security in NewCo. John assumes that most securities on the market are legally marketable. Therefore, John figures that there is a high probability his security is legally marketable—not touched by fraud. As a result, the security’s presence on the market meets the § 10(b) reliance prong. The court expressed concern that every possible security transaction would prove analogous to the above example and give rise to a § 10(b) claim. Any investor could point to the security’s existence on the market and claim reliance. The insurance argument exists because a remedy for a § 10(b) claim is economic loss, that is, the difference between what John paid for the security and the security’s present value. So if John bought the security for \$1,000 and its present value is \$100, John suffered an economic loss of \$900. Under a § 10(b) claim, John can now recover his \$900 loss. The FCTM presumption allowed John to make a § 10(b) claim that put John in the same position that he would have been in had he never made the investment. Just like insurance, John is made whole and has no loss.

191. *Id.*

192. *Malack*, 617 F.3d at 752.

193. *Id.*

194. *Id.*

ing a policy of full disclosure to investors.¹⁹⁵ Such disclosures place investors in a position to help themselves by relying upon disclosures that others are obligated to make.¹⁹⁶ FCTM runs against this goal because it allows recovery for investors who refuse to look out for themselves.¹⁹⁷ An investor has no incentive to read and consider material because the mere presence of the security on a market gives rise to a claim to cover the investor's losses.¹⁹⁸ In fact, FCTM may go so far as to actually encourage investors to keep their heads in the sand regarding potential bad investments. A defendant can rebut an FOTM reliance presumption by showing that the investor acted unreasonably because she ignored obvious warning signs.¹⁹⁹ Under FCTM, a savvy investor would avoid reading any material on the security because the less she knew about the security, the less likely that a defendant can show that she acted unreasonably.²⁰⁰

Second, policy considerations supported rejecting FCTM. Recent legislative and judicial actions narrowed the scope of § 10(b) liabilities.²⁰¹ The Third Circuit remarked that—when the Supreme Court held in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*²⁰² that § 10(b) liability did not extend to aiders and abettors—public calls emerged for Congress to enact legislation creating such liability.²⁰³ Instead, Congress enacted the Private Securities Litigation Reform Act of 1995 (PSLRA),²⁰⁴ which affirmed the Supreme Court's ruling and limited actions against aiders and abettors to the SEC.²⁰⁵ The PSLRA also heightened pleading and loss causation requirements for “any private action” emerging from the Securities Act.²⁰⁶ Finally, the Third Circuit noted that, in *Stoneridge Investment Partners, LLC v. Scientific–Atlanta, Inc.*,²⁰⁷ the Supreme Court stated that “the § 10(b) private right should not be extended beyond its pre-

195. *Id.* at 752–53.

196. *Id.* at 757.

197. *Malack*, 617 F.3d at 747.

198. *Id.*

199. See Johnson & Smith, *supra* note 53. While no court has held that the FOTM defenses apply to FCTM, it is reasonable to assume that the same defenses would apply to FCTM. The Third Circuit's concern that an investor may consciously avoid bad information about a security suggests that the court believes the FOTM defenses would also work for FCTM.

200. *Id.*

201. *Malack*, 617 F.3d at 754.

202. *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994).

203. *Malack*, 617 F.3d at 754.

204. 15 U.S.C. § 78u-4 (2006).

205. *Malack*, 617 F.3d at 754.

206. *Id.*

207. *Stoneridge Inv. Partners, LLC v. Scientific–Atlanta, Inc.*, 552 U.S. 148 (2008).

sent boundaries.”²⁰⁸ In *Stoneridge*, the Supreme Court recognized only two accepted presumptions of reliance: (1) the *Affiliated Ute* omission and (2) the *Basic FOTM*.²⁰⁹ The Third Circuit found the Supreme Court’s omission of FCTM meant that FCTM was not a permissible reliance presumption.²¹⁰

Finally, the Third Circuit discussed litigation costs as a policy consideration that weighed against allowing FCTM.²¹¹ The court noted that § 10(b) litigation carries extremely high costs for all parties involved and that those costs are eventually passed down to consumers through higher fees for services.²¹² Also, high litigation costs pressure defendants into settling frivolous litigation.²¹³

Finally, the Third Circuit considered what would happen if it endorsed FCTM and applied Malack’s facts to the Tenth Circuit’s legal unmarketability theory. The court held that Malack’s claim still failed.²¹⁴ Under legal unmarketability, a plaintiff may invoke FCTM if the security was not legally qualified to be issued.²¹⁵ In *T.J. Raney*, the company issued the security in violation of state law because the issuer was not a valid public trust.²¹⁶ Because the issuer never had legal authority to issue a bond, the bonds were legally unmarketable.²¹⁷ In Malack’s case, his own counsel conceded that the SEC still would have allowed the securities to enter the market had the auditor produced proper audits.²¹⁸ Under the Tenth Circuit’s test, only a security that *cannot* go to market may invoke FCTM as opposed to a security, like Malack’s, that *should not* go to market.²¹⁹ Therefore, Malack’s claim failed under the legal unmarketability test.²²⁰

208. *Malack*, 617 F.3d at 754 (quoting *Stoneridge*, 552 U.S. at 165) (internal quotation marks omitted).

209. *Id.*

210. *Id.*

211. *Id.*

212. *Id.* at 755. A basic economic principle is that there is no such thing as a free lunch. Somewhere along the way, higher costs are incorporated into higher prices.

213. *Malack*, 617 F.3d at 755.

214. *Id.*

215. *Id.*

216. *T.J. Raney & Sons, Inc. v. Fort Cobb, Okla. Irrigation Fuel Auth.*, 717 F.2d 1330 (10th Cir. 1983).

217. *Malack*, 617 F.3d at 755.

218. *Id.* at 756.

219. *Id.*

220. *Id.*

VI. ANALYSIS OF *MALACK*A. *Correctly Interpreted Legislative Guidance*

In 1995, Congress passed the PSLRA to curb the expansion of private securities fraud litigation.²²¹ Congress found significant evidence of abuse in private securities lawsuits.²²² Specifically, Congress found that plaintiffs filed lawsuits whenever a security's price changed significantly and that these lawsuits created high discovery costs that forced defendants into settling meritless claims.²²³

The PSLRA amended securities fraud laws to require a heightened pleading standard for a securities fraud claim.²²⁴ Under the new standard, a plaintiff must plead each element of the claim with particularity.²²⁵ A complaint that is not pleaded with particularity can be dismissed at the end of the pleadings stage and before discovery begins. As 80% of litigation costs occur during discovery in securities fraud cases, early dismissal should lower defense costs and prevent rising litigation costs from forcing defendants to settle meritless claims.²²⁶

In order to avoid the heightened pleading standards, plaintiff attorneys started filing their securities fraud class actions in state courts.²²⁷ Congress then enacted the Securities Litigation Uniform Standards Act of 1998 (SLUSA), which required plaintiffs to file certain securities class actions in federal courts.²²⁸

The Third Circuit correctly commented that the current legislative trend is to curb the growth of securities fraud litigation. For example, Congress enacted the PSLRA to limit private securities actions. When plaintiff attorneys found a loophole around the heightened pleading standards, Congress enacted SLUSA to close that loophole. The closing of the loophole provides clear evidence that Congress intended to make certain that no securities fraud class action could escape the increased scrutiny of the PSLRA's heightened pleading

221. H.R. REP. NO. 104-369, at 31 (1995) (Conf. Rep.), *reprinted in* 1995 U.S.C.C.A.N. 730, 730.

222. *Id.*

223. *Id.*

224. *Id.* at 41.

225. *Id.* Note that a particularity pleading standard was already required under Rule 9(b) of the Federal Rules of Civil Procedure. FED. R. CIV. P. 9(b). Congress determined that judges were reluctant to dismiss securities fraud cases under Rule 9(b), so it enacted the PSLRA to provide additional statutory support for the early dismissal of frivolous claims. H.R. REP. NO. 104-369, at 32.

226. H.R. REP. NO. 104-369, at 37.

227. H.R. REP. NO. 105-803, at 13 (1998) (Conf. Rep.).

228. *Id.*

standard. The Third Circuit correctly commented that the PSLRA and SLUSA evidence a legislative climate seeking to chill the expansion of securities lawsuits. However, congressional intentions are persuasive, not binding. While the court correctly commented on the legislative climate, it incorrectly interpreted the Supreme Court's post-PSLRA jurisprudence.

B. *Incorrectly Interpreted Judicial Guidance*

The Third Circuit incorrectly held that the Supreme Court's *Stoneridge* decision foreclosed a claim raised under an FCTM theory.²²⁹ In *Stoneridge*, the Supreme Court confirmed that two reliance theories are permissible in securities fraud litigation: the *Affiliated Ute* omission and the *Basic* FOTM.²³⁰ The *Stoneridge* plaintiffs based their claim on a version of FOTM called "scheme liability."²³¹ This theory would allow the plaintiffs to raise FOTM even though the defendant made no public misstatement.²³² The Court declined to extend FOTM.²³³ The Court reasoned that since Congress enacted the PSLRA to limit the expansion of private securities fraud litigation, the Court should decline to accept any new theories that expand private securities fraud litigation beyond what existed in 1995, the year Congress passed the PSLRA.²³⁴ The scheme liability expansion that the *Stoneridge* plaintiffs sought did not exist prior to 1995 and, therefore, was impermissible.

The Third Circuit incorrectly interpreted this holding to mean that any reliance theory not endorsed by the Supreme Court before 1995 was not permissible. The Supreme Court expressly recognized the *Affiliated Ute* omission and the *Basic* FOTM theories in the *Stoneridge* opinion, but the Court never stated that those were the only two reli-

229. *Malack v. BDO Seidman, LLP*, 617 F.3d 743, 754 (3d Cir. 2010).

230. *See Stoneridge Inv. Partners v. Scientific-Atlanta, Inc.*, 552 U.S. 148, 159 (2008).

231. *Id.* Scheme liability exists when a party engages in conduct with the purpose and effect of creating a false appearance of a material fact to further a scheme. In *Stoneridge*, Charter Communications purchased cable boxes from its supplier, Scientific-Atlanta, at a higher price and then had the supplier use the surplus money to purchase advertising from Charter. Charter then had its accountant, Arthur Andersen, record that purchase as revenue. This made it look like the company met projected revenue targets when it in fact fell short. FOTM requires a public misstatement. The problem petitioner faced was that the entire agreement was never disclosed to the public. Petitioner argued that a public financial statement issued by Arthur Andersen, even though it contained correct accounting figures, actually contained misstatements because the means used to produce the figures were the result of a behind-the-scenes scheme. As the statement was public, the petitioners argued that it constituted a public misstatement that allowed them to invoke FOTM. *Id.* at 154.

232. *Id.* at 159.

233. *Id.* at 165.

234. *Stoneridge*, 552 U.S. at 165-66.

ance theories available.²³⁵ A recent article on FCTM argued that *Stoneridge* does not preclude an FCTM claim because the Court never considered a claim based on FCTM or other reliance theories in deciding *Stoneridge*.²³⁶ The article suggests that the Court merely confirmed its prior jurisprudence on the matter without outright rejecting any possible expansion of permissible reliance theories.²³⁷ The language of *Stoneridge* lends this argument further support. *Stoneridge* said that the PSLRA cautioned against the acceptance of any new securities fraud theories developed after 1995.²³⁸ FCTM existed as a legal theory since 1981, well before 1995.²³⁹ The decision did not say that only theories recognized by the Supreme Court prior to 1995 are permissible. The Supreme Court has never expressly dismissed FCTM as a viable theory. The Third Circuit erred in finding that *Stoneridge* precluded Malack's FCTM claim.

VII. IMPACT

After *Malack*, a securities claim based on FCTM succeeds in three circuits, fails in three circuits, and is a gamble in the remaining circuits. A rational lawyer will seek to raise the best case possible. In the class action context, that would undoubtedly mean raising a reliance presumption based on the two theories the Supreme Court expressly recognized: the *Affiliated Ute* omission or the *Basic* FOTM. Not every case contains a set of facts that supports either of these theories. Sometimes a claim must rely on FCTM. Since the federal jurisprudence on FCTM is inconsistent, plaintiff attorneys will flock to the Fifth Circuit, Tenth Circuit, and Eleventh Circuit to file their FCTM claims. This creates forum shopping.

A. *The Supreme Court Should Articulate a Clear Standard for FCTM*

The Supreme Court should create a uniform standard for FCTM to avoid forum shopping. Forum shopping is unwanted because it raises litigation costs by forcing defendants to defend cases in venues far away from the home office.²⁴⁰ Forum shopping creates higher costs

235. See Michael J. Kaufman & John M. Wunderlich, *Fraud Created the Market*, 63 ALA. L. REV. 275, 301–02 (2012) (arguing that FCTM and other reliance theories argued in the circuit courts were not considered by the Court).

236. *Id.*

237. *Id.*

238. See *Stoneridge*, 552 U.S. at 155–56.

239. See *Shores v. Sklar*, 647 F.2d 462 (5th Cir. 1981) (en banc).

240. See Maloy, *supra* note 7.

that run counter to one of the PSLRA's goals: reducing high litigation costs that force defendants to settle weak claims.²⁴¹

A uniform, national standard for FCTM will lower litigation costs and promote judicial efficiency.²⁴² Prior to 1933, every state had a rule against fraud.²⁴³ The federal statutes were created, in part, to increase judicial efficiency and decrease litigation costs.²⁴⁴ The federal securities laws created a clear standard. Attorneys and judges only needed to learn one set of laws, rather than fifty separate state statutes. This lowered trial preparation costs. Since securities cases involved one set of laws, a compendium of judicial case law developed that improved nationwide consistency in the interpretation and adjudication of securities laws. For example, the case law on securities law is so voluminous that a securities attorney knows what facts he must plead to show the element of scienter in a § 10(b) claim. This lowers litigation costs because he does not need to spend time researching several inconsistent cases. It also saves the courts time because they do not have to review multiple briefs and arguments on the subject because the case law is clear. A Supreme Court decision on FCTM will create a uniform standard that lowers litigation costs and promotes judicial efficiency.

B. *The Supreme Court Should Adopt FCTM but Limit It to the Legal Marketability Standard*

1. Why Adopt FCTM at All?

The Court should adopt FCTM because it can assist the SEC in combating securities fraud in smaller, primary markets. The PSLRA recognized a private right of action in securities fraud cases.²⁴⁵ Congress recognized the potential assistance that private litigation can have in affecting one of the Securities Act's goals: deterring fraud through civil damage awards.²⁴⁶ Most litigation on the primary market involves class actions.²⁴⁷ This is because one claim alone may not yield a remedy greater than the cost and time it takes to litigate a securities case. However, if plaintiffs can aggregate their claims, then the potential remedy increases. Should the Court decline to extend

241. H.R. REP. NO. 104-369, at 31 (1995) (Conf. Rep.), *reprinted in* 1995 U.S.C.C.A.N. 730, 730.

242. Easterbrook & Fischel, *supra* note 9, at 679.

243. *Id.*

244. *Id.*

245. See H.R. REP. NO. 104-369, at 31 (explaining that "[t]he private securities litigation system is too important to the integrity of the American capital markets").

246. See *id.* ("Such private lawsuits . . . help to deter wrongdoing . . .").

247. See Johnson & Smith, *supra* note 53.

FCTM, it would mean that plaintiffs in a class action lawsuit would need to show actual reliance on a misstatement for every member of the class.²⁴⁸ This would decrease judicial efficiency because the same element must be proven multiple times in court. Time and money spent on litigation will increase. This will chill securities fraud litigation. Less class action litigation means less of the meritorious private litigation that Congress recognized as beneficial in the PSLRA.²⁴⁹

Critics argue that the SEC can still bring a civil action in its own name against companies that commit fraud.²⁵⁰ However, the SEC is an agency that has limited resources.²⁵¹ It must pick and choose which cases it tries. FCTM is used in primary markets. Many of these cases involve a smaller pool of investors than similar cases on the secondary market.²⁵² The SEC's desire to litigate these smaller cases is not as strong as a group of investors who suffered personal losses because of fraud. The cumulative effect of rejecting FCTM is that the individuals that commit fraud, the very persons that the securities laws target, may escape liability.

FCTM is not without its drawbacks. Most notably it can create de facto investor insurance that incentivizes meritless lawsuits. Therefore, the Court should not adopt a broad interpretation of FCTM. Instead, the Court should adopt the Tenth Circuit's legal unmarketability standard because it will limit the circumstances in which a plaintiff can raise a claim under an FCTM theory.

2. The Supreme Court Should Recognize FCTM Based on a Legal Unmarketability Standard

The Court should recognize FCTM based on a legal unmarketability standard. The legal unmarketability standard asks whether the security's issuer had the legal authority to issue the security in the first place, and, if not, whether the issuer lied about having that authority.²⁵³

248. *Id.*

249. See H.R. REP. NO. 104-369, at 31.

250. 17 C.F.R. § 240.10b-5 (2012).

251. In the first quarter of 2012, the SEC filed only one hundred civil suits nationally for both the primary and secondary markets. Based on the size of both markets, this is a very small number. See *Litigation Releases*, *supra* note 17.

252. For example, a stock issued on the secondary market may have millions of shares circulated daily. A security on the primary market may only involve the one-time purchase of three municipal construction bonds.

253. *T.J. Raney & Sons, Inc. v. Fort Cobb, Okla. Irrigation Fuel Auth.*, 717 F.2d 1330, 1333 (10th Cir. 1983).

First, it is reasonable to assume that a security's existence on the market means that the business issuing the security had the appropriate legal authority to offer the security in the first place. All securities pass through the SEC before entering the market.²⁵⁴ There is no dispute that the SEC does not evaluate a security's merits before releasing it on to the market.²⁵⁵ However, the SEC's own website cautions investors that the SEC does not guarantee the accuracy of a filing's *financial* information.²⁵⁶ They provide no warning that information outside of the financial disclosures, such as the company's legal authority to issue the security, may be a fabrication. If the SEC warns investors about only financial misstatements, why is it reasonable to assume that an investor would ever think to verify information outside of the financial statements? As the Tenth Circuit commented, "Federal and state regulation of new securities at a minimum should permit a purchaser to assume that the securities were lawfully issued."²⁵⁷

Second, legal unmarketability would not expand private securities fraud litigation because the facts supporting a claim under this standard are rare. The circuit courts heard six FCTM cases, and only one of the six gave rise to a claim that would survive a motion to dismiss under a legal unmarketability standard.²⁵⁸ The typical FCTM claim occurs when an issuer makes a misstatement on a financial disclosure.²⁵⁹ These claims would not survive under a legal unmarketability standard. Under the PSLRA's heightened pleading standard, a legal unmarketability claim will survive a motion to dismiss only if the plaintiff can plead facts with particularity that the defendant lacked the legal authority to issue the security.²⁶⁰ As the Tenth Circuit noted, legal unmarketability gives rise to claims in a narrow context.²⁶¹ The high pleading standard, combined with the narrow set of facts giving rise to a claim, will cut down on meritless lawsuits. Legal un-

254. Easterbrook & Fischel, *supra* note 9. This gatekeeping function is the mechanism by which the SEC ensures that an issuer has complied with the Securities Act's mandatory disclosure requirements.

255. *Id.*

256. *The Laws that Govern the Securities Industry*, *supra* note 17.

257. *T.J. Raney*, 717 F.2d at 1333.

258. Compare *T.J. Raney*, 717 F.2d at 1330, with *Malack v. BDO Seidman, LLP*, 617 F.3d 743 (3d Cir. 2010), *Ockerman v. May Zima & Co.*, 27 F.3d 1151 (6th Cir. 1994), *Eckstein v. Balcor Film Investors*, 8 F.3d 1121 (7th Cir. 1993), *Ross v. Bank S., N.A.*, 885 F.2d 723 (11th Cir. 1989), and *Shores v. Sklar*, 647 F.2d 462 (5th Cir. 1981) (en banc).

259. See *Malack*, 617 F.3d at 743; *Ockerman*, 27 F.3d at 1151; *Eckstein*, 8 F.3d at 1121; *Ross*, 885 F.2d at 723; *Shores*, 647 F.2d at 462.

260. 15 U.S.C. § 78u-4(a)(2)(A) (2006).

261. *T.J. Raney*, 717 F.2d at 1333.

marketability is unlikely to significantly increase securities fraud litigation because few cases give rise to a claim under this standard.

Third, legal unmarketability encourages investor due diligence before purchasing a security. An investor cannot rely on litigation as a windfall to cover her potential losses because the high pleading standard and narrow set of facts make it very difficult to successfully raise a claim under FCTM. This provides the investor with extra incentive to research the company before investing her money. If the investor could reasonably anticipate recovering her losses through litigation, why would she take time out of her schedule to conduct due diligence before investing? The limited availability of a legal unmarketability claim will encourage investor due diligence.

Fourth, legal unmarketability is the only one of the three unmarketability standards that has never been rejected by a circuit court. In *Eckstein*, the Seventh Circuit rejected FCTM by focusing on the *Shores* factual unmarketability standard.²⁶² Legal unmarketability asks an entirely different question than factual unmarketability. Legal unmarketability asks whether the security legally may be offered, unlike factual marketability which asks what is the security's worth. The Seventh Circuit never rejected an FCTM theory based on the narrow legal unmarketability approach.

The Sixth and Third Circuits rejected FCTM by arguing that the economic and factual unmarketability standards would broadly encompass most securities in the primary market, thus expanding securities litigation.²⁶³ Unlike economic and factual unmarketability, legal unmarketability considers only misstatements as to the company's legal authority to issue the security. It applies in a very narrow set of circumstances. This limits the pool of potential claims and chills the expansion fears of the Sixth and Third Circuits. The Eleventh Circuit, which accepted FCTM, never addressed the legal unmarketability theory.²⁶⁴ Six circuit courts have considered FCTM, and no circuit rejected the legal unmarketability standard.²⁶⁵

262. *Eckstein*, 8 F.3d at 1132.

263. See *Ockerman*, 27 F.3d at 1160; see also *Malack*, 617 F.3d at 752. Both courts distinguished their cases from the facts present in the Tenth Circuit's *T.J. Raney* decision and never rejected the legal unmarketability standard.

264. *Ross*, 885 F.2d 723.

265. See *Malack*, 617 F.3d at 743; *Ockerman*, 27 F.3d at 1151; *Eckstein*, 8 F.3d at 1121; *Ross*, 885 F.2d at 723; *T.J. Raney*, 717 F.2d at 1330; *Shores v. Sklar*, 647 F.2d 462 (5th Cir. 1981) (en banc).

3. Why Not Economic or Factual Unmarketability?

First, adopting FCTM based on a factual or economic unmarketability standard would expand private securities fraud litigation. Many courts reject FCTM because it may create investor insurance.²⁶⁶ FCTM allows an investor to rely on a reliance presumption rather than having to prove actual reliance on a misstatement. Without having to show actual reliance, an investor can easily raise a meritless claim for fraud anytime she loses her investment.²⁶⁷ If the security's value drops, for example, the investor can sue for fraud, raise an FCTM presumption, and look to recover her loss. Investor insurance expands frivolous securities litigation. Such a concern is not present under a legal unmarketability standard. A plaintiff can raise an FCTM presumption only if she can plead facts with particularity that the defendant lied about having the legal authority to issue the security. This is a rare set of facts. In contrast, factual and economic unmarketability standards broadly allow a plaintiff to claim that any misstatement, financial or otherwise, impacted the price. This greatly expands the pool of potential FCTM claims.

Second, factual and economic unmarketability standards require a showing that a security is *worthless*.²⁶⁸ In order to determine a security's value, judges will need to undertake financial evaluations. Judges are experts in the law. They are not experts in securities valuations. Having a nonexpert make such valuations will lead to inconsistent valuations of securities. Moreover, should the court seek experts, it will increase litigations costs. Higher litigation costs will ultimately trickle down to the consumers. The rules against fraud are most effective when enforcement costs are low and when it is possible to separate truths from untruths.²⁶⁹ Legal unmarketability is the best approach because it creates a clear, uniform standard such that a judge can easily answer—Was the defendant legally authorized to issue the security and did she lie about it?

266. See *Ockerman*, 27 F.3d at 1162; see also *Malack*, 617 F.3d at 752.

267. See John M. Hynes, Comment, *The Unjustified Presumption of Reliance for Newly Issued Securities: Why the Private Securities Litigation Reform Act of 1995 Rang the Death Knell for the Fraud-Created-the-Market Theory*, 38 Sw. U. L. REV. 333, 353–54 (2008) (stating that a concern with investor's insurance is that it would lead to an increase in meritless litigation because investors would sue anytime that they suffered a loss even if they had no reason to suspect fraud).

268. See *Ross*, 885 F.2d at 736 (Tjoflat, J., concurring).

269. Easterbrook & Fischel, *supra* note 9, at 679.

VIII. CONCLUSION

FCTM is a controversial interpretation of federal securities laws. Three circuit courts allow FCTM while three reject the theory. The Supreme Court should review FCTM because the inconsistent application of FCTM in the circuit courts will produce forum shopping. The Court should adopt a narrow application of FCTM because it can assist the SEC in targeting companies that defraud investors. The legal unmarketability standard is the appropriate narrow application of FCTM. It protects investors against the most egregious fraud while narrowing the potential pool of FCTM claims to prevent clever investor's from turning FCTM into de facto investor's insurance.

