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Articles

FRAUD BY HINDSIGHT*

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INTRODUCTION

"In sum, the complaint is an example of alleging *fraud by hindsight.*"
—Judge Henry Friendly, in his 1978 opinion *Denny v. Barber*[1]

Most people today believe that Enron's CEO, Ken Lay, knew his subordinates were rigging the corporate books. Likewise, it is not hard to believe that the managers at MCI, WorldCom, and Tyco knew their businesses were performing badly even as they issued rosy forecasts. It also is hard to believe that twenty years ago the management at Apple failed to predict that the Macintosh predecessor, "Lisa," was a doomed product, whose release was a futile act intended only to boost stock prices. Most of us recognize, however, that hindsight colors these beliefs. Events tend to seem more predictable than may have been the case.[2] One could recount this tale for a thousand other corporate failures. What looks today like fraud, in many circumstances might have once been nothing more than misplaced optimism. Small wonder then that courts worry about "fraud by hindsight" in cases alleging securities fraud.

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[1] 576 F.2d 465, 470 (2d Cir. 1978) (emphasis added).

[2] *See* Baruch Fischhoff, *Hindsight ≠ Foresight: The Effect of Outcome Knowledge on Judgment Under Uncertainty*, 1 J. EXPERIMENTAL PSYCHOL. 288 (1975) (documenting the effects of hindsight on judgment).

Hindsight blurs the distinction between fraud and mistake. People consistently overstate what could have been predicted after events have unfolded—a phenomenon psychologists call the hindsight bias.[3] People believe they could have predicted events better than was actually the case and believe that others should have been able to predict them. Consequently, they blame others for failing to have foreseen events that reasonable people in foresight could not have foreseen.[4] In the context of securities regulation, hindsight can mistakenly lead people to conclude that a bad outcome was not only predictable, but was actually predicted by managers.[5] Even in the absence of any misconduct, a bad outcome alone might lead people to believe that corporate managers committed securities fraud. The hindsight bias thus creates a considerable obstacle to the fundamental task in securities regulation of sorting fraud from mistake.

Punishing mistakes as if they were fraud undermines the deterrent function of securities regulation.[6] If corporate managers are as likely to be punished for bad decisions as for acts of fraud, then the securities laws provide little real disincentive to engage in fraud. The recent financial scandals raise precisely this concern. How could managers at Enron and others who were manipulating revenue reports have thought that they could continue to do so indefinitely? Indeed, given the high likelihood of getting caught, few instances of alleged securities fraud make much sense.[7] This question has

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[3] *See id.* at 289. For discussions of the hindsight bias on legal judgments, see Hal R. Arkes & Cindy A. Schipani, *Medical Malpractice v. the Business Judgment Rule: Differences in Hindsight Bias*, 73 OR. L. REV. 587 (1994); Donald C. Langevoort, *The Epistemology of Corporate-Securities Lawyering: Beliefs, Biases and Organizational Behavior*, 63 BROOK. L. REV. 629, 661–62 (1997); Jeffrey J. Rachlinski, *A Positive Psychological Theory of Judging in Hindsight*, 65 U. CHI. L. REV. 571 (1998).

[4] *See* Kim A. Kamin & Jeffrey J. Rachlinski, *Ex Post ≠ Ex Ante: Determining Liability in Hindsight*, 19 LAW & HUM. BEHAV. 89 (1995) (describing research indicating that the hindsight bias leads people to over-attribute blame).

[5] One finds numerous discussions of the hindsight problem in discussions of securities disclosure law by members of the securities bar, including, on occasion, references to the psychological literature on the bias. *See, e.g.*, Herbert S. Wander, *Securities Law Disclosure After Sarbanes Oxley*, 1381 PLI/CORP 11, 52, 55, 60 (2003) (discussing the problem of courts judging securities disclosure questions in hindsight); Herbert S. Wander & Russell N. Pallesen, *Developments in Securities Law Disclosure*, 908 PLI/CORP 327, 399, 447, 497–98 (1995) (similar concern); C. Evan Stewart, *Basics of Accounting and Finance—What Every Practicing Lawyer Needs to Know: Liability for Securities Lawyers in the Post-Enron Era*, 1380 PLI/CORP 1075, 1090 & n.2 (2003) (citing to the academic literature on the hindsight bias). Going back in time, to the year after Judge Friendly uttered the phrase "fraud by hindsight," one sees the concern about courts judging securities matters in hindsight expressed in the leading securities disclosure articles of the time. *See* Jeffrey D. Bauman, *Rule 10b-5 and the Corporation's Affirmative Duty to Disclose*, 67 GEO. L.J. 935, 939 (1979) (describing the unfairness of penalizing corporations because of hindsight-biased judgments); Ted J. Fiflis, *Soft Information: The SEC's Former Exogenous Zone*, 26 UCLA L. REV. 95, 96 (1978) (noting the problem of courts being willing to second guess disclosure decisions by managers).

[6] *See* Rachlinski, *supra* note 3, at 596–600 (discussing the tendency for the hindsight bias to undermine the deterrent function of law).

[7] *See generally* Donald C. Langevoort, *Organized Illusions: A Behavioral Theory of Why Corporations Mislead Stock Market Investors (And Cause Other Social Harms)*, 146 U. PA. L. REV. 101 (1997) (discussing why corporate managers might mislead the public).

many answers, but one of them might well be the inability of the courts in securities fraud cases to sort fraud from mistake accurately.[8]

Courts' difficulties with sorting fraud from mistake accurately is not the result of ignorance of the basing effects of hindsight. Courts cite concerns with hindsight in nearly one-third of all published opinions in securities class action cases.[9] As the epithet at the beginning of this Article shows, courts seem generally aware of the problem posed by judging securities fraud cases in hindsight. Judges routinely admonish plaintiffs not to rely on hindsight to support allegations of fraud in pleading securities claims. Increasingly, the doctrine against "fraud by hindsight" ("FBH") has become a hurdle that plaintiffs in securities cases must overcome

The FBH doctrine arises from judges' awareness that knowledge of the bad outcome biases judgments in favor of concluding that fraud had occurred, even if it had not.[10] Arguably, the FBH doctrine reveals judges to be intuitive psychologists, struggling to correct for the influence of the hindsight bias on litigation.[11] A properly debiased system of litigation would accurately sort the cases of fraud from innocently mistaken predictions, thereby maintaining the deterrent function of the securities fraud system. The FBH doctrine might thus reflect an effort to debias the adjudication process in securities cases.

The relationship between the FBH doctrine and the hindsight bias, however, might be epiphenomenal. The notion that a serious bias in judgment affects the system, however, gives judges a legitimate justification for departing from the notice pleading system and actively judging cases on the merits at an early stage of litigation. Several aspects of both securities litigation and the hindsight bias support this "case management" over a "debi-

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[8] The recent financial scandals have resulted in a spate of articles and symposia analyzing the possible causes and cures. *See, e.g.*, William W. Bratton, *Rules Versus Principles Versus Rents*, 48 VILL. L. REV. 1023 (2003); John C. Coffee, Jr., *The Attorney as Gatekeeper: An Agenda for the SEC*, 103 COLUM. L. REV. 1293 (2003); Lawrence A. Cunningham, *The Sarbanes-Oxley Yawn: Heavy Rhetoric, Light Reform (And It Just Might Work)*, 35 CONN. L. REV. 915 (2003); Robert W. Hamilton, *The Crisis in Corporate Governance: 2002 Style*, 40 HOUS. L. REV. 1 (2003); *see also* Panel Discussion, *The Private Securities Law Reform Act: Is It Working?*, 71 FORDHAM L. REV. 2363 (2003) (discussing the impact of the PSLRA).

[9] *See infra* Part IV.A.

[10] One court has described the "typical fraud by hindsight case" as one in which:

> [T]he defendant company has experienced some business misfortune which is ultimately reported in its own periodic reports to stockholders and in the financial press. The publication of this information produces a drop in the market price of the company's stock and many unhappy stockholders. The suit which follows normally alleges that information concerning the impending misfortune or its root causes was omitted from earlier management publications despite the fact that management then knew the information. The omitted material is frequently contrasted with optimistic rhetoric from the pre-misfortune period in connection with an assertion that the earlier publications were false and misleading.

Klein v. King, No. C-88-3141, 1990 WL 61950, at *7 (N.D. Cal. Mar. 26, 1990).

[11] *See* Rachlinski, *supra* note 3, at 602–24 (arguing that courts engage in efforts to correct for the influence of hindsight bias in a wide range of cases).

asing" account of the FBH doctrine. First, the influence of hindsight on judgment is notoriously difficult to avoid.[12] It might be unrealistic to suppose that courts have developed a sensible response in just the few decades of active private securities litigation. Second, although securities cases often include high-profile claims that might be attractive for judges to resolve, these cases also commonly produce a quagmire of discovery disputes and time-consuming procedural motions. Third, judges are also somewhat suspicious of these cases and might be motivated to police them early in the litigation process. Rather than a debiasing effort, the FBH doctrine might be one of several mechanisms courts have developed for managing securities fraud actions in the federal courts.[13]

A number of scholars (including all three of us) have remarked that the emergence of the FBH doctrine is linked to the hindsight bias.[14] Thus far, however, the discussions of the FBH doctrine have been brief and have lacked a systematic examination of whether the doctrine represents an honest effort to guard against the hindsight bias. This Article tests the competing hypotheses that the FBH doctrine is either a debiasing effort or a case-management strategy, using a variety of methods. We trace the history and development of the doctrine to determine whether its origins suggest debiasing or other motives. We then provide empirical evidence to identify what circumstances lead judges to use the doctrine and how judges' reliance on the doctrine relates to case outcomes. These statistics test whether the doctrine is used in circumstances in which it makes sense from a debiasing perspective. Finally, we use traditional legal analysis (reading the cases) to assess whether the substance of the doctrine maps well onto a debiasing strategy. Our study is thus a quasi-empirical examination of judicial opinions in securities fraud cases.

To give away the punchline early, our analysis reveals that the FBH doctrine is not an effort to control the influence of the hindsight bias in securities litigation, but is part of an effort to manage securities cases. Although case management can take many forms, from limiting discovery to facilitating settlement,[15] in this context, judges are seeking to manage secu-

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[12] *See* Scott A. Hawkins & Reid Hastie, *Hindsight: Biased Judgments of Past Events After the Outcomes Are Known*, 107 PSYCHOL. BULL. 311, 312 (1990) (describing the difficulty of avoiding the hindsight bias).

[13] *See* Stephen M. Bainbridge & G. Mitu Gulati, *How Do Judges Maximize? (The Same Way Everybody Else Does—Boundedly): Rules of Thumb in Securities Fraud Opinions*, 51 EMORY L.J. 83 (2002) (describing rules of thumb judges adopt in securities fraud cases).

[14] *Id.* at 126–29; Langevoort, *supra* note 3, at 661–62; Rachlinski, *supra* note 3, at 615–17; *see also* Lynn A. Stout, *The Investor Confidence Game*, 68 BROOK. L. REV. 407, 433–34 (2002) (discussing the problem of the hindsight bias in securities cases); Eric Talley, *Disclosure Norms*, 149 U. PA. L. REV. 1955, 2000 n.121 (2001) (discussing the role of the hindsight bias in securities-fraud cases). For an article predating FBH discussions in the literature that identified the problem of judges or juries evaluating scienter in hindsight, see Donald C. Langevoort, *Capping Damages for Open-Market Securities Fraud*, 38 ARIZ. L. REV. 639, 644–46 (1996).

[15] *See* Judith Resnik, *Managerial Judges*, 96 HARV. L. REV. 374 (1982).

rities cases through a thinly disguised effort to screen securities cases at an early stage of the proceedings.

Although the creation of the FBH doctrine can plausibly be traced to efforts to reduce the effect of the hindsight bias, the development of the doctrine does not effectively track the underlying limitation on judgment. First, courts apply the doctrine to determinations that are the least likely to be affected by the hindsight bias and fail to apply it where the bias is most likely to play a role. Second, they apply the doctrine primarily at the pleadings stage—when outcome knowledge is most relevant to an assessment of whether fraud occurred. Third, the manner in which the doctrine is applied makes it unlikely to guard against the hindsight bias; judges rely on their own impressions of the case, assuming they are free from the effects of the bias. Fourth, even though the hindsight bias can benefit or harm a plaintiff's case, judges selectively target the FBH doctrine at instances in which the doctrine benefits plaintiffs. Finally, the doctrine has not gained any nuance or subtlety over time; instead, it has merely expanded to facilitate greater authority for judges to screen securities cases on the pleadings.

Even if early adjudication of securities cases makes sense, it comes at a price. The use of hindsight as a pretense for case management leaves many residual problems with the system of private securities litigation. Instead of developing a serious effort to reduce the influence of hindsight, judges assume they can identify those cases that raise real suspicion of fraud without the influence of the hindsight bias. Research suggests that this is not realistic. Studies show that judges are vulnerable to the bias,[16] and that mere awareness of the phenomenon does not ameliorate its influence on judgment.[17] The failure to develop a doctrine that addresses the underlying problem of judging in hindsight means that the adverse consequences of the hindsight bias remain a part of securities litigation. Judges are not accurately sorting fraud from mistake, thereby undermining the system, even as they seek to improve it.

Part I of this Article describes the role that the hindsight bias might play in securities fraud cases. Part II develops a set of predictions about what one would expect to see if judges were to put in place an effective protection against the hindsight bias in the securities fraud context. We contrast those predictions with the predictions that arise from a competing model of judicial behavior, one where judges use the specter of the hindsight bias to further other goals. Part III begins our test of the competing hypotheses by tracing the development of the FBH doctrine. Part IV sets out our observations from examining the 300-plus securities class action

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[16] *See* Chris Guthrie et al., *Inside the Judicial Mind*, 86 CORNELL L. REV. 777, 799–805 (2001); John C. Anderson et al., *The Mitigation of Hindsight Bias in Judges' Evaluation of Auditor Decisions*, AUDITING: J. PRACTICE & THEORY, Fall 1997, at 20.

[17] *See* Rachlinski, *supra* note 3, at 586–88 (reviewing interventions designed to mitigate the hindsight bias).

opinions that have invoked the phrase "fraud by hindsight" between 1978 and 2002. Part V then matches up the observations from Part IV against the two contrasting sets of predictions from the models. Finally, Part VI performs an additional set of tests on the models that emerge from Part V.

I. HINDSIGHT IN SECURITIES LITIGATION: TWO THEORIES

In cases alleging securities fraud, courts must determine what corporate managers knew and when they knew it. Such judgments might be clouded by the present knowledge of how events ultimately unfolded. In many contexts, courts have developed adaptations to the problem of judging in hindsight.[18] The FBH doctrine might be one such adaptation. Alternatively, the invocation of the FBH doctrine might mask a judicial effort to gain greater control over these cases. In this Part, we describe these two possible explanations for the development of the FBH doctrine.

A. The Debiasing Hypothesis

The development of the FBH doctrine might represent a clever judicial adaptation to the cognitive limitations of human judgment. Judicial concern with judging in hindsight is well founded. Psychologists who study human judgment and choice have found that people overstate the predictability of outcomes—a phenomenon that psychologists refer to as the hindsight bias.[19] Psychologist Baruch Fischhoff describes the bias as follows:

> In hindsight, people consistently exaggerate what could have been anticipated in foresight. They not only tend to view what has happened as having been inevitable but also view it as having appeared "relatively inevitable" before it happened. People believe that others should have been able to anticipate events much better than was actually the case.[20]

Hindsight bias is a well-understood and extensively documented bias in human judgment.[21] It occurs because people integrate their knowledge of the outcome into a coherent set of beliefs.[22] When people learn how events unfold, they learn more than just the outcome. Outcome knowledge also teaches people something about why that outcome occurred. People naturally make secondary inferences about the causal events leading up to the outcome. Even if people could suppress their knowledge of the outcome,

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[18] *See* Jeffrey J. Rachlinski, *Heuristics and Biases in the Courts: Ignorance or Adaptation?*, 79 OR. L. REV. 61, 70–73 (2000) (arguing that courts adapt to cognitive errors in judgment).

[19] *See* Hawkins & Hastie, *supra* note 12, at 311.

[20] Baruch Fischhoff, *For Those Condemned To Study the Past: Heuristics and Biases in Hindsight*, *in* JUDGMENT UNDER UNCERTAINTY: HEURISTICS AND BIASES 335, 341 (Daniel Kahneman et al. eds., 1982).

[21] *See* Hawkins & Hastie, *supra* note 12, at 314 (identifying a "substantial record" of hindsight bias studies, making it a "well-established" finding).

[22] *See id.* at 320–23 (describing explanations for the hindsight bias); Rachlinski, *supra* note 3, at 584–86 (recounting cognitive explanations for the hindsight bias).

they cannot suppress their newfound understanding of the ancillary circumstances surrounding that outcome.[23]

For example, suppose that a software company was attempting to develop a new version of a popular word processing program that incorporated voice recognition software. Further suppose that the company predicted that the product could be produced in six months. It might have made this prediction based on the estimates of its software managers, with some allowance for the estimated difficulty of the project and time needed to debug the program. When people learn that the company failed to complete the project within six months, they are apt to make several inferences about the nature of the project. From the failure to meet the deadline, people might (reasonably) infer that voice recognition is a trickier concept than it might seem. When asked whether the company's managers knew that the deadline was unattainable, people will tend to rely on this secondary inference about voice recognition, which the company managers themselves would not necessarily have known beforehand. This reliance on inferences made from knowing the outcome will lead people to overstate the predictability of the outcome.

The hindsight bias causes little real harm in everyday life. Few judgments require ignoring known outcomes. It is much more important to incorporate new knowledge and experience to make predictions about the future than to re-predict the past. Indeed, the hindsight bias might be a product of the importance of learning quickly and easily from experience.[24] Automatically updating beliefs in light of new information is a valuable cognitive skill in most situations. The mind so efficiently incorporates new information into its view of the world, however, that it cannot disregard new information and the inferences that new information inspire.

Re-predicting the past, however, is a ubiquitous task in the courtroom.[25] The law is filled with requirements that courts determine what people should have known, could have foreseen, and actually knew, all of which are made in the full light of what is now known to all. Everything from determining whether a defendant was negligent or determining whether a manager's decision was so erroneous so as to constitute waste, to identifying whether an invention was non-obvious, involve recreating an ex ante judgment in the light of ex post knowledge. The cognitive processes

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[23] *See* Hawkins & Hastie, *supra* note 12, at 314–16.

[24] *See* Stephen J. Hoch & George F. Loewenstein, *Outcome Feedback: Hindsight and Information*, 15 J. EXPERIMENTAL PSYCHOL.: LEARNING, MEMORY, AND COGNITION, 605, 606–09 (1997) (describing the value of relying on outcome information); Ulrich Hoffrage & Ralph Hertwig, *Hindsight Bias: A Price Worth Paying for Fast and Frugal Memory*, *in* SIMPLE HEURISTICS THAT MAKE US SMART 191, 191–92 (Gerd Gigerenzer et al. eds., 1999) (arguing that the hindsight bias is the product of useful cognitive processes).

[25] *See* Rachlinski, *supra* note 3, at 602–24 (identifying a wide range of legal judgments as potentially affected by the hindsight bias).

that serve people well in most contexts might lead them astray in making these unfamiliar legal judgments.

Courts have developed multiple adaptations designed to compensate for the hindsight bias.[26] In tort law, courts look for ex ante assessments of what constitutes reasonable conduct, such as custom, rather than relying on ex post judgments.[27] Courts also suppress the introduction of evidence that might exacerbate the hindsight bias, such as subsequent remedial measures taken by a tort defendant.[28] When determining the liability of corporate officers for mistaken decisions, courts refuse to hold defendants liable for negligent decisions because judging in hindsight is too prone to error.[29] Although the courts have failed to recognize the influence of the hindsight bias in some areas of law, our inquiry suggests that the bias is intuitive and robust enough that the courts have largely adapted to its influence as best they can.[30]

Courts' adaptations to the hindsight bias have been subtle. They have not settled for the usual judicial remedy for a possible misuse of evidence—admonition against certain inferences.[31] In many circumstances, courts attempt to reduce unwanted uses of evidence and unjustified inferences by instructing the decision-maker to ignore evidence.[32] In the case of the hindsight bias, however, the psychological research indicates that mere awareness of the bias does not reduce its influence on judgment.[33] Consequently, admonitions and instructions would be of no value. In keeping with these findings, courts typically do not rely on warnings against making inferences in hindsight. Courts, therefore, appear to be adapting well to the problem of hindsight bias.[34]

On its face, the FBH doctrine appears to be another judicial adaptation designed to reduce the biasing effects of judging corporate misconduct in hindsight. The doctrine explicitly invokes the term "hindsight." In their

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[26] *See id.* at 623–24 (summarizing adaptations to the influence of hindsight bias).

[27] *See id.* at 608–13 (describing defenses based on compliance with ex ante norms as an adaptation to the hindsight bias).

[28] *See id.* at 617–18 (describing the suppression of subsequent remedial measures as an adaptation to the hindsight bias); *see also* Flaminio v. Honda Motor Co., 733 F.2d 463, 471 (7th Cir. 1984) ("It is only because juries are believed to overreact to evidence of subsequent remedial measures that the admissibility of such evidence could deter defendants from taking such measures.").

[29] *See* Rachlinski, *supra* note 3, at 619–23; Lynn A. Stout, *In Praise of Procedure: An Economic and Behavioral Defense of* Smith v. Van Gorkom *and the Business Judgment Rule*, 96 NW. U. L. REV. 675, 681 (2002) (discussing the problem of hindsight in the liability of corporate officers).

[30] *See* Rachlinski, *supra* note 18, at 64–65 (noting that courts sometimes fail to notice the effects of the hindsight bias).

[31] *See* Rachlinski, *supra* note 3, at 602–05.

[32] *See id.* at 602 ("Judicial instructions . . . are [among the] usual quality-control mechanisms for judgment in the courtroom.").

[33] *See id.* at 586–88 (reviewing interventions designed to mitigate the hindsight bias).

[34] *See id.* at 602–05 (asserting that courts do not rely on admonitions as a means of correcting the hindsight bias).

opinions, judges explain that the FBH doctrine is a palliative for the influence of "20/20 hindsight," "second guessing," "Monday Morning Quarterbacking," "clairvoyance," confusing "ex ante" with "ex post," and decision-making using "crystal balls."[35] Furthermore, when invoking the doctrine, judges insist that plaintiffs do more than cite bad outcomes as evidence of fraud, insisting that plaintiffs produce evidence "contemporaneous" to the alleged fraud.[36] Judges assert that a company's announcement of bad results, by itself, does not mean that a prior optimistic statement was fraudulent.[37] This seems to be an effort to divert attention away from the bad outcome and toward the circumstances that gave rise to that outcome, which is exactly the problem the hindsight bias raises. That is, if people overweigh the fact of a bad outcome in hindsight, then the cure is to reconstruct the situation as people saw it beforehand. Thus, the development of the FBH doctrine suggests a judicial understanding of the biasing effects of judging in hindsight and of a means to address the problem.

To restate, the debiasing hypothesis supposes that judges have developed the FBH doctrine as an attempt to insulate judgments from the hindsight bias. To reduce the adverse effects of the biases, judges must recognize limitations on the ability to make accurate judgments in court. The debiasing hypothesis suggests that judges have both recognized this limitation and devised a means to correct for it.

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[35] *See, e.g.*, *In re* Ikon Office Solutions, Inc., 277 F.3d 658, 673 (3d Cir. 2002) ("[T]o give rise to section 10(b) liability for fraud, the mere second-guessing of calculations will not suffice . . . ."); *id.* (citing Denny v. Barber, 576 F.2d 465, 470 (2d Cir. 1978), for the proposition that there is no FBH "because the law does not require clairvoyance"); *In re* Burlington Coat Factory Sec. Reg., 114 F.3d 1410, 1429 n.16 (3d Cir. 1997) ("Securities laws approach matters from an ex ante perspective. The fact that we see in hindsight that earnings per share did in fact turn out to be roughly within the range they were projected does not tell us conclusively that the forecasts were reasonable *at the time they were made*." (citation omitted)); Stranksy v. Cummins Engine Co., 51 F.3d 1329, 1332 (7th Cir. 1995) ("[T]he securities laws typically do not act as a Monday Morning Quarterback. 'The securities laws approach matters from an ex ante perspective: just as a statement true when made does not become fraudulent because things unexpectedly go wrong, so a statement materially false when made does not become acceptable because it happens to come true.'" (citing Pommer v. Medtest Corp., 961 F.2d 620, 623 (7th Cir. 1992)); Feasby v. Industri-Matematik Int'l Corp., No. 99 Civ 8761, 2000 WL 977673, at *4 (S.D.N.Y. July 17, 2000) ("Plaintiffs cannot prevail [on a 10b-5 fraud claim] by using crystal balls or 20/20 hindsight . . . ."); Borow v. nView Corp., 829 F. Supp. 828, 833 n.7 (E.D. Va. 1993) ("[P]laintiffs have failed to allege that materially misleading statements were made. Instead, they have relied on 20/20 hindsight to insinuate that later shortcomings amounted to earlier fraud."); *In re* Donald J. Trump Sec. Litig., 793 F. Supp 543, 556–57 (D.N.J. 1992) ("We are wary, too, of the dangers raised by claims of 'fraud by hindsight.' Monday morning quarterbacking cannot present actionable securities fraud claims . . . .").

[36] *See, e.g.*, Polk v. Fritz, No. C96-2712, 1998 U.S. Dist. LEXIS 23063, at *3 (N.D. Cal. Mar. 5, 1998). The court explained:

> [P]laintiffs cannot plead "fraud by hindsight," in which later events are used to support the falsity of earlier statements. Instead, a plaintiff must set forth not only why a given statement was false or misleading, but why it was false or misleading when made. This is done most directly by citing inconsistent contemporaneous statements or internal information available to defendants.

Id. (citations omitted).

[37] *See, e.g.*, Berliner v. Lotus Dev. Corp., 783 F. Supp. 708, 710 (D. Mass. 1992).

B. The Case Management Hypothesis

Despite appearances, it might be unrealistic to suppose that judges have developed this clever adaptation to resolve a psychological phenomenon. Instead, the references to hindsight might be little more than a pretext for legitimizing greater judicial control over securities fraud cases filed in federal court. The FBH doctrine might not really be a well-developed adaptation, but might serve merely as a judging "heuristic" or "shortcut" that allows judges to sort what they perceive to be plausible and frivolous cases early in the litigation process.[38]

As with the debiasing hypothesis, a number of factors support the case management hypothesis. Judges routinely express concern that securities class actions are often lawyer-driven suits brought in the hope of settling for their nuisance value.[39] Judges are not alone in expressing this concern; academics have complained that these suits settle without regard to merit and do little to deter real fraud, operating instead as a needless tax on capital raising.[40] Federal judges, faced with overwhelming caseloads, must allocate

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[38] For a set of contrasting perspectives on the use of heuristics or shortcuts by judges in the securities-fraud area, see Bainbridge & Gulati, *supra* note 13; Donald C. Langevoort, *Are Judges Motivated To Create "Good" Securities Fraud Doctrine?*, 51 EMORY L.J. 309 (2002); Hillary A. Sale, *Judging Heuristics*, 35 U.C. DAVIS L. REV. 903 (2002).

[39] For examples of cases in which the judges discuss the problem of strike suits in conjunction with FBH, see *Katz v. Household International, Inc.*, 897 F. Supp. 1106, 1110 (N.D. Ill. 1995), and *In re Copley Pharmaceutical., Inc.*, No. 94-11897, 1995 WL 169215, at *5 (D. Mass. Mar. 16, 1995).

[40] In the pre-Enron era, this was a question of significant academic debate. *See, e.g.*, Janet Cooper Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 STAN. L. REV. 497, 570–77 (1991); James Bohn & Stephen Choi, *Fraud in the New-Issues Market: Empirical Evidence on Securities Class Actions*, 144 U. PA. L. REV. 903, 918–23 (1996); Joseph A. Grundfest, *Disimplying Private Rights of Action Under the Federal Securities Laws: The Commission's Authority*, 107 HARV. L. REV. 963 (1994); Hillary A. Sale, *Heightened Pleading and Discovery Stays: An Analysis of the Effect of the PSLRA's Internal-Information Standard on '33 and '34 Act Claims*, 76 WASH. U. L.Q. 537, 552–55 (1998); Joel Seligman, *The Merits Do Matter: A Comment on Professor Grundfest's* "Disimplying Private Rights of Action Under the Federal Securities Laws: The Commission's Authority", 108 HARV. L. REV. 438 (1994); James Hamilton, *The Private Securities Litigation Reform Act of 1995*, 932 PLI/CORP. 475 (1996). The popular press echoed the concern about excessive suits. *See, e.g.*, Cindy Krischer Goodman, *Shareholders Find Benefits, Limits To Suing Firms When Stock Price Plummets*, MIAMI HERALD, Jan. 3, 2000, at 2 (describing the recent increase in the number of shareholder lawsuits filed); Cindy Krischer Goodman, *Lawyer King of Stock Fraud Suits: When Prices Take Dramatic Fall, Shareholders Call Melvin Weiss*, HOUS. CHRON., Jan. 9, 2000, at 2 (noting that "[w]hen a company's stock drops precipitously, [shareholders' attorneys] often file a lawsuit within days, sometimes hours"); Kelly Greene & Carrick Mollenkamp, *MedPartners Settles Suits By Investors*, WALL ST. J., July 28, 1999, at F1 (observing that the number of shareholder securities lawsuits in the Southeast is "skyrocketing"). These concerns resonated with Congress as well. *See, e.g.*, S. REP. NO. 104-98, at 9 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 688; 141 CONG. REC. H15215 (daily ed. Dec. 20, 1995) (statement of Rep. Bliley) (likening "strike suits" to extortion); 141 CONG. REC. H15216 (daily ed. Dec. 20, 1995) (statement of Rep. Fields) (recognizing that many shareholders file lawsuits "only because the market price on the securities has dropped"). Ultimately, these beliefs appear to have motivated Congress to reform the securities laws in 1995. *See* Elliott J. Weiss, *Pleading Securities Fraud*, 64 LAW & CONTEMP. PROBS. 5 (2001) (describing congressional goals in enacting the PSLRA).

their limited resources.[41] Securities lawsuits that are often complex, lengthy, and perceived to be extortionate are unlikely to be a high priority. Judges might thus embrace any doctrine that allows them to dispose of these cases quickly.

Additionally, the debiasing hypothesis arguably gives judges too much credit. Although other areas of law seem to have developed adaptations to the hindsight bias,[42] the best adaptations tend to be found in common-law cases. These developments may have taken generations of judicial opinions and thousands of cases of judges building on past mistakes. Claims brought under the federal securities laws are, relative to the common law, a novel development. Judges have only had a couple of decades of experience with them. Judges have thus had little chance to learn from experience and perhaps little opportunity to recognize the bias, to say nothing of developing adaptations.[43]

Other aspects of federal securities cases make it difficult for judges to create sensible doctrine. First, it is probably safe to assume that few federal judges have a background in psychology. Even though the existence of the hindsight bias is intuitive, the cognitive processes that produce the bias are complex. Thus, efforts to ameliorate the influence of the bias can be elusive. Second, the voluminous records (even at the preliminary motion stages) that securities cases frequently create can overwhelm judges. Because of the high stakes in these cases, they tend to be argued by lawyers who devote enormous attention to them, thereby creating even more paper for the judge to sort through. The intricacies these cases can create thereby leave the judge with little time to develop a careful response to any one as-

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[41] Numerous commentators have documented the dramatic increase in the volume of cases in the federal courts over the past few decades. *See, e.g.*, Jeffrey O. Cooper & Douglas A. Berman, *Passive Virtues and Casual Vices in the Federal Courts of Appeals*, 66 BROOK. L. REV. 685, 690–94 (2000); Martha J. Dragich, *Once a Century: Time for a Structural Overhaul of the Federal Courts*, 1996 WIS. L. REV. 11, 26; Robert M. Parker & Ron Chapman, Jr., *Accepting Reality: The Time for Adopting Discretionary Review in the Courts of Appeal Has Arrived*, 50 SMU L. REV. 573, 574–76 (1996); *see also* COMM'N ON STRUCTURAL ALTERNATIVES FOR THE FED. CTS., FINAL REPORT 14 & tbls.2–3 (providing numbers showing how the rise in numbers of judgeships has not kept pace with the rise in the number of filings).

[42] *See* Rachlinski, *supra* note 3, at 602–24 (describing adaptations to the hindsight bias in law).

[43] On the other hand, a proponent of the debiasing hypothesis might counter that, while securities-fraud class actions are a relatively recent phenomena, the key question here is the judgment of fraud using the benefit of hindsight. And that latter question has been around as long as there have been lawsuits for fraud, that is, centuries. Indeed, we have seen expressions of concern about hindsight bias in the common law securities disclosure cases from the 1930s that were the predecessors of the current federal actions. *See* Goodwin v. Agassiz, 186 N.E. 659, 661 (Mass. 1933) (giving, as a reason for not requiring disclosure of a speculative theory about the possible presence of copper on a certain piece of land, that "[d]isclosure of the theory, if it ultimately proved to be erroneous . . . might [lead to litigation]"). For an early federal securities case articulating such a concern (but not the FBH doctrine), see *SEC v. Texas Gulf Sulfur Co.*, 258 F. Supp. 262, 280 (S.D.N.Y 1966), which explains that "the test of materiality must necessarily be a conservative one, particularly since many actions under Section 10(b) are brought on the basis of hindsight".

pect of a securities case. Third, these cases frequently become cluttered with discovery disputes, motions for sanctions, and other ancillary disputes that further draw on the judge's resources. Even the most diligent judge can get lost in the procedural mire that a complex securities class action case can create.

With all this in mind, it is important to note that the Federal Rules of Civil Procedure discourage judging cases on their merits until after the conclusion of discovery.[44] The Rules' "notice pleading" system deliberately keeps the barriers to entry into the court system low.[45] Many scholars have argued that system makes it too easy for plaintiffs to bring securities cases into the courts.[46] As a general matter, notice pleading is on the defensive in many areas as concern with frivolous litigation spreads.[47] Doctrines that allow judges to sort and manage cases before discovery have begun to arise with increasing frequency in many areas of law.[48]

These concerns have led courts and Congress to raise the pleading standards in securities fraud cases. Judges in a number of circuits (most notably, the Second, which has traditionally been the leader in making securities law doctrine) began to require not only that the elements of a fraud claim be pled with particularity as required by Federal Rule of Civil Procedure Rule 9(b), but also that plaintiffs allege facts that produce a strong inference of scienter.[49] Scienter is the state of mind required for such a fraud claim and is satisfied if the misconduct is "knowing or intentional."[50] Heightening the barriers on the pleading of state of mind went against Rule 9(b)'s admonition that state of mind could be pled generally, the assumption being that facts going to the defendant's state of mind would be unlikely to emerge until after discovery.[51] On that basis, the Ninth Circuit refused to follow the lead of the Second.[52] In 1995, however, through the passage of the Private Securities Litigation Reform Act of 1995 (the "PSLRA"), Congress explicitly ratified the Second Circuit's approach.[53] In

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[44] *See* Resnik, *supra* note 15, at 383–85 (documenting the structure of the system of civil litigation in the federal courts).

[45] *See* RICHARD H. FIELD ET AL., CIVIL PROCEDURE: MATERIALS FOR A BASIC COURSE 1078–80 (8th ed. 2003) (describing the system of notice pleading in the federal courts).

[46] *See generally* Alexander, *supra* note 40; Grundfest, *supra* note 40.

[47] *See* Christopher M. Fairman, *Heightened Pleading*, 81 TEX. L. REV. 551 (2002) (arguing that notice pleading generally is in a state of decline).

[48] *See* Resnik, *supra* note 15, at 378–80 (documenting the growing trend toward active case management among judges).

[49] This evolution is described in Joseph A. Grundfest & A.C. Pritchard, *Statutes with Multiple Personality Disorders: The Value of Ambiguity in Statutory Design and Interpretation*, 54 STAN. L. REV. 627, 652 (2002).

[50] Ernst & Ernst v. Hochfelder, 425 U.S. 185, 197 (1976).

[51] FED. R. CIV. P. 9(b).

[52] *In re* Glenfed, Inc. Sec. Litig., 42 F.3d 1541, 1545 (9th Cir. 1994) (en banc).

[53] *See* Grundfest & Pritchard, *supra* note 49, at 650–75 (describing the passage of the PSLRA and the cases that followed).

both contexts, the concern that plaintiffs often plead "fraud by hindsight" provided justification for raising barriers to entry into court.[54]

To restate, the case management hypothesis supposes that judges have developed the FBH doctrine as an attempt to gain control over securities fraud cases.[55] The reference to the biasing effects of hindsight might thus provide only the ostensible justification for departing from the open notice pleading system laid down in the Federal Rules of Civil Procedure. Rather than as a careful effort to control bias, judges are using the real influence of the hindsight bias as a pretext for judging cases on the merits early in the litigation process.

II. DISTINGUISHING BETWEEN THE TWO ACCOUNTS

The debiasing and case management accounts of the FBH doctrine will produce different patterns of case law. Both hypotheses predict that courts will cite the doctrine when dismissing cases, but the two accounts will produce subtle differences that distinguish which of the two hypotheses best describes courts' behavior. Specifically, the two theories predict differences: in what stage of the proceedings the FBH doctrine will apply; to what elements of securities fraud the FBH doctrine will apply; what the appropriate remedy for the influence of hindsight will be; whether the doctrine will apply to "reverse hindsight"; and how the FBH doctrine will develop.

A. *When Does the FBH Doctrine Apply?*

Judicial interventions to remedy the hindsight bias can occur at several stages of the litigation process. Courts can actively scrutinize the pleadings for cases that look like they might be founded on hindsight, grant summary judgment more willingly for defendants, adopt rules of evidence designed to reduce the influence of the hindsight bias, develop heightened standards of proof to ameliorate the effect of the bias, or be open to the possibility that a jury verdict was the product of hindsight and hence be more willing to grant judgment as a matter of law. As discussed below, as a lawsuit proceeds, the influence of the hindsight bias becomes more pronounced. Hence, if the FBH doctrine represents an effort to guard against the hindsight bias, it will become more of a factor as a case proceeds. In contrast, if the FBH doctrine reflects only an active effort to screen cases at an early stage, then it will be more of a factor early in the process.

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[54] *See infra* Part VI.

[55] Although we term this thesis the "case management hypothesis" (in contrast to the "debiasing" hypothesis), we recognize that "case management" has many meanings. Judges can manage cases in a wide variety of ways, only one of which is to dispose of a case at an early stage of the proceedings. The "early adjudication" hypothesis might thus be a more accurate description of this theory than the "case management" hypothesis. Because the early adjudication arises from an effort to manage securities cases effectively, however, we retain the term "case management."

Even though knowledge of an outcome is misleading, an outcome can be a useful guide in determining the predictability of past events under some circumstances.[56] Intuitively, knowing that the outcome differed from a company's forecast suggests that the decision-making process was faulty or that the company's managers were engaged in intentional misconduct. Logic supports this intuition. If poor predictions and misconduct are more likely to produce a failed forecast than good predictions and honest conduct, then the fact of the bad outcome, by itself, supports an inference that the conduct was unreasonable.

The relevance of the outcome to an assessment of fraud depends upon whether the managers have some ability to make accurate forecasts. When the managers have some ability to predict the outcome, their forecasts should tend to be accurate and fraud becomes a plausible explanation for an inaccurate prediction. Under these circumstances, a judge operating in hindsight *should* rely on the outcome as an indicator of fraud. To be sure, evidence of a failed forecast does not necessarily mean that fraud was more likely than not; this conclusion would depend upon the rate at which fraud can be expected to occur and on the predictive ability of the managers. Also, the psychological literature suggests that even when the outcome is relevant to the sensibility of the process, people attach too much weight to the outcome, a phenomenon known as the "outcome bias."[57] Consequently, judges might overstate the relevance of the outcome to the determination of fraud. So long as the managers can make forecasts with some degree of accuracy, however, the accuracy of their forecasts alone is relevant to the likelihood that the inaccurate forecast was the result of fraud.

This analysis does not mean that the hindsight bias is not a bias. Judges commonly have much more information available than just the accuracy of the managers' forecasts. In a lawsuit, the adversarial system will likely ensure that the judge has at least as much information available as the managers did before making their predictions. In fact, because the dispute in the lawsuit is more focused than the diffuse predictions of the managers, and the stakes are larger and more well-defined than they were ex ante, the judges may have an even greater ability to make accurate forecasts than the managers did, even though they lack the managers' expertise.[58] The infor-

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[56] *See* Jonathan Baron & John C. Hershey, *Outcome Bias in Decision Evaluation*, 54 J. PERSONALITY & SOC. PSYCHOL. 569, 570 (1988) (describing the relevance of outcome in evaluating decision quality).

[57] Psychologists refer to an excessive reliance on the outcome as the "outcome bias." *See id.* at 569–71.

[58] The general point is that it may be less important to avoid errors (and allow evidence of ambiguous value) at early stages of the litigation if there are later stages at which errors will likely be corrected. But this general point can get flipped around when one adds other considerations, such as the cost of each additional stage. For economic analyses of the value of accuracy at different points in the litigation process, see Louis Kaplow, *The Value of Accuracy in Adjudication: An Economic Analysis*, 23 J. LEGAL STUD. 307 (1994), and Steven Shavell, *The Appeals Process as a Means of Error Correction*, 24 J. LEGAL STUD. 379 (1995). We are indebted to Steven Shavell for helping us work through this point.

mation available to the judges will reduce, or even eliminate, the value of knowing the outcome in assessing fraud.

As applied to the use of FBH, this analysis shows that courts should use the doctrine only sparingly at the pleadings stage of proceedings. Citing the influence of hindsight in support of a dismissal at the pleadings stage of a securities suit, in fact, has a somewhat different meaning than dismissing a case at the summary judgment stage. Because most securities cases involve an allegation of fraud,[59] they must comport with the requirements of Federal Rule of Civil Procedure 9(b), which requires that allegations of fraud be "stated with particularity."[60] Unlike most suits, pleadings that must comply with Rule 9(b) must identify details supporting their theory of recovery. This requirement allows courts to assess whether the details plead support the allegations. However, at this stage, a court must be cautious. The case has not yet developed. In cutting off the case on the pleadings by citing hindsight, the court is essentially making a prediction that the discovery process will yield only evidence that requires the benefit of the hindsight bias to seem adequate. At the summary judgment stage, by contrast, the court actually has much of the evidence that was available to the corporate managers and hence is in a position to ascertain the extent to which their judgment is being influenced by hindsight. It is simply not accurate to say that there is no fraud by hindsight at the pleadings stage; at this stage, the allegation that a forecast has turned out to be inaccurate provides at least some affirmative evidence that fraud might have occurred.

Even the prevalence of an outcome bias does not undermine this conclusion. If judges are affected by the outcome bias at the pleadings stage, then they will tend to see fraud where there was none, which is unfortunate. Under a notice pleading system, however, judges are not supposed to assess the merits of the case at the pleadings stage. Thus, even if the outcome bias leads them to draw erroneous conclusions about the merits of the case, these conclusions will not adversely affect the outcome of the case. Only during dispositive proceedings, such as during a summary judgment motion or judgment at trial, will the outcome and hindsight biases threaten to lead courts to mistakenly label innocent conduct as fraud.

As a lawsuit proceeds to summary judgment or trial, however, the situation changes. The court begins to learn the underlying facts that supported the forecast. Although judges are not business experts, they may have a greater ability to forecast because the litigants will have focused their energy on the specific forecast or forecasts that are the subject of the

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[59] Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j (2000), is a general anti-fraud provision. Most securities class actions are brought under section 10(b). When there is a public offering, however, those who purchased in that offering, and satisfy the other conditions of that provision, can bring a claim under section 11 of the 1933 Securities Act, *id.* § 77k, without needing to allege fraud.

[60] FED. R. CIV. P. 9(b).

lawsuit. At summary judgment, and more so at trial, the outcome fades in importance relative to the pleadings stage. Even if the judges do not have quite as much ability to predict the outcome as the managers, they have more ability at the summary judgment stage than at the pleadings stage. Thus, at this stage, the hindsight bias becomes a greater concern.

To the extent that courts are attempting to debias securities litigation, they will largely refrain from applying the FBH doctrine at the pleadings stage, but will apply it at the summary judgment stage instead. By contrast, the case management hypothesis predicts that judges will cite the doctrine as early as possible in an effort to police their dockets.

B. To Which Aspect of Securities Fraud Does the FBH Doctrine Apply: Materiality Versus Scienter?

The hindsight bias implicates two distinct elements in securities fraud claims: scienter and materiality.[61] Scienter refers to the state of mind the defendant must possess for there to be a valid fraud claim under the federal securities laws.[62] The implication of the hindsight bias to determinations of scienter is straightforward. A manager's knowledge of a violation or a high degree of recklessness in allowing the violation will suffice to satisfy the scienter requirement.[63] The hindsight bias is implicated to the extent that one is using evidence of an outcome (usually, a bad one) to assess whether the manager knew of it ahead of time or was reckless in not knowing. As noted, the bias makes unpredictable events seem predictable. Thus, hindsight might not only facilitate an inference that managers should have predicted an adverse event, but also that they did predict it.

A material event is one that a reasonable investor would consider important.[64] Here, given the occurrence of some bad event, the judge has to assess whether a prior warning sign should have been recognized (and disclosed). The hindsight problem arises because, once the bad event has occurred, the judge will be biased toward finding that the warning should have been disclosed. Courts refer to the information regarding such warnings as contingent.[65] Examples include the following: early reports about problems that customers are having with a new product; preliminary indications that a lawsuit might not be going well; financial results for an early portion of a quarter that are lower than those at the same point in time in prior quarters;

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[61] To state a securities-fraud claim, the plaintiff must allege "that in connection with the purchase or sale of securities, the defendant, acting with scienter, made a false material representation or omitted to disclose material information and that plaintiff's reliance on defendant's conduct caused [plaintiff] injury." Caiola v. Citibank, N.A., 295 F.3d 312, 321 (2d Cir. 2002) (citation omitted).

[62] On the definition of scienter, see JAMES D. COX ET AL., SECURITIES REGULATION: CASES AND MATERIALS 730–34 (3d ed. 2001).

[63] *See id.*

[64] On the relationship between the reasonable investor and the market, see *In re* Sprint Corp. Sec. Litig., 232 F. Supp. 2d 1193, 1217 (D. Kan. 2002).

[65] *See* COX ET AL., *supra* note 62, at 44–52.

or preliminary discussions about a possible merger or takeover.[66] These events themselves are not material except that they might warn of the possibility of some later bad event. When managers fail to disclose contingent information, and the contingent event occurs, the hindsight bias will make the contingent information seem more like an early warning of real problems to follow than was actually the case.

Although both scienter and materiality determinations present potential hindsight bias problems, they have differences.[67] First, the implication of the bias for scienter is less direct than for contingent materiality. For the bias to affect determinations of scienter, not only must the bias affect the probability assessments of the judge, it must also lead the judge to make an inference about the mental state of corporate managers.[68] A conclusion that managers should have been able to predict the adverse event does not support scienter; they must have actually made the prediction or at least recklessly failed to make the prediction.[69] In ex ante probability terms, this means that the judge has to determine that the bad event was *so* likely to occur at the time that the company made an optimistic forecast that making the optimistic forecast amounted to something like deliberate indifference. With the exception of a single study, all of the research on the hindsight bias in legal contexts is limited to inferences of what people should have known, not what they actually knew.[70] This is not to say that the hindsight bias cannot influence judgments of scienter.[71] Rather, the point is that the

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[66] *See id.* (discussing cases).

[67] For extensive discussions of scienter and materiality, see *id.* at 40–41 and 730–34.

[68] *See* Mark Kelman et al., *Decomposing Hindsight Bias*, 16 J. RISK & UNCERTAINTY 251 (1998) (arguing that, under such circumstances, the bias has more of an indirect affect on judgment).

[69] *See* COX ET AL., *supra* note 62, at 730–34.

[70] *See* Rachlinski, *supra* note 3, at 592 (reviewing the effect of the hindsight bias on judgments of subjective beliefs). The exception is Reid Hastie & W. Kip Viscusi, *What Juries Can't Do Well: The Jury's Performance as a Risk Manager*, 40 ARIZ. L. REV. 901 (1998). This study has received severe criticism. *See* Richard Lempert, *Juries, Hindsight, and Punitive Damage Awards: Failures of a Social Science Case for Change*, 48 DEPAUL L. REV. 867 (1999).

[71] As one of us wrote in a recent article:

> The nature of the hindsight bias suggests that the bias will result in judges and juries finding defendants reckless (and liable for punitive damages) when they were not actually reckless. The data on judging in hindsight clearly indicates that past events seem more predictable than they actually were. Nevertheless, it requires an extra logical inference from this overestimate to support the conclusion that defendants were, in fact, reckless. Judges and juries must also assume that because past events were so predictable, the defendant actually did predict them. In other words, the judge or jury must convert an objective conclusion (the event was predictable) into a subjective one (the defendant did predict the unwanted outcome).
>
> The evidence that the hindsight bias has this effect, however, is scant. Virtually all of the data on the hindsight bias speak only to the objective judgment. One recent study, however, shows that the hindsight bias leads people to conclude that others acted recklessly when they did not. Professors Reid Hastie and Kip Viscusi created a set of stimulus materials to directly test whether the hindsight bias makes defendants appear more reckless than they actually were. To test this theory, Hastie and Viscusi had one set of subjects review a set of trial-type materials to determine whether an administrative agency was reckless for failing to close a dangerous section of railway track. Another set of subjects assessed whether a railroad company that had a train wreck on this same

effect of the bias on the judgments might be more attenuated than in inquiries under objective standards.[72]

In contrast, with materiality the question is simply whether the occurrence of the bad event biases the ex post evaluation of a prior warning.[73] The hindsight bias directly implicates this kind of judgment. After the material event occurs, the warning sign will come to seem like a clear harbinger of the adversity that followed. Numerous studies of the hindsight bias reveal that knowing the outcome makes the antecedents seem more significant than was actually the case.[74]

This distinction between scienter and materiality thus creates a testable prediction. If the FBH doctrine is an attempt to rid securities litigation of the hindsight bias, it should play a more important role in assessments of contingent materiality cases than assessments of scienter.[75] In contrast, if case management is the true goal of FBH, judges would prefer to attack claims of scienter. If a court finds that no reasonable inference of scienter can be made against an individual, the case against that individual ends be-

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> section of track was reckless. Even though most of the subjects in foresight determined that the agency was not reckless for keeping the track open, most of the subjects in hindsight found that the railroad was reckless for using it. Thus, the available evidence at least suggests that the hindsight bias does influence subjective assessments, such as whether a company was reckless.

Jeffrey J. Rachlinski, *Regulating in Foresight Versus Judging Liability in Hindsight*, 33 GA. L. REV. 813, 840–41 (1999) (citing Hastie & Viscusi, *supra* note 70) (other citations omitted).

[72] Also, subjective evaluations are inherently messy and there is reason to expect that other cognitive biases are likely to show up as well. One bias likely to show up is the fundamental attribution error. The fundamental attribution bias says that people overestimate their ability to predict how another will act based on their knowledge of that person's character and disposition, underestimating the influence of situational factors. *See* Donald C. Langevoort, *Taking Myths Seriously: An Essay for Lawyers*, 74 CHI.-KENT L. REV. 1569, 1573 (2000). Knowing the outcome evidence, in a sense, gives the judge some information about the person's character and may bias the judge in her determination (presumably against the defendant). Cutting against the possible anti-defendant effect is (in what is likely to be a significant manner) the general bias that judges appear to have, which is that the plaintiffs' lawyers are rascals bringing frivolous suits and that the corporate managers are just good guys trying to do their jobs. We have no direct evidence that a number of judges have a jaundiced view of the plaintiffs' lawyers bringing securities case. We make this statement based only on our anecdotal impressions from having read a number of securities cases and being struck by the frequency with which judges talk about the problem of strike suits in securities area. *See, e.g.*, *In re* Merrill Lynch & Co., Inc., 273 F. Supp. 2d 351, 366 n.28 (S.D.N.Y. 2003) (expressing the concern that, after any drop in price, plaintiffs' lawyers will, "with the benefit of hindsight," file strike suits that are wholly unrelated to the defendants' conduct).

[73] *See* COX ET AL., *supra* note 62, at 44–52.

[74] *See* Hawkins & Hastie, *supra* note 12, at 312–16 (reviewing studies).

[75] A critic could fault our predictions on the ground that we do not conclusively know that the hindsight bias is less of a problem in scienter determinations than in materiality ones. And the critic might even argue that when the research on scienter-type determinations is done, it might show that the hindsight bias is more of a problem in these cases (and that somehow judges have intuited this result through the process of repeated interactions with these cases). We think that unlikely, but it is possible. Even if one were to take this extreme position, one would still expect a significant number of materiality applications because the evidence is clear that the hindsight bias will affect the materiality determination. As discussed later, the data shows that almost none of the applications of FBH are to materiality determinations; they are all to scienter determinations.

cause the person lacked the intent to commit fraud. In contrast, the conclusion that a particular event was not material, even contingently material, only eliminates that particular event as the basis for the materiality prong. Plaintiffs will likely have identified numerous events that the corporate managers failed to disclose, alleging all are material. Eliminating the cause of action requires concluding that none of these events are material. Hence, from a case management standpoint, a doctrine that can undermine scienter is more useful than one that can undermine materiality.

As a practical matter, the objective/subjective distinction between materiality and scienter is artificial. Plaintiffs generally do not have direct evidence going to the defendant's subjective state of mind at the motion to dismiss stage. The question on scienter thus becomes whether the information in question was *so obviously important* to investors that the failure to disclose it constituted severe recklessness. That articulation of scienter is merely a heightened level of materiality: the information was so *obviously important*, which is scienter, as opposed to *important*, which is materiality. It will be easier to justify a dismissal on scienter grounds because the standard is higher. Thus, the case management hypothesis predicts that judges will focus on applying the FBH doctrine to scienter.

While finding a complaint wanting on either grounds is adequate grounds for dismissal, there is often a difference in the type of dismissal. Judges often give the defendants leave to replead on the scienter dismissals because it is harder to say that repleading would be futile.[76] The judge might still find the scienter ruling serves her purposes, however, because this dismissal does move the case off the docket.

C. Remedying the Hindsight Bias

The hindsight bias persists even when decision-makers are aware of it.[77] Remedying the bias, therefore, requires either limiting the types of decisions courts make or restricting the evidence that a decision-maker has available. Merely warning of the bias's effects does not reduce its influence. If the FBH doctrine represents an effort to make unbiased decisions, then courts will carefully tailor the doctrine to use remedies that are effective at eliminating the bias.

In other contexts, courts do not rely on mere awareness of the bias as a remedy. No set of case law supports giving admonitions against the dangers of judging in hindsight, but restrictions on the inference process are relatively common.[78] For example, in medical malpractice cases, doctors cannot be found liable for malpractice unless they failed to provide custom-

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[76] *See In re* Burlington Coat Factory Sec. Litig., 114 F.3d 1410, 1434–45 (3d Cir. 1997) ("Ordinarily where a complaint is dismissed on Rule 9(b) 'failure to plead with particularity' grounds alone, leave to amend is granted." (citations omitted)).

[77] *See* Rachlinski, *supra* note 3, at 586–88 (reviewing studies).

[78] *See id.* at 607–18 (describing adaptations to the hindsight bias).

ary medical care. Similarly, in cases involving the issue of whether an invention was obvious and therefore could not be patented, courts do not simply assess, in hindsight, whether an invention was obvious. Rather, they make an inquiry into factors concerning the invention that can be assessed more accurately in hindsight, such as whether the invention satisfied a long-felt and unresolved need.[79] These rules appear designed to correct for the hindsight bias by keeping judges and juries from inquiring into the quality of the decision and instead direct attention toward inquiries that can be made in an unbiased fashion. Courts also restrict certain information, such as the fact that a tort defendant undertook subsequent remedial measures after causing the injury, so as not to exacerbate the bias.[80]

To be sure, it is hard to see how courts could restrict access to outcome information in securities fraud cases. The courts inevitably confront the failure of the managers to make accurate forecasts. It is hard to imagine what a trial would look like if the mistaken forecast were not admissible; without the mistake, for the most part, there would be no damages and therefore no case. Courts face a similar problem in torts cases; the judge or jury inevitably knows that the defendant's level of care failed to protect the plaintiff from harm. Even though this knowledge might produce some hindsight bias, such an effect is unavoidable. The judge or juror knows that she is being asked to evaluate the level of care for a reason; it is not an "academic exercise."[81] Likewise, in securities fraud cases the judge or juror knows she is there because someone lost money on shares of the defendant's company.[82]

If the FBH doctrine is meant to protect against the hindsight bias, then it must consist of more than just an admonition against the dangers of judging in hindsight. It must alter the nature of the inquiry. Courts attempting to debias the system should try to structure the inquiry to assess whether the corporate managers behaved in a manner consistent with corporate managers who are not committing fraud. Courts could rely on ex ante standards, such as generally accepted accounting principles or other financial standards.[83]

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[79] *See id.* at 613–15.

[80] *See id.* at 617–18.

[81] David B. Wexler & Robert F. Schopp, *How and When To Correct for Juror Hindsight Bias in Mental Health Malpractice Litigation: Some Preliminary Observations*, 7 BEHAV. SCI. & L. 485, 494 (1989) ("[T]he jury will undoubtedly know that they are not being asked simply to engage in an academic exercise.").

[82] In theory, there could be SEC enforcement actions in cases in which there are no monetary losses for investors (that is, the forecast was erroneous when made, but turns out to be correct because of some unforeseen positive intervening event), but these do not occur often.

[83] As things stand now, there is no ready inventory of ex ante standards to draw from. And part of the reason for that is that courts have not asked litigants to produce evidence on these standards. One could imagine expert testimony on the point in a merger discussion at which analysts or brokers begin recommending that that stock be bought or sold or, if the market reaction is the relevant benchmark, expert testimony on the question of when the market generally considers merger talks relevant. At that point, the court could presume materiality. Or, in cases involving intra-quarterly disclosure issues, there

In contrast, the case management hypothesis predicts a different pattern of responses to the hindsight bias. If courts are merely using the excuse of hindsight to adjudicate cases as they see fit, then they will adopt a different approach. Efforts to compare the defendant's conduct to an ex ante standard, in reality, constrains the power of the decision-maker to exercise an independent judgment. Reliance on medical custom, for example, requires that courts refrain from substituting their own judgment for that of the medical profession. Thus, courts will not pursue such efforts if case management is their primary goal. Rather, they will identify hindsight as a problem that justifies active adjudication at an early stage of the proceeding. In effect, courts might adopt the "admonition" approach to addressing the hindsight bias as a means of increasing their control over the cases. Ironically, inasmuch as mere admonition does nothing to reduce the bias, this approach will give judges more discretion, but will not eliminate the influence of the bias on outcomes.

D. Reverse Hindsight

If judges are seeking to root the influence of the hindsight bias out of the system, they will attempt to protect against the bias wherever they find it. This should include situations in which the hindsight bias might benefit defendants in securities cases—which is the reverse of the usual tendency of the bias to benefit plaintiffs.[84] Once a bad event occurs, the evaluation of a warning that was given earlier will be biased. In terms of evaluating a decision-maker's failure to heed a warning, knowledge that the warned-of outcome occurred will increase the salience of the warning in the evaluator's mind and bias her in the direction of finding fault with the failure to heed the warning. In effect, the hindsight bias becomes an "I-told-you-so" bias.

Securities cases contain such an "I told you so" issue, formally referred to as "bespeaks caution."[85] Case law indicates that the materiality of forward-looking statements must be evaluated in light of warnings or caution-

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could be expert testimony on the question as to the point in an ongoing quarter at which preliminary results become interesting to analysts. For a discussion of a handful of instances where courts have attempted to look to external indications of the type discussed, see *infra* note 125.

[84] By reverse hindsight, we thus mean to refer to situations in which the bias benefits plaintiffs. We do not mean to refer to any reversal of the hindsight bias in which the outcome seems less predictable after it happens. A couple of researchers have claimed to have found such reversals, but these reversals have been debunked. *See* Rachlinski, *supra* note 3, at 580 n.31 (describing both the alleged reversals and the reasons the criticisms of these studies).

[85] For discussions of this doctrine, see Donald C. Langevoort, *Disclosures that "Bespeak Caution"*, 49 BUS. LAW. 481 (1994), and Jennifer O'Hare, *Good Faith and the Bespeaks Caution Doctrine: It's Not Just a State of Mind*, 58 U. PITT. L. REV. 619, 630 (1997). Among the problems with the bespeaks caution doctrine, one of us identified a hindsight bias problem in an article from some years ago: "Courts pass judgment . . . knowing that this particular reliance was indeed unwise. In hindsight, it is easy to find fault with reliance on self-interested others." Langevoort, *supra*, at 494.

ary statements made by the defendants prior to the release of the bad news.[86] That is, defendants commonly include warnings or cautionary notes with their forecasts and predictions that suggest that the company's future might not be so rosy. Once a bad outcome occurs, these warnings will seem more important than they seemed when they were made. This tendency is similar to that of contingent information that was not disclosed; in foresight, managers might reasonably believe that the contingency was too unlikely to merit disclosure, whereas in hindsight it seems obvious a reasonable investor would have wanted to know it. Likewise, as to warnings a company actually made, in foresight most investors might reasonably ignore them, whereas in hindsight they seem profoundly important. If defendants are allowed to defend themselves by arguing that a reasonable investor would have attended closely to these warnings, then the hindsight bias might benefit defendants.

If judges are engaged in a serious effort to rid securities cases of the hindsight bias, then they will make efforts to account for the hindsight bias in assessments of whether cautionary language should justify dismissal of a securities fraud claim. Judges seeking to debias the system should be concerned about how these problems might adversely affect the plaintiff.

In contrast, the extensive use of the "bespeaks caution" doctrine and the failure to accommodate the concerns raised by the hindsight bias in application of this doctrine would support the case management hypothesis.[87] Adopting measures to guard against defendants' ability to take advantage of the hindsight bias would make it harder for judges to dismiss a case, thereby undermining judge's ability to decide cases as they see fit. Hence, if case management dominates judicial thinking in securities cases, then we should not expect to see the use of such measures in the application of the bespeaks caution doctrine.

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[86] *See, e.g.*, Stavroff v. Meyo, No. 95-4118, 1997 WL 720475, at *5 (6th Cir. Nov. 12, 1997) ("To determine whether statements fall under the bespeaks caution doctrine, we review the statements in context and examine the 'total mix' of information available to the reasonable investor." (citations omitted)).

[87] The following hypothetical should help illustrate how the doctrine applies: Company *X* is highly dependent on its CEO (for example, Martha Stewart's company). Three months ago, the company did a public offering of securities. In that context, the company put out the following statement: "We are optimistic that our CEO will lead us to produce consistent increases in revenues and stock prices over the next decade." A month ago, it was revealed that the CEO had suffered a massive coronary and had resigned her position. The company's stock price tanks and the disgruntled shareholders sue. They say the company misled them with its optimistic statement about increasing revenues over the next decade into believing that the CEO was healthy. The court, however, finds a cautionary statement in the prospectus (one of many) that says: "Our financial viability is highly dependent on the health of our CEO and we can make no guarantees as to her continued good health." Reasonable investors, the court says, would have read the company's optimistic statement in light of the warning about health risks and would have appropriately discounted it to the point of making it immaterial.

E. Evolutionary Path

Implicit in both the debiasing and case management theories is a sub-story about evolution of the doctrine. Doctrine evolves as judges learn from their experiences and those of their colleagues. Under the debiasing hypothesis, the doctrine should evolve toward a better application of the protection against the hindsight bias as judges learn from experience how to structure the proceedings to produce more accurate outcomes. Over time, judges should learn which reforms will facilitate their ability to sort fraud from mere mistake. Under the case management hypothesis, however, the doctrine should slowly expand to make it easier for judges to dispose of cases. If the FBH doctrine is merely a pretense for aggressively disposing of cases early in the process, then the doctrine should simply spread over time, without much refinement.

F. Summary of the Distinctions

The following table summarizes the predictions from the two stories.

TABLE 1: DISTINGUISHING DEBIASING FROM CASE MANAGEMENT

	PREDICTIONS: THE DEBIASING HYPOTHESIS	PREDICTIONS: THE CASE MANAGEMENT HYPOTHESIS
1. Stage of the litigation at which courts apply the FBH doctrine	Summary judgment or trial	Judgment on the pleadings
2. Elements of securities fraud to which courts apply the FBH doctrine	Materiality determinations of contingent information	Determinations of scienter
3. The form that the FBH doctrine takes	Efforts to find ex ante customs or standards	Admonitions against allowing the bias to affect judgment
4. Reverse hindsight	Courts will make efforts to remedy the adverse effects of the bias on plaintiffs	Courts will only attempt to remedy the doctrine so as to help defendants
5. Pattern of evolution of the FBH doctrine	Doctrine will evolve over time into a better correction for the problem of hindsight bias	Doctrine will evolve over time toward creating more discretion for judges

III. THE ORIGINS AND DEVELOPMENT OF THE FBH DOCTRINE

As a preliminary step toward testing the competing hypotheses, we identify the historical development of the doctrine. The originators of the FBH doctrine were Judges Henry Friendly and Frank Easterbrook. Judges Friendly and Easterbrook are among the most prominent business-law judges of the past century.[88] Their description of the FBH doctrine is therefore critical to understanding the doctrine.

A. *The Origin: Judge Friendly Utters the Magic Words*

The doctrine originates in 1978 with Judge Friendly's opinion in *Denny v. Barber*.[89] As with many of the early cases applying the FBH doctrine, *Denny* involved a bank and loans that turned out badly. As part of a securities fraud claim against the bank, plaintiffs alleged that the bank had engaged in unsound lending practices, maintained insufficient loan loss reserves, delayed writing off bad loans, and undertaken speculative investments. The fraud allegedly arose from the bank's failure to disclose these problems in reports issued in 1973 and early 1974, when it had instead issued an optimistic report on conditions. The plaintiffs alleged that the bank hid these problems until it issued a report discussing the problems in late 1974.[90] The defendants brought a motion to dismiss on the pleadings that the district court granted. Plaintiffs appealed the order and that brought the case before a Second Circuit panel that included Judge Friendly.

Judge Friendly ruled that merely identifying the disclosure in late 1974 was inadequate to show that the defendants had the requisite state of mind in 1973 and early 1974. He wrote:

> In sum, the complaint is an example of alleging fraud by hindsight. For the most part, plaintiff has simply seized upon disclosures made in later reports and alleged that they should have been made in earlier ones. While greater

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[88] Judge Easterbrook, along with his frequent coauthor, Professor Dan Fischel, has written a number of the most important articles in the corporate and securities law areas. For a collection, see FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW (1991). In addition, Judge Easterbrook is the author of a number of the most prominent securities cases such as *Weilgos v. Commonwealth Edison Co.*, *Pommer v. Medtest*, and *Jordan v. Duff & Phelps Inc.*—cases that find their way into a number of the leading casebooks in the area. *See, e.g.*, COX ET AL., *supra* note 62, at 54, 755 (including *Jordan* and *Weilgos*); WILLIAM A. KLEIN ET AL., BUSINESS ASSOCIATIONS 462, 660 (5th ed. 2003) (including *Pommer* and *Jordan*), MARC I. STEINBERG, SECURITIES REGULATION 757 (3d ed. 1998) (including *Weilgos*). For a measurement of judicial influence that shows Judge Easterbrook as outstripping his current colleagues on the appellate bench (with the exception of Judge Richard Posner), see Mitu Gulati & Veronica Sanchez, *Giants in a World of Pygmies? Testing the Superstar Hypothesis with Judicial Opinions in Casebooks*, 87 IOWA L. REV. 1141 (2002). On Judge Friendly and his influence on the development of securities law, see Margaret Sachs, *Judge Friendly and the Law of Securities Regulation: The Creation of a Judicial Reputation*, 50 SMU L. REV. 777 (1997).

[89] 576 F.2d 465 (2d Cir. 1978).

[90] *See id.* at 467.

> clairvoyance in 1973 might have led to a realization that [certain loans and investments were not wise] . . . failure to make such perceptions does not constitute fraud. Nowhere does the complaint allege with the required particularity transactions about which defendants in fact had such perceptions or were reckless in not having them when the 1973 and early 1974 reports were issued.[91]

Important to understanding this outcome is Judge Friendly's discussion of intervening events. Only a few sentences after using the term "fraud by hindsight," Judge Friendly explained that this was a case in which there were a number of intervening events, such as the dramatic increase in petroleum prices in the early 1970s and the City of New York's financial crisis.[92] These events were not specific to the bank, which clearly had no greater ability to predict them than the general public. Thus, Judge Friendly was probably not concerned with the hindsight bias per se. Instead, he was concerned with the plaintiffs' use of a general change in the business climate as a basis for a securities fraud claim.

Indeed, the facts of *Denny* make it an unlikely candidate for influence by the hindsight bias. As discussed, the bias works largely because learning the outcome leads people to make secondary inferences about the underlying facts. When events that cause the outcome have no connection to the antecedent events, observers learn nothing from the outcome that would lead them to view the antecedents any differently.[93] For example, in one study of the hindsight bias, when people were told that the outcome of a war was determined by a freak snowstorm, rather than to one of the innate advantages of one side or the other, they did not overstate their ability to have predicted the outcome.[94] In the case of *Denny*, learning that the bank suffered financial problems as a result of high oil prices and a potential municipal bankruptcy teaches people a lot about the American economy, but not so much about this particular bank or its lending practices. Despite Judge Friendly's reference to hindsight, the case is probably not one in which the hindsight bias would play much of a role.

Judge Friendly's phrase, "fraud by hindsight," attracted little attention over the next decade. The phrase appears only eighteen times in published opinions in securities cases over the next eleven years.[95] The courts that used Judge Friendly's language in that period largely remained faithful to the point he was making. That is, that hindsight alone *might not* constitute

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[91] *Id.* at 470.

[92] *Id.*

[93] *See* Hawkins & Hastie, *supra* note 12, at 313.

[94] David Wasserman et al., *Hindsight and Causality*, 17 PERSONALITY & SOC. PSYCHOL. BULL. 30 (1991).

[95] The phrase was not cited elsewhere in 1978 or in 1979. It appears once in 1980; not at all in 1981; twice in 1982; once in 1983; twice in 1984; twice in 1985; four times in 1986; once in 1987; not at all in 1988; and four times in 1989. The phrase then appears three times in 1990, including in *DiLeo v. Ernst & Young*, which we discuss in more detail *infra* Part III.B. These results were obtained with a Westlaw search of the ALLFEDS database.

a sufficient demonstration that the defendants made some predictive decision with knowledge of its falsity or something close to it. Unlike *Denny*, however, it does not appear that any of these cases had intervening events outside the control of the managers (or, even if there were such events, the judges did not flag them).

B. *The Doctrine Expands: Judge Easterbrook's Contribution*

Judge Easterbrook's use of the phrase "fraud by hindsight" in *DiLeo v. Ernst & Young*[96] in 1990 produced a much greater impact on securities law than *Denny*. Once Judge Easterbrook articulated the FBH doctrine in *DiLeo*, courts immediately began to recite it in securities cases with frequency, as Figure 1, below, demonstrates. Whereas the phrase was cited only about twice per year before *DiLeo*, this rose to an average of nearly twenty-seven times per year afterwards.[97] A portion of this increased usage of FBH can probably be explained by the roughly three-fold increase in the number of securities class actions that were filed. But the fact that the proportional increase in FBH usage was much larger (thirteen-fold as compared to three-fold) suggests that Judge Easterbrook's articulation may have had a strong independent effect on the increased usage.[98] More important though, as we explain later in this subpart, reading the cases reveals that it is Easterbrook's articulation of FBH that gets picked up by the subsequent cases rather than that of Friendly. Judge Friendly coined the phrase, but Judge Easterbrook gave it life.

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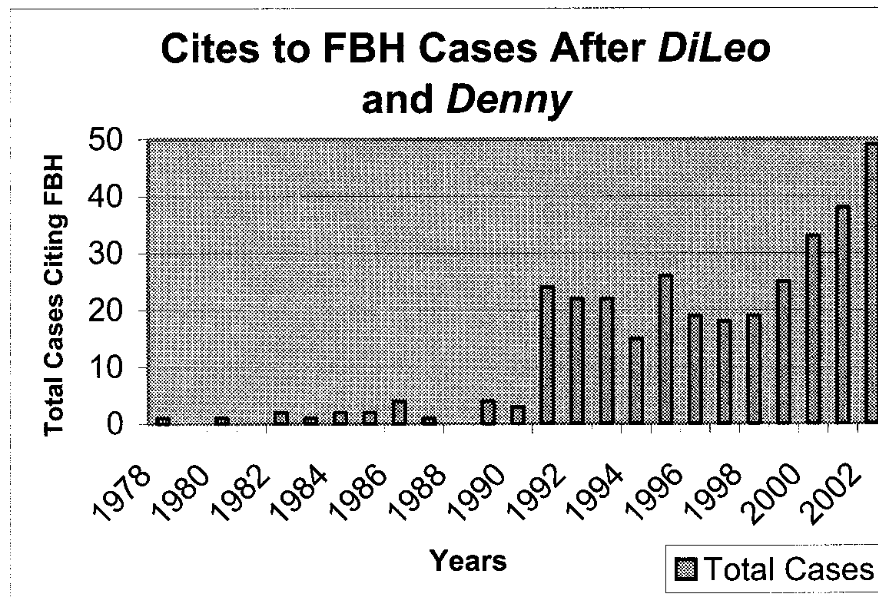
[96] 901 F.2d 624 (7th Cir. 1990).

[97] The phrase appears 296 times between 1992 and 2002, inclusive. Dividing 296 by 11 produces an average of 26.9 citations per year.

[98] *See* Class Action Reports, Statistics, *at* http://www.classactionreports.com/classactionreports/stats4.htm (reporting data on annual filings of securities class actions).

FIGURE 1: CITATIONS TO THE PHRASE "FRAUD BY HINDSIGHT" BETWEEN 1978 AND 2002 IN PUBLISHED OPINIONS



Like *Denny*, *DiLeo* involved problems with loans; problems that the defendants failed to disclose. Bank shareholders brought a securities fraud action against the bank's accountants. They alleged that the bank's non-performing loans had increased regularly over time, and so should have the reserves established for those loans. They also contended that the bank and its accountants had known and failed to disclose that a substantial portion of the bank's loans were uncollectible.[99] In affirming the district court's dismissal of the complaint, Judge Easterbrook wrote the following:

> The story in this complaint is familiar in securities litigation. At one time the firm bathes itself in a favorable light. Later the firm discloses that things are less rosy. The plaintiff contends that the difference must be attributable to fraud. "Must be" is the critical phrase, for the complaint offers no information other than the differences between the two statements of the firm's condition. Because only a fraction of financial deteriorations reflect fraud, plaintiffs may not proffer the differential financial statements and rest . . . . Rule 9(b) required the district court to dismiss the complaint, which discloses none of the circumstances that might separate fraud from the benefit of hindsight. There is no "fraud by hindsight", in Judge Friendly's felicitous phrase, *Denny*, 576 at 470, and hindsight is all the DiLeos offer.[100]

Judge Easterbrook begins by articulating something close to what Judge Friendly had said in *Denny*. Specifically, the fact that the loans

[99] *DiLeo*, 901 F.2d at 627.

[100] *Id.* at 627–28.

turned out badly does not mean that the defendants knew (or should have known) that this was going to happen. Judge Easterbrook, however, said more. He not only said that the hindsight evidence was inadequate, but also talked about the kind of evidence that plaintiffs must have presented to satisfy Rule 9(b)'s requirement that fraud be pled with particularity—contemporaneous evidence.[101] Judge Easterbrook's oft-quoted admonition is that that plaintiffs need to plead the "what, where, when, and how" of the allegedly fraudulent statements.[102]

Judge Easterbrook thus moves beyond Judge Friendly in two important respects. First, he not only says that hindsight evidence is inadequate, but suggests that what is needed is contemporaneous evidence.[103] Second, while Judge Friendly merely said that the hindsight evidence in *that* case was inadequate because of certain *big intervening events*, Judge Easterbrook takes the position that hindsight evidence should not be used as a general matter. Judge Easterbrook makes the empirical claim that "only a fraction of business reverses are attributable to fraud," which leads up to his statement that "defendants must point to some facts suggesting that the difference [in the past statement and current results] is attributable to fraud."[104] The plaintiffs, he tells us, must provide the court with evidence that enables it to "separate" the cases with mere hindsight from those where there is fraud. The implication is that hindsight-only cases are not fraud cases and that the judge's task is to separate the two categories of cases: hindsight (bad cases that should be dismissed) and real fraud (good cases that should be allowed to proceed).

But why did Judge Easterbrook's articulation of the FBH doctrine attract more attention from subsequent courts than Judge Friendly's articulation? Perhaps Judge Easterbrook's articulation was broader and easier to apply. Judge Friendly found the hindsight evidence problematic because of a specific and idiosyncratic set of conditions. Judge Easterbrook's articulation of the FBH doctrine makes hindsight evidence problematic as a general matter, thereby removing the need for a fact-specific inquiry to determine whether to dismiss a case.[105]

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[101] As we discuss later, FBH in its early forms appears to have been the forerunner of the Second Circuit's heightened pleading requirements regarding the state of mind element in fraud cases. This heightened pleading requirement was later codified (and some say heightened even further) by Congress in the 1995 Private Securities Litigation Reform Act. On the debate over the heightened pleading standard, see Greebel v. FTP Software, Inc., 194 F.3d 185 (1st Cir. 1999).

[102] Judge Easterbrook also described this as "the first paragraph of any newspaper story." *DiLeo*, 901 F.2d at 627.

[103] The need for an ex ante perspective in analyzing securities cases is one that Easterbrook has emphasized on other occasions. In other oft-quoted language, he has said, "an inability to foresee the future does not constitute fraud because 'the securities laws approach matters from an ex ante perspective.'" Eckstein v. Balcor Film Investors, 8 F.3d 1121, 1132 (7th Cir. 1993) (quoting Pommer v. Medtest Corp., 961 F. 2d 620, 623 (7th Cir. 1992)).

[104] *DiLeo*, 901 F.2d at 627.

[105] A different simplifying empirical assumption by Judge Easterbrook in *DiLeo*, that accounting firms tend to behave rationally, has also been cited frequently by other courts. *See* Robert A. Prentice,

The popularity of Judge Easterbrook's articulation of the FBH doctrine also supports the case management hypothesis over the debiasing hypothesis for two reasons. First, on the face of it, Judge Easterbrook's articulation is not consistent with the problems hindsight raises. Judge Easterbrook declares that "[t]here is no 'fraud by hindsight'." This articulation denies that a bad outcome is even relevant to the matter of fraud at the pleadings stage. In contrast, Judge Friendly asserted that the plaintiffs in *Denny* had relied only on hindsight, which he found inconsistent with FRCP 9(b)'s insistence upon particularity. He did not assert that the hindsight is irrelevant to the existence of fraud, merely that hindsight alone is not enough to sustain a complaint. As discussed above,[106] Judge Easterbrook is wrong about this—the existence of an inaccurate assessment of the business is relevant to whether fraud has occurred. The statement is inconsistent with the concept that the FBH doctrine is meant to identify and eliminate the effect of the bias. Yet it is this inaccurate version of the doctrine that the judiciary ultimately finds compelling.

Second, Judge Easterbrook's articulation of the problem invited courts to engage in aggressive policing of complaints. Judge Easterbrook's quote about the inadequacy of hindsight evidence began: "The story of this complaint is familiar in securities litigation." This suggested that the danger of hindsight is greater in securities class action cases, and therefore courts must more rigorously scrutinize the basis for the allegations.[107] Further, he indicated that complaints in securities fraud cases fall into two categories: cases that reference little more than hindsight in support of the allegations of fraud, and cases that identify contemporaneous evidence of fraud. This distinction facilitates the judicial role in adjudicating cases solely on the complaint.[108] Judge Easterbrook urged his colleagues to use their own

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The Case of the Irrational Auditor: A Behavioral Insight into Securities Fraud Litigation, 95 NW. U. L. REV. 133, 136–41 (2000) (criticizing Easterbrook's assumption that auditors behave rationally); *see also* Stephen J. Choi & A.C. Pritchard, *Behavioral Economics and the SEC*, 56 STAN. L. REV. 1, 49 n.228 (2003) (justifying Easterbrook's analysis and criticizing Prentice, in part, on the grounds of a need for a correction against the hindsight bias).

[106] *See supra* Part II.A.

[107] Even if Judge Easterbrook did not intend this meaning, other courts have interpreted him in this manner. For example, in setting out the particularity requirements under Rule 9(b) for a securities plaintiff, the court in *Shields v. NCNB Corp.*, said:

> As explained by other courts, in the area of securities violations, Rule 9(b) requires greater specificity as to the fraud than may be required in other suits. The greater specificity is appropriate and necessary because of the potential for abuse of a strike suit brought for its *in terrorem* effect.

No. C-90-0090, 1991 WL 146854, at *2 (W.D.N.C. Mar. 28, 1991) (citations omitted).

[108] It is worth noting that Judge Friendly expressed similar concerns about frivolous securities filings in *Denny*. In justifying requiring more in the way of evidence than vague allegations, Judge Friendly explained:

> The Supreme Court has admonished that to the extent that such discovery [that would be permitted if the plaintiffs were to get beyond the motion to dismiss] 'permits a plaintiff with a largely groundless claim to simply take up the time of a number of other people, with the right to do so representing an in terrorem increment of the settlement value, rather than a reasonably founded

judgment to identify cases that are likely to rely solely on hindsight to support the allegations of fraud.

IV. EMPIRICAL SUMMARY OF THE FBH CASES IN THE POST-*DILEO* PERIOD

The discussion that follows describes our findings about the state of the FBH doctrine. We present the evidence used to test the two competing hypotheses on the nature of the FBH doctrine. For the most part, we restrict our analysis to the post-*DiLeo* period because the doctrine expanded so dramatically after Judge Easterbrook's reformulation.

A. Basic Data

Our source of data was the Westlaw database, where we examined the population of published opinions on securities class action cases.[109] We conducted a search for the term "fraud by hindsight" in every year from 1978 forward in the ALLFEDS database. To compare the FBH cases to those that do not use the term, we also generated a database of opinions in securities fraud class actions that do not use the phrase. This was also done by searching the ALLFEDS database from 1978 to the end of 2002.[110]

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hope that the process will reveal relevant evidence, it is a social cost rather than a benefit.'

Denny v. Barber, 576 F.2d 465, 470 (2d Cir. 1978) (quoting Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 741 (1975)).

[109] This is a more expansive definition of "published opinion" than is ordinarily used; ordinarily, the term is only used for those opinions that the judges designate as "for publication." The reason for our usage is that we were interested in estimating the level of use of the doctrine and we would have undercounted use levels had we left out the "not for publication" ("NFP") opinions. There is a problem here, however, in that there are some circuits that do not place their NFPs online, or have only begun doing so recently. Hence, to the extent there are a number of FBH cases in these NFPs, we have undercounted and possibly biased the data. *See* Johanna S. Schiavoni, *Who's Afraid of Precedent? The Debate over the Precedential Value of Opinions*, 49 UCLA L. REV. 1859, 1861 n.8 (2002) (reporting that the Third, Fifth, and Eleventh Circuits limit placement of certain opinions on the online data bases). For more detail on publication practices, see Melissa M. Serfass & Jessie L. Cranford, *Federal and State Court Rules Governing Publication and Citation of Opinions*, 3 J. APP. PRAC. & PROCESS 251, 253 & tbl.1 (2001).

[110] Although the FBH doctrine is used almost exclusively in the securities fraud context, a Westlaw search revealed a handful of cases in other settings. The search was conducted in both the state and federal case databases on Westlaw. Cases involving 9(b) outside the securities litigation setting include: Harrison v. Westinghouse Savannah River Co., 176 F.3d 776, 784 (4th Cir. 1999) (asserting that FBH claims do not satisfy Rule 9(b)'s particularity requirements); United States v. Graham County Soil & Water Conservation Dist., No. 2:01CV19, 2002 WL 487162, at *11 (W.D.N.C. Mar. 5, 2002) (explaining, in the context of a case under the False Claims Act, that "fraud by hindsight does not satisfy Rule 9(b)"); Little v. Brown & Williamson Tobacco Corp., 243 F. Supp. 2d 480, 505 (D.S.C. 2001) (explaining, in the context of alleging misleading advertising about the risks of smoking, that claims of fraud must satisfy Rule 9(b)'s particularity requirements and FBH claims do not satisfy these); *In re* Grady L. Wicker, No. 99-07108, 2000 WL 33709668, at *3, n.3 (D.S.C. May 23, 2000) (same, but in a Chapter 7 bankruptcy case); Glen Holly Entm't, Inc., 100 F. Supp. 2d 1086, 1094 (C.D. Cal. 1999) (same, California law fraud case); Nepomoceno v. Knights of Columbus, No. Civ.A.96C4789, 1999 WL 66570, at *13 (N.D. Ill. Feb. 8, 1999) (rejecting, in an insurance fraud case, defendants' 9(b) argument and holding

The data suffer from an incompleteness problem arising from reliance on published opinions. The dispositions in our sample are those available online. There are likely a number of dispositions (especially at the district court level) in which judges have chosen not to put their opinions online. The question, for our purposes, is whether a large number of unpublished, yet influential, dispositions exist. We suspect that this is unlikely because at least one of the parties to a complex securities case, along with the judge, would be motivated to ensure that an important securities opinion received publication. Of greater concern to us is that the likelihood of publication interacts in some important way with our hypotheses. While we cannot know for sure, we do not see reason to expect a large number of unpublished decisions on the merits of any kind in these cases.

Table 2 shows the percent of class action securities cases invoking FBH, from 1991 to the present (after *DiLeo*). The phrase has appeared in roughly 20 to 30 percent of all securities class action opinions. Although the raw numbers of cases using the phrase have increased, the percentage of opinions using it has remained roughly constant since the publication of *DiLeo*. The passage of the PSLRA did not affect the percentage of cases that use the doctrine.

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that the purpose of 9(b) is to give adequate notice to an adverse party); De Jesus v. Sears Roebuck & Co., No. 93Civ.2605, 1995 WL 122726, at *3 (S.D.N.Y. Mar. 22, 1995) (claims must satisfy Rule 9(b)'s particularity requirements, ERISA case); United States v. Planning Research Group, No. 92-1951, 1994 WL 118222, at *3 (D.D.C. Mar. 31, 1994) (same, False Claims Act case); Hewlett v. Hewlett Packard Co., No. CIV.A.19513, 2002 WL 549137, at *11 (Del. Ch. Apr. 8, 2002) (rejecting, in the context of a merger case involving alleged misrepresentations producing claims under state law, defendants' argument that plaintiffs had done no more than plead FBH); Lewis v. Austen, No. C.A.12937, 1999 WL 378125, at *5 (Del. Ch. June 2, 1999) (rejecting, for lack of contemporaneous evidence, plaintiffs' request that court infer, from the fact that merger occurred, that preliminary discussions had taken place some months prior). Seven of the ten are unpublished dispositions.

TABLE 2: PREVALENCE OF THE FBH DOCTRINE IN PUBLISHED OPINIONS IN SECURITIES CLASS ACTION CASES[111]

Year	Number of Opinions Using FBH	Total Number of Opinions (securities fraud class actions)	Percent of Opinions using FBH
1991	24	70	34%
1992	22	66	33%
1993	22	65	34%
1994	15	58	26%
1995	26	74	35%
1996	19	76	25%
1997	18	81	22%
1998	19	79	24%
1999	25	94	27%
2000	42	111	37%
2001	39	139	27%
2002	49	184	27%
Total	320	1097	29%

Note: From 1978 to 1990, there were 21 opinions with FBH.

Table 3 breaks the data down further to identify the defendants' win rates when FBH is invoked versus when it is not mentioned. The ledger tilts significantly (both practically and statistically) in the defendants' favor for every one of the ten years between 1991 and 2000 (Column 4 versus Column 2).[112] Overall, the win rate for the defendants since *DiLeo* in FBH cases is 70 percent, as compared with 47 percent in those cases that did not mention it—a statistically significant difference.[113]

[111] These data do not allow for a sensible comparison of district courts with appellate courts. Unfortunately, there are not enough circuit court cases to make a meaningful comparison on a per-year basis. In the ten years between 1992 and 2001, there were thirty circuit court cases in our population of FBH (as compared to 200-plus district court cases). Defendants won in eighteen out of these thirty, a 60 percent victory rate that is lower than the defendant–win rates in the district courts for all but two of these years. So, overall, the defendant win rate in FBH cases appears lower at the circuit court level. Given the low number of circuit court cases, however, we are reluctant to make much of this.

[112] The percentage differences are large enough to easily satisfy standard statistical significance tests (with z statistics well above 2 for almost all the differences). On the relevant calculations to be made, see DAVID FREEDMAN ET AL., STATISTICS 508 (3d ed. 1998).

[113] $p < .001$, using Fisher's exact z.

TABLE 3: THE FBH DOCTRINE & DEFENDANT SUCCESS RATE

Year	FBH Cases	In Securities Class Action Opinions *not* using FBH	Difference (columns 2 and 3)
1987	—	31%	—
1988	—	31%	—
1989	—	46%	—
1990	—	32%	—
1991	71%	43%	+28
1992	64%	47%	+17
1993	68%	42%	+24
1994	67%	51%	+16
1995	85%	54%	+31
1996	53%	44%	+9
1997	78%	51%	+27
1998	63%	53%	+10
1999	72%	49%	+23
2000	76%	41%	+35
2001	58%	45%	+13
2002	80%	46%	+34
Overall (Post *DiLeo*)	70%	47%	+23

B. *Timing and Win-Loss Rates*

As Table 4 demonstrates, over 90 percent of the FBH opinions involve determinations at the motion to dismiss stage, while fewer than 10 percent occur in summary judgment proceedings. The problem with this skew, however, is that it makes it difficult to make meaningful comparisons between the win-loss rates on the cases decided at the pleadings versus those at the summary judgment stage (the number of cases at the latter stage being so few). As noted earlier, the invocation of FBH by a court seems to be a positive sign for the defendants because they win in 70 percent of the cases (as compared to fewer than 50 percent in the non-FBH cases). The key observation here, however, is that the majority of applications of the FBH doctrine occur at the motion to dismiss stage and not at either summary judgment or some later stage.

TABLE 4: TIMING AND WIN-LOSS RATES FOR CASES APPLYING FBH

		Defendant Win Rate	
Year	Percent	Pleadings	Summary Judgment
1991 (24)	8.3	72.7 (22)	50.0 (2)
1992 (22)	4.6	66.7 (21)	0.0 (1)
1993 (22)	9.1	65.0 (20)	100.0 (2)
1994 (15)	20.0	58.3 (12)	100.0 (3)
1995 (26)	11.5	82.6 (23)	100.0 (3)
1996 (19)	21.1	53.3 (15)	50.0 (4)
1997 (18)	11.1	81.3 (16)	50.0 (2)
1998 (19)	0.0	63.2 (19)	—
1999 (25)	0.0	72.0 (25)	—
2000 (42)	4.9	74.4 (40)	100.0 (2)
2001 (39)	2.6	58.0 (38)	100.0 (1)
2002 (49)	2.0	80.0 (48)	100.0 (1)
All > '90	7.0	70.0 (299)	75.0 (21)

The question, however, is whether the use of the doctrine on pleadings is something unusual, or merely the general pattern in securities class action cases. As one securities casebook notes, in securities cases, "if the class is certified and the defendant's pre-discovery motions are denied, [the case] will almost certainly be settled."[114] To answer that question, we compared the fraction of summary judgment determinations in FBH cases to those in non-FBH securities cases over the most recent five years. For each year, the fraction of summary judgment determinations in the non-FBH cases, while low, was higher than that in the FBH cases. Overall, only 3 percent (5/192) of the FBH determinations occurred at the summary judgment stage, whereas the corresponding number for non-FBH securities cases was 12 percent (60/498), a statistically significant difference.[115]

[114] COX ET AL., *supra* note 62, at 734.

[115] $p < .001$, by Fisher's exact *z*.

TABLE 5: PLEADINGS VERSUS SUMMARY JUDGMENT IN FBH AND OTHER SECURITIES FRAUD CLASS ACTION CASES

Year	Percent of SJ determinations in FBH cases (total number of FBH cases)	Percent of SJ determinations in non-FBH cases (total number of non-FBH cases)
1997	11.1 (18)	12.9 (63)
1998	0.0 (19)	10.0 (80)
1999	0.0 (25)	18.3 (60)
2000	2.4 (42)	7.2 (69)
2001	2.6 (39)	12.8 (101)
2002	2.0 (49)	11.9 (135)

C. *The Different Applications of the FBH Doctrine*

Courts apply FBH doctrine in at least three different ways: to scienter determinations; to materiality determinations; and in non-specific ways—as a garnish to the discussion. Initially, we coded the cases based on the section of the opinion in which the reference to FBH appeared. If it appeared in the scienter section of the opinion, we coded that case as a scienter application; if in the materiality portion, it was coded as materiality; if in a preliminary statement about the applicable evidentiary burdens in a securities case or in a conclusory statement about the kind of case, we coded the case as garnish. Our initial coding indicated that approximately 60 percent of the applications were to scienter, 35 percent to materiality, and the remainder garnish. Scrutinizing the text of the applications (our secondary coding), however, reveals that over 98 percent of the applications of the FBH doctrine involved discussions of scienter. Typically, the reason why the application of the FBH doctrine to scienter occurred in a non-scienter section of the opinion was that the judge was connecting his or her analysis of scienter to either the discussion of materiality or her conclusion about the case as a whole. In sum, the courts overwhelmingly apply the FBH doctrine to determinations of scienter, rather than to determinations of materiality.

Materiality is typically a central issue in a securities disclosure case. A significant portion of these disclosure cases involve contingent or unripe information that plaintiffs say should have been revealed earlier. Indeed, every attack on a forecast that turned out wrong involves an implicit assertion that the defendants had preliminary and material information at the time of the forecast that indicated that the forecast was unreasonable at the time made.[116] The point here is to draw a rough comparison between the

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[116] This is because the attack that a plaintiff is allowed to make on a forecast is that it was unreasonable when made. *See* Glassman v. Computervision, 90 F.3d 617, 627 (1st Cir. 1996) ("[W]hile forecasts are not actionable merely because they do not come true, they may be actionable because they are not reasonably based on, or are inconsistent with, the facts at the time the forecast is made.").

number of FBH scienter and materiality cases. All of the former (which were either forecast or contingent information cases) involve the latter question as well. The hindsight bias should therefore affect both determinations in every case. Yet, we see FBH invoked almost exclusively in scienter determinations.

D. The Substance of the FBH Doctrine

Thus far, our analysis of the FBH doctrine has been confined to a social science approach. We have described the doctrine in numeric, rather than substantive, terms. In this section, we present a more traditional, legal analysis of the cases. We assess how courts describe the doctrine. We then present a puzzle that arises from how the courts actually apply the doctrine, which differs markedly from the courts' assertions as to the doctrine's meaning.

1. What the Courts Say the FBH Doctrine Means.—What is it that the courts are saying when they say that plaintiffs may not plead fraud by hindsight? Courts seem to indicate that the FBH doctrine is designed to prevent reliance on a bad outcome as a basis for an allegation of fraud. The Second Circuit's opinion in *Novak v. Kasaks* sets out the standard language on FBH, which is:

> [W]e have identified several important limitations on the scope of liability for securities fraud based on reckless conduct. First, we have refused to allow plaintiffs to proceed with allegations of "fraud by hindsight." Corporate officials need not be clairvoyant; they are only responsible for revealing those material facts reasonably available to them. Thus, allegations that defendants should have anticipated future events and made certain disclosures earlier than they actually did do not suffice to make out a claim of securities fraud.[117]

The court describes the FBH doctrine as a "limitation" on the scope of liability and then says the Circuit does not permit plaintiffs to proceed using allegations of "fraud by hindsight."[118] Taken together, these statements must mean that corporate managers are not liable merely because the future of their company turned out to be less rosy than they had predicted. The allegation of a failed forecast does not, by itself, constitute a specific allegation of fraud, necessary to satisfy Rule 9(b). Even though such allegations can be quite specific, the courts, citing the FBH doctrine, say this is not enough. Courts explicitly assert that the law "prohibits" pleading fraud by hindsight.[119]

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[117] Novak v. Kasaks, 216 F.3d 300, 309 (2d Cir. 2000) (citations omitted).

[118] For other examples of courts discussing FBH as a "limitation" on the scope of liability for securities fraud, see *City of Philadelphia v. Fleming Companies*, 265 F.3d 1245, 1260 (10th Cir. 2001), and *In re Mercator Software, Inc. Securities Litigation*, 161 F. Supp. 2d 143, 149 (D. Conn. 2001).

[119] *See* Gross v. Summa Four, Inc., 93 F.3d 987, 991 (1st Cir. 1996); Meyer v. Biopure Corp., 221 F. Supp. 2d 195 n.1 (D. Mass 2002).

The FBH doctrine does not alter how courts can analyze the relationship between a bad outcome and the likelihood of fraud, but whether they can do so. If the FBH doctrine were some sort of guide as to how to conduct an unbiased assessment of the relationship between a bad outcome and the likelihood that fraud occurred, then the cases would look different. Courts would assess the evidence in context, including the outcome, and sometimes conclude that there was not enough to produce the required inference.[120] Instead, the courts set up the FBH doctrine as a limitation or prohibition on the type of pleading that is allowed in all securities fraud cases.

The handful of cases that discuss the problem of evaluating materiality in hindsight are somewhat more explicit about their concern with allowing allegations based solely on bad outcomes. As one court noted: "Hindsight is always 20/20. 'The probability of a transaction occurring must be considered in light of the facts as they then existed, not with the hindsight knowledge that the transaction was or was not completed.'"[121] Another court remarked that, "[i]n assessing whether a misrepresentation or omission was material, courts may not employ 20/20 hindsight; instead, they must consider whether the misrepresentation or omission was material on the date the prospectus or registration statement was issued."[122]

In some cases, judges explicitly allow a pleading based largely on the outcome, in spite of the FBH doctrine. These cases provide a different view of how *judges* assess the barriers to using outcomes to support pleadings of fraud. Judges in these cases always articulate a need to explain either why their case is an exception to the general rule or why the rule is not really a rule. For example, one recent Third Circuit panel circumvented the FBH doctrine and allowed the plaintiffs the benefit of hindsight evidence. The

[120] One possibility is that what the courts are saying is that hindsight evidence is never enough "*by itself*" to produce the requisite inference; there are courts that explicitly use this language. *See, e.g.*, *In re* Sprint Corp. Sec. Litig., 232 F. Supp. 2d 1193, 1226 (D. Kan. 2002); *In re* MCI Worldcom Inc., Sec. Litig., 191 F. Supp. 2d 778, 789 (S.D. Miss. 2002). As a logical matter, that cannot be right. After all, if one makes the time difference between the outcome and the time at which the prior state of mind needs to be determined short enough, a very high level inference can be produced in a number of contexts. For example, if a company announces today that its CEO is resigning because of difference with the other members of the board, one can be almost certain that the company knew of this information five minutes prior. Indeed, one can be fairly certain that there was knowledge of the disputes a week prior or even a month prior. There are a host of such examples that one can spin out—with disclosures of bad quarterly results or product failures—all of them involving precisely the types of failures to disclose that are routinely at the center of a securities disclosure case and all of them involving hindsight evidence that could produce a very high inference of prior knowledge on the part of the defendant. Strict logic aside though, perhaps the courts are making an approximation given the types of hindsight evidence that they are typically presented with (which is a far cry from that discussed in the above hypothetical).

[121] Sedighim v. Donaldson, Lufkin & Jenrette, Inc., No. 00Civ.7351, 2001 WL 1191009 (S.D.N.Y. Oct. 5, 2001) (quoting Panfil v. ACC Corp., 768 F. Supp. 54, 58–59 (W.D.N.Y. 1991)).

[122] Sule v. Kloehn Co., 149 F. Supp. 2d 135 (citing Rudd v. Suburban Lodges of Am., Inc., 67 F. Supp. 2d 1366, 1370 (N.D. Ga. 1999) and *In re* Mobile Media Sec. Litig., 28 F. Supp. 2d 901, 924 (D.N.J. 1998)).

court explained that FBH was really a doctrine about restricting the kinds of evidence that could be the basis of inferences in *securities class actions*, and not all securities fraud claims (the case at hand was one involving a large purchaser of the securities who was suing the defendant directly).[123]

A handful of courts have justified their use of hindsight evidence on the grounds that the FBH doctrine does not restrict them to considering only that evidence that can be described as "contemporaneous" (for example, a whistle-blower who says that she was at the meetings in which company officials acknowledged they were intentionally misleading the public). Instead, these courts explain that, in certain narrow sets of circumstances (such as when the time gap is small or where the company in question has a highly effective information reporting system[124]), hindsight and other non-contemporaneous evidence can be considered. The point here is that these discussions by the anti-FBH courts show that they recognize that FBH discussions in prior opinions suggest a bar on the use of hindsight evidence

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[123] *See* ED Medsystems, Inc. v. Echocath, Inc., 235 F.3d 865, 880–81 (3d Cir. 2000) (making the point that the fear of frivolous lawsuits that is present in securities class actions was not present in this case).

[124] For example, in *Novak* itself, the appellate court held that the complaint alleged scienter with sufficient particularity, even though the key piece of evidence that the plaintiffs presented was the company's disclosure of its overstatement of inventory levels. Novak v. Kasaks, 216 F.3d 300, 303–05 (2d Cir. 2000); *cf.* COX ET AL., *supra* note 62, at 744 (discussing *Novak* and the court's decision not to require that the plaintiffs identify their confidential sources). Implicit in the court's decision to reverse the district court appears to be the conclusion that large inventory overstatements are the kind of thing that company officers typically know about. More directly on point is *Shaw v. Digital Equipment Corp.*, where the court, while acknowledging the line of courts saying that plaintiffs may not plead "fraud by hindsight," said that this did not mean that plaintiffs had to plead "fraud with complete insight." 82 F.3d 1194, 1225 (1st Cir. 1996). In *Shaw*, in which the court did seem to find the fact that there was only a short time gap between the date of the public offering and the release of bad news about the just completed quarter, the court suggested that it might be okay to make an exception to the general rule disfavoring hindsight evidence in those contexts in which the company in question had the kind of effective reporting system that would have likely forewarned them about the bad quarterly results much earlier than they disclosed them to the public. What the court said in its footnote 38 was, however, couched:

> In asserting that defendants had direct knowledge of DEC's third quarter operating results as they developed, plaintiffs allege that "[m]ore so than the management of most companies, DEC's management, including the Individual Defendants, was virtually immediately cognizant of the Company's sales information" by virtue of the company's use of "a highly-efficient reporting system which allows the Company to forward sales and cost information to senior management virtually as sales are made." The defendants argue that these allegations should be viewed with skepticism and as the product of nothing more than "pure speculation." Speculation or not, we think that the plaintiffs' allegations of a "highly-efficient reporting system" may speak to the question of how defendants might have known what they allegedly knew, but absent some indication of the specific factual content of any single report generated by the alleged reporting system, do not independently provide a factual basis for inferring any such knowledge. On balance, we do not think that generalized allegations regarding the existence of an internal "reporting system" substantially assist a securities-fraud complaint in overcoming the hurdle of Rule 9(b). *See* Pitten v. Jacobs, 903 F. Supp. 937, 949–50 (D.S.C. 1995); *cf.* Arazie v. Mullane, 2 F.3d 1456, 1467 (7th Cir. 1993) (refusing to credit "scanty" allegations concerning internal documents, absent indication of "who prepared the projected figures, when they were prepared, how firm the numbers were, or which . . . officers reviewed them").

Id. at 1224 n.38.

and a requirement that only contemporaneous evidence be considered. That, in turn, means that for these non-FBH courts to be able to justify their use of hindsight evidence, they have to either explain why the FBH doctrine does not apply to their case or why, despite the language in prior opinions, the FBH doctrine allows for some consideration of hindsight evidence.[125]

Courts also sometimes allow complaints based on hindsight in materiality cases. In *SEC v. Trikilis*, the defendants protested that "materiality like scienter, cannot be determined through hindsight."[126] In rejecting this contention, the court explained that the FBH doctrine did not preclude the court from considering subsequent events. Rather, according to this court, the doctrine asserts only that the withheld information must be considered material at the time it was withheld, not later. Notwithstanding the protestations of this court (note that this was a government prosecution and not a private class action), the signal from the other cases seems to be that hindsight evidence is not to be considered in making inferences.[127]

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[125] Language along the following lines points to the pro-contemporaneous evidence (and anti-hindsight evidence) position. In *In re Vantive Corp. Securities Litigation*, the judge explained that the heightened factual pleading requirement of the PSLRA "is the single most important weapon against pleading fraud by hindsight because it forces plaintiffs to reveal whether they base their allegations *on an inference of earlier knowledge drawn from later disclosures or from contemporaneous documents or other facts*." 110 F. Supp. 2d 1209 (N.D. Cal. 2000) (emphasis added).

The language from a couple of non-FBH cases that was cited in a recent Massachusetts district court opinion by Judge Saris (in which she was navigating around FBH) is illustrative of the point made in the text:

> Nonetheless, even when the true state of affairs does not come to light until after the defendant's allegedly false statement, it is permissible in some instances to infer from the later disclosure that the defendant's statement was knowingly or recklessly false when made. *See, e.g., In re* Grand Casinos, Inc. Sec. Litig., 988 F. Supp. 1273, 1283 (D. Minn. 1997) ("while the underlying facts on which plaintiffs rely are *not contemporaneous* with defendants' allegedly false statements, they create a strong inference that defendants knew there were significant problems when the statements were made."); *In re* Stratosphere Corp. Sec. Litig., 1 F. Supp. 2d 1096, 1111 (D. Nev. 1998) (stating that there is no "bright line rule that any documents offered to allege statements were false or misleading must either proceed the statements or be precisely *contemporaneous* with them."). Some reliance on post-statement revelations is appropriate where, as here, no catastrophic event occurred between the time of the challenged statement and the revelation of the truth; it is also appropriate when the nature of the problem is such that it likely would have been apparent to management before it was disclosed to the public. *See In re Stratosphere*, 1 F. Supp. 2d at 1112; *In re Grand Casinos*, 988 F. Supp. at 1283. Moreover, the plaintiff provides allegations which, if proven, would show that Raytheon's officers had contemporaneous knowledge of the problems with the P-3 Orion contract. More specifically, the plaintiff alleges that the "Team 30" group was assembled to investigate the schedule issues and cost overruns in February 1999.

In re Raytheon Sec. Litig.,157 F. Supp. 2d 131, 151 (D. Mass. 2001).

The language quoted from the cases that Judge Saris cites suggests that those courts were trying to navigate around a presumption in favor of contemporaneous or ex ante evidence. In addition, to confirm her use of the noncontemporaneous evidence, Judge Saris goes on to explain that "moreover," there is contemporaneous evidence in this case—suggesting that she is attempting to protect her analysis against reversal by an appellate court that sees her as permitting the pleading of "fraud by hindsight."

[126] No. CV 92-1336, 1992 WL 301398, at *11 (C.D. Cal. July 28, 1992).

[127] To quote another exhortation: "[T]he merits of a securities-fraud claim must be adjudicated 'upon all the facts as of the time of the transaction and not upon a 20/20 hindsight view long after the event.'" Jaroslawicz v. Engelhard Corp., No. 84-3641, 1989 WL 32864, at *15–*16 (D.N.J. Apr. 5,

The courts thus say that the FBH doctrine is a prohibition on using the fact of a bad outcome as sufficient support for satisfying Rule 9(b)'s requirement of specificity. The FBH doctrine is therefore not a means of assessing the relevance of the bad outcome to the likelihood of fraud in an unbiased fashion. The doctrine does not identify circumstances in which the bad outcome itself would be more or less likely to support an allegation of fraud. Neither does it identify the types of contemporary evidence that would be more or less useful in assessing the likelihood of fraud.

2. *The FBH Doctrine's Apparent Lack of "Bite".*—The analysis thus far suggests that courts say that the FBH doctrine means that a bad outcome is not to form the basis for a complaint in a securities fraud case. But do they do so out of a belief that the outcome information is an unreliable indicator of fraud? If so, this would suggest that an intuition about the hindsight bias motivates the FBH doctrine, even though the remedy for the bias seems somewhat drastic. To assess this, we took a sample of 125 cases using the phrase FBH and examined their discussions of the FBH doctrine for evidence that the doctrine influenced judicial assessments of the relevance of outcome information.[128] If so, then the doctrine may be said to have some "bite."

To our surprise, we found little evidence that judges cited the FBH doctrine as support for declaring outcome information to be irrelevant; in our terms, that the doctrine had some "bite." References to that effect occurred in only one out of five FBH applications, even by a generous count. In the majority of cases (100/125), the outcome appeared to have been given full consideration and then, in most cases, rejected as inadequate to support an allegation of fraud.

Furthermore, in twenty-one of the other twenty-five cases, the court mentioned the FBH doctrine without any apparent connection to the outcome. Only in four of these twenty-five cases did the court assert that outcome formed an inadequate basis for an allegation of securities fraud because of the unreliability of outcome evidence. Even in these cases, the courts simply gave FBH as a justification for not drawing an inference in favor of the plaintiffs from a piece of hindsight evidence.

The result that the FBH doctrine lacked bite, however, creates a bit of a puzzle. As reported in the previous section, the articulation of FBH in the opinion is usually good news for the defendant. They are more likely to win such cases. Defendants argue vigorously that plaintiff's complaints depend upon "fraud by hindsight," plaintiffs offer spirited replies, and courts spill much ink categorizing a complaint as one involving FBH or not. Thus,

1989) (quoting *In re* Union Carbide Class Action Sec. Litig., 648 F. Supp. 1322, 1327 (S.D.N.Y. 1986) (quoting Spielman v. Gen. Host Corp., 462 F. Supp. 190, 194 (S.D.N.Y. 1975))).

[128] The sample was only partially random. Since we were interested in the evolution of the doctrine and its most recent form, we looked for "bite" in all the cases from 2002 (forty-nine opinions). To that, we added seventy-six randomly chosen opinions from the years prior to 2001.

the doctrine is not a meaningless one—it influences the outcome of securities cases. At the same time, the empirical evidence on the influence of the doctrine and our review of the courts' articulation of the doctrine, could not easily be reconciled with its application in practice. Resolving the competing debiasing and case management theories of the FBH doctrine helps resolve this somewhat, although complete resolution requires refining our case management hypothesis in Part VI.

V. EVALUATING THE COMPETING HYPOTHESES

Part II set forth five sets of predictions from the debiasing and case-management hypotheses. To recap, the debiasing hypothesis supposes that the FBH doctrine is an effort to purge the system of the hindsight bias and produce more accurate judgments. If that is the purpose of the FBH doctrine, one should observe the following: the doctrine will have more utility later in the proceedings, when courts know more about the case and can therefore discount the fact of the bad outcome; the doctrine will be applied more to determinations of contingent materiality than scienter; the doctrine will restructure the decision to apply ex ante standards of conduct; the doctrine will be used to benefit plaintiffs in some cases; and the doctrine will improve over time, becoming more focused on eliminating hindsight. In contrast, if the case management hypothesis is correct, then one should observe the following: the doctrine will be applied early, so as to maximize judicial control over the cases; the doctrine will be applied mostly to scienter; the doctrine will not set forth clear standards, but rather it will simply facilitate judicial control with an admonition about hindsight; the doctrine will not be used to help plaintiffs; and the doctrine will grow in usage, without nuance.

A. Test 1: The Stage of the Proceedings

There are contexts in which hindsight evidence is likely to be more helpful than biasing and vice versa. The key is whether the judge has the information and decision-making ability to put herself in the same (or similar) position as the defendant manager. If the judge can do that, the relevance of the bad outcome is minimal because the judge presumably has all the tools she needs to make the same ex ante determination the managers made. If, however, the judge has little evidence about the manager's position, then the bad outcome is relevant to the likelihood that fraud occurred. Thus, the greatest danger posed by the hindsight bias is after discovery. To be sure, the outcome and hindsight biases might cloud judgment at the pleadings stage, making defendants appear to have been engaged in fraud when they were merely mistaken in their forecasts. The bad outcome, however, is relevant at this stage. If judges want a tool to engage in case management, reference to the problem of judging in hindsight might provide a convenient assertion to legitimize judging the case early.

The evidence that over 90 percent of FBH applications involve judgments on the pleadings supports the case management hypothesis. Furthermore, although published opinions in securities class actions more commonly deal with the pleadings than with summary judgment,[129] the trend is stronger for cases citing FBH.[130] If courts were trying to debias cases, they would attend more closely to the problem of hindsight at the summary judgment stage than at the pleadings stage. That courts use the doctrine more at the pleadings stage supports the case management hypothesis.

B. Test 2: Materiality Versus Scienter

The data are also clear on the issues of materiality and scienter. The dominant application of FBH is to scienter. Unlike the comparison of pleadings and summary judgment, in which one would expect more pleadings cases regardless of the hypothesis, both scienter and materiality are essential elements of a successful securities fraud claim and are available issues to be raised in every case. To be sure, hindsight is only an issue in contingent information cases, but contingent information is routinely a part of securities cases.[131] Furthermore, since a plaintiff is apt to allege several material misstatements, a court has multiple opportunities to cite the FBH doctrine when assessing materiality. By contrast, scienter is only alleged once per defendant. Combined with the more straightforward application of the hindsight bias to contingent materiality than to scienter, the fact that so few FBH cases assess contingent materiality constitutes evidence against the debiasing hypothesis.

C. Test 3: The Substance of the Doctrine

The debiasing hypothesis suggests that judges will attempt to correct for the hindsight bias by resting the decision on some form of ex ante standard of conduct for the defendant. At the least, judges will recognize that mere awareness of the hindsight bias problem will not help them correct for it. In neither the scienter nor the materiality contexts did we observe evidence of this. Rather, the reasoning and supposed correction for the bias matches the case management hypothesis.

The FBH doctrine appears to function as a heightened pleading standard. Courts assert that simply reciting the bad outcome and alleging that the managers must have known this bad outcome would come to pass is not enough to support and allegation of fraud. It is hard to trace such a remedy

[129] As a general matter, the bulk of securities law opinions today tackle motion to dismiss dispositions. *Cf.* Bainbridge & Gulati, *supra* note 13, at n.113 (reporting, for a random sample of opinions, that 91 percent involved dispositions at the motion to dismiss).

[130] *See supra* tbl.5 (setting forth comparative data for the 1997–2002 period).

[131] For a discussion of the ubiquity of contingent information in securities cases, see COX ET AL., *supra* note 62, at 44–52.

to the problems of judgment that the hindsight bias creates. Arguably, the remedy resembles the business judgment rule governing liability for corporate mismanagement. In that context, courts have concluded that because the hindsight bias prevents them from reliably identifying negligent mismanagement after a bad outcome, they should refrain from holding corporate officers liable even when their conduct appears to be negligent.[132] If courts concluded that hindsight prevents them from properly sorting fraud from mistake in the securities context, then the refusal to find fraud in the presence of a bad outcome alone would be a similar remedy. The problem, however, is that the remedy is applied at the pleadings stage, not the summary judgment stage. At the pleadings stage, a bad outcome truly is relevant to the likelihood of fraud. At this stage, the Federal Rules do not ask the courts to make a judgment on the merits, and hence the remedy of foreclosing further litigation is inappropriate. By foreclosing further proceedings, courts are not saying that they do not trust their own judgment, but that they do not trust the process of civil discovery to identify whether fraud occurred. Concerns with the hindsight bias do not support such a broad remedy.

Furthermore, as the cases show, judges sometimes make exceptions to the FBH doctrine's prohibitions when they feel a case looks bad.[133] In effect, judges flag the problem with hindsight evidence, but they do not tie their hands in a way that will protect them from being influenced by the evidence. They allow cases to proceed past the pleadings when they believe there is some credible evidence of fraud. For example, the *Trikilis* court was so taken with the apparent predictability of the subsequent events that it reconstructed the FBH doctrine to allow it to consider these events explicitly. In truth, this reconstruction might differ from the other cases only in the transparency of the courts' decision-making processes. In effect, judges assume that identifying the problem and asserting that the issue in question needs to be considered from an ex ante and not a hindsight perspective provides adequate protection.[134] Although the psychological re-

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[132] Rachlinski, *supra* note 3, at 619–23.

[133] *See supra* Part IV.B.

[134] Theresa Gabaldon suggested to us that one explanation for why judges have not come up with more effective protections against the hindsight bias in the materiality/contingent information context is that the Supreme Court's decision in *Basic v. Levinson* can be read as telling the lower courts that this is a type of backward probabilistic evaluation that they can and should make (or allow the juries to make). 485 U.S. 224 (1988). In that context, it is interesting to note that the *Basic* court was rejecting Judge Easterbrook's bright line rule for disclosure in *Flamm v. Eberstadt*, in which he concluded that the better rule was to require managers to disclose merger talks only when they had reached a "price and structure" agreement. 814 F.2d 1169 (7th Cir. 1987). Judge Easterbrook's rule would have been an effective protection against the hindsight bias because it ties the determination to an easily verifiable externally determined criterion (i.e., has the agreement as to price and structure been reached?). Judge Easterbrook, in fact, expressed concern that allowing for a fuzzier determination would facilitate undesirable second-guessing of managerial decisions. *Id.* at 1178. That said, the language in *Flamm* suggests that Judge Easterbrook's primary reason for using this rule was something other than a concern about the

search suggests that this identification will not be effective by itself, it provides judges with the justification to exercise discretion as to which cases will go forward and which will be dismissed. Once again, the case management hypothesis is more consistent with actual judicial practice.

One exception to the FBH doctrine, in particular, reveals that the doctrine cannot really be said to remedy the problem of judging in hindsight. In several cases the courts explain that citing contemporary evidence of fraud will suffice to allow a complaint to proceed.[135] The problem with such an exception is that the hindsight bias consists precisely of the tendency of the outcome to affect how people assess contemporary information.[136] At the time managers make a prediction or forecast, a whole range of indicators are likely to both support and refute the reasonableness of that forecast. Once the forecast fails, however, the evidence refuting the forecast will come to be more significant. Plaintiffs will thus be able to cite this contemporaneous evidence in support of a claim that managers could not reasonably have believed their predictions. It is thus hard to see why the availablility of contemporary information could possibly be a safeguard against the hindsight bias.

This problem is particularly acute in the context of materiality. In cases in which contingent materiality is an issue (essentially all cases in which materiality is an issue in dispute), the contemporaneous evidence that courts assert they must assess is precisely the evidence that the hindsight bias will influence. The unripe information that plaintiffs allege to be material is always contemporary and hence always fair game for the courts to consider. So too would be other contemporary information that would give added context to the unripe information. The managers' failure to disclose the unripe information will thus seem less reasonable in hindsight than in foresight. The acute problem of the hindsight bias in materiality cases thus makes the lack of materiality cases particularly troubling for the debiasing

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hindsight bias (i.e., he thought that it was sometimes in the interests of the shareholders for corporations to be able to withhold information). *Basic*, 485 U.S. at 235 (citing *Flamm*, 814 F.2d at 1177).

Returning to Professor Gabaldon's hypothesis, there is at least some support in the cases for her suggestion regarding the materiality of intra-quarterly results. There, lower courts had adopted the rule that quarterly results were not material until the quarter was completed (i.e., a bright-line externally verifiable rule). *See* Zucker v. Quasha, 891 F. Supp. 1010 (D.N.J. 1995). As with Judge Easterbrook's rule in *Flamm*, this is the kind of rule that would have protected against the hindsight bias because, regardless of the quarterly results themselves, materiality would rest on whether the quarter was complete or not. The First Circuit, in *Shaw v. Digital*, 82 F.3d 1194 (1st Cir. 1996), however, rejected this position on grounds that the Supreme Court had made clear in *Basic* that the lower courts were supposed to make precisely these kinds of fuzzy materiality determinations. In sum, it is possible that Professor Gabaldon's explanation shows why there are so few applications of the FBH doctrine in the context of materiality and why effective protections against the hindsight bias have not been developed in this context. But we still do not have an explanation for the lack of development of an effective protective mechanism in the scienter context.

[135] Sedighim v. Donaldson, Lufkin & Jenrette, Inc., 167 F. Supp. 2d 639 (S.D.N.Y. 2001).

[136] *See supra* Part II (describing the bias).

hypothesis. It may be that the lack of materiality cases occurred precisely because courts believe that contingent information is inherently contemporaneous to the fraud and therefore inherently reliable. If so, this constitutes a profound failure to identify the role that hindsight might play in these cases and a real failure for the debiasing hypothesis.

In effect, the substance of the FBH doctrine does little to eliminate the influence of the hindsight bias. First, the hindsight bias might support a preclusion of liability based solely on outcome information, but would not preclude an entry into the civil discovery process. Second, the case law shows that judges are willing to allow a case to proceed when, in their own judgment, it seems like there might be fraud. Only if judges themselves are not vulnerable to the hindsight bias would such an inquiry make sense as a debiasing strategy. Third, the exception to the FBH doctrine that cases can proceed if contemporaneous evidence of fraud exists also makes little sense as a debiasing strategy because the hindsight bias implicates how such evidence will be evaluated.

D. *Test 4: Reverse Hindsight*

Under the case management hypothesis, the use of the hindsight bias correction is a convenient justification for excluding evidence that would otherwise help keep a case alive. To the extent judges are seeking case management, as opposed to correcting for the hindsight bias, one should not be surprised to find an asymmetry in the treatment of hindsight evidence. In other words, perhaps we will find that judges embrace hindsight evidence when it facilitates the dismissal of a case.

Indeed they do. Courts embrace hindsight evidence in their extensive and enthusiastic use of the "bespeaks caution" doctrine; something that has been described in detail in the literature.[137] As noted in the discussion of the hypotheses, this doctrine utilizes hindsight evidence of a warning (typically given in the discussion of risks section of the prospectus) to say that the investors had had fair warning that things might turn out badly for them.

The point is that the court's view of what the importance of the warning should have been to reasonable investors ex ante is likely to be biased by the knowledge of the outcome. Nevertheless, while using this doctrine, the courts show little reluctance in using hindsight evidence to dismiss a case—a result that once again supports the case management hypothesis, but not the debiasing one.[138]

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[137] *See, e.g.*, Bainbridge & Gulati, *supra* note 13, at 121–24; Allan Horwich, *Section 11 of the Securities Act: The Cornerstone Needs Some Tuckpointing*, 58 BUS. LAW. 1, 38–40 (2002); Langevoort, *supra* note 85; O'Hare, *supra* note 85.

[138] We have found a number of cases in which courts discuss FBH and bespeak caution in conjunction and apply both doctrines in the same case. *See, e.g.*, *In re* Integrated Res. Real Estate Ltd. P'ships Sec. Litig., 850 F. Supp. 1105, 1143–44 (S.D.N.Y. 1993); *In re* Donald J. Trump Casino Sec. Litig., 793 F. Supp. 543, 557 (D.N.J. 1992). One court even went so far as to suggest that bespeaks caution oper-

E. Test 5: Evolutionary Path

Under the debiasing hypothesis, the law would evolve toward an effective protection against the bias. As judges see more cases that seem to raise hindsight issues, they will be able to evaluate the performance of FBH in prior cases and improve the doctrine to better reduce the biasing effects of judging in hindsight. The doctrine, however, has not evolved this way.

The FBH doctrine originated with Judge Friendly's articulation in *Denny.* In terms of the hindsight bias and making inferences, Judge Friendly seems to have been on the right track—especially in suggesting that intervening catastrophic events make it hard to draw a backward inference. Judge Easterbrook, in *DiLeo*, expanded Judge Friendly's conception from, in a sense, *disfavoring the pleading* of fraud by hindsight to saying that there is *no fraud by hindsight.* Since Judge Easterbrook, however, the doctrine has evolved little. Our reading of the cases has revealed no improved understanding of the doctrine over time. If anything, it has degenerated into a label that is attached to outcome evidence and claims that outcome evidence is either disfavored or will not be considered. In sum, the evolutionary story is not one of evolution towards accuracy, but rather simple expansion.

VI. REFINING THE CASE MANAGEMENT HYPOTHESIS

In each of the tests described, the case management hypothesis came out ahead of the debiasing hypothesis. It is clear that the FBH doctrine has not evolved into an effective correction for the hindsight bias. Nor does it appear that the doctrine is becoming a better corrective. Indeed, we observed few signs of any evolutionary direction of the doctrine. All the signs—the high victory rate for defendants, the high level of determinations at the pleadings stage, and the abundant use of reverse hindsight in the bespeaks caution context (often in the same case where FBH was used)—pointed toward case management.

These findings are productive, but left us wanting to know more about how the FBH doctrine helped judges manage cases. Our specification of the case management hypothesis was broad in that we generally assumed that judges, for many reasons, seek discretion to dismiss securities fraud cases at an early stage of the proceedings. To attain a greater degree of specificity, we tried to refine this hypothesis. One puzzle that arose from the data that could help clarify the nature of the case management hypothesis is the apparent lack of bite of the FBH doctrine. Even as courts recite the words FBH, they do not use hindsight as support for the unreliability of bad outcomes as evidence of fraud. At the same time that the doctrine seemed to lack bite, it clearly had an effect on the proceedings; defendants

ated as a protection *against* the problem of judging in hindsight. Worlds of Wonder Sec. Litig., 814 F. Supp. 850, 858 (N.D. Cal. 1993).

were more likely to be successful when courts assessed their assertions that a complaint consisted of fraud by hindsight.

In an effort to reconcile these conflicting results, we refined the case management hypothesis. Assume that judges believe that many lawsuits are brought entirely for their settlement value, but that there are also a sizable number of meritorious ones. The frustration judges confront is that both categories lead to settlements, with both companies and investors being net losers when the settlement occurs simply for nuisance reasons. What the judge wants under these circumstances is a method for separating the good cases from the bad before the pressure to settle grows (i.e., shortly after the filing of the complaint) and before discovery.

The traditional post-complaint motions, such as motions to dismiss for failure to state a cause of action or summary judgment, do not work well because of the factual nature of securities fraud claims. Plaintiffs readily *allege* what would be fraud if true. What the moderate judge needs are tools to dismiss cases, as a matter of law, looking at little more than what is in the complaint. The late 1980s and early 1990s brought an explosion of doctrines that let judges do this and hence operate to give judges more power over the fate of a lawsuit at the outset of litigation.[139] Presumably, a judge's willingness to grant these motions—whatever the particular doctrinal invention—reflects her view of the potential merits of the case.

We suspect that the FBH doctrine is such an invention, but must explain why it seems to be doing less work than meets the eye. One clue comes from the doctrine's beginnings in *Denny*. The case is often cited for a broader proposition than just a caution about hindsight evidence: It reads as a call for plaintiffs to plead more facts in their complaints than normal "notice pleading." Rule 9(b) of the Federal Rules demands that fraud be pleaded with particularity, although state of mind can be averred generally. What *Denny* and its progeny famously did is place a substantial gloss on that and demand that facts giving rise to a "strong inference" of intentional fraud be presented in plaintiffs' complaint. If the judge was not persuaded that there was a strong enough inference of fraud, the case would be dismissed immediately. Until Congress codified the "strong inference" requirement in 1995, there was a split among the circuits on whether this heightened pleading standard was permissible.[140] Most notably, the Ninth Circuit said no, preferring a literal reading of Rule 9(b).[141]

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[139] Other such doctrines included the "puffery" defense and the "bespeaks caution" doctrine. *See* Langevoort, *supra* note 38, at 310 (observing that the explosion in securities fraud class action cases in the mid-1980s and the early 1990s coincided with the creation of a number of judge-made doctrines that helped the judges tackle these cases).

[140] *See* Fairman, *supra* note 47, at 599–601 ("By making it more difficult for defrauded investors to pursue their claims on the merits, the PSLRA may actually encourage more securities fraud.").

[141] *See id.* at 598–99.

The possible connection between FBH and a heightened pleading standard seems obvious. FBH is another way of saying that plaintiffs must have more in their complaints than just backwards induction from the fact that a problem subsequently surfaced—there have to be facts showing awareness at the time of the fraud. What we suspect, then, is that the FBH doctrine was really an early articulation of the judicial desire to see more in complaints than skeletal inferences about scienter. It expressed, in a catchy way, the judge's sense that a complaint was lacking in particularized facts. Our revised hypothesis was that over time—and especially as of 1995—the heightened pleading requirement had ripened so that it would do the real work as judges sifted through complaints to decide whether they had enough merit to go forward. FBH, just a prototype, became largely a catchphrase. A judge still might use it, but simply to describe a holding that, for all practical purposes, was the result of applying the heightened pleading standard.

Happily, this refinement to the hypothesis is testable. If the hypothesis is true, we would expect to see relatively few FBH cases in the Ninth Circuit and its districts prior to the passage of the PSLRA in 1995. As Table VI indicates, this is what we see. Despite the fact that the Ninth Circuit consistently has the largest number of securities cases—approximately one-third of all securities class action filings in any given year are in the Ninth Circuit—there was almost no use of FBH in the pre-1995 era. For almost all of this period, fewer than 10 percent of the FBH cases are from the Ninth Circuit.[142] That amounts to no more than one or two cases a year. With the enactment of the PSLRA in 1995, this changed. The PSLRA imposes heightened scienter pleading standards on all the circuits and subsequently the use of FBH in the Ninth Circuit begins to more closely approximate the patterns in the other circuits.

The results from the Ninth Circuit also confirm the rejection of the debiasing and an extreme version of the case management stories. If those evolutionary path stories held, we would expect them to manifest themselves most clearly in the circuit with the most securities cases, the Ninth Circuit. Either in terms of learning how to best correct for the hindsight bias or being frustrated with the time and effort that securities cases were taking, one would expect Ninth Circuit judges to be ahead of the others. Yet, what we see is that the Ninth does not pick up on FBH until well after the others; specifically, it picks up on FBH after it receives congressional approval.

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[142] These differences are statistically significant: $p < .001$, by Fisher's exact z.

TABLE 6: FILINGS AND FBH CASES IN THE NINTH CIRCUIT VERSUS THE OTHER CIRCUITS

Year	# of FBH Cases in Ninth / # of FBH Cases in all Circuits	% of FBH Cases Filed in Ninth Circuit	# of Case Filings in Ninth / # of Case Filings in all Circuits[143]	% of Cases Filed in the Ninth Circuit
1980-89	1/18	6%	—	
1990	1/3	33%	—	
1991	1/24	4%	35/105	33%
1992	1/22	5%	51/146	35%
1993	2/22	9%	45/130	35%
1994	1/15	7%	60/167	36%
1995 (PSLRA)	5/26	19%	53/129	41%
1996	2/19	11%	26/82	32%
1997	3/18	17%	50/148	34%
1998	4/19	21%	17/42	40%
1999	7/25	28%	32/122	26%
2000	6/42	14%	—	
2001	4/39	11%	—	
2002	8/49	16%	—	

So, the refined case management hypothesis fits the data better than either the debiasing or an extreme version of the case management hypotheses. The balancing of agency costs is more measured and nuanced than in either hypothesis. The FBH doctrine operates as a rule of thumb, but the story is not as simple as saying that judges use FBH to dismiss cases because they dislike them. Instead, judges balance the likelihood of frivolous filings against the likelihood that there was real fraud. FBH operates as

[143] As an approximation, we use the figures from Mukesh Bajaj et al., Securities Class Action Settlements: An Empirical Analysis (Nov. 16, 2000), *at* http://securities.stanford.edu/research/studies/20001116_SSRN_Bajaj.html. These are figures for a representative sample of cases that the authors collected from the Securities Class Action Alert. *See id.* at 2–3 & tbl.1.1, panel E. The pattern in the Bajaj sample, where the Ninth Circuit makes up approximately 30 percent of all the securities class action filings in any given year, is similar to that described in other studies. *See* Laura E. Simmons, Securities Lawsuits: Settlement Statistics for 10b-5 Cases tbl.1 (1997), *at* http://www.cornerstone.com/pdfs/sec_law.pdf; Laura E. Simmons, Post-Reform Act Securities Case Settlements: Cases Reported Through December 2002 tbl.1 (1999), *at* http://www.cornerstone.com/pdfs/settle.pdf. Both studies report that roughly 30 percent of the settlements in such cases are from the Ninth Circuit.

something of a place marker for the judges or, to use a different metaphor, a hook they can hang their hats on. Cases on one side (with hindsight evidence and little more) are presumptively frivolous and are treated with skepticism. On the other side, the cases with contemporaneous evidence are given more leeway. Most cases fit the former characterization and get knocked out. But when there are exceptional circumstances and the hindsight evidence of fraud is strong, the courts attempt to navigate around the rule of thumb.

We need not take a position on whether the FBH doctrine is a sound invention or conclude that, as applied, it displays moderation. As scholars have pointed out, it is possible that the heightened pleading standard is a mistake—that discovery should occur in an effort to expose the facts underlying a fraud claim upon a lower standard than "strong inference."[144] This criticism stems from the belief that even if judges are well-intentioned, the complaint stage is too early for any sensible determination of whether the suit has merit. Once basic pleading rules are satisfied, plaintiffs should be afforded at least some discovery.

Not enough is known about the incidence of frivolous litigation to be confident in any policy reform. On the other hand, there is evidence that investors themselves perceive the winnowing of securities fraud claims as a good thing.[145] What is clear, however, is that judges are actively managing the entry and exit of cases at the pleading stage. In a sense, then, the PSLRA's heightened pleading standards and the FBH doctrine are not just about raising the bar to entry into court, but also about granting the judges more discretion in deciding who gains entry and who does not.

This story poses a risk. In reality, we suspect most judges are unclear about what the FBH doctrine is. They are likely to have read a few cases discussing FBH, but to have little sense of the patterns in the doctrine. They will know that prior courts have stated that it is well-established that their circuit does not permit the pleading of "fraud by hindsight" and that that amounts to disfavoring hindsight evidence. For the most part, this is not a problem because these are going to be cases that the judges want to dismiss under Rule 9(b). Uttering the phrase "fraud by hindsight" to characterize the case serves as a rhetorical flourish to describe the judge's gut feeling. The problem, however, is in the few cases in which the plaintiffs' case rests on hindsight evidence and the hindsight evidence is highly suggestive of fraud. Some judges will figure out ways around the barriers they see the FBH doctrine imposing.[146] The problem, however, arises with those

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[144] *See, e.g.*, Charles M. Yablon, *A Dangerous Supplement? Longshot Claims and the Private Securities Litigation*, 94 NW. U. L. REV. 567, 572 (2000) (arguing that heightened pleading requirements encourage fraud).

[145] *See* Karen Johnson et al., In re Silicon Graphics Inc., *Shareholder Wealth Effects Resulting from the Interpretation of the Private Securities Litigation Reform Act's Pleading Standard*, 73 S. CAL. L. REV. 773 (2000).

[146] *See* Aldridge v. A.T. Cross Corp., 284 F.3d 72, 81–82 (1st Cir. 2002) (in which defendants use

judges who perceive fraud, but see the FBH doctrine as an independent and insurmountable barrier. In the hundred-plus cases we examined for bite, we found a handful where this appears to have been the case.[147]

Zucker v. Quasha is one such case.[148] *Zucker* involved the direct-mail company, Hanover Direct. In 1994, Hanover publicly issued securities near the end of its first quarter. Specifically, at the offering point, 95 percent of the quarter had concluded.[149] Hanover made no disclosures about the quarter in progress. Soon thereafter (and after the offering was complete), Hanover disclosed that the company's return rates for the just-concluded quarter had dropped from their previous mark and that the response rates for its mailings had been lower than usual.[150] The plaintiffs asked the court to infer from the company's later disclosure of full quarter results that, at the point of the offering, when 95 percent of the quarter had been completed, the company must have known about these downward trends. The court, having set up the discussion by saying that pleading fraud by hindsight was not permitted, refused, saying:[151]

> Even if HDI had some duty to disclose financial data for a fiscal quarter in progress, Plaintiff has simply failed to allege *any facts capable of supporting a*

FBH to argue that the court should not infer from defendants' admissions as to certain contingencies in 1999 that these were known in 1998, but the court finds the inferences reasonable); Shaw v. Digital, 82 F.3d 1194 (1st Cir. 1996) (putting forth this fact scenario: soon after conducting a large public offering, company announces a large quarterly loss and then argues that plaintiffs are not entitled to the inference that the company may have known about the potential losses prior to the public offering; the court rejects the FBH argument on the grounds that the proximity in time makes the inference reasonable in this case); Allaire Corp. Sec. Litig., 224 F. Supp. 2d 319, 329 (D. Mass. 2002) (in which defendants argue that FBH bars the court from contrasting company's announcement of disastrous results with earlier optimistic statements and inferring that earlier statements were false; the court sidesteps the argument by saying that, in this case, the contrast was so stark as to justify an exception to FBH).

[147] It is possible that the judges in these cases thought that the hindsight evidence was inadequate regardless of FBH and that it was not that FBH imposed a barrier, but rather that they were using FBH as a justification for knocking out the case (in other words, the case management hypothesis). The following are the handful of cases we found. *See* Faulkner v. Verizon Communications, 156 F. Supp. 2d 384 (S.D.N.Y. 2001) (announcement that merger has been terminated follows shortly after announcement that it was "on track," but the court refuses to infer backwards on account of FBH); Zeid v. Kimberley, 930 F. Supp. 431, 436 (N.D. Cal. 1996) (company makes a number of optimistic statements regarding its future immediately prior to an offering of securities and soon thereafter announces disappointing results for the quarter at hand; the court, however, refuses to infer backwards on account of FBH); Zucker v. Quasha, 891 F. Supp 1010, 1014, 1017 (D.N.J. 1995) (same).

[148] *Zucker*, 891 F. Supp at 1010.

[149] *Id.* at 1013. The first quarter of 1994 ended three days before the Prospectus and Registration Statement became effective. *Id.* at 1018.

[150] *Id.* at 1015.

[151] The set up language was:

> A court evaluates whether the statement or omission was misleading at the time it was made. *Trump Casino*, 793 F. Supp. at 553. "'[F]raud by hindsight,' the attempt to impose liability on management for unrealized economic predictions, is not actionable." *Id.* at 551 (quoting *Sinay v. Lamson & Sessions Co.*, 948 F.2d 1037, 1040 (6th Cir.1991)).

Id. at 1014.

reasonable inference that HDI's statement that the return rate for 1993 was 13% was misleading at the time it was made.[152]

But there were facts from which one could infer. The company had done a public offering of securities to the public, had not disclosed anything about the quarter in progress (that was 95 percent over), and later disclosed that the quarter in progress had produced disappointing results. To us, there seems to have been plenty of evidence from which to infer that the company likely knew something; certainly enough evidence to merit the plaintiffs getting to discovery.[153] The court, however, waved the FBH mantra and said that plaintiffs failed to allege any worthwhile facts. In other words, the court thought that the facts just described were tainted because they constituted hindsight evidence and as a result discarded what would have otherwise been good evidence.

Had the judges in *Zucker* and the handful of similar cases known what we know after this study, that is, that the FBH doctrine should not be read as imposing an additional barrier to Rule 9(b), perhaps their cases would have come out differently. It bears reiterating though that cases like *Zucker* are the exception, not the norm.

CONCLUSION

This project began with the goal of using the evolution of the FBH doctrine to test two alternate conceptions of judicial behavior. The first had judges recognizing the judicial system's cognitive biases and making corrections for them, while the second had them using the excuse that they were correcting for the hindsight bias as a front for managing their case loads. Doctrines such as FBH, we hypothesized, evolved over time to effectively further the goal in question. Even though judges are human, prone to error and bias, and subject to time and other constraints, the evolutionary process should allow us to model the doctrines in aggregate as if the judges were acting rationally and effectively. The data on the FBH doctrine, however, support the case management hypothesis rather than the debiasing one.

We also found that the case management hypothesis was more complex than initially hypothesized. The FBH doctrine is a rule of thumb that simplifies decision-making by heightening the barriers to entry into court. But it is a discretionary standard that allows judges to carve exceptions when they suspect fraud. Viewed that way, the FBH doctrine becomes synonymous with the heightened pleading standards of the PSLRA. And this is what the data suggest: It is a case management technique that judges,

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[152] *Id.* (emphasis added) (citing *Trump Casino*, 793 F. Supp. at 553, the case cited earlier for the FBH proposition). The court makes the same point about there being no evidence from which to infer the plaintiffs' claim about the lower return rates. *Id.* at 1019.

[153] The events at issue having taken place in 1994, this was a pre-PSLRA case.

invoking the authority of Judge Friendly first and then Judge Easterbrook, created for themselves and that was subsequently ratified by Congress in 1995.

In terms of corrections for the hindsight bias, federal judges in securities cases, it would seem, are not intuitive psychologists. Rather, their development of the FBH doctrine can best be described as an example of "naïve cynicism."[154] Even as the judges in these cases identify a real, tangible problem in human judgment, they express the belief that the problem does not affect their own judgment. Instead of developing the doctrine into a clear rule about what constitutes fraud by hindsight, judges rely on their own intuition to sort out facts that suggest real problems and facts that suggest nothing more than fraud by hindsight. Therein arises the paradox of these cases: Judges simultaneously claim that human judgment cannot be trusted, and yet they rely on their judgment.

The naively cynical approach judges have taken to the FBH doctrine seems to have found the worst of both worlds. If judges' judgment is affected by hindsight, then some cases that are wholly without merit might remain in the system, supported by inferences based on hindsight, and some cases that really involve fraud might be dismissed. Rather than a nuanced approach to the problem of sorting fraud from mistake, securities regulation is governed by moods. In the 1980s and 1990s, as concern with frivolous securities litigation rose, courts and Congress simply made it more difficult for plaintiffs to file suit. In the post-Enron era, this skepticism about private enforcement of securities fraud might have abated somewhat, leading to lesser pleading requirements. The courts simply raise and lower the bar for private litigation. In the absence of a sensible mechanism for sorting fraud from mistake, the deterrent effort of private securities litigation will be slim, at best.

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[154] *See* Justin Kruger & Thomas Gilovich, *"Naive Cynicism" in Everyday Theories of Responsibility Assessment: On Biased Assumptions of Bias*, 76 J. PERSONALITY & SOC. PSYCHOL. 743, 743–44 (1999) (discussing the difficulty with identifying bias in oneself).