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2002

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51 Emory L.J. 309-318 (2002)

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January 2010

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## REVIEW ESSAY

### ARE JUDGES MOTIVATED TO CREATE “GOOD” SECURITIES FRAUD DOCTRINE?

*Donald C. Langevoort\**

*How Do Judges Maximize? (The Same Way Everybody Else Does—Boundedly): Rules of Thumb in Securities Fraud Opinions*, by Stephen M. Bainbridge and G. Mitu Gulati,<sup>1</sup> confronts the reader with a theory about judicial behavior in the face of complex, “unexciting” cases such as those involving securities fraud. The story is simple: few judges find any opportunity for personal satisfaction or enhanced reputation here, so they simply try to minimize cognitive effort, off-loading much of the work that has to be done to their clerks.<sup>2</sup> The evidence that Bainbridge and Gulati offer is the creation of some ten or so “heuristic” legal doctrines in securities law marked by two essential features: (1) they rest on superficial, or at least not self-evidently accurate, empirical assumptions about marketplace behavior, and (2) they readily permit the summary dismissal of cases “as a matter of law.”<sup>3</sup> The authors find no good explanation for these besides some form of cognitive sloth.<sup>4</sup>

This claim is bound to touch a sensitive nerve, especially among judges, former clerks, and academics who want to see much more going on in the case

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\* Professor of Law, Georgetown University Law Center. I should say at the outset that I consider the Bainbridge and Gulati article an extremely impressive work of scholarship, and hope to make clear why herein. Any particularly critical tone detected by the reader should be read mainly as self-serving on my part. Psychological research shows that people are considered smarter when they make critical comments as opposed to supportive or constructive ones. See Jeffrey Pfeffer, *The Smart Talk Trap*, 77 HARV. BUS. REV. 134 (May-June 1999).

<sup>1</sup> 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).

<sup>2</sup> *Id.* at 100-11.

<sup>3</sup> *Id.* at 118-19.

<sup>4</sup> *Id.* at 111-12.

law than this. My hunch is that the authors have put their finger on something very important, but that they have oversimplified. I suspect that, on average, judges are more motivated than they suggest and try fairly hard to get their cases right. But severe constraints of time and lack of knowledge force them to rely more on *intuition* about the right result than careful inquiry. Intuitively, the heuristics identified by Bainbridge and Gulati appeal to the judges as substantively reasonable, in the sense that even if they are imperfect, they do more good than harm. The question this commentary explores is what makes judges think that. The answer is not likely to be simple.

## I.

Because Bainbridge and Gulati's theory is so provocative, it is easy to overlook the immense contribution to the securities law literature that they make simply by cataloging and dissecting the doctrines. Scholars have taken note of some of them—for example, “puffery”<sup>5</sup> and the “bespeaks caution doctrine”<sup>6</sup>—and demonstrated the shakiness of their specific intellectual foundations. For the most part, however, these critiques have treated these doctrines as outliers in an otherwise rational securities fraud regime. By contrast, Bainbridge and Gulati demonstrate that a large cluster of doctrines have been infected by a single strain of a judicially spread virus.<sup>7</sup> Moreover, they tie these doctrines to an aggressive methodological move by the courts, a willingness to dismiss cases as a matter of law even when they pose subtle questions of fact and inference.<sup>8</sup> Consider the puffery case of *Eisenstadt v. Centel Corp.*,<sup>9</sup> where the “Herculean” Judge Richard A. Posner determined that a company was not making a material misrepresentation when it stated that an auction of telecommunications assets it was conducting was going “smoothly.” In fact, the auction process was thus far a serious disappointment, though Centel was still hoping for a good end. Judge Posner said that a reasonable investor would understand that “smoothly” coheres with “disappointingly,” if not “disastrously.”<sup>10</sup> While this conclusion *may* be right (I am not sure by any means), it is rather stunning for Judge Posner to conclude

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<sup>5</sup> See, e.g., Jennifer O'Hare, *The Resurrection of the Dodo: The Unfortunate Re-emergence of the Puffery Defense in Private Securities Fraud Actions*, 59 OHIO ST. L.J. 1697 (1998).

<sup>6</sup> See Donald C. Langevoort, *Disclosures that "Bespeak Caution,"* 49 BUS. L. 481 (1994).

<sup>7</sup> Bainbridge & Gulati, *supra* note 1, at 119-36.

<sup>8</sup> *Id.* at 118-19.

<sup>9</sup> 113 F.3d 738 (7th Cir. 1997).

<sup>10</sup> *Id.* at 745.

that this inference is so clear that no reasonable juror could possibly think otherwise, the standard test for dismissal as a matter of law. Bainbridge and Gulati discover many mutations of this same genetic pattern.<sup>11</sup>

There are other commonalities among these doctrines. First, and most intriguingly, they are largely inventions of the mid- to late-1980s and early 1990s. Puffery, for example, was declared "all but gone the way of the dodo" by Louis Loss in the early 1980s,<sup>12</sup> before its stunning resurrection. Bespeaks caution has its roots in a 1986 Second Circuit decision,<sup>13</sup> and by the early 1990s had become a standard defense-side weapon.

Second, the doctrines evolved in a common fashion. The first cases were highly fact-specific and not terribly controversial. Even a "wannabe" can get it right in deciding that defendants should not be held liable for not disclosing some particular risk factor if, elsewhere in the same document, they did indeed caution the reader about that very kind of risk, which is how the bespeaks caution doctrine began. So, too, with puffery. It is not laziness by which a judge concludes that investors should not be able to sue E.F. Hutton based on nothing more than the old advertising slogan "When E.F. Hutton talks, people listen."<sup>14</sup> But gradually, judges become far more aggressive in the way they draw inferences "as a matter of law" that terminate plaintiffs' cases, as in *Eisenstadt*.

Another observation, admittedly anecdotal, is important, too. Anyone who reads securities fraud cases in bulk notices that while these heuristics are both powerful and (often) troublesome, they do not always dominate. That is to say, many judges who write securities fraud opinions seem to work hard at their cases, presenting lengthy factual analyses even when the result they reach is dismissal. And there are numerous cases where the heuristics are rejected and the claim is allowed to go forward, even when the heuristics plausibly could be invoked. Any theory of judicial behavior in the securities fraud area has to explain a voluminous work product as well as the apparent shirking.

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<sup>11</sup> Bainbridge & Gulati, *supra* note 1, at 119-36.

<sup>12</sup> See LOUIS LOSS, *FUNDAMENTALS OF SECURITIES REGULATION* 717 (2d ed. 1988).

<sup>13</sup> Luce v. Edelstein, 802 F.2d 49 (2d Cir. 1986).

<sup>14</sup> Zerman v. Ball, 735 F.2d 15, 20-21 (2d Cir. 1984).

## II.

Clearly, something curious is happening in the rapid embrace of the defenses. The question is what. An odd feature of the Bainbridge and Gulati article is that while it says it is drawing on the literature on human cognition and bounded rationality, it makes no effort to tie its analysis to any of the known heuristics or biases that psychologists find so robust.<sup>15</sup> The heuristic defenses are not themselves identifiable forms of cognition; they are naïve inferences that are the product of some deeper form of bounded rationality. Because the authors never identify any underlying subconscious psychological process that would lead to an embrace of the defenses, they can be read as suggesting that judges *deliberately* shortcut their cases to save cognitive effort. To that, we would expect strong objection. Those who know federal judges (as well as the judges themselves) will swear that, with notable exceptions, judges are *not* shirkers, but instead committed to deciding cases on the merits best they can, if not always expertly.

I take the authors' claim, however, to be not that judges purposefully shortcut their cases, but simply that they act as if that is what they are doing. This is the economist's standard move. If so, I can supply the missing psychological mechanism, for here is one place where cognitive psychology bolsters the economists' orthodoxy. People are prone to self-serving inference, enabling them to see as normatively "reasonable" what is really just utility-maximizing.<sup>16</sup> That is to say, an easy case can be made that judges convince themselves of the desirability of the heuristics on the merits, but are biased in this construal when the incentive is to shirk. For this reason, the good faith protestations of judges and their former clerks do not alone undercut the plausibility of the authors' claim.

In this spirit, let me offer a slight modification of the authors' story that seems less insulting to the judiciary but still captures their thrust. Assume that judges have substantially differing dispositions toward securities cases, with some highly motivated, some uninterested, and many in between. A defense is initially recognized, as I suggested above, in common sense form, perhaps even by the most motivated of judges. Thereafter, however, it is adopted and extended by a mindless judge or two. What happens then is that precedent

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<sup>15</sup> Bainbridge & Gulati, *supra* note 1, at 90. Cf. Chris Guthrie et al., *Inside the Judicial Mind*, 86 CORNELL L. REV. 777 (2001).

<sup>16</sup> E.g., George Lowenstein et al., *Self-Serving Assessments of Fairness and Pre-trial Bargaining*, 22 J. LEGAL STUD. 135 (1993).

builds that gradually attracts more of those in the middle. This attraction is mainly because of the institutionally legitimate pull of precedent, aided by only a slight dose of self-serving inference. As the attraction grows, the precedent gradually becomes more a self-fulfilling prophecy and begins to crowd out the efforts of the more diligent judges.<sup>17</sup> In fact, this strikes me as an apt description of the doctrinal reality described earlier, wherein many judges today are explicitly critical of the heuristics and much hard work still gets done in securities cases, but those heuristics gradually exert more and more strength disproportionate to their logic as the case law evolves. In other words, one need not make strong assumptions about slothful judicial dispositions to get the effect we observe: a mild tendency in the judiciary as a whole is enough to generate a perceptible bias in the law over time.

Thus, Bainbridge and Gulati have convinced me that cognitive sloth is a sizable part of the story. But they want it to be *the* story, and dismiss all other possibilities. Here is where they stumble a bit. Two aspects of the proof disturb me. First, why would these doctrines emerge and spread so quickly from 1985 to 1994 if the story is simply about judicial slack? What happened at that particular time to trigger a contagion of laziness?<sup>18</sup> Second, why would appellate judges be as enamored with the heuristics as trial judges? Trial judges surely have an incentive to shortcut their cognitive effort by adopting heuristic forms of reasoning. On the appellate level, however, the incentive structure is less clear, even if we assume a low level of interest in the subject matter. Again, consider the puffery defense, which gained its new life largely through an appellate decision, *Raab v. General Physics Corp.*<sup>19</sup> Treating something as immaterial puffery does indeed cut short the thinking process. But from the standpoint of the appellate judge, it is just as convenient to rule that materiality is generally a question of factual inference on which trial judges should take a restrained posture. Having said that, any unresolved factual matters would be remanded for further proceedings. If factual findings have been made, they can be reviewed deferentially. In other words, the appellate court does not have to do much more thinking in a non-puffery regime than in one where the doctrine is embraced. But appellate courts were the lead inventors of puffery and its doctrinal siblings, all of which tilt the law in defendants' favor.

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<sup>17</sup> For a related perspective, see Eric Talley, *Precedential Cascades: An Appraisal*, 73 S. CAL. L. REV. 87 (1999).

<sup>18</sup> Obviously, this could correlate with an increase in judicial workload during that time. Bainbridge and Gulati offer no evidence along these lines, so we can only speculate.

<sup>19</sup> 4 F.3d 286, 289 (4th Cir. 1993).

These two doubts lead to a third and more general concern with the authors' theory. Their theory is that the judges are conserving cognitive effort, as opposed to undertaking hard work. That hard work, apparently, is that of figuring out how investors really react to things like puffery and cautionary warnings, or what motivates managers to mislead. However, Bainbridge and Gulati concede at many places in their article that even the best economics scholars have not been able to answer these questions, notwithstanding exhaustive research. If so, the judges could try, but it would hardly be productive. The heuristics may thus just be their educated *guesses* about whether plaintiffs' theory of harm has merit, motivated not by laziness but by the frustrations of imperfect information.

For these reasons, I am drawn back to the more conventional explanation that Bainbridge and Gulati work so hard to reject—a shift in the ideology of the judiciary leading to a pronounced pro-defendant bias. The standard account of securities fraud jurisprudence is that its unrestrained growth years lasted until 1975, fueled largely by Supreme Court and Second Circuit jurisprudence (with respect to the latter, at least, a time and place where securities law seemed clearly to be a priority of the judges<sup>20</sup>). That ended with the advent of the Burger Court and its famous set of “retrenchment” decisions.<sup>21</sup> The fact that the heuristic case law was the product of a decade that began right after these strong signals were sent by the Court is consistent with the view that the lower courts—their ranks now filled with the Reagan and Bush appointees of the 1980s—were simply extending an ideological shift.

In response, the authors simply state that there is no evidence that judges care enough about the securities laws to spread their ideology to it, and that institutional constraints prevent judges inclined to try from straying too far from prevailing norms.<sup>22</sup> The former claim is impossible to assess one way or the other without better data, though I speculate below. As to the latter, the obvious response is that there was a norm shift that changed perceptions of what open-market securities fraud cases were all about. In this regard, I don't want to confuse ideology with simple political labels like liberal or conservative. Rather, it is a socially conditioned belief about who the good

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<sup>20</sup> For an interesting account, see Margaret Sachs, *Judge Friendly and the Law of Securities Regulation: The Creation of a Judicial Reputation*, 50 SMU L. REV. 777 (1997). It would be interesting to test whether particular locations today (e.g., the Southern District of New York) are less prone to using heuristic reasoning because of the relative importance of the financial world there and the cultural proximity of judges to it.

<sup>21</sup> E.g., *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975).

<sup>22</sup> Bainbridge & Gulati, *supra* note 1, at 96-98.



guys and the bad guys are in a particular domain, and of the virtue of assertive legal protectionism favoring one side or the other. Along these lines, a variety of factors may have changed perceptions of what is normatively legitimate in securities law policymaking. One is the Supreme Court's dramatic shift, which could easily trigger a reevaluation among lower court judges of what the constraining norms were or should be. The Court expressed, and many scholars and others gradually concurred, that class actions in the securities area could readily be speculative and thus in need of more careful judicial winnowing prior to discovery.<sup>23</sup> The tarring of the plaintiffs' securities bar in informed professional opinion was, for better or worse, a notable intellectual feature of the 1980s and 1990s, and could easily undermine any judicial desire to bolster their chances. Again, the perceptions on that issue cannot be put into simple political categories: it is entirely possible to be fairly progressive and at the same time doubt the functionality of the class action litigation system for open-market fraud cases.<sup>24</sup> All a moderate judge needs is some doubts about the merits of securities actions to find winnowing doctrines appealing. Again, the heuristic defenses might appeal as reasonable bets: even if they cause the dismissal of some meritorious cases, they make up for it in getting rid of probably weak lawsuits before the pressure to settle becomes strong.

Also, the early 1980s brought the emergence of the efficient market hypothesis to the forefront of thinking. While I cannot prove that judges either understood or approved of the hypothesis, I suspect that the idea that markets are extremely difficult to fool—the underpinning of many of the heuristics—was both accessible and resonant to many judges, especially after the Supreme Court's ringing endorsement of the theory in *Basic Inc. v. Levinson*.<sup>25</sup> Taken seriously, the theory says that judicial policing in this area is unimportant except in cases of clear-cut fraud. Hence, judges ought not go out of their way to support marginal-sounding claims. Judges may not be skilled enough, as Bainbridge and Gulati say, to evaluate the hypothesis scientifically, but that would not stop them from having a naïve faith in it, especially if it coincides

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<sup>23</sup> For a comparable social constructionist account in the tort law setting, see Michael J. Saks, *Do We Really Know Anything About the Behavior of the Tort Litigation System—And Why Not?*, 140 U. PA. L. REV. 1147 (1992).

<sup>24</sup> In this regard, it is worth noting how much powerful Democratic support (e.g., Sen. Christopher Dodd) the Private Securities Litigation Reform Act of 1995 had—enough to override President Clinton's veto. Academically, the work of Jack Coffee, generally a proponent of strong securities regulation, was very influential in pointing to serious agency cost problems in large class actions. E.g., John C. Coffee, *Understanding the Plaintiff's Attorney: The Implications of Economic Theory for Private Enforcement of Law Through Class and Derivative Actions*, 86 COLUM. L. REV. 669 (1986).

<sup>25</sup> 485 U.S. 224 (1988).

with some deeper political bias against legal intervention in market transactions or distaste for lawyer-dominated shareholder class actions.

To their credit, the authors do not dismiss these possibilities entirely. But I think they downplay them too much. The rapid appearance and evolution of the doctrinal heuristics were probably the product of a desire to minimize effort in response to some change in institutional incentives *and* a shift in the socially constructed vision of good securities law policy. Indeed, if self-serving inference is at work here, it would operate all the more powerfully if there are two distinct motivations being served. Trying to disentangle the causal strands, however, is much too hard.

### III.

Bainbridge and Gulati are right to ask why judges should be at all interested in their securities fraud cases, or expect to bring anything resembling insight to their resolution. Law professors specializing in securities law err in assuming that smart people naturally find securities fraud policy issues fascinating, and I concede that the ideological pull described above is not universal or spread evenly among judges. As to insight, it is certainly true that predictions of investor and managerial behavior are difficult and highly contested, even among experts.

But here is another place where the authors' conclusion—that as a result we see daunted judges retreating to a posture of profound lack of interest<sup>26</sup>—doesn't ring completely true. While the right policy might be hard to fathom, even pre-heuristic securities law simplified the underlying set of questions, especially those involving materiality.<sup>27</sup> The law asks whether the fact omitted or misstated would likely be considered significant by a "reasonable investor."

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<sup>26</sup> Bainbridge & Gulati, *supra* note 1, at 86.

<sup>27</sup> Besides those explicitly described by the authors as materiality heuristics, there are essentially two other groups. The "duty" heuristics deal with whether and when managers must disclose hidden facts. While this seems to be disconnected from materiality, it is not. Properly understood, the duty issues in open market fraud cases are about whether, in the absence of disclosure, investors could reasonably be said to have been misled by the issuer's words, actions, or silence. In other words, like materiality, it is about the appropriate interpretation of corporate discourse. See Donald C. Langevoort, *Half-Truths: Protecting Mistaken Inferences by Investors and Others*, 52 STAN. L. REV. 87 (1999). The final set of heuristics are predictions of managerial rather than investor behavior. Why the thought process here is different may be that judges consider themselves reasonably adept at thinking through, for example, whether selling some shares would give an executive the motive to lie to investors.

This simple-sounding articulation tempts judges to treat the question as easier than it really is and proceed with excessive confidence toward an answer.

This is particularly so because most judges are investors themselves, and many (at least those leaving a successful private practice) have sizable portfolios. This alone gives them reason to be more interested in securities cases than other technical areas of law.<sup>28</sup> It also means that judges have an anecdotal base of experience from which to draw, which psychologists tell us will influence their normative judgments considerably. That does not mean they get it right, of course, because cognitive biases skew these perceptions. And I would venture a guess that these biases, too, may help explain some of the heuristic doctrines that the authors attribute to judicial laziness. Take a case of an alleged material misrepresentation of some soft information. One thing to note is that the judge is placed in a hindsight situation: she is likely to overestimate the foreseeability of the firm's eventual decline in fortunes. This by itself may bias her against the plaintiff's claim of unfair surprise, and toward victim-blaming.

More powerfully, the judge is likely to intuit the answer to a materiality question by asking herself whether *she* would have put much stock in the publicity. After all, she has made many investment decisions and has a sense about how reasonable people do these things. Most successful people, however, overestimate their own prudence, caution, reasonableness, etc., especially in hindsight.<sup>29</sup> It is easy to look at what the firm allegedly said and conclude that she would have thought carefully enough at the time not to be taken in by corporate spin. And that gets projected onto the mental image of the hypothetical "reasonable investor" employed in making materiality and puffery determinations. Whether even the judge would really have behaved in accord with her own prediction is far from clear, and even if so, she may overestimate the number of others who would act similarly (something psychologists call the "false consensus effect.") I suspect that lawyers in particular are prone to self-attributions that overweight the level of caution and skepticism they bring to their decisionmaking and thus to their construals of reasonableness, partly because lawyers are socialized to value caution and

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<sup>28</sup> I would add that, during the 1980s and 1990s, there arose a broad cultural fascination with the process of investing, as so much money was made in the sustained bull market, a fascination to which the judiciary could hardly be immune. And at the risk of speculating too much, the wealth created by this market may have blinded people (including judges) to the risks therein, lessening the perception of a need for strong regulatory intervention.

<sup>29</sup> See Donald C. Langevoort, *Ego, Human Behavior, and Law*, 81 VA. L. REV. 853, 881-83 (1995).

skepticism so highly. If judges display these egocentric “lawyer’s biases,”<sup>30</sup> their embrace of heuristics like puffery and bespeaks caution on both normative and descriptive grounds should hardly be surprising. It is easy for the judge to suspect that the investors’ claim of fraud is really just a risk gone bad, or of foolish greed getting the better of good judgment. Political conservatives are especially inclined to discount psychological excuses and project onto the world an unrealistic level of intentionality.<sup>31</sup>

I do not put this forward as the whole story of judicial behavior in securities cases, just as a further complicating factor. Judicial investment experience does strike me as a good reason why judges are somewhat more interested in and confident about securities questions than Bainbridge and Gulati suggest. On the other hand, it does not help explain why the heuristic doctrines took hold so suddenly in the 1980s and 1990s; I will assume that judges have long been prone to these perceptions. But if we add to the total mix the emergence of a socially constructed belief of frequent meritless litigation in the securities area, and of the market-efficiency driven vision that paternalism is unnecessary in open-market cases because smart money so dominates the price-setting function, norms that might otherwise check these biases weaken considerably. In that setting, giving voice to the biases is easier.

In the end, then, Bainbridge and Gulati have convinced me that the institutional incentive structure in a world of heavy caseloads itself inclines judges to think less hard than they should about their securities cases. Just as important, they have also uncovered a body of evidence that cries out for explanation. While I doubt that their behavioral theory explains quite as much as they say, it is, at the very least, a compelling invitation to look deeper into the judicial mind for why securities law has evolved in the curious way it has.

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<sup>30</sup> Langevoort, *supra* note 6, at 494.

<sup>31</sup> See Philip Tetlock, *Cognitive Biases and Organizational Correctives: Do Both Disease and Cure Depend on the Politics of the Beholder?*, 45 ADMIN. SCI. Q. 293 (2000).